

# Insurance Defense Costs: Allocation in Mixed Actions, Recoupment for Non-Covered Claims, Independent Counsel Fees

Maximizing Recovery or Limiting Exposure for Defense Costs

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## *Speaker Biographies*

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**WILLIAM T. BARKER** is a Senior Counsel in the Chicago office of Dentons U.S. LLP, with a nationwide practice representing insurers in complex litigation, including matters relating to coverage, claims handling, sales practices, risk classification and selection, agent relationships, and regulatory matters. He sometimes serves as an expert witness on matters of insurance, professional responsibility and standard of care. He is a co-author (with Ronald D. Kent) of *INSURANCE BAD FAITH LITIGATION, SECOND EDITION* and (with Charles Silver) of *PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL*. He has been described as the leading lawyer-commentator on the connections between procedure and insurance. See Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 257 n.4 (1995). Mr. Barker is a member of the American Law Institute and an Adviser to its project on the Restatement of the Law of Liability Insurance. He is a Special Advisor to the ABA Standing Committee on Ethics & Professional Responsibility.

## *Speaker Biographies*

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**HELEN K. MICHAEL** is a partner in the D.C. office of Kilpatrick Stockton & Townsend LLP. She handles high stakes coverage disputes for policyholders in every major coverage area. In total, Ms. Michael has assisted her clients in recovering more than a billion dollars in insurance proceeds. Ms. Michael also regularly counsels her clients during the policy placement renewal process to help ensure they obtain insurance appropriate for the principal risks presented by their businesses. Ms. Michael has repeatedly been recognized as a leading lawyer in numerous publications, including by *Chambers USA*, *The Best Lawyers in America*<sup>®</sup>, the *Expert Guide to the World's Leading Women in Business Law* and the *Expert Guide to the World's Leading Insurance and Reinsurance Lawyers*, and as among DC's top 50 women lawyers and DC's top 100 lawyers by *Super Lawyers*<sup>®</sup> magazine. Ms. Michael is a Member of the American College of Coverage and Extracontractual Counsel, an honorary society for preeminent coverage attorneys. She also is a leader in the American Bar Association Torts, Trial and Insurance Section, where she has served as a national chair of the Insurance Coverage Litigation Committee. She publishes and speaks frequently on insurance coverage issues.

## *Speaker Biographies*

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**SHERILYN PASTOR** is the Practice Leader of McCarter & English’s Insurance Coverage Group. She has secured hundreds of millions of dollars in insurance assets for a broad range of policyholder clients. She also assists clients in assessing their potential risks and in analyzing their insurance programs. Ms. Pastor is on the Board of Regents of the American College of Coverage and Extracontractual Counsel. She is a past Chair of the ABA’s Insurance Coverage Litigation Committee (Policyholder Side). Ms. Pastor is rated AV Preeminent by Martindale-Hubbell, recognized by Chambers USA as among “Leaders in their Field,” and she is a recipient of the YMCA’s Tribute to Women in Industry award. She also was named one of New Jersey’s “Best 50 Women in Business” by NJBIZ, and is recognized as a New Jersey Super Lawyer and by Best Lawyers. Ms. Pastor publishes and lectures frequently on a variety of topics including insurance coverage, trial advocacy, pretrial practice and professional responsibility.

# *Defense Costs & Independent Counsel*

## *When is insured entitled to independent counsel?*

- Two rules:
  1. Conflict of interest (dominant rule)
    - New Jersey wrinkle
  2. Reject the defense

# *When is insured entitled to independent counsel?*

## *Conflict of Interest*

- Analysis driven by lawyer conflict of interest rules:
  - "[T]he [independent counsel] rule is not based on insurance law but on the ethical duty of an attorney to avoid representing conflicting interests.' Thus, when the ethical bar to dual representation does not exist, the insurer has no duty to provide and pay for *Cumis* counsel." *Swanson v. State Farm Gen. Ins. Co*, 219 Cal. App. 4th 1153, 1164 (2013) (citations omitted).
- Normal case, most jurisdictions: two clients; undivided loyalty to each
- Dual clients not possible if conflict about way case defended
- Even if insurer not client, lawyer can't accept direction from it if insurer has conflict with insured about way case defended

