Don’t Get Thrown Under The Buss:  
Insurers’ Duties and Rights in Mixed Claims

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**I. Introduction: Some Differences Between Recoupment and Allocation**

Although allocation and recoupment both involve apportioning dollars, the concepts are not the same. Allocation involves apportioning costs between and among triggered insurance policies and/or the policyholder (reflecting periods of self-insurance, insufficient limits, insolvent insurers, and where insurance, for whatever reason, is unavailable). Allocation generally involves apportionment of defense costs or indemnity dollars (paid in settlement or to satisfy a judgment) associated with claims that are covered by the insurance policies at issue. A proper allocation – for instant purposes defined as a *pro rata* allocation – resolves the apportionment in the coverage action. It obviates the need for additional proceedings to reallocate through contribution claims and “other insurance” clauses. Although there are many cogent equitable and jurisprudential reasons supporting a *pro rata* allocation, the overwhelming majority of courts adopting a *pro rata* allocation recognize that it is required by the contract language. Most general liability policies expressly provide coverage only for injuries or damages that take place “during the policy period.” The policyholders that advocate and the courts that adopt an “all sums” approach to allocation generally view the language as only relevant to the issue of trigger and capable of being compartmentalized out of existence for purposes of determining the allocation method. Properly viewed, however, the express “during the policy period” requirement applies with full force to the issue of allocation and evinces a clear intent to not cover damages happening before a policy incepts or after a policy period ends.

Recoupment or restitution may be available to insurers in a variety of contexts, including payments made as a result of mistake or fraud. For purposes of this article, we focus on recoupment in the context of “mixed claims.” Mixed claims are suits in which one or more of the claims (or some damages) alleged against the policyholder are covered and one or more of the claims or some elements of relief are not covered. See, e.g., *Buss v. Superior Court*, 16 Cal. 4th 35, 48 (Cal. 1998) (a mixed claim is one involving both claims that are potentially covered and claims that are not even potentially covered); *Tex. Ass’n of Cty’s. Cty. Gov’t Risk Mgmt. Pool v. Matagorda Cty.*, 52 S.W.3d 128, 136 (Tex. 2000) (in a mixed action, “some of the claims [are] covered by the insured’s policy and some [are] not”); *St. Paul Fire & Marine Ins. Co. v. Compaq Computer Corp.*, 377 F. Supp. 2d 719, 723 (D. Minn. 2005), aff’d, 457 F.3d 766 (8th Cir. 2006) (a mixed action is “one which include[s] both covered and non-covered claims”). Mixed claims can arise in a variety of ways, including: some (but not all) claims fall under an exclusion; both negligent and intentional acts are alleged; potentially covered and non-covered damages or injuries take place partially within and partially outside of the policy period or the coverage territory; or multiple plaintiffs or class members are involved and some allege non-covered injury or damages.

Recoupment, like a *pro rata* allocation, may help effectuate fairness or at least ameliorate some unfairness or unjust enrichment. However, recoupment involves reimbursement for indemnity dollars paid by the insurer on claims not covered or in defense of claims not even potentially covered by the insurance contract. Also, in contrast to a proper allocation done at the front end, recoupment is effectuated after the insurer has not only honored its obligations to the policyholder, but also has advanced benefits to which the policyholder is not entitled under the insurance contract. Whether driven by altruistic motives or, much more commonly, to operate within the framework of the law and to avoid the potential risks associated with a subsequent finding of a breach of its obligations, the insurer has done more than it is required to do and the policyholder has received more than it is entitled to receive.
Fundamentally, recoupment is not a matter of contract. It is a matter of quasi contract, implied contract – unjust enrichment to the policyholder or unjust impoverishment of the insurer. For this reason, courts that deny insurers the right to recoup in the mixed claims context entirely miss the point of recoupment or simply refuse to recognize quasi contractual rights in the context of a relationship that is predicated upon an express contract.2

This article examines insurers’ rights and obligations in the context of mixed claims, with a focus on the availability of recoupment to insurers. First, we examine recoupment of defense costs related to claims not even potentially covered and then we examine recoupment of indemnity paid on non-covered claims.

II. Who Drives The Buss: Insurers’ Rights And Duties With Respect To Defending Mixed Claims3

Before addressing the issue of recoupment of defense costs, we examine the scope of a primary insurers’ duty to defend, the corresponding right to control the defense, the impact of conflicts between the interests of the insurer and the interests of the policyholder, and the impact of reservation of rights letters.

A. Responsible For One Passenger, Responsible For All: The Primary Insurer’s Duty to Defend Generally Extends to the Entire Action Where Mixed Claims are Involved


The various rationale offered in support of this general rule include: the broad language included in the policy regarding the duty to defend; the absence of a reasonable means for allocating defense costs between covered and non-covered claims; separate representation for covered and non-covered claims may not be reasonable or might produce duplicative and inconsistent results; and the failure to provide a complete defense would violate the policyholder’s “reasonable expectations” that the insurer will defend the entire suit. See, generally Windt, Insurance Claims and Disputes, §4.13 (1990).

It is important to keep in mind that the state of the law is always evolving even with respect to fundamental issues such as duty to defend and rights of recoupment and even in jurisdictions thought to have a fairly well developed body of law. For example, many believe New York’s high court fundamentally changed long-standing New York law on the duty to defend in its recent decision in K2 Investment Group, LLC v. American Guarantee & Liability Insurance, Co., No. 04270, slip op. (N.Y. June 11, 2013), which appears to make New York an estoppel jurisdiction. At the time this article is being prepared, the New York Court of Appeal agreed to rehear the matter.

Even in the majority of jurisdictions that require an insurer to defend the entire action, consideration should be given to whether the language of the policy at issue differs materially from the language in policies involved in decisions upon which a jurisdiction’s pronouncements regarding the scope of the duty to defend and recoupment have been rendered. In the context of allocation, for example, the “all sums” language that was the sole asserted contractual basis relied upon by those courts issuing “all sum” or “joint and several liability” allocation rulings has not appeared in ISO general liability contract forms for decades and never appeared in most excess contracts. Similarly, the language requiring an insurer to defend suits even if “groundless, false, or fraudulent” relied upon by many courts in ruling on the scope of the duty to defend was removed in 1985. The difference in language may not alter the result where the court is reluctant to depart from precedent or insofar as the precedent is deemed to have a public policy component. Nonetheless, insurers and their counsel should at least consider the impact of differences in policy language when making strategic decisions and when advocating their positions.

A distinct minority of courts have held that an insurer may be required to defend only those causes of action that are covered by the policy. See, e.g., Farmland Mut. Ins. Co. v. Scruggs, 886 So. 2d 714, 719 (Miss. 2004). Some have relied upon Zurich American Insurance Company v. Public Storage, 743 F. Supp. 2d 525 (E.D. Va. 2010) (applying Washington law) for the proposition that Washington, unlike most jurisdictions, allows for the insurer to defend only the covered claims of an action containing both covered and non-covered claims. However, if the notion that Washington law would be more favorable to insurers than the majority of jurisdictions strikes you as fanciful at best, you may be correct. Earlier this year, the Washington Supreme Court held that an insurer is not entitled to recoup defense costs incurred prior to a determination that there is no coverage. National Security Corp. v. Immunex Corp., 297 P.3d 688 (Wash. 2013).

Although insurers may properly view the approach of requiring them to defend only the potentially covered claims to be a more equitable, very few cases allow an insurer to only defend covered claims in the mixed claims context. Further, this approach does present several issues concerning the right to control the defense, counsel selection, and coordination of the defense where there are disputes in strategy and multiple
defense counsel involved. We now examine the right to recoup defense costs where, in the majority of jurisdictions, the insurer is required to defend the suit in its entirety.

**B. Getting Behind the Wheel: Insurers With a Duty to Defend Generally Have the Corresponding Right to Control the Defense**

Where an insurer has a duty to defend, the insurer typically has a right to control the policyholder’s defense. The insurer’s right to control the policyholder’s defense includes the right to select defense counsel and to make strategic decisions concerning the defense of the suit pending against the policyholder. See, e.g., *Rx.com Inc. v. Hartford Fire Ins. Co.*, 426 F. Supp. 2d 546, 559 (S.D. Tex. 2006) (applying Texas law) (stating “an insurer’s ‘right to defend’ a lawsuit encompasses ‘the authority to select the attorney who will defend that claim and to make other decisions that would normally be vested in the insured as the named party in the case’”); *Carolina Cas. Ins. Co. v. Bolling, Walter & Gawthrop*, No. Civ. S-04-2445FCDPAN, 2005 WL 1367096, *7 (E.D. Cal. May 31, 2005) (unpublished opinion), aff’d, 244 Fed. Appx. 762 (9th Cir. 2007) (applying California law) (recognizing “[t]he right and duty to defend affords an insurer the right to control the defense. . . [and] the right to control the defense generally includes the right to select defense counsel”); *Wells Dairy, Inc. v. Travelers Indem. Co. of Ill.*, 266 F. Supp. 2d 964, 967 (N.D. Iowa 2003), reconsideration denied, 336 F. Supp. 2d 906 (N.D. Iowa 2004) (applying Iowa law) (ruling that “[w]hen an insurer defends an insured, it has control over the defense and over settlement”); *Givens v. Mullikin ex rel. Estate of McElwaney*, 75 S.W.3d 383, 395 (Tenn. 2002) (noting the insurance contract “typically reserves for the insurer the right to select defense counsel, to guide the litigation of the claim, [and] to control decisions regarding settlement of the claim”); *Allied Am. Ins. Co. v. Ayala*, 616 N.E.2d 1349 (Ill. App. Ct. 1993), appeal denied, 624 N.E.2d 804 (Ill. 1993); *Golden Eagle Ins. Co. v. Foremost Ins. Co.*, 20 Cal. App. 4th 1372 (1993), as modified on denial of rehg (Jan. 7, 1994).


