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New York Federal Court Rules Insurer Cannot Recoup Defense Costs

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PRACTICAL POLICYHOLDER ADVICE

The duty of an insurer to defend its policyholder is construed broadly, while a policyholder's reimbursement of defense costs paid by its insurer where an insurer is later deemed not liable for coverage (i.e., recoupment) is viewed narrowly. A recent New York federal court decision demonstrates yet another instance of a court requiring that recoupment must be bargained-for and agreed to by both the insurer and its policyholder. New York courts will permit recoupment only if (a) the policy contains specific language providing for recoupment or (b) the policyholder agrees to an insurer's request for recoupment. Not all courts, however, take such a policyholder-friendly view of recoupment. If an insurance policy does not contain a recoupment provision, many insurers will issue a reservation of rights letter asserting a right of recoupment or seeking a policyholder's approval of the right to recoupment. A policyholder should thus be sure to clearly and explicitly reject such an attempt in writing when confronted with it.

Many insurance policies provide both for the duty to indemnify as well as the duty to defend. New York law views an insurer's duty to defend as extremely broad and compels an insurer to come forward to defend its insured no matter how groundless, false, or baseless a suit may be. Thus, an insurer may be contractually bound to defend even though it may not ultimately be bound to indemnify. In response, some insurers request recoupment from a policyholder for defense costs paid for claims that are later deemed to be outside of coverage. New York law had been unclear on whether such recoupment was appropriate or permitted under circumstances where policy language did not provide for recoupment and where a policyholder had resisted recoupment requests by its insurer.

Earlier this year, in *General Star Indemnity. Co. v. Driven Sports, Inc.*, 14-CV-3579, 2015 WL 307017 (E.D.N.Y. Jan. 23, 2015), the United States District Court for the Eastern District of New York addressed whether New York law would permit an insurer to recoup defense costs paid for claims that were excluded from its policy, where the policy did not specifically provide for recoupment. The Court recognized that New York law had not addressed the issue and thus predicted that New York state courts would find recoupment to be inappropriate because (1) the insurance policy did not provide for recoupment and (2) the policyholder was not unjustly enriched. *Id.* at *14-18.

The insurance policy at issue in *General Star* provided that the insurer, General Star, would afford certain liability coverage for it policyholder, Driven Sports, as well as defend against any suits. Specifically, the policy stated that General Star "will pay, with respect to any claim we investigate or settle or any 'suit' against an insured we defend: ...[a]ll expenses we incur." *Id.* at *2. The policy did not contain any provision regarding recoupment or General Star's ability to recoup on claims that fell outside of the policy's coverage.

In late 2013, Driven Sports was sued by multiple claimants for false advertising and misrepresentation about its product "Craze." *Id.* at *3. General Star agreed to defend these actions, but proposed that Driven Sports sign a

"non-waiver and defense funding agreement" that would have required Driven Sports to repay any defense costs for claims that were determined to be outside of coverage. *Id.* at *4. Driven Sports rejected General Star's offer. *Id.*

Both General Star and Driven Sports moved for summary judgment on General Star's obligations to defend. The Court held that the claims against Driven Sports clearly fell under a Failure to Conform Exclusion, such that General Star was no longer required to defend. *Id.* at *6. Accordingly, General Star argued that it should be entitled to recoup its costs in defending Driven Sports in the underlying – and now uncovered – actions. The Court ruled that recoupment was not permitted for two main reasons.

First, the Court reasoned that the insurance policy terms provided no recoupment rights. *Id*. at *15. The Court explained that General Star "could have contracted for a right to seek recoupment, but it did not do so;" thus, according to New York law, the Court was obligated to "interpret the Policy as it is written in keeping with an average insured's reasonable expectations." *Id*. at *15.

Second, the Court reasoned that General Star's "quasi-contract" argument based on unjust enrichment should not overcome the lack of specific policy terms allowing for recoupment. *Id.* The Court stated that while New York law generally precludes unjust enrichment claims where a contract is clear on a topic, even if such a claim could be made here, equity and good conscience permitted Driven Sports to retain the defense costs provided by General Star. *Id.* at *16. According to the Court, General Star should not be relieved from its own deliberate failure to provide for recoupment in its policy during negotiations. *Id.* Further bolstering the Court's reasoning was the fact that Driven Sports had flatly rejected General Star's request for recoupment after claims had been made. *Id.* And adding a recoupment term to the policy after the fact would be contrary to an average policyholder's reasonable expectations at the time of contracting. *Id*.

In granting summary judgment in favor of Driven Sports on the recoupment issue, the Court distinguished cases cited by General Star. In those cases, while each policy at issue did not contain a provision for recoupment, the policyholder had failed to oppose the insurer's request for recoupment. *Id.* at *17.

General Star is a very favorable decision for policyholders who have received defense coverage for claims that are later determined to fall outside of liability coverage. Where the language of a policy does not clearly provide an insurer with recoupment rights, a policyholder should be sure to explicitly reject in writing any attempts by an insurer to assert such a right.

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