IN THE

Supreme Court of Pennsylvania

No. 2 WAP 2014

THE BABCOCK & WILCOX COMPANY AND B&W NUCLEAR ENVIRONMENTAL SERVICES, INC.

v.

AMERICAN NUCLEAR INSURERS AND MUTUAL ATOMIC ENERGY LIABILITY UNDERWRITERS,

OTHER INTERESTED PARTY: ATLANTIC RICHFIELD COMPANY

AMERICAN NUCLEAR INSURERS AND MUTUAL ATOMIC ENERGY LIABILITY UNDERWRITERS,

v.

THE BABCOCK AND WILCOX COMPANY AND B&W NUCLEAR ENVIRONMENTAL SERVICES, INC., AND ATLANTIC RICHFIELD COMPANY

BRIEF OF *AMICI CURIAE* UNITED POLICYHOLDERS, DRAVO CORPORATION, E.W. BOWMAN, INC., HAJOCA CORPORATION, KENNAMETAL, MATTHEWS INTERNATIONAL, MINE SAFETY APPLIANCES, SAINT JOSEPH'S UNIVERSITY, SYLVAN INCORPORATED AND TRUMBULL CORPORATION IN SUPPORT OF APPELLANTS

Appeal from the July 10, 2013 Judgment
of the Pennsylvania Superior Court, No. 525 WDA 2012
Vacating the February 17, 2012 Judgment of the Court of Common Pleas of
Allegheny County, Nos. 99-11498 and 99-16227

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STATEMENT OF INTERESTS OF *AMICI CURIAE*

The corporate *amici* on this brief represent a wide variety of Pennsylvania companies from different business sectors who have purchased commercial insurance policies to protect against the risk of third party lawsuits. The corporate *amici* include:

Dravo Corporation, a Pennsylvania corporation that historically performed engineering and construction services in Pennsylvania;

E.W. Bowman, Inc., a privately owned company that specializes in making annealing and decorating lehrs—a type of kiln—for glass products. Founded in 1959, Bowman has a production plant in Uniontown, Pennsylvania and in the Czech Republic, and Bowman's lehrs operate in over fifty-six (56) countries on six (6) continents;

Hajoca Corporation, a privately owned plumbing supply company. Founded in 1858, Hajoca has been supplying plumbing, heating and industrial supplies to its customers in Philadelphia for more than a hundred and fifty years;

Kennametal, a public company that supplies tooling and industrial materials. Founded in 1938 in Latrobe, Pennsylvania, the company now has nearly 14,000 employees worldwide, serves customers in more than sixty (60) countries, and has annual sales of approximately $3 billion;

Matthews International, a public company that designs, manufactures, and markets, principally, memorialization products and brand solutions. Founded in 1850 and incorporated in Pennsylvania in 1902, Matthews employs over 5,700 people in nearly two dozen countries in four continents, and generates approximately $900 million in annual revenues;

Mine Safety Appliances, the world's leading manufacturer of high-quality safety products since its incorporation in 1914. Headquartered in Cranberry Township, Pennsylvania, it is a public company that employs approximately 5,300 people, has business operations in over forty (40) countries, and generates more than $1 billion in annual revenues;

Saint Joseph's University, a university located near Philadelphia, Pennsylvania that has provided a rigorous Jesuit education to its students for over 160 years;

Sylvan Incorporated, the world's largest producer and distributor of mushroom spawn. Sylvan was founded in 1946 and is based in Kittanning, Pennsylvania. Sylvan has locations in seventeen (17) countries and approximately four hundred (400) employees; and

Trumbull Corporation, founded in 1955, Trumbull is headquartered in Pittsburgh, PA and has performed over $3 billion of heavy and highway construction activity.

In addition, *amicus* **United Policyholders** is a not-for-profit corporation founded in 1991 as an educational resource for the public on insurance issues and insurance consumer rights. It operates nationwide and is funded by donations and grants from individuals, businesses, and foundations. United Policyholders contributes on an ongoing basis to the formulation of insurance-related public policy at both the national and state levels and is a general information clearinghouse on consumer issues related to commercial and personal lines insurance products.

The coverage afforded by their commercial insurance policies is an integral part of the corporate *amici's* business operations. As a result, they have a strong and abiding interest in the legal standards governing their relationship with their insurers, particularly in connection with the defense and settlement of litigation that might be brought against them. Here, the Superior Court's ruling under review directly impacts the rights conferred to the corporate *amici* under their policies, including the very valuable rights to be defended by their insurers in good faith and to settle claims consistent with the best interests of the company. *Amicus* United Policyholders also has a significant interest in the ruling under review, as it will greatly affect the rights of insurance policyholders, who are the focus of its educational mission. *Amici* collectively file this brief to urge the Court to adopt a

reasonable settlement standard that will fairly balance the interests of the parties to commercial insurance policies and preserve the coverage they have purchased.

VIEWS OF *AMICI CURIAE*

This case presents an issue of first impression in this Commonwealth: When an insurer defends its insured under a reservation of rights, can the insured recover reasonable settlement amounts if the insurer refuses to consent to the settlement? While no Pennsylvania precedent addresses this issue directly, Pennsylvania law delineates the obligations under liability insurance policies that define its resolution. Specifically, those obligations include: (i) the insurer's paramount duty to indemnify its insured; (ii) the insurer's independent duty to provide a defense; (iii) the insurer's fiduciary duty to conduct that defense in the insured's best interest; and (iv) the insured's parallel duty to cooperate in the defense so the insurer's interests are not prejudiced.

When a reasonable settlement offer is made in litigation defended under a reservation of rights, these obligations must be balanced in determining the rights of the insured and its insurer. And, when that balancing is properly undertaken, Pennsylvania law should allow an insured to settle litigation against it when its insurer is defending under a reservation of rights and to then recover reasonable amounts – within the insurance policy's limits – paid to settle covered claims. Under this standard, the settling insured would have the burden to prove both the settlement's reasonableness and that the settled claim falls within the policy's

coverage. The burden to prove any allegedly applicable exclusions from coverage would, as always, fall to the insurer.

