ROUNDING THE CORNERS OF THE DUTY TO DEFEND: WHERE ARE WE AND WHERE ARE WE GOING?

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CHAPTER 9.1

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ROUNDING THE CORNERS OF THE DUTY TO DEFEND

I. INTRODUCTION

The duty to defend may be the single most important aspect of a liability policy. At the very least, it is on equal footing with the duty to indemnify. The reasons are simple: We live in a litigious society and lawyers are expensive. In many cases, defense costs exceed (and sometimes far exceed) the amount of a judgment or settlement. Many insureds, whether individuals or small corporations, simply cannot afford to retain counsel and/or lack the litigation sophistication to retain appropriate counsel to staff a particular lawsuit.

The duty to defend helps to solve these problems by requiring the insurer to fund the defense and play an active role in the litigation process. Moreover, since an insurer has a duty to defend its insured even if the allegations against it are groundless, false, or fraudulent, the duty to defend helps prevent an insured from being bankrupted by frivolous lawsuits. Thus, in a very real sense, the duty to defend can be considered litigation insurance.

The importance of the duty to defend and its role in the litigation process cannot be understated. As one noted commentator has recognized, an insurer's defense obligation can have an influence on every step of the litigation process, including pleading and filing, case strategy, the jury charge, negotiation, and settlement strategies. *See* Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721, 1725–38 (1997).

Despite the fact that issues related to the duty to defend may be the most frequently litigated and written about in the insurance coverage world, many issues remain unsettled and in a state of flux. Notably, until 2006, the Supreme Court of Texas had never directly addressed the extrinsic evidence issue. And, as will be discussed, it is not entirely clear where Texas law stands on the issue even today. Likewise, although hornbook insurance law teaches us that that doubts as to the duty to defend are to be resolved in favor of the insured, it is not entirely clear as to how much doubt is too much doubt. In other words, what does it really mean for allegations in a pleading to *potentially* trigger coverage? This paper will explore some of these thorny duty to defend issues. In addition, the paper will address other duty to defend issues such as the tripartite relationship, control of the defense, selection of counsel, and recoupment of defense costs.

II. THE CONTRACTUAL BASIS FOR THE DUTY TO DEEND

A. Read the Policy

The duty to defend is a contractual obligation. *See Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81 (Tex. 1997); *Houston Petroleum v. Highlands Ins. Co.*, 830 S.W.2d 153, 155 (Tex. App.—Houston [1st Dist.] 1990, writ denied). Texas does not recognize a common law or statutory duty to defend. Thus, absent a provision in the policy, an insurer has no obligation to assume the defense of its insured or to reimburse its insured for incurred defense costs. A typical duty to defend provision provides as follows:

> *We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages. However, we will have no duty to defend the insured against any "suit" seeking damages for "bodily injury" or "property damage" to which this insurance does not apply. We may, at our discretion, investigate any "occurrence" and settle any claim or "suit" that may result.*
>
> *But:*
>
> *(1) The amount we will pay for damages is limited as described in Section III—Limits of Insurance; and*
> *(2) Our right and duty to defend ends when we have used up the applicable limit of insurance in the payment of judgments or settlements under Coverage A or B or medical expenses under Coverage C.*

ISO Properties, Inc., 2001 Occurrence Form (CG 00 01 10 01).

In contrast, some policies provide for the reimbursement of defense costs. In those policies, the insurer has no duty to *assume* the defense of its insured, but rather has a duty to *reimburse* the insured for reasonable and necessary defense costs. Such provisions are typical in D&O policies—although, many modern D&O policies contain a provision whereby the insurer will front the defense costs. Other policy forms provide the insurer with an option—but not a duty—to assume its insured's defense. *See, e.g.*, *Comsys Information Tech. Servs. Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 190 (Tex. App.—Houston [14th Dist.] 2004, no pet.) (noting that policy gave the insurer the option, but not the duty, to defend). These "voluntary defense" provisions

oftentimes are found in excess and umbrella policy forms.

Given the contractual nature of the duty to defend, it always is important to read the policy language carefully to determine the scope of an insurer's defense obligation. For example, while it is common for defense costs to be outside the limits of insurance (i.e., non-eroding), that is not always the case. Some policy forms provide for "wasting" or "eroding" limits whereby every dollar spent on defense costs erode the available policy limits. For example, it is quite common for professional liability and/or E&O policies to be written on such a basis. Obviously, whether a particular policy is written on a wasting basis or not is something that the insured (and the third-party claimant for that matter) would want to know from the very beginning. Moreover, the scope of the duty to defend can be affected by self-insured retentions and deductible provisions within the policy. The bottom line: Read the policy.

B. Who Gets a Defense?

An insurer's duty to defend extends to all insureds and additional insureds. In some cases, an insurer may have a duty to defend both its insured and an additional insured. *See Hill & Wilkinson, Inc. v. American Motorists Ins. Co.*, 1999 WL 151668 (N.D. Tex. Mar. 15, 1999); *Texas Med. Liab. Trust v. Zurich Ins. Co.*, 945 S.W.2d 839, 843 (Tex. App.—Austin 1997, writ denied). Additionally, under certain circumstances, an insurer may assume the defense of a contractual indemnitee of the named insured. In particular, the modern CGL policy provides for a duty to defend a contractual indemnitee when: (i) the suit against the indemnitee seeks damages for which the insured has assumed the liability of the indemnitee in an "insured contract"; (ii) the insurance applies to such liability assumed by the insured; (iii) the obligation to defend, or the cost of the defense, has also been assumed by the insured in the same "insured contract"; (iv) no conflict of interest exists between the interests of the insured and the interests of the indemnitee; and (v) the indemnitee and the insured ask the insurer to conduct and control the defense of the indemnitee with the same counsel. *See* ISO Properties, Inc., 2001 Occurrence Form (CG 00 01 10 01).

C. The Duty to Defend Begins at Tender

Under Texas law, an insurer does not have a duty to defend until the lawsuit is "tendered" to the insurer for a defense. *See E & L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 278 (Tex. App.—Beaumont 1998, no writ); *Members Ins. Co. v. Branscum*, 803 S.W.2d 462, 466–67 (Tex. App.—Dallas 1991, no writ); *see also Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761, 768 (5th Cir. 1999). Compliance with the notice of suit provision is a condition precedent to the insurer's liability on the policy. Moreover, CGL policies specifically prohibit voluntary payments. *See LaFarge Corp. v. Hartford Cas.Co.*, 61 F.3d 389, 399–400 (5th Cir. 1995).

Texas courts, consistent with this view, have not recognized a right to pre-tender defense costs even when the insurer cannot establish prejudice. *See L'Atrium on the Creek I, L.P. v. National Union Fire Ins. Co.*, 326 F. Supp. 2d 787, 792 (N.D. Tex. 2004); *Kirby Co. v. Hartford Cas. Ins. Co.*, 2004 WL 2165367 (N.D. Tex. Sept. 23, 2004); *Amica Mut. Ins. Co. v. St. Paul Fire & Marine Life Ins. Co.*, 2003 WL 21281666 (N.D. Tex. May 29, 2003). What is necessary to constitute "tender" depends on the terms of the policy. At the very least, however, an insured must provide the insurer with a copy of the latest amended pleading. *See Branscum*, 803 S.W.2d at 467.

D. Termination of the Duty to Defend

The duty to defend terminates in one of three ways: (i) the pleadings are amended in such a way as to defeat the duty, *see Consol. Underwriters v. Loyd W. Richardson C. Corp.*, 444 S.W.2d 781, 784–85 (Tex. Civ. App.—Beaumont 1969, writ ref'd n.r.e.); (ii) the covered portion of a petition or complaint is dismissed, *see Travelers Ins. Co. v. Volentine*, 578 S.W.2d 501, 505 (Tex. Civ. App.—Texarkana 1979, no writ); or (iii) depending on policy language, when the policy limits are exhausted by payment of a judgment or settlement, *see Am. States Ins. Co. v. Arnold*, 930 S.W.2d 196, 201 (Tex. App.—Dallas 1996, writ denied).

E. The Duty to Appeal

At least one Texas court has addressed an insurer's duty to appeal an adverse judgment. In *Waffle House, Inc. v. Travelers Indem. Co. of Ill.*, 114 S.W.3d 601 (Tex. App.—Fort Worth 2003, pet. denied), the Fort Worth Court of Appeals held that "Travelers' duty to defend Waffle House continues through the appellate process until the applicable limits of the policy are exhausted according to the terms of the policy." *Id.* at 611.

Leading commentators agree with this view. According to Windt, for example, an insurer should be required to finance an appeal either: "(a) if there are reasonable grounds to believe that a judgment in excess of the policy limits might be reversed or materially reduced; or (b) if there are reasonable grounds to believe that a judgment entered in a noncovered area might be reversed." *See* ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 4.17, at 360–62 (4th ed. 2001). Likewise, Ostrager & Newman note that "[m]ost courts hold that an unparticularized 'right and duty to defend' clause in a liability insurance policy obligates the insurer to appeal a judgment against the insured in an underlying action where there are reasonable grounds for appeal." *See* BARRY S. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES

§5.02[d], at 267–68 (12th ed. 2004) (citations omitted). Ostrager & Newman go on to note that "[i]t would appear that an insurer's duty to pursue post-trial remedies such as a motion for judgment notwithstanding the verdict or motion for new trial would be governed by the same test." *Id.* at 267.

Simply put, the duty to appeal is a logical extension of the duty to defend. Accordingly, once the duty to defend is triggered, the insurer should be obligated to see the case through to the end. Any other result would overlook the fact that the trial court is only the first step in the litigation ladder. Of course, the insurer need only appeal when the insured's interests are at stake. Thus, if the entire judgment falls within coverage, an insurer can forgo any duty to appeal by simply satisfying its duty to indemnify.

F. Excess and Umbrella Insurers

Whether an excess or umbrella insurer has a duty to defend depends upon the terms of the excess or umbrella policy. Stated simply, the duty to defend is contractual in nature regardless of the layer. Some excess and/or umbrella policies provide the insurer with the *option* to assume the defense and/or to participate in the defense of its insured. The purpose of such language is to permit excess insurers to participate in the defense of the insured in situations when the insured's liability exposure likely exceeds the primary layer. When an excess insurer is provided the *option* to provide a defense, it may decline to do so without breaching its duties under the insurance contract. *See Laster v. Am. Nat'l Fire Ins. Co.*, 775 F. Supp. 985, 994 (N.D. Tex. 1991); *Warren v. Am. Nat'l Fire Ins. Co.*, 826 S.W.2d 185, 187 (Tex. App.—Fort Worth 1992, writ denied).

Other excess and/or umbrella policy forms, however, require the insurer to actually assume the duty to defend. Typically, in such policy forms, the excess or umbrella insurer's duty to defend will not be triggered until the limits of the primary insurance have been exhausted. *See Texas Employers Ins. Ass'n v. Underwriting Members of Lloyd's*, 836 F. Supp. 398, 404 (S.D. Tex. 1993). Issues can arise in this context when the primary insurer goes insolvent. Under Texas law, absent a specific contractual provision to the contrary, insolvency does not equate with exhaustion. Thus, an excess or umbrella insurer has no duty to "drop down" and defend its insured when the primary insurer is declared insolvent. *See Harville v. Twin City Fire Ins. Co.*, 885 F.2d 276, 278–79 (5th Cir. 1989); *Taylor Serv. Co. v. Tex. Prop. & Cas. Ins. Guar. Ass'n*, 918 S.W.2d 89, 91 (Tex. App.—Austin 1996, no writ).

