

insured is or should be aware of an ongoing progressive or known loss at the time the policy is purchased.²⁹⁸ Essentially, if an insured knows, or should have known, at the time it purchased the insurance policy, that its current behavior is wrongful and could result in liability, it effectively removes the risk element inherent in insurance, and therefore, a Texas court will not require the insurer to pay the claim.²⁹⁹

13 HANDLING THIRD-PARTY CLAIMS.

A. **The Insurer's Duties for Third-Party Claims - Defend & Indemnify.** Under most common liability policies, such as a standard CGL policy, an insurer has two separate, distinct and independent duties, the duty to defend, and the duty to indemnify.³⁰⁰ An insurer's duty to defend and its duty to indemnify are separate duties, and an insurer may have a duty to defend even when it has no duty to indemnify, and vice versa, an insurer may have a duty to indemnify even when it had no duty to defend.³⁰¹ Accordingly, allegations raised against the insured may fit within the policy coverage and trigger a duty to defend even if the facts actually established in the underlying suit negate the insurer's duty to indemnify.³⁰² However, if the factual allegations in an underlying complaint fall outside the policy coverage, neither duty is triggered.³⁰³

1) **Duty to Defend.** Whether an insurer has a duty to defend an insured in a lawsuit is determined by the “**eight corners rule**” which compares the factual allegations of the plaintiff's petition to the insurance policy, without regard to the truth or falsity of the allegations.³⁰⁴ Even if the allegations are groundless, false, or fraudulent the insurer is obligated to defend.³⁰⁵ When applying the eight corners rule, courts are to give the allegations in the petition a liberal interpretation, focus on the factual allegations that show the origin of the damages rather than on the legal theories alleged, and resolve all doubts concerning the duty to defend in favor of the insured.³⁰⁶ "It is not the cause of action alleged that determines coverage, but the facts giving rise to the

²⁹⁸ *Id.* (citing *Two Pesos, Inc. v. Gulf Ins. Co.*, 901 S.W.2d 495, 502 (Tex. App.– Houston [14th Dist.] 1995, no writ).

²⁹⁹ *RLI Ins. Co. v. Maxxon Southwest Inc.*, 108 Fed. Appx. 194, 2004 WL 1941757, P*3 (5th Cir. 2004).

³⁰⁰ *D.R. Horton-Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 300 S.W.3d 740, 743-744 (Tex. 2009). *See also Trinity Universal Ins. Co. v. Callan*, 945 S.W.2d 819, 921-22 (Tex. 1997); *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997).

³⁰¹ *Id.*

³⁰² *Id.*; *see also GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305, 307 (Tex. 2006).

³⁰³ *Griffin*, 955 S.W.2d at 84.

³⁰⁴ *GuideOne* at 307; *Nat'l Union Fire Ins. Co. v. Merchs. Fast Motorlines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997).

³⁰⁵ *Zurich Amer. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 491 (Tex. 2008).

³⁰⁶ *Nat'l Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997).

alleged actionable conduct.³⁰⁷ An insurer has a duty to defend if the facts as alleged by the plaintiff against the insured, when fairly and reasonably construed, whether true or not, state a cause of action potentially covered by the policy.³⁰⁸ Where the petition does not state facts sufficient to clearly bring the case within or without the coverage, the general rule is that the insurer is obligated to defend if potentially, there is a case under the petition within the coverage of the policy.³⁰⁹ Stated differently, in case of doubt as to whether or not the allegations of a petition or complaint against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt is to be resolved in the insured's favor.³¹⁰ If an insurer has a duty to defend its insured against any one claim plead in the petition of the underlying suit, then the insurer is required to defend its insured against all claims in that petition.³¹¹

- a. **Use of extrinsic evidence in determining duty to defend.** The general rule is that extrinsic evidence, that is, evidence outside the plaintiff's petition, is not admissible on the issue of the duty to defend.³¹² Extrinsic evidence that is relevant to both coverage and the merits of the plaintiff's petition against the insured has been referred to as "mixed" or "overlapping" extrinsic evidence, and its use in determining the duty to defend is prohibited.³¹³ While the Texas Supreme Court has not recognized any exception to the eight corners rule, it has discussed the possibility of an exception.³¹⁴ By not foreclosing the possibility of such an exception when it had the chance, some lower state appellate courts and federal courts have taken this cue to recognize a very narrow exception to the general prohibition against the use of extrinsic evidence in duty to defend cases for circumstances involving pure coverage questions.³¹⁵ For example, the federal Fifth Circuit Court of Appeals interpreted the Texas Supreme Court's discussion but not rejection of the exception as tacitly approving of it.³¹⁶ Specifically, extrinsic evidence has been permitted by some

³⁰⁷ *Adamo v. State Farm Lloyds Co.*, 853 S.W.2d 673, 676 (Tex.App.- Houston [14th Dist.] 1993, writ denied).

³⁰⁸ *Folsum Investment, Inc. v. American Motorists Ins. Co.*, 26 S.W.3d 556, 558-9 (Tex. App. – Dallas 2000, n.w.h.); *Ranger Inc. Co. v. Ins. Co. of State of Pennsylvania*, 2000 WL 1281192 (Tex. App.–Dallas 2000, n.w.h.) (not designated for publication).

³⁰⁹ *Zurich*, 268 S.W.3d at 491.

³¹⁰ *Id.*

³¹¹ *Id.*

³¹² *GuideOne* at 307.

³¹³ *Id.*

³¹⁴ *GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305, 309-10 (Tex. 2006).

