

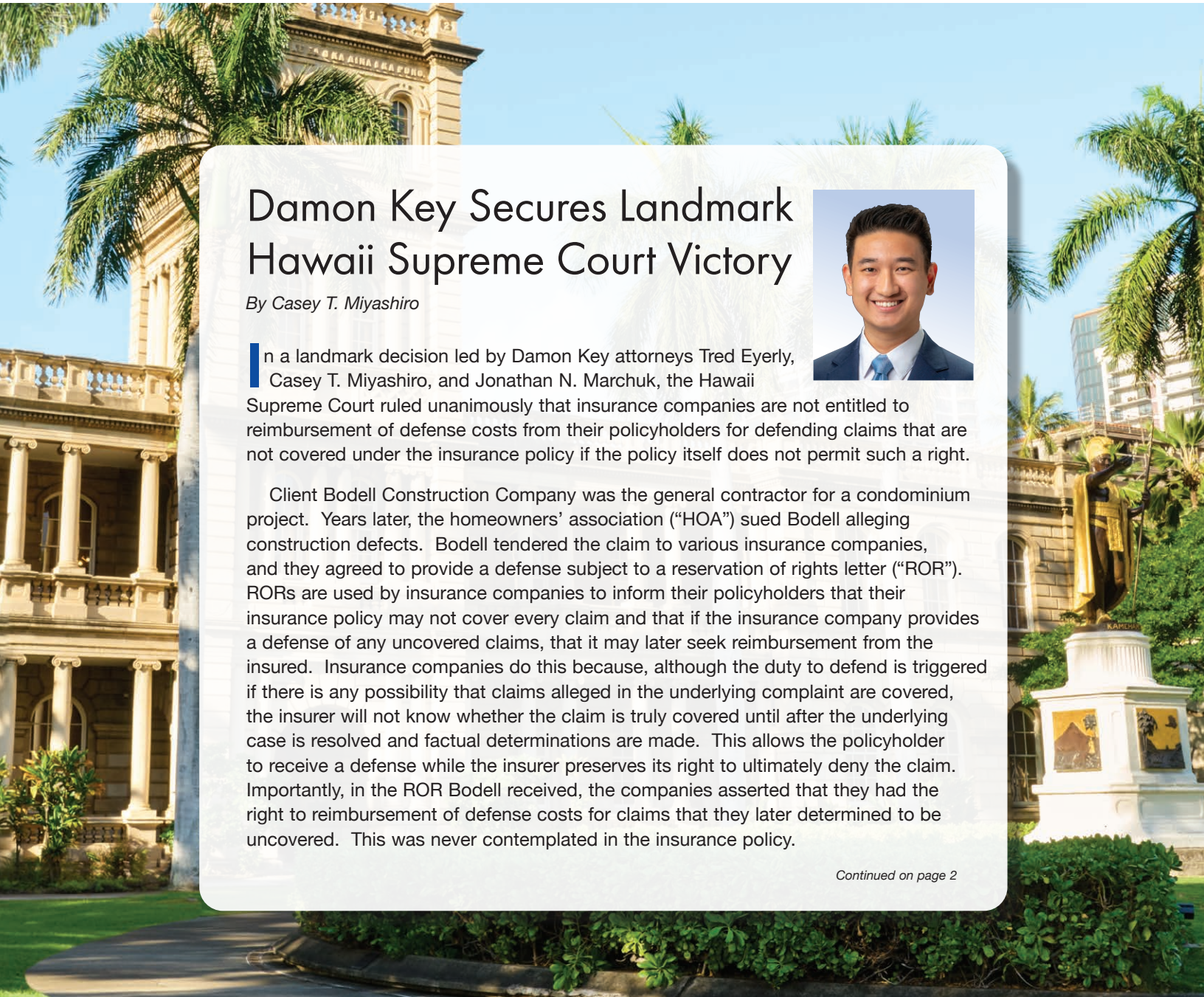
# LEGAL ALERT

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## Damon Key Secures Landmark Hawaii Supreme Court Victory

By Casey T. Miyashiro



In a landmark decision led by Damon Key attorneys Tred Eyerly, Casey T. Miyashiro, and Jonathan N. Marchuk, the Hawaii Supreme Court ruled unanimously that insurance companies are not entitled to reimbursement of defense costs from their policyholders for defending claims that are not covered under the insurance policy if the policy itself does not permit such a right.

