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Give & Take: The Battle Over Defense and Settlement Dollars

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I. INTRODUCTION

A company gets sued in tort for alleged bodily injury or property damage. It has general liability insurance. Its insurer steps up and handles the whole defense, paying the defense bills in full. Later the insurer pays a full settlement. Easy, right? Well, sometimes, yes, but often, no.

This paper and presentation focus on three moments of common frustration for policyholders and insurers: (1) selection of the defense counsel; (2) defense counsel rates; and (3) the settlement decision. We also address the issue of insurer claims for reimbursement of advanced defense fees.

Below we review how these questions arise in three basic scenarios – when the insurer defends unconditionally, when the insurer defends under a reservation of rights to later disclaim coverage, and when the insurer denies coverage in full. We also note certain distinctions in treatment between a duty to defend and duty to reimburse policy.

II. WHEN THE INSURER DEFENDS UNCONDITIONALLY

There are some differences under state law, but by and large, the basic principles are the same. The liability insurer's duty to defend is broader than its duty to indemnify because the duty to defend is triggered by the mere *potential* for coverage based on the allegations of the complaint. Thus, if there is any possibility of coverage under the allegations in the complaint, the duty to defend is triggered. *See, e.g., United States Fid. Guar. Co. v. Advance Roofing & Supply Co.*, 788 P.2d 1227, 1231 (Ariz. Ct. App. 1989); *Scottsdale Ins. Co. v. MV Transp*., 36 Cal. 4th 643, 654 (2005); *Imperial Cas. and Indem. Co. v. State of Connecticut*, 714 A.2d 1230, 1236 (Conn. 1998); *Jones v. Florida Ins. Guar. Ass'n, Inc*., 908 So. 2d 435, 443 (Fla. 2005); *Valley Forge Ins. Co. v. Swiderski Elecs., Inc*., 223 Ill. 2d 352, 363(2005); *Auto. Ins. Co. of Hartford v. Cook*, 7 N.Y.3d 131, 137 (2006); *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006).

And where there is a duty to defend, it is complete, requiring the insurer to pay for the entire defense regardless of the presence of uncovered claims or parties. *See, e.g., Lennar Corp. v. Auto-Owners Ins. Co*., 151 P.3d 538, 544 (Ariz. Ct. App. 2007); *Waller v. Truck Ins. Exchange, Inc.*, 11 Cal. 4th 1, 19(1995); *Imperial Cas. and Indem. Co. v. State of Connecticut*, 714 A.2d 1230, 1240 (Conn. 1998); *Colony Ins. Co. v. G & E Tires & Service, Inc.*, 777 So. 2d 1034, 1037 (Fla. Dist. Ct. App. 2000); *Valley Forge Ins. Co. v. Swiderski Elecs., Inc*., 223 Ill. 2d 352, 363 (2005); *Frontier Insulation Contractors, Inc. v. Merchants Mut. Ins. Co*., 91 N.Y.2d 169, 175(1993); *Nokia, Inc. v. Zurich Amer. Ins. Co.*, 202 S.W.3d 384, 388 (Tex. App.—Dallas 2006, pet granted).

In many cases, the insurer accepts the total defense unconditionally, with no reservations of rights to disclaim coverage at a later time. Such an unconditional acceptance makes the related decisions quite easy.

A. Selection of Defense Counsel

In a duty to defend policy, where the insurer is footing the defense bill, the insurer appoints defense counsel at whatever rates and under whatever terms the insurance defense counsel has accepted. The policyholder typically receives a letter informing of the defense counsel selection and contact information. The policyholder can ask to appoint its own defense counsel, but the insurer usually has the absolute right to make the selection. If the policyholder prefers its own defense counsel, it can try to persuade the insurer by, for example, accepting the same hourly rate (paying any excess), having its counsel agree to abide by the insurer's other conditions (bill review, etc.), and most importantly, convincing the insurer that its preferred counsel has specialized experience or skills that will enhance the defense and reduce the potential indemnity. If this is important to the policyholder, it cannot hurt to ask, and in some cases, the insurer will accept.

In the context of a defense-reimbursement policy, where the policyholder defends (while the insurer "associates" or monitors), often there is pre-approved panel counsel,

and if the policyholder sticks to the list, the selection is automatically approved. Sometimes the policyholder wishes to select off the panel counsel list. Many policies provide that insurer consent is needed to go off the list, and sometimes such consent is absolute, while other times it is not to be "unreasonably withheld." In either case, if the policyholder wishes to go off the panel list, where the insurer is paying without reservation, it should state a persuasive case that relates to the merits of the defense while also controlling cost.

B. Defense Counsel Rates

When the insurer defends and appoints counsel, it pays in full. If the policyholder successfully persuades the insurer to accept its own selected counsel, rates are often restricted to those the insurer pays its usual defense counsel, whether under a duty to defend scenario or on a panel counsel list. In rare cases, the policyholder might persuade the insurer of the importance of certain defense counsel selection at rates higher than the insurer would otherwise pay (because, for example, of the positive impact a particularly reputable defense might have on a potentially high-exposure case).

C. The Settlement Decision

When the insurer has accepted its defense and indemnity obligations without reservation, paying for all of it, the insurer usually controls the settlement decision. Some liability policies give the policyholder a degree of control over the settlement decision, but with a proviso, such as a clause stating that if the insurer recommends settlement (and will pay for it), but the policyholder declines (as it might do, for example, where it feels its reputation is at stake), then going forward, the policyholder pays all or some of the defense, or pays some percentage of any amount or judgment over the recommended settlement amount.

The most common policyholder frustration in a scenario where the insurer defends unconditionally is when the primary insurer will not consent to a settlement within policy limits that the policyholder would like to finalize. In most states, if a subsequent judgment exceeds policy limits, the primary insurer can be held liable for such excess amount, sometimes as a matter of "bad faith." When such a moment presents itself for a policyholder, wanting to settle but not having insurer consent, then it is important to document the disconnect, noting that the insurer's gamble means that it will pay any judgment regardless of limits. When there is disagreement, in most cases, the exchange of letters (sometimes between coverage counsel) sets down the markers.

A related policyholder frustration is the situation where the policyholder has excess liability insurance, wants to settle at a number that penetrates the excess, with the primary offering up full limits, but the excess will not consent. In such a case, the policyholder is advised to write a letter (or email) to the excess insurer, sometimes now allied with the primary insurer, stating the case for settlement into its layer. The same "bad faith" rule applies to excess insurers. There are various other intricacies when an excess insurer is involved, beyond the scope of this paper.

III. WHEN THE INSURER DEFENDS UNDER A RESERVATION OF RIGHTS

When a liability insurer accepts a duty to defend but reserves the right to disclaim coverage at a later time, there is a potential conflict of interest. Defense counsel must

defend its policyholder client but might be inclined to develop or concede facts that would negate coverage for the policyholder, to the benefit of its insurer client that pays counsel's bills. Such a potential conflict of interest affects the issues of counsel selection, counsel rates, and settlement. The rare policy addresses expressly how to handle such a conflict situation. In most cases, state law provides the answer.