G. The Duty to Defend Does Not Apply to Affirmative Claims

An issue that may arise in the course of defending an insured is whether the duty to defend extends to the cost of prosecuting affirmative claims, such as cross-claims or counterclaims. The answer to this question—at least under typical insuring agreements—is "no." *See* BARRY S. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §5.02[e], at 268–69 (12th ed. 2004) (citations omitted). This follows directly from the language of typical insuring agreements, which provide for a defense obligation only for claims brought "against" the insured. *See* ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 4.41, at 457–60 (4th ed. 2001). As a practical matter, however, it is quite common for an insurer to finance the insured's affirmative claims in circumstances when the affirmative claim may reduce the insured's (and insurer's) ultimate liability. This is especially so where the affirmative claim is being pursued for defensive purposes.

III. THE GENERAL CONTOURS OFTHE DUTY TO DEFEND

A. The "Eight Corners" or "Complaint Allegation" Rule

Texas courts apply the "eight corners rule" to determine whether an insurer has a duty to defend its insured. *See Guideone Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006); *Nat'l Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 528–35 (5th Cir. 2004). In undertaking the "eight corners" analysis, a court must compare the allegations in the live pleading to the insurance policy without regard to the truth, falsity, or veracity of the allegations. *See King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191 (Tex. 2002); *Northfield*, 363 F.3d at 528. Thus, at least in most circumstances, only two documents are relevant to the duty to defend analysis: (i) the insurance policy; and (ii) the pleading of the third-party claimant. *See King*, 85 S.W.3d at 187. Facts ascertained before suit, developed in the process of litigation, or determined by the ultimate outcome of the suit do not affect the duty to defend. *See Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 829 (Tex. 1997); *Northfield*, 363 F.3d at 528. Accordingly, except in very limited circumstances, the duty to defend is a question of law. *See State Farm Gen. Ins. Co. v. White*, 955 S.W.2d 474, 475 (Tex. App.—Austin 1997, no writ); *State Farm Lloyds v. Kessler*, 932 S.W.2d 732, 736 (Tex. App.—Fort Worth 1996, writ denied).

The Supreme Court of Texas has explained the "eight corners" rule in the following way:

> Where the [complaint] 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 there is, potentially, a case under the complaint within

> the coverage of the policy. Stated differently, in case of doubt as to whether or not the allegations of a 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 will be resolved in the insured's favor.

Merchants, 939 S.W.2d at 141 (quoting *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965)). The above quote from the Supreme Court of Texas and the case law (both state and federal) that has followed reveals the following important contours of the duty to defend:

- An insurer is required to defend its insured if the allegations state a *potential* claim for coverage under the policy.
- The truth or veracity of the allegations is irrelevant—all factual allegations must be taken as true.
- The allegations should be interpreted liberally with any doubts being resolved in favor of the duty to defend.
- Insurers are not, however, required to read facts into the pleadings and/or imagine factual scenarios that might trigger coverage.
- When a petition alleges multiple or alternative causes of action, the insurer must examine each separate allegation to determine whether it has a duty to defend. If one alternative cause of action or allegation is within the terms of the policy, the insurer has a duty to defend the entire lawsuit.
- The proper focus is on the factual allegations that establish the origin of the damages alleged in the petition rather than on the legal theories asserted in the petition.

In short, an insurer has a duty to defend a lawsuit against its insured *unless* it can establish that a comparison of the policy with the complaint or petition shows on its face that no potential for coverage exists. Stated otherwise, an insurer can refuse to provide a defense only when the facts as alleged fall outside of the coverage grant or when an exclusion applies that negates any potential for coverage.

While it sounds simple enough, an issue exists as to how far an insurer needs to go in liberally construing a pleading in favor of the duty to defend. On the one hand, courts have continuously held that pleadings should be liberally construed with all doubts resolved in favor of a duty to defend. On the other hand, courts also have continuously held that the liberal standards of the eight corners rule do not mandate that courts imagine factual scenarios that might trigger coverage. Adding to the confusion is a steady stream of inconsistent applications of the so-called "eight-corners" rule. For example, when it comes to determining trigger, what do you do if the petition or complaint is completely date-deprived? Likewise, when applying the "subcontractor exception" to exclusion L or in determining additional insured status for a general contractor on a construction project, what do you do if the petition or complaint is silent as to the use of subcontractors? Recently, the trend seems to be that courts appear willing to make logical inferences from pleaded facts while, at the same time, courts will refuse to completely fill in gaps in pleadings. *See, e.g.*, *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. filed) (refusing to read facts into the pleading or rely on extrinsic evidence). Oftentimes, the debate centers on whether it is ever appropriate to use extrinsic evidence.

B. The Burden of Proof

The burden of proof for the duty to defend is the same as for the duty to indemnify. The burden is on the insured to show that a claim against it is potentially within the scope of coverage under the policy. *See Federated Mut. Ins. Co. v. Grapevine Excavation Inc.*, 197 F.3d 720, 723 (5th Cir. 1999). If, however, the insurer relies on policy exclusions or other affirmative defenses to defeat the duty to defend, the burden shifts to the insurer to prove that one or more of the exclusions defeat the duty to defend. *See Guar. Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 193 (5th Cir. 1998); *see also* TEX. INS. CODE ANN. art. 554.002 (previously 21.58(b)) ("The insurer has the burden of proof as to any avoidance or affirmative defense . . . ."). Once the insurer proves that an exclusion applies, the burden then shifts back to the insured to show that the claim falls within an exception to the exclusion. *See Guaranty Nat'l*, 143 F.3d at 193; *Telepak v. United Servs. Auto. Ass'n*, 887 S.W.2d 506, 507–08 (Tex. App.—San Antonio 1994, writ denied).

IV. THE EXTRINSIC EVIDENCE DEBATE

The role of extrinsic evidence in the duty to defend analysis continues to be an area of confusion and debate. As a general rule, the use of extrinsic evidence to either create or defeat a duty to defend violates a strict eight corners rule. Most jurisdictions, however, recognize an exception to the eight corners rule when the insurer knows or reasonably should know facts that would establish coverage. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 111[c][2] (2d ed. 1996). A leading insurance treatise concurs with this approach:

> The existence of the duty to defend is normally determined by an analysis of the pleadings. Extrinsic evidence can, however, serve to

> create a duty to defend when such a duty would not exist based solely on the allegations in the complaint.
>
> * * *
>
> An insurer should not be able to escape its defense obligation by ignoring the true facts and relying on either erroneous allegations in the complaint or the absence of certain material allegations in the complaint. The insurer's sole concern should be with whether the judgment that may ultimately be entered against the insured might, either in whole or in part, be encompassed by the policy. There is authority to the contrary, holding that the insurer's defense obligation should be determined solely from the from the complaint, but such authority is unreasoned and consists merely of a blind adherence to the general rule in a situation in which the general rule was never intended to apply.

ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES, REPRESENTATION OF INSURANCE COMPANIES AND INSUREDS, § 4:3 (4th ed. 2001); *see also* Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty to Defend in Texas*, 31 TEX. TECH L. REV. 869, 890–98 (2000).

California, for example, permits both the insured and the insurer to use extrinsic evidence in determining the duty to defend. Texas courts, to put it kindly, have been sporadic in their application of the "eight corners" rule. In June 2006, the Supreme Court of Texas weighed in on the debate. *See Guideone Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006). Unfortunately, the opinion has provided more questions than it did answers. Prior to discussing *Fielder Road*, a little bit of historical background is in order.

A. History of Extrinsic Evidence Prior to 2006

Prior to 2006, although the Supreme Court had hinted that Texas was a strict "eight corners" state, the Supreme Court had never squarely rejected an exception to the "eight corners" rule. Whether and in what instances an exception existed basically was left to the trial and appellate courts to decide on a case-by-case basis. While a vast majority of the cases declined to recognize or apply any exception to the eight corners rule, such was not always the result.

Several state appellate courts have concluded that the so-called eight corners rule is not absolute. *See Utica Lloyd's of Tex. v. Sitech Eng'g Corp.*, 38 S.W.3d 260, 263 (Tex. App.—Texarkana 2001, no pet.) ("Where the terms of the policy are ambiguous, or where the petition in the underlying suit does not contain factual allegations sufficient to enable the court to determine whether the claims are within the policy coverage, the court may consider extrinsic evidence to assist in making the determination."); *Mid-Continent Cas. Co. v. Safe Tire Disposal Corp.*, 16 S.W.3d 418, 421 (Tex. App.—Waco 2000, pet. denied) ("The exception to this general rule occurs '[w]hen the petition in the Underlying Litigation does not allege facts sufficient for a determination of whether those facts, even if true, are covered by the policy.'"); *Providence Wash. Ins. Co. v. A&A Coating, Inc.*, 30 S.W.3d 554, 556 (Tex. App.—Texarkana 2000, pet. denied) ("However, there are certain limited circumstances where extrinsic evidence beyond the 'eight corners' will be allowed to aid in the determination of whether an insurer has a duty to defend."); *Tri-Coastal Contractors, Inc. v. Hartford Underwriters Ins. Co.*, 981 S.W.2d 861, 863–64 (Tex. App.—Houston [1st Dist.] 1998, pet. denied) (recognizing limited exceptions to the eight corners rule); *State Farm Fire & Cas. Co. v. Wade*, 827 S.W.2d 448, 451–52 (Tex. App.—Corpus Christi 1992, writ denied) (allowing extrinsic evidence to be used to fill gaps in a petition or complaint); *Cook v. Ohio Cas. Ins. Co.*, 418 S.W.2d 712, 715–16 (Tex. Civ. App.—Texarkana 1967, no writ.) (holding extrinsic evidence allowed to show automobile involved in accident was excluded from coverage); *Int'l Serv. Ins. Co. v. Boll*, 392 S.W.2d 158, 161 (Tex. Civ. App.—Houston 1965, writ ref'd n.r.e.) (holding extrinsic evidence allowed to show person involved in accident was excluded from policy).

Some federal courts have likewise concluded that the "eight corners" rule may not be absolute. *See Primrose Operating Co. v. Nat'l Am. Ins. Co.*, 382 F.3d 546, 552 (5th Cir. 2004) (permitting the review of extrinsic evidence when the underlying complaint did not contain sufficient facts to determine whether a potential for coverage exists); *Mid-Continent Cas. Co. v. Oney*, 2004 WL 1175569 (N.D. Tex. May 27, 2004) (noting that extrinsic evidence can be considered to determine fundamental coverage issues); *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F. Supp. 2d 601, 612–25 (E.D. Tex. 2003) (recognizing that extrinsic evidence may be used to establish fundamental coverage facts, such as whether the party bringing the claim is a named insured under the policy); *John Deere Ins. Co. v. Truckin' U.S.A.*, 122 F.3d 270, 272 (5th Cir. 1997) (holding that extrinsic evidence can be considered where the allegations in the underlying petition are not sufficient to determine whether a potential for coverage exists); *Sw. Tank & Treater Mfg. Co. v. Mid-Continent Cas. Co.*, 243 F. Supp. 2d 597, 602 (E.D. Tex. 2003) (holding that the consideration of extrinsic evidence is warranted in certain circumstances); *Matagorda Ventures, Inc. v. Travelers Lloyds Ins. Co.*, 203 F. Supp. 2d 704, 714 (S.D. Tex. 2000) (noting that

the eight corners rule does not apply rigidly in every case).

