What Every Young and Growing Business Needs to Know About Insurance

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TexasBarCLE
ESSENTIALS OF BUSINESS LAW COURSE
MARCH 6-7, 2014
HOUSTON, TEXAS

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Starting and growing a new business necessarily means taking on risk. But that risk can be significantly reduced through purchasing—and taking advantage of—the proper insurance.

Each business presents a unique set of exposures and financial circumstances. For instance, young businesses have different needs than established ones, and requirements vary significantly from industry to industry. Moreover, even the same company can have vastly different needs as time goes, necessitating risk management plans that can adapt as the business grows and changes.

While the specific coverages and limits that a business needs will vary, though, one critical thing remains the same: Policyholders must have a working knowledge of their rights and responsibilities. If they fail to understand what coverage they have purchased—and the conditions required to actually obtain coverage—a valuable investment is lost.

I. Types of Coverage Frequently Purchased By Businesses

New businesses should and generally do carry a variety of coverages:

A. Business Property Insurance

Insurance for business property follows a pattern that is similar in many ways to the one for individual property. A commonly used form is the "building and personal property coverage form." This form permits a business owner to cover in one policy fixed assets like the buildings, fixtures, machinery and equipment, and personal property used in business and the personal property of others. Coverage is generally on a replacement cost basis and includes theft.

B. Business Interruption Insurance

Business Interruption Insurance pays for the income a company will lose if the company is displaced by fire or other insured perils. Coverage usually includes salaries, taxes, rents, net profits, and necessary operating expenses during the period required to restore operations with due diligence. Business interruption insurance is different from fire or property insurance and does not, as such, provide indemnity for physical loss of or damage to property. This type of insurance is generally in the form of an endorsement or rider to a policy insuring against loss or damage to physical assets as the direct result of specific perils, although it may be the only loss covered by the particular policy.

C. Commercial General Liability and Product Liability Insurance

General liability coverage will pay for defense costs and damages resulting from claims of bodily injury and/or property damage for which your business is legally liable. Product liability insurance protects against financial loss as a result of a defect product that causes injury or bodily harm.

D. Directors' and Officers' Liability Insurance

Directors' & Officers' Liability Insurance provides financial protection for the directors and officers of a company in the event they are sued in connection with the performance of their duties. In other words, Directors' & Officers' ("D&O") insurance is professional "malpractice" insurance.

This specialized form of professional liability insurance covers legal expenses and liability to shareholders, bondholders, creditors or others due to actions or omissions by a director or officer of a corporation or nonprofit organization. Directors and officers are not liable for an honest mistake of business judgment made with reasonable prudence or care that results in a financial loss; however, officers and directors are held personally liable for actions or omissions made with negligence, recklessness, or bad faith.

A traditional D&O policy generally consists of three insuring agreements, known as Sides A, B, and C. Side A covers individual directors and officers for nonindemnifiable losses—those losses that the company cannot pay for. Side B reimburses the company for payments it is required to make to individual directors and officers to cover the cost of claims, settlements and legal defense. Side C reimburses the company for securities claims made against the corporate entity itself. Coverage is on a claims-made basis. Some policies contain only coverage A, and some pay expenses on behalf of directors and officers, as opposed to paying on an indemnity basis.

E. Errors and Omissions Insurance

Errors and omissions ("E&O") insurance is broader in scope than Directors' & Officers' insurance. In many ways, D&O coverage is a management E&O policy. E&O policies offer coverage for damages arising out of the insured's negligence, mistakes, or failure to take appropriate action in the performance of business or professional duties. E&O insurance does not provide coverage for employment-related claims such as sexual harassment, administrative actions, or employment discrimination.

F. Crime Insurance

Crime insurance covers losses resulting from criminal acts such as robbery, burglary and other forms of theft. It is also called "fidelity insurance" and may appear as a stand-alone policy or part of the Business Property policy.

G. Key Man Life Insurance

Crime insurance. This type of coverage is designed to protect a business upon the loss of a key employee. It is a generally accepted practice for corporations, particularly those in which the stock is held by a small group, who often also compose its management, to purchase insurance upon the lives of its key stockholders and officers. Sole proprietorships do not generally carry key man insurance; however, a partnership may. Usually, the corporation or partnership is named as the beneficiary. If a company is operating on a business loan, the bank may require key man insurance as a way to get its money back if the company is incapacitated in some way. According to Texas law, a corporation does not lose its rights under a life insurance policy for its president and director even in bankruptcy. *Lincoln Nat'l Life Ins. Co. v. Scales*, 62 F.2d 582 (5th Cir. 1933)(applying Texas law).

A company may not take out key man life insurance on all employees, however. Texas law requires that the beneficiary of a life insurance policy have an "insurable interest" in the subject of the policy. *Mayo v. Hartford*, 354 F.3d 400, 402 (5th Cir. 2004). A policy procured by one lacking such an interest is unenforceable. *Id*. at 406. Under Texas law, persons having an insurable interest in the

life of another include: (1) close relatives; (2) creditors; and (3) those having an expectation of financial gain from the insured's continued life. Id. However, an employer has no insurable interest in an ordinary employee. *Id.* at 402.

H. Workers' Compensation Insurance

Workers' comp, as it is commonly known, provides coverage for bodily injuries sustained by employees that arise out of, and occur during, the course of their employment. If an employee is injured, workers' comp pays the employee benefits such as lost wages and medical expenses following the state workers' compensation scheme. It does not provide coverage for injuries or damages resulting from the rendering of professional services.

I. Commercial Auto Insurance

Commercial auto insurance policies protect a company's vehicles, including vehicles that transport employees, products and/or equipment. Even if the company does not own its own vehicles, but employees drive their own cars on company business, it may carry non-owned auto liability to protect itself in case the employee lacks insurance or has inadequate coverage.

J. Data Breach Insurance

More and more companies are carrying data breach or cyberliability coverage, which protects against breaches of sensitive or non-public information about employees or clients.

II. The Difference between First Party and Third Party Coverage

Insurance policies may be broadly categorized as providing either "first party" or "third party" coverage. First party coverages, such as property and health insurance policies, protect the insured for losses suffered directly by the insured. Third party coverages, such as commercial general liability policies, protect the insured against liability to a third party.

The distinction between first party and third party policies is particularly important in the context of common law bad faith claims against the carrier. Although no implied duty of good faith and fair dealing is imposed in ordinary contractual relationships, the courts have imposed such a duty with respect to contracts of insurance. *See, e.g., English v. Fischer,* 660 S.W.2d 521, 522 (Tex. 1983); *Arnold v. National County Mut. Fire Ins. Co*., 725 S.W.2d 165, 167 (Tex. 1987). The carrier's duty of good faith and fair dealing arises from the special relationship between the parties resulting from the disparity of bargaining power inherent in the insurer - insured relationship. *Arnold*, 725 S.W.2d at 167.

With respect to first party policies, an insurer may be held liable for breach of the duty of good faith and fair dealing if the insurer denies a claim when the carrier knew or should have known that that it was reasonably clear that the claim was covered. *Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10, 17 (Tex. 1994). In the context of third party liability insurance, however, the courts have refused to recognize a duty of good faith and fair dealing. *Maryland Ins. Co. v. Head Indus. Coatings & Svcs., Inc.*, 938 S.W.2d 27, 28-29 (Tex. 1996). These courts reason that an insured is protected by the

Stowers doctrine, which requires an insurer to exercise ordinary care in the settlement of claims to protect its insureds against judgments in excess of policy limits. *Id*. The Stowers doctrine is discussed in greater detail below.

EXAMPLES OF FIRST PARTY AND THIRD PARTY POLICIES

First Party:	Third Party:
Property	Commercial General Liability
Health	Directors' and Officers' Liability
Disability	Errors and Omissions
Life	Products Liability

III. The Basic Anatomy of an Insurance Policy

A. The Declarations Page

Typically referred to as the "dec sheet," the declarations page provides the basic information about the policy. The information found on the declarations page generally includes the following:

1. The identity of the insurer providing the coverage.
2. The identity of the policyholder(s) covered by the policy.
3. The type of insurance coverage provided by the policy (e.g. commercial general liability, directors and officers liability, professional liability, etc.)
4. The effective dates of insurance coverage.
5. The amount of coverage provided by the policy (i.e. the policy's dollar limits of coverage) including per occurrence and aggregate limits.
6. The inclusion of SIRs and deductibles.
7. The identity of any insurance agent or broker involved in placing the coverage.
8. The amount of premium to be charged for the insurance coverage.

B. The Insuring Agreement

The insuring agreement sets forth the coverage afforded by the policy. In particular, the insuring agreement will establish the carrier's duty to indemnify and, depending on the type of policy, the duty to defend. The duty to defend and the duty to indemnify are distinct obligations. *Farmers Texas County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997).

1. *Duty to Defend*

As explained in detail below, the factual allegations in the underlying suit against the insured, rather than the legal theories asserted, determine whether a duty to defend exists. *Texas Medical Liab. Trust v. Zurich Ins. Co.*, 945 S.W.2d 839, 842 (Tex. App.—Austin 1997, writ denied). The duty to defend is unaffected by facts ascertained before suit, developed in trial, or the ultimate outcome of the case. *Reser v. State Farm Fire & Cas. Co.*, 981 S.W.2d 260, 263 (Tex. App.—San Antonio

1998, no writ). The insurer's duty to defend is of critical importance to the insured, as defense costs are often the biggest expense the insured will incur as a result of a lawsuit.

2. *Duty to Indemnify*

Unlike the duty to defend, the duty to indemnify arises only after an insured has been adjudicated to be legally responsible for damages in a lawsuit. *Id.*

C. Definitions

Definitions often make or break coverage under a policy. Because definitions vary policy by policy, the insured should be aware of the specific definitions set forth in its policy. If not defined, a policy term should be given its "plain and ordinary meaning." *Canutillo I.S.D. v. National Union Fire Ins. Co.*, 99 F.3d 695, 700 (5th Cir. 1996).

D. Exclusions

Exclusions are policy provisions which eliminate coverage under particular circumstances. Under Texas law, policy exclusions should be construed narrowly, with all doubts as to their application construed in favor of the policyholder. *Puckett v. U.S. Fire Ins. Co.*, 678 S.W.2d 936, 938 (Tex. 1984). In fact, the construction of an exclusionary clause urged by the insured must be adopted as long as that construction is not unreasonable, even if the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties' intent. *Nat'l Union Fire Ins. Co. v. Hudson Energy Co.*, 811 S.W.2d 552, 555 (Tex. 1991).

E. Conditions

Coverage under a general liability policy will be subject to certain standard conditions in the coverage form. Typical conditions found in insurance policies include:

1. Payment of the applicable premium.
2. Notification to the insurer and/or its designated agent of losses or claims under the policy.
3. Assistance to and cooperation with the insurer in its investigation of losses and claims under the policy.
4. In the case of first-party insurance (e.g., property coverage, business interruption insurance, fidelity bonds), submission of proofs of losses claimed to be covered under the policy.

In addition, most liability policies contain conditions concerning cancellation, changes, examination of the named insured's books and records, inspections and surveys, and assignment.

F. Endorsements

Policies often contain a number of endorsements. Endorsements may operate either to provide additional coverage or to exclude coverage which otherwise would have existed under the policy. Policyholders should carefully examine endorsements, as they may significantly alter coverage.

IV. Duties of the Policyholder

A. Duty to Provide Notice

1. *Occurrence Policies*

Occurrence policies, such as most Commercial General Liability ("CGL") policies, provide coverage for claims based on covered events occurring during the policy period, regardless of whether the claim or occurrence is made known to the insurer during the policy period. The occurrence need not mature into a claim during the policy period, therefore, occurrence policies may provide coverage for claims asserted long after the policy expires. CGL insurance policies typically contain a requirement that the insured "immediately" (or "as soon as possible" or "as soon as practicable") forward every demand, notice, claim, summons, suit or other process to the insurer.

(a) ***Which Policies Apply?***

Always provide notice under any and all policies—both primary and excess—that could even possibly apply to a claim. Until recently, there has been a great deal of uncertainty as to what the proper rule under Texas law for determining the time at which property damage occurs for the purposes of an occurrence-based general liability policy. This issue is of particular importance in those cases where damage allegedly occurred during the policy period but was inherently undiscoverable until after the policy expired. Much of that uncertainty has been erased, however, by the Texas Supreme Court's adoption of the "actual injury" or "injury-in-fact" approach in *Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008). Under the "injury-in-fact" approach, property damage is deemed to occur when the property is actually damaged – not when the property is exposed to whatever agent ultimately causes the damage or when the property damage manifests or is otherwise discovered. *Id*. at 22 (instructing "the key date is when injury happens, not when someone happens upon it").

2. *"Claims Made" and "Claims Made and Reported" Policies*

By contrast, "claims made" policies, such as D&O insurance, cover occurrences giving rise to a claim which is actually made during the policy period. Such policies are designed to avoid the "long tail" effect of occurrence policies. Claims made policies may require that the claim be reported within a specified period of time after the expiration or earlier termination of the policy. Alternatively, the policy may be written on a "claims made and reported" basis, in which case coverage will be provided only if the claim was made and reported during the policy period. For this reason, the insured must remain mindful of the type of claims made policy it holds.

B. Purpose of the Notice Provision

The purpose of the notice provision is to advise the insurer that the insured has been served with process and that the insurer is expected to timely file an answer. *Weaver v. Hartford Acc. & Indem. Co.*, 570 S.W.2d 367, 369 (Tex. 1978); *Harwell v. State Farm Mut. Auto. Ins. Co.*, 896 S.W.2d 170, 173 (Tex. 1993).

1. *Insurer Must Receive Notice of Service of Suit, Not Just Notice of a Claim*

An insurer's notice of a claim against an insured does not equate to actual knowledge of suit against an insured. *Harwell*, 896 S.W.2d at 174. The insured has the duty to notify its insurer of the filing of a suit once it is served with process - the insurer has no duty to determine when or if the policyholder is served. *Id*.; *National Union Fire Ins. Co. v. Crocker*, 296 S.W.2d 603 (Tex. 2008).

2. *Insurer Must Receive Notice From Each Insured Seeking Coverage*

In *National Union Fire Ins. Co. v. Crocker*, 296 S.W.2d 603 (Tex. 2008) the Court held that an additional insured must notify the carrier that it seeks coverage under the policy even when the carrier knows of the claim and knows that the insured is covered. *Id.* at 610.

