SMU Annual Texas Survey

Volume 2

2016

Franchise Law

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I. INTRODUCTION

Texas courts continue to examine frequently-litigated franchising issues, and this Survey period produced a "blockbuster" development concerning joint-employer liability in the franchise context: the imposition of vicarious liability on the franchisor for labor law violations asserted by a franchisee's employees against the franchisee. In response to the National Labor Relations Board's recent decision to classify franchisors as joint-employers with their franchisees, the Texas Legislature passed a bill restricting such classification only to situations where the franchisor exercises direct control over those employees beyond what is necessary to protect the franchisor's brand. Other Texas cases during this Survey period provide guidance for franchisors on a number of procedural issues—including personal jurisdiction, choice-of-law, arbitration, and jury waiver provisions—and courts also continue to define the contours of common law and statutory claims in the unique franchising model.

II. PROCEDURE

A. Personal Jurisdiction

Two recent cases considered questions of personal jurisdiction in the context of minimum contacts with the State of Texas. In *Great American Food Chain, Inc. v. Andreottola*, the plaintiff was a Nevada company with its principal place of business in Texas that had hired Andreottola, a Georgia resident, as its president and director.[1] Andreottolla later allegedly "sought and obtained a position with defendants American Franchise Capital and Apple Central" (AFC defendants), who were residents of Delaware, Connecticut, and Kansas.[2] The plaintiff sued Andreottola and the AFC defendants in Texas for, *inter alia*, breach of contract and tortious interference with an existing contract.[3] After removing the case to federal court, the AFC defendants then moved to dismiss the case for lack of personal jurisdiction.[4]

The U.S. District Court for the Northern District of Texas focused on specific personal jurisdiction, considering whether the non-resident defendants had established minimum contacts in Texas by either (1) purposefully availing themselves of the benefits of conducting activities in Texas; or (2) purposely directing their activities at residents in Texas such that the alleged injuries arose from those activities.[5] The only alleged contacts that the AFC defendants had with Texas were the effects of the AFC defendants' alleged tortious interference between the plaintiff and Andreottola.[6] However, "in a commercial tort situation[,] the place of the

1. Great Am. Food Chain, Inc. v. Andreottola, No. 3:14-CV-1727-L, 2015 WL 493758, at *1, *3 (N.D. Tex. Feb. 4, 2015).
2. *Id.*
3. *Id.* at *1.
4. *Id.*
5. *Id.* at *2.
6. *Id.*

injury will usually be deemed to be the place where the critical events associated with the dispute took place."[7] In this particular case, the court found that none of the crucial events among the defendants occurred in Texas.[8] Moreover, the defendants must have purposefully directed their activities to Texas to establish minimum contacts.[9] Here, Andreottola's contract was set to be performed in Georgia, and the injurious acts (i.e., the AFC defendants' negotiations with Andreottola) did not take place in Texas.[10] The district court held these facts were "insufficient to confer specific jurisdiction" and dismissed the case.[11]

Great American serves as a reminder that personal jurisdiction cannot be established where the only minimum contacts stemmed from the plaintiff's residence and suffering of harm in the forum.[12] Instead, the defendant must have purposefully availed itself of the benefits of, or directed its activities to, the forum state.[13]

SGIC Strategic Global Investment Capital, Inc. v. Burger King Europe GMBH (*SGIC I*) presents another example of minimum contacts that will not confer personal jurisdiction.[14] In *SGIC I*, the plaintiffs (various interconnected entities and their shareholder) owned and operated Burger King franchises in Germany through various franchise agreements, and the franchise fee payments were personally guaranteed by plaintiff Christian Groenke (Groenke)—the sole shareholder of SGIC Strategic Global Investment Capital, Inc. (SGIC).[15] The plaintiffs alleged that Burger King induced Groenke to purchase shares of a certain corporation "in exchange for a development agreement and the opportunity to purchase [several] Burger King restaurants."[16] But Burger King later terminated the agreement and sold the restaurants to others.[17] When the plaintiffs' non-performing restaurants fell into bankruptcy, Groenke attempted to sell his shares in plaintiff SGIC to another buyer. Plaintiffs alleged that the deal fell through due to Burger King's contacts with the buyer.[18] While Burger King sued Groenke in Texas for franchise fees based on his personal guaranty, the plaintiffs filed a separate lawsuit against Burger King in Texas for tortious interference with a contract.[19] Burger King responded by moving to dismiss for lack of personal jurisdiction and on

7. *Id.* at *5 (quoting Jobe v. ATR Mktg., Inc., 87 F.3d 751, 753 n.3 (5th Cir. 1996)) (internal quotation marks omitted).
8. *Id.*
9. *Id.*
10. *Id.* at *3, *7.
11. *Id.* at *7.
12. *Id.* at *5 (citing Revell v. Lidov, 317 F.3d 467, 473 (5th Cir. 2002)).
13. *Andreottola*, 2015 WL 493758, at *6.
14. SGIC Strategic Glob. Inv. Capital, Inc. v. Burger King Europe GMBH, No. 3:14-CV-3300-B, 2015 U.S. Dist. LEXIS 89501 (N.D. Tex. July 9, 2015) [hereinafter *SGIC I*]. Haynes and Boone served as co-counsel for Burger King in this matter.
15. *Id.* at *2–3.
16. *Id.* at *3.
17. *Id.*
18. *Id.*
19. *Id.* at *4.

forum non conveniens grounds, and plaintiffs sought leave to conduct jurisdictional discovery.[20]

The U.S. District Court for the Northern District of Texas agreed with Burger King, finding that the plaintiffs "failed to make a preliminary showing of specific jurisdiction."[21] The district court, however, also noted that "[v]oluntarily filing a lawsuit may constitute purposeful availment and subject a party to personal jurisdiction in another lawsuit when the lawsuits arise from the same general transaction."[22] The plaintiffs argued that Burger King had submitted to personal jurisdiction in Texas by filing a lawsuit against Groenke, which Groenke argued was related to the present suit because he would never have entered the franchise agreement if not for Burger King's promises regarding the development agreement.[23] The district court, however, rejected plaintiffs' argument, finding that the present suit concerned Burger King's "alleged tortious interference with the sale of" Groenke's interest in SGIC—not Burger King's alleged actions regarding failed promises in the development agreement.[24] Because the two lawsuits did not arise from the same transaction, the district court ruled that Burger King had not purposefully availed itself of Texas's jurisdiction.[25]

SGIC I makes clear that the mere act of filing a separate lawsuit in a forum state does not, in itself, automatically confer jurisdiction upon that party in a different lawsuit. Even if that lawsuit stems from a related set of facts, both lawsuits *must* arise from the same general transaction within that set of facts.

B. Choice of Law

Gator Apple, LLC v. Apple Texas Restaurants, Inc. involved a choice-of-law provision dictating which state law should be applied to a breach of contract claim.[26] Gator Apple assumed a Florida franchise agreement with Applebee's. The agreement contained a choice-of-law provision prohibiting either party from soliciting the other's former employees within six months of their previous employment without first obtaining written consent.[27] In an unrelated transaction, Apple Texas also became a franchisee of Applebee's in North Texas.[28] Eventually, Gator Apple hired five former employees of Apple Texas without first obtaining a letter of release from Apple Texas.[29] Apple Texas, acting as a third-party beneficiary of Gator Apple's franchise agreement, sued Gator Apple for

20. *Id.*
21. *Id.* at *8, *10.
22. *Id.* at *8.
23. *Id.* at *8, *10.
24. *Id.* at *10–11.
25. *Id.*
26. Gator Apple, LLC v. Apple Tex. Rest., Inc., 442 S.W.3d 521, 530–31 (Tex. App.—Dallas 2014, pet. denied).
27. *Id.* at 525–26.
28. *Id.* at 526.
29. *Id.* at 528.

breach of contract for violations of the employment provision of Gator Apple's franchise agreement.[30] Apple Texas then moved for summary judgment, which the trial court granted and found, *inter alia*, that Kansas law governed the franchise agreement.[31] After the trial court entered final judgment for Apple Texas, Gator Apple filed a motion for a new trial. The trial court overruled the motion, and Gator Apple appealed.[32]

The Dallas Court of Appeals found that the trial court correctly applied Kansas law to the breach of contract claim as well as to the franchise agreement's liquidated damages provision.[33] First, the choice-of-law provision stated that Kansas law applied to the construction of the agreement and all questions arising with reference to it.[34] The court of appeals found that this provision, coupled with its stated purpose to ensure that all Applebee's franchise agreements be "uniformly interpreted," indicated the parties' "clear intent for the franchise agreement to be uniformly interpreted" across all similar franchise agreements with Applebee's.[35] Because the question of whether the contract was breached arose with reference to the agreement, the breach of contract claim was covered by the choice-of-law provision, and Kansas law applied to the claim.[36]