The *Wade* decision from the Corpus Christi Court of Appeals, at least traditionally, had been the most widely cited case in connection with the use of extrinsic evidence under Texas law. The facts of *Wade* are as follows. Williamson owned a boat that was insured by State Farm. Williamson and a passenger set off from Port O'Connor, Texas in Williamson's boat, but subsequently they were found drowned in the Gulf of Mexico. The passenger's estate brought suit against Williamson. State Farm tendered a defense under reservation of rights and filed a declaratory judgment action to determine its policy obligations. The applicable policy contained a "business pursuits" exclusion. The problem, according to the court, was that the petition did not contain sufficient factual allegations to determine whether State Farm owed a defense:

> Texas courts allow extrinsic evidence to be admitted to show a lack of a duty to defend. We conclude that the underlying petition, read broadly, does not address the issue of how the boat was used, which is an essential fact for determining coverage under this private boatowner's policy, and whether State Farm has a duty to defend the wrongful death suit. It makes no sense to us, in light of these holdings, to say that extrinsic evidence should not be admitted to show that an instrumentality (boat) was being used for a purpose explicitly excluded from coverage particularly, when doing so does not question the truth or falsity of any facts alleged in the underlying petition filed against the insured.

Wade, 827 S.W.2d at 453. Thus, under the *Wade* exception to the eight corners rule, extrinsic evidence may be admitted in a declaratory judgment proceeding when the petition does not set out facts sufficient to allow a determination of whether those facts—even if true—would state a covered claim. Stated differently, under *Wade*, extrinsic evidence can be admitted where a "gap" in the pleadings exists.

Wade has been cited favorably by numerous federal courts. *See Guar. Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 194–95 (5th Cir. 1998) (acknowledging a "narrow exception" to the eight corners rule when a petition does not contain sufficient facts to enable a court to determine if the duty to defend exists); *W. Heritage Ins. Co. v. River Entm't*, 998 F.2d 311, 313 (5th Cir. 1993) (same); *Acceptance Ins. Co. v. Hood*, 895 F. Supp. 2d. 131, 134 n.1 (E.D. Tex. 1995) (same). In contrast, Texas state courts generally had rejected the *Wade* approach to extrinsic evidence. In *Tri-Coastal*, for example, the court noted that "we are unable to find other Texas appellate courts that have followed the *Wade* rationale." *Tri-Coastal*, 981 S.W.2d at 863–64.

Although rejecting *Wade*, the *Tri-Coastal* court did recognize certain instances when extrinsic evidence may be permissible:

> In Texas, extrinsic evidence is permitted to show no duty to defend only in very limited circumstances, for example where the evidence is used to disprove the fundamentals of insurance coverage, such as whether the person sued is excluded from the policy, whether a policy contract exists, or whether the property in question is insured under the policy.

Id. at 863 n.1. The *Tri-Coastal* court adopted what can be called a "fundamentals of insurance exception" to the eight-corners rule. *See, e.g.*, *Landmark Chevrolet Corp. v. Universal Underwriters Ins. Co.*, 121 S.W.3d 886, 890–91 (Tex. App.—Houston [1st Dist.] 2003, pet. filed); *Chapman*, 2005 WL 20541, at *7–8. In a treatise-like opinion, District Judge Folsom essentially adopted the *Tri-Coastal* analysis and, in so doing, concluded:

> Only in very limited circumstances is extrinsic evidence admissible to rebut [the presumption of coverage]. These instances are ones in which "fundamental" policy coverage questions are resolved by "readily determined facts."

Westport, 267 F. Supp. 2d at 621. The *Westport* opinion is perhaps the most comprehensive discussion of Texas case law on the extrinsic evidence issue.

Both *Westport* and *Tri-Coastal*, at least impliedly, recognized that the extrinsic evidence debate may turn on the *type* of extrinsic evidence being considered. Generally speaking, extrinsic evidence can be broken down into three categories: (i) evidence that relates only to liability; (ii) evidence that relates only to coverage; and (iii) mixed or overlapping evidence that relates to both liability and coverage. *See* Pryor, *Mapping Changing Boundaries*, *supra*, at 869; *see also* Randall L. Smith & Fred A. Simpson, *Extrinsic Facts & The Eight Corners Rule Under Texas Law—The World is Not as Flat as Some Would Have You Believe*, 46 S. TEX. L. REV. 463 (2004).

In the past couple of years, the confusion has reached new heights. In *Northfield*, which was issued in March of 2004, the Fifth Circuit reviewed the long and winding road of Texas case law and made an "*Erie* guess that the current Texas Supreme Court would not recognize any exception to the strict eight corners rule." *Northfield*, 363 F.3d at 531. The *Northfield* court went on to say that:

> [I]n the unlikely situation that the Texas Supreme Court were to recognize an exception to the strict eight corners rule, we conclude any exception would only apply in very limited circumstances: when it is initially impossible to discern whether coverage is potentially implicated *and* when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case.

Id. (emphasis in original).

Following *Northfield*, one would have expected the extrinsic evidence issue to be settled within the Fifth Circuit (at least until such time as the Supreme Court of Texas weighed in on the issue). Expectations do not always come true. Two months after *Northfield* was issued, a federal district court in Lubbock held that "[t]his court may properly consider extrinsic evidence on the duty to defend only in the very narrow circumstance of 'where fundamental policy coverage questions can be resolved by readily determined facts that do not engage the truth or falsity of the allegations in the underlying suit.'" *Oney*, 2004 WL 1175569, at *5 (citing *Northfield*, 633 F.3d at 530). Given the *Erie* guess made in *Northfield*, the *Oney* analysis appears to be flawed. Or was it? A few months later, in August of 2004, the Fifth Circuit issued another opinion, concluding that "[f]act finders . . . may look to extrinsic evidence if the petition 'does not contain sufficient facts to enable the court to determine if coverage exists.'" *Primrose*, 382 F.3d at 552 (citing *Western Heritage*, 998 F.2d at 313). Ironically, the judge that authored *Primrose* is the very same judge that authored *Northfield*.

Right about the same time, the Fort Worth Court of Appeals issued its opinion in *Fielder Road Baptist Church v. Guideone Elite Insurance Co.*, 139 S.W.3d 384, 388–89 (Tex. App.—Fort Worth 2004), *aff'd*, 197 S.W.3d 305 (Tex. 2006). The facts are as follows: Jane Doe filed a sexual misconduct lawsuit against the Church and Charles Patrick Evans. In her petition, Jane Doe alleged that "[a]t all times material herein from 1992 to 1994, Evans was employed as an associate youth minister and was under Fielder Road's direct supervision and control when he sexually exploited and abused Plaintiff." The Church tendered the lawsuit to Guideone, who undertook the Church's defense under a reservation of rights. A few months later, Guideone initiated a declaratory judgment action. In the declaratory judgment action, Guideone sought discovery of Evans' employment history with the Church. Ultimately, the Church stipulated that Evans had ceased working at the Church *prior* to the time the Guideone policy took effect. The trial court relied on the stipulation in granting Guideone's summary judgment. The court of appeals, however, reversed by concluding that it was improper for the trial court to consider extrinsic evidence. In particular, despite recognizing that the allegations in the pleading may not have been truthful, the court of appeals rejected the use of extrinsic evidence in such circumstances because the extrinsic evidence at issue did not fall within the fundamentals of insurance exception. *Id.* In other words, the Fort Worth Court of Appeals essentially adopted the "fundamentals of insurance exception" from *Tri-Coastal*. The Supreme Court accepted the petition for review.

B. The Supreme Court Weighs In

On June 30, 2006, the Texas Supreme Court handed down its long-awaited opinion in *Fielder Road*. In so doing, the court agreed with the court of appeals and *declined* to adopt an exception to the eight corners rule. Nevertheless, the Supreme Court was careful to limit its decision to situations when the extrinsic evidence is "relevant both to coverage and the merits . . . ." *Fielder Road*, 197 S.W.3d at 310. More specifically, the court refused to adopt any exception to the eight corners rule for "liability only" or "overlapping/mixed fact" scenarios:

> [W]ere we to recognize the exception urged here, we would by necessity conflate the insurer's defense and indemnity duties without regard for the policy's express terms. Although these duties are created by contract, they are rarely coextensive.

Id. at 310. Moreover, in reaching its decision, the court did not disapprove of other case law and commentary that discussed a coverage-only exception to the eight corners rule. As noted in the prior section, and as recognized by the Supreme Court of Texas, authority exists for admitting extrinsic evidence in "coverage only" situations—at least when the coverage-only evidence involves fundamental coverage facts that can be readily ascertained and are undisputed. Although allowing extrinsic evidence in such circumstances may technically violate a strict eight corners rule, the reality is that considering "coverage only" evidence does not violate the contractual underpinnings of the duty to defend. Moreover, insurers still will have to defend groundless, false, or fraudulent claims that otherwise state a potential for coverage. Under a "coverage only" exception, for example, insurers only will be able to avoid the duty to defend in situations when the insured has not paid premiums for a defense (e.g., when the defendant is not listed as an insured, or where the property is not scheduled on the policy). Unfortunately, the Texas Supreme Court in *Fielder Road* did not expressly say one

way or the other whether it would recognize the exception.

Subsequent to the issuance of *Fielder Road*, one court noted the following:

> Although the Texas Supreme Court explicitly rejected the use of extrinsic evidence that was relevant both to coverage and to the merits of the underlying action, it did not rule on the validity of a more narrow exception that would allow extrinsic evidence solely on the issue of coverage. In fact, the language of the opinion hints that the court views the more narrow exception favorably. For example, the court specifically acknowledged that other courts recognized a narrow exception for extrinsic evidence that is relevant to the discrete issue of coverage and noted that the Fifth Circuit had opined that, were any exception to be recognized by the Texas high court, it would likely be such a narrow exception.

Bayou Bend Homes v. Scottsdale Ins. Co., 2006 WL 2037564 (S.D. Tex. July 18, 2006). And, subsequent to *Bayou Bend Homes*, one court has expressly concluded that a "coverage only" exception applies under Texas law. *See B. Hall Contracting, Inc. v. Evanston Ins. Co.*, 447 F. Supp.2d 634, 647 (N.D. Tex. 2006) (holding that "coverage only" extrinsic evidence can be considered in the duty to defend analysis).[1] Likewise, the Fifth Circuit has interpreted *Fielder Road* as permitting extrinsic evidence in "coverage only" scenarios. *See Liberty Mutual Ins. Co. v. Graham*, 2006 WL 3743108 (5th Cir. Dec. 21, 2006).

Even if admission of "coverage only" facts is allowed, an insurer should not be permitted to use such evidence to contradict allegations in a petition. Likewise, when a potential for coverage can be found from the face of a pleading, an insurer should not be permitted to develop extrinsic evidence through discovery in an effort to defeat the duty to defend. *See Fair Operating, Inc. v. Mid-Continent Cas. Co.*, 2006 WL 2242547 (5th Cir. Aug. 1, 2006) (affirming district court's order refusing insurer's request to undertake discovery of extrinsic evidence).

Given the uncertainty surrounding the *Fielder Road* opinion, it appears that the extrinsic evidence debate will continue until the Supreme Court of Texas once again weighs in on the issue. The Supreme Court may get that opportunity very soon. *See D.R. Horton-Texas, Ltd. v. Markel Int'l Ins. Co.*, 2006 WL 3040756 (Tex App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed).

