RECENT DEVELOPMENTS IN TEXAS INSURANCE AND BAD FAITH LAW

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State and Federal Courts analyzing Texas insurance and bad faith law have handed down interesting opinions on several issues recently. The results have been inconsistent with the state courts reaching different results from the federal courts on many issues including statutory bad faith damages and the contractual liability exclusion. Meanwhile, the Texas Supreme Court has accepted and is accepting numerous insurance cases with certified questions from the Fifth Circuit and on many occasions, it has reversed the federal court holdings. This paper analyzes some of the recent results and pending decisions.

I. The Contractual Liability Exclusion

Front and center in this Texas state court/Texas federal court dichotomy on insurance law is the litany of recent cases in the construction defect arena in which a liability policy's contractual liability exclusion determines whether a claim is covered. It started with the Texas Supreme Court's decision in *Gilbert Texas Construction, L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118 (Tex. 2010), which involved an unusual fact situation to negate coverage due to the policy's contractual liability exclusion because the insured's contractual risk was actually greater than the insured's liability in the absence of the contract under the common law.

The holding in *Gilbert* led to the appellate odyssey in *Ewing Construction Co., Inc. v. Amerisure Ins. Co.*, 420 S.W.3d 30 (Tex. 2014). *Ewing* began as a federal district court summary judgment in favor of the insurer in a coverage suit analyzing a garden variety construction defect situation on the basis that in as much as the insured's liability was totally contractually based, the contractual liability exclusion precluded coverage in its entirety. That result was initially affirmed by the Fifth Circuit in a 2-1 decision. While the initial Fifth Circuit opinion was on rehearing, the Fifth Circuit certified two questions to the Texas Supreme Court pertaining to the contractual liability exclusion and the exception to the exclusion for legal exposure that the insured would have in the absence of the contract.

Meanwhile, the Dallas Court of Appeals was addressing the contractual liability exclusion on its own timeline in *Mid-Continent Casualty Co. v. Castagna*, 410 S.W.3d 445 (Tex. App.--Dallas 2013, pet. denied). As it relates to the Contractual Liability exclusion, the insurer argued that because attorneys fees were awarded against its insured in the underlying arbitration proceeding, the breach of the implied warranty of good workmanship sounded in contract therefore invoking the contractual liability exclusion. Castagna countered by arguing that the implied warranty of good workmanship arose under the common law. In light of that, the damages awarded against Castagna in the arbitration were not damages the insured only assumed in the contract. The Dallas Court of Appeals ruled that the contractual liability exclusion did not negate coverage for the contractor because the contract terms "actually add nothing to the scope of the insured's liability for the foundation problems." *Id.* at 461. An interesting result in *Castagna* is the court held that the attorneys fees awarded against the insured in the underlying arbitration were covered under the policy.

This brings us back to *Ewing*, in which the Texas Supreme Court had to decide which school of thought on the contractual liability exclusion was the law of Texas. In response to the certified questions from the Fifth Circuit, the Texas Supreme Court held that a general contractor who enters into a contract in which it agrees to perform its construction work in a good and workmanlike manner, without more, does not "assume liability" for damages arising out of the contractor's defective work so as to trigger the contractual liability exclusion. In light of that holding, the Texas Supreme Court did not have to analyze the exception to the exclusion for liability the insured would otherwise have in the absence of the contract. In essence, the Texas Supreme Court rejected the reasoning of the Texas federal courts and followed the reasoning of the Dallas Court of Appeals on the contractual liability exclusion.

II. The Prejudice Requirement is Alive and Well

Very interesting estoppel/prejudice issues arose in *Gilbert* because the insurer apparently forced the insured to move for summary judgment on the plaintiff's causes of action that once removed cleared the way for a coverage denial based on the contractual liability exclusion. As noted in the opinion, the insured's defense counsel was afraid that the insurer would raise lack of cooperation as a coverage defense in the event he did not pursue summary judgment on the plaintiff's claims that were covered under the policy.

