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Weber Gallagher

Pennsylvania Superior Court Addresses Control of Settlement where Insurer Defends under Reservation of Rights

The Pennsylvania Superior Court recently issued a decision that will affect how insurers and insureds interact when the insurer is providing a defense under a reservation of rights.

In Babcock & Wilcox v. American Nuclear Insurers et. al., 2013 Pa. Super 174 (July 10, 2013) the Court held that when an insurer offers an insured a defense under a reservation of rights the insured has the option to either reject that defense and defend itself, at its own cost, or accept that defense. If the insured rejects the defense it will be able to subsequently recover its attorney's fees and reimbursement for any settlement, assuming the settlement is reasonable. However, if the insured accepts the defense it will not be able to subsequently settle the case over the insurer's objection and obtain reimbursement for the settlement.

Babcock involved insurance coverage for two nuclear fuel processing facilities owned first by ARCO and later by Babcock & Wilcox (B&W). In 1994, B&W and ARCO were sued by five individuals and three purported class representatives in federal court alleging that they had sustained bodily injury and property damage caused by radioactive emissions from the facilities. Their liability insurer, American Nuclear Insurers (ANI), provided a defense to the lawsuits under a reservation of rights.

Counsel retained by the insureds negotiated a settlement of the underlying claims for $80 million. The settlement funds were provided by the ARCO and B&W. The settlement was made over ANI's objection and, based on the policies' consent to settle clauses, ANI denied any obligation to indemnify the insureds for the settlement, citing the insurance policy's "consent to settlement" clause, which prohibits an insured from settling claims without the insurer's consent.

ANI filed a declaratory judgment action and the court was called on to decide the standard applicable to determining whether ANI had an obligation to indemnify the insureds for the settlement made over ANI's objection. The trial court determined that the insureds simply needed to prove that the settlement was fair, reasonable and non-collusive. The Superior Court reversed and remanded on appeal, setting forth a new rule for Pennsylvania insurance law:

[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 ...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 cost and the cost of settlement, to the extent that these costs are deemed fair, reasonable, and non-collusive.

Babcock, Slip Opinion at 39-40.

Where the insured accepts the defense with reservation and an excess verdict results, the insured may still be able to hold the insurer responsible for the amount of the verdict in excess of policy limits by filing suit for "bad faith" under the Supreme Court's decision in Cowden v. Aetna Cas. & Sur. Co., 389 Pa. 459, 134 A.2d 223 (1957).

Babcock provides clear guidance with regard to the parties' rights and obligations when a defense is offered under a reservation of rights. But it also provides answers to some other questions and leaves certain questions unanswered.

Babcock appears to put to rest the question of "independent counsel" for insureds. Insureds sometimes claim that when an insurer offers a defense under a reservation of rights it creates a conflict of interest that allows the insured to hire counsel of its choosing (i.e. independent counsel), but at the insurer's expense. See e.g. Eckman v. Erie Ins. Exch., 21 A.3d 1203, 1207 (Pa. Super. 2011). Under Babcock an insured that accepts a defense under a reservation of rights cedes control of the defense to the insurer, and this would logically include selection of counsel. Babcock suggests that where the insured believes that the reservation creates an irresolvable conflict with regard to the conduct of the defense, the insured's recourse would be to reject the defense and recover the cost of defense in addition to indemnity if coverage is later found. However, there do not seem to be any circumstances under which an insured could compel an insurer to pay for counsel selected by the insured prospectively.