IN THE SUPREME COURT OF PENNSYLVANIA

Docket No. 88 MAP 2008

AMERICAN AND FOREIGN INSURANCE COMPANY, ROYAL INSURANCE CO. OF AMERICA, SAFEGUARD INSURANCE COMPANY AND ROYAL INDEMNITY COMPANY,

Petitioners/Appellants

v.

JERRY'S SPORT CENTER, INC., JERRY'S SPORT CENTER NORTHEAST, INC., BONITZ BROTHERS, INC., OUTDOOR SPORTS HEADQUARTERS, INC., SIMMONS GUN SPECIALTIES, INC., NATIONAL ASSOC. FOR THE ADVANCEMENT OF COLORED PEOPLE, NATIONAL SPINAL CORD INJURY ASSOC., AMERICAN INTERNATIONAL INSURANCE COMPANY, DOE CORPORATIONS 1-15,

Respondents/Appellees

BRIEF OF AMICUS CURIAE UNITED POLICYHOLDERS IN SUPPORT OF RESPONDENTS/APPELLEES

OPPOSITION TO APPEAL FROM THE ORDER OF THE SUPERIOR COURT OF PENNSYLVANIA OF MAY 5, 2008 AT NO. 1098 MDA 2006 REVERSING THE JUDGMENT OF THE COURT OF COMMON PLEAS OF SUSQUEHANNA COUNTY, PENNSYLVANIA OF 6-13, 2006 AT CIVIL DIVISION 2001-939

JOHN N. ELLISON, ESQ. (I.D. No. 51098)
TIMOTHY P. LAW, ESQ. (I.D. No. 76793)
BRYAN W. PETRILLA, ESQ. (I.D. No. 200936)
Reed Smith, LLP
2500 One Liberty Place
1650 Market Street
Philadelphia, PA 19103
Tel: (215) 851-8100
Fax: (215) 851-1420
jellison@reedsmith.com
tlaw@reedsmith.com
bpetrilla@reedsmith.com

– and –

AMY BACH, ESQ.
United Policyholders
222 Columbus Avenue, # 412
San Francisco, CA 94133
amy@unitedpolicyholders.org
Tel: (415) 393-9990
Fax: (415) 677-4170

Counsel for *Amicus Curiae* United Policyholders

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STATEMENT OF INTEREST OF AMICUS CURIAE

United Policyholders was founded in 1991 as a non-profit organization dedicated to educating the public on insurance issues and consumer rights. The organization is tax exempt under Internal Revenue Code § 501 (c)(3). United Policyholders is funded by donations and grants from individuals, businesses and foundations.

In addition to serving as a resource on insurance claims for disaster victims and commercial policyholders, United Policyholders actively monitors legal and marketplace developments affecting the interests of all policyholders. United Policyholders receives frequent invitations to testify at legislative and other public hearings, and to participate in regulatory proceedings on rate and policy issues.

A diverse range of policyholders throughout the United States communicate on a regular basis with United Policyholders, which allows us to provide important and topical information to courts throughout the country via the submission of *amicus curiae* briefs in cases involving insurance principles that are likely to impact large segments of the public.

STATEMENT OF THE QUESTION

Whether an insurer is entitled to reimbursement of defense costs when a court has determined that the insurer had no duty to defend the insured and the insurer had reserved its right to reimbursement in a reservation of rights letter.

SUMMARY OF ARGUMENT

American and Foreign Insurance Company, Royal Insurance Company of America and Safeguard Insurance Company and Royal Indemnity Company (collectively "Royal") are not entitled to "recoup" or obtain "reimbursement" of defense costs from Jerry's Sport Center, Inc. and its subsidiaries, Jerry's Sport Center Northeast, Inc., Bonitz Brothers, Inc., Outdoor Sports

Headquarters, Inc. and Simmons Gun Specialties Inc. (collectively "Jerry's Sport"). The Superior Court's decision should be affirmed.[1]

When an insurance company assumes the defense of a policyholder, the insurance company generally does not pay the policyholder, so the terms "reimbursement" and "recoupment" are somewhat misleading. The insurance company assumes control over the defense of the case, selecting and paying for its own choice of counsel. Its motivation in assuming the defense is not altruistic. Instead, it is governed by contractual obligation, statutory bad faith law, well-established legal precedent recognizing a fiduciary duty of utmost good faith, and to a degree, self-interest in ensuring that the defense is conducted cost-effectively to minimize the ultimate combined cost of the defense and settlement or judgment for which the insurance company could potentially be responsible. Standard-form insurance policies, including the one sold by Royal to Jerry's Sport, explicitly state that an insurance company is liable to pay all expenses incurred in its defense of the policyholder. Under well-established Pennsylvania law, additional contract terms (particularly ones that contradict the actual contract terms) cannot be read into an insurance policy to the detriment of the policyholder. Accordingly, this Court should not create an extra-contractual right for an insurance company to recover from a policyholder the cost of the defense provided for the policyholder.

[1] The citation to the Superior Court decision is American & General Insurance Co. v. Jerry's Sport Center, Inc., 948 A.2d 834 (Pa. Super. Ct. 2008), hereinafter "Super. Ct. Decision."