A. Selection of Defense Counsel

Under most state laws, due to the conflict, the policyholder regains the right to select defense counsel. If there a panel counsel list, the policyholder can still select from it, or may select counsel elsewhere. Some policies reserve the right of consent to the insurer, not to be unreasonably withheld, but the policyholder gains the upper hand in selection. If the insurer states that is has an absolute right over defense counsel selection even while reserving rights to deny coverage, this may be at odds with state law and ethical rules in this conflict-of-interest scenario.

State courts follow two major approaches, with nuances depending on the state. First, under what is sometimes called the "dual client" approach, the majority of states hold that when an insurer reserves rights to deny coverage, the policyholder has the right to select independent counsel of its own choosing. For example, this is the case in **Florida** (*see* FLA. STAT. § 627.426(2); *Aguero v. First Am. Ins. Co*., 927 So. 2d 894, 898 (Fla. Dist. Ct. App. 2005); **Illinois** (*Mobil Oil Corp. v. Maryland Cas. Co.*, 288 Ill. App. 3d 743, 756(1st Dist. 1997); **Maryland** (*Roussos v. Allstate Ins. Co*., 655 A.2d 40 (Md. 1995); **Massachusetts** (*Herbert A. Sullivan Inc. v. Utica Mut. Ins. Co*.), 788 N.E.2d 522, 530 (Mass. 2003); **New York** (*Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392 (1981)); and **Texas** (*Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558-59 (Tex. 1973)).

California follows the dual client approach, with a twist. Where the insurer's reservation of rights creates an actual conflict, the policyholder selects "*Cumis*" counsel. CAL. CIV. CODE § 2860(a) (2007); *San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358, 364 (1984). But the conflict "must be significant, not merely theoretical, [and] actual, not merely potential," as mere theoretical conflicts do not allow for the policyholder's independent selection. *Dynamic Concepts, Inc. v. Truck Ins. Exch*., 61 Cal. App. 4th 999, 1007 (1998). Thus, in California, an insurer's reservation of rights does not trigger the right to independent counsel unless the outcome of the coverage issue upon which the reservation is based can be controlled by counsel retained by the insurer. *Id*.

Additional states do not automatically allow the policyholder to select counsel in the face of a reservation of rights. *See also, e.g., L & S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987) (the mere fact that an insurer is defending under a reservation of rights does not entitle a policyholder to independent counsel); *Finley v. Home Ins. Co*., 975 P.2d 1145 (Haw. 1998) (insurer's reservation of rights does not require insurer to pay for separate "independent" counsel); *Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co. of S.C., LP*, 336 F. Supp. 2d 610, 621 (D.S.C., 2004) (a reservation of rights does not create an automatic right to independent counsel because a reservation only gives rise to a "potential," not actual, conflict of interest).

Even in some states that do not automatically allow the policyholder to select counsel in the face of a reservation of rights, defense counsel's primary duties are to the

policyholder over the insurer. For example, the Connecticut Supreme Court has explained that "even when an attorney is compensated or expects to be compensated by a liability insurer, his or her duty of loyalty and representation nonetheless remains exclusively with the insured." *Metropolitan Life Ins. Co. v. Aetna Cas. & Sur. Co*., 730 A.2d 51, 65 (Conn. 1999).

B. Defense Counsel Rates

1. The "Reasonable" Rate

A common disconnect occurs when the policyholder controls defense counsel selection, but the insurer limits the rates it will pay or reimburse, thus constraining that selection. Many policies provide little guidance, other than the condition of the insurer paying "reasonable" amounts. For example, a policy might provide: "In the event an 'insured' is entitled by law to select independent counsel…the attorneys' fees and all other litigation expenses [Insurer] must pay to that counsel are limited to reasonable legal costs." What is a "reasonable" rate? In many states, there is no statutory or case law guidance – only the clash of policyholder and insurer (or their counsel) as to what is a "reasonable" rate for the defense of the case.

Some states, like California, provide more guidance, as addressed below, but if it just comes down to a debate about what is "reasonable," how can this be resolved? For its part, an insurer might make reference to the rates that its panel counsel charge, as proof of "reasonable" rates available in the market. An insurer might present a specific, reputable firm to take up the defense, and cite that rate as "reasonable" because it is available in the market. On its behalf, the policyholder might point out that the rates offered by insurer panel firms are often driven down by the high-volume of defense work provided to them by insurers, so they are not realistic in measuring what a policyholder, on its own, will pay. A policyholder can bolster its case with some research and effective correspondence. First and foremost, the policyholder should draw attention to the skills and expertise of its selected counsel, justifying their rates. Second, comparable counsel should be identified, with their rates noted. There are also some public databases that might be cited to show an average rate in the area.[1]

In the pure "reasonableness" debate, in the end, it is a matter of negotiation between insurer, policyholder, and defense counsel. For example, the sequence may go as follows: (a) policyholder selects independent counsel who charges rates of $700/partner and $400/associate; (b) the insurer offers to pay half that, $350/$200, citing rates paid to its usual high-volume defense counsel; (c) the firm indicates a willingness to accept $600/$350; (d) the insurer comes up to $400/$250; and (e) the policyholder accepts and agrees with the firm to pay the difference.

A policyholder can, of course, reach an agreement with the insurer, pay the differential, but reserve the right to seek such defense fees in a subsequent coverage action. This is advisable, and it can help with the settlement decision later when the policyholder and insurer try to resolve all their differences. An insurer cannot rightfully

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[1] For example, the "Valeo Attorney Hourly Rates and AFA [Alternative Fee Arrangement] Database" contains hourly rates for attorneys and staff at more than 600 law firms – large, middle-market, small and boutique – in 80 practice areas. Valeo lists only "actual rates," meaning rates attorneys actually billed, as opposed to surveyed, self-reported, or estimated rates.

agree to rates but only on the condition that the policyholder waive such rights, as this would hold the defense hostage to waiver, possibly an act of insurer bad faith.

2. The "Community" Rate

In California, the matter is addressed by California Civil Code section 2860(c), which provides that unless the policy provides otherwise, "the insurer's obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended." Liability policies across the country increasingly repeat this California code language. For example, a policy might provide: "attorneys fees . . . in connection with the defense of a 'claim' . . . are limited to rates we actually pay to counsel we retain in the ordinary course of business in the defense of similar 'claims' or negotiation of similar matters in the community where the 'claim' arose." This can add a subjective element to the debate – the insurer has an artificial cap defined by what it pays in other cases. But the policyholder would have no way to test the insurer's assertions, short of discovery.

