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The Right of Reimbursement – Can Counsel Be Forced to Disgorge Uncovered Defense Payments?

From virtually the dawn of insurance time, insurers, attorneys, and of course, the courts have struggled with how to equitably balance competing interests which arise when a suit triggers a duty to defend, but also contains counts, causes of action, or legal claims which inarguably are outside the ambit of coverage. It would seem that some sort of mathematic apportionment would suffice to resolve the issue, but that is not often the case as work and expense by counsel is generally, and even properly, overlapping.

The evolving trend has been to have a full defense be provided to the insured by the carrier, and then an apportionment and reimbursement made at case's end. This places the carrier in the position of being an involuntary lender of defense expense, with no certainty of an actual, rather than a theoretical, right of recoupment.

It is, of course, easier, when the insured has dual counsel, one paid by it to pursue affirmative claims, and a separate counsel to provide a defense to a cross or counter claim.

It is more complicated when independent counsel selected by the insured is defending the claim, and when the defense costs skyrocket.

<u>The Conundrum Posed by "Mixed Claims"</u>

I. Historical Antecedents

The duty to defend, being generally recognized as broader than the duty to indemnify, has led to insurers being compelled to defend lawsuits and claims that contain clearly non-covered allegations. The courts have long struggled with the concept. On the one hand, the insured is entitled to its bargained-for contractual rights, on the other hand, so is the insurer. In the event a non-covered claim is defended, there is, accordingly, an unanticipated windfall. Sometimes it inures to the benefit of the insured, other times, to counsel retained to defend the insured. Thus, a line of cases has established that defense counsel has a tripartite relationship with both the insured and the insurer that a carrier must, in the first instance, afford a full defense, and lastly, a carefully drafted reservation is required to secure reimbursement for costs incurred in defending uncovered claims. Generally, the reimbursement is obtained from the insured, but recently, insurers have gone after counsel whom they believe have engaged in overbilling.

A. A suit containing both covered and uncovered claims has always presented a challenge

1. The issue posed by a broad duty to defend – all claims alleged in a single suit are swept up into the duty to defend. Thus, clearly non-covered claims have to be defended as well, even when they are the gravamen of the dispute. Most savvy attorneys determine whether they want to involve the insurer, given the risk of a well-funded defense balanced with the chance to recover against a known source of funds, e.g., the policy limits, and proceed accordingly.

2. How Courts have grappled with the duty in mixed claims – the courts have long ago resolved the question that mixed claims must all be defended.

3. How Courts have resolved carrier rights arising from the duty to defend mixed claims – over time, several remedies have evolved for the insurer. The first is coupled with the obligation to retain independent counsel when a reservation of rights or non-waiver would cause panel counsel to have an ethical conflict, mechanisms have evolved to cap rates and resolve fee disputes. See, e.g., Cal. Civ. Code 2860, the so-called "Cumis" statute. The second is a line of cases allowing for allocation and recoupment of non-covered defense expense. See, e.g., Buss v. Superior Court, 16 Cal. 4th 35 (1997); see Okada v. MGIC Indem. Corp., 823 F.2d 276, 282 (9th Cir. 1986) [D&O policy: "If an action against the directors incorporates both covered and uncovered claims [e.g., claims against the corporation], the parties must apportion the costs so that MGIC need only pay for amounts generated in defense of covered claims"].

B. The Dawn of Reimbursement

1. Over the past 20 years, courts have begun to seriously deal with reimbursement issues. This is likely sparked by a rise in suits that generally did not encompass 'garden variety' CGL-type claims such as business torts, economic claims, employment claims and intellectual property and trade secret disputes.

2. Preservation of the right of reimbursement requires a precise reservation of rights. Whether the recoupment is attorneys' fees and other defense costs or indemnity for settlement of non-covered claims (see, Travelers Property Cas. Co. of America. V. Hillerich & Bradsby Co., Inc. (6th Cir., 2010) 598 F. 3d 257), a timely and express reservation of rights, other appropriate notification to the insured (e.g. insurers intent to accept settlement offer) and offer to the insureds that they may instead assume their own defense if they disagree)

3. The courts have held that acceptance of a conditional defense by an insured is enforceable by the insurer. e.g., Colony Ins. Co. v. G & E Tires & Serv., Inc., 777 So. 2d 1034, 1039 (Fla. Dist. Ct. App. 2000). But see American and Foreign Ins. Co. v. Jerry's Sport Center (2010) 606 Pa. 584, 2 A. 3d 526 for a different result.

II. Recent Decisions Allow Reimbursement From Counsel

A. General Principles Applicable to Fee Disputes With 'Independent Counsel'

Courts and legislatures have fashioned some long existing remedies to provide relief and curbs on billing excesses by independent counsel.

1. Standards, experience, rate caps – one method of curbing excesses has been to impose limits on who can serve as independent counsel, as well as limiting their hourly rates to those usually paid in the locale in which the claim arises.

2. Mechanisms for dispute resolution over billings – in the event a fee dispute arises, an ADR mechanism has been applied to resolve disputes before they spill over into extra contractual or other types of litigation. These provide both an immediate and available remedy as well as a relief valve when utilized in good faith by both sides to the dispute.

B. Alternate Theories For Proceeding Directly Against Counsel

1. Unjust enrichment – in the recent case of Hartford Ins. Co. v. J.R. Marketing, LLC 190 Cal. Rptr. 3d 599, 2015 WL 4716917, 15 Cal. Daily Op. Serv. 8727, 2015 Daily Journal D.A.R. 9111 (Cal. 2015), the California Supreme Court allowed a carrier to proceed directly against defense counsel instead of the insured on an unjust enrichment theory to recoup excess expenditures. The case stands on unique facts, as expressly recognized by the Court – the trial court in finding a duty to defend in a prior declaratory relief action expressly ordered that the carrier would have a right to seek reimbursement. After the defense was completed, the carrier sued defense counsel directly seeking recoupment of fees paid for uncovered defendants and uncovered claims. The California Supreme Court "conclude[d] that, given the facts of this case [i.e., a court order expressly preserving the insurer's post-litigation right to recover "unreasonable and unnecessary" amounts billed by counsel] and within the limits discussed below, such a right of reimbursement should run directly against *Cumis* counsel.

   The court soundly rejected defense counsels' assertions that allowing recovery on unjust enrichment theories would run afoul of contract law, public policy, constitutional and procedural issues, or that they should be limited to an action against the insured. The standard, though, is "'[W]hether the charges were *objectively reasonable at the time they were incurred,* under the circumstances then known to counsel.'" "[T]he burden to prove that *Cumis* counsel's fees were in fact unreasonable and unnecessary falls entirely on the insurer."

2. Malpractice – courts have also allowed direct suits against defense counsel for malpractice. However, it is questionable whether independent counsel may be sued for malpractice, and while a suit may be brought, the carrier may face issues in trying to prove both causation and damages in the underlying case. For instance, if a case needed to be resolved, it is difficult to prove how much more was paid in settlement due to the misfeasance or malfeasance of counsel, or that counsel affected the "bad facts" of the claim to any extent whatsoever.

III. The Takeaway

In the event of runaway defense expenses and costs, the ability to recover will be dependent on the carrier's timely, express and explicit and detailed reservation of rights to recoupment for non-covered claims, and an ability to carry the evidentiary burden of demonstrating the fees and costs paid counsel were not reasonable and necessary by an objective standard. In the event of gross and demonstrable misfeasance, such as failure to conduct discovery or prepare for trial, an action for breach of professional legal obligation might be an option.