This balanced approach protects: (1) an insurer's right to raise and preserve its coverage defenses while maintaining control over the defense of the underlying litigation; (2) an insured's right to protect itself from the risk of non-coverage or an excess judgment by entering into a reasonable settlement; and (3) an insurer's right to deny payment for unreasonable or collusive settlement amounts. It also preserves the benefits of the parties' bargain and furthers Pennsylvania's public policy of encouraging reasonable settlements of disputed claims. *Amici* thus urge its adoption.

INTRODUCTION

This case arises from an insurance coverage dispute between Babcock & Wilcox Company and its insurer, American Nuclear Insurers. Babcock purchased insurance policies from ANI to indemnify it against liabilities to third-parties resulting from the operation of Babcock's nuclear fuel processing facilities. In 1994, several bodily injury and property damage lawsuits were filed against Babcock allegedly due to emissions emanating from Babcock's facilities (the "*Hall* Litigation").

Babcock tendered the *Hall* Litigation to ANI. ANI agreed to provide a defense subject to a reservation of ANI's rights to later deny coverage. ANI also

filed a declaratory judgment action seeking a ruling that its policies did not cover the *Hall* Litigation. The court ultimately found that ANI had a duty to defend Babcock under the insurance policies it sold by paying for Babcock's independently retained counsel. Babcock subsequently settled the *Hall* Litigation, over ANI's objections, for less than the limits of ANI's insurance policies. ANI refused to consider settlement and never authorized any amount to settle the *Hall* Litigation. It also continued to maintain its reservation of rights and its declaratory relief action seeking to deprive Babcock of coverage.

The dispute here relates to whether Babcock can recover the amounts paid to settle the *Hall* Litigation even though ANI would not consent to it. The answer to this novel question lies in the obligations of the parties to commercial liability policies as interpreted under Pennsylvania law. Once those obligations are fairly understood, settled law and public policy should lead to the adoption of the reasonable settlement standard advanced by *amici*.

I. Commercial Insurance Policies Create Independent Obligations For Insurers And Insureds That Must Be Balanced When A Dispute Arises Over Settlement Of Ongoing Litigation.

Commercial liability policies are indemnity contracts and their scope of coverage is determined, at least in part, by principles of contract construction. *See Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 589

Pa. 317, 332, 908 A.2d 888, 897 (2006). But as Pennsylvania courts have recognized, insurance policies are not ordinary contracts by any means. *See Brakeman v. Potomac Ins. Co.*, 472 Pa. 66, 72-77, 371 A.2d 193, 196-198 (1977) (noting special nature of insurance contracts that give rise to unique public policy considerations). They are purchased to give policyholders peace of mind from the risks presented by accidental events and inure to the benefit of innocent, injured parties. As a result, insurance contracts are imbued with aspects of public policy and their provisions and sale are publicly regulated. *Brakeman*, 472 Pa. at 76 n.8, 371 A.2d at 198 n.8; *see also* 31 Pa. Code §§ 1.1-303.1; 40 Pa. Stat. §§ 1-4305; 40 Pa. Cons. Stat. §§ 101-6701 (statutory provisions regulating various aspects of insurance sold in Pennsylvania).

In addition, the rights of the insured and insurer under the agreement are not in equipoise. Policies are construed, whenever possible, to further their primary purpose of indemnification. *Kvaerner,* 589 Pa. at 331, 908 A.2d at 897. Accordingly, when doubts arise about the scope of coverage, they are resolved in favor of the insured's reasonable expectations of coverage precisely because of the special nature of the insuring agreement. *See, e.g., Donegal Mut. Ins. Co. v. Baumhammers*, 595 Pa. 147, 155, 938 A.2d 286, 290 (2007) (ambiguities in coverage are construed in favor of the insured); *Collister v. Nationwide Life Ins. Co.*, 479 Pa. 579, 594, 388 A.2d 1346, 1353 (1978) ("Courts should be concerned

with assuring that the insurance purchasing public's reasonable expectations are fulfilled.").

As is relevant to the coverage dispute here, a commercial insurance policy creates three distinct obligations for an insurer, and one parallel obligation on the part of the insured, that must be balanced when settlement of potentially covered litigation is considered.

The insurer's paramount obligation to indemnify covered claims. The insurer's first obligation is to indemnify its insured against damages resulting from any occurrence covered by the policy. *See Gedeon v. State Farm Mut. Auto. Ins Co.,* 410 Pa. 55, 58, 188 A.2d 320, 321 (1963). Commercial insurance policies, at their essence, shift the risk of covered liability exposures from the insured to the insurer. In exchange for the insurer's agreement to indemnify its insured for third-party liability, the insurer charges a premium that it deems sufficient to cover the risks assumed under the policy. Insurance policies, thus, are essentially indemnity contracts between the parties and they are interpreted to further their primary purpose of indemnification. *See Kvaerner,* 589 Pa. at 331, 908 A.2d at 897.

With respect to its indemnity obligation, an insurer is required to pay all sums the insured is legally obligated to pay by reason of an occurrence that falls within the coverage afforded by the policy. *Accord Babcock & Wilcox Co. v. Am. Nuclear Insurers*, 51 Pa. D & C.4th 353, 365 (Pa. Com. Pl. 2001) (quoting "all

sums" indemnity language in Babcock's policy), *aff'd*, 823 A.2d 1020 (Pa. Super. Ct. 2002). This includes amounts paid to satisfy a judgment rendered against the insured as well as amounts paid to settle a covered claim. *See, e.g., Keystone Spray Equip. v. Regis Ins. Co.,* 767 A.2d 572, 576, 2001 PA Super 13 (2001) (insured may seek indemnification for a reasonable settlement of a covered claim); *Alfiero v. Berks Mut. Leasing Co.*, 347 Pa. Super. 86, 91, 500 A.2d 169, 172 (1985) (same).