The Texas Supreme Court's estoppel and prejudice analysis in *Gilbert* are important in all types of insurance claims and policies. For example in *Gilbert*, the Texas Supreme Court reaffirmed its analysis in *Ulico Cas. Co. v. Allied Pilots Ass'n*, 262 S.W.3d 773, 787 (Tex. 2008) that coverage does not necessarily exist "simply because the insurer assumes control of the lawsuit defense," however, "if the insurer's actions prejudice the insured, the lack of coverage does not preclude the insured from asserting an estoppel theory to recover for any damages it sustains because of the insurer's actions."

The Texas Supreme Court noted that Underwriters at Lloyd's issued excess policies and that Gilbert Texas' primary insurer assumed its defense. *Gilbert Texas*, 327

S.W.3d at 122. While the court of appeals specifically concluded that Underwriters at Lloyd's did not assume control of the defense of Gilbert Texas, the Texas Supreme Court held that "[w]e need not address whether Underwriters assumed control of the defense, however, because we conclude that even if Gilbert was deprived of the opportunity to make an informed decision as it claims, it was not prejudiced by the deprivation because in the final analysis, Gilbert did not have coverage for the contract claim." *Id.* at 137.

It should be noted that the Texas Supreme Court expressed no opinion on whether Gilbert Texas would have breached the policy's cooperation clause if Gilbert Texas refused to assert its governmental immunity defense. *Id.* at 138. Also, *Gilbert* involved coverage for a settlement and it did not analyze the duty to defend. There is no indication that Gilbert Texas' primary insurer ever withdrew its defense. Thus, the propriety of an insurer providing a defense to an insured and then taking steps to force the insured to obtain dismissals of covered claims to support a withdrawal of a defense was not decided by *Gilbert*. Another important aspect of the *Gilbert* opinion's prejudice analysis is that it focused on the prejudice, if any, suffered by the insured. In that there was no coverage for the claim, the insured was not prejudiced by the insurer's claims handling.

Post *Gilbert*, the Texas Supreme Court issued another important opinion on the prejudice requirement; this time on what is required to support a denial of coverage, in *Lennar Corp. v. Markel American Ins. Co.*, 413 S.W.3d 750 (Tex. 2013). This opinion tackled a pesky construction defect coverage situation involving a homebuilder's remediation of 800 homes it built with faulty exterior insulation and finish systems. While the Texas Supreme Court's holding that the insurance policy at issue covered the remediation project was indeed noteworthy, also important was the Texas Supreme Court's holding that the lack of prejudice suffered by the insurer, as found by the jury, precluded the insurer from denying coverage based on the homebuilder's voluntary payments to fund the remediation project without the insurer's consent.

In *Lennar Corp v. Markel*, the insurer argued that it was prejudiced as a matter of law because it was "not asked to adjust [the] claim, provide a defense, or be involved in negotiating [the] settlement[s], but [was] simply told that it [had] to pay for a voluntary payment." *Lennar Corp. v. Markel*, 413 S.W.3d at 755-56. The Texas Supreme Court, however, agreed with the homebuilder that the issue of prejudice, i.e., whether "insured's unilateral settlement was a material breach of the policy--that is, that it significantly impaired the insurer's position … is a question of fact, not of law." *Id.* at 756.

Interestingly, the consent to settlement requirement was located not only in the policy's Conditions, but also in the policy's Insuring Agreement. Thus, the insurer argued that even if it was not prejudiced as a matter of law for purposes of the insured's breach of the consent to settle condition, the fact that this requirement also existed in the Loss Establishment Provision in the Insuring Agreement excused the insurer from having to show prejudice. The Texas Supreme Court essentially found this to be a distinction without a difference. Here, the Texas Supreme Court held that the purpose of the consent to settle condition and the Loss Establishment Provision were "exactly the same," i.e., "precluding liability for the insured's voluntary payments without the insurer's consent."

Id. Accordingly, *Lennar Corp. v. Markel* can be read to expand the prejudice requirement to the entire insurance contract; not just the conditions.