In the absence of a conflict of interest, generally the insurer retains the right to select counsel and the policyholder may retain its own counsel but at its own expense. See *Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co. of S.C.*, 433 F.3d 365 (4th Cir. 2005) (applying South Carolina law) (holding where no conflict of interest exists and the policyholder does not consent to counsel chosen by the insurer, the policyholder can employ another counsel at its own cost). Although insurers may not always appreciate the right to control the defense, where the duty to defend exists, it often represents a considerably more favorable state of affairs as compared to having to reimburse independent counsel.

**C. When Does the Policyholder Get to Select the Driver: The Insurer’s Right to Control the Defense May Be Lost Where the Interests of the Policyholder and Insurer Conflict**

Where the interests of the insurer and the policyholder conflict in connection with the defense of a suit, courts sometimes transform the insurer’s right and duty to defend into an obligation to pay defense costs. See, e.g., *Md. Cas. Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1976). In such conflict situations, the insurer frequently loses its right to select counsel and to control the policyholder’s defense, but retains the obligation to pay the policyholder’s selected counsel’s reasonable attorneys’ fees. *Id.; Rx.com Inc. v. Hartford Fire Ins. Co.*, 426 F. Supp. 2d 546, 559 (S.D. Tex. 2006) (applying Texas law) (finding the presence of a conflict of interest results in the policyholder being allowed to pick counsel of her own choice at the expense of the insurer); *Travelers Indem. Co. of Ill. v. Royal Oak Enters., Inc.*, 344 F. Supp. 2d 1358, 1372 (M.D. Fla. 2004), aff’d, 171 Fed. Appx.

In some jurisdictions, an insurer’s issuance of a reservation of rights may cause it to lose control of the defense. A conflict of interest analysis initially depends upon who is considered to be the client of the insurer-selected counsel. To resolve this issue, courts have adopted two divergent theories: the “one-client theory” and the “tripartite” theory. Under the one-client theory, the defense counsel appointed by the insurer represents only the policyholder. See Metro. Life Ins. Co. v. Aetna Cas. & Sur. Co., 730 A.2d 51, 65 (Conn. 1999) (recognizing that, “when an insurer retains an attorney in order to defend a suit against an insured, the attorney’s only allegiance is to the client, the insured”); State Farm Fire & Cas. Co. v. Mabry, 497 S.E.2d 844, 847 (Va. 1998) (finding that “attorney employed by the insurer to defend the insured . . . owes the insured the same duty as if he were privately retained by the insured”); Finley v. Home Ins. Co., 975 P.2d 1145, 1152 (Haw. 1998) (noting that the Hawaii Rules of Professional Conduct dictate that “retained counsel solely represents the insured when a conflict arises between the interest of the insurer and the insured”).

Based upon this attorney-client relationship between the defense counsel and the policyholder, the defense counsel hired by the insurer owes a duty of loyalty to the policyholder and represents only the interests of the policyholder. See, e.g., Pine Island Farmers Coop v. Erstad & Riemer, P.A., 649 N.W.2d 444, 449 (Minn. 2002) (holding defense counsel hired by an insurer to defend a claim against its policyholder “owes a duty of undivided loyalty to the insured and must faithfully represent the insured’s interests”); In re Rules of Prof’l Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806, 814 (Mont. 2000) (holding the “insured is the sole client of defense counsel”). Simply stated, a conflict analysis does not come into play under the one-client theory as counsel’s loyalty is owed to the policyholder.

A conflict of interest analysis with respect to the right to independent counsel may come into play, however, in jurisdictions adhering to the two-client theory or “tripartite” relationship theory. In these jurisdictions, defense counsel is considered to be involved in a dual representation of both the policyholder and the insurer. See, e.g., Armstrong Cleaners, Inc. v. Erie Ins. Exch., 364 F. Supp. 2d 797, 806 (S.D. Ind. 2005) (recognizing that defense counsel selected by the insurer represents the interests of both the policyholder and the insurer); McCourt Co., Inc. v. FPC Props., Inc., 434 N.E.2d 1234, 1235 (Mass. 1982) (noting that defense counsel “is attorney for the insured as well as the insurer”); Lieberman v. Emp’rs Ins. of Wausau, 419 A.2d 417, 424 (N.J. 1980) (concluding that “[t]he insurance defense counsel routinely and necessarily represent two clients: the insurer and the insured”); Cent. Cab Co. v. Clarke, 270 A.2d 662 (Md. 1970) (recognizing that counsel chosen by the insurer represents the policyholder as well as the insurer). Based upon this dual representation, the defense counsel owes a duty of loyalty to the policyholder and to the insurer. See Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone, 79 Cal. App. 4th 114 (2000), as modified, (Mar. 17, 2000) (holding the attorney hired by the insurance company to defend an action against the policyholder owes fiduciary duties to the policyholder and to the insurer); Hartford Acc. & Indem. Co. v. Foster, 528 So. 2d 255, 272 (Miss. 1988) (stating “it is the attorney’s ethical obligation to have undiluted loyalty to both clients”); Nandorf, Inc. v. CNA Ins. Cos., 479 N.E.2d 988, 992 (Ill. App. Ct. 1985) (holding “attorney hired by the insurance company to defend in an action against the insured owed fiduciary duties to two clients: the insurer and the insured”).

Unlike the one-client theory, courts that have adopted the two-client theory have found that the defense coun-
sel’s dual duties to both the policyholder and insurer may create conflicts of interest under certain circumstances where the defense is being provided subject to a reservation of rights.

The finding of a conflict of interest sometimes is based on the perceived risk that the defense attorney’s representation of the policyholder will somehow be impaired by his relationship with the insurer. The court in Travelers Indemnity Co. of Illinois v. Royal Oak Enterprises, Inc., 344 F. Supp. 2d 1358, 1373 (M.D. Fla. 2004), explained what are purported to be the potential problems arising from the insurer’s defense under a reservation of rights:

> [t]hese courts generally hold that the conflict of interest inherent in an insurer’s defense of a complaint against its insured containing both covered and non-covered claims divides the loyalty of counsel selected and paid by the insurer and creates an unacceptable danger that, as counsel for the insured, he would somehow, consciously or unconsciously, skew his defense efforts to favor the insurer.


A minority of courts, however, have found that the insurer’s issuance of a reservation of rights establishes a conflict of interest for purposes of permitting a policyholder to select counsel. See Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co., 788 N.E.2d 522, 539 (Mass. 2003) (finding “[w]hen an insurer seeks to defend its insured under a reservation of rights, . . . the insured may require the insurer to either relinquish its reservation of rights or relinquish its defense of the insured and reimburse the insured for its defense costs”); Moeller v. Am. Guar. and Liab. Ins. Co., 707 So. 2d 1062, 1069 (Miss. 1996), as corrected, (Sept. 19, 1996) (stating “[w]hen defending under a reservation of rights . . . not only must the insured be given the opportunity to select his own counsel to defend the claim, the carrier must also pay the legal fees reasonably incurred in the defense”).

