A Smorgasbord of Insurance Issues for the Construction Law Practitioner

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University of Texas School of Law
Construction Law and Litigation
September 7–8, 2006

I.
Introduction

Insurance coverage is oftentimes a critical aspect of construction defect litigation. Certainly, numerous issues exist in the interpretation and application of builders risk, commercial general liability (CGL), and professional liability policies in the context of a construction defect case. The purpose of this paper, however, is to address collateral insurance issues that may affect the day-to-day life of a construction defect litigator. In particular, this paper will address recent developments on: (i) the duty to defend and extrinsic evidence; (ii) the availability of independent counsel; (iii) trigger of coverage; (iv) conditions in a CGL policy; and (v) the right of an insurer to seek recoupment of defense costs and indemnity payments. These topics will be discussed in a somewhat summary fashion as any one of them could be the subject of a lengthy paper.

So as not to cheat anybody out of a long-winded discussion of the classic "property damage" and "occurrence" coverage issues that are so pervasive in our courts today, a recently published article on the *Lamar Homes* case that is pending before the Supreme Court of Texas also is included in the CLE materials.

II.
Duty to Defend and Extrinsic Evidence

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 solves 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 sense, the duty to defend is litigation insurance.

The importance of the duty to defend and its role in litigation cannot be understated. As one commentator has noted, 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, and 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). This observation certainly rings true in the context of construction defect litigation.

A. Contours of the Eight Corners Rule

Texas courts apply the "eight corners rule" to determine whether an insurer has a duty to defend its insured. *See 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 pleadings 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.W2d 819, 829 (Tex. 1997); *Northfield*, 363 F.3d at 528.

Under the "eight corners rule," the allegations in the pleadings are given a "liberal interpretation." *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Guar. Nat'l Ins. Co. v. Azrock Indus.*, 211 F.3d 239, 243 (5th Cir. 2000). Any doubts must be resolved in favor of the insured. *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466, 474 (5th Cir. 2001). Moreover, even if the underlying plaintiff's allegations do not clearly show there is coverage, the insurer, as a general rule, will be obligated to defend if there is, potentially, an action alleged within the coverage of the policy. *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Harken*, 261 F.3d at 471. Likewise, if the potential for coverage is found for any portion of a suit, the insurer must defend the entire suit. *See St. Paul Ins. Co. v. Tex. Dep't of Transp.*, 999 S.W.2d 881, 884 (Tex. App.—Austin 1999, pet. denied); *Northfield*, 363 F.3d at 528. Accordingly, alternative allegations of intentional and even malicious conduct will not defeat the duty to defend if combined with allegations that would otherwise trigger a potential for coverage. *See Harken*, 261 F.3d at 474; *Stumph v. Dallas Fire Ins. Co.*, 34 S.W.3d 722, 729 (Tex. App.—Austin 2000, no pet.).

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 construction defect claim *unless* the 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.

B. 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.
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> 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 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*, 2006 WL 1791689 (Tex. June 30, 2006). Unfortunately, the opinion has provided as many questions as it did answers. Prior to discussing *Fielder Road*, a little bit of historical background is in order.

1. History of Extrinsic Evidence Prior to 2006

Prior to 2006, although the Supreme Court had hinted that Texas is 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, it was basically left to the trial courts 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, that was not always the result.

Several state appellate courts had 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).

Federal court had 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 & Hlavinkaa, 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 boat-owner'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); *Western Heritage Ins. Co. v. River Entertainment*, 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 p. 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 Company*, 139 S.W.3d 384, 388-89 (Tex. App.—Fort Worth 2004), *aff'd*, 2006 WL 1791689 (Tex. June 30, 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 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.

2. 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 court was careful to limit its decision to situations when the extrinsic evidence is "relevant both to coverage and the merits . . . ." *Fielder Road*, 2006 WL 1791689, at *3. In other words, the court's holding arguably is limited to situations when the extrinsic evidence is relevant to both the coverage case and the underlying case (i.e., mixed or overlapping extrinsic evidence). By implication, its seems that the court also would decline to adopt any exception to the eight corners rule that deals only with liability facts.