III. Texas Becomes an All-Sums State

Relatively late to the party of deciding whether Texas is an All Sums or Pro-Rata jurisdiction for the purpose of triggering policies for claims encompassing multiple policies, the Texas Supreme Court recently rejected the Pro-Rata approach to allocate coverage amongst multiple insurers in long tail claims and instead reaffirmed its language approving the *Keene* All-Sums approach allowing the policyholder to pick its coverage period offering the most insurance. *Lennar Corp. v. Markel American Ins. Co.*, 413 S.W.3d 750 (Tex. 2013). Interestingly, the court did not conduct an in-depth analysis of the trigger issue; rather it adopted dicta in a 20 year old opinion in which it cited to *Keene Corp. v. Insurance Co. of N. Am.*, 667 F.2d 1034, 1049-50 (D.C. Cir. 1981) with approval in ruling that a tort claimant could not stack multiple policies over successive years in order to increase the limits for making a settlement demand within limits and invoke an insurer's duty to settle within limits--a/k/a the "*Stowers*" doctrine. *Lennar Corp. v. Markel,* 413 S.W.3d at 758-59 (citing and quoting *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842, 855 (Tex. 1994)).

Accordingly under Texas law, an insured can now take the position that it is singling out the policy year with the most coverage and then it can force the insurers on that year to cover a long tail claim. As a practical matter, prior to the handing down of the opinion, many policyholder counsel were handling their cases and negotiating settlements based on the premise that Texas was a *Keene* All-Sums state.

IV. Policy Benefits as Bad Faith Damages

An issue that has spawned considerable and critical commentary involves recoverable damages for breaches of the claims handling sections of the Texas Insurance Code. Courts taking the lead from the Fifth Circuit Court of Appeals have held that the only recoverable damages for breaches of the insurance code are those damages attributable to injuries independent from the policy benefits. *See, e.g., Parkans International, LLC v. Zurich Ins. Co.*, 299 F.3d 514 (5th Cir. 2002); Thus, an insurer that wrongfully denies or delays payment of a $50,000 claim may be liable to its insured under a breach of contract theory; but those $50,000 in policy benefits are not recoverable as damages for breaches of the insurance code. Naturally this result significantly weakens the impact of the Texas Insurance Code as a weapon in litigation against insurers. In many situations, an insured, particularly a corporate insured, will find it difficult to prove the suffering of damages that are independent from the policy benefits on which the insurer denied or delayed coverage.

The first recent case not to follow the Fifth Circuit's requirement that an insured must show an independent injury to support damages due to insurance code violations is *United National Insurance Co. v. AMJ Investments LLC,* 2014 Tex. App. LEXIS 6969 (Tex. App.—Houston [14th Dist.] 2014). *AMJ Investments* involved a first party hurricane

related property damage claim in which the jury found both breach of contract and insurance code violations and awarded identical $300,000 damage awards for each. The jury also found that the insurance code unfair claims handling violations were committed knowingly and the court trebled those damages (the jury assessed $1 million in additional insurance code violations to which the court limited to 2 times the actual damages). At the election of remedies, the insured elected to recover under the insurance code.

On appeal, a 2-1 majority of the court of appeals analyzed the evidence to conclude it was sufficient to support the finding that the insurer knowingly violated the insurance code. *Id.* at * 12-22 and *26-30. The court of appeals then held that the insurance code does not require the showing of an insured's independent injury separate and apart from the wrongfully denied policy benefits. Rather, the court of appeals found that the amount of the wrongfully denied benefits were the amount of damages recoverable under the insurance code. Interestingly, the court of appeals did not even acknowledge the existence of the Fifth Circuit inspired line of cases requiring the showing of an independent injury to support damages for violations of the claims handling Texas Insurance Code provisions.

The court of appeals denied the final rehearing motions on October 7, 2014. Barring a settlement, it would seem certain that the insurer will appeal on to the Texas Supreme Court. If so, it will be interesting to see if the Texas Supreme Court decides to enter this fray and whether it will again reject the Fifth Circuit's conclusion on a Texas insurance issue; this time on the type of damages to support an award under the Texas Insurance Code.

