THE INSURER'S RIGHT TO RECOUPMENT OF DEFENSE COSTS

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As noted by well-respected commentators, Hon. Barry Ostrager and Thomas R. Newman, in their excellent Handbook on Insurance Coverage Disputes (Aspen Publishers), at §5.07, "Authority is divided as to whether an insurer may reserve its right to recover defense costs in the event it is subsequently determined that there is no coverage." Indeed, independent research on this issue has revealed a significant number of decisions -- mostly from the federal courts acting in their role of interpreters of New York State law and predictors of how the New York State courts would rule -- with apparently conflicting and fact-based results. My wish, therefore, for a thorough and detailed analysis of the issue by a New York State court recently has been granted with the Appellate Division, Second Department's December 30, 2020 decision in *American Western Home Ins. Co. v. Gjonaj Realty & Management Co.*, 192 AD3d 28 (2d Dept. 2020) ("*American Western*").

As described by the author of the Opinion and Order, Justice Colleen Duffy, *American Western*, *supra,* "presents a novel issue of law that this court has not yet addressed -- whether an insurance company... may recover the costs of defending its insureds... in an underlying personal injury action against those insureds where there has been a reservation of rights by the insurance company and a determination by the court that the insurance company has no obligation to defend and provide

insurance coverage to the insureds in an underlying personal injury action commenced against them."

Factual Background

In its discussion of the facts of this case, the Second Department noted, *inter alia*, that the underlying action involved a claim for personal injuries on behalf of a Mr. Gecaj, who was injured in a fall from a ladder at premises owned and managed by American Western's insureds. Under the terms of the subject insurance policy, upon timely notice to the insurance company of Mr. Gecaj's claim, the insureds would have been entitled to a defense and identification in the action brought against them. However, it was undisputed that the insureds failed to notify the insurer until more than four years after the accident, and after an inquest on damages was held and a judgment in the sum of $900,000 had been entered against the insureds. Approximately a week after it received the belated notice of Mr. Gecaj's accident, the insurer advised its insureds, in writing, that it was refusing to defend or indemnify them based upon their breach of the notice provisions of the policy. More than a year later, upon receipt of notice that the court had vacated the insureds' default, the insurer advised the insureds that it reconsidered its coverage position and would defend and indemnify them in the underlying action. However, at that time, the insurer also notified that it was reserving its rights under the terms of the policy to deny any coverage, as it was not then aware whether it had been prejudiced in its

investigation or ability to defend the action. Two months later, the insurer further notified the insureds that, since it had been notified that Mr. Gecaj had appealed the vacatur of the default judgment, it was reserving its rights to refuse to defend or provide indemnity coverage to the insureds upon any reinstatement on appeal of the default judgment.

One week after the Appellate Division's subsequent reversal of the vacatur of the default judgment and reinstatement of the default judgment against the insureds, the insurer advised the insureds, and Mr. Gecaj, that it was again denying coverage and, this time, reserving its right to recover any fees and costs it incurred in defending the insureds in the underlying action. The insurer subsequently (timely) commenced a Declaratory Judgment action and moved for summary judgment for a judicial declaration that: (1) it had no obligation to defend and indemnify the insureds in the underlying action; (2) it had no obligation to pay the judgment against the insureds in the underlying action; and (3) it was entitled to recover the defense fees and costs incurred on behalf of the insureds in the underlying action, from the date of its most recent reservation of rights letter. The insureds and Mr. Gecaj both cross-moved for summary judgment declaring that the insurer must provide indemnification to them and satisfy the judgment entered against the insureds. The Supreme Court granted the insurer's motion and denied the cross-motions, and the insureds and Mr. Gecaj appealed.

The Second Department's Opinion and Order

As pertinent hereto, the Second Department disagreed with those portions of the Supreme Court's determination as declared that the insurer was entitled to recover defense fees and costs incurred in the underlying action on the insured's behalf. With respect to that issue, the court stated that although "the insurance company points to several cases in New York (discussed below) in which the courts have awarded insurers their defense costs when the insurer has notified the insured that it was reserving its right to seek such reimbursement," "[t]o the extent that certain federal courts interpreting New York law and our sister appellate courts in New York have held that an insurer may recover its defense costs when there has been a determination that no duty to indemnify exists, for the reasons that follow, *we decline to adopt that view*" [emphasis added].