Courts that have not adopted the per se rule, generally hold that a conflict of interest must be actual and not potential in order for the policyholder to gain the right to pick and/or control the defense counsel. See, e.g., Clarendon Nat. Ins. Co. v. Ins. Co. of the West, 442 F. Supp. 2d 914, 943 (E.D. Cal. 2006), aff’d, 290 Fed. Appx. 62 (9th Cir. 2008) (applying California law) (holding “[t]he conflict must be actual and significant, not merely potential and theoretical”); Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co. of S.C., 433 F.3d 365 (4th Cir. 2005) (applying South Carolina law); Williams v. Am. Country Ins. Co., 833 N.E.2d 971, 981 (Ill. App. Ct. 2005), appeal denied, 844 N.E.2d 48 (Ill. 2005) (finding an “actual conflict of interest existed” that
allowed the policyholder to assume control over its defense); *HK Systems, Inc. v. Admiral Ins. Co.*, No. 03 C 0795, 2005 WL 1563340, *9 (E.D. Wis. June 27, 2005) (applying Wisconsin law) (recognizing that a “real conflict of interest based on opposing defenses of insured and insurer requires the insurer to give up control” of the defense); *Travelers Indem. Co. of Ill. v. Royal Oak Enters.*, Inc., 344 F. Supp. 2d 1358, 1374 (M.D. Fla. 2004) (applying Florida law) (holding the insurer was not required to relinquish control of the defense where “there existed the potential for insurer-selected counsel to become impermissibly conflicted in its representation”); *Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone*, 79 Cal. App. 4th 114, 130 (2000) (noting “the conflict must be significant, not merely theoretical, and actual, not merely potential”).

Courts have employed different tests in determining whether an actual conflict exists. For example, some courts conclude that an actual conflict of interest exists only where the facts at issue in the underlying litigation are identical to the facts shaping the insurer’s coverage determination. See, e.g., *Clarendon Nat. Ins. Co. v. Ins. Co. of the W.*, 442 F. Supp. 2d 914, 942 (E.D. Cal. 2006) (applying California law) (recognizing policyholder does not have the right to select counsel “where the [coverage] issue is independent of and extrinsic to the issues in the underlying action”); *Rx.com Inc. v. Hartford Fire Ins. Co.*, 426 F. Supp. 2d 546, 561 (S.D. Tex. 2006) (applying Texas law) (holding a conflict of interest did not exist because the policyholder did not show that “the facts to be decided in the underlying lawsuit [were] the same facts that would defeat coverage”); *Stoneridge Dev. Co. v. Essex Ins. Co.*, 888 N.E.2d 633, 645 (Ill. App. Ct. 2008), appeal denied, 897 N.E.2d 264 (Ill. 2008) (a conflict exists where “it appears that factual issues will be resolved in the underlying suit that allow insurer-retained counsel to ‘lay the groundwork’ for a later denial of coverage”); *Am. Family Mut. Ins. Co. v. W.H. McNaughton Builders, Inc.*, 843 N.E.2d 492, 498 (Ill. App. Ct. 2006) (finding that “if, in the underlying suit, insurer-retained counsel would have the opportunity to shift facts in a way that takes the case outside the scope of the policy coverage, then the insured is not required to defend the underlying suit with insurer-retained counsel”); *Armstrong Cleaners, Inc. v. Erie Ins. Exch.*, 364 F. Supp. 2d 797, 808-09 (S.D. Ind. 2005) (applying Indiana law) (examining the “undisputed facts concerning the coverage issues [the insurer] has raised and their relationship to the likely course of the underlying litigation”); *N. Cnty. Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 689 (Tex. 2004) (ruling that “when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest will prevent the insurer from conducting the defense”); *James 3 Corp. v. Truck Ins. Exch.*, 91 Cal. App. 4th 1093, 1102 (2001) (holding the policyholder has no right to choose defense counsel “where the coverage issue is independent of, or extrinsic to, the issues in the underlying action of where the damages are only partially covered by the policy”).

Other courts require the presentation of evidence that the defense counsel’s actions put the interests of the insurer over the policyholder in order for a conflict to exist. *Travelers Indem. Co. of Ill. v. Royal Oak Enters.*, Inc., 344 F. Supp. 2d 1358, 1374 (M.D. Fla. 2004) (applying Florida law) (holding “there must be some evidence to suggest that the conflict between the insurer and the insured actually affected counsel’s representation so that it may be said that counsel’s actions elevated the interests of the insurer over those of his client, the insured”); *C.H. Robinson Co. v. Zurich Am. Ins. Co.*, No. Civ. 02-4794 PAM/RLE, 2004 WL 2538468, *5 (D. Minn. Nov. 5, 2004) (unpublished opinion) (applying Minnesota law) (requiring “substantial evidence that actual conflict exists, such as actions that demonstrate a greater concern for the insurer’s interest than the insured’s interests”).

Examples of situations in which courts have found a conflict of interest to exist for purposes of allowing the policyholder to select counsel include the following: (1) the insurer reserves the right to deny coverage based upon a breach of contract exclusion and the underlying litigation raises claims for breach of contract and negligence (*HK Systems, Inc. v. Admiral Insurance Co.*, No. 03 C 0795, 2005 WL 1563340 (E.D. Wis. June 27, 2005) (applying Florida law)); (2) the same defense counsel represents two policyholders with diametrically opposed interests in defending the underlying suit (*Williams v. American Country Insurance Co.*, 833...
The reservation of rights letter identified possible defenses for an “expected and intended” exclusion and “occurrence” requirement where allocation of damages among defendants in an underlying pollution litigation was determined by the intent of the polluting parties (Armstrong Cleaners, Inc. v. Erie Insurance Exchange, 364 F. Supp. 2d 797 (S.D. Ind. 2005) (applying Indiana law)); (4) the insurer reserved its rights to deny coverage for damages taking place outside the contract period and the action involved the issue of when damages took place (American Family Mutual Insurance Co. v. W.H. McNaughton Builders, Inc., 843 N.E.2d 492 (Ill. App. Ct. 2006)); (5) the insurer pursued settlement in excess of contract limits without the policyholder’s consent and left the policyholder exposed to claims by third parties (Golden Eagle Insurance Co. v. Foremost Insurance Co., 20 Cal. App. 4th 1372 (Cal. App. 1993)); (6) the insurer provided insurance coverage to both the plaintiff and defendant (O’Morrow v. Borad, 167 P.2d 483, (Cal. 1946)); (7) the underlying complaint alleged injuries based upon the policyholder’s alleged intentional conduct that, if proved, would not be covered by the insurance contract (Maryland Casualty Co. v. Peppers, 355 N.E.2d 24 (Ill. 1976)); (8) the reservation of rights letter issued by the insurer disclaimed coverage for punitive damage relief raised in the underlying litigation that far exceeded any compensatory damages sought (Nandorf v. CNA Insurance Cos., 479 N.E. 2d 988 (Ill. App. Ct. 1985)).

Situations in which courts have found a conflict of interest does not exist include the following: (1) the underlying litigation raised claims against the policyholder that fell within the personal injury and advertising injury coverage part of the insurance contract and the insurer issued a reservation of rights letter emphasizing certain limiting words in the “personal injury” definition (Rx.com Inc. v. Hartford Fire Insurance Co., 426 F. Supp. 2d 546, 559 (S.D. Tex. 2006)); (2) the policyholder disagreed with the insurer-appointed counsel as to the strategically appropriate venue for the underlying action (North County Mutual Insurance Co. v. Davalos, 140 S.W.3d 685 (Tex. 2004)); (3) the insurer’s reservation of rights relating to punitive damages became moot once the insurer offered its contract limits towards a settlement (C.H. Robinson Co. v. Zurich American Insurance Co., No. Civ. 02-4794 PAM/RLE, 2004 WL 2538468 (D. Minn. Nov. 5, 2004)); (4) the insurer-selected counsel refused to pursue an affirmative defense that was requested by the policyholder (James 3 Corp. v. Truck Insurance Exchange, 91 Cal. App. 4th 1093 (Cal. App. 2001)); (5) the reservation of rights letter cited to the absolute pollution exclusion where it was undisputed in the underlying litigation that the petroleum products in the policyholder’s ruptured pipeline caused the pollution injury and the underlying litigation dispute was over the cause of the ruptured pipeline (Driggs Corp. v. Pennsylvania Manufacturers Ass’n Insurance Co., 181 F.3d 87 (4th Cir. 1999) (applying Maryland law) (unpublished opinion).

Some courts recognize that reserving rights to recover defense costs of non-covered claims may create a conflict of interest reasoning that, by reserving rights, the insurer protects itself against claims for breach of a duty to defend and against waiver and estoppel while also imposing a condition on its defense that was not bargained for. See e.g., Morrone v. Harleysville Mut. Ins. Co., 662 A.2d 562, 567 (N.J. Super. Ct. App. Div. 1995) (“the existence of both covered and non-covered claims also present a potential conflict between an insured and insurer vis-à-vis defense strategy”), citing Burd v. Sussex Mut. Ins. Co., 267 A.2d 7 (N.J. 1970); Nat’l Sur. Corp. v. Immunex Corp., 297 P.3d 688, 694 (Wash. 2013) (holding an insurer may not seek to recover defense costs under a reservation of rights while the insurer’s duty to defend is uncertain).

As discussed in greater detail below, an insurer is well-served to consider the impact of a reservation of rights not only in terms of avoiding estoppel or waiver of a right or defense, but also in terms of whether its reservation places its right to control the defense at risk. In many instances the right to control the defense and contain costs may be more important and more achievable than effectuating recoupment of a meaningful amount of defense costs.