The insurer's independent promise to defend litigation involving potentially covered claims. The insurer's second obligation entails paying for the defense of the insured in any suits potentially triggering the policy's coverage. With respect to this defense obligation, an insurer must defend any suit against its insured whenever the complaint filed by the injured party may potentially come within the coverage of the policy. *See Gedeon*, 410 Pa. at 58, 188 A.2d at 322; *Am. and Foreign Ins. Co. v. Jerry's Sport Ctr., Inc.,* 606 Pa. 584, 609, 2 A.3d 526, 541 (2010). An insurer breaches this obligation when it improvidently refuses to defend an action with allegations that potentially trigger coverage under the policy. *Gedeon*, 410 Pa. at 59, 188 A.2d at 322. Alternatively, if an insurer undertakes a defense without reserving any rights to later deny coverage, it elects to treat the claim as covered and waives the ability to claim that there is no coverage. *See Malley v. Am. Indemn. Corp.,* 297 Pa. 216, 146 A. 571 (1929).

Finally, if the insurer disputes the potential for coverage, it has the option to defend the litigation under a reservation of rights that must clearly set forth all grounds on which it believes coverage may be denied. *See Brugnoli v. United Nat'l Ins. Co.,* 284 Pa. Super. 511, 518, 426 A.2d 164, 167 (1981); *Bedwell Co. v. D. Allen Bros., Inc.,* Nov. Term 2004 No. 1328, 2006 WL 3692592, at *2 (Pa. Com. Pl. Dec. 6, 2006). By undertaking a defense under a reservation of rights, the insurer benefits both by controlling the defense (and thereby protecting itself against potential indemnity exposure) and guarding against a bad faith claim brought on by a refusal to defend what later proves to be a covered claim. *See Jerry's Sport,* 606 Pa. at 616-17, 2 A.3d at 545-46.

The insurer's additional obligation to conduct a defense in the best interest of its insured. The insurer's third obligation arises when it asserts the right to control the defense and settlement. Specifically, by undertaking the defense, the insurer assumes a fiduciary duty and must act in the best interest of its insured. *See Gedeon*, 410 Pa. at 59, 188 A.2d at 322 (by assuming the defense, "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."); *see also Gray v. Nationwide Mut. Ins. Co.,* 422 Pa. 500, 504, 223 A.2d 8, 9 (1966) (same). The insurer thus "assumes a position of trust and confidence" which calls for "an exercise of the utmost good faith, particularly in view of the

possible conflict of interest . . ." *Perkoski v. Wilson*, 371 Pa. 553, 556, 92 A.2d 189, 191 (1952). When an insurer hires counsel to defend its insured, the ***insured*** is the client. *See Bedwell*, 2006 WL 3692592, at *3.[1] In conducting the defense of its insured, the insurer is required, by good conscience and fair dealing, to "pursue a course that was not advantageous to itself while disadvantageous to its policyholder . . . ." *Perkoski*, 371 Pa. at 557, 92 A.2d at 191.

The insured's parallel obligation to cooperate in the defense so that the insurer's rights are not prejudiced. For its part, the insured independently is obligated to cooperate in an insurer-provided defense so as not to prejudice the insurer's interests. The avowed purpose of the cooperation clause is to prevent collusion between the insured and the injured party. *See Forest City Grant Liberty Assocs. v. Genro II, Inc.*, 438 Pa. Super. 553, 559, 652 A.2d 948, 951 (1995) (citing 8 *Appleman, Insurance Law and Practice* § 4741). Pennsylvania law is clear, however, that, to escape liability under the policy due to an alleged breach of the cooperation clause, the insurer "must show that the breach is something more than a mere technical departure from the letter of the [policy], that it is a departure

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[1] In fact, under the Pennsylvania Rules of Professional Conduct, not only is the insured the client, but the insurer is not permitted to interfere with the attorney-client relationship, including the insured's decision to settle the matter. *See* Pa. Rules of Prof'l Conduct 1.8 (f)(2) (providing that a lawyer may not accept compensation for representing a client from anyone other than the client unless there is no interference with the client-lawyer relationship) and 1.2 (a) (requiring a lawyer to abide by a client's decision to settle a matter) (2013).

that results in a substantial prejudice and injury to its position in the matter . . . ." *Paxton Nat'l Ins. Co. v. Brickajlik*, 513 Pa. 627, 630, 522 A.2d 531, 532 (1987) (quoting *Conroy v. Commercial Cas. Ins. Co.*, 292 Pa. 219, 224, 140 A. 905, 907 (1928)). This rule recognizes that an insurer's denial of coverage for a breach of cooperation from which it suffers no prejudice frustrates public policy by "depriving the insured of the benefits for which she has paid." *Cerankowski v. State Farm Mut. Auto. Ins. Co.*, 783 A.2d 343, 347, 2001 PA Super 269 (2001); *see also Nationwide Ins. Co. v. Schneider*, 906 A.2d 586, 592, 2006 PA Super 219 (2006), *aff'd*, 599 Pa. 131, 960 A.2d 442 (2008).

The balancing of obligations in the settlement of litigation. Pennsylvania courts consistently have looked to the foregoing obligations in formulating rules governing the settlement of litigation brought against an insured. For example, where an insurer refuses to defend, the courts hold that the insured may settle the litigation as it sees fit and recover any reasonable amounts paid in settlement notwithstanding the policy's cooperation clause. *See Keystone,* 767 A.2d at 576; *Alfiero*, 347 Pa. Super. at 91, 500 A.2d at 172. This outcome follows from the well-established principle that, once an insurer has breached its obligations under an insurance policy, an insured is relieved of its corresponding obligations. *See Alfiero*, 347 Pa. Super. at 91, 500 A.2d at 171-72; *see also* 14 *Couch on Insurance*

§ 199:66 (3d ed. 2013) ("Once an insurer has denied coverage, a policyholder no longer has a duty to cooperate with its carrier . . . .").

