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***EXCESS UNDERWRITERS V. FRANK'S CASING*:**

The Supreme Court of Texas reverses itself and rules that no implied right of reimbursement exists under Texas law.

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Coup d'état : The End of Re*coup*ment in Texas?

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. On February 1, 2008, the Supreme Court of Texas answered the long-awaited question in the negative. *See Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, 2008 WL 274878 (Tex. Feb. 1, 2008). In doing so, the Court signaled what could be the end of the right of recoupment by an insurer against its insured in Texas—Maybe.

A. Leading up to *Frank's Casing*

1. *Matagorda County*

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

In 1995, TAC informed the county that it had received a $300,000 offer to settle the prisoners' lawsuit. The $300,000 settlement offer was within policy limits. Although the county believed that the $300,000 offer was reasonable, it refused to fund the settlement because of its belief that the claim was covered. TAC then issued a second reservation of rights letter wherein TAC informed the county that it planned to accept the settlement offer but that it would seek reimbursement of the full settlement amount if the declaratory judgment action established that the prisoners' claim was excluded from coverage. The county did not respond to TAC's letter. After settling the prisoners' lawsuit, TAC amended its declaratory judgment action to request reimbursement of its defense and settlement costs associated with the prisoners' lawsuit against the county.

The trial court granted a partial summary judgment finding that the "jail" exclusion precluded coverage for the prisoners' lawsuit. Then, after a trial on various defenses asserted by the county, the jury returned a verdict finding

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CASES TO WATCH:

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)

OneBeacon Ins. Co. v. Don's Building Supply, Inc., 2007 WL 2258192 (5th Cir. Aug. 8, 2007) (certifying trigger issue to the Supreme Court of Texas)

Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted) (scope of the eight-corners rule and proper trigger theory to apply to "property damage" cases)

that the county had accepted the jail exclusion and that it was estopped from claiming that it was unaware of its presence in the policy. Following the jury's verdict, the trial court entered a final judgment granting TAC recovery of both its $300,000 settlement payment and $53,522.15 in attorneys' fees paid by TAC for defending the prisoners' lawsuit.

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

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

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

Relying, at least in part, on the California Supreme Court's decision in *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997), the Corpus Christi Court of Appeals rejected TAC's claim for reimbursement of defense costs on the ground that TAC's reservation of rights letter failed to specifically notify the county that reimbursement of defense costs would later be sought. *See Matagorda County*, 975 S.W.2d 782. While the Corpus Christi Court of Appeals did not squarely hold that Texas law recognized a right of reimbursement, the language of the opinion strongly suggests that TAC would have had a "quasi-contractual" right to reimbursement of defense costs had it specifically reserved its right to seek recoupment. 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 County*, 975 S.W.2d at 784. The court then went on to hold that reimbursement of settlement costs was dependent on a "specific agreement by the insured to be bound by the settlement and to allow reimbursement to the insurer if the coverage issue is later determined against the insured . . . ." *Matagorda County*, 975 S.W.2d at 787.

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

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CASES TO WATCH:
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Johnson v. State Farm Lloyds, 204 S.W.2d 897 (Tex. App.—Dallas 2006, pet. granted) (scope of the standard appraisal clause)

Mid-Continent Cas. Co. v. JHP Development, Inc., 2005 WL 1123759 (W.D. Tex. Apr. 21, 2005) (appealed to the Fifth Circuit Court of Appeals) (application of exclusions j(5) and j(6))

D.R. Horton—Texas, Ltd. v. Markel International Ins. Co., Ltd., 2006 WL 3040756 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed) (scope of the eight-corners rule and the relationship between the duty to defend and the duty to indemnify)

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

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

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

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

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. . . .'" *Id.* at 133 (citing *Shoshone*, 2 P.3d at 516). Accordingly, although the defense costs issue was not squarely before it, the Court's statements and reliance on *Shoshone* strongly suggest that the Supreme Court of Texas would disapprove of any attempt by an insurer to unilaterally reserve its right to recoup defense costs for uncovered claims.

Even the dissent in *Matagorda County*, 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 the Supreme Court in *Matagorda County*: While a unilateral reservation of rights likely is not sufficient for recoupment of defense costs, it is definitely not sufficient to preserve an insurer's right to seek recoupment of indemnity payments.

These issues are never as simple as they seem . . .

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2. *Frank's Casing I*

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

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

As ARCO's lawsuit proceeded to trial, it became readily apparent that Frank's Casing was the target defendant. After the close of the second day of trial, Frank's Casing's in-house counsel contacted ARCO and requested that it make a settlement demand within the excess policy's limits. ARCO responded with a demand of $7.5 million, which was immediately communicated to Frank's Casing's carriers. In communicating the settlement offer, Frank's Casing demanded that Excess Underwriters accept the settlement demand. Excess Underwriters agreed that the case should be

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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's approval of any settlement, and Frank's Casing consented to the settlement.