III. Boarding The Buss: An Insurer’s Right to Recoup Defense Costs Related to Non-Covered Claims

In view of the broad scope of the duty to defend and the potential adverse consequences for breach of that duty, primary insurers often resolve doubts in favor of providing a defense under a reservation of rights, a non-waiver agreement, and/or by filing an action seeking a declaration that it has no duty to defend or indemnify the policyholder in connection with the subject claim. Insurers sometimes seek to recover defense costs associated with those claims that are not potentially covered. This may be the case where the insurer defends an action that it believes is not covered at all or where it defends an action involving “mixed claims.”

Courts are split as to whether an insurer may seek recoupment from its policyholder of defense costs incurred solely in defending non-covered claims. See Westchester Fire Ins. Co. v. Wallerich, 563 F.3d 707 (8th Cir. 2009) (recognizing that there is a split among courts and noting that allowing recoupment appears to be the majority view); Gen. Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., 828 N.E.2d 1092 (Ill. 2005) (identifying the split among courts); LA Weight Loss Ctrs., Inc. v. Lexington Ins. Co., No. 1560, 2006 WL 689109 (Pa. C.P. Mar.1, 2006) (unpublished opinion) (recognizing the divergent viewpoints between courts).

A. Welcome Aboard: Decisions Recognizing an Insurer’s Right of Recoupment

One of the leading decisions allowing recoupment is the case from which the title of this article is derived – the California Supreme Court decision in Buss v. Superior Court, 16 Cal. 4th 35 (Cal. 1997). The California Supreme Court addressed an insurer’s right to obtain reimbursement of defense costs in a “mixed” underlying action involving both covered and non-covered claims.

In Buss, H&H Sports, Inc. brought an action against the late owner of the Los Angeles Lakers, Jerry Buss, and others alleging several counts, including: breach of contract; breach of the implied covenant of good faith and fair dealing; intentional and negligent interference with economic relations; fraud and deceit; and defamation. Buss tendered the defense of this action to his insurers.

All of the insurers of Buss denied coverage, except Transamerica Insurance Company, which issued two commercial general liability contracts. Taking the position that the only count covered was the single defamation claim, Transamerica accepted the defense of the H&H Sports action under a reservation of rights, including the right to deny that any cause of action actually was covered and the right to seek reimbursement of defense costs for all non-covered claims. Due to the conflict created by its reservation of rights, Transamerica agreed to pay for independent Cumis counsel for Buss. Transamerica paid Buss’ independent counsel slightly more than $1 million in defense costs.

Buss eventually settled the H&H Sports suit, paying $8.5 million. Buss then brought an action against Transamerica seeking a declaration that Transamerica had a duty to defend and contribute to the settlement. Transamerica cross-claimed, seeking a declaration of its right to reimbursement for defense costs allocable to all claims other than the covered defamation cause of action, and its right to refuse to contribute to the settlement.
The court categorized the types of claims brought against a policyholder into three categories: covered claims; potentially covered claims; and claims that are not potentially covered. The court held that the insurer may not seek reimbursement for costs of defending claims that are covered or potentially covered because the insurer has been paid premiums by the policyholder to defend against such claims. The court noted that, if either the insurance contract itself provides for reimbursement, or if there is a separate contract supported by separate consideration that provides for reimbursement, then the insurer is permitted to seek reimbursement for the potentially covered claims in the event that these claims are subsequently determined to be non-covered. Id. at 49-50.

Regarding claims that are not even potentially covered, the court held that an insurer may seek reimbursement of defense costs associated with such claims. The court based its holding upon equitable theories of unjust enrichment and the insurer’s quasi-contractual implied-in-law right of reimbursement for defending claims it did not bargain to defend and did not receive premiums to defend. Id. at 49-52. The court held that the insurer may obtain reimbursement for defense costs that can be allocated solely to the claims that are not even potentially covered. Id. at 52-53.

The court held that, consistent with the California Evidence Code Section 500 requirement that the party seeking relief bears the burden of proof, the insurer bears the burden of proof on the issue of reimbursement. The court rejected and specifically overruled Hogan v. Midland National Insurance Co., 3 Cal. 3d 553 (1970), which held that an insurer must establish by “undeniable evidence” those defense costs allocable to claims that are not even potentially covered in order to obtain reimbursement, and instead applied the civil standard of “preponderance of evidence” as the burden of proof the insurer must establish. The court reiterated the insurer’s obligation is to defend prophylactically both promptly and in their entirety actions containing potentially covered claims.

The California Court of Appeals in Prichard v. Liberty Mutual Insurance Co., 84 Cal. App. 4th 890, 895 (Cal. App. 2000), as modified on denial of reh’g, (Dec. 6, 2000), held that Buss made clear that an insurer did “nothing wrong in unilaterally reserving its reimbursement rights in a mixed action.” The court held that the “whole point of the Buss case is that an insurer’s right to reimbursement for defense costs for claims not even potentially covered is predicated on a legal right ‘implied in law as quasi-contractual,’ not a matter of any agreement between the parties.” Prichard, 84 Cal. App. 4th 905. The court held that Buss was “very clear that an insurer can reserve its reimbursement right unilaterally and without any agreement.” Id. at 906.

The holding in Buss has been embraced by other courts. For example, the Florida Court of Appeals followed Buss in Colony Insurance Co. v. G & E Tires & Service, Inc., 777 So. 2d 1034 (Fla. Dist. Ct. App. 2000) and held that an insurer was entitled to reimbursement of costs expended to defend the policyholder for claims that were not covered under the insurance contract. Colony insured G&E under a garage liability contract that contained exclusions for intentional acts, acts by fellow employees, and bodily injury arising out of the course of the employment. An employee working at G&E allegedly was harassed by other G&E employees and filed suit against G&E alleging battery, sexual harassment, invasion of privacy, and intentional infliction of emotional distress. Id. at 1035.

G&E tendered the suit to Colony for a defense, but Colony refused the tender. Later, Colony agreed to defend the suit under a reservation of rights, including the right to be reimbursed for defense costs incurred in defending G&E in the action. Id. In the reservation of rights letter, Colony stated it was reserving its right to “deny coverage and/or defense. . . with respect to defense costs incurred or to be incurred in the future, to be reimbursed and/or obtain an allocation of attorney’s fees. . . .” Id. at 1036. Soon after Colony agreed to defend G&E, it filed a declaratory judgment action disclaiming coverage. At the trial court level, Colony moved for a declaration that it had no obligation under the insurance contract to either defend or indemnify G&E. After
the trial court granted the motion and found that no coverage existed under the contract, Colony filed a motion seeking reimbursement of the fees and costs expended in defending G&E against the underlying suit.

In deciding whether to allow the insurer to recoup, the court cited to *Buss* as persuasive authority for the proposition that the policyholder did not remit premiums to the insurer to cover defense of claims that are not even potentially covered by the insurance contract. The court found that Colony's reservation of rights and appointment of mutually agreeable counsel made any claim that G&E detrimentally relied on the defense it received untenable. Further, the court held that Colony timely and expressly reserved the right to seek reimbursement of the costs of defending clearly uncovered claims and that G&E accepted the offer. The court concluded that the case involved two apparently sophisticated parties and that G&E accepted the defense on the terms set forth by Colony's reservation of rights letter. Accordingly, the court held that Colony was entitled to reimbursement.

Min. Co. v. New Hampshire Ins. Co., 811 P.2d 1083 (Colo. 1991); Nationwide Mut. Ins. Co. v. Flagg, 789 A.2d 586, 596-97 (Del. Super. Ct. 2001); Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107, 124 (Conn. 2003) (where insurer defends a policyholder against a claim not even potentially covered, reimbursement will be ordered to prevent the policyholder from receiving a windfall); Valley Forge Ins. Co. v. Health Care Mgmt. Partners, Ltd., 616 F.3d 1086 (10th Cir. 2010) (applying Colorado law) (affirming insurers’ rights to obtain reimbursement for defense costs where defense was provided pursuant to a reservation of rights including the right to obtain reimbursement and where it was ultimately determined that the insurers had no duty to defend and rejecting policyholder’s argument that insurers must wait until underlying litigation is resolved to seek reimbursement).

The Restatement (Third) of Restitution and Unjust Enrichment supports the view that insurers should be permitted to pursue reimbursement:

If one party to a contract demands from the other a performance that is not in fact due by the terms of their agreement, under circumstances making it reasonable to accede to the demand rather than to insist on an immediate test of the disputed obligation, the party on whom the demand is made may render such performance under protest or with reservation of rights, preserving a claim in restitution to recover the value of the benefit conferred in excess of the recipient’s contractual entitlement.

Restatement (Third) of Restitution and Unjust Enrichment §351 at 571 (2011). Indeed, the illustration used in the Restatement involves an insurer defending claims not even potentially covered under a reservation of rights based upon the Buss case.