## ***When is insured entitled to independent counsel?***

### ***Reservation of Rights & Conflict of Interest***

- Reservation can create conflict; e.g., complaint alleges both negligent and intentional injury and insurer reserves on intentional injury. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc’y, Inc.*, 162 Cal. App. 3d 358, 365 (1984); *Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 198-99 (1976).
- Not all reservations create conflicts: e.g., environmental case and reservation on absolute pollution exclusion. *Fed. Ins. Co. v. MBL, Inc.*, 219 Cal. App. 4th 29, 44 (2013).

## *When is insured entitled to independent counsel?*

### *Reservation of Rights & Conflict of Interest*

- Usual key question: do factual issues in underlying action overlap with those on coverage issue?
- Sometimes significant: will case expose defense counsel to confidential information of insured that would be useful to insurer on coverage
  - *See WILLIAM T. BARKER & CHARLES SILVER, PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL, § 6.04 (detailed analysis of case law on conflict rule).*

# When is insured entitled to independent counsel?

## Conflict of Interest: *Armstrong Cleaners v. Erie*

- Illustrative case: *Armstrong Cleaners, Inc. v. Erie Ins. Exch.*, 364 F. Supp. 2d 797 (S.D. Ind. 2005)
  - Erie insured Armstrong, whose former business was possible source of cleaning solvents in groundwater
  - Armstrong leased property from Ivey; Rays leased property before and after Armstrong; cross-claims among parties re possible liability
  - Erie reserves on occurrence and expected/intended and on pollution exclusion; declines to pay independent counsel

## *When is insured entitled to independent counsel?*

### *Conflict of Interest: Armstrong Cleaners v. Erie*

- Standard: "If there is a reasonable possibility that the manner in which the policyholder is defended could affect the outcome of the insurer's coverage dispute, then the conflict may be sufficient to require the insurer to pay for counsel of the policyholder's choice."
  - Pollution exclusion creates no conflict, because issue does not overlap with issues in clean-up.

***When is insured entitled to independent counsel?***  
***Conflict of Interest: Armstrong Cleaners v. Erie***

- Erie argued that clean-up action is strict liability, so issue of expectation or intent to cause injury also does not overlap the clean-up action
- But, if liability found, court will need to allocate among parties.

## *When is insured entitled to independent counsel?*

### *Conflict of Interest: Armstrong Cleaners v. Erie*

- Conflict exists if "significant risk" that defense of Armstrong might be "materially limited" by counsel serving Erie's interests
- Shaping of investigation and discovery
- Splitting file doesn't solve problem

# When is insured entitled to independent counsel?

## Conflict of Interest: Non-Coverage Issues

- Cross-insureds: two insureds involved in accident and sue one another:
  - *E.g.*, *O'Morrow v. Borad*, 27 Cal. 2d 794 (1946) (no coverage issue, but in defending each insured, insurer has duty and incentive to try to show contributory negligence of the other, which creates a conflict regarding the defense of the other insured).
- Inconsistent defenses:
  - *E.g.*, *Murphy v. Urso*, 88 Ill. 2d 444, 452-55 (1981) (employer disputes course and scope of employment, but success on that would leave employee with no coverage); *Wolpaw v. Gen. Acc. Ins. Co.*, 272 N.J. Super. 41, 45 (App. Div. 1994) (insureds disagree on allocation of fault between them, if fault is found).