³¹⁵ *Ooida Risk Retention Group, Inc. v. Williams*, 579 F.3d 469 (5th Cir. 2009); see also *VRV Development, L.P. v. Mid-Continent Cas. Co.*, 2010 WL 375499, p. *3 (N.D.Tex., 2010); *Colony Ins. Co. V. Peachtree Constr., Ltd.*, 2009 WL 3334885, P*4 (N.D.Tex., 2009).

³¹⁶ *Ooida*, 579 F.3d at 475-476 ..

lower courts in duty to defend declaratory judgment cases when it is initially impossible to discern whether coverage is potentially implicated *and* the extrinsic evidence goes solely to the fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case.³¹⁷ Courts have allowed it when the evidence is readily ascertainable, does not contradict any of the allegations in the underlying suit, and controls the question of policy coverage.³¹⁸ Caution is recommended in the use of this exception, for while this narrow exception has been discussed without rejection by the Texas Supreme Court, it has not been accepted either.³¹⁹ Not all courts agree that an exception is permissible under current Texas law.³²⁰ In fact, the Texas Supreme Court's last pronouncement on the issue is that a court deciding the duty to defend should not consider extrinsic evidence from either the insurer or the insured that contradicts the allegations of the underlying petition, and the duty to defend is limited to those claims actually asserted in the underlying suit.³²¹

i **KEY LESSON.** Carriers should not count on the ability to use extrinsic evidence in a duty to defend case. In all cases where the Texas Supreme Court has had the opportunity to consider the use of extrinsic evidence in duty to defend cases, it has reaffirmed the traditional view that it is not to be considered. Some federal courts, but certainly not all, appear more willing to allow the use extrinsic evidence in such situations. Until a clear pronouncement from the Texas Supreme Court, whether extrinsic evidence is permitted in a given duty to defend case depends largely on what the function of whether the declaratory judgment action is filed in state or federal court and what Judge is assigned to the case.

b. **Contracting out of the Eight Corners Rule?** Over the last several years an increasing number of insurance cases have dealt with insurance issues arising out of improper officer and director conduct related to allegations of criminal theft and fraud. While the standard D & O policy does not impose a duty to defend on the insurer, it does provide a duty to reimburse defense costs on a regular basis, and such a duty has been

³¹⁷ *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 (5th Cir. 2004).

³¹⁸ *VRV Development, L.P. v. Mid-Continent Cas. Co.*, 2010 WL 375499, p. *3 (N.D.Tex., 2010).

³¹⁹ *Zurich* at 497-498.

³²⁰ *See Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, __ F.Supp.2d ___, 201 WL 317684, p.*7-8 (S.D. Dist Tex., 2010), *modified* __ F.3d ___, 2010 WL 909090 (5th Cir. 2010).

³²¹ *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, 279 S.W.3d 650, 655 (Tex. 2009).

likened and compared to the duty to defend. In a recent case arising out of the Stanford Financial misconduct, the Fifth Circuit Court of Appeals held that a provision in the D & O policy that provided that the insurer is to pay defense costs “until such time that it is considered that the alleged act or alleged acts [the exclusion] did in fact occur” is a contractual provision displacing the eight corners rule and requires a separate trial for the consideration of all evidence on the issue of the specific exclusion.³²² While this holding is unique to the particular policy at issue, it illustrates the general trend that the federal courts, especially the Fifth Circuit Court of Appeals, are more inclined to allow a carrier to use extrinsic evidence to disclaim coverage.

- c. **Use of inferences in determining duty to defend.** While extrinsic evidence is generally prohibited, it is permissible for a court to draw inferences from the allegations in the petition.³²³ An inference is a fact or proposition drawn from an admitted or otherwise proven fact.³²⁴ It is a logical consequence flowing from a fact.³²⁵ In other words, the eight corners rule does not require a court to ignore those inferences that logically flow from the facts alleged.³²⁶
- d. **Excess Insurance.** The majority rule is that where the insured maintains both primary and excess policies, the excess liability insurer is not obligated to participate in the defense until the primary policy limits are exhausted.³²⁷
- e. **Burden.** The insured bears the burden of showing that the claim against it is potentially within the insurance policy's scope of coverage.³²⁸ If the insurer relies on a policy exclusion to deny coverage, the burden shifts to the insurer.³²⁹
- f. Note that an insurer's duty to defend an insured is only triggered by the actual service of process of the pleading upon its insured and then it being relayed to the insurer.³³⁰

³²² *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, ___ F.3d ___, 2010 WL 909090, p.*10 (5th Cir. 2010).

³²³ *D.R. Horton - Texas, Ltd. v. Markel Intern. Ins. Co., Ltd.*, 300 S.W.3d 773, 780 (Tex. App.—Houston [14th Dist.] 2006, *aff'd in part and rev'd in part on other grounds*, 300 S.W.3d 740 (Tex. 2009).

³²⁴ *Marshall Field Stores, Inc. v. Gardiner*, 859 S.W.2d 391, 400 (Tex. App.—Houston [1st Dist.] 1993, writ *dism'd w.o.j.*).

³²⁵ *Id.*

³²⁶ *Allstate Ins. Co. v. Hallman*, 159 S.W.3d 640, 645 (Tex. 2005).

³²⁷ *Texas Employers Ins. Ass'n v. Underwriting Members of Lloyds*, 836 F.Supp. 398, 404 (S.D.Tex.1993).

³²⁸ *Harken Exploration Co. v. Sphere Drake Ins. P.L.C.*, 261 F.3d 466, 471 (5th Cir.2001).

