WHAT EVERY LAWYER NEEDS TO KNOW ABOUT INSURANCE LAW

H. ROBERT POWELL
BOBBY M. RUBARTS
PAUL K. STAFFORD

JONATHAN R. DOTSON
T. BLAKE EDWARDS
JOHN R. HARDIN
RICHARD D. VILLA

Hughes & Luce, LLP
1717 Main Street, Suite 2800
Dallas, TX 75201

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I. Introduction

Imagine that a potential client contacts you to defend it in a large and important case. The client, a relatively sophisticated corporation, explains it contacted you because, after researching several prominent trial lawyers, it discovered you have the best reputation among the group. In addition to being flattered, you are intrigued by the potential client's case: it sounds interesting, and will most likely be lucrative for you, as well. After clearing conflicts, and spending several hours conferring with your potential client, you agree to the representation.

During the entire visit, your client never once mentioned the possibility it might have an insurance policy covering the claim. You never asked about insurance. In fact, it never even occurred to you to ask. (You do not have a clear idea of the types of commercial insurance policies available, in any event. In fact, you have never even read your own insurance policies. Once you tried to read your professional liability policy, but it was so confusing and contradictory you gave up half-way through it.)

Surely you are not required to know anything about liability insurance, are you? After all, your client is sophisticated: it should know whether it has insurance for the claim. Further, you are the client's counsel of choice. If there were insurance for the claim, the insurance company might insist upon hiring another lawyer with which it regularly worked.

Is ignorance bliss in this situation? Or do you and your client potentially have problems resulting from your not having even a basic understanding of insurance?

We know that not even asking about insurance could get you sued. In *Thornton, Summers, Biechlin, Duham & Brown, Inc. v. Cook Paint & Varnish*, 82 F.3d 114 (5th Cir. 1996), a former client sued its firm, alleging legal malpractice for failing to investigate the availability of insurance coverage in the underlying suit in which the firm had defended the client. Because of other issues in the case, the court never reached whether the lawyers had a duty to investigate potentially available coverage. Similarly, in *Poth v. Small, Craig & Werkenthin, L.L.P.*, 967 S.W.2d 511 (Tex. App.—Austin 1998, pet. denied), the court disposed of the case with the same claims on grounds that did not require it to address the duty issue.

As a result, it is not clear whether such a suit against you would be successful. Even so, is insurance-ignorance worth the risk? Wouldn't it be better to have a general understanding of policies the client may have? At a minimum, we think a lawyer in this situation could not go wrong asking his or her client or potential client the following question: Have you investigated whether you have a liability insurance policy that might cover this claim?

This paper is designed to provide the civil trial lawyer with enough basic information about insurance to spot some issues, know when to ask for help, and, hopefully, keep yourself and your client out of trouble. It also discusses some recent cases and trends in insurance law that we think will impact every civil trial lawyer, whether or not he or she handles "insurance" cases.

II. Common, Potential Insurance Policies

There are so many "insurance products" available, it would be impossible for anyone other than an insurance specialist to be familiar with them all. Nonetheless, there are a few common policies with which civil trial attorneys should be generally familiar. And these policies may well cover claims—or at least provide a defense to claims—that one might not typically consider to be an "insurance claim."

A. CGL Policies

Commercial General Liability ("CGL") Policies are purchased by business entities, essentially to insure against negligent conduct arising out of business operations. They traditionally have been "occurrence" based policies.[1] Under the Coverage A part of a standard CGL policy, the policyholder is indemnified for damages related to "bodily injury" and "property damage" resulting from an "occurrence." "Occurrence" usually is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful condition."

Additionally, Coverage B of the standard CGL form affords coverage for "personal and advertising injury," arising from the following acts: a) False arrest, detention or imprisonment; b) malicious

[1] An "occurrence" policy applies to the time the damage occurred. For example, if the plaintiff sued the insured in 2004 for damage that occurred in 2000, the 2000 CGL policy would apply.

prosecution; c) wrongful eviction; d) publication of defamatory material of a person or of an organization's goods, products, or services; e) oral or written publication of material that violates a person's right of privacy; f) the use of another's advertising ideas in the insured's advertisement; or g) infringing upon another's copyright, trade dress or slogan in the insured's advertisement. Obviously, a wide variety of claims potentially fit within these parameters.

Importantly, a standard CGL policy requires the insurer to defend the policyholder against any covered claims. This is an extremely valuable right. Under Texas law, in a suit with multiple claims, the insurer must provide a defense if plaintiff's pleadings "potentially" state one claim that is within coverage. *Utica Nat'l Ins. Co. v. American Indem. Co.*, 141 S.W.3d 198, 201 (Tex. 2004); *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997) (citing *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965)). As a result, as just one example, while patent litigation has not typically been held to be within the scope of a CGL policy, if one of the claims is related to infringement in "advertising," the policy may provide coverage for a costly defense.

B. D&O Policies and Potential Endorsements

Directors & Officer's ("D&O") Policies insure against the "wrongful acts" of the organization, its directors, officers, and employees that cause harm to a third-party. They typically are "claims-made" policies.[2] Each policy defines "wrongful act" differently, but it generally includes the insured's actual or alleged acts or omissions, including breaches of duty. Lawyers typically think of these policies as covering claims alleging securities law violations, including securities class actions for corporate mismanagement.

Originally, the focus of these policies was for personal financial protection for individual officers and directors. That is no longer the case. Today, D&O insurance is often coupled with coverage designed to protect the corporation from a wide-variety of claims. For example, many policies cover the corporation for its own liability, even in cases in which the directors and officers are not also sued.

For example, Employment Practices Liability ("EPL") coverage has become a common coverage for corporations, often as an endorsement to the D&O policy. EPL policies typically protect directors, officers, employees and/or the company against employment-related claims brought by employees, such as wrongful dismissal, failure to promote, sexual harassment, and other violations of federal, state or local employment and discrimination laws.

Additionally, derivative suits unrelated to securities laws, governmental investigations, and criminal complaints may also be covered. In fact, many D&O policies expressly define covered claims to include "criminal proceedings commenced by the return of an indictment." Even without this language, however, governmental action—even short of a formal indictment or charge—may still fall within the definition of "Wrongful Act."

Significantly, even if some of the claims appear to be excluded by policy, the insurer may still owe a duty to pay for the defense—which is typically the duty assumed. This is because most policies state that an insurer cannot rely on exclusions to avoid payment unless and until there is a final adjudication of fraud or dishonesty.

C. E&O Policies

An Errors and Omissions ("E&O") Policy, also known as professional liability or malpractice insurance, provides coverage for mistakes made by a person or persons, in a profession not involved with the human body, such as lawyers, accountants, and engineers. E&O Policies are typically claims-made policies.

The wild-card with these policies is that other businesses that typically are not considered to be "professional" may also have an E&O policy. For example, a shipper may cause substantial damage by shipping a product to the wrong location, and have coverage for the resulting loss under an E&O policy. Would it occur to most lawyers that there may be insurance to cover such a claim? Additionally, some insurers offer E&O insurance that even covers the products a business manufactures and the contracts they execute. These policies can be stand alone, or, even easier to overlook, could be endorsements to other types of policies.

D. Excess / Umbrella Policies

It also is important to know whether the potential client has an excess or umbrella policy. An excess

[2] A "claims-made" policy applies to a claim first made during the policy period. For example, if a plaintiff sued in 2004 for an act that occurred in 2000, the 2004 D&O Policy would apply.

policy provides extra limits above and beyond the amount of primary coverage. An umbrella liability policy, however, provides not only excess amounts, but may also provide coverage in several areas not covered by the primary liability policies.

Because these policies may be occurrence based, it is possible an old umbrella could apply to a current claim that has been tolled by limitations. Older umbrellas could cover a claim that seemingly would not be the subject of insurance. For example, early umbrellas contained no exclusion for damage to property owned by others in the insured's care, custody, or control. Even some first-party coverage under an umbrella could be construed to provide liability protection. Coverage also applied to a wide variety of personal injury claims, and even patent infringement. While this is no longer the case, some current umbrella policies will offer a "drop down" feature, and apply on a primary basis, for claims not covered by the primary policies. This is called Coverage B on the umbrella policy.

III. Notice to Insurance Company

Assuming an insurance policy potentially applies to a claim, it usually requires policyholders to provide notice. The purpose of notice is to advise the insurer of a claim that it is required to defend. *Weaver v. Hartford Accident. & Indem. Co.*, 570 S.W.2d 367, 369 (Tex. 1978); *Harwell v. State Farm Mut. Auto. Ins. Co.*, 896 S.W.2d 170, 173 (Tex. 1995). The timing of the notice is governed by the policy. Policy provisions requiring notice "promptly," "as soon as practicable" or "immediately" have been liberally construed to require only that notice be given within a reasonable time in light of the circumstances. *Continental Sav. Ass'n v. U.S. Fid. & Guar. Co.*, 762 F.2d 1239, 1243, *amended in part*, 768 F.2d 89 (5th Cir. 1985); *see also Ridglea Estate Condo. Ass'n v. Lexington Ins. Co.*, 415 F.3d 474, 477 n.1 (5th Cir. 2005).

Compliance with the notice condition is a condition precedent to an insurer's liability under the policy. *Liberty Mut. Ins. Co. v. Cruz*, 883 S.W.2d 164, 165 (Tex. 1993); *Harwell*, 896 S.W.2d at 173; *Weaver*, 570 S.W.2d at 369; *Filley v. Ohio Cas. Ins. Co.*, 805 S.W.2d 844, 847 (Tex. App.—Corpus Christi 1991, writ denied). Thus, failure to comply with a notice provision may relieve an insurer of its obligations under the policy. *McGuire v. Commercial Union Ins. Co.*, 431 S.W.2d 347 (Tex. 1968); *Filley*, 805 S.W.2d at 847.

A. Occurrence Policies—Prejudice Required

Texas law requires the insurer to demonstrate prejudice to avoid its obligations based upon a breach of a notice requirement on certain types of insurance policies. The Texas Department of Insurance issued orders requiring mandatory endorsements in general liability and automobile insurance policies stating that, with respect to bodily injury and property damage liability, "unless the company is prejudiced by the insured's failure to comply with the requirement, any provision of this policy requiring the insured to give notice of . . . occurrence or loss . . . shall not bar liability under this policy." *Ridglea Estate Condo. Ass'n v. Lexington Ins. Co.*, 415 F.3d 474, 479 (5th Cir. 2005) (citing *Hanson Prod. Co. v. American Ins. Co.*, 108 F.3d 627, 629 (5th Cir. 1997) (quoting TEXAS STATE BOARD OF INSURANCE, Order No. 23080 1973)).

Whether an insurer is prejudiced by its insured's failure to give notice has generally been recognized to constitute a question of fact. *P.G. Bell Co. v. U.S. Fid. & Guar. Co.*, 853 S.W.2d 187, 191 (Tex. App.—Corpus Christi 1993, no writ); *Harbor Ins. Co. v. Trammel Crow Co.*, 854 F.2d 94, 98 (5th Cir. 1998). However, when the facts are undisputed, the question is one of law for the court. *E.B. Smith Co. v. U.S. Fid. & Guar. Co.*, 850 S.W.2d 621, 625 (Tex. App.—Corpus Christi 1993, writ denied). Courts also hold that, as a matter of law, an insurer is prejudiced when an insured fails to notify its insurer of a suit until after judgment entered against the insured has become final and non-appealable. *Harwell*, 896 S.W.2d at 174; *Liberty*, 883 S.W.2d at 165 ("an insurer that is not notified of suit against its insured until a default judgment has become final, absent actual knowledge of the suit, is prejudiced as a matter of law").

Although the orders mention only general liability and automobile insurance policies, the Fifth Circuit has extended the prejudice requirement to a property insurance policy. *Ridglea*, 415 F.3d at 479-80. The *Ridglea* court was persuaded by the rationale and holding of the Texas Supreme Court in *Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691 (Tex. 1994). In *Hernandez*, the Court held that an insured's violation of a settlement-without-consent provision did not bar his recovery under an uninsured motorist provision unless the insurer demonstrated prejudice. The *Ridglea* court mentioned, however that it was not saying the prejudice requirement extended to claims-made policies. *Id*. at 480 n.4.

The Fifth Circuit's decision has not been universally accepted. At least one Texas court of appeals has refused to extend the prejudice requirement to policies unless the policy specifically includes the

prejudice requirement. *PAJ, Inc. v. Hanover Ins. Co*., 170 S.W.3d 258 (Tex. App.—Dallas 2005, pet. granted) (holding that the failure to perform a notice condition was an absolute defense to liability on the policy because the policy endorsement requiring prejudice was limited to claims for bodily injury and property damage, and because the endorsement did not specify advertising injury, the court would not imply such a change in the policy).

The Texas Supreme Court has granted the petition to review the decision in *PAJ, Inc. v. Hanover Ins. Co.* Thus, the Court should resolve this inconsistency in the law regarding the prejudice requirement for the failure to provide notice. *See also Motiva Enters., LLC v. St. Paul Fire & Marine Ins. Co*., 445 F.3d 381, 386 (5th Cir. 2006) (recognizing that the law in Texas is not clear as to whether an insurer must demonstrate prejudice before it can avoid its obligations under a policy when an insured fails to comply with the prompt-notice provision).

B. Claims Made Policies—Some Courts Have Said No Prejudice Is Required

Claims-made policies cover occurrences giving rise to a claim that is made during the policy period. Some courts have held that there is no requirement to show prejudice if the failure to provide notice was under a claims-made policy. *See Hirsch v. Texas, Lawyers Ins. Exch.*, 808 S.W.2d 561, 565 (Tex. App.—EI Paso, 1991, writ denied) (holding that the notice-prejudice rule is not applicable to claims-made policies because requiring a showing of prejudice would defeat the purpose of a claims made policy, and, in effect, convert such a policy into an occurrence policy); *Federal Ins. Co. v. CompUSA, Inc*., 319 F.3d 746, 754 (5th Cir. 2003).

C. The Notice Requirement May Be Excused

In some circumstances, the insured may be excused from the notice requirement. At least one Texas court has recognized four situations in which an insured may be excused from notifying the insurer of a claim: (1) if the insured had no knowledge of the incident; (2) the insured believed that the incident was so trivial that no claim could be made; (3) the insured believed there was no insurance coverage for the incident; or (4) the insured was incapacitated by illness or injury and was thus unable to comply with the notice requirement. *Employers Cas. Co. v. Scott Elec. Co.*, 513 S.W.2d 642, 646 (Tex. Civ. App.—Corpus Christi 1974, no writ).

IV. Insurance Companies' 3 Basic Options After Notice

Once an insured has notified the insurer of a claim, the insurer ordinarily has three options: (1) accept coverage and provide an unqualified defense; (2) if coverage is questionable on one or all of the claims, provide a defense but reserve the right to contest coverage on one or more of the claims later; or (3) deny coverage and refuse to provide a defense. *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 713 (Tex. 1996). Each action has different ramifications.

A. Providing an Unqualified Defense

Although the general rule is that waiver and estoppel cannot create coverage if it does not exist under the policy's terms, *see Texas Farmers Ins. Co. v. McGuire*, 744 S.W.2d 601, 602-03 (Tex. 1988), when an insured chooses to provide an unqualified defense (i.e. provide a defense without reserving its right to contest coverage), it may waive or be estopped from raising coverage defenses if it had sufficient knowledge indicating that the claims were potentially not covered. *Paradigm Ins. Co. v. Texas Richmond Corp*., 942 S.W.2d 645, 652 (Tex. App.—Houston [14th Dist.] 1997, writ denied); *State Farm Lloyds, Inc. v. Williams*, 791 S.W.2d 542, 550 (Tex. App.—Dallas 1990, writ denied); *Farmers Tex. County Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 521-22 (Tex. Civ. App.—Austin 1980, writ ref. n.r.e.*); see also Katerndahl v. State Farm Fire & Cas. Co.*, 961 S.W.2d 518, 523 (Tex. App.—San Antonio 1997, no pet.); *Pennsylvania Nat'l Mut. Cas. Ins. Co. v. Kitty Hawk Airways, Inc.*, 964 F.2d 478, 481 (5th Cir. 1992). This exception exists: (1) because when an insurer has chosen to provide an unqualified defense the insured does not have the right to control its own defense; and (2) to protect the insured against conflicts that may arise between the insurer and the insured such as when the insurer provides a defense but at the same time begins formulating coverage defenses. *See Williams*, 791 S.W.2d at 551; *see also Wilkinson*, 601 S.W.2d 522*; Akwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991); *Pacific Indem. Co. v. Acel Delivery Serv., Inc.*, 485 F.2d 1169, 1173 (5th Cir. 1973).