LEGAL ARGUMENT

I. THE DUTY TO DEFEND IS A BROAD DUTY THAT CREATES SPECIAL, FIDUCIARY OBLIGATIONS IN A LIABILITY INSURANCE COMPANY.

A. The Duty to Defend Places The Insurance Company In the Role of a Fiduciary.

An insurance policy is not simply a contract to pay money. Nor is it a generic widget. It is a special product that creates a special relationship. An insurance policy is strengthened by the fiduciary and good faith duties an insurance company owes its policyholder, long recognized under Pennsylvania law. See, e.g., Fedas v. Insurance Co. of State of Pa., 300 Pa. 555, 559, 151 A. 285, 286 (1930) (holding that "utmost fair dealing should characterize the transactions between an insurance company and the insured").

Under the duty to defend, an insurance company owes a fiduciary duty to its policyholder because "by asserting in the policy the right to handle all claims against the insured, including the right to make a binding settlement, the insurer assumes a fiduciary position towards the insured and becomes obligated to act in good faith and with due care in representing the interests of the insured." Birth Center v. St. Paul Cos., 567 Pa. 386, 400, 787 A.2d 376, 389 n. 17 (2001) (noting that "[b]ecause of the insurer's controlling role in the litigation, the insurer enters a fiduciary relationship with its insured and accepts the responsibility to protect its insured"); see also Gray v. Nationwide Mut. Ins. Co., 422 Pa. 500, 504, 223 A.2d 8, 9 (1966); Gedeon v. State Farm Mut. Auto. Ins. Co., 410 Pa. 55, 60, 188 A.2d 320, 322 (1963).

B. The Duty To Defend Arises Whenever There Is A Potentially Covered Claim.

An insurance company's duty to defend litigation is a distinct obligation, different from the duty to pay judgments or settlements (often called the duty to indemnify). Erie Ins. Exch. v. Muff, 851 A.2d 919, 925 (Pa. Super. Ct. 2004); D'Auria v. Zurich Ins. Co., 352 Pa. Super. 231,

233, 507 A.2d 857, 859 (1986). "It is well-established that the duty to defend and pay the costs of defense is broader than the duty to indemnify." J.H. France Refractories v. Allstate Ins. Co., 626 A.2d 502, 510 (Pa. 1993). Indeed, an insurance company's duty to defend is interpreted expansively. General Accident Ins. Co. of Am. v. Allen, 547 Pa. 693, 706, 692 A.2d 1089, 1095 (1997); Gedeon v. State Farm Mut. Auto. Ins. Co., 410 Pa. 55, 56, 188 A.2d 320, 322 (1963). The duty to defend is broad in the sense that "[a]n insured has purchased not only the insurer's duty to indemnify successful claims which fall within the policy's coverage, but also protection against those groundless, false or fraudulent claims regardless of the insurer's ultimate liability to pay." Muff, 851 A.2d at 925-26.

An insurance company is obligated to defend its policyholder if the factual allegations of the complaint on its face encompass an injury that is actually or potentially within the scope of the policy. Gedeon, 410 Pa. at 56, 188 A.2d at 322; Wilson v. Maryland Cas. Co., 377 Pa. 588, 105 A.2d 304 (1954); Sorbee Int'l Ltd. v. Chubb Custom Ins. Co., 735 A.2d 712, 714 (Pa. Super. Ct. 1999). Pennsylvania courts look to the language of the policy at issue and the allegations in the underlying complaint to evaluate whether any claim could potentially fall within the coverage of the policy. Gene's Restaurant, Inc. v. Nationwide Ins. Co., 519 Pa. 306, 548 A.2d 246, 246-47 (1988); Cadwallader v. New Amsterdam Cas. Co., 396 Pa. 582, 152 A.2d 484 (1959). In doing so, "the factual allegations of the underlying complaint against the insured are to be taken as true and liberally construed in favor of the insured." Frog, Switch & Mfg. Co., Inc. v. Travelers Ins. Co., 193 F.3d 743, 746 (3d Cir. 1999) (citing Biborosch v. Transamerica Ins. Co., 412 Pa. Super. 505, 509, 603 A.2d 1050, 1052 (1992)). It has long been held that so long as the complaint filed by the injured party might or might not fall within the coverage of the

insurance policy, the insurance company is obligated to defend the action. Cadwallader, 396 Pa. at 589-90, 152 A.2d at 488.

As long as there is at least one claim in the complaint filed by the underlying claimant that "might or might not" fall within the coverage of the policy, the insurance company is obligated to defend the entire suit, regardless of whether there are also claims that clearly fall outside the policy. Frog, Switch & Mfg., 193 F.3d at 746; Biborosch v. Transamerica Ins. Co., 412 Pa. Super. at 509-10, 603 A.2d at 1052. The duty to defend is not limited to meritorious actions; it even extends to actions that are "groundless, false, or fraudulent" so long as there exists the possibility that the allegations implicate the insurance policy coverage. Erie Ins. Exch. v. Transamerica Ins. Co., 516 Pa. 574, 582, 533 A.2d 1363, 1368 (1987); Gedeon, 188 A.2d at 321-22. Judgment in the insurance company's favor with regard to the duty to defend is appropriate only if there is no possibility that any of the underlying claims could be covered by the policy at issue. See, e.g., Germantown Ins. Co. v. Martin, 407 Pa. Super. 326, 595 A.2d 1172 (1991), alloc. denied, 531 Pa. 646, 612 A.2d 985 (1992).