V. The Texas *Stowers* Doctrine

The Texas "*Stowers* duty involves a duty to protect the insured by accepting reasonable settlement offers that are within policy limits." *Mid-Continent Insurance Co, v. Liberty Mut. Ins. Co.,* 236 S.W.3d 765, 776 (Tex. 2007). The three prongs of the Texas *Stowers* doctrine are that: 1) the claim is covered; 2) the demand is within limits; and 3) "the terms of the demand are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's exposure to an excess judgment." *Id.*

From about 1990 to 2004, the courts, including the Texas Supreme Court, were very active in deciding cases involving the Texas *Stowers* doctrine. Since that time, there have been a few *Stowers* cases decided by Texas state and federal courts; but there has not been the activity of a decade ago. Currently, however, two pending cases involving the *Stowers* doctrine are getting the attention of Texas insurance practitioners. *Patterson v. Home State County Mut. Ins. Co.*, 2014 LEXIS 4460 (Tex. App.—Houston [1st Dist.] 2014) and *OneBeacon Ins. Co. v. T. Wade Welch,* Cause No. 4:11-cv-3061 on file in the Southern District of Texas, Houston Division.

Patterson involves the application of the *Stowers* doctrine in the context of the multiple beneficiaries of a single wrongful death claim. On the one hand, there are many

categories of legal entitled beneficiaries under Tex. Civ. Prac. & Rem. Code § 71.004, the Texas Wrongful Death statute. On the other hand, only a single claim on behalf of all of the beneficiaries may be brought against the tortfeasor. Accordingly, the *Patterson* court of appeals had to evaluate the validity of a *Stowers* demand offering settle on behalf of some, but not all, of the beneficiaries.

Prior to trial, the insurer rejected, at the strong urging of the insured's personal counsel, two offers to partially settle the claims on behalf of some but not all of the beneficiaries. Next, the insurer deposited its limits into the court registry and a bench trial ensued to value the damages of the different claimants for purposes of allocating the tendered policy limits and invoking the *Stowers* doctrine. The bench trial resulted in significant damage awards, in total substantially in excess of the policy limits, to the various wrongful death beneficiaries.

The court of appeals held that the insurer's *Stowers* duties were not invoked under these circumstances. "[B]y settling in the full amount of the policy limits with only one of the claimants, [the insurer] could have potentially exposed [its insured] to an excess judgment by one of the other claimants. Accordingly, we hold that the … settlement offers did not trigger [the insurer's] *Stowers* duty to settle." *Id.* at * 24. .

Other interesting issues involving the *Stowers* doctrine present in *Patterson* included a third demand that offered to settle on behalf of all of the claimants, however, it did not offer to release all of the defendant insureds. To this, the court of appeals held that an offer that failed to include all of the insureds "did not constitute an unconditional offer." *Id.* at *26-27. Since that ruling is difficult to reconcile with precedent from other courts, it will be interesting to see how *Patterson* will be utilized on this point. As a practical matter, the *Stowers* doctrine has become very technical, particularly when dealing with multiple claimants and insureds. While the *Stowers* doctrine might work seamlessly in situations involving one claimant and one insured for a covered claim, adding additional claimants and insureds into the fray can make matters very complicating and difficult to invoke the *Stowers* doctrine.

One additional *Stowers* issue present in *Patterson* involves whether the position taken by the insured can be used by the insurer to defeat a *Stowers* action. Here, the insured's counsel instructed defense counsel of the insured's position against "any settlement demands to be accepted that didn't involve a release of all of the … claims against both [insureds]." Since the court of appeals referenced these instructions in the opinion, it can be expected that parties will heed this factor in potential *Stowers* situations. On the one hand, an insured's support of rejecting a settlement demand will be raised by an insurer against invoking the *Stowers* doctrine. On the other hand, an insured demanding its insurer to accept a within policy limits settlement offer will argue that its demand supports the application of the *Stowers* doctrine.