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

The Supreme Court of Texas accepted the invitation and, in so doing, initially concluded that *Matagorda County* did not control under the facts before it. The Court noted that, in *Matagorda 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) (*Frank's Casing I*).The Court viewed *Frank's Casing I* 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.* That decision had three concurring opinions and left many questions unanswered.

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3. *Frank's Casing II*

Frank's Casing I ignited a clash—particularly between insureds and defense counsel on the one hand and the insurance industry on the other. A motion for rehearing was filed and an *amicus curiae* battle ensued. Insurers loved the result of *Frank's Casing I* whereas insureds and insurance defense counsel strongly contested the result. Apparently, a battle existed within the Supreme Court as well as it took nearly two years to issue a new opinion *on rehearing*.

On motion for rehearing in *Frank's Casing*, the Court, without ever mentioning its prior reasoning in the case, reversed itself and found that no exception existed to the rule set forth in *Matagorda County*. *See Excess Underwriters at Lloyd's London v. Frank's Casing Crew & Rental Tools, Inc.*, 2008 WL 274878 (Tex. Feb. 1, 2008) (*Frank's Casing II*). That is, no right of reimbursement exists after settlement if the insurer has not first obtained "the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement." *Id.* at *1. Because Frank's Casing had agreed to the settlement, but not the insurer's right to seek reimbursement, the Court found that Excess Underwriters was not entitled to reimbursement.

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In support of its decision, the Court explained the state's laws regarding reimbursement, starting with its prior decision in *Matagorda County*. The majority explained that its analysis in that case highlighted the dilemma faced by the insured and its insurer when a claimant presents a reasonable settlement offer, within policy limits, but coverage is unclear. An insurer that rejects such an offer faces "significant potential liability for bad-faith insurance practices" under the *Stowers* doctrine if it ultimately fails in its coverage contest. By preventing the insurer from seeking reimbursement, coverage in such cases is created even though it is ultimately determined not to exist. On the other hand, though, the insured in such situations is forced "to choose between rejecting a settlement within policy limits or accepting a possible financial obligation to pay an amount that may be beyond its means, at a time when the insured is most vulnerable." *Id.* at *3 (quoting *Matagorda County*, 52 S.W.3d at 134). The quandary was resolved by determining that the risk of coverage uncertainties was best placed with the insurer.

After discussing its reasoning for that resolution in *Matagorda County*, the Court acknowledged that several *amicus curiae* in the case before it had warned that an implied reimbursement right would create a significant conflict for defense counsel during settlement negotiations. In particular, if the insured acknowledges the reasonableness of a settlement offer, and the right of reimbursement is implied, the insured's defense counsel's role in evaluating and recommending settlement may advance the insurer's interest over that of its insured. Thus, the *amici* argued that with defense counsel hindered, both the insured and insurer may be forced to retain "settlement counsel" to evaluate the case before it and formulate strategy for a future battle regarding reimbursement. While noting that the fears may not be real, the Court noted that they do foreshadow the significant distrust possible in the insured/insurer relationship during settlement if the right of reimbursement were implied.

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Similarly, the Court also discussed the concerns held by the *amici* that the insurer's incentive for negotiating a favorable settlement for its insured is weakened by an implied right of reimbursement. That is, because the insured likely will bear the obligation of ultimately paying a settlement if coverage does not exist, the insurer might shortchange the insured during the settlement negotiations, curtailing attorneys' fees and expenses, settling quickly at a high settlement amount, and avoiding any potential *Stowers* liability. Thereafter, any litigation as to reimbursement likely will be protracted with the insured footing its own bill, effectively negating the insurance it purchased "for the very purpose of hedging the risk and expense of future litigation." *Id.* at *5. Because the Court in *Matagorda County* had weighed these various concerns and found the insurer was better positioned to handle them, the Court refused to overrule that decision—even though it had done so in *Frank's Casing I*.