This also leaves room for debate over the relevant "community" where the claim arose. Is this strictly geographic, or given the complexity of a particular defense, can this be national or global in scope? In *Arbor Hill Concerned Citizens Neighborhood Assoc. v. Cnty. of Albany*, 522 F.3d 182 (2d Cir. April 10, 2008) (*citing Polk v. N.Y. State Dep't of Corr. Servs.*, 722 F.2d 23, 25 (2d Cir. 1983), the Second Circuit observed that "[t]he legal communities of today are increasingly interconnected. To define markets simply by geography is too simplistic. Sometimes, legal markets may be defined by practice area."[2] Thus, the Second Circuit noted that, where circumstances have warranted it, the court will not insist on "strict adherence to the forum rule." *Id.*

Thus, even the "community" clause leaves much room for debate over the rate, resulting in the usual give-and-take negotiation. If an agreement is reached and the policyholder is left paying an incremental amount to secure counsel of its choosing, the policyholder may reserve rights to seek reimbursement of such amounts at a later time.

C. The Settlement Decision

In the reservation of rights scenario, the settlement decision can be difficult. The insurer may claim an absolute right of consent to settlement, citing its "voluntary consent" clause. The policyholder will argue that such consent cannot be unreasonably withheld, and given the conflict of interest, the insurer cannot hold up settlement for the artificial reason that facts might later be determined that will eviscerate coverage. The insurer has to have a principled, objective reason for declining a settlement in such circumstances. Most dangerous are situations where the insurer offers approval but only on the condition that the policyholder pays a portion of the settlement, making suggestions that the settlement in part relates to non-covered claims or damages. These can be difficult conversations, conflicting with principles of fairness or even ethics, but informed by practical considerations. Here, there can be a very thin line between acceptable and unacceptable insurer conduct.

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[2] 522 F.3d at 192. *Arbor Hill* was abrogated in part, to the extent it advocated for abandoning the lodestar formula. *See Trs. of the Empire State Carpenters Welfare v. M.R. Drywall Servs.*, No. CV-11-1842, 2012 U.S. Dist. LEXIS 123937, at *9-10 (E.D.N.Y. Aug. 6, 2012) (discussing subsequent Supreme Court decision that endorsed the lodestar method, but noting that several factors are still considered in the "reasonable fee" analysis). *Arbor Hill*'s analysis of the forum rule was unaffected.

Under some state laws, when the insurer will not consent, the policyholder can settle nonetheless and then sue the insurer for coverage of the settlement, where coverage and reasonableness might be the controlling issues. Or under many state laws, the policyholder can stipulate to a judgment with the underlying plaintiff, with a covenant not to execute, and assign the claim to the plaintiff for pursuit in a direct action against the insurer (where coverage becomes the controlling issue). *See, e.g., Damron v Sledge*, 105 Ariz. 151, 460 P.2d 997 (1969) (denial of coverage) and *U.S.A.A. v. Morris*, 154 Ariz. 113, 741 P.2d 246 (1987) (reservation of rights). Such vehicles for settlement are beyond the scope of this paper. But state courts have recognized such alternatives precisely because the policyholder is placed in an "untenable" situation, feeling the "thrust" of liability. *Id*. The prevailing rationale is fairness to all in the tense settlement situation, which concept extends when excess insurers get involved as well (excess insurer issues are beyond the scope of this paper).

In nearly every case on the topic, basic fairness is the guiding principle.

IV. WHEN THE INSURER DECLINES COVERAGE IN FULL

When a liability insurer denies a defense in full, if it turns out to be correct in its denial, it is off the hook. But an insurer denial gives all decision-making power to the policyholder, and the insurer runs the risk of being found liable for all defense costs and settlement amounts.

A. Selection of Defense Counsel

In a full denial scenario, the policyholder has the absolute right to select defense counsel. The insurer need not be asked, although the information might be passed along to the insurer.

B. Defense Counsel Rates

Likewise, where it denies a defense, the insurer has no say over defense counsel rates, and the insurer need not be asked. Later, an insurer might still argue that rates must be "reasonable," just as all damages must be mitigated. But any doubt should be resolved in favor of the actual rates paid by the policyholder. A policyholder might keep a denying insurer informed of the bills as they are issued, tendering them for payment each month, in part to set a record for damages and provide an opportunity for the insurer to make comment.

Instructive on this point is the recent ruling in *Louisiana Generating LLC and NRG Energy, Inc. v. Illinois Union Insurance Company*, 2014 WL 1270049 (M.D.La. 2014). The insurer initially denied defense coverage. After the policyholder completed its defense, the court found there had been a duty to defend. The insurer challenged the reasonableness of the defense counsel rates on the grounds that they were inconsistent with reasonable rates in the local forum. The court found the rates to be "presumptively reasonable." The court cited Judge Posner's well-repeated reasoning in *Taco Bell Corp. v. Continental Cas. Co.*, 388 F.3d 1069 (7th Cir.2004) as "particularly persuasive." There, Judge Posner found that the defense costs sought were reasonable because of the uncertainty the plaintiff had concerning whether it would be reimbursed for its defense costs. Judge Posner wrote, "When [the insured] hired its lawyers, and indeed at all times since, [the insurer] was vigorously denying that it had any duty to defend—any duty,

therefore, to reimburse [the insured]. Because of the resulting uncertainty about reimbursement, [the insured] had an incentive to minimize its legal expenses (for it might not be able to shift them); and where there are market incentives to economize, there is no occasion for a painstaking judicial review." *Taco Bell Corp*, 388 F.3d at 1076–77 (citations omitted).[3]

C. The Settlement Decision

In a full denial situation, the settlement decision also belongs to the policyholder. The insurer need not be informed or consulted, although there may be a duty to inform the insurer of changes in facts or claims that might impact coverage. If informed of a possible or recommended settlement, a denying insurer might be reluctant to weigh in, lest its views create an argument for waiver or estoppel. Under most state laws, the policyholder can settle, pay the plaintiff, and then sue for coverage. Or the policyholder can stipulate to a judgment with the underlying plaintiff, with a covenant not to execute, and assign the claim to the plaintiff for pursuit in a direct action against the insurer. In the full denial scenario, the insurer usually cannot question the reasonableness of the settlement after the fact, leaving only coverage as a defense. *See, e.g.*, *Damron v Sledge*, 105 Ariz. 151, 460 P.2d 997 (1969).

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Note that many of the above-discussed issues are addressed in the emerging American law Institute "Principles of the Law and Liability Insurance," Tentative Draft No. 2 (revised) (July 23, 2014) (available at www.ali.org). This set of principles, yet to be finalized as a full, formal ALI "Restatement of the Law," purports to set forth the rules that apply to the duty to defend, addressing the various issues noted above. The principles follow what might be called the "majority" rules notes above. When finalized, whether as a Restatement or otherwise, these principles will have no formal precedential or binding impact, but may emerge as a persuasive set of principles of these topics.

V. GIVE AND TAKE: ACTIONS FOR REIMBURSEMENT

The final give-and-take issue addressed in this paper is the situation where the insurer pays defense costs but then late wants its money back. When the insurer defends under a reservation of rights, it often expressly reserves the right to seek reimbursement of defense costs if they can later be shown to relate to non-covered claims. Similarly, if a settlement is paid in full but then can be allocated, in whole or in part, to non-covered claims, the insurer might seek reimbursement.