³²⁹ *Id.*

³³⁰ *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761 (Fifth Cir. 1999); *see also* *Members Ins. Co. v. Branscum*, 803 S.W.2d 462, 466-67 (Tex. App.--Dallas 1991, no writ).

2) **Duty to Indemnify.** The duty to indemnify, unlike the duty to defend, arises only on proven, adjudicated facts establishing liability against the insured.³³¹ No duty to indemnify arises unless the underlying litigation establishes an insured's liability for damages covered by the insurance policy. An insurer has no duty to pay unless the insured's liability for covered damages is established in the underlying litigation.³³²

B. **Responding to the Insured's Tender of Defense.** Generally, when an insurance company is asked to defend an insured against a liability claim, the insurer is required to either accept coverage or make a good faith effort to resolve coverage before adjudication of the Plaintiff's claim.³³³ When an insurer is faced with a dilemma of whether to defend an insured against a particular claim, an insurer has four options: 1) completely decline to assume the insured's defense; 2) file a declaratory judgment lawsuit against the insured seeking a judicial determination as to the insurer's obligations and rights; 3) defend under a reservation of rights or a non-waiver agreement; or 4) assume the insured's unqualified defense.³³⁴

C. **Reservation of Rights.** Because claims are often plead under several different causes of action, it is common to see an insurer defend under a reservation of rights. A reservation of rights is a written notice to the insured that the insurer may interpose a policy defense to deny coverage, following adjudication of the plaintiff's suit against the insured.³³⁵ The rationale for requiring a reservation of rights letter when a duty to defend exists, is to avoid the potential conflict of interest between the insured and policyholder when the insurer defends, but at the same time is formulating its defense against the policyholder for non-coverage.³³⁶

1) A reservation of rights letter should be sent as promptly as possible after receipt of the lawsuit. The Texas Insurance Code requires an insurer to promptly issue a reservation of rights letter to a policyholder.³³⁷ Defending under a reservation of rights is a proper course of action when the insurer has a good faith belief that the petition alleges conduct which may not be covered by the policy.³³⁸ In such a situation, the reservation of rights will not breach the duty to

³³¹ *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 823 (Tex. 1997).

³³² *Heyden Newport Chem. Corp.*, 387 S.W.2d at 25; *Reser v. State Farm Fire & Cas. Co.*, 981 S.W.2d 260, 263 (Tex. App.-San Antonio 1998, no pet.).

³³³ *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996).

³³⁴ *Farmers Tex. County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 522 (Tex. App. – Austin 1980, writ ref'd n.r.e.).

³³⁵ *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991).

³³⁶ *Farmers Texas County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 522 (Tex. App.-Austin 1980, writ ref'd); *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552,560 (Tex. 1973).

³³⁷ TEX. INS CODE ANN. § 541.060(a)(4)(B).

³³⁸ *American Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App. – El Paso 1996, writ denied).

defend if timely notice of intent to reserve rights is sufficient to inform the insured of the insurer's position.³³⁹ Upon receiving notice of the reservation of rights, the insured may properly refuse the tender of defense and defend the suit personally.³⁴⁰

- 2) For insurers, the reservation of rights letter or non waiver agreement is crucial for protecting itself against claims not covered under the policy. As discussed previously, without a reservation of rights, there is a risk that the doctrines of waiver and estoppel can be used to create insurance coverage when none exists by the terms of the policy. Coverage defenses can be waived when an insurer, with knowledge of facts indicating non-coverage, assumes the defense of its insured without obtaining a non-waiver agreement or issuing a reservation of rights and the insurer's conduct prejudices the insured.³⁴¹
- 3) Carriers also need to be careful in terms of what is stated in the reservation of rights letter to the insured, especially with respect to such things as, whether the carrier intends to seek reimbursement of defense costs for uncovered claims, or provide any further notice to the insured should the carrier decide to withdraw the conditional defense it is providing to the insured. Generally, Texas courts look very strictly at reservation of rights letters, and hold insurers to statements contained therein. Unless an insurer gives notice to the insured, usually in the reservation of rights letter, that it intends to seek reimbursement from the insured for defense costs of uncovered claims, then the insurer is precluded from later pursuing such a claim against the insured.³⁴² If an insurer indicates to the insured that further notice will be given before the defense is withdrawn, then the insurer is bound to follow that notice before being allowed to withdraw the defense.
- 4) Accordingly, a reservation of right letter should specifically:
 - a. identify the pleading received from insured;
 - b. identify the insurance policies at issue, including policy periods;
 - c. identify the relevant facts plead in the latest lawsuit pleading that may affect coverage;
 - d. identify to the extent possible, any policy defenses that may be applicable to a given case, depending on later fact determinations made in the case;
 - e. identify the policy terms that may apply so as to limit or deny coverage;
 - f. identify whether a defense is being provided or not;

³³⁹ *Id.*

³⁴⁰ *Id.*

³⁴¹ *Ulico Ins. Co. v. Allied Pilots Assoc.*, 262 S.W.3d 773, 787 (Tex. 2008).

³⁴² *Alliance Gen. Ins. Co. v. Club Hospitality, Inc.*, 1999 WL 500229, p. 1, (N.D. Tex. 1999).

- g. identify counsel retained for defense of insured,
- h. indicate carrier's intentions with regard to withdrawing defense of insured at some point in future of litigation;
- i. indicate whether carrier intends to seek reimbursement of defense costs, should a determination be made that carrier had no duty to defend;
- j. if the defense is denied entirely, encourage insured to forward any new or revised pleadings for additional review.