Also, under Pennsylvania law, an indemnitor's contractual obligation to pay for a settlement is established if: (1) the settlement was reasonable: (2) the underlying claim was valid; and (3) the claim is within the coverage of the agreement. *See County of Delaware v. J.P. Mascaro & Sons, Inc.*, 830 A.2d 587, 593, 2003 PA Super 284 (2003) (citing *McClure v. Deerland Corp.*, 401 Pa. Super. 226, 585 A.2d 19 (1991)), *aff'd*, 582 Pa. 590, 873 A.2d 1285 (2005). A similar analysis applies in insurance coverage actions. Thus, when an insurer fails to defend, amounts paid in settlement are covered if: (1) the settlement amount is reasonable; and (2) the claim is covered by the insurance policy. *See Keystone,* 767 A.2d at 576; *Alfiero*, 347 Pa. Super. at 91, 500 A.2d at 172.

The insurer's fiduciary duty in conducting the defense also plays a critical role in disputes over settlements. Here, an insurer breaches that duty by "unreasonably refusing an offer of settlement." *See Gedeon*, 410 Pa. at 59, 188 A.2d at 322; *Gray*, 422 Pa. at 504, 223 A.2d at 10. In fact, if the insurer acts in bad faith in failing to settle a claim against its insured, it can be liable for the entire verdict entered against its insured, even if that verdict exceeds the limits of the insurance policy. *See Birth Ctr. v. St. Paul Cos., Inc.*, 567 Pa. 386, 787 A.2d 376

(2001); *Cowden v. Aetna Cas. and Sur. Co.*, 389 Pa. 459, 134 A.2d 223 (1957). As this Court explained in *Birth Center*:

> Today, we hold that where an insurer acts in bad faith, by unreasonably refusing to settle a claim, it breaches its contractual duty to act in good faith and its fiduciary duty to its insured. Therefore, the insurer is liable for the known and/or foreseeable compensatory damages of its insured that reasonably flow from the insurer's bad faith conduct.

Birth Ctr., 567 Pa. at 408, 787 A.2d at 389. Thus, as illustrated by *Birth Center*, when an insurer breaches its fiduciary duty to conduct the defense in the insured's best interest, it may be held liable for foreseeable compensatory damages that reasonably flow from that breach.

II. A Reasonable Settlement Standard Provides The Fairest Means Of Balancing The Respective Obligations Of Insurers And Insureds When Disputes Arise Over The Settlement Of Ongoing Litigation.

As the foregoing analysis shows, these settlement outcomes are premised on fundamental Pennsylvania insurance principles recognizing: (1) an insurer's contractual obligation to fund reasonable settlements of covered claims; (2) an insurer's fiduciary obligation to conduct the defense of the litigation in the best interest of its insured, including the obligation to settle the litigation when appropriate; and (3) an insured's rights to protect its best interests in entering into a reasonable settlement when coverage is uncertain. On the discrete question presented here, the Court should adopt a standard that fairly accounts for these established obligations as set forth under Pennsylvania law.

A. A Reasonable Settlement Standard Fairly Accounts For The Parties' Respective Obligations Under The Policy.

When an insurer is defending its insured under a reservation of rights and a reasonable settlement demand is presented, the respective obligations of the parties are dictated by the unique nature of the insuring relationship.

As this Court has recognized, where an insurer is defending a case under a reservation of rights, there is significant risk to the insured in surrendering all control of the litigation ***if*** the insurer will not be assuming the resulting liability. *See Malley,* 146 A. at 571, 297 Pa. at 222-23 ("[an insurer's] undertaking to defend is of no value, and may be of great danger, to the assured, where he thus abandons all control of the suit to the [insurer] if it does not mean that whatever liability is established shall be discharged [by the insurer]."). Thus, where an insurer defends under a reservation of rights, there is an inherent conflict once a reasonable settlement demand for the underlying litigation is presented. *Accord Shearer v. Reed*, 286 Pa. Super. 188, 196, 428 A.2d 635, 639 (1981) (noting "inherent conflict of interest between an insurance company and its insured once an offer to settle within policy limits has been received."). In light of its fiduciary duty under the policy, however, the insurer is obligated to resolve that conflict in favor of its insured.

Accordingly, when defending pursuant to a reservation of rights, if the insurer refuses to authorize the insured's request to settle at an objectively

reasonable amount, it breaches its duty to conduct the defense in the best interests of its insured. *Accord Gedeon*, 410 Pa. at 59, 188 A.2d at 322; *Gray*, 422 Pa. at 504, 223 A.2d at 10; *Perkoski*, 371 Pa. 553, 92 A.2d 189; *see also* 1 Allan D. Windt, *Insurance Claims & Disputes* § 5.01 at 295 (3d ed. 1995) ("One of an insurer's obligations under a contract of liability insurance, arising out of its implied duty of good faith and fair dealing, is to settle a claim that has been brought against the insured when it is appropriate to do so."); *Shearer*, 286 Pa. Super. at 194, 428 A.2d at 639 ("[w]henever the insurance company decides not to settle, it has, in effect, chosen its own interests over that of its insured [.] . . ."). At that point, the insured's hands should no longer be tied by a strict interpretation of a cooperation clause. *Accord Alfiero*, 347 Pa. Super. at 91, 500 A.2d at 172 (once insurer has breached its obligations under the policy, insured is relieved of obligation to comply with cooperation clause); *see also* 14 *Couch on Insurance* § 199:66 (3d ed. 2013) ("Once an insurer has denied coverage, a policyholder no longer has a duty to cooperate with its carrier . . . .").