"However, unless a conflict of interest or other harm is clear and unmistakable," courts generally decline to apply the exception unless the insured shows how it was actually harmed or prejudiced by the insurer's unqualified assumption of the defense. *Williams*, 791 S.W.2d at 552-53; *see also State Farm Lloyds, Inc. v. Williams* ("*Williams II*"), 960 S.W.2d

781, 786-87 (Tex. App.—Dallas 1997, pet. dism'd by agr.) (estoppel requires showing of prejudice); *Paradigm Ins. Co.*, 942 S.W.2d at 652-53 (no waiver of policy defenses where insurer filed answer but sent reservation of rights letter 15 days later because no evidence of harm to insured); *Pacific Indem. Co..*, 485 F.2d at 1173-76 (estoppel requires showing of prejudice); *Kitty Hawk Airways, Inc.*, 964 F.2d at 481-82 & n.11 (estoppel and waiver require showing of harm); *cf. Katerndahl*, 961 S.W.2d at 524 (waiver requires showing of harm or prejudice); *but see generally Wilkinson*, 601 S.W.2d at 520-22 (applying exception with no discussion of harm or prejudice requirement). Where there is no evidence that the counsel chosen by the insurer manipulated the defense to preclude coverage, it can be difficult to demonstrate actual harm, especially if the coverage issue is not relevant to the issues in the underlying suit. *See, e.g., Kitty Hawk Airways, Inc.*, 964 F.2d at 482-83. But an insured may also be able to demonstrate harm where the insurer refuses to accept a settlement offer and later a judgment is rendered against the insured for an amount in excess of the settlement offer. *Williams II*, 960 S.W.2d at 786-87 (although plaintiff agrees not to execute judgment except against policy, insured may be found to have been harmed where agreement not to execute was entered into after judgment because insured will face threat of execution for some period of time).[3]

B. Providing a Defense Subject to Reservation of Rights

When an insurer determines coverage is questionable, it may offer to defend the case subject to a reservation of its rights to contest coverage. Doing so does not breach the insurer's duty to defend. *First Gen. Realty Corp. v. Maryland Cas. Co.*, 981 S.W.2d 495, 501 (Tex. App.—Austin 1998, pet. denied); *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983). A reservation of rights may also be appropriate if the suit against the insured must be answered prior to the insurer having an opportunity to determine whether the policy provides coverage. *Costley v. State Farm Fire & Cas. Co.*, 894 S.W.2d 380, 384-85 (Tex. App.—Amarillo 1994, writ denied).

While a reservation of rights need not categorically deny coverage, *see J.E.M. v. Fidelity & Cas. Co.*, 928 S.W.2d 668, 673 (Tex. App.—Houston [1st Dist.] 1996, no writ), it must inform the insured of the insurer's position. *Rhodes*, 719 F.2d at 120. Additionally, it should clearly set forth the specific defenses upon which the insurer is relying, as well as disclose any potential conflicts that might arise due to the insurer's retention of and payment to an attorney that will represent the insured. *See Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 559 (Tex. 1973); *see also Y.M.C.A. of Metro. Fort Worth v. Commercial Std. Ins. Co.*, 552 S.W.2d 497, 499, 502-04 (Tex. Civ. App.—Fort Worth 1977), *writ ref. n.r.e.*, 563 S.W.2d 246 (Tex. 1978) (per curiam); *J.E.M.*, 928 S.W.2d at 673-74.

As discussed below in Section VI, these conflicts may give rise to a right to independent counsel for the insured. As a lawyer for a client that has made a claim on its insurance policy, it is important to understand and be prepared to advise one's client when the right to independent counsel arises and how to exercise that right.

Finally, although a reservation of rights must be timely, *see Rhodes*, 719 F.2d at 120, the 5th Circuit has allowed an insurer to reserve its rights more than a year after assuming the defense when the insured could not establish that it was harmed by the delay. *Kitty Hawk Airways*, 964 F.2d at 481-83.

The Texas Supreme Court has not directly addressed whether an insurer that has purportedly reserved its right to reimbursement of defense costs may recover such costs when it is later determined that there was no duty to defend. *See St. Paul Fire & Marine Ins. Co. v. Compaq Computer Corp.*, 377 F. Supp. 2d 719, 722 (D. Minn. 2005). While the Dallas Court of Appeals in *Matagorda County v. Tex. Association of Counties County Government Risk Management Pool* "found no Texas cases that would recognize such a right to reimbursement," it also observed that courts in other states allowed such a right if the insurer specifically reserved the right and the insured failed to object. 975 S.W.2d 782, 784-85 (Tex. App.—Dallas 1998), *aff'd*, 52 S.W.3d 128 (Tex. 2000). Further, the court suggested these decisions were consistent with the doctrine of *quantum meruit*. *Id.* at 785. But because the insurer in that case had failed to provide the insured with specific notice that it might later attempt to recover defense costs, the court held that the insurer had no right to reimbursement.

[3] It should be noted that when: (1) an assignment of the insured's claims against the insurer to the plaintiff is made prior to the adjudication of plaintiff's claims against the insured in a fully adversarial trial; (2) the insurer has tendered a defense; and (3) either (a) the insurer has accepted coverage or (b) the insurer has made a good faith effort to adjudicate coverage issues prior to adjudication of plaintiff's claims, such assignment is invalid. *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996).

Last year, in *St. Paul Fire & Marine Insurance Co. v. Compaq Computer Corp*., the United States District Court for the District of Minnesota determined that the Texas Supreme Court would apply the doctrine of *quantum meruit* in such a situation. *See generally Compaq Computer Corp*., 377 F. Supp. 2d 719. Relying upon the statements made by the Dallas Court of Appeals and the Texas Supreme Court in *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.* (*see* Section VII below for a discussion of *Frank's Casing*), the court determined that the application of *quantum meruit* was appropriate and held that an insurer is entitled to reimbursement of defense costs. It made this finding, even though the policy was silent on the issue, as long as the insurer properly reserved such rights and there was no duty to defend. *See generally id.* (Note that, the Texas Supreme Court granted rehearing on *Frank's Casing* this year. Thus, it remains to be seen how persuasive *Compaq Computer Corp*. will be.)

C. Denial of Coverage and Refusal to Provide a Defense

When the insurer decides none of the claims in the underlying suit against the insured are potentially covered—or all of the claims that would otherwise have been potentially covered are excluded—an insurer will refuse to provide a defense. If the insurer's analysis is incorrect, it risks liability for breach of contract. This liability may include damages representing: 1) the amount of judgment in the underlying suit that is recovered against the insured, subject to applicable policy limits; 2) the reasonable and necessary expenses, including attorneys' fees, incurred by the insured in defending the underlying suit; and 3) the necessary and reasonable costs and expenses, including attorneys' fees, incurred in prosecuting the breach of contract suit against the insured. *Travelers Ins. Co. v. Chicago Bridge & Iron Co.*, 442 S.W.2d 888, 900 (Tex. Civ. App.—Houston [1st Dist.] 1969, writ ref'd n.r.e.); *Texas United Ins. Co. v. Burt Ford Enters., Inc.*, 703 S.W.2d 828, 835 (Tex. App.—Tyler 1986, no writ). As discussed below, the insurer may also be liable for extra-contractual penalties under the old article 21.55 of the Texas Insurance Code (re-codified at TEX. INS. CODE ANN. § 542.051-542.061). But an insured does not have a negligence or DTPA cause of action based on the insurer's wrongful refusal to provide a defense. *Southstar Corp. v. St. Paul Surplus Lines Ins. Co.*, 42 S.W.3d 187, 192-94 (Tex. App.—Corpus Christi 2001, no pet.).

Further, when an insurer wrongfully refuses to provide a defense after it is given a reasonable opportunity to do so, it waives its right to require that the insured comply with conditions precedent to coverage under the policy (e.g., "no action" or "no settlement without consent" provisions). *Gulf Ins. Co. v. Parker Prods., Inc.*, 498 S.W.2d 676, 679 (Tex. 1973); *cf. Comsys Info. Tech. Servs. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 191 (Tex. App.—Houston [14th Dist.] 2003, pet. denied). Therefore, an insured is free to enter into a reasonable good-faith settlement rather than continue with litigation. *Parker Prods., Inc.*, 498 S.W.2d at 679; *Comsys Info. Tech. Servs.*, 130 S.W.3d at 191. However, if a judgment is entered against the insured without a fully adversarial trial (e.g. consent judgment) it is not binding on the insurer nor is it admissible as evidence of damages in a suit against the insurer by the underlying plaintiff as the insured's assignee. *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996).

V. Duty to Defend / Duty To Pay Defense Costs / Duty to Indemnify

A. Duty to Defend

In Texas, the duty of an insurer to defend its insured against third party claims is a contractual duty, arising when a third-party makes at least one claim for damages that potentially is within the policy's coverage. *See Houston Petroleum v. Highlands Ins.*, 830 S.W.2d 153, 155 (Tex. App.—Houston [1st Dist.] 1990, writ denied).

The broad rule, under which most of the other rules fall, is commonly referred to as the "8 Corners Rule." It provides that an insurer's duty to defend is determined by a comparison between the factual allegations in the "four corners" of the petition against the "four corners" of the insurance policy—without regard to the truth or falsity of the allegations. *GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, No. 04-0692, 2006 WL 1791689, at *2 (Tex. June 30, 2006); *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 187 (Tex. 2002); *see also National Union Fire, Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997).

A corollary of the 8 Corners Rule is the general proposition that extrinsic evidence may not be considered. This proposition is not without its critics, *see, e.g.*, Randel L. Smith & Fred A. Simpson, *Extrinsic Facts & the Eight Corners Rule Under Texas Law—The World is Not as Flat as Some Would Have You Believe*, 46 S. TEX. L. REV. 463 (2004), and, as discussed below, the proposition is not as clear-cut as many courts and trial lawyers may think. Indeed, Texas appellate courts, from time to time, have

considered extrinsic evidence. In doing so, these courts have created what can be considered exceptions to the 8 Corners Rule. [4]

In addition to the ongoing debate over whether and to what extent extrinsic evidence may be used, Texas courts and federal courts applying Texas law are split on whether article 21.55 of the Texas Insurance Code (re-codified at TEX. INS. CODE ANN. § 542.051-542.061) applies to the duty to defend. (Essentially, it is a question whether one can recover 18% interest on the damages incurred.) This issue is now conditionally before the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, No. 04-51074, on certification from 5th Circuit.

1. General Principles Governing the Duty to Defend

Whether a duty to defend exists is a question of law. *Southstar Corp. v. St. Paul Surplus Lines Ins. Co.*, 42 S.W.3d 187, 190 (Tex. App.—Corpus Christi 2001, no pet.). Under the 8 Corners Rule, if the petition does not allege facts within the scope of the insurance coverage, an insurer is not required to provide a defense. *King*, 85 S.W.3d at 187; *Merchants Fast Motor Lines, Inc.*, 939 S.W.2d at 141. Conversely, if the petition alleges facts potentially giving rise to any claim(s) within coverage, the insurer will be obligated to defend the entire lawsuit. *Utica Nat'l Ins. Co. v. American Indem. Co.*, 141 S.W.3d 198, 201 (Tex. 2004); *see also Merchants Fast Motor Lines, Inc.*, 939 S.W.2d at 141. However, there is no duty to defend if a petition alleges facts establishing an exclusion(s) under the policy of all the claims that otherwise would have been covered. *See Fidelity & Guar. Ins. Underwriters, Inc. v. McManus*, 633 S.W.2d 787, 788 (Tex. 1982); *Adamo v. State Farm Lloyds Co.*, 853 S.W.2d 673, 677 (Tex. App.—Houston [14th Dist.] 1993, writ denied). The Texas Supreme Court has set forth additional principles to guide in making these determinations, including rules regarding: (1) factual allegations versus legal theories; (2) the truth or falsity of factual allegations; and (3) the interpretation of factual allegations.

a. *The Focus is on Factual Allegations not Legal Theories*

When applying the 8 Corners Rule, courts focus on the factual allegations showing the origin of the damages claimed rather than the legal theories alleged. *National Union Fire, Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997). In other words, "[i]t is not the cause of action alleged which determines coverage but the *facts* giving rise to the alleged actionable conduct." *Adamo v. State Farm Lloyds Co.*, 853 S.W.2d 673, 676 (Tex. App.—Houston [14th Dist.] 1993, writ denied). The same rule applies in determining the applicability of an exclusion. *Continental Cas. Co. v. Hall*, 761 S.W.2d 54, 56 (Tex. App.—Houston [14th Dist.] 1988, writ denied).

b. *The Truth or Falsity of the Allegations is Irrelevant*

When courts are considering the factual allegations in light of the policy provisions, it must do so without reference to: (1) the truth or falsity of the allegations; (2) what is known by the parties or what the parties believe the true facts to be; or (3) a legal determination of such facts. *See Argonaught Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633, 635 (Tex. 1973); *see also Colony Ins. Co. v. H.R.K., Inc.*, 728 S.W.2d 848, 850 (Tex. App.—Dallas 1987, no writ). Further, the duty to defend is not affected by the ultimate outcome of the underlying lawsuit. *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 829 (Tex. 1997); *see also Argonaught*, 500 S.W.2d at 636. Therefore, the issue is whether the petition alleges facts that, if true, potentially give rise to a claim covered within the terms of the policy.

c. *The Allegations are Liberally Interpreted*

The factual allegations in the petition are to be liberally construed, resolving any doubts concerning the duty to defend in favor of coverage. *Merchants Fast Motor Lines, Inc.*, 939 S.W.2d at 141. But not every doubt requires resolution in the insured's favor. For example, courts should not read facts into the petition, look outside the petition, or imagine factual scenarios that may trigger coverage. *Id.* at 142.

[4] One author has recognized that these types of cases can be considered exceptions to the 8 Corners Rule. However, the author also seemed to suggest that such cases were not really exceptions but rather are a set of new rules established by intermediate appellate courts in the absence of controlling authority on the issue of whether certain extrinsic facts relating solely to whether a claim falls within a policy exclusion or outside an insuring agreement (i.e. "coverage-only facts"), as opposed to facts relating solely to the merits of the underlying litigation (i.e. "merits-only facts"), can be considered. *See generally,* 46 S. TEX. L. REV. 463. In support of this proposition, the author contended that when the Texas Supreme Court addressed the issue of extrinsic evidence in *Heyden Newport Chemical Corp. v. Southern General Insurance Co.*, 387 S.W.2d 22 (Tex. 1965) it "restricted its holding to prohibit use of extrinsic merits-only facts" and did not restrict us of "coverage-only facts" and that the Texas Supreme Court had never ruled on whether extrinsic coverage-only facts may be used. *Id.* at 465-68.

2. Extrinsic Evidence Exceptions

Although the 8 Corners Rule has been adopted in Texas, some appellate courts have allowed the consideration of extrinsic evidence "[w]hen the petition in the underlying lawsuit does not allege facts sufficient for a determination of whether those facts, even if true, are covered by the policy . . . ." *State Farm Fire & Cas. Co. v. Wade*, 827 S.W.2d 448, 452 (Tex. App.—Corpus Christi 1992, writ denied); *Urethane Int'l Prods. v. Mid-Continent Cas. Co.*, 187 S.W.3d 172, 176 (Tex. App.—Waco 2006, no pet. h.); *Gonzalez v. American States Ins. Co.*, 628 S.W.2d 184, 186 (Tex. App.—Corpus Christi 1982, no writ); *see also Harken Exploration Co. v Sphere Drake Ins., PLC*, 261 F.3d 466, 476-77 (5th Cir. 2001) (applying exception; citing *Wade*); *Western Heritage Ins. Co. v. River Entm't*, 998 F.2d 311, 313-15 (5th Cir. 1993) (applying exception; analyzing *Wade*); *but see Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 & n.3 (5th Cir. 2004) ("Erie guess that Texas Supreme Court would not recognize any exception to the strict eight corners rules," alternatively finding that if they did it would be more limited than *Wade*; also noting alternative position not inconsistent with ruling in *Western Heritage*). However, as discussed below, other courts have rejected this approach. Further, to determine the breadth of this exception in those courts adopting it, it is important to review the cases upon which the exception is founded, and then review the cases applying the exception.

a. *Policy Exclusions and Extrinsic Evidence After Texas Supreme Court's Adoption of 8 Corners Rule*

(i) Allowance of Extrinsic Evidence: *Boll, Cook, Gonzalez, Wade, Urethane International Products*

Soon after the Supreme Court's 1965 decision in *Heyden Newport Chemical Corp. v. Southern General Insurance Co*. setting forth the 8 Corners Rule in Texas, *see generally*, 387 S.W.2d 22 (Tex. 1965), the Houston Court of Appeals in *International Service Insurance Co. v. Boll* and the Texarkana Court of Appeals in *Cook v. Ohio Casualty Insurance Co.* addressed situations in which the plaintiff's underlying petition against the insured did not allege facts necessary to determine whether an exclusion under the policy applied. *See generally Boll*, 392 S.W.2d 158 (Tex. Civ. App.—Houston 1965, writ ref'd n.r.e.); *Cook*, 418 S.W.2d 712 (Tex. Civ. App.—Texarkana 1967, no writ). Although citing to *Heyden*, both courts relied on extrinsic evidence to determine the insurer did not have a duty to defend due to policy exclusions. *Boll*, 392 S.W.2d at 160-61; *Cook*, 418 S.W.2d at 714-16. The *Cook* court explained that the situations before it and in *Boll* were distinguishable from *Heyden*. According to the court, *Heyden* involved extrinsic facts regarding the merits of the underlying lawsuit, but the case before it—similar to the situation in *Boll* involved extrinsic coverage facts (i.e. facts regarding exclusions not addressed in the underlying petitions). *See Cook v. Ohio Cas. Ins. Co.*, 418 S.W.2d 712, 715-16 (Tex. Civ. App.—Texarkana 1967, no writ).