D. **The Carrier's Right to Control the Defense.** Whether an insurer has the right to conduct its insured's defense is initially a matter of contract, i.e., does the insurance policy give the insurer the right to control the defense. The right to conduct the defense includes the authority to select the attorney who will defend the claim and to make other defense decisions, just as if the insurer was the client and named party in the case.³⁴³ However, where there is an actual "disqualifying" conflict of interest, an insured may rightfully reject the tendered defense and the insurer lose its contractual right to control the defense of the insured.³⁴⁴

- 1) The Texas Supreme Court has held that if a disqualifying conflict of interest exists, an insured may rightfully refuse an inadequate defense and may also refuse any defense conditioned on an unreasonable, extra-contractual demand that threatens the insured's independent legal rights.³⁴⁵ The court acknowledged five situations that would present a "disqualifying" conflict of interest:³⁴⁶
 - a. when a carrier issues reservation of rights relating to existence or scope of coverage;³⁴⁷
 - b. when the defense tendered is not a complete defense under circumstances in which it should have been;
 - c. when the attorney hired by the carrier acts unethically and, at the insurer's direction, advances the insurer's interests at the expense of the insured's;
 - d. when the defense would not, under the governing law, satisfy the insurer's duty to defend;
 - e. when, though the defense is otherwise proper, the insurer attempts to obtain some type of concession from the insured before it will defend.

- 2) A disagreement between the insurer and insured about how the

³⁴³ *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627, 42 (Tex. 1998).

³⁴⁴ *Northern County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 689 (Tex. 2004).

³⁴⁵ *Id.*

³⁴⁶ *Id.*

³⁴⁷ *But see, Unauthorized Practice of Law Committee v. Amer. Home Assur. Co.*, 261 S.W.3d 24, 40 Tex. 2008)(A reservation of rights letter ordinarily does not by itself create a conflict of interest between the insured and the insurer such that it cannot use staff counsel, it only recognizes the possibility that such a conflict may arise in the future.).

defense should be conducted does not amount to a disqualifying conflict.³⁴⁸

- 3) The defense attorney hired by the insurance carrier to represent an insured is considered an independent contractor,³⁴⁹ whose ethical duty requires unqualified loyalty to the insured, that is, "owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured."³⁵⁰ The lawyer must at all times protect the interests of the insured even if those interests would be compromised by the insurer's instructions.³⁵¹ Accordingly, an insurer cannot be vicariously responsible for the conduct of an independent attorney it selects to defend an insured.³⁵²

- 4) In a 2008 case, the Texas Supreme Court determined that a liability insurer may use staff attorneys to defend its insureds if the insurer's interest and the insured's interest are congruent, but not otherwise.³⁵³ Their interests are congruent when they are aligned in defeating the claim and there is no conflict of interest between the insurer and the insured.³⁵⁴ In such a situation the staff attorney must fully disclose to an insured the identity of the lawyer's employer. Interestingly, the Court noted a distinction between "routine" reservation of rights letters, and those that identify a serious coverage issue, and that a "routine" reservation of rights letter does not as a rule create the kind of conflict that would mean that a staff attorney could not represent an insured.³⁵⁵ This particular part of the Court's opinion is subject to criticism because it conflicts with well established precedent that any reservation of rights letter creates a conflict of interest, and leaves open unnecessary questions of what rises to the level of a serious coverage issue and who determines that. While the ultimate result in this particular case may be correct, this is another example of how the current Texas Supreme Court struggles with insurance issues and has a tendency to create more problems with its opinions than are resolved.

E. **Should a Declaratory Judgment Action be Commenced on Coverage?**

- 1) Generally speaking a declaratory judgment action should only be filed if the carrier believes it has no duty to defend any of the claims asserted, or if it was clear that while there may be a duty to defend, little or no indemnity would be owed on the underlying claims against

³⁴⁸ *Id.*

³⁴⁹ *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628-629 (Tex. 1998).

³⁵⁰ *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex.1973).

³⁵¹ *Traver* at 628-629.

³⁵² *Id.*

³⁵³ *Unauthorized Practice of Law Committee v. Amer. Home Assur. Co.*, 261 S.W.3d 24, 46 (Tex. 2008).

³⁵⁴ *Id.*

³⁵⁵ *Id.* at 40.

the insured. The declaratory judgment in that case is used more to preserve the carrier's rights to deny any indemnity obligation following a judgment against the insured.

- 2) A declaratory judgment action is always mandated in the situation where the same reasons that negate the duty to defend, likewise, negate any possibility that the insurer will have a duty to indemnify for any judgment.³⁵⁶ In such a case, a declaratory judgment action is appropriate and can decide both the defense and indemnity issue at the same time.

F. Wrongfully Denial of Coverage. Under Texas law, an insurer who wrongfully refuses to defend an insured or wrongfully denies coverage under a policy loses the benefit of the policy's procedural protections.³⁵⁷ The insurer loses all procedural protections, including the ability to enforce "no action" and "no voluntary assumption of liability" clauses.³⁵⁸ Subject to certain exceptions, discussed below, the insurer also loses the ability to object to the reasonableness of a settlement or agreed judgment the insured enters into after the insurer denies coverage.³⁵⁹

G. Assignments Against Insurers - Important New Development. Since 1996, insurance carriers had the security of the Texas Supreme Court's *Gandy* decision which held that in no event is a judgment for a plaintiff against a defendant, rendered without a fully adversarial trial, binding on the defendant's insurer or admissible as evidence of damages in an action against the defendant's insurer by the plaintiff as the defendant's assignee.³⁶⁰ The *Gandy* rule arose out of a time, when it was not unusual for an insured, whose carrier had reserved rights or denied coverage, to settle with the insured, or take an agreed judgment against the insured, for policy limits and then assign the insured's rights under the policy to the Plaintiff with an agreement not to execute against the insured. The insurer was stuck with a large agreed settlement or judgment and was only left with arguing about coverage exclusions. Obviously, these deals between plaintiff and insured defendant were setting up an action against the insurance carrier without the underlying claim facts being litigated. *Gandy* prohibited those deals. The 2008 Texas Supreme Court case of *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.* limits the rule in *Gandy*, and re-opens the enforceability of agreed judgments or settlements against a wrongfully denying insurance carrier.