Insurers have sought reimbursement under varying legal theories, including: (a) unjust enrichment; (b) restitution; (c) quasi-contract; (d) *quantum meruit*, and (e) implied-in-fact contract. Policyholders have argued that if there is no right to reimbursement in the policy, to add such a provision after the fact would provide the insurer an additional benefit that was not part of the original bargain. Policyholders have also argued that the potential for insurance coverage drives up the settlement value of a case, which should not be borne by the policyholder if there is no coverage.

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[3] Coverage counsel fees were also awarded. "Specifically addressing [John] Heintz's hourly rate of $1,000, while without context, this hourly rate may seem high, Heintz's decades worth of experience, honed expertise, and the complex nature of the issues involved justify such an hourly rate." Many attendees at this conference share in this assessment of John Heintz, long a member of the policyholder bar and active attendee here.

Courts across the country have reached opposite conclusions on these issues. An examination of the rulings of state Supreme and appellate courts (excluding federal court predictions of state law on the issue) reveals that *six* states allow reimbursement and *seven* disallow it.

Federal courts have predicted state law (or stated their view of the law in clear comment) by a score of federal courts in *six* states appearing to allow reimbursement and federal courts in *ten* states appearing to disallow reimbursement. A breakdown by state and federal courts follows.

A. Six States Allow Reimbursement

A close review of state Supreme Court or appellate court decisions yields five states that allow reimbursement, based either on a clear on-point ruling, or significant statement of the law.

1. California

Under California law, an insurance company has a right to be reimbursed amounts it pays in indemnity, defense, or otherwise, if such amounts are proven to be allocable to claims that are not potentially covered by the policy. *Buss v. Superior Court,* 16 Cal. 4th 35 (1997). An insurer is not required to file a declaratory relief action and obtain a determination of coverage prior to paying amounts on the policyholder's behalf. California courts recognize that would be impractical. *See Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 505 (2001); *Scottsdale Ins. Co. v. MV Transportation*, 36 Cal. 4th 643, 661 (2005); *Montrose Chemical Corp. v. Superior Court*, 6 Cal. 4th 287, 305 (1993) (declaratory relief action can be stayed so as to not prejudice policyholder's defense of underlying claim).

The right to reimbursement of amounts paid on an insured's behalf does not have to be expressly provided in the insurance policy. *Buss*, 16 Cal. 4th at 51, fn. 13; *Blue Ridge*, 25 Cal. 4th at 504. To preserve its rights, the insurer may unilaterally reserve its rights, regardless of whether the policyholder explicitly agrees with this reservation or not. *See, e.g., Buss*, 16 Cal. 4th at 42, 61, fn. 27. However, it is not enough to generally reserve rights. *See, e.g., Golden Eagle Ins. Co. v. Foremost Ins. Co.*, 20 Cal. App. 4th 1372, 1392-1393 (1993) (insurer defended without reserving rights and settled using policyholder's money without policyholder's consent). The written communication to the policyholder must apprise the policyholder of the fact that the insurer reserves the right to seek reimbursement of amounts paid on the policyholder's behalf. *See, e.g., Scottsdale*, 36 Cal. 4th at 655; *Blue Ridge,* 25 Cal. 4th at 503, *Buss,* 16 Cal. 4th at 42; *Golden Eagle Ins. Co. v. Cen-Fed, Ltd. ("Cen-Fed")*, 148 Cal. App. 4th 976, 982, fn. 4 (2007) (it was not clear to the court whether Golden Eagle reserved its right to seek reimbursement of defense costs and expenses, an issue for the trial court on remand).

In the indemnity context, an insurer can obtain reimbursement from its policyholder of amounts paid to settle on behalf of its policyholder. *See, e.g., Johannsen v. Calif. State Auto. Assoc.*, 15 Cal. 3d 9, 19 (1975). This is because the duty to indemnify is narrower than the duty to defend and only exists if there is actual coverage for the claim. *See, e.g., Johannsen*, 15 Cal. 3d at 12. This right also arises out of the obligation imposed on insurers to settle claims for a reasonable amount within policy limits if given the opportunity to do so, if the claim is covered by the policy. *Id.*, at 15-

16. The right to seek reimbursement of indemnity amounts exists regardless of whether the policyholder objects to the settlement, if the claims are later found to not be covered by the policy. *Blue Ridge*, 25 Cal. 4th 489. This result is appropriate, explained the court, in order to not have the insurer placed in a "Catch 22" — at risk if it refuses to pay the settlement and forced to indemnify non-covered claims if it agrees to pay. *Id.* at 502.

2. Colorado

The Colorado Supreme Court explained in *Hecla Min. Co., v. New Hampshire Ins. Co*., 811 P.2d 1083, 1089 (Colo. 1991) that "[t]he appropriate course of action for an insurer who believes that it is under no obligation to defend, is to provide a defense to the policyholder under a reservation of its rights [and] seek reimbursement should the facts at trial prove that the incident resulting in liability was not covered by the policy, or to file a declaratory judgment action after the underlying case has been adjudicated." *See also Cotter Corp. v. American Empire Surplus Lines Ins. Co.*, 90 P.3d 814, 828 (Colo. 2004),

Most recently, the 10th Circuit, applying Colorado law, ruled that an insurer can recover defense costs. In *Valley Forge Insurance Company v. Health Care Management Partners, Ltd.*, 616 F.3d 1086 (10th Cir. 2010), the insurers agreed to defend under a general reservation of rights, and the policyholder did not object. During the defense of the underlying case, the insurers filed a declaratory judgment action to deny their duty to defend and recoup defense costs. While noting that the right to recoup defense costs was not a provision of the insurance policy, the 10th Circuit, nevertheless, found that Colorado state law allowed recoupment. As the court noted, "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."

See also Certain Underwriters at Lloyd's v. Health Care Management Partners, Ltd., No. 05-CV-00373-RPM, 2006 WL 2050962 (D. Colo. July 20, 2006) (allowed reimbursement of fees where insurer had properly reserved right to seek reimbursement).

3. Connecticut

The Connecticut Supreme Court held in *Security Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co.*, 826 A.2d 107, 124 (Conn. 2003) that "[w]here the insurer defends the policyholder against an action that includes claims not even potentially covered by the insurance policy, a court will order reimbursement for the cost of defending the non-covered claims in order to prevent the policyholder from receiving a windfall."

4. Florida

The Florida Supreme Court has not ruled on the issue. Several appellate courts, however, have allowed reimbursement. *See Colony Ins. Co. v. G & E Tires & Service, Inc.*, 777 So. 2d 1034, 1038-39 (Fla. Dist. Ct. App. 2000) (insurer entitled to reimbursement of defense costs allocable to non-covered claims where the insurer had "timely and expressly reserved the right to seek reimbursement of the costs"); *Jim Black & Assoc. Inc. v. Transcontinental Ins. Co.*, 932 So. 2d 516 (Fla. Dist. Ct. App. 2006) (insurer was entitled to reimbursement of defense fees and costs where it reserved the right). Regarding settlement costs, a federal court held that an insurer cannot recover

them until coverage is resolved. *Steadfast Ins. Co. v. Sheridan Children's Healthcare Servs. Inc.*, 34 F.Supp.2d 1364, 1366-67 (S.D. Fla. 1998).