C. Ambiguous Insurance Policy Language Is Construed In Favor of the Insured.

Where a provision of an insurance policy is ambiguous, it will be construed against the insurance company and in favor of coverage. Prudential Prop. & Cas. Ins. Co. v. Sartno, 588 Pa. 205, 212, 903 A.2d 1170, 1174 (2006). The standard for determining whether an insurance policy term is ambiguous is whether reasonably intelligent persons considering the term in the context of the entire policy would honestly differ as to its meaning. Celley v. Mutual Benefit Health & Acc. Ass'n, 229 Pa. Super. 474, 481-82, 324 A.2d 430, 434 (1974). If the words of an insurance policy are subject to different reasonable interpretations, the language is construed in favor of coverage for the policyholder:

> Regardless of which [interpretation] is "right" or "wrong," the fact is that because each interpretation is reasonable, the exclusionary term is ambiguous, and we must construe it in favor of the insured. "Where a provision of a policy is ambiguous, the policy provision is to be construed in favor of the insured and against the insurer, the drafter of the agreement. *Madison Constr. Co. v. Harleysville Mut. Ins. Co.*, 557 Pa. 595, 735 A.2d 100, 106 (1999).
>
> The insurance company is the drafter of the terms of the policies it issues to its insureds, and, being the one who selects the language in the contract, must be specific in its use;...

Id., 588 Pa. at 217, 903 A.2d at 1177. See also Motley v. State Farm Mut. Auto Ins. Co., 502 Pa. 335, 340, 466 A.2d 609, 611 (1983) ("if we should err in determining the meaning of an insurance policy provision or the legislative intent of a statute, our error should be in favor of coverage for the insured").

D. The Superior Court Properly Determined That Royal Had A Duty To Defend Until a Court Relieved It of that Obligation.

The Superior Court properly applied this well-established law relating to the duty to defend and insurance policies, stating "we conclude that Royal's duty to defend was triggered when it was faced with what it characterized (in its own letters and communications with Jerry's Sport) as potentially covered claims...." Super. Ct. Decision, 948 A.2d at 848. While a court may have ultimately relieved Royal of the continuing obligation to defend Jerry's Sport, Royal itself decided to defend pending judicial review.

In some instances, as here, an insurance company will be uncertain as to whether the claims alleged in an action fall, or even potentially fall, within the scope of its insurance policy. In those instances, the insurance company has an obligation to assume the defense of its policyholder. It may decide to seek a judicial determination through a declaratory judgment as to its duty to defend the allegations of the complaint, which if successful would relieve the insurance company of the continuing obligation to defend the action. However, such declaratory

judgment actions should be brought sparingly, as the policyholder bought protection from lawsuits not an invitation to further lawsuits.

Accordingly, the duty to defend law encourages insurance companies to broadly construe their insurance policies and the complaints against their insureds to defend all claims where there is any potential coverage. When there is absolutely no potential for coverage, the insurance company should deny coverage and allow the insured to handle its own defense, leaving the insured to make its own decisions about the selection of counsel and the course of the defense, because the insurance company will never be liable to pay any settlement or judgment. In order to ensure that insurance companies assume coverage whenever there is the potential for coverage, the consequences for an insurance company's failure to do so should be severe.[2]

II. INSURANCE COMPANIES MAY NOT BE RETROACTIVELY RELIEVED FROM THEIR DUTY TO DEFEND POTENTIALLY COVERED CLAIMS.

Royal alleges that it can be retroactively relieved of its obligation to pay for the defense of potentially covered claims. It supports its theory by asserting that a court determines whether claims are potentially covered and not the insurance company. It states that if a court does eventually determine that a suit against its policyholder does not allege any claims that are covered under the terms of the policy, such a determination reaches back and eliminates the earlier moment when the insurance company examined the complaint and decided that the allegations might potentially amount to covered claims, thereby triggering its duty to defend

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[2] In particular, the insurance company should not be permitted to complain about the cost of the defense or any decisions made in the defense of the claim if it erroneously fails to assume the defense. Having disclaimed its duty to defend, and waived its right to defend, the insurance company should be precluded from raising any issues relating to the defense that it could and should have controlled. If the insurance company lacked a reasonable basis for believing that there was no potential for coverage, bad faith damages should be imposed. See 42 Pa.C.S. § 8371.

under Pennsylvania law. See Royal Br. at 16-20. Royal's theory, however, utterly destroys the concept of potentiality and the insurance company's fiduciary duty to defend its policyholder.

