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PENNSYLVANIA SUPREME COURT REJECTS REIMBURSEMENT OF DEFENSE COSTS WHILE TENTH CIRCUIT FINDS SUPPORT UNDER COLORADO LAW

Richard J. Bortnick • 610.832.8357 • *rbortnick@cozen.com*
Bryan W. Petrilla • 610.832.7459 • *bpetrilla@cozen.com*

Two cases decided only one day apart illustrate the growing divide over whether an insurer is entitled to recover the costs of defending a claim that is ultimately determined not to be covered. In both cases, the policies at issue did not specifically address the reimbursement of defense costs, but the insurers asserted the right in their reservation of rights letters. The Pennsylvania Supreme Court rejected the right to do so, while the U.S. Court of Appeals for the 10th Circuit predicted that an insurer would be entitled to recover defense costs from a policyholder under Colorado law in the face of a no-coverage determination.

In American and Foreign Ins. Co. v. Jerry's Sport Center, No. J-48-2009 (Pa. Aug. 17, 2010), the policyholders were sued for negligently creating a public nuisance by failing to distribute firearms reasonably and safely. The insurer issued a reservation of rights letter stating that it would provide a defense subject to its right to "seek reimbursement for any and all defense costs ultimately determined not to be covered." The insurer argued that it had no duty to defend or indemnify the policyholders and sought reimbursement of the defense costs it incurred and/or paid following the date it filed a declaratory judgment action.

Ruling on the insurer's motion for reimbursement, the trial court determined that the underlying claims were not covered and held that the insurer was entitled to recover its defense costs based on the equitable doctrine of "unjust enrichment." It reasoned that the insurer had conferred the benefit of a legal defense upon the policyholders and that to allow the policyholders to accept and retain those benefits without payment would unjustly enrich them. On appeal, the Pennsylvania Superior Court reversed, concluding that permitting reimbursement of defense costs pursuant to the insurer's reservation of rights letter amounted to an impermissible unilateral modification of the insurance policy. On a following appeal to the Pennsylvania Supreme Court, the Court granted *allocatur*, defining the issue as "whether an insurer is entitled to reimbursement of defense costs when a court has determined that the insurer had no duty to defend the [policyholder] and the insurer has claimed a right to reimbursement only in a series of reservation of rights letters."

In its August 17, 2010 decision, the Pennsylvania Supreme Court first rejected the insurer's argument that because the trial court had determined that the claims were not covered, the insurer's duty to defend was never triggered. As to this point, the Court observed that "whether a complaint raises a claim against an insured that is potentially covered [and thereby triggers an insurer's duty to defend] is a question to be answered by the insurer in the first instance." The Court noted that the insurer had answered the question in the affirmative by providing a defense. "The trial court's subsequent declaratory judgment determination that the claim was not covered relieved [the insurer] of having to defend the case going forward, but did not somehow nullify its initial determination that the claim was potentially covered." In other words, the Court ruled that an insurer has the initial obligation to determine whether a claim is potentially covered and, consequently, whether it has a duty to defend. Once decided, it is a threshold issue that cannot be retroactively undone by a court.

The Court next rejected the insurer's argument that its reservation of rights letter created a new contract, holding that an insurer cannot reserve a right it does not already have under the explicit terms of the policy. According to the Court, to hold otherwise would be "tantamount to allowing the insurer to extract a unilateral amendment to

the insurance contract." The Court further noted that the insurer had already attempted to amend the scope of its right to reimbursement several times throughout the course of the underlying litigation by way of its correspondence with the policyholders. If such conduct was permissible, the Court found that "a right of reimbursement outside of the policy would empower each insurer to design its own right of reimbursement subject only to the insurer's designs."

Finally, the Court rejected the insurer's unjust enrichment position, holding that the insurer's right to control the defense of its policyholders conferred a benefit upon it, protecting it against potential indemnity exposure and a claim for bad faith. "Accordingly, if the insurer could recover defense costs from its policyholder, then the policyholder would be paying for the insurer to protect itself."

It is important to note that the Court *did not* hold that reimbursement of defense costs was against public policy or that an explicit policy provision would not be enforced. Furthermore, the Court's decision does not impact an insurer's right to allocation of defense costs, nor does it address the ability of an insurer to recover defense costs for those claims the parties agreed were not potentially covered when the insurer defended against a mix of covered and uncovered claims.

In stark contrast, the 10th Circuit in Valley Forge Ins. Co. v. Health Care Mgmt. Partners., Ltd., No. 09-1251 (10th Cir. Aug. 16, 2010), predicted that under Colorado law, an insurer *would be* permitted to recoup defense costs from its policyholder with respect to uncovered claims. In so stating, the 10th Circuit observed that the Colorado Supreme Court, without issuing specific rulings, has clearly recognized "an insurer's entitlement to reimbursement of defense costs in the event it is later determined that the insurer did not have a duty to defend."

The 10th Circuit found support for its conclusion in Hecla Mining Co. v. New Hampshire Ins. Co., 811 P.2d 1083 (Colo. 1991), where the Colorado Supreme Court held that when an insurer is uncertain as to its duty to defend, it should provide a defense while reserving its right to seek reimbursement for claims ultimately determined not to be covered. The 10th Circuit noted that the Colorado Supreme Court further explained its position in Cotter Corp. v. American Empire Surplus Lines Ins. Co., 90 P.3d 814 (Colo. 2004), where it stated that it had attempted in Hecla to properly define the scope of an insurer's broad duty to defend under Colorado law by ensuring that insurance companies are not required "to pay defense costs if coverage ultimately does not exist under the policies." Thus, the Court reasoned, Colorado law ensures "that [the policyholders] will receive a defense and that insurers won't be left holding the bag if it turns out they had no duty to provide one."

In reaching its decision, the 10th Circuit apparently weighed the equitable balance of competing rights and interests of both insurers and policyholders, although it did not specifically cite to a particular theory of recovery or public policy. "Regardless [of] whether the Colorado courts situate the rule in equity, contract, policy, rule of court, or someplace else — whatever doctrinal pigeonhole best fits — one thing is clear: Colorado permits insurers to recoup defense costs in the circumstances before us." The 10th Circuit also refused to decide whether the policyholder could contest the reasonableness of the attorney fees incurred in its defense when determining how much the insurer was entitled to recover, stating that it was not necessary to the disposition of the case. It further held that the insurer could not recover prejudgment interest on the defense costs because Colorado courts had not addressed the issue and the additional expense might "disincentivize" policyholders from exercising their rights to a defense and "push them to shoulder their own defense costs."

These two decisions are indicative of the continuing split of authority evolving around the critical reimbursement of defense costs issue. In fact, the Pennsylvania Supreme Court noted that, to date, an almost equal number of courts have either supported or denied an insurer's right to reimbursement. It is a closely debated and important right that will continue to impact the bottom line of insurers and policyholders alike, and it should continually be monitored on a state-by-state basis.

Cozen O'Connor is a global leader in representing the insurance industry in coverage matters. For further analysis of this case and other coverage issues, please contact Richard J. Bortnick (rbortnick@cozen.com (West Conshohocken)) or Bryan W. Petrilla (bpetrilla@cozen.com (West Conshohocken)).