

First Circuit Limits Insurers' Right to Recoup Defense Costs or Settlement Payments

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Weighing in on an issue that has divided courts nationwide, the U.S. Court of Appeals for the First Circuit has ruled that an insurer under Massachusetts law has no right to recoup defense costs, or amounts the insurer pays in settlement – even if the insurer reserves rights prior to payment and obtains a ruling, after the fact, that no defense or indemnity was owed. *Berkley Natl. Ins. Co. v. Atlantic-Newport Realty LLC*, No. 22-1959, 2024 U.S. App. LEXIS 4115 (1st Cir. Feb 22, 2024) (“*Granite Telecomm*”). However, the First Circuit rested its ruling on narrow procedural grounds, which may prolong the controversy rather than resolve it.

The insureds in *Granite Telecomm* owned a company cafeteria. They were sued by a food service worker who suffered a foot infection after being exposed to bacteria during a sewage backup. They sought coverage from their insurer, Berkley. Berkley argued that coverage was barred by a fungus and bacteria exclusion in the policy. The insureds disagreed. They threatened suit under M.G.L. ch. 93A, and demanded that Berkley defend the case.

Eventually Berkley agreed to defend, but reserved rights “to bring an action for declaratory relief to be relieved of any continuing obligation.” It said, “[p]ending the receipt of such a determination, [it would] provide a full defense ... and [would] pay all reasonable costs and fees associated with [the] defense.”^[1] In April 2021, Berkley filed an action for declaratory judgment, seeking a ruling that no defense was owed.

In the meantime, the parties to the underlying case had scheduled a mediation. One week before the mediation, the insureds insisted in a letter that Berkley “must make reasonable settlement offers to [the injured claimant] without any contribution from the Defendants.” Berkley complied with the insured’s demand. It reached a settlement with the claimant. It offered to split the settlement payment with the insured, but the insured refused. Berkley then amended its declaratory judgment complaint, reiterating its belief that the claims were not covered, and requesting restitution of the amounts it had paid in settlement and defense.

On the issue of coverage, the trial court granted summary judgment for Berkley.^[2] It found the fungus exclusion applied, and no defense or indemnity was owed. As to the question of recoupment, the trial court noted the Massachusetts courts had not yet squarely addressed “whether an insured may seek reimbursement” for a settlement of un-covered claims, or “for the costs of a defense undertaken pursuant to a unilateral reservation of rights.”^[3] Nonetheless, the court allowed recoupment, on a theory of unjust enrichment. It based its ruling, in part, on a finding that “defendants’ unfair behavior in forcing Berkley to defend the [underlying] lawsuit [bore] a flavor of extortion,” and “[a]llowing defendants to retain the benefit of Berkley’s defense coverage would be manifestly unjust.”^[4]

The First Circuit reversed the trial court’s decision. Adopting a narrow view of *Med. Malpractice Joint Underwriting Ass’n of Mass. v. Goldberg*,^[5] and distinguishing a later SJC ruling, *Metro. Life Ins. Co. v. Cotter*,^[6] the court found Massachusetts law allowed an insurer to seek reimbursement of settlement payments only in the three narrow circumstances *Goldberg* identified:

- when the insured agreed to the insurer’s right to seek reimbursement; or
- when the insured gave “specific authority” to the insurer to “reach a particular settlement” which the insured itself agreed to pay; or

- when the insurer told the insured of a “reasonable settlement offer,” and gave the insured “an opportunity to accept the offer or assume its own defense,” and the insured refused.^[7]

In this case, the First Circuit found Berkley had not followed the precise steps *Goldberg* set out. In particular, Berkley had not advised the insured, at mediation, that it considered the plaintiff’s settlement offer reasonable, and it had not given the insured “an opportunity to accept the offer or assume its own defense.” By failing to go through these precise procedural steps, the First Circuit suggested, Berkley lost the right to seek recoupment of the settlement payment.

As to the recoupment of defense costs: the First Circuit found this right – to the extent it existed – could only be exercised after “an express reservation of the right to seek reimbursement.”^[8] It found Berkley’s reservation letter fell short of an “express reservation.” Although the letter reserved Berkley’s rights to “to bring an action for declaratory relief to be relieved of any continuing obligation to provide a defense,” the letter did not specifically address a right to seek recoupment of defense costs once those costs were paid.^[9]

Insurers in Massachusetts will want to study *Granite State* carefully for guidance on how best to preserve recoupment rights. In drafting reservation of rights letters, they will want to expressly reserve the right to seek reimbursement of defense costs. In settling cases they believe are not covered, they will want to adhere closely to the *Goldberg* protocols the First Circuit laid out.

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^[1] *Id.* at *4.

^[2] *Berkley Nat’l Ins. Co. v. Granite Telecomm., LLC*, 617 F. Supp. 3d 77 (D. Mass. 2022).

^[3] *Id.* at 84.

^[4] *Id.* at n. 3.

^[5] 425 Mass. 46, 680 N.E. 2d 1121 (Mass. 1997).

^[6] 464 Mass. 623, 984 N.E.2d 835 (2013).

^[7] 2024 U.S. App. LEXIS 4115 at *18, citing *Goldberg* at 1129. The third of these procedures – i.e., offering the insured “an opportunity to accept the offer or assume its own defense” – appears to be the procedure the insurer followed in *Blue Ridge v. Jacobsen*, 25 Cal.4th 489 (2001).

^[8] 2024 U.S. App. LEXIS 4115 at *33, citing *Lexington Ins. Co. v. CareCore Nat’l, LLC*, 2014 (Mass. Super. LEXIS 200, at *12-13 (Mass. Super. July 18, 2014). (“[a]lthough some jurisdictions outside of Massachusetts have concluded that an insurer may recoup [defense] costs, they have so held only where the insurer ... made it clear to the insured, either in the policy itself or in its reservation of rights, that it retains the right to seek reimbursement of those costs if a court later determines there was no duty to defend.”).

^[9] 2024 U.S. App. LEXIS 4115 at *4. The First Circuit did not address, and seems to have ignored, the district court’s suggestion that the insureds’ extortionate conduct rendered such an outcome “manifestly unjust.”

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