

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

THE RECTOR, WARDENS AND	:	CIVIL ACTION
VESTRYMAN OF ST. PETER'S CHURCH	:	
IN THE CITY OF PHILADELPHIA	:	
	:	
	:	
v.	:	
	:	
AMERICAN NATIONAL FIRE INSURANCE	:	
COMPANY, <u>et. al.</u>	:	NO. 00-2806

MEMORANDUM AND ORDER

HUTTON, J.

January 14, 2002

Presently before the Court are Defendants' Motion for Summary Judgment (Docket No. 15), Plaintiff's Memorandum of Law in Opposition to Defendants' Motion for Summary Judgment (Docket No. 19), Defendants' Reply Memorandum in Further Support of its Motion for Summary Judgment (Docket No. 21), Defendants' Supplemental Reply in Support of its Motion for Summary Judgment (Docket No. 42), Plaintiff's Memorandum in Response to Defendants' Supplemental Reply Memorandum in Support of Summary Judgment (Docket No. 43), Plaintiff's Motion for Partial Summary Judgment (Docket No. 14), Defendants' Answer to Plaintiff's Motion for Partial Summary Judgment, and Plaintiff's Memorandum of Law in Further Support of its Motion for Partial Summary Judgment (Docket No. 22). For the reasons discussed below, Defendants' motion for summary judgment is granted in part, denied and part, and Plaintiff's motion for partial summary judgment is granted.

I. BACKGROUND

On June 5, 2000, Plaintiff St. Peter's Church ("St. Peter's") instituted the instant action against Defendants American National Fire Insurance Company and Agricultural Insurance Company ("Defendants") seeking a declaration of Defendants' duty to provide St. Peter's a defense in an underlying lawsuit. St. Peter's, along with two other defendants, was accused of diverting funds of a trust in a complaint filed in the Court of Common Pleas of Philadelphia County on March 11, 1999. Specifically, the 19th Street Baptist Church and five of its members alleged that the defendants unlawfully diverted the funds of a trust from its intended beneficiaries because of their race and ethnic origin. Because the facts alleged in the underlying complaint are essential to a resolution of the motions currently before this Court, it is necessary to review the underlying litigation in greater detail.

A. The Underlying Lawsuit

The claim against St. Peter's "involves the ownership and disposition of certain proceeds of a trust instrument (the 'Trust') executed in the late nineteenth century by Ms. Margaretta Lewis." 19th Street Baptist Church v. St. Peter's Episcopal Church, 190 F.R.D. 345, 346 (E.D. Pa. 2000). The original complaint¹ named three defendants: St. Peter's, the Episcopal Dioceses of

¹ In total, plaintiffs in the underlying lawsuit filed three complaints. The first complaint was filed in the Court of Common Pleas of Philadelphia County on March 11, 1999. Plaintiffs then filed an amended complaint on April 21, 1999. The Court of Common Pleas then dismissed the state-court action on November 15, 1999. By this time, Plaintiffs had filed an action in federal court on October 15, 1999.

Pennsylvania, and First Union Bank. According to the complaint, "Ms. Lewis executed a will which provided, in part, that upon her death, the Trust was to be established to fund religious activities for the benefit of the community surrounding the Church. The St. Peter's Episcopal Church was initially appointed trustee of the Trust. First Union later succeeded St. Peter's in that position." Id. The complaint goes on to state that in 1945, the church building was sold to the Church with the approval of the Orphans Court of Philadelphia County, Pennsylvania. Id. However, "St. Peter's (and the Episcopal Diocese) failed to notify the surrounding community of the Orphans Court proceeding and of the existence of the Trust because 'the community [was now comprised of] African-Americans and/or Italians.'" Id. The complaint concluded that, as a direct result of the defendants' actions, "the principal was invaded and the proceeds of the Trust were diverted from the community and the Church to defendants." Id.

B. The Insurance Policies

The American National Fire Insurance Company ("American National") issued St. Peter's a policy of insurance for the period beginning March 15, 1997. This policy was renewed through June of 1999. Under the terms of the policy, American National agreed to "pay those sums that the Insured becomes legally obligated to pay as 'damages' because of a 'wrongful act' to which the insurance applies." Defs.' Mot. Summ. J., Ex. M, Church Directors and

Officers Coverage Form, at § I, ¶ 1 (hereinafter "Church Directors and Officers Coverage Form"). The policy applies to "any 'wrongful act' which occurs in the 'coverage territory' and during the policy period." Id. The policy further provides that American National would have the "right and duty to defend any 'suit' seeking those 'damages.'" Id. Agricultural Insurance Company ("Agricultural") issued an insurance policy to St. Peter's for the term March 15, 1997, which was renewed through June 15, 1999. This policy provided umbrella coverage for Directors and Officers Liability.