3. *What Does Prompt, Immediate or As Soon As Possible/Practicable Notice Mean?*

Policy provisions requiring notice "promptly," "as soon as practicable" or "immediately" have been liberally construed to require only that notice be given within a reasonable time in light of the surrounding circumstances. *Continental Sav. Ass'n v. U.S. Fidelity & Guar. Co.*, 762 F.2d 1239, 1243 (5th Cir. 1985).

4. *What is the Consequence of a Failure to Comply with a Notice Provision?*

Compliance with the notice condition is a condition precedent to an insurer's liability under the policy. *Liberty Mut. Ins. Co. v. Cruz*, 883 S.W.2d 164, 165 (Tex. 1993); *Harwell*, 896 S.W.2d at 173; *Weaver*, 570 S.W.2d at 369; *Filley v. Ohio Cas. Ins. Co*., 805 S.W.2d 844, 847 (Tex. App.--Corpus Christi 1991, writ denied). Thus, the failure to comply with a policy notice provision may relieve an insurer of its obligations under the policy. *McGuire v. Commercial Union Ins. Co.*, 431 S.W.2d 347 (Tex. 1968); *Filley*, 805 S.W.2d at 847.

5. *Will Any Violation of a Notice Provision Avoid Coverage?*

(a) *Occurrence Policies - Prejudice Required*

Prior to 1973, insurers did not have to show prejudice in order to prevail on a late notice defense. In 1973, however, the Texas State Board of Insurance issued an order requiring automobile and general liability insurers to show prejudice resulting from an insured's failure to comply with a policy notice provision in order to avoid liability under the policy. *See e.g., Chiles v. Chubb Lloyd's Ins. Co.*, 858 S.W.2d 633, 635-36 (Tex. App.—Houston [1st Dist.] 1993, writ denied). As a result of this Board

Order, it is now widely-recognized (at least with respect to claims for bodily injury and/or property damage) that an insurer must demonstrate that it was prejudiced by the insured's non-compliance with a notice provision in order to escape its obligations under the policy. *See, e.g., Cruz*, 883 S.W.2d at 165; *Harwell*, 896 S.W.2d at 174; *Hanson Prod. Co. v. Americas Ins. Co*., 108 F.3d 627, 629 (5th Cir. 1997) (applying Texas law).

(b) *Claims Made Policies - Prejudice Requirement for Denials Based on Violations of the Prompt-Notice Provision*

For a long time, no prejudice had to be shown for a carrier to deny coverage based on late notice under claims made and reported policies. *See Hirsch v. Texas Lawyers Ins. Exchange*, 808 S.W.2d 561, 565 (Tex. App.--El Paso, 1991, writ denied) (holding that the notice-prejudice rule is not applicable to claims-made policies covering only listed periods because requiring a showing of prejudice would defeat the purpose of a claims made policy, and, in effect, convert such a policy into an occurrence policy); *Federal Ins. Co. v. CompUSA, Inc.* 319 F.3d 746, 754 (5th Cir. 2003). However, the Texas Supreme Court modified this precedent in *Prodigy Comms. Corp. v. Agric. Excess & Surplus Ins. Co.*, 288 S.W.3d 374 (2009). In this case, the Court analyzed a claims-made policy and held that an insurer must show prejudice before it can deny coverage "when an insured gives notice of a claim within the policy period or other specified reporting period" but fails to comply with the policy's "as soon as practicable" notice provision. *Id.* at 382. The Court held the same way in *Fin. Industries v. XL Specialty Ins.*, 285 S.W.3d 877, 879 (Tex. 2009) finding "that an insurer must show prejudice to deny payment on a claims-made policy, when the denial is based upon the insured's breach of the policy's prompt-notice provision, but the notice is given within the policy's coverage period."

(c) *Coverage B of a CGL Policy – No Prejudice Requirement?*

One case has held that no prejudice need be shown in order to establish a violation of a notice provision where the claim arises under Coverage B, which sets forth coverage for "personal injury" and "advertising injury" under a CGL policy. *See, Gemmy Indus. Corp. v. Alliance Gen. Ins. Co.*, 190 F.Supp.2d 915, 922-23 (N.D. Tex. 1998) (reasoning that, since the State Board of Insurance order requiring an insurer to demonstrate prejudice in order to establish a violation of a general liability policy, by its express terms, applied only to bodily injury and property damage claims, no prejudice requirement exists with respect to a claim for coverage for an advertising injury). This reasoning, if followed, would appear to apply with equal force to a claim for coverage for a "personal injury." However, in *St. Paul Guardian Ins. Co. v. Centrum G.S. Ltd.*, 383 F.Supp.2d 891 (N.D. Tex. 2003) the same court declined to follow *Gemmy Indus.* because the Fifth Circuit had recently recognized "a modern trend away from the traditional contractual approach towards a view that considers prejudice to an insurer a relevant factor in determining whether to enforce a condition precedent to insurance coverage." *Id.* at 901 (citing to *Hanson Prod. Co. v. Americas Ins. Co.*, 108 F.3d 627, 631 (5th Cir. 1997). The Northern District of Texas, in analyzing a CGL policy without an express provision stating notice is a condition precedent to liability, held that the insurer must show it was prejudiced by the insured's late notice of personal injury claims before it could deny coverage or benefits.

6. *Who Determines Whether An Insurer is Prejudiced?*

Whether an insurer is prejudiced by its insured's failure to give notice has generally been recognized to constitute a question of fact. *Coastal Ref. & Mktg, Inc. v. U.S. Fid. & Guaranty Co.*, 218 S.W.3d 279, 287 (Tex.App.—Houston [14th Dist.] 2007, pet. denied); *P.G. Bell Co. v. U.S. Fidelity & Guar. Co.*, 853 S.W.2d 187, 191 (Tex. App.—Corpus Christi 1993, no writ); *Harbor Ins. Co. v. Trammel Crow Co., Inc*., 854 F.2d 94, 98 (5th Cir. 1998) (notwithstanding fact that notice was not given until after a jury verdict, a genuine issue of material fact existed as to whether insured timely gave notice of suit under an excess policy requiring the insurer to give notice as soon as practicable after it had information from which it might reasonably have concluded that injuries or damages were likely to involve the policy where the insured demonstrated that its attorneys had evaluated the case within the limits of the primary policy.) However, when the facts are undisputed, the question is one of law for the court. *E.B. Smith Co. v. USF&G Co*., 850 S.W.2d 621, 625 (Tex. App.—Corpus Christi 1993, writ denied).

Exception: An insured's failure to notify its insurer of a suit until after judgment entered against the insured has become final and non-appealable prejudices the insurer as a matter of law. *Harwell*, 896 S.W.2d at 174; *Liberty*, 883 S.W.2d at 165 (". . . an insurer that is not notified of suit against its insured until a default judgment has become final, absent actual knowledge of the suit, is prejudiced as a matter of law."). At least one lower Texas appellate court has held that prejudice is established as a matter of law by the mere entry of a default judgment against the insured prior to the carrier being notified of the suit, even if the time for an appeal has not yet expired. *Kimble v. Aetna Cas. & Sur. Co.*, 767 S.W.2d 846, 850 (Tex. App.--Amarillo 1989, writ denied). However, the Fifth Circuit seems to recognize an exception to that rule when the default is overturned. In *Gibbons-Markey v. Texas Medical Liability Trust*, 163 Fed. Appx. 342, 343 (5th Cir. 2006), the court applied Texas law and forgave an insured who waited five months between discovery that a default judgment had been taken against her before informing her insurer. After denial of coverage, the insured hired private counsel and successfully overturned the default judgment through a Bill of Review proceeding. The insured subsequently sued her carrier for breaching its duty to defend. The carrier responded by arguing that it was prejudiced by the five-month delay between the insured's discovery of the suit and its notification of the carrier. In that time span, the insured's right to seek a Restricted Appeal lapsed, leaving a Bill of Review as the only remedy to directly attack the default judgment. The appeals court (1) rejected the insurer's contention that it was prejudiced, noting that the failure to properly serve process was ground to set aside the judgment in either proceeding, and (2) found that reasonable fees expended in setting aside the default judgment were recoverable.

C. Duty to Cooperate

CGL policies ordinarily require the insured to cooperate in the investigation, settlement or defense of the claim or suit.

1. *Purpose of the Clause*

The purpose of the cooperation clause is to ensure the policyholder's cooperation and assistance in the defense of lawsuits brought against it by way of disclosing facts and names of witnesses,

procuring and giving evidence, attending trial and obtaining the attendance of witnesses. *See, e.g., Filley*, 805 S.W.2d at 846-847.

2. *An Insurer Must Show Prejudice in Order to Establish a Breach of the Cooperation Clause*

A policyholder's breach of a cooperation clause may relieve an insurer from liability under the policy. *See, e.g., Filley*, 805 S.W.2d at 847. However, an insured's failure to cooperate will not constitute a breach unless the insurance company is prejudiced by the actions of the insured. *McGuire v. Commercial Union Ins. Co. of New York*, 431 S.W.2d 347, 353 (Tex. 1968) (insured's settlement of her claim against the claimant did not prejudice insurer's defense of counterclaims being asserted by the claimant); *Martinez v. ACCC Ins. Co.*, 343 S.W.3d 924, 930 (Tex.App.—Dallas 2011, no pet.). The insurer has the burden to prove that (1) the insured failed to cooperate and (2) this failure to cooperate prejudiced the insurer. *Coastal Ref.*, 218 S.W. at 298 (citing *Struna v. Concord Ins. Servs., Inc.*, 11 S.W.3d 355, 360 (Tex. App.—Houston [1st Dist.] 2000, no pet.)).

3. *Who Determines Whether There Has Been a Breach?*

The determination of whether the conduct at issue constitutes a breach of the cooperation clause is usually a question of fact. *Frazier v. Glens Falls Indem. Co.*, 278 S.W.2d 388, 392 (Tex. App.--Fort Worth 1955, writ ref. n.r.e.). However, the determination may be made as a matter of law in some circumstances, i.e., when the undisputed facts are particularly egregious. *Id*. The Fifth Circuit has noted some possible considerations when determining whether an insurer was prejudiced where its insured violated the no voluntary payment clause by settling a case on its own:

- Whether the insured had no liability;
- Whether the insured had no coverage;
- Whether the insurer was prevented from asserting a valid defense to liability or coverage; and
- Whether the settlement was unreasonable.

Motiva Enterprises, LLC v. St. Paul First Marine Ins. Co., 445 F.3d 381(5th Cir. 2006).

4. *What Type of Conduct Does and Does Not Constitute a Violation of the Cooperation Clause?*

As a general rule, the cooperation clause precludes the insured from making any agreement which would impose liability upon his insurer or deprive the insurer of a valid defense. *McGuire*, 431 S.W.2d at 352-53.

The disappearance of the insured precluding the insurer from developing any defenses at time of trial has been held to constitute a breach of the cooperation clause. *Filley*, 805 S.W.2d at 847; *Arebalos v. Evanston Ins. Co*., No. 3:95-CV-285-R, 1996 U.S. Dist. LEXIS 19703, at *10 (N.D. Tex. 1996) (insured's failure to attend trial, notify the carrier of the trial setting, notify the carrier of a judgment, and alert the carrier that counsel had ceased its defense constituted a failure to cooperation and precluded the insured from obtaining coverage).

A Texas court has also found that when, under the terms of an insurance policy the insured may be required to submit to an examination under oath, refusal to submit to an examination that is separate and segregated from the examination of any other person constitutes a breach of the cooperation clause. *Lidawi v. Progressive County Mut. Ins. Co.*, 112 S.W.3d 725 (Tex. App.—Houston [14th Dist.] 2003, no pet.).

Cooperation with the claimant, standing alone, will not constitute a breach of the cooperation clause so long as no fraud is practiced upon the insurer. *Frazier*, 278 S.W.2d at 392 (same attorney represented claimant in action against insured and insured with respect to claims for insurance coverage).

5. *Is There a Duty to Cooperate Where the Carrier Refuses to Defend?*

There is no duty to "cooperate" where the insurer does not "operate," i.e., defend. *American Fidelity & Cas. Co. v. Williams*, 34 S.W.2d 396, 405 (Tex. App.—Amarillo 1931, writ ref.). However, an insured must cooperate when its insurer agrees to defend under a full reservation of rights. *Motiva,* 445 F.3d at 384*; State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38 (Tex. 1998).

6. *May the Carrier Use the Cooperation Clause to Develop a Coverage Defense?*

An insurer may not invoke the cooperation clause to require an insured to disclose information designed solely to assist the insurer in developing a coverage defense. *Martin v. Travelers Indem. Co.*, 450 F.2d 542, 553 (5th Cir. 1971) (applying Mississippi law). *See also LaFarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 397-98 (5th Cir. 1995) (applying Texas law and holding that, once a coverage suit arises between the insurer and the insured, the insurer cannot rely on the cooperation clause to gain access to information outside of formal discovery methods). Cooperation clauses are intended to help develop defenses for the insured's liability on the underlying claim, not to decide whether an occurrence is covered by the insurance policy. *Ocean Garden Prods. v. Northfield Ins. Co.*, 2010 U.S. Dist. LEXIS 39851 (S.D. Tex. 2010).

7. *Does the Cooperation Clause Require The Policyholder to Turn Over Privileged Information?*

At least one court has concluded that the cooperation clause in an insurance policy renders the attorney-client privilege unavailable to the insured vis-a-vis its insurer. *See Waste Management, Inc. v. Int'l Surplus Lines Ins. Co.*, 579 N.E.2d 322, 328 (Ill. 1991). The better-reasoned view, however, is that a cooperation clause in an insurance policy does not impose a duty on the insured to produce documents protected by the attorney-client privilege to its insurer. Indeed, a number of courts have specifically rejected a construction of a cooperation clause which would compel the conclusion that the insured has contractually waived its attorney-client privilege. See, e.g., *Remington Arms Co. v. Liberty Mut. Ins. Co.*, 142 F.R.D. 408, 416-17 (D.Del. 1992) (refusing to follow Waste Management); *Bituminous Cas. Corp. v. Tonka Corp.*, 140 F.R.D. 381, 387 (D.Minn. 1992) (criticizing Waste Management as "fundamentally unsound"); *Pittston Co. v. Allianz Ins. Co.*, 143 F.R.D. 66,72 (D.N.J. 1992); *North River Ins. v. Philadelphia Reinsurance*, 797 F. Supp. 363, 369 (D.N.J. 1992); *Rockwell Int'l Corp. v. Superior Court*, 32 Cal. Rptr. 153, 156-59 (Cal. App.

1994) (following *Bituminous, Remington, Pittston* and *North River* and refusing to follow *Waste Management*, labeling its holding that the cooperation clause negates any expectation of confidentiality "fanciful"); *Aiossa v. Bank of Am., N.A.*, 2011 U.S. Dist. LEXIS 102207 (E.D.N.Y., Sept. 12, 2011).