As the Superior Court properly noted, "the duty to defend may be triggered even if it is later determined by a court that there is no actual coverage and, thus, no duty to indemnify." Super. Ct. Decision, 948 A.2d at 852; see also Shoshone First Bank v. Pacific Employers Ins. Co., 2 P.3d 510, 516 (Wyo. 2000) (holding that "[t]he question as to whether there is a duty to defend an insured is a difficult one, but because that is the business of an insurance carrier, it is the insurance carrier's duty to make that decision"). By its very nature, potential exists when there is uncertainty as to an outcome. Once the outcome is known, it does not retroactively eliminate that period of time in which uncertainty existed. It merely establishes that going forward, there is no longer any uncertainty. See, e.g., Liberty Mut. Ins. Co. v. FAG Bearings Corp., 153 F.3d 919, 924 (8th Cir. 1998) (rejecting insurance company's attempt to recoup defense costs, holding that it "remained obligated to defend [its insured] so long as there remained any question as to whether the underlying claims were covered by the policies. Upon determination that the claims against [the insured] were therefore excluded from coverage, the district court properly concluded that [the insurer's] duty to defend [its insured] in this action expired").

Royal is attempting to obscure its duty to defend, and the time that duty is triggered, by merging it with its duty to indemnify. The triggering events for these separate duties occur at different times for a reason. If this Court adopts Royal's position, it will indeed result in a "retroactive erosion of the breadth of its duty to defend" under Pennsylvania law, reducing the protection against litigation bought and paid for by policyholders. See Super. Ct. Decision, 948 A.2d at 852. According to Royal, the duty to defend would not be triggered until after a court

intervened and determined that complaint alleged covered claims. This would dramatically upset well-established Pennsylvania law regarding an insurance company's broad duty to defend at the outset of litigation. A policyholder would no longer be purchasing protection from litigation. It would be purchasing the right to litigate against its insurance company.

III. AN INSURANCE COMPANY MUST PROVIDE ITS POLICYHOLDER WITH A DEFENSE, NOT A COERCIVE DEMAND FOR NEW AND UNFAVORABLE POLICY TERMS OR AN INVITATION TO LITIGATE.

Policyholders buy insurance coverage not only to shift the cost of ultimate liability to a third party, but to alleviate the risk of incurring what can quickly amount to substantial attorney's fees that are often the necessary result of a vigorous and sustained defense. This is a critical component of what is essentially "litigation insurance." Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am., 448 F.3d 252, 259 (4th Cir. 2006) (rejecting insurance company's attempt to recoup defense costs because it would "significantly tip the scales in favor of the insurer"). Potential liability arising from a lawsuit can pose a serious threat to the continuation of a company's operations. In this case, for example, trial counsel for Jerry's Sport determined that because of the breadth of the allegations against it and the potential for serious damages, Jerry's Sport "would have to dramatically change the way it did business, and might not even survive into the future" if it was found liable. Super. Ct. Decision, 948 A.2d at 839.

Instead of finding solace in the midst of the economic stress and consternation that arises from such a crisis, a policyholder under Royal's proposed scheme is instead faced with what courts have properly termed a Hobson's choice, whereby the policyholder is offered a "take it or leave it" defense with onerous terms not included within the insurance policy. See, e.g., General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., 828 N.E.2d 1092, 1102 (Ill. 2005) ("recognizing such an implied agreement effectively places the insured in the position of making

a Hobson's choice between accepting the insurer's additional conditions on its defense or losing its right to a defense from the insurer"). In the policyholder's hour of need, it is given an unfavorable take it or leave it "choice" to acquiesce to any new terms the insurance company wants, or fending for itself and resorting to a series of lawsuits.

It would be contrary to public policy, particularly the duty of good faith arising from the insurance company's fiduciary position toward the insured, to force policyholders into a Hobson's choice of accepting a defense unilaterally modified to include new detrimental terms or accepting no defense at all. The Superior Court recognized the patent inequity of such a scheme and rejected the insurance company's attempts to introduce it into Pennsylvania insurance coverage law. By affirming the Superior Court's decision, not only will this Court be upholding the well-established principles of insurance contract interpretation under Pennsylvania law, but also will be affirming the fundamental purpose underlying the creation and sale of every liability insurance policy in the Commonwealth: protection of the policyholder.

Take, for example, a homeowner who is sued when someone slips and falls on her property. She provides notice of the lawsuit to her insurance company which offers to defend her under the added condition that if it is eventually determined that the allegations in the lawsuit are not covered by the policy, she has to reimburse the insurance company for all of her defense costs. Faced with this "choice," she can: (1) accept the insurance company's additional terms and receive a defense against the slip and fall lawsuit or (2) retain her own counsel, at her own expense, not only to defend against the original lawsuit, but also to defend or prosecute a declaratory judgment action. Most policyholders would not know where to begin as a practical matter. They purchase insurance not only to protect against the risk of incurring defense costs,

but also to take advantage of the insurance company's expertise as an institutional litigator defending against thousands of claims every year.

