

FEBRUARY 2007

SPECIAL ADVERTISING SECTION

Beware! D&O Insurance Companies May Improperly Attempt To Recoup Defense Costs Paid To Policyholders

Historically, attempts by insurance companies to recoup defense costs or other amounts already paid to their policyholders have been rare. Much has changed. In the last few years,

it has become increasingly common for insurance companies to assert that any payments (usually payments for the policyholder's legal bills) they make on a policyholder's behalf are "subject" to the

insurance company's "right" to seek the money back if it is ultimately demonstrated that there is no coverage for the claim. Such assertions are made now in a number of insurance contexts including claims made under: errors & omissions insurance; general liability insurance; and fiduciary liability insurance. Nowhere, however, is this issue more prevalent than in the context of directors' and officers' (D&O) insurance claims. Many D&O insurance companies now routinely raise arguments about their purported "rights" to reimbursement of amounts paid on an insurance claim as a method of extracting concessions from policyholders on disputed insurance claims or, on occasion, in an effort to avoid payment for a claim altogether.

A careful analysis of the circum-

stances surrounding these disputes, however, indicates that insurance company efforts to recoup amounts paid to policyholders should rarely be successful. This is for two main reasons. First, insurance companies typically bear the legal burden of establishing their "right" to recoupment of amounts paid toward a policyholder's insurance claim (e.g., satisfying their burden in demonstrating that they expressly "reserved their right" to seek reimbursement or that the insurance policy explicitly permitted recoupment or that coverage for the insurance claim was precluded, etc.). Second, the very nature of the claim that led the insurance company to make a payment of defense costs in the first place often forecloses reimbursement to the insurance company because defense cost coverage is established or apparent. Therefore, the legal basis is lacking for the insurance company to seek reimbursement of the amounts it paid toward the defense of the policyholder in the underlying claim. These factors make it substantially difficult for insurance companies to prove that they are entitled to reimbursement of defense costs paid.

The Insurance Company's Burden

The majority of cases to have analyzed an insurance company's efforts to recoup defense costs have determined that it is the insurance company

that carries the burden of establishing that the defense costs paid were not for covered claims. Courts typically require that there has to be a specific legal basis permitting the insurance company to seek reimbursement of amounts paid to the policyholder, either by expressly providing for recoupment in the insurance policy itself, or by expressly reserving a reimbursement right at the time that the insurance company pays amounts to the policyholder for a claim under the insurance policy.

In one reimbursement case, *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Guam Housing and Urban Renewal Auth.*, AIG paid certain defense costs for an underlying claim against the insureds under a "Public Officials and Employees Liability Insurance Policy." AIG expressly reserved its rights to seek reimbursement for non-covered claims. AIG later sued the policyholder in the Superior Court of Guam seeking reimbursement for three underlying actions. The trial court ruled against AIG and held that there was defense coverage for all the underlying actions. On appeal, the Supreme Court of the Territory of Guam held that certain claims were covered and certain claims were not. The court held that AIG would be entitled to reimbursement of defense costs paid solely for non-covered claims if it bore its burden to demonstrate the appropriate allocation of



JOSHUA GOLD

defense costs for covered and non-covered claims. The court also held that a right of "reimbursement of defense costs [exists] only if the insurer sufficiently reserves its rights."

The court ruled that the reservation of its right to recoup defense costs must be: (1) made in a timely and explicit manner; and (2) must provide "specific and adequate notice of the possibility of reimbursement." In one case applying Pennsylvania law, the court refused to recognize any right to reimbursement of defense costs already paid by a general liability insurance company, even if set forth in a reservation of rights.

In a decision from a bankruptcy court, the court refused to allow a reimbursement of defense costs to the insurance company. The court stated,

Nowhere does either [insurance company] letter mention that Republic expects the insureds to reimburse it for the costs of defense of the state tort suit should it be found to have no duty to defend the insureds. Even assuming Republic could have created this right through a subsequent agreement with the insureds, these letters fail to put the reader on notice that such a right is claimed.

The court further stated, "we hold that the allocation and recovery of the costs attributable to the defense of claims that were not covered by the policy of insurance is not permitted under Wyoming law so long as one or more of the claims alleged is covered..."

These cases, including the ones that permit — in theory — reimbursement to the insurance compa-

ny, make clear the considerable obstacles that insurance companies must overcome before the court will require the policyholder to return any amounts.

D&O Insurance Policies Provide Broad Coverage for Defense Costs

It is axiomatic that the duty to defend obligates insurance companies to provide broad insurance protection to policyholders for their expenses in litigation. To establish coverage for defense costs, the underlying claim against the policyholder need only be shown to fall potentially within the grant of coverage under the insurance policy. Accordingly, it should be a very rare occasion where an insurance company can seek the recovery of defense costs paid given the breadth of their obligations to cover any claim that falls potentially within coverage.

Some D&O and E&O insurance companies try to escape this broad obligation by arguing that their defense cost coverage is more narrow than that offered by duty to defend policies. Essentially, these insurance companies argue that their policies are "reimbursement" policies and therefore they are not duty-bound to defend. These arguments are not persuasive. First, policyholders purchase reimbursement policies not to have less coverage, but instead to have greater control over the defense counsel hired and the strategy employed to defend against the underlying plaintiffs' claims. Second, a number of courts in a variety of jurisdictions, including Delaware, New York, Ohio, and Massachusetts have determined that under a D&O policy's reimbursement promise for defense costs, there need only be a demonstration that the claim potentially comes

within the coverage grants of the policy. As such, these courts use the duty to defend standard to determine coverage for defense costs under D&O and some E&O insurance policies. Given this standard, in most instances, insurance companies should have great difficulty in demonstrating that they are entitled to reimbursement of defense costs. In one decision, the court denied the insurance company's attempt to seek reimbursement of defense costs and held that California law does not permit reimbursement of defense costs "relating to claims that are at least potentially covered." Reimbursement can only be had when the insurer carries its burden to show that defense costs are allocable "solely" to claims that are not even potentially covered.

As such, policyholders should resist unwarranted attempts by insurance companies to renege on their coverage obligations by, among other things, seeking reimbursement of defense costs already paid.

Joshua Gold is a shareholder in the New York office of Anderson Kill & Olick, P.C. Mr. Gold has extensive experience in insurance coverage analysis, consulting and litigation, with an emphasis on directors' and officers' insurance. Mr. Gold can be reached at jgold@andersonkill.com or (212) 278-1886.