D. Duty to Obtain Carrier's Consent to the Expenditure of Defense Costs and/or to a Settlement

CGL policies ordinarily contain "no voluntary assumption of liability" and/or "no action" clauses. A "no voluntary assumption of liability" clause provides that the policyholder cannot make any payment or assume any obligation except at its own cost. A "no action" clause typically provides that the policyholder shall have no action against the carrier unless the amount to be paid has been determined by judgment against entered the insured after actual trial, or by written agreement of the claimant, the insured and the insurer.

1. *No Action/No Voluntary Assumption of Liability Clauses Mean What they Say.*

A settlement entered into by the insured without the insurer's consent in violation of a "no action" and/or a "no voluntary assumption of liability" clause cannot be recovered from a defending carrier. *Charter Roofing Co., Inc. v. Tri-State Ins. Co.*, 841 S.W.2d 903, 907 (Tex. App.--Houston [14th Dist.] 1992, writ denied).

2. *No Voluntary Assumption of Liability Clauses Have Also Been Held Applicable to Preclude Recovery of Pre-Notice Defense Costs.*

No voluntary assumption of liability clauses have been held to preclude a policyholder from recovering pre-tender of notice defense costs from its insurer. *E&L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 278 (Tex. App.—Beaumont 1998); *Nagel v. Kentucky Cent. Ins. Co*., 894 S.W.2d 19 (Tex. App.—Austin 1994, writ denied); *LaFarge*, 61 F.3d at 399-400.

3. *No Action/No Voluntary Assumption of Liability Clauses Are Subject to Being Waived by a Carrier That Refuses to Defend.*

An insurer that denies coverage to its insured waives its right to insist upon compliance with a policy "no action" or "no voluntary assumption of liability" clause. *Gulf Ins. Co. v. Parker Products, Inc*., 498 S.W.2d 676, 679 (Tex. 1973).

V. Defense Issues

A. The Insurer's Duty to Defend -- Generally

The insurer's obligation to defend its insured is set forth in the insurance policy. As one commentator stated, "the duty of a general liability insurer to provide a defense for claims asserted against its insured is contractual, and the courts will therefore look to the language of the policy at issue to determine an insurer's defense obligations." BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 5.01 (7th ed. 1994). *See also Whatley v. City of*

Dallas, 758 S.W.2d 301, 304 (Tex. App.—Dallas 1988, writ denied); *National Sav. Ins. Co. v. Gaskins*, 572 S.W.2d 573, 576 (Tex. Civ. App.—Fort Worth 1978, no writ).

The typical general liability policy broadly sets out the insurer's duty to defend. The typical provision in the insurance policy which sets forth the defense obligation reads as follows:

> Coverage A - Bodily Injury and Property Damage Liability
>
> 1. Insuring Agreement
>
> (a) We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages.

See, e.g., 1986 version of the Commercial General Liability Policy promulgated by the Insurance Services Office (ISO).

B. How Is the Duty to Defend Determined?

1. *The "Eight Corners" Rule*

As noted above, the insurer's contractual obligation to defend is very broad. Generally, if the allegations of the complainant fall within the coverage of the policy, the insurer is obligated to defend the insured. See JACK P. GIBSON, ET. AL, 1 COMMERCIAL LIABILITY INSURANCE, V.C.5. (1993).

Texas has adopted what is known as the "complaint-allegation" or "eight corners" rule. Under this rule, an insurer must look only to policy language and the allegations in the complaint or petition to determine whether a defense is required. If the plaintiff's complaint or petition alleges facts that would be covered if true, the duty to defend arises even if the allegations are groundless, false or fraudulent. *See Zurich Am. Ins. Co. v. Nokia, Inc.*, 268 S.W.3d 487, 491 (Tex. 2008); *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 24 (Tex. 1965). *See also GuideOne Elite v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006); *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 847-48 (Tex. 1994); *American Alliance Ins. Co. v. Frito-Lay, Inc.*, 788 S.W.2d 152, 153 (Tex. App.--Dallas 1990, writ dism'd). The genesis of the "complaint allegation" rule is in the insurance policy itself. In essence, the duty to defend is determined by the allegations in the third-party's complaint because the insurance contract so provides. *See Travelers Ins. Co. v. Newsome*, 352 S.W.2d 888, 893 (Tex. Civ. App.—Amarillo 1961, writ ref'd n.r.e.).

The allegations of the complaint or petition are strictly construed against the insurer. Any doubt will be resolved in favor of coverage. *Fiess v. State Farm Lloyds*, 202 S.W.3d 744, 746 (Tex. 2006); *Cluett v. Medical Protective Co.*, 829 S.W.2d 822, 829 (Tex. App.—Dallas 1992, writ denied); *Terra Int'l Inc. v. Commonwealth Lloyd's Ins. Co.*, 829 S.W.2d 270, 272 (Tex. App.—Dallas 1992, writ denied). In considering the allegations for the purpose of determining whether a liability insurer is obligated under its policy to defend, a liberal interpretation of the meaning of those allegations

should be indulged. *Heyden*, 387 S.W.2d at 26. In the event of an ambiguity in either the pleadings or the policy, the ambiguity must be resolved in favor of coverage. *Evanston Ins. Co. v. Legacy of Life, Inc.*, 370 S.W.3d 377, 380 (Tex. 2012); *Fiess*, 202 S.W.3d at 746; *Texas United Ins. Co. v. Burt Ford Enters*., 703 S.W.2d 828, 832 (Tex. App.--Tyler 1986, no writ)(pleadings); *Amparo v. Mission Am. Ins. Co*., 795 S.W.2d 734, 737 (Tex. 1990)(policy). The clear import of these cases is that there is a duty to defend unless the allegations in the complaint affirmatively establish that there is no coverage.

2. *Limited Exception to the "Eight Corners" Rule*

Although the general rule is that one does not look beyond the "eight corners" in determining the insurer's duty to defend, courts have permitted review of extrinsic facts in limited circumstances. For example, in *Farm Fire & Cas. Co. v. Wade*, 827 S.W.2d 448 (Tex. App.—Corpus Christi 1992, writ denied), the court stated in dicta that, although the facts in the petition are controlling, when the stated facts are inadequate to discern whether or not there is coverage, extrinsic evidence may be used. *Id.* at 453. The court discussed the fact that extrinsic evidence is appropriate in cases where there is an issue about whether a defendant is a "covered person" under a policy, or where there is a question of whether a vehicle qualifies as a "covered vehicle." The allegations in the petition may not answer these questions one way or the other. A concurring opinion questions whether extrinsic evidence should ever be used.

Several other appellate opinions have held that the "eight corners" rule does not apply (i.e., that extrinsic evidence may be considered) to determine certain "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." *Tri-Coastal Contractors, Inc. v. Hartford Underwriters Ins. Co.*, 981 S.W.2d 861, 863 n.1 (Tex. App.—Houston [1st Dist.] 1998, pet. denied); *see Providence Washington Ins. Co. v. A & A Coating, Inc.*, 30 S.W.3d 554, 555 (Tex. App.—Texarkana 2000, review denied).

Of the exceptions to the eight corners rule described above, the most widely adopted is the admissibility of extrinsic evidence to determine the Ainsured status" of a putative insured", i.e., to determine whether or not the person claiming coverage is an insured under the policy. *See Tri-Coastal*, 981 S.W.2d at 863 n.1; *Providence Washington*, 30 S.W.3d at 555; *John Deere Ins. Co. v. Truckin' USA*, 1996 WL 734952, at *2 (N.D. Tex. 1996) (applying Texas law); *Blue Ridge Ins. Co. v. Hanover Ins. Co*., 748 F. Supp. 470, 473 (N.D. Tex. 1990) (applying Texas law); *International Serv. Ins. Co. v. Boll*, 392 S.W.2d 158, 161 (Tex. App.—Houston 1965, writ ref'd n.r.e.); Ellen S. Pryor, Mapping the Changing Boundaries of the Duty to Defend in Texas, 31 TEXAS TECH L. REV. 869, 885 (2000). The rationale behind this exception is that determining the insured status of the claimant is a "predicate" to applying the eight corners rule. *Blue Ridge*, 748 F. Supp. at 473.

However, the Fifth Circuit has made an *Erie* guess that the Texas Supreme Court would not recognize *any* exception to the strict eight corners rule. *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 (5th Cir. 2004). The Court stressed the fact that the Texas Supreme Court has never recognized any exception to the eight corners rule and that no other Texas appellate decision had both cited and applied the *Wade* line of cases. *Id.* at 529-30. In addition, the Court concluded that if the Texas Supreme Court were to recognize any exception to the eight corners rule,

any exception would apply only 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.* at 531 (emphasis in original).

As noted in *Northfield*, the Texas Supreme Court has not endorsed any of the proposed exceptions to the eight corners rule thus far. However, in a recent development, an insurance company has petitioned the Court for review of a Fort Worth Court of Appeals decision on this very issue. However, in *GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, the Texas Supreme Court discussed whether an exception to the eight corners rule exists when the insurer tries to use extrinsic evidence to establish a lack of coverage for a third-party plaintiff claim. 197 S.W.3d at 308. While the Court acknowledged the limited exceptions lower courts had implemented, it refrained from affirming these exceptions, instead holding that any exception would not extend to evidence that is relevant to both insurance coverage and the factual merits of the underlying case. *Id.*at 309-310.

The Supreme Court later examined whether extrinsic evidence to the eight corners of the policy and underlying lawsuit may be used to establish the insurer's duty to defend in *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, 279 S.W.3d 650, 653 (Tex. 2009). The insured sought to introduce extrinsic evidence that contradicted the facts in the underlying suit. *Id.* at 654. The Court rejected this extrinsic evidence, reiterating that "'an insurer is entitled to rely solely on the factual allegations contained in the petition in conjunction with the terms of the policy to determine whether it has a duty to defend.'" *Id.* at 655 (quoting *Trinity Universal Co. v. Cowan*, 945 S.W.2d 819, 829 (Tex. 1997)).

In *Weingarten Realty Mgmt. Co. v. Liberty Mut. Fire Ins.*, 343 S.W.3d 859, 865 (Tex.App.—Houston [14th Dist.] 2011, pet. denied), however, a Texas appellate court carved out an exception to the eight corners rule that "applies only when an insurer establishes by extrinsic evidence that a party seeking a defense is a stranger to the policy and could not be entitled to a defense under any set of facts." The Court limited this narrow exception by requiring that the extrinsic evidence only address the coverage issue and not contradict the underlying pleadings material to the merits of the claim. *Id.* The Texas Supreme Court denied the petition for review filed in this case.

C. Who Controls the Defense?

Whether an insurer has the right to conduct its insured's defense is a matter of contract. *Northern County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex. 2004). Generally, the insurance company may step into the shoes of its insured, assert various defenses, appoint counsel, and manage the defense. *Baze v. Marine Office of Amer. Corp.*, 828 S.W.2d 152, 157 (Tex. App.—Corpus Christi 1992). The right to conduct the defense includes the authority to select the attorney who will defend the claim and to make other decisions that would normally be vested in the insured as the named party in the case. *See State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998). However, under certain limited circumstances, an insurer must cede this contractual right of control to the insured. For instance, upon receiving notice of a reservation of rights, the insured may refuse tender of a defense and defend the suit personally. *American Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App.—El Paso 1996); *Housing Auth. of City of Dallas v. Northland Ins. Co.*,

333 F.Supp.2d 595, 600 (N.D. Tex. 2004). In *Traver*, the Court noted that the insured could control the defense as if it were the client "where no conflict of interest exists." *Traver,* 980 S.W.2d at 627.

The Texas Supreme Court clarified its position in *Davalos,* holding that a dispute over venue does not rise to the level necessary to strip the contractual right of control from the insurer. *Davalos*, 140 S.W.3d at 686. In the typical case involving a conflict of interest, the Court stated, an insurer will issue a reservation of rights letter. *Id.* at 689. Then, if the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends, the conflict of interest will prevent the insurer from controlling the defense. *Id.* The Court also held that other types of conflicts may justify an insured's control of his own defense: (1) when the defense tendered "is not a complete defense under circumstances in which it should have been;" (2) when "the attorney hired by the carrier acts unethically and, at the insurer's direction, advances the insurer's interests at the expense of the insured's;" (3) when "the defense would not, under the governing law, satisfy the insurer's duty to defend;" and (4) when, though the defense is otherwise proper, "the insurer attempts to obtain some type of concession from the insured before it will defend." *Id.* (quoting 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.25 at 393 (4th ed. 2001)).

D. Does the Defense Obligation Include a Duty to Appeal?

The CGL policy does not define the parameters of the insurer's duty to defend. While it may be easier to determine when an insurer's duty to defend begins (when the policyholder notifies the insurer of the suit), it may not be as easy to determine when the insurer's duty to defend ends. Does an insurer's obligation continue after an unfavorable judgment has been rendered against the policyholder? Does the defense obligation include a duty to appeal?

The duty to defend appears to include a duty to appeal under Texas law. In *Waffle House, Inc. v. Travelers Indem. Co. of Ill.*, 114 S.W.3d 601 (Tex.App.—Fort Worth 2003, pet. denied), the Fort Worth Court of Appeals found that the insurer's duty to defend "continues through the appellate process until the applicable limits of the policy are exhausted according to the terms of the policy." *Id.* at 611. The insurance policy in this case provided that "the duty to defend ends when the applicable policy limits are exhausted by qualifying payments." *Id.* The Court found this language to state unambiguous conditions that terminated the policy, thus the duty to defend included appeals until the policy limits were depleted. *Id.* The Southern District of Texas further expounded on the insurer's duty to appeal in *Associated Automotive Inc. v. Acceptance Indemnity Ins. Co.*, 705 F. Supp. 2d 714 (S.D. Tex. 2010). Because the Southern District found the *Waffle House* rationale to be non-dispositive, the Court made an "*Erie* guess" as to how the Texas Supreme Court would rule. *Id.* at 723-24. The Court followed decisions of other states and the Fifth Circuit rationale in *Gibbons-Markey v. Texas Med. Liab. Trust*, 163 Fed.Appx. 342, 346 (5th Cir. 2006) and held that "Texas courts would likely interpret Texas laws to be that, in the absence of an express insurance policy provision to the contrary, an insurer's duty to defend includes a duty to appeal an adverse judgment against its insured if there are reasonable grounds for the appeal." *Id.* at 725.