³⁵⁶ *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex.1997).

³⁵⁷ *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Puget Plastics Corp.* 649 F.Supp2d 613, 620 (S.D. Tex 2009)(citing *Gulf Ins. Co. v. Parker Prods., Inc.*, 498 S.W.2d 676, 679 (Tex.1973); *Enserch Corp. v. Shand Morahan & Co., Inc.*, 952 F.2d 1485, 1496 n. 17 (5th Cir.1992); *McGinnis v. Union Pac. R. Co.*, 612 F.Supp.2d 776, 811 (S.D. Tex.2009)).

³⁵⁸ *Id.*

³⁵⁹ *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.*, 256 S.W.3d 660, 674 (Tex. 2008).

³⁶⁰ *State Farm Fire and Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex.1996).

- 1) **The rule in *Gandy*.** *Gandy* held that a defendant's assignment of his claims against his insurer to a plaintiff is invalid as against public policy if: (1) it is made prior to an 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 prior to the adjudication of the plaintiff's claim.³⁶¹ The rationale underlying this decision was that, if an insurer's liability is to be litigated in an action by a plaintiff as a defendant's assignee after a judgment is rendered, then it should be done on the strength of the plaintiff's claims rather than on the generosity of the defendant's concessions.³⁶² Thus, under *Gandy* in no event were agreed judgments negotiated between a plaintiff and defendant, binding on a defendant's insurer.³⁶³

- 2) The new case of ***Evanston v. Atofina***. In *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.*, Atofina was sued by an employee of a subcontractor who fell through a corroded roof of a storage tank and drowned.³⁶⁴ Atofina was an additional insured on the subcontractor's primary and excess policies.³⁶⁵ After the primary carrier tendered its limits, Atofina demanded coverage from the excess carrier, Evanston, who denied the claim. Atofina settled the death claim for \$6.75 million and sought reimbursement for the amounts it paid in settlement of the claim.³⁶⁶ On appeal, Atofina argued that because Evanston denied coverage it was barred from arguing about the reasonableness of the settlement.³⁶⁷ The Court applied a pre-*Gandy* decision from the case of *Employers Cas. Co. v. Block*, in which the Court held that if an insurer wrongfully denies coverage and its insured enters into an agreed judgment, the insurer is barred from challenging the reasonableness of the settlement amount.³⁶⁸ The Court held that the holding in *Gandy* was "explicit and narrow, applying only to a specific set of assignments with special attributes," and did not disrupt the application of *Block* to the *Atofina* case.³⁶⁹ *Gandy* only applies to cases that present its unique set of elements.³⁷⁰ Because Atofina sued Evanston directly, the court held that one of the distinguishing factors from *Gandy* was that there was no assignment, and therefore, the *Gandy* rule did not apply.³⁷¹ Accordingly, the Court held that

³⁶¹ *Id.* at 714.

³⁶² *Id.* at 719.

³⁶³ *Id.*

³⁶⁴ *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.*, 256 S.W.3d 660, 663 (Tex. 2008).

³⁶⁵ *Id.*

³⁶⁶ *Id.*

³⁶⁷ *Id.* at 670-671.

³⁶⁸ *Id.* (citing *Employers Cas. Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988)).

³⁶⁹ *Id.* at 673-674.

³⁷⁰ *Id.*

³⁷¹ *Id.*

Evanston's denial of coverage barred it from challenging the reasonableness of the settlement amount.³⁷²

- 3) **KEY LESSON.** The *Atofina* decision is a marked departure from how the Texas Supreme Court has viewed friendly settlements or agreed judgments entered into without an adversarial trial to set up the insurer. The Court in *Atofina* has limited *Gandy* to its specific unique elements. Presumably, if any one of those *Gandy* elements is missing, then an agreed judgement, friendly settlement, or assignment may be enforced against a wrongfully denying liability insurer. This decision will likely introduce a period of time where settlements will be more common and carriers who deny coverage will be stuck with having no argument to dispute the reasonableness of the settlement amounts. Carriers are encouraged to get competent coverage counsel to render coverage opinions in all cases where the carrier expects or intends to deny coverage.

H. **Equitable "Virtual-Representation" Doctrine.** Virtual Representation refers to the concept where a non-named party to a case is allowed to intervene in the case which is on appeal. Generally, only parties of record may appeal a trial court's judgment.³⁷³ There are a few exceptions to the rule, where a person or entity who was not a named party in the trial court may pursue an appeal in order to vindicate important rights. Depending on the facts of the particular case, an insurer may have the right to intervene as a party to case on appeal involving its insured. For example, in the *In re Lumbermens* case, the Texas Supreme Court determined that an insurer that posted a \$29 million bond to supersede an adverse judgment against its insured may intervene in the insured's appeal to assert a potentially dispositive issue that its insured abandoned in order to settle certain uninsured claims in another pending lawsuit.