## ***When is insured entitled to independent counsel?***

### ***Conflict of Interest: Excess Exposure***

- “[A] damage claim beyond policy limits in and of itself presents no ethical problem to the lawyer employed to defend the case, because his employment is for one of two purposes: either win the case outright, or keep the damages as low as possible. Everything he does in fulfillment of either objective must of necessity benefit both [insurer and policyholder].” *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 269 (Miss. 1988).
- *But see R.G. Wegman Constr. Co. v. Admiral Ins. Co.*, 629 F.3d 724, 730 (7th Cir. 2011) (conflict arose when insurer “learned that an excess judgment ... was a *nontrivial probability*”).

## ***When is insured entitled to independent counsel?***

### ***Conflict of Interest: Punitive Damages***

- *Foremost Ins. Co. v. Wilks*, 206 Cal. App. 3d 251 (1988) (uninsured punitive damage claim does not create conflict; compensatory damages best minimized by vigorous defense).
- *But see Nandorf, Inc. v. CNA Ins. Cos.*, 134 Ill. App. 3d 134 (1985) (punitive damages claim created conflict because far larger than compensatory damage claim; possible that argument of counsel might influence how much of award for wrongful detention for shop lifting would be characterized as emotional distress and how much punitive damages).

## *When is insured entitled to independent counsel?*

### *Reject the Defense*

- Small minority rule: any reservation entitles insured to reject insurer's defense.
- Avoiding breach requires insurer to fund independent defense.
  - *E.g., Three Sons, Inc. v. Phoenix Ins. Co.*, 357 Mass. 271, 276 (1970).
- Missouri law is even more stringent, effectively treating reservation of rights as a breach.
  - *E.g., State Farm Mut. Auto. Ins. Co. v. Ballmer*, 899 S.W.2d 523 (Mo. 1995).

## ***When is insured entitled to independent counsel?***

### ***New Jersey wrinkle***

- *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 390 (1970) (unless the policyholder agrees to a defense under reservation, a conflict converts the duty to defend into a duty to reimburse, after coverage is determined).
- *Flomerfelt v. Cardiello*, 202 N.J. 432 (2010) (“in circumstances in which the underlying coverage question cannot be decided from the face of the complaint, the insurer is obligated to provide a defense until all potentially covered claims are resolved”).
- *Abouzaid v. Mansard Gardens Associates LLC*, 207 N.J. 67 (2011) (“potentially coverable claims require a defense”).

## *Selection of Independent Counsel*

- In most jurisdictions, the policyholder is entitled (at least in the absence of any contrary policy provision) to select independent counsel.
  - *E.g., San Diego Navy Fed. Credit Union v. Cumis Ins. Soc’y*, 162 Cal. App. 3d 358, 371 (1984).
- In some, the insurer is entitled to approve the policyholder’s selection of counsel, approval not to be unreasonably withheld.
  - *Employers’ Fire Ins. Co. v. Beals*, 103 R.I. 623, 632-35 (1968).
- In a few others, the insurer may select independent counsel, subject to an enhanced duty of good faith.
  - *Tank v. State Farm Fire & Cas. Co.*, 105 Wash. 2d 381, 390 (1986) (while insurer selects, counsel must represent only the insured and give insured undivided loyalty).

## *Rates for Independent Counsel*

- Ethical rules permit only reasonable fees.
- A few states regulate by statute.
  - CAL. CIV. CODE § 2860(c) (rates usually paid for panel counsel in similar cases); ALASKA STAT. § 21.96.100(d) (same); OR. REV. STAT. § 465.843(3)(a) (environmental claims only).
- Principle employed by some courts in the absence of a controlling statute:
  - " [T]he duty of good faith imposed upon an insured includes the obligation to act reasonably in selecting as independent counsel an attorney qualified to present a meaningful defense and willing to engage in ethical billing practices at a standard stricter than that of the marketplace. Conduct arguably acceptable in the ordinary attorney-client relationship where the latter pays the former from his own pocket is not necessarily appropriate in the tripartite context created when independent counsel undertakes to represent the insured at the expense of the insurer."
    - *Center Found. v. Chicago Ins. Co.*, 278 Cal. Rptr. 13, 21 (Cal. Ct. App. 1991).

