INSURANCE ISSUES

FROM THE TRIAL LAWYER'S PERSPECTIVE:

A PRACTICAL GUIDE FOR THE NON-INSURANCE PRACTITIONER

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"Fundamentals of Marine Insurance," (co-author), Admiralty & Maritime Conference, University of Texas, 2000;

"Additional Insured and Indemnification Issues in the Oil Patch and Offshore," Insurance Law Institute, University of Texas, 2001;

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“Duty to Defend: The Eight Corners Rule,” (author), Advanced Insurance Seminar, University of Houston Law Foundation, 2003;

“Insurance for Trial Attorneys,” (author, work in progress), Advanced Civil Trial Practice, State Bar of Texas, 2003;

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I. INTRODUCTION

This short paper and presentation cannot possibly do justice to the myriad of intricate problems that arise out of the simple circumstance that parties involved in litigation - - or some of them - - may have insurance available to defend or pay damages in the suit.

Entire papers regularly examine, with excruciating thoroughness, such delicate matters as when the insurer's duty to defend is triggered; when the insurer is required to settle a case or suffer potential consequences for a verdict beyond policy limits; what role the defense lawyer plays in the insured-attorney-policyholder triad; whether the terms of the policy actually provide coverage for the matters and types of damages alleged or proven in the particular suit; and which policy applies among potentially applicable policy years and primary-excess layers. Many such papers are presented in a continuing conversation and adversarial debate among trial lawyer involved in litigating substantive questions of insurance coverage; other papers speak principally to the defense lawyer representing a policyholder but having a relationship with and being paid by an insurer who has varying degrees of control over the handling and settlement of the suit. No doubt those perspectives are necessary and helpful, and it is not surprising that the legal problems they grapple with oftentimes are difficult and complex.

In contrast to those approaches, though, this paper attempts to provide a practical guide to important insurance issues that the non-coverage trial lawyer - - whether on the defense or plaintiff's side - - is likely to encounter in suits that are not primarily about insurance coverage as such.

Necessarily, then, we leave to another day and forum the more abstruse and detailed discussion of the fine points involved in each of these insurance questions. Simply put, however, the trial lawyer who understands the unique problems and issues concerning insurance is often in a better position to recognize and take opportunities to advance the interests of his client.

II. NOTICE

The very first Rule for any trial lawyer, and especially any defense lawyer, should be: *Always (always!) be sure to provide notice of the suit to any and all potentially applicable insurers.*

Failure to provide timely notice may be considered a breach of a condition precedent to coverage under applicable insurance, and may absolve the insurer from providing coverage otherwise available under the policy. *See e.g. Lowe v. Employers Casualty Co.*, 479 S.W.2d 383, 388 (Tex. Civ. App.--Fort Worth 1972, no writ). The prompt notice requirement is said to be included in a policy for the benefit of the insurer to allow prompt investigation into the circumstances of an incident while the matter is still fresh, to prevent fraud, and to allow an accurate assessment by the insurer of its liabilities and rights under a policy. *Weaver v. Hartford Accident & Indem. Co.*, 570 S.W.2d 367, 369 (Tex. 1978).

There is additional good reason for a policyholder to be diligent in providing prompt notice: an insurer's duty to defend is not triggered until insurers are provided with notice of the suit against each party by receipt of the forwarded suit papers. *Weaver v. Hartford Accident and Indem. Co.*, 570 S.W.2d 367, 369 (Tex. 1978); *Harwell v. State Farm Mut. Auto. Ins. Co.*, 896 S.W.2d 170 (Tex. 1995); *Members Ins. Co. v. Branscum,* 803 S.W.2d 462, 466 (Tex. App.--Dallas 1991, no writ). Hence, insurers may refuse responsibility for defense costs incurred by an insured prior to the insured providing notice. *Nagel v. Kentucky Central Ins. Co.,* 894 S.W.2d 19 (Tex. App.--Austin 1994).

Plaintiff's counsel, too, may have good reason to implement notice to the defendant's insurer. Where a defendant-insured fails to provide timely notice, the insurer's actual notice of suit may prevent it from showing prejudice necessary for avoiding coverage obligations. It is not sufficient that the insurer be aware that suit might be filed, as the insurer has no obligation to monitor the courthouse to determine whether and when suit is actually filed. *See Harwell v. State Farm Mut. Auto. Ins. Co.*, 896 S.W.2d at 174.

On the other hand, where the plaintiff provided the insurer with a courtesy copy of the filed suit and the agent in fact periodically reviewed the court's file wherein resided a return of service, then the insurer's actual knowledge was sufficient to constitute notice and preclude the prejudice required to avoid coverage. *Ohio Cas. Group v. Risinger*, 960 S.W.2d 708 (Tex. App. - Tyler 1997, no writ). Similarly, where the plaintiff's attorney had contacted the defendant's auto liability insurer before all significant action in the case - - before filing suit; before effecting substituted service; before hearing on the default motion; and before the damages hearing and entry of the final default judgment - - the insurer failed to show they were prejudiced by the insured's own failure to notify, in light of the uncontroverted evidence of the insurer's actual notice. *Struna v. Concord Ins. Services*, 11 S.W.3d 355, 360 (Tex. App. - Houston [1st Dist.] 2000, no pet. hist.)

A. Potential Malpractice for Failing to Notify Insurer on Client-Defendant's Behalf

Although the authors have not located and are unaware of any Texas cases specifically upholding a malpractice suit against a defense attorney who fails to put insurers on notice of a claim against the client-defendant, other jurisdictions have allowed clients to proceed against the defense lawyer in such circumstances. *See e.g. Jordache Enterprises, Inc. v. Brobeck, Phleger & Harrison*, 18 Cal.4th 739, 958 P.2d 1062, 1072, 76 Cal.Rptr.2d 749, 759 (Cal, 1998) (client sustained actual injury as result of law firm's failure to investigate whether client's insurance might cover pending action against client, or notify or advise client to notify insurers of action); *Darby & Darby, P.C. v. VSI Int'l, Inc.*, 178 Misc.2d 113, 678 N.Y.S.2d 482 (N.Y. Sup., 1998); *see generally* Edward Susolik & Reed N. Archambault, *The Tender Trap*, 42-JUN Orange County Law. 28, 28 (2000).

As noted below, recent years have seen a proliferation of policy forms and new types of coverages. It may be difficult for the trial lawyer unfamiliar with the variety of possible insurance policies to ensure that all appropriate recourse has been taken to notify potentially applicable insurers. It is important that the trial lawyer make diligent inquiry with the client to ascertain whether notice has been given to all insurers who might cover the loss, and perhaps seek specialized guidance from insurance coverage counsel where the insurance seems questionable.

B. Representative Types of Third-Party Liability Insurance Policies

Unless they are engaged in coverage litigation between the insurer and policyholder, most trial lawyers typically will be involved with some form of third-party insurance, so-called because it protects the policyholder insured from claims against it by third-parties. Third-party liability insurance is thus distinguished from first-party insurance in which the policyholder insures its own property and seeks recompense in the event of a loss directly against the insurer.

Some common and well-known policy forms, such as Auto insurance and Homeowners insurance, combine aspects of first-party property and third-party liability insurance into different parts of a single form.

1. Primary Liability Policy

Primary liability insurance is the first layer of insurance protecting the policyholder against third-party claims. The primary insurer owes a duty to pay damages in settlement or judgment, up to the amount of the policy limit. Most notably, the primary insurer typically also has a duty to defend the policyholder, and ordinarily (but not always) the expenses for defense do not defray the policy limits but constitute a separate and unlimited obligation of the primary insurer until the policy limits are exhausted through payment of settlements or judgments.

2. Excess & Umbrella Liability Policies / Layers

Excess liability insurance comprises an additional layer or layers of indemnity insurance. Typically, the excess insurer has no duty to defend the policyholder, unless and until the primary insurer has exhausted its underlying policy limit (and sometimes not even then). *See Keck, Mahin & Cate v. Nat. Union Fire Ins. Co.*, 20 S.W.3d 692, 700 (Tex. 2000) for a more thorough discussion of the relationship between primary and excess insurers, and the role and responsibilities of each.

Excess insurance can be "following form," which means its adopts the terms and conditions of the primary policy in all respects except the limits, or the excess insurance may be issued under a separate form with terms and conditions different than the underlying primary policy. Some excess insurance includes an undertaking to "drop down" in and act as primary insurance, in the event the policyholder is sued for damages that are covered in the excess policy but not in the underlying primary policy.

Umbrella insurance is a type of excess policy,

typically offering one of the higher layers of coverage over intervening excess layers and/or providing excess insurance over and above a variety of underlying liability policies and risks, such as auto, CGL, and specialty standalone insurances. Umbrella insurance may "follow form" to the underlying insurances and otherwise may be virtually indistinguishable from excess policies, but more often an umbrella policy consists of substantive provisions that may include provisions for coverage different from the underlying insurances.