This comports with the general national consensus. An overwhelming majority of jurisdictions has determined that an insurer's duty to defend includes the duty to prosecute an appeal where reasonable grounds for an appeal exist. *See, e.g., Chrestman v. United States Fid. and Guar. Co.*, 511 F.2d 129 (5th Cir. 1975); *Educational Testing Serv. v. Liberty Mut. Fire Ins. Co*., No. C-96-2790-

VRW, 1997 U.S. Dist. LEXIS 5561 (N.D. Cal. Apr. 18, 1997); *Cathay Mortuary (Wah Sang) Inc. v. United Pac. Ins. Co.*, 582 F. Supp. 650 (N.D. Cal. 1984); *Ursprung v. Safeco Ins. Co. of America*, 497 S.W.2d 726 (Ky. 1973); *Arenson v. National Auto. and Cas. Ins. Co*., 310 P.2d 961 (Cal. 1957); *Truck Ins. Exch. v. Century Indem. Co.*, 887 P.2d 455 (Wash. Ct. App. 1995); *Illinois Founders Ins. Co. v. Guidish*, 618 N.E.2d 436 (Ill. Ct. App. 1993); *Jenkins v. Insurance Co. of North America*, 272 Cal. Rptr. 7 (Cal. Ct. App. 1990); *Reichert v. Continental Ins. Co.*, 290 So.2d 730 (La. Ct. App. 1974); *Home Ins. Co. v. Royal Indem. Co*., 327 N.Y.S.2d 745 (N.Y. Sup. Ct.), *aff'd*, 332 N.Y.S.2d 1003 (N.Y. App. Div. 1972); *Fidelity Gen. Ins. Co. v. Aetna Ins. Co*., 278 N.Y.S.2d 787 (N.Y. App. Div. 1967); *Kaste v. Hartford Accident & Indem. Co.*, 170 N.Y.S.2d 614 (N.Y. App. Div. 1958). Courts analyzing the duty to appeal as a matter of first impression have acknowledged this weight of authority. *See Cathay Mortuary*, 582 F. Supp. at 657 ("From the Court's reading of all the decisions, the Court finds that there is a general consensus that an insurer is obliged to pursue an appeal on behalf of its insured where there are reasonable grounds for appeal"); *Jenkins*, 272 Cal. Rptr. at 13 (same).

Other jurisdictions are even more favorable to insureds, holding that a duty to defend always includes a duty to appeal, without even requiring the insured to show that reasonable grounds for an appeal exist. See, e.g., *Ziebart Int'l Corp. v. CNA Ins. Cos*., 78 F.3d 245 (6th Cir. 1996); *City of Westhaven v. Commercial Union Ins. Co.*, 894 F.2d 540 (2d Cir. 1990); *Wilcox v. Board of Educ.*, 779 S.W.2d 221 (Ky. Ct. App. 1989); *Iacobelli Constr. Co., Inc. v. Western Cas. & Sur. Co.*, 343 N.W.2d 517 (Mich. Ct. App. 1983); *Palmer v. Pacific Indem. Co.*, 254 N.W.2d 52 (Mich. Ct. App. 1977).

E. Can the Insurer Apportion Defense Costs Between Covered and Non-Covered Claims?

It is a rare lawsuit that has only one claim. Often, a claimant will assert numerous claims against the insured. Many times, some of those claims are potentially covered by the policy, while others are not. In providing a defense to the insured, can the insurer be reimbursed for those defense costs associated with non-covered claims? No Texas state court has addressed this precise issue.

1. *The Argument against Reimbursement*

As a preliminary matter, an axiomatic principle of Texas law is that, where a suit includes both potentially covered and non-covered claims, the insurer must defend the entire lawsuit, not just the covered claims. *See, e.g., Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965); *St. Paul Surplus Lines v. Dal-Worth Tank Co., Inc.*, 917 S.W.2d 29, 56 (Tex. App.--Amarillo 1995, no writ); *Sewer Constructors, Inc. v. Employers Cas. Co*., 388 S.W.2d 20 (Tex. Civ. App.--Houston 1965, writ ref'd n.r.e.); *Superior Ins. Co. v. Jenkins*, 388 S.W.2d 243, 244 (Tex. Civ. App.--Eastland 1962, writ ref'd n.r.e.); *Houston Title Guar. Co. v. Fontenot*, 339 S.W.2d 347, 350 (Tex. Civ. App.--Houston 1960, writ ref'd n.r.e.); *Maryland Cas. Co. v. Moritz*, 138 S.W.2d 1095, 1097 (Tex. Civ. App.--Austin 1940, writ ref'd); *Hartford Cas. Co. v. Cruse*, 938 F.2d 601, 603, 605 (5th Cir. 1991) (applying Texas law); *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 119 (5th Cir. 1983) (applying Texas law); *Maryland Cas. Co. v. Mitchell*, 322 F.2d 37, 39 (5th Cir. 1963) (applying Texas law).

This well-settled tenant of Texas law is incompatible with allowing an insurer to apportion defense costs among covered and non-covered claims. An insurer cannot defend an entire suit while refusing to pay for the defense of certain claims within that suit. This principle of Texas law is also reflected in the language in the CGL policy. Specifically, the insuring language of the CGL policy provides that the Company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage. . . By its own terms, then, the CGL policy obligates the insurer to defend the entire suit, not merely certain claims asserted within that suit.

2. *The Cases*

(a) *The LaFarge Decision*

While no Texas state case has explicitly addressed an insurer's ability to recoup defense costs, the Fifth Circuit has indicated its willingness to allow apportionment. In *Lafarge Corp. v. Hartford Casualty Ins. Co.*, 61 F.3d 389 (5th Cir. 1995) (applying Texas law), the Fifth Circuit addressed the issue of apportionment of defense costs. According to the Fifth Circuit, a liability carrier generally may not apportion defense costs between covered and non-covered claims. However, the carrier may apportion these costs if (1) failure to apportion would result in inequity; or (2) a means exists to clearly determine which costs were incurred in relation to covered and non-covered claims.

In *Lafarge*, the insured (Lafarge) was a sub-contractor hired by American West to provide protective coating for a petroleum pipeline. The coating failed at the field joints, damaging the pipeline. American West sued Lafarge and several related entities on a variety of theories, only one of which was potentially covered by Lafarge's liability insurance policy. The carrier (Hartford) argued that it should only be required to pay defense costs for the covered claims. The court was willing to allow apportionment but only if a "clear distinction" existed between the covered and non-covered claims. *Id*. at 398. The court held that there was no clear distinction if both the covered and non-covered claims arose from a "single accident." In other words, if the covered and non-covered claims were intertwined, the carrier would be required to pay for the entire defense. Importantly, the court in *Lafarge* placed the burden on the carrier to demonstrate that this "clear distinction" between covered and non-covered claims existed.

(b) *The Matagorda County and Frank's Casing Decisions*

However, the Texas Supreme Court has indicated that Texas law may not—under most circumstances—allow a carrier to seek reimbursement of defense or indemnity payments. In *Matagorda County v. Texas Ass'n of Counties County Gov't Risk Mgmt. Pool*, 975 S.W.2d 782 (Tex. App.—Corpus Christi 1998), aff'd, 52 S.W.3d 128 (Tex. 2000), the carrier provided law enforcement insurance to Matagorda County, protecting the County against claims for personal injury, bodily injury, property damage, and violation of civil rights. Matagorda County's policy, however, included an endorsement specifically excluding from coverage any claim "arising out of jail." In 1993, the County requested coverage and a defense under its policy after three prisoners from the Matagorda County jail sued the County in federal court for damages arising out of assaults that occurred in the jail.

The carrier disputed coverage and sought a declaratory judgment that the claims were not covered under the policy. Nonetheless, the carrier defended the County against the prisoners' lawsuit while reserving its right to challenge coverage. After settling the prisoners' lawsuit in 1996, the carrier amended its declaratory judgment action to request reimbursement of its defense and settlement costs associated with the suit. The trial court granted a partial summary judgment finding that the policy excluded the suit from coverage and entered a judgment granting the carrier recovery both of its settlement payment of $300,000 and more than $53,000 in attorney's fees paid by the carrier for its defense of the prisoners' lawsuit and its prosecution of the coverage suit.

The Texas Supreme Court rejected the carrier's argument that it had a quasi-contractual right to reimbursement of defense and settlement costs. *Texas Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128 (Tex. 2000). Rather, the Court reached the narrower holding that "the insurer may fund the settlement and seek reimbursement only if it obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement." *Id*. at 135. This holding only specifically addresses a carrier's right to seek reimbursement of settlement payments, not defense costs. However, the Court's analysis preceding its holding does mention defense costs, and does not appear to consider their reimbursement subject to a different analysis from that applicable to settlement payments. *Id.* at 135-36.

While the decision's application to defense costs is therefore less than clear, it appears that the insured's consent to reimbursement is the key. The insured could consent either in advance, by purchasing a policy that specifically provides for reimbursement, or after the fact, by expressly consenting to a carrier's request to seek reimbursement.

This construct was generally approved, but modified somewhat by *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, 246 S.W.3d 42 (Tex. 2008), in which the Texas Supreme Court denied a carrier's right to reimbursement for settlement amounts paid on behalf of its insured. The Court originally decided the case in May 2005, but reversed and replaced its original opinion on February 1, 2008.

In its original opinion, the Court held that a liability insurer may accept a reasonable settlement offer within policy limits and at the same time reserve its rights to dispute coverage and seek reimbursement for the amounts paid on uncovered claims. Under the original opinion, a policyholder that consents to a settlement could have been obligated to reimburse the insurer for settlement amounts paid where the insurer is successful on its coverage position, even if the insured did not expressly consent to the reimbursement right. The Court's subsequent February 1, 2008 opinion wholly rejected that approach.

Frank's Casing fabricated a drilling platform for ARCO/Vastar. The platform collapsed and ARCO sued several entities, including Frank's Casing. Frank's Casing had a $1 million primary liability policy and excess coverage up to $10 million with Excess Underwriter's at Lloyd's, London and certain additional carriers. Upon being notified of ARCO's claims, the excess carriers issued reservation-of-rights letters regarding coverage. Frank's Casing received and forwarded a $7.5 million settlement demand to its excess carriers. Frank's Casing informed the excess carriers that it believed the demand was reasonable. The excess carriers offered to fund the entire settlement if Frank's Casing would agree to reserve coverage issues for resolution later. Frank's Casing rejected

the proposal. The excess carriers then informed Frank's Casing they would fund the settlement and seek reimbursement later. Within hours, the excess carriers contacted ARCO and accepted the settlement offer. Before the settlement agreement was signed, the excess carriers filed a lawsuit seeking reimbursement. Both the trial court and the appellate court ultimately held in Frank's Casing favor, denying the excess carriers' a right to reimbursement.

The *Frank's Casing* Court was faced with the issue of whether to create an exception to its *Matagorda County* decision. In *Frank's Casing*, the excess carriers pointed to two facts that distinguished their facts from those presented in *Matagorda County*: (1) Frank's Casing solicited the settlement; and (2) the excess carriers needed Frank's Casing's consent for any settlement. These two factual distinctions, the excess carriers contended, entitled them to either an implied-in-fact reimbursement right or equitable reimbursement right. The Court reinforced the *Matagorda County* ruling, however, and declined to create an implied or equitable right to reimbursement.

The excess carriers argued that Frank's Casing impliedly agreed to reimbursement by taking an active role in procuring the settlement offer and by demanding that the excess carriers settle the claims. The Court recognized Frank's Casing's desire to settle the claims. But the Court declined to equate such a desire with an agreement to a reimbursement obligation that does not appear in the policy. In fact, Frank's Casing expressed the opposite intent. In numerous letters to the excess carriers, Frank's Casing expressed disagreement with the carriers' coverage position, expressed a desire for the carriers to fund the entire settlement, and threatened to seek recourse against the carriers if a judgment in excess of the policy limits was rendered. That Frank's Casing had a right to approve of any settlement was inconsequential. Both Frank's Casing and the excess carriers took steps to reserve their rights with respect to their coverage positions. In effect, they agreed to disagree on the issue of reimbursement rights. This, the Court held, was a far cry from the meeting of the minds required to find an implied-in-fact contract.

The Court also rejected any reimbursement right under the equitable theories of *quantum meruit* and *assumpsit*. The *Frank's Casing* Court reinforced the sentiment expressed in *Matagorda County*: "when coverage is disputed and the insurer is presented with a reasonable settlement demand within policy limits, the insurer may fund the settlement and seek reimbursement *only if* it obtains the insured's clear and unequivocal consent to the settlement *and* the insured's right to seek reimbursement."

(c) *The Warren E&P Decision*

Even more recently, one court of appeals held that a reimbursement right must be in the insurance policy or another additional contract. This is the rule that the El Paso Court of Appeals followed in *Warran E&P, et. al. v. Gotham Insurance Co.*, 368 S.W.3d 633 (Tex.App.—El Paso 2012, pet. granted). The court held that the insurer had no right to reimbursement for the payment of a non-covered claim because the insurance policy did not provide for a right to reimbursement for the payment of non-covered claims. *Id.* at 638-39. The insurer appealed the decision and the Supreme Court agreed to hear the case. Depending on the Texas Supreme Court's ruling, this case may amend the case law governing an insurer's right to reimbursement.

F. Lamar Homes – The Insurer Will Pay Penalties If It Fails to Pay Defense Costs Promptly

In 2007, the Texas Supreme Court resolved a long-standing controversy between policyholders and insurance carriers as to whether CGL policies cover property damage resulting from defective workmanship. *Lamar Homes, Inc. v. Mid-Continent Casualty Company,* 242 S.W.3d 1 (Tex. 2007). This case arises out of a dispute between homeowners Vincent and Janice DeMare and their homebuilder, Lamar Homes, Inc. Several years after purchasing their home, the DeMares encountered problems that they attributed to defects in their foundation. The DiMare's sued Lamar and its subcontractor complaining about these defects. Lamar forwarded the lawsuit to its insurer, Mid-Continent Casualty Company, seeking a defense and indemnification under its CGL policy,. Mid-Continent refused to defend, prompting Lamar to seek a declaration of its rights. Lamar also sought recover under Article 21.55 of the Texas Insurance Code (recodified as § 541.051-061 of the Texas Insurance Code) for failing to promptly provide a defense.

The federal district court granted summary judgment in favor of Mid-Continent, concluding it had no duty to defend Lamar for construction defects that harmed only Lamar's own product. *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 335 F. Supp. 2d 754 (W.D. Tex. 2004). The court reasoned that the purpose of a CGL policy is to "protect the insured from liability resulting from property damage (or bodily injury) caused by the insured's product, but not for the replacement or repair of that product." *Id*. at 759. The court was concerned that if an insurance policy were to be interpreted as providing coverage for construction defects, it would allow a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from the carrier to repair and correct defects to the contractor's own work.