C. The Instant Lawsuit

Seven days after the commencement of the underlying lawsuit, St. Peter's forwarded a copy of the original complaint to its insurance broker. St. Peter's then retained the law firm of Sprague and Sprague to defend its interests. On June 25, 1999, American National responded to St. Peter's request for defense and indemnity, subject to a reservation of rights. American National first offered St. Peter's the same counsel as those retained for its co-defendant, the Episcopal Diocese of Pennsylvania. Pl.'s Mot. Summ. J. at 12-13. St. Peter's rejected this counsel on the grounds that a conflict of interest existed. Id. at 13. St. Peter's also rejected the next counsel offered because it again saw a potential conflict of interest since this counsel had advised American National on whether it owed a duty to defend St. Peter's. Id. at 14. The third counsel had been removed from the approved

list. Id. American National then offered to retain Sprauge and Sprauge at a value discount rate on the condition that the firm agreed to abide by American National's guidelines. Id. St. Peter's also rejected this offer. Since the parties disagreed as to the terms and conditions of the defense, St. Peter's commenced the instant lawsuit on June 5, 2000.

The parties now file cross-motions for summary judgment. Defendants seek a declaration that the policy provisions at issue impose no duty to defend. St. Peter's, on the other hand, seeks partial summary judgment against Defendant American National based on its contention that the filing of the original complaint in the underlying action triggered American National's duty to defend, and that American National subsequently violated that duty. See Pl.'s Mot. Partial Summ. J. at 1.

II. LEGAL STANDARD

A. Summary Judgment

Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). The party moving for summary judgment has the initial burden of showing the basis for its motion. Celotex Corp. v. Catrett, 477 U.S. 317, 323, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). Once the movant

adequately supports its motion pursuant to Rule 56(c), the burden shifts to the nonmoving party to go beyond the mere pleadings and present evidence through affidavits, depositions, or admissions on file to show that there is a genuine issue for trial. See id. at 324. A genuine issue is one in which the evidence is such that a reasonable jury could return a verdict for the nonmoving party. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

When deciding a motion for summary judgment, a court must draw all reasonable inferences in the light most favorable to the nonmovant. Big Apple BMW, Inc. v. BMW of N. Am., Inc., 974 F.2d 1358, 1363 (3d Cir. 1992), cert. denied, 507 U.S. 912, 113 S.Ct. 1262, 122 L.Ed.2d 659 (1993). Moreover, a court may not consider the credibility or weight of the evidence in deciding a motion for summary judgment, even if the quantity of the moving party's evidence far outweighs that of its opponent. Id. When parties file cross-motions for summary judgment, the court must determine separately on each party's motion whether the standard to enter summary judgment has been met. See Am. Guarantee & Liab. Ins. Co. v. Fojanini, 90 F.Supp.2d 615, 619 (E.D. Pa. 2000).

B. Contract Interpretation

Under Pennsylvania law,² the interpretation of the terms

² Neither party disputes the applicability of Pennsylvania law to the policy at issue. See Centennial Ins. Co. v. Meritor Sav. Bank, Inc., 1992 WL 164906, at *2 (E.D. Pa. July 6, 1992) (holding that "an insurance contract is governed by the law of the state in which the contract was made"), aff'd, 993 F.2d 876 (3d Cir. 1993).

of an insurance contract is a question of law to be decided by the court. See PECO Energy Co. v. Boden, 64 F.3d 852, 855 (3d Cir. 1995); Travelers Cas. & Sur. Co. v. Castegnaro, 772 A.2d 456, 458 (Pa. 2001). Accordingly, where no genuine issue of material fact exists, the issue before the court need not be submitted to a jury. See Reliance Ins. Co. v. Moessner, 121 F.3d 895, 900 (3d Cir. 1997); Standard Venetian Blind Co. v. Am. Empire Ins. Co., 469 A.2d 563, 566 (Pa. 1983). When construing an insurance policy, the court must ascertain the intent of the parties as evidenced by the language of the written agreement. Castegnaro, 772 A.2d at 459; Riccio v. Am. Republic Ins. Co., 705 A.2d 422, 426 (Pa. 1997). "When the policy language is clear and unambiguous, the court must give effect to the language in the contract." Castegnaro, 772 A.2d at 459; see also Med. Protective Co. v. Watkins, 198 F.3d 100, 103 (3d Cir. 1999). Conversely, where the policy is ambiguous, the ambiguous word or phrase must be construed in favor of the insured. Med. Protective Co., 198 F.3d at 103; Moessner, 121 F.3d at 900-01; Standard Venetian Blind, 469 A.2d at 566. The court must nonetheless interpret the policy with an eye toward avoiding ambiguities and giving effect to all of the provisions in the policy. Med. Protective Co., 198 F.3d at 103 (citing Little v. MGIC Indem. Corp., 836 F.2d 789, 793 (3d Cir. 1987)).