3. Standalone & Special Endorsement Coverages, and Business & Professional Coverages

In early forms the comprehensive general liability (also known as the or commercial general liability policy, or CGL) was intended to collapse a broad variety of liability risks into a single coverage. CGL coverage typically insures a policyholder's liability for damages to a third party due to bodily injury, property damage, advertising injury, and personal injury (intentional personal conduct type claims, such as defamation or false imprisonment, for example). Some unusual coverages are still available under the advertising / personal injury portion of the standard CGL policy (known as Coverage B); standalone policies have also been issued for some of these risks. *See e.g.* Robert M. (Randy) Roach, Jr. & Daniel L. McKay, *technology Risks and Liabilities: Are You Covered?*, 54 SMU L. Rev. 2009
(Symposium on Insurance and Technology, Fall 2001).

In recent years, insurers have been retreating from that approach and offering "standalone" policies that protect against specific risks now excluded (or which the insurer's have tried to exclude) from the CGL form. These may include Product liabilities and Pollution risks, Employment Practices liability, Sexual Misconduct, and a host of other types of specific risks. A variety of standalone policies also exist to insure professional and business risks, such as Professional liabilities, Directors & Officers insurance, Fiduciary insurance (ERISA liabilities), and others. Specific industries also may have common forms of specialized insurance, such as Garage liability for auto repair facilities, or Operators Extra Expense (blowout and pollution coverage) for oil and gas contractors.[1]

This variety of forms with their differing procedural and substantive provisions can be bewildering. Although a great many policyholders have relatively simple insurance arrangements, and most case may involve only standard forms of CGL insurance and possibly excess layers of the same, nonetheless it is crucial to inventory and consider whether coverage may be available under the full gamut of policies. Each may have its own particular requirements for notice, or for other critical features such as control of defense, settlement, or contribution with other potentially applicable insurance. It is important for the trial lawyer to appreciate how all these specific terms may affect the course of the litigation and the protection afforded to his client, the policyholder.

4. Reinsurance Cut-through

Reinsurance is an arrangement in which an insurance company, the "reinsurer" (or the "assuming company"), agrees to indemnify another insurance company, the "reinsured" (or the "ceding company"), against all or a portion of the insurance risks underwritten by the ceding company under one or more insurance contracts. In the absence of a cut-through, the policyholder has no contractual relationship with the reinsurer and generally is unable to obtain relief from the reinsurer if there is a problem with the insurer's performance under the policy. Cut-through provisions are generally recognized and enforced by courts without great controversy, although there are only a handful of reported cases.

Typically, a cut-through allows the insured to assert a claim directly against a reinsurer of the policy, rather than against the immediate insurer alone. Subject to particular wording variations, the cut-through essentially obliges the reinsurer to act in place of the insurer and to assume the same contractual relationship as that existing between the insured-insurer.

As a practical matter, it is generally quite difficult to obtain discovery pertaining to reinsurance in the normal course of litigation. If the trial lawyer suspects a potential problem with the solvency of the direct insurer, however, or if it appears that the insurer may be taking direction from the reinsurer in handling the claim, then it may be worthwhile to attempt to determine the

[1] For a good overview of a variety of insurance policies and aspects of providing notice to the insurer, *see* Janis H. Detloff, *Insurance Issues: What the Business Lawyer Needs to Know*, Corporate, Partnership and Business Law seminar, University of Houston Law Foundation (June 2003).

terms of any reinsurance agreement. If the reinsurance includes a cut-through, then the policyholder may be entitled to deal directly with the reinsurer, and it is the reinsurer who may be ultimately liable to a successful plaintiff to pay damages obtained in judgment or settlement. Notice is rarely an issue with respect to reinsurance, and proper notice to the direct insured should also suffice to provide notice to a reinsurer under a cut-through.

C. Notice under Occurrence-Based Liability Policies

Most third-party liability policies require timely notice of an occurrence out of which a covered claim may arise, and require separate and additional notice when suit is filed. Where the policy requires notice "promptly" or "as soon as practicable", these terms have been construed to require notice "within a reasonable time." *See e.g. Broussard v. Lumberman's Cas. Co.*, 582 S.W.2d 261, 263 (Tex. App.--Beaumont 1979, no writ); *Chicago Ins. Co. v. Western World Ins. Co.*, 1998 WL 51363 (N.D. Tex. 1998) *citing State Farm County Mut. v. Plunk*, 491 S.W.2d 728, 731 (Tex. Civ. App.--Dallas 1973, no writ). Although the question of whether notice is reasonable is usually a question of fact, it may become a question of law when the underlying facts are undisputed. *Broussard v. Lumbermens Mut. Cas. Co.*, 582 S.W.2d at 262.

1. Prejudice to Insurer Required to Avoid Coverage for Late Notice

If the insurer is prejudiced by the insured's failure to comply with such a provision, then the insurer has no obligation under the policy. *See Liberty Mut. Ins. Co. v. Cruz*, 883 S.W.2d 164, 165 (Tex.1993) (insured's failure to notify insurer of suit does not relieve insurer from liability for underlying judgment unless the lack of notice prejudices insurer); *see also Duzich v. Marine Office of America Corp*., 980 S.W.2d 857 (Tex.App.-Corpus Christi 1998, pet. denied)*; Ohio Cas. Group v. Risinger*, 960 S.W.2d 708, 710 (Tex. App. - Tyler 1997, writ denied). Whether an insurer is prejudiced by an untimely notice is generally a question of fact. *See P.G. Bell Co. v. U.S. Fidelity and Guar. Co.*, 853 S.W.2d 187, 192 (Tex.App.--Corpus Christi 1993, no writ).

Many common varieties of liability policies issued in Texas must be endorsed to require a showing of prejudice before late notice may be used by an insurer to avoid its coverage under the policy. *See Chiles v. Chubb Lloyds Ins. Co.*, 858 S.W.2d 633, 635 (Tex.App.--Houston [1st Dist.] 1993, writ denied); STATE BD. OF INS., REVISION OF TEXAS STANDARD PROVISION FOR GENERAL LIABILITY POLICIES -- Amendatory Endorsement--Notice, Order No. 23080 (March 13, 1973).

The Fifth Circuit adopted this "prejudice" rule for surplus lines insurance not governed by the Amendatory Endorsement. *Hanson Production Co. v. Americas Ins. Co.*, 108 F.3d 627 (5th Cir. 1997); *see also Bay Electric Supply, Inc. v. Travelers Lloyds Ins. Co.*, 61 F.Supp. 611, 620 (S.D. Tex. 1999). Despite cogent reasoning based on avoiding a contract obligation only for material (i.e., prejudicial) breach by the other party, *Hanson* has since been limited to personal injury and property damage insurance, only, and an insurer may be allowed to avoid coverage without a showing of prejudice in a case involving coverage within an alternate section of the general liability policy such as for an advertising injury. *Gemmy Indus. Corp. v. Alliance Gen. Ins. Co*., 190 F.Supp.2d 915, 920 (N.D. Tex. 1998) aff'd 200 F.3d 816 (5th Cir. 1999).

D. Notice under Claims-Made Liability Policies

The preceding discussion contemplates the requirements for notice in a policy which provides insurance on an "occurrence" basis, which is standard for most CGL policies. Notice under a "claims-made" policy almost invariably is much more rigorous, and the policyholder's failure to provide appropriate notice can defeat coverage altogether, regardless of whether the insurer has thereby been prejudiced. If the policyholder (or his lawyer) fails to provide notice within the strict requirements of the claims-made policy, the tardiness or other defect may well be fatal to obtaining coverage under the policy.

1. Critical Distinctions Between Occurrence and Claims-Made Policies

Courts generally note that the major distinction between "occurrence" policies and "claims-made" policies is the difference between the risk insured. In the "occurrence" policy, the peril insured is the "occurrence" itself. Once the "occurrence" takes place, coverage attaches even though the claim may not be made for some time thereafter. In the "claims-made" policy, it is the making of the claim which is the event and peril being insured and, subject to the policy language, regardless of when the occurrence took place. *Hirsch v. Texas Lawyers' Ins. Exchange,* 808 S.W.2d 561, 563

(Tex. App.--El Paso 1991, writ denied). Generally, the nature of a claims-made policy is that the policy will provide insurance for covered damages no matter when they occur, as long as the claim is first made during the policy period (or an extended reporting period).

2. Types of Policies & Coverages Often Issued on Claims-Made Basis

Many standard types of insurance are issued virtually exclusively on a claims-made form. These include policies covering Errors & Omissions (E&O, or Professional Liability insurance); Directors & Officers (D&)), Fiduciary Liability. Increasingly, various standalone forms derived from standard general liability policies are issued on a claims-made basis, such as Employment Practices Liability insurance, Pollution insurance or Sexual Misconduct coverage. Moreover, special endorsements attached to otherwise occurrence-based general liability policies also may be issued on a form of claims-made coverage, such as for Pollution risks or for Product Liability / Completed Operations Coverage.

3. Some Unique Features of Claims-Made Policies

Some claims-made policies include their own definition of "claim;" where none is provided, a a "claim" for the purposes of a claims-made policy is usually considered to be a "demand for money or property." *Edinburgh Consolidated ISD v. INA*, 806 S.W.2d 910, 913 (Tex. App.--Corpus Christi 1991, no writ). Sometimes claims-made policies may also include options to provide the insurer with a so-called "Notice of Circumstance" or "Loss Notification Option" which can augment and broaden the scope of claims covered under the policy beyond those actually made during the policy period. These provisions can themselves become a battleground if information about a potential claim was transmitted to a prior insurer before a formal claim was made and tendered. Some claims-made policies require not only that a claim be made within the policy period, but that the claim also be notified to the insures before expiration of the policy. In the parlance of some of the cases, this sort of policy is said to provide coverage on a "claims-made and reported" basis, not merely "claims-made".