Lamar appealed the federal district court's decisions to the Fifth Circuit. Noting disagreement among Texas courts about the application of a CGL policy under these circumstances, the Fifth Circuit certified the following three questions to the Texas Supreme Court as the final authority on questions of Texas civil law:

1) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an "accident" or "occurrence" sufficient to trigger the duty to defend or indemnity under a CGL policy?

2) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege "property damage" sufficient to trigger the duty to defend or indemnify under a CGL policy?

3) If the answers to certified questions 1 and 2 are answered in the affirmative, does Article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?

Lamar Homes, Inc. v. Mid-Continent Cas. Co., 428 F.3d 193, 200-01 (5th Cir. 2005).

Fortunately for policyholders, the Texas Supreme Court concluded that allegations of unintended construction defects may constitute an "accident" or "occurrence" under a CGL policy and that allegations of damage to or loss of use of the home itself may also constitute "property damage"

sufficient to trigger the duty to defend under a CGL policy. In coming to this conclusion, the Supreme Court rejected the insurer's false assumption that construction defects resulting from a contract's failure to perform under contract are always intended or expected and thus, not an "accident" or "occurrence." In addition, the Supreme Court rejected the notion that damage to the contractor's own work is not "property damage" but rather a contractual, economic loss. In doing so, the Supreme Court sternly noted that the economic loss rule is a liability defense or remedies doctrine, not a test for insurance coverage. Quite simply, whether a third-party's claim lies in contract or tort is irrelevant to the existence of coverage. The Supreme Court did not address the duty to indemnify, because as the Court noted, that duty is not triggered by mere allegations, but rather proof at trial.

With respect to the third and final question, the Supreme Court concluded that the prompt-payment statute, formerly Article 21.55, and now codified in Chapter 542 of the Texas Insurance Code, may be applied when an insurer wrongfully refuses to promptly pay a defense benefit owed to an insured. The prompt-payment statute provides that an insurer, who is "liable for a claim under an insurance policy" and who does not promptly respond to, or pay, the claim as the statute required, is liable to the policyholder not only for the amount of the claim, but also for "interest on the amount of the claim at that rate of eighteen percent a year as damages, together with reasonable attorney's fees." Tex. Ins. Code § 542.060(a). Not merely limited to the construction industry, this holding provides all general liability policyholders the hammer necessary to compel their insurers to provide a defense.

VI. The *Stowers* Doctrine

A. A *Stowers* Claim

The duty of an insurer to exercise ordinary care in the settlement of claims to protect its insureds against judgments in excess of policy limits is generally referred to in Texas as the "*Stowers*" duty. *Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544 (Tex. Comm. App. 1929, holding approved). The test for determining whether an insurer acted negligently in refusing a settlement offer within policy limits is whether a prudent person in the exercise of ordinary care would have accepted the settlement offer. *Id.* at 547. In other words, an insurer is under a duty to act, in the handling of the lawsuit against its insured, as an ordinarily prudent person would act in the management of his own business. *Id.* If an ordinarily prudent person would have settled the lawsuit and the insurer failed or refused to do so, it is liable to the insured for the amount of damages eventually recovered in excess of policy limits. *Id.*

Among the guidelines to be used in determining whether or not an insurer is negligent in failing to accept an offer to settle are: (1)an opportunity to settle during the course of an investigation or a trial; (2) failure to carry on negotiations to settle or to make a counter-offer after receiving an offer to settle; (3) failure to investigate all facts necessary to protect the insured against liability; (4) the existence of a greater duty to settle where liability is clear; (5) whether the insurer acts negligently, fraudulently or in bad faith; and (6) the increased possibility of the insurer being held liable for negligence where there are conflicts in evidence that increase the uncertainty of the insured's defense to the injured party's claim. *Globe Indem. Co. v. Gen-Aero, Inc.*, 459 S.W.2d 205 (Tex. App.—San Antonio 1970 writ ref'd n.r.e.).

B. Prerequisites to a Stowers Claim

An insurer's *Stowers* duty is not triggered by a settlement demand received from a claimant against the insured unless three prerequisites are satisfied: (1) the claim against the insured is within the scope of coverage, (2) the demand is within policy 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 potential exposure to an excess judgment. *State Farm Lloyd's Ins. Co. v. Maldonado*, 963 S.W.2d 38, 41 (Tex. 1998); *APIE v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994). In addition, a settlement demand must propose to release the insured fully in exchange for a stated sum of money or may substitute the term "policy limits" for a sum certain. *APIE*, 876 S.W.2d at 848-49; *Trinity Universal Ins. Co. v. Bleeker*, 960 S.W.2d 489 (Tex. 1998). Under the *Stowers* doctrine, an insurer has no duty to initiate settlement negotiations. *APIE*, 876 S.W.2d at 851. A failure to satisfy any of the three elements of a *Stowers* claim will preclude an insurer's *Stowers* duties from being triggered.

C. Damages

An insured which prevails on a *Stowers* claim may recover from its insurer the entire amount of damages in excess of policy limits rendered against it. *Stowers*, 15 S.W.2d at 547; *Ecotech Int'l, Inc. v. Griggs & Harrison*, 928 S.W.2d 644, 646 (Tex. App.—San Antonio 1996, writ denied); *Stroman v. Fidelity Cas. Co. of New York*, 792 S.W.2d 257, 260 (Tex. App.—Austin 1990, writ denied).

D. The Tension Between the Measure of Damages for a Stowers Violation and the Requirement That the Claim be Covered in Order to Trigger the Stowers Doctrine

1. *Claims Involving "Mixed" Petitions*

Many lawsuits involve multiple claims against an insured some of which may be covered and some of which may not. This gives rise to a question as to whether an insurer has a duty to settle in order to avoid exposing its insured to liability on a non-covered claim. In *Camelot by the Bay Condominium Owner's Assoc., Inc. v. Scottsdale Ins. Co.*, 32 Cal. Rptr. 2d 354 (Cal. App. 4th Dist. 1994), the insured was sued for a variety of construction defects. An exclusion in the policy eliminated coverage for many, but not all, of the defects. A policy limits settlement demand was made by the claimant. However, the total cost to repair the project, including the uncovered defects, was less than the policy limits. Under these facts, the court held that the carrier had no good faith duty to accept a within-limits settlement demand:

> Here, the trial court attempted to hold Scottsdale to a duty to protect [the insured] against financial risk for even those defects which would ultimately be determined to be noncovered items . . . . [An] insurer denies coverage at its own risk if, and only if, coverage is ultimately found . . . . We do not believe that Scottsdale can reasonably be said to have run the risk of bad faith liability by refusing to settle the case for the amount demanded, where no danger of excess liability of the insured existed and where it was essentially undisputed that some of the defects at the property fell outside the scope of its policy. Where coverage up to the settlement demand is ultimately found, and an excess judgment is ultimately entered, the situation is far

different from the case before us in which some of the defects were found not to be covered . . . .

Camelot, 32 Cal. Rptr.2d at 364-365.

2. *Claims Involving Insurable Conduct and Potentially Uninsurable Punitive Damages*

Punitive damages are uninsurable on public policy grounds in a number of jurisdictions. Courts in these jurisdictions have generally held that insurers cannot be held liable for punitive damages awarded against an insured which could have been avoided had the insurer accepted a settlement offer. *See, e.g., Soto v. State Farm Ins. Co.*, 613 N.Y.S.2d 352 (N.Y. 1994); *Lira v. Shelter Ins. Co.*, 913 P.2d 514 (Co. 1996*); PPG Indus., Inc. v. TransAmerica Ins. Co.*, 84 Cal. Rptr. 2d 455, 461 (Cal. 1999); *Zieman Mfg. Co. v. St. Paul Fire & Marine Ins. Co.*, 724 F.2d 1343, 1346 (9th Cir. 1983)

Other courts have, however, required insurers to give consideration to the insured's exposure to a punitive damages award in determining whether or not to accept a settlement offer. *See, e.g., Ging v. American Liberty Ins. Co.*, 423 F.2d 115, 116 (5th Cir. 1970); *Magnum Foods, Inc. v. Continental Cas. Co.*, 36 F.3d 1491, 1505-06 (10th Cir. 1994)

Although the Texas Supreme Court addressed punitive damages in *Fairfield Ins. Co. v. Stephens Martin Paving, LP, et al.* , 246 S.W.3d 653 (Tex. 2008), whether punitive damages will be insurable under Texas law remains a muddled question. In *Fairfield*, the state's high court addressed a certified question certified from the Fifth Circuit Court of Appeals: "Does Texas public policy prohibit a liability insurance provider from indemnifying an award for punitive damages imposed on its insured because of gross negligence?" The Texas Supreme Court answered in the negative, citing the state's general policy in favor of freedom of contract, but limiting its opinion to the workers' compensation context. In this case, the Texas Supreme Court established a two-part test to determine whether exemplary damages awarded for gross negligence are insurable under Texas law. *Id.* at 655. The two-step analysis examines:

(1) "[W]hether the plain language of the policy covers the exemplary damages sought in the underlying suit against the insured."
(2) And if the policy does provide coverage, the court will "determine whether the public policy of Texas allows or prohibits coverage in the circumstances of the underlying suit." *Id.*

Under the second step, the court will first examine "express statutory provisions" to determine if the Legislature made a policy decision regarding the insurability of exemplary damages in that specific insurance context. *Id.* If there are not any express statutory provisions, the court will consider "general public policies of Texas." *Id.*

The general public policy analysis weighs "Texas' general policy favoring freedom of contract" against "the extent to which the agreement frustrates important public policy." *See id.* at 663-64. Texas has a strong public policy that favors contractual freedom; however, the court must also consider the purpose of exemplary damages in its balancing analysis. *Id.* at 665-66 ("[T]he

punishment imposed through exemplary damages is to be directed at the wrongdoer" (internal citations omitted)).

The Fifth Circuit Court of Appeals implemented this public policy balancing analysis in *Am. Int'l Speciality Lines Ins. Co. v. Res-Care, Inc.* and found coverage for exemplary damages to be against public policy. 529 F.3d 649, 654 (5th Cir. 2008). An employee at Res-Care (a group home for the mentally disabled) left a resident lying on the floor in a puddle of bleach; then subsequent employees failed to clean and care for the resident, resulting in chemical burns and the resident's eventual death. *Id.* Res-Care sought insurance coverage for exemplary damages assessed against it because no officers, directors, or shareholders participated or had knowledge about the accident and subsequent death. *Id.* at 663. The Court found that the gross negligence in this case constituted extreme circumstances and held it would be against public policy to shift the payment responsibility from the defendant to its insurer. *Id.* at 663-64 (holding the circumstances in this case "were so extreme that the purposes of punishment and deterrence of conscious indifference outweigh the normally strong public policy of permitting the right to contract between insurer and insured").

Similarly, in *Minter v. Great Am. Ins. Co.*, the Fifth Circuit once again held that allowing insurance coverage for exemplary damages would be against public policy. 394 Fed. Appx. 47, 50 (5th Cir. 2010). A tractor-trailer driver, driving while intoxicated, wrecked into another vehicle and injured the other driver. *Id.* at 49. The tractor-trailer driver, convicted of two previous DWIs, admitted to being intoxicated while driving and acknowledged someone might get hurt as a result. *Id.* Consequently, the Court found the driver had "not learned his lesson" and held that public policy prohibited the insurer from providing coverage for the exemplary damages assessed against the driver.

While the Texas Supreme Court has provided some guidance, decisions of the Texas courts of appeals reflect a split of authority. Compare *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026 (5th Cir. 1978)(applying Texas law)(punitives insurable); *American Home Assur. Co. v. Safway Steel Prods. Co.*, 743 S.W.2d 698 (Tex. App.--Austin 1987, writ denied)(same); *Home Indem. Co. v. Tyler*, 522 S.W.2d 594 (Tex. Civ. App.--Houston [14th Dist.] 1975, writ ref'd n.r.e.)(same); *Dairyland County Mut. Ins. Co. v. Wallgren*, 477 S.W.2d 341 (Tex. Civ. App.--Forth Worth 1972, writ ref'd n.r.e.)(same); *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, 2003 WL 21475423 (Tex. App.-- Fort Worth); with *Milligan v. State Farm Mut. Auto. Ins. Co.*, 940 S.W.2d 228 (Tex. App.--Houston [14th Dist.] 1997, writ denied)(punitives uninsurable); *State Farm Mut. Auto. Ins. Co. v. Shaffer*, 888 S.W.2d 146 (Tex. App.--Houston [1st Dist.] 1994, writ denied)(same); *Vanderlinden v. United Servs. Auto. Ass'n Property & Cas. Ins. Co.*, 885 S.W.2d 239 (Tex. App.-- Texarkana 1994, writ denied)(same); *Government Employees Ins. Co. v. Lichte*, 792 S.W.2d 546 (Tex. App.-- El Paso 1990), writ denied per curiam, 825 S.W.2d 431 (Tex. 1991)(same). The *Fairfield* two-part test likely will continue this trend of varying decisions based on a factual analysis and the public policy interpretations of the specific court.

E. Can an Excess or Other Insurer Without a Defense Obligation be Stowerized?

Non-defending excess insurers may not owe *Stowers* duties to their insureds. A number of cases decided under Texas law have recognized that an insurer *Stowers* duties spring from an insurer's contractual defense obligation . *See, e.g., Stowers*, 15 S.W.2d at 547 (insurer's contractual right to

control defense and settlement of suit against insured imposed tort duties on insurer). *APIE v. Garcia*, 876 S.W.2d 842, 846 (Tex. 1994) (contractual duties to defend and indemnify the insured coupled with the provision granting control over the insured's defense are what give rise to an insurer's implied duty under *Stowers* to accept reasonable settlement demands within policy limits); *Foremost County Mut. Ins. Co. v. Home Indemnity Co.*, 897 F.2d 754, 758 fn. 5 (5th Cir. 1990) (*Stowers* doctrine protects insured when insurer, in exercising its contractual right to defend, is in complete control of the litigation).

