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IN THIS ISSUE

Eric Mull and Katelyn Fischer examine a recent Tenth Circuit Court of Appeals Decision, which affirms an insurer's right to seek reimbursement for its defense of a suit when it is later determined that coverage ultimately did not exist, specifically providing an insurer the right to seek reimbursement for both the costs incurred in litigation as well as any settlement amounts paid.

10th Circuit Creates Opportunity for Liability Insurers to Hedge Their Bets Against Future Bad Faith Litigation in Claims with Questionable Coverage

ABOUT THE AUTHORS

Eric R. Mull has been practicing for 13 years in insurance defense litigation, with a focus in the areas of construction defect, professional malpractice, and first party property insurance matters. He represents his clients in their investigation and adjustment of large scale property claims and in defending his clients in coverage, bad faith litigation and arson, fraud, and property damage cases in State and Federal Courts in Georgia and the Southeastern United States. He can be reached at emull@deflaw.com.

Katelyn E. Fischer practices in the area of civil litigation defense with an emphasis on First Party Property Insurance Defense. She collaborates with clients in the investigation and adjustment of property claims and defends insurers in coverage, bad faith, arson, fraud, and property damage matters. She can be reached at kfischer@deflaw.com.

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Bryan D. Bolton
Vice Chair of Newsletters
Funk & Bolton
bbolton@fblaw.com

A recent Tenth Circuit Court of Appeals Decision affirms an insurer's right to seek reimbursement for its defense of a suit when it is later determined that coverage ultimately did not exist, specifically providing an insurer the right to seek reimbursement for both the costs incurred in litigation as well as any settlement amounts paid.

In *Evanston Insurance Company v. Aminokit Labs, Inc.*, the Tenth Circuit Court of Appeals affirmed the United States District Court for the District of Colorado's judgment that allowed an insurer to recover reimbursement for all the costs it incurred in defending a suit against its insured after the insurer fully funded the settlement of the case due to the insured's threat to institute bad faith litigation.1 The *Aminokit Labs* decision involved a coverage dispute between Evanston Insurance Company ("Evanston") and those claiming benefits under an insurance policy Evanston issued to the policyholder, Aminokit Laboratories, Inc. ("Aminokit"), which provided professional and general liability coverage for "outpatient drug/alcohol rehab services" being provided at an addiction-treatment facility that Aminokit owned and operated.

After the policy was issued, it was revealed that certain application misrepresentations were made in order to procure the Evanston policy. Specifically, Aminokit failed to disclose that it maintained overnight beds for its patients and instead misrepresented on its application that it only operated its business during daytime hours. Likewise, Aminokit also "falsely denied that any of its employees had ever been evaluated or treated for alcoholism or drug addiction[,]" and misrepresented "the circumstances by which its [chief executive officer] (who provided medical care to Aminokit patients) had lost her chiropractic license."2

Less than a year after the policy was issued, a former Aminokit patient sued Aminokit, its medical director, and its chief executive officer, alleging violations of state consumer protection and racketeering laws, as well as state and federal conspiracy claims. After being served with the complaint, the three defendants requested defense coverage and indemnification from Evanston under Aminokit's policy. Evanston denied coverage on the basis that the former patient's allegations were for intentional and fraudulent conduct, which was outside the scope of coverage provided under the policy.

When the former patient amended his complaint to include additional claims for negligence and breach of fiduciary duty, the defendants once again tendered the amended complaint to Evanston. In response, Evanston reiterated its coverage opinion that no coverage existed, but nonetheless agreed to provide a defense with the caveat that it would also be filing a separate declaratory judgment action to determine its rights and duties under the

[1] No. 19-1065, 2020 WL 1285848 (10th Cir. Mar. 18, 2020).