4. Failure to Properly Notify Claims-Made Insurer Defeats Coverage Without Prejudice Requirement

Texas state courts and federal courts applying Texas law virtually universally require strict interpretation of notice requirements in a claims- made policy without a showing of prejudice. *See Hirsch v. Texas Lawyers' Ins. Exchange,* 808 S.W.2d at 565 (to require a showing of prejudice for late notice would defeat the purpose of "claims-made" policies, and, in effect, change such a policy into an "occurrence" policy); *see also Yancey v. Floyd West & Co. , 755* S.W.2d 914 (Tex. App.--Fort Worth 1988, writ denied) (reviewing the historical development of occurrence and claims-made policies and their respective benefits and shortcomings, and refusing coverage for claim first made prior to retroactive date); *Komatsu v. United States Fire Ins. Co.*, 806 S.W.2d 603 (Tex. App.--Fort Worth 1991, writ denied) (claims-made provision requiring claim AND notice within policy period upheld and coverage denied, where notice was provided 5 days after policy expired, reasoning that extension of the notice period in a claims-made policy constitutes an unbargained for expansion of coverage).

Moreover, some policies require that notice be given of any "claim" whether or not the claim is asserted in a formal suit. In the absence of a policy definition, a "claim" for the purposes of a claims-made policy may be considered the equivalent of a "demand for money or property." *Edinburgh Consolidated ISD v. INA*, 806 S.W.2d 910, 913 (Tex. App.--Corpus Christi 1991, no writ) ("a demand for something rightfully or allegedly due; assertion of one's right to something . . . " is a claim for purposes of a claims-made policy). Thus, failure to timely report even a non-litigation "claim" may be used by the insurer to defeat coverage.

Obviously, this means that timely and proper notice under a claims-made policy is crucial to obtaining coverage, and the trial lawyer should act promptly to ensure that any claims-made insurer receives appropriate notice within the terms of the policy.

5. Examples of Claims-Made Pitfalls

As if the standard provisions for providing notice under a claims-made policy were not onerous enough, some relatively recent cases demonstrate just how deep and dangerous the pitfalls may be if the policyholder or his lawyer misstep accidentally. In *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Willis*, 296 F.3d 336 (5th Cir. 2002), a policyholder was sued under three successive amended pleadings alleging various forms of fraud, contractual interference, contract and equitable claims in a stock transaction. The policyholder did not give its insurer notice of the suit, because he believed the policy did not provide coverage for the intentional torts alleged

in the because of a policy exclusion for claims "arising out of, based upon, or attributable to the committing in fact of any criminal or deliberate fraudulent act." The plaintiffs filed their fourth amended petition adding a claim for negligent misrepresentation, based on the same alleged misrepresentations underlying the fraud, fraudulent inducement, and statutory fraud claims. The policyholder promptly gave notice of the fourth amended pleading to its claims-made insurer, which denied the claim arguing that notice should have been provided upon the first pleading because it alleged facts sufficiently close to coverage as to trigger the notice requirement under the particular policy wording. Glossing over the question whether the first three petitions had alleged facts sufficient to come within the potential coverage of the policy due to the cited exclusion, the court relied heavily upon the nature of the claims-made policy and interpreted the notice wording strictly against the policyholder.

This case provides a stern lesson that notice must be provided to each and any insurance provider, especially if issued on a claims-made form, even if the policyholder has good reason to believe (and may even be correct in believing) that the policy does not provide coverage for the claims actually being asserted in the particular pleading presented in the litigation.

Similarly, the cases of *Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 658-60 (5th Cir. 1999); *Certain Underwriters at Lloyd's London v. C.A. Turner Constr. Co.*, 941 F. Supp. 623, 629 (S. D. Tex. 1996) aff'd, 112 F.3d 184 (5th Cir. 1997); and *Clarendon America Ins. Co. v. Bay, Inc*., 10 F. Supp. 736, 746 (S. D. Tex. 1998) provide a lesson in being alert to the varying features of particular coverages within a liability policy. All involve claims-made type pollution coverages attached as endorsements to policies otherwise providing coverage on an occurrence basis. In each case, the court held that the insurer could avoid coverage for otherwise covered pollution damages, without any showing that it had been prejudiced by the delay (in one case, a delay of only 8 days), because the policyholder failed to meet the strict timetable established in the claims-made endorsement.

Again, these cases provide a cautionary tale of the importance of checking all provisions and endorsements in applicable policies, so as to ensure that improper notice does not provide an occasion for the insurer to deny coverage that otherwise would be available to protect the policyholder against the claim or suit.

E. Notice to Excess Insurers

Policyholders should take note of the standard rationale given in support of the timely notice requirement, that prompt notification enables the insurer to take appropriate action to adjust the claim or to control the litigation and interpose a defense of the case, as is the insurer's right and duty under certain standard commercial liability policies. Where the policy does not include an independent right and duty of the insurer to adjust the claim or to defend the suit (as with most excess policies and certain other indemnity-only primary insurance),then in that case the insurer may not have been prejudiced by tardy or improper notice, and this usual basis for demonstrating harm may be absent.

Since excess insurers typically do not include a duty to defend, they do not ordinarily rely on timely notice to conduct an investigation and defend the insured in the ongoing suit. Thus, greater latitude is often given in evaluating whether late notice really affects the interests of occurrence-based excess insurers. *See, Duzich v. Marine Office of America Corp*., 980 S.W.2d 857 (Tex.App.-Corpus Christi 1998, pet. denied); *Harbor Ins. Co. v. Trammel Crow Co.*, 854 F.2d 94 (5th Cir. 1998).

However, some forms of excess insurance include provisions requiring notice when a claim is alleged in a specific amount or proportion of the excess limit, and it would be wise to heed those provisions to ensure timely notification.

F. Notice by and Advantages of Additional Assured

Is your client entitled to the benefits of another party's insurance, as an additional insured under the contracts applicable to the litigation? It is important to check for additional insured prospects as early as possible. To be on the safe side, a policyholder who is an additional assured under another's policy should affirmatively provide independent notice of any claim, occurrence, or suit, and should not rely upon the named insured to perform that function on the additional assured's behalf.

Notice of an accident or incident by the named insured inures to the benefit of any additional or omnibus insured as a matter of law if it is timely and sufficient to place insurers on notice as to the extent of possible liability and omnibus coverage under the policy. *Employers Cas. Co. v. Glens Falls Ins. Co.*, 484 S.W.2d 570 (Tex. 1972). Where neither the named insured nor the purported additional assured tender timely notice of the occurrence to underwriters in accordance with the

policy, coverage for both may be compromised.

When it comes to providing notice of an actual suit (as contrasted with notice of an accident or incident potentially within coverage), it is incumbent upon an additional insured to independently forward to the insurers a copy of any summons and pleading for which the additional insured seeks defense in coverage, regardless whether the direct insured has provided such notice. *Weaver v. Hartford Accident Indem. Co.*, 570 S.W.2d 367, 369 (Tex. 1978).

It is easy to appreciate, then, the importance of and rationale behind reviewing all relevant contracts and potentially applicable insurance policies from the outset, to determine if your client may be entitled to additional insured status and, if so, what coverage rights and affirmative obligations the additional insured may be entitled to or burdened with under the policy.

G. Notice to First-Party Policies

Although there is a dearth of reported cases discussing notice for first party insurance, those policies often contain similar notice provisions and timely notice should also be given to those insurers in order to preserve coverage. Barry R. Ostranger & Thomas R. Newman, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 4.02(B)(6) (9th ed.)

H. Practical Pointers for Providing Proper Notice

Impress upon the client the importance of inventorying and compiling full policy wording on all insurance that conceivably might be relevant to the claim or suit. Oftentimes the policyholder's broker may be the best resource for historic policies from prior years, if the suit may involve damages that were incurred some time ago or accrued over a period of time. Be sure to include the full policy wording together with all endorsements, declarations, and other ancillary parts of the policies, in order to ensure that the information on coverages and other aspects of the policies has not been amended and otherwise is up to date.

Check the client's policy(ies) for the particulars of notice that may be required, as this may differ somewhat among the various policies. In particular, the specific addressee to whom notice should be directed (oftentimes the broker) is usually included in the Declarations or the Cover Note accompanying the issued policy. Primary layer insurers, in particular, may require notice more strictly, and excess layer insurers may have provisions requiring notice when the claim alleged by plaintiff reaches a certain amount or proportion of excess policy limits.

