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NEWSLETTER

Reservation of Right to Recoup Defense Expenses Entitles E&O Insurer to Reimbursement When Court Determines No Duty to Defend

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A federal district court in Minnesota, predicting Texas law, has held that an E&O insurer that reserved its right to recoup defense costs prior to undertaking the defense of an underlying action was entitled to reimbursement of defense expenses where it was later determined that it had no duty to defend the suit, despite the fact that its policy did not expressly provide for reimbursement. *St. Paul Fire & Marine Ins. Co. v. Compaq Computer Corp.*, 2005 WL 1648684 (D. Minn. July 13, 2005).

The insurer issued a multicover package policy to a company, which contained three discrete insuring agreements, including technology errors and omissions liability protection (tech E&O coverage). The underlying claimants brought a class action lawsuit against the company alleging, *inter alia*, violations of the Computer Fraud and Abuse Act of 1986. The insurer accepted the company's tender of the claim and initially acknowledged its apparent duty to defend under the tech E&O coverage, subject to a reservation of rights. The insurer sent a second reservation of rights letter prior to paying any defense expenses, in which it reserved the right "to withdraw from [the company's] defense . . . and seek recovery of all fees and expenses incurred in this matter, if it is later determined there is no coverage or duty to defend." The insurer then made several payments to the company for defense expenses. The insurer later withdrew from the defense and obtained a declaratory judgment in state court that it had no duty to defend the company in the underlying action. The insurer then commenced the instant action seeking reimbursement for the amounts it spent defending the company.

Relying on *Matagorda County v. Texas Association of Counties County Government Risk Management Pool*, 975 S.W.2d 782 (Tex. App. 1998), the district court predicted that the Texas Supreme Court would apply the doctrine of *quantum meruit* to permit the insurer to recoup its defense expenses. Under Texas law, a party may recover in *quantum meruit* when: (1) valuable services or materials were furnished, (2) to the party sought to be charged, (3) which were accepted by the party to be charged, (4) under such circumstances as reasonably notified the recipient that the plaintiff, in performing, expected to be paid by the recipient. With respect to the first three elements, the court determined that payment of defense expenses was a "valuable

service" furnished by the insurer and accepted by the company. By clearly and unequivocally reserving its right to recover those expenses should it later be determined there was no duty to defend, the court held, the insurer "reasonably notified" the company that it expected to be paid for those services.

The court rejected the company's argument that Texas courts would not permit an insurer to recover defense expenses under a unilateral reservation of rights when no such right is created by policy language. The court noted that the Texas Supreme Court recently held in *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, 2005 WL 1252321 (Tex. May 27, 2005), that in certain circumstances, unilateral conduct of the insurer can give rise to a right of reimbursement. The court concluded that unilateral acts that satisfy the elements of *quantum meruit*, like the insurer's second reservation of rights letter, fall within the *Frank's Casing* rule.

The court also rejected the company's voluntary payment and judicial estoppel arguments. Relying on *HS Resources, Inc. v. Wingate*, 327 F.3d 432 (5th Cir. 2003), the court noted that "a payment made with a reservation of the right to bring suit for recovery is not a voluntary payment." The court also held that regardless of what the insurer argued before the state courts in its declaratory judgment action, those courts determined that it was not obligated to defend the company before or after the filing of claimants' second amended complaint in the underlying action. The court concluded that the insurer therefore was not estopped from arguing in the instant matter that it had no duty to defend the company prior to claimants' filing of their second amended complaint.

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