The issue becomes more difficult when the extrinsic evidence relates solely to "coverage" facts. As noted in the prior section, at least some support exists for admitting extrinsic evidence in "pure coverage" 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 underpinnings of the duty to defend. In other words, insurers still will have to defend "groundless, false, or fraudulent" claims that otherwise state a potential for coverage. Under a "coverage only" exception, insurers will only 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 say one way or the other whether it would recognize the exception. On the one hand, the court did note that "[r]esort to evidence outside the four corners . . . is *generally* prohibited." *Fielder Road*, 2006 WL 1791689, at *1 (emphasis added). On the other hand, the court cited to other courts that had recognized a limited exception to the eight corners rule for "pure coverage questions" without disapproving of those cases. 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). It seems clear that the extrinsic evidence debate will continue until the Texas Supreme Court once again weighs in on the issue.

III.
The Right to Independent Counsel

Once an insured gets past the duty to defend hurdle, another "hot" issue centers on the selection of counsel and, in particular, the right to independent counsel. More specifically, issues oftentimes arise as to whether the insurer or the insured gets to select counsel, who has to pay for independent counsel, and the appropriate rate to be paid by the insurer to independent counsel. 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 the insurer has the right to select defense counsel. Moreover, if no conflict of interest exists, the insurer may have exclusive control over the defense. When a conflict of interest exists (e.g., when the outcome of a coverage issue can

be affected by the manner in which the underlying action is defended); however, one must be cognizant of the relationship among the liability insurer, its insured, and the defense counsel selected by the liability insurer to defend the insured. 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. Texas law is clear, however, 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 unqualified loyalty to the insured, the fact remains that the "so-called tripartite relationship 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 under a reservation of rights 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 as 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 so-called "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, 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). Both courts held that the use of staff counsel to represent insureds does not constitute the unauthorized practice of law. The Eastland Court of Appeals specifically held that a defense lawyer has two clients. *American 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 Mut. Ins.*, 155 S.W.3d at 598; *Am. Home Assurance*, 121 S.W.3d at 838.

The use of staff counsel and the broader issue of whether Texas is a "one client" or "two client" state is a controversial issue. Oral argument took place in the *American Home Assurance* case 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/.

C. Who Gets to Select 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) Limited*, 2005 WL 81722 (N.D. Tex. Jan. 14, 2005). "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 that a reservation of rights does in fact 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 Ins. Co.*, 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.
>
> ***
>
> 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 Ins. Co., 333 F. Supp. 2d at 601-02 (internal quotations and citations omitted). *Northland Ins Co.* stands for the proposition that 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. *See id.*

> 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 expense 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., 2006 WL 801133 (S.D. Tex. Mar. 29, 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* at *13.

Even when the right to independent counsel is recognized, a big fight oftentimes ensues as to "how much" the insurer must pay independent counsel. In particular, if independent counsel normally charges $250 per hour whereas the counsel selected by the insurer charges $165 per hour, can the insurer insist on paying the lower rate? Very little guidance is provided by the Texas courts on this issue. The most rationale answer is that the insurer should be forced to pay what is reasonable and customary for the type and sophistication of the particular case. Notably, defense counsel that receive a large volume of work from a particular insurer oftentimes discount their rates. Independent counsel, who may or may not ever have another case involving the insurer, should not be forced to accept the discounted rate. For example, after deciding that Northland had breached its duty to defend in the *Northland Insurance Co.* case, Judge Lindsay issued a subsequent opinion in which he concluded that the fees charged by the lawyers DHA retained to represent it after refusing 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, Jan. 27,*

2005 Order.

Another fight centers on whether independent counsel must follow litigation/billing guidelines. Very little guidance is provided by the Texas courts on this issue as well. A Texas Ethics Opinion, however, does provide some insight. *See* Tex. Comm. on Prof'l Ethics, Op. 533 (2000) ("It's 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 the insured/client."). Ethics Opinion 533 basically stands for the proposition that a defense lawyer can follow billing/litigation guidelines so long as such guidelines do not interfere with the defense counsel's professional judgment. *Id.* In addition, 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." *Traver*, 980 S.W.2d at 628. In other words, while a prohibition on block billing may be permissible, it likely would not be permissible for an insurer to restrict research, discovery, or other matters that fall within the professional judgment of defense counsel.