Be as liberal as possible in providing notice to potentially applicable insurers. It may be difficult to later contend you were ignorant of the available coverage or that you did not initially believe your available insurance might cover this claim. This may be considered an insufficient excuse for failing to meet the conditions of a policy for providing timely notice. *See Norman v. St. Paul Fire & Marine Ins. Co.*, 431 S.W.2d at 396 (and cases cited therein); *Sandefer Oil & Gas, Inc. v. AIG Oil Rig of Tex., Inc*., 846 F.2d 319 (5th Cir. 1988) (holding as a matter of law that insured's ignorance of potential coverage under the policy was not good cause for delay in providing notice).

In the absence of truly extenuating circumstances, under Texas law an insured usually is deemed to know the contents of the insurance contract he makes. *Shindler v. Mid-Continent Life Ins. Co.*, 768 S.W.2d 331, 334 (Tex. App.--Houston [14th Dist.] 1989, no writ). Be particularly careful and rigorous about providing notice to any insurer involved in any form of claims-made coverage.

III. Duty to Defend

Most primary layer third-party liability policies include a provision that imposes a duty on the part of the insurer to defend claims and suits within coverage brought against the policyholder. This duty typically is separate and apart from the duty to indemnify, and is not subject to the policy limits (although some policies, particularly some forms of stand-alone and claims-made policies, provide that the defense costs are part of and "erode" the policy limit).

Texas courts follow the "complaint-allegation" or so-called "eight corners" rule in determining the scope of a duty to defend in a third-party liability policy. *American Alliance Ins. Co. v. Frito-Lay, Inc.*, 788 S.W.2d 152, 153 (Tex.App.--Dallas 1990, writ dism'd w.o.j.).

Under this rule, the insurer must determine if it owes a duty to defend based solely on an examination of the factual allegations in the complaint and the provisions of the insurance policy. *Feed Store, Inc. v. Reliance Ins. Co.*, 774 S.W.2d 73, 74 (Tex.App.--Houston [14th Dist.] 1989, writ denied); *Dorchester Development Corp. v. Safeco Ins. Co.*, 737 S.W.2d 380, 382 (Tex.App.--Dallas 1987, no writ). If at least one or more of the plaintiff's claims, if taken as true, allege a factual circumstance within the terms of the policy, then the insurer must defend the insured against the entire

suit. *Maryland Casualty Co. v. Moritz*, 138 S.W.2d 1095, 1097-98 (Tex. Civ. App.--Austin 1940, writ ref'd); *see Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 119 (5th Cir. 1983). Only the most recent pleading is determinative of the duty to defend, so a claim that initially was not within coverage may become so, and vice versa, when the pleading is amended. *Id.*

When the alleged cause of action is neither clearly outside nor clearly within coverage, "the insurer is obligated to defend if there is, potentially, a cause under the complaint within the coverage of the policy." *Heyden Newport Chemical Corp. v. Southern General Insurance Co.,* 387 S.W.2d 22, 26 (Tex.1965). If there is doubt as to whether the complaint states a covered cause of action, such doubt "will be resolved in insured's favor." *Id.*

Where the pleading simply does not provide sufficient facts to determine the duty to defend, then a court may explore extrinsic facts so long as those facts speak only to the issue of coverage, and do not affect or illuminate the policyholder's potential liability to the claimant. This is a very convoluted area of insurance law, worthy of its own detailed treatment. *See e.g.* Robert M. (Randy) Roach, *Insurer's Duty to Defend in Texas: The Eight Corners Rule*, Advanced Insurance Law, University of Houston Law Foundation (February 2003). Perhaps one of the more cogent explanations and application of the extrinsic evidence rule in determining the duty to defend is found in the recent case of *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466 (5th Cir. 2001).

By contrast to the duty to defend, the duty to indemnify - - that is, the duty of the insurer to pay settlements or judgments, - - is triggered by the actual facts establishing liability in the underlying suit. *State Farm Fir and Cas. Co. v. Brooks*, 43 F. Supp. 695 (E.D. Tex. 1998). Because the duty to defend is based only on the "potential" for coverage based on the pleading, while the duty to indemnify is based on actual facts developed in the case, the duty to defend is sometimes said to be "broader" than the duty to indemnify. In reality, if the facts proved at trial demonstrate coverage even though the allegations of the pleading did not assert a potentially covered claim, then the duty to indemnify demonstrably would be the "broader" duty insofar as the insurer would have to pay the judgment even though it did not have to pay for the defense.

A. Plaintiff's Pleading Controls Duty to Defend

Within certain limits, the Plaintiff determines whether or not a Defendant is entitled to insurance coverage for the claim asserted. Since the duty to defend is based upon the facts alleged in the pleading, and Plaintiff is the master of his own pleadings, what the Plaintiff chooses to state or not state often may determine whether or not the duty to defend is triggered. So, for example, in *Reser v. State Farm Fire & Cas. Co.*, 981 S.W.2d 260, 266 (Tex. App.-San Antonio 1998, no pet.) the Insurer withdrew defense after the plaintiff initially alleged a covered claim for defamation, but then deleted that claim in an amended pleading. The court sustained the Insurer's right to withdraw the defense on the basis that:

> [T]he critical issue is what claims were actually asserted against [the Policyholder]. . . [The plaintiff] had the burden of asserting its claim, and ultimately, in its amended counterclaim, [plaintiff] asserted neither facts nor legal theories stating a defamation claim. In the absence of a stated claim against its insured, [the Insurer] was not obligated to defend its insured.

Thus, the court held in *Reser* that the Insurer had no duty to defend, even though both the Insurer and the Policyholder knew of facts that would potentially support a covered claim of defamation as described in the prior pleading. Rather, the coverage determination was made strictly on the basis of the Plaintiff's most recent pleading which no longer alleged a covered cause of action nor any facts that would potentially support the covered claim.

Plaintiff's ability to control the duty to defend ultimately depends on the necessary facts, and Plaintiff cannot necessarily turn a non-covered claim into a covered one by artful pleading. Thus, where the pleading alleged facts that Plaintiff was injured by gunfire "negligently" " fired into a crowd by Defendant from a passing vehicle, Plaintiff's characterization of the facts did not bind the court, and coverage was denied because the facts alleged necessarily involved intentionally caused damages and was not an accident or "occurrence" under the policy. *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 83 (Tex. 1997). The same result is often encountered in sexual misconduct and assault / battery cases, where the court's deny coverage based upon facts that necessarily cannot be covered, despite Plaintiff's attempts to characterize the alleged conduct as negligence rather than intentional.

Nonetheless, Plaintiff has broad latitude to add or subtract facts upon which the Defendant's insurer's duty to defend relies, and thereby can significantly influence whether the insurer is involved in handling the case or not. Most often, perhaps, it is to the Plaintiff's benefit to craft the pleading so that the insurer's duty to defend is implicated, so as to reach the insurer's "deep pocket" for purposes of negotiation and settlement. On more rare occasions, Plaintiff may want to intentionally plead out of coverage in order to preclude insurance and put greater pressure to settle upon a potentially uninsured - - but presumably large and solvent - - Defendant. It is important, then, for the Plaintiff to determine the extent and status of insurance coverage as closely as possible. This means the Plaintiff should insist upon obtaining the full insurance policy at the outset of discovery disclosures, and must read and understand the coverage in order to avoid pleading out of (or into) coverage inadvertently.

A more difficult situation is presented to the Defendant's trial lawyer where the pleading alleges facts upon which the insurer has denied or reserved rights, but the pleading could be amended to eliminate the insurer's coverage defense. Does the policyholder's duty to cooperate with its insurer preclude the defense attorney from drawing this circumstance to Plaintiff's attention and even advising Plaintiff on the sorts of allegations that would bring the claim within coverage so that the insurance proceeds may be reached? No Texas case provides guidance, but the insurer certainly would not be pleased - - and might attempt to defeat coverage - - if it believed the defense lawyer was colluding with the Plaintiff in order to obtain coverage. Short of such "collusion" the defense lawyer still has options for informing a perspicacious Plaintiff of the problems the pleading has caused for insurance coverage, so that an amended pleading can be filed to resolve the coverage difficulties. One simple method is for the defense attorney to overcome the knee-jerk instinct to withhold reservation letters and the like from discovery. Arguably, any reservations and all such correspondence delineating the potential problems with insurance coverage are just as relevant and necessary for Plaintiff to receive as is the plain insurance policy. After all, the purpose of requiring production of the insurance policy is to inform the Plaintiff of the amount available to pay the judgment; the same purpose is served by likewise producing supplementary correspondence such as a reservation letter, that identifies potential limitations on the insurance available to pay an eventual settlement or judgment. It seems unlikely an insurer would prevail in characterizing such a discovery exchange as a failure to cooperate, nor prevent a policyholder from sharing such coverage information in discovery. Another route for properly telegraphing coverage problems to the Plaintiff is during mediation, where the mediator may be utilized to carry specific information about the limitations on or reservations to coverage caused by the way Plaintiff has pleaded the case.

It should go without saying that trial lawyers on both sides should be acutely aware of the effect that certain evidence may have upon insurance coverage for the ultimate judgment or settlement, as well as the duty to defend. Unless trial counsel for both sides appreciate potential coverage defenses, they may blithely take an approach to the defense or prosecution of a case which ultimately tenders evidence and proves facts that are inimical to the insurance coverage, leaving the policyholder without insurance protection and the Plaintiff without a "deep pocket" to pay the judgment. In particular, defense lawyers who neglect (or even affirmatively refuse!) to familiarize themselves with coverage reservations may accidentally prejudice their Defendant's insurance coverage through a defense strategy or piece of evidence, without appreciating this untoward effect on their Defendant.