I. **Settlement Issues.**

- 1) **Insurer's Statutory Duty regarding settlement.** Under the Texas common law, an insurer generally has no obligation to settle a third-party claim against its insured unless the claim is covered under the policy.³⁷⁴ But as discussed above, the Texas Insurance Code requires a carrier to attempt in good faith to effectuate a prompt, fair, and equitable settlement of a claim with respect to which the insurer's liability has become reasonably clear.³⁷⁵ This extends to third-party claims. The Supreme Court has held that to trigger an insurer's statutory duty to reasonably attempt settlement of a third-party claim against its insured, **the policy must cover the claim and the**

³⁷² *Id.* at 674.

³⁷³ *In re Lumbermens Mut. Cas. Co.*, 184 S.W.3d 718, 723 (Tex. 2006).

³⁷⁴ *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex.1997).

³⁷⁵ TEX. INS CODE ANN. 541.060(a)(2)(A).

insured's liability to the third party must be reasonably clear, such that an ordinarily prudent insurer would accept it.³⁷⁶

Accordingly, to impose liability against an insurer under the Insurance Code for the failure to effectuate a prompt, fair, and equitable settlement of a claim with respect to which the insurer's liability has become reasonably clear, the insured must prove the following elements: 1) the policy covers the claim; 2) the insured's liability is reasonably clear; 3) the claimant has made a proper settlement demand within policy limits; and 4) the demand's terms are such that an ordinarily prudent insurer would accept it.³⁷⁷

- 2) **Settling One of Multiple Claims Arising From One Occurrence.** Texas law permits an insurer, when faced with a settlement demand arising out of multiple claims from the same occurrence and inadequate insurance proceeds, to enter into a reasonable settlement with one of the several claimants, even though such settlement exhausts or diminishes the insurance proceeds available to satisfy other claims.³⁷⁸ The same basic rule applies in a multi-insured case, when there are two or more insureds covered by the same policy and who face potential liability for the same incident.³⁷⁹ In this situation, an insurer can make a reasonable settlement on behalf of one of the insureds, even though such settlement reduces or eliminates coverage for another insured under the same policy.³⁸⁰ The general rule, therefore, is that each claim against each insured is to be evaluated on its own merits, and if it is reasonable for an insurer to accept a settlement demand, even though it reduces or eliminates coverage for other claimants or other insureds, then the insurer can do so without regard to such other claimants or insureds.

- 3) **Hospital Liens.** Section 55.001 of the Texas Property Code provides a mechanism for Texas hospitals who provide emergency medical services to file a valid lien against any cause of action the injured party may have arising out of the incident. While a full analysis of that provision is beyond the scope of this article, it is important to note that failure to check for hospital liens can mean paying a claim twice. The Texas hospital lien is enforceable against a Defendant even if the Plaintiff and Defendant have already settled the claim. Hospital liens can be found in the County Clerk's records, and should be searched if there is any question about emergency services being provided to the Plaintiff.

³⁷⁶ *Rocor Int'l Inc. v. Nat'l Union Fire Ins. Co.*, 77 S.W.3d 253, 261, 265 (Tex.2002).

³⁷⁷ *Id.* at 262.

³⁷⁸ *Soriano* at 315.

³⁷⁹ *American States Ins. Co. v. Arnold*, 930 S.W.2d 196, 202-03 (Tex. App.–Dallas 1996, writ denied); *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761, 768 (5th Cir. 1999).

³⁸⁰ *Id.*

- 4) **Medicare and Medicaid Liens.** Medicare and Medicaid also have very strong liens or subrogation rights on payments made to a plaintiff who has received medicaid or medicare benefits. Because these liens can be enforced directly against the Defendant, and the Defendant's insurer, even if a settlement has already taken place and a release from the injured party received, it is important to check for any liens before a settlement is consummated. These liens have to be determined through the agency that administers the program. If such a lien is discovered, the name of the lien holder needs to be put on any settlement check or arrangements made for the negotiation and release of that lien as a part of the settlement.
- a. **IMPORTANT:** Section 111 of the Medicare, Medicaid and SCHIP Extension Act of 2007 (MMSEA) requires insurers and self-insurers to report to the Center for Medicare and Medicaid Services information related to medicare or medicaid recipients who may receive a settlement or judgment, and those recipients who are receiving no fault insurance benefits such as worker's compensation, PIP, or other insurance coverage. This applies to self-insureds. Entities that are required to report can be fined up to \$1,000 per day for failure to report. It is beyond the scope of this Guide to provide all of the details about these requirements as they are long and involved. Go to www.cms.hhs.gov/mandatoryinsrep/ for further information about this or contact us directly to provide consultation.
- 5) **Texas' settlement statute.** The Texas settlement statute was enacted in 2003, adding Chapter 42 to the Texas Civil Practice and Remedies Code. At first blush, this looks like a convenient mechanism to try to resolve nuisance cases, and perhaps get some defense costs back in a no liability case. *But care should be exercised by a carrier that tries to use this. Because of the cost shifting provisions in the statute, if a carrier makes an offer and invokes this statute, but the insured ultimately loses at trial, the carrier could unwittingly make the insured liable for additional damages that are not covered by the insurance policy. If a carrier is interested in using the statute in a particular case, the carrier should discuss the impact with the insured before invoking this statute and making an offer.*
- a. This law provides, with respect to claims seeking monetary relief, a framework for the recovery of litigation costs, including attorneys fees, after the rejection of a favorable settlement offer.³⁸¹ Specifically, if a settlement offer is made and rejected and the judgment of the trial court is significantly less favorable to the rejecting party than the settlement offer, the offering