Second, the court of appeals considered Gator Apple's argument that, "even if the parties intended for Kansas law to apply to the performance of the franchise agreement," a choice-of-law analysis required the application of Texas law, particularly because Kansas law conflicted with Texas policy regarding the liquidated damages provision.[37] The court of appeals rejected this argument and concluded that the mere fact that the application of one state's law may lead to a different result does not mean it is contrary to the fundamental policy of the forum state.[38] Instead, the court of appeals turned to the Restatement to evaluate the express choice-of-law provision.[39] According to § 187(1) of the Restatement, a contractual choice-of-law provision must be applied unless the specific issue is one that could be resolved by an explicit provision.[40] Because the enforceability of a contract cannot be resolved by an explicit provision, the court of appeals found that the exception in § 187(1) did not apply.[41] Section 187(2) also requires that a contractual choice-of-law provision be applied unless either "the chosen state has no substantial relationship to the parties" or the application of the chosen state's law would be "contrary to

30. *Id.* at 529.
31. *Id.*
32. *Id.* at 529–30.
33. *Id.* at 534–35.
34. *Id.* at 530.
35. *Id.* at 531.
36. *Id.*
37. *Id.*
38. *Id.* at 532.
39. *Id.*
40. *Id.*
41. *Id.*

the fundamental policy of a state which has a materially greater interest."[42] The court of appeals found that Kansas had "a substantial relationship to the parties and the transaction" because Applebee's was headquartered in Kansas when Gator Apple entered the franchise agreement and Applebee's had to perform its obligations under the franchise agreement in Kansas.[43] By contrast, Texas had "no relationship with the franchise agreement at the time it was signed."[44] Gator Apple urged the court of appeals to consider the relationship that Texas had to the case given that Gator Apple hired Apple Texas employees.[45] But the court of appeals found no authority to support the argument that the court should consider the facts existing at the time of breach.[46] Thus, the court of appeals concluded that Kansas law applied to the breach of contract claim because no state had a more significant relationship at the time the contract was executed.[47]

Gator Apple reflects the importance of *timing* as it relates to a choice-of-law provision. Although a party's actions may involve the forum state after the execution of an agreement, the analysis focuses on the facts at the time the parties signed the contract—"contracts should be governed by the law the parties had in mind when the contract was made."[48]

C. Forum Selection

Pritchett v. Gold's Gym Franchising, LLC concerned the issue of whether a forum selection clause was incorporated by reference into a guaranty agreement.[49] In this case, Pritchett's daughter and her husband, on behalf of their corporation, entered into a franchise agreement with Gold's Gym for a Georgia location, which all three individuals, including Pritchett, personally guaranteed.[50] The parties later entered into a new franchise agreement, which contained a provision consenting to the jurisdiction of federal courts in Dallas County, Texas.[51] Pritchett's son-in-law, as president of the corporation, signed the new franchise agreement, and all three individuals signed the guaranty agreement (which Pritchett later denied).[52] Gold's Gym later filed suit against Pritchett, his daughter, and her husband for failure to pay franchise fees owed.[53] Asserting that he had no contacts with Texas, Pritchett filed a special appearance, but the

42. *Id.* at 532–33 (quoting Restatement (Second) of Conflict of Laws § 187(2)(a), (b) (Am. Law. Inst. 1989)).
43. *Id.* at 533.
44. *Id.* at 534.
45. *Id.*
46. *Id.*
47. *Id.* at 534–35.
48. *Id.* at 534 (quoting Sonat Expl. Co. v. Cudd Pressure Control Inc., 271 S.W.3d 228, 236 (Tex. 2008)).
49. Pritchett v. Gold's Gym Franchising, LLC, No. 05-13-00464-CV, 2014 WL 465450, at *3–4 (Tex. App.—Dallas Feb. 4, 2014, pet. denied) (mem. op.).
50. *Id.* at *1.
51. *Id.*
52. *Id.* at *4–5.
53. *Id.* at *2.

trial court denied the special appearance.[54]

The Dallas Court of Appeals affirmed the trial court's order, finding that Pritchett was subject to the forum selection clause because of the guaranty agreement.[55] Because a forum selection clause is *prima facie* valid, a party opposing the clause's enforcement bears a heavy burden of arguing against enforcement.[56] Pritchett argued that the forum selection clause did not apply to him because he did not sign the franchise agreement containing the forum selection clause.[57] The forum selection clause, however, explicitly applied to the "Owners" named in an attached exhibit to the agreement, which listed Pritchett's name.[58] Also, the guaranty agreement stated that the "Guarantors" (which the franchise agreement had defined as any "Owner" having a certain ownership interest in the corporation) "agree[d] to be personally bound by . . . each and every provision in the [franchise] [a]greement."[59] Pritchett initialed the ownership list and signed the guaranty agreement.[60] The court of appeals found that the language of the guaranty agreement reflected the parties' intent for the franchise agreement and forum selection clause to be part of the guaranty agreement.[61] Because the forum selection clause was incorporated by reference, it made no difference that Pritchett did not sign the franchise agreement containing the forum selection clause.[62] As a named "Owner," Pritchett was bound by the forum selection clause and waived any objection.[63] While Pritchett argued that his signature on the guaranty agreement was forged, the court of appeals adhered to the trial court's finding that Pritchett signed the agreement and denied the special appearance.[64]

Pritchett serves as a reminder that a non-signatory to a franchise agreement may still be bound if the party has signed a guaranty agreement incorporating the franchise agreement by reference.[65] Thus, even an unsigned document may become part of the contract if the language reflects the parties' intent to do so.[66]

In the *SGIC I* case, discussed above for its personal jurisdiction issues, the U.S. District Court for the Northern District of Texas also considered whether it could and should assert jurisdiction over the defendant in light

54. *Id.*
55. *Id.* at *6.
56. *Id.* at *3 (citing M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 10, 17, 19 (1972)).
57. *Id.* at *4.
58. *Id.*
59. *Id.* at *4–5.
60. *Id.*
61. *Id.* at *5.
62. *Id.*
63. *Id.* at *6.
64. *Id.*
65. *See id.* at *6 (citing *In re* 24R, Inc., 324 S.W.3d 564, 567 (Tex. 2010)).
66. *See id.* at *5 (citing One Beacon Ins. Co. v. Crowley Marine Servs., Inc., 648 F.3d 258, 267 (5th Cir. 2011); *In re 24R, Inc.*, 324 S.W.3d at 567).

of a forum selection clause (*SGIC II*).[67] The franchise agreements at issue contained a forum selection clause that named Munich, Germany as the forum for the litigation of any disputes between the parties.[68] After Burger King filed suit against Groenke in Texas for franchise fees due under a guaranty agreement with Groenke, Groenke and the other plaintiffs sued Burger King in the same court for tortious interference with a contract.[69] Burger King then filed a motion to dismiss for lack of jurisdiction and *forum non conveniens* based on the forum selection clause contained within the franchise agreements.[70]

The district court examined the forum selection clause under the doctrine of *forum non conveniens*, the legal mechanism for cases in which the transferee court is not within the federal court system.[71] The district court considered the motion under the following guidelines: (1) a plaintiff's choice of forum is irrelevant to the court's analysis; (2) the court should disregard the parties' private interest arguments; and (3) if "'a party has disregarded the forum selection clause and filed suit in a different forum,' a § 1404(a) transfer of venue will not carry with it the original venue's choice-of-law rules' which may, in some circumstances, affect a district court's evaluation of the public interest factors."[72] Similar to its previous jurisdictional analysis, the district court found that Burger King did not intend to waive its right to enforce the forum selection clause by filing suit against the plaintiff in Texas.[73] Although the franchise agreements contained a forum selection clause, the guaranty contract under which Burger King sued Groenke did not contain that clause.[74] Because Burger King sued Groenke under that distinct guaranty agreement, the district court held that Burger King could not have intended to waive its right to enforce the forum selection clause in the franchise agreements.[75]

Further, the district court found that the forum selection clause applied to all plaintiffs even though only plaintiff Groenke signed the franchise agreements.[76] "First, plaintiffs SGIC and GRIL directly benefitted from [Burger King's] performance under the franchise agreements" with Groenke.[77] Second, the plaintiffs' claims could be determined only by referring to certain provisions of the franchise agreements, so plaintiffs SGIC and GRIL could not selectively rely on those parts of the franchise agreements without being subject to the agreements' forum selection