In fact, because ***only*** a material and prejudicial breach of a cooperation clause can relieve an insurer of its indemnity obligations, to the extent the settlement is subsequently deemed to be reasonable, the insured has not breached the cooperation clause at all. *Accord Paxton*, 513 Pa. at 630, 522 A.2d at 532; *Conroy,* 292 Pa. at 224, 140 A. 905 at 907. Policyholders are entitled to

indemnification for reasonable settlements of covered claims. An insurer sustains no prejudice by being required to indemnify the insured for what is held to be a reasonable settlement of a covered claim – that is exactly why companies purchase insurance.[2]

Thus, when presented with a reasonable settlement demand, the insured is required to request consent from its insurer to settle pursuant to the policy's cooperation clause. Thereafter, if the insurer refuses to consent to a reasonable settlement within its policy limits and is unwilling to abandon its coverage defenses in order to continue to control the defense of the underlying action, then the insurer effectively breaches its obligation to conduct the defense in the best interests of its insured. In this circumstance, the insured should be permitted to

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[2] Several federal courts have held that the obligation to obtain an insurer's consent to settle does not apply when the insurer is defending under a reservation of rights. *See Cay Divers, Inc. v. Raven*, 812 F.2d 866, 870 (3d Cir. 1987); *Ins. Co. of North Am. v. Spangler*, 881 F. Supp. 539, 545 (D. Wyo. 1995). The highest courts of several states have reached similar conclusions. *See Miller v. Shugart*, 316 N.W.2d 729, 734 (Minn. 1982); *United Servs. Auto. Ass'n v. Morris*, 741 P.2d 246, 252 (Ariz. 1987); *Patrons Oxford Ins. Co. v. Harris*, 905 A.2d 819, 827 (Me. 2006); *see also Martin v. Johnson*, 170 P.3d 1198, 1202 (Wash. Ct. App. 2007). Commentators also have concluded that, if an insurer is defending under a reservation of rights, the insured does not breach a cooperation clause by entering into a good faith settlement without the insurer's consent. *See* 16 Williston on Contracts § 49:108 (4th ed. 2010); 14 Couch on Insurance § 199:48 (3d ed. 2010). The reasonable settlement standard advocated by *amici* reaches this same, inherently fair result, but does so by virtue of well-established Pennsylvania insurance law principles.

settle the litigation without violating the cooperation clause and may seek to recover any reasonable settlement amount from its insurer in subsequent coverage litigation.

The insured, concomitantly, is entitled to recover amounts paid in settlement, up to the policy's limits of coverage, if: (1) the settlement amount was reasonable; (2) the settlement was not collusive; and (3) the underlying claim falls within the scope of the policy's coverage language. The insured properly assumes the burden of establishing these three elements, while the insurer would bear the burden of proving, as always, that the alleged liability is excluded from coverage.

This standard not only accords with the parties' respective obligations under the policy, but its application is fair to both, as illustrated by the following hypotheticals:

> ***Scenario 1:*** An insured is sued by a third party and tenders the litigation to its insurer under a commercial liability policy. The insurer has legitimate and significant concerns regarding whether the underlying litigation is covered by its policy. It issues a reservation of rights letter, but continues to control the defense to protect itself from a claim for bad faith refusal to defend. A reasonable settlement demand is presented that the insured wishes to accept. The insurer feels strongly that the claim is not covered and that the demand is not reasonable. It refuses to consent to the demand.

The insured settles the litigation, but is forced in subsequent coverage litigation to prove that: (1) the claim is covered; (2) the settlement was reasonable; and (3) the settlement was non-collusive. The insured fails to prove the claim was covered by the policy and the insurer bears no liability for the settlement.

Scenario 2: The insured tenders third-party litigation to its insurer and the insurer issues a reservation of rights letter as a matter of course to preserve its rights to raise coverage defenses. A settlement demand within policy limits is presented that the insured deems reasonable and seeks to accept. The insurer feels strongly that the demand is not reasonable and that a defense verdict can be obtained. The insurer rejects the settlement offer, but agrees to forego its coverage defenses in order to maintain control of the litigation. A defense verdict is subsequently entered resulting in no indemnity payment by the insurer or the insured.

Scenario 3: Litigation is filed against the insured for which it requests a defense from its insurer. The insurer issues a reservation of rights letter as a matter of course to preserve its coverage defenses. A reasonable settlement demand is presented within policy limits that the insured wishes to accept. The insurer refuses to either accept the demand or forego its coverage defenses. The insured accepts the reasonable settlement offer and proves in

subsequent litigation that the settlement was non-collusive and reasonable and that the claim was covered by the policy. The insurer is then liable solely for the coverage it agreed to provide when the policy was issued, *i.e.*, reasonable settlement amounts within the policy's limits.

Scenario 4: The insured tenders covered litigation to its insurer. The insurer defends under a reservation of rights. A reasonable settlement offer is presented that the insured wishes to accept. The insurer unreasonably refuses to accept the offer or to forego its coverage defenses. The insured allows the insurer to control the litigation and a verdict is entered in excess of policy limits. In subsequent coverage litigation, the insured establishes that the insurer acted in bad faith in refusing to settle and recovers the entire verdict amount, even though it exceeds policy limits.

As these hypotheticals illustrate, when an insurer defends under a reservation of rights, the outcome of both a trial in the underlying litigation and a future coverage determination is uncertain. *See generally, Jerry's Sports,* 606 Pa. 584, 2 A.2d 526 (discussing inherent uncertainty in case in which the insurer defends under a reservation of rights). The reasonable settlement standard does not hedge that uncertainty in favor of either party; instead, it requires no more than what the insurer agreed to provide when issuing its policy, *i.e.,* indemnity for objectively reasonable amounts paid to settle covered claims.

On balance, therefore, the standard harmonizes existing Pennsylvania law relating to the primary obligations under the insurance contract. It protects: (1) an insurer's right to raise and preserve its coverage defenses while maintaining control over the defense of the underlying litigation; (2) an insured's right to protect itself from the risk of non-coverage or an excess judgment by entering into a reasonable settlement; and (3) an insurer's right to deny payment for an unreasonable or collusive settlement. It further recognizes that an insurer who is disputing coverage, and ultimately may not be required to indemnify its insured, should not be permitted to compel its insured to forego a reasonable settlement which is in the insured's best interest.