**B. Thrown Under The Buss: In Some Jurisdictions Insurers are Not Permitted to Recoup Costs**

In contrast to the Buss line of cases, other courts have not permitted an insurer to obtain recoupment of defense costs for certain claims not covered under the insurance contract. In Shoshone First Bank v. Pacific Employers Insurance Co., 2 P.3d 510 (Wyo. 2000), the Supreme Court of Wyoming was presented with a certified question by the United States District Court for the District of Wyoming regarding whether Wyoming law recognized a legal or equitable right of an insurer to allocate the costs of defending non-covered claims to the policyholder where there was at least one covered claim and the insurer was providing a defense. Id. at 512.

In that case, Pacific issued a commercial general liability contract to Shoshone. A former director of Shoshone filed a lawsuit against Shoshone alleging that his termination constituted a breach of contract, breach of the covenant of good faith and fair dealing, invasion of privacy, infliction of severe emotional distress, and abuse of process. Pacific agreed to defend the suit under a reservation of rights and specifically reserved the right to allocate to Shoshone the costs of defense related to non-covered claims. Pacific undertook the defense because one count of the complaint alleging invasion of privacy was potentially covered under the liability insurance contract. The action was ultimately settled, and Pacific sought to recover a portion of the defense costs it incurred in defending Shoshone. Id. at 513.

Although the court recognized that other jurisdictions allowed recoupment, it held that, “unless an agreement to the contrary is found in the policy, the insurer is liable for all of the costs of defending the action.” Id. at 514. The court declined to follow the opinion in Buss, noting that the court in Buss also found that there was a “pragmatic difficulty” of an insurer providing only a “partial defense” to the policyholder. Id. at 514.

Further, the court reasoned that there was “no indication in the policy of any distinction to be made between covered and non-covered claims so far as the defense of those claims [were] concerned, and we will
not permit the policy to be modified by subsequent letters from the insurer to the insured.” The court rejected Pacific’s contention that its reservation of rights letter, which specifically reserved the right of recoupment, permitted it to allocate costs between covered and non-covered claims. The court held that the insurer was “not permitted to unilaterally modify and change policy coverage.” Id. at 515. The court held that Pacific could have included apportionment language in the insurance contract but failed to do so.

The Illinois Supreme Court reached a similar conclusion in General Agents Insurance Co. of America, Inc. v. Midwest Sporting Goods Co., 828 N.E.2d 1092 (Ill. 2005). In Midwest, General Agents Insurance Company of America (“Gainsco”) provided general liability insurance to Midwest Sporting Goods Company (“Midwest”). The City of Chicago and Cook County brought suit against Midwest alleging that Midwest created a public nuisance by selling guns to inappropriate purchasers. Midwest tendered the suit to Gainsco, which initially denied coverage. However, after an amended complaint was filed, Gainsco agreed to pay the defense costs subject to a reservation of rights. In the reservation of rights letter, Gainsco stated that it agreed to provide a defense subject to the “right to recoup any defense costs paid in the event that it is determined that the Company does not owe the insured a defense in this matter. . . .” Id. at 596. Gainsco then filed a declaratory judgment action seeking a determination that the suit was not covered and asserting a claim for recovery of all defense costs. The trial court found that Gainsco had no duty to defend Midwest in the underlying litigation and later granted Gainsco’s motion for recoupment of defense costs. The court of appeals affirmed the trial court’s order requiring Midwest to reimburse Gainsco for the defense costs incurred in defending the entire underlying litigation.

Before the Illinois Supreme Court, Midwest contended that Gainsco was not entitled to recoupment of the defense costs because: (1) the insurance contract included no provision allowing for reimbursement of defense costs; (2) the reservation of rights letter issued by Gainsco could not create new rights not contained in the insurance contract; and (3) the theory of unjust enrichment was inapplicable due to the presence of a written insurance contract between Gainsco and Midwest.

The Illinois Supreme Court held that a unilateral reservation of rights letter cannot create rights not contained in the insurance contract. Relying on Shoshone First Bank, the court explained that implying an agreement due to the policyholder’s acceptance of the defense provided by the insurer “effectively places the insured in the position of making a Hobson’s choice between accepting the insurer’s additional conditions on its defense or losing its right to a defense from the insurer.” Id. at 604. The court further stated that it could not condone the insurer’s actions of unilaterally modifying the insurance contract through the issuance of a reservation of rights letter. The court also agreed with the Shoshone court that the insurer could have included specific language addressing reimbursement in the contract.

Gainsco also argued that it was entitled to reimbursement under the doctrine of unjust enrichment. In rejecting Gainsco’s argument, the court noted that an insurer agrees to defend an underlying lawsuit for the purpose of benefiting the policyholder and also to avoid the risks of exposure that may result if the policyholder provides its own inept defense of the underlying litigation. The court held that Gainsco was not entitled to reimbursement under an unjust enrichment theory because the insurer undertakes defense of the policyholder to protect itself at least as much as it is protecting its policyholder. Id. at 605. Compare with Steadfast Ins. Co. v. Caremark Rx, Inc., 869 N.E.2d 910 (Ill. App. Ct. 2007), appeal allowed, 875 N.E.2d 1124 (Ill. 2007) (insurer was allowed to recoup defense costs it paid pursuant to an erroneous trial court ruling that the insurer had a duty to defend and indemnify policyholder that was subsequently reversed in its entirety on appeal).

Other courts have also prohibited the insurer from recouping costs incurred to defend non-covered claims. See, e.g., Pekin Ins. Co. v. Tysa, Inc., No. 3:05-cv-00030-JEG, 2006 WL 3827232 (S.D. Iowa Dec. 27, 2006) (predicting Iowa law) (holding reimbursement of defense costs were not allowed despite the insurer’s
reservation of the right to recoup); *Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 448 F.3d 252 (4th Cir. 2006) (applying Maryland law) (finding that allowing reimbursement of costs expended in defending non-covered claims would improperly narrow an insurer’s broad duty to defend); *Westchester Fire Ins. Co. v. Wallerich*, 563 F.3d 707 (8th Cir. 2009) (predicting Minnesota law) (refusing to allow reimbursement of defense costs unless such a right is specifically identified in insurance policy, reasoning that a reservation of rights letter can only retain defenses under the policy); *Emp’rs Mut. Cas. Co. v. Indus. Rubber Prods. Inc.*, No. Civ. 04-3839, 2006 WL 453207 (D. Minn. Feb. 23, 2006) (applying Minnesota law) (finding an “insurer is not entitled to the reimbursement of defense costs expended prior to the determination of coverage, unless specifically provided for in the insurance policy”); *Gen. Star Indem. Co. v. Virgin Islands Port Auth.*, 564 F. Supp. 2d 473 (D.V.I. 2008) (denying reimbursement of defense costs paid by an insurer where the insurance contract did not specifically provide a right to reimbursement); *Med. Liab. Mut. Ins. Co. v. Alan Curtis Enters.*, Inc., 285 S.W.3d 233 (Ark. 2008), opinion supplemented on other grounds, on denial of reh’g, 2008 WL 2525818 (Ark. 2008) (holding that defense costs could not be recouped because there was not an Arkansas statute providing for reimbursement under the circumstances); *Bedoya v. Ill. Founders Ins. Co.*, 688 N.E.2d 757 (Ill. App. Ct. 1997), appeal denied, 698 N.E.2d 542 (Ill. 1998) (refusing to allow apportionment between covered and non-covered claims); *LA Weight Loss Ctrs., Inc. v. Lexington Ins. Co.*, No. 1560, 2006 WL 689109 (Pa. C.P. Mar. 1, 2006) (precluding insurer from recouping defense costs incurred in defending non-covered claims absent an express right in the insurance contract); *Am. and Foreign Ins. Co. v. Jerry’s Sport Ctr.*, Inc., 2 A.3d 526 (Pa. 2010) (insurer received a declaratory judgment that it had no duty to defend but was not entitled to reimbursement of defense costs absent an express provision in the written insurance contract providing for reimbursement); *Tex. Ass’n of Cty’s Gov’t Risk Mgmt. Pool v. Matagorda Cty.*, 52 S.W.3d 128 (Tex. 2000) (holding a unilateral reservation of rights letter cannot create the right to recoup settlement payments on non-covered claims when such right was not contained in the insurance contract); *Welch Foods Inc. v. Nat’l Union Fire Ins. Co.*, Civ. A. No. 09-12087-RWZ, 2011 WL 576600 (D. Mass. Feb. 9, 2011); *Nat’l Sur. Corp. v. Immunex Corp.*, 297 P.3d 688 (Wash. 2013). See also *U.S. Fid. & Guar. Co. v. U.S. Sports Specialty Ass’n*, 270 P.3d 464 (Utah 2012) (holding liability insurer’s right to reimbursement for amount paid beyond policy limits was within the subject matter of the policy and, therefore, insurer was not permitted to seek restitution from insured based on extra-contractual theory of unjust enrichment).