The Duty to Defend

In explaining its decision, the court first noted and discussed the "long held principle in New York," established by a venerable line of precedent, that "an insurer's duty to defend an insured is broader than its duty to indemnify," and that, indeed, "[i]f , liberally construed, the claim is within the embrace of the policy, the insurer must come forward to defend its insured no matter how groundless, false or baseless the suit may be [citation omitted] ." Indeed, as the Court of Appeals noted in *Fitzpatrick v. American Honda Motor Co.*, 78 NY2d 61, 65 (1991), "an insurer

may be contractually bound to defend even though it may not ultimately be bound to pay, either because its insured is not factually or legally liable or because the occurrence is later proven to be outside the policy's coverage." As such, the court observed that "allowing the insurance company to recover the costs it incurred in defending the underlying action risks eroding this well established doctrine and effectively would make the duty to defend merely coextensive with the duty to indemnify."

The court went on to note as critical the fact that the insurance policy at issue included a duty to defend in the insuring agreement, but that there was "no provision in the policy that expressly grants the insurer the right to recoup defense costs."

Review of Precedents and Recognition of Trend

Next, the court examined a series of earlier precedents on the issue of recovery of defense costs and noted what it perceived to be a trend in decisions on that issue. As noted by the court, "A trend allowing insurance companies to recoup defense costs in actions where no duty to indemnify has been found began in state courts in the United States in 1997, after the California Supreme Court, in *Buss v. Superior Court* (16 Cal. 4th 35, 49-51, 939 P. 2d 766, 776-777), held that a liability insurer has a right of recoupment against its insured for the costs of defending an underlying action where most or all of the claims are later found to be outside of the policy coverage. Recently, however, courts deciding in the first instance whether insurers

can recover defense costs have generally concluded that they cannot (*see* Bob Allen, Gary Thompson, Sara Thorpe, "*Reversing Course: Can an Insurer Seek Reimbursement from its Policyholder for Amounts Related to Noncovered Claims?*," https:\\perma.cc/YEX8-JXNV [last accessed December 15, 2020]; *see also* Crescent Beach Club LLC v. Indian Harbor Ins. Co., 468 F. Supp.3d 515, 554-555 [EDNY]; Angela R. Albert and Stanley C. Nardoni, "*Buss Stop: A Policy Language Based Analysis*," 13 Conn. Ins. L. J., 61, 70 (2006/2007) (analyzing the leading decisions in several states that adopt the *Buss* analysis as well as the leading decisions in states that have rejected the *Buss* analysis)."

More specifically, the court recognized that "in New York, although there are a handful of cases wherein courts -- including federal courts interpreting New York law -- have affirmed orders allowing an insurance company to recoup its defense costs upon a determination that no duty to indemnify exists" -- citing American Home Assurance Co. v. Port Auth. of N.Y. & N. J., 166 AD3d 464, 465 (1st Dept. 2018)(affirming denial of dismissal insurance companies recoupment cause of action since it reserved right to recoup expenses it incurred not covered by policy at issue); Certain Underwriters at Lloyd's London Subscribing to Policy No. SYN-1000263 v. Lacher & Lovell-Taylor, PC, 112 AD3d 434, 435 (1st Dept. 2013) (affirming order awarding plaintiff defense costs against defendants because it reserved its right to seek reimbursement for such costs in the event of finding of no

coverage); *see also* Max Specialty Ins. Co. v. WSG Investors, LLC, 2012 WL 3150577 (EDNY, No. 09-CV-05237 [CBA] [JMA]) (adopting recommendation of Magistrate that insurer should be entitled to recoup fees already expended defending insured in underlying action and noting that insured did not object to that recommendation); OneBeacon Ins. Co. v. Freundschuh, 2011 WL 3739427 (WDNY, No. 08-CV-823) (insurer entitled to recoup reasonable defense costs upon declaration by court of non-coverage under policy]; Gotham Ins. Co. v. GLNX, Inc., 1993 WL 312243 (SDNY, No. 92 CV 6415 [TPG]) (insurer entitled to recoup defense costs where its reservation of rights letter explicitly advised insured of same and no evidence was offered to show insured refused to consent to reservation of rights) – "*we decline to follow them*" [emphasis added].

