

Hawaii Supreme Court Rules Insurers Can't Recoup Defense Costs from Insureds

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An insurer cannot seek reimbursement from its insured for the cost of defending a lawsuit after learning that no coverage was owed unless the policy says it can, the Hawaii Supreme Court ruled.

“Hawaii’s stout duty to defend clashes with repayment,” the court said in a unanimous decision Tuesday. “So we side with policyholders and hold that insurers do not have a right to reimbursement of defense costs.”

The ruling was made in response to a pair of certified questions by the US District Court for Hawaii. A group of primary and excess insurers that sold liability policies to Bodell Construction sought reimbursement for the cost of defending the company against construction defect claims after the District Court ruled that none of the claims were covered.

The trial court, finding no guidance from state courts and conflicting decisions in the federal District Court, sought guidance. It asked the state Supreme Court if an insurer can seek reimbursement for the cost of defending an insured under a reservation of rights if the policy doesn’t specifically allow it. If so, the court also asked, which specific fees and costs are reimbursable?

The Supreme Court ignored the second question because the answer to the first question was “no.” An opinion written by Associate Justice Todd W. Eddins rejected an argument by insurers that a decision against reimbursement would unjustly enrich insureds. An insurer that defends its insured protects itself by warding off bad faith and breach-of-contract claims, Eddins wrote.

“If we allowed reimbursement, the unjustly enriched party may very well be the insurer,” the opinion says. “When the insured pays back defense costs to the insurer, it pays for the insurer to protect itself.”

The litigation at issue stems from the construction of the 200-unit Ali'i Cove condominium complex in Kona, on the big island of Hawaii, in 2003. The homeowner's association that represents owners of the condos filed a lawsuit in 2015 against the developer, Sunstone Realty Partners X, seeking damages in excess of \$20 million. The civil complaint alleged that embedded straps instead of bolts were used to fasten the walls of the buildings to the foundation. The straps were defective and are corroding, endangering residents and rendering the condominiums unsafe for habitation in a location that frequently experiences hurricanes, the lawsuit says.

Sunstone filed a lawsuit in state court against the general contractor, Bodell Construction. Bodell had purchased insurance policies from St. Paul Fire and Marine Insurance Co., Travelers Indemnity Co. of America, Phoenix Insurance Co., and Travelers Property Casualty Co. of America, which paid to defend the lawsuit under a reservation of rights. The case went to arbitration and eventually settlements were reached with the homeowners association. By that time, the insurers had spent \$1.9 million in fees and costs.

In 2020, the insurers filed a lawsuit seeking a declaration for the US District Court that no coverage was owed. After they won summary judgment, they filed a motion to recoup their defense costs from the insureds.

US District Court Judge Derrick K. Watson found no binding precedent in Hawaii state law. He found a California appellate case that found insurers can ask for reimbursement from insureds if there is a finding that no coverage is owed, but also a Pennsylvania decision that reached the opposite conclusion. Watson asked the state Supreme Court to resolve the matter.

Attorney Tristan Andres Deeley King Pang & Van Etten in Honolulu was co-author of an amicus brief filed on behalf of United Policyholders in the case. He said a decision in favor of the insurers would have placed Hawaii policyholders in a precarious position. In cases where coverage was in question, insureds would have to decide early on whether to allow their insurer to pay the cost of defense. Defendants who opted to allow the insurer to pay defense costs could end up facing a multi-million legal bill when the case finally resolves, he said.

In the alternative, a defendant could file a lawsuit against the insurers seeking a declaratory judgment that coverage is owed, but that would force the insured to pay for a "two-front war," Andres said.

Cid H. Inouye, a partner with O'Connor Playdon Guben & Inouye, who represented Sunstone, said the insurers' argument forced him to defend the status quo. He said a question asked during oral arguments illustrated the difficult position that a contrary opinion might have had on policyholders. If a court imposed punitive damages against a motorist who caused a motor vehicle crash, could the auto insurer demand reimbursement?

Inouye said because punitive damages are never insurable, such a consequence would impact every motorist in the state.

"The law in Hawaii is if you defend one claim you defend all of the claims," he said. "That has been the law in Hawaii for a long time."