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IN THIS ISSUE:

THE DUTY TO INDEMNIFY:

Does a finding of no duty to defend based on an "eight corners" analysis necessarily mean that there will be no duty to indemnify based on the actual facts?

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The *D.R. Horton* Case: Does a Finding of No Duty to Defend Necessarily Mean No Duty to Indemnify?

On June 30, 2006, the Supreme Court of Texas handed down its long-awaited opinion on whether extrinsic evidence is admissible in the duty to defend analysis. *See GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305 (Tex. 2006). In so doing, the Court *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 (citations omitted). 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 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, in *Fielder Road*, the Supreme Court of Texas did not expressly say one way or the other whether it would recognize a "coverage only" exception.

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

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CASES TO WATCH:

***Lamar Homes v. Mid-Continent Cas, Ins. Co.*, 428 F.3d 193 (5th Cir. 2005) (certified to the Supreme Court of Texas and argued on February 14, 2006) (whether allegations of faulty workmanship constitute "property damage" and "occurrence" under a CGL policy as well as whether the "prompt payment of claims" act of the Texas Insurance Code applies to liability insurers)**

***Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, 2005 WL 1252321 (Tex. May 27, 2005) (pending on rehearing) (whether Texas recognizes a right of recoupment by an insurer against its insured)**

***Fairfield Ins. Co. v. Stephens Martin Paving*, 381 F.3d 435 (5th Cir. 2004) (certified to the Supreme Court of Texas and argued on November 9, 2004) (whether an award of punitive damages is insurable under an employers liability policy)**

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). Likewise, the Fifth Circuit has interpreted *Fielder Road* as permitting extrinsic evidence in "coverage only" scenarios. *See Liberty Mut. Ins. Co. v. Graham*, 473 F.3d 596 (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.*, 193 Fed. Appx. 302 (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.

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CASES TO WATCH: (continued)

***Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91 (Tex. App.—Ft. Worth 2005, pet. granted) (argued on April 11, 2007) (whether Texas recognizes coverage by waiver and/or estoppel when an insurer undertakes the defense without adequately reserving rights)**

***American Home Assur. Co., Inc. v. Unauthorized Practice of Law Comm.*, 121 S.W.3d 831 (Tex. App.—Eastland 2003, pet granted) (argued on September 28, 2005) (scope of the tripartite relationship between insurer, insured, and defense counsel retained by insurer)**

NOTE:

The Supreme Court of Texas goes on summer recess at the end of June. Accordingly, some of these Cases to Watch may be released in the next two weeks. If that occurs, a special edition of this Newsletter will be released to bring you up-to-date on any significant developments.

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 of or otherwise reference any subcontractors. In particular, 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).

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. *D.R. Horton*, 2006 WL 3050756, at *5. 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 and the Supreme Court has requested full briefing. 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.

Besides the fact that the *D.R. Horton* case may provide the Supreme Court of Texas with a chance to clarify the extrinsic evidence rule, it is important for another reason. After ruling that no duty to defend existed, based on a strict "eight-corners" analysis, the court of appeals then ruled that there necessarily can be no duty to indemnify.

In most cases, the negation of the duty to defend also will negate the duty to indemnify. *See Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex. 1997). 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 Sur. 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

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insurer obtains a judgment as to defense and indemnity based on a particular petition or complaint, for example, it always is 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), *vacated and remanded*, 202 Fed. Appx. 667 (5th Cir. 2006), 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. 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 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**

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the complaint allegation rule."); s*ee also* Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty to Defend in Texas*, 31 TEX. TECH. L. REV. 869, 890–98 (2000). 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.

Commentary:

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. 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 based on a strict "eight-corners" analysis, 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 absolutely is proper for a court to consider extrinsic evidence.**

The bottom line is that the "no duty to defend necessarily means no duty to indemnify" language that is repeated in case after case *should not* be an absolute rule and the *D.R.Horton* case provides a perfect example of why not.

For a more in-depth analysis of the duty to defend and the use of extrinsic evidence, please see my article "Rounding the Corners of the Duty to Defend: Where are We and Where are We Going," which can be found at our website, www.vsfirm.com under Publications.

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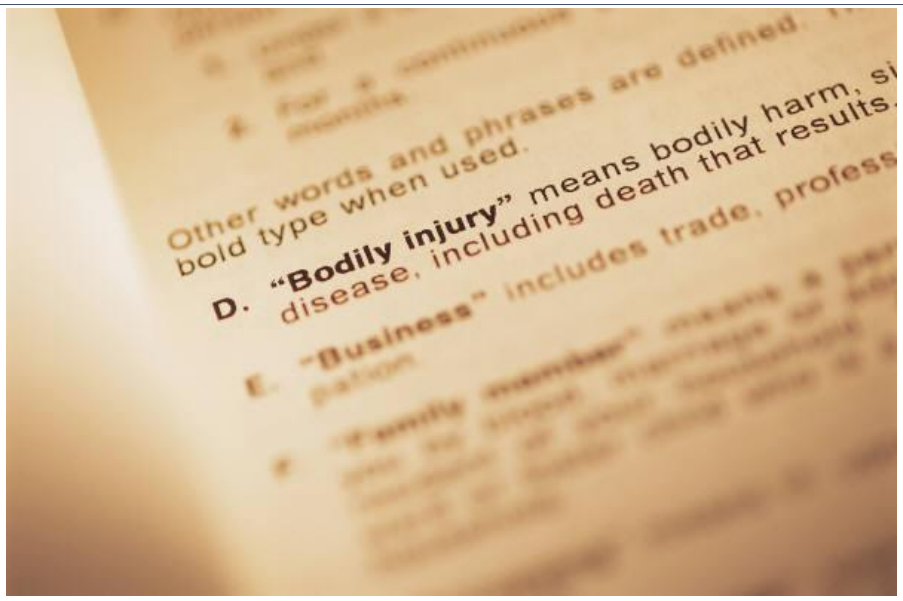

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Lee Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He holds council positions with the Insurance Law Section and the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Mr. Shidlofsky has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004 and is ranked as a top insurance coverage lawyer by Chambers USA.

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