Courts denying an insurer the right to recoup may well be providing a benefit to the policyholder before it. However, such rulings ultimately may not accrue to the benefit of policyholders as they may discourage insurers from defending under a reservation of rights in some instances or encourage them to be more aggressive in instituting declaratory judgment actions and withdrawing from the defense in others. It also may result in an increase in premiums over time, making some policyholders pay more to have their potentially covered claims defended so that other policyholders may obtain a defense of claims not even potentially covered. It also encourages insurers to include provisions in their policies that ultimately provide less defense coverage to policyholders or allocates more defense costs to policyholders than otherwise would be the case in a recoupment action.

C. Reserving a Seat on the Buss Destined for “Recoupmentville”

Insurers and counsel representing them must consider the role and content of reservation of rights letters in terms of preserving (or avoiding waiving or being estopped from asserting) rights, remedies, and defenses, including the right to recoup defense costs associated with claims not potentially covered and the right to withdraw from the defense. Insurers are generally focused on these considerations and often deem it prudent to advise their policyholders of any issue no matter how remote it may appear and regardless of
whether they intend to pursue it. Recognizing that they often lack full information at the time they render their initial coverage determination, insurers often are over inclusive with respect to the grounds stated in their coverage position letters.

Although insurers and their counsel are well served in focusing on not waiving rights and defenses, they must also be mindful that reserving rights in some instances may produce a conflict, costing the insurer the right to control the defense and obligating the insurer to pay for independent counsel. The loss of the right to control the defense may be significant in several respects. The insurer no longer controls decisions regarding case strategy or settlement, yet its indemnity limits remain at risk. It also loses the ability to select and to control counsel and hinders its ability to contain the costs of litigation. Often, it significantly cuts off the insurer’s access to information, leaving the insurer on the outside looking in with respect to the defense for which it is paying the bills.


Arguments can be advanced as to why no reservation should be required and why it would be unfair to preclude an insurer from being entitled to recoupment based upon its failure to expressly reserve the right to seek recoupment in an initial reservation of rights letter. However, it also should be noted that recoupment fundamentally is a matter of fairness, and allowing an insurer to recoup amounts associated with expenses incurred prior to the policyholder being notified that the insurer may seek to recoup costs in whole or in part arguably would be unfair to the policyholder.

Insurers and their counsel should not be unmindful of the impact that its communications with policyholders will have in the trial of a coverage or bad faith case. Many times, the comprehensive reservation of
rights letter done with the laudable purpose of informing the policyholder of any potential issues is portrayed at trial as an insurance company stretching for any reason to deny coverage.

D. Is the Buss Ride Worth the Fare? The Utility of the Right of Recoupment

Many insurers and counsel have fought hard for the right to recoup defense costs associated with non-covered claims. In some instances, the right can indeed be valuable in terms of recovery. The existence of the right to recoup also can serve as a counterbalance where policyholders are being unreasonable in their demands. However, even where the right to recoupment has been held to exist, rarely will an insurer realize a full recovery for sums paid on claims that are not even potentially covered. The insurer must obtain a judicial determination that one or more claims are not covered and the costs of pursuing recovery make the effort economically impractical in many instances even where the financial condition of the policyholder does not present collectability issues.

Where the insurer is allowed to recoup defense costs for claims not even potentially covered, it generally bears the burden of proving by a preponderance of the evidence both: (1) that the claim is not even potentially covered, (Colony Insurance Co. v. G & E Tires & Service, Inc., 777 So. 2d 1034 (Fla. Dist. Ct. App. 2000); Aerojet-General Corp. v. Transport Indemnity Co., 17 Cal. 4th 38 (Cal. 1997), as modified on denial of reh'g, (Mar. 11, 1998)); and (2) that specific costs can be allocated solely to causes of action that are not even potentially covered (National Union Fire Insurance Co. of Pittsburgh, Pa. v. Guam Housing & Urban Renewal Authority, Nos. CVA02-012, CV1849-01, 2003 WL 22497996, *18 (Guam Nov. 4, 2003) (stating the insurer must “identify those costs which were attributable solely to non-covered claims”); Travelers Casualty & Surety Co. v. Ribi Immunochem Research, Inc., 108 P.3d 469 (Mont. 2005)). See also LA Sound USA, Inc. v. St. Paul Fire & Marine Ins. Co., 156 Cal. App. 4th 1259 (2007), review denied, (Feb. 27, 2008) (requiring the insurer to allocate defense costs and settlement payment among each particular insured).

An insurer often confronts substantial challenges in discharging its burden of proving that costs are solely related to the defense of claims not even potentially covered. In reality, many activities may relate to multiple claims or defenses that transcend a particular claim. In terms of evidence, the insurer often ends up holding the short end of the stick. The policyholder and defense counsel – particularly “independent counsel” retained by the policyholder – simply have no incentive to provide legal descriptions or billing breakouts that will expose fees and costs as being related to non-covered claims. As a practical matter, insurers will be hard pressed to require defense counsel to apportion particular costs and fees between and among claims.

In many instances, reserving a particular right or defense and setting up a strategy geared at recoupment may not be the best course of action. Although adjustments may be required along the way, insurers should consider the following in connection with mixed claims: (1) whether failing to enumerate a particular right, defense, or issue is likely to effectuate a waiver or estoppel; (2) the likelihood of ultimate success with respect to the right, defense, or issue; (3) the monetary and strategic significance of the right, defense, or issue; (4) the risk that asserting the right, defense, or issue will create a conflict and empower the policyholder to select independent counsel; (5) the monetary and other costs associated with losing control of the defense; (6) the likelihood of recouping defense costs and the amount likely to be reimbursed in view of the burden of showing that costs relate solely to uncovered claims and the amount likely to be recovered; and (7) the costs of pursuing recoupment. Often, the loss of control of the defense and the increased costs associated with independent counsel outweigh the preservation of a particular right, defense, or issue. Accordingly, a deliberate decision not to reserve a right or defense even if it means foregoing the right to recoup defense costs is the proper decision.
E. Alternative Means of Transportation With Respect to Mixed Claims

As discussed above, recoupment is a matter of *quasi* contract and equity. Most of the courts that deny insurers the right to recoup in the mixed claims context do so under the guise of refusing to re-write the insurance contact or at least point to the absence of any contractual provision regarding reimbursement. As a result of some court rulings holding that an insurer is not entitled to recoup monies from the policyholder absent an express policy provision, some insurance contracts now expressly provide for rights of reimbursement. In such instances, of course, the right to reimbursement is contractual.

One such provision provides:

In the event that a claim or suit seeks “damages,” some of which are covered and others of which are not covered by this policy, the insured must agree to a reasonable allocation of the costs and fees of defense, and the insured will be responsible for payment of the costs and fees to defend the non-covered “damages” or claims. This agreement shall be reached in writing, signed by the insurer and the insured, prior to the date when a responsive pleading to the claim or suit is filed on behalf of the insured. In the absence of such agreement our duty to defend will only apply to those specific portions of the suit which are covered.


An Illinois Amendatory ISO Endorsement promulgated after the Illinois Supreme Court decision in *General Agents Insurance Co. of America, Inc. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092 (Ill. 2005) provides:

If we initially defend an insured or pay for an insured’s defense but later determine that claim(s) is (are) not covered under this insurance, we will have the right to reimbursement for the defense costs we have incurred.

The right to reimbursement for the defense costs under this provision will only apply to defense costs we have incurred after we notify you in writing that there may not be coverage, and that we are reserving our rights to terminate the defense and seek reimbursement of defense costs.

Prospectively, an insurer can better protect itself by including an appropriate provision or endorsement expressly entitling it to reimbursement of costs spent defending non-covered claims.

Depending upon the jurisdiction and factual circumstances, an insurer may have several potential options other than recoupment such as: (1) retaining control of the defense, including strategies and costs; (2) forgoing reserving rights where reserving would entitle the policyholder to retain independent counsel in appropriate circumstances; (3) filing a declaratory judgment action and promptly seeking a determination of non-coverage (there may be challenges in avoiding having the coverage action stayed); (4) exploring opportunities to apportion costs where permitted to do so; and (5) negotiating with the policyholder on issues relating to control, counsel, non-waiver, and rates. Many times, the policyholder and insurer are able to establish parameters that are acceptable.