D. 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 Texas Supreme Court 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.

IV.
Which Policy Is Triggered?

Construction defect cases oftentimes involve latent damage or progressive damage that occurs over a period of time. This issue typically spawns fights among insurers and between insureds and insurers as to *when* the damage occurred and *which* policy or policies must respond. The reason for the fight is that most CGL policies are written on an "occurrence" basis. In occurrence-based policies, the insuring agreement specifically requires that the "property damage" must take place during the policy period. Contrast that with a claims-made policy wherein it is the *claim* that must be made and oftentimes reported during the policy period, even if the particular act or omission that caused the property damage happened prior to policy period. Many professional liability policies issued to architects and engineers are written on a claims-made basis. The trigger analysis for claims-made policies is straightforward—the policy in place at the time a "claim" is first made is the one (and typically the only one) that is triggered provided that the claim is reported in a timely manner under the terms of the policy. The trigger analysis for occurrence-based policies is less than straightforward.

Texas courts have applied different "trigger" theories to determine whether a particular

"occurrence" policy or whether numerous "occurrence" policies are triggered for a particular loss. While an in-depth analysis of the various trigger theories is beyond the scope of this paper, it is important to clarify certain misconceptions that surround the triggering of occurrence-based CGL policies.

Most notably, insureds oftentimes assume that the policy in place at the time of the alleged defective construction is the one that will be triggered. Typically, that is not the case. Although the Texas Supreme Court has never adopted a particular trigger theory, the vast majority of cases that have addressed the issue hold that it is the policy in place at the time that the resulting damage becomes readily apparent that is triggered. *See Am. Home Assur. Co. v. Unitramp, Ltd.*, 146 F.3d 311, 313 (5th Cir. 1998); *Matthews Heating & Air Conditioning*, 2004 WL 2451923, at *3; *Gehan Homes*, 146 S.W.3d at 845-46; *Cullen/Frost Bank of Dallas, N.A. v. Commonwealth Lloyd's Ins. Co.*, 852 S.W.2d 252, 257 (Tex. App.—Dallas 1993, writ denied); *State Farm Mut. Auto. Ins. Co. v. Kelly*, 945 S.W.2d 905, 910 (Tex. App.—Austin 1997, writ denied) ("Texas courts have held that property loss occurs when the injury or damage is manifested."). Although it is always dangerous to place labels on trigger theories, this theory is commonly referred to as the "manifestation" trigger.

In a nutshell, the manifestation trigger provides that actual damage occurs when it becomes apparent or readily identifiable. Even so, damage does not automatically qualify as apparent or identifiable merely because it is "capable of being known by testing." *See Unitramp*, 146 F.3d at 313. In particular, an insured is not required or duty bound to "conduct limitless tests and inspections for hidden defects." *Id.* Instead, although it is a somewhat murky concept that is decided on a case-by-case basis, damage will be considered apparent and/or identifiable at the point when it is "capable of being perceived, recognized and understood." *Id.* at 314. Adding to the confusion is the fact that courts have been careful to state that manifestation does not equate to discovery. *See Unitramp*, 146 F.3d at 314 (noting that "it is important to understand that 'apparent' does not mean 'discovered'; just because something is unknown to an individual does not render it, in an objective sense, unapparent").

A common misconception surrounding the manifestation trigger is that only one policy can be triggered. In reality, although the manifestation trigger often results in only a single triggered policy, several policies can be triggered when allegations exist of separate and distinct manifestations of "property damage." *See Cullen/Frost*, 852 S.W.2d at 257 ("In cases involving continuous or repeated exposure to a condition, there can be more than one manifestation of damage and, hence, an occurrence under more than one policy."); *Encore Homes, Inc. v. Assurance Co. of Am.*, 2000 WL 798193 (N.D. Tex. June 21, 2000) ("Although Petroff bought her home in 1994, she alleges that '[a]dditional defects and problems with the home continue to arise on an almost daily basis' and that 'defects continue to become evident on almost a daily basis.' Given that the lawsuit was filed while the policy was still in effect, this allegation is sufficient to suggest that at least one occurrence became manifest during the policy period."); *see also Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833, 845-46 (Tex. App.—Dallas 2004, pet. filed) (holding that multiple policies were triggered based on a broad allegation of when the damages occurred).