B. A Reasonable Settlement Standard Furthers Pennsylvania's Policy Of Encouraging Reasonable Settlements Of Claims.

Pennsylvania law strongly favors the voluntary settlement of lawsuits. *See Rothman v. Fillette*, 503 Pa. 259, 266-67, 469 A.2d 543, 546 (1983); *Schlosser v. Weiler*, 377 Pa. 582, 587, 105 A.2d 331, 333 (1954) ("settlement in matters of dispute are favored by the law"). This policy allows victims of tortious conduct to more expediently receive compensation. *Rothman*, 503 Pa. at 266-67, 469 A.2d at 546. It also reduces the burden on the courts and the parties by minimizing the time and expense of protracted litigation. *Id.*

The reasonable settlement standard furthers these policy considerations. It minimizes the costs and time associated with litigation by permitting a reasonable settlement of the underlying liability while simultaneously allowing both parties to the insurance contract to preserve their rights on the coverage issues. It likewise allows an injured party to receive compensation more quickly, without delays that inevitably would be occasioned by disputes over coverage. The reasonable settlement standard accordingly should be adopted for this reason as well.

C. A Reasonable Settlement Standard Is Consistent With Pennsylvania Insurance Bad Faith Principles.

The reasonable settlement standard also is consistent with, and a necessary corollary to, Pennsylvania's bad faith insurance jurisprudence. As *Birth Center* illustrates, in Pennsylvania, an insured may recover a verdict in excess of its policy limits if its insurer acted in bad faith in refusing to settle the litigation. *See Birth Ctr.*, 567 Pa. at 407, 787 A.2d at 389.

This rule was first announced in the Court's decision in *Cowden v. Aetna Cas. and Sur. Co.*, 389 Pa. 459, 134 A.2d 223 (1957). As the *Cowden* Court explained, the rationale for this rule rests on the "peculiar relationship between the parties where control over litigation covered by the policy is vested in one of the parties." *Cowden*, 389 Pa. at 468, 134 A.2d at 227. As the Court noted:

> When the company voluntarily undertook the defense of the insured in pursuance of its privilege under the policy, it assumed a position of trust and confidence which called for an exercise of the utmost good

> faith, particularly in view of the possible conflict of interest between the insurer and the insured such as later developed . . . . [T]he contractual relationship under an indemnity policy [is] one requiring a high degree of good faith in the conduct of the indemnity company' s counsel . . . .

Id. at 468, 134 A.2d at 228. The Court thus has consistently recognized an insurer's fiduciary duty in representing its insured's interests. *See Gedeon*, 410 Pa. at 59, 188 A.2d at 322; *Gray*, 422 Pa. at 504, 223 A.2d at 10; *Perkoski*, 371 Pa. 553, 92 A.2d 189.

In light of this fiduciary obligation, an insurer must consider settlement by according the insured's interests at least the same consideration it gives its own interests. *See Cowden*, 389 Pa. at 471, 134 A.2d at 228. An insurer breaches that duty when it unreasonably fails to accept a settlement offer for the underlying litigation and allows the case to go to trial where a verdict is entered in excess of the policy limits. *Id.; see also Birth Ctr.,* 567 Pa. at 407, 787 A.2d at 389 (insurer acts in bad faith when it unreasonably refuses to settle a claim). In that situation, *Cowden* teaches that an insurer may be liable for damages that exceed the policy's contractual limits.

These cases correctly focus on the insurer's conduct in determining whether it is liable for damages in excess of the contractual limits established by the policy. The issue currently before the Court, however, does not involve the type of extra-contractual damages at issue in *Cowden*. Here, the question involves solely

payment of damages within the contractual limits set by the policy for reasonable settlement amounts.

Where, as here, the question is the extent to which an insurer must pay for a reasonable settlement that does not exceed its policy limits – the very indemnity payments for which the parties bargained – the insurer's intent or "bad faith" has no place in the analysis. Instead, because an insurer agrees to indemnify its policyholder for reasonable amounts to settle covered claims when issuing its policy, if an insurer defends under a reservation of rights and refuses to consent to a reasonable settlement that is in the best interest of its insured, it breaches its fiduciary obligation to conduct the defense in its insured's best interest. *Accord Gedeon*, 410 Pa. at 59, 188 A.2d at 322; *Gray*, 422 Pa. at 504, 223 A.2d at 10; *Perkoski*, 371 Pa. 553, 92 A.2d 189; Windt, § 5.01 at 295; *see also Isaacson v. Cal. Ins. Guar. Ass'n*, 44 Cal.3d 775, 793 (Cal. 1988) (insurer has a "duty to settle the case for a reasonable amount."). That breach, in turn, relieves the insured of its obligation to obtain its insurer's consent to the settlement. *Accord Alfiero*, 347 Pa. Super. at 91, 500 A.2d at 172; 14 *Couch on Insurance* § 199:66 (3d ed. 2013); *see also Cay*, 812 F.2d at 870; *Spangler*, 881 F. Supp. at 545; *Miller*, 316 N.W.2d at 734; *Morris*, 741 P.2d at 252. And, thereafter, the sole inquiry in the subsequent

coverage litigation to recover a settlement payment within policy limits turns on whether the claim was covered and the settlement reasonable.[3]

The Iowa Supreme Court followed this same analytical path in resolving a coverage dispute similar to the one presented here. In *Kelly v. Iowa Mut. Ins. Co.*, 620 N.W.2d 637 (Iowa 2000), the court, like this Court, was faced with the issue of first impression of whether an insured is required to adhere to a cooperation clause when presented with a reasonable settlement demand in a case where its insurer is defending under a reservation of rights. The court initially noted that, when an insurer undertakes the defense of its insured, a covenant of good faith and fair dealing is implied. *Id.* at 643. It further recognized that this good faith duty includes a duty to settle claims in appropriate cases. *Id.* at 643-44. The court also made clear that, where an insurer has reserved its rights and the insured may be responsible for any judgment against it, "it is extremely important that the

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[3] Were the rule otherwise, an insurer could escape its bargained-for contractual obligations through its own negligence. If an insurer's conduct amounts to negligence but does not rise to the standard of "bad faith" articulated in *Cowden* and its progeny, it can avoid its contractual obligation to pay a reasonable settlement within policy limits of a covered claim. But the law does not recognize "good faith" as a defense in an action seeking solely to recover bargained-for contractual damages. *See, e.g., Bodum USA, Inc. v. La Cafetiere, Inc.*, 621 F.3d 624, 634 (7th Cir. 2010) (discussing the irrelevance of intent or "fault" in breach of contract claims); *see also* 11-57 Corbin on Contracts § 57.11 (2013) ("liability for breach of contract is primarily based on a no-fault principle . . . .").

insurance company, who is controlling the defense, fulfill its contractual obligation to settle where appropriate." *Id.* at 644.

