KnightBrook Insurance Co. v. Payless Car Rental System Inc.

Citation: 409 P.3d 293 (Ariz. 2018).
Date Filed: February 8, 2018
Author: Justice Lopez
Joined by: Chief Justice Bales, Vice Chief Justice Pelander, Justices Brutinel, Timmer, Bolick, and Gould.

Facts: Bovre rented a vehicle from Payless Car Rental System Inc. ("Payless"). Payless offered Bovre supplemental liability insurance ("SLI") under a master policy provided by KnightBrook Insurance Co. ("KnightBrook"). Bovre neither paid the daily $13.95 premium for SLI coverage, nor did he decline it by initialing the space provided in the rental contract. Bovre then caused an accident while driving the rental car and injured the McGills.

After commencing suit against Bovre, the McGills made an offer to settle, which included, *inter alia,* $970,000 for the SLI coverage. But, because he did not purchase it, KnightBrook denied Bovre's demand for the $970,000. In ultimately settling with the McGills, Bovre executed a *Damron* agreement, assigning to the McGills all claims against KnightBrook and Payless for their alleged failure to provide SLI insurance (i.e., breach of contract, negligence, and insurance bad faith). Bovre then agreed to an $8 million adverse judgment in exchange for the McGills' covenant not to execute on the judgment against his personal assets.

The McGills then sued Payless and KnightBrook for the $8 million judgment. In a subsequent settlement with KnightBrook only, the McGills assigned what were previously Bovre's claims to KnightBrook. KnightBrook also paid the McGills the $970,00 SLI policy limit and promised them a percentage of any recovery from Payless. This resolved the McGills' insurance bad faith and *Damron* claims but not the breach of contract and negligence claims against Payless.

Procedural history: KnightBrook brought suit against Payless in the United States District Court for the District of Arizona. The action included not only its assigned claims but also an equitable indemnification claim for the $970,000 SLI payment made to the McGills. KnightBrook contended that the Payless employee at the rental counter was at fault for not memorializing Bovre's denial of SLI coverage. The district court dismissed the contract claims, holding that KnightBrook and the McGills' settlement extinguished them.

Then, the district court, relying on the First Restatement's § 78, ruled for KnightBrook with regard to the equitable indemnification claim. In doing so, the district court termed § 78 as a "refinement" of the First Restatement's § 76, stating that KnightBrook need not prove that it or Payless was actually liable to the McGills.[1] Rather, the district court held that KnightBrook was subject to a "supposed obligation" which Payless had a greater responsibility to discharge; Payless's fault subjected KnightBrook to the purported

[1] KnightBrook Ins. Co. v. Payless Car Rental System Inc., 409 P.3d 293, 295 (Ariz. 2018) (quoting KnightBrook Ins. Co. v. Payless Car Rental Sys., Inc., 100 F. Supp. 3d 817, 829 (D. Ariz. 2015)).

obligation; and KnightBrook made the settlement payment to the McGills under the "justifiable belief" that it would be liable in the McGills' lawsuit.[2]

Payless appealed to the Ninth Circuit. The Ninth Circuit determined that the outcome rested on answers to the two questions certified to the Arizona Supreme Court.

The Arizona Supreme Court accepted jurisdiction over the two certified questions.

Issue: Equitable indemnity law in Arizona allows recovery only when an indemnity plaintiff subject to derivative or imputed liability discharges an *actual* obligation that a culpable indemnity defendant owed to the underlying plaintiff. As such, does Arizona equitable indemnity law incorporate the First Restatement's § 78 (which entitles an indemnity plaintiff to restitution when, under the justifiable belief in the existence of an obligation, the indemnity plaintiff becomes subject to a *supposed* obligation with another); and, if so, does § 78 require that the indemnity plaintiff and indemnity defendant's liability be coextensive as to the underlying plaintiff?

Holding: No, Arizona law does not incorporate § 78 because it conflicts with Arizona's general equitable indemnity principles. Consequently, the second certified question is moot.[3]

Disposition: The first certified question posed by the Ninth Circuit is answered in the negative and KnightBrook is not awarded equitable indemnification against Payless.

Rule: Equitable indemnification law in Arizona does not impose a duty of indemnity unless the indemnity plaintiff's payment discharges the indemnity defendant from an actual obligation; an indemnity plaintiff's justifiable belief in a *supposed* obligation is not sufficient.

Reasoning:

- **Section 78 of the First Restatement:** The court began its discussion by noting that § 78 of the First Restatement, in the relevant part, provided:

> 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,
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> (a) is not entitled to restitution if he became subject to the obligation without the consent or fault of the other;

[2] *Id.* (quoting *KnightBrook Ins*. at 100 F. Supp. 3d at 829).
[3] *Id.* at 298.

