



July 14, 2017

Volume 21 Issue 2

Articles of Note

A Duty to Reimburse Defense Costs When Accepting a Defense as an Additional Insured in Pennsylvania-Practical Considerations

by Robert M. Palumbi



Insurance coverage issues on commercial construction projects are complex. Add in the contractual requirement of providing additional insured status and problems can arise when tendering and accepting a defense.

This article discusses a unique insurance coverage issue which may arise in a multi-defendant property damage action involving additional insured requirements among contractors. It is common in a property damage action for a carrier to provide a defense and later file a declaratory judgment when evidence discerned in discovery establishes that no coverage existed. In these situations, the policy language and jurisdiction determines whether the insured owes defense costs to the carrier.

But what is the duty of an additional insured to reimburse the carrier for defense costs when it is subsequently determined that coverage did not exist? The additional insured has no written contract with the carrier. Moreover, what if the additional insured was provided a defense from its own carrier, only to have the defense tendered to a different carrier based upon additional insured status? What is the obligation of the primary insurer? Let's address this through a factual example.

The Owner hires Contractor to construct a mixed-use building and the Contractor subsequently hires a Subcontractor. The contract between Contractor and Subcontractor calls for Subcontractor to add and recognize Contractor as an additional insured to its policy.

Substantial completion is achieved and the Owner takes possession of the building despite a payment dispute between Contractor and Owner. The Contractor files suit against the Owner. The Owner claims major structural issues with the building. The Owner then files a Counterclaim for breach of contract and negligence against the Contractor and joins the Subcontractor under a negligence theory.

Contractor and Subcontractor each turn the claims over to their respective carriers, and each provide a defense under a reservation of rights. Contractor's carrier recognizes its insured is entitled to additional insured status under the Subcontractor's policy. On this basis, Contractor's carrier tenders the claim to Subcontractor, who accepts the tender under a reservation of rights.

Subcontractor's carrier provides a defense to both Contractor and Subcontractor under a reservation of rights. In the middle of discovery, it is determined that the allegations against Contractor and Subcontractor are not covered by the policy.

The carrier for Subcontractor files a declaratory judgment against both Contractor and Subcontractor, seeking a determination that it does not owe a duty to defend **and** seeking to be reimbursed for the defense costs expended on behalf of the Contractor, the additional insured. The Subcontractor's carrier relies on policy language which states:

“If we initially defend an insured or pay for an insured’s defense but later determine that none of the claims, for which we provided a defense or defense costs, are covered under this insurance, we have the right to reimbursement of the defense costs we have incurred.”

First, let’s discuss the Subcontractor, the insured who is a party to the contract with the carrier. The Subcontractor was provided a defense under the policy. The issue regarding the right to reimbursement from an insured has existed for some time, with the majority position holding that an insurance carrier has no right to reimbursement. Both sides of the argument are understandable.

The insured argues the “duty to defend” is a critical element in the insurance carrier’s obligation to its policyholder. The cost of defense then is a business risk to the insurer, even if it is later determined that the claim is not covered. The carrier argues it should be able to recover the cost of defense when it becomes clear that a claim is not covered and would not have been covered if all the facts were known at the time the Complaint is filed. The carrier’s argument is that the insured is unjustly enriched by a defense when it was contractually not entitled to one.

In these situations, some states have held the carrier is entitled to a full reimbursement, while other states have held there is no reimbursement. Pennsylvania took a different approach.

In *American and Foreign Insurance Company v. Jerry’s Sports Center, Inc.*, 606 Pa. 583 (Pa. 2010), the Pennsylvania Supreme Court held that insurers are not eligible for defense cost reimbursement **which is not provided for or made clear within the policy contract itself**. This opened the door for insurance carriers to modify policy language to make clear a carrier’s right to recovery.

Many PA carriers adopted new policy language which expressly stated their rights to recover. Endorsement Pennsylvania Changes- Defense Costs- IL 20 2013 generally states:

“If we initially defend an insured or pay for an insured’s defense but later determine that none of the claims, for which we provided a defense or defense costs, are covered under this insurance, we have the right to reimbursement of the defense costs we have incurred.”