5. Montana

The Montana Supreme Court held in *Horace Mann Insurance Company v. Hanke* that the insurer could be reimbursed for indemnity costs for uncovered claims, as long as the insurer properly reserves its right to do so. 312 P.3d 429 (Mont. 2013). In *Horace Mann*, the policyholder allegedly converted the personal property of an acquaintance who had stopped paying the policyholder storage fees. The acquaintance sued the policyholder for theft, conversion and negligence, and sought compensatory and punitive damages. Horace Mann agreed to defend the policyholder under a reservation of rights, and filed a declaratory judgment action against the policyholder seeking a declaration that it had no duty to defend or indemnify the policyholder for the lawsuit. *Horace Mann*, 312 P.3d at 353-54.

While the coverage action was pending, the underlying case settled, with Horace Mann agreeing to pay $20,000 and the policyholder agreeing to pay $34,000. However, when the policyholder was unable to fund his portion of the settlement, Horace Mann agreed to loan the policyholder $34,000, subject to recoupment in the declaratory judgment action. The trial court held that the claims against the policyholder were not covered, and that Horace Mann had properly reserved its rights to recover the $34,000 in indemnity. However, the trial court denied Horace Mann's request for recoupment of defense costs, holding that Horace Mann had not properly reserved its rights on that issue. The Montana Supreme Court affirmed the district court's opinion, concluding that Horace Mann had expressly reserved its right to recoupment on indemnity, following the procedures set forth by the court in *Travelers Casualty & Surety Company v. Ribi Immunochem Research, Inc.*, 108 P.3d 460 (Mont. 2005).

6. New Jersey

New Jersey generally permits reimbursement. *See Hebela v. Healthcare Ins. Co.*, 851 A.2d 75, 86 (N.J. App. Div. 2004) (applying equitable principle of "unjust enrichment," court allowed recoupment of defense costs); *SL Indus., Inc. v. America Motorists Ins. Co.*, 607 A.2d 1266, 1280 (N.J. 1992) (insurer can seek reimbursement if it can carry the burden to show defense costs that are allocable to non-covered claims). However, a New York state appellate court, applying New Jersey law, held that the right of recoupment may be waived by the terms of the policy. *National Union Fire Ins. Co. v. Turner Constr. Co.*, 986 N.Y.S.2d 74 (N.Y. App. Div. 2014). In *Turner Construction*, the policy contained an endorsement stating that "the insurance carrier agrees not to take action or recourse against any insured for loss paid or expenses incurred because of any claims made against this policy." The court held that, despite the fact that the construction claims were not covered, National Union had no right to seek recoupment of defense costs that it had incurred on this matter.

B. Seven States Disallow Reimbursement

1. Alabama

Alabama courts have not ruled on the defense cost issue. But the Alabama Supreme Court refused to recognize an insurer's right to reimbursement of an uncovered indemnity payment, absent unusual circumstances. *See Mt. Airy Ins. Co. v. The Doe Law*

Firm, 668 So.2d 534 (Ala. 1995) (holding that an insurer's payment of a malpractice claim against its insured was voluntary and, therefore, the insurer was not entitled to reimbursement where it paid a settlement to an underlying plaintiff in a legal malpractice case and filed a declaratory judgment action seeking a determination of coverage and the right to reimbursement).

2. Arkansas

The Arkansas Supreme Court ruled that an insurer cannot seek reimbursement of defense costs based upon a reservation of rights letter. *See Medical Liability Mutual Ins. Co. v. Alan Curtis Enterprises, Inc*., 373 Ark. 525 (2008). This ruling overrides the prior federal court predictive ruling in *Nobel Insurance Co. v. Austin Powder Co.*, 256 F. Supp. 2d 937, 940 (W.D. Ark. 2003) ("an insurer who defends a claim for which coverage did not exist is entitled to reimbursement [of] costs for both the settlement amount and litigation expenses only if the insurer: 1) timely and explicitly reserved its right to recoup the costs; and 2) provided specific and adequate notice of the possibility of reimbursement").

3. Illinois

In *General Agents Insurance Co. of America, Inc. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092 (Ill. 2005), the Supreme Court of Illinois clearly held that an insurer has no right of reimbursement for defense costs allocable to non-covered causes of action, absent an express policy provision stating otherwise. This is the major ruling disallowing reimbursement, and a strong counterpoint to cases allowing reimbursement. Midwest Sporting Goods was sued for creating a "public nuisance" by selling guns to inappropriate purchasers. The insurer agreed to defend in a mixed action, reserving rights to recoupment of defense costs. Midwest did not reply to the ROR letter, but accepted the defense. The insurer then filed a DJ action on coverage. The trial and appellate courts found no duty to defend and ruled that the insurer could seek reimbursement, following *Buss*.

The Illinois Supreme Court reversed. Notably, the Court also rejected a prior federal court prediction of Illinois law on this point. In its analysis, the Court was persuaded by the point that "[i]f an insurance carrier believes that no coverage exists, then it should deny its insured a defense at the beginning instead of defending and later attempting to recoup from its insured the costs of defending the underlying action." *Id*. at 1102 (citation omitted). The Court explained that the insurer should not be allowed to place the policyholder in the "Hobson's Choice" between suing to establish a defense or accepting a defense but under the threat of reimbursement later. "Furthermore, endorsing such conduct is tantamount to allowing the insurer to extract a unilateral amendment to the insurance contract." *Id*. The Court stated it was following the "minority" rule on this issue. Interestingly, its own ruling (which turned the tide in Pennsylvania) has nearly reversed the majority and minority, at least when viewed by state court rulings.

4. Pennsylvania

Pennsylvania generally disallows reimbursement, as the Pennsylvania Supreme Court affirmed in *American and Foreign Ins. Co. v. Jerry's Sports Center Inc.*, 2 A.3d 526, 529 (2010). The Court declined to accept the insurers' various arguments in favor of reimbursement – contractual, quasi-contractual, or equitable. The insured was one of several firearms wholesalers-distributors sued for negligent creation of a public nuisance.

While there was some question as to whether the suit alleged bodily injury insured by the policy, the insurer provided a defense under a reservation of rights; after prevailing on declaratory judgment that it had no duty to defend or indemnify, it moved for reimbursement of defense costs.

The Court held that allowing the insurer to recoup defense costs absent a reimbursement provision in the policy would amount to a retroactive erosion of the duty to defend. Under basic rules of contract interpretation, because the policy contained no reimbursement provision, the insurer had no right to reimbursement under the policy and without that right, could not create a contract by virtue of a reservation of rights letter. Nor did the insurer have an equitable right to reimbursement, since the insurer's exercise of its right and duty to defend did not unjustly enrich the insured. Instead, it was the insurer who benefited by exercising control over the defense of a potentially covered claim and thus insulating itself from bad faith liability.