About fifteen (15) years later, in *Gonzales v. American States Insurance Co.*, the Corpus Christi Court of Appeals cited with approval the holdings in *Boll* and *Cook* in the context of a declaratory action filed against the insured. 628 S.W.2d 184, 185-86 (Tex. Civ. App.—Corpus Christi 1982, no writ). While the court ultimately considered only the allegations in the pleadings, the court gleaned the following rules from *Heyden*, *Boll* and *Cook*:

> Where the insurance company refuses to defend its insured on the ground that the insured is not *liable* to the claimant, the allegations in the claimant's petition control, and facts extrinsic to those alleged in the petition *may not be used* to controvert those allegations. But, where the basis for the refusal to defend is that the events giving rise to the suit are *outside the coverage* of the insurance policy, facts extrinsic to the claimant's petition *may be used* to determine whether a duty to defend exits. *Id*. at 187.

In 1992, the Corpus Christi Court of Appeals revisited these cases in *State Farm Fire & Casualty Co. v. Wade*. 827 S.W.2d 448 (Tex. App—Corpus Christi 1992, writ denied). State Farm brought a declaratory action against its insured seeking "an interpretation of a business pursuit exclusion . . . in a personal boat-owner's liability policy and a declaration that State Farm did not owe a duty to defend" a pending lawsuit against the estate of its insured. *Id*. at 449. The lower court dismissed State Farm's petition. *Id.* State Farm appealed, contending that a determination whether a policy exclusion applies is not limited to the face of the pleadings in the underlying suit when the allegations in the pleadings are "silent or neutral about an asserted policy exclusion . . . ." *Id.* at 451.

In evaluating State Farm's contention, the court recognized that, generally, "an insurer's duty to defend . . . is determined by the allegations against the insured without regard to the truth or falsity of those allegations, and all doubts are resolved in favor of the insured." *Id.* However, the court was faced with a

situation in which it was impossible to know how the boat was used, even when reading the underlying petition broadly and in favor of the insured; therefore, it was impossible to determine whether the business pursuits exclusion applied. *Id.* In this situation, the court concluded that it made no sense to exclude extrinsic evidence showing that the boat "was being used for a purpose explicitly excluded from coverage particularly, when doing so . . . [did] not question the truth or falsity of any facts alleged in the underlying petition . . . ."

This year, in *Urethane International Products v. Mid-Continent Casualty Co.*, the Waco Court of Appeals also recognized the exception created by *Wade* and its predecessor cases—when the underlying petition "'does not allege facts sufficient for a determination of whether those facts, even if true, are covered by the policy.'" 187 S.W.3d 172, 176 (Tex. App.—Waco 2006, no pet.). Similar to the situations in *Boll*, *Cook* and *Wade*, the court considered facts outside the petition when determining whether a policy exclusion applied. *See generally id.*

(ii) Other Appellate Courts and the 5th Circuit Reject *Wade*

While the Waco Court of Appeals recently recognized the exception(s) to the 8 Corners Rule created by *Wade* and its predecessor cases, the Houston Court of Appeals [1st Dist] has consistently criticized and/or rejected such exception(s). *See Tri-Coastal Contactors, Inc. v. Hartford Underwriters Ins. Co.*, 981 S.W.2d 861, 863-64 (Tex. App.—Houston [1st Dist.] 1998, pet. denied); *Landmark Chevrolet Corp. v. Universal Underwriters Ins. Co.*, 121 S.W.3d 886, 890-91 (Tex. App.—Houston [1st Dist.] 2003, no pet.); *Chapman v. National Union Fire Ins. Co.*, 171 S.W.3d 222, 230-31 (Tex. App.—Houston [1st Dist.], 2005, no pet.); *see also Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F. Supp. 2d 601, 616-22 (E.D. Tex. 2003) (rejecting majority opinion in *Wade* in favor of concurrence). In its 2005 opinion, *Chapman v. Insurance. Co.*, the court not only squarely rejected *Wade* but also indicated that no exception to the 8 Corners Rule exists. 171 S.W.3d at 230-31. But, because the *Chapman* court did not clearly overrule its earlier statement in *Tri-Coastal Contractors, Inc. v. Hartford Underwriters Insurance Co.*, in the First District, one limited exception may still exist:

> [E]xtrinsic evidence is permitted to show no duty to defend only in very limited circumstances, for example where the evidence is used to disprove the fundamentals of insurance coverage, such as whether the person sued is excluded from the policy, whether a policy contract exists, or whether the property in question is insured under the policy. *Tri-Coastal Contactors, Inc. v. Hartford Underwriters Ins. Co.*, 981 S.W.2d 861, n.1 (Tex. App.—Houston [1st Dist.] 1998, pet. denied).[5]

Further, the Fort Worth Court of Appeals and the Houston Court of Appeals [14th District] recently rejected any exceptions to the 8 Corners Rule. *Smith v. McCarthy*, No. 2-05-202-CV, 2006 WL 1174238, at *7 (Tex. App.—Ft. Worth May 4, 2006, no pet.); *D.R. Horton-Texas, Ltd. v. Markel Int'l Ins. Co.*, No. 14-05-00486-CV, 2006 WL 1766120, at *5 (Tex. App.—Houston [14th Dist.] June 29, 2006, no pet.) (Memorandum Opinion). Finally, the 5th Circuit, in *Northfield Insurance Co. v. Loving Home Care, Inc.*, also recently made an Erie guess that the Supreme Court of Texas would "not recognize any exception to the strict eight corners rule." 363 F.3d 523, 531 (5th Cir. 2004). On the other hand, the court also stated, in the alternative, that, if the Texas Supreme Court were to recognize an exception it would apply only "in very limited circumstances: when it is initially impossible to discern whether coverage is potentially implicated and when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged . . . ." *Id.*

(iii) Texas Supreme Court Rules that Extrinsic Evidence Relevant to both Coverage Issues and the Merits of the Underlying Claims cannot be Considered

On June 30, 2006, the Texas Supreme Court in *GuideOne Elite Insurance Co. v. Fielder Road Baptist Church* held that extrinsic evidence (in that case stipulated facts) relevant to both: 1) claims in an underlying suit for which coverage is sought; and 2) coverage issues, is extrinsic evidence that cannot be considered in determining an insurer's duty to defend. 2006 WL 1791689, at *3; *see also id.* at *5 (Justice Hecht concurring). The court did not directly address whether extrinsic evidence that relates solely to coverage issues may be considered. *See generally id.* But the language of the opinion raises the question

[5] *See also Landmark Chevrolet Corp. v. Universal Underwriters Ins. Co.*, 121 S.W.3d 886, n.3 (Tex. App.—Houston [1st Dist.] 2003, no pet.) (noting some intermediate appellate courts have allowed extrinsic evidence under same circumstances); *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F. Supp. 2d 601, 621 (E.D. Tex. 2003) (stating same but adding that determination must be made by readily determinable facts that do not engage truth/falsity of underlying allegations).

whether the court will soften or is softening its position on the use of such evidence when it does not overlap with the merits of or engage the truth and/or falsity of facts alleged in the underlying suit. For example, the court stated several times that extrinsic evidence is generally and/or ordinarily prohibited, indicating that extrinsic evidence may be considered in certain circumstances. *See generally id.* Further, the court, without criticism, recognized that other Texas and Federal courts have considered such evidence under limited circumstances involving purely coverage issues. *See id.* at *2-3 & n.1. Finally, after quoting the 5th Circuit's Erie guess as to what exception the court would likely adopt if it were to recognize an exception, the court stated that the Insured did "not fit the above exception to the rule." *See id*. at *2-3.

b. *Undisputed / Stipulated Facts*

There are examples in Texas in which courts have considered undisputed and/or stipulated extrinsic facts when making a determination on the duty to defend. *See, e.g., Urethane Int'l Prods. v. Mid-Continent Cas. Co.*, 187 S.W.3d 172, 175-76 (Tex. App.—Waco 2006, no pet.) (undisputed facts considered); *International Service Ins. Co. v. Boll*, 392 S.W.2d 158, 159 (Tex. Civ. App.—Houston 1965, writ ref'd, n.r.e.) (undisputed or stipulated facts considered); *Western Heritage Ins. Co. v. River Entertainment*, 998 F.2d 311, 312 (5th Cir. 1993) (stipulated facts considered). However, *GuideOne Elite Ins. Co.* makes clear that extrinsic stipulated and/or admitted facts that are relevant to the merits of the underlying claim and not solely to coverage issues cannot be considered. *See generally* 2006 WL 1791689, at *3; *see also id.* at *5 (Justice Hecht concurring); *Westport Ins. Co.*, 267 F. Supp. 2d at 622. Therefore, extrinsic stipulated and/or admitted facts should be considered only where they go solely to coverage issues and fall under an applicable exception to the 8 Corners Rule.

3. Article 21.55 (re-codified at TEX. INS. CODE ANN. § 542.051-542.061)

Article 21.55 of the Texas Insurance Code (re-codified at TEX. INS. CODE ANN. § 542.051-542.061) "provides for an eighteen percent (18%) penalty and attorneys' fees when an insurer wrongfully refuses or delays payment of a claim." TEX. INS. CODE ANN. art. 21.55 (re-codified at TEX. INS. CODE ANN. § 542.051-542.061). It defines "claim" as "first party claims made by an insured or a policyholder under an insurance policy or contract or by an beneficiary named in a policy or contract that must be paid by the insurer directly to the insured or beneficiary." TEX. INS. CODE ANN. art. 21.55 § 1. The term "first party claim" is not defined by article 21.55.

Insurers generally argue that the term "first party claim" means that article 21.55 is only applicable to first-party insurance policies—not to requests for defense coverage because such requests are claims arising under third-party liability policies. On the other hand, insureds generally argue that article 21.55 applies to a request for an insurer to provide a defense under a liability policy because the term first party claim refers to claims made by those persons in a first-party relationship with the insurer. Thus, a request by an insured that its insurer provide a defense is a akin to a first-party claim. Indeed, the insurer and insured are in a first-party relationship with respect to the duty to defend even though it is contained in a liability policy.

The Texas Supreme Court has addressed this issue in dicta suggesting that article 21.55 may be a remedy for a breach of the duty to defend. *See State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996). However, Texas appellate courts and federal courts applying Texas law are split on the issue. *Compare*, *Rx. Com, Inc. v. Hartford Fire Ins. Co.*, 364 F. Supp. 2d 609 (S.D. Tex. 2005) (article 21.55 applies); *Housing Auth. v. Northland Ins. Co.*, 333 F. Supp. 2d 595, 602 (N.D. Tex. 2004) (same); *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka*, L.L.P., 267 F. Supp. 2d 601, 632 n. 19 (E.D. Tex. 2003) (same); *Ryland Group, Inc. v. Travelers Indem. Co.*, No. Civ. A-00-CA-233 JRN, 2000 WL 33544086 (W.D. Tex. Oct. 25, 2000) (same); *Northern County Mut. Ins. Co. v. Davalos*, 84 S.W.3d 314, 318-19 (Tex. App.—Corpus Christi 2002) (same), *rev'd on other grounds*, 140 S.W.3d 685 (Tex. 2004), *with*, *Summit Custom Homes, Inc. v. Great Am. Lloyds Ins.* Co., No. 05-05-00851-CV, 2006 WL 1985964, at *8 (Tex. App.—Dallas July 18, 2006, no pet. h.) (article 21.55 does not apply); *TIG Ins. Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232 (Tex. App.—Dallas 2004, pet. denied) (same); *Service Lloyds' Ins. Co. v. J.C. Wink, Inc.*, 182 S.W.2d 19, 31 (Tex. App.—San Antonio 2005, pet. filed) (same); *Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91, 107 (Tex. App.—Fort Worth 2005, pet. filed) (same). Perhaps an answer is around the corner inasmuch as this issue is now conditionally pending before the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, No. 05-832, on certification from 5th Circuit.

B. Duty to Pay / Advance Defense Costs

The law governing the duty to pay/advance defense costs is not well-developed in Texas.[6] Federal courts have analyzed the duty, however, under various state laws. *See, e.g., Gon v. First State Ins. Co.*, 871 F.2d 863 (9th Cir. 1989) (applying California law); *Little v. MGIC Indem. Corp.*, 836 F.2d 789 (3rd Cir. 1987) (applying Pennsylvania law); *Okada v. MGIC Indem. Corp.*, 823 F.2d 276 (9th Cir. 1986) (applying Hawaii law); *Commercial Capital Bancorp, Inc. v. St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d 1173 (C.D. Cal. 2006) (applying California law); *In re Worldcom, Inc., Sec. Litig.*, 354 F. Supp. 2d 455 (S.D.N.Y. 2005) (applying New York law); *Nu-Way Envtl, Inc. v. Planet Ins. Co.*, No. 95-573(HB), 1997 WL 462010 (S.D.N.Y. 1997); *National Union Fire Ins. Co. v. Brown*, 787 F. Supp. 1424 (S.D. Fla. 1991) (applying Florida law), *aff'd*, 963 F.3d 597 (11th Cir. 1992) (unpublished table opinion); *see also National Union Firs Ins. Co. v. Guam Housing and Urban Renewal Auth.*, Nos. CVA02-012, CV 1849-01, 2003 WL 22497996 (Guam Nov. 4, 2003) (applying Guam law); *Liggett Group Inc. v. Affiliated FM Ins. Co.*, No. 00C-01-207-HDR, 2001 WL 1456853 (Del. Super. Ct. Sept. 12, 2001) (applying North Carolina law) *aff'd*, 798 A.2d 1024 (Del. 2002). Like the duty to defend, the duty to pay/advance defense costs arises from the language in the insurance policy, but is most commonly found in D&O policies. *See, e.g., Gon*, 871 F.2d at 868 (D&O Policy); *Little*, 836 F.2d at 791-93 (D&O Policy); *Okada*, 823 F.2d at 278 (D&O policy); *St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d 1173 (D&O policy); *In re Worldcom, Inc., Sec. Litig.*, 354 F. Supp. 2d at 464 (D&O Policy); *Brown*, 787 F. Supp. at 1429 (D&O policy); *but see Guam Housing & Urban Renewal Auth.*, 2003 WL 22497996 (analyzing duty to pay defense costs under Public Officials and Employees Liability policy resembling a D&O policy); *Liggett Group Inc.*, 2001 WL 1456853, at *1-3 (analyzing duty to pay defense costs under Media Special Perils Policy); *Planet Ins. Co.*, 1997 WL 462010, at *1-3 (analyzing duty to pay defense costs under Contractor's Pollution Legal Liability policy). Such policies generally disclaim any duty to defend and/or provide that the insurer has the right but not the duty to assume the defense. *See, e.g., St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d at 1180 (disclaiming duty to defend); *Brown*, 787 F. Supp. at 1430 & n.12 (same); *Guam Housing & Urban Renewal Auth.*, 2003 WL 22497996 (policy stated that insurer had right but not duty to assume defense); *Gon*, 871 F.2d at 868 (D&O policies generally do not contain a duty to defend). Two areas that have been consistently litigated are: (1) whether the insurer must pay/advance defense costs on a current basis (i.e. as they are incurred); and (2) whether and to what extent defense costs are to be allocated between the insured and the insurer when not all claims brought against the insured are covered by the policy.

1. Payment on a current / as incurred basis vs. reimbursement

Generally, absent clear contractual language to the contrary, courts outside of Texas have found that an insurer's duty to pay defense costs requires payment on a current/as incurred basis. *See, e.g., Gon*, 871 F.2d at 868; *Little*, 836 F.2d at 794; *Okada*, 823 F.2d at 280-82; *In re Worldcom, Inc., Sec. Litig.*, 354 F. Supp. 2d at 464 (collecting cases including cases under Iowa, Hawaii, Pennsylvania, and Louisiana law); *Planet Ins. Co.*, 1997 WL 462010, at *2-3; *Brown*, 787 F. Supp. at 1429-34 (finding duty to advance/pay as incurred although policy contained option clause permitting insurer to advance costs at its option); *but see McAllen Indep. Sch. Dist.*, 1987 WL 109258, at *3-4 (under Texas law, finding no duty to advance costs as incurred because policy contained option clause which permitted insurer to advance costs at its option); *Zaborac v. American Casualty*, 663 F. Supp. 330, 333-34 (C.D. Ill. 1987) (finding same under Illinois law). However, since the duty is contractual in nature, the parties are free to contract otherwise. *See generally Okada*, 823 F.2d 276; *see also St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d at 1181; *Planet Ins. Co.*, 1997 WL 462010, at *2-3. Therefore, when a policy clearly and unambiguously provides that the insurer does not have to pay defense costs until resolution of the underlying claims (or some other time, such as upon the parties' agreement regarding any allocation disputes), the insurer will be allowed to wait until such resolution before reimbursing any defense costs covered by the policy. *See Okada*, 823 F.2d at 280-82; *c.f. St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d at 1179-85. But where the language is ambiguous, courts interpret the provisions in favor of the insured, and will generally require payment on an as incurred basis. *See, e.g., Okada*, 823 F.2d at 281; *Little*, 836 F.2d at 793.

2. Allocation

[6] The 5th Circuit and the United Stated District Court for the Southern District of Texas have addressed this duty in passing but without much detail. *See National Union Fire Ins. Co. v. U.S. Liquids, Inc.*, No. 03-20542, 2004 WL 304084 (5th Cir. 2004) (finding no duty to advance defense costs because policy excluded coverage for all claims brought against insured); *Continental Cas. Co. v. McAllen Indep. Sch. Dist.*, No. B-86-007, 1987 WL 109258 (S.D. Tex. 1987) (no duty to defend because policy provided insured shall select and retain counsel; also no duty to advance defense costs because policy permitted insurer to advance costs at its option), *aff'd* 850 F.3d 1044 (5th Cir. 1988).

