

Pennsylvania Superior Court Renders Pro-Policyholder Decision on
Primary Insurer's Attempt to Obtain Reimbursement of Defense Costs

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On May 5, 2008, the Superior Court of Pennsylvania rendered a decision in American and Foreign Insurance Company v. Jerry's Sport Center, Inc., ___ A.2d ___, 2008 WL 1932282, No. 1098 MDA 2006 (Pa. Super. Ct. 2008) that is likely to have significant and beneficial implications for Pennsylvania policyholders who have purchased primary commercial general liability insurance policies that contain a duty to defend and are faced with claims for which coverage may be in dispute. In Jerry's Sport Center, the court addressed whether an insurer could pursue a claim of a right to reimbursement of defense costs in the following circumstances: (a) the insurer acknowledged that the claims were potentially covered; (b) the insurer provided a defense subject to a reservation of its right to deny coverage and its right to seek reimbursement of defense costs; and (c) ultimately, it was judicially determined that the claims against the policyholder were not covered under the policy. No Pennsylvania appellate court had addressed this issue previously.

The court held that the insurer had no such "right" to reimbursement of defense costs in the insurance policy and that the insurer could not unilaterally create such a right by issuing a reservation of rights letter. The court also held that the policyholder was not "unjustly enriched" when the insurer provided a defense of a potentially covered suit that was ultimately judicially determined to be not covered. Id. at *13. In reaching this conclusion, the court reasoned that if the insurer were able to create a right to reimbursement in this manner, it would impermissibly erode the breadth of the insurer's broad duty to defend its policyholder under Pennsylvania common law. Id. at *16.¹

¹ The judges on the Superior Court panel that rendered the decision were the Hon. John T. Bender, the Hon. Correale F. Stevens and the Hon. Joan Orié Melvin.

This decision is important for Pennsylvania policyholders. Courts across the country have split on the issue, but this decision places Pennsylvania squarely among those jurisdictions that protect the policyholder’s valuable right to a defense of litigation in circumstances where coverage of the underlying claim is in question, so long as there is a potential for coverage.

I. THE BACKGROUND

In Jerry’s Sport Center, the policyholder and the primary insurer faced a common situation – based on the initial allegations of the complaint, there was a question as to whether the commercial general liability insurance policy at issue provided coverage for the claims against the policyholder. The underlying lawsuit alleged that the policyholder was negligent in the marketing and distribution of handguns, thereby causing injury and death to members of the plaintiffs’ organizations. Id. at *1. The insurer (generally referred to in the opinion as “Royal”) had provided a primary policy that contained common language with respect to the defense obligation. This policy provided, in pertinent part, that Royal has “the right and duty to defend the insured against any suit seeking” damages for bodily injury and that the policyholder is required to notify the insurer “as soon as practicable of an ‘occurrence’ *which may result* in a claim.” Id. at *11 (emphasis in original).

In this case, upon notice of the underlying lawsuit, Royal informed the policyholder in writing that it was providing the policyholder with a defense under a full reservation of rights, including the right to seek reimbursement of all defense fees advanced after Royal made a final determination that the policy did not obligate Royal to

defend or indemnify the policyholder in the underlying gun action. The policy did not contain any provisions providing Royal with a right to seek reimbursement of defense costs. Ultimately, Royal denied coverage, but continued to advance the cost of defense while it pursued an insurance coverage action for declaratory relief. Id. at *2. It appears from the opinion that the policyholder did not respond to or object to this reservation. The policyholder accepted the defense.

Royal was active in providing the defense. It retained counsel and approved the retention of several experts. Royal reviewed the defense counsel invoices to ensure that the work reflected the defense strategy addressed with the defense counsel and whether the invoices were fair and reasonable for the work performed. After this process was completed, Royal paid its share of the invoices. Royal also utilized its litigation guidelines in connection with its supervision of the defense of the underlying case, but authorized its adjusters to deviate from those guidelines in light of the complexity of the case. Id. at *5.

In earlier rulings in Royal's insurance coverage case, the trial court and Pennsylvania Superior Court each determined that the allegations in the underlying complaint did not trigger coverage under Royal's policy because the policy provided coverage for liabilities arising from bodily injury and the complaint did not seek compensation for bodily injury. Id. at *6. Thus, Royal's denial of coverage under the policy was upheld as a correct determination that the policy did not provide coverage. Royal then sought to recover in excess of \$300,000 that it had expended in the defense of the underlying case. The trial court entered judgment in favor of Royal, requiring the policyholder to reimburse Royal \$309,215.86, plus pre-judgment interest. The trial court

determined that Royal had retained a right to reimbursement (even though the policy granted Royal no such right) and that the policyholder had been “unjustly enriched” by receiving a defense on a non-covered claim. Id. at *7-*9.

II. THE DECISION

In Jerry’s Sport Center, the Superior Court of Pennsylvania held that the trial court should not have granted the insurer’s motion for reimbursement of defense costs even though the underlying claim was not covered under the policy. The court based this decision on: (1) the nature of the duty to defend; (2) a determination that the insurer could not use a reservation of rights letter to create unilaterally a contractual right to reimbursement of defense costs when the policy contained no such provision; and (3) a rejection of the insurer’s position that the policyholder had been unjustly enriched at the expense of the insurer.