Although the so-called manifestation trigger is the majority rule in Texas, it is not the *only* trigger theory that has been applied in the context of a "property damage" case. *See Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, no pet. h.); *Pilgrim Enters., Inc. v. Md. Cas. Co.*, 24 S.W.3d 488 (Tex. App.—Houston [14th Dist.] 2000, no pet.); *see also Royal Indem. Group v. Travelers Indem. Co.*, 2005 WL 2176896 (N.D. Cal. Sept. 6, 2005) (applying Texas law). At least three courts have applied a broader "exposure" trigger to determine which policy or policies are potentially triggered. Under an exposure trigger, it is the policy or policies in place at the time of the exposure to the conditions that cause the property damage that is triggered. Courts applying a broader exposure trigger note that the CGL policy itself contains no "manifestation" requirement and that applying a manifestation trigger essentially converts an "occurrence" policy into a claims-made policy. *See Pine Oak Builders*, 2006 WL 1892669, at *7; *Pilgrim*, 24 S.W.3d at 496. Under the broader exposure trigger, allegations of continuous and repeated exposure to conditions (e.g., water intrusion) might implicate more than one policy. *See Pine Oak Builders*, 2006 WL 1892669, at *8.

Until the Supreme Court of Texas definitively rules on the proper trigger theory, insureds must be careful to place all *potentially* triggered policies on notice. As a rule of thumb, it is oftentimes a good idea to put all carriers from the time of construction through the time of the claim on notice.

V.
Notice and Other Conditions

In addition to the insuring agreement and exclusions, insurance policies have numerous "conditions" or "rules" that must be followed. Failure to follow the conditions can, in certain circumstances, lead to a forfeiture of coverage. The most common conditions involve notice, cooperation, and settlement without consent. A prevalent issue, and one that is in a state of flux, is whether an insurer must demonstrate prejudice in order to rely on a breach of these common conditions.

A. Notice

This paper already has addressed trigger and the importance of placing all potentially triggered policies on notice of a particular loss. This section will go into a bit more detail as to what notice is required for a property damage claim in the context of a CGL policy. Most liability policies require that the insured provide notice of an occurrence "as soon as practicable." This condition is often coupled with a requirement that the insured must "immediately" forward any suit papers. The stated purpose of the notice requirements is to give insurers an opportunity to adequately investigate a claim. Although the notice requirements are seemingly straightforward, they have generated a significant amount of case law.

The notice provisions, at least in most policies, are a condition precedent to coverage. Accordingly, a breach of the notice provision may result in the forfeiture of coverage. The general

rule for notice is:

> It is the service of citation upon the insured which imposes on the insured the duty to answer to prevent a default judgment. No duty is imposed on an insurer until its insured is served and sends the suit papers to the insurer. This action by the insured triggers the insurer's obligation to tender a defense and answer the suit.

Members Ins. Co. v. Branscum, 803 S.W.2d 462, 466-67 (Tex. App.—Dallas 1991, no writ). Stated otherwise, an insurer has no duty to defend *until* it has been put on notice. *See Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761 (5th Cir. 1999). Texas courts have consistently held that an insurer is not required to reimburse an insured for pre-tender defense costs. *See L'Atrium on the Creek I, L.P. v. Nat'l 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).

Although pre-tender defense costs may not be recoverable, the heart of the debate stems over whether an insurer must demonstrate prejudice in order to rely on late notice as a *total* bar to coverage.[1] As part of this analysis, one must consider a 1973 Mandatory Endorsement required by the State Board of Insurance. More specifically, in 1973, the State Board of Insurance (n/k/a Department of Insurance), promulgated Board Order 23080 and required that it be applied to all CGL policies issued in the State of Texas. Board Order 23080 provides as follows:

> As respects *bodily injury* liability coverage and *property damage* liability coverage, unless the company is prejudiced by the insured's failure to comply with the requirement, any provision of this policy requiring the insured to give notice of action, occurrence or loss, or requiring the insured to forward demands, notices, summons or other legal process, shall not bar liability under this policy.