Unlike policies containing duty to defend provisions, policies creating the duty to pay/advance defense costs commonly contain allocation provisions providing that the insurer must pay defense costs only for covered claims and that the insured is responsible for payment of defense costs for uncovered claims. *See, e.g., Gon*, 871 F.2d at 868-69; *St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d at 1177. However, where it is not feasible to make an initial determination of allocation (e.g. claims based on alleged act that would be covered if done negligently but not if done intentionally), and assuming the policy requires payment on an as incurred basis, an insurer will be required to advance all defense costs as long as one claim is potentially covered. *See, e.g., Gon*, 871 F.2d at 868-69 (apportionment not feasible).

At least one court has found, though, where the policy provides that the initial allocation can be made at the insurer's discretion based on what it "believes to be covered," the insurer will be free to make the allocation as the costs are incurred "until a different allocation is negotiated, arbitrated, or judicially determined." *St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d at 1185. Further, if the insurer pays all defense costs, but later is able to establish that specific costs were incurred solely for defense of uncovered claims, the insurer will be entitled to reimbursement for such amounts. *Guam Housing & Urban Renewal Auth.*, 2003 WL 22497996; *St. Paul Mercury Ins. Co.*, 419 F. Supp. 2d at 1185.

C. Duty to Indemnify / Declaratory Judgments / Extra-Contractual Liability

1. Duty to Indemnify

The duty to indemnify obligates an insurer to pay a judgment that is taken against its insured. The duty to defend and the duty to indemnify are distinct and separate duties. *Utica Nat'l Ins. Co. v. American Indemn. Co.*, 141 S.W.3d 198, 203 (Tex. 2004); *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821-22 (Tex. 1997). In contrast to the duty to defend, the duty to indemnify is not based on the third party's allegations, but upon the actual facts that comprise the third party's claim. *See Canutillo Indep. Sch. Dist. v. National Union Fire Ins. Co.*, 99 F.3d 695, 701 (5th Cir. 1996). In fact, "[a]n insurer is not obligated to pay a liability claim until [the] insured has been adjudicated to be legally responsible." *Southern County Mut. Ins. Co. v. Ochoa*, 19 S.W.3d 452, 460 (Tex. App.—Corpus Christi 2000, no pet.). As a result, the duty to indemnify is much narrower than the duty to defend. *See St. Paul Fire & Marine Ins. Co. v. Green Tree Fin. Corp.*, 249 F.3d 389, 391 (5th Cir. 2001); *Burlington Ins. Co. v. Texas Krishnas, Inc.*, 143 S.W.3d 226, 229 (Tex. App.—Eastland 2004, no pet.). Simply because an insurer has a duty to defend does not mean it will be obligated to indemnify the insured for a judgment or settlement. *See Utica Nat'l Ins. Co. v. American Indem. Co.*, 141 S.W.3d 198, 203 (Tex. 2004).

a. *Burden of Proof on Coverage and Exclusion Issues*

The burden is on the insured to show that a claim against it is potentially within the scope of coverage under the policy. *Utica v. Nat. Ins. Co. v. American Indemn. Co.*, 141 S.W.3d 198, 203 (Tex. 2004); *Federated Mut. Ins. Co. v. Grapevine Excavation Inc.*, 197 F.3d 720, 723 (5th Cir. 1999). If, however, the insurer relies on policy exclusions or other affirmative defenses to defeat the duty to indemnify, the burden shifts to the insurer to prove that one or more of the exclusions defeat the duty to indemnify. *See Guaranty Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 193 (5th Cir. 1998); *see also* TEX. INS. CODE § 554.002 ("The insurer has the burden of proof as to any avoidance or affirmative defense."). Once the insurer proves an exclusion applies, the burden shifts back to the insured to show that the claim falls within an exception to the exclusion. *See Guaranty Nat'l*, 143 F.3d at 193; *Comsys Info. Tech. Servs., Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 193 (Tex. App.—Houston [14th Dist.] 2003, pet. denied).

b. *Interpretation of Policy Provisions and Determination of Ambiguity*

The interpretation of an insurance contract is governed by the general rules of contract construction. *Texas Farmers Ins. Co. v. Murphy*, 996 S.W.2d 873, 879 (Tex. 1999). When evaluating the policy, courts look to the policy as a whole to ascertain the true intent of the parties. *Utica v. Nat. Ins. Co. v. American Indemn. Co.*, 141 S.W.3d 198, 203 (Tex. 2004). The words in the insurance policy are given their ordinary meaning unless the policy clearly assigns something different. *Grimes Constr., Inc. v. Great Am. Lloyds Ins. Co.*, 188 S.W.3d 805, 810 (Tex. App.—Ft. Worth 2006, pet. filed). If a provision can be given only one reasonable meaning, it is unambiguous, and will be enforced as written. *State Farm Fire & Cas. Co. v. Vaughan*, 968 S.W.2d 931, 933 (Tex. 1998); *see also Progressive County Mut. Ins. Co. v. Sink*, 107 S.W.3d 547 (Tex. 2003). If, however, the provision is susceptible to two or more reasonable interpretations, it is ambiguous. *Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d 462, 464 (Tex. 1998). An ambiguity

does not arise in a policy simply because the parties offer conflicting interpretations. *American Mfrs. Mut. Ins. Co. v. Schaefer*, 124 S.W.3d 154, 157 (Tex. 2003). Instead, the conflicting interpretations must both be reasonable. *Id*. Whether an ambiguity exists is a question of law for the court to decide by examining the entire contract in light of the surrounding circumstances. *See id*; *State Farm Fire & Cas. Co. v. Vaughan*, 968 S.W.2d 931, 933 (Tex. 1998).

c. *Effect of an Ambiguity*

Generally, when the court finds an ambiguity with a term that limits or excludes coverage, the court will adopt any reasonable interpretation urged by the insured, even if the insurer's interpretation appears to be more reasonable or a more accurate reflection of the parties' intent. *Baladran v. Safeco Ins. Co.*, 972 S.W.2d 738, 741 (Tex. 1998); *see State Farm Fire & Cas. Co. v. Vaughan*, 968 S.W.2d 931, 933 (Tex. 1998); *see also EMCASCO Ins. Co. v. American Int'l Specialty Lines Ins. Co*., 438 F.3d 519, 524 (5th Cir. 2006). In other words, when there is an ambiguity, the court construes the policy strictly against the insurer and in favor of coverage. *McDonald v. Southern County Mut. Ins. Co*., 176 S.W.3d 464, 469 (Tex. App.—Houston [1st Dist.] 2004, no pet.). This is known as the doctrine of *contra proferentem*. *See, e.g., Evergreen Nat'l Indem. Co. v. Tan it All, Inc.*, 111 S.W.3d 669, 676 (Tex. App.—Austin 2003, no pet.).

There may be instances, however, where the doctrine of *contra proferentem* does not apply. For instance, the Fifth Circuit has held the doctrine inapplicable when the insured was not a person, but rather a corporation of immense size, carrying insurance with annual premiums in six figures, managed by sophisticated businessmen and represented by counsel of the same professional level as counsel for insurers, and when the policy at issue was not just a usual printed form, but a "manuscript" policy containing some printed clauses but prepared especially for the insured. *Eagle Leasing Corp. v. Hartford Fire Ins. Co*., 540 F.2d 1257 (5th Cir. 1976). Other analysts suggest that the doctrine of *contra proferentem* is inapplicable in other situations, such as disputes between insurers, sophisticated parties who fully negotiated the insurance contract, and self-funded ERISA plans that provide discretionary authority upon an administrator to determine eligibility for benefits. 2 LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE §22:24 (3d ed. 1996).

d. *Fortuity Doctrine*

An insurer may successfully avoid its duty to indemnify based on the fortuity doctrine. Texas courts have long recognized the fortuity doctrine as an inherent requirement of all risk insurance policies. *See Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App.—Dallas 2001, pet. denied). Insurance is designed to protect against unknown and fortuitous risks. *Two Pesos, Inc. v. Gulf Ins. Co*., 901 S.W.2d 495, 502 (Tex. App.—Houston [14th Dist.] 1995, no writ). The fortuity doctrine precludes insurance coverage "where the insured is, or should be, aware of an ongoing progressive loss or known loss at the time the policy is purchased." *See Id.* at 501. A "known loss" is when the insured knew before entering into the policy that a loss had occurred. *Burch v. Commonwealth County Mut. Ins. Co*., 450 S.W.2d 838, 840-41 (Tex. 1970). A "loss in progress" is when the insured knows, or should know, of a loss that is ongoing at the time the policy is issued. *Two Pesos*, 901 S.W.2d at 501.

The fortuity doctrine has also surfaced in oral arguments to the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.,*. In *Lamar Homes*, an insured-contractor pursued a declaratory judgment action seeking a declaration that a CGL policy covered claims against the insured-contractor alleging negligence in designing and constructing a residential foundation, and breach of express and implied warranties. 428 F.3d 193, 195 (5th Cir. 2005). The insurer denied the claim on the basis that it was a claim for breach of warranty, not covered by the CGL policy. *Id*. at 195-96. After the trial court held in favor of the insurer, the case was appealed to the Fifth Circuit. *Id*. Upon appeal, the Fifth Circuit immediately certified the following question to the Texas Supreme Court: (1) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an "accident" or "occurrence" sufficient to trigger the duty to defend or indemnify under a CGL policy. *Id*. at 200 When certifying the question, the Fifth Circuit noted the conflict among the courts on this issue because some courts have held that damages resulting from shoddy work are not an accidental loss because they were foreseeable, while other courts have held that where damages are the result of the contractor's negligence, the loss is unexpected and therefore accidental. *Id*. at 196-98. During oral arguments in the Texas Supreme Court, the Justices questioned whether defective construction is an "occurrence" as envisioned by the insurance policy because it may amount only to a simple breach of contract action, which, as insinuated by the Justices, would lack any type of fortuity.[7] As of

[7] Oral arguments for *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, Cause No. 05-832, pending in the Texas Supreme

the printing date, the Court has not yet issued its opinion in the *Lamar Homes* case.

2. Declaratory Judgment Actions

When an insured is sued by a third party for which the insurance company contests coverage, the insurer may institute a separate lawsuit in the form of a declaratory judgment action to determine coverage on the underlying lawsuit. These declaratory judgment actions are used to obtain a judicial determination, while the underlying case is proceeding, of the rights and obligations under the insurance contract, including the duty to defend, the duty to indemnify, the number of occurrences in an underlying litigation, whether there are "additional insureds" and the effect of an "other insurance" clause, among others. *J.E.M. v. Fidelity & Cas. Co*., 928 S.W.2d 668 (Tex. App.—Houston [1st Dist.] 1996, no writ) (duty to defend); *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81 (Tex. 1997) (duty to indemnify); *Foust v. Ranger Ins. Co*., 975 S.W.2d 329 (Tex. App.—San Antonio 1998, pet. denied) (number of occurrences); *Duke Energy Field Servs. Assets v. National Union Fire Ins. Co*., 68 S.W.3d 848 (Tex. App.—Texarkana 2002, pet. denied) (whether a party is an "additional insured" under a policy); *Hartford Cas. Ins. Co. v. Executive Risk Specialty Ins. Co*., No. 05-03-00546-CV, 2004 WL 2404382 (Tex. App.—Dallas Oct. 28, 2004, pet. denied.) (effects of an "other insurance" clause).

Declaratory judgment actions can be brought in federal court pursuant to 28 U.S.C. § 2201 or in state court pursuant to Chapter 37 of the Texas Civil Practice & Remedies Code.[8] A declaratory judgment is appropriate if (1) a justiciable controversy exists as to the rights and status of the parties and (2) the controversy will be resolved by the declaration sought. *See Bonham State Bank v. Beadle*, 907 S.W.2d 465, 467 (Tex. 1995); *see also Monticello Ins. Co. v. Patriot Sec., Inc.*, 926 F. Supp. 97, 98 (E.D. Tex. 1996) ("In the trial court, of course, a party seeking declaratory judgment has the burden of establishing the existence of an actual case or controversy."). A justiciable controversy is one in which a real and substantial controversy exists involving a genuine conflict of tangible interest and not merely a theoretical dispute. *See Beadle*, 907 S.W.2d at 467. A declaratory judgment is not appropriate to request merely an advisory opinion. *Foust v. Ranger Ins. Co.*, 975 S.W.2d 329, 331 (Tex. App.—San Antonio 1998, pet. denied).

a. *Applicability to the Duty to Indemnify*

The declaratory judgment action may be used to determine the insurance company's duty to indemnify and the duty to defend, which usually arise in a liability policy. Prior to 1997, a declaratory judgment action was only successful to resolve the duty to defend because the issue of the duty to indemnify had to await resolution of the underlying lawsuit, while the duty to defend could simply be determined by the 8 Corners Rule. *See Firemen's Ins. Co. v. Burch*, 442 S.W.2d 331 (Tex. 1968).

In 1997, however, the Texas Supreme Court held that the duty to indemnify could be determined prior to the resolution of the underlying lawsuit. Specifically, the Court said that "the duty to indemnify is justiciable before the insured's liability is determined in the [underlying] lawsuit when the insurer has no duty to defend and the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify." *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex. 1997) (granting a declaratory judgment on the duty to indemnify because there was no duty to defend, and no facts can be developed in the underlying tort suit that can transform a drive-by shooting into an "auto accident"). In other words, the only instance where a court would resolve the duty to indemnify before the establishment of liability in the underlying case is "by proving coverage is impossible in the underlying case." *Roman Catholic Diocese of Dallas v. Interstate Fire & Cas. Co.*, 133 S.W.3d 887, 890 (Tex. App.—Dallas 2004, pet. denied).

If the court finds there is a duty to defend, however, then there is a possibility that coverage will exist in the underlying lawsuit, and the court will await the resolution of the underlying lawsuit before ruling on the duty to indemnify. *See Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc*., 215 F. Supp. 2d 783, 793 (E.D. Tex. 2002); *see also Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833, 846 (Tex. App.—Dallas 2004, pet. filed).

b. *Proper Parties in Declaratory Judgment Action*

Texas state courts and federal courts have reached different conclusions as to whether a tort claimant should be included in the declaratory judgment action.

Court, are available at http://www.supreme.courts.state.tx.us/oralarguments/audio_2005.asp.

[8] To pursue a declaratory judgment action in federal court, there still must be federal jurisdiction either by diversity or federal question. *See Commercial Metals Co. v. Balfour, Guthrie & Co., Ltd.*, 577 F.2d 264 (5th Cir. 1978).

Texas state courts do not consider a tort claimant a proper party until final resolution of the liability issues. *See Firemen's Ins. Co. v. Burch*, 442 S.W.2d 331 (Tex. 1968); *Feria v. CU Lloyd's of Tex.*, No. 05-00-01245-CV, 2001 WL 1263666 (Tex. App.—Dallas 2001, no pet.); *Safeway Managing Gen. Agency for State & County Mut. Fire Ins. Co. v. Cooper*, 952 S.W.2d 861, 868-69 (Tex. App.—Amarillo 1997, no writ). In contrast, the Texas federal courts are inconsistent on this issue. Some federal courts consider a tort claimant as a proper party while others do not. *See Bituminous Cas. Co. v. Garcia*, 223 F.R.D. 308, 311 (N.D. Tex. 2004) (considering tort claimant as proper party); *Ohio Cas. Ins. Co. v. Cooper Mach. Corp.*, 817 F. Supp. 45 (N.D. Tex. 1993) (same); *Standard Fire Ins. v. Sassin*, 894 F. Supp. 1023 (N.D. Tex. 1995) (dismissing the tort claimant).

c. *Bad Faith When Pursuing a Declaratory Judgment Action*

Typically, courts indicate that insurers do not engage in bad faith by pursuing a declaratory judgment action against its insured to resolve the coverage dispute while the underlying lawsuit is pending. *See Reassure Am. Life Ins. Co. v. Rogers*, 248 F. Supp. 2d 974, 987 (D. Haw. 2003) (insurer not guilty of bad faith because it filed a declaratory judgment action asking a court to decide whether first party benefits were owed); *Labonte v. National Grange Mut. Ins. Co.*, 810 A.2d 250, 254 (R.I. 2002) (not bad faith to file declaratory judgment action in order to clarify coverage); *see also Stratford Ins. Co. v. Cooley*, 985 F. Supp. 665, 673 (S.D. Miss. 1996) ("[u]nder no circumstances could it reasonably be concluded that [the insurer] acted in bad faith by instituting this declaratory judgment action to determine a legitimate coverage dispute"); *see generally Masonic Temple Ass'n v. Indiana Farmers Mut. Ins. Co.*, 779 N.E.2d 21, 29 (Ind. Ct. App. 2002) ("the proper response when an insurer questions whether an insured's claim falls within the scope of its policy coverage is to file a declaratory judgment action").

Some courts, however, recognize that bad faith could potentially occur by an insurer pursuing a declaratory judgment action if the action was pursued for an improper purpose. *See, e.g., International Surplus Lines Ins. Co. v. University of Wyo. Research Corp.*, 850 F. Supp. 1509, 1527 (D. Wy. 1994), *aff'd*, 52 F.3d 901 (10th Cir. 1995) (stating that an insurer's filing of a declaratory judgment action is not bad faith, unless there is a showing of an improper or illegitimate purpose); *see also American Family Life Ins. Co. v. United States Fire Co.*, 885 F.2d 826 (11th Cir. 1989) (stating that because there was no indication of improper motives in filing the declaratory judgment action, there was no bad faith). For instance, as the Kentucky Supreme Court noted,

> Some may argue that the insurer, by notifying its insured that it is defending under a reservation of right and filing a declaratory judgment action, is automatically absolved of bad faith. We do not so hold. Clearly, one can envision factual situations where an insurer could abuse its legal prerogative in requesting a court to determine coverage issues. Those may well be addressed through a motion . . . or, in certain circumstances, an action for bad faith. *Guaranty Nat. Ins. Co. v. George*, 953 S.W.2d 946, 949 (Ky. 1997).