The Court then turned to Excess Underwriters' arguments that this case was distinguishable from that of *Matagorda County*. The Excess Underwriters argued that Frank's Casing had impliedly agreed to the right of reimbursement by actively procuring the settlement offer and then demanding that its insurer settle the claim. The Court failed to see how those actions by Frank's Casing amounted to anything more than a demonstration of its belief that the claim should be settled. In fact, both parties merely stuck to their guns in regard to their respective coverage positions, including the existence of a right to reimbursement. The Court said, "This is a far cry from impliedly consenting to reimbursement. . . . Given the parties' explicit efforts to preserve their positions, it makes no more sense to say that Frank's Casing impliedly agreed to reimburse the carriers than it would to say that the carriers impliedly agreed to waive their coverage position." *Id.* at *5. As such, because of Frank's Casing's consistent position that the insurers alone were responsible for the claims, its agreement to reimbursement could not be implied. In addition, the Court disagreed that the policy's "consent-to-settle" language had anything to do with the Excess Underwriters' right to reimbursement should they choose to negotiate settlement of a claim.

The Excess Underwriters also alleged that a right of reimbursement existed under the equitable theories of *quantum meruit* and *assumpsit*. Those same theories had been rejected in *Matagorda County*, but Excess Underwriters argued that that case did not apply because Frank's Casing sought a settlement demand from its claimant and demanded that its insurer pay for it. The Court found those distinctions did not allay the concerns underlying the Court's analysis in *Matagorda County*. The Court continued to be concerned that an insured would be forced to choose between rejecting a settlement within policy limits or accept a financial obligation in an amount that may be beyond its means. Thus, it would not grant a right of reimbursement. And the Court refused to rewrite the parties' contract or add to its language. The Court also rejected a request that it overrule its decision in *Matagorda County* and follow the opinions of a California court and a Florida court, both of which permitted a right of reimbursement.

In closing its opinion the Court addressed the dissenting opinions of Justice Hecht and Justice Wainwright. Justice Hecht believed that an equitable reimbursement obligation should have been imposed on Frank's Casing.

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Justice Wainwright, on the other hand, thought that Frank's Casing's acquiescence in the settlement meant that Excess Underwriters should be entitled to an implied-in-fact right of reimbursement. The Court had addressed these arguments previously in *Matagorda County* and again refused to adopt either position. With regard to Justice Hecht's opinion, the Court said that his "approach would breed uncertainty and 'promote litigation rather than settle it.'" *Id.* at *9. That is, whether an insured would be faced with a reimbursement obligation would depend upon the financial status of the insured. Those "with less economic heft than Frank's Casing but more than Matagorda County might or might not be on the hook, depending upon how a court might view the 'equities' presented." *Id.* And, as for Justice Wainwright's arguments, the Court again explained that Frank's Casing's insistence on its position as to the right of reimbursement cannot be read as an agreement to allow such a right just because the insured demanded that the reasonable settlement offer be paid.

Commentary:

The Court's holding in *Frank's Casing II* is yet another favorable decision for insureds (**Warning:** we may have a trend on our hands) and certainly qualifies as one of the most significant decisions issued by the Supreme Court of Texas in recent years. Without ever mentioning its prior analysis in *Frank's Casing I*, which was authored by Justice Owens who now sits on the Fifth Circuit Court of Appeals, the Court returned Texas law to its post-*Matagorda County* state. Stated otherwise, an insurer only is entitled to a right of reimbursement if the insurer first obtains the insured's clear and unequivocal consent to a settlement offer *and* to the insurer's right of reimbursement. This is significant in that defense counsel and/or coverage counsel for the insured are no longer constrained when a *Stowers* demand is received (**Note:** without discussing the issue, the Court assumed that a demand within the policy limits of an *excess* policy qualified as a *Stowers* demand). Before *Frank's Casing II*, a letter from defense counsel or coverage counsel that merely stated that the settlement demand was reasonable could have subjected the insured to a right of recoupment. Now, defense counsel is free to evaluate the merits of the *Stowers* demand and coverage counsel is free to demand that the insurer accept the *Stowers* demand without fear of subjecting the insured to a right of recoupment. It is the insurer that must weigh the extra-contractual risk of rejecting a settlement offer.

Whether this means that more insurers will be less likely to settle claims quickly on behalf of their insureds remains to be seen. Even with no guarantee of a right of reimbursement, however, insurers likely still will be willing to enter settlements when coverage is questionable in light of their continued *Stowers* liability. That is, even if they are not assured of a right to reimbursement, an insurer will think twice before rejecting a *Stowers* demand that could subject them to a significant financial obligation if they are wrong about coverage. That being said, the potential downside to *Frank's Casing II* is that it likely will lead to more (and earlier) declaratory judgments wherein insurers will attempt to get a declaration as to their rights and obligations under a policy when coverage is in question. In fact, the Court basically encouraged insurers to seek "prompt resolution" of coverage disputes. Moreover, it will not be surprising if insurers seek approval for amendatory endorsements that specifically provide for a right of recoupment. Stay tuned.

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Lee H. 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 is Treasurer of the Insurance Law Section and holds a council position in 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, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal.

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