In *D.R. Horton*, the Houston Court of Appeals addressed the duty to defend and extrinsic evidence issue in the context of an additional insured tender. In 2002, James and Cicely Holmes sued D.R. Horton alleging that their house contained latent defects that led to the propagation of toxic mold. The Holmes' petition was silent about D.R. Horton's use of subcontractors to construct the home. In particular, the Holmes' petition did not name any subcontractors, nor did it make any reference to damage caused by any of D.R. Horton's subcontractors. D.R. Horton, however, had extrinsic evidence that demonstrated that the alleged damages to the home were caused, at least in part, by work performed on D.R. Horton's behalf by its masonry subcontractor. Accordingly, since D.R. Horton required its subcontractors to name it as an additional insured, D.R. Horton tendered the Holmes' lawsuit to the liability carriers for the masonry subcontractor. Those insurers, however, declined to defend D.R. Horton based on the fact that the Holmes' petition failed to mention the use or otherwise reference any subcontractors.[2] In the coverage litigation against the additional insured carriers, D.R. Horton sought to introduce extrinsic evidence that the damages to the home were caused by the masonry subcontractor (i.e., the named insured). The trial court refused to permit the use of extrinsic evidence. The court of appeals, while recognizing that D.R. Horton "produced a significant amount of summary judgment evidence that . . . links [the masonry subcontractor] to the injuries claimed by the Holmeses," concluded that the trial court properly excluded the evidence. In particular, without explaining its basis, the court of appeals side-stepped the debate by classifying the extrinsic evidence before it as relating to *both* coverage and liability. *See D.R. Horton*, 2006 WL 3050756, at *5 n.11.

D.R. Horton has filed a petition for review with the Supreme Court of Texas. In the petition for review, D.R. Horton refutes the contention that the extrinsic evidence related to both liability and coverage. Rather, D.R. Horton contends that the extrinsic evidence it sought to introduce went solely to coverage (i.e., additional insured status). D.R. Horton then urges the Supreme Court to take *Fielder Road* one step further by expressly adopting a "coverage only" exception to the eight corners rule.

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[1] Interestingly, the court in *B. Hall* concluded that the "'eight-corners or complaint-allegation rule' is not applicable to this case" because the policy in question did not contain language requiring the insurer to defend suits that contain allegations that are "groundless, false, or fraudulent." *B. Hall*, 447 F. Supp. 2d at 645. In so doing, the court placed too much emphasis on the missing language.

[2] The additional insured endorsement limits the insurer's liability to those claims arising out of the named insured's [i.e., the masonry subcontractor] work for the additional insured [D.R. Horton].

V. DOES A FINDING OF NO DUTY TO DEFEND *NECESSARILY* MEAN NO DUTY TO INDEMNIFY?

It is uniformly accepted that the duty to defend is broader than the duty to indemnify. *See Burlington Ins. Co. v. Tex. Krishnas, Inc.*, 143 S.W.3d 226, 229 (Tex. App.—Eastland 2004, no pet.); *E&L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 274 (Tex. App.—Beaumont 1998, no writ); *Northfield*, 363 F.3d at 528. Accordingly, an insurer may have a duty to defend even when the adjudicated facts ultimately result in a finding that the insurer has no duty to indemnify. *See Utica Nat'l Ins. Co. v. Am. Indem. Co.*, 141 S.W.3d 198, 203 (Tex. 2004); *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997). In other words, it is well-settled that the duty to defend and the duty to indemnify are distinct and separate duties. *See Griffin*, 955 S.W.2d at 82; *Cowan*, 945 S.W.2d at 821–22. In contrast to the duty to defend, the duty to indemnify is not based on the third-party claimant's allegations, but rather upon the actual facts that comprise the third party's claim. *See Am. Alliance Ins. Co. v. Frito-Lay, Inc.*, 788 S.W.2d 152, 154 (Tex. App.—Dallas 1990, writ dism'd); *Canutillo Indep. Sch. Dist. v. Nat'l Union Fire Ins. Co.*, 99 F.3d 695, 701 (5TH Cir. 1996). In fact, "[a]n insurer is not obligated to pay a liability claim until [the] insured has been adjudicated to be legally responsible." *S. County Mut. Ins. Co. v. Ochoa*, 19 S.W.3d 452, 460 (Tex. App.—Corpus Christi 2000, no pet.). For this reason, the duty to indemnify is not ripe for determination prior to the resolution of the underlying lawsuit *unless* a court first determines, based on the eight corners rule, that there is no duty to defend and the same reasons that negate the duty to defend also negate any potential for indemnity. *See Griffin*, 955 S.W.2d at 82.

In most cases, the negation of the duty to defend also will negate the duty to indemnify. *See Griffin*, 955 S.W.2d at 84. This fact, however, oftentimes is overstated as an absolute rule. *See, e.g.*, *Am. States Ins. Co. v. Bailey*, 133 F.3d 363 (5th Cir. 1998) ("Logic and common sense dictate that if there is no duty to defend then there must be no duty to indemnify."); *see also Century Surety Co. v. Hardscape Constr. Specialties*, 2006 WL 1948063 (N.D. Tex. July 13, 2006) ("Of course, when there is no duty to defend, there is also no duty to indemnify."). Notably, a quick Westlaw or Lexis search will reveal dozens of cases that stand for the proposition that if there is no duty to defend, there can be no duty to indemnify. While oftentimes true, such a conclusion is by no means automatic. Even if an insurer obtains a judgment as to defense and indemnity based on a particular petition or complaint, for example, it is always possible that the petition or complaint can be amended to trigger a duty to defend. For example, in *Nautilus Insurance Co. v. Nevco Waterproofing, Inc.*, 2005 WL 1847094 (S.D. Tex. Aug. 3, 2005), the court noted as follows:

> This Court's ruling [on the duty to indemnify] is issued without prejudice and is based on the petition in the underlying suit at the time the court ruled. The Court does not intend to preclude Nevco from seeking indemnity from Evanston if Nevco is found liable on a theory that was not pleaded in Concierge's operative petition when construed broadly.

Id. at *3 n.6.[3] Similarly, in *Markel International Insurance Co. v. Campise Homes, Inc.*, 2006 WL 1662604 (S.D. Tex. June 6, 2006), the court concluded that:

> The resolution of the duty to defend issue is not automatically dispositive of the issue of indemnity. An insurer's duty to indemnify is distinct and separate from its duty to defend . . . . However, "[l]anguage in some cases can be read to indicate that if the live pleading at the time a determination of the duty to indemnify is sought did not trigger the duty to defend, no duty to indemnify can be found." For example, if the same basis that negates the duty to defend likewise negates any possible duty to indemnify, then a court may properly consider the issue of indemnify. In the instant case, the Court cannot find that the same basis that negated the duty to defend negates any possible duty to indemnify. Due to the sloppy pleading in the underlying lawsuit, it remains a fundamental mystery when the alleged property damage occurred. The Wolfes' did not allege property damage within the policy period, therefore, there is no duty to defend. However, this does not conclusively resolve the issue of indemnification. Presumably, the conclusion of the underlying lawsuit will clarify when the alleged damaged occurred—outside or within the policy period. If the alleged damage occurred within the policy period, then there may be a duty to indemnify. It is impossible at this juncture to make a determination as to indemnification.

Id. at *3 (internal citations omitted). Likewise, if a plaintiff brings a lawsuit against the insured alleging only intentional conduct but is granted a trial

[3] This decision was ultimately vacated and remanded by the Fifth Circuit based on mootness after the underlying action against the insured was dismissed after settlement was made with a major contractor.

amendment alleging non-intentional conduct and obtains a judgment on the alternative ground, the duty to indemnify should be triggered even though the insurer never defended. *See Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 825 n.4 (Tex. 1997) ("This holding does not affect a party's right to introduce evidence of physical manifestations of mental anguish against a tortfeasor under the 'fair notice' rule . . . . Our holding extends only to the duty to defend under the complaint allegation rule."); s*ee also* Pryor, *Mapping Changing Boundaries*, *supra.* Accordingly, the rule is better stated as follows: When no duty to defend exists, and no facts can be developed at the trial of the underlying lawsuit to impose coverage, an insurer's duty to indemnify may be determined by summary judgment.

The *D.R. Horton* case provides the perfect example of a mistaken application of the "if no duty to defend, then no duty to indemnify" rule. As noted in the previous section, the *D.R. Horton* court concluded that no duty to defend existed because the underlying petition failed to mention the use of subcontractors so as to trigger additional insured status. After reaching this conclusion, the court stated as follows:

> Even though we do not look at the specific legal theories alleged to determine the duty to indemnify, if the underlying petition does not raise factual allegations sufficient to invoke the duty to defend, then even proof of all of those allegations could not invoke the insurer's duty to indemnify. For this reason, the same arguments that disposed of Markel's duty to defend also dispose of its duty indemnify. Because the *Holmes* suit did not allege facts covered by the policy, even proof of those facts would not trigger coverage. We therefore affirm the trial court's summary judgment in favor of Markel on the issue of Markel's duty to indemnify.

D.R. Horton, 2006 WL 2040756, at *6 (internal citations omitted). The court clearly was wrong in this regard. In particular, as noted in the opinion, D.R Horton had produced ample summary judgment evidence demonstrating the requisite causal link between the named insured's work and D.R. Horton's liability. Even if such evidence is not admissible at the duty to defend context, no valid reason exists to ignore the extrinsic evidence at the duty to indemnify stage. In fact, since the duty to indemnify is based on *actual* facts, it is definitely proper for a court to consider extrinsic evidence.[4]

VI. ETHICAL ISSUES INVOLVING THE DUTY TO DEFEND

Once an insured gets past the duty to defend hurdle, issues oftentimes arise as to who gets to "control" the defense and, in particular, the right to independent counsel. In particular, issues such as whether the insurer or the insured gets to select counsel, who has to pay for independent counsel, and the appropriate rate to be paid to independent counsel are common. A brief review of the so-called "tripartite" relationship between the insurer, the defense counsel, and the insured will help set the stage for the independent counsel debate.

A. The Tripartite Relationship

When an insurer assumes its insured's defense, generally it has the right to select defense counsel pursuant to the terms of the policy. If no conflict of interest exists, the insurer also may have exclusive control over the defense. When a conflict of interest does exist (e.g., when the outcome of a coverage issue can be affected by the manner in which the underlying action is defended), the relationships between the liability insurer, its insured, and the defense counsel selected by the liability insurer to defend the insured can give rise to ethical issues that can be tricky to navigate. The relationship among these parties is known as the "tripartite relationship."

