STRATEGIC DECISIONS:
PRE-SUIT COVERAGE LITIGATION TACTICS

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I. Introduction

All too often, coverage litigation begins without adequate pre-lawsuit preparation by either side. Many of the important decisions that will affect the outcome of a coverage dispute or coverage litigation are made before the lawsuit is even filed. Decisions, such as whether to negotiate before filing suit, who should negotiate, and where a suit should be filed, should be made on the basis of careful consideration, not mere convenience or habit.

This paper outlines some of the factors that attorneys may want to consider in a coverage dispute before litigation. The paper reflects two points of view: the attorney for the corporate policyholder and the attorney for the insurer.[1]

II. Whether to negotiate before filing suit

A. Policyholder considerations

(1) The race to the courthouse

One disadvantage to pre-suit negotiation is that it is likely to alert the insurer that the policyholder is contemplating a lawsuit. The insurer may then preemptively file a declaratory judgment action in the forum of its choice.

(2) Costs of filing suit

Filing suit often requires attorney time and additional fees and costs that are charged to the client. A resolution before suit is filed may be less costly in terms of legal fees and expenses.

(3) Relationship with the insurer

Often a policyholder may wish to resolve coverage disputes without litigation because it values its continuing relationship with its insurer. Attorneys should be sensitive to the fact that a coverage dispute may not exist in a vacuum, but may become an obstacle in an otherwise valuable business relationship.

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[1] This paper reflects the often disparate views of the authors, some of whom represent primarily policyholders and some of whom represent primarily insurers. As such, the statements in this paper do not necessarily reflect the views of each of the authors, their firm, or their clients and may not be used to estop any of them from taking any other positions.

B. Insurer considerations

(1) Advantages to filing a declaratory action promptly

An insurer may want to file a declaratory judgment action before the policyholder files suit so that the insurer has the first choice of available forums. Filing a declaratory judgment action on coverage issues may be necessary to defeat a policyholder's assignment of its claims to a plaintiff in an underlying action. The Texas Supreme Court has held that an assignment to a plaintiff of a defendant's claims against its insurer is invalid if it is (1) made before the adjudication of the plaintiff's claim against the defendant in a fully adversarial trial, (2) the defendant's insurer has tendered a defense, and (3) either (a) the defendant's insurer has accepted coverage, or (b) the defendant's insurer has made a good faith effort to adjudicate coverage issues before adjudication of plaintiff's claim. *State Farm Fire and Casualty Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996). In third party insurance cases, *Gandy* provides impetus to an insurer to file and resolve any coverage action promptly.

(2) Costs of litigation

Negotiation before lawyers have spent substantial time in litigation may result in less costs to the insurer and a lower settlement demand from the policyholder.

(3) Relationship with policyholder

Just as with the policyholder, the insurer may prefer negotiation over litigation in order to preserve a continuing business relationship with the corporate policyholder.

III. Who should negotiate?

A. Policyholder

In choosing counsel to represent it in a coverage dispute, a corporate policyholder must consider cost, preservation of the attorney-client privilege, and avoidance of conflicts of interest. The three types of attorneys typically handle coverage negotiations: the defense counsel for the policyholder in the underlying action; the counsel who is to act as the litigator for the policyholder in coverage litigation; and the counsel who is brought in to advise the policyholder in coverage negotiations, but not to act as coverage litigation counsel.

(1) Defense counsel in underlying action?

A policyholder may wish to retain counsel for a coverage dispute other than the defense counsel handling the underlying action for three reasons. First, defense counsel may not be familiar with the subtleties of insurance coverage. A policyholder's interests are often best served by separate counsel who is experienced in coverage disputes.

Second, potential conflicts of interest can arise when an attorney is handling both the defense of a policyholder in an underlying action and the negotiation of coverage with the insurer. If the insurer, for instance, is defending the underlying action under a reservation of rights, the defense attorney is in the difficult position of being paid by the insurer and negotiating against the insurer regarding coverage. This may not be a problem, however, if the insurer has refused to defend or the policyholder has rejected a qualified defense and selected independent counsel.

Third, defense counsel is likely to be a witness in a coverage action on such issues as the reasonableness of the settlement of the underlying action, factual knowledge about the issues in the underlying action that have a bearing on coverage, and attorney's fees in the underlying action.

(2) Coverage litigation counsel?

If the attorney who is likely to litigate the coverage dispute conducts pre-lawsuit coverage negotiations, the attorney risks a later attempt by the insurer to disqualify the attorney in the coverage lawsuit on the ground that the attorney may have become a fact witness in the coverage litigation on such issues as notice, improper claims handling, and representations about the scope of coverage.

One solution to this problem is for the policyholder's attorney to draft all correspondence to be sent under the client's signature and for the client to conduct all oral communications with the insurer. The drawback to this solution is that the policyholder may lose some of the value of having a skilled coverage attorney visibly conduct the negotiations for the policyholder.

(3) Separate coverage litigation and coverage advisory counsel?