III. DISCUSSION

St. Peter's contends that Defendant American National was bound under the terms of the policy to provide a defense in the underlying lawsuit, and that Defendant breached this duty by failing to both respond to its insured in a reasonable amount of time and provide conflict-free counsel. Defendants respond that they do not owe St. Peter's a duty to defend based on the facts of the underlying case, and, if they did, they fulfilled such a duty by offering several defense options that St. Peter's rejected. "It is clear that in order to determine whether the insurer is obligated to defend an insured, the reviewing court must decide whether, if the facts alleged in the complaint are proved to be true, the policy would provide coverage." Keystone Automated Equip. Co. v. Reliance Ins. Co., 535 A.2d 648, 649 (Pa. Super. Ct. 1988). Therefore, the Court must first determine whether, based on the facts in the underlying complaint, Defendants were obligated to defend St. Peter's against the claims brought against the church.

A. Duty to Defend

Under Pennsylvania law, the duty to defend arises "whenever an underlying complaint may 'potentially' come within the insurance coverage." Frog, Switch & Mfg. Co. v. Travelers Ins. Co., 193 F.3d 742, 746 (3d Cir. 1999) (citing Erie Ins. Exch. V. Claypoole, 673 A.2d 348, 355 (Pa. Super. Ct. 1996)). In other

words, "[i]f a single allegation of a complaint is potentially covered by a policy, an insurer has an obligation to defend its insured against all claims until there is no possibility of recovery for a covered claim." CAT Internet Sys., Inc. v. Providence Washington Ins., 153 F.Supp.2d 755, 759 (E.D. Pa. 2001) (citing Frog, Switch, 193 F.3d at 746). Moreover, it is not the cause of action plead that is determinative as to whether coverage is triggered, but rather the factual allegations that comprise the complaint. See CAT Internet Sys., 153 F.Supp.2d at 760; Green Mach. Corp. v. Zurich Am. Ins. Group, Civ. A. No. 99-3048, 2001 WL 1003217, at *3 (E.D. Pa. Aug. 24, 2001); Mut. Ben. Ins. Co. v. Haver, 725 A.2d 743, 745 (Pa. 1999). These factual allegations must be liberally construed with all doubts as to whether the claims may fall within the policy coverage to be resolved in favor of the insured. Roman Mosaic & Tile Co. v. Aetna Cas. & Sur. Co., 704 A.2d 665, 669 (Pa. Super. Ct. 1997).

In the instant case, the underlying complaints clearly plead facts that allege a breach of a fiduciary duty based on the alleged diversion of funds from a trust. Moreover, Defendants concede that "[a]fter reviewing the amended complaint, the defendant insurers concluded that Count II of the amended complaint, alleging 'diversion of assets as fiduciaries or successors to fiduciaries who denied notice of pleadings' . . . could potentially be covered under the applicable insurance

policies." Defs.' Answer to Pl.'s Mot. Summ. J. at 10. Therefore, since at least some of the allegations in the underlying complaints were potentially covered by the policy, Defendants duty to defend was triggered.

1. Wrongful Acts Committed During the Policy Period

Defendants argue that the underlying complaint did not allege that any "wrongful act" was committed during the relevant "policy period." According to Defendants, the acts that lead to the underlying lawsuit arose in 1945 when "defendants invaded the principal of the trust, put the Church up for sale, and diverted income from the trust for other purposes . . ." Defs.' Mot. Summ. J. at 14-15. "Since it is clear that any wrongful act alleged in the [i]nitial . . . complaint is alleged to have occurred prior to the inception of the American National policy, that policy cannot be applicable." Id. at 15.

Under the American National policy, the insurer agreed to "pay those sums that the Insured becomes legally obligated to pay as 'damages' because of a 'wrongful act' to which this insurance applies." Church Directors and Officers Coverage Form, at § I, ¶ 1. "This insurance applies to any 'wrongful act' which occurs in the 'coverage territory' and during the 'policy period.'" Id. The agreement goes on to define "wrongful act" as "actual or alleged error; misstatement or misleading statement; act or omission; or negligent act or breach of duty; by the 'Directors' or 'Officers'

while acting in their capacity as such." Id at ¶ 12.

