

“The New Majority Trend: Insurers Can't Recoup Defense Costs From Their Policyholders,” *Bloomberg Law*

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Copyright 2023 Bloomberg Industry Group, Inc. (800-372-1033) Reproduced with permission. The New Majority Trend: Insurers Can't Recoup Defense Costs From Their Policyholders

In an article for *Bloomberg Law*, Partner Brian Scarbrough and Associate Michael Pearson discuss the emerging trend of courts holding that there is no right to reimbursement of defense costs for non-covered claims.

The authors write, “when the policyholder and the insurer disagree about whether the policy covers the defense in a specific case, another court battle can ensue.” They reference a recent Eleventh Circuit case predicting Georgia law, *Cont'l Cas. Co. v. Winder Lab'ys, LLC*, which offers a forceful rejection of pro-reimbursement rationales.

The authors also write, “policyholders should consider whether to respond and object in writing to any insurer’s assertion of a right to recoup defense costs.”

Litigation can be expensive, and often parties have insurance policies providing a defense and covering defense costs. But when the policyholder and the insurer disagree about whether the policy covers the defense in a specific case, another court battle can ensue.

In one common scenario for policyholders, an insurer provides the policyholder with a defense and pays the policyholder's defense costs, but a court later determines that the insurer had no obligation to do so under its policy. The insurer, who provided the defense under a reservation of its rights to disclaim coverage later, now seeks reimbursement from the policyholder for defense costs the insurer paid prior to the no-coverage ruling.

In the absence of an express contractual right to recoupment, will the policyholder be on the hook to reimburse the insurer for its defense costs? According to what previously has been characterized as the “majority rule,” the answer is “yes”—the policyholder must reimburse the insurer, especially if the insurer defended under a reservation of rights.

However, courts and commentators have noted a growing trend in favor of the opposite rule, rejecting a right of recoupment for the insurer unless the parties expressly contracted for that right. This anti-recoupment trend is supported by a growing body of case law from state high courts and from federal courts predicting state law under *Erie*, including a recent decision from the Eleventh Circuit. Policyholders should be aware of this trend and its implications for recoupment or reimbursement disputes.

The Former “Majority” Rule – Policyholders Must Reimburse Insurers

Courts that have adopted the “majority” rule allowing recoupment of defense costs have generally justified the rule either by applying a theory of unjust enrichment or by finding that a policyholder's acceptance of an insurer's defense under a reservation of rights creates an implied-in-fact contract. Several cases refer to this rule as the majority position. See, e.g., *United Nat. Ins. Co. v. SST Fitness Corp.*, 309 F.3d 914, 921 (6th Cir. 2002) (predicting Ohio law); *Gen. Agents Ins. Co. of Am. v. Midwest Sporting Goods Co.*, 215 Ill.2d 146, 166 (Ill. 2005) (adopting the “minority” position); *Cont'l Cas. Co. v. Indian Head Indus., Inc.*, 666 F. App'x 456, 468 (6th Cir. 2016) (predicting Michigan law).

A seminal case allowing reimbursement under an unjust enrichment theory is *Buss v. Superior Ct.*, 16 Cal. 4th 35, 939 P.2d 766 (Ca. 1997), a decision by the California Supreme Court. In *Buss*, the court affirmed a ruling that an insurer was entitled to reimbursement of defense costs for claims not covered under its policy, despite the fact that the policy itself did not provide the insurer with such a reimbursement right.

According to the court in *Buss*, the insurer had not bargained to pay, and the policyholder had not paid premiums in consideration for, the defense of the uncovered claims. The insurer's right to reimbursement for these costs was thus implied under the law of restitution and did not need to be made explicit in the insurance policy. According to the court, to hold otherwise would unjustly enrich the policyholder by requiring the insurer to pay costs it had never agreed to pay.

Other courts have permitted reimbursement on the theory that the policyholder's acceptance of the insurer's defense, when accompanied by the insurer's reservation of rights, creates a new implied-in-fact contract between the parties including the reservation. *United Nat. Ins. Co. v. SST Fitness Corp.*, 309 F.3d 914 (6th Cir. 2002), a case predicting Ohio law, is representative of this approach.

In *United National*, the insurer defended its policyholder in a patent infringement action after sending a letter reserving the right to recoup defense costs in the event of a no-coverage determination. The policyholder did not expressly accept this condition of defense, but it did accept the insurer's payment of defense costs.