Absent a defense obligation placing an insurer in control of the insured's defense, Stowers duties may not arise. *See, e.g., Emscor Manufacturing, Inc. v. Alliance Ins. Group*, 879 S.W.2d 894, 909 (Tex. App.--Houston [14th Dist.] 1994, writ denied) (excess insurer with no duty to defend could not be held liable under *Stowers*); *National Union Fire Ins. Co. v. CNA Ins. Companies*, 28 F.3d 29, 33 n. 5 (5th Cir. 1994) (lower level excess insurer lacking ability to control defense did not owe Stowers duty to upper level excess carrier). *Cf. Employers Cas. Co. v. Hicks Rubber Co.*, 160 S.W.2d 96, 100 (Tex. Civ. App.—Waco 1942), *rev'd on other grounds*, 169 S.W.2d 142 (Tex. 1943) ("The reserved right of each insurer with respect to settlement was an equal one, which, however, could not be effectively exercised without reasonable cooperation on the part of the other. We think under the facts of this case each insurance company owed the duty to the other and to the assured to exercise ordinary care in deciding whether it would or would not cooperate with the other in consummating any settlement proposed by the injured claimant.").

If an excess insurer assumes the responsibility for conducting settlement negotiations, however, it may be subjected to liability under the *Stowers* doctrine. *Rocor Int'l, Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 77 S.W.3d 253, 255 (Tex. 2002). Along similar lines, if an excess insurer becomes primarily responsible for the defense of the insured, then the excess insurer's conduct becomes actionable. *Keck, Mahin, & Cate v. Nat'l Union Fire Ins. Co.*, 20 S.W.3d 692, 701 (Tex. 2000) ("An excess insurer owes its insured a duty to accept reasonable settlements, but that duty is also not typically invoked until the primary insurer has tendered its policy limits." (citations omitted)).

F. Can a Primary Insurer Be Stowerized Where the Insured Offers to Pay the Difference Between the Policy Limits and the Claimant's Settlement Demand?

Possibly. *See State Farm Lloyd's Ins. Co. v. Maldonado*, 935 S.W.2d 805, 816 (Tex. App.--San Antonio 1996), rev'd, 963 S.W.2d 38 (Tex. 1998) ("If the insured is amenable to funding the portion of the demand in excess of policy limits, as he was in the present case, the demand to the insurer falls within [policy] limits."). However, in reversing *Maldonado*, the Texas Supreme Court expressly refused to decide whether a bifurcated *Stowers* demand could trigger an insurer's *Stowers* duty. *Maldonado*, 963 S.W.2d at 41, n. 6. Similarly, the court refused to reach the issue in *APIE*. *APIE*, 876 S.W.2d at 849, n. 13.

G. Mid-Continent Ins. Co. v. Liberty Mutual Ins. Co. Effect on Stowers Demands

In *Mid-Continent Ins. Co. v. Liberty Mutual*, 236 S.W.3d 765 (Tex. 2007), the Supreme Court held that when one of two liable insurers funded an entire settlement on behalf of its insured, it could not seek contribution from the other insurer, even when the other insurer acted unreasonably. *Id.* at 772.

Because both policies at issue – Mid-Continent's and Liberty's contained identical "other insurance" clauses that provided for pro-rata sharing of responsibility, the Court concluded that each insurer had contractually agreed only to pay its proportionate share of a covered loss. *Id.* The Court concluded that, for a variety of reasons, the paying insurer could not recover from the obstinate insurer under contractual or common law notions of contribution or subrogation. *Id.*

The Court essentially based its opinion on the notion that when more than one insurer is responsible for the same insured on a pro-rata basis, each individual insurer is only responsible for its pro-rata share of any judgment or settlement. Thus, if two carriers are equally responsible for an insured who receives a settlement demand for $5 million, under the Supreme Court's logic, neither carrier is responsible for more than $2.5 million. Great confusion has arisen in light of *Mid-Continent* as to what is an effective Stowers demand. Carriers argue that the $5 million demand is not within their limits, because those limits for this claim are $2.5 million. In fact, the Court in *Mid-Continental* essentially told each carrier that it cannot settle the case for $5 million, and then recover $2.5 million from the other carrier. *Mid-Continent* has affected the way that carriers can settle lawsuits.

VII. Additional Insured Coverage: Multiple Parties In The Same Suit Covered By The Same Policy

Many aspects of the modern business world involve some aspect of "additional insured" coverage. Manufacturers require additional insured status from their distributors. Distributors require such status from sellers. Contractors generally require their subcontractors to provide them with such coverage. Additional insured status is provided by an endorsement or written amendment to the underlying policy. Unlike other more formalized parts of the CGL policy, there are many different forms of additional insured endorsements, and the precise form used in a given policy drastically affects the scope of the coverage.

Like a named insured's coverage, the additional insured endorsement typically provides both a defense and indemnity to the additional insured. However, the terms of an additional insured endorsement vary greatly, and must specifically be reviewed to determine exactly what coverage is provided. The scope and amount of applicable additional insured coverage affect many aspects of multi-party litigation from both the plaintiffs' and defendants' points of view.

A. Who Are Additional Insureds?

The term "additional insured" generally refers to those insureds that are not named insureds under the liability policy of another but for whom the named insured wants or is required to provide coverage.

B. Potential Issues

1. *Notice Requirements*

One significant distinction between the named insured's obligations and those of the additional insureds concerns "notice" of a claim. Under the current CGL forms, the named insured is obligated to give notice. Under these forms, any insured that is sued must provide copies of the suit, but only

the named insured is required to provide notice of the suit. Conversely, under the 1973 CGL policy provisions, the additional insured itself had to give notice.

Under the CGL forms commonly used before 1986, an additional insured may have an independent duty to notify the insurer of any occurrence, claim, or suit. Failure to provide such notice might preclude coverage, especially if the delay prejudiced the insurer. With respect to the newer CGL forms, since the named insured must provide notice to the insurer, the named insured must notify the insurer of claims against additional insureds. If it fails so to do, it may cost the additional insured coverage, and might thus have to defend itself against a claim that it breached its promise to procure insurance for others.

Always keep *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 246 S.W.2d 653 (Tex. 2008) in mind. If you are an additional insured and you want coverage, make sure the carrier knows it, one way or the other!

2. *The Obligation to Defend Multiple Defendants in the Same Lawsuit*

Interesting conflict-of-interest issues arise for the insurer when a lawsuit is brought against both a named insured and an additional insured. Often the best defense for one of the insureds involves condemnation of the actions of the other. This can present an insurer charged with defending both parties with severe conflicts of interest. Under Texas law in this situation the carriers must retain separate counsel at its own expense. *Kirby Co. v. Hartford Cas. Ins. Co.*, 2004 U.S. Dist. LEXIS 11736, *27-28 (N.D. Tex. June 10, 2004) (holding that insurer's insistence on a joint defense despite an apparent conflict of interest between the named insured and additional insured was a breach of insurer's duty to defend).

3. *Dilution of Limits*

Under some policies, each dollar spent on defense erodes the limits of the policy available to settle the case or pay judgments. Standard CGL forms provide a defense in addition to policy limits, and thus are not depleted by the defense of multiple insureds. On the other hand, such increased defense costs could be a problem for named insureds that must buy coverage on non-standard forms.

Even if defense payments do not dilute the limits, settlement payment will. CGL policies are typically "occurrence based" policies, and their limits are "per occurrence" limits. "Occurrence" means, generally speaking, an accident. When other insureds have access to a named insured's per occurrence limits, the limits are easily diluted. The problem also exists when another party has access to the named insured's limits through an enforceable hold harmless clause, i.e., when the named insured's contractual liability insurance protects the other party. Under a standard CGL policy, the limits may reduce even more quickly under these circumstances, because covered defense costs are often within policy limits. Thus, dilution of limits poses the same problems absent additional insured status that it does with it, when the named insured has agreed to indemnify another. Either way, the policy limits available to settle or pay the claim will be diluted.

Moreover, liability policies usually state that the insurer's right and duty to defend ends when it has paid its applicable limits in the payment of judgments or settlements. Thus, every insured's defense may be cut off by the payment of policy limits to settle the claim on behalf of any one.

4. *Severability of Interests and the Application of Exclusions and Conditions*

Most CGL policies contain a clause – referred to commonly as a severability clause—to the effect that when multiple insureds are involved in the same claim, coverage will be assessed as to each insured separately (with blinders on), as if it was the only covered insured.1 As these clauses are applied, it is possible for a liability policy to apply to an additional insured even though coverage for the named insured is excluded. The purpose of the severability of interests provision of insurance policies is to clarify that the word "insured," as it appears within various parts of a policy, applies severally and not collectively. Thus, a policy provision that refers to "the insured" is not limited in its application to the named insured.

Most exclusions in the CGL policy also apply to additional insureds. In determining their application, however, it is important to assess each exclusion from the specific standpoint of the additional insured. For example, what happens when an additional insured is sued as a result of a bodily injury to the named insured's employee? The policy has a typical "Employers Liability Exclusion" excluding liability for injuries to the insured's employees.

The question boils down to this: Does the employers liability exclusion apply when the injured employee is not in the employ of the additional insured at the time of the injury? The answer is no. *Admiral Ins. Co. v. Trident NGL, Inc*., 988 S.W.2d 451, 455-56 (Tex. App.—Houston [1st Dist.] 1999, pet denied) ("When, as here, a policy has a "severability of interests" clause, each insured against whom a claim is brought is treated as it was the only insured under the policy. Neither party disputed that Santos was an employee of KD. If Santo had sued KD for his injuries, KD would have been denied coverage under the exclusion. The exclusion did not apply to Trident, however, because Trident was not Santo's employer."); *Zaiontz v. Trinity Universal Ins. Co.*, 87 S.W.3d 565 (Tex. App.—San Antonio 2002, pet. denied) (holding that because the policy contained a "Separation of Insureds" clause, the employee exclusion only applied if the insured seeking coverage was the injured claimant's employer; *Commercial Standard Ins. Co. v. Amer. General Ins. Co*., 455 S.W.2d 714 (Tex. 1970) (concluding that although the general contractor was "an insured" under the policy, the injuries to the general contractor's employees did not fall within the exclusion for bodily injury to employees of "the insured," when the insured "requesting coverage was the subcontractor who was not injured employees' employer). The intent of the employers liability exclusion is to preclude those claims involving employer-employee relationships that are or should be covered by the workers compensation policy. Thus, if an employee of the named insured is injured at the hands of an additional insured that is deemed not to be the employer of such injured employee, the employers liability exclusion does not apply to the additional insured.

1 The one exception to this is that the policy limits are not cumulative; that is, one set of limits applies to all insureds collectively.

5. *Cross-Liability Exclusions and Endorsements*

What happens when one insured (i.e., the named insured) sues another insured (i.e., an additional insured)? Such a claim is sometimes referred to as a "cross-liability claim" and the severability of interests clause generally requires liability insurers to defend such suits.

Some liability policies contain so-called "cross-liability" or "insured versus insured" exclusions. These exclusions purport to preclude coverage for claims and suits between insureds. Although rare in primary CGL policies, these exclusions are found frequently in umbrella and excess policies.

6. *Vicarious vs. Direct Liability*

Insurers have historically argued that coverage for additional insureds is limited to the additional insured's vicarious liability for the acts of the named insured. Texas courts have consistently shot this interpretation down. The construction of an exclusionary clause urged by the insured must be adopted as long as that construction is not unreasonable, even if the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties' intent. *National Union Fire Ins. Co. v. Hudson Energy Co.*, 811 S.W.2d 552, 555 (Tex. 1991); *Kelly Associates, Ltd. v. Aetna Cas. & Sur. Co*., 681 S.W.2d 593, 596 (Tex. 1984).

Texas law does not preclude coverage for claims arising from the additional insured's own negligence unless the policy clearly states otherwise. Three cases decided under Texas law support the notion that the Endorsement should be interpreted broadly in favor of coverage. In *Mid-Continent Cas. Co. v. Swift*, 206 F.3d 487, 499 (5th Cir. 2000) the court indicated that, when the insurer could have, but did not, expressly provide that coverage available to an additional insured was limited to liability arising from the named insured's sole negligence, the court would not read such a limitation into the policy, and, as a result, the additional insured was entitled to coverage even though the named insured was not negligent. In *Mid-Continent Cas. Co. v. Chevron Pipeline Co.*, 205 F.3d 222, 227 (5th Cir. 2000) the court recognized implicitly that findings in an underlying action that the additional insured was negligent did not preclude coverage under the additional insured endorsement given that suit against the named insured was barred by the workers' compensation bar. Thus, the court determined that the lack of any findings regarding the named insured's fault was not the equivalent of a finding of "no fault." The court interpreted the coverage limitations strictly, and held that the insurer could have limited coverage by including terms such as "vicarious liability" or "negligence of the named insured" in the endorsement. And finally, in *Atofina Petrochemicals, Inc. v. Cont'l Cas. Co*., 185 S.W.3d 440, 444-45 (Tex. 2005), the court rejected the view offered by the insurer and concluded that adopting an interpretation of the exclusion that bars all coverage when any negligence on the part of the premises owner is pleaded, unless the owner's responsibility is based solely on vicarious liability for the acts of the contractor, would render coverage under the endorsement largely illusory.

7. *Other Insurance*

The toughest issue for both additional insureds and named insureds is the conflict between the carriers as to which has the primary obligation to defend or settle. An additional insured is often covered both by its own liability policies and by those on which it is an additional insured. Often

these policies will have identical "other insurance" clauses. Sometimes the policies have conflicting other insurance clauses. The competing carriers often bicker and sometimes even litigate which policy(ies) pay and how.

In Texas, the language of the "other insurance" clauses of the insurance contracts determine how liability is to be apportioned between insurers. *See Nutmeg Ins. Co. v. Employers Ins. Co. of Wausau*, 2006 U.S. Dist. LEXIS 7246 (N.D. Tex. Feb. 24, 2006); see also *St. Paul Mercury Ins. Co. v. Lexington Ins. Co.*, 78 F.3d 202, 206 (5th Cir. 1996). When insurance policies contain competing "other insurance" clauses, the court must examine the policies to determine whether the clauses "conflict or can be harmonized." *See, e.g., Hardware Dealers Mut. Fire Ins. Co. v. Farmers Ins. Exch.*, 444 S.W.2d 583, 584-85, 12 Tex. Sup. Ct. J. 570 (Tex. 1969) (court must consider "whether the two restrictive provisions conflict, and if so, how the conflict should be resolved"); *U.S. Fire Ins. Co. v. Aetna Cas. & Sur. Co.*, 781 S.W.2d 394, 396 (Tex. App.--Houston [1st Dist.] 1989, no writ); *Travelers Lloyds Ins. Co. v. Pac. Emplrs. Ins. Co.*, 2007 U.S. Dist. LEXIS 2191, *21 (N.D. Tex. 2007); see also 1 Allan D. Windt, Ins. Claims & Disputes § 7.1 (4th ed. 2001) (where there are competing other insurance clauses, the first question is "whether the clauses are contradictory").