There is no question that the alleged wrongful diversion of the funds from a trust constitutes a wrongful act within the meaning of the policy. The contentious issue, however, is whether these alleged "wrongful acts" occurred during the relevant "policy period" - that is, between the effective date of the policy in March 15, 1997, through its renewal date of June 15, 1999. To aid the Court in its determination, Defendants encourage the use of the "effect" test adopted for "occurrence policies" by the United States Court of Appeals for the Third Circuit in Appalachian Ins. Co. v. Liberty Mut. Ins. Co., 676 F.2d 56 (3d Cir. 1982).

Appalachian Ins. Co. established the "law in Pennsylvania on the timing of the 'occurrence' of a tort for insurance purposes . . ." City of Erie, Pa. V. Guaranty Nat'l Ins. Co., 109 F.3d 156, 162 (3d Cir. 1997). The Third Circuit classified the insurance policy at issue as an "occurrence policy." See Appalachian Ins. Co., 676 F.2d at 60. An occurrence policy is a policy that "provides coverage for any 'occurrence' which takes place during the policy period." PECO Energy Co. v. Boden, 64 F.3d 852, 856 (3d Cir. 1995); see also Consulting Eng'rs, Inc. v. Ins. Co. of North Am., 710 A.2d 82, 85 (Pa. Super. Ct. 1998). The Third Circuit found that "the determination of when an occurrence happens must be made by reference to the time when the injurious effects of the

occurrence took place." Appalachian Ins. Co., 676 F.2d at 61. Under Pennsylvania law, occurrence policies do not cover injuries which manifest themselves before policy period begins. See id.

In the instant case, Defendants classify the policy not as an "occurrence" policy, but rather as a "wrongful act" policy. Nevertheless, Defendants argue that the same test to determine whether an "occurrence" took place within a policy period should apply. See Defs.' Mot. Summ. J. at 15. According to Defendants, "an occurrence which began prior to the policy period is simply not covered by the latter policy of insurance." Id. at 17. The "effect" test, however, fails to advance Defendants' position under the insurance policy at issue.

Unlike the policy in Appalachian Ins. Co., which required the Third Circuit to construe the meaning of "occurrence" and whether the loss at issue was caused by a single or multiple occurrence, the American National policy gauged its liability solely on a "wrongful act" taking place during the "policy period." This Court need look no further than the face of the underlying complaints to determine whether the plaintiffs alleged that wrongful acts took place during the policy period. According to the underlying complaints, the wrongful diversion of funds "commenced and have perpetrated until the present time . . ." See Orig. State Compl. at ¶ 14. Contrary to the Defendants' assertion, it is not clear that all wrongful acts alleged in the underlying

complaints occurred prior to the inception of the American National policy.

While it is undisputed that some of the alleged wrongful acts transpired prior to the inception of the American National Policy in 1997, this did not fully alleviate Defendants of their contractual obligation to defend. The duty to defend arises "whenever an underlying complaint may 'potentially' come within the insurance coverage." Frog, Switch & Mfg. Co. v. Travelers Ins. Co., 193 F.3d 742, 746 (3d Cir. 1999) (citing Erie Ins. Exch. V. Claypoole, 673 A.2d 348, 355 (Pa. Super. Ct. 1996)). "If a single allegation of a complaint is potentially covered by a policy, an insurer has an obligation to defend its insured against all claims until there is no possibility of recovery for a covered claim." CAT Internet Sys., Inc. v. Providence Washington Ins., 153 F.Supp.2d 755, 759 (E.D. Pa. 2001). Drawing all reasonable inferences in the light most favorable to the nonmovant, the underlying complaints allege that wrongful acts were taking place from 1997 through the filing of the complaint in June of 2000.

2. Discrimination and Personal Profit Exclusions

Next, Defendants contend that, even if St. Peter's alleged "wrongful acts" occurred during the policy period, they are nonetheless excluded from coverage based on the discrimination and personal profit exclusions included in the policy. See Defs.' Mot. Summ. J. at 19. "Under Pennsylvania law, exclusions from coverage