The *United National* court interpreted the policyholder's acceptance of defense costs as acceptance of the condition, finding that the parties had entered into a new contract in which the insurer “offered defense costs subject to potential reimbursement and [the policyholder] accepted that

offer by accepting the defense costs.” The court stated that, at the time, most jurisdictions took the same approach, allowing insurers to recoup defense costs when the insurer “1) timely and explicitly reserve[d] its rights to reimbursement; and 2) provide[d] sufficient notice of the specific possibility of reimbursement.”

The Emerging Trend – Policyholders Need Not Reimburse Insurers

More than 20 years later, the winds are shifting. A recent Eleventh Circuit case predicting Georgia law, *Cont'l Cas. Co. v. Winder Lab'ys, LLC*, 73 F.4th 934 (11th Cir. 2023), offers a forceful rejection of the pro-reimbursement rationales described above and illustrates the emerging trend of courts holding that there is no right to reimbursement of defense costs for non-covered claims.

In *Continental Casualty*, the insurers defended their policyholder against a false advertising claim after issuing a reservation of rights that included a reimbursement provision. The court rejected the insurers’ claim for reimbursement after a no-coverage finding, ruling that the reservation of rights letters failed to create a new contract between the parties and that the insurers were not entitled to reimbursement of defense costs under an unjust enrichment theory.

The court first found that the insurers’ reservation of rights letters did not create a new contract under Georgia law for the simple reason that they offered no new consideration in exchange for the reimbursement provision. The court rejected the insurers’ argument that the offer to provide a defense constituted consideration, finding that the existing insurance policies already required the insurers to provide such a defense and that the letters thus promised nothing more than performance of a preexisting contractual duty.

The court also rejected the insurers’ unjust enrichment argument, finding that there was nothing unjust about holding the insurers to their contractual obligation to provide a defense before a no-coverage determination was made. The court added that the insurers’ defense had not provided the policyholder with any “one-sided enrichment” because the insurers also benefited from their choice to defend under a reservation of rights. By defending, the insurers avoided the risk of liability that could accompany a breach of their duty to defend and maintained their reputation, among other things.

The Restatement of the Law of Liability Insurance expands on this point, pointing out that insurers receive other substantial benefits by agreeing to defend when coverage is uncertain. For example, a defending insurer, depending upon the policy language and coverage position, is able to maintain control over the quality, cost, and strategy of the defense; may obtain access to defense-related materials; and may participate in settlement discussions. All of these provide important benefits to the insurer.

The *Continental Casualty* court closed by predicting that the Georgia Supreme Court would not establish a right to reimbursement for an insurer based on a reservation of rights letter. Notably, the court explicitly rejected the insurer's characterization of the pro-reimbursement approach as the

“majority” rule, finding that “[t]his description of a ‘majority rule’ may have been correct in the past, but it is not an accurate depiction of the current case law, which appears to be more or less in equipoise with the recent trend favoring the ‘no recoupment’ rule.”

To demonstrate this trend, the court referenced the Restatement of the Law of Liability Insurance, which in 2019 noted a trend away from the old “majority position” and adopted the view rejecting a right of recoupment for the insurer unless that right is established in an express contract.

Practical Considerations for Policyholders

Policyholders should be aware of this trend and keep in mind the following practical considerations.

- First, because the law on this issue varies substantially from state to state and is evolving rapidly, it is crucial to stay abreast of the case law (both from state and federal courts) for the state law most likely to apply to any coverage issues or reimbursement claims. It is also important to review existing policies to determine whether they already contain any applicable reimbursement provisions and to be aware of insurer attempts to add reimbursement language to policies during renewal.
- Additionally, a policyholder who receives a reservation of rights letter from its insurer should examine it closely and consider whether the letter adequately explains to the policyholder that the insurer may seek reimbursement. In some jurisdictions, an insurer is entitled to reimbursement only if its reservation of rights letter adequately and specifically notifies the policyholder that reimbursement is possible.
- Finally, policyholders should consider whether to respond and object in writing to any insurer's assertion of a right to recoup defense costs. At least one court has ruled against reimbursement of defense costs when a policyholder accepted the insurer's defense but explicitly noted its rejection of the reservation of rights letter's terms.

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