This scenario is simply unacceptable. As the Wyoming Supreme Court rightly observed, "[i]f this became common practice, the insurance industry might extract coercive arrangements from their insureds, destroying the concept of liability and litigation insurance." Shoshone First Bank v. Pacific Employers Ins. Co., 2 P.3d 510, 516 (Wyo. 2000). Indeed, if insurance companies are allowed to water down their duty to defend policyholders, we will quickly reach a point at which liability insurance, a requirement for homeowners, car owners, and businesses alike, becomes a product of highly questionable worth. It is precisely to avoid such an outcome, and in recognition of the essential utility that insurance provides in our society, that Pennsylvania imposes fiduciary good faith duties on insurance companies. Royal's entire quest to recoup defense costs ignores this special relationship it has with its policyholders and with our society in general.[3]

Courts that have determined an insurance company has a "right" to recoup defense costs often reduce the relationship between an insurance company and its policyholder to that of two generic entities engaged in a run of the mill commercial transaction. For example, the California Supreme Court, upon which Royal heavily relies, provided the following illustration to support its conclusion:

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[3] It was long ago observed that insurance falls within the realm of the public interest:

> [W]e have taken the law of insurance practically out of the category of contract, and we have listed that the duties of public service companies are not contractual, as the nineteenth century sought to make them but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he as engaged and his consequent relation to the public.

Roscoe Pound, The Spirit of the Common Law 29 (1929).

> It is like the case of A and B. A has a contractual duty to pay B $50. He has only a $100 bill. He may be held to have a prophylactic duty to tender the note. But he surely has a right, implied in law if not in fact, to get back $50. Even if the policy's language were unclear, the hypothetical insured could not have an objectively reasonable expectation that it was entitled to what would in fact be a windfall.

Buss v. Superior Court, 939 P.2d 766, 777 (Cal. 1997); see also Security Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107, 125 (Conn. 2003) (adopting analogy). There are critical problems with this analysis that are exemplary of the arguments supporting reimbursement of defense costs. In this hypothetical, the insurance company is contractually obligated to pay $50. When it pays more than that, the court concludes that the policyholder could not reasonably expect to keep the excess, "[e]ven if the policy's language was unclear."

First, there is a distinct difference between the insurance company's duty to indemnify a policyholder for judgments or settlements and its separate and independent duty to fund the defense of the underlying action. This is not a case in which an insurance company has an insurance policy with $50 limits of liability and is being asked to pay a $100 judgment. In that instance, if the insurance company paid the $100 judgment, may be entitled to the $50 recovery from its policyholder. Similarly, if there were limits of liability of $100, and a $50 deductible, the analogy might make sense. When an insurance company assumes the defense, however, the insurance company generally is not paying the policyholder anything. The insurance company will generally make its choice of counsel and pay its choice of counsel.

Second, the example is incongruous with Pennsylvania law, under which a policyholder's reasonable expectations are the "focal point" of insurance policy interpretation, a component of any analysis of this issue that cannot be cast aside as perfunctory or incidental. See, e.g., Tonkovic v. State Farm Mut. Auto. Ins. Co., 513 Pa. 445, 456-57, 521 A.2d 920, 926 (1987); Beckham v. Travelers Ins. Co., 424 Pa. 107, 117-118, 225 A.2d 532, 537 (1967). A policyholder

pays for the insurance company to assume its defense without any expectation that its insurance company will ultimately demand reimbursement of those costs incurred prior to a legal determination that no coverage exists under the policy. There is nothing in the standard language of the often voluminous general liability insurance policy establishing the right of the insurance company to seek reimbursement of defense costs. Therefore, there can be no expectation by the insurance purchasing public that an insurance company will seek payment from the policyholder.

IV. ALLOWING "REIMBURSEMENT" OF DEFENSE COSTS PROVIDES THE WRONG INCENTIVES, NOT THE RIGHT ONES.

Royal asserts that if an insurance company is not permitted to impose a reimbursement requirement upon its policyholder (outside of the policy Royal drafted), the insurance company "might be tempted to refuse to defend an action in any part...." Royal Br. at 30 (quotation omitted). Royal states that "allowing reimbursement of defense fees provides the proper inducement to encourage insurers to provide a defense under a reservation of rights where there is a dispute between the insurer and the insured over whether a claim is potentially covered by the policy...." Id. at 29. Royal complains that if an insurance company is not permitted to recoup defense costs, it will be penalized "for not refusing to provide a defense." Id. at 30.

Royal's concern is baffling. First, it describes a situation "where there is a dispute between the insurer and insured over whether a claim is potentially covered by the policy." When there is a reasonable dispute about whether claims are potentially covered, the insurance company should defend until a court determines that there is no potential for coverage. If there is truly no potential that the claims are covered, then the insurance company risks nothing by refusing to defend. Royal's assertion that an insurance company might provide a defense while knowing there are no potentially covered claims is simply not credible. The more likely scenario is that an insurance company thinks the claims are not covered, but cannot be sure. In that

instance, there remains the potential for coverage and there is a duty to defend the claims until a court determines the good faith dispute about the scope of coverage.