The court justified that determination by distinguishing the above-cited cases by noting that "none of the above cases addressed the issue of whether recouping defense costs is appropriate or authorized (*see* General Star Indemnity Co. v. Driven Sports Inc., 80 F. Supp.3d 442, 460-461 [EDNY])." Moreover, the court noted, "in three of the cases cited by the insurance company, unlike this case, there is no indication that the request for defense costs was opposed by the insured on appeal." *See* American Family Home Ins. Co. v. Delia, 2013 WL 6061937, *5 (EDNY, CV12-5380 [ADS] [WDW]) (order adopting Magistrate's report and recommendation); Max Specialty Ins. Co. v. WSG Investors, LLC, *supra*; Gotham Insurance Co. v.

GLNX, Inc., supra. I would additionally note that none of those cases contained any indication as to whether or not the insurance policy at issue expressly allowed for recoupment of defense costs.

Indeed, the *American Western* court noted that "Significantly, some of the federal courts -- interpreting New York law -- appeared to be shifting course on this issue." In support of that contention, the court cited *Crescent Beach Club LLC v. Indian Harbor Ins. Co.*, 468 F. Supp.3d at 554, and *Century Sur. Co. v. Vas & Sons Corp.*, 2018 WL 6164724 (EDNY, No. 17-CV-5392 [DLI], report and recommendation adopted, 2018 WL 4804656, EDNY 2018), in which the federal court for the Eastern District of New York found that insurance companies' recoupment of defense costs was inappropriate where the policy at issue provided a duty to defend, but had no express contractual provision allowing for recruitment of defense costs. *See* also *BX Third Avenue Partners, LLC v. Fidelity Nat'l Title Ins. Co.*, 112 AD3d 430 (1st Dept. 2013). As stated by the Second Department, "*We agree with this view*" [emphasis added].

Application of the Law of Contracts

Continuing, the Second Department applied "the law of contracts" to the policy at issue, to conclude, pertinently, that "Here, the policy and the supplementary payment provision expressly promised the insureds that the insurance company will bear all the costs 'to defend the insured against any "suit"' to which the policy covers

while the policy is silent as to any reimbursement by the insurance company for the costs of defense incurred prior to a declaratory judgment determining that the insurer has no obligation to defend or indemnify the insured in the underlying action. Thus, the basic rules that govern contract law -- that clear and explicit provisions of insurance policy should be enforced as written -- must govern [citation omitted]. Indeed, if the insurance company had wanted to include language that allowed it to recover the costs of defending claims that are later determined not covered, it could have done so. It did not. Since insurance policies are written contracts, when a policy such as the one at issue uses language obligating the insurer to defend any 'suit' alleging a covered claim, and does not reserve a right to seek reimbursement from the insured, it obligates the insurance company at its own cost to defend the insureds until a judicial determination ... that the underlying action was not covered by the policy."

Similarly, "To the extent that the insurance company argues that the policy does not cover the defense of an excluded claim, the policy also does not expressly provide that where a claim is excluded, the insurance company may seek and obtain reimbursement of the costs for defending the excluded claim [citation omitted]. There is little doubt that the insurance company could have included in the policy a provision wherein it could recover its defense costs (upon a reservation of rights and

a judicial determination that it is not required to indemnify) had it wanted to, but it did not do so here."

Reservation of Rights

Addressing the insurer's reservation of rights, and those cases from other jurisdictions (not applying New York law), that have held that "where an insurer reserves its right to recover defense costs and the insured accepts payment of the defense costs, a new 'implied' contract is created" [citation omitted], the court specifically stated that "*we do not agree with that position*." As the court explained, "Plainly, a unilateral reservation of rights letter 'cannot create rights not contained in the insurance policy'" Indeed, "awarding an insurer its defense costs when the insurer issues a reservation of rights letter for the same despite the lack of any language in the policy at issue permitting the insurer to recover the costs of defending claims that are later determined not covered by the policy flies in the face of basic contract principles and allows an insurer to impose a condition on its defense that was not bargained for (*General Star Indemnity Co. v. Driven Sports, Inc.*, *supra*, 80 F. Supp.3d at 461-462) and 'amounts to a *pro tanto* supersession of the policy without separate agreement and separate consideration'." Further, "'[S]trong policy considerations militate against allowing an insurer to unilaterally declare that it can recoup the costs of defending an insured where it is later determined [that the policy at issue did not cover the asserted claims]' as doing so would allow an insurer to

define its duty to defend based upon the outcome of a declaratory judgment action and significantly curtail New York's long held view that the duty to defend is broader than the duty to indemnify [citation omitted]."