As a general rule, where each of two liability insurance policies issued by different insurers provides primary coverage to the same insured in respect to the claim in question and contains mutually consistent "other insurance" provisions, the insurer paying more than its share of the claim is ordinarily entitled to recover from the other insurer for the excess so paid. *Am. Indem. Lloyds v. Travelers Prop. & Cas. Ins. Co.*, 335 F.3d 429, 435-36 (5th Cir. 2003). This appears to be the general rule in Texas. *See, e.g., Texas Employers Ins. v. Underwriting Members*, 836 F. Supp. 398, 404, n. 5 & 6 (S.D. Tex. 1993). Under Texas law, such recovery is not based on the theory that the separate policies create any contract between the two insurance companies issuing them to a common insured, nor upon common law contribution, but rather upon conventional or equitable subrogation to the rights of the common insured against the nonpaying insurer. *See id.; Employers Casualty Co. v. Transport Ins. Co.*, 444 S.W.2d 606, 610, 12 Tex. Sup. Ct. J. 560 (Tex. 1969).

If the "other insurance clauses" conflict, Texas law follows the rule of "dominant consideration" of the rights of the insured. *Hardware Dealers Mut. Fire Ins. Co. v. Farmers Ins. Exch.*, 444 S.W.2d 583, 590 (Tex. 1969); *Nutmeg Ins. Co. v. Emplrs Ins. Co.*, 2006 U.S. Dist. LEXIS 7246, *37 (N.D. Tex. 2006). Under this rule, if a conflict would cause a gap in the coverage for the insured, the policies must be prorated. *Hardware*, 444 S.W.2d at 590; *Nutmeg*, 2006 U.S. Dist. LEXIS 7246 at *37. However, if the terms of an insurance policy are clear and unambiguous, a court may not vary the policy's terms. *Canutillo Indep. Sch. Dist. v. National Union Fire Ins. Co.*, 99 F.3d 696, 700 (5th Cir. 1996).

C. Certificates of Insurance

Unfortunately, the certificate of insurance is the primary vehicle that businesses use to verify that insurance requirements have been met. The fact is, however, that these certificates are not worth the paper on which they are written. Typically, they do not include sufficient information to verify that all of the requirements are met, particularly when they are very specific and comprehensive. Instead, certificates provide evidence that certain general types of policies are in place on the date the certificate is issued and that these policies have the limits and policy periods shown. By their

express terms (as indicated on both front and the back of the form), the form disclaims providing any evidence of the terms of any policy mentioned in it. Texas courts have specifically held that, given these disclaimers, a purported additional insured is not justified in relying on these forms even as an indicia that coverage exists at all.

Moreover, certificates do not guarantee that:

(1) the coverage will not be canceled;

(2) limits will not be exhausted by claims in other projects or activities in which the party providing the certificates is involved;

(3) required endorsements will be attached to the policy; or

(4) the policy has not been neutered with restrictive endorsements. Some examples of details that generally would not be revealed on a certificate are the inclusion of a cross-liability exclusion endorsement, a contractual liability limitation endorsement, or a limited additional insured endorsement.

Some people maintain that the certificate holder only receives the benefit of the coverages and limits as shown on the certificate and no more. Others argue that the carriers are bound by the certificates. Neither argument holds water, however because the certificate does not alter, extend, or amend coverage. It is for information only, and it is the policy or policies applicable to the claim that control. RNA Invs., Inc. v. Employers Ins. of Wausau, 2000 Tex. App. LEXIS 7804, *12 (Tex. App.—Dallas 2000, no pet.) (holding that certificates of insurance could not create insurance coverage where none existed); Granite Constr. Co. v. Bituminous Ins. Cos., 832 S.W.2d 427, 429 (Tex. App.—Amarillo 1992, no pet.) (holding that the certificate of insurance did not manifest the insurance coverage afforded but rather evidenced the status as an insured and specified that the insurance coverage was provided by the insurance policies themselves)

VIII. The Relationship Between Primary And Excess Insurance Coverage

A. Understanding Some Basic Terms

1. *Primary Coverage*

Although the insurance industry has made efforts to simplify the insurance policy for the benefit of the policyholder, it still remains a formidable document not only to the policyholder but also to those with legal training. It is not surprising, therefore, that the determination of whether an insurance policy provides primary or excess coverage is not readily ascertainable from a review of the policy. While some insurance policies may be entitled "excess," and thus are specifically identified as excess insurance coverage, many insurance policies are not so identified. Accordingly, one must go beyond the title of the policy to ascertain if it provides primary or excess coverage.

In general, "primary insurance is coverage that attaches immediately upon the happening of an occurrence that is covered under the terms of the policy." BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 6.03 [a] (7th Ed. 1994), (citing *American Home Assur. Co. v. Republic Ins. Co.*, 984 F.2d 76 (2d Cir.), cert. denied, 113 S.Ct. 2964 (1993). *See also Union Indem. Ins. Co. v. Certain Underwriters at Lloyd's*, 614 F. Supp. 1015, 1017 (S.D. Tex. 1985) ("Primary insurance coverage is insurance coverage whereby, under the terms of the policy, liability attaches immediately upon the happening of the occurrence that gives rise to liability.") More importantly, the insurer who issues a primary policy typically has the duty to defend the policyholder. *See Harville v. Twin City Fire Ins. Co.*, 885 F.2d 276, 278-79 (5th Cir. 1989) (stating that "... the duty to defend rests primarily on the primary insurer.").

2. *Excess Coverage*

Excess insurance has been defined by the courts as follows:

> Excess or secondary coverage is coverage whereby, under the terms of the policy, liability attaches only after a predetermined amount of primary coverage has been exhausted. A second insurer thus greatly reduces his risk of loss. This reduced risk is reflected in the cost of the policy.

See Continental Marble & Granite v. Canal Ins. Co., 785 F.2d 1258, 1259 (5th Cir. 1986) quoting *Whitehead v. Fleet Towing Co.*, 110 Ill. App. 3d 759, 442 N.E. 2d 1362, 1366 (Ill.App.Ct. 1982). *See also Union Indem. Ins. Co. v. Certain Underwriters at Lloyd's*, 614 F. Supp. 1015, 1017 (S.D. Tex. 1985) (explaining that "an excess policy is one that provides that the insurer is liable for the excess above and beyond that which may be collected on primary insurance."); BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 6.03 [a] (7th ed. 1994).

A policyholder may have more than one layer of excess coverage. For example, the policyholder may have five million dollars of excess coverage under one policy and ten million dollars on top of the five million dollar amount under a separate insurance policy. The type and amount of excess coverage vary widely depending on the needs of the insured. There are four types of excess insurance policies. They include (a) following form; (b) specific excess; (c) umbrella; and (d) stand alone. See MANUAL FOR COMPLEX INSURANCE LITIGATION, ' 1.05 (1993).

(a) *Following Form Policies*

This type of excess insurance policy "follows the form" of the underlying policy. Thus, it will provide coverage for the same risks covered by the underlying policy. *Laster v. American Int'l Fire Ins. Co.*, 775 F. Supp. 985, 992 (N.D. Tex. 1991); *aff'd without op.*, 986 F.2d 676 (5th Cir. 1992)(A "following form insuring agreement is one that subjects the excess insurer to the terms, conditions and exclusions of the underlying policy"). Unless there is an express exception to the form of the underlying insurance, the excess insurance which is "following form" must respond according to the primary insurance policy's terms. *See Hartford Accident and Indem. Co., v. Pacific Employers Ins. Co.*, 862 F. Supp. 160, 162 (S.D. Tex. 1994). A typical following form provision reads as follows:

> Except to the extent the insuring agreements, terms, definitions, conditions and exclusions of this policy differ, the coverage provided by this policy shall follow the insuring agreements, definitions, conditions and exclusions of the first underlying insurance policy as shown in the schedule of underlying policies.

JACK P. GIBSON, ET. AL, 2 COMMERCIAL LIABILITY INSURANCE, X.B.3 (October 1986).

(b) *Specific Excess Policies*

This type of excess insurance policy provides excess coverage for only specified types of risks. *See* MANUAL FOR COMPLEX INSURANCE COVERAGE LITIGATION, ' 1.05 [b] (1994). For example, if the underlying insurance policy provides coverage for a wide range of risks such as personal injury, automobile liability, and products liability, the specific excess policy may only provide coverage for one or more of those risks (such as products liability).

(c) *Umbrella Policies*

Umbrella policies often provide broader coverage than the underlying insurance policies. Thus, an umbrella policy could conceivably be both primary and excess. But, as one commentator stated, "with respect to the risks not insured by the underlying policies, the policyholder usually is required to pay a self-insured retention before the umbrella policy applies to the claim or loss. Hence, the umbrella policy covers claims or losses in excess of a self-insured retention for certain risks and in excess of an underlying policy or policies for other risks." *See* MANUAL FOR COMPLEX INSURANCE COVERAGE LITIGATION, ' 1.05 [c] (1994).

> The umbrella policy is designed to fulfill three basic functions:
>
> 1. To extend the limits of the primary (underlying) liability policies;
>
> 2. To replace primary coverage once the primary aggregate limits of liability have been exhausted; and
>
> 3. To afford broader coverage (in some areas) than primary policies provide, subject to a retention amount.
>
> JACK P. GIBSON, ET. AL, 2 COMMERCIAL LIABILITY INSURANCE, X.B.3 (October 1986).

Often, the umbrella policy is distinguished from a pure "excess" policy in that the umbrella policy provides broad excess coverage and applies to certain risks not covered by the underlying policy whereas the pure excess policy does not. *Id.*

(d) *Stand Alone Policies*

This type of policy provides specific excess coverage that is not related to any underlying policy or self-insured retention. *See* MANUAL FOR COMPLEX INSURANCE COVERAGE LITIGATION, ' 1.05 [d] (1994). This type of policy provides excess limits for risks specifically defined in the policy itself.

JACK P. GIBSON, ET. AL, 2 COMMERCIAL LIABILITY INSURANCE, X.B.3 (October 1986). It relies exclusively on its own policy terms, conditions and exclusions. The insuring language of the underlying policy is thus inapplicable to the determination of coverage under the excess policy.

B. The "Other Insurance" Clause May Determine if a Policy is Primary or Excess

Although the issues arising out of an "other insurance" clause in a policy are beyond the scope of this article, the "other insurance" clause may be critical in determining whether or not the insurance policy provides primary or excess coverage. The term "other insurance" describes the situation in which two or more insurance policies cover the same risk. BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 11.01 (7th ed. 1994*). See also, Texas Employers Ins. Ass'n v. Underwriting Members of Lloyd's,* 836 F. Supp. 398, 405 n. 7 (S.D. Tex. 1993) ("An 'other insurance' clause addresses a situation where the claimant may be entitled to indemnification from more than one insurance policy.").

There are many types of "other insurance" clauses in insurance policies. They include the following: (1) the escape clause: under this type of "other insurance" clause the insurer shall have no liability if there is other insurance; (2) the pro rata clause: under this clause, the insurer's liability is limited to a proportional share of the loss; (3) the excess clause: under this type of "other insurance" clause the policy applies only as excess insurance over any other insurance. *See id*. In essence, the "other insurance" clause results in limiting or eliminating the liability of an insurer. *See Stracener v. United Servs. Auto. Ass'n,* 777 S.W.2d 378, 382 (Tex. 1989); 16 COUCH ON INSURANCE 2D, ' 62:41 (1983). Examples of the typical "other insurance" clauses:

- the excess clause

  Unless otherwise endorsed, this policy shall be excess over any other insurance whether prior or subsequent hereto, and by whomsoever effected, directly or indirectly covering loss or damage insured hereunder, and this company shall be liable only for the excess of such loss or damage beyond the amount due from such other insurance, whether collectible or not, however, not exceeding the limits as set forth in the Declarations.
- the pro rata clause

  If the insured has other insurance against liability or loss covered by this policy, the company shall not be liable for a greater proportion of such liability or loss than the applicable limit of liability bears to the total applicable limit of liability of all collectible insurance against such liability or loss.

- the escape clause

  If any other Assured included in this insurance is covered by valid and collectible insurance against a claim also covered by this Policy he shall not be entitled to protection under this Policy.

BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 11.02 (7th ed. 1994). By virtue of the above "other insurance" clauses, it is apparent that the applicable insurance policies must be carefully scrutinized before determining which policy provides primary coverage and which one provides excess coverage.

Sometimes a review of the competing "other insurance" clauses of policies will not help in determining which policy is primary and which is excess. In such instances, a review of the premiums may help distinguish between primary and excess policies. A comparison of the premiums for the policies may indicate which one was intended to be primary and which one was intended to be excess. *See* 16 COUCH ON INSURANCE 2D, ' 62:46 (1983). As the Fifth Circuit has noted, "excess liability insurer's contracts provide inexpensive insurance with high policy limits by requiring the insured to contract for primary insurance with another carrier. The premium is also held down by the fact that the duty to defend rests primarily on the primary insurer." *See National Union Fire Ins. v. CNA Ins. Co.*, 28 F.3d 29, 31 n.1 (5th Cir. 1994), *cert. denied*, 115 S.Ct. 1252 (1995).

C. The "Self-Insured Retention" As Primary Coverage

1. *"SIR" vs. "Deductible"*

At the outset, there is a difference between a self-insured retention (SIR) and a deductible. A "self-insured retention" is the dollar amount of a loss that is retained by the policyholder and not covered by insurance. See BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 13.13 (7th ed. 1994). Where there is an SIR under an excess or umbrella policy, it is often referred to as the "retained limit." *Id.*

2. *The Two Major Differences between an SIR and a Deductible*

(a) *The Effect Each Has on the Policy Limits*

If an insured has an SIR in the policy, the insurer's limits will not be available until the full amount of the SIR has been satisfied. This is not true with respect to a deductible. Since the insurer is not liable to pay its policy limits until the SIR is satisfied, the insurer's obligations may never be triggered if the insured becomes insolvent. Again, a deductible in a policy will not have this result.

(b) *The Effect Each Has on the Handling of Claims*

If an insured has an SIR, that generally means that the insured is responsible for handling claims under the policy. In contrast, a policy with a deductible will not afford that right (or duty) to the insured. Instead, all claims are to be reported to the insurer for handling. *Id*. at ' 13.13 [a] at 601.

With the distinction between a "self-insured retention" and deductible in mind, one can see how, under an SIR, the "primary coverage" may actually be provided by the insured and not the insurer (at least until the SIR has been satisfied).