## *Rates for Independent Counsel*

- Absent controlling statute, rates not limited to those customarily paid to panel counsel (RESTATEMENT OF THE LAW OF LIABILITY INSURANCE, § 17, cmt. *b* (Prop. Final Dr. Mar. 28, 2017)):
  - “The reasonableness of defense fees in relation to the complexity of the claim and the risks at stake is a fact question. What the insurer usually pays lawyers to defend similar claims is relevant but not dispositive. Law firms regularly retained by an insurer commonly accept reduced rates in return for a good supply of business. A lawyer providing an independent defense should not be required to accept the rates paid to the insurer’s regular defense lawyers, unless the lawyer so regularly accepts other business at those rates that they represent the reasonable value of his or her services.”
  - “On the other hand, the lawyer’s regular rates or amount of time spend on a matter may be excessive in relation to the complexity of the claim or the amount at stake in the matter.”

# Independence of Counsel

- Once counsel has been selected, “[t]he *Cumis* rule requires complete independence of counsel.”
  - *State Farm Fire & Cas. Co. v. Super. Ct.*, 216 Cal. App. 3d 1222, 1226 (1989).
- Insurer may not direct.
  - *Jacob v. W. Bend Mut. Ins. Co.*, 203 Wis. 2d 524, 536 (Ct. App. 1996) (explaining that unless the insurer is willing to accept coverage, it has no authority to affect independent counsel’s defense of the insured).
- Counsel may select defense strategies disadvantageous to the carrier.
  - *Nelson Elec. Contr. Corp. v. Transcontinental Ins. Co.*, 231 A.D.2d 207, \_\_\_ (N.Y. App. Div. 1997) (subcontractor policyholder did not breach duty of cooperation by having independent counsel forego claim against general contractor which would have reduced carrier’s net liability, but required subcontractor to provide uninsured indemnity to general contractor, on the basis that the best defense strategy was to present a common defense against the injured workers).

## *Involvement in Coverage Disputes*

- Because the insurer is not a client of independent counsel, there is no ethical obstacle to counsel also representing the policyholder on coverage and other disputes with the insurer.
  - *Maddox v. St. Paul Fire & Mar. Ins. Co.*, 2002 U.S. Dist. LEXIS 26686, at \*10 n.6 (W.D. Pa. May 29, 2002), *appeal dismissed*, 2003 U.S. App. LEXIS 14715 (3d Cir. Jul. 22, 2003); *Emons Indus, Inc. v. Liberty Mut. Ins. Co.*, 747 F. Supp. 1079, 1083-84 (S.D.N.Y. 1990).
- The insurer is entitled to have bills limited to services required to defend the policyholder, so it does not pay for the policyholder's representation in coverage disputes.

## Can the Insurer Sue Independent Counsel?

- Because of conflict of interest, the insurer cannot be a client of independent counsel.
- Except in unusual circumstances, a lawyer owes no duty of care to a nonclient.
  - 1 RONALD E. MALLIN & JEFFREY M. SMITH, LEGAL MALPRACTICE, § 7:8 (2011 ed.).
- But insurer may be able to assert claim as insured's equitable subrogee.
  - *E.g., Atlanta Int'l Ins. Co. v. Bell*, 475 N.W.2d 294, 298 (Mich. 1991) (primary insurer not recognized as client but entitled to sue for botched defense).
  - *Contra Assurance Co. of Am. v. Haven*, 32 Cal. App. 4th 78, 80 (1995) (“*Cumis* counsel cannot be held negligently or statutorily liable to the insurer for failing to investigate, prepare, assert, establish, or perform similar functions regarding [a] complete defense.”).