A case that was recently tried that raises interesting *Stowers* issues is *OneBeacon Insurance Co. v. T. Wade Welch & Assoc.*, Cause No. H-11-3061 on file in the United States District Court for the Southern District of Texas Houston Division. Underlying

OneBeacon v. T. Wade Welch was a legal malpractice action with significant financial exposure. The insurer denied coverage and defended its position in part on the basis that the policy should be rescinded for the insured's failure to disclose the claim earlier. Additionally, the insurer sought to use evidence regarding its view on the strength of its coverage position to support its defense to the *Stowers* claim

During trial last month, October 2014, the parties filed briefs on whether an insurer can consider its believed strength of its coverage defenses in deciding to whether to accept a within limits settlement demand. On this issue, the court ruled for the insured because the jury was instructed: "[y]ou cannot consider [the insurer's] belief that it had coverage defenses in evaluating what an ordinarily prudent insurer would do" for all of the jury questions involving the insured plaintiff's *Stowers* cause of action,

The jury returned a favorable jury verdict to the insured, including the rejection of the insurer's rescission defense and finding both common law and statutory *Stowers* violations with substantial actual, additional and punitive damage awards. So, there will undoubtedly be an extensive post trial motion practice before the case is either settled or appealed. In the meantime, *OneBeacon v. T. Wade Welch* is noteworthy in light of the various legal issues raised in the case.

VI. Right to Independent Counsel

An issue that has for the most part developed in the federal courts is when a conflict of interest arises between the defending insurer and its insured so as to provide the insured with the right to select its own counsel at the insurer's expense. Although the current status on this issue derives from the Texas Supreme Court opinion in *Northern County Mut. Ins. Co. v. Davalos,* 140 S.W.3d 685 (Tex. 2004), the Texas federal courts have repeatedly analyzed this issue. *See Graper v. Mid-Continent Cas. Co. v. Floyd*, 756 F.3d 388 (5th Cir. 2014) and *Downhole Navigator, L.L.C. v. Nautilis Ins. Co.,* 686 F.3d 325 (5th Cir. 2012) (and cases cited therein).

Continuing on its tradition of construing very narrowly what constitutes a disqualifying conflict, the Fifth Circuit again rejected an insured's attempt to be represented by counsel of its own choosing in *Graper v. Mid-Continent.* In this regard, the Fifth Circuit in *Graper* analyzed a situation involving an insured being sued for copyright violations. Here, the insurer agreed to defend under a reservation of rights to which the insured did not accept because of the conflict it contended was created by the insurer's reservation of rights. When the insurer refused to fund the insured's defense by counsel of the insured's own choosing, the insured filed suit seeking a declaration that it was entitled to be represented by counsel of its own choosing at its insurer's expense.

Under *Davalos*, a disqualifying conflict only exists when "the facts to be adjudicated in the [underlying] lawsuit are the same facts upon which coverage depends." *Davalos,* 140 S.W.3d at 689. Here, the insured argued that insurer's reservation of rights to deny coverage based on the timing of the claimant's injury created a disqualifying conflict because the jury would be asked to answer a question on when the claim for

infringement accrued. To this, the Fifth Circuit held that the insurer did not lose its right to control the insured's defense and select counsel since the jury's determination of when a claim for infringement accrues is different than a finding of whether the infringement took place in the first place. *Graper,* 756 F.3d at 393-94.

The next disqualifying conflict asserted by the insured arose because of the insured being sued for intentional and willful infringement to which the insured alleged created a conflict with the insurer's reservation of rights to deny coverage based on the policy's exclusion for knowing violations of another's rights. The Fifth Circuit again took a very narrow view on what constitutes a disqualifying conflict and held that no such conflict existed since a finding of willful infringement under the Copyright Act does not require proof of knowing conduct. *Id.* at 394-95.

VII. Prompt Payment of Claims

A very effective and powerful statute for policyholders is Tex. Ins. Code §542.056, the Texas Prompt Payment of Claims statute. This statute creates deadlines by which insurers must make decisions on first party claims or face an 18% interest penalty and payment of the insured's attorneys fees on top of other remedies that may be afforded to the insured. The Prompt Payment of Claims statute imposes strict liability for denials or delays of coverage that violate the statute. In other words, even if the insurer possesses a reasonable basis to deny or delay payment of a claim because it did not believe the claim was covered, if the denied or delayed claim is indeed covered, then the Prompt Payment of Claims penalty is automatically assessed.