Regardless of whether or not recoupment will be sought, insurers generally should make known to the policyholder and to defense counsel that detailed descriptions of billing activities are required and that billings must be broken down into discrete entries (i.e., bulk billing is not acceptable). In this regard, at least the policyholder and defense counsel will be on notice of the expected billing practices. Where practical, tools such as billing and litigation management guidelines, controls, and audits should be employed. These practices may only be of modest assistance to an insurer in obtaining reimbursement, but they promote proper practices of counsel and help contain defense costs regardless of whether they relate to covered or non-covered claims. Neither courts nor insurers should be tolerant of practices or attempts to frustrate the ability to
understand what services were performed, why the tasks were performed, and whether or not the costs and fees were reasonable.

IV. When the Buss Has Left the Station: An Insurer’s Right to Recoup Settlement Amounts Associated with Non-Covered Claims

Conceptually at least, an insurers’ right to recoup indemnity payments associated with non-covered claims should be even more straightforward and the standard more favorable to insurers than recoupment of defense costs. The duty to indemnify is narrower than the duty to defend, involving only claims actually (as opposed to potentially) covered. Payments on judgments or in settlement generally take place at a time after the claims have been subjected to greater scrutiny, after evaluation, and even after a judgment or verdict is entered in the underlying action. Indeed, many courts have held that, where an insurer defends a suit under a reservation of rights, it may recover settlement payments if it is later determined in a declaratory judgment action that the underlying claims are not covered by the policy.

Once again, California has a well-established body of law allowing for reimbursement of indemnity payments. For example, in Blue Ridge Insurance Co. v. Jacobsen, 25 Cal. 4th 489, 502-03 (2001) the court relied upon the reasoning in Buss and recognized an insurer’s right to obtain reimbursement for non-covered claims included within a reasonable settlement payment. To obtain reimbursement, the insurer must:

(1) send a timely and express reservation of rights [including the right to seek such reimbursement]; (2) expressly notify the policyholders of the insurer’s intent to accept a proposed settlement offer; and (3) expressly offer to the policyholders that they may assume their own defense when the insurer and insureds disagree whether to accept the proposed settlement.


Recently, in Park Townsend, LLC v. Clarendon America Insurance. Co., 916 F. Supp. 2d 1045 (N.D. Cal. 2013), the court recognized the insurer was entitled to seek reimbursement of settlement amounts associated with non-covered claims. When the insurer, Clarendon, reserved its rights to seek future reimbursement of settlement amounts of non-covered claims, the policyholder protested and sought a declaratory judgment that the insurer was required to fully indemnify the insured in the underlying action.

Clarendon recognized its duty to defend and did not dispute that some of the damages in the underlying action were covered under its policy. It did dispute, however, the policyholder’s assertion that it sought to have the insured contribute to the settlement. Instead, Clarendon, in reserving its rights, intended to bring a separate action for reimbursement for non-covered damages in the event it settled the underlying action. The court recognized this approach is permitted by California law. Citing Blue Ridge, the court explained that “[t]he rationale behind permitting an insurer’s reimbursement is to prevent unjust enrichment on the part of the insured.” Id. at 1051. Where Clarendon made a timely and express reservation of rights upon agreeing to defend the policyholder, informed the policyholder of its interest in settlement and offered the policyholder the opportunity to assume their own defense should the parties disagree about whether Clarendon should accept the proposed settlement, the court found that Clarendon’s reservation of rights did not appear to be forcing the
policyholder to contribute toward the costs of settlement. The court concluded that Clarendon’s reservation of rights and interest in seeking future reimbursement for non-covered costs did not amount to misconduct.

*Park Townsend* reaffirms that, at least under California law, an insurer is entitled to reserve its rights for future reimbursement of settlement amounts associated with non-covered claims, so long as the insurer follows the steps outlined in *Blue Ridge*. When such steps are taken, a court will view the insurer’s actions as reasonable and not an attempt at forcing the insured to contribute toward the settlement.5

Other courts also have allowed an insurer to seek reimbursement of indemnity payments pursuant to a unilateral reservation of rights. *Travelers Prop. & Cas. Co. of Am. v. Hillerich & Bradby Co.*, 598 F.3d 257 (6th Cir. 2010) (applying Kentucky law) (a right to reimbursement arose under an implied-in-law contract theory in light of the insurer’s explicit reservation of rights, including notification of the right to seek reimbursement, and the policyholder’s control of the defense and settlement process); *Cincinnati Ins. Co. v. Grand Pointe, LLC*, 501 F. Supp. 2d 1145 (E.D. Tenn. 2007) (insurer may recoup settlement payments from policyholder where court has concluded that there is no duty to defend); *Am. Guar. & Liab. Ins. Co. v. CNA Reins. Co.*, 791 N.Y.S.2d 525 (N.Y. App. Div. 2005) (where insurer reserved right to reimbursement, and it was subsequently established that there was no additional insured coverage, insurer was entitled to reimbursement of settlement costs paid on behalf of additional insured), on subsequent appeal, 839 N.Y.S.2d 740 (N.Y. App. Div. 2007); *Med. Malpractice Joint Underwriting Ass’n v. Goldberg*, 680 N.E.2d 1121 (Mass. 1997) (suggesting an insurer could obtain reimbursement for a non-covered settlement if it first obtained court approval).

Courts in other jurisdictions have refused to allow an insurer to obtain reimbursement unless there is a specific provision in the policy, a written agreement from the insured, or a court order requiring such reimbursement. See, e.g., *Am. Modern Home Ins. Co. v. Reeds at Bayview Mobile Home Park, LLC*, No. 05-1149, 176 Fed. Appx. 363, 9-10 (4th Cir. Apr. 14, 2006) (unpublished opinion) (insurer does not have right to reimbursement despite assertion of such right in reservation of rights); *Houston Cas. Co. v. Sprint Nextel Corp.*, No. 01-09-cv-1387, 2010 WL 48352649 (E.D. Va. Nov. 22, 2010) (rejecting insurer’s unilateral attempt to recoup settlement payment where policyholder did not consent to such recoupment); *Utica Mut. Ins. Co. v. Rohm and Haas Co.*, 683 F. Supp. 2d 368 (E.D. Pa. 2010) (applying Pennsylvania and Illinois law) (insurer was not entitled to reimbursement of settlement costs from policyholder, absent express agreement providing for such reimbursement); *Am. Motors Ins. Co. v. Custom Rubber Extrusions, Inc.*, No. 1:05-cv-2331, 2006 WL 2460861, at *7-8 (N.D. Ohio Aug. 23, 2006); *Coregis Ins. Co. v. Law Offices of Carole F. Kafriessen, P.C.*, 140 F. Supp. 2d 461, 463-66 (E.D. Pa. 2001) (absent fraud by the policyholder, settlement by insurer constituted a “voluntary payment” not subject to reimbursement); *Excess Underwriters at Lloyd’s, London v. Frank’s Casing Crew & Rental Tools, Inc.*, 246 S.W.3d 42 (Tex. 2008) (absent unequivocal consent from the insured to allow reimbursement, an insurer was not entitled to reimbursement of uncovered portion of a claim or suit that it settled); *Steadfast Ins. Co. v. Sheridan Children’s Healthcare Servs., Inc.*, 34 F. Supp. 2d 1364, 1366-67 (S.D. Fla. 1998) (settlement by insurer precluded an action against policyholder for reimbursement); *Med. Malpractice Joint Underwriting Ass’n v. Goldberg*, 680 N.E.2d 1121, 1128-29 (Mass. 1997); *Mt. Airy Ins. Co. v. Doe Law Firm*, 668 So. 2d 534, 538 (Ala. 1995) (in order to preserve its right to be reimbursed for settlement payments, insurer must obtain either a written agreement with insured or a court order); and *U.S. Fid. & Guar. Co. v. U.S. Sports Specialty Ass’n*, 270 P.3d 468 (Utah 2012) (stating that “an insurer’s right to reimbursement from an insured must be expressly provided in an insurance policy before it can be enforced”).

A divided Texas Supreme Court, on rehearing of a prior decision, held that an excess insurer was not entitled to reimbursement for settlement payments from the policyholder unless the policy so provides or unless the policyholder has consented to the right to reimbursement. *Excess Underwriters at Lloyd’s, London v. Frank’s Casing Crew & Rental Tools, Inc.*, 246 S.W.3d 42 (Tex. 2008). The ruling vacated an earlier decision.
in which the court had ruled that reimbursement was appropriate where it was subsequently determined that the claims against the insured were not covered. See Excess Underwriters at Lloyd’s London v. Frank’s Casing Crew & Rental Tools, Inc., No. 02-0730, 2005 WL 1252321 (Tex. May 27, 2005), reh'g granted (Jan. 6, 2006). On rehearing, the high court reaffirmed the rule set forth in Matagorda County, 52 S.W.3d 128.