67. SGIC Strategic Glob. Inv. Capital, Inc. v. Burger King Europe GMBH, No. 3:14-cv-03300-B, slip op. at 8 (N.D. Tex. Aug. 26, 2015) [hereinafter *SGIC II*].
68. *Id.* at 2.
69. *Id.* at 4; *SGIC I*, No. 3:14-CV-3300-B, 2015 U.S. Dist. LEXIS 89501 (N.D. Tex. July 9, 2015).
70. *SGIC II*, No. 3:14-cv-03300-B, slip op. at 1.
71. *Id.* at 8 (citing Atlantic Marine Constr. Co., Inc. v. U.S. Dist. Ct. for W. Dist. of Tex., 134 S. Ct. 568, 579–80 (2013)).
72. *Id.* at 10.
73. *Id.* at 20.
74. *Id.* at 20–21.
75. *Id.* at 21.
76. *Id.* at 21, 23.
77. *Id.* at 23.

clause.[78] Finally, the district court held that Germany's interest in resolving local disputes and the district court's avoidance of issues regarding conflict of laws or the application of foreign law weighed against keeping the suit in the Texas forum.[79] Accordingly, the district court granted Burger King's motion to dismiss.[80]

SGIC II presents another example of the strong tendency to enforce a valid and agreed forum selection clause. As with *Pritchett*, *SGIC II* shows that even non-signatories to a franchise agreement may be bound by any of its forum clauses, especially when the non-signatories have directly benefited from the other party's performance under the agreement.

D. Class Actions

In *Aguayo v. Bassam Odeh, Inc.*, plaintiffs were current or former fast food employees at the Jack in the Box restaurant owned and operated by the defendants.[81] The defendants also had ownership interest in other companies that owned and operated Jack in the Box and Qdoba franchises.[82] The plaintiffs alleged that the defendants regularly required them to work more than 40 hours per week without overtime compensation by falsely crediting the hours to fictitious employees and threatening to have the plaintiffs deported if they complained.[83] The plaintiffs filed suit under the Fair Labor Standards Act (FLSA) and asserted claims on behalf of similarly situated fast food employees who had worked for the defendants in the past three years in Texas and Louisiana and who were not paid for hours worked overtime.[84]

The U.S. District Court for the Northern District of Texas examined the presented evidence according to the following evidentiary requirements for the class certification of similarly situated aggrieved individuals:

> (1) there is a reasonable basis for crediting the assertion that aggrieved individuals exist; (2) those aggrieved individuals are similarly situated to the plaintiff[s] in relevant aspects given the claims and defenses asserted; and (3) those individuals want to opt in to the lawsuit.[85]

But a court will not certify a class if the claim arises from "purely personal" circumstances.[86]

First, the district court found that plaintiffs had stated a claim for the

78. *Id.* at 24.
79. *Id.* at 26.
80. *Id.*
81. Aguayo v. Bassam Odeh, Inc., No. 3:13-CV-2951-B, 2014 WL 737314, at *1 (N.D. Tex. Feb. 26, 2014).
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.* at *2–3 (quoting Morales v. Thang Hung Corp., No. 4:08-2795, 2009 WL 2524601, at *2 (S.D. Tex. Aug. 14, 2009)).
86. *Id.* at *3 (quoting Tolentino v. C & J Spec-Rent Servs. Inc., 716 F. Supp. 2d 642, 647 (S.D. Tex. 2010)).

aggrieved individuals by alleging that they were denied overtime pay.[87] The plaintiffs provided declarations identifying the fictitious employees used and alleging that the defendants applied this policy to all Hispanic employees.[88] Additionally, the defendants acknowledged that the same manager—accused of making threats—also worked at other franchise locations; accordingly, the court found that there was a reasonable basis for concluding that other aggrieved individuals existed.[89]

Second, plaintiffs detailed their duties as fast food employees and claimed to have worked at several other franchise locations.[90] Coupled with the fraudulent pay scheme using fictitious employees, the district court found that there was sufficient evidence to indicate that similarly situated individuals existed in this case.[91]

Third, based on the prior reasons, the district court found that similarly situated individuals would want to opt into the lawsuit.[92] Plaintiffs' declarations stated that they knew of other individuals who had also been denied overtime pay and argued that "courts have allowed for class certification without either the submission of statements from similarly situated employees or affidavits from named plaintiffs that provide specific information about other employees."[93]

Despite the above reasons, the district court found that the plaintiffs' proposed class was too broad without evidence indicating that the fraudulent pay scheme existed in restaurants in Louisiana or throughout Texas.[94] Instead, the evidence only showed that the plaintiffs and the manager who had threatened the plaintiffs had all worked in various franchise locations owned and operated by the defendants or by companies in which the defendants had an interest.[95] The district court limited the prospective class to current and former employees who had been denied overtime pay and had worked at specific franchise locations identified by the plaintiffs.[96]

Similarly, the U.S. District Court for the Western District of Texas in *Pacheco v. Aldeeb* conditionally certified a class based on minimal evidence of similarly situated aggrieved individuals who might want to join the lawsuit.[97] The plaintiffs were food service workers at fast food franchise restaurants. Two of the plaintiffs worked as managers in different locations.[98] The plaintiffs alleged that the defendants did not properly

87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.* at *4.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.* at *5.
95. *Id.*
96. *Id.*
97. Pacheco v. Aldeeb, No. 5:14-CV-121-DAE, 2015 WL 1509570, at *8 (W.D. Tex. Mar. 31, 2015).
98. *Id.* at *1.

compensate them for overtime, required unpaid work outside of their shifts, and made unlawful deductions from their paychecks in violation of the FLSA.[99] The plaintiffs sought conditional class certification of current and former employees who had worked in the defendants' franchise stores in Bexar and Kendall Counties within the three years preceding the suit.[100]

As in *Aguayo*, the district court used a three-step analysis to determine whether to certify the proposed class.[101] The district court, however, noted that its determination at that stage was made "using a fairly lenient standard because the court generally has minimal evidence and because [t]he remedial nature of the FLSA . . . militate[s] strongly in favor of allowing cases to proceed collectively."[102] And, affidavits and declarations based on personal knowledge are acceptable forms of evidence, regardless of whether such evidence would be admissible at trial.[103] The plaintiffs offered three declarations of employees who worked at some of the franchise locations, were not paid for their overtime work, and had spoken with other similarly situated employees.[104] The plaintiffs also alleged that the defendants' policies of denying overtime pay applied to many (if not all) employees. The plaintiffs presented paystubs indicating that they had not received overtime pay.[105] Based on this evidence, the district court found that the plaintiffs had offered sufficient evidence to support their allegations and to establish that aggrieved individuals existed.[106]

The district court ultimately found that only two of the plaintiffs were similarly situated to the proposed class, while the third plaintiff was not.[107] In its analysis, the district court determined whether the individuals executed the same basic tasks and experienced the same pay practices.[108] The district court held that two of the plaintiffs were similarly situated because they received the same hourly compensation, performed duties similar to those performed by non-supervisory employees, and faced the same policies of non-payment for overtime work.[109] On the other hand, the district court found that plaintiff Pacheco was not similarly situated because he had worked as an area manager, supervised operations for several locations, and was authorized to make personnel

99. *Id.* at *1–2.
100. *Id.* at *2–3.
101. *Id.* at *3–8.
102. *Id.* at *2 (quoting Lee v. Metrocare Servs., 980 F. Supp. 2d 754, 759 (N.D. Tex. 2013); Tolentino v. C & J Servs. Inc., 716 F. Supp. 2d 642, 647 (S.D. Tex. 2010) (internal quotation marks omitted).
103. *Pacheco*, 2015 WL 1509570, at *3–4.
104. *Id.* at *4.
105. *Id.*
106. *Id.* at *4–5.
107. *Id.* at *6.
108. *Id.* (quoting Tice v. AOC Senior Home Health Corp., 826 F. Supp. 2d 990, 996 (E.D. Tex. 2011)).
109. *Id.*

decisions.[110] Although serving in a managerial role does not, standing alone, preclude one from representing non-managerial employees, Pacheco had markedly different responsibilities, was paid on a unique bonus compensation plan, and was initially hired by the defendants as an independent contractor.[111] Accordingly, the district court found that Pacheco could proceed as an individual plaintiff but could not join the class.[112]

Finally, the district court found that the plaintiffs established that other aggrieved individuals would join the suit by presenting minimal evidence—plaintiffs' declarations referring to over 100 employees that had worked at some of the locations.[113] In fact, two opt-in plaintiffs had already filed notices to join the suit.[114] The district court also allowed the plaintiffs to send notice of the class action by posting notices in the defendants' franchise locations.[115] While the defendants objected that such postings would damage their reputation, the district court noted that the notice should be placed at a location readily accessible only to the defendants' employees, not its customers.[116]

Aguayo and *Pacheco* are similar cases but with one key difference: the district court excluded plaintiff Pacheco because his duties and pay were not sufficiently similar to the other plaintiffs in the suit and to the members of the proposed class.[117] *Pacheco* indicates that although some managerial employees may remain in a class with non-managerial employees, the line drawn depends upon the specific duties and pay scheme of each individual plaintiff. While the evidentiary standard is low, a court may still exclude an individual plaintiff from a class action if that plaintiff's circumstances are not sufficiently similar to the proposed class members.