A debate exists as to whether Texas is a one-client or two-client state. Essentially, the debate focuses on whether the insurer also is the client of defense counsel hired by the insurer to represent the insured. *See* Charles Silver, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 Duke L.J. 255 (1995); Charles Silver & Michael Quinn, *Wrong Turns on the Three-Way Street: Dispelling Nonsense about Insurance Defense Lawyers*, Coverage, Nov.–Dec. 1995, at 1. Texas law is far from clear on this point with some cases pointing to a one-client state and others pointing toward a two-client state. Even so, regardless of the one-client versus two-client debate, Texas law is clear that defense counsel owes "unqualified loyalty" to the insured. *See State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998); *Employers Ins. Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973). As the Supreme Court of Texas pointed out in *Traver*, "the lawyer must at all times protect the interests of the insured . . . ." *Traver*, 980 S.W.2d at 628. Despite the fact that defense counsel undeniably owes its unqualified loyalty to the insured, the fact remains that the "so-called tripartite relationship

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[4] Insurers sometimes attempt an end run around the "eight corners" rule by trying to use extrinsic evidence on the duty to indemnify while the underlying lawsuit is pending. Assuming the extrinsic evidence would defeat the duty to indemnify, insurers then argue that no potential for coverage exists and thus no duty to defend. Such a tactic is wholly improper. When an insurer has a duty to defend, based on the eight corners rule, it is wholly improper to use extrinsic evidence during the pendency of the underlying lawsuit. The only exception to this rule is if the extrinsic evidence is wholly unrelated to the merits of the underlying lawsuit (e.g., a late notice defense).

has been well documented as a source of unending ethical, legal, and economic tension." *Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting). As Justice Gonzalez further noted:

> The duty to defend in a liability policy at times makes for an uneasy alliance. The insured wants the best defense possible. The insurance company, always looking at the bottom line, wants to provide a defense at the lowest possible cost. The lawyer the insurer retains to defend the insured is caught in the middle. There is a lot of wisdom in the old proverb: He who pays the piper calls the tune. The lawyer wants to provide a competent defense, yet knows who pays the bills and who is most likely to send new business.

Id.

The import of *Traver* and *Tilley* in the duty to defend context is that an insurer should not use the same counsel to review coverage that it does to defend the insured. *See Employers Cas. Co. v. Mireles*, 520 S.W.2d 516 (Tex. Civ. App.—San Antonio 1975, writ ref'd n.r.e.) (holding that the employment of separate firms to defend the insured and to address coverage issues eliminates conflicts of interest). Accordingly, when an insurer offers a qualified defense under a reservation of rights and proceeds by hiring defense counsel, the defense counsel should remain "independent." Likewise, when a qualified defense is provided, defense counsel should never communicate with the insurer with respect to "coverage" issues. *See Rhodes v. Chicago Ins. Co.*, 719 F.2d 116 (5th Cir. 1983).

B. The Use of Captive Firms

Another issue that has come to the forefront of late is the use of "captive firms" to defend insureds. A captive firm is a law office staffed by lawyers who actually are employees of the insurance company. The use of captive firms has increased over the past few years as insurers have searched for ways to be cost-effective. *See Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting).

The Unauthorized Practice of Law Committee (UPLC) has waged war against the use of captive firms to defend insureds. According to the UPLC, the use of captive firms raises serious ethical issues. In particular, the UPLC questions whether captive lawyers truly will look out for the best interests of the insureds. The use of captive firms also has caught the attention of the Supreme Court of Texas. *See Traver*, 980 S.W.2d at 633 (Gonzalez, J., concurring and dissenting) (noting that "it is probably impossible for an attorney to provide the insured the unqualified loyalty that *Tilley* requires" where the insured is being represented by a captive firm).

Even so, for the most part, the UPLC has been unsuccessful in its prosecution of insurers that use captive firms. *See Unauthorized Practice of Law Comm. v. Nationwide Mut. Ins. Co.*, 155 S.W.3d 590 (Tex. App.—San Antonio 2004, pet. filed); *Am. Home Assurance Co. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831(Tex. App.—Eastland 2003, pet. granted).[5] Notably, both courts held that the use of staff counsel to represent insureds does not constitute the unauthorized practice of law. Interestingly, the Eastland Court of Appeals specifically held that a defense lawyer has two clients. *Am. Home*, 121 S.W.3d at 838 ("Reality and common sense dictate that the insurance company is also a client. The insurance company retains the attorney, controls the legal defense, decides if the case should be settled, and pays any judgment or settlement amount up to policy limits. It is a fiction to say that the insured is the only client in view of the contractual relationships."). Despite the result, no question exists that staff counsel still owe the insured unqualified loyalty. *See Nationwide*, 155 S.W.3d at 598; *Am. Home*, 121 S.W.3d at 838.

C. The Right to Independent Counsel

Whether an insurer has the right to control the defense, which involves the right to select counsel, is a matter of contract. *See N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex. 2004); *see also Traver,* 980 S.W.2d at 627. Most policies vest this right in insurers. In fact, it may be a violation of the cooperation clause to refuse to allow an insurer to select counsel and control the defense when the insurer agrees to provide an unqualified defense. *See Burney v. Odyssey Re (London) Ltd.*, 2005 WL 81722 (N.D. Tex. Jan. 14, 2005), *aff'd*, 169 Fed. Appx. 828 (5th Cir. 2006). "Under certain circumstances, however, an insurer may not insist upon its contractual right to control the defense." *Davalos*, 140 S.W.3d at 688. In particular, an insurer must relinquish this right when a "conflict of interest" exists. *Traver*, 980 S.W.2d at 627. Even so, according to the Supreme Court of Texas, not every disagreement about how the defense should be conducted rises to the level of a conflict of interest. *See Davalos*, 140 S.W.3d at 689 (holding that a disagreement as to the proper venue for the defense of a third-party claim did not amount to a conflict of interest).

A big issue is whether the issuance of a reservation of rights constitutes a per se conflict of interest. To date, most courts that have addressed the issue have concluded

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[5] Oral argument took place in *American Home* on September 28, 2005. All of the briefing can be found on the Supreme Court's website at http://www.supreme.courts.state.tx.us/.

that a reservation of rights can create a sufficient conflict of interest that would warrant an insurer to relinquish its contractual right to control the defense. *See Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) ("When a reservation of rights is made, however, the insured may properly refuse the tender of defense and pursue his own defense" and the "insurer remains liable for attorneys' fees incurred by the insured and may not insist on conducting the defense."); *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991) ("The insured, confronted by notice of the potential conflict [through a reservation of rights], may then choose to defend the suit personally."); *Am. Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App.—El Paso 1996, writ denied) ("Upon receiving notice of the reservation of rights, the insured may properly refuse tender of defense and defend the suit personally."); *see also Britt v. Cambridge Mut. Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. App.—San Antonio 1986, writ ref'd n.r.e.); *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713 (Tex. App.—San Antonio 1965, writ ref'd n.r.e.).

One of the most recent opinions to address this issue was authored by Judge Lindsay from the Northern District. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.*, 333 F. Supp. 2d 595 (N.D. Tex. 2004). In *Northland*, Judge Lindsay noted as follows:

> Northland contends that despite that the facts in the [underlying lawsuit] are the same as those upon which coverage depends, there is no evidence that the facts could have been "steered" to exclude coverage. In other words, Northland contends that DHA has offered no evidence that the counsel it selected would have manipulated the facts of the case, thereby allowing it to avoid coverage.
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> ***
>
> Northland next contends that regardless of whether the reservation of rights letter created a potential conflict of interest, DHA's only opposition at the time it tendered a defense was the slow progress of DHA's cases . . . which, it contends, is insufficient to create a disqualifying conflict of interest. It is true that the record establishes that the slow progress of its cases . . . was DHA's only concern, and that the conflict of interest matter seemingly just fell into DHA's lap; however, the facts are what they are and necessarily establish or create a disqualifying conflict of interest. Specifically, Northland issued a reservation of rights letter, which created a potential conflict of interest. . . .As previously stated, Northland acknowledged that the liability facts and coverage facts are the same, or at a minimum, did not dispute that the facts were the same, although it had the opportunity to do so. The court, therefore, determines that because the liability facts and coverage facts were the same and because a potential conflict of interest was created by the issuance of the reservation of rights letter, a disqualifying conflict existed; therefore Northland could not conduct the defense of the *Bell* lawsuit. Under these circumstances, DHA properly refused Northland's qualified tender of defense and defended the *Bell* lawsuit on its own.

Northland, 333 F. Supp. 2d at 601–02. Thus, under *Northland*, a reservation of rights creates a disqualifying conflict so long as the facts to be developed in the underlying lawsuit are the same facts upon which coverage depends.

Judge Rosenthal recently issued an opinion that addresses this issue:

> Not every reservation of rights creates a conflict of interest allowing an insured to select independent counsel. Rather, the existence of a conflict depends on the nature of the coverage issue as it relates to the underlying case. If the insurance policy (like the policy in this case) gives the insurer the right to control the defense of a case the insurer is defending on the insured's behalf, the insured cannot choose independent counsel and require the insurer to reimburse the expenses unless "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends."

RX.Com Inc. v. Hartford Fire Ins. Co., 426 F. Supp. 2d 546, 559 (S.D. Tex. 2006) (citing *Davalos*, 140 S.W.3d at 689). In other words, according to *RX.Com*: "A conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim." *Id.*

Thus, in those cases where a conflict of interest of sufficient magnitude arises between the insurer and the insured, Texas courts require that the insurer's rights under the policy to select counsel and control the defense pass to the insured. In those instances, courts are responding to the perceived unfairness of allowing the insurer, which has not unequivocally accepted a duty ultimately to indemnify its insured, to control the defense and potentially manipulate or steer the outcome of the defense toward a denial of coverage. In the event an

insured is entitled to independent counsel, the next question is how much the insurer is required to pay independent counsel selected by the insured.

D. Fees for Independent Counsel

In those instances when the carrier recognizes its insured's right to independent counsel, the carrier then often wrangles with its insured over how much they must pay independent counsel. For example, if independent counsel normally charges $250 per hour whereas the counsel selected by the insurer charges $150 per hour, can the insurer insist on paying the lower rate? The most rational answer is that the insurer should be forced to pay what is reasonable and customary for the type and sophistication of the particular case. Carriers, on the other hand, argue that they should only be required to pay those rates they normally pay defense counsel. In fact, some carriers now are including provisions in their policies that contractually provide for this result. For example, an Arch Specialty Insurance Policy issued in 2004 states: "In the event that you are entitled by law to select independent counsel to defend you at the Company's expense and you elect to select such counsel, the attorney's fees and all other litigation expenses we must pay are limited to the rates we actually pay to counsel we retain in the ordinary course of business in the defense of similar claims in the community where the claim arose or is being defended."

Similarly, the Legislatures of Alaska and California have enacted statutes declaring that in independent counsel situations, the reasonableness of defense costs must be measured from the carrier's perspective based upon what the carrier typically pays defense counsel. Alaska Stat. § 21.98.100(d) (1995) ("[T]he obligation of the carrier to pay the fee charged by the independent counsel is limited to the rate that is actually paid by the carrier to an attorney in the ordinary course of business in the defense of a similar civil action in the community in which the claim arose or is being defended."); Cal. Civ. Code § 2860(c) (1987) ("The carrier's obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the carrier to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended.").

The Legislatures of Alaska and California seem to ignore the fact that defense counsel who receive a large volume of work from a particular insurer oftentimes discount their rates and thus their fees usually are significantly lower than those charged by independent counsel selected by insureds in conflict-of-interest situations. Independent counsel, who may or may not ever have another case involving the insurer, should not be forced to accept the discounted rate. Likewise, the insured should not be forced to pay the difference between what the carrier typically pays defense counsel and what independent counsel charges. Simply put, it should come down to what is reasonable under the circumstances of the particular case.

