

Commercial Insurance

Commercial Liability

Deductibles

Turning Full Circle: Seeking Reimbursement of Insurer Advances for Large Deductibles

Contributed by Charlotte E. Thomas and Myles A. Seidenfrau, Duane Morris LLP

Large deductible insurance policies provide many advantages, particularly for large, financially secure employers.¹ They have the essential components of self-insurance, given per occurrence deductibles that typically range between \$100,000 and \$1,000,000,² while at the same time provide the financial assurance of the insurer. Large deductible policies require claims payments to be advanced by the insurer,³ thereby allowing the insured to forego the usual bonding requirement of true self-insurance. Moreover, since claims payments within the deductible limit are subject to reimbursement by the named insured, the insured pays a substantially reduced premium.⁴

Despite contractually shifting risk for claims to the insured, the insurer remains primarily liable for defense and indemnification.⁵ The insurer's right to reimbursement under large deductible

policies is just that - a right to claim over against the named insured.⁶ To be sure, most carriers require collateral from the insured to secure the reimbursement obligation.⁷ In addition, many large deductible endorsements authorize cancellation of the policy for failure to reimburse amounts advanced by the insurer. Occasionally, claims exceed reasonable expectations and exhaust the collateral. The cancellation right provides little leverage if the insured has changed carriers or if reimbursement is sought for ongoing claims. Accordingly, litigation may ensue if an insured refuses to reimburse the insurer.

Reimbursement as a cause of action is an offshoot of subrogation law. Instead of the typical subrogation claim that seeks repayment of money paid out on a policy from the party at fault, reimbursement seeks to recover payment from the person to or for whom payment was made.⁸ Increasingly, insureds with large deductible and other loss sensitive policies⁹ refuse to pay the insurer advances, claiming *inter alia*, that insurers have mismanaged their claims responsibilities so as to raise the ultimate cost to the insured. Insureds may refuse to reimburse the insurer for amounts paid within the deductible limit or affirmatively assert the mishandling of claims as a cause of action for damages.

Claims and Defenses Based on Contract Theories

Insurer claims for reimbursement hinge upon the insurer's rights under the policy, and thus both the insurer's claim and the insured's defenses should sound in contract. However, the line between duties established by contract and tortious duties in the insurance context can be vague, and not all states agree that claims between insured and insurer are limited to the insurance policy or other agreement relating to large deductibles.

Originally published by Bloomberg Finance L.P. in the Vol. 5, No. 7 edition of the Bloomberg Law Reports—Commercial Insurance. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

This document and any discussions set forth herein are for informational purposes only, and should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Review or use of the document and any discussions does not create an attorney-client relationship with the author or publisher. To the extent that this document may contain suggested provisions, they will require modification to suit a particular transaction, jurisdiction or situation. Please consult with an attorney with the appropriate level of experience if you have any questions. Any tax information contained in the document or discussions is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. Any opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content in this document or discussions and do not make any representation or warranty as to their completeness or accuracy.

An insured may claim it owes less than the amount sought by the insurer, or indeed owes the insurer nothing, because the insurer or its delegate mishandled claims. Had the insurer properly handled claims - the argument goes - claims expenses and losses would have been less costly and the insured should not be responsible for some or all of the amounts advanced for claims by the insurer.

Whether such claims or defenses can be asserted, however, depends in the first instance on the language of the policy.¹⁰ For example, where the policy requires that claims be “properly” handled, an action and/or defense for improper claims handling will lie.¹¹ If claims investigation and payment is left to the discretion of the insurer, however, the insured may be without a contract-based theory.¹²

Insureds have challenged an insurer’s right to reimbursement of deductibles advanced on an implied contract basis. Most states recognize implied covenants of good faith in contractual arrangements, and an insurer’s duty to act in good faith emanates from such an implied covenant in the policy.¹³ But, turnabout is fair play, and an insured also may owe a duty to act in good faith to the insurer.¹⁴ Some states hold that the implied duty to act in good faith cannot be breached apart from the contract provisions it modifies, and therefore does not provide an independent basis for liability.¹⁵

Claims and Defenses Based on Tort Theories

A majority of states have adopted the economic loss doctrine, which limits tort damages where malfeasance results in economic loss as opposed to personal injury or property damage.¹⁶ In theory, the economic loss doctrine or gist of the action doctrine should preclude tort recovery where the parties negotiated a particular contractual arrangement and the tortious duties are contrary to the terms of the contract between insurer and insured.¹⁷ Some states, however, have ruled that the availability of contract remedies does not preclude recovery in tort where an independent tort duty exists between the parties.¹⁸

Most states do not recognize a fiduciary duty by the insurer to the insured, although in some loss sensitive policies courts have recognized a duty independent of the policy to act in good faith.¹⁹ The duty to act in good faith requires that an insurer act reasonably and in good faith in defending and settling claims.²⁰