However, a recent Third Circuit decision held that an insurer may recoup its defense costs if the insurance policy expressly provides for that right. *Camico Mut. Ins. Co. v. Heffler, Radetich & Saitta, LLP*, 2014 WL 5070473 (Oct. 10, 2014). In *Heffler*, the policyholder was insured under an errors & omissions policy with a $100,000 sublimit for claims for misuse, misappropriation, theft or embezzlement. The firm was sued after an employee was arrested for submitting and approving false claims while overseeing a class action settlement. The policy contained a provision stating that if the insurer paid any claims expenses or damages in excess of the applicable limits of liability, Heffler would reimburse the insurer for those amounts within thirty days. In the coverage action, Heffler disputed that the $100,000 sublimit applied. The district court held, and the appeals court affirmed, that the sublimit applied. The appeals court also affirmed the district court's holding that the policy language required Heffler to reimburse the insurer for the defense costs paid in excess of the sublimit, in an exception to the rule set forth in *Jerry's Sports Center*.

5. Texas

Reimbursement and the scope of an insurer's rights following payment of an uncovered claim has been addressed by the Texas Supreme Court in three opinions; first in *Texas Ass'n of Counties County Government Risk Management Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000) ("*Matagorda County*") and later in two opinions issued *in Excess Underwriters at Lloyd's v. Frank's Casing Crew & Rental Tools, Inc*. 2005 Tex. LEXIS 418 (Tex. May 27, 2005) & 246 S.W.3d 42 (Tex. 2008) ("*Frank's Casing*").

In *Matagorda County*, the Court addressed two main issues: first, because, the County did not expressly consent to reimbursement, was there an "implied consent" or an "implied-in-fact contract" for reimbursement; and second, did the circumstances of the case warrant imposing an equitable right to reimbursement under either a doctrine of "equitable subrogation" or quasi-contract theories of unjust enrichment or quantum meruit? The Court answered these questions in the negative, summing up its holding by stating that "when coverage is disputed and the insurer is presented with a reasonable settlement demand within policy limits, the insurer may fund the settlement and seek reimbursement only if it obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement."

In *Frank's Casing*, the Texas Supreme Court withdrew its original opinion and reversed course. Because Franks had only consented to the settlement and not to the insurer's right to seek reimbursement, the Court found that insurer had no right to reimbursement. While the Court recognized that the insurer is also in a difficult situation in such cases, it resolved that dilemma by determining that the risk of such coverage uncertainties is best placed on the insurer.

6. Washington

In *National Surety Corporation v. Immunex Corporation*, 297 P.3d 688 (Wash. 2013), the Washington Supreme Court held in a 5-4 decision that an insurer does not have a right of recoupment of defense costs, even if it is subsequently determined that the claims are not covered under its policy. The Court held that National Surety was obligated to pay for the cost of the defense from the date of tender until the date on which the trial court in the coverage action determined that National Surety had no duty to defend the policyholder. *Immunex*, 297 P.3d 887 – 88. In the *Immunex* case, National Surety had agreed to defend Immunex, subject to a reservation of rights, and agreed to reimburse Immunex for its past defense costs, subject to a right of recoupment. However, when the trial court held that the claims were not covered, National Surety had not actually reimbursed Immunex for any defense costs. The dissenting opinion held that Immunex was unjustly enriched by the majority's decision and questioned adopting a blanket rule as opposed to a review of the equities in each case. *Id*. at 898 – 99.

7. Wyoming

Wyoming disallows reimbursement. *See Shoshone First Bank v. Pacific Employers Ins. Co.*, 2 P.3d 510, 513-14 (Wyo. 2000) (unless an agreement to the contrary is found in the policy, the insurer is liable for all costs of defending the action and may not allocate any of those costs to the policyholder). As the court explained, "the insurer is not permitted to unilaterally modify and change policy coverage . . . . In light of the failure of the policy language to provide for allocation, we will not permit the contract to be amended or altered by a reservation of rights letter").

C. Federal Court Rulings Allowing Reimbursement in Six States

1. Alaska. *See Unionamerica Ins. Co., Ltd. v. General Star Indem. Co.*, 2005 WL 757386, at *7-8 (D. Alaska Mar. 7, 2005) (predicting the Alaska Supreme Court would allow reimbursement if the insurer expressly reserves its right to seek it).

2. Hawaii. *See Okada v. MGIC Indem. Corp.*, 823 F.2d 276 (9th Cir. 1986) (applying Hawaii law) (court found an insurer can seek reimbursement of defense costs allocable to non-covered claims if the insurer reserved its rights). However, see *Scottsdale Insurance Co. v. Sullivan Properties, Inc*. 2006 WL 505170, at *1 (D. Haw. 2006), (court predicted that, under Hawaii law, an insurer could seek reimbursement of defense costs only if it had no duty to defend the underlying action; the court did not reach the issue of whether the insurer could seek reimbursement for defense of non-covered claims if some claims were covered and triggered a complete duty to defend).

3. Kentucky. *See Employers Reinsurance Corporation v. Mutual Ins. Co., Ltd.*, No. 3:05CV556-S, 2006 WL 2734437 (W.D. Ky., September 22, 2006) (court recognized that Sixth Circuit allows reimbursement where the parties have expressly agreed through a reservation that the insurer has the right to reimbursement if coverage is

later found not to exist). *See also Travelers Prop. & Cas. Co. of America v. Hillerich & Bradsby Co., Inc*., 598 F.3d 257, 265-66 (6th Cir. 2010) (insurer who settles a non-covered claim is entitled to reimbursement of settlement costs where the insurer has reserved rights and notified the policyholder of its intent to seek reimbursement of such costs).

4. Michigan. *See Budd v. Travelers Indem. Co.*, 820 F.2d 787 (6th Cir. 1987) (reimbursement is allowed where allocation between covered and non-covered claims can be established by the insurer). *See also Dow Chem. Corp v. Associated Indem. Corp.*, 1991 WL 568033 (E.D. Mich. Dec. 6, 1991).

5. New York. *See Gotham Ins. Co. v. GLNX, Inc*., 1993 WL 312243 (S.D.N.Y. Aug. 6, 1993) (applying New York law, the court allowed the insurer to pursue reimbursement against the policyholder for defense costs allocable to non-covered claims).

6. Tennessee. There is no reported Tennessee authority on point. However, in *Cincinnati Ins. Co. v. Grand Pointe, LLC*, 2007 WL 2301179 (E.D. Tenn. 2007), a federal district court, predicting Tennessee law, held that an insurer was entitled to recoup defense costs when it defended the insured subject to a reservation of the right of recoupment, and when it was later determined that no duty to defend existed.