E. Arbitration

As arbitration provisions are common in franchise agreements, courts continue to explore the scope of those provisions to determine which claims may be litigated. In *DXP Enterprises v. Goulds Pumps, Inc.*, the U.S. District Court for the Southern District of Texas traversed the issue

110. *Id.*

111. *Id.* at *6–7 (citing Aguilar v. Complete Landsculpture, Inc., No. 3:04 CV 0776 D, 2004 WL 2293842, at *4 (N.D. Tex. Oct. 7, 2004)).

112. *Id.* at *7 (citing Tolentino v. C & J Spec-Rent Servs. Inc., 716 F. Supp. 2d 642, 647 (S.D. Tex. 2010) ("Requiring a prospective class to share similar job requirements and pay provisions ensures the economy of scale and judicial efficiency envisioned by the FLSA by avoiding the need for individualized inquiries into whether a defendant's policy violates the FLSA as to some employees but not others.")).

113. *Id.* at *8.

114. *Id.*

115. *Id.* at *9.

116. *Id.* Previous courts have even approved posting notice in newspapers and radio advertisements over objections of reputational damage. *Id.* (citing Rodriguez v. Mech. Tech. Servs., Inc., 299 F.R.D. 154, 156–57 (W.D. Tex. 2014); Romero v. Producers Dairy Foods, Inc., 235 F.R.D. 474, 493 (E.D. Cal. 2005); Johnson v. Am. Airlines, Inc., 531 F. Supp. 957, 961 (N.D. Tex. 1982)).

117. *Id.* at *6.

of whether an arbitration provision containing an exception for equitable remedies allowed a party to seek a permanent injunction in court.[118] DXP, an industrial equipment dealer, signed a distributor agreement with Goulds, a manufacturer of pumps, parts, and accessories.[119] The distributor agreement contained an arbitration clause that covered any controversy or claims "arising out of or related to" the agreement.[120] When the relationship between the parties soured, Goulds sought to terminate the agreement and demanded arbitration.[121] DXP responded with a lawsuit and sought preliminary and permanent injunctions to prevent termination without statutory notice or good cause.[122] The parties agreed to stay termination pending arbitration, and the district court denied the preliminary injunction.[123]

The district court then considered DXP's motion for a permanent injunction under federal policy and statutes favoring arbitration.[124] DXP's ability to seek a permanent injunction through litigation depended upon whether its claim fell under any exception within the arbitration clause.[125] While broadly covering claims arising out of or related to the agreement, the arbitration provision also allowed either party to seek "an equitable remedy (such as a Restraining Order or Injunction)" in court.[126] In cases involving similar contractual language, courts have held that under this exemption a party may seek a "temporary injunctive relief to maintain the status quo" but cannot do so if it "would require the court to consider and decide the merits of a[ ] . . . claim" that could otherwise be arbitrated.[127] Instead, courts have required "the most forceful evidence" to allow parties to litigate all claims for injunctive relief that would otherwise appear before the arbitrator.[128] Thus, "[a]ribtration agreements that lack such unambiguous language and simply state that parties can ask courts for injunctive relief 'notwithstanding' an agreement to arbitrate do not sufficiently show that claims for permanent injunctive relief are nonarbitrable."[129] Because the distributor agreement did not contain clear

118. DXP Enters. v. Goulds Pumps, Inc, No. H-14-1112, 2014 U.S. Dist. LEXIS 156158, at *1–2 (S.D. Tex. Nov. 4, 2014).
119. *Id.* at *2.
120. *Id.*
121. *Id.* at *4–5.
122. *Id.* at *5.
123. *Id.* at *5–6.
124. *Id.* at *7–8.
125. *See id.* at *9–11.
126. *Id.* at *3, *9.
127. *Id.* at *11–12 (citing Comedy Club, Inc. v. Improv West Assocs., 553 F.3d 1277, 1281–82, 1285 (9th Cir. 2009); WMT Inv'rs, LLC v. Visionwall Corp, No. 09-CIV-10509-RMB, 2010 U.S. Dist. LEXIS 65869, at *2–4 (S.D.N.Y. June 28, 2010); Clarus Med., LLC v. Myelotec, Inc., No. 05-934, 2005 U.S. Dist. LEXIS 30540, at *3–4 (D. Minn. Nov. 30, 2005)).
128. *Id.* at *15–16 (quoting AT&T Tech., Inc. v. Comms. Workers of Am., 475 U.S. 643, 650 (1986)). The district court cited several examples of such strong evidence, including *Dickeys Barbecue Restraunts v. Mathieus*. *Id.* (citing Dickeys Barbecue Rests. v. Mathieu, No. 3:12-cv-5119-G, 2013 U.S. Dist. LEXIS 133204, at *5 (N.D. Tex. Sept. 18, 2013)).
129. *Id.* at *16–17 (citing Lawrence v. Comprehensive Bus. Servs. Co., 833 F.2d 1159, 1164 (5th Cir. 1987); *Clarus Med.*, 2005 U.S. Dist. LEXIS 30540, at *3–4; ESecuritel Hold-

evidence of the parties' intent to allow claims for permanent injunctive relief to be litigated, the district court found that DXP's claim should be submitted to arbitration.[130]

The district court also made much of the fact that the issue that DXP sought to litigate was the very same issue that Goulds had already brought before arbitration—that is, whether Goulds could terminate the agreement based on DXP's prior alleged breach.[131] A finding that DXP had not breached the agreement and preventing Goulds from terminating the agreement would effectively deny Goulds the opportunity to have an arbitrator decide the issues, which would defeat the purpose of a valid arbitration clause.[132]

DXP serves as a cautionary case for parties including an arbitration clause in their franchise agreement: "notwithstanding" language conflicts with the arbitration provision and does not provide sufficiently clear or explicit exemptions for permanent injunction claims.[133] Although the line is not so easily drawn, the *DXP* ruling indicates a preference that exemptions from arbitration be identified and stated using explicit language.

Allee Corp. v. Reynolds & Reynolds Co. also reflects an inclination to broadly interpret an arbitration clause to include all possible claims.[134] Two car dealerships sued a professional services company for wrongfully deleting its electronic business records, alleging causes of action for declaratory judgment, negligence, and breach of contract.[135] The defendant moved to compel arbitration based on the arbitration clause in the contract.[136]

Once again, the U.S. District Court for the Northern District of Texas considered whether a plaintiff's claims could be litigated under a strong presumption that favors arbitration.[137] The arbitration clause covered "[a]ny disputes . . . related directly or indirectly" to the agreement or an exhibit specifying items or services—language that indicated a broad ar-

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ings v. Youghiogheny, No. 4-12-0302-cv, 2012 Tex. App. LEXIS 10017, at *3–4 (Tex. App.—San Antonio Dec. 5, 2012, pet. denied)).

130. *DXP Enters.*, 2014 U.S. Dist. LEXIS 156158, at *18, *20.

131. *Id.* at *8–9.

132. *Id.* at *19–20 (citing Halide Grp Inc. v. Hyo-sung Corp., No. 10-02392, 2010 U.S. Dist. LEXIS 118739, at *3–4 (E.D. Pa. Nov. 8, 2010); H2O to Go, LLC v. Martinez, No. 05-21353, 2005 U.S. Dist. LEXIS 49317, at *4–5 (S.D. Fla. Aug. 22, 2005); Baychar v. Frisby Techs., No. 01-cv-28-B-S, 2001 U.S. Dist. LEXIS 11037, at *9 (D. Me. July 26, 2001)).

133. *See id.* at *12–13, *16–18; *cf. Dickeys*, 2013 U.S. Dist. LEXIS 133204, at *6–9 (finding that all claims for injunctive relief were excluded from arbitration where the provision contained the word "notwithstanding" while exempting claims for injunctive relief in court and without having first been brought to arbitration).