At least two Texas courts are in agreement. In *Northland*, after deciding that the carrier had breached its duty to defend, Judge Lindsay issued a subsequent opinion in which he concluded that the fees charged by the lawyers that the insured had retained to represent it after the insured refused to accept the insurer's qualified defense were "on the low end of reasonableness," despite the fact that they were significantly higher than the rates that would have been charged by the insurer's selected counsel. *See Hous. Auth. of City of Dallas v. Northland Ins. Co.*, Civil Action No. 3:03-CV-385-L, In the United States District Court for the Northern District of Texas, Order dated January 27, 2005.[6] In *Kirby v. Hartford Casualty Insurance Co.*, a magistrate judge from the Northern District of Texas stated:

> In addition to its failure to offer any evidence to support its assertion that $135.00 per hour represents the only "reasonable and customary" rate for defense counsel in a matter like the Underlying Lawsuit . . . , Hartford cites no authority for its conclusion that Kirby is obligated to accept defense counsel "appointed" by Hartford or be limited to any rate the insurer is able to negotiate with such counsel. Hartford cites one case confirming that the insurer is obligated to pay "reasonable and necessary" defense costs. . . . (*Travelers Ins. Co. v. Chicago Bridge & Iron Co.*, 442 S.W.2d 888, 900 (Tex. Civ. App.—Houston [1st Dist.] 1969, writ ref'd n.r.e.). Neither that case nor any other authority establishes, as Hartford contends, that "any rate above [$135 per hour] simply cannot be deemed as necessary." *See Ripepi v. Am. Ins. Cos.*, 234 F. Supp. 156, 158 (W.D. Pa. 1964) (insured "was not required to employ the cheapest lawyer he could get, or solicit competitive bids" after insurer failed to defend, *aff'd*, 349 F.2d 300 (3d Cir.1965)).

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[6] In determining the amount of fees to be awarded, Judge Lindsay relied on the factors set out in *Johnson v. Georgia Hwy. Express, Inc.*, 488 F.2d 714 (5th Cir. 1974). The *Johnson* factors are virtually identical to the factors that the Texas Supreme Court has set out as a guide when awarding attorneys' fees. *See Arthur Anderson & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 818 (Tex. 1997). There is no published Texas case law at this time that applies the *Arthur Anderson* (or *Johnson*) factors in the independent counsel context; however, no rational basis exists for departing from applying these factors in the insurance context.

> Hartford's position flies in the face of cases from Texas and other jurisdictions confirming that an insurer forfeits its control of an insured's defense by not promptly tendering a defense or by creating a conflict of interest. *See Witt v. Universal Auto. Ins. Co.*, 116 S.W.2d 1095, 1098 (Tex. Civ. App.—Waco 1938, writ dism'd); *see also Grube v. Daun*, 496 N.W.2d 106, 124 (Wis. Ct. App. 1992) (insurer lost its right to control insured's defense by initially breaching duty to defend); *Home Indem. Co. v. Leo L. Davis, Inc.*, 145 Cal. Rptr. 158, 163 (Cal. Ct. App. 1978) (insured not "obligated to content himself" with a defense offered "only after almost a year's delay . . . by an insurer who persistently maintained a position adverse to his interests").

Kirby, 2003 WL 23676809, *2 (N.D. Tex. 2003).

Overall, other than to recite the general rule that the insurer must pay "reasonable" attorney fees of independent counsel, there is a dearth of case law from any jurisdiction that defines what constitutes a reasonable fee for independent counsel. *See, e.g.*, *Golotrade Shipping & Chartering, Inc. v. Travelers Indem. Co.*, 706 F. Supp. 214, 219 (S.D.N.Y. 1989) (stating that once a conflict of interest arises, "the duty to defend includes a duty to provide independent defense counsel to the insured, whose reasonable fee is to be paid by the insurer but who is to be appointed by the insured"); *U.S. Fid. & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 941 (8th Cir.1978) ("USF & G must now reimburse appellant for the fair and reasonable value of the services rendered by appellant's independent counsel in defending the Kemp action."); *Armstrong Cleaners, Inc. v. Erie Ins. Exch.*, 364 F. Supp. 2d 797, 801 (S.D. Ind. 2005) ("[T]he policyholders are entitled to select their own counsel to defend the underlying claim, subject to reasonable approval by the insurer, with reasonable fees and expenses paid by the insurer."); *HK Sys., Inc. v. Admiral Ins. Co.*, 2005 WL 1563340, at *18 (E.D. Wis. June 27, 2005) (opining that the Wisconsin Supreme Court "would find that the insurer's responsibility for defense costs extends only to a reasonable charge"); *Aquino v. State Farm Ins. Cos.*, 793 A.2d 824, 832 (N.J. Super. 2002) ("It does not follow, however, that he is entitled to be compensated by the carriers for that defense work on the same basis that he is entitled to be compensated for work performed in connection with the declaratory judgment action. While [the insured] may have been entitled to an attorney of his selection to handle the claim of intentional conduct, he does not have the right to dictate to the insurers the hourly rate they must pay. The trial court here should have determined a reasonable hourly rate for defense work of this nature and set a fee accordingly.").

For the time being, therefore, insureds and their independent counsel may simply have to negotiate the rates of independent counsel with their carriers, which in some cases may result in independent counsel agreeing to compromise their rates somewhat. Insureds and independent counsel should not, however, agree to accept below market rates simply because the insurer oftentimes receives a volume discount.

E. Litigation/Billing Guidelines

Beginning in 1997, a large number of ethics advisory opinions were issued across the country in response to inquiries from defense counsel, regarding whether counsel must follow a carrier's litigation/billing guidelines.[7] In almost every instance, the ethics opinions concluded that defense counsel could not allow a carrier's litigation guidelines to interfere with or otherwise impede their professional judgment about how best to competently represent the insured. In fact, the various state ethical boards nearly uniformly treated insurers' attempts to impose guidelines as being directly at odds with the ethical obligations of attorneys to their clients. Based on these opinions, while a prohibition on block billing or other non-substantive restrictions may be permissible, it likely would not be permissible for an insurer to restrict research, discovery, motions practice, or other matters that fall within the professional judgment of the defense counsel.

Texas courts provide very little guidance on this issue. A Texas ethics opinion, however, does provide some insight. *See* Tex. Comm. on Prof'l Ethics, Op. 533 (2000) ("It is impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in rendering such legal services to the insured/client."). Ethics Opinion 533 basically stands for the proposition that a defense lawyer can follow billing/litigation guidelines so long as the guidelines do not interfere with the defense counsel's professional judgment. *Id.* In *Traver*, the Texas Supreme Court recognized that "the lawyer must at all times protect the interests of the insured if those interests would be compromised by the insurer's instructions." *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998). *See also In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 (Mont. 2000) (finding that insurer's litigation guidelines requiring defense counsel to obtain the insurer's prior approval of depositions, motions, research, and experts fundamentally interferes with

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[7] The attached appendix contains summaries of ethics opinions from across the country.

counsel's exercise of independent judgment and undivided loyalty).

In *WNS, Inc. v. American Motorists Insurance Co.*, 270th Judicial District of Harris County, Texas, Cause No. 98-49195, June 19, 2000, WNS had accused American Motorists of engaging unfair settlement practices by using Kemper litigation guidelines to avoid paying reasonable and necessary defense costs related to a claim covered under WNS' CGL policy with American Motorists. WNS argued that the litigation guidelines, which required the attorney paid by the insurer (in this case, independent counsel) to seek approval prior to undertaking certain legal tasks, interfered with WNS' attorneys' exercise of professional judgment. WNS further alleged that the audit, which was performed after the conclusion of the litigation, was nothing more than a sham and pretext to deny payment of reasonable and necessary attorneys' fees and costs. A Houston jury found that the guidelines and the audit constituted unfair settlement and deceptive trade practices, and awarded WNS more than $900,000 in damages.

In *WNS*, the audit company was a wholly-owned subsidiary of American Motorists' parent company. Oftentimes, however, the audit company is an outside company that the carrier hires to perform the audits. In that context, questions often arise as to whether the release of fee bills to an outside audit company results in a waiver of privilege. Around thirty jurisdictions have issued case law, ethics rulings, or opinions concerning whether fee bills may be released to third-party auditors without the consent of the insured. Out of that number, at least twenty-eight have found that the insured's consent is required before fee statements containing confidential information may be submitted to auditors. Texas follows the majority in that regard.

> Texas Ethics Opinion Number 532 states:
>
> When a lawyer is retained by an insurance company to represent an insured, the lawyer is obligated to protect the confidential information of the insured as defined in Texas Disciplinary Rule 1.05. A lawyer's invoice or fee statement describing legal services rendered by the lawyer constitutes "confidential information." Without first obtaining the informed consent of the insured, a lawyer cannot, at the request of the insurance company paying his fees for the representation, provide fee statements to a third-party auditor describing legal services rendered by the lawyer for the insured.

Tex. Comm. on Prof'l Ethics, Op. 532 (2000). *See also* Tex. Comm. on Prof'l Ethics, Op. 552 (2004) ("A lawyer's fee statement or invoice is confidential information, which the lawyer must protect, notwithstanding the payment of the lawyer's fees by the insured's insurance company. The delivery of confidential information to a third party, by any means or media, without the informed consent of the insured client violates Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct."). The question then becomes, once the lawyer obtains the informed consent of the insured, does submission of the fee statements to a third-party auditor result in a loss of the attorney-client privilege with respect to the information described in the fee statement?

F. The Continuing Debate

Issues surrounding the tripartite relationship, the use of captive counsel, and the selection and control of defense counsel are extremely prevalent. To date, as noted, Texas courts have provided little guidance in resolving these issues. It is expected that at least some of the issues discussed above will be resolved by the Supreme Court of Texas in the near future. Other issues, such as reasonable rates to be paid to independent counsel and the application of litigation/billing guidelines, simply may have to be decided on a case-by-case basis.

VII. THE RIGHT OF RECOUPMENT

One of the "hottest" issues in insurance law that also directly corresponds with the duty to defend is whether an insurer can seek recoupment from its insured of defense costs and/or indemnity payments when it turns out that no coverage exists. For purposes of this paper, the focus will be on the two Supreme Court of Texas cases that address the recoupment issue.

A. *Matagorda County*

In 1993, three prisoners from the Matagorda County jail sued Matagorda County (and Sheriff Keith Gilgore) in federal court for damages arising out of assaults that occurred in the jail. *See Matagorda County v. Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool*, 975 S.W.2d 782 (Tex. App.—Corpus Christi 1998, pet. granted). The county tendered the defense of the claim to its law enforcement liability insurer, Texas Association of Counties County Government Risk Management Pool (TAC). TAC contested coverage on the ground that the county's policy included an exclusion for claims "arising out of jail." After initially denying coverage, TAC ultimately agreed to defend the county under a reservation of rights. TAC also filed a declaratory judgment action seeking a declaration of no coverage.

In 1995, TAC informed the county that it had received a $300,000 offer to settle the prisoners' lawsuit. The $300,000 settlement offer was within policy limits. Although the county believed that the $300,000 offer was reasonable, it refused to fund the settlement because of

its belief that the claim was covered. TAC then issued a second reservation of rights letter wherein TAC informed the county that it planned to accept the settlement offer but that it would seek reimbursement of the full settlement amount if the declaratory judgment action established that the prisoners' claim was excluded from coverage. The county did not respond to TAC's letter. After settling the prisoners' lawsuit, TAC amended its declaratory judgment action to request reimbursement of its defense and settlement costs associated with the prisoners' lawsuit against the county.