Perhaps the ideal approach for the policyholder is to have separate defense counsel, coverage negotiation counsel, and coverage litigation counsel. This avoids the potential conflicts that may arise when defense counsel or coverage negotiation counsel becomes the coverage litigation counsel. The drawback to this approach is redundancy and the expense of litigation. Three separate attorneys will have to educate themselves about the facts of the underlying litigation and two separate attorneys will have to educate themselves about additional facts regarding coverage. Many policyholders are unwilling to accept such a multiplication of legal costs.

B. Insurer

(1) Coverage opinion attorney?

The counsel who is to prepare a coverage opinion for an insurer should approach the coverage opinion objectively, not as an advocate. The coverage opinion attorney also should be available to explain the analysis behind the coverage opinion to the policyholder. If the analysis is compelling, the insured rarely pursues litigation. If the policyholder does pursue litigation, however, the attorney who wrote the coverage opinion may become a witness. Consequently, the insurer may

be required to retain separate litigation counsel. On the other hand, retaining the attorney who provided the coverage recommendation may be more cost effective. For example, that attorney already will be familiar with the factual background, policy wording, and coverage issues.

(2) Separate coverage litigation and coverage advisory counsel?

One approach for insurers is to retain one attorney to render a coverage opinion and a second attorney, if necessary, to litigate coverage. This avoids the potential attempt to disqualify the litigation attorney on the grounds that the attorney is a fact witness.

IV. Choice of forum

Either a policyholder or an insurer filing suit may have the choice of filing in either state or federal court, as well as choosing among multiple states, or multiple districts. The following are a list of questions that an attorney advising either a policyholder or an insurer about a coverage suit will want to determine before filing suit:

A. What are the possible forums?

(1) Federal courts - jurisdiction

Federal court is a possible forum in an insurance coverage lawsuit when there is complete diversity of the parties. To remain in federal court, the party filing suit should only name parties that are diverse. Conversely, to defeat diversity, a party may want to join entities or persons with Texas citizenship, such as an agent in Texas who misrepresented the terms of the policy.

One issue that arises occasionally in coverage disputes is how a court will determine the citizenship of a "Lloyd's plan" insurance association for purposes of diversity jurisdiction. The Court of Appeals for the Fifth Circuit has held that a court must consider the citizenship of each of the underwriter members that constitutes a Lloyd's group, but not the citizenship of the group's attorney in fact. *Royal Insurance Company of America v. Quinn Capital Corp.*, 3 F.3d 877, 833 (5th Cir. 1993), *cert. den.* 511 U.S. 1032 (1994).

Even with complete diversity, it may not always be possible to retain a coverage dispute in federal court. In *Wilton v. Seven Falls Co.*, 115 S.Ct. 2137 (1995), the United States Supreme Court reaffirmed the rule that a federal district court possesses discretion in determining whether and when to hear a declaratory judgment action. The Supreme Court specifically held in *Wilton* that a federal district court may stay or dismiss a declaratory judgment action regarding insurance coverage, even if the jurisdictional prerequisites are satisfied. 115 S.Ct. at 2143.

(2) State courts - venue

Depending on the facts of a case, an insurance coverage case may offer a number of different state court venues in which a party may sue. Under the general venue rule, when the defendant is an organization, the suit may be brought in:

(1) the county where all or a substantial part of the events giving rise to the claim occurred,

(2) the county of the defendant's principal office in Texas, or

(3) if neither of the other two provisions applies, in the county where the plaintiff resided at the time the action accrued.

TEX. CIV. PRAC. & REM. CODE § 15.001(a), 15.002(1), (3), (4) (Vernon Supp. 1998). In a coverage suit, determining where "all or a substantial part of the events giving rise to the claim occurred" may be open to substantial interpretation. For instance, if the issue is coverage in a third party insurance dispute, the cause of action is one for breach of contract. Does the breach occur: (1) where the denial of coverage is signed?; (2) where the policyholder receives the denial?; (3) where the policy was issued?; (4) where the underlying action is being litigated?; or (5) where the events giving rise to the underlying action took place?

A separate permissive venue provision further expands the venue options for a policyholder bringing suit against an insurer. The statute provides that a "life insurance company, or accident insurance company, or life and accident, or health and accident, or life, health and accident insurance company" may be sued on a policy in the county in which:

(1) the company's principal office in this state is located,

(2) the loss has occurred, or

(3) the policyholder or beneficiary instituting the suit resided at the time the cause of action accrued.

TEX. CIV. PRAC. & REM. CODE § 15.032 (Vernon Supp. 1998).

B. Which state's law will most likely be applied in each potential forum?

To determine which state's law will be applied, an attorney must ask two questions. First, what choice of law rule does the forum state apply? Second, which state's law is the most likely to be applied under the choice of law rule?

The Texas Insurance Code provides that any contract of insurance payable to any citizen of Texas by any insurance company doing business in Texas is to be construed under Texas law. TEX.

INS. CODE ANN. art. 21.55 (Vernon 1998). Of course, a non-Texas court may not be constrained to follow this rule if it follows its own choice of law analysis and determines that another state's law applies.