contained in an insurance policy will be effective against an insured if they are clearly worded and conspicuously displayed, irrespective of whether the insured read the limitations or understood their import." Princeton Ins. Co. v. Kosoy, Civ. A. No. 98-4985, 1999 WL 79055, at *3 (E.D. Pa. Feb. 9, 1999) (citing Pacific Indem. Co. v. Linn, 766 F.2d 754, 761 (3d Cir. 1985)); Standard Venetian Blind Co. v. Am. Empire Ins. Co., 469 A.2d 563, 567 (Pa. 1983)). "If the insurer seeks to avoid its duty to defend on the basis of an exclusion, the burden is on the insurer to prove that the exclusion encompasses the underlying action." Lang Tendons, Inc. v. Northern Ins. Co. of New York, Civ. A. No. 00-2030, 2001 WL 228920, at *4 (E.D. Pa. March 7, 2001); see also Madison Constr. Co. v. Harleysville Mut. Ins. Co., 735 A.2d 100, 106 (Pa. 1999) ("Where an insurer relies on a policy exclusion as the basis for its denial of coverage and refusal to defend, the insurer has asserted an affirmative defense and, accordingly, bears the burden of proving such defense."); White v. Keystone Ins. Co., 775 A.2d 812, 813 (Pa. Super. Ct. 2001) (same).

a. Discrimination Exclusion

The discrimination exclusion of the policy provides that the "insurance does not apply to . . . discrimination on account of race, religion, sex or age, or in any way connected with a violation of any state or federal civil rights law." See Church Directors and Officers Coverage Form, at § I, ¶ 2(h). According to

Defendants, the underlying complaint "expressly alleges that the reason for [St. Peter's] allegedly improper conduct racially motivated and racially discriminatory, but also expressly a violation of state or federal civil rights laws." See Defs.' Mot. Summ. J. at 20. Therefore, Defendants assert that they have no duty to defend St. Peter's in the underlying lawsuit.

"The duty to defend is limited to only those claims covered by the policy." Aetna Cas. & Sur. Co. v. Roe, 650 A.2d 94, 98 (Pa. Super. Ct. 1994). The policy at issue here contains a "clearly worded and conspicuously displayed" exclusion of claims based upon racial discrimination and a violation of civil rights law. See Kosoy, 1999 WL 79055, at *3. However, while plaintiffs in the underlying action plead facts relating to claims of racial discrimination, the underlying complaints also contain facts alleging a breach of a fiduciary duty based. Again, "[i]f a single allegation of a complaint is potentially covered by a policy, an insurer has an obligation to defend its insured against all claims until there is no possibility of recovery for a covered claim." CAT Internet Sys., 153 F.Supp.2d at 759.

In cases such as this where some claims are covered by the policy, but others are successfully excluded, the insurer's duty to defend can be terminated at a point in the litigation when it is determined that the claim is one that is outside the scope of coverage. C. Raymond Davis & Sons, Inc. v. Liberty Mut. Ins. Co.,

467 F.Supp. 17, 19 (E.D. Pa. 1979). Until that time, however, the insurer has the duty to defend the entire claim. Moreover, the policies at issue do not exclude a duty to defend a breach of a fiduciary duty claim. To the contrary, the policy expressly covers a "wrongful act" including "breach of duty . . . by the 'Directors' or 'Officers' while acting in their capacity as such." See Church Directors and Officers Coverage Form, at § V, ¶ 12. Accordingly, the discrimination exclusion did not relieve Defendants of their duty to defend.

b. Personal Profit Exclusion

The policy's personal profit exclusion prevents coverage in the case of "an insured gaining any personal profit or remuneration or advantage to which the 'insured' is not legally entitled." Church Directors and Officers Coverage Form, at § I, ¶ 2(f). The Court agrees with St. Peter's that this exclusion is also inapplicable to the instant case. The policy excludes "an 'insured' gaining any personal profit or remuneration or advantage to which the 'insured' is not legally entitled." Id. at § I, ¶ 2. The policy goes on to define the "insured" as "any person who is an 'Officer' or 'Director' . . ." Id. at § V, ¶ 6. The plaintiffs in the underlying action make no allegation that the Directors or Officers of St. Peter's are personally profiting from the alleged diversion of the trust. Therefore, the exclusion does not alleviate Defendants of their duty to defend.

In sum, the undisputed facts of record indicate that the underlying complaints set forth a cause of action for a breach of a fiduciary duty against St. Peter's. Moreover, the facts clearly demonstrate that the underlying complaints allege that the breach of the trust continues to the present day. None of the exclusions listed in the policy relieve Defendants of their duty to defend. Accordingly, the Court finds that Defendants have a duty to defend St. Peter's in the underlying lawsuit.