Where the policyholder and insurer can agree upon the amount of the payment relating to covered claims and the amount attributable to the uncovered claims, the simplest approach is for each to fund their respective portions of the settlement. Alternatively, the insurer could reach an agreement with the policyholder whereby the policyholder agrees to reimburse the insurer for whatever amount is agreed to relate to the non-covered claims or subsequently determined to relate to the non-covered claim. A separate agreement to reimburse settlement payments has been held to be enforceable. Revco D.S., Inc. v. Gov’t Emps. Ins. Co., 791 F. Supp. 1254, 1272, 1275-77, 1279 (N.D. Ohio 1991), aff’d per curiam on opinion below, 984 F.2d 154 (6th Cir. 1992). See also T.H.E. Ins. Co. v. Larsen Intermodal Servs., Inc., 242 F.3d 667, 676 (5th Cir. 2001).

Babcock & Wilcox Co. v. American Nuclear Insurers, No. 525 WDA 2012, 2013 WL 3456969 (Pa. App. July 10, 2013) (unpublished opinion) is an interesting recent decision. In this case, the intermediate Pennsylvania appellate court was presented with the issue of whether a policyholder that settled within policy limits but without the consent of its insurer was able to seek reimbursement for the settlement despite the insurer’s continued defense of the policyholder and the presence of a “consent to settlement” clause in the policy. Initially, the trial court applied Pennsylvania’s bad faith standard, finding that the insurer was only obligated to indemnify the policyholder if it declined to settle in bad faith. Id. at *3-4. But, upon rehearing, the trial court came to the opposite conclusion, holding that, where an insurer defends under a reservation of rights it is the essential equivalent of denying a defense and requires the insurer to reimburse the insured as long as the settlement was fair and reasonable. Id. at *4.

The appellate court took a different approach – one not previously recognized under Pennsylvania case law. It held that a policyholder has two options when its insurer offers a defense under a reservation of rights. It may accept the defense, remain bound by all policy provisions, and allow the insurer to retain full control of the defense. Id. at *17. In this scenario, the policyholder’s only recourse against the insurer is a bad faith action. Id. Alternatively, the policyholder may decline the insurer’s defense and procure its own defense. Id. at *18. Under this option, the policyholder retains control over the defense and is able to litigate in the manner it deems best. If coverage is found, the policyholder is able to recover defense and settlement costs from the insurer. Id. Based on this ruling, insurers in Pennsylvania now risk losing control of the defense any time they issue a reservation of rights while still remaining liable to indemnify the insured for reasonable settlements or judgments of covered claims.

Many courts have ruled that the policyholder bears the burden of apportioning a settlement or verdict between covered and non-covered claims. See, e.g., MedMarc Cas. Ins. Co. v. Forest Health Care, Inc., 199 S.W.3d 58, 61 (Ark. 2004); Perdue Farms, Inc. v. Travelers Cas. & Sur. Co., 448 F.3d 252, 263 (4th Cir. 2006) (where allocation of a settlement between covered and noncovered claims must be resolved through litigation, the burden is on the policyholder to prove the amount attributable to covered claims); Fiess v. State Farm Lloyds, 392 F.3d 802, 807 (5th Cir. 2004) (holding that “the policyholder bears the burden of presenting evidence that will allow a trier of fact to segregate the covered losses from non-covered losses”); Raychem Corp. v. Fed. Ins. Co., 853 F. Supp. 1170, 1175-76 (N.D. Cal. 1994) (holding that the policyholder bears the burden of proving allocation of settlement liability between insured and uninsured parties, especially when the insured controlled its own defense); Keller Indus., Inc. v. Emp'rs Mut. Liab. Ins. Co. of Wis., 429 So. 2d 779, 780 (Fla. Dist. Ct. App. 1983) (holding that “the party claiming coverage . . . ha[s] the burden . . . to apportion damages and show that the settlement, or portions thereof, represented costs that fell within the coverage provisions”).
Other courts apply a shifting burden of proof. Some courts first require the insurer to show that at least some claims or damages are not covered before placing the burden on the policyholder to prove what portion of the settlement is covered. *Cont’l Cas. Co. v. Can. Univeral Ins. Co.*, 924 F.2d 370, 376 (1st Cir. 1991). Other decisions initially place the burden on the policyholder to show that coverage exists for some claims and then shift the burden to the insurer to show “how much of the damage was caused by a non-covered cause.” *Imperial Trading Co. v. Travelers Prop. & Cas. Co. of Am.*, 638 F.Supp.2d 692, 694 (E.D. La. 2009).

Still other decisions hold that, where the insurer controls the defense, it assumes the burden of apportioning any judgment or settlement between covered and non-covered claims. *Forest Health Care, Inc.*, 199 S.W.3d at 61-62. In *Automax Hyundai South, LLC v. Zurich American Insurance Co.*, 720 F.3d 798, 807 (10th Cir. 2013), the court shifted the burden of proving allocation from the policyholder to the insurer, holding that “where both covered and noncovered causes of action are alleged, the insurer – assuming it is in charge of the insured’s defense – must request a special verdict to disentangle the facts relevant to its indemnification of the insured,” (citing *Magnum Foods, Inc. v. Cont’l Cas. Co.*, 36 F.3d 1491, 1498 (10th Cir. 1994) (applying Oklahoma law)). The court reasoned that, if the burden were placed on the policyholder to apportion a settlement or judgment while the insurer controlled the defense, “the insurer could obtain for itself an escape from responsibility merely by failing to request a special verdict or special interrogatories.” *Automax*, 720 F.3d at 808 (quoting *Magnum Foods, Inc.*, 36 F.3d at 1498). The same reasoning would apply to require the policyholder to bear the burden of proof when it is controlling the defense directly or through independent counsel. *Camden-Clark Mem’l Hosp. Ass’n v. St. Paul Fire & Marine Ins. Co.*, 682 S.E.2d 566, 576 (W.Va. 2009) (holding the policyholder has the burden of proof to establish proper allocation between covered claims and non-covered claims if the policyholder has controlled the defense of the underlying claims). See also *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1175-76 (N.D. Cal. 1994) (court gave extra weight to the fact that the insured controlled its own defense in deciding to place the burden of allocation on the insured).

The insurer may also bear the burden of allocating between covered and non-covered claims if it wrongfully refuses to defend the insured. See *Liquor Liab. Joint Underwriting Ass’n of Mass. v. Hermitage Ins. Co.*, 644 N.E.2d 964, 969 (Mass. 1995) (holding that, where an insurer breaches its duty to defend and some claims are covered and others are not, the insurer has the burden of proving allocation). However, not every court takes this approach. See *Keller Indus., Inc. v. Empr’rs Mut. Liab. Ins. Co. of Wis.*, 429 So. 2d 779, 780-81 (Fla. Dist. Ct. App. 1983) (holding that, even though the insurer breached its duty to defend, it did not have to pay a settlement where no coverage existed and the party claiming coverage had the burden of allocating damages and showing that the settlement represented costs that fell within the coverage provided by the policy).

**V. Conclusion: Buss Seats are Not Always Comfortable and the Buss Ride Can Be a Little Bumpy**

Mixed claims provide opportunities as well as challenges to insurers and their counsel. As with so many issues in the insurance coverage world, each matter must be handled on its own accord based upon consideration of the applicable law, the policy language, and the facts. Although knowledge of the applicable legal principles is essential, very often the factual context of the claim and practical considerations dictate the appropriate course of action.
Endnotes

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2 As a result of some court rulings holding an insurer is not entitled to recoup monies from the policyholder, some insurance contracts now contain provisions expressly providing for rights of reimbursement. In such instances, of course, the right to reimbursement is contractual. Such provisions are discussed in Section III.E below.

3 Portions of the discussion are excerpted with permission from Allocation of Losses in Complex Insurance Coverage Claims by Scott M. Seaman and Jason R. Schulze (Thomson Reuters 2d 2012), available at www.west.thomson.com. © Thomson Reuters. All rights reserved.

4 Earlier versions provided that “the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if the allegations of the suit are groundless, false, or fraudulent . . . .” In November 1985, the italicized language was removed from the ISO Commercial General Liability Form. The May 1992 ISO Commercial General Liability Form, for example, provides: “we will have no duty to defend the insured against any 'suit' seeking damages for 'bodily injury' or 'property damage' to which this insurance does not apply.”

5 A discussion of indemnity and an insurer’s duty to settle, which involve a host of issues and considerations, is beyond the scope of this article. One of many issues that arise is whether an insurer can request or insist that the policyholder contribute to a settlement to reflect a portion of the settlement attributable to non-covered claims. Though the context, facts, and law will determine the appropriate response, Stephen Ashley’s thoughts may be worth considering: “[t]hough the insurer may not coerce the insured to contribute to a settlement, the insurer must take care not to commit bad faith by failing to inform the insured of his right to contribute to settlement if the amount demanded exceeds either the policy limits or the claim's reasonable settlement value. A suggestion of, rather than insistence upon, contribution is not bad faith.” Stephen S. Ashley, Bad Faith Actions: Liability and Damages (West 2d. at 3-6).