There is some confusion developing over the trigger date for the penalties to accrue that is witnessed by analyzing the cases of *Weiser-Brown Operating Co. v. St. Paul Surplus Lines Co.,* 2013 U.S. Dist. LEXIS 83792 (S. D. Tex 2013) and *Cox Operating, LLC v. St. Paul Surplus Lines Co.,* 2014 U.S. Dist. LEXIS 3140 (S.D. Tex. 2014). While insureds tend to seek penalties beginning on the date of the first statutory violation, insurers argue for penalty dates accruing from the date of the denial of the claim or sixty days following the submission by the insured of all of the information the insurer requests.

In *Weiser-Brown*, the insurer claimed that the statute did not run at all because it awaited the insured's answers to supplemental questions, which never came. The district judge, however, ruled that the insured submitted enough information for the insurer to make a coverage determination and that the supplemental information requested was not required to determine coverage. Accordingly, the court began running the penalty interest based on the deadlines created by the insurer possessing enough information to make a coverage determination.

In *Cox Operating*, the court confronted arguments that the penalty interest should start accruing on the date of the first statutory violation and whether the penalty for not paying defense costs should be calculated on a rolling basis because defense costs are accrued on a rolling basis. After changing his opinions in light of Motions for

Reconsideration, the judge ruled that "penalty interest should begin accruing 60 days after [the insurer] received notice of the claim and failed to commence an investigation and request all items, statements, and forms that [the insurer] reasonably believed would be required from [the insured]." This date was selected over an earlier date created by the insurer's violation of section 542.055 for not initiating its investigation within 30 days of the insured giving notice of the claim. *Cox Operating*, 2014 LEXIS 3140 at *10-11 (S.D. Tex. 2014). In so doing, the court held that "[p]ractically speaking, when an insurer fails to timely request information under Section 542.055, it waives the right to do so (and the additional benefits of requesting more time) and signals to the insured that it has all the information that it reasonably believes will be required from the insured." *Id.* at *9-10.

VIII. Bad Faith Discovery

On October 31, 2014, the Texas Supreme Court issued an opinion in *In Re: National Lloyds Ins. Co.*, Cause No. 13-0761 (Tex. 2014) that going forward that will undoubtedly profoundly impact discovery in Texas bad faith litigation by prohibiting in most instances a policyholder's use of institutional bad faith discovery requests in connection with litigation involving a single claim. *In Re: National Lloyds* involved a Mandamus review of a trial court discovery order requiring an insurer to produce all of the claims files of two of its outside adjusting firms handling storm damage claims in the policyholder's city. The policyholder had sued the insurer for breach of contract and for common law and statutory bad faith for undervaluing her claims "by 'establishing a baseline' and comparing her claims to that baseline." The trial court ordered the production of the subject files of the two adjusting firms who valued the policyholder's claims. The appeals court denied National Lloyds mandamus relief.

The Texas Supreme Court recognized that the policyholder sought to compare the insurer's damage evaluation of the policyholder's claim with other claims to show that the insurer undervalued the policyholder's claim. Rejecting this argument, the Texas Supreme Court held that it "fail[ed] to see how [the insurer's] overpayment, underpayment, or proper payment of the claims of unrelated third parties is probative of its conduct with respect to Erving's undervaluation claims at issue in this case." In this regard, the Texas Supreme Court recognized "the many variables associated with a particular claim, such as when the claim was filed, the condition of the property at the time of filing (including the presence of any preexisting damage) and the type and extent of damage inflicted by the covered event" made the discovery requests "at best an 'impermissible fishing expedition.'" Even so, the Texas Supreme Court noted in a footnote that "[w]e do not hold that evidence of third-party insurance claims can never be relevant in coverage litigation," but that based on the policyholder's allegations in the case at bar, "there is at best a remote possibility that such claims could lead to the discovery of admissible evidence."