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AVIATION, INSURANCE SERVICES, AND PRODUCT LIABILITY ALERT

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PENNSYLVANIA PERMITS INSUREDS BEING DEFENDED UNDER A RESERVATION OF RIGHTS TO SETTLE WITHOUT THEIR INSURER'S CONSENT

By Jonathan M. Stern

A standard provision in the commercial general liability policy and many other liability policies precludes voluntary payments—settlements—by the insured without the insurer's consent. The Supreme Court of Pennsylvania's decision in *The Babcock & Wilcox Company v. American Nuclear Insurers*, No. 2 WAP 2014 (Pa. July 21, 2015), potentially vitiates that provision when the insurer has reserved its right to deny coverage and will not consent to a settlement.

In a three-to-two decision addressing the question "whether an insured forfeits insurance coverage by settling a tort claim without the consent of its insurer, when the insurer defends the insured subject to a reservation of rights, asserting that the claims may not be covered by the policy," the court adopted "a variant" of the minority position set forth in *United Services Auto. Ass'n v. Morris*, 741 P.2d 246 (Ariz. 1987).

The case grew out of longstanding federal class action litigation by plaintiffs claiming to have suffered bodily injury and property damage caused by radiation emissions from nuclear facilities owned by Babcock & Wilcox Company (B&W) and Atlantic Richfield Company (ARCO). B&W and ARCO denied that there were nuclear emissions or that bodily injury or property damage resulted from emissions.

The insurers had reserved rights to deny coverage on a variety of grounds. These included that the insurance would not cover damages not caused by a nuclear energy hazard, damages in excess of liability limits, claims for injunctive relief, and punitive damages. There also was a reservation as to B&W for failure to cooperate.

The insurers declined all settlement proposals on the basis that a defense verdict was highly likely. The insured companies settled all claims with the class for a total of $80 million, well below the insurance liability limit, after a jury trial of eight test cases produced a substantial verdict. The settlement was reached, without the insurers' consent, after a new trial had been granted because of evidentiary issues.

B&W and ARCO then sued in state court in Pennsylvania for reimbursement of the settlement. When the case reached the Supreme Court, the issue was the standard to apply. The insureds argued for the *Morris* standard, which would require the insureds to prove that their settlement was fair, reasonable, and not collusive. The insurers argued for *Cowden v. Aetna Cas. and Sur. Co.*, 134 A.2d 223 (Pa. 1957), which would require the insureds to prove that the insurer had acted in bad faith in failing to accept a settlement within policy limits. After assessing its own body of

insurance law and that of sister states, the majority settled on

> a variation on the *Morris* fair and reasonable standard limited to those cases where an insured accepts a settlement offer after an insurer breaches its duty by refusing the fair and reasonable settlement while maintaining its reservation of rights and, thus, subjects an insured to potential responsibility for the judgment in a case where the policy is ultimately deemed to cover the relevant claims.

The majority noted that the question whether the settlement was fair and reasonable "necessarily entails consideration of the terms of the settlement, the strength of the insured's defense against the asserted claims, and whether there is any evidence of fraud or collusion on the part of the insured."

The concurring and dissenting opinion stated that the case should be remanded to the trial court for application of the *Cowden* bad faith test. In the view of the concurring and dissenting justices, the majority had deviated from binding Pennsylvania law that precluded the insureds from settling without consent unless the insurers had acted in bad faith in declining to settle.

Questions Created

The *Babcock & Wilcox* decision leaves open some significant questions for another day. For example, would a reservation of the right to disclaim coverage for punitive damages—or liability in excess of the policy's limit—trigger the right of the insured to settle without consent? After all, such reservations threaten the insured with noncoverage of only a portion of any judgment, not the entirety. Likewise, when will a settlement be held to be "collusive?" After all, the insured's principal interest will be in avoiding personal liability, and the plaintiff's interest will be in maximizing recovery. If these interests produce a number high on the reasonableness scale, will that be determined to be collusive?

Some Implications

So, what are the implications of the *Babcock & Wilcox* decision?

- Recognizing that there usually is a broad range of reasonableness of settlements, the decision exposes insurers to settlements that, while reasonable, are significantly costlier than a settlement that an insurer in good faith could decline to make. Therefore, settlements in cases where rights have been reserved could become costlier as they push to the high end of the range of reasonableness.
- Insurers defending under a reservation of rights will have to rethink those reservations when presented with settlements they do not wish to make. In many cases, reservations of rights are never acted upon, and an insurer may choose to withdraw a reservation rather than risk liability for an unconsented settlement.
- Insureds will seek out settlement opportunities and present them to their insurers in an effort to have cases settled within policy limits or reservations withdrawn.
- Cases where insurers previously would have defended under reservation of rights will be litigated in declaratory judgment proceedings to obtain an early determination of non-coverage. The so-called "courtesy defense" will become a less frequent occurrence.

The impact of *Babcock & Wilcox* is yet to be seen. What is clear is that, going forward, insurers will need to rethink reservations of rights when faced with settlement demands they do not desire to fund and insureds will look for opportunities to use the pendency of a reservation of rights to allow settlement without the insurer's consent. Advice of counsel can be critical in negotiating these issues. ◆

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