Thus, the only "inducement" an insurance company needs to defend its policyholder against potentially covered claims is the threat of bad faith damages if it does not. In the context of a liability policy, the insurance company's obligations are especially acute, rising to the level of a "fiduciary duty." Gedeon v. State Farm Mut. Auto. Ins. Co., 410 Pa. 55, 60, 188 A.2d 320, 322 (1963); see also Gray v. Nationwide Mut. Ins. Co., 422 Pa. 500, 504, 223 A.2d 8, 9 (1966) (noting that "by asserting in the policy the right to handle all claims against the insured...the insurer assumes a fiduciary position towards the insured and becomes obligated to act in good faith and with due care in representing the interests of the insured"). Any uncertainty as to an insurance company's duty to defend must be immediately resolved in favor of defending the policyholder. That is the responsibility of the insurance company as a fiduciary, to err on the side of protecting its policyholder and not its own financial interests. If the insurance company is properly considering the interests of its policyholder before its own and fulfilling its duties as required by long-standing Pennsylvania law, its course of action is clear and the supposed dilemma presented by Royal's scenario ceases to exist.

Certainly, it is the insurance company's job to make coverage decisions and bear the consequences of those decisions. The insurance company can assume the defense without reservation, and thereby maintain control over the defense and settlement of the action. It can defend under a reservation of rights, which may allow the policyholder additional rights in the selection of counsel and participation in the defense.[4] Alternatively, the insurance company can

[4] In Pennsylvania state and federal courts, several cases have addressed the question of a policyholder's right to independent counsel when a conflict of interest arises. See Consolidated Rail Corp. v. Hartford Acc. & Indem. Co.,

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deny the defense entirely, losing all control of the defense, and then suffer the consequences if the case is defended expensively or poorly yet the insurance company is ultimately held responsible for the results under its insurance policy. As the Third Circuit observed, "[i]f the insurer could recover defense costs, the insured would be required to pay for the insurer's action in protecting itself against the estoppel to deny coverage that would be implied if it undertook the defense without reservation." Terra Nova Ins. Co. v. 900 Bar, Inc., 887 F.2d 1213, 1219-1220 (3d Cir. 1989). Burdening the policyholder with these risks would erode the purpose and value of purchasing insurance coverage in the first instance and unravel firmly entrenched

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676 F. Supp. 82, 86 (E.D. Pa. 1987); Babcock & Wilcox Co. v. American Nuclear Insurers, No. 1916 WDA 2000, 2002 WL 31749119 (Pa. Super. Ct. Nov. 25, 2002), alloc. denied, 576 Pa. 709, 839 A.2d 350 (2003) ; St. Peter's Church v. American Nat'l Fire Ins. Co., No. Civ. A. 00-2806, 2002 WL 59333, at *9 (E.D. Pa. Jan. 14, 2002), aff'd, 97 Fed. App'x 374 (3d Cir. 2004) (hereinafter "St. Peter's"); St. Paul Fire & Marine Co. v. Roach Bros. Co., 639 F. Supp. 134 (E.D. Pa. 1986). Those cases, particularly St. Peter's, follow the majority rule that where an actual conflict exists, a policyholder may select independent counsel paid for by the insurance company. Numerous state high courts have held that where an insurance company has reserved its rights to deny coverage, the policyholder has the right to select independent counsel (paid for by the insurance companies) to defend its interests. See generally Todd R. Smyth, Annotation, Duty of Insurer to Pay for Independent Counsel When Conflict of Interest Exists Between Insured and Insurer, 50 A.L.R.4th 932 § 4 (Supp. 2005). See also, e.g., CHI of Alaska, Inc. v. Employers Reins. Corp., 844 P.2d 1113, 1118 (Alaska 1993) (holding that a conflict of interest arises if an insurance company defends under a reservation of rights, and that the policyholder has the right to select independent counsel, subject to the covenant of good faith and fair dealing, and that if there is a conflict, the insurance company is required to pay reasonable defense costs); United Servs. Auto Ass'n v. Morris, 741 P.2d 246, 252 (Ariz. 1987) (holding that the insurance company's reservation of its duty to pay "relinquishes to the insured control of the litigation," including the right to settle); Boise Motor Car Co. v. St. Paul Mercury Indem. Co., 112 P.2d 1011, 1016 (Idaho 1941) (holding that when an insurance company defended under a reservation of rights with retained counsel, without the consent of the policyholder, the insurance company "created a hazard" from which the policyholder may protect itself by employing attorneys at the insurance company's expense); Murphy v. Urso, 430 N.E.2d 1079, 1084 (Ill. 1981) (requiring the insurance company to pay for independent counsel selected by the policyholder, finding that a "ruling that required an insured to be defended by what amounted to his enemy in the litigation would be foolish"); Maryland Cas. Co. v. Peppers, 355 N.E.2d 24, 31 (Ill. 1976) (finding insurance company must, if a conflict arises, allow the policyholder to control his own defense or pay for the policyholder to retain his own counsel), Magoun v. Liberty Mut. Ins. Co., 195 N.E.2d 514 (Mass. 1964) (holding that because there was a possibility of a divergence of interests, the insurance company was obligated to pay the costs of the policyholder's counsel); Prashker v. United States Guar. Co., 136 N.E.2d 871, 876 (N.Y. 1956) (holding that the conflict required the insurance company to allow the policyholders to select their own counsel, and to pay for such counsel); Employers Fire Ins. Co. v. Beals, 240 A.2d 397, 403 (R.I. 1968) (insurance company must pay for independent counsel for policyholder because right of insurance company to control defense must yield to its obligation to defend); Connolly v. Standard Cas. Co., 73 N.W.2d 119, 122 (S.D. 1955) (ruling that where an insurance company issues a reservation of rights, the policyholder may obtain independent counsel at insurance company's expense).

