

New York Appellate Division: Second Department Contradicts First Department, Denying Insurer's Recoupment of Defense Costs for Uncovered Claims.

New York law has historically allowed insurers to recoup defense costs paid on behalf of an insured if there is ultimately no coverage for the underlying action, provided that the insurer reserved its rights to seek reimbursement. On December 30, 2020, the New York Appellate Division, Second Department declined to follow this longstanding principle in American Western Home Insurance Co. v. Gjonaj Realty & Mgt. Co.,¹ by holding that the insurer was not entitled to recoup defense costs, even where it was determined that the claim was not covered under the insurance policy.

In *American W. Home Ins. Co.*, the insureds were named as defendants in an underlying personal injury action. More than four years after the accident, and a \$900,000 default judgment against the insureds, they tendered the lawsuit to their commercial general liability insurer, American Western Home Insurance Company ("American"). American denied coverage based on untimely notice, but after the default judgment was subsequently vacated, it agreed to defend the underlying action subject to a reservation of rights. The reservation of rights specifically reserved American's right to deny coverage if the vacatur of the default judgment against the insureds was reversed. Further, American reserved its right to recover the costs of defending the underlying litigation.

After that, the Appellate Division, First Department reversed the lower court's order and reinstated the judgment against the insureds. American then denied coverage and commenced an action seeking a declaration that it was entitled to recover the defense costs it incurred in the underlying action. The lower court found for American, holding that it was entitled to recoupment.

On appeal, the Appellate Division, Second Department, affirmed that the insurers owed no duty to defend or indemnify based on the insureds' late notice. However, the court reversed the First Department's decision on the issue of recoupment. Recognizing the long-held principle that an "insurer's duty to defend is broader than the duty to indemnify," the court clarified that this principle could not create a remedy beyond the policy's express terms. Since the policy did not contain any provision permitting the insurer to seek reimbursement of defense fees, it was not permitted to do so.

Expressly declining to adopt other New York federal and appellate courts' interpretations, the Second Department held that an insurer's "unilateral" reservation of rights could not create an implied right to reimbursement of legal fees. Public policy weighs against allowing an insurer to recoup defense costs separately because "doing so would allow an insurer to define its duty to defend based upon the outcome of a declaratory judgment action and significantly curtail New York's long-held view that the duty to defend is broader than the duty to indemnify."²

¹No. 2018-03435, 2020 WL 7767944 (2d Dept Dec. 30, 2020).

²Id. at 5.

Moreover, the court rejected the insurer's equitable unjust enrichment claim, finding that this type of claim, relying on quasi-contract, is not permitted when an express contract governs the dispute. The insurer cannot bind itself, and the insured to a contract and then seek unjust enrichment for its own failure to draft the policy adequately. Even if unjust enrichment were an available remedy, the court saw no grounds to claim it based on the insurer's broad duty to defend. When the insured's default judgment was initially vacated, the insurer's legal obligation to defend was triggered. Therefore, the insureds were not unjustly enriched by a defense to which they were entitled.

The Second Department's holding contradicts several cases decided by the First Department,³ creating an interpretive split between the Appellate Divisions. New York's highest court has yet to weigh in on the issue. Still, until it resolves the divide between the Departments, insurers seeking recovery of defense costs, without express policy provisions, will not prevail in the Second Department. In light of this decision, there is a possibility that insurers may be compelled to avoid the Second Department. Additionally, insurers may also attempt to add policy language that expressly allows for recovery of defense costs when there is no coverage for an underlying claim.

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³See *Certain Underwriters at Lloyd's London Subscribing to Policy No., PGIARK01449-05 v. Advance Transit Co.*, 132 N.Y.S.3d 621 (1st Dept 2020); *Am. Home Assurance Co. v. Port Auth. of New York & New Jersey*, 89 N.Y.S.3d 81 (1st Dept 2018); *Certain Underwriters at Lloyd's London Subscribing to Policy No. SYN-1000263 v. Lacher & Lovell-Taylor, P.C.*, 975 N.Y.S.2d 870 (1st Dept 2013).