***Allocation of Losses in  
Cases Involving  
a Mix of Covered &  
Non-Covered  
Claims or Parties***

## EXAMPLES OF CASES INVOLVING “MIXED” COVERAGE SITUATIONS

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- Lawsuit alleging claims involving negligence and tort committed with intent to cause injury.
- Lawsuit seeking both compensatory and punitive damages.
- Lawsuit asserting claims against an insured (e.g., the director of a corporation) and non-insured co-defendant (e.g., the corporation itself).
- Lawsuit asserting claims involving non-covered acts occurring before a retroactive coverage date and claims involving covered acts occurring after that retroactive date.

## ***KEY QUESTION***

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Is the insurer obligated to pay for all of the defense costs incurred in the lawsuit involving a mix of covered and non-covered claims or parties?

# ALLOCATION OF DEFENSE COSTS?

- Where policy language is silent, courts have reached conflicting results:
  - No Allocation: Insurer Must Pay 100% of Defense Costs.
    - **California Variation:** Insurer Must Pay 100% of Defense Costs, but can seek recoupment if it meets the burden of showing that particular costs relate solely to the defense of non-covered claims.
      - *Buss v. Superior Court*, 16 Cal. 4th 35, 48-49 (1997).
  - “Reasonably Related” Rule: Insurer must pay all defense costs reasonably related to a covered claim when there is no reasonable means of pro-rating the costs.
    - *Cont'l Cas. Co. v. Bd. of Educ. of Charles Cnty.*, 302 Md. 516, 489 A.2d 536 (1985); *Hercules Inc. v. Aetna Cas. & Sur. Co.*, 92C-10-105, 1998 WL 962089 (Del. Super. Sept. 30, 1998).

## ***MORE ON REASONABLY RELATED TEST***

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### ■ Common Formulation of Test:

- The insurer must pay all defense costs that benefited the defense of the covered claim, even if those costs also benefitted the defense of the non-covered claim.
  - *Cont'l Cas. Co. v. Bd. of Educ. of Charles Cnty.*, 302 Md. 516 (1985).

### ■ Burden of Proof:

- Some courts require the insured to prove that costs are reasonably related.
- Insurer may have to prove the appropriate allocation when it has refused to defend.

## ***EXPRESS ALLOCATION PROVISIONS***

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- Many policies now contain express allocation provisions.
- Representative allocation provision:  
“The Insureds and the Carrier shall use their best efforts to allocate such amount between covered Loss and uncovered loss based upon the relative legal and financial exposures of the parties to covered and uncovered matters.”

## ***TIPS FOR MINIMIZING COVERAGE DISPUTES***

- Evaluate applicable policy language and negotiate for most favorable terms during policy placement and renewal:
  - Provision that 100% of the defense costs will be allocated to covered claim.
  - Provision allowing for negotiation with respect to allocation of indemnity costs to be paid for a mixed claim.
  - Provision obligating insurer to pay all indemnity costs it agrees are allocable to covered claim, and a specified percentage of additional, disputed costs pending resolution of dispute.
- Set up separate billing numbers for costs unrelated to defense of covered claims.
- Communicate early and often about defense coverage for “mixed” claim.
- Consider need to provide allocation of settlement amount in settlement agreement.
- Consider need for special verdict form and jury interrogatories if case involves “mixed” claims that need to be tried.

# *Compliance with Billing & Litigation Guidelines*

# ***INSURER LITIGATION GUIDELINES***

- Guidelines may include case planning, strategy, tactics, and expenditures.
  - Example of Litigation Guidelines:  
[http://www.zurichna.com/zna/onlineservices/online\\_customer/customer\\_services/management\\_guidelines.htm](http://www.zurichna.com/zna/onlineservices/online_customer/customer_services/management_guidelines.htm)
- Types of guidelines:
  - How many lawyers can work on a matter;
  - Number of lawyers that may attend depositions, court hearings, etc.;
  - Time that may be spent on research and drafting documents;
  - Restrictions on expenses for travel and photocopying;
  - Restrictions on reimbursement for internal communications;
  - Pre-approval required to perform specified tasks.