In light of this heightened obligation to conduct the defense in good faith, the court held that, if an insurance company has breached the contract by wrongfully rejecting a reasonable settlement offer, the insured may accept the settlement offer over the insurer's objections without breaching the insurance contract and losing his right to seek coverage. *Id.* at 639. In so holding, the court made clear that its "bad faith" standard (similar to the standard articulated in *Cowden*) was not the governing rule because the issue was one of contractual liability as opposed to extra-contractual damages. Instead, the court held that when an insurer provides a defense under a reservation of rights and rejects a fair and reasonable settlement demand, "the insured is free to consummate the settlement on terms that protect the insured from any personal exposure." *Id.* at 645; *see also Ariz. Prop. and Cas. Ins. Guar. Fund v. Helme*, 735 P.2d 451, 460 (Ariz. 1987) (insured did not breach the cooperation clause by entering into a reasonable settlement where insurer anticipatorily breached its duties by failing to fairly consider a settlement proposal).

The Iowa Supreme Court's differentiation between the reasonable settlement standard, as compared to the bad faith standard, makes abundant good sense. The contractual obligations in play where a reasonable settlement demand is made

within policy limits and the insurer is defending under a reservation of rights do not implicate the extra-contractual principles that govern bad faith claims where a settlement is rejected and an excess verdict is entered. The resolutions of a reasonable settlement dispute, on the one hand, and a bad faith claim for damages in excess of policy limits, on the other, can and should be kept analytically distinct.

D. A Reasonable Settlement Standard Protects Policyholders' Reasonable Expectations Of Coverage And Prevents An Unfair Forfeiture Of That Coverage.

The reasonable settlement standard further preserves the insured's reasonable expectations of coverage and protects against an unfair forfeiture of that coverage in keeping with the Court's teachings in *Brakeman*, 472 Pa. 66, 371 A.2d 193. In *Brakeman,* the Court addressed the enforceability of an insurance policy provision requiring the insured to provide prompt notice of a claim in order to maintain coverage. In analyzing that issue, the Court found it significant that insurance policies are not negotiated agreements; rather their conditions are largely dictated by the insurance company to the insured. *Brakeman*, 472 Pa. at 73, 371 A.2d at 196. The Court also expressed concern that strict interpretation of the notice requirement would result in an unfair forfeiture of coverage. *Id.* The Court rejected the proposition that an insurer could collect premiums for promised coverage and thereafter deny that coverage based simply on a breach of a notice provision where it suffered no prejudice. *Id.* at 74, 371 A.2d at 197. In light of

these special policy concerns inherent in the insurance relationship, the Court held that an insurer could not avoid its coverage obligations based on a breach of a policy's notice provision unless it could establish prejudice as a result of the late notice.

In adopting this rule, the Court harkened back to the purpose of the notice provision and balanced that purpose with the policy considerations disfavoring a forfeiture of coverage. As the Court explained:

> [A] reasonable notice clause is designed to protect the insurance company from being placed in a substantially less favorable position than it would have been in had timely notice been provided . . . . Where the insurance company's interests have not been harmed by a late notice . . . the reason behind the notice condition in the policy is lacking, and it follows neither logic nor fairness to relieve the insurance company of its obligations under the policy in such a situation.

Id. at 75, 371 A.2d at 197.

The policy concerns and analysis set forth in *Brakeman* are equally applicable here. Here, the purpose of a cooperation clause in the context of a settlement of the underlying litigation is to protect the insurer from a collusive settlement between the insured and the injured party. *See Forest City,* 438 Pa. Super. at 559, 652 A.2d at 951. Where the insured is required to establish that a settlement is reasonable and non-collusive in order to recover the settlement amount from its insurer, the purpose of the cooperation clause evaporates. Given that the insurer suffers no prejudice from being required to fund a reasonable and

non-collusive settlement within the policy limits, as in *Brakeman*, a forfeiture of coverage based on a technical breach of the cooperation clause would be "unduly severe and inequitable." *Brakeman*, 472 Pa. at 76, 371 A.2d at 198. Instead, as with *Brakeman*'s late-notice-prejudice rule, the reasonable settlement rule preserves the reasonable expectations of the policyholder in purchasing coverage. *Id.*

III. The Superior Court's Settlement Standard Deprives Insureds Of Valuable Rights And Should Not Be Adopted As A Matter Of Law Or Policy.

The Superior Court rejected the reasonable settlement standard in favor of a different rule. Citing to *Taylor v. Safeco Ins. Co.*, 361 So.2d 743 (Fla. Dist. Ct. 1978), the Superior Court held that, when an insurer offers to defend its insured under a reservation of rights, the insured has two options: (1) it can accept the defense and relinquish all control over any settlement negotiations; or (2) it can reject the defense, pay for its own defense, and attempt to recover any reasonable settlement amounts from its insurer in subsequent coverage litigation. The *Taylor* standard, however, contravenes Pennsylvania law in several important respects.