A. The Nature of the Duty to Defend

The court began its analysis by reviewing the nature of the duty to defend. At the outset, the court noted that the insurer’s duty to defend arises when the allegations of “*the complaint filed by the injured party may potentially come within the coverage of the policy.*” Id. at *10, *11 (emphasis in original) (quoting Britamco Underwriters, Inc. v. Grzeskiewicz, 639 A.2d 1208, 1210 (Pa. Super. 1994)). The court noted that, in some instances, other descriptions of the claim in the case, such as interrogatory answers, may make it evident that a claim is potentially covered, even though the injured party has not yet amended its complaint. See Heffernan & Co. v. Hartford Ins. Co., 614 A.2d 295, 298 (Pa. Super. 1992). Thus, the duty to defend is triggered when a potentially covered claim becomes apparent to the insurer, rather than later when a declaratory judgment is entered

regarding whether the policy actually provides coverage for the claims. Accordingly, as an initial matter, the court concluded that Royal's duty to defend Jerry's Sport Center arose when the policyholder was faced with potentially covered claims in the underlying case. Id. at *12.

Building on this initial determination, the court emphasized the importance of the common law rule that the duty to defend is broader than the duty to indemnify. Id. at *10, *16. The court reasoned that because the duty to defend may be triggered by claims for which it turns out there is no actual coverage and duty to indemnify, a rule that permits the insurer to recoup defense costs expended in performing its duty to defend in such circumstances would be inappropriate. Such a rule "would result in, essentially, retroactive erosion of the breadth of the duty to defend." Id. at *16. The court concluded: "This we refuse to do." Id.

B. The Policy Does Not Provide a Right for the Insurer to Recoup Defense Costs and the Insurer Cannot Unilaterally Create such a Right in a Reservation of Rights Letter

It was undisputed that the policy, like most commercial general liability insurance policies, did not contain a provision providing the insurer with a right to reimbursement of defense costs. The court determined that the insurer's letters to the policyholder purporting to reserve its right to seek reimbursement of defense costs did not create an implied contractual right for the insurer. Although the court followed what it viewed as the minority position nationwide on this issue, the court found this position to be persuasive because it is based on the language of the policy. Id. at *14. Specifically, the court adopted the reasoning of the Philadelphia Court of Common Pleas in LA Weight Loss Ctrs. v. Lexington Ins. Co., 2006 WL 689109 (Phila. Ct. Cm. Pleas 2006):

A reservation of rights letter does not create a contract allowing an insurer to recoup defense costs from its insured, but rather is a mean[s] to assert defenses and exclusions which are already set forth in the policy... Absent such a provision in the policy, an insurer should not be permitted to unilaterally amend the policy by including the right to reimbursement in its reservation of rights letter.

Jerry's Sport Center, at *13. The court concluded that if Royal had wanted to be able to seek reimbursement of attorneys' fees in situations where the underlying claim may be potentially covered and Royal provided a defense under the policy, Royal could have included such a provision in the policy as part of its right and duty to defend. Id. at *15. It could not unilaterally impose such a right once a claim arose under the policy.

C. The Policyholder Was Not Unjustly Enriched

Finally, the Superior Court rejected Royal's theory that the policyholder had been "unjustly enriched" when it received the defense of a claim that ultimately turned out to be not covered, and therefore the policyholder should reimburse the insurer for the amounts it expended on defense costs. The court noted that the policy language provided the insurer with the "right and duty to defend" and that Royal had exercised this right to defend to its benefit. Again, the court adopted the reasoning of the Philadelphia Court of Common Pleas in LA Weight Loss that a policyholder "is not unjustly enriched 'when its insurer tenders a defense in order to protect its own interests, even if it is later determined that the insurer did not owe a defense.'" Jerry's Sport Center, at *13 (quoting LA Weight Loss, at *7). Specifically, the court found that Royal obtained significant benefits when it undertook the defense of the policyholder. For example, Royal was able to select defense counsel, evaluate the reasonableness of legal costs and maintain involvement in the strategy for the defense of the claim. The court concluded that "certainly these

actions benefited Royal to the extent that it maintained control over the defense and could take the opportunity to mitigate any potential future indemnification burdens.” Id. at *13.

III. THE LESSON

The Superior Court’s decision in Jerry’s Sport Center provides important protection for policyholders under Pennsylvania law with respect to the valuable right to a defense of potentially covered claims under primary commercial general liability policies. In particular, insurers should not be able to present Pennsylvania policyholders with what several courts have referred to as a Hobson’s choice between (a) accepting the insurer’s unilateral imposition of a right to reimbursement as a condition to receiving a defense and thereby being made subject to the possibility of repaying the insurer for the entire cost of a defense that the insurer controlled, or (b) rejecting the condition and either having to (i) front the funds for a defense itself and seek reimbursement of those costs through a coverage action, or (ii) give up on the insurance defense right altogether.

The broad right to a defense against suits that include potentially covered claims is extremely valuable to policyholders. Indeed, if faced with a complex litigation in which the claims against the policyholder are ultimately ruled to be non-meritorious, the defense obligation is the most critical element of the coverage that the primary commercial general liability policy provides. Indeed, a small or mid-size business policyholder that finds itself in complex and extended litigation could face serious financial disruptions if it has to pay for the defense itself.

Thus, under Pennsylvania law as set forth in Jerry’s Sport Center, when an insurer acknowledges that a suit contains claims that are potentially covered, the policyholder is entitled to a defense without its insurer obtaining a right to reimbursement

of defense costs if the claims in the suit turn out to be not covered. If an insurer attempts to “reserve” such a right in connection with providing a defense to a Pennsylvania policyholder, the policyholder should present the decision in Jerry’s Sport Center to the insurer, reject the insurer’s purported “reservation” out-of-hand and demand that the insurer provide the unfettered defense to which the policyholder is entitled.