[2] *Id*. at *1.

policy. IN so doing, Evanston fully reserved its right to withdraw the defense and/or seek reimbursement. Thereafter, Evanston filed its declaratory judgment action against all three defendants in the underlying suit brought by the former patient, seeking a declaration that "no defense or indemnity coverage [was] owed pursuant to the Aminokit insurance policy for the [former patient's] [s]uit."3

While the declaratory judgment action was still pending, Evanston participated in a mediation with the defendants and the former patient, which resulted in a proposed settlement of $260,000. Initially, Evanston refused to pay the full settlement amount out of concern that the amount comprised a settlement of claims and damages for which it was not obligated to provide coverage. Rather, Evanston offered to pay $165,000 of the settlement and requested the three defendants contribute the remaining $95,000. The defendants would not agree to contribute any amount to the settlement and Aminokit's attorney went so far as to threaten Evanston with the possibility of a future bad faith action if it refused to pay the full $260,000 settlement amount. In response, Evanston advised the defendants that if it were to agree to fund the full $260,000 settlement amount, it would pursue reimbursement for the entire cost incurred to defend and indemnify the defendants, meaning Evanston would not dismiss its declaratory judgment action as part of the settlement. The defendants nonetheless still requested that Evanston accept and fully fund the $260,000 settlement offer, so Evanston timely accepted the settlement offer and agreed to fund the settlement in full in exchange for a dismissal with prejudice of all three defendants.

After funding the full $260,000 settlement amount, Evanston amended its complaint for declaratory judgment to assert three new claims—two separate fraud claims based on the fact that Aminokit made fraudulent misrepresentations and concealments in its application to Evanston, and a final claim for unjust enrichment for the litigation expenses Evanston incurred and settlement payment it made to fund the settlement.4 Aminokit filed a responsive motion to dismiss asserting that Evanston was not entitled to recover the settlement amount under either the unjust enrichment or fraud claims. Aminokit's motion was summarily denied. Thereafter, Aminokit made a series of procedural blunders resulting in an entry of default judgment being entered against it for $472,280.30—$286,407.36 for the settlement payment Evanston made to Aminokit's former patient, $63,304.07 in litigation costs, and

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3 *Id*. at *2.

4 Aminokit's chief executive officer was eventually dismissed from the suit, and Evanston eventually obtained a judgment against Aminokit's medical director for unjust enrichment, holding him jointly and severely liable with Aminokit for both the litigation costs Evanston incurred in funding the defense of the former patient's suit as well as for the settlement payment Evanston had funded. *See Evanston Insurance Company v. Aminokit Laboratories, Inc.*, No. 15-cv-02665-RM-NYW, 2019 WL 479204, at FN 1, *1, *7 (D. Colo. Feb. 7, 2019).

$77,568.87 in prejudgment interest.5 The district court's order held Aminokit liable to reimburse Evanston under both the fraud and unjust enrichment theories of recovery.6 In so doing, the district court rejected all three of Aminokit's arguments concerning the settlement amount.

First, the district court rejected the argument that Evanston's recovery was barred by the "voluntary payment rule" because it made the decision to settle the underlying case with "knowledge of all facts and circumstances".7 Instead, the court held that the settlement payment at issue was not voluntary under applicable state law and that "Aminokit could not refuse to contribute to a settlement, demand that the insurance carrier fund the entire settlement of the claims or risk bad faith, and then later claim that the settlement payment was 'voluntary.'"8

Second, the district court rejected Aminokit's argument that any damages Evanston incurred were not the proximate result of Aminokit's alleged fraud.9 Instead, the court held that in light of Evanston's assertion that it would not have issued the policy if Aminokit had been truthful in its policy application, by extension, all the money Evanston expended in defending and settling the former patient's suit were the natural and proximate consequence of the fraud.10 The court reasoned that but for Aminokit's fraud, there would not have been a policy under which the defendants would have had a basis to induce Evanston into funding their defense or the settlement of the action.11