B. Breach of Duty to Defend

Next, St. Peter's requests a declaration that Defendant American National breached its duty to defend in the underlying state and federal litigation. St. Peters asserts that it has the right under the policy to select independent counsel, and that American National, in turn, must reimburse St. Peter's for its reasonable fees and costs incurred in its defense of the underlying lawsuit.³ St. Peter's first alleges that American National breached its duty to defend by issuing a reservation of rights letter three months after the complaint in the underlying lawsuit was filed. In addition, St. Peter's asserts that American National's failure to provide conflict-free counsel in light of the conflict of interests between the insurer and the insured, and its refusal to relinquish control of the defense, also constituted a

³ St. Peter's concedes that the issue of whether the defense costs actually incurred were reasonable is an issue of fact, and is therefore not properly before this Court in the instant motion for summary judgment.

breach of its duty.

1. Reservation of Rights

Defendants did not breach their duty to defend by issuing a reservation of rights letter. "Under Pennsylvania law, the general rule is that an insurance company may not assume the defense of a suit which entails the defendant's relinquishing to the insurer the management of the case and then later deny liability under the policy. However, the insurer may protect its rights under the policy by a timely reservation of rights which fairly informs the insured of the insurer's position." Merchants Mut. Ins. Co. v. Artis, 907 F.Supp. 886, 891 (E.D. Pa. 1995) (citation omitted); see also Aetna Life and Cas. Co. v. McCabe, 556 F.Supp. 1342, 1354 (E.D. Pa. 1983). "[L]etters of reservation . . . are properly issued as soon as the defending insurer becomes aware of the possibility of liability for which the insured may not be covered." New Castle Mut. Ins. Co. v. Johnston, 1991 WL 1803, at *3 (E.D. Pa. Jan. 9, 1991).

In the instant case, Defendants responded to St. Peter's three months after the filing of the underlying complaint by sending a reservation of rights letter. During this time, Defendants inquired as to whether their duty to defend was triggered based upon the nature of the underlying complaint. The delay in the instant case is not sufficient to deem the reservation of rights letter invalid. See e.g. Johnston, 1991 WL 1803, at *3

(holding that sixteen month delay in issuing a reservation of rights letter after the filing of the underlying complaint was "of sufficient duration to justify deeming the letter of reservation invalid"); McCabe, 556 F.Supp. at 1354 (finding reservation of rights letter, which was issued more than a year after the complaint was filed, untimely because insurer's delay denied insured the opportunity to use his personal attorney in investigating the case and conducting discovery). Rather, the letter at issue was sent within a reasonable time after the insurer determined its liability. See e.g., St. Leger v. Am. Fire and Cas. Ins. Co., 870 F.Supp. 641, 644 (E.D. Pa. 1994) aff'd 61 F.3d 896 (3d Cir. Pa. 1995) (finding insurer did not waive right to deny coverage where it sent reservation of rights letter approximately two and one-half months after underlying suit was filed).

2. Conflict of Interest

Defendants, however, have breached their duty to defend by failing to provide conflict-free counsel and relinquish control of the defense. "It is clear that in Pennsylvania, as in most other jurisdictions, if an insurance company breaches its duty to defend, it is liable to reimburse the [insured] the costs the latter incurred in conducting its own defense." St. Paul Fire & Marine Ins. Co. v. Roach Bros. Co., 639 F.Supp. 134, 138-39 (E.D. Pa. 1986). An insurance company breaches its duty to defend when a conflict of interests arises between the insurer and its insured

"such that the company's pursuit of its own best interests in the litigation is incompatible with the best interests of the [insured]." Id. at 139. A conflict of interest between an insurer and its insured will not relieve insurer of its duty to provide a defense. See Consolidated Rail Corp. v. Hartford Acc. & Indem. Co., 676 F.Supp. 82, 86 (E.D. Pa. 1987). Rather, courts have concluded that one appropriate resolution in this circumstance "is for the insurer to obtain separate, independent counsel for each of its insureds, or to pay the costs incurred by an insured in hiring counsel." Id.

In support of its contention that it is entitled to remuneration for the procurement of conflict-free counsel, St. Peter's cites to Cay Divers, Inc. v. Raven, 812 F.2d 866 (3d Cir. 1987) (applying law of the Virgin Islands). In Raven, the Third Circuit found that the

Provision of independent counsel or reimbursement for the insured's choice of counsel and expenses ordinarily fulfills the duty to defend, and is particularly appropriate where, as here, there is a conflict of interest between the insurer and the insured. . . . Indeed, where there is a conflict of interest, ethical considerations may even require that the insurer provide

independent counsel rather than participate in the defense.