State Bd. of Ins., Revision of Texas Standard Provision for General Liability Policies — Amendatory Endorsement, Order No. 23080 (Mar. 13, 1973) (emphasis added). The Fifth Circuit has applied the prejudice requirement contained in Board Order 23080, to CGL policies issued by surplus lines carriers even though the Board Order is not required to be added to surplus lines policies. *See Hanson Prod. Co. v. Am. Ins. Co.*, 108 F.3d 627, 630 (5th Cir. 1997).

Whether an insurer is prejudiced by late notice is generally a question of fact. *See Struna v. Concord Ins. Servs., Inc.*, 11 S.W.3d 355, 359-60 (Tex. App.—Houston [1st Dist.] 2000, no pet.).

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[1]The prejudice discussion, for purposes of this paper, is limited to "property damage" claims brought under occcurence-based CGL policies. Different rules may exist for other types of policy forms (*e.g.*, D&O and E&O policies) or for different types of claims brought under a CGL policy (*e.g.*, claims for advertising injury). Moreover, no showing of prejudice is required in the context of a claims-made policy. *See Precis, Inc. v. Federal Ins. Co.*, 2006 WL 1675177 (5th Cir. 2006); *Federal Ins. Co. v. CompUSA, Inc.*, 319 F.3d 746 (5th Cir. 2003). Accordingly, an insured must make sure it strictly follows the notice requirements of any claims-made policy.

Moreover, the burden is on the insurer to prove prejudice. It is a difficult burden for an insurer to overcome. As one court has noted, the "abstract loss of the rights to investigate, defend, participate in negotiations, and control settlement are not sufficient to show prejudice." *Coastal Ref. & Mktg., Inc. v. USF&G Co.*, 2006 WL 1459869 (Tex. App.—Houston [14th Dist.] May 30, 2006, no pet.). Even so, at least some courts will presume prejudice as a matter of law if the insured does not present an adequate excuse for the delinquent notice. *See Blanton v. Vesta Lloyds Ins. Co.*, 185 S.W.3d 607, 612-13 (Tex. App.—Dallas 2006, no pet.) (noting that insured had no excuse for delaying notice for two and one-half years).

Simply put, courts reach different results when it comes to applying a prejudice standard. "What constitutes a reasonable time within which notice must be given depends on the individual facts and circumstances of each particular case, including but not limited to age, experience, and capacity for understanding and knowledge that coverage exists in one's favor." *Blanton*, 185 S.W.3d at 611. Accordingly, insureds should always err on the side of providing notice as early as possible.

B. Settlement Without Consent

Another condition in the policy is that the insured must not settle without the consent of the insurer. This condition oftentimes is referred to as the voluntary assumption of liability condition. Some courts have held that an insurer must show prejudice in order to deny coverage based on breach of the settlement without consent condition. *See, e.g., Ins. Co. of N. Am. v. McCarthy Bros. Co.*, 123 F. Supp. 2d 373, 379 (S.D. Tex. 2000) ("By demanding that an insurer prove prejudice, Texas law recognizes that only a material breach of a contract excuses performance."); *Comsys Info. Tech. Servs., Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 191-92 (Tex. App.—Houston [14th Dist.] 2003, pet. denied) ("The mere fact that the insurer owes money that it does not wish to pay does not constitute prejudice as a matter of law."); *Coastal Ref.*, 2006 WL 1459869, at *6 ("Given the existence of fact questions and USF&G's failure to provide evidence of prejudice, summary judgment in favor of USF&G cannot be sustained on this basis.").