³⁸¹ TEX. CIV. PRAC. & REM. CODE § 42.001 *et seq.*

party is entitled to recover from the rejecting party, litigation costs incurred by the offering party after the date of the rejection.³⁸² A judgment is significantly less favorable to the rejecting party than the settlement offer if either: 1) the rejecting party is a claimant and the award is less than 80 percent of the rejected offer; or 2) the rejecting party is a defendant and the award is more than 120 percent of the rejected offer.³⁸³ Litigation costs refers to money actually spent and obligations actually incurred that are directly related to the case in which a settlement offer is made and includes reasonable attorney's fees, court costs, and reasonable fees for not more than two testifying expert witnesses.³⁸⁴ Litigation costs recoverable are limited to a calculated amount of the sum of 50 percent of the economic damages, plus all of the noneconomic, exemplary, or additional damages to be awarded to the claimant in the judgment, minus the amount of any statutory or contractual liens in connection with the occurrences or incidents giving rise to the claim.³⁸⁵ If litigation costs are to be awarded against a claimant, those litigation costs will be awarded to the defendant in the judgment as an offset against the claimant's recovery from that defendant.³⁸⁶

- b. This settlement procedure does not apply until a defendant files a declaration that this particular settlement procedure is available in the action. The declaration must be filed no later than 45 days before the case is set for trial.³⁸⁷ If there is more than one defendant, this settlement procedure is available only in relation to the defendant that filed the declaration and to the parties that make or receive offers of settlement in relation to that defendant.³⁸⁸ To be in compliance with this law, a settlement offer must: (1) be in writing; (2) state that it is made pursuant to Rule 167 of the Texas Rules of Civil Procedure and Chapter 42 of the Civil Practice and Remedies Code; (3) identify the parties making the offer and the parties to whom the offer is made; (4) state the terms by which the monetary claims may be settled; (5) state a deadline by which the settlement offer must be accepted; and (6) be served on all parties to whom the settlement offer is made.³⁸⁹ An offer under this law, must not include non-monetary claims.³⁹⁰ The offer may be made subject to reasonable conditions such as the

³⁸² TEX. CIV. PRAC. & REM. CODE § 42.004(a),©).

³⁸³ TEX. CIV. PRAC. & REM. CODE § 42.004(b).

³⁸⁴ TEX. CIV. PRAC. & REM. CODE § 42.001(5).

³⁸⁵ TEX. CIV. PRAC. & REM. CODE § 42.004(d).

³⁸⁶ TEX. CIV. PRAC. & REM. CODE § 42.004(f).

³⁸⁷ TEX. R. CIV. P. 167.2(a).

³⁸⁸ TEX. CIV. PRAC. & REM. CODE § 42.002©.

³⁸⁹ TEX. CIV. PRAC. & REM. CODE § 42.003; TEX. R. CIV. P. 167.2(b).

³⁹⁰ TEX. R. CIV. P. 167.2(d).

execution of appropriate releases and other documents. Unless an offeree objects by written notice within the specified time deadline, the condition is presumed reasonable.³⁹¹ Rejection of an offer subject to a condition that is subsequently found to be unreasonable by the trial court cannot be the basis of an award of litigation costs.³⁹²

- c. An offer made under this statute may not be made before a Defendant files a declaration, and may not be made within 60 days after the appearance in the case of the offeror or offeree, whichever is later.³⁹³ Additionally, the offer may not be made within 14 days before the case is set for conventional trial on the merits, except that an offer may be made within 14 days of trial if it is in response to and within seven days of a prior offer.³⁹⁴ A party is permitted to make an offer after having made or rejected a prior offer.³⁹⁵ An offer can be withdrawn in writing before it is accepted.³⁹⁶ Acceptance of an offer can only be done by written notice served on the offeror before the deadline stated in the offer.³⁹⁷

- d. This law is applicable only to actions filed on or after January 1, 2004. But it does not apply to class actions, shareholder derivative actions, actions by or against a governmental unit, actions brought under the Family Code, actions to collect workers' compensation benefits, or actions filed in justice of the peace court.³⁹⁸ If a claimant or defendant is entitled to recover fees and costs under another law, that claimant or defendant may not recover litigation costs in addition to the fees and costs recoverable under the other law. This procedure does not affect the ability of any party to make an offer to settle a case, or any other law regarding settlement offers in a particular case,³⁹⁹ but an offer not made in compliance with this settlement procedure or in a case where this provision is not applicable does not allow the offering party to recover litigation costs.⁴⁰⁰

³⁹¹ TEX. R. CIV. P. 167.2(a).

³⁹² *Id.*

³⁹³ TEX. R. CIV. P. 167.2(e)(2).

³⁹⁴ TEX. R. CIV. P. 167.2(e)(3).

³⁹⁵ TEX. R. CIV. P. 167.2(f).

³⁹⁶ TEX. R. CIV. P. 167.3(a).

³⁹⁷ TEX. R. CIV. P. 167.3(b).

³⁹⁸ TEX. CIV. PRAC. & REM. CODE § 42.002(b).

³⁹⁹ TEX. CIV. PRAC. & REM. CODE § 42.002(d).

⁴⁰⁰ TEX. CIV. PRAC. & REM. CODE § 42.002(e).