Id. at 870 n.3. Defendants argue that the application of Raven to the case at bar is tenuous since the case hails from the Virgin Islands. The principle enunciated by the Third Circuit, however, is not a legal anomaly specific to the Virgin Islands. Rather, it is a restatement of a basic contract principle that the insurer has a duty to pay for independent counsel when conflict of interest exists between insured and insurer. See 14 Couch on Ins. § 202:34 (3d ed. 1997); see also See Pennbank v. St. Paul Fire & Marine Ins. Co., 669 F.Supp. 112, 126 (E.D. Pa. 1987) (crediting insurer who did not dispute the "premise that where a conflict arises between insurer and insured, the insurer is obligated to under the policy to provide the insured with independent counsel at no expense to the insured."). "Accordingly, when a conflict of interest develops, an insured's duty to cooperate with the insurer does not require the insured to surrender control of his or her defense, and permits the insured to obtain separate counsel." See id. at § 199:17.

Defendants remind the Court that "[w]ith respect to the existence of both covered and uncovered claims or theories of liability, the potential for conflict is much greater, but actual conflict is not inevitable." See St. Paul Fire & Marine Ins. Co. v. Roach Bros. Co., 639 F.Supp. 134, 139 (E.D. Pa. 1986). The case

before this Court, however, presents more than "the mere theoretical possibility of such a conflict." Id. Rather, the undisputed facts of record establish that an actual conflict exists that requires the insurer to provide independent, conflict-free counsel. The interest of American National and St. Peter's are not joint. Rather, the Court is presented with a "case where liability can rest on either of two causes of action, one which is covered [breach of a fiduciary duty] and the other [racial discrimination, which is] not." See Pennbank v. St. Paul Fire & Marine Ins. Co., 669 F.Supp. 112, 127 (E.D. Pa. 1987). In this situation, an insurer "would be tempted to construct a defense which would place any damage award outside policy coverage." Id.

"When a liability insurer retains counsel to defend an insured, the insured is considered the client. . . . If a conflict of interest arises between an insurer and its insured, the attorney representing the insured must act exclusively on behalf of and in the best interests of the insured." Builders Square, Inc. v. Saraco, Civ. A. Nos. 94-4116, 95-164, 1997 WL 3205, at *3 (E.D. Pa. Jan. 7, 1997); see also Point Pleasant Canoe Rental Inc. v. Tinicum Township, 110 F.R.D. 166, 170 (E.D. Pa. 1986). In the instant case, St. Peter's counsel will be unable to fulfill this duty to its client so long as American National insists on retaining control over the defense. American National's interest in configuring the underlying lawsuit as one based upon racial

discrimination rather than the breach of a trust so that it may exclude coverage creates a clear conflict of interest. "It is settled law that 'where conflicts of interest between an insurer and its insured arise, such that a question as to the loyalty of the insurer's counsel to that insured is raised, the insured is entitled to select its counsel, whose reasonable fee is to be paid by the insurer.'" Krueger Assoc., Inc. v. ADT Sec. Sys., Mid-South, Inc., Civ. A. No. 93-1040, 1994 WL 709380, at *5 (E.D. Pa. Dec. 20 1994). Because of the conflict of interests between the insurer and its insured, American National is obligated to provide conflict-free counsel and relinquish control of the defense.

C. Bad Faith Claim

Defendants⁴ seek the entry of summary judgment in their favor on Count IV of St. Peter's complaint which states a cause of action for bad faith under 42 Pa.C.S. § 8371.⁵ Bad faith on the part of an insurer has been described as "any frivolous or unfounded refusal to pay proceeds of a policy . . . [that] imports a dishonest purpose and means a breach of a known duty (i.e., good faith and fair dealing), through some motive of self-interest or

⁴ Only Defendants, and not St. Peter's, have moved this Court for summary judgment on St. Peter's bad faith claim.

⁵ Pennsylvania's bad faith statute provides:
In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may . . .
(1) Award interest on the amount of the claim . . .
(2) Award punitive damages against insurer.
(3) Assess court costs and attorney's fees against the insurer.
42 Pa.C.S. § 8371; see also Marks v. Nationwide Ins. Co., 762 A.2d 1098, 1100 (Pa. Super. Ct. 2000).

ill will; mere negligence or bad judgment is not bad faith.'" Williams v. Nationwide Mut. Ins. Co., 750 A.2d 881, 887 (Pa. Super. Ct. 2000) (quoting MGA Ins. Co. v. Bakos, 699 A.2d 751, 754-55 (Pa. Super. Ct. 1997)). In order to recover on a claim of bad faith under this statute, the moving party must provide "'clear and convincing evidence of bad faith, rather than mere insinuation, and a showing by the insured that the insurer did not have a reasonable basis for denying benefits under the policy and that the insurer knew of or recklessly disregarded its lack of a reasonable basis in denying the claim.'" Id. "The basis for this heightened standard, however, is not just that a potential conflict of interest exists, but the inflammatory nature of an allegation of bad faith, 'conduct [that] imports a dishonest purpose and means a breach of a known duty . . . through some motive of self-interest or ill will.'" Liberty Mut. Ins. Co. v. Marty's Express, Inc., 910 F.Supp. 221, 224 (E.D. Pa. 1996).

