

# Insurer May Recoup Defense Costs Absent Duty to Defend; Reservation of Rights Preserves Right to Recoup Costs

---

December 2003

The Supreme Court of the Territory of Guam, applying Guam law, has held that where a professional liability policy obligates an insurer to advance defense costs, but does not impose a duty to defend, the insurer may recoup defense costs for allegations "for which there was no possibility of coverage." *Nat'l Union Fire Ins. Co. v. Guam Hous. & Urban Renewal Auth.*, 2003 WL 22497996 (Guam Terr. Nov. 4, 2003). The court also held that the right to recoup costs was preserved by a unilateral reservation of rights that was timely made, and specifically notified the policyholder that the insurer may seek reimbursement of defense costs.

The insurer had issued a public officials and employees liability insurance policy to a governmental agency. The policy provided that "[w]ith respect to any such Wrongful Act for which insurance is afforded by this policy...the Company shall, as part of and subject to the limits of liability, pay on behalf of the Insured Defense Costs, Charges and Expenses." The policy also stated that the insurer had "the right but not the duty to assume the defense of any claim or suit against the Insured." The policy excluded coverage for "any Wrongful Act committed with knowledge that it was a Wrongful Act"; "claims alleging...malicious acts"; "any claim seeking non-pecuniary relief"; "any awards...of back salary or wages"; and "fines, penalties, or punitive, exemplary or multiplied damages."

The coverage action arose from three wrongful termination lawsuits filed by former employees of the agency, who alleged that the agency violated their constitutional and statutory rights and breached their employment contracts. The first two lawsuits sought compensatory, treble and punitive damages, reinstatement of the employees to their former positions and back pay commencing from the date of termination. The third lawsuit requested reinstatement, back pay, interest and costs. After the first lawsuit was filed, the insurer agreed as an accommodation to defend and reserved the insurer's right to withdraw from the defense and to "seek reimbursement of defense costs incurred [in] defending claims for which there is no potential for coverage." The insurer subsequently agreed to defend the second and third lawsuits, but did not issue a further reservation of rights. After the three lawsuits were dismissed, the insurer sought reimbursement for defense costs incurred in the three actions. Coverage litigation ensued.

The court initially explained that under the terms of the policy, the insurer did not have a duty to defend, but instead had an obligation to pay defense costs for claims "for which there was a possibility of coverage." However, since the insurer did not have a duty to defend, it could seek to recoup defense costs for claims for which there was no possibility of coverage.

The court then reviewed the counts in the complaints to determine which ones were potentially covered. The court held that the insurer had a duty to pay defense costs related to the claims in the first two lawsuits that the agency had violated the employees' constitutional rights, holding that the exclusion for "any Wrongful Act committed with knowledge that it was a Wrongful Act" did not preclude coverage for the constitutional claims, even though the claims required proof of more than negligence. The court reasoned that the plain language of the exclusion precluded coverage only for "intentional acts which were done with appreciation of [their] wrongfulness," and not for acts that were merely intentional. The court stated that neither the employees' constitutional claims nor almost any other possible causes of action required such proof, but opined that if the insurer "intended the exclusion to cover intentional acts, it could have drafted the exclusion more precisely." The court also concluded that the breach of contract counts in the first two lawsuits were "more properly viewed as one[s] to vindicate constitutional rights," and consequently held that the defense costs related to these counts were covered. However, the court concluded that the policy precluded coverage for back pay and wages, reasoning that since the policy exclusions precluded coverage for "awards" of such amounts and not specifically for "claims" seeking these amounts, the policy necessarily precluded coverage for counts whose sole relief requested is excluded. The court also held that the exclusion for "fines, penalties, or punitive, exemplary or multiplied damages" precluded coverage for the employee's treble damages request. The court noted that even though the remainder of the exclusion allowed coverage for up to \$25,000 of punitive damages "where permitted by law," this provision did not apply because punitive damages were non-recoverable in suits against governmental entities.

The court next held that the insurer did not have a duty to pay defense costs for the employees' demands for reinstatement and back pay. The court first reasoned that injunctive relief did not qualify as "damages" under the policy, and that the policy specifically precluded coverage for any non-pecuniary relief. Moreover, "to the extent that back pay is considered damages," the court held that the back pay and wages exclusions precluded coverage. Finally, the court concluded that even though the plaintiffs sought punitive damages in the first two lawsuits and the policy excluded coverage for malicious acts and punitive damages, coverage for these lawsuits was not precluded because the lawsuits potentially could also have resulted in covered compensatory or nominal damages. The court held that no coverage was afforded for the third lawsuit because the plaintiffs sought only reinstatement and back pay, which were excluded by the policy.

The court then held that the insurer had preserved its right to recoup defense costs in a reservation of rights letter. Relying heavily on the decision by the United States Court of Appeals for the Sixth Circuit in *United National Insurance Co. v. SST Fitness Corp.*, 309 F.3d 914 (6th Cir. 2002), the court concluded that "the use of a unilateral reservation of rights letter is appropriate to apprise the insured of the fact that it cannot accept the windfall of defense costs for which it was not entitled to under the Policy." In so holding, the court reasoned that the insured had no reasonable expectation of coverage for defense costs that relate to claims that "are

not potentially covered," and thus had a duty to reimburse the insurer for such amounts which the insurer advanced under a sufficient reservation of rights. The court explained that a reservation of rights protected this interest when made "in a timely and explicit manner" with "specific and adequate notice of the possibility of reimbursement." The court further noted that although the insurer's reservation of rights acknowledged only the first lawsuit, the insurer had reserved its right to recoupment with respect to all three lawsuits because the letter met the necessary criteria and "was broad enough to extend to all suits involving the claims raised in [the first lawsuit.]" In so holding, the court reasoned that the first lawsuit's claims "were the exact same claims in the later two suits," and that it would be "disingenuous" for the agency to claim that it was not notified of the insurer's position with respect to the latter two suits after having received the insurer's reservation of rights letter and accepted the insurer's defense.

Finally, the court remanded the case to the trial court to determine whether the insurer could demonstrate which portion of the defense costs were attributable to non-covered claims, and whether the insurer had made its claim for reimbursement from the agency within the relevant deadlines imposed by Guam's Claims Act.

For more information, please contact us at 202.719.7130.