Although the court recognized that there could be situations where a filing of a declaratory judgment action would be bad faith, the court did not elaborate on what would actually constitute bad faith. In fact, the court ultimately held that the insurer's use of a declaratory judgment action was not bad faith. *Id*.

Further, in *Dalrymple v. United Services Automobile Association*, the court stated,

> It is at least arguable that pursuing a declaratory relief action regarding coverage could be done for reasons indicating bad faith may be present; *e.g.*, if there were no proper cause to dispute coverage, and if more than an erroneous interpretation of a policy (*e.g.*, a willfully misguided one) were concerned. 40 Cal. App. 4th 497, 515 (1996).

Afterwards, the court held that the standard to determine whether an insurer acted in bad faith by pursuing a declaratory judgment action is essentially the same standard as a claim for malicious prosecution. *Id*. at 515-18. As part of this analysis, the court stated that it "must determine if the underlying declaratory relief action to resolve coverage was legally tenable on the known facts, under the view of a reasonable attorney." *Id.* at 517. After evaluating the specific facts in that case, the court ultimately held that there was no bad faith on the part of the insurer for filing the declaratory judgment action. *Id*. at 522-23.

A California Federal Court case provides the most thorough description of when a bad faith action is appropriate. *See Provident Life & Accident Ins. Co. v. Van Gemert*, 262 F. Supp. 2d 1047, 1052 (C.D. Cal. 2003). According to the court, an insurer may be liable for bad faith when "the insurer's position regarding liability under the policy [is] both erroneous and

unreasonable." *Id*. Thus, as the court explains, the insured must show that the insurer's conduct by pursuing the declaratory judgment action "demonstrates a failure or refusal to discharge contractual responsibilities, prompted not by an honest mistake, bad judgment or negligence but rather by a conscious and deliberate act." *Id*. The court continues by stating, "where there is a genuine issue as to the insurer's liability under the policy for the claim asserted by the insured, there can be no bad faith liability imposed on the insurer for advancing its side of that dispute." *Id*. After analyzing the circumstances of that case, particularly that the issue was an unresolved question of law, the court held that there was no bad faith on the part of the insurer. *Id*.

Another issue is the potential for the insurer to disclose—inadvertently or otherwise—prejudicial information received in the declaratory judgment action to the underlying plaintiff, who otherwise might not have had the information. In this instance, the insured may potentially have a bad faith claim by showing that it was prejudiced in defending the underlying lawsuit. In *Travelers Insurance Co. v. Lesher*, an insurer brought a declaratory judgment action against its insured, who was accused of anti-trust violations. 187 Cal. App. 3d 169 (1986). The insurer first assumed the defense under a reservation of rights, but subsequently filed a declaratory judgment action seeking a ruling that there was no coverage. The insured responded with a cross-complaint, alleging bad faith. *Id*. at 181. The insured's theory was that once the insurer undertook the defense, it was obligated to conduct that defense with the same duty of care as if there were no coverage dispute. *Id*. at 187.

While the insurer initially provided a defense, the insured's attorney felt unable to continue the representation after prejudicial information surfaced in the declaratory judgment action, and was disclosed to the opposing counsel in the underlying lawsuit. *Id*. at 183. The insurer, however, failed to select new counsel until very shortly before trial, thus placing the insured in a precarious position with its defense, and forcing the insured to enter into unfavorable settlement agreements with the underlying plaintiffs. *Id.* As a result, the jury found that the insurer had engaged in bad faith. *Id*. at 180.

Upon appellate review, the court considered whether there was sufficient evidence of proximate cause of damage to the insured. The court held that the jury could reasonably have concluded that the disclosure of the prejudicial information was the catalyst causing the insured's attorney to withdraw from the underlying lawsuit. It was this withdrawal, coupled with the insurer's failure to promptly appoint new counsel, which placed the insured in an unfavorable defensive posture. *See id*. at 196.

Whether Texas law would allow a claim in certain circumstances for bad faith against an insurer who files for a declaratory judgment action against its insured during the underlying lawsuit is an open question. No cases in Texas appear to address this issue. In addition, the potential application of a bad faith action in this instance is further complicated by the law in Texas that the duty of good faith and fair dealing is limited to first-party coverage (i.e., property insurance policy, life insurance policy, etc.) rather than third-party coverage (i.e., commercial general liability policy, etc.). *See Maryland Ins. Co. v. Head Indus. Coatings & Servs., Inc.*, 938 S.W.2d 27, 28-29 (Tex. 1996). However, the courts do apply the *Stowers* doctrine to third party-coverage cases. *See American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848 (Tex. 1994).

Even if Texas would disallow a bad faith claim in this context, an insured may still have other viable theories, such as wrongful interference with business relationships. In *Employers' Fire Insurance Co. v. Love It Ice Cream Co.*, an Oregon case, the insured claimed that the insurer engaged in bad faith and wrongful interference with business relationships by filing a declaratory judgment action on the coverage issue. 670 P.2d 160, 165 (Or. 1983). Although the court disregarded the insured's bad faith claim, it held that the insured's tort claim for interference with business relationships was viable because the insurer filed the declaratory judgment action solely to delay paying the claim. In this connection, it did so intending that the insured would be unable to resume its business, thereby reducing the amount that insurer would be required to pay under its policy, *e.g.*, the cost of replacing equipment and leasehold improvements, business interruption and extra expenses of continuing business. *Id*. Thus, the tort claim of wrongful interference with business relationships was an appropriate substitute for a bad faith theory.

Additionally, the insured may consider characterizing the claim as a malicious prosecution claim. *Cf. Dalrymple v. United Services Automobile Association*, 40 Cal. App. 4th 497, 515-18 (1996) (analogizing the claim of malicious prosecution to bad faith for filing an improper declaratory judgment action).

3. Extra-Contractual Liability

a. *Common Law Bad Faith*

The Texas Supreme Court has recognized a bad faith tort action against an insurer because "in the insurance context a special relationship arises out of the parties' unequal bargaining power and the nature of insurance contracts which would allow unscrupulous insurers to take advantage of their insureds' misfortunes in bargaining for settlement or resolution of claims." *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 56 (Tex. 1997). The Court has limited this tort, however, to the first-party context. *Maryland Ins. Co. v. Head Indus. Coatings & Servs., Inc.*, 938 S.W.2d 27 (Tex. 1996). To be liable for bad faith, an insurer must fail to pay a first party claim when the insurer knew or should have known that it was reasonably clear that the claim was covered. *See Giles*, 950 S.W.2d at 56. For a violation of the bad faith tort, an insured could potentially recover punitive damages. *See id.* at 54. To recover punitive damages, however, there must be actual damages independent of the loss of policy benefits, and the insurer's conduct must be fraudulent, malicious or grossly negligent. *See id.*; *Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10, 18-19 (Tex. 1994).

b. *Article 21.21 (now re-codified at TEX. INS. CODE § 541.001 et seq.)*

Article 21.21's purpose (now re-codified at TEX. INS. CODE § 541.001 *et seq.*) "is to regulate trade practices in the business of insurance." TEX. INS. CODE § 541.001. The insurance code provides a private cause of action for an insured against an insurer that commits an unfair act or practice as defined by Sections 541.051 through 541.061 of the Texas Insurance Code. TEX. INS. CODE § 541.151. *Rocor Int'l v. National Union Fire Ins. Co.*, 77 S.W.3d 253, 260 (Tex. 2002). Most commonly, insureds will rely upon the provisions in Section 541.060, which specifies the statutory prohibitions of unfair settlement practices, which include:

> (1) misrepresenting to a claimant a material fact or policy provision relating to coverage at issue;
>
> (2) failing to attempt in good faith to effectuate a prompt, fair, and equitable settlement of: (A) a claim with respect to which the insurer's liability has become reasonably clear; or (B) a claim under one portion of a policy with respect to which the insurer's liability has become reasonably clear to influence the claimant to settle another claim under another portion of the coverage unless payment under one portion of the coverage constitutes evidence of liability under another portion;
>
> (3) failing to promptly provide to a policyholder a reasonable explanation of the basis in the policy, in relation to the facts or applicable law, for the insurer's denial of a claim or offer of a compromise settlement of a claim;
>
> (4) failing within a reasonable time to: (A) affirm or deny coverage of a claim to a policyholder; or (B) submit a reservation of rights to a policyholder;
>
> (5) refusing, failing, or unreasonably delaying a settlement offer under applicable first-party coverage on the basis that other coverage may be available or that third parties are responsible for the damages suffered, except as may be specifically provided in the policy;
>
> (6) undertaking to enforce a full and final release of a claim from a policyholder when only a partial payment has been made, unless the payment is a compromise settlement of a doubtful or disputed claim;
>
> (7) refusing to pay a claim without conducting a reasonable investigation with respect to the claim;
>
> (8) with respect to a Texas personal automobile insurance policy, delaying or refusing settlement of a claim solely because there is other insurance of a different kind available to satisfy all or part of the loss forming the basis of that claim; or
>
> (9) requiring a claimant as a condition of settling a claim to produce the claimant's federal income tax returns for examination or investigation by the person unless: (A) a court orders the claimant to produce those tax returns; (B) the claim involves a fire loss; or (C) the claim involves lost profits or income.

Before pursuing an action for one of these statutory violations, the insured must provide written notice to the insurer not later than the 61st day before the date the action is filed. TEX. INS. CODE § 541.154. The notice must include the specific complaint and the amount of actual damages and expenses, including attorney's fees. *Id.* The notice is not required, however, if it is impracticable to give it to avoid the statute of limitations from expiring. *Id.* The notice is

also not required if the statutory violation is raised as a counterclaim in a proceeding. *Id.*

If an insured is successful in proving a statutory violation, the insured can recover its actual damages, attorney's fees and costs. TEX. INS. CODE § 541.152. Additionally, if the insurer's conduct was committed "knowingly," the insured may recover an additional sum of not more than three times the amount of actual damages. *Id.*

c. *Article 21.55 (now re-codified at TEX. INS. CODE § 542.051 et seq.)* (Prompt Payment)

Article 21.55 (now re-codified at TEX. INS. CODE § 542.051 *et seq.*) is designed to "ensure prompt payment of insurance claims by penalizing the insurer when the insurer fails to follow the steps required by the article." *J.C. Penney Life Ins. Co. v. Heinrich*, 32 S.W.3d 280, 289 (Tex. App.—San Antonio 2000, pet. denied). The prompt payment statute establishes a series of time limits for the insurer when assessing and paying a claim. Accordingly, the statute may be violated in a number of ways. For example, the statute may be violated if: 1) within the 15th day after receiving notice, the insurer failed to acknowledge receipt of the claim, commence any investigation of the claim and request from the claimant all items, statements and forms that the insurer reasonably believes, at that time, will be required from the claimant; or 2) within the 15th business day after the date the insurer receives all items, statements and forms from the insured, the insurer failed to notify a claimant in writing of the acceptance or rejection of a claim, or if the insurer requested additional time to assess the claim, the insured failed to accept or reject the claim within the 45th day after the date the insurer requested the additional time; or 3) within five business days after notifying the insured that it will pay the claim or part of the claim, the insurer fails to pay the claim; or 4) within 60 days after receiving all items, statements and forms reasonably requested, or within the period specified by other applicable statutes, the insurer fails to pay the claim. TEX. INS. CODE § 542.055 (basis #1); TEX. INS. CODE § 542.056 (basis #2); TEX. INS. CODE § 542.057 (basis #3); TEX. INS. CODE § 542.058 (basis #4).

If violated, the statute provides that a plaintiff is entitled to statutory damages of 18% per year on the amount of the claim, plus attorney's fees. TEX. INS. CODE § 542.060. This 18% is calculated as simple interest, not compound interest. *Texas Farmers Ins. Co. v. Cameron*, 24 S.W.3d 386, 400 (Tex. App.—Dallas 2000, pet. denied). The 18% accrues on the date the insurer violates the statute. *See Cameron*, 24 S.W.3d at 400. The amount subject to the 18% penalty is that which the insurer is required to pay under the policy, not the amount claimed by the insured. *See Mid-Century Ins. Co. v. Barclay*, 880 S.W.2d 807, 811 (Tex. App.—Austin 1994, writ denied).

When suing an insurer for breach of contract for failing to pay a claim, the insured must also bring a claim under the prompt payment statute or it may be barred by *res judicata*. *See United States Fire Ins. Co. v. Fugate*, 171 S.W.3d 508, 510-11 (Tex. App.—Waco 2005, pet. filed). On the other hand, if the insurer is not liable contractually to pay the claim, then the insured cannot succeed on a claim under the prompt payment statute. *See Harris v. American Protection Ins. Co.*, 158 S.W.3d 614, 623 (Tex. App.—Fort Worth 2005, no pet.).

d. Stowers *doctrine*

(i) *Stowers* Demand

In general, when a liability insurer is defending an insured against a covered third-party claim, the insurer has a duty to exercise reasonable care in responding to a reasonable settlement demand made within policy limits. *See G.A. Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929, *holding approved*). If an insurer unreasonably rejects a proper *Stowers* demand, and the insured eventually is the subject of an excess verdict, an insured may recover from its insurer the entire amount of damages in excess of policy limits rendered against it. *Ecotech Int'l, Inc. v. Griggs & Harrison*, 928 S.W.2d 644, 646 (Tex. App.—San Antonio 1996, writ denied); *Stroman v. Fidelity Cas. Co.*, 792 S.W.2d 257, 260 (Tex. App.—Austin 1990, writ denied). The insured may also be entitled to punitive damages. *See Texoma Ag-Prods., Inc. v. Hartford Accident & Indem.* Co., 755 F.2d 445, 449 n.2 (5th Cir. 1985) ("Because the Texas courts have discussed the *Stowers* action in terms of negligence and tortious conduct, we suspect that there would be no impediment here to the award of punitive damages.").

There are certain elements that must be present for the demand to be an effective "*Stowers* Demand:" 1) the claim must be covered by the insurance policy; 2) the demand must be either for the policy limits or a specific amount within policy limits; 3) the third party must offer a full and final settlement for the insured; and 4) the demand made by the third party must be one that a reasonably prudent insurer would have accepted, considering the likelihood and degree of the insured's exposure to an excess judgment. *See American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848

(Tex. 1994); *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 314 (Tex. 1994); *see also Rocor Int'l v. National Union Fire Ins.*, 77 S.W.3d 253, 262 (Tex. 2002).

(ii) Potential Issues

(a) *Demand must be within policy limits*

A third party's demand must be for a sum certain that is equal to or less than the insurer's policy limit obligations. *See Garcia*, 876 S.W.2d at 848. Generally, a *Stowers* settlement demand must propose to release the insured fully in exchange for a stated sum of money, but it may substitute "policy limits" for a sum certain. *Id.* The use of general language such as "policy limits," or "remaining policy limits" may be required in situations where the policy limits are reduced by defense costs. In this situation, the exact amount of remaining policy limits is usually not available, and is constantly reduced with every bill submitted by the defense counsel. Thus, under the holding in *Garcia*, it is proper to simply request the remaining policy limits.

(b) *If insured is willing to pay excess*

If a third-party demands in excess of policy limits, yet the insured is willing to pay the amount exceeding policy limits, the *Stowers* duty *may* be triggered. In *State Farm Lloyds Ins. Co. v. Maldonado*, the *Stowers* demand made by the Plaintiffs was in excess of the policy limits. 963 S.W.2d 38, 41 (Tex. 1998). The insured was agreeable to paying the excess amount of the demand above policy limits. However, this information was not conveyed to the insurer. The Texas Supreme Court held that the demand did not trigger a *Stowers* duty, but left open the question as to what would happen if the insured had informed the insurer of his willingness to fund the excess. *Id.*

(c) *Primary / Excess Carrier*

The requirement that the demand must be within policy limits is less clear when the primary carrier receives a *Stowers* demand that is in excess of its policy limits, but within the limits of an excess layer of insurance. Under these circumstances, the primary carrier cannot end the litigation against its insured by tendering or paying its policy limits. In this situation, a *Stowers* duty may not be triggered on the part of the primary carrier, because it is not within its power to settle. Moreover, the excess carrier often has no duty to defend or participate in a settlement until the primary carrier has exhausted its limits. *See Keck, Mahin & Cate v. National Union Fire Ins. Co.*, 20 S.W.3d 692 (Tex. 2000) (adopting the majority rule that "[w]here the insured maintains both primary and excess policies . . . the excess liability insurer is not obligated to participate in the defense until the underlying limits are exhausted"). Thus, there is still an open question as to whether a demand that exceeds the primary carrier's limits but within the excess carrier's limits is a proper *Stowers* demand.

(d) *Multiple Insureds*

When there are multiple insureds covered under a single policy, and there is a proper *Stowers* demand on one of the insureds, the insurer can settle the claim against the one insured even when the settlement eliminates the policy limits or substantially reduces the funds for further settlement. *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761, 764 (5th Cir. 1999); *see American States Ins. Co. v. Arnold*, 930 S.W.2d 196, 202 (Tex. App.—Dallas 1996, writ denied).

