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Federal District Court in Virginia Denies Recoupment of Defense Costs for Uncovered Claims Under Contract for General Liability Insurance

The U.S. District Court for the Eastern District of Virginia refused to “blaze a new trail in Washington insurance law” and create an entitlement for insurers to recoup defense costs incurred while defending uncovered claims. See *Zurich Am. Ins. Co. v. Public Storage*, No. 1:09cv1394 (E.D. Va. filed Sept. 17, 2010).

Background

Zurich American Insurance Co. (“Zurich”) brought a declaratory judgment action against Public Storage in federal court in Virginia seeking a determination of its duty to defend Public Storage in an ongoing Virginia state court action. At the same time, Zurich continued to defend Public Storage under a reservation of rights in the underlying lawsuit. The court determined that Zurich was obligated to defend only one of eight claims in the underlying action because, under controlling Washington law, an insurer has a duty to defend only claims that potentially are covered under the policy. Accordingly, the court ruled that Zurich was required to defend only the one covered claim, while Public Storage was responsible for defending the remaining seven claims.

Decision of the Court Concerning Recoupment of Defense Costs

Zurich argued that it was entitled to recover defense costs and fees it incurred defending the seven uncovered claims. The court looked to Washington insurance law to resolve the issue. The court determined, however, that Washington courts have not addressed whether an insurer may recover from its insured costs expended defending uncovered claims. The court further determined that courts in jurisdictions that have addressed the issue are split on whether the costs may be recovered. Thus, the court concluded that it would be “inappropriate to blaze a new trail in Washington insurance law for which there is absolutely no invitation in the prior cases.” Accordingly, the court denied Zurich’s request for recovery of its defense costs incurred in defending the seven uncovered claims.

Other Recent Decisions Concerning Recoupment of Defense Costs

The decision by the Eastern District of Virginia is consistent with recent decisions from other courts on this same issue. For instance, the Supreme Court of Pennsylvania recently joined the growing number of courts rejecting an entitlement for insurers to recoup defense costs. See

American & Foreign Ins. Co. v. Jerry's Sport Ctr., Inc., 2 A.3d 526 (Pa. 2010). In that case, the insurers sought reimbursement of defense costs incurred in defending their insured, Jerry's Sport, in an underlying action for which it was ultimately determined that there was no duty to defend. The insurers' request for recoupment of defense costs was rejected.

There, the court reasoned that, under Pennsylvania law, the insurers' duty to defend was not based solely on the outcome of the declaratory judgment action. Rather, under Pennsylvania law, an insurer must defend its insured for claims that are potentially covered under the policy. Further, the court explained that the declaration that the insurers did not owe Jerry's Sport a defense did not retroactively "nullify its initial determination that the claim was potentially covered." As such, the insurers could not rely on the

subsequent declaration as a basis for recouping their defense costs. The court likewise rejected the insurers' attempt to obtain recoupment based on their reservation of rights letters, which specified that the insurers retained the right to seek recoupment if the claim was found to be uncovered. The court rejected that argument, finding that the insurers could not create a new contract through their reservation of rights letters. To allow the insurers to do so would be "tantamount to allowing the insurer[s] to extract a unilateral amendment to the insurance contract[s]."

Finally, the court rejected the insurers' argument that they were entitled to recover defense costs under an unjust enrichment theory. This argument failed because, as the court explained, the insurers had both a right and a duty to defend Jerry's Sport. Moreover, the court noted that by defending, as they were obligated to do, the

insurers protected themselves from a bad faith claim. Thus, the court concluded that permitting the insurers to recover the costs they were obligated to expend would be akin to requiring the insured to pay for the insurers to protect their own interests.

Implications

The *Public Storage* and *Jerry's Sport* decisions are illustrative of how a growing number of jurisdictions have refused to permit insurers to recoup defense costs expended on claims that are ultimately found not to be covered. Policyholders and insurers should be mindful of the apparently changing climate on this issue. Thus, in addition to being determined by the particular policy language at issue, the availability of recoupment may be determined or substantially affected by the jurisdictional law governing the insurer's duty to defend.

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