Client Bodell Construction Company was the general contractor for a condominium project. Years later, the homeowners' association ("HOA") sued Bodell alleging construction defects. Bodell tendered the claim to various insurance companies, and they agreed to provide a defense subject to a reservation of rights letter ("ROR"). RORs are used by insurance companies to inform their policyholders that their insurance policy may not cover every claim and that if the insurance company provides a defense of any uncovered claims, that it may later seek reimbursement from the insured. Insurance companies do this because, although the duty to defend is triggered if there is any possibility that claims alleged in the underlying complaint are covered, the insurer will not know whether the claim is truly covered until after the underlying case is resolved and factual determinations are made. This allows the policyholder to receive a defense while the insurer preserves its right to ultimately deny the claim. Importantly, in the ROR Bodell received, the companies asserted that they had the right to reimbursement of defense costs for claims that they later determined to be uncovered. This was never contemplated in the insurance policy.

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The insurance companies eventually determined that some of the claims were not covered by the policy, so they filed a declaratory action in Federal court seeking a determination whether all, some, or none of the HOA's claims are covered. The court determined that some of the claims were covered, and some were not. Using this, the insurance companies asked for a determination that Bodell reimburse them for the defense costs of the non-covered claims. As indicated previously, Bodell never agreed to that in their policy; the only time it was addressed was in the ROR. The insurance companies' position was that because they never agreed to defend uncovered claims, they should not have to pay for defending those claims. Thus, out of fairness, Bodell should reimburse them for the costs they incurred defending Bodell for uncovered claims. The Federal court, applying Hawaii law in the case, had no guidance because this was an unsettled question under Hawaii State law, so the Federal court sent the question to the Hawaii Supreme Court for disposition. Cases across the country have addressed the issue with some courts deciding the insurer is entitled to reimbursement of defense costs for uncovered claims, while other courts holding the insurer has no right to reimbursement.

In a major victory for Bodell and other insureds, the Hawaii Supreme Court unanimously rejected the insurers' claim: "We hold that an insurer may not recover defense costs for defended claims unless the insurance policy contains an express reimbursement provision. A reservation of rights letter will not do." The Court noted three key reasons for its decision. First, the insurance contract did not provide a right of reimbursement. Even though the ROR claimed to have given the insurers a right to reimbursement in exchange for defending against the HOA's claims, that meant nothing – insureds cannot be forced to pay for something to which it never agreed. "A reservation of rights letter does not alter policy coverage or remake a contract," said the Court.

Second, the Court observed that allowing a right to reimbursement would erode an insurance company's duty to defend. When people purchase an insurance policy, they are paying for the right to be immediately defended against all claims potentially covered under the policy. If one claim is potentially covered, the insurer must defend all claims. This includes uncovered claims; claims that are groundless, false, or fraudulent; and even mixed actions (i.e., some claims covered, some not). Reimbursement for defense costs of non-covered claims would effectively erode the duty to defend because the insurance companies would only be financially responsible for defending covered claims. That would diminish the value of premiums, which the insured paid with the expectation that it would receive a full defense for all claims.

Finally, the Court rejected the insurance companies' argument that policyholders will be unjustly enriched if they receive a defense for non-covered claims. When insurance companies issue an insurance policy, it is with the agreement that the company will get full control of the defense because the company bears the risk of having to pay out a claim. This means the insurance company gets to decide how much it wants to spend on a defense and whether and when to settle. They do so mindful of the financial loss they might suffer relative to the premium and deductible they received from the policyholder. Allowing reimbursement would destroy this arrangement and harm the policyholder. Indeed, it would be the insurance companies that are enriched because it could spend all the money it wants defending non-covered claims knowing that the policyholder will reimburse them at the end. In other words, the insurance company would have nothing to lose organizing an overzealous defense so that it does not have to pay a claim because the policyholder would just pay for it later! The Court soundly rejected such an outrageous result.

With this decision, Hawaii joins a growing number of states rejecting a right of reimbursement of defense costs where the contract is silent. At a time when insurance claims are becoming far more frequent due to the proliferation of natural disasters, court decisions like this are key to ensuring fair play for policyholders. Many legal commentators have also praised the decision for its simplicity and no-nonsense approach, suggesting that other appellate courts around the country and elsewhere are likely to cite to it and adopt its reasoning. Damon Key attorneys don't just apply the law, they help make it too.

**For more information or questions, please call Casey at (808) 531-8031, email him at [ctm@hawaiilawyer.com](mailto:ctm@hawaiilawyer.com) or scan the code with your smartphone.**