Some states have grappled with the bad faith doctrine²¹ against insurers in loss sensitive insurance programs. Bad faith claims typically involve exposure to insurers above policy limits where the insurer failed or elected not to settle in bad faith, thereby exposing the insured to liability above policy limits.²² In the context of large deductibles, insureds have, with varying degrees of success, asserted insurer “bad faith” for handling claims in disregard of the insured’s rights and economic interests.²³

Annual Aggregate Limits

Many large deductible programs limit the insured’s ultimate exposure for claims administration in a given policy year, thereby providing a significant distinction between large deductible policies and true self-insurance. The aggregate limit may be a set number, but it also may be a function of adjusted final payroll, final audited premium, or some other calculated amount. Accordingly, some insureds argue in litigation involving loss sensitive policies that the limit of their exposure may be lower based on a recalculation of these numbers.²⁴

Ultimately, this is just a numbers game, and the calculation of the aggregate limit only changes the damages ceiling. Accordingly, insurers should be in a position to document the calculation, including not only the actual numeric calculation, but any documentary bases for the calculation such as the adjustment based upon audited premium.

Unsigned Endorsements

One argument advanced by insureds in litigation involving large deductibles is that the large deductible endorsement was not signed by the insured.²⁵ Although endorsements calling for a signature should be signed, the reality of insurance placement is that they often are not.²⁶ Failing to enforce an unsigned endorsement will materially alter the intended arrangement between insured and insurer. Since premium for large deductible policies is significantly discounted, ruling that such an endorsement is unenforceable is tantamount to policy reformation.

Many courts have enforced unsigned endorsements. In *Crews v. National Boat Owners Association Marine Insurance Agency, Inc.*,²⁷ the Alabama Supreme Court ruled that an arbitration endorsement was enforceable even though it was unsigned by either the insurer or the insured. The Court reasoned that an “unsigned endorsement is valid if it is attached to the policy and is referenced in the policy.”²⁸ The Court added that the Endorsement in bold print stated that it changed the policy and should be carefully read, thus the insured manifested his intent to be bound by the endorsement by reading it and not exercising his right to cancel the policy.²⁹ Other courts have enforced an insurance agreement in the absence of execution by signature finding that a party “by his acts and conduct, assent[s] to contract terms and become[s] bound by them even though he has not signed the contract, if it is clear that his contract relates to the specific contract in question.”³⁰

State Approval of Large Deductible Endorsement Forms and Rates

Large deductible endorsement forms and premium rates must be approved by the various state insurance regulators, and at least one state requires that forms be submitted to a rating agency prior to regulatory approval.³¹ Some insureds in

actions for reimbursement of large deductibles claim that form endorsements are unenforceable because they were not properly approved by state regulators.

The effect of the failure of the insurer to submit and obtain approval of forms by the applicable state regulatory agency depends upon the applicable state law. A majority of states have concluded that the failure to obtain regulatory approval of the form does not render the endorsement unenforceable, but might subject the insurer to an administrative penalty.³² Other states have ruled that the failure to follow mandatory review and pre-approval with state insurance regulators can render the endorsement unenforceable.³³ Although regulatory violations may not directly create a private right of action³⁴ or affirmative defense,³⁵ it may provide a factual premise for claims or defenses under a state's unfair trade practices law.³⁶

Where the insured's challenge relates to regulatory approval of an insurer's rates, some courts have required exhaustion of administrative rating remedies prior to allowing a private cause of action to proceed.³⁷ Other courts have concluded that the failure to obtain approval of rates does not necessarily render the rate unlawful.³⁸ Indeed, an insured that has enjoyed coverage benefits under a large deductible policy may be hard-pressed to challenge its reimbursement obligation based upon the failure to obtain rating approval. The Second Circuit rejected an insured's attempt at avoiding its premium obligation in *In re Ionosphere Clubs, Inc.*,³⁹ in which the insured challenged the premium owed from a loss sensitive worker's compensation policy due to alleged regulatory rate violations. The Court found that "once a party accepts the proceeds and benefits of a contract, that party is estopped from renouncing the burdens the contract places upon him."⁴⁰

Litigation Over Large Deductible Endorsements

Litigation concerning large deductible endorsements can be costly if claims handling is challenged. Depending on the number of claims involved, discovery of claims handling procedures may involve voluminous documentation and electronically stored information.⁴¹ Moreover, any insured claiming improper claims handling will have to retain an expert with respect to the alleged improper way the claims were investigated and/or paid.⁴² Put simply, this type of defense is costly, and where possible, it may be wise to engage in mediation or arbitration if the dispute is incapable of resolution.

Conclusion

In this economic climate, large deductible policies have retained their allure. By the same token, the economic stresses on marginal businesses prompt insureds to challenge an insurer's right to seek reimbursement of large deductible advances. While courts endeavor to enforce the original intent of the parties, the rights and remedies of insured and insurer may vary depending upon the jurisdiction reviewing the insurance relationship.