(e) *When punitive damages are assessed against the insured*

An interesting issue is whether an insurer would be liable for punitive damages assessed against its insured when the insurer fails to settle the underlying case after a proper *Stowers* demand and then takes the case to trial resulting in a verdict against the insured exceeding the policy limits along with a sizeable punitive damages award. In this instance, the insurer will no doubt argue that it is not liable for the punitive damages award because it is against public policy for an insurer to indemnify against punitive damages.[9] Arguably, however, the insurer would be liable for the punitive damages because it would not be indemnifying the insured for the punitive damages, rather the punitive damages assessed against the insured would represent the actual damages suffered by the insured for the insurer's breach of its *Stowers* duty. There appears to be no Texas cases addressing this issue and it is an open question in Texas law.

VI. Independent Counsel

A. The Tripartite Relationship

The triangular relationship between the insurer, policyholder, and insurance-appointed defense counsel

[9] The Fifth Circuit has certified a question to the Texas Supreme Court, which it had accepted, regarding whether Texas public policy prohibits an insurer from indemnifying an award for punitive damages. *Fairfield Ins. Co. v. Stephens Martin Paving, L.P.*, 381 F.3d 435 (5th Cir. 2004).

is commonly known as the "tripartite relationship" of insurance defense, and any discussion of a policyholder's right to independent counsel begins here. While there is some debate whether Texas is a "one client" state—meaning appointed defense counsel's only client is the insured—or a "two client" state—meaning appointed counsel represents both the insured and the insurer, *see* Charles Silver, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255 (1995); Charles Silver & Michael Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense about Insurance Defense Lawyers*, 5-6 COVERAGE 1 (Nov. – Dec. 1995), the answer is probably unimportant in light of Texas law unequivocally saying appointed defense counsel owes the insured a duty of "unqualified loyalty." *See State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998). *See also Employers Ins. Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973). At times, the tension inherent in the tripartite relationship results in potential or actual conflicts, which may require the retention of "independent counsel" for the insured, most likely at the insurer's expense.

B. Appointed Counsel's Unqualified Duty to the Insured (*Tilley* and *Traver*), the Duty to Defend (*Rhodes*) and the Right to Independent Counsel (*Cumis*)

1. *Tilley*: The Appointed Counsel's Unqualified Duty to the Insured

In *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973), the insurer ("Employers") filed a declaratory judgment action against its insured, Tilley. *See id.* at 554. Employers sought a declaration that it was not required to defend Tilley in a personal injury lawsuit filed by Douglas Starky ("Starky Lawsuit"). *Id.* Starky was injured on November 25, 1967, but Tilley did not notify Employers of the potential for nearly two years. Employers argued that Tilley violated the terms of the insurance policy by giving "late notice" of the Starky Lawsuit. *Id.*

In support of its position, Employers argued that Tilley was required to give notice "as soon as practicable." *Id.* at 555. Tilley claimed it did not know of the occurrence until suit was filed. Employers countered that Tilley, through one of its foremen, knew of the occurrence on the date Starky was injured. *Id.*

Both parties moved for summary judgment. *Id.* at 554. Employers' motion was based solely upon the undisputed proof that Tilley's foreman was present and knew of the occurrence on November 25, 1967. *Id.* In response, Tilley proved that the attorney Employer's appointed to represent Tilley (the "Attorney") was the one who developed this adverse evidence. *Id.* Tilley asserted that the Attorney's conduct created a waiver and estoppel against Employers as a matter of law. *Id.*

The Texas Supreme Court noted that the following factors were important to its analysis:

- It was the Attorney who developed the evidence upon which Employers' claim was based;
- The Attorney's work that harmed Tilley was sought and paid for by Employers, *without informing Tilley of the conflict* of services being performed by the Attorney; and
- the Attorney, continued to represent Tilley for nearly 18 months before withdrawing.

Id. at 557.

In holding that the Attorney's conduct resulted in a waiver and estoppel in connection with Employer's policy defense, the court held that the appointed attorney "becomes the attorney of record and the legal representative of the insured, and as such he owes the insured the same type of *unqualified loyalty* as if he had been originally employed by the insured." *Id.* at 558 (emphasis added). Further, the court noted that, if a conflict arises between the insurer and the insured, appointed defense counsel owes a duty to the insured to *immediately advise it of the conflict*. *Id.* (emphasis added). Because the Attorney's and Employer's conduct violated these principles, *see id.* at 559-61, Employers was estopped from denying its responsibility to defend. *Id.* at 561.

The court explained that these principles have long been supported in Texas caselaw, as well as under the Code of Professional Responsibility. *Id.* Moreover, the court approved of the "Guiding Principles" of the American Bar Association National Conference of Lawyers and Liability Insurers, which provide:

> In any claim or in any suit where the attorney selected by the company to defend the claim or action becomes aware of facts or information which indicate to him a *question of coverage* in the matter being defended or *any other conflict of interest between the company and the insured with respect to the defense of the matter*, the attorney should promptly inform both the company and the insured, preferably in writing, of the nature

> and extent of the conflicting interest . . . . Where there is a question of coverage or other conflict of interest, the company and the attorney selected by the company to defend the claim or suit should not thereafter continue to defend the insured in the matter in question unless, after a full explanation of the coverage question, the insured acquiesces in the continuation of such defense. *Id*. at 559. (emphasis added).

2. *Traver*: *Tilley* Means What it Says

In *State Farm Mutual Automobile Ins. Co. v. Traver*, 980 S.W.2d 625 (Tex 1998), Mary Davidson collided with Calvin Klause in an automobile. *Id.* at 626. Mary Jordan, a passenger in Klause's car, was severely injured. *Id.* Davidson and Klause were both insured by State Farm Mutual Automobile Insurance Company. *Id.* After settlement attempts failed, the case went to trial, and the jury found Davidson 100 percent responsible for the accident. *Id.*

Davidson died shortly after the trial. Her executor, Traver, sued State Farm, claiming, among other things, that it was negligent and breached its duty to defend. *Id.* Traver also sued the insurance-appointed counsel for malpractice, and alleged State Farm was vicariously liable for the attorney's conduct. *Id.*

In rejecting Traver's vicarious liability argument, the Court noted that, while a liability policy may grant the insurer the right to take "complete and exclusive control" of the insured's defense, appointed counsel is not an agent of the insurer. *Id.* at 627 (citing *G.A. Stowers Furniture Co. v. American Indem. Co*., 15 S.W.2d 544, 547 (Tex. Comm'n App. 1929, holding approved). Because the lawyer hired by the insurer to represent the insured owes "unqualified loyalty" to the insured, the lawyer must at all times protect the interests, regardless of the insurer's instructions. *Id*. at 628. Thus, even if the insurer has instructed counsel to take or refrain from some action in the defense, as an independent contractor, counsel has discretion regarding the day-to-day details of conducting the defense, and is not subject to the insurer's control regarding those details. *Id.* (citing RESTATEMENT (SECOND) OF AGENCY, § 385, cmt. a.). It is the attorney alone who is in complete charge of the minutiae of the court proceedings, and he or she can properly withdraw from the case, subject to the control of the court, if he or she is not permitted to act as he thinks best. *Id.* at 627-28.

In fact, ethical rules prohibit defense counsel from accepting direction or regulation by insurers in the defense of the insured. For example, ABA Model Rule 5.4(c), adopted by most states, and Texas Disciplinary Rule of Professional Conduct 5.04 (c) provide: A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services. TEX. DISCIPLINARY R. PROF'L CONDUCT 5.04; *see also* TEX. DISCIPLINARY R. PROF'L CONDUCT 1.08. Rule 1.08(e) provides: A lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client consents; (2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and (3) information relating to representation of a client is protected as required by Rule 1.05. TEX. DISCIPLINARY R. PROF'L CONDUCT 1.08(e) (emphasis added).

Justice Gonzalez, concurring and dissenting in part, observed:

> [T]he duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking at the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business. *Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting).

Justice Gonzalez actually concluded that, under the circumstances of the case, it is probably impossible for an attorney to provide the insured the unqualified loyalty that Tilley requires." *Id.*[10]

[10] In *American Home Assurance Co. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831 (Tex. App.—Eastland 2003, pet. granted), a case involving so-called "captive counsel," the court echoed these sentiments:

> Reality and common sense dictate that the insurance company is also a client. The insurance company retains the attorney, controls the legal defense, decides if the case should settle, and pays any judgment or settlement amount up to the policy limits. It is a fiction to say that the insured is the only

3. *Rhodes*: The Duty to Defend and Costs for Independent Counsel

In *Rhodes v. Chicago Insurance Co.*, 719 F.2d 116 (5th Cir. 1983), aspiring model Laura Marie Rhodes ("Rhodes") sued psychologist John L. Shirley ("Shirley") for, among other things, sexual misconduct and negligence in performing as a personnel and guidance counselor (the "Shirley Lawsuit"). *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 118 (5th Cir. (Tex) 1983). Chicago Insurance Company ("Chicago") and Interstate Fire and Casualty Company ("Interstate") insured Shirley for malpractice (the "Policy"). *Id.* After Shirley notified Chicago of the claim, Chicago:

- Refused to defend Shirley under Rhodes' original complaint;
- Did not respond to requests for a defense under the first amended complaint; and
- Tendered a defense to Shirley under the second amended original complaint, reserving its rights and contending that Rhodes' complaint only alleged conduct by Shirley that was excluded from coverage under the Policy.

Id.

After receiving Chicago's responses, Shirley refused this tender, and provided his own defense. *Id.* Ultimately, Rhodes and Shirley settled the Shirley Lawsuit for the $200,000 policy limits. *Id.* Rhodes then sued Chicago and Interstate, seeking payment of the settlement amount and defense costs, but the district court granted summary judgment for Chicago and Interstate (collectively the "Defendants"). *Id.* at 118-19.

On appeal, the court defined the issues as:

- whether the Defendants had a duty to defend Shirley in the initial litigation in the state district court, and if so, when it arose;
- whether the duty was breached, and if so, when; and
- the consequences of the failure to defend as to both the insured and the insurer.

Id. at 119.

a. *Rules Relating to the Duty to Defend*

The court noted that the duty to defend is determined by examining the latest amended pleading, meaning that a complaint that does not initially state a cause of action under the policy may be amended so as to give rise to a duty to defend. *Id.* Likewise, a complaint that initially alleges a cause of action covered under the policy may be amended to terminate the duty to defend. *Id.* If the cause of action is neither clearly without nor clearly within coverage, the insurer must defend if there is, potentially, a cause of action under the complaint within the coverage of the policy. *Id.* (citing *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965)).

In this case, the Defendants claimed that any duty to defend arose only under the second amended petition, while the Plaintiffs maintained that the duty arose under the original complaint. *Id.* If the duty to defend arose under the original or first amended original complaint, the duty was breached by the insurer's denial of coverage and failure to defend, meaning that the Defendants would be liable for the settlement amount and attorneys' fees, and would be estopped from alleging failure by the insured to comply with conditions of the policy. *Id.* at 120.

b. *Rules Relating to the Reservation of Rights*

If, however, the duty to defend arose under the second amended complaint, the court stated that the issue whether the Defendants breached the duty to defend is more "complex" because the Defendants offered to defend, but only with a reservation of rights. *Id.* The court found that a reservation of rights does not breach the duty to defend, but when such a reservation is made, the insurer may still refuse the tender of defense and pursue his own defense. *Id.* The court further stated that the insurer remains liable for attorneys' fees incurred by the insured in order to defend the suit. *Id.* "Refusal of the tender of defense is particularly appropriate where, as here, the insurer's interests conflict with those of the insured." *Id.* As the court noted:

> When the insurer is denying coverage, . . . and where coverage, vel non, will depend upon the finding of the trier of facts as to certain issues in the main case, . . . the insurer is not in a position to defend the

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> client in view of the contractual relationships.

The *American Home* court's holding views the tripartite relationship from a "two client" context rather than a "one-client" context. Again, in light of appointed counsel's "unqualified loyalty" owed to the insured, it probably does not matter.

insured. *Id.* at 120-21 (citing *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713, 716 (Tex. Civ. App.—San Antonio 1965, writ ref'd n.r.e.)).

Under these rules, the court found that if Chicago acted properly in tendering a defense only under the second amended original complaint, there was no breach of its duty to defend, but that Shirley was free to refuse the tender and to defend the suit on his own, unrestricted by conditions in the Policy. *Id.* at 121.

c. *Rules for determining the Consequences to both the Insured and the Insurer*

In determining the consequences to both the Insured and the Insurer, the court found that the following two rules should apply:

- If the Insurer breached its duty to defend, it is bound to pay any damages up to the policy limits assessed against the Insured.
- If the Insurer properly reserved its rights and the Insured elected to pursue his own defense, the Insurer is bound to pay damages which resulted from covered conduct and which were reasonable and prudent, up to the policy limits.

Id.

Finally, the court found that these rules apply regardless of whether damages are claimed under a settlement or a judgment. *Id.* The court further found that, if the duty to defend arose under the original or first amended original complaint, the Insured breached its duty to defend, and is liable for all damages assessed. *Id.* If, however, the reservation of rights was proper, the court found that the damages must be apportioned between covered and uncovered conduct, and the reasonableness of the amount of damages determined. *Id.*

4. *Cumis*: The Right to Independent Counsel

In *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*, 162 Cal. App. 3d 358 (1984), the insureds were sued by Magdaline Eisenmann for actual and punitive damages ("Eisenmann Action"). *Id.* at 362. Under an insurance policy issued by insurer Cumis (the "Policy"), the isureds tendered the defense of the Eisenmann Action to Cumis. *Id.* Cumis determined that it had a duty to defend the Eisenmann Action, and selected a law firm to represent the insureds ("Appointed Attorney"). *Id.* at 361-62. Cumis then sent a letter to the insureds, accepting the defense but reserving its right to disclaim coverage, and denying coverage for punitive damages. The insureds responded by retaining their own attorneys ("independent counsel"). *Id.* at 362. Independent counsel notified Cumis that it was retained to act as co-counsel with the insurance-appointed counsel, and presented Cumis a claim for its attorneys' fees and costs. *Id.* Cumis initially agreed to pay the fees and costs, but subsequently notified independent counsel that it would not pay. *Id.* at 362-63. The insureds ultimately sued Cumis for the costs associated with hiring independent counsel. *Id.*

a. *Who Pays for Independent Counsel?*

The *Cumis* court framed the issue as: "whether an insurer is required to pay for independent counsel for an insured when the insurer provides its own counsel but reserves its right to assert non-coverage at a later date." *See id.* at 361. In deciding the issue in the insureds' favor, the court noted that, in the usual tripartite relationship, there is a single common interest of minimizing or eliminating liability to a third party. *Id.* at 364. To the contrary, though, when all or some of the allegations in the complaint do not fall within the scope of coverage under the policy, and an insurer defends under a reservation or rights, there is little commonality of interest. *Id.* In this situation, the insurer wants to establish in the third party liability suit that the insured's liability rested on intentional (i.e. non-covered) conduct, while the insured wants to obtain a ruling that such liability was the result of unintentional conduct within the scope of insurance coverage. *Id.* (citing *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 279 (1966)). As the court noted, "[a]lthough issues of coverage under the policy are not actually litigated in the third party suit, this does not detract from the force of these opposing interests as they operate on the attorney selected by the insurer, who has a dual agency status." *Id.* at 364-65 (citing *Tomerlin v. Canadian Indem. Co.*, 61 Cal. 2d 638, 647 (1964)). In sum, the court held that the insured is entitled to independent counsel when there is a coverage issue preserved in a reservation of rights, and the issue can be affected by the manner in which the underlying case is tried (a "steerable" issue).

The court noted that such a conflict of interest can present itself during trial, at pre-trial settlement conferences, and even during pre-trial discovery. *Id.* at 365-66. At trial, for example, the attorney hired to represent both the insured and the insurer will be required to seek or oppose certain liability questions, the answers to which may benefit the insureds and harm the insurer. *Id.* at 365. At settlement conferences, the attorney may be asked by the insured

to settle for any amount within the policy limits, while the insurer may be seeking to settle for an amount substantially less than the policy limits. *See id.* at 365-66. In such a situation, "no matter how honest the intentions, counsel cannot discharge inconsistent duties." *Id.* at 366.

During pretrial discovery, investigations by the attorney may provide information relating directly to the coverage issue, and the attorney may also form an opinion about the insured's credibility. *Id.* As between the insured, the insurer, and the attorney, there is no confidentiality regarding communications intended to promote common goals. *Id.* Confidentiality is essential, though, where communications can affect coverage. *Id.* The result, then, is that "the lawyer is forced to walk an ethical tightrope, and not communicate relevant information which is beneficial to one or the other of his clients." *See id.* As a result, the court noted that there are indeed multiple conflicts of interest present when a single attorney seeks to represent both an insured and an insurer in a case where the insured has tendered a defense under a reservation of rights. *Id.*

In further exploring the conflicts of interest present in these situations, the court noted that the American Bar Association Code of Professional Responsibility Ethical Considerations provide that:

> The professional judgment of a lawyer should be exercised, within the bounds of the new law, solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client.
>
> A lawyer should never represent in litigation multiple clients with differing interests, and there are few situations in which he would be justified in representing in litigation multiple clients with potentially differing interests. *Id.* (citing MODEL CODE OF PROF'L RESPONSIBILITY EC 5-1, EC 5-15).

b. *Counsel Must Disclose the Conflict*

In addition, the court noted that the California Rules of Professional Conduct, as well as California caselaw, require an attorney to disclose all facts and circumstances to both clients to enable them to make intelligent decisions regarding representation when their interests diverge. *Id.* at 373-74. "[T]he existence of a conflict of interest should be identified early in the proceedings so it can be treated effectively before prejudice has occurred to either party." *See id.* at 371 n.7. One commentator analyzing the ethical considerations of this type of conflict stated:

> The emphasis of the . . . Rules suggests a functional means of resolving the conflicts which confront counsel hired by an insurer to defend its insured. The best course is for an attorney to beware of the potential conflict at the outset. . . . Where a question exists as to whether an occurrence is within coverage, independent counsel representing the insured's interests is required. The insurer is contractually obligated to pay for the insured's independent counsel. *Id.* at 374 (citing Dondanville, *Defense Counsel Beware: The Perils of Conflicts of Interest* 26 TRIAL LAW. GUIDE 408, 415 (1982)).