Recently, however, the Fifth Circuit concluded that an insurer is prejudiced as a matter of law when "the insurer is not consulted about the settlement, the settlement is not tendered to it and the insurer has no opportunity to participate in or consent to the ultimate settlement decision . . . ." *Motiva Enters., LLC v. St. Paul Fire & Marine Ins. Co.*, 445 F.3d 381, 386 (5th Cir. 2006). Until the Texas Supreme Court addresses the issue more clearly, the prejudice issue in the context of settlement without consent is likely to be resolved on a case-by-case basis.

It should be noted that once the insurer has denied coverage, it can no longer insist on the insured's compliance with the settlement without consent clause. *See Enserch Corp. v. Shand Morahan & Co., Inc.*, 952 F.2d 1485, 1496 n.17. Accordingly, the discussion set forth above regarding application of the settlement without consent clause is limited to situations in which the insurer has not denied coverage.

C. Cooperation

In addition to notice and consent to settlement, insureds have a general duty to cooperate with the insurer in connection with the defense of the lawsuit. *See Quorum Health Resources, LLC v. Maverick County Hosp. Dist.*, 308 F.3d 451, 468 (5th Cir. 2002). The cooperation clause serves to assist the insurance company to: (i) obtain information concerning a loss while the information is still fresh; (ii) determine its obligations to indemnify the loss and/or defend its insured; (iii) protect itself from fraudulent claims; and (iv) pursue a subrogation claim against a responsible third-party, if applicable. *See* Rick Virnig, THE INSURED'S DUTY TO COOPERATE, 6 J. OF TEX. INS. L. 11 (Fall 2005). To breach its duty to cooperate, an insured's conduct must materially prejudice the insurer's ability to defend the lawsuit on the insured's behalf. *See Martin v. Travelers Indem. Co.*, 450 F.2d 542, 553 (5th Cir. 1971). Assuming such a showing is made, however, the breach can relieve an insurer of any liability under the policy. *See Filley v. Ohio Cas. Ins. Co.*, 805 S.W.2d 844, 847 (Tex. App.—Corpus Christi 1991, writ denied); *see also Progessive County Mut. Ins. Co. v. Trevino*, 2006 WL 1751147 (Tex. App.—San Antonio June 28, 2006, no pet. h.) (holding that insured's total lack of cooperation constituted prejudice as a matter of law).

The duty to cooperate is limited to the insured's assistance in the liability lawsuit and does not extend to assisting the insurer in its coverage determination. *See Lafarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 397 (5th Cir. 1995). Moreover, like the settlement without consent clause, the insurer cannot insist on compliance of the cooperation clause once it has denied coverage. *See Quorum*, 308 F.3d at 468.

VI.
The Right of Recoupment

One of the "hottest" issues in insurance law 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 the particular claim. Any discussion of recoupment must center around the two Texas Supreme Court cases on the issue. The issue, however, is far from settled.

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. 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.

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*, 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 v. Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool*, 975 S.W.2d 782 (Tex. App.—Corpus Christi 1998, pet. granted). Although 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*, 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 Texas Supreme Court 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 court 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 Texas Supreme Court 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." 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 Texas Supreme Court, the right of reimbursement of defense costs for uncovered claims still is technically 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 Texas Supreme Court 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 Texas Supreme Court 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 Texas Supreme Court 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*: A unilateral reservation of rights *may* be sufficient for recoupment of defense costs, but is *not* sufficient to preserve an insurer's right to seek recoupment of indemnity payments.

Maybe.

B. *Frank's Casing*

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 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.) In fact, the appellate court invited the Texas Supreme Court to revisit the issue. *See id.*

The Texas Supreme Court 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.*[2]

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 Texas Supreme Court granted Frank's Casing's 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 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 Texas Supreme Court 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.

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[2]Although the court said that it was not overruling *Matagroda 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.

Compaq appealed to the Eighth Circuit. On August 4, 2006, the Eighth Circuit affirmed the district court. *See St. Paul Fire & Marine Ins. Co. v. Compaq Computer Corp.*, 2006 WL 2192634 (8th Cir. Aug. 4, 2006).

D. Where Do We Stand?

It is difficult to synthesize *Matagorda County* and *Frank's Casing*. Hopefully, the Texas Supreme Court 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.