J. **Attorney Billing Guidelines and Attorney Ethical Issues.**

- 1) **Attorney's duty to insured.** The relationship between insured, carrier and attorney has been described as a tripartite relationship, a term suggestive of an uneasy alliance.⁴⁰¹ The defense attorney is often faced with competing ethical concerns, created by law which imposes on him an absolute loyalty to the insured and yet subjects him to controls imposed by an insurance carrier.⁴⁰² In Texas, a defense attorney hired by an insurance carrier, is an independent contractor, and has discretion regarding the day-to-day details of conducting the defense and is not subject to the client's control regarding those details.⁴⁰³ Because a lawyer owes unqualified loyalty to the insured,⁴⁰⁴ the lawyer must at all times protect the interests of the insured even if those interests would be compromised by the insurer's instructions.⁴⁰⁵ That is, a lawyer must act in the client's best interest even if it conflicts with guidelines or instructions from the insurance carrier. It is for this reason that an insurer is not vicariously responsible for the defense lawyer's conduct on behalf of the insured.⁴⁰⁶ Over the last several years, the State Bar of Texas Professional Ethics Committee has issued opinions on issues related to an attorney's duties when representing a client where the defense is being paid for by an insurance company.⁴⁰⁷ In this regard, the Committee has opined that it is impermissible, under the Texas Disciplinary Rules of Professional Conduct, for a lawyer to agree with any insurance company restriction which interferes with the lawyer's exercise of his or her independent professional judgment in rendering such legal services to the insured-client.⁴⁰⁸ As a practical matter, most billing guidelines do not interfere with the lawyer's ability to defend the client. This issue can come into play when an attorney's request for permission to do a certain activity on a case, such as hire an expert, is denied by the carrier. In such a case, the attorney has to weigh the issue and determine whether he believes it is essential to the defense. If it is, he will need to discuss the issue with the insured, and possibly go forward with the task of doing the activity even if it is not reimbursed by the carrier.

- 2) **Use of Third-Party Auditors for Attorney Bills.** The Texas Disciplinary Rules of Professional Conduct provide that a lawyer shall

⁴⁰¹ *In re Cooper*, 47 S.W.3d 206, 210 (Tex. App.- - Beaumont 2001, no pet.)(Gaultney, J. concurring).

⁴⁰² *Id.*

⁴⁰³ *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex.1998)(citing RESTATEMENT (SECOND) OF AGENCY, § 385, cmt. a).

⁴⁰⁴ *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex.1973).

⁴⁰⁵ *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d at 627-628.

⁴⁰⁶ *Id.*

⁴⁰⁷ Tex. Comm. on Prof'l Ethics, Op. 552, 67 TEX. B. J. 981 (2004); Tex. Comm. on Prof'l Ethics, Op. 533, 63 TEX. B. J. 806 (2000); Tex. Comm. on Prof'l Ethics, Op. 532, 63 TEX. B. J. 805 (2000).

⁴⁰⁸ Tex. Comm. on Prof'l Ethics, Op. 533, 63 TEX. B. J. 806 (2000).

not undertake representation where someone else pays for a client's defense, such as in the insurer/insured context, unless: 1) the client consents; 2) there is no interference with the lawyer's independent professional judgment or with the client-lawyer relationship; and 3) information relating to representation of a client is protected as required by Rule 1.05. Rule 1.05 provides that a lawyer shall not knowingly reveal a client's confidential information. Because a lawyer's invoice or bill contains information describing the legal services rendered on behalf of the client, the Professional Ethics Committee for the State Bar of Texas has opined that attorneys in Texas are not permitted to forward any legal bills to an outside auditor without first obtaining the client's informed consent.⁴⁰⁹ Accordingly, if a carrier requires an attorney to send his bills to an outside third-party auditor, the attorney is only able to send bills to the outside auditor if the insured-client consents to the disclosure. If the client will not consent to the disclosure, the attorney is required to send his bills directly to the carrier for payment.

- 14 **DEMANDS FOR POLICY LIMITS - STOWERS LIABILITY.** *Stowers* is a Texas insurance term which refers to an insurance company's responsibility to an insured when responding to a settlement demand within policy limits. Since the 1929 case of *G.A. Stowers Furniture Co. v. American Indem. Co.*,⁴¹⁰ Texas law has required an insurer, when confronted with a claim against an insured and a settlement demand within policy limits, to exercise that degree of care and diligence which an ordinarily prudent person would exercise in the management of that person's own business.⁴¹¹ If an ordinarily prudent person, as viewed from the standpoint of the insured, would have settled the case, but the insurer fails to do so, then the insurer may have liability for damages awarded against the insured, including damages in excess of the policy limits.⁴¹² Although the *Stowers* concept is easy to understand, the task of analyzing the various *Stowers* issues for potential liability and response often proves difficult. Without a good understanding of the *Stowers* issues, insurers are prone to either overpay claims out of a mistaken fear of potential *Stowers* liability, or make themselves vulnerable to actual *Stowers* liability for failing to appreciate the true risk in a given case. Insurers do not need to leave the risk of *Stowers* liability up to a game of chance as to whether the insured is going to be found liable for damages in excess of policy limits at the underlying liability trial against the insured. A prompt and prudent analysis and response to the *Stowers* demand, can provide effective protection to an insurer even in cases where the *Stowers* demand is not accepted and the subsequent liability trial against the insured results in damages in excess of the policy limits. This section explores *Stowers* liability issues and Appendix G is a worksheet to guide attorneys and

⁴⁰⁹ Tex. Comm. on Prof'l Ethics, Op. 552, 67 Tex. B. J. 981 (2004); Tex. Comm. on Prof'l Ethics, Op. 532, 63 Tex. B. J. 805 (2000).

⁴¹⁰ 15 S.W.2d 544, 547 (Tex.Comm'n App.1929, holding approved).

⁴¹¹ *American Physicians Ins. Exchange v. Garcia*, 876 S.W.2d 842, 848 (Tex.1994).

⁴¹² *Stowers*, at 547.