Alert

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COZEN O'CONNOR

New York Appellate Court: Liability Insurer Cannot Recover Defense Costs Absent Express Policy Provision

Given the breadth of the duty to defend, liability insurers often must defend insureds against claims that do not ultimately trigger the duty to indemnify. In some states, an insurer can offer a defense under a reservation of rights, to later withdraw and recover its defense costs once it is determined that there is no coverage for the claim.

New York may not permit this type of recovery. According to a recent New York appellate court decision of first impression, an insurer may not recover defense costs in the event that there are no covered claims, even if it has reserved the right to do so, unless the policy explicitly provides for such recovery. S*ee American W. Home Ins. Co. v. Gjonaj Realty & Mgt. Co.*, 2018-03435, 2020 N.Y. App. Div. LEXIS 8286 (2d Dept., Dec. 30, 2020).

In that case, Victor Gecaj allegedly fell off a defective ladder and sued the building owner and property manager, both insureds under a liability policy issued by insurer American Western Home Insurance Company. In October 2014, Gecaj secured a $900,000 default judgment against the insureds. Thereafter, the insureds notified the insurer of Gecaj's accident. The insurer denied coverage based on late notice. The judgment was later vacated, and the insurer agreed to defend the insureds, but reserved its right to deny coverage if it discovered that it had been prejudiced by the delay. Ultimately, the default judgment was reinstated and the insurer denied coverage again based on late notice, this time reserving the right to recover its defense costs. The insurer filed a declaratory judgment action seeking to recover its defense fees.

In its recent decision, the Second Department agreed with the insurer that there was no coverage, but disagreed that the insurer was entitled to recover defense costs, offering the following rationale.

First, the court outlined the broad duty to defend, and the corollary principal, that an insurer may have a duty to defend but no duty to indemnify. It held that allowing the insurer to recover past defense costs "effectively would make the duty to defend merely coextensive with the duty to indemnify."

Second, the court rejected previous New York state and federal cases allowing insurers to recover defense fees, finding "none of the above cases addresses the issue of whether recouping defense costs was opposed by the insured on appeal." The court also pointed out that "some of the federal courts — interpreting New York law — appear to be shifting course on that issue," *citing Century Sur. Co. v. Vas & Sons Corp.*, 17-cv-5392, 2018 U.S. Dist. LEXIS 151209 (E.D.N.Y.). The court agreed with the holding of *Century Sur.*, that it was inappropriate for an insurer to recover defense costs where the policy provided a duty to defend but had no express provision for recovery of defense costs.

Third, the court reiterated that general contract principles apply to insurance policies, including the principle that contracts must be enforced as written. Again, the policy had no provision for recovery of defense costs. Had the insurer wanted to include such a provision it could have done so.

Fourth, the court held that an insurer's reservation of the right to recover defense costs was "unilateral [and] cannot create rights not contained in the insurance policy." To award an insurer recovery based on such a reservation "flies in the face of basic contract principles and allows an insurer to impose a condition on its defense that was not bargained for" and "amounts to a pro tanto supersession of the policy without a separate agreement and separate consideration."

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Finally, the court held that the insurer could not pursue an unjust enrichment theory because such a *quasi*-contractual remedy is unavailable under New York law when there is an *actual* agreement governing the subject matter. In any event, unjust enrichment creates an obligation imposed by equity and fairness. But "equity and fairness weigh against allowing the insurance company to obtain reimbursement of its defense costs because an insurer benefits unfairly if it can hedge on its defense obligations by reserving its right to reimbursement while potentially controlling the defense and avoiding a bad faith claim from its insured."

New York's highest court has yet to weigh in on the issue. Because only the Second Department has ruled, the decision is currently binding on New York trial courts. Other Appellate Departments are not bound by the decision, but may find it persuasive.

The bottom line is that in New York, if an insurer wants to recover its defense fees when there is ultimately no duty to indemnify, it should consider including such a provision in the policy.