St. Peter's bad faith claims are premised on what St. Peter's characterizes as Defendants' "unreasonable delay in responding to its insured's request for coverage," as well as American National's refusal to provide conflict-free counsel and relinquish control of the defense. See Pl.'s Mem. in Opp'n to Defs.' Mot. Summ. J. at 45. The Court finds that St. Peter's has failed to meet its burden to support a claim of bad faith. As noted above, American National's three-month delay in respond to

St. Peter's was not unreasonable. Moreover, while this Court disagreed with American National's contention that it was permitted to retain control over St. Peter's defense, mere bad judgment on the part of the insurer does not amount to bad faith. Dearry v. Liberty Mut. Ins. Co., Civ. A. No. 95-6569, 1997 WL 129099, (E.D. Pa. March 17, 1997) (quoting PolSELLI v. Nationwide Mut. Fire Ins. Co., 23 F.3d 747, 751 (3d Cir. 1994)).

"Bad faith necessitates clear and convincing evidence that the insurer unreasonably declined to carry out the terms of the policy or recklessly disregarded the basis of the underlying claim." Scranton Dunlap, Inc. v. St. Paul Fire & Marine Ins. Co., Civ. A. No. 00-2138, 2000 WL 1100779, at *2 (E.D. Pa. 2000). Viewing the facts in the light most favorable to the nonmovant, St. Peter's has failed to place before this Court clear and convincing evidence that supports a contention that Defendants acted in bad faith. Cohen v. State Auto Prop. & Cas. Co., Civ. A. No. 00-3168, 2001 WL 120145, at *3 (E.D. Pa. Feb. 8, 2001). Defendants were not reckless in debating whether their policies covered the allegations in the underlying lawsuit. They merely engaged in the same dialogue that has occupied this Court for many pages in this Memorandum. "A reasonable but incorrect interpretation of an insurance provision does not rise to bad faith." Scranton Dunlap, Inc., 2000 WL 1100779, at *2. Therefore, the Court grants summary judgment in Defendants' favor on Count VI, St. Peter's bad faith

claim.

An appropriate Order follows.

**IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

THE RECTOR, WARDENS AND	:	CIVIL ACTION
VESTRYMAN OF ST. PETER'S CHURCH	:	
IN THE CITY OF PHILADELPHIA	:	
	:	
	:	
v.	:	
	:	
AMERICAN NATIONAL FIRE INSURANCE	:	
COMPANY, <u>et. al.</u>	:	NO. 00-2806

O R D E R

AND NOW, this 14th day of January, 2002, upon consideration of Defendants' Motion for Summary Judgment (Docket No. 15), Plaintiff's Memorandum of Law in Opposition to Defendants' Motion for Summary Judgment (Docket No. 19), Defendants' Reply Memorandum in Further Support of its Motion for Summary Judgment (Docket No. 21), Defendants' Supplemental Reply in Support of its Motion for Summary Judgment (Docket No. 42), Plaintiff's Memorandum in Response to Defendants' Supplemental Reply Memorandum in Support of Summary Judgment (Docket No. 43), Plaintiff's Motion for Partial Summary Judgment (Docket No. 14), Defendants' Answer to Plaintiff's Motion for Partial Summary Judgment, and Plaintiff's Memorandum of Law in Further Support of its Motion for Partial Summary Judgment (Docket No. 22), IT IS HEREBY ORDERED that Plaintiff's Motion for Partial Summary Judgment is **GRANTED**.

IT IS FURTHER ORDERED AND DECLARED that:

- (1) Defendant American National Fire Insurance Company had a duty to defend Plaintiff St. Peter's Church in the

underlying lawsuit;

- (2) Defendant American National Fire Insurance Company breached its duty to defend Plaintiff St. Peter's Church;
- (3) Defendant American National Fire Insurance Company has a duty to pay for reasonable fees and expenses incurred by independent counsel selected by Plaintiff St. Peter's Church in its defense of the underlying action.

IT IS FURTHER ORDERED that Defendants' Motion for Summary Judgment as to Count IV of Plaintiff's complaint is **GRANTED**.

BY THE COURT:

HERBERT J. HUTTON, J.