D. Federal Court Rulings Disallowing Reimbursement in Ten States

1. Idaho. Federal district courts, predicting Idaho law, disallow reimbursement, most recently in *Blue Cross of Idaho Health Service, Inc. v. Atlantic Mutual Ins. Co*., 734 F.Supp.2d 1107 (D. Idaho 2010). *See* also *St. Paul Fire & Marine Ins. Co. v. Aspen Realty*, No. CV 05-355-S-MHW, 2006 U.S. Dist. LEXIS 94061 (D. Idaho Dec. 27, 2006) (held that no insurer right of reimbursement existed absent a reservation of such a right in the policy).

2. Iowa. One federal district, predicting Iowa law, has held that insurer's have no right to reimbursement of defense costs when was determined that an entire lawsuit is not covered. *See, e.g., Pekin Ins. Co. v. Tysa, Inc.*, No. 3:05-cv-00030-JEG, 2006 U.S. Dist. LEXIS 93525 (S.D. Iowa Dec. 27, 2006) (predicting that the Iowa Supreme Court would not allow reimbursement of defense costs, even when an insurer reserved its rights to reimbursement). The court did not address whether an insurer can recoup that portion of defense costs attributable to uncovered claims where some claims are covered.

3. Kansas. Kansas law was applied recently by a Virginia federal court in *Houston Cas. Co. v. Sprint Nextel Corp*., Case No. 09-CV-1387, 2010 WL 4852649 (E.D.Va. 2010). The dispute arose out of an underlying securities action where a settlement was reached in the amount of $57.5 million. Sprint was insured under a number of D&O policies providing $100 million in coverage, including an excess policy issued by Houston Casualty providing $15 million in coverage. Houston Casualty agreed to contribute to the settlement, but reserved the right to deny coverage and seek reimbursement. Houston Casualty filed a reimbursement action after another insurer secured a decision declaring that it was not required to provide coverage for the underlying securities claim. The court held that Houston Casualty could not obtain reimbursement because there was no basis under the policy for an insurer to make a settlement advance and later seek its return.

4. Maryland. *See Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 448 F.3d 252, 258 (4th Cir. 2006) (disallowing reimbursement even though the insurer had agreed to defend subject to a reservation of its right to seek reimbursement for defense costs allocable to non-covered claims, the court found that, under Maryland law, a right of reimbursement for defense costs for non-covered claims would "serve only as a backdoor narrowing of the duty to defend, and would appreciably erode Maryland's long-held view that the duty to defend is broader than the duty to indemnify").

5. Massachusetts. *See Dash v. Chicago Insurance Co*., 2004 WL 1932760 (D. Mass. Aug. 3, 2004) (court declined to adopt the rule set forth in *Buss* where the insurer had defaulted on its duty to defend entirely and sought to avoid reimbursing its policyholder for defense costs allocable to non-covered defense costs). The district court further opined that it was appropriate for a federal court to carve out an exception to established precedent: "Massachusetts courts have unambiguously adopted the broad rule that an insurer has a duty to defend an entire suit in which any claim is even potentially covered. There is no reason to assume that in establishing such a rule the courts failed to anticipate the possibility of 'mixed' cases or have otherwise not fully contemplated the consequences of this rule." *Id.* at *10. A state court has also ruled that there is no right to reimbursement where the insurer enters into a settlement agreement without notification to the policyholder. *Medical Malpractice Joint Underwriting Ass'n of Massachusetts v. Goldberg*, 680 N.E.2d 1121 (Mass. 1997).

6. Missouri. *Liberty Mut. Ins. Co. v. FAG Bearings Corp*., 153 F.3d 919 (8th Cir. 1998) (applying Missouri law) (finding that the insurer had no right to reimbursement for defense costs allocable to non-covered claims because the insurer had the duty to defend those claims until the time that it was determined the claims were excluded from coverage and the insurer's remedy at that time was that it was allowed to withdraw from the defense).

7. Nevada. *See Capitol Indem. Corp. v. Blazer*, 51 F. Supp. 2d 1080, 1090 (D. Nev. 1999) (an insurer may be reimbursed for costs incurred in defending against "claims not potentially covered under the insurance policy *only* if there was a clear understanding between the parties that [the insurer] reserved the right to reimbursement for the costs of the investigation and/or defense"). The apparent requirement of agreement by the policyholder effectively disallows reimbursement.

8. New Mexico. *See Resure, Inc. v. Chemical Distrib. Inc.*, 927 F. Supp. 190, 193 (M.D. La. 1996) (applying New Mexico law) (the court suggested that a right of reimbursement might not be available to the insurer if the policyholder objects to the insurer's reservation of rights).

9. Ohio. A split panel of the Sixth Circuit predicted that the Ohio Supreme Court would permit an insurer to recoup defense costs following a judicial determination that there was no duty to defend, if the insurer had defended under a reservation of rights that expressly included the right of reimbursement and the policyholder accepted the defense *without objection* to the reservation. *United Nat'l Ins. V. SST Fitness*, 309 F.3d 914 (6th Cir. 2002). In effect, this disallows reimbursement as a policyholder can readily reject the reservation.

10. Virginia. *See Medical Protective Co. v. McMillan*, 2002 WL 31990490 (W.D. Va. Dec. 16, 2002) (while the court held that an insurer may seek

reimbursement when some claims in the underlying action are potentially covered and others are not, the court held that, even accepting *Buss*, there was no right to reimbursement with respect to potentially covered claims and no right to reimbursement if such right is not specifically articulated in the reservation of rights letter).

E. Unresolved – 20 States

Twenty states have not addressed the issue directly, whether at the state or federal court level (apart from off-point dicta and vague hints that can be debated either way). These are Arizona, Delaware, Georgia, Indiana, Louisiana, Maine, Minnesota, Mississippi, Nebraska, New Hampshire, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Utah, Vermont, West Virginia, and Wisconsin.

A Delaware lower court came close to the issue in *Nationwide Mut. Ins. Co. v. Flagg*, 789 A.2d 586, 596-97 (Del. Super. Ct. 2001), but expressly noted it lacked a factual and legal record to decide the issue of whether an insurer may seek reimbursement from the policyholder for defense fees and costs relating to claims later proven to fall outside coverage.

In Georgia, the federal courts have reached contradictory holdings. *In Illinois Union Insurance Company v. NRI Construction, Inc.*, 846 F. Supp. 2d 1366, 1377 (N.D. Ga. 2012), the district court held, after reviewing cases on both sides of the issue, that Illinois Union had a right to recoupment of its defense expenses from the policyholder because Illinois Union's reservation of rights letter had (1) timely and explicitly reserved its right of recoupment; and (2) provided specific and adequate notice of the possibility of reimbursement. However, the court's decision did not refer to an earlier case, *Transportation Insurance Co. v. Freedom Electronics*, Inc. 264 F. Supp. 2d 1214, 1221 (N.D. Ga. 2003), in which the court reached the opposite conclusion, stating that "in the absence of a provision requiring reimbursement or case law instructing the Court otherwise, the Court is unwilling to require the [policyholder] Defendants to repay the costs already expended by Plaintiff."

