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High court decision enforces insurance companies' duty to defend policyholders

■ *Insurance companies who defend a lawsuit cannot seek reimbursement of defense costs from the insured, even when it turns out the insurer didn't have a legal duty to defend the case in the first place.*

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For the second time in as many months the Washington Supreme Court has decided an important insurance case, siding once again with the insureds, and ruling against the position taken by the insurance industry.

The new case declares that insurance companies who defend a lawsuit cannot seek reimbursement of defense costs from the insured, even when it turns out the insurer didn't have a legal duty to defend the case in the first place.

Almost all liability policies promise not only to pay any judgments or settlements relating to covered claims, they also promise to defend the insured.

Washington courts have previously ruled that the insurance defense benefit is much broader than the indemnity benefit, because any claim that is even potentially covered by an insurance policy triggers the insurer's obligation to defend the claim. That means the insurer must pay the legal costs for a defense until such time as the insurer can "rule out the potential" that the underlying claim is covered under the policy.

The defense benefit is frequently more valuable to the insured than whatever indemnity the policy may provide because defense costs are often a more immediate financial concern than the ultimate liability may be. In many instances, businesses may win the ultimate suit filed against them, but the costs of getting there would be overwhelming without insurance.

The Supreme Court's recent decision stemmed from liability insurance policies purchased by Immunex.

In 2001 Immunex told its insurer that Immunex was facing claims for allegedly inflated wholesale drug pricing. Although Immunex was ultimately named in 23 different lawsuits, it didn't tender defense of those suits to its insurer until 2006. At that point the insurer had to decide whether claims in the underlying cases were potentially covered, and therefore whether it owed a defense to Immunex.

Washington law already places powerful incentives on insurers to be careful when deciding whether they should provide a defense, even of claims for which coverage is doubtful. If the insurer refuses to defend and is later found to have owed a defense, the insurer may be liable not only for the costs of defense but also for paying any settlement or judgment on the underlying claim, even if coverage for the underlying liability was excluded by the policy.

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Because any decision not to defend a case could cause damage to both the insurer and the insured, Washington law allows the insurer to defend under a reservation of rights to pull out of the defense and deny coverage altogether.

When the insurer invokes this option, it defends until such time as it can establish that its insurance policy does not actually cover the underlying liability. At that point the insurer can terminate its defense and deny coverage for any judgment or settlement.

Once Immunex tendered the 23 lawsuits to its insurer, the insurer agreed to defend under a reservation of its rights to later deny coverage. But the insurer also declared that it would have the right to reimbursement of what it spent toward Immunex's defense if it later determined that the insurance did not cover the underlying claims. It did so even though its policy did not expressly grant this right.

Ultimately the insurer established that its insurance did not cover the claims against Immunex. At that point the insurer asserted a right to reimbursement of defense benefits it had promised to pay, and that its reimbursement rights protected it against liability for any defense costs that the insurer had agreed to pay or that Immunex had itself incurred.

In a close 5-4 decision, the Washington Supreme Court rejected that position. The court ruled that the insurer had no right to reimbursement of any defense benefits that the insured was entitled to under the policy, including all defense expenses incurred before the insurer established that its policies excluded coverage for the underlying claims.

A critical aspect of the court's reasoning was that the insurance policies did not express any right for the insurer to recoup defense costs from the insured, so the court refused to give the insurance company the benefit of a provision that the insurer hadn't written into the policies and that the insured therefore hadn't agreed to.

The upshot of this new Supreme Court decision is that policyholders who learn they face liability claims should carefully consider whether their liability insurance offers any potential for coverage, and therefore whether tender to their insurer would entitle them to a paid defense. The normal rule of thumb is to tender if there is any possibility the claims would implicate insurance.

The Immunex case gives insurance companies strong incentives to be cautious about denying a defense to their insured, and to do so only when the policy terms and the nature of the claim make it virtually certain that the insured has no prospect of coverage.

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