The court cited *Tomerlin*, which held: "[I]n actions in which . . . the insurer and insured have conflicting interests, the insurer may not compel the insured to surrender control of the litigation." In the end, the court found the insurance-appointed counsel had a conflict of interest in representing the insureds, and held Cumis was required to pay for independent counsel. The court said:

> the Canons of Ethics impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible noncoverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation…Disregarding the common interests of both insured and insurer in finding total nonliability in the third party action, the remaining interests of the two diverge to such an extent as to create an actual, ethical conflict of interest warranting payment for the insureds' independent counsel (internal citations omitted). *Id.* (citing *Tomerlin*, 61 Cal. 2d at 648).

C. Texas Law's Take on *Cumis*: *Davalos* and *Northland Insurance*

1. *Davalos*

In *Northern County Mutual Insurance Co. v. Davalos*, 140 S.W.3d 685 (Tex. 2004), the Texas Supreme Court addressed the independent counsel issue for the first time. The conflict between the insured and the insurer, however, did not center on coverage. Instead, it sprang from a difference in trial strategy.

Davalos was injured in a automobile accident in Dallas County. *Id.* at 687. He sued the driver of the other car, however, in Matagorda County ("Matagorda County Suit"). *Id.* The other driver then sued Davalos and a third driver in a separate action in Dallas County ("Dallas County Suit"). *Id.* The attorneys representing Davalos in the Matagorda County Suit ("Matagorda Attorneys") answered the Dallas County Suit, and moved to transfer venue to Matagorda County. *Id.*

Davalos then notified his insurer ("Northern") of the Dallas County Suit. *Id.* Northern responded by telling Davalos 1) it did not wish to hire the Matagorda Attorneys, 2) it opposed the pending motion to transfer venue, and 3) it had chosen another attorney to defend the Dallas County Suit ("Dallas Attorney"). *Id.* The letter also suggested that Davalos' liability coverage was at peril if the Matagorda Attorneys did not immediately abandon their venue motion and withdraw. *Id.* The Matagorda Attorneys responded, rejecting Northern's offered defense, and advising it that the venue conflict gave Davalos the right to choose independent counsel. *Id.*

Ultimately, the Matagorda Attorney's motion to transfer venue was denied. In fact, the Matagorda County Suit was transferred to Dallas County. *Id.* The insurer eventually settled the claims against Davalos in the Matagorda County Suit. *Id.* at 688.

Davalos then sued Northern for his independent attorney's defense costs, asserting Northern breached its duty to defend in the Dallas County Suit. *Id.* The trial court rendered judgment in Davalos' favor. *Id.* The Court of Appeals affirmed, holding the insurer breached its duty to defend by insisting Davalos withdraw his motion to transfer venue. *Id.*

Northern argued to the Texas Supreme Court that a coverage dispute is the only type of disagreement sufficient to defeat an insurer's contractual right to conduct the defense. *Id.* Because it never disputed coverage or reserved its rights, Northern argued that Davalos had no right to refuse its defense. *Id.*

Davalos responded that Northern attached improper conditions to the defense and inappropriately threatened coverage, thereby forfeiting its right to conduct the defense. *Id.* Davalos further argued that his disagreement with Northern about venue was itself a sufficient conflict of interest to defeat Northern's contractual right to conduct his defense. *Id.*

The Texas Supreme Court explained that whether an insurer has the right to conduct an insured's defense is a matter of contract. In this case, Northern had the right to "settle or defend, as [it] consider[ed] appropriate, any claim or suit asking for…damages." *See id.* In light of this provision, the court said that the insurer's right to conduct the defense included not only the right to select defense counsel, but also to make other strategic decisions that normally would be vested in a defendant. *Id.* The court also found, however, that "under certain circumstances…an insurer may not insist upon its contractual right to control the defense. The dispute here is over what those circumstances might be." *See id.*

Citing *Traver*, the court said an insurer's right of control includes the authority to make defense decisions as if it were the client "where no conflict of interest exists." *Id.* (citing *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)). Rejecting the Court of Appeals finding that the parties' venue disagreement was the type of conflict that would disqualify the insurer from controlling the defense, the court said,

> [T]he existence or scope of coverage is the basis for a disqualifying conflict. In the typical coverage dispute, an insurer will issue a reservation of rights letter, which creates a potential conflict of interest. *See* 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.20 at 369 (4th ed. 2001). And when the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest will prevent the insurer from conducting the defense. *Id.*

In sum, the court said it would be difficult to imagine a set of circumstances in which a choice of venue might amount to a disqualifying conflict of interest. *Id.* Simply choosing the county in which to defend a covered claim is a strategic litigation decision within the insurer's discretion in conducting the insured's defense. *Id.* at 690. As a result, because

Davalos had no right to reject Northern's tendered defense, he had no right to recover the costs of conducting his own defense. *Id.*

2. *Northland Insurance*

In *Housing Authority of City of Dallas v. Northland Insurance Co.*, 333 F. Supp. 2d 595 (N.D. Tex. 2004), the court grappled with the question of whether *every* coverage dispute gives birth to the insured's right to independent counsel. The insurer ("Northland") contended that, even though the facts to be adjudicated in the liability suit were the same as those upon which coverage depended, there still should not be a right to independent counsel. Northern argued that the right to independent counsel only arose if there were some way the underlying facts can be "steered" to exclude coverage. *Id.* at 601.

The court rejected Northland's argument, holding broadly that:

> because a potential conflict of interest was created by the issuance of the reservation of rights letter, a disqualifying conflict existed; therefore, Northland could not conduct the defense of the . . . lawsuit. Under these circumstances, DHA properly refused Northland's qualified tender of defense and defended the *Bell* lawsuit on its own. *See id.* at 602.

D. What is a Reasonable Fee for Independent Counsel

As independent counsel become more prevalent, conflicts will escalate with respect to what constitutes a "reasonable" fee for independent counsel. Insurers required to pay for such counsel, will contend that a reasonable attorney fee rate would be the rate that would have been charged by staff counsel, captive counsel or panel counsel. It is estimated that defense attorneys who serve as "panel counsel" or "captive counsel" are paid 15 – 50 % less than the hourly rate of outside counsel selected by the insured. *See* Charles Silver, *Does Insurance Defense Counsel Represent the Company of the Insured?*, 72 TEX. L. REV. 1583, 1597–98 n.72 (1994). On the other hand, policyholders will argue that higher rates should be considered reasonable by the courts.

E. New Sources of Potential Conflicts in the Tripartite Relationship

Recently, in light of the Texas Supreme Court's decision in *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew and Rental Tools, Inc.*, 2005 WL 1252321 (Tex. 2005), focus on the tripartite relationship has increased from a different angle. In *Frank's Casing*, the court held that insurers may seek reimbursement for payments made on the insured's behalf, whether or not the policy provides for it. This case, which focused on a settlement payment made by the insurer, has garnered the bulk of public attention, and is discussed in more detail below. Less attention, however, has been given to the implications of the decision as it relates to defense costs, potentially required allocations of defense costs, and allocation of settlement amounts.

In this connection, it is helpful to review one aspect of *Texas Association of Counties County Government Risk Management Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000). Although the court found that the insurer did not have a right to reimbursement under the circumstances of the case, Justices Owen and Hecht dissented, asserting that:

> when an insurer reserves its right to contest coverage and there has been a settlement demand within policy limits that the insured agrees is reasonable, the insurer may settle the claim and recover settlement costs based on an obligation that is implied in law. In order to prevent unjust enrichment, obligations are implied in law even when there is no agreement, either express or implied. *Id.*

(Of course, these views would later carry the day in *Frank's Casing*.)

Important to whether the court ultimately will hold the insurer has the right to reimbursement of defense costs—or a portion of such costs—Justices Owen and Hecht relied upon *Buss v. Superior Court of Los Angeles County*, 939 P.2d 766 (Cal. 1997). *Buss* involved 27 causes of action, only one of which (defamation) was potentially covered. *Id.* at 766-67. The court held that, even though the insurer has a duty to defend all claims in a "mixed action" such as *Buss*, the insurer's right of reimbursement for defense costs should be implied in law, and it, therefore, is allowed to recover these costs if they can properly be segregated between covered and uncovered claims. *See Matagorda*, 52 S.W.3d at 136-37; *Buss*, 939 P.2d at 775-76.

As discussed further below, if this rule ultimately is approved in Texas, there will be additional, potential conflicts between insurer, insurer-retained counsel for the insured, and the insured. Appointed counsel may

ultimately be the star witness against the insured in a reimbursement action for attorney's fees and costs. That counsel will be placed in the uncomfortable position of testifying whether the claims were "inextricably intertwined," or whether some portion of the fees should be paid by the insured for uncovered claims. Appointed counsel's detailed time sheets and case reports may be the key exhibits in such reimbursement suits.

VII. *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, No. 02-0730, 2005 WL 1252321 (Tex. May 27, 2005).

In one of the most important insurance cases in recent years, the Texas Supreme Court dramatically altered the landscape for settlements and reimbursement rights in *Excess Underwriters at Lloyd's London v. Frank's Casing Crew & Rental Tools, Inc*, 2005 WL 1252321 (Tex. 2005).[11] *Frank's Casing* expands an insurer's ability to seek reimbursement from an insured after paying a settlement or judgment amount—regardless whether the policy expressly provides for a right of reimbursement—and, along the way, creates a myriad of new questions for any practitioner coming in contact with a case involving an insurance policy. As discussed at various parts in this paper, the insured's right to independent counsel may have dramatically expanded as a result of this decision.

A. Prior Law – *Texas Association of Counties County Government Risk Management Pool v. Matagorda County*

In *Frank's Casing*, the Texas Supreme Court abandoned its relatively recent decision in *Matagorda County*, 52 S.W.3d 128 (Tex. 2000), in which it had pronounced a fundamentally different rule regarding reimbursement. In that case, the insured had demanded a defense and indemnity, but the insurer denied the claims and reserved its rights. *See id*. at 129. After negotiations, however, the insurer agreed to provide a defense, subject to its reservation of rights, while also seeking a declaratory judgment that the claims were not covered. *See id.*

Two years later, the injured third-party proposed a settlement that all parties agreed was reasonable. *See id.* at 129-30. The insurer requested the insured to fund the settlement because it alleged the claims were not covered. *See id*. at 130. When the insured refused, the insurer sent a second reservation of rights letter, "reserving its rights to continue to deny coverage and to seek reimbursement of the settlement funds from the [insured] if the declaratory-judgment action established that [the claims were] not covered." *See id.* The insured did not respond. *See id.*

In a 7-2 decision (with Justices Owen and Hecht dissenting), the court held that "when coverage is disputed, and the insurer is presented with a reasonable settlement demand within policy limits, the insurer may fund the settlement and seek reimbursement only if it obtains the insured's clear and unequivocal consent to both the settlement and the insurer's right to seek reimbursement." *See id.* at 136. Important to the court's analysis was the insurance policy's failure to "provide [the insurer] with a right of reimbursement." *See id.* at 130-31.

B. *Frank's Casing*

With *Matagorda County* as the backdrop, the court was presented with *Frank's Casing* in 2003. 2005 WL 1252321 (Tex. 2005). Frank's Casing, along with several other defendants, was sued for the collapse of a fabricated drilling platform. *See Frank's Casing*, 2005 WL 1252321, at *1. Frank's Casing had a primary liability policy with limits of $1 million, and excess coverage of $10 million. *See id*. The excess underwriters issued reservation of rights letters, contesting coverage on some of the claims. *See id*.

There were multiple settlement offers before the trial, and *Frank's Casing* rejected them all. *See id.* Well before the trial, the excess underwriters attempted to settle the claims with the injured third-party, but were unsuccessful. *See id*. Shortly before trial, the third-party offered to settle the claims against Frank's Casing, and, this time, the excess underwriters proposed to either have Frank's Casing fund a portion of the settlement in exchange for the excess underwriters waiving all coverage issues or to have the excess underwriters fund the majority of the settlement and have the coverage issues be determined in arbitration. *See id*. Frank's Casing rejected both scenarios. *See id*.

When the trial started, it became apparent Frank's Casing was the target defendant. Frank's Casing's in-house counsel actively sought and received a settlement offer. *See id*. Frank's Casing communicated the offer to the excess underwriters, and demanded that the excess underwriters accept the offer. The court characterized this demand as "'*Stower*iz[ing]' the excess underwriters." *See id.* While agreeing the case should be settled for this amount, the excess underwriters conditioned their

[11] Note, however, that the court has reheard the case, but, as of the printing of this article, has not issued another opinion.

funding of the settlement on Frank's Casing's agreement that all coverage issues would be decided at a later date. *See id*. Again, Frank's Casing refused, but demanded that the excess underwriters accept the offer nonetheless. *See id*. The excess underwriters informed Frank's Casing it would fund the settlement, but would seek reimbursement later. *See id*.

In a decision participated in by only 7 of the 9 Justices, the court allowed the excess underwriters a right of reimbursement. Despite the unanimity of the result, the court's rationale lacked a majority of the Justices currently on the court. Only Section I—the fact section—was joined by all Justices.

Part IIA was the opinion's most far-reaching portion, and was adopted by only four Justices currently on the court: Jefferson, Hecht, Medina and Green. The only case cited in IIA was *Matagorda County*, particularly its discussion of the concern that, "when an insurer has the unilateral right to settle, an insurer could accept a settlement that the insured considered out of the insured's financial reach, and the insured could be required to reimburse the insurer for that amount." *See id*. Recognizing the concern as valid, the court held that *Frank's Casing*'s facts "lead us to conclude that [the concerns presented in *Matagorda County* are] ameliorated if not eliminated in at least two circumstances: 1) when an insured has demanded that its insurer accept a settlement offer that is within policy limits, or 2) when an insured expressly agrees that the settlement offer should be accepted." *See id*. (Interestingly, the "us" now only refers to four Justices, given Owen's departure to the Fifth Circuit and, thus, one issue on rehearing will be whether this broad holding stands.[12])

Part IIB contains the rationale for the broad holding in IIA, but again consists only of four Justices currently on the court – Hecht, Jefferson, Medina and Green. The court starts by pointing to the insured's demand that the excess underwriters accept the settlement offer, which the court characterized as "'*Stower[izing]*' the excess underwriters." *See Frank's Casing*, 2005 WL 1252321 at *3. In this light, the court held that the insured "could not thereafter take the inconsistent position that the settlement offer was reasonable if the insurer bore the cost of settling but unreasonable if the insured ultimately bore the cost." *See Frank's Casing*, 2005 WL 1252321, at *3.[13]

Part IIC was joined by Justices O'Neill and Wainwright and, even with Justice Owen's departure, represents the views of six Justices still on the court. In IIC, the court held that a right of reimbursement is acceptable if it is implied in fact. That is those situations in which: "there is a coverage dispute, the insured has expressly agreed the third party's settlement offer should be accepted, and the insurer has notified the insured that it intends to seek reimbursement." *See id*. at *5.

In Part IID, the court "clarified" *Matagorda County* to mean that there are additional instances in which a right of reimbursement would be implied-in-law, and those instances would include the present facts, but the court gave little guidance as to what additional circumstances that might include.

C. "Tangled Mound of Considerations"[14]

What does all this mean? For Justice Wainwright (and practitioners), it means a "tangled mound of considerations." *See id*. These far-reaching considerations resulted in numerous articles and several *amicus curiae* briefs when the court granted rehearing.[15] On the most basic of level, *Frank's Casing* indicates a shift away from *Matagorda County's* policyholder protection stance—"[[h]olding otherwise, would force the insured] to chose between rejecting a settlement within policy limits or accepting a possible financial obligation to pay an amount that may be beyond its means, at a time when the insured is most vulnerable," *see Matagorda County*, 52 S.W.3d at 135—to a more insurer friendly position: "[r]equiring an insured to reimburse its insurer for settlement payments if it is later determined there was no coverage does not prejudice the insured." *See Frank's Casing*, 2005 WL 1252321, at *4.

[12] Adding an exclamation point to the uncertainty that has quickly become *Frank's Casing* is Justice Brister participating in later suits, but not *Frank's Casing*. Justice Brister, who heard *Frank's Casing* in the appellate court, did not participate in the rehearing. Thus, it is altogether possible that IIA will not survive rehearing (with only four Justices adopting it) only to have it resurrected in a subsequent case in which Justice Brister participates.

[13] By using the *Stowers* standard, has the court turned the demand component into one of simple reasonableness? To conflate the two would certainly "fit" if the singular goal is to ensure that an insured is not required to reimburse a portion of a settlement that it considered "out of [its] financial reach," but what of the express language of the policy—or better stated lack of express reimbursement rights? Is the court signaling an intention to shift the uncertainty and risk back to the insured so long as the demand is "reasonable?"