134. *See generally* Allee Corp. v. Reynolds & Reynolds Co., No. 3:15-CV-0744-D, 2015 U.S. Dist. LEXIS 55548 (N.D. Tex. Apr. 28, 2015).

135. *Id.* at *1–2.

136. *Id.* at *3.

137. *Id.* at *13–14 ("Thus the party seeking to compel arbitration need only show that the arbitration clause can plausibly be read to cover the dispute in issue.") (citing Neal v. Hardee's Food Sys., Inc., 918 F.2d 34, 37 (5th Cir. 1990)).

bitration clause.[138] Given this low bar, the district court found that the defendant established that the plaintiffs' claims related at least indirectly to the agreement.[139] The plaintiffs alleged that the defendant breached the agreement and complained about the defendant's services performed under the agreement.[140] The plaintiffs also argued that the defendant's assertion that the amount in controversy for the case was $1.7 million indicated that the parties' dispute related to failures to pay amounts due under the agreement—an explicit exception to the arbitration clause.[141] The district court rejected the plaintiffs' attempts to use the amount in controversy assertion outside of its intended context.[142] However, even if the plaintiffs had presented sufficient evidence, "[w]hen the scope of an arbitration clause is reasonably in doubt, it should be construed in favor of arbitration. . . . This strong presumption in favor of arbitration applies with even greater force when the parties include a broad arbitration clause."[143]

The *DXP* and *Allee* holdings stand as prime examples of the continuing, strong inclination to give effect to an arbitration clause reasonably interpreted as broad in scope.

F. Jury Waiver Provisions

In *Yumilicious Franchise, L.L.C. v. Barrie* (*Yumilicious I*), franchisor Yumilicious sued the franchisee and its individual guarantors for breach of two franchise agreements after the franchisee failed to make payments and closed a store without Yumilicious's prior consent.[144] After the defendants counterclaimed that Yumilicious had fraudulently induced them into entering the franchise agreements, Yumilicious moved to dismiss the counterclaims and to strike defendants' jury demand based on a jury waiver provision in one of the franchise agreements.[145] The defendants argued that the individual defendants were not bound by the waiver because they were not parties to the franchise agreement, while Yumilicious responded that language in the guaranty agreement bound the individual defendants to the waiver provision.[146]

The U.S. District Court for the Northern District of Texas determined that Yumilicious did not prove that the defendants had "waived their right to a jury trial."[147] As a protected constitutional right, the right to a

138. *Id.* at *14–16 (citing *In re* Complaint of Hornbeck Offshore (1984) Corp., 981 F.2d 752, 755 (5th Cir. 1993)).
139. *Id.* at *16–17.
140. *Id.* at *17.
141. *Id.* at *18.
142. *Id.* at *18–19.
143. *Id.* at *19–20 (quoting Sharifi v. AAMCO Transmission Repair Ctrs., 2007 U.S. Dist. LEXIS 47311, at *2 (N.D. Tex. June 28, 2007)).
144. Yumilicious Franchise, L.L.C. v. Barrie, No. 3:13-CV-4841-L, 2014 WL 4055475, at *1 (N.D. Tex. Aug. 14, 2014) [hereinafter *Yumilicious I*].
145. *Id.* at *1, *10–11.
146. *Id.* at *10.
147. *Id.* at *12.

jury trial carries a presumption against its waiver.[148] A party may overcome this presumption by presenting sufficient evidence of a contractual waiver that "was made knowingly, voluntarily, and intelligently."[149] The district court then followed the majority of federal courts in concluding "that the party seeking to enforce the waiver has the burden of establishing it."[150]

The district court considered whether the waiver "was made knowingly, voluntarily, and intelligently" according to the following factors:

> (1) whether there was gross disparity in bargaining power between the parties; (2) the business or professional experience of the party opposing the waiver; (3) whether the opposing party had an opportunity to negotiate contract terms; and (4) whether the clause containing the waiver was inconspicuous.[151]

The district court found that the waiver provision was conspicuous because the words were bolded and the letters were capitalized.[152] However, the contractual language that bound the franchisee's beneficiaries to the franchise agreement was not bolded or capitalized and, thus, not conspicuous.[153] Further, the guaranty agreement did not specifically refer to the jury waiver provision as it did other franchise agreement provisions.[154] Because Yumilicious failed to establish the other factors, the district court denied the motion to strike the defendants' jury demand.[155]

The holding in *Yumilicious I* indicates that a party seeking to enforce a contractual waiver of the right to a jury trial against individual guarantors must submit evidence that specifically ties the individuals to the general franchise agreement.[156] Where a guaranty agreement references some sections of the franchise agreement but not others, a court may find that the individual guarantors did not intend to bind themselves to all provisions of the franchise agreement.[157] *Yumilicious I* also signals an inclination to place the burden on the party seeking to enforce a jury trial waiver, although the U.S. Court of Appeals for the Fifth Circuit has not yet determined that issue.[158]

G. Statute of Limitations

The *Yumilicious* court also considered the statute of limitations for counterclaims based on violations of the Texas Deceptive Trade Prac-

148. *Id.* at *11.
149. *Id.*
150. *Id.*
151. *Id.* (quoting RDO Fin. Servs. Co. v. Powell, 191 F. Supp. 2d 811, 813–14 (N.D. Tex. 2002)).
152. *Id.*
153. *Id.*
154. *Id.*
155. *Id.* at *12.
156. *See id.* at *11–12.
157. *See id.* at *11.
158. *See id.*

tices-Consumer Protection Act (DTPA) (*Yumilicious II*).[159] When Yumilicious sued the franchisees for failing to make payments and prematually closing a yogurt shop, defendants counterclaimed that Yumilicious violated the DTPA by providing a materially deficient franchise disclosure document (FDD).[160]

In *Yumilicious I*, Yumilicious moved to dismiss the DTPA counterclaim, asserting that the claim was barred by the DTPA's two-year statute of limitations.[161] The district court agreed, finding that the statute of limitations had expired before the defendants had asserted their counterclaims.[162] According to the defendants, Yumilicious had provided an FDD that was dated two years earlier than the franchise agreement and incorrectly stated that Yumilicious had provided earnings financial performance representations six weeks before the defendants signed the franchise agreements.[163] The district court dismissed these arguments, noting that the defendants acknowledged having received the document in the same month they signed the franchise agreement.[164] Because that event triggered the statute of limitations, which expired by the time the defendants asserted their counterclaim, the district court held that the DTPA claim was barred.[165]

But when the defendants subsequently moved for reconsideration in *Yumilicious II*, the district court found that the DTPA claim was not barred by the statute of limitations for DTPA claims.[166] Instead, the statute of limitations for counterclaims permitted the DTPA claim.[167] First, the district court considered the defendants' argument that the discovery rule saved their DTPA claim, because "[t]he discovery rule tolls a statute of limitations 'until the plaintiff knew or . . . should have known of the facts giving rise to [the claim].'"[168] The defendants claimed they did not discover the ongoing fraudulent misrepresentations until shortly before the stores failed and the suit commenced.[169] The district court found that the defendants did not meet their burden of affirmatively pleading the discovery rule and, thus, had waived the matter.[170] Even if the defendants had met this requirement, the district court determined that their pleadings did not establish that Yumilicious's alleged misrepresentations continued for two years until the stores failed because all the alleged

159. *See generally id.*; Yumilicious Franchise, L.L.C. v. Barrie, No. 3:13-CV-4841-L, 2015 WL 1822877 (N.D. Tex. Apr. 22, 2015) [hereinafter *Yumilicious II*].
160. *Yumilicious I*, 2014 WL 4055475, at *1, *4.
161. *Id.* at *3.
162. *Id.* at *4.
163. *Id.*
164. *Id.*
165. *Id.*
166. *Yumilicious II*, No. 3:13-CV-4841-L, 2015 WL 1822877, at *1–3 (N.D. Tex. Apr. 22, 2015).
167. *Id.*
168. *See id.* at *1–2 (citing Barker v. Eckman, 213 S.W.3d 306, 311–12 (Tex. 2006)).
169. *See id.*
170. *Id.* at *2 (citing Woods v. William M. Mercer, Inc., 769 S.W.2d 515, 518 (Tex. 1988)).

misrepresentations occurred before the franchise agreements were signed.[171] The defendants also claimed that they were not aware that Yumilicious's requirement that the franchisee purchase the products in bulk, pallet-sized quantities would lead to their franchise business being unable to compete with other yogurt shops.[172] The defendants, however, were aware of this requirement from the beginning. While Yumilicious stated that "it was in the process of negotiating a contract with a national distributor" to obtain fair market prices, Yumilicious did not assure the defendants that such negotiations would eliminate the bulk-size purchase requirement.[173] Because the defendants were aware of these circumstances before entering the franchise agreements, the district court found that the "[d]efendants knew or reasonably should have known the facts giving rise to their DTPA claim," such that the discovery rule did not toll the statute of limitations.[174]

On the other hand, the district court then accepted the defendants' argument that their DTPA claim was not barred under § 16.069 of the Texas Civil Practice and Remedies Act regarding the statute of limitations for counterclaims.[175] Although the two-year statute of limitations for DTPA claims had expired, the statute of limitations for counterclaims had not.[176]

Yumilicious II suggests that certain facts or events that occur before a franchisee enters a franchise agreement may not be sufficient to toll the statute of limitations under the discovery rule if the franchisee was aware of their existence before entering the franchise agreement. Further, while DTPA claims are typically subject to a two-year statute of limitations, counterclaims are subject to the general statute of limitations for counterclaims.