B. Insurer Accepts, Denies, or Reserves Rights to Dispute Coverage for Duty to Defend

Once notice has been provided to the insurer under a liability policy, the insurer may respond by either accepting defense fully, by denying coverage altogether, or by accepting defense while reserving rights to deny coverage later if certain of the allegations in the pleading are proven true under the actual facts. Each of these options present a cascade of consequences for the trial lawyer, especially the defense lawyer representing the policyholder. It is well beyond the scope of this paper to treat these issues in any detail. Some recent CLE papers with a Texas slant on the subject include the presentation at this seminar last year: Terry W. Rhoads & Donna K. McElroy, *A Trail Guide for the Insurance Defense Lawyer,* Advanced Civil Trial Course 2002, Chapter 26; *see also* Brian S. Martin & Janis H. Detloff, *Reservation of Rights and Declining Coverage in Texas*, Advanced Personal Injury and Insurance Law, University of Houston Law Foundation (June 2002); Michael W. McCoy & Geoffrey C. Sansom, *The Insurance Company and Defense Firm Relationship: Control of Counsel, Cooperation, Economic Diffeeerences, Etc.*, (February

2003), located online at <http://www.texaslawinstitute.com/Newsletters/Articles/Index.asp>; and, Robert D. Allen & Charles L. Levy, *Duty to Defend: Control of Defense, Reservations of Rights, and Conflicts of Interest*, Insurance Law Institute, University of Texas School of Law (September 2002).

1. Time to Respond - Statutory Timetable of Article 21.55

Article 21.55 of the Texas Insurance Code provides for prompt payment of first-party insurance claims by imposing time deadlines on an insurer to investigate and pay a covered claim. By its own terms, it applies to a broad range of insurers and insurance policies. Recent trends in Texas case law have applied Art. 21.55 where the insurer fails to provide a defense, characterizing the duty to defend as a first-party type of insurance (albeit contained in a third-party policy) because the duty is owed by the insurer directly to the policyholder and not to the third-party to whom the policyholder is potentially liable. *See Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc.*, 215 F. Supp.2d 783 (E.D. Tex. Jul 25, 2002); *E & R Rubalcava Const., Inc. v. Burlington Ins. Co.*, 148 F. Supp.2d 746 (N.D. Tex. 2001); *Ryland Group, Inc. v. Travelers Indemnity Co. of Illinois*, 2000 WL 33544086 (W.D. Tex.2000).

Under Article 21.55 the claimant must give the insurer notice of the claim in writing, with sufficient particularity to reasonably apprise the insurer of facts relating to the claim. When the insurer receives notice of a claim, it is obligated to take specific action to acknowledge the claim, commence an investigation, and to reasonably request further information from the insured as may be necessary to determine if the claim is covered. Art. 21.55 § 2.

Once the insurer receives all information and paperwork supporting the claim, the insurer must accept or deny the claim within a short period (15 business days in the typical case); the insurer can obtain an additional 45-day extension from this deadline. Art. 21.55 § 3. The insurer must pay the claim within 60 days of receiving the items requested of the claimant, Art. 21.55 § 3(f), or within 5 business days of after notifying the claimant the claim would be paid or after the claimant satisfies any condition imposed by the insurer, Art. 21.55 § 4.

Since an insurer's duty to defend is based, as we have seen, strictly and solely on the eight corners of the policy and the pleading, there should be little reason the insurer would need time to investigate or obtain further information or documentation once it has received the precipitating pleading and the policy wording.

Perhaps most significantly, an insurer is liable to pay an additional 18 percent per annum interest as damages on any claim not paid in accordance with this timetable, together with reasonable attorney fees. Art. 21.55 § 6. The 18% interest is owed regardless of whether the insurer had a reasonable basis for denying coverage; in effect, the insurer assumes the risk of paying additional damages if it decides to deny coverage in the event it is proven to be mistaken. *Higginbotham v. State Farm Mut. Auto. Ins. Co.*, 103 F.3d 456 (5th Cir. 1997); *Oram v. State Farm Lloyds*, 977 S.W.2d 163 (Tex. App.--Austin 1998, no pet.);*Cater v. United Services Automobile Ass'n*, 27 S.W.3d 81 (Tex.App.-San Antonio 2000, pet. denied).

2. Insurer Accepts Duty to Defend Without Qualification

When the insurer timely and fully accepts coverage of a third- party claim, the policyholder has no more worries, right? Well, almost right.

When the insurer undertakes an unreserved defense and the loss is within policy limits, and when developments in the litigation do not implicate any impediment to coverage, then all should go smoothly and the claim should be resolved in the usual course. This situation is the locus of the "tripartite relationship" in which the defense attorney represents the interests of both the insurer and the policyholder without conflict. Much has been written and argued over this "relationship", and this paper will not attempt to delve into the ethical intricacies of this problem. *See generally Symposium: Liability Insurance Conflicts and Professional Responsibility,* 4 CONN. INS. L. REV., No. 1,(1997-98); *see also Conflict of Interest Symposium*, 16 REV. OF LITIGATION, No. 3, (Summer 1997).

Even in this ideal situation, though, Texas law teaches that the defense attorney owes his absolute duty of loyalty to the policyholder, not the insurance company. *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625 (Tex. 1998). In that case, the Texas Supreme court clarified that the defense counsel, albeit appointed by the insurer, must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions and must exercise their judgment on behalf of the policyholder without direction or control of the insurance company over the details of their work.. *Id*. at 628; *Employers*

Cas. Co. v. Tilley, 496 S.W.2d 552 (Tex. 1973).

In particular, much controversy has surrounded the insurance companies' tendency to utilize billing / budget guidelines and audits of defense counsel, arguably restricting the defense attorney's independent judgment in determining the course of defense and potentially exposing privileged information to open discovery. Recently, the Professional Ethics Committee of the State Bar of Texas addressed these issues, in Opinions 532 (third-party auditing) and 533 (litigation budget and billing guidelines). TEX. COMM. ON PROFESSIONAL ETHICS, OP. 532, 63 Tex.B.J. 805(2000), and TEX. COMM. ON PROFESSIONAL ETHICS, OP. 533, 63 Tex.B.J. 806 (2000).

In a nutshell, under Opinion 532 the defense lawyer may not submit bills to a third-party auditor without obtaining the client's informed consent, including informing the client of the potential adverse consequences of disclosure, including the possibility of losing the attorney-client privilege over the material submitted. Opinion 533 states that it is impermissible for a defense lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his / her independent professional judgment in rendering such legal services to the insured / client. Trial lawyers for policyholders should be aware of these Opinions, and conduct themselves accordingly in their relationship with the insurer.

3. Insurer Denies Duty to Defend

When an insurer wrongfully denies coverage and breaches its duty to defend, the policyholder is released from other conditions in the policy (such as the duty to cooperate, or the requirement of an actual trial to fix liability and damages) and may reach settlement with the Plaintiff on whatever terms possible. The insurer may not later contest the liability of the policyholder or the amount of the verdict or settlement.

However, if an insurer wrongfully fails to defend, the insurer is not automatically liable to indemnify the policyholder against such settlement or judgment, but the insurer is entitled to assert its coverage defenses. A finding of liability against the policyholder, to which the insurer who breached its duty to defend is bound, is distinct from the question of coverage, which "cannot be created ex nihilo by estoppel". *Hartford Cas. Co. v. Cruse,* 938 F.2d 601, 605 (5th Cir.1991) (*citing Hargis v. Maryland American Gen. Ins. Co.*, 567 S.W.2d 923, 927 (Tex.Civ.App.--Eastland 1978, writ ref'd n.r.e.) (no binding findings on coverage in prior judgment)). If an insurer under a liability insurance contract fails to defend a suit which it has a legal duty to defend, it is bound by the results of the suit and the judgment therein "to the extent that the judgment involves a cause of action within the coverage of the policy". *Maryland Cas. Co. v. Mitchell*, 322 F.2d 37 (5th Cir.1963).

Thus, an insurer may be bound as to specific issues determined in the prior suit which were essential to the judgment in the prior suit, but the insurer ordinarily will not, merely by denying defense, forfeit its right to challenge whether the underlying claim was within the coverage of the policy. *Employers Cas. Co. v. Block*, 744 S.W.2d 940 (Tex.1988). Even an unfaithful insurer, it is said, may not be bound to an insurance contract it did not write. *Enserch Corp. v. Shand Morahan & Co., Inc.*, 952 F.2d 1485, 1493-94 (5th Cir. 1992)

In no event will an insurer be bound by an assignment or other consented judgment between a policyholder and a third-party claimant without a fully adversarial trial, and such evidence is inadmissible as evidence of damages in an action against the insurer. *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996). An agreed judgment between a plaintiff and a defendant is not binding on the insurer because an insurer's liability to a plaintiff who is the policyholder's assignee should be determined by "the strength of plaintiff's claims rather than the generosity of defendant's concessions." *Id.* at 719. *See also Trinity Universal Insurance Co. v. Cowan,* 945 S.W.2d 819, 821 (Tex. 1997); *First General Realty Corp. v. Maryland Cas. Co.*, 981 S.W.2d 495 (Tex. App.--Austin 1998, pet. denied). On the other hand, where the insurer was given an opportunity to defend the suit, but declines, a default judgment taken against the policyholder may serve, in the absence of any evidence of collusion, as an "actual trial" for purposes of the *Gandy* requirement. *See Scottsdale Ins. Co. v. Sessions*, 2003 WL 21738429, *7-9 (N.D. Tex., July 22, 2003).