In Minnesota, federal courts have gone opposite ways. *Compare Knapp v. Commonwealth Land Title Ins. Co., Inc.*, 932 F. Supp. 1169, 1171-72 (D. Minn. 1996) (where there is ultimately a determination of non-coverage, an insurer which has provided a defense pursuant to a reservation of rights may recoup defense costs if the right to recoup defense costs is sufficiently reserved), with *Employers Mutual Casualty Co. v. Industrial Rubber Prods., Inc.*, 2006 WL 453207 (D. Minn. Feb. 23, 2006) (absent an express provision in the insurance policy, an insurer was not entitled to reimbursement for defense costs allocable to non-covered claims) and *Westchester Fire Ins. Co. v. Wallerich*, 527 F. Supp. 2d 896 (D. Minn. 2007) (same).

In Wisconsin, an appeals court held that the insurer had a right to recoupment where the automobile policy had lapsed due to non-payment of premium, but the insurer was still obligated to pay a claim asserted against the policyholder for an accident that occurred after the policy had expired but before the insurer's notice to the state of the cancellation was effective. *Acuity v. Albert*, 819 N.W.2d 340 (Wis. Ct. App. 2012).

VI. PRACTICAL CONSIDERATIONS

Know the Jurisdiction

Because the law differs from state to state, it is imperative to know the rules and case law in the state most likely to determine the coverage issues and reimbursement claim.

Understand Coverage

The policyholder and insurer alike must understand the insurance coverage issues. Make sure a complete copy of the policy is available and has been reviewed. Although unlikely, the policy should be reviewed to determine if it has any reimbursement provision. Examine applicable case law on the coverage issues.

Reservation of Rights

Policyholders need not assume the insurer has adequately reserved rights and what is "adequate" may differ depending on the applicable state law. When was the reservation of rights sent? Because of its timing, it may apply to only some of the claim. Did the letter adequately apprise the policyholder of the insurer's intention to seek reimbursement of defense costs, indemnity and other amounts paid on the policyholder's behalf. If not, would the policyholder have handled the case differently if so apprised?

Response to Reservation of Rights

Although a reservation of rights may be unilaterally made in some jurisdictions, the policyholder should consider whether to respond and note objection to the reservation and examine whether the reservation of rights creates conflicts which may entitle the policyholder in some jurisdictions to select counsel of its choice.

Considerations for Settlement Demands

Plaintiffs may tailor settlement demands to impact later reimbursement claims, for example by crafting the demand only on certain issues for "payment," but with the release of all claims. This "rationalization" of the demand may also have an impact on evaluation and reasonableness for bad faith purposes.

The policyholder, defense counsel, and personal counsel must use extreme care in commenting on settlement demands. There should not be knee-jerk letters to the insurer. On the insurer side, adjusters should be careful about what they comment upon and how they characterize settlement opportunities in their claim notes.

A prudent policyholder might want to pass along the plaintiff's settlement demand to the insurer with a communication to this effect: "Dear Carrier: Here is a demand from the plaintiff. We leave it to you to protect our interests. We want you to pay everything you are contractually obligated to pay. Please do not pay any more." In this way, the insurer will have to decide whether the settlement is reasonable under the circumstances even though the policyholder has not demanded that the matter be settled.

Mediation

Mediators need to have a full understanding of the nuances of an insurer's right (or lack thereof) to reimbursement. If a final resolution and "peace" are the goal, defense counsel and insurers may want to expressly agree to mediate solely on the condition that all rights to reimbursement are waived by all insurers in writing in advance of the mediation. Insurers will want to factor in their reimbursement rights in valuing the claims to be resolved.

Reimbursement issues should be explored and understood prior to the agreement to mediate and certainly at any mediation. Unless care is used, there could be an inadvertent "*trigger*" of reimbursement by "demands" made at mediation. Query: Would the mediation privilege bar these conversations? Answer: Probably not.

Settlement Negotiations

Carriers should be highly sensitive to last minute demands and use reimbursement issues to offset this pressure. Reimbursement equalizes the power considerations in last minute demands.

Settlement Documentation

Care should be used in settlement documents and settlement documentation. Should reimbursement be addressed? If so, how? Should the insurers formally sign the settlement papers waiving reimbursement?

Allocation

Allocation is an issue and may impact an insurer's ability to recover or prove its reimbursement claim. The insurer could state that the case was settled for $100,000 and thereafter seek reimbursement for $30,000 on the grounds that out of the $100,000, $30,000 was allocated to "non-covered claims."

Consideration should be given to whether there should be any agreement confirmed in writing as to whether amounts paid in any settlement were for particular claims in the lawsuit, defense costs, or other expenses.

Declaratory Relief Action

Consider whether to file a Declaratory Relief Action, for several purposes. Know whether the jurisdiction requires one be filed prior to payment of amounts in dispute. Certainly such an action can be filed to apprise the parties of the seriousness of the coverage issue, even if the chances of getting the coverage issue resolved prior to resolution of the underlying dispute is unlikely.

Reimbursement Claim

The insurer, before pursuing a reimbursement claim, must determine if it is worthwhile to pursue. The transaction costs (e.g., attorneys fees) of pursuing a reimbursement claim are not generally reimbursable and if the policyholder is unable to pay at the end of the day, the claim may not be worth the effort. For this reason, the policyholder may want to provide the insurer with reasons, prior to institution of a reimbursement claim why the effort would not be worthwhile.

Policy Drafting

Carriers should consider, in order to address the variance between the law in the states, drafting policy provisions that clearly provide a right to reimbursement when payments are made on an policyholder's behalf for non-covered claims. Carriers should also consider rewording their "supplementary payments" provisions in order to avoid covering attorneys fees awards that are based on claims not covered by the policy, if they do not want to cover those types of expenses.

Ethical Issues for Defense Counsel: *Frank's Casing* and *Davalos*

Nearly every commentator or observer who has read *Frank's Casing* has noted that the defense lawyer hired by the same insurer who may be later seeking reimbursement is going to face numerous and repetitive ethical quandaries. The leading case that is relevant to these ethical issues is *Davalos v. Northern County Mutual*, 140 S.W. 3d 685 (Tex. 2004). It has been suggested that a reservation of the right to seek reimbursement is an irreconcilable conflict under *Davalos* for which the policyholder is entitled to separate and independent counsel. Justice Hecht's concurrence can be read to support the need for independent counsel since Hecht "highlights" the potential significant conflict between the insurer and the policyholder. Carriers frequently attempt to "reserve their rights" on provisions which almost certainly never would be applied. Under *Davalos* and in light of *Frank's Casing*, "prophylactic" reservations may tip the scales over to a requirement for independent counsel under *Davalos*.

Malpractice Implications

Where coverage issues are important, the reality now is that the policyholder will be under pressure of exposure more than ever before in Texas. This pressure will almost certainly be shifted to some extent downstream – first to the defense lawyer hired by the insurer in the form of *legal malpractice*, and then to the E&O insurer for the agent. Where there is no coverage, frequently one finds the claim that "the agent made me do it" or that the agent was responsible for the lack of coverages. It is highly likely that both of these causes of action will become far more frequent than in the past.