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INSURANCE LAW

The 'Selective Way' Decision: A Catalyst For Increased Coverage Litigation?

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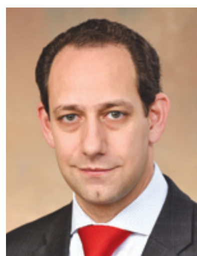
Insurance litigants in Pennsylvania—insurers and policyholders alike—have traditionally approached the determination of an insurer's duty to indemnify an insured with respect to a third party action with the understanding that the question of indemnity may be adjudicated via a declaratory judgment action subsequent to an adverse judgment against the insured. In many cases, the pursuit of a declaratory judgment to obtain an answer to that question does not become necessary where the underlying third party action is either settled on behalf of the insured or the insured is successful in the defense of the action. The Pennsylvania Superior Court's holding in *Selective Way Insurance v. Hospitality Group Services*, 119 A.3d 1035 (Pa. Super. Ct. 2015), however, may have altered this traditional approach to determining an insurer's duty to indemnify and may require an insurer to take proactive and protective steps to preserve its right to litigate its duty to indemnify in the event of an adverse judgment against its insured.



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In *Selective Way*, the Pennsylvania Superior Court ruled that the determination of the duty to defend and the duty to indemnify are inextricably intertwined such that the statute of limitations for an insurer to file a declaratory judgment action regarding its duty to defend and indemnify its insured begins to run when the insurance company has a "sufficient factual basis" to support its contentions that it has no duty to defend or indemnify the insured.

The insureds in *Selective Way* were sued in 2007 for liability arising out of a fatal accident that was caused by an intoxicated third-party underage driver. The insurer initially provided the insured with a defense subject to a reservation of rights and filed a declaratory judgment action in 2012, seeking a declaration that it had no duty to defend or indemnify the insured. The trial court

granted the insured's motion for summary judgment, finding that the four-year statute of limitations relative to the declaratory judgment action had expired.

On appeal, the Superior Court found that a cause of action for declaratory judgment accrues when an actual controversy exists between the parties, stating that the four-year statute of limitations for a declaratory judgment does not necessarily begin to run when an insurer receives the complaint because there "is no antagonistic claim, actual controversy, or inevitable litigation from the insurance company's point of view until it concludes that the claims made in a third party's action are 'confined to a recovery that the policy does not cover.'" Rather, the Superior Court concluded that the determination of when the statute of limitations for a declaratory judgment action begins to run involves a fact-intensive inquiry as to when the insurer had "a sufficient factual basis to decline to defend (and thus, decline to indemnify) its insured in a third party's action."

It is axiomatic in Pennsylvania that the factual allegations contained in a complaint filed against an insured control the question of whether an insurer has a duty to defend and that an insurer's duty to defend may be extinguished only at such time as the allegations within the complaint are confined to noncovered claims, such that the *Selective Way* decision did not announce anything new or surprising with respect to the accrual of a declaratory judgment action relating to a duty to defend. Regarding the triggering of the statute of limitations relative to a declaratory judgment action concerning an insurer's separate duty to indemnify, however, the Superior Court recognized that "an insurance company's substantive duty to indemnify an insured in a third party's action does not arise until there is a verdict," but drew a distinction between the determination of the extent to which an insurer may ultimately be required to indemnify an insured and the determination of whether the insurer would have a duty to indemnify in the first instance, in the event of an adverse judgment against the insured. In this regard, the Superior Court stated that "'the question before a court in a declaratory judgment action is not whether the insurer owes indemnification in a specific amount, which would be a premature inquiry absent a full resolution of the underlying action ... [but that] the question is whether the insurer has a duty to indemnify the insured in the event of liability in the underlying action.'" Consequently, the Superior Court stated that "the question of an insurance company's duty to indemnify an insured in a third party's action is properly considered in a declaratory judgment action at the same time as the court determines whether an insurance company has a duty to defend." The Superior Court thus held that "for purposes of determining the triggering event for the commencement of the statute of limitations to file a declaratory judgment action, we cannot disentangle the duty to indemnify from the duty to defend because both relate to the question of whether the policy provides coverage."

The Superior Court's waxing academic about the difficulties associated with the disentanglement of the distinct duties of defense and indemnity may have a very real and practical effect on the way insurers reserve and preserve their rights concerning their potential coverage obligations relative to an insured that has been sued.

Both practitioners and insurance professionals are well aware that third-party litigation against an insured—no matter how seemingly straightforward—can last for years, for a variety of reasons, and notwithstanding the litigants' best efforts and intentions to reach a resolution. Post-*Selective Way*, insurers must be

mindful that inasmuch as the clock may begin to tick—for the purposes of coverage litigation—upon the filing of a complaint against the insured (or sometime thereafter when a "sufficient factual basis" pertaining to coverage arises), the prophylactic issuance of reservation of rights letters and the filing of declaratory judgment actions prior to the entry of a verdict in the action against the insured may be necessary, even where the insurer does not challenge the duty to defend based on the allegations of the underlying complaint, lest a finding at a later time that the statute of limitations on the duty to indemnify has run. Indeed, given the inherently amorphous nature of identifying when an insurer possesses a "sufficient factual basis" to determine its coverage position, there may be an increase in the filing of precautionary declaratory judgment actions by insurers solely on the duty to indemnify, well before the conclusion of the underlying action against their insureds.

In those instances where the duty to defend is not in dispute, a practical rule concerning the issuance of such reservation of rights letters is: "early and often." An initial reservation of rights that clearly advises that a declaratory judgment action on the duty to indemnify may be necessary to the extent that the underlying litigation extends four years beyond the filing of the complaint against the insured will put the insured on notice of this possibility and may help foreclose future waiver and estoppel arguments. As the underlying litigation progresses, periodic and supplemental letters may be issued to refresh the insurer's reservations on this point and possibly others.

It remains to be seen whether the 'Selective Way' decision will actually precipitate an increase in coverage litigation as a result of the Superior Court's holding regarding the running of the statute of limitations with respect to the adjudication of the duty to indemnify.

As it becomes increasingly apparent that the underlying litigation against the insured may last for a substantial period, and as the four-year statute of limitations approaches, the insurer may consider a tolling agreement in lieu of—and as an alternative to—the institution of a declaratory judgment action concerning the duty to indemnify before the issue may be ripe for adjudication. A tolling agreement may serve as a useful mechanism that can have the effect of avoiding:

- The time and expense associated with a declaratory judgment action that may ultimately be unnecessary;
- The potential challenge of convincing the court in which a declaratory judgment action is filed that the litigation should be stayed pending the outcome of the underlying action;
- Any adversarial process between the insurer and insured; and
- Making allegations or establishing facts that are inconsistent with the insured's defense of the third party action.

It remains to be seen whether the *Selective Way* decision will actually precipitate an increase in coverage litigation as a result of the Superior Court's holding regarding the running of the statute of limitations with respect to the adjudication of the duty to indemnify. In any event, insurers must now be vigilant or potentially more aggressive in taking measures to preserve their rights to challenge the duty to indemnify, if and when that time comes. •

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