Unjust Enrichment

Finally, the Second Department determined that the insurance company could not rely on an equitable argument that the insureds would be unjustly enriched if the insurance company has to bear the costs of defending the underlying litigation. As stated by the court, "We join those courts that have determined, as a general rule, that New York law precludes claims of unjust enrichment where an insurance policy governs the subject matter at issue (*see* *Crescent Beach Club LLC v. Indian Harbor Ins. Co.*, 468 F. Supp.3d at 554-555; *General Star Indemnity Co. v. Driven Sports, Inc.*, 80 F. Supp.3d at 460- 462). In fact, quasi contractual remedies are not designed to overcome express contractual terms [citation omitted]. '[T]he theory of unjust enrichment lies as a quasi- contract claim and contemplates an obligation imposed by equity to prevent injustice, in the absence of an actual agreement between the parties [citation omitted]. Indeed, public policy prohibits a party to an agreement from seeking relief under unjust enrichment or other quasi contractual remedies as that party should' not be relieved of the consequences of [its] own failure to proceed with diligence or to exercise caution with respect to a business transaction [citation omitted]. Thus, where, as here, the insurance company and the insureds are

contractually bound by the terms of the policy, any resort to equitable remedies as a basis for an award of defense costs is unavailing."

Moreover, the court observed that "even if an unjust enrichment claim were available, there is no unjust enrichment here." Given New York's policy imposing upon insurers a broad duty to defend, there could be no finding that the insureds were unjustly enriched as result of the defense provided by the insurance company for claims that were later found to be outside of the policy [citation omitted]. Indeed, the policies of equity and fairness weigh against allowing the insurance company to obtain reimbursement of its defense costs because 'an insurer benefits unfairly if it can hedge on its defense obligations by reserving its right to reimbursement while potentially controlling the defense and avoiding a bad faith claim' from its insured. *Crescent Beach Club LLC v. Indian Harbor Ins. Co.*, 468 F. Supp.3d at 555, quoting *General Star Indem. Co. v. Driven Sports, Inc.*, 80 F. Supp.3d at 463."

Accordingly, and for all of the above reasons, the Second Department held that the insurance company was *not* entitled to recover its defense costs in the underlying action and that the Supreme Court should have denied that branch of the insurer's motion.

Recent First Department Decision

To be fair, it should be noted that on November 17, 2020-- just 43 days prior to the Second Department's decision in *American Western*, *supra* -- the First

Department, in *Certain Underwriters at Lloyd's Subscribing to Policy No. PGIARK 01449-05 v. Advanced Transit Co., Inc.*, 188 AD3d 523 (1st Dept. 2020), in a brief Decision and Order, without the factual and legal analysis provided by the court in *American Western*, affirmed an Order of the Supreme Court, N.Y. County, which granted the plaintiff insurer's cross-motion for summary judgment declaring: (1) that it was not obligated to defend or indemnify its insured in the underlying personal injury action; (2) that the insurer was entitled to withdraw its defense of the insured in the underlying action, and (3) that the insured was obligated to reimburse the insurer for defense fees, costs and expenses incurred in that defense. As noted by the First Department, "New York law further permits insurers to provide their insureds with a defense subject to a reservation of rights to, among other things, later recoup their defense costs upon a determination of non-coverage." The court further pointed out that "In its reservation of rights letter, [the insurer] reserved the right to recover payments made by [the insurer] including payment for defense costs and expenses, attorneys' fees and costs of suit." The court did not, however, indicate whether the right of recoupment was provided for in the policy itself, although the Appellate Briefs make clear that, as in *American Western*, *supra*, no such policy provisions existed.

To the extent that the First and Second Departments take opposing views on the question of defense cost recoupment, this important issue may warrant

clarification by the Court of Appeals. In the meantime, the Second Department has spoken as clearly as possible against such attempts at recoupment when it is not specifically provided for in the policy, but, rather, only in a reservation of rights.