Finally, the district court rejected the argument that Evanston could not recover on its fraud claims because it knew of the fraud at the time it agreed to fund the settlement.12 The court rejected this argument, concluding that by the time Evanston discovered the possibility of alleged fraud, Evanston was already bound by the insurance contract and thereby required to provide a defense to Aminokit or else risk running afoul of state law.13

Aminokit timely appealed the district court's default judgment order, challenging the portion of the order that allowed Evanston to recover the amount it paid to fund the settlement of the former Aminokit patient's suit. Specifically, Aminokit contended on appeal that Evanston's fraud claims did not constitute legitimate causes of action such that default judgment could be entered because Evanston's complaint failed to establish the necessary damages element for both its fraudulent misrepresentation and fraudulent concealment claims. In support of this contention, Aminokit put forth two arguments—first, Aminokit argued

5 Order Entering Default Judgment, 11, *Evanston Insurance Co. v. Aminokit Laboratories, Inc.*, No. 15-cv-02665-RM-NYW (D. Colo. Feb. 7, 2019).
6 *Id*. at 4-10.
7 *Id*. at 7-9.
8 *Id*. at 8.
9 *Id*. at 9-10.
10 *Id*.
11 *Id*.
12 *Id*. at 9.
13 *Id*. (referencing Abbott & Costello, *Who's On First?*).

that the fraud "did not give rise to a duty to settle because issuing the policy did not impact Evanston's decision to settle the case[,]" and second, that because Evanston knew of the fraud when it agreed to fund the settlement, Evanston "could not have been relying on the representations contained in the policy application at the time it decided to settle."14

The Tenth Circuit Court of Appeals disagreed with Aminokit's position and affirmed the district court's ruling that Evanston was entitled to recover the settlement payment as fraud damages.15 The appellate court noted the general rule that a defrauded party cannot recover damages incurred after the fraud has been discovered because the party no longer has a basis for relying on the misrepresentations, but went on to hold that the factual scenario in *Aminokit Laboratories* fell squarely within an exception for situations where it would be "economically unreasonable" for the defrauded party to terminate the relationship after the fraud had been discovered.16 Specifically, the court noted that regardless of whether Evanston was aware of the fraud, by threatening Evanston with bad faith claim, Aminokit put Evanston in a position where it could not abandon its defense without, at a minimum, incurring substantial litigation costs defending a bad faith suit. Thus, the court held that it would have been economically unreasonable for Evanston to have refused to pay the full settlement amount even though it knew of the application misrepresentations and concealments at the time it did so.17

The court also recognized that this conclusion furthered important public policy interests in both encouraging settlements and discouraging insurance fraud.18 It noted that if Aminokit's position were enforced, there would be less likelihood for insurers to agree to settlements in situations where the insurers believed there was no coverage because the insurers would forego funding settlements out of concern that they would not be able to recoup the payments.19 Likewise the court emphasized that "allowing insureds to receive the benefits of insurance coverage, even when they have fraudulently obtained it, would foster—not deter—insurance fraud" because "[i]t would signal…that if they can convince their insurance company to settle via the threat of bad-faith litigation, they will benefit from their fraud."20

The *Aminokit Labs* decision provides an new way for insurers to eliminate a bad faith threat while still protecting their interests regarding questions of coverage, at least in situations where the benefit of avoiding bad faith litigation outweighs the risk that the insured will not be able to make good on the reimbursement. And, in situations where this benefit does not outweigh the risk,

[14] *Aminokit Laboratories*, 2020 WL 1285848, at *3.
[15] *Id*. at *1.
[16] *Id*. at *4 (quoting *Thor Power Tool Co. v. Weintraub*, 791 F.2d 579, 585 (7th Cir. 1986)).
[17] *Id*.
[18] *Id*. at *4-5.
[19] *Id*. at *4.
[20] *Id*. at *5.

Aminokit Labs serves as a tale of caution to insureds who seek to use the threat of a bad faith suit as a coercive tool to force insurers to provide coverage when the insured may not be truly owed coverage under their policy.

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