Under Pennsylvania law, the Subcontractor in our example above is obligated to repay its carrier for the defense costs. But what about the Contractor? There are two interesting legal issues which arise out of the situation.

Contractor vs. Subcontractor’s Carrier

Is the Contractor obligated to repay defense costs incurred by a carrier which it had no contract with? An insurance policy is a contract. How can the Contractor, who isn’t a party to the insurance contract, be bound to the terms of the contract between Subcontractor and its policy?

The Subcontractor’s carrier will likely argue that the Contractor accepted the defense, received a benefit, and was unjustly enriched by a defense it was not entitled to. While there are no cases directly on point in Pennsylvania, it would appear the ruling in *Jerry’s Sports Center, Inc.*, would support the Contractor’s argument- since the policy language/contract was not made clear to Contractor, the carrier cannot recoup such costs from the Contractor.

Contractor vs. Contractor’s Carrier

The more salient analysis is the relationship between the Contractor and its own carrier. The Contractor was provided coverage from its own carrier pursuant to the insurance contract.

The Contractor’s carrier then tendered the claim to the Subcontractor’s carrier because of Contractor’s additional insured status on the Subcontractor’s policy. If the Contractor **is** required to repay defense costs to the Subcontractor’s carrier, should the Contractor’s carrier be responsible? While no case is on point in Pennsylvania, it certainly seems like a probable outcome.

The analysis takes a different turn if the Contractor and Subcontractor’s policy language provides different levels of protection.

Suppose the Contractor's policy does not include Endorsement Pennsylvania Changes- Defense Costs- IL 20 2013 while the Subcontractor's policy includes the endorsement. In this instance, Contractor's policy provides more protection than the Subcontractor policy- the Contractor is provided a defense without worrying about an obligation of repayment of defense costs under its own policy, while it may be responsible for repaying defense costs as an additional insured under the Subcontractor policy.

By tendering the claim to Subcontractor's carrier as an additional insured under an inferior policy rather than assuming the defense, what is the Contractor's carrier's obligation to Contractor?

It would certainly appear that tendering an insured's claim to another carrier under an inferior policy would constitute a breach of the duty to defend and potentially bad faith. At the very least, the Contractor's carrier would have to agree upon tender to reimburse the Subcontractor's carrier for defense costs if it were later determined coverage did not exist.

Practical Considerations for Clients

Many of these issues can be dealt with preemptively while negotiating the contracts for the Project, or at the very least upon tender to the carrier as an additional insured.

When representing a general contractor and requiring subcontractors to add your client as an additional insured, consider the following actions:

1. Have a thorough grasp of your client's insurance policies and the protections they provide.
2. When requiring a subcontractor to add your client as an additional insured to its policy, request a copy of the policy before executing the contract. Make sure the policy provides for at least as much protection as your own.
3. If the subcontractor's policy does not provide the same level of protection as your own but meets the minimum requirements of the Owner, put your carrier on notice of the weaknesses in the subcontractor's policies. This will create a paper trail in the event your carrier attempts to tender a claim to the subcontractor's carrier later.
4. Prior to your carrier's tender of the claim to the subcontractor as an additional insured, thoroughly evaluate the underlying claim and the protections provided by each policy. If you believe your client's interests will be better served by its own carrier, make that known in writing to the carrier. At the very least, require that your client's carrier fill the gaps of any weaknesses provided to your client as an additional insured.

Robert M. Palumbi is an associate with the law firm of Babst, Calland, Clements and Zomnir, P.C., in Pittsburgh, Pennsylvania where he is a member of the Construction Services Group. His practice involves advising contractors, subcontractors and materials suppliers on a variety of construction related issues including mechanic's liens, payment act claims, construction code issues and construction insurance coverage matters. He can be reached at rpalumbi@babstcalland.com

To learn more about DRI, an international membership organization of attorneys defending the interests of business and individuals in civil litigation, visit www.dri.org.