The trial court granted a partial summary judgment finding that the "jail" exclusion precluded coverage for the prisoners' lawsuit. Then, after a trial on various defenses asserted by the county, the jury returned a verdict finding that the county had accepted the jail exclusion and that it was estopped from claiming that it was unaware of its presence in the policy. Following the jury's verdict, the trial court entered a final judgment granting TAC recovery of both its $300,000 settlement payment and $53,522.15 in attorneys' fees paid by TAC for defending the prisoners' lawsuit.

The county appealed the trial court's judgment on the grounds that TAC had no right to reimbursement for either defense costs or the cost of settling the prisoners' lawsuit. The county argued that neither the insurance policy nor the unilateral reservation of rights letter conferred any right of reimbursement. In particular, TAC's reservation of rights letter made no mention of reimbursement:

> This letter notifies you about certain coverage conditions and exclusions and informs you that a defense will be provided to you under [the insurance policy] subject to a "reservation of rights," meaning the Pool reserves its right to contend that the allegations in the Complaint may not be covered under the coverage document.

Matagorda County, 975 S.W.2d at 782.

Although TAC apparently raised only the theory of equitable subrogation, the court nevertheless undertook an analysis as to whether a right of reimbursement was supported under theories of implied and quasi-contract. *See* Bob Allen, *Insurer Reimbursement of Defense Costs and Settlements in Light of Buss and Matagorda*, *in* UNIV. OF TEXAS, 4TH ANNUAL INSURANCE LAW INSTITUTE 4 (2000) (noting that the only reimbursement theory raised by TAC in either the trial court or the court of appeals was a claim for equitable subrogation). Relying, at least in part, on the California Supreme Court's decision in *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997), the Corpus Christi Court of Appeals rejected TAC's claim for reimbursement of defense costs on the ground that TAC's reservation of rights letter failed to *specifically* notify the county that reimbursement of defense costs would later be sought. *See Matagorda County*, 975 S.W.2d 782. While the Corpus Christi Court of Appeals did not squarely hold that Texas law recognized a right of reimbursement, the language of the opinion strongly suggests that TAC would have had a "quasi-contractual" right to reimbursement of defense costs had it specifically reserved its right to seek recoupment. *See* Dennis J. Wall, *Insured's Reimbursement of Insurer's Defense Expenses*: When to Ask, When to Say "No," 9 COVERAGE 3 (May/June 1999); Michael Huddleston, *Buss* Arrives in Texas Via *Matagorda*—The Right of Reimbursement, 8 COVERAGE 1 (Sept./Oct. 1998). As noted by the Corpus Christi Court of Appeals, the *Buss* court "found a quasi-contractual right of a liability insurer to collect from its insured reimbursement for defense costs of certain claims only if the insurer specifically reserved its right to seek reimbursement of defense costs at or before the time it provided a defense." *Matagorda*, 975 S.W.2d at 784. The court then went on to hold that reimbursement of settlement costs was dependent on a "specific agreement by the insured to be bound by the settlement and to allow reimbursement to the insurer if the coverage issue is later determined against the insured . . . ." *Matagorda County*, 975 S.W.2d at 787.

The decision from the Corpus Christi Court of Appeals left some unanswered questions. First, although the court implied that a unilateral reservation of rights would be sufficient to preserve a claim for reimbursement of defense costs, the court did not actually rule on whether Texas recognized such a claim. Second, although the court held that a specific agreement was required for reimbursement of settlement costs under an equitable subrogation theory, the court did not elaborate as to whether something short of a bilateral agreement could trigger a claim for reimbursement under other theories of reimbursement. The Supreme Court of Texas granted review of the *Matagorda* case, but *only* the issue of reimbursement of settlement costs was appealed to the Supreme Court.

After noting that the right of reimbursement of settlement costs was an issue of first impression, the Supreme Court of Texas began its analysis by examining the insurance contract. In so doing, the court noted that "[i]t is undisputed that the insurance policy that defines the parties' rights and obligations does not provide TAC a right of reimbursement; TAC first asserted such a right in its reservation-of-rights letter. It is similarly undisputed that the county did not otherwise expressly agree to reimburse TAC for the . . . settlement." *See Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 131 (Tex. 2000). In light of these facts, the court framed the issue as whether the county's consent to reimburse TAC may be implied

or whether the circumstances presented warranted imposing, in law, an equitable reimbursement obligation. *See id.*

With the issue framed, the court considered whether an implied consent to reimburse existed. TAC contended that the county's silence in response to its second reservation of rights letter signaled consent by acquiescence. The Supreme Court of Texas disagreed. Relying on the *Shoshone* decision from the Wyoming Supreme Court, the court held that "a unilateral reservation-of-rights letter cannot create rights not contained in the insurance policy." *Id.* (citing *Shoshone First Bank v. Pac. Employers Ins. Co.*, 2 P.3d 510, 515-16 (Wyo. 2000)). Accordingly, whereas silence after a reservation of rights letter implies agreement that the insurer will not waive its right to later contest coverage, the court clearly held that silence cannot imply "consent to additional obligations not contained in the insurance contract." *Matagorda County*, 52 S.W.3d at 131. Moreover, as noted by the court, "a meeting of the minds is an essential element of any implied-in-fact contract." *Id.* at 133. Consequently, when an insurer seeks to append a reimbursement provision to the insurance contract, it will be binding *only* if accepted by the insured. Because TAC failed to get the county's agreement, no implied-in-fact contract existed. Accordingly, the court ruled that TAC could not seek reimbursement of the settlement. *Id.* at 135.

Considering that the intermediate appellate court's decision did not actually rule on whether Texas law recognized a right of reimbursement of defense costs and the fact that the issue was not before the Supreme Court of Texas, the right of reimbursement of defense costs for uncovered claims technically still is up in the air in Texas. Technicalities aside, both the majority and the dissent in *Matagorda County* unmistakably addressed the issue.

The majority's reliance on the Wyoming Supreme Court's decision in *Shoshone* at least is an indicator as to how the Supreme Court of Texas would address the reimbursement of defense costs issue if squarely presented with it. The *Shoshone* opinion stands for the proposition that an insurer cannot unilaterally reserve its right to recoup defense costs. *Id.* at 131 (noting that *Shoshone* "reject[ed] the notion that the insurer could base a right to recover defense costs on a reservation letter"). The Supreme Court of Texas also cited *Shoshone* for the proposition that allowing reimbursement of defense costs by way of a unilateral reservation of rights would be "'tantamount to allowing the insurer to extract a unilateral amendment to the insurance contract. If this became common practice, the insurance industry might extract coercive arrangements from their insureds . . . .'" *Id.* at 133 (citing *Shoshone*, 2 P.3d at 516). Accordingly, although the defense costs issue was not squarely before it, the court's statements and reliance on *Shoshone* strongly suggest that the Supreme Court of Texas would disapprove of any attempt by an insurer to *unilaterally* reserve its right to recoup defense costs for uncovered claims.

Even the dissent in *Matagorda*, which spent a considerable amount of ink discussing the defense costs issue, acknowledged that "insurers should be on notice that today's decision may foreshadow how the court will decide the [defense costs] issue if it is presented." *Id.* at 140 (Owen, J., dissenting). Accordingly, after *Matagorda*, it was reasonable to conclude that the majority opinion—albeit in dicta—provided guidance for Texas trial courts and intermediate appellate courts.

The message from *Matagorda County*: While a unilateral reservation of rights likely is *not* sufficient for recoupment of defense costs, it is definitely *not* sufficient to preserve an insurer's right to seek recoupment of indemnity payments.

Maybe.

B. *Frank's Casing*

In *Excess Underwriters at Lloyds v. Frank's Casing Crew & Rental Tools*, 975 S.W.2d 782 (Tex. App.—Houston [14th Dist.] 2002, pet. granted) (Brister, J.), Frank's Casing Crew & Rental Tools, Inc. fabricated a drilling platform at its facility in Louisiana for ARCO. Unfortunately, the platform collapsed several months later. Subsequently, ARCO sued Frank's Casing and other defendants. Frank's Casing had a primary policy with limits of $1.0 million and an excess policy with limits of up to $10.0 million from Excess Underwriters. Following notice of the claim, Excess Underwriters issued a reservation of rights letter stating that certain of ARCO's claims against Frank's Casing were not covered.

ARCO made a pre-trial settlement offer of $9.9 million, which was rejected by Frank's Casing. Two weeks before trial, Excess Underwriters contacted ARCO directly and attempted to settle the covered portion of the claim. No agreement could be reached. ARCO subsequently offered to settle all claims against all defendants for $8.8 million, which would have required Frank's Casing to contribute about $7.55 million. Due to the coverage issues, Excess Underwriters offered to pay two-thirds of that amount if Frank's Casing would pay one-third with all coverage issues being waived. Alternatively, Excess Underwriters offered to pay $5.0 million and to resolve the coverage issues in an arbitration. Frank's Casing rejected both options.

As ARCO's lawsuit proceeded to trial, it became readily apparent that Frank's Casing was the target defendant. After the close of the second day of trial, Frank's Casing's in-house counsel contacted ARCO and requested that it make a settlement demand within the excess policy's limits. ARCO responded with a demand

of $7.5 million, which was immediately communicated to Frank's Casing's carriers. In communicating the settlement offer, Frank's Casing demanded that Excess Underwriters accept the settlement demand. Excess Underwriters agreed that the case should be settled and stated that they would fund the settlement minus the primary limits if Frank's Casing agreed to resolve the coverage issues at a subsequent date. Frank's Casing refused and sent a second letter to Excess Underwriters demanding that it accept ARCO's settlement offer. Ultimately, Excess Underwriters agreed to fund the settlement less any contribution from the primary carrier—but reserved its right to seek recoupment from Frank's Casing. The Excess Underwriters policy required Frank's Casing approval of any settlement, and Frank's Casing consented to the settlement.

Prior to the execution of the final settlement agreement, Excess Underwriters filed a declaratory judgment action against Frank's Casing. The trial court ultimately ruled that no coverage existed for ARCO's lawsuit. But the trial court interpreted *Matagorda County* as not providing a right of reimbursement since Frank's Casing had not expressly agreed that Excess Underwriters could seek recoupment. The appellate court, although clearly not happy about it, affirmed. *See Frank's Casing*, 975 S.W.2d 782. In fact, the appellate court invited the Supreme Court of Texas to revisit the issue. *See id.*

The Supreme Court of Texas accepted the invitation and, in so doing, concluded that *Matagorda County* **did not** control under the facts before it. The court noted that, in *Matagroda County*, it was concerned with the situation when an insurer has a unilateral right to settle and the insurer could accept a settlement that the insured considered out of the insured's financial reach. *See Excess Underwriters at Lloyd's v. Frank's Casing Crew & Rental Tools*, 2005 WL 1252321 (Tex. May 27, 2005) (reh'g pending).The court viewed *Frank's Casing* in a different light:

> The facts of the case before us today lead us to conclude that this concern is ameliorated if not eliminated in at least two circumstances:
>
> 1) when an insured has demanded that its insurer accept a settlement offer that is within policy limits; *or*
> 2) when an insured expressly agrees that the settlement offer should be accepted.
>
> In these situations, the insurer has a right to be reimbursed if it has timely asserted its reservation of rights, notified the insured it intends to seek reimbursement, and paid to settle claims that were not covered.