4. Insurer Offers Defense but Reserves Right to Contest Coverage

The requirement for an insurer to present reservations of rights to an insured arises principally by virtue of the insurer's duty to defend. The central purpose of the reservation of rights letter is to permit an insurer to provide a defense to its policyholder while it preserves and investigates questionable coverage issues. *Katerndahl v. State Farm Fire & Cas. Co.*, 961 S.W.2d 518, 521, 523 (Tex. App.--San Antonio 1997). The rationale for requiring a reservation of rights in this

context is to avoid the potential conflict of interest between the insured and policyholder when the insurer defends the policyholder in a lawsuit and at the same time formulates its defense against the policyholder for non-coverage. *Farmers Texas County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 522 (Tex. Civ. App.--Austin 1980, writ ref'd n.r.e.); *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 560 (Tex. 1973).

For this reason, an excess insurer or other insurer without a duty to defend the insured, ordinarily does not have an obligation to reserve its rights as to coverage defenses prior to actual payment of an excess judgment or settlement. *See Keck, Mahin & Cate v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 20 S.W.3d 692 (Tex. 2000)*; see also Emscor Mfg., Inc. v. Alliance Ins. Group*, 879 S.W.2d 894, 903, 912 (Tex. App.--Houston [14th Dist.] 1994, writ denied). However, an excess insurer which affirmatively controls settlement under a policy that prohibits settlement except with the excess insurer's consent, may also be subject to liabilities and obligations which ordinarily would be placed upon a primary insurer. *Rocor Intern., Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA,* 77 S.W.3d 253,263-64 (Tex. 2002).

The general rule under Texas law is that neither the doctrine of estoppel nor waiver can be used to create insurance coverage where none exists. In other words, estoppel and waiver cannot create a new and different contract with respect to risks covered by the policy. *Texas Farmers Ins. Co. v. McGuire*, 744 S.W.2d 601, 603 (Tex. 1988).

The principal exception to this rule is expressed in *Farmers Texas County Mutual Ins. Co. v. Wilkinson*, 601 S.W.2d 520 (Tex. Civ. App.-- Austin 1980, writ ref'd n.r.e.). The *Wilkinson* exception is triggered when each of the following elements is met: (i) the insurer had sufficient knowledge of the facts or circumstances indicating non-coverage but (ii) assumed or continued to defend its insured without obtaining an effective reservation of rights or non-waiver agreement and, as a result (iii) the insured suffered harm as a result of this defense. *See also Pacific Indemnity Co. v. Acel Delivery Serv., Inc.*, 485 F.2d 1169 (5th Cir. 1973), cert. denied, 415 U.S. 921, 39 L. Ed. 2d 476, 94 S. Ct. 1422 (1974); 7C JOHN A. APPLEMAN, INSURANCE LAW AND PRACTICE § 4692, at 289 (Walter F. Berdal ed., 1979) (an insurer which undertakes the defense of an action against the insured with knowledge of a policy breach sufficient to avoid protection, without disclaiming liability or reserving its rights, generally is deemed to have waived such breach, or is estopped to invoke its coverage defenses subsequently.)

This rule is intended to prohibit the insurer from self-dealing by exploiting its position as the policyholder's defense counsel to formulate coverage defenses, losing the litigation, and then refusing to pay on the ground of non-coverage. *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991).

In order to avoid this conflict of interest and estoppel, an insurer may undertake the insured's defense and later deny coverage if it "reserves its rights" by advising the insured that it may interpose a policy defense following adjudication of the claimant's suit against the insured. *Aries Marine Corp.,* 932 F.2d at 445*; Rhodes*, 719 F.2d at 120; *see State Farm Lloyds, Inc. v. Williams*, 791 S.W.2d 542, 551 (Tex.App.-Dallas 1990, writ denied). An offer to defend subject to a proper reservation of rights does not constitute a refusal to defend. *See State Farm Lloyds Ins. Co. v. Maldonado,* 963 S.W.2d 38, 40 (Tex. 1997) This is a proper course of action only when the insurer has a good faith belief that the complaint alleges conduct which may not be covered by the policy. *Rhodes*, 719 F.2d at 120. In such a situation, the reservation of rights will not breach the duty to defend if timely notice of intent to reserve rights is sufficient to inform the insured of the insurer's position. *Id*.

Upon receiving notice of the reservation of rights, the insured may properly refuse the tender of defense and may control the defense of the suit personally through independent counsel. *American Eagle Ins. Co v. Nettleton*, 932 S.W.2d 169(Tex. App.--El Paso 1996, writ denied); *Aries Marine Corp*., 932 F.2d 442 at 445; *Rhodes*, 719 F.2d at 120. As a matter of practice, insurers generally will agree to pay for such independent counsel where the reservation involves a potential conflict of interest; although this is a relatively well-established practice, the authors are aware of only one case in Texas that specifically imposes this requirement on the insurer to pay for independent counsel. *See Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex.App.-San Antonio 1986, writ refused n.r.e.) (Policyholder had the privilege of rejecting the limited representation and hiring a lawyer of his own choosing and looking to Cambridge for the payment of the attorney's fees, citing *Rhodes*, 719 F.2d at 120).

Even when the insurer agrees to pay for independent counsel, agreement on an appropriate billing rate often becomes problematic. The insurer often wishes to pay

only the low rate which it has bargained for with its standard defense counsel, while the policyholder as often seeks to have the insurer pay the full rate of the trial lawyer from policyholder's sophisticated outside law firm. Presumably, in the absence of a statutory rubric such as exists in California and some other states for determining the appropriate billing rate, the insurer and policyholder will have to refer to more general guidelines established by the ABA and/or by Texas courts.

In order to prevent the insurer from raising a coverage defense, and for the policyholder to affirmatively assert that the insurer has waived or is estopped from relying on coverage defenses that were not reserved prior to undertaking the defense, a policyholder must show actual harm suffered as a result of the insurer undertaking an unqualified defense. *Paradigm Ins. Co. v. Tex. Richmond Corp*., 942 S.W.2d 646 (Tex. App.-- Houston [14th Dist.] 1997, no writ). Even where an insurer tendered a defense without qualification and conducted the insured's defense for over a year, the insurer will not necessarily be held to have waived its coverage defenses or be estopped from raising such defenses, where the policyholder is unable to demonstrate that the insurer's defense had actually caused harm or that defense counsel had the opportunity to manipulate the defense in favor of the insured to better its claim of non-coverage. *Pennsylvania Nat. v. Kitty Hawk Airways,* 964 F.2d 478 (5th Cir. 1992), reh den'd 971 F.2d 750.

An insurer is not prevented from participating in settlement conferences to protect its interests with respect to covered claims because it has issued a reservation of rights, and its actions in that regard do not estop the insurer from denying liability nor constitute a waiver of a defenses asserted in the reservation. *American Eagle Ins. Co v. Nettleton*, 932 S.W.2d at 174 (citations omitted).

IV. Duty to Indemnify

In contrast to the "Eight Corners" rule by which the duty to defend is determined merely on the allegations of the pleading, the duty to indemnify is determined by the "actual facts establishing liability in the underlying case." *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819 (Tex. 1997). The duty to indemnify arises when the underlying litigation establishes liability for damages covered by the insuring agreement of the policy (and is not otherwise excluded by other provisions). *Hartrick v. Great American Lloyds Ins. Co.*, 62 S.W.3d 270, 275 (Tex. App. - - Houston [1st Dist.] 2001, rule 53.7(f) motion filed).

Beyond these platitudes, Texas law is surprisingly sparse on details pertaining to determination of the duty to indemnify from the facts of the underlying litigation. So, for example, cases seem to differ on whether a negligence finding in the underlying suit is sufficient, in and of itself, to provide a basis for coverage regardless whether the underlying suit also included facts and holdings proving that the policyholder's actions were intentional and therefore outside coverage. *Compare National Union Fire Ins. Co. v. Bourne,* 411 S.W.2d 592 (Tex. Civ. App. -- Fort Worth 1969, writ ref'd n.r.e.) *with Scottsdale Ins. Co. v. Sessions*, 2003 WL 21738429, *4 (N.D. Tex., July 22, 2003).

More often, problems involving the duty to indemnify arise in the context of settlement. The remainder of the discussion of the duty to indemnify, then, revolves around the special problems posed by the parameters of the insurer's responsibilities to settle the suit on behalf of its policyholder.