First, as this Court has implicitly recognized, insurance policies do not provide an insured the right to reject a defense offered by its insurer. In fact, if an insured were to attempt to do so, it could be considered a breach of the policy resulting in a forfeiture of coverage. *See Jerry's Sport*, 606 Pa. at 616, 2 A.3d at

545 ("Insured would have been at risk of breaching the insurance contract if it had rejected [its insurer's] defense and it was later determined that the claim was covered."); *see also Widener Univ. v. Fred S. James & Co., Inc.,* 371 Pa. Super. 79, 87 n.9, 537 A.2d 829, 833 n.9 (1988) (suggesting that if insured rejects insurer's proffered defense, the insurer has no further defense obligations). As the Superior Court recognized, an insurer does not breach the policy under Pennsylvania law by offering a defense under a reservation of rights. *See Babcock & Wilcox Co. v. Am. Nuclear Insurers*, 76 A.3d 1, 12, 2013 PA Super 174 (2013). There accordingly is no basis, or authority, to conclude that an insured may unilaterally reject a defense tendered under a reservation of rights without forfeiting coverage under the policy.[4]

Second, the *Taylor* approach effectively strips Pennsylvania insureds of their very valuable right to a defense for potentially covered litigation. Pennsylvania law is clear that the duty to defend is broader than the duty to indemnify and extends to any suit asserting potentially covered claims. *See Jerry's Sport,* 606 Pa. at 609, 2 A.3d at 541. The *Taylor* rule unfairly forces the insured to either give up

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[4] In fact, in *Taylor,* the insurer withdrew its previously offered conditional defense and disclaimed any coverage obligation. *See Taylor*, 361 So.2d at 744. In that situation, the insurer clearly breached its defense obligation. The unique facts of *Taylor* are much different than a typical situation where an insurer attempts to fulfill its policy obligations by defending the litigation pursuant to a reservation of rights. In that situation, *Taylor* is inapposite.

its right to indemnity for a reasonable settlement that is in its best interest or relinquish its right to a defense. And it requires the insured to make this election as soon as a reservation of rights letter is issued, despite the fact that the insured may have no way of assessing the strength of any coverage defenses while the litigation against it is in its infancy.[5]

Corporate insureds purchase insurance policies specifically to cover the risk of expending substantial funds to defend claims against them that potentially fall within the coverage offered. Those insureds may not have the financial ability to pay to: (1) litigate the underlying suit: (2) fund any settlement or judgment; ***and*** (3) hire insurance coverage counsel to pursue litigation against its insurer to recover those amounts. More importantly, they should not have to: that is both the *raison d'etre* of commercial insurance policies and the very benefit that the insured paid substantial premiums to secure.

Third, it takes little imagination to quickly conclude that this standard is fraught with mischief and contravenes sound Pennsylvania policy favoring both reasonable settlements and the enforcement of the benefit of the parties' bargain.

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[5] As a practical matter, the only way an insured could effectively do so would be to hire insurance coverage counsel, an expense it should not have to incur in order to obtain its right to a defense of any potentially covered claims. *Accord Jerry's Sport*, 606 Pa. at 610-11, 2 A.3d at 541-42 (holding that it is the ***insurer's*** obligation to assess coverage once a claim is filed because "[i]nsurers are in the business of making this decision.").

If the *Taylor* approach were adopted, insurers would be incentivized to issue reservations of rights letters on every claim, even claims that are clearly covered. For insureds who cannot afford to pay to defend the underlying litigation, the insurer will then be able to control the litigation in a way that may not be in the insureds' best interests. The insurer will be quick to reject reasonable settlement demands. If the insured wishes to enter into a reasonable settlement to avoid reputational risks, an excess verdict or a substantial verdict that may not be covered, it will be forced to pay for the settlement out of its own funds and forfeit coverage, simply to protect its best interests.

If the insured instead stands by, does nothing and allows the insurer to take it into an improvident trial where a substantial verdict is rendered, the insurer will only be obligated to pay its policy limits unless the insured can establish that the insurer's actions were taken in bad faith, a difficult and costly proposition. Then too, the insurer has an additional avenue to avoid payment by litigating any defenses it may have to coverage. For an insured without the financial ability to engage on that battlefront, the only natural result is complete capitulation.

In short, insurers with substantial capital would be furnished with an arsenal of tactics to attempt to avoid their insurance coverage obligations. For an insured with limited funds to devote to the distractions of such unnecessary litigation, the likely result is an unfair forfeiture of coverage. For even those insureds who can

afford this new battle, the additional cost of doing business in Pennsylvania would substantially hamper companies' abilities to compete with non-Pennsylvania insureds who need not incur these costs to obtain the insurance benefits that they purchased.

The *Taylor* approach thus not only contravenes the Commonwealth's policy of encouraging settlement, but would actually proliferate unnecessary litigation of both the underlying claim and insurance coverage actions. It further deprives Pennsylvania insureds of the benefit of their insurance bargain and unnecessarily increases the cost of doing business in Pennsylvania. The Court should not support, or adopt, a rule that would have such draconian implications for Pennsylvania policyholders.

CONCLUSION

Amici's proposed reasonable settlement standard best balances the competing rights and obligations of the parties to commercial insurance policies in a manner faithful to Pennsylvania law. The *Taylor* standard, by contrast, is neither faithful to Pennsylvania law nor workable in practice. *Amici* accordingly urge the Court to adopt the reasonable settlement standard set forth above.

Respectfully submitted,

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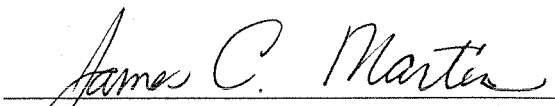

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CERTIFICATE OF COMPLIANCE

I hereby certify that the foregoing brief has a word count of 8,199 words based on the word count of Microsoft Word 2010, the word processing system used to prepare the brief. Thus, the brief complies with the word limit of Pennsylvania Rule of Appellate Procedure 2135.

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CERTIFICATE OF SERVICE

I hereby certify that on this 31st day of March, 2014, I caused the two copies of the Brief of *Amici Curiae* United Policyholders, *et al.* in support of the Appellants to be served upon each of the following persons via United States first-class mail:

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