Id. at *3. Having found those conditions satisfied under the facts of the case, the court reversed the appellate court and remanded the case to the trial court to render judgment in favor of Excess Underwriters. Notably, the court concluded that "[r]equiring an insured to reimburse its insurer for settlement payments if it is later determined there was no coverage does not prejudice the insured." *Id.* at *4. Moreover, the court noted that "[t]he insurer should be entitled to settle with the injured party for an amount the insured has agreed is reasonable and to seek recoupment from the insured if the claims against it were not covered." *Id.*[8]

Frank's Casing had three concurring opinions and left many questions unanswered. In particular, after *Frank's Casing*, it is not clear how and/or when *Matagorda County* still applies. It also is not clear whether recoupment applies in policies in which the insured has no right to consent to settlement. Moreover, it remains unclear how *Frank's Casing* applies, if at all, to the recoupment of defense costs. On January 6, 2006, after receiving numerous amicus briefs, the Supreme Court of Texas granted a motion for rehearing and ordered a second oral argument, which occurred on February 15, 2006.

C. Post-*Frank's Casing*

In *St. Paul Fire & Marine Insurance Co. v. Compaq Computer Corp.*, 377 F. Supp. 2d 719 (D. Minn. 2005) (applying Texas law), a federal district judge in Minnesota was asked to determine whether, under Texas law, an insurer was entitled to recover defense costs made a under reservation of rights. In *Compaq*, the court had already concluded that no coverage existed and that St. Paul had no duty to defend. St. Paul, who had unilaterally reserved its right to seek recoupment of the defense costs it had paid, then sought recoupment from Compaq. The district judge started the opinion by noting that *Matagorda County* had "suggested" the possibility of recoupment of defense costs if the right was adequately reserved. *Id.* at 722. The district judge then noted that the Supreme Court of Texas in *Frank's Casing* had seemingly backed away from the stance that a unilateral reservation of rights is not sufficient. *Id.* at 724. Ultimately, based on *Matagorda County* and *Frank's Casing*, the district judge ruled that the unilateral reservation of rights issued by St. Paul **was** sufficient and ordered Compaq to repay St. Paul. Compaq appealed to the Eighth Circuit. On August 4, 2006, the Eighth Circuit affirmed the district court. *See St. Paul Fire & Marine*

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[8]Although the court said that it was not overruling *Matagorda County*, its holding undoubtedly is inconsistent with *Matagorda County* in several respects. In particular, in *Matagorda County*, the insured stipulated that the settlement was reasonable. Given that fact, it is difficult to see how the court reached different conclusions in the two cases.

Ins. Co. v. Compaq Computer Corp., 457 F.3d 766 (8th Cir. 2006).

D. Where Do We Stand?

It is difficult to synthesize *Matagorda County* and *Frank's Casing*. Hopefully, the Supreme Court of Texas will clarify how and when recoupment applies when it issues its opinion on rehearing. For now, it seems clear that Texas does recognize recoupment in certain situations: (i) when the insured and insurer agree that the insurer may seek recoupment; (ii) when an insured has demanded that its insurer accept a settlement offer that is within policy limits; and (iii) when an insured expressly agrees that a settlement offer should be accepted. It remains unclear whether a unilateral reservation of rights is sufficient for recoupment of *defense* costs. *See, e.g., Gemini Ins. Co. v. S&J Diving, Inc.*, 464 F. Supp.2d 641, 651 (S.D. Tex. Aug. 25, 2006) (reserving decision until Supreme Court issues its opinion on rehearing in *Frank's Casing*). It also remains unclear whether recoupment applies outside of a settlement context. *See Colony Ins. Co. v. Kroger Co.*, 2007 WL 268731 (S.D. Tex. Jan. 26, 2007) ("Because there has been no settlement in this case, *Frank's Casing* does not apply.").

VALIDITY OF LITIGATION MANAGEMENT GUIDELINES

COURT DECISIONS

In re Rules of Professional Conduct, 2 P.3d 806 (Mont. 2000)

The requirement of prior approval fundamentally interferes with defense counsel's exercise of their independent professional judgment (notwithstanding the insured's duty to cooperate with its insurer).

ETHICS OPINIONS

ABA Comm. on Ethics and Prof'l Resp., Op. 01-421 (2001)

Defense counsel may not agree to abide by litigation guidelines if they will materially impede his/her independent professional judgment. If the lawyer believes that his representation will be materially impaired, he must consult with both the insurer and the insured. If the insurer insists on retaining the limitation on the lawyer's representation and the insured refuses to consent to this limited representation, a conflict exists that would require the lawyer to either withdraw from the case or continue to appear on behalf of the insured without compensation from the insurer.

Alabama State Bar Disciplinary Comm., Op. RO-98-02 (1998)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Arizona State Bar Comm. on the Rules of Prof'l Conduct, Formal Op. 99-08 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment.

Colorado Bar Ass'n Ethics Comm., Formal Op. 107 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. Whenever an attorney reasonably believes that a particular action is reasonably necessary to the defense but finds that it is impermissible under relevant guidelines, the attorney must advise the insurer and request authority to take the action and incur the related fees and costs. If the request is denied, the attorney must inform the insured of the decision and advise why the specified action is necessary or recommended. If the insured desires for the attorney to take the action one of the following will happen. The insured may convince the insurer to authorize the action or the insured may pay the legal fees and associated legal costs. If neither the insurer nor the insured are willing or able to make satisfactory arrangements for payment, the attorney may decide to take the action and waive the fee or the attorney may determine whether it is permissible or mandatory to withdraw from the representation.

Florida Bar Staff, Informal Op. 20591 (1997)

"Guidelines discourage use of senior, experienced attorneys when preparing cases for settlement and trial, even when use of a senior attorney would be best for the insured. Some . . . forbid summarizing depositions . . . which in the inquirer's opinion places the insured at a distinct disadvantage. Other billing guidelines forbid defense attorneys from preparing for trial until the last minute."

Florida Ethics Op. 97-1 (1997)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Illinois State Bar Ass'n, Advisory Op. on Prof'l Conduct 98-08 (1998)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Indiana State Bar Ass'n Legal Ethics Comm., Op. 3 (1998)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Iowa Supreme Court Bd. of Prof'l Ethics and Conduct, Op. 99-01 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. It would be improper for an Iowa lawyer to agree to, accept or follow guidelines which seek to direct, control or regulate the lawyer's professional judgment or details of the lawyer's performance; dictate the strategy or tactics to be employed; or limit the professional discretion and control of the lawyer.

Kentucky Bar Ass'n Ethics Comm., Op. 00-416 (2001)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. Requirements of prior approval before defense counsel can undertake discovery, legal research or motion practice constitute unethical constraints on a lawyer's independent professional judgment. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Michigan Ethics Op. RI-293 (1997)

Lawyers may not comply with litigation management guidelines that interfere with the exercise of independent professional judgment. However, insureds may consent to limitations imposed on the representation after receiving full disclosure and consulting with the lawyer.

Mississippi State Bar Ass'n, Op. 246 (1990)

Defense counsel's obligation to independently exercise professional judgment on behalf of an insured client may not be waived or compromised by compliance with claims handling or litigation guidelines from an insurance company.

Missouri Office of Chief Disciplinary Counsel, Informal Op. 980188 (1998)

Defense counsel is required to fully disclose guidelines to the insured and obtain the insured's consent in order to abide by billing guidelines which restrict the use of certain attorneys or discovery and otherwise defer legal activity until the time of trial. If the insured does not consent or the insurance company does not waive its guidelines and requests in the case, defense counsel should withdraw.

State Bar of Montana Ethics Comm., Op. 900517 (1999)

"(C)ounsel may not comply with those billing practice and procedure requirements which materially limit his representation of the insured (Rule 1.7), which interfere with his independence of professional judgment, or which interfere with the client-lawyer relationship (Rule 1.7 (f)(2))."

Nebraska Advisory Comm., Advisory Op. 00-1 (2000)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment.

North Carolina State Bar, Formal Ethics Op. 1723 (1999)

Defense counsel may follow any guideline if the client gives fully informed consent after disclosure of the possible risks and implications of the limitations.

Ohio Supreme Court Bd. of Comm'rs on Grievances and Discipline, Op. 2000-3 (2000)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. Guidelines that interfere with the lawyer's professional judgment include those that (1) restrict or require prior approval before performing computerized or legal research, (2) dictate how work is to be allocated among defense team members, and (3) require approval before discovery, taking a deposition, or consulting with an expert witness.

Oregon Formal Op. 2002-166 (2002)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Pennsylvania Bar Ass'n Comm. on Legal Ethics, Formal Op. 2001-200 (Jun. 28, 2001)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Rhode Island Supreme Court Ethics Advisory Panel, Op. 99-18 (1999)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. "It is reasonably apparent to this Panel that certain guidelines under consideration, even though intended to achieve cost efficiency, infringe upon the independent judgment of counsel and induce violations of our rules."

Tennessee Supreme Court Bd. of Prof'l Resp., Formal Ethics Op. 2000-F-145 (Sep. 8, 2000)

Defense counsel may follow any guideline if the client gives fully informed consent after disclosure of the possible risks and implications of the limitations.

Texas Comm. on Prof'l Ethics, Op. 533 (2000)

Litigation guidelines inherently violate the Rules of Professional Conduct. Defense lawyers cannot ethically abide by programs that direct, regulate, or restrict the counsel's independent professional judgment. It is impermissible under the Texas Disciplinary Rules of Professional Conduct for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in rendering such legal services to the insured/client.

Utah State Bar Ethics Advisory Op. Comm., Op. 02-03 (2002)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.

Vermont Bar Ass'n Comm. of Prof'l Resp., Ethics Op. 98-7 (1998)

Before complying with claim handling guidelines, the defense counsel must obtain informed consent after informing insured of the Company's demands and/or restrictions with regard to trial preparation.

Virginia Bar Standing Comm. on Legal Ethics, Op. LEO 1723 (1998)

Defense counsel may follow any guideline if the client gives fully informed consent after disclosure of the possible risks and implications of the limitations. The opinion warned Virginia practitioners against influence in the guise of overly restrictive litigation management guidelines.

Washington State Bar Ass'n Formal Op. 195 (1999)

"(A)ttorney whose professional services are paid for by a person other than the client can ethically comply with (guidelines) of the person paying the billing, provided the billing guidelines do not: (1) require disclosure of confidential or secret information of the client, without the client's consent; (2) interfere with the attorney's independent professional judgment or with the attorney-client relationship; or (3) direct or regulate the attorney's independent professional judgment in rendering legal service to the client." "Where a lawyer reasonably believes that representation of the client will be materially affected by any limitations in (litigation) guidelines of the person paying the billings, the lawyer must withdraw, subject to the requirements of RPC 1.15, and notify the client of the basis of the withdrawal."

West Virginia Lawyer Disciplinary Bd., LEI 2005-01 (2005)

Defense counsel cannot ethically agree to adhere to guidelines that (1) dictate how work is to be allocated among defense team members, (2) restrict or require approval before conducting discovery, engaging in motion practice, preparing for trial, or otherwise performing substantive work, or (3) otherwise impose a financial penalty or create an economic disincentive with respect to the exercise of independent professional judgment.

Wisconsin State Bar Comm. on Prof'l Ethics Comm., Formal Op. E-99-1 (1999)

Although litigation management guidelines may often interfere with the exercise of defense counsel's independent judgment, they are not a per se violation of the Rules of Professional Conduct. A case-by-case analysis is required to determine how the guidelines may affect representation. If defense counsel finds himself/herself in a conflict of interest, he/she may have to withdraw from the case.