Charlotte E. Thomas is a partner in the Trial Practice Group of Duane Morris LLP in Philadelphia. She practices in the area of complex business litigation, including securities and broker-dealer litigation, class action disputes, alternative dispute resolution and insurance and financial institutions insolvencies. She can be reached at cthomas@duanemorris.com.

Myles A. Seidenfrau is an associate in the Trial Practice Group of Duane Morris in Cherry Hill, N.J. He is a trial lawyer representing clients in commercial disputes and counseling them on various matters such as fraud, contract rights, securities disputes, insurance issues, unfair competition and products liability. He can be reached at mseidenfrau@duanemorris.com.

¹ Although large deductible insurance policies are primarily used to insure workers compensation exposures, they are also used to insure other commercial exposures, such as general liability and business auto.

² Deductibles differ from self-insured retentions in that a deductible amount is subtracted from the policy limits while full policy limits are available after the retention has been satisfied. *Hartford Fire Ins. Co. v. Terra Ins. Co.*, No. 01-5961, 2004 BL 3104, *8-9 (E.D. Pa. Aug. 2, 2004), citing *Richmond, D., Issues and Problems in "Other Insurance" Multiple Insurance, and Self-Insurance*, 22 Pepp. L. Rev. 1373, 1449 (2002).

³ *Ceradyne, Inc. v. Argonaut Ins. Co.*, No. G039873, slip op. at 3 (Cal. Ct. App. June 2, 2009) (the court described the mechanism as "amounts paid on claims under the deductible amount are paid by [the insurer], but reimbursed by [the insured] by way of a deposit account required and maintained by [the insurer].")

⁴ *Liberty Mut. Ins. Co. v. Precisionaire, Inc.*, No. 8:00-CV-1971, 2006 BL 48692 (M.D. Fla. Apr. 7, 2006).

⁵ *SEC v. Huff*, 745 F. Supp. 2d 1284, 1384, 1305 (S.D. Fla. 2010) (the insurer "bears the ultimate responsibility for ensuring that legitimate claims are paid, regardless of whether the insured eventually reimburses the carrier").

⁶ See *Barletta Heavy Div., Inc. v. Layne Christensen Co.*, No. 07-12084-DPW, 2011 BL 97880 (D. Mass. Apr. 13, 2011) (noting that generally the named insured is responsible for the reimbursement of large deductibles to the insurer).

⁷ *Huff*, 745 F. Supp. 2d at 1305.

⁸ 16 Lee R. Russ and Thomas F. Segalla, *Couch On Insurance 3d* § 226.1 (West Group Publishing 2000).

⁹ Loss sensitive policies are policies the overall cost of which to the insured is affected by the amount of loss paid out by the insurer. See *Arch Ins. Co. v. R.A. Bright Constr., Inc.*, No. 07-CV-5060, 2009 BL 115194 (N.D. Ill. May 28, 2009). Two examples are large deductible policies and retrospectively rated premium adjustment policies.

¹⁰ *American Prot. Ins. Co. v. Airborne, Inc.*, 476 F. Supp. 2d 985, 990 (N.D. Ill. 2007) ("an insured cannot complain that such a provision inevitably allows an insurer to commit an insured's funds – the policy deductible – without the insured's consent, because that is exactly the bargain that the insured struck under the policy that it bought and paid for").

¹¹ *Atlas Res., Inc. v. Liberty Mut. Ins. Co.*, No. 09-CV-1113, 2010 BL 145839 (D.N.M. June 24, 2010).

¹² *Methodist Hosp. v. Zurich Am. Ins. Co.*, 329 S.W.3d 510, 522-25 (Tex. Ct. App. 2009).

¹³ *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171 (Wis. 1986); *American Prot. Ins. Co. v. Airborne, Inc.*, 476 F. Supp. 2d 985 (N.D. Ill. 2007).

¹⁴ *Transit Cas. Co. v. Spink Corp.*, 156 Cal. Rptr. 360 (Cal. Ct. App. 1979).

¹⁵ *Cone Fin. Group, Inc. v. Employers Ins. Co. of Wausau*, No. 7:09-CV-118, 2010 BL 188044 (M.D. Ga. Aug. 13, 2010); but see *Atlas Res.*, 2010 BL 145839 (breach of the implied covenant sounds in both contract and tort).

¹⁶ *Fireman's Fund Ins. Co. v. Childs*, 52 F. Supp. 2d 139, 142 (D. Me. 1999).

¹⁷ *Methodist Hosp.*, 329 S.W.3d 510 (Tex. App. Ct. 2009).

¹⁸ *Cone Fin. Group, Inc. v. Employers Ins. Group of Wausau*, No. 09-CV-118, 2010 BL 262088 (M.D. Ga. Nov. 4, 2010).