A. Initiating Insurer's Obligations for Settlement Stowers

The standard wording of a primary-layer general liability policy gives the insurer the right to settle the claim against the policyholder, or not, within the insurer's own discretion. Conjoined with this right to control the defense comes certain duties on the primary insurer's part. Under the so-called Stowers doctrine, one of those duties is that the insurer must act with "that degree of care and diligence which an ordinarily prudent person would exercise in the management of his own business" in responding to settlement demands within policy limits. *Stowers Furniture Co. v. American Indem. Co*., 15 S.W.2d 544, 547-48 (Tex. Comm'n App.1929, holding approved).

Ordinarily, an insurer is liable to the insured for no more than the amount specified in the policy limit of their contract, the insurance policy. Violation of the Stowers duty, however, has the effect of shifting the risk of an excess judgment onto the primary insurer when that insurer was presented with a reasonable opportunity to prevent the excess judgment but failed to settle within the applicable policy limits. *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994). Imposition of the Stowers duty is intended to protect the policyholder from an insurer abusing its control of defense and settlement and gambling at the policyholder's risk and expense, by failing to settle a

claim that can and should be settled within the primary policy limits.

The Stowers duty is activated by a settlement demand when three prerequisites are met:

- ♦ the claim against the insured is within the scope of coverage;
- ♦ the demand is within the policy limits, and
- ♦ the terms of the demand are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment.

An insurer is not required under Stowers to initiate any settlement offer nor to engage in any give-and-take settlement negotiations; the Stowers duty arises solely in relation to the actual settlement demand proposed by the claimant. *Id*. It is imperative, then, that the Plaintiff's trial lawyer include all elements necessary for a Stowers claim if a real threat of excess exposure is to be imposed on an insurer to encourage current settlement.

Texas law recognizes only a single tort duty with respect to an insurer's practices concerning third-party claims handling, that being the duty stated in Stowers. *Maryland Ins. Co. v. Head Industr. Coatings & Servs., Inc.*, 938 S.W.2d 27, 28 (Tex. 1996). A Stowers claim is essentially a negligence claim, and it does not comprise an action or remedy for bad faith. *Id.*

Texas law does recognize a statutory action for the unfair insurance practice of "[n]ot attempting in good faith to effectuate prompt, fair, and equitable settlements of claims submitted in which liability has become reasonably clear." TEX. INS. CODE, Art. 21.21-2, § 2(b)(4). However, the Texas Supreme Court has determined that this standard is the equivalent of the Stowers duty and involves meeting the three essential prerequisites noted above, together with a 4th requirement that "the insured's liability has become reasonably clear." *Rocor Int'l, Inc. v. Nat. Union Fire Ins. Co. of Pittsburgh, Pa.*, 77 S.W.3d 253, 262 (Tex. 2002). As under Stowers, the statutory standard requires that the insurer respond properly to an actual settlement demand, but does not obligate the insurer to initiate, solicit, or engage in give-and-take settlement negotiations. *Id*. at 261-62.

1. <u>The Claim is Within the Scope of Coverage</u>

When a claim against the policyholder includes both covered and uncovered claims, or where the insured's total liability likely will exceed the policy limits, the relationship of the policyholder and the insurer may not be entirely allied for purposes of settlement. Since the insurer has no duty to settle a claim that is not covered under the policy, the insurer may not be required to take into consideration the insured's potential uninsured exposure during settlement negotiations regarding covered claims.

Thus, the insurer may reject a reasonable demand to settle the entire case within policy limits without incurring liability for an excess verdict, if the demand was not a reasonable amount to pay in settlement for the covered portion of the claim. *St. Paul Fire and Marine Ins. Co. v. Convalescent Services, Inc.,* 193 F.3d 340 (5th Cir. 1999).

Alternatively, the insurer may attempt to pressure the policyholder into consenting to allow the insurer to bring a subsequent action for reimbursement of such amounts as it paid in settlement that were not attributable to covered claims. *See Texas Ass'n of Counties County Government Risk Management Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000); *see also Excess Underwriters At Lloyd's v. Frank's Casing Crew & Rental Tools, Inc.*, 93 S.W.3d 178 (Tex.App.-Hous. (14 Dist.) 2002, rev. granted).

This disputed coverage situation has obvious potential to become a divisive element between the insurer and the policyholder during mediation and other settlement negotiations.

a. Coverage Issue: Punitive Damages

The coverage problem in *Convalescent Services* involved a specific punitive damages exclusion, but insurers lately have taken to disputing the insurability of punitive damages in Texas cases regardless whether the policy specifically excludes such damages. There seems to be no hotter issue for coverage attorneys, no hotter potato for Texas courts, than whether Texas law and public policy does or does not allow insurance coverage for punitive damages.

The Texas Supreme Court has yet to rule definitively on this issue. Older intermediate Texas appellate state court opinions virtually universally concluded that punitive damages were covered unless specifically excluded (except where insurance is afforded under an auto policy for uninsured motorist coverage). A recent and controversial decision from the

federal court in the Northern District of Texas, however, raised serious questions about the validity of those earlier cases in light of interim developments in Texas statutory law.

Early cases in Texas state courts rejected the concept that public policy prohibited insurance coverage for punitive damages; so long as the insurance policy did not specifically exclude punitive damages, those damages were considered to be included as part of the "all sums" which the policy covered in the standard insuring agreement. *See Dairyland County Mut. Ins. Co. v. Wallgren*, 477 S.W.2d 341 (Tex. Civ. App.--Fort Worth 1972, writ ref'd n.r.e.); *American Home Assurance Co. v. Safway Steel Prods. Co.*, 743 S.W.2d 693 (Tex. App.--Austin 1987, writ denied). The Fifth Circuit adopted this view as the Texas position for *Erie* purposes in *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026 (5th Cir.1978).

More recently, however, the rationale of these courts in justifying coverage for punitive damages was criticized and rejected in a lengthy and comprehensive decision of Judge McBryde in *Hartford Cas. Ins. v. Powell,* 19 F. Supp. 2d 678 (N.D. Tex. 1998). This opinion argues that Texas public policy should now prohibit insurance coverage for punitive damages because of intervening developments in Texas law.

Powell reasons that the Texas Supreme Court has since determined, under *Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10 (Tex.1994), that the sole purpose of punitive damages is to punish and deter, and that no compensatory feature is involved. *Powell* held that this punitive and deterrent purpose would be frustrated if the punishment did not fall directly on the liable party, but instead was ameliorated by passing the liability for punitive damages on to an insurance company. Moreover, according to *Powell*, the public policy of Texas that a punitive damage award serve as punishment was also confirmed by the adoption by the Texas Legislature in 1987 of a statute essentially codifying *Moriel* principles and defining exemplary damages to mean damages "awarded as an example to others, as a penalty, or by way of punishment," further amended in 1995 to specifically restrict the purpose of punitive damages by stating that "any damages awarded as a penalty or by way of punishment." Tex. Civ. Prac. & Rem. Code § 41.001(5).

Attorneys representing insurance carriers have loudly trumpeted the *Powell* decision as definitive, and in recent years it has not been uncommon for insurers to cite the case to reserve their rights or attempt to decline coverage for punitive damages. Insurance lawyers also have been quick to point to the new formulation of exemplary damages established in Article 13.02(5) of the new Texas legislation under H.B.4, amending Chapter 41 of the Civil Practices and Remedies Code, which specifies that exemplary damages have no compensatory purpose but are meant for punitive purposes, only. They argue that this new formulation fits with *Powell's* argument, that the punitive purpose is frustrated if a policyholder is able to pass on the punishment to its insurer. To date, however, no other Texas state court or federal court in Texas has followed *Powell's* example and refused insurance coverage for punitive damages on the basis of Texas public policy. Nor has the Texas legislature addressed the issue of insurance for punitive damages under a standard general liability policy.

An argument to be raised in favor of continued coverage for punitive damages, is that the Texas legislature has prohibited medical professional liability insurance coverage for punitive damages against physicians and health-care providers, specifically on the basis that the intentional or grossly negligent wrongdoer should be penalized and hopefully deterred; however, that very statute also excepts hospitals and nursing homes from the prohibition against obtaining insurance coverage for punitive damages. Tex. Ins. Code art. 5.15-1, § 8. The Texas Supreme Court has noted these dichotomous statutory prohibitions / allowances of insurance coverage for punitive damages in the medical liability context, without making any mention of or taking any position regarding potentially broader implications for insurance coverage of punitive damages in other forms of policies as a matter of Texas public policy. Horizon / CMS Healthcare Corp. v. Auld, 34 S.W.3d 887, 895 (Tex. 2000). And, of course, there is the argument that insurers are perfectly capable of including a punitive damages exclusion in their policies if they do not wish to provide that coverage; in the absence of a specific exclusion and of a wholly countervailing public policy, insurer's should not be allowed to restrict their coverage beyond the terms they have actually offered to a policyholder.

Within the last month, the Texas court of appeals in Fort Worth directly addressed the question of punitive damages raised by Powell and rejected Powell's reasoning, holding that insurance coverage for punitive damages was not void as against public policy. *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, 2003 WL 21475423 (Tex.App.-Fort Worth Jun 26, 2003, no pet.). The court rejected *Powell's* assumption that the

policyholder would be unpunished if it could pass on exemplary damages to its insurer, noting that such damages could well serve as a deterrent because of the increased premium the policyholder would have to pay to underwriter its risks in the future.