If article 21.55 does not apply, Texas courts will follow the most significant relationship test to determine the choice of law. Under the most significant relationship test, the rights and duties of the parties with respect to an issue in contract are determined by the state law which, with respect to that issue, has the most significant relationship to the transaction and the parties. *Maxus Exploration Co. v. Moran Bros., Inc.*, 817 S.W.2d 50, 53 (Tex. 1991). The factors to be considered in determining the state with the most significant relationship to the transaction include: (a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicil, residence, nationality, place of incorporation and place of business of the parties. *Id.*

C. Which forum's law is the most attractive in the case?

If the choice of forum could result in the application of the law of one of two or more states, the attorney will want to evaluate which state's law is the most attractive in light of the likely issues in the case. Even if only one state's law will apply, however, the attorney will still want to evaluate the different precedent that may apply in the forum. For instance, if a case may be brought in federal court in Dallas or in state court in Dallas, the attorney will want to evaluate not only the decisions of the state courts of appeals and the Texas Supreme Court, but also the Court of Appeals for the Fifth Circuit and federal district courts. Similarly, if a case may be brought in state court in Austin or Beaumont, the attorney will want to evaluate the relevant decisions of the courts of appeals in which any appeal is likely to be heard.

D. Which forum's pretrial practice is preferable?

When choosing a forum for coverage litigation, the party filing suit should consider what discovery is required and what limits are placed on discovery in a forum. For instance, some federal district courts require extensive initial disclosures pursuant to Federal Rule of Civil Procedure 26(a). Other district courts opt out of Rule 26(a) initial disclosure requirements. Federal Rules of Civil Procedure 30(a) also limits the number of depositions to ten per party without leave of court.

The Texas Rules of Civil Procedure currently contain neither an initial disclosure requirement nor a limit on the number of depositions. Thus, if given a choice between a federal district court or a Texas state court, a party should have a clear idea before filing suit how much discovery is desirable, and make the choice of forum in light of the discovery mechanisms that are required and those that are permitted in that forum.

E. How soon will the case be tried in a forum?

Another factor in the choice of forum is the likely length of time before the case is called to trial. A party with an interest in a rapid adjudication should seek out a forum with little case backlog

and a short pretrial scheduling calendar. A party who does not wish to be rushed to trial is more likely to prefer a forum with more backlog and longer delays between the filing of suit and trial.

V. Time constraints

A. Policyholder

The policyholder is faced with two time constraints in bringing its coverage action: (1) filing the lawsuit in a desirable venue before the insurer files a declaratory judgment action in a less desirable venue; and (2) filing before the statute of limitations expire. The Texas Supreme Court recently held that the statute of limitations in a coverage dispute begins running upon the denial of coverage by the insurer. *See Johnson & Higgins of Texas, Inc. v. Kenneco Energy*, 962 S.W.2d 507, 514 (Tex. 1998). What constitutes a denial of coverage is less clear, however. A policyholder should be sensitive to the fact that the insurer may argue any act that could be construed as a denial of coverage potentially could begin the running of the limitations period.

B. Insurer

An insurer has two primary pretrial time constraints. First, the insurer must respond to a notice of a claim within a specified statutory timetable. *See* TEX. INS. CODE ANN. art. 21.55 (Vernon Supp. 1998).

Second, as discussed in section II(B)(1) of this paper, *Gandy* may require that an insurer make a good faith effort to adjudicate coverage issues before adjudication of a plaintiff's claim in an underlying action as a prerequisite to avoiding an assignment of coverage claims from a defendant to a plaintiff. *State Farm Fire and Casualty Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996). Thus, under *Gandy*, insurers may feel compelled to litigate coverage issues before the underlying claims are resolved.

On the other hand, filing a declaratory action regarding coverage while the underlying action is pending may create problems because the plaintiff in the underlying action may amend its petition and causes of action after the coverage declaratory action has been resolved. In such a circumstance, the declaratory judgment regarding coverage may have little or no effect. Although *Gandy* places pressure to litigate coverage issues early on insurers who fear an agreed judgment and a subsequent assignment to a judgment creditor, insurers should carefully consider whether the declaratory judgment will be effective if the grounds for the underlying lawsuit are amended.

VI. Standstill Agreements

After going through the exercise of applying the often complex considerations raised in this paper to the facts of a particular case, a party may wish to follow another route than a race to the courthouse. One such alternative route is a standstill agreement. Under a standstill agreement, the

parties may agree to not file suit against each other and to toll the statute of limitations until (1) a specified date, (2) the resolution of the underlying action from which the coverage dispute arises, or (3) the completion of alternative dispute resolution.

A standstill agreement may be advantageous to all parties for a number of reasons. First, it may help preserve the business relationship between the insurer and the policyholder. Second, it may prevent costly litigation that is unnecessary if the defense of the underlying action is successful or if the insurer and policyholder can resolve their dispute through alternative dispute resolution. Third, it provides all parties with additional time to analyze their procedural options and substantive positions when they might otherwise be engaged in a race to the courthouse.