¹⁹ *Liberty Mut. Fire Ins. Co. v. Cagle's Inc.*, No. 1:10-CV-2158-TWT, 2010 BL 298602 at *4-6.

²⁰ *Id.*

²¹ Depending on the state, bad faith claims can sound in tort or contract, and many states have enacted statutes governing such bad faith claims. See, e.g., *Birth Ctr. v. St. Paul Cos., Inc.*, 787 A.2d 376 (Pa. 2001). The damages available and statute of limitations in litigation may be impacted by the legal theory of the bad faith alleged.

²² *Roehl Transp. Inc. v. Liberty Mut. Ins. Co.*, 784 N.W.2d 542, 550-51 (Wis. 2010).

²³ See, e.g., *Cas. Ins. Co. v. Town & Country Pre-Sch., Inc.*, 498 N.E.2d 1177 (Ill. App. Ct. 1986), citing *Marginian v. Allstate Ins. Co.*, 481 N.E.2d 600 (Ohio 1985); *Orion Ins. Co. v. Gen. Elec. Co.*, 493 N.Y.S. 2d 397 (N.Y. Sup. Ct. 1985). Compare *Roehl Transp.*, 784 N.W.2d at 553-55, with *Am. Home Assurance Co. Inc. v. Hermann's Warehouse Corp.*, 563 A.2d 444 (N.J. 1989).

²⁴ See *Reliance Ins. Co. v. Safeharbor Emp'r Servs. I, Inc.*, No. 6:04-CV-1236, 2006 BL 41450 (M.D. Fla. Mar. 24, 2006) (challenging the underlying data for the calculation of retrospective premium due).

²⁵ Increasingly, insurers are not requiring that insureds sign such endorsements.

²⁶ See, e.g., *Playtex FP, Inc. v. Columbia Cas. Co.*, 609 A.2d 1087 (Del. Super. Ct. 1991).

²⁷ 46 So. 3d 933 (Ala. 2010).

²⁸ *Id.* (citing *Greene v. Hanover Ins. Co.*, 700 So. 2d 1354, 1357 n.3 (Ala. 1997)).

²⁹ *Id.*

³⁰ *All Am. Roofing, Inc. v. Zurich Am. Ins. Co.*, 934 N.E.2d 679, 693 (Ill. App. Ct. 2010).

³¹ See, e.g., 10 Cal. Code Reg. § 2218 (requiring submission to a rating agency prior to approval by insurance regulators).

³² *Great Lakes Container Corp. v. Nat'l Union Fire Ins. Co.*, 727 F.2d 30, 32 (1st Cir. 1984); *Urrutia v. Decker*, 992 S.W.2d 440, 443-44 (Tex. 1999); *Protective Ins. Co. v. Coleman*, 494 N.E.2d 1241 (Ill. App. Ct. 1986); *Cage v. Litchfield Mut. Ins. Co.*, 713 A.2d 281, 284-89 (Conn. Super. Ct. 1997) (noting that "the majority of jurisdictions which have addressed this issue have concluded that the failure to file the policy or endorsement does not render it invalid").

³³ *Ceradyne, Inc.*, No. G039873 (Cal. Ct. App. June 2, 2009) (unapproved arbitration clause unenforceable).

³⁴ *Specialty Ins. Agency, Inc. v. Royal Indem. Co.*, No. 00-2482 (E.D. Pa. Mar. 22, 2002).

³⁵ *Banque Indosuez v. Pandeff*, 603 N.Y.S.2d 300, 303 (N.Y. App. Div. 1993).

³⁶ *Bristol Hotels & Resorts v. NCCI*, No. E027037 (Cal. Ct. App. Mar. 13, 2002).

³⁷ *Continental Cas. Co. v. First Fin. Emp. Leasing, Inc.*, 716 F. Supp. 2d 1176 (M.D. Fla. 2010) (exhaustion required by statute).

³⁸ *Bristol Hotels & Resorts*, (ruling that forms must be approved but that "an unfiled rate is not an unlawful rate unless and until the commissioner conducts a hearing and disapproves the rate.").

³⁹ 85 F.3d 992, 999-1000 (2d Cir. 1996).

⁴⁰ *Id.* at 1000.

⁴¹ See, e.g., *Republic Servs., Inc. v. Liberty Mut. Ins. Co.*, No. 03-494, 2006 BL 104159 (E.D. Ky. Oct. 2, 2006) (noting the difficulty of proving improper claims handling, administration, and management in 7740 claims and denying judicial notice of statistical sampling method).

⁴² *Providence Prop. & Cas. Ins. Co. v. Peoplease Corp.*, No. 4:06cv285, 2007 BL 187311 (E.D. Tex. Nov. 21, 2007) (excluding expert testimony based on "eyeballing" and estimating potential damages).