The competing positions of Powell and Westchester, and the continued silence of the Texas Supreme Court or Texas legislature on the subject of punitive damages, promises that this will continue to be a point of dispute between insurer and policyholder interests with respect to coverage under a standard liability policy. Trial lawyers for Defendants should anticipate the problem for purposes of conducting settlement evaluations and negotiations; trial lawyers for Plaintiffs should consider the problems they may cause with respect to coverage if they allege exemplary damages, and may wish to consider whether it is worth the settlement problems it may cause now that the proof required under H.B. 4 effectively removes all but the most egregious cases from real likelihood that such damages will be awarded.

b. Coverage Issue: Occurrence or Accident

The other coverage defense being commonly asserted by insurer's relates to whether the alleged injury was the result of an "accident" within the usual policy definition of an "occurrence," for purposes of bringing the claim within the policy's initial insuring agreement. This coverage defense arises when the Plaintiff alleges that the Defendant / policyholder acted intentionally to cause the harm suffered. Texas jurisprudence on this issue is extremely complicated and somewhat confused.

The definition of "accident" anticipates coverage for "negligent acts of the insured causing damage which is undesigned and unexpected." *Massachusetts Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396, 400 (Tex.1967); *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 828 (Tex.1997). Both state and federal courts in Texas have interpreted the terms "accident" and "occurrence" to include damage that is the "unexpected, unforeseen or undesigned happening or consequence" of an insured's negligent behavior. *See Federated Mut. Ins. Co. v. Grapevine Excavation Inc.*, 197 F.3d 720, 725 (5th Cir.1999); *Mid-Century Ins. Co. of Texas, a Div. of Farmers Ins. Group of Companies v. Lindsey*, 997 S.W.2d 153, 155 (Tex. 1999). Where injuries or damage result from an intentional tort, however, there is no accident or occurrence and coverage may be precluded. *See Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633, 635 (Tex.1973)

This coverage issue is particularly acute in construction cases, with some courts holding that insurance coverage should not apply where the contractor "intended" to build a structure the way that it was built, and therefore it is no "accident" when the structure turns out to have been built deficiently. It is noteworthy that, contrarily, some courts have even found coverage for breach of contract, where the negligent breach made the policyholder liable to a claimant. *See e.g. Venture Encoding Service, Inc. v. Atlantic Mut. Ins. Co.*, 107 S.W.3d 729 (Tex.App.-Fort Worth, May 01, 2003, pet. filed). Again, this is a convoluted area of insurance law, to which reference to more detailed works is necessary. A helpful case discussing the problem is, once again, found in *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466 (5th Cir. 2001).

The application of these general standards varies wildly among the courts that have addressed this question, and the unsettled state of Texas insurance law on this issue has been the subject of many CLE articles and presentations within the insurance coverage bar. *See e.g.* Lee H. Shidlofsky, *Finding Coverage: Insurance Covers Everything Except What Happens* , 7th Annual Insurance Law Institute, University of Texas School of Law (September 2002), also at <http://www.texaslawinstitute.com/Newsletters/Articles/Index.asp>.. For purposes of this paper, it is sufficient that trial lawyers should be alert to the issue both for purposes of potential reservations to the duty to defend, and for development of evidence in the course of discovery and trial. Again, Planitiff's counsel may wish to consider whether they may create more problems with potential settlement than are worthwhile, if they allege uninsured intentional conduct against a Defendant when the evidence is more likely to show mere negligence.

2. The Demand is within Policy Limits

A Stowers demand preferably should be in writing in order to ensure there is no question of its terms; in all events, the demand must be clear and undisputed. *Rocor Int'l, Inc. v. Nat. Union Fire Ins. Co. of Pittsburgh, Pa.*, 77 S.W.3d at 263. The demand must specifically offer settlement within the policy limits, although this can be accomplished by substituting "policy limits" for a sum certain. *Amercan Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848 (Tex. 1994). The demand must release all claims, including applicable liens. *Trinity Universal Ins. Co. v. Bleeker*, 966 S.W.2d 489, 491 (Tex. 1998). The demand must be unconditional. *Ins. Corp. of America v. Webster*, 906 S.W.2d 77 (Tex. App. —

Houston [1st Dist.] 1995, writ denied) (settlement conditioned on understanding that there was no additional insurance available).

Arguably, a demand above the primary policy limits might still be effective, if the primary insurer is notified that the policyholder or excess insurer is prepared to pay the settlement amount excess to primary limits. *See State Farm Lloyds Ins. Co. v. Maldonado*, 935 S.W.2d 805, 815-16 (Tex. App. - San Antonio 1996, n.w.h.). Special problems arise - - and are currently unaddressed and unresolved in Texas jurisprudence - - if the claim applies across multiple policies in different policy years or issued concurrently to the same policyholder.

The settlement must offer to fully release all claimants from further liability to the claimant. *Garcia*, 876 S.W.2d at 848; *Rocor*, 77 S.W.3d at 262.However, when faced with a settlement demand arising from multiple claims and inadequate insurance proceeds to cover them all, an insurer may enter into a reasonable settlement with some of the claimants even though such settlement exhausts the proceeds available to satisfy the remaining claims. *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312 (Tex. 1994). Similarly, where the same policy insures multiple policyholders against the same claims, the insurer may reasonably settle on behalf of one or some of the policyholders even though such settlement will exhaust the policy and leave the policyholders subsequently brought into the suit without defense or indemnity against the claimants. *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761 (5th Cir. 1999). In both cases, the insurer is entitled to settle partially, but is not required to do so. Neither case specifically considers what the insurer may do if faced with multiple concurrent Stowers demand as to different policyholders where the demands in total exceed the policy limits. *Id.* at 768.

3. The Demand is Reasonable

This prong of the Stowers test does not really have much jurisprudential substance. Certainly, a third-party liability insurer must exercise "that degree of care and diligence which an ordinarily prudent person would exercise in the management of his own business" in responding to settlement demands within policy limits. *Stowers,* 15 S.W.2d at 547; *Garcia*, 876 S.W.2d at 848. The terms of the demand must be such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment. *Id*. at 849. Some courts have indicated that part of the "reasonableness" quotient is whether the insurer had a reasonable amount of time in which to respond to the settlement demand.

These are notably slippery concepts, closely aligned to the particular facts of a case. One important factor, presumably, would be the defense lawyer's evaluation of the case, and an insured would be hard pressed to avoid paying an excess judgment if it ignored defense counsel's recommendations to the policyholder's detriment when an excess verdict is awarded. Similarly, a well-reasoned demand from Plaintiff's counsel establishing the likelihood of excess damages may go far towards preventing an insurer from avoiding such an excess judgment if it fails to take the opportunity to settle within policy limits.

C. Stowers and Excess Insurance -- Subrogation by Excess against Primary

A primary insurer is not allowed to benefit or escape liability from its own negligent claims handling due to the happy accident that the policyholder is also protected by its excess insurance. In circumstances where the primary insurer's breach of Stowers obligations results in an excess judgment that the excess insurer is liable to pay, the excess insurer is subrogated to the policyholder's interests against the primary insurer, ncluding any right to proceed against the primary insurer for an excess judgment due to the primary's negligence or misfeasance in handling the claim. Thus, if an excess insurer is required to pay a portion of a judgment rendered against the policyholder, then the excess insurer is equitably subrogated to the policyholder's rights against the primary insurer under Stowers for negligently investigating, preparing to defend, trying or settling the third party action. *See American Centennial Ins. Co. v. Canal Ins. Co.,* 843 S.W.2d 480 (Tex. 1992); *see also General Star Indemn. Co. v. Vesta Fire Ins. Corp*., 173 F.3d 946 (5th Cir. 1999).

Equitable subrogation by the excess insurer is limited to a remedy in negligence for reimbursement of monies paid in an excess judgment, and does not include an action against the primary insurer for gross negligence or under the insurance code or other statute. *Nat. Union Fire Ins. Co. of Pittsburgh, Pa. v. Ins. Co. of N. America*, 955 S.W.2d 120, 133-34 (Tex. App. - Houston [14th Dist.] 1997), *aff'd, Keck, Mahin & Cate v. Nat. Union Fire Ins. Co. of Pittsburgh, Pa.,* 955 S.W.2d 120 (Tex. 2000).

V. Conclusion

Trial lawyers are best suited for - - and presumably most enjoy - - trying cases. The insurance problems that crop up in the course of regular litigation often are bothersome and seem tangential to the real mission of developing the case for settlement or trial.

As this paper has demonstrated though, we hope, it is important that trial lawyers for both defendants and plaintiffs be aware of the serious implications and complexities presented by many insurance issues that can seriously affect the outcome of the litigation. Understanding the insurance issues — or at least being aware that they exist so as to seek the specialized assistance of or consultation with insurance coverage counsel - - can make the difference between obtaining defense and coverage, or losing the benefit of insurance proceeds forever.

These issues are fraught with complexities, and rife with pitfalls for the unwary or unprepared. The wise trial lawyer considers the implications of insurance from the outset, and maintains the insurance issues within the core of every strategic decision regarding any litigation where insurance plays a significant part.