The Legal Intelligencer
THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2017
PHILADELPHIA, THURSDAY, AUGUST 3, 2017
An ALM Publication

INSURANCE LAW

Third Circuit Clarifies Discretion to Reject Declaratory Judgment Actions

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Insurance companies often prefer to litigate insurance coverage issues in federal courts. There are a number of reasons for this. First, well-founded or not, there is a general perception that the federal bench is more accustomed to addressing the complex legal issues that can sometimes arise in insurance coverage disputes. Second, while insurance coverage litigation is often adjudicated on dispositive motions, where there is a factual dispute to be resolved, the federal courts offer a more diverse jury pool, an important factor where the state court jury pool is perceived as unfriendly to insurers. Finally, litigation in federal court insulates an insurer from any perceived local bias in favor of a local insured.

Insurance coverage litigation usually ends up in federal court in two ways. First, assuming there is a basis for diversity jurisdiction under 28 U.S.C. Section 1332, an insurer seeking adjudication of a coverage dispute can file an action in federal court asking the court to make a declaration of its rights and obligations under the insurance policy. Alternatively, where an insurer has been sued by its insured in state court, and again, where there is a basis for diversity jurisdiction under 28 U.S.C. Section 1332, an insurer can remove the action to federal court under 28 U.S.C. Section 1441. However, the fact that the litigation starts in federal court or is removed to federal court doesn't necessarily mean it will stay there. Due to the nature of the federal declaratory remedy and principles of comity, an insurer's invocation of federal jurisdiction is often challenged.

The Federal Declaratory Judgment Act, 28 U.S.C. Section 2201 et. seq., authorizes any court of the United States to declare the rights and other legal relations of any interested party seeking such declaration. This confers discretionary, rather than compulsory, jurisdiction on the federal courts, as in Brillhart v. Excess Insurance, 316 U.S. 491, 494, 62 S. Ct. 1173, 1175 (1942); Wilton v. Seven Falls, 515 U.S. 277, 279, 115 S. Ct. 2137, 2139 (1995). Over the years, the U.S. Court of Appeals for the Third Circuit has identified a series of factors for district courts to consider in determining whether to exercise that discretion. (See Reifer v. Westport Insurance, 751 F.3d 129 (3d Cir. 2014).) The court has also addressed the question both where there are parallel state proceedings pending, State Auto Insurance v. Summy, 234 F.3d 131, 131 (3d Cir. 2000), and where no parallel state proceedings exist. In the latter circumstance, a rebuttable presumption arises in favor of jurisdiction.

The contours of the district court's discretion to entertain a declaratory judgment action are thus fairly well-established in the Third Circuit. However, until earlier this year, the Third Circuit had not answered the question of whether a district court has discretion to decline to enter a declaration when the suit in question asserts both a claim under the Declaratory Judgment Act and a claim legal relief like a claim for breach of contract. The Third Circuit answered this question in Rarick v. Federated Services Insurance, 852 F.3d 223 (2017).

In Rarick, the court considered consolidated appeals. An employee of the named insured was involved in an auto accident while driving a company car. The employee made a claim for uninsured motorist benefits (UM) under the named insured's business automobile policy. The insurer denied the claim, asserting that the named insured had waived UM benefits in accordance with Pennsylvania law. After his claim was denied, the employee filed a class action lawsuit in the Philadelphia Court of Common Pleas. The suit sought a judgment declaring that Pennsylvania's Motor Vehicle Financial Responsibility Law (MVFRL) required the insurer to provide him with UM coverage. The suit also requested damages for breach of contract alleging-in nearly identical language to the prayer for declaratory relief that the insurer had breached its contract by failing to provide UM benefits. The insurer removed the case to the District Court pursuant to 28 U.S.C. Sections 1441 and 1332. After the removal, no related case remained pending in state court.

The district court applied a "heart of the matter" test to determine whether it had discretion to decline jurisdiction. It determined that the crux of the litigation was declaratory because the employee sought a declaration that he was entitled to uninsured motorist benefits. It concluded that the case should be remanded because of "the nature and novelty of the state law issues." The district court followed its holding in the second case, which had substantially the same pertinent facts, and also remanded that matter.

On appeal, the Third Circuit noted that a federal district court's discretion to decline jurisdiction depends on whether the complaint seeks legal or declaratory relief. When an action seeks legal relief, federal courts have a "virtually unflagging obligation" to exercise jurisdiction, as in Colorado River Water Conservation District v. United States, 424 U.S. 800, 817, 96 S. Ct. 1236, 1246 (1976). There are but a few "extraordinary and narrow exceptions" to this rule. By contrast, federal courts may decline jurisdiction under the Declaratory Judgment Act.

The court reviewed the various approaches to the issue adopted by the federal courts and concluded that the most appropriate is the "independent claim test" adopted by the Seventh Circuit. Under this test, the court must determine whether the legal claims are independent of the declaratory claims. Nondeclaratory claims are independent when they

alone are sufficient to invoke the court's subject matter jurisdiction and can be adjudicated without the requested declaratory relief.

Where the legal claims are independent, the court has a "virtually unflagging obligation" to hear those claims. If the legal claims are dependent on the declaratory claims, however, the court retains discretion to decline jurisdiction of the entire action. The court explained that it preferred the independent claim test because it prevents plaintiffs from evading federal jurisdiction through artful pleading by including a declaratory judgment claim in their complaints when such a claim is unnecessary. That being said, the court also noted with approval the Seventh Circuit's observation that the mere fact that a litigant seeks "some nonfrivolous, nondeclaratory relief in addition to declaratory relief" does not mean that a district court's discretion to decline to hear the declaratory claim should be supplanted by the Colorado River doctrine.

Applying the independent claim test to the facts, the court concluded that claims were independent because the insureds could have obtained their desired relief in federal courts without requesting a declaratory judgment.

The independent claim test announced in Rarick has been applied in a number of district court decisions this year. In Continental Casualty v. Westfield Insurance, No. 16-5299, 2017 U.S. Dist. LEXIS 61889, at *11 (E.D. Pa. Apr. 24), the Eastern District of Pennsylvania applied the test to a suit for declaratory relief, breach of contract and equitable contribution brought by one insurer against another where the defendant insurer refused to provide additional insured coverage to the plaintiff's named insured. The district court held that plaintiff insurer's claims for monetary relief were substantively independent of the claim for declaratory relief even though they arose from the same underlying legal obligation. The district court explained that all the claims centered around the objective of obtaining money damages for a past refusal to defend and a declaration to prevent such refusal in the future. Even though the claims were based on the same legal obligations, they were substantively independent because they could be adjudicated without adjudicating the requested declaratory relief.

Practically speaking, Rarick means that most coverage lawsuits initiated by insurers in federal court will continue to be vulnerable to dismissal. This is because insurers initiating a coverage action are typically seeking a declaration as to their rights and obligations under the policy. They do not typically have a claim for damages or other legal relief against their insured which could serve as an independent claim. By contrast, most coverage actions initiated by insureds seek an award of damages in addition to declaratory relief. In these cases, the district courts will see their discretion curtailed. •

Special to the Law Weekly Kenneth M. Portner, a partner in Weber Gallagher Simpson Stapleton Fires & Newby's Philadelphia office, focuses his practice on advising, counseling and representing insurance companies in coverage and bad-faith avoidance matters. He also represents lenders/creditors in collection, workout and bankruptcy matters. He regularly appears in state and federal courts in New Jersey, New York and Pennsylvania.