> (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[.][4]

- **Equitable Indemnity in Arizona:** The court then asserted that, in order to avoid unjust enrichment, Arizona equitable indemnity law, which mirrors § 76 of the First Restatement,[5] allows recovery only when a plaintiff subject to derivative or imputed liability discharges an *actual* obligation that a culpable defendant owed to a third party.[6] In delineating the elements a plaintiff in a common law indemnity action generally must show, the court relied on two cases, which recited § 76 in their respective holdings—*Mt. Builders, LLC v. Fisher Roofing, Inc.* and *Am. & Foreign Ins. Co. Mt. Builders* provided that 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 [indemnity] defendant."[7] Put more exactly in *Am. & Foreign Ins.*, there is no "duty of indemnity unless the payment discharges the primary obligor from an existing duty."[8]

- **KnightBrook's Reliance on *Hatch*:** *Hatch Development, LLC v. Solomon* is the only Arizona case, cited by KnightBrook, that relies on § 78 and rejects the three-pronged *MT Builders* test as the sole basis for equitable indemnity.[9] In *Hatch*, the property owner hired a contractor; the contractor negligently damages a neighbor's property; the neighbor sued the property owner; and the property owner and the neighbor then settled the lawsuit.[10] The court of appeals held that, because the property owner justifiably believed he owed an obligation to the neighbor, the neighbor was entitled to common law indemnity against the contractor, despite the statute of limitations having run on the neighbor's claims against the contractor.[11] Thus, while the settlement did not discharge an obligation owed by the contractor (and, thus, entitled the property owner to indemnification under § 76), the court of appeals reasoned that, because the contractor was still at fault for the neighbor's damages, indemnification was proper under § 78.[12] *Hatch*'s reasoning, however, is based exclusively on the earlier district court's opinion in the instant controversy between KnightBrook and Payless, which this court rejects.[13]

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[4] *Id.* at 295 (quoting RESTATEMENT (FIRST) OF RESTITUTION § 78 (AM. LAW INST. 1937)).
[5] *Id.* (quoting RESTATEMENT (FIRST) OF RESTITUTION § 76), ("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. . . .").
[6] *Id.*
[7] *Id.* (quoting MT Builders, L.L.C. v. Fisher Roofing, Inc., 197 P.3d 758, 764 n.2 (Ariz. Ct. App. 2008)).
[8] *Id.* at 296 (quoting Am. & Foreign Ins. Co. v. Allstate Ins. Co., 677 P.2d 1331, 1333 (Ariz. Ct. App. 1983)).
[9] *Id.* (citing Hatch Dev., LLC v. Solomon, 377 P.3d 368, 372–73 (Ariz. Ct. App. 2016)).
[10] *Id.* (citing *Hatch Dev.*, 377 P.3d at 370).
[11] *Id.* (citing *Hatch Dev.*, 377 P.3d at 373).
[12] *Id.* (citing *Hatch Dev.*, 377 P.3d at 373).
[13] *Id.*

- **KnightBrook's Reliance on *Evans*:** KnightBrook also relied on *Evans Withycombe, Inc. v. Western Innovations, Inc.*, positing that *Evans* applies the principles of § 78 despite not citing it.[14] *Evans*, contrary to KnightBrook's contention, only acknowledged the general rule that an indemnity plaintiff must not have been negligent when making an indemnity claim.[15] Thus, *Evans* neither implicated § 78 nor included a "supposed obligation" to the scope of equitable indemnity law in Arizona.[16]

- **Section 78 is not a "refinement" of § 76:** The court then stated that § 78, unlike § 76, does not require an actual legal obligation or a discharge of the defendant's liability.[17] Its very comments make clear that § 78 provides equitable indemnity where § 76 does not: in "situations [where] the performance is not a benefit to the primary obligor and hence there can be no recovery by the payor because of unjust enrichment."[18] Thus, rather than refining § 76, § 78 creates a new cause of action.[19]

  The court continued, stating that § 78's lower standard departs sharply from Arizona equitable indemnity law because it grants indemnification with the mere "justifiable belief" that a duty exists, rather than requiring an *actual* duty to exist.[20] The court warned that incorporating § 78 may preclude an indemnitor from raising viable defenses to the underlying claim.[21]

- **Arizona and the Restatement of Restitution:** Additionally, KnightBrook urged the court to adopt § 78 because, absent contrary authority, Arizona follows the Restatement of Law.[22] The court rejected this argument for two reasons: (1) in superseding the First Restatement, the Third Restatement attempted to clarify the law of restitution by abandoning § 78, declining the inclusion of a comparable provision, and curbing its equitable indemnity language to language analogous with § 76; and (2) § 78, as previously discussed, contravenes Arizona's equitable indemnity principles.[23] Moreover, there is no reason to create additional remedies because Arizona already recognizes causes of action in contract and tort for compensation that seek to redress the situations § 78 aims to remedy (i.e., when a person subject to a "supposed obligation" makes a payment to satisfy the perceived obligation, but the payment does not benefit the other purportedly culpable party).[24]

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[14] *Id.*
[15] *Id.* at 297 (citing to Evans Withycombe, Inc. v. Western Innovations, Inc., 159 P.3d 547, 551–52 (Ariz. Ct. App. 2006)).
[16] *Id.*
[17] *Id.*
[18] *Id.* (quoting RESTATEMENT (FIRST) OF RESTITUTION § 78 cmt. a. (AM. LAW INST. 1937)).
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*

In brief, the court declined to adopt § 78 because it conflicted with Arizona's long-established equitable indemnity principles and did not reflect a sound rule.[25] As such, Arizona equitable indemnity law does not incorporate § 78 and, thus, the second certified question (i.e., whether § 78 requires coextensive liability between parties) is moot.[26]

[25] *Id.* at 298.
[26] *Id.*