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Insurer Entitled to Unilaterally Reserve the Right to Recoup Amounts Paid for Defense and Settlement If It Prevails on Merits of Coverage Dispute

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The United States District Court for the District of Arizona has held that under Arizona and California law an insurer may unilaterally reserve the right to recoup amounts paid in defending and settling an underlying action if it later prevails in a coverage dispute with the insured. *Phillips & Associates, P.C. v. Navigators Ins. Co.*, No. CV-10-781-PHX-DGC (D. Ariz. Feb. 11, 2011). Wiley Rein LLP and Meagher & Geer, PLLP, represented the insurer in this case.

An insurer issued a lawyer's professional liability policy to a law firm. The insured law firm tendered a lawsuit alleging legal malpractice to the insurer, for which the insurer provided a defense and later settled. The insurer's defense and settlement of the underlying action was subject to a reservation of rights, including a reservation of the insurer's right to seek recoupment of any amounts paid if it were determined that the policy afforded no coverage for the underlying action. The law firm initiated a coverage action seeking a declaration that the policy afforded coverage for the underlying action, and the insurer filed a counterclaim to rescind the policy or, alternatively, seeking a declaration that the policy afforded no coverage for the underlying action due to alleged material misrepresentations on the insurance application.

The insurer and the law firm disputed whether the insurer was entitled to seek reimbursement for settlement amounts and defense costs it had paid should it prevail in the coverage dispute. Ruling on cross-motions for partial judgment on the pleadings, the court concluded

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that both Arizona and California recognize that the right to recoup is proper, absent bad faith and if the insurer gives notice of its reservation of rights to the insured. The court found that the insurer "provided the Insureds with express notice of its reservation [of the right to seek recoupment] both at the time it accepted the Insureds' defense and at settlement." Further, the court noted that such a reservation protected the insurer against the unjust enrichment of the insured and furthered public policy interests by providing for the settlement of cases – and therefore compensation to the injured party – where coverage may be uncertain.

The court rejected the law firm's arguments that the insurer lost the right to contest coverage when it settled the underlying action. The court cited *Blue Ridge Ins. Co. v. Jacobsen*, 22 P.3d 313 (Cal. 2001), with approval and agreed that it would violate "basic notions of fairness" to force insurers to indemnify non-covered claims by allowing the settlement of a claim to waive insurers' coverage positions.

In addition, the court found that the law firm's reliance on *United Services Automobile Association v. Morris*, 741. P.2d 246 (Ariz. 1987), to argue that Arizona law favored preventing the insurer from controlling the conditions of payment and favored the protection of the insured was misplaced. The court noted that it was undisputed that the law firm demanded that the insurer settle the underlying action within policy limits, that the insurer then settled the underlying action within policy limits, and that the law firm consented to the settlement amount, all while the law firm knew that the insurer would seek reimbursement if it were determined that the settlement was not covered. As such, the law firm did not need protection "from the sharp thrust of personal liability" contemplated in *Morris*. The court also stated that Texas cases relied upon by the law firm to argue that an insurer cannot unilaterally reserve its right to seek reimbursement were unpersuasive.

Finally, the court rejected the law firm's argument that, with respect to California law, *Blue Ridge* was not controlling law because the insurer had not expressly offered the law firm an opportunity to assume the defense. The court noted that the law firm signed a waiver of its right to seek independent counsel, was aware of the insurer's reservation of the right to recoup well in advance of the underlying settlement, and did not disagree with the insurer on whether to accept the settlement. Accordingly, the insurer had satisfied all prerequisites to seeking reimbursement under *Blue Ridge*.

The court therefore granted the insurer's motion for partial judgment on the pleadings and denied the law firm's cross-motion for partial judgment on the pleadings.