

Pennsylvania Supreme Court: General Liability Insurers Have No Right to “Recoup” Defense Costs from Their Insureds

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On August 17, a unanimous Pennsylvania Supreme Court handed down a decision important not only for Pennsylvania, but potentially for many other states as well. In *American and Foreign Insurance Company v. Jerry’s Sport Center, Inc.*,¹ the court ruled that insurers that issue commercial general liability (CGL) policies obligating them to defend any suit that seeks damages to which the insurance may apply, do not have the right to recover defense costs from the insured if a court later determines that the suit does not obligate the insurer to pay indemnity.

With this decision, Pennsylvania adopts what has to this point been considered the “minority view” rejecting an insurance company’s right to such reimbursement. The decision reflects the trend of courts to reject the rationale of the California Supreme Court in *Buss v. Superior Court*,² where a right of reimbursement of defense costs was recognized, based on the insurer’s unilateral assertion of such a right in a standard reservation of rights letter. Not only does the decision finally resolve Pennsylvania law on the issue, it is likely that *Jerry’s Sport Center* will be carefully considered by courts in the many states where the supreme court has not yet addressed the insurance industry’s claimed right to recoup defense costs paid pursuant to the duty to defend in CGL policies.

Background

For more than 60 years, a standard CGL policy written and sold by the insurance industry has provided that the insurer assumes two separate and distinct obligations—the duty to indemnify the insured against any liability for damages for bodily injury or property damage covered under the policy and the duty to defend the insured against any suit seeking those damages even if the allegations are groundless, false or fraudulent. Based on that policy language, courts have universally held that the duty to defend is separate from and broader than the duty to indemnify, and that the duty to defend is triggered whenever the factual allegations and/or claims in a suit against the insured give rise to merely the potential that the insurer will be required to indemnify the insured against liability to a third party.

¹ 2010 WL 3222404 (Pa. Supreme Court, Aug. 17, 2010).

² 939 P.2d 766 (Cal. 1997).

Courts have routinely held that (i) all doubts as to whether the insurer is required to defend are to be resolved in favor of the insured and (ii) even if only one claim of a multiclaim complaint creates a potential indemnity obligation, the insurer must defend the entire suit. The defense obligation includes paying reasonable attorneys' fees, as well as costs of suit. Importantly, absent some special policy language, defense costs are in addition to, and do not reduce, the indemnity limits in the policy. Based on the standard CGL policy language and the court decisions, the duty to defend has been characterized as "peace of mind" insurance because it is supposed to offer the insured a vigorous defense at no cost to the insured.

In the past 15 years, however, insurers have tried to chip away at the broad defense obligation—which can often cost an insurer more than any indemnity payment—by claiming a right to recoup from the insured all costs of defense paid before the point at which a court determines that the insurer has no obligation to indemnify under the policy. This argument has met with success in some states, most notably with the 1997 California Supreme Court decision in *Buss*—a decision insurers have cited in similar cases throughout the country. Although insurers have had some success in convincing courts to follow *Buss*, the *Jerry's Sport Center* court refused to do so.

The Pennsylvania Supreme Court Decision

Jerry's Sport Center arose out of suit against the insured brought by several organizations attempting to hold the firearms industry liable on the theory that its creation of a public nuisance resulted in injury, death, and other damages to association members who were the victims of firearms. The insurers had issued standard CGL policies to Jerry's Sports Center which required them to defend potentially covered claims, and the policies contained no right to reimbursement of defense costs. One of the insurers agreed to provide a defense, but it claimed the right to reimbursement of defense costs if it was ultimately determined not to have a duty to provide coverage.

In the coverage action, the trial court held that there was no covered claim because the plaintiffs did not seek damages for bodily injury to particular individuals, a conclusion the Pennsylvania Supreme Court found "suspect,"³ but which was never appealed. The trial court also found the insurer had a right to recoup all defense costs paid up until the determination that there was no possible duty to indemnify. On appeal, the Pennsylvania Superior Court, reversed the trial court's ruling on the issue of the right to recover defense costs.

The Pennsylvania Supreme Court considered the two lines of cases that had developed on the issue. One line of cases, as exemplified in *Buss*, found an insurer's reservation of the right to recover defense costs created a basis for such a recovery. The other line, exemplified by the Illinois Supreme Court decision in *General Agents. Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co.*,⁴ concluded that there could be no right of reimbursement of defense costs absent a contractual provision to that effect, and the insurer could not unilaterally modify the contract through a reservation of rights letter.