## ***CONSULTATION WITH ADJUSTER***

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- Consultation by independent counsel
- Panel counsel may defer to adjuster's desires if no substantial risk to insured.
  - Restatement Sec. 134, cmt. *f*.
- Independent counsel need not defer

## ***LITIGATION GUIDELINES & PRIOR APPROVAL***

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- Adjusters usually do not overrule counsel recommendations, but want input on expense and want to integrate defense strategy with settlement strategy
- Forces counsel to think harder about cost/benefit
- But there may be issues for defense counsel if prior approval requirement could affect insured's defense

## ***BUDGETARY DECISIONS***

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- Right to defend includes right to make budgetary decisions
- Duty of competent representation
- Independent counsel and adequate resources
- Budgetary decisions that threaten insured's interests trigger duties to insured

## **ABA 01-421**

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- Tell insured at outset about adjuster role
- If adjuster rejects recommended action and insured's interests may be threatened, seek reconsideration, possibly from supervisor
- If adjuster unmoved, consult with policyholder
- If policyholder does not consent to adjuster's direction, seek leave to withdraw

## *In re Rules of Prof'l Conduct*

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- Requirements of prior approval forbidden in Montana
- Colloquy at argument indicates that requirements of consultation permissible

# ***Extra-Contractual Recoupment of Defense Costs***

# *The Insurer's Right of Reimbursement*

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- Liability insurers defend potentially covered claims.
- Insurers may seek reimbursement if it turns out that a claim ultimately was not covered or potentially covered.
- The law is mixed on whether and when an insurer may obtain reimbursement.

# *Unjust Enrichment?*

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- "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, § 35(1) (2011).

## ***Only Applies Where No Duty To Defend***

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- *But see Buss v. Superior Court*, 16 Cal. 4th 35, 46-53 (1997) (allowing recoupment of costs for defending non-covered claims in "mixed action"); *compare id.* at 62-66 (dissenting on this point).
- No other jurisdiction has followed CA on this point.

## ***Requires Reservation of Rights***

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- Performance must be rendered “under protest or with reservation of rights.”
- Prevents insured from relying on apparent finality of payment.

## *Courts Divided*

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- Yes: 7 states; federal court of appeals predictions for 4 states, federal district court predictions for 10 states.
- No: 9 states; federal court of appeals predictions for 4 states; federal district court predictions for 5 states.
- Mixed: 3 states/territories; federal district court predictions

# *Unjust Enrichment Analysis*

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- Party who receives performance not required by contract is unjustly enriched.
- But voluntary payment cannot be recovered.
- Payment is not voluntary if paying party faces greater liability if refusal of payment found erroneous and timely judicial resolution not available.

## *Analysis Applied*

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- If defense incorrectly denied, insured may default, defend ineptly, or settle generously on a nonrecourse basis, all magnifying cost beyond simple belated payment of defense costs.
- Except in Wisconsin, almost never possible to get duty to defend resolved before defense must be provided or refused.

## *Arguments for Recoupment*

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- Allowing recoupment encourages insurers to defend in doubtful cases.
- Insured always gets entitlement: a free defense when due.
- Insured also gets benefit of a free loan for defense costs when defense wasn't due.

# *Arguments Against Recoupment*

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- Existence of contract precludes unjust enrichment claim.
- If insurer wants right to recoup, should say so in the contract.
  - *See* RESTATEMENT OF THE LAW OF LIABILITY INSURANCE, § 25(2) (Prop. Final Dr. No. 1 Mar. 28, 2017).
- Insurer defends for its own benefit, so insured is not unjustly enriched.
- Reservation of rights can't create new contract.

# *Arguments Against Recoupment*

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- Allowing recoupment is contrary to policyholder reasonable expectations.
- Duty to defend does not expire until a court determines that the claim is not covered.

## *Further Reading*

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- Arguments on both sides are fully developed, with a full survey of decisions on both sides in WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION (2d ed.), § 2.11, adapting Sherilyn Pastor & William T. Barker, *Recoupment of Defense Costs for Noncovered Claims* (2012).

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