IX. Primary And Excess Policies: Issues Related To The Defense Of The Insured

A. The Excess Insurer's Duty to Defend -- Generally

1. *Defined by the Policy*

As noted above, an insurer's defense obligation is contractual in nature and, therefore, an excess insurer's duty to defend, if any, is set forth in the provisions of the excess insurance policy. Suffice it to say, some excess and/or umbrella policies provide a defense obligation while others do not. Generally, umbrella policies provide defense obligations although those obligations vary widely depending upon the policy. Most umbrella policies provide for a duty to defend the insured in covered claims not insured by underlying insurance or when the underlying policy's limits have been exhausted and its defense obligation has ended. *See* JACK P. GIBSON, ET. AL, 2 COMMERCIAL LIABILITY INS. XI.B.11 (1995). A typical defense provision of this type is set forth below:

> A. We shall have the right and duty to defend any claim or suit seeking damages covered by the terms and conditions of this policy, even if the allegations are groundless, false or fraudulent, when:
>
> 1. the applicable limits of underlying insurance and other insurance have been exhausted by payments; or
>
> 2. damages are sought which are not covered by the terms and conditions of underlying insurance or other insurance.
>
> B. When we assume the defense of any claim or suit, we may investigate any occurrence and negotiate and settle any claim, suit or trial. We will pay our expenses as incurred in addition to the applicable limits of insurance stated in ... the declarations.
>
> *See* CRUM & FORSTER, FM 101.0.1108, cited in JACK P. GIBSON, ET. AL, 2 COMMERCIAL LIABILITY INS. XI.B.11 (1995).

2. *Only After Primary Coverage Exhausts*

One must look to the contractual provisions of the insurance policy to determine an excess carrier's defense obligations. Typically, however, an excess insurer's duty to defend is triggered only after the primary insurer's coverage has exhausted. This means that the excess insurer has no defense obligations until the limits of the primary policy have been exhausted. *Keck v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 20 S.W.3d 692, 700 (Tex. 2000). Most umbrella policies specifically provide for a duty to defend when (1) there are covered claims not insured by underlying insurance or (2) the underlying policy limits have been exhausted and its defense obligation has ended. JACK P. GIBSON, ET. AL, 2 COMMERCIAL LIABILITY INSURANCE XI.B.11 (June 1995).

In *Texas Employers Ins. Ass'n v. Underwriting Members of Lloyd's*, 836 F. Supp. 398 (S.D. Tex. 1993), the Court in applying Texas law held that an excess insurer was not obligated to participate in

the costs of defense until the primary policy limits were exhausted. In this case, the primary carrier argued that it tendered its policy limits thereby terminating its obligations and triggering the excess carrier's defense obligations. The primary carrier sought contribution from the excess carrier for the defense costs incurred by the primary carrier before the entry of a judgment or the making of a settlement which exceeded the limits of the primary policy. The Court found this to be a case of first impression under Texas law.

In reaching the conclusion that the excess carrier was not obligated to participate in the cost of the defense until the primary limits were exhausted, the Court first turned to the general principle that "where the insured maintains both primary and excess policies, the general rule is that an excess liability insurer is not obligated to participate in the defense until the primary policy limits are exhausted." *Id.* at 404 (citing 14 COUCH ON INSURANCE 2D ' 51:36 at 446). Then, in turning to a review of the excess policy, the Court found that the excess carrier had no contractual obligation to contribute to defense costs incurred before exhaustion of the primary limits. Incidentally, the Court also held that a mere declaration of a "tender" of policy limits by the primary carrier, unaccompanied by actual payment of settlement or judgment or production of policy proceeds into the registry of the Court, could not, in and of itself, constitute a valid "tender" of policy limits under Texas law.

Keck, Mahin, & Cate v. Nat. Union Fire Ins. confirmed this rule by holding "[t]he majority rule is that "[w]here the insured maintains both primary and excess policies, . . . the excess liability insurer is not obligated to participate in the defense until the primary policy limits are exhausted." 20 S.W.3d at 700 (internal citations omitted).

3. *No Obligation if the Primary Insurer is Insolvent*

What obligation, if any, does an excess insurer have to defend a policyholder when the underlying primary insurer becomes insolvent? Is the excess insurer required to "drop down" in place of the insolvent primary carrier and assume the defense obligations held by the primary carrier? Texas courts have addressed these questions.

In *Harville v. Twin City Fire Ins. Co.*, 885 F.2d 276 (5th Cir. 1989), the excess liability policy in issue provided that "the Company will defend any claim or suit against the insured seeking damages on account of injury or damage to which this policy applies and which no underlying insurer is obligated to defend ..." *Id.* at 278. The insured argued that since the primary insurer was placed into receivership, the primary insurer was no longer "obligated" to defend the insured. Therefore, the policyholder argued, the excess carrier would be obligated to provide a defense. The Fifth Circuit disagreed and held that the excess carrier was not obligated to cover the primary loss or to provide a defense. In part, the Fifth Circuit's holding was guided by a recognition of economic realities. That is, the premium on an excess insurance policy is less than the premium on a primary policy because the duty to defend rests primarily on the primary insurer.

Federal Ins. Co. v. Srivastava, 2 F.3d 98 (5th Cir. 1993) is in accord, holding that Texas courts do not require excess insurers to "drop down" in place of insolvent primary carriers. In *Mission Nat'l Ins. Co. v. Duke Transp. Co.*, 792 F.2d 550 (5th Cir. 1986), the court after first noting that the excess policy provided that the insurer would have a defense obligation if the occurrences were covered under the excess policy but not covered under underlying insurance then held that "covered" meant

only that some primary insurance applied, not that it applied and was collectible. *See also Continental Marble & Granite v. Canal Ins. Co.*, 785 F.2d 1258 (5th Cir. 1986) (stating that in construing the language of the excess policy, the court held that the primary insurance was not "inapplicable" even though the primary carrier was insolvent and thus the excess insurer was not obligated to "drop down" to defend the insured.); *Emscor Mfg., Inc. v. Alliance Ins. Group*, 879 S.W.2d 894 (Tex. App.—Houston [14th Dist.] 1994, writ denied) (holding also that an excess liability insurer has no duty to defend an insured in the event of the insolvency of the insured's primary liability carrier).

In *Taylor Serv. Co. v. Texas Property & Casualty Ins. Guar. Ass'n*, 918 S.W.2d 89 (Tex. App.—Austin 1996, no writ), the Austin Court of Appeals held that an excess carrier was not required to "drop down" if the primary carrier was insolvent, where the policy provided that it applied in excess of the applicable limit of insurance specified in the schedule of underlying insurance. The Court found that the literal meaning of this language was that an underlying insurer's insolvency did not enlarge coverage under the excess policy.

B. The Primary Insurer's Duty to Settle

1. *The Stowers Doctrine*

As discussed above, the primary insurer's duty to settle, based in contract, is also governed by the *Stowers* doctrine. Note here that a self-insured does not owe any *Stowers* type duties to the excess carrier. *See International Ins. Co. v. Dresser Indust., Inc*., 841 S.W.2d 437 (Tex. App.--Dallas 1992, writ denied).

2. *The Primary Insurer's Duty to Tender Its Limits*

When an insured has multiple layers of coverage available to it, the issue of the insured's accessibility to the upper limits can often be paramount. This is especially the case when an insured is faced with a settlement demand beyond the primary limits, but within the excess limits. In those instances, does the primary carrier have an obligation to tender its limits so as to trigger the coverage obligations to the insured afforded by the excess policy?

For many years, the question was an open one under Texas law. Recall that in *APIE v. Garcia*, the Texas Supreme Court held that the *Stowers* duty is not triggered where the settlement demand is above policy limits. The *Garcia* court went on to say, however, that it was not addressing "the *Stowers* duty when a settlement requires funding from multiple insurers and no single insurer can fund the settlement within the limits that apply to its particular policy." *See Garcia* 876 S.W.2d at 849, n. 13.

Under *Garcia* then, an insurer need only wait to respond to a reasonable settlement demand which is within the policy limits. Arguably, nothing beyond that is required of the insurer. This, of course, is a significant change from the broader language in *Stowers* which did not absolve the insurer from liability for failing to negotiate and affirmatively pursue a settlement of the claim. So does *Garcia* mean that, under all circumstances, a primary insurer is never required to tender its limits so as to effectuate a reasonable settlement? Take, for example, a common settlement scenario. Let us say an

insured has a primary policy with limits of $1,000,000.00 and an excess policy with limits of $5,000,000.00. In litigation, the insured is presented with a settlement demand of $1,000,025.00. Let us say the demand is reasonable.

According to *Garcia*, the primary insurer has no duty to do anything because the settlement demand is $25.00 over policy limits. Although the sensible thing would be for the insurer to settle, even though the demand exceeds policy limits, the insurer is free to act unreasonably by not settling and suffer no consequences. Furthermore, the insured has no recourse against the excess insurer because the excess insurer's obligation is not triggered until the primary limits are exhausted.

The unfortunate consequences of the *Garcia* opinion did not take long to manifest. In *Westchester Fire Insurance Co. v. American Contractors Ins. Co. Risk Retention Group*, 1 S.W.3d 872 (Tex. App.—Houston [1st Dist.] 1999), the court considered whether an excess insurer is entitled to equitable subrogation against a primary insurer for breach of its *Stowers* duty when the initial settlement demand exceeded the limits of the primary policy. The excess carrier in *Westchester* accused the primary carrier of mishandling the settlement negotiation in the underlying case and alleged that the primary carrier never intended to settle or negotiate in good faith. As such, the excess carrier sought equitable subrogation for the $1.3 million it paid in settlement of the case.

Citing the above-quoted language from footnote 13 of the *Garcia* opinion, the excess carrier urged the court to construe *Garcia* as an invitation to examine the *Stowers* duty anew in the context of multiple layers of insurance. The excess carrier then argued that, when an insured has multiple layers of excess insurance, the primary insurer should not be permitted to engage in misconduct in settlement negotiations. Unpersuaded, the *Westchester* court held that "nothing in [*Garcia*] . . . addresses whether affirmative misconduct should trigger the *Stowers* duty, and we decline to recognize such an exception. The opening demand of $1.8 million, although consonant with [defense counsel's] estimate of the case's value and apparently reasonable, was not within [the primary policy's] limits. Accordingly, the *Stowers* duty was not triggered." *Id.* at 874.

Courts have continued to apply the same rule: if the initial demand is not within the primary policy's limits, then a *Stowers* duty is not triggered, even if the demand falls within the limits of the combined primary and excess insurer's limits. *See AFTCO Enters. v. Acceptance Indem. Ins.*, 321 S.W.3d 65, 70 (Tex.App.—Houston [1st Dist.] 2010, pet. denied); *West Oaks Hosp., Inc. v. Jones*, No. 01-98-00879-CV, 2001 WL 83528, at *10 (Tex.App.—Houston [1st Dist.] Feb. 1, 2001, pet. denied) (not designated for publication).

C. The Excess Insurer's Duty to Settle

1. *The Applicability of Stowers to an Excess Insurer*

Can an insured pursue a *Stowers* action against an excess carrier? Although both *Stowers* and *Garcia* focused on a primary carrier's duties, neither case limited its holding to primary carriers. Arguably, the prerequisites of a *Stowers* action (claim within the scope of coverage; demand within policy limits; and reasonable demand) should equally apply to primary and excess carriers.

To date, no Texas Court has found an excess carrier liable under the *Stowers* doctrine. In *Emscor Mfg., Inc. v. Alliance Ins. Group*, 879 S.W.2d 894 (Tex. App.—Houston [14th Dist.] 1994, writ denied), the Houston Court of Appeals at least analyzed the applicability of the *Stowers* doctrine to an excess carrier. The Houston Court noted at the outset that the *Stowers* doctrine "has never been applied to an excess carrier like Alliance." (emphasis added). The language "like Alliance" suggests that the Court did not mean to say that an excess carrier could never be held liable under the *Stowers* doctrine. The reason the Court found no *Stowers* liability against the excess carrier was because the excess insurer had no contractual duty to defend the insured. This makes sense because (1) the excess carrier had no contractual duty to settle and (2) did not assume exclusive control of the defense of the case and therefore did not become an agent of the insured for purposes of settlement.

The *Emscor* holding leaves open the possibility of *Stowers* liability against an excess carrier. If an excess carrier is obligated to defend the insured, then there is no reason to believe that an excess carrier could escape *Stower*s liability.

2. *The Excess Insurer's Obligation to Contribute to a Settlement*

Generally speaking, an excess insurer has no duty to contribute to a settlement until the primary policy limits have been exhausted. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, ' 13.04 (7th ed. 1994). Texas follows this general rule. In *Union Indem. Ins. Co. v. Certain Underwriters of Lloyd's*, 614 F. Supp. 1015, 1017 (S.D. Tex. 1985), the court stated "in a situation in which there are primary and excess insurance coverages, the limits of the primary insurance must be exhausted before the primary carrier has a right to acquire the excess carrier to contribute to a settlement." *Id.* at 1017 (citations omitted). As the court explained, the excess insurer has a reduced risk, as reflected in the cost of the excess policy, as compared to the primary policy. *Id.* The court held that the obligations of the excess carrier under its policy were not triggered because the underlying primary limits were not exhausted.

Interestingly, in *Federal Ins. Co. v. Srivastava*, 2 F.3d 98 (5th Cir. 1993), the Fifth Circuit held that an excess insurer had no obligation to participate in a settlement where the excess policy provided that the insurance afforded would apply only in excess of and after all underlying insurance had been exhausted and only upon final determination of a loss where the court found that a trial court judgment on appeal with execution suspended by a supersedeas bond was not a final determination of loss under the excess policy.

Taking this analysis a step further, the Texas Supreme Court recently held that an excess carrier not only lacks a duty to settle before primary limits are exhausted, but also lacks a duty of ordinary care when faced with an opportunity to settle in that context. *See Keck v. National Union Fire Ins. Co. of Pittsburgh, P.A.*, 20 S.W.3d 692 (Tex. 2000). The *Keck* opinion primarily involved a suit by an excess carrier, National Union, against a primary carrier, INA, for negligently handling the insured's defense, resulting in an excess judgment. *Id*. at 695-96. As an affirmative defense, INA claimed that National Union was contributorily negligent. *Id.* at 701-02. Specifically, INA argued that National Union should have:

> [E]xplored coverage issues more diligently, reserved its rights against the insured, investigated the merits of the third-party claim more

> thoroughly, hired independent counsel to monitor the third-party claim, supervised its claims adjuster more closely, and demanded to settle the claim months before trial.

Id. at 702. The Texas Supreme Court rejected this argument, agreeing with the court of appeals that "National Union could not have been negligent in failing to take the actions suggested by INA because it had no duty to act before INA tendered its policy limits." *Id.*

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