Navigating the Risks of an Insurer-Provided Defense

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You are an executive of a company that has been sued by a group of disgruntled investors. The case is complex and will be expensive to defend. Thankfully, the company has liability insurance that includes the insurer's promise to defend the company against lawsuits. After tendering the claim, the company receives a multi-page response from the insurer full of policy language and disclaimers. You see that the insurer has agreed to defend, but with a very important caveat. The insurer has reserved its right to recoup any defense costs paid in the event that it is later determined the claims asserted in the lawsuit are not covered.

The insurer's letter—commonly referred to as a "reservation of rights" letter—allows the insurer to defend the company under a "reservation" of the right to later deny coverage. While the insurer has, for the time accepted the defense, it has not accepted coverage. As the Supreme Court of Nevada recently illustrated, a belated determination that coverage does not exist under the policy, after the insurance company has already provided a defense can have severe consequences for the policyholder.

Nevada Supreme Court Decision

In Nautilus Ins. Co. v. Access Med., LLC, 482 P.3d 683 (Nev. 2021), the Supreme Court of Nevada addressed (on certification from the Ninth Circuit) an insurer's ability to recoup defense costs following a no coverage determination. By way of background, Nautilus agreed to defend its policyholder subject to a reservation of rights, including the reservation to seek reimbursement for the legal fees it paid to defend the policyholder if it was determined that the policy does not provide for coverage. After defending the policyholder for nine months, Nautilus decided to commence a declaratory judgment action seeking a determination that the claim was not covered. It ultimately prevailed and sought reimbursement of all the defense costs it had expended in the underlying case, despite the policy never providing for a right to reimbursement in the first place.

In a sharply divided decision, the majority found that Nautilus was indeed entitled to reimbursement. The court reasoned that even though there was no such right to reimbursement contained in the insurance policy, Nautilus could still recover from its policyholder on a quantum meruit theory. According to the court, since a determination was ultimately made that the policyholder's claim was not covered, "the contract between the parties does not apply to the instant dispute, and the existence of that contract does not foreclose an unjust enrichment claim." The court found that "when a court holds that there never was a duty to defend, it is holding that the claims were never even potentially covered by the policy. Therefore, when the insurer reserved its right to seek reimbursement, it was not extracting an amendment to a contract that would otherwise govern its defense. No contract governed its defense."

Theory of Unjust Enrichment

In New Jersey (as in Nevada), the right of reimbursement exists in cases where an insurer honored its duty to defend but sought reimbursement from an insured for fees incurred in defending a non-covered claim "because the insured would be unjustly enriched in benefiting by, without paying for, the defense of a non-covered claim." In these cases, the insurer specifically issued a reservation of rights letter to the policyholder, reserving its right to seek reimbursement of defense costs for non-covered claims.

Recouping Legal Fees

Unlike Nevada and New Jersey, Pennsylvania law allows an insurer to recoup legal fees only when such recoupment is provided for in the insurance policy. In Am. & Foreign Ins. Co. v. Jerry's Sport Ctr., Inc., 606 Pa. 584 (2010), the Supreme Court of Pennsylvania stated, "an insurer is not entitled to be reimbursed for defense costs absent an express provision in the written insurance contract." The court held that following a court's declaration that an insurer has no duty to defend its insured, an insurer is not entitled to reimbursement of defense costs absent an express provision in the written contract or policy. Even if the insurer employs a reservation of rights letter to reserve its right to reimbursement of defense costs, such right is not sufficient as an insurer cannot reserve a right it does not have pursuant to a contract.

Best Practices for Policyholders

How does a policyholder square receiving an insurer-provided defense with the onerous possibility of having to repay all defense cost incurred? To be sure, this presents a difficult decision, but there are best practices to keep in mind.

First, the insurance company probably involved its lawyers in preparing the reservations of rights letter. You too should consult experienced coverage counsel as you decide how to proceed. You and your coverage counsel should review all documents carefully, including the reservation of rights letter, the policy, and any other documents from the insurer in connection with the defense. In certain circumstances, the policyholder may have an argument against recoupment based on the conduct of the insurer or the language of the relevant documents.

Second, a policyholder can and should object to any purported "reservation" of a right that was never contained in the policy. Lodging a written objection to such reservations can put the policyholder in a stronger position should the matter ever be litigated. A policyholder can also reject the defense under an improper reservation altogether and defend itself, seeking a coverage determination from the court through a declaratory judgment action. This allows the policyholder to choose its preferred counsel and otherwise direct the defense without foregoing its right to receive proceeds from the policy after a judicial determination that coverage exists.

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