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***KnightBrook Insurance Co. v. Payless Car Rental System Inc. CV-17-0156-CQ, (2018)***

Although Arizona has adopted sections of the RESTATEMENT (FIRST) OF RESTITUTION, it has not adopted § 78 because the section conflicts with Arizona’s equitable-indemnity principles.

***Background***

Procedurally, this decision stemmed from a certified question from the Ninth Circuit Court of Appeals.

Michael Borge rented a vehicle from Payless Car Rental System (“Payless”). At the time of rental, Payless offered Borge supplemental liability insurance under a policy provided by KnightBrook Insurance Co. (“KnightBrook”). Although Borge did not pay the premium, he contended he was entitled to supplemental coverage because he did not expressly decline the coverage.

Borge caused an accident and injured the McGills, who then sued him. Borge tendered the suit to KnightBrook who denied coverage because Borge did not pay the premium. After KnightBrook’s denial, Borge executed a settlement agreement with the McGills for \$530,000—his full policy limits. As part of the settlement, Borge executed a *Damron* agreement assigning his insurance-bad-faith claims against KnightBrook and Payless for the coverage denial. Borge also agreed to an \$8 million adverse judgment in exchange for the McGills covenant not to execute.

The McGills then sued KnightBrook and Payless on the \$8 million judgment. KnightBrook settled with the McGills and took assignment of the McGills’ claims against Payless. As a part of the settlement, KnightBrook paid the McGills the \$970,000—the policy limits of the supplemental policy.

KnightBrook then filed this action against Payless asserting in part equitable indemnification for the amounts paid to the McGills. The District Court held KnightBrook was entitled to equitable indemnification from Payless based on RESTATEMENT (FIRST) OF RESTITUTION § 78.

On appeal, the Ninth Circuit concluded the case’s outcome turned on two questions: (1) whether equitable indemnity in Arizona incorporates RESTATEMENT (FIRST) OF RESTITUTION § 78, and (2) if so, whether the indemnity and liability must be equal as to the underlying plaintiff. The Ninth Circuit certified these questions for the Arizona Supreme Court for review.

***Equitable Indemnity in Arizona***

In Arizona equitable (or common law) indemnity seeks to avoid unjust enrichment. A plaintiff must show: (1) it discharged a legal obligation owed to a third party; (2) for which the indemnity defendant was also liable; and (3) as between the two, the obligation should have been discharged by the defendant.

Importantly, Arizona courts consistently apply the general, equitable indemnity rule of RESTATEMENT (FIRST) OF RESTITUTION § 76 rather than § 78. Section 76 states:

A person who, in whole or in part, has discharged a duty which is owed by him but which as between himself and another should have been discharged by the other, is entitled to indemnity from the other, unless the payor is barred by the wrongful nature of his conduct.

By contrast, § 78 states, in part:

A person who with another became subject to an obligation or **supposed obligation** upon which, as between the two, the other had a prior duty of performance, and who has made payment thereon although the other had a defense thereto,

- (a) is not entitled to restitution if he became subject to the obligation without the consent or fault of the other;
- (b) is entitled to restitution if he became subject to the obligation with the consent of or because of the fault of the other and, if in making payment, he acted ...
  - (ii) in the **justifiable belief** that such a duty existed. (emphasis added)

The District Court found § 78 was a “refinement” of § 76.

The Arizona Supreme Court disagreed holding § 78 expands the scope of equitable indemnity inconsistent with equitable indemnity in Arizona by not requiring an actual “legal obligation or discharge of the ... defendant’s liability.” Instead, § 78 creates a “new cause of action based on the relationship of the indemnitor and the indemnitee.” In the Court’s view, § 78 was an impermissible expansion of equitable indemnity because it included “‘supposed obligations’ that may be based on the payor’s ‘justifiable belief’ that he owed a duty to the third party.” This approach was a lower standard imposing liability based on the “justifiable belief” that a duty exists rather than an actual obligation. In addition, § 78 could “preclude an indemnitor from raising viable defenses to the underlying claim” as Payless did here.

As a result, the Arizona Supreme Court declined to adopt RESTATEMENT (FIRST) OF RESTITUTION § 78.