The court concluded that the approach of *Midwest Sporting Goods*, which had also been followed by the U.S. Court of Appeals for the Third Circuit in *Terra Nova Ins. Co. Lt. v. 900 Bar, Inc.*,⁵ was the

³ *American and Foreign Insurance Company v. Jerry's Sport Center, Inc.*, 2010 WL 3222404 at *18, n.4.

⁴ 828 N.E.2d 1092 (Ill. 2005).

⁵ 887 F.2d 1213 (3d Cir. 1989).

correct one. It carefully considered and explicitly rejected each of the insurers' arguments in support of such a supposed right.

First, the insurers argued that the reservation of rights letter created a contract implied-in-fact, vesting them with the right to recover defense costs in connection with a claim that a court determines is not potentially covered. The court rejected this claim, reasoning that an insurer "cannot employ a reservation of rights letter to reserve a right it does not have pursuant to the contract," and that to recognize such a right would be "tantamount to allowing the insurer to extract a unilateral amendment to the insurance contract."⁶

Second, the insurers claimed there was an equitable right to reimbursement because otherwise the insured would be unjustly enriched by receiving a defense it had no right to receive. The court also found no merit in this argument. It explained that an insurer has a right, as well as a duty, to defend, and in so doing benefits its own interests as well as those of the insured. It further reasoned that the duty to defend is extremely broad in Pennsylvania and this encourages insurers to construe their contract broadly and to defend all actions where there is any potential for coverage.

The *Jerry's Sport Center* court explained that the duty to defend arises if, on its face, the factual allegations of the complaint encompass an injury that is actually or potentially within the scope of the policy. Whether or not the complaint might fall within the policy's coverage, the duty to defend exists. It is the insurer's duty to determine whether it believes there is a potential indemnity obligation. If it is uncertain as to whether there is such an obligation, it should defend and seek resolution of the issue through a declaratory judgment action. If it believes there is no such obligation, it can deny coverage and allow the insured to defend, subject to its potential liability if the coverage decision is incorrect. Because of this settled law, the Pennsylvania Supreme Court concluded that to find a right of reimbursement of defense costs would "amount to a reactive erosion of the broad duty to defend" and "would . . . narrow Pennsylvania's long-standing view that the duty to defend is broader than the duty to indemnify."⁷

For insureds whose CGL policies are construed under Pennsylvania law, *Jerry's Sport Center* removes the risk that their insurers can use a reservation of rights letter to unilaterally create a right of reimbursement of defense costs that is nowhere set forth in the insurance policy. Nonetheless, there remains considerable uncertainty on this issue throughout the country. The highest courts of California and Minnesota, as well as intermediate appellate courts in Florida and New Jersey, have recognized an insurer's right of reimbursement of defense costs for uncovered claims, while the supreme courts in Alabama, Hawaii, Illinois, Louisiana, Massachusetts, Texas, and Wyoming (and now Pennsylvania) have held there is no right of reimbursement. Moreover, numerous federal court cases on the issue, which are predictions of how a state supreme court will resolve the issue, reach differing results.

In view of the unsettled state of the law on this issue nationally, we recommend the following. First, insureds should carefully review their CGL policies at renewal to be sure that the insurers are not proposing to add a contractual right of reimbursement of defense costs because such a contractual provision would be enforced by the courts. Second, in the event of a third-party claim that triggers coverage, insureds need to reject in writing any claimed right of reimbursement in an insurer

⁶ *American and Foreign Insurance Company v. Jerry's Sport Center, Inc.*, 2010 WL 3222404 at *15.

⁷ *American and Foreign Insurance Company v. Jerry's Sport Center, Inc.*, 2010 WL 3222404 at *14.

reservation of rights letters. Third, because the applicable substantive law governing the construction of an insurance policy is often unclear, and frequently depends upon which court is asked to resolve a disputed coverage issue, insureds need to consider promptly with experienced coverage counsel whether they need to respond to an assertion of a right to recover defense costs with a declaratory judgment action in a court that will apply favorable law on this issue. This protects the insured against any liability to re-pay defense costs to its own insurers, which costs often can be quite substantial.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Philadelphia

Richard F. McMenamin 215.963.5596 rmcmenamin@morganlewis.com

Washington, D.C.

Paul A. Zevnik 202.739.5755 pzevnik@morganlewis.com

Los Angeles

Michel Yves Horton 213.612.7300 mhorton@morganlewis.com

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