[14] *See id*. at *19.

[15] The court granted rehearing on January 6, 2006 and held oral argument on February 15, 2006. As of July 24, 2006, the court had not issued another opinion.

On a more practical level, *Frank's Casing* presents a world of uncertainty for practitioners and businesses alike. Does it apply only in situations in which a settlement payment is made and 100% of the claims were uncovered, or does it apply to a mixed bag of covered and uncovered claims, requiring an allocation of the settlement payment between the two? Does the rule apply beyond the settlement payment context? As mentioned above, does it apply to attorneys' fees incurred in connection with uncovered claims? What about expert's fees related to uncovered claims? With respect to the fee issue, as mentioned above, a Minnesota court, applying Texas law, already has held that *Frank's Casing* required reimbursement not only of settlement payments, but also attorneys' fees for claims that are not covered by a policy. *See St. Paul Fire & Marine Insurance Co. v. Compaq Computer Corp.*, 377 F. Supp. 2d 719 (D. Minn. July 13, 2005). But, cutting the issue finer, may the insurer require appointed defense counsel to allocate the fees and expenses to covered and non-covered claims, and seek reimbursement later for the work expended in connection with uncovered claims?.

1. Reservation of Rights

As mentioned above, one of the first events of any lawsuit involving potential insurance coverage is the insurer's reservation of rights letter. With *Frank's Casing*, insureds should expect every reservation of rights letter to include a mention of the right to reimbursement—not only of any settlement/judgment payment, but also of attorneys' fees and costs. In this light, *Frank's Casing* has impacted your practice whether you are a lawyer representing the insured, the appointed defense counsel, or the plaintiff's lawyer who has sued the insured.

2. The Impact of Coverage Issues on Various Counsel

Before *Frank's Casing*, more than 9 times out of 10, a case involving insurance would be resolved after the insurer funded all or part of a settlement. Even when there were coverage issues, with no right to reimbursement unless agreed upon by the insurer and the insured, the case was over. But that is not true anymore. All counsel must at least recognize when a coverage issue exists. What impact does Frank's Casing have on you as 1) the insured's personal counsel, 2) insurance company appointed defense counsel, and 3) the plaintiff's lawyer?

a. *Personal or Independent Counsel*

As an insured's personal counsel, with whom the insured probably first confers—or even as the counsel first contacted to potentially represent the client in the case—what obligations do you have with respect to understanding and advising on insurance matters? Can you simply turn over your client to appointed counsel and forget it? Or should you advise your client of *Frank's Casing's* impact? In most cases involving insurance, the most important issue for the client is being certain the insurer pays the costs and any judgment. Should you advise your client that these issues may survive the underlying case, and it should begin preparing now to litigate those issues? In that connection, should you advise your client that it should be careful what information it provides to appointed counsel because he or she likely will share it with the insurer, and it might be used against the client later in a reimbursement suit? Should you advise your client of any particular instructions it should provide appointed counsel with respect to communicating with the insurer? Should you advise the insured of the right to or need for independent counsel?

b. *Appointed Defense Counsel*

Appointed defense counsel's traditional approach of "I don't deal with coverage issues" may no longer be feasible. In fact, the conflict quagmire presented by *Frank's Casing* to appointed counsel was troubling enough to lead the Texas Association of Defense Counsel to file an *amicus curiae* brief when the court granted rehearing. *See Unauthorized Practice of Law Committee v. American Home Assurance Co.*, No. 04-0138, 2005 WL 2546992 (Tex. Aug. 29, 2005).

But there are issues beyond those raised by TADC. Think of the common situation in which a policyholder has been sued by a plaintiff asserting multiple claims, some of which are covered under the insurance policy, while others are not—e.g. negligence (covered) and fraud (uncovered). In a typical liability policy, the insurer has the duty to defend the entire case if *any* of the claims are covered. *See St. Paul Ins. Co. v. Texas Dept. of Transp.*, 999 S.W.2d 881, 884 (Tex. App.-Austin 1999, pet. denied); *Maryland Cas. Co. v. Moritz*, 138 S.W.2d 1095,1097(Tex. Civ. App.—Austin 1940, writ ref'd). Appointed counsel could simply defend the suit—without worrying about a later dispute between the insured and insurer over allocating his or her defense costs between covered and uncovered claims. Consistent with *Frank's Casing's* rationale, however, insurers will surely now seek reimbursement for defense costs expended for uncovered claims. Indeed, California law, the apparent new model for insurance law for the Texas Supreme Court, allows it. *See Walbrook Ins. Co. v. Goshgarian*

& Goshgarian, 726 F. Supp. 777, 782 (C.D. Cal. 1989) (Acceptance of the benefit of defense costs created an agreement to reimburse them if there was no duty to defend.).

Appointed counsel may well be required to change habits formed over years or generations. In the face of guidelines requiring detailed reports, when coverage is at issue, what—if anything—should appointed counsel report to the insurance company? Traditionally, appointed counsel developed the case, evaluated the case and periodically updated the insurance company on the progress, prospects for settlement and whether claims were covered or not, along with the validity of the non-covered claims and covered claims. If *Frank's Casing* is extended even to *allocating* costs and attorneys' fees between covered and non-covered claims, those summaries and detailed fee statements may harm the client. If the insurance-appointed counsel is to zealously protect its client's interest, it may need to refuse sending the insurer these reports and detailed fee statements—a result that insurance carriers probably never envisioned and certainly do not want.

If counsel nonetheless provides the reports, at a minimum, should he or she explain to the client that the detailed case reports likely will be "Exhibit 1" in the later reimbursement case? Should you inform your client that the insurer may sue later for reimbursement, and that you may be the key and main witness against your client on these issues?

Similarly, should appointed defense counsel advise the insured that the insurance company may ultimately sue the insured for the defense costs, using appointed counsel's detailed fee statements and testimony as the primary evidence against the insured?

In connection with both of these issues, should you advise your client to confer with independent counsel? The insurer may be building a case for reimbursement, but the insured may be completely unaware of it. Is it fair for the insurer to build its case over a period of years and then spring a suit on your client, who will have to start from scratch? Should you tell your client that the insurer may be required to pay for independent counsel now, but the client will be on its own in a reimbursement suit later?

The problems may even intensify at settlement discussions. Because the insured's agreement to a settlement may give the insurer a right to reimbursement, should appointed counsel be wary of any statements and recommendations to the insurer that could be construed as an opinion on the reasonableness of any settlement offer? While the Court has not technically ruled on the issue, it is a logical extension of *Frank's Casing* and a dicey proposition that every insurance-appointed counsel will have to face. Until it is fleshed-out by the Court, as explained below, the most prudent course is simply not to make any such representations.

The reality is that one wrong statement by the appointed counsel may expose the insured to additional liability in a reimbursement suit and, consequently, the appointed counsel for a subsequent malpractice action. Given the multitude of potential conflicts, even the mere possibility of a subsequent reimbursement suit may require separate additional counsel, for settlement purposes.

c. *The Plaintiff's lawyer*

Knowledge of the precise topics on which the insurer has reserved its rights, including reimbursement, also is important to the Plaintiff's counsel. In the first place, no longer can Plaintiff's counsel rely on insurance-appointed counsel to be an ally in pushing for settlement. Thus, discovering and understanding every reservation of rights letter, along with every implicated policy, is now more critical and time sensitive than ever. To maximize recovery for his or her client, Plaintiff's counsel may be required to focus early on covered rather than uncovered claims. A *Stower's* demand based upon uncovered claims may be ineffective after *Frank's Casing*.

Similarly, broad ranging, costly discovery focusing on non-covered claims may simply reduce the funds available for settlement, especially if the insurer already is counting the costs and budgeting for a later reimbursement suit against the insured. Additionally, the likelihood of some type of reimbursement suit (or at least the threat of one), will increase the tension between the insured and insurer, decreasing the likelihood of an early settlement, as the two entities squabble over, and posture themselves for, a subsequent reimbursement suit.

3. Triggering Right to Reimbursement

Even more troubling in this regard is whether *Frank's Casing* has eliminated the need for a timely reservation of rights letter altogether as a condition of seeking reimbursement. In that event, are the potential issues mentioned above present in *any* case involving insurance? In Justice Hecht's view, no reservation of rights letter would be required. He views the issue simply as: "may a liability insurer accept a reasonable offer within policy limits to settle a claim for which

coverage is disputed and, if the claim is later determined not to have been covered, obtain reimbursement from the insured." *See Frank's Casing*, 2005 WL 1252321 at *7. Justice Hecht says: "An insurer's right to recoup from its insured the amount paid to settle a claim **depends on two things: the reasonableness of the settlement, and coverage**." *See id*. at *10. (emphasis added).

Justice Wainwright, while espousing a general theory that reimbursement should not be allowed absent an express provision in the underlying policy, provides two exceptions "under contract law, including under the theories of implied-in-fact contracts and quasi-contract":

- "If the insurer gives notice of its intention to recoup the payment in a timely reservation of rights letter; ***or***"
- "Makes reimbursement a term or condition of a subsequent agreement." *See id*. at *18. (emphasis added).

If Justices Wainwright and Hecht's opinions do stand for the proposition that no reservation of rights is needed to preserve the right to reimbursement, again, one must question whether the insured is entitled to independent counsel in every case. For now, a majority of the Court has not eliminated the need for such a reservation and Justices Hecht and Wainwright may clarify their position on rehearing.

4. Settlement

While the *Frank's Casing* court fancied its decision as one that promoted settlement, the reality is it may have the opposite effect. It will force an insured "to chose between rejecting a settlement within policy limits or accepting a possible financial obligation to pay an amount that may be beyond its means, at a time when the insured is most vulnerable." *See Matagorda County*, 52 S.W.3d at 135. Policyholders typically are not in the business of evaluating and paying claims, and usually do not have the ability to reserve an amount of funds ultimately to effectuate a settlement, as an insurer would. Faced with a "potential obligation to pay an amount that may be beyond its means, at a time when [it] is most vulnerable," it is possible the insured may chose to push ahead in the original lawsuit in hopes of a favorable outcome.

Even when the underlying case is settled, overall litigation may well increase because of subsequent reimbursement suits. As mentioned, in many cases, the outcome of the underlying litigation is less important to the insured than whether insurance pays. In fact, from the insurer's perspective, there may be an incentive to engage in subsequent contract litigation with its insured rather than defend it in the underlying case. To avoid substantial defense costs and the potential of *Stowers* liability, insurers could reasonably choose to settle suits—even at inflated amounts—and fight with the insured on coverage in a reimbursement suit.

(i) *Stowers*

Whether the *Stowers* doctrine has changed after *Frank's Casing* is not altogether clear. First, in part IIB the court states that the insured "*Stower*ized" the excess carrier, but *Stowers* previously only applied when the injured third-party made a demand; it has nothing to do with whether the insured "demands" anything. *See American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842 (Tex. 1994); *G.A. Stowers Furniture Co. v. Am. Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929, *holdings approved*). If the court is analogizing the insured's "demand" to a *Stowers* scenario, is the court simply equating "demand" to "reasonableness of the offer," which is the *Stowers* standard?

More fundamentally: is the court signaling an upcoming change in *Stowers*? Prior to *Frank's Casing*, the crux of a subsequent *Stowers* suit was whether the *Stowers* demand was reasonable in light of the covered claims. *See American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842 (Tex. 1994). Now, the issue of whether the claim is covered can be reserved for a separate lawsuit; one which would also allow for reimbursement if the claim is ultimately not covered. Thus, the question becomes: has the court changed the *Stowers* standard to whether the demand was reasonable in light of covered ***and*** non-covered claims?

Notwithstanding whether the court is signaling a change in *Stowers* jurisprudence, *Frank's Casing* places any counsel representing the insured in a difficult position of transmitting the demand, without demanding that it be accepted or providing any language that may be construed as commenting on the reasonableness of the offer. Silence is probably golden. For example, one commentator cites the following:

> Dear Carrier: Here is a demand from the Plaintiff. We leave it to you to protect our interests. We want you to pay everything you are contractually obligated to pay. Please do not pay any more.

See Frank's Casing -- Practice Implications of the Anticipated Opinions on Rehearing, Glen M. Wilkerson, Davis & Wilkerson, p. 15 (CLE May 25-26, 2006)(stating that "it has been suggested that a prudent insured would respond to a Plaintiff's demand" with the above language).

But even this communication is not without peril. This language gives rise to an argument that it recognizes that the insurer is only responsible for settling covered claims and, thus, entitled to reimbursement on non-covered claims by and through an implied-in-fact theory. (Perhaps, "Please find the enclosed" is a better course.)

For the Plaintiff's counsel, it is critical to understand *Frank's Casing* in connection with *Stowers* demands. *See G.A. Stowers Furniture Co. v. Am. Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929, *holdings approved*). As mentioned, no longer can one assume the defense counsel—insurance appointed, personal, or independent—will be an ally in pushing the insurer to settle. Further, a *Stowers* demand, which relies on covered and uncovered claims, may well lessen the likelihood of a settlement. On the other hand, a *Stowers* demand requiring payment based only on covered claims, while also offering to extinguish all claims, may assist in the coverage evaluation, lessen subsequent reimbursement suits, and quicken the resolution of the underlying controversy.

(ii) Mediation

"I think it's the best offer we're going to get." Has *Frank's Casing* made this common mediation statement dangerous? Can an insurer who overheard insured's counsel utter this statement use that comment in a subsequent *Frank's Casing* suit as evidence that the insured thought the offer was reasonable and sufficient under the "*Stowers* demand" analysis articulated in Part IIB of *Frank's Casing*?[16] No answers exist yet, but the point is simple: *Frank's Casing* has now made mediation-negotiations a mire of quick-sand—whether it is the insurance-appointed counsel discussing issues with the adjustor or the independent counsel simply commenting aloud.

Commentators have suggested the following solution to this particular problem: For defense counsel—insurance appointed, independent or counsel for the carrier—you can expressly agree to mediate on the condition that all *Frank's Casing* reimbursement rights are waived, in writing, before the mediation begins. *See Frank's Casing* -- Practice Implications of the Anticipated Opinions on Rehearing, Glen M. Wilkerson, Davis & Wilkerson (CLE May 25-26, 2006).

5. Need for Independent Counsel

The ultimate fallout from *Frank's Casing* may be that the policyholder needs independent counsel, who can asses coverage without any pressure from the insurer, evaluate potential liability in a subsequent reimbursement suit, and, perhaps, defend the insured in the underlying case. Because of the potential for allocating substantial defense costs, this right may arise in *every* case involving coverage issues.

VIII. Reinsurance

A. What is Reinsurance?

- Almost every insurance company that underwrites substantial business risk eventually purchases reinsurance to protect themselves against the financial risks that they do not wish to fully retain.
- It effectively reduces the loss exposure and potential pay-out by an insurance company in the event of large claim or loss.

Definition

- *A form of insurance, being the insurance of one insurer (the reinsured) by another insurance company (the reinsurer) by means of which the reinsured is indemnified for loss under insurance policies issued by the reinsured to the public.*
- A contract of reinsurance is a contract under which one insurer agrees to indemnify another with respect to actual loss sustained under the latter's policy or policies of insurance.
- There are two types of reinsurance:
- Facultative
  - Reinsurance of *individual* risks—the reinsurer retains the "faculty" to accept or reject each risk offered.
- Treaty
  - General reinsurance agreement containing the contractual terms applying to the reinsurance of some class or classes of business (automatic).

B. The Right to Control[17]

[16] This raises the question whether any such statement from mediation would be admissible in a subsequent suit.

[17] This section is primarily based upon an article entitled "Reinsurance Issues" 455 PLI/Comm 381.

Generally, the reinsured retains the right to control the handling and defense of the claim against the insured. Typically, however, the reinsurer contractually has the right to "associate" in the defense of claims. An example of a typical provision is as follows:

> While the reinsurer does not undertake to investigate or defend claims or suits, it shall nevertheless have the right and be given the opportunity to associate with the reinsured and its representatives at the reinsurer's own expense in the defense and control of any claim, suit, or proceeding which may involve this reinsurance with the full cooperation of the reinsured.

With a provision of this type, the reinsurer has no duty to defend, but does have the right to exercise *control* over the defense. While reinsurers historically have played a passive role in this regard, reinsurers today increasingly are asserting their rights to participate in and control the defense.

C. Discovery Issues

That being the case, there appears to be no reason the existence of the reinsurance and the reinsurance agreement should not be provided in discovery. Rule 194 provides that parties are to disclose "any indemnity and insuring agreements described in Rule 192.3(f)." Rule 192.3(f) reads as follows:

> Except as otherwise provided by law, a party may obtain discovery of the existence and contents of any indemnity or insurance agreement under which any person may be liable to satisfy all or part of a judgment rendered in the action to indemnify or reimburse for payments made to satisfy the judgment.

Reinsurance agreements fit this definition.

D. Claims Against Reinsurer

To the extent the Reinsurer controls the reinsured—or insurer's conduct—is a bad faith claim available to the insured against the reinsurer? While, as a general matter, the insured has no right to recover directly under the reinsurance contract, *see State & County Mutual Fore Insur. Co. v. Miller*, 52 S.W.3d 693 (Tex. 2001), whether the insured could assert a bad faith claim based upon the reinsurer's control has not yet been thoroughly tested.

E. Should the Reinsurer Be Required to Attend mediation?

Assuming there is a reinsurer calling the shots, should the reinsurer be required to attend mediation? It is not at all uncommon for a court to order the parties with final settlement authority to attend.