III. INTELLECTUAL PROPERTY—TRADEMARKS

In *New York Pizzeria, Inc. v. Syal*, the U.S. District Court for the Southern District of Texas considered whether a pizzeria franchisor could pursue claims against a former franchisee, and individual defendants, for infringement of a distinctive flavor mark and plating trade dress.[177]

New York Pizzeria, Inc. (NYPI), a franchisor of pizza restaurants, filed suit alleging that a former vice president of NYPI and owner of an NYPI-franchised restaurant conspired with others "to create a knockoff restaurant chain called Gina's Italian Kitchen using NYPI's [trade secrets and proprietary information, including] recipes, suppliers, and internal docu-

171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.*
175. *Id.* at *3.
176. *Id.* The district court eventually dismissed the defendants' DTPA claims on other grounds. *See infra* Section V.A. Texas Deceptive Trade Practices—Consumer Protection Act.
177. N.Y.C. Pizzeria, Inc. v. Syal, 56 F. Supp. 3d 875, 877 (S.D. Tex. 2014).

ments and manuals."[178] NYPI argued that the defendants "infringed on its trademarks and trade dress," and brought "two distinct claims under the Lanham Act."[179] One claim related to the "'distinctive flavor' of NYPI's [food]"; the other related "to the distinctive presentation, or 'plating,' of [NYPI's] dishes."[180]

First, NYPI argued that its "specially sourced branded ingredients and innovative preparation and preservation techniques contribute[d] to the distinctive flavor" of its products.[181] And by using those ingredients and processes, defendants had "infringed and/or diluted NYPI's protected trademark interest in the distinctive trademark flavor of its products" and were therefore liable under the Lanham Act.[182]

The district court noted that while there was "no special legal rule" in the Lanham Act that prevented a flavor from serving as a trademark, "it is the source-distinguishing ability of a mark—not its ontological status as color, shape, fragrance, word, or sign—that permits it to serve [trademark] purposes."[183] The district court found that it is possible for flavor to "'carry meaning' . . . only if it distinguishes the source of a product"; however, it is only when a flavor has acquired distinctiveness, or "secondary meaning," that the flavor has any chance to serve as a valid trademark.[184]The district court also found that it was unlikely that flavors—like colors—could "ever be inherently distinctive because they do not automatically suggest a product's source."[185] Thus, the district court held that in order to be protectable as a trademark, a flavor must have acquired secondary meaning such that customers associate the flavor with its source.[186]

In addition, the district court addressed the functionality doctrine: "A product feature is functional if 'it is essential to the use or purpose of the article or if it affects the cost or quality of the article, that is, if exclusive use of the feature would put competitors at a significant non-reputation-

178. *Id.* at 877.

179. *Id.* at 880 (citing 15 U.S.C. § 1125(a)).

180. *Id.*

181. *Id.* (quoting First Amend. Compl. at ¶ 76, N.Y.C. Pizzeria, Inc. v. Sval, 56 F. Supp. 3d 875 (S.D. Tex. 2014) (No. 3:13-cv-00335), 2013 WL 11109493).

182. *Id.* (quoting First Amend. Compl. at ¶ 77, N.Y.C. Pizzeria, Inc. v. Sval, 56 F. Supp. 3d 875 (S.D. Tex. 2014) (No. 3:13-cv-00335), 2013 WL 11109493).

183. *Id.* at 880–81.

184. *Id.* at 881.

185. *Id.*

186. *Id.* (citing Sunbeam Prods., Inc. v. W. Bend Co., 123 F.3d 246, 252 (5th Cir. 1997) ("[T]he essence of a protected mark is its capacity to distinguish a product and identify its source."); Wal-Mart Stores, Inc. v. Samara Bros., Inc., 529 U.S. 205, 211 (2000) ("[A] mark has acquired distinctiveness, even if it is not inherently distinctive, if it has developed secondary meaning, which occurs when, 'in the minds of the public, the primary significance of a [mark] is to identify the source of the product rather than the product itself.'"); *In re* N.V. Organon, 79 U.S.P.Q.2d 1639, at *15 (T.T.A.B. June 14, 2006) ("Because flavor is generally seen as a characteristic of the goods, rather than as a trademark, a flavor, just as in the cases of color and scent, can never be inherently distinctive.")).

related disadvantage.'"[187] In the case of food, the district court observed that the functionality hurdle may be insurmountable because the "flavor of food undoubtedly affects its quality, and is therefore . . . a functional element of the product."[188]

NYPI was "unable to cite any case recognizing a trademark in the flavor of food."[189] Indeed, NYPI did "not allege that its supposedly unique flavoring was merely an identifier, and any such allegation would be implausible given that the flavor of pasta and pizza has a functional purpose."[190] Therefore, the district court dismissed NYPI's trademark claim.[191]

Next, the district court considered NYPI's plating infringement claim and found that "[w]hile the flavor infringement claim [was] plainly half-baked, NYPI's plating infringement claim deserve[d] closer consideration" because, unlike the flavor infringement claim, plating does not always serve a functional purpose.[192] NYPI alleged a protected trade dress interest in "the distinctive visual presentation of the product to customers . . . [which] includes, but is not limited to, the presentation of baked ziti, eggplant parmesan, and chicken parmesan."[193]

The district court recognized that there might be some rare circumstances in which the plating of food could be given trade dress protection, for example, for a well-known "signature dish."[194] But, in the trade dress context, a plaintiff must articulate the elements that comprise its protected trade dress so that the district court can evaluate the plausibility of its claim and the defendant has fair notice of the grounds of the claim.[195] Here, the district court held that NYPI did not identify its trade dress with sufficient particularity because NYPI did not explain why its dishes' presentations were distinctive and nonfunctional, or how they were infringed.[196] Therefore, the district court dismissed NYPI's trade dress claim.[197]

Though this may seem like a tough ruling for franchisors of distinctive food flavors, it is an appropriate outcome. Otherwise, the first food distributor to trademark a flavor profile could prevent all others from replicating that flavor and could greatly restrict innovation in our food supply.

The ruling also makes sense because food vendors can still rely on

187. *Id.* (citing Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159, 165 (1995) (internal quotation marks omitted)).

188. *Id.* at 882 (citing *Qualitex*, 514 U.S. at 165).

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.* at 883 (citing Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007); Alpha Kappa Alpha Sorority, Inc. v. Converse Inc., 175 F. App'x 672, 677–81 (5th Cir. 2006)).

196. *Id.*

197. *Id.*

trade secret law to protect their recipes.[198] However, this case serves as a good reminder to those in the restaurant industry to protect their trade secrets. For example, franchisors should take precautions to guard their cooking secrets and to ensure that they are employing effective nondisclosures and confidentiality agreements with their franchisees.[199]

IV. COMMON LAW CLAIMS

A. Contract Issues—The Duty of Good Faith and Fair Dealing

Texas courts impose extra-contractual duties of "good faith and fair dealing" only when a special relationship between the parties exists.[200] These duties generally result from the unequal bargaining positions between parties to a contract.[201] Texas courts have found no special relationship between or among the parties to an extensive laundry list of contractually-based transactions.[202] In particular, Texas courts have found no special relationship exists between parties to a franchise agreement.[203] In *Williamson-Dickie Manufacturing Co. v. Apparel Ltd, Inc.*, the U.S. District Court for the Northern District of Texas considered whether Texas would recognize a special relationship between a licensor and licensee.[204] Not surprisingly, the district court determined that no special relationship existed.[205]

