

The Coverage Inkwell

Emerging Coverage Issues in Intellectual Property, Privacy,
and Cyber Liability



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NEW PENNSYLVANIA LAW ON DUTY TO DEFEND AND THE INSURED'S RIGHT TO SETTLE

This summer, my son's 11yr baseball team turned a triple play. I kid you not. Believe me, I was shocked. We all were. (The team had just turned its first ever 6-4-3 double play the weekend before.) When it happened, we parents (and even my daughter) jumped and cheered despite the fact that (1) it was like 1,000 degrees out, (2) we were in the middle of a field with no shade, (3) we had been onsite since early morning, and (4) the team was on its way to a crushing defeat. (Actually, we didn't feel that bad about #4—a loss meant we could finally go home.) I tell this story not because of fatherly pride (well, maybe just a little), but because it's a good example on how sometimes the completely unexpected can happen.

In *The Babcock & Wilcox Co. v. American Nuclear Insurers*, 2013 WL 3456969 (Pa. Super. Ct. July 10, 2013), the unexpected happened, and not in a necessarily good way, for duty to defend law in Pennsylvania. The *Babcock* Court held that when an insurer tenders a defense subject to a reservation of rights, the insured may either (1) accept the defense, in which case the insured remains bound to the terms of the consent to settlement provision of the insurance policy and the insurer retains full control of the defense; or (2) the insured may reject the defense and furnish its own defense through independent counsel retained at the insured's expense. Under the latter option, the insured retains full control of the defense, including the option to settle without the insurer's consent, along with the right to seek coverage for the costs of defense and settlement at a later date so long as the costs are deemed fair, reasonable, and non-collusive.

When reaching this decision, the trial court ignored 56-year-old precedent to determine that an insured did not forfeit coverage when it went ahead and settled underlying litigation over the insurer's objection and in breach of the consent-to-settle provision despite the fact that the insurer was providing the insured a \$40 million defense. The Pennsylvania Superior Court reversed the trial court, but created its own approach based on a 1970s Florida appellate court decision. The underlying action involved environmental contamination, but *Babcock* warrants attention here for two primary reasons: if insurers have policies issued in Pennsylvania, they need to know about this case; and (2) cyber policies can cover liability involving significant loss and significant amounts of money. I anticipate that *Babcock* will have a disproportionate effect upon those types of cases.

Babcock involved multiple underlying class actions alleging bodily injury and property damage caused by the release of radioactive and toxic materials into the environment. *Id.*, *1. The insureds, the Babcock and Wilcox Company and B&W Nuclear Environmental Services (collectively, “B&W”), settled the underlying litigation for \$80 million, which was within the available policy limits of \$320 million, but without the consent of the insurers, American Nuclear Insurers and Mutual Atomic Energy Liability Underwriters (collectively, “ANI”). *Id.*, *1-2. ANI had been defending B&W in the underlying action, incurring over \$40 million in defense costs. When B&W sought reimbursement for the settlement, ANI refused, contending that B&W had breached the consent-to-settle provision in the insurance policies, thereby forfeiting coverage and relieving ANI of any duty to indemnify B&W. *Id.*, *2.

In the concurrent coverage litigation, B&W argued it was entitled to reimbursement, contending that where an insurer breaches its duty to consent to a reasonable settlement within the policy limits, the insured may settle without the insurer’s consent, and without forfeiting insurance coverage, so long as the settlement is reasonable and entered into in good faith.” *Id.*, *3. ANI, on the other hand, argued that under the Pennsylvania Supreme Court’s longstanding decision *Cowden v. Aetna Cas. & Sur. Co.*, 134 A.2d 223 (Pa. 1957), an insured in breach of a policy’s consent-to-settle clause forfeits coverage unless the insured demonstrates by clear and convincing evidence that: (1) there was no real chance of a defense verdict in the underlying litigation; (2) there was little possibility of a verdict or settlement within policy limits; (3) the insurer’s decision to proceed to trial rather than settle was not based on a *bona fide* belief of a good possibility of winning; and (4) the insurer’s decision to litigate instead of settling was made dishonestly. *Id.*

After reviewing the policies in question, the trial court initially concluded that under *Cowden*, unless B&W could demonstrate that ANI had refused to settle in bad faith and satisfy the four-pronged test articulated by the Pennsylvania Supreme Court, ANI would have no duty to indemnify because B&W had breached the policies’ consent-to-settle provision. *Id.*

However, two years later, the trial court revisited the issue. *Id.*, *4. Noting that the case before involved a settlement within the available policy limits and which had been paid for by the insured itself, and that the settlement did not involve a promise of enforcement against the insurer only, the trial court concluded that B&W had “a strong interest to hold out for the best possible deal because of the likelihood that the [policies] will not cover the [Underlying Action].” *Id.* Based on that understanding, the trial court returned to the legal issue of enforcement of the consent-to-settle clauses.

Instead of holding that under *Cowden*, ANI only would have to indemnify B&W if ANI had refused to settle in bad faith, the trial court held that in the context before it, “there was no principled distinction between a case in which an insurer provides a defense subject to a reservation of rights ... and a case where the insurer denies both defense and coverage.” *Id.* Therefore, the trial court determined that ANI had the duty to reimburse B&W so long as the settlement was fair, reasonable, and non-collusive, notwithstanding that ANI had been providing B&W a \$40 million defense. *Id.*

The trial court reasoned that the interests of the insurer and insured become antagonistic where an insured seeks to settle a claim within the policy limits and the insurer believes it has a strong case against coverage:

Because the insured may be responsible for paying any verdict, in most instances it desires to cap potential liability through a settlement at the lowest amount it can achieve. However, the insurance company is likely to reject a settlement offer that is fair and reasonable because by accepting the offer, it would be giving up its claim that there is no coverage.

The more that the insurance company believes that it can establish that there is no coverage, the more likely the insurance company will deny the insured's request to agree to what appears to be a very reasonable settlement offer because (unless the parties otherwise agree) the only way for the insurance company to challenge coverage is by having the underlying case proceed to trial.

Id., *5.

The trial court concluded that by allowing coverage for a fair, reasonable, and non-collusive settlement in violation of a consent-to-settle clause, the interests of both the insured and the insurer were protected because “[i]t allows the insurance company to continue to make decisions as to settlement (including the right to reject reasonable settlement offers) by withdrawing the right to challenge coverage. However, if the insurance company wants to preserve the option of questioning coverage, it cannot prevent the insured from protecting its interests in capping liability through a settlement that is fair and reasonable.” *Id.*, *6.

ANI appealed, arguing that it had the right to deny coverage for the settlement where: (1) the policies unambiguously afforded it the right to control settlement and exclude coverage for unauthorized payments; (2) ANI was fully performing its policy obligations by funding B&W's \$40 million defense; and (3) ANI's decision to continue defending the underlying action comported with the holding in *Cowden*, which permitted an insurer to refuse to settle in the absence of bad faith. *Id.*, *7. The Pennsylvania Superior Court reversed the trial court's decision, but promulgated a new approach that departed from *Cowden*.

The Pennsylvania Superior Court noted that many jurisdictions conclude that defending under a reservation of rights creates an irreconcilable conflict of interest between the insurer and the insured. *Id.*, *9-10. The Court also observed that in many jurisdictions, the solution to such a conflict is to “permit an insured to reject a defense offered under a reservation of rights, thereby forcing the insurer either to defend unconditionally (i.e., without reservation regarding coverage), or ‘to refuse to defend at its peril.’” *Id.*, *11. The trial court followed this approach. The Pennsylvania Superior Court, however, rejected it, calling the approach too extreme because the insurer either must surrender its right to raise

tenable coverage defenses or its right to insist on full application of the cooperation clause. Such an approach, the Court agreed, “puts an insurer honestly attempting to perform its duties between Scylla and Charybdis.” *Id.*

The *Babcock* Court, however, also departed from *Cowden*. In doing so, it rejected the approach that an insured, when being defended under a reservation of rights, forfeits coverage if it enters into a settlement without the insurer’s consent. *Id.*, *12-13. The court characterized the approach as “too cavalier regarding the risk imposed upon the insured when an insurer rejects an opportunity to accept a reasonable settlement offer and opts to proceed to trial,” a risk that, the Court concluded, originates “in the inherent conflict between the insured’s interest in settling a claim against him expeditiously and within the policy limits and the insurer’s interest in establishing a basis to deny coverage.” *Id.*, *13.

Looking to a 1970’s Florida appellate court decision in *Taylor v. Safeco Ins. Co.*, 361 So. 2d 743 (Fla. Ct. App. 1978), the *Babcock* Court adopted a third approach. Believing that it had struck a “middle ground,” the *Babcock* Court held that an insurer may either accept the offered defense and thereby be bound by the insurer’s control of litigation, or reject the defense and proceed on its own with the right to seek coverage at a later date:

We find that the *Taylor* approach, in providing an insured the option to decline a defense tendered subject to a reservation of rights, but protecting an insurer’s right to control the defense when it is accepted by the insured, best balances the interests of insurer and insured, and better honors the binding nature of the insurance contract. By granting the insured a basis upon which to eliminate the risk of a conflict of interest at the outset of a claim, it does not consign the insured solely to the protection of our strictly-construed bad-faith standard. At the same time, our approach protects an insurer’s right to control litigation when it provides a defense. [Citations omitted.] We deem it essential that the party defending a suit, whether insurer or insured, retain the unqualified prerogative to proceed in the way that it determines is best. This approach also honors the essence of a consent to settlement clause: When an insured avails itself of the insurer’s obligation to defend, the insured remains bound to the corollary requirement that the insurer have sole authority to control the defense.

Id., *16.

Thus, the *Babcock* Court held that an insured may either accept a tendered defense or reject it, and identified the effects of either decision:

[W]e hold that, when an insurer tenders a defense subject to a reservation, the insured may choose either of two options. It may accept the defense, in which event it remains unqualifiedly bound to

the terms of the consent to settlement provision of the underlying policy. Should the insured choose this option, the insurer retains full control of the litigation, consistently with the policy's terms. In that event, the insured's sole protection against any injuries arising from the insurer's conduct of the defense lies in the bad faith standard articulated in *Cowden*.

Alternatively, the insured may decline the insurer's tender of a qualified defense and furnish its own defense, either *pro se* or through independent counsel retained at the insured's expense. In this event, the insured retains full control of its defense, including the option of settling the underlying claim under terms it believes best. Should the insured select this path, and should coverage be found, the insured may recover from the insurer the insured's defense costs and the costs of settlement, to the extent that these costs are deemed fair, reasonable, and non-collusive.

Id., *17-18.

The *Babcock* Court then remanded the case to the trial court to determine (1) whether B&W had rejected ANI's defense and, if not, (2) whether, pursuant to *Cowden*, ANI had acted in bad faith by refusing to settle, which would relieve B&W of the forfeiture of coverage for breaching the consent-to-settle provision in the ANI policies. *Id.*, *18.

In a concurring and dissenting opinion, Justice Olson agreed that the trial court's decision required reversal, but rejected the Pennsylvania Superior Court's newly adopted approach. Justice Olson reasoned that Pennsylvania law was clear and binding: B&W was obligated to comply with the consent-to-settle provision unless ANI had acted in bad faith:

Notwithstanding its acknowledgement of the foregoing principles as set forth in binding precedents handed down by our Supreme Court [in *Cowden*], the learned Majority remands this matter for further proceedings consistent with the Florida court's decision in *Taylor*. In so doing, the Majority alters the parties' insurance contract, bestowing upon the insured a new option, never before recognized under Pennsylvania law, to reject a defense offered pursuant to a valid reservation of rights clause in an insurance agreement.

Id., *20. Further appeals are expected. For now, *Babcock* is binding law.

What does this case mean? If *Babcock* is affirmed (or simply not reversed), the law in Pennsylvania has been significantly changed. Unanswered questions and effects of this new approach are too numerous to address adequately here. But I offer two quick observations.

First, given the financial risk that comes with rejecting a tendered defense, *Babcock's* effect may be limited. The simple truth of the matter is that many insureds may lack the financial resources for—or may be unwilling to incur the risk of—walking away from a paid defense with the uncertain hope of recovering that money, and the money from a settlement or verdict, at a later date. More likely, large corporate policyholders with significant financial resources will take advantage of *Babcock's* new approach.

Second, these large corporate policyholders could very well exploit this case in a manner that the *Babcock* Court did not anticipate. Consider this: having rejected a tendered defense, a large corporate policyholder can hire an expensive law firm—with the insurer having no say whatsoever about staffing or rates. Large defense bills logically will follow. As the underlying action proceeds towards settlement, the corporate policyholder could then use the threat of future coverage litigation and coverage for the large defense bill as leverage to strike a deal with the carrier to partially fund the defense and the settlement it had no say over. How can this happen? The *Babcock* Court never addresses the effect of a rejected defense on the duty to defend standard. The fact that a policyholder can seek coverage after-the-fact demonstrates that duties under the insurance contract are not fully repudiated by a rejected defense. Under Pennsylvania law, once an insurer issues a reservation of rights, it in effect stipulates that defense coverage exists. *Cf. American & Foreign Ins. Co. v. Jerry's Sport Ctr., Inc.*, 2 A.3d 526 (Pa. 2010). How will this stipulation play out? The scenario seems to go against the spirit of *Babcock*, and I can argue why a rejection of a defense also repudiates the duty to defend. (By the way, it's also a right of the insurer.) But will a trial court bound by the decisions of higher courts see it that way?

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