Pennsylvania law regarding the good faith and fiduciary duties an insurance company owes its policyholder.

Royal's argument is reminiscent of Birth Center, where the insurance company argued that allowing policyholders to recover additional damages would discourage insurance companies from satisfying verdicts in excess of policy limits where the insurance company failed to settle within limits:

> While St. Paul's argument has facial appeal, it does not stand up to closer examination. St. Paul did not pay the excess verdict out of the goodness of its heart. It had reason to believe that The Birth Center was going to sue for bad faith and it knew that if it were found to have acted in bad faith, it would be liable for punitive damages as well as the amount of the excess verdict. 42 Pa. C.S.A. § 8371. It, therefore, appears that St. Paul paid the excess in an attempt to avoid a punitive damages award.

Birth Center v. St. Paul Cos., 567 Pa. 386, 399-400, 787 A.2d 376, 384 (2001).

V. THERE IS NO RIGHT TO RECOUP DEFENSE COSTS UNDER EITHER THE THEORY OF AN IMPLIED CONTRACT IN FACT OR LAW OR UNJUST ENRICHMENT.

Royal argues that under Pennsylvania law it is entitled to recoup defense costs on the basis that that its reservation of rights letter reserved a pre-existing "right" to reimbursement that arises implicitly in fact or at law, or alternatively, that the policyholder will be unjustly enriched unless it is forced to reimburse the insurance company for defense costs. Neither theory survives scrutiny. Royal is simply attempting, as the Superior Court concluded, to unilaterally modify the insurance policy in order to place itself in a more favorable position than that of its policyholder, which its fiduciary and utmost good faith duties should preclude as a matter of law.

Royal asserts that its "right" to recoup defense costs is "implied in the policy's language." Royal Br. at 20 (citation omitted). Accordingly, Royal alleges that its reservation of rights letter was sufficient to invoke this implicit "right." It notes that "in each of Royal's letters

to the insured it reserved all rights including the right to seek reimbursement of defense fees and costs advanced by Royal on behalf of Jerry's." Royal Br. at 20. It further asserts that other jurisdictions that have mandated reimbursement have done so "carefully," requiring "that the insurer give the insured specific notice regarding its intent to seek reimbursement, typically done in a reservation of rights letter – as Royal appropriately did in this case." Royal Br. at 22. However, "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." LA Weight Loss Ctrs., Inc. v. Lexington Ins. Co., Dec. Term 2003, No. 1560, 2006 WL 689109 (C.P. Phila. Cty. Mar. 1, 2006).

It is undisputed that the express terms of the insurance policy in this case do not grant Royal a right of reimbursement. In addressing a similar argument, the Court of Appeals for the Fourth Circuit held that because the insurance company never had a right to reimbursement to begin with, its "repeated reservation of its asserted right to reimbursement is entirely inconsequential." American Modern Home Ins. Co. v. Reeds at Bayview Mobile Home Park, LLC, No. 05-1149, 2006 WL 994573, at *3 (4th Cir. Apr. 14, 2006). This Court should not permit Royal, or any other insurance company, to create rights not contained in the policy, then construe and enforce them to the detriment of the policyholder.

Standard commercial general liability policies are not silent with regard to an insurance company's right to recoup defense costs, but expressly negate such a right. Standard supplementary payment provisions state that the insurance company will pay, with respect to any claim or suit it defends, all expenses it incurs. Such is the case here, with the insurance policy at issue unambiguously stating that, with regard to cases Royal defends, Royal shall pay all

expenses it incurs. (R. 993a). This explicit language has been identified by scholarly commentators:

> Allowing the insurer to shift defense costs back to the insured through reimbursement would contravene the clause's express promise that the insurer will pay them. Accordingly, contrary to what a reader may conclude from reviewing cases on both sides of the question, standard liability policies are not silent about allocation or recoupment. They expressly disclaim it.

Angela R. Elbert & Stanley C. Nardoni, Buss Stop: A Policy Language Based Analysis, 13 Conn. Ins. L.J. 61 (2006/2007).

Royal argues that granting an insurance company the right to recoup defense costs after it is determined there are no covered claims is supported by the equitable theory of unjust enrichment. See Royal Br. at 20-28. The Superior Court wisely rejected this argument. In order for the unjust enrichment argument to be viable, the insurance company must first concede that its reservation of rights letter does not create a new and enforceable contract. That leaves the insurance company to seek enforcement on equitable rather than legal grounds. As the Superior Court noted, the equitable theory of restitution imposes a duty, despite the lack of an agreement, where one party confers a benefit on the other and that benefit is accepted and retained "under such circumstances that it would be inequitable...to retain the benefit without payment of value." Super. Ct. Decision, 948 A.2d at 849 (citation omitted).

The fallacy of Royal's position is apparent. As the Superior Court quickly pointed out, Royal, as well as countless other insurance companies providing liability insurance, does indeed receive a benefit when it assumes control of a policyholder's defense. The insurance policy Royal sold to Jerry's Sport not only states that Royal has the duty to provide a defense, but the affirmative *right* to do so. See id. at 837 (emphasis added). Securing such a right affords insurance companies a degree of control over the underlying litigation with the aim of reducing

their ultimate indemnification obligation. As the Third Circuit noted, "an insurer offers a defense under a reservation of rights to avoid the risks that an inept or lackadaisical defense of the underlying action may expose it to if the defense is unsuccessful. Thus, such an offer is made at least as much for the insurer's own benefit as for the insured's." Terra Nova, 887 F.2d at 1219-20; see also LA Weight Loss Ctrs., Inc. v. Lexington Ins. Co., Dec. Term 2003, No. 1560, 2006 WL 689109, at * 7 (C.P. Phila. Cty. Mar. 1, 2006) (refusing to find that the insurance company was entitled to recoupment of defense costs under a theory of unjust enrichment and holding 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 does not owe a defense"); General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., 828 N.E.2d 1092 (Ill. 2005) (rejecting unjust enrichment argument and holding when the insurance company tenders a defense for its policyholder it is "protecting itself at least as much as it is protecting its insured).

The benefit to the insurance company is not merely hypothetical. In this case, the Superior Court noted precisely how Royal's right to control the defense of Jerry's Sport limited its potential liability under the insurance policy. For example, Royal retained independent counsel for Jerry's Sport rather than having it participate in a group or joint defense with other defendants. As a result of this arrangement, counsel was solely devoted to the interests of Jerry's Sport. Super. Ct. Decision, 948 A.2d at 837. Furthermore, Royal was able to select counsel who had been involved in previous gun litigation with plaintiff's counsel. Royal also independently evaluated the reasonableness of the legal fees being incurred. See id. at 848. Jerry's Sport was the only defendant dismissed from the case prior to trial. See id. "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 840.

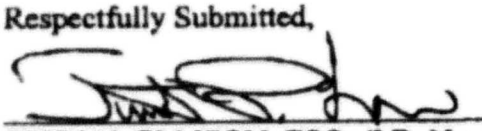
In the face of these facts, Royal should not be heard to complain that it has conferred a one-sided benefit upon its policyholder by exercising its right to assume and control the defense. Its attempt to find a basis under Pennsylvania law for recouping defense costs hinges entirely upon the conclusion that it was victimized by exercising the very contractual right it created for itself. Such an assertion simply does not withstand scrutiny and should not be incorporated into the canon of law governing insurance coverage disputes in Pennsylvania.

VI. CONCLUSION

For the forgoing reasons, United Policyholders respectfully requests that this Court affirm the Superior Court's decision.

Dated: April 22, 2009

Respectfully Submitted,



JOHN N. ELLISON, ESQ. (I.D. No. 51098)
TIMOTHY P. LAW, ESQ. (I.D. No. 76793)
BRYAN W. PETRILLA, ESQ. (I.D. No. 200936)
Reed Smith, LLP
2500 One Liberty Place
1650 Market Street
Philadelphia, PA 19103
Tel: (215) 851-8100
Fax: (215) 851-1420
jellison@reedsmith.com
tlaw@reedsmith.com
bpetrilla@reedsmith.com

– and –

AMY BACH, ESQ.
United Policyholders
222 Columbus Avenue, # 412

San Francisco, CA 94133
amy@unitedpolicyholders.org
Tel: (415) 393-9990
Fax: (415) 677-4170

Counsel for *Amicus Curiae* United Policyholders

CERTIFICATE OF SERVICE

I certify that a true and correct copy of the Brief of *Amicus Curiae* United Policyholders in Support of Respondents/Appellees was served by U.S. Mail on this date to the following counsel:

Jamie Lynn Lenzi, Esq.
Cipriani & Werner, P.C.
650 Washington Road, Suite 700
Pittsburgh, PA 15228

Eugene F. Hickey, II, Esq.
Cipriani & Werner, P.C.
409 Lackawanna Avenue, Suite 210
Scranton, PA 18503

Celeste M. Butera, Esq.
Rivkin Radler, LLP
926 Reckson Plaza
Uniondale, NY 11556

Sal Cognetti, Jr. Esq.
Foley, Cognetti, Comerford,
Cimini & Cummins
700 Scranton Electric Bldg.
507 Linden Street
Scranton, PA 18503

David Joseph Solfanelli, Esq.
800 Penn Security Bank Bldg.
142 N. Washington Avenue
Scranton, PA 18503

Frederick A. Tecce, Esq.
Conrad O. Kattner, Esq.
McShea & Tecce, P.C.
1717 Arch Street, 28th Floor
Philadelphia, PA 19103

Richard Charles Mason, Esq.
C. Tyler Havey, Esq.
Stephen A. Cozen, Esq.
Cozen O'Connor
1900 Market Street
Philadelphia, PA 19103

Dated: April 22, 2009

By: 
Timothy P. Law, Esq.

REED SMITH LLP
2500 One Liberty Place
1650 Market Street
Philadelphia, PA 19103
Tel. 215-851-8100
Fax 215-851-1420
tlaw@reedsmith.com

Counsel for *Amicus Curiae* United Policyholders