Williamson-Dickie Manufacturing Co. (Williamson-Dickie) and Apparel Ltd. (Apparel) entered into a licensing agreement granting Apparel the exclusive right to sell Williamson-Dickie branded products using Williamson-Dickie's trademarks through "authorized channels," including mass-merchandisers, in the United States.[206] After Williamson-Dickie sued Apparel, Apparel counterclaimed for breach of good faith and fair dealing based on the allegation that Williamson-Dickie had sold products directly to mass merchandisers.[207] Observing that no Texas court has addressed the issue of whether a licensor owes a licensee a duty of good faith and fair dealing, the court made an "Erie guess" as to how the Texas Supreme Court would rule.[208]

198. Mark S. VanderBroek & Christian B. Turner, *Protecting and Enforcing Trade Secrets*, 25 Franchise L.J. 191, 192 (2006).
199. *Id.*
200. *See* Williamson-Dickie Mfg. Co. v. Apparel Ltd., No. 4:15-CV-164-A, 2015 U.S. Dist. LEXIS 75227, at *5 (N.D. Tex. June 10, 2015) (citing City of Maryland v. O'Bryant, 18 S.W.3d 209, 215 (Tex. 2000); Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 225 (Tex. 2002)).
201. *See id.* at *6
202. *See id.*
203. *See id.* (citing Subaru of Am., Inc. v. David McDavid Nissan, Inc., 84 S.W.3d 212, 225 (Tex. 2002)).
204. *Id.* at *5.
205. *Id.* at *7.
206. *Id.* at *2.
207. *Id.* at *3.
208. *Id.* at *6.

Applying Texas law, the district court recognized that Texas law does not recognize an implied covenant of good faith and fair duty in contracts, absent a special relationship, such as insurance contracts.[209] Comparing the licensor-licensee relationship to the franchisor-franchisee relationship, where Texas courts have already declined to find a special relationship, the court determined that the implied covenant did not exist in a trademark license agreement because the licensor-licensee relationship closely resembled the franchisor-franchisee relationship.[210] Thus, the court added the trademark license agreement to the list of contractually-based transactions in which no special relationship between the parties exists.[211]

B. Fraud and Misrepresentation

In a third *Yumilicious* decision (*Yumilicious III*)—a separate opinion from the other two *Yumilicious* cases mentioned above—the U.S. District Court for the Northern District of Texas considered Yumilicious's motion for partial dismissal of the defendant's counterclaims and motion for partial summary judgment.[212] After Yumilicious brought an action against franchisee defendants for breaches of the two franchise agreements, franchisees counterclaimed that Yumilicious fraudulently induced them into entering into the franchise agreements and asserted claims for fraud and negligent misrepresentation, among other claims.[213] The franchisee's claims were based on Yumilicious's alleged failure to perform on-site evaluations and inspections, operational advice, and product sourcing pursuant to the terms of the franchise agreements, as well as alleged misstatements made regarding product pricing.[214]

First, the district court dealt with the fraud claims. In granting Yumilicious's motion to dismiss the fraud and negligent misrepresentation claims, the district court determined that these claims were barred by the economic loss rule, which prevents recovery in tort for a party's failure to perform under a contract.[215] The district court determined that the economic loss rule applied because the fraud and negligent misrepresentation claims were tied directly to the franchise agreements and arose only from the contractual relationship between the parties.[216] Nor did the franchisee show "any loss independent of the franchise agreement."[217]

Next, the district court turned to the alleged misrepresentations regarding price allegedly made by the franchisor's sales representative.[218] The

209. *Id.* at *5–6.
210. *Id.*
211. *Id.*
212. Yumilicious Franchise, L.L.C. v. Barrie, No. 3:13-CV-4841-L, 2015 U.S. Dist. LEXIS 53144, at *10–14 (N.D. Tex. Apr. 23, 2015) [hereinafter *Yumilicious III*].
213. *Id.* at *2–3.
214. *Id.* at *15, *21–22.
215. *Id.* at *19–20.
216. *Id.* at *20.
217. *Id.*
218. *Id.* at *21–22.

district court dismissed these claims as well because the franchisee failed to provide any evidence that any representations were made, whether through depositions, testimony, or other evidence.[219]

C. Vicarious Liability

The issue of joint employment, which results essentially in imposing vicarious liability on the franchisor for labor law violations asserted by a franchisee's employees against the franchisee, has been front and center in franchising since the National Labor Relations Board (NLRB) issued complaints against McDonald's USA, LLC (McDonald's) and franchisees of McDonald's, as joint employers of the franchisee's employees.[220] The complaints are based upon the NLRB's new standard that by possessing the ability to exercise control over a franchisee's employment policies, the franchisor becomes a joint employer of the franchisee's employees even if the franchisor does not actually exercise any control.[221]

In response to the NLRB's wide-reaching determination that would classify franchisors as joint employers with its franchisees, the 84th Regular Legislative Session passed SB 652, which became effective on September 1, 2015.[222] SB 652 generally protects franchisors from blanket exposure to liability for employment claims asserted by franchisees and the employees of franchisees. The bill amends Texas Labor Law to establish that unless a franchisor exercises direct control over a franchisee or a franchisee's employees above and beyond what is necessary to protect the franchisor's trademarks brand, the franchisor will not be deemed an employer of a franchisee or a joint employer of the franchisee's employees.[223] SB 652 sets forth a joint employment standard previously utilized by the NLRB prior to the complaints issued against McDonald's.[224] The standard applies in the context of employment discrimination, wage and hour payment, minimum wage law, professional employer organization law, unemployment law, workers compensation law, and workplace safety law.[225] Future court decisions should clarify what conduct constitutes "necessary" control versus control that is "above and beyond."

Franchisors often face the issue of whether the franchisor is a proper party to an employment proceeding brought before an administrative

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219. *Id.* at *22.

220. *See NLRB Office of the General Counsel Issues Consolidated Complaints Against McDonald's Franchisees and their Franchisor McDonald's USA, LLC as Joint Employers*, Nat'l Lab. Relations Bd. (Dec. 19, 2014), https://www.nlrb.gov/news-outreach/news-story/nlrb-office-general-counsel-issues-consolidated-complaints-against [https://perma.cc/A87X-NFS6].

221. *See Board Issues Decision in Browning-Ferris Industries*, Nat'l Lab. Relations Bd. (Aug. 27, 2015), https://www.nlrb.gov/news-outreach/news-story/board-issues-decision-browning-ferris-industries [https://perma.cc/GY8S-NWQH].

222. Tex. S.B. 652, 84th Leg., R.S. (2015) (codified as Tex. Lab. Code Ann. § 91.0013 (West 2015)).

223. *Id.*

224. *Id.*

225. *Id.*

agency by a franchisee's employee. The U.S. Court of Appeals for the Fifth Circuit considered this issue in *EEOC v. Simbaki, Ltd.*,[226] which potentially expanded the number of discrimination and harassment suits franchisors may face for discrimination and harassment committed by franchisees.

Here, two female employees of a Berryhill Baja Grill & Cantina franchise filed separate charges of sexual harassment with the Equal Opportunity Commission (EEOC), naming "Berryhill Baja Grill" and listing the franchisee's address.[227] Even though the franchisor, Berryhill Hot Tamales Corporation, was not named as a party, the EEOC served notice on the franchisor that charges had been filed against "your organization."[228] The franchisor was not "invited to the fact-finding conference, and the majority of the notices relating to EEOC proceedings appear to have gone solely to" the franchisee.[229]

After investigating, the EEOC determined that the franchisee "had engaged in sexual harassment in violation of Title VII" and filed suit against the franchisee in the Southern District of Texas.[230] The employees then intervened and added the franchisor as a defendant, alleging that the franchisor was their single or joint employer under Title VII.[231] The franchisor moved for summary judgment on two grounds: (1) the employees "failed to exhaust their administrative remedies" because the franchisor was not named as a party in their EEOC charges; and (2) the employees could not show that the franchisor was either a single or joint employer under Title VII.[232] The district court granted summary judgment on the first ground, determining that the employees "could not invoke the judicially-recognized exceptions to Title VII's named-party requirement because they were represented by counsel when they filed their charges" with the EEOC.[233]

On appeal, the employees argued: (1) by identifying "Berryhill Baja Grill," the trade name of the franchisor in their EEOC complaint, they had, in fact, named the franchisor; and (2) even if the franchisor had not been named in the EEOC charges, represented parties are entitled to invoke the judicially-recognized exceptions to Title VII's named-party requirement.[234] The Fifth Circuit rejected the first argument but agreed with the second—represented parties, and not just pro se litigants, can invoke the exception to the rule that only named parties can be subsequently sued in federal court.[235] The Fifth Circuit found no justification

226. 767 F.3d 475 (5th Cir. 2014). Haynes and Boone represented the franchisor Berryhill in this matter.
227. *Id.* at 479.
228. *Id.*
229. *Id.* at 480.
230. *Id.*
231. *Id.*
232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.* at 481–85.

for limiting the exceptions to pro se litigants.[236] First, the Fifth Circuit determined that allowing represented parties to invoke the exceptions is more consistent with the principle that pro se litigants are required to follow the federal rules of procedure and are held to the same pleading requirements as represented parties.[237] Second, the holding, which allows all litigants to invoke the exceptions, is more consistent with the liberal construction of Title VII's requirements.[238] Accordingly, the Fifth Circuit remanded the case back to the district court for a determination as to whether franchisor was a proper defendant.[239]

For franchisors, the named-party issue arises at the EEOC level with some frequency. *Simbaki* may therefore increase the legal risks faced by corporate parents. Thus, franchisors should pay close attention to Title VII allegations even if they are not directly identified in the EEOC charge. If the franchisor receives sufficient notice of the allegations, the named-party requirement may not be a defense to liability.

In *Domino's Pizza, L.L.C. v. Reddy*, the Beaumont Court of Appeals overturned a jury verdict that found Domino's franchisor vicariously liable for a death and serious injuries resulting from an accident caused by the defective vehicle of a delivery driver.[240] The court of appeals declared that whether a franchisor may be held vicariously liable for the acts of its franchisees depends on whether the franchisor had the right to the control the injury-causing conduct.[241] The court of appeals held that the "evidence was legally insufficient to support the jury's finding that Domino's controlled or had the right to control the details of the [franchisees and its employees'] injury-producing acts or omissions."[242] And because of the legally insufficient evidence, the court of appeals determined that it could not hold franchisor Domino's vicariously liable.[243] Accordingly, the court of appeals reversed the trial court's judgment and dismissed the negligence claims against Domino's.[244]

A vehicle driven by the franchisee's employee hydroplaned due to a bald tire and wet pavement, and struck a vehicle, killing one of the plaintiffs and injuring another.[245] The guardian of the estate and persons of plaintiffs sued Domino's and the franchisee for negligence.[246] After the franchisee settled, the case proceeded to trial against Domino's.[247] The jury apportioned liability and determined that the employee was 10%

236. *Id.* at 484–85.
237. *Id.*
238. *Id.* at 485.
239. *Id.*
240. Domino's Pizza, L.L.C. v. Reddy, No. 09-14-00058-CV, 2015 Tex. App. LEXIS 2578, at *1 (Tex. App.—Beaumont Mar. 19, 2015, pet. filed) (mem. op.).
241. *Id.* at *3.
242. *Id.* at *18.
243. *Id.*
244. *Id.*
245. *Id.* at *1.
246. *Id.*
247. *Id.*

negligent, the franchisee was 30% negligent, and Domino's was 60% negligent.[248] After apportioning negligence, the jury then found that Domino's was vicariously liable because of four reasons: (1) Domino's "controlled or had the right to control . . . the injury-producing acts or omissions" of the franchisee and the franchisee's employees; (2) "Domino's failed to exercise ordinary care in the control or right to control those details"; (3) Domino's failure to use this "ordinary care was the proximate cause of the occurrence in question"; and (4) the franchisee's employee was "operating his vehicle in furtherance of a mission for the benefit of Domino's and subject to Domino's control."[249] Domino's appealed, contending that "the evidence [was] legally insufficient to establish that [Domino's] owed a duty to the [plaintiffs] because . . . it had no right to control the [franchisee's] day-to-day operations, did not exercise control over the injury-producing acts," and that, therefore, a court could not hold Domino's vicariously liable for the acts of the franchisee or the franchisee's employees.[250]

To determine whether a franchisor is vicariously liable for a franchisee's conduct, the court of appeals considered "whether the franchisor has the right to control the franchisee with respect to the details" of the specific injury-causing conduct at issue.[251] Right to control can be established by evidence of either a contractual agreement that explicitly assigns the franchisor a right to control or the franchisor's actual control.[252] Pointing to the following evidence as support, Plaintiffs contended that Domino's had both a contractual right of control and actual control:

> (1) [the franchisee] must comply with Domino's specifications, standards, and operating procedures, including the "methods and procedures relating to receiving, preparing, and delivering customer orders[;]" (2) Domino's can unilaterally modify its standards and procedures and can conduct inspections; (3) Domino's [could] terminate the franchise agreement if [the franchisee] fails to comply with corporate standards and procedures; (4) Domino's standards regulate driver age and history, safety, vehicle inspections, and driver conduct during deliveries; (5) [Domino's standards] promote speeding among delivery drivers by use of the thirty-minute rule, . . . time tracking, evaluations that factored delivery times into their scores and affected bonuses, and encouragement of incentives to improve job performance; and (6) Domino's decided the store's delivery area and provided directions and maps though [software that its franchisees were required to use].[253]

The court of appeals first considered whether Domino's had actual control over the franchisee and determined that no "right to control" ex-

248. *Id.*
249. *Id.* at *1–2.
250. *Id.* at *2.
251. *Id.* at *3.
252. *Id.*
253. *Id.* at *12–13.

isted.[254] In making this determination, the court of appeals looked to the franchise agreement, which expressly provided that:

> (1) [the franchisee] is an independent contractor; (2) the store's staff are employed by [the franchisee, not Domino's]; (3) Domino's has no legal right to direct [the franchisee's] employees; (4) [the franchisee] is solely responsible for recruiting, hiring, training, scheduling, supervising, and paying its employees; (5) [the franchisee] is solely responsible for operating the store; and (6) Domino's does not assume [the franchisee's] responsibilities by providing "reasonable operating assistance."[255]

That Domino's could terminate the franchise agreement, had a right to receive evaluations and other reports, could conduct inspections, or required franchisee to comply with Domino's procedures and rules was "not evidence that Domino's had the right to control."[256]

The court of appeals next rejected plaintiff's argument that Domino's had a contractual right to control.[257] Under the franchise agreement, the relationship between franchisee and franchisor was that of independent contractor.[258] The express provisions of a contract indicating that the parties' relationship is an independent contractor may be determinative absent the following evidence: (1) "the contract is a mere sham"; (2) the contract is a "subterfuge designed to conceal the true legal status of the parties"; or (3) "the contract has been modified by a subsequent agreement between the parties."[259] Here, the court of appeals found no evidence to negate the franchise agreement's express provision that sets an independent contractor relationship between the parties.[260] The court of appeals characterized the franchise agreement as "merely set[ting] forth the standards related to work," while leaving the "responsibility of implementing the details of those standards" to the franchisee's discretion.[261] An "occasional assertion of control or sporadic action directing the details of work" would not be enough to negate the express provision in the franchise agreement that sets the parties' independent contractor relationship.[262]

Finally, the court of appeals rejected franchisee's argument that "Domino's may be liable for unreasonably increasing the risk of harm."[263] The court of appeals worked with the premise that a contract, such as the franchise agreement, which "requir[es] independent contractors to comply with general safety practices and train their employees to do so can-

254. *Id.* at *14–15.
255. *Id.* at *13–14.
256. *Id.* at *14.
257. *Id.* at *15–16.
258. *Id.* at *4.
259. *Id.*
260. *Id.* at *15–16.
261. *Id.* at *15.
262. *Id.* at *15–16.
263. *Id.* at *16.

not constitute a right to control."[264] Nor could the franchisee's allegations that Domino's failed to implement or enforce a safety rule amount to actual control.[265] Here, the "means, methods, and details of implementing Domino's standards" were left to the franchisee's discretions, and the franchisee was responsible for training its employees, including drivers.[266] Therefore, Domino's imposition of contractual safety requirements, alone, did not subject Domino's to a duty of care to prevent its independent-contractor franchisee's negligent conduct or to vicarious liability for its independent contractor's negligence.[267]

Therefore, the court of appeals concluded that "the evidence [was] legally insufficient to support the jury's findings that Domino's controlled or had the right to control the details of the injury-producing acts or omissions of [the franchisee] and [the franchisee's] employees."[268]

Domino's is an example of how most courts are recognizing that the franchising model presents a unique situation for vicarious liability analysis. Although the Plaintiffs brought direct negligence claims against Domino's, the court's analysis focused on whether the franchisor owed a duty to Plaintiffs by following traditional vicarious liability analysis in the franchise context.[269] The court focused on which party actually had control over the instrumentality that caused the accident—in this case, driver training and means, method, and details of delivery safety.[270] The court also emphasized that the franchise agreement designated that the franchisee was an independent contractor.[271]

D. Tortious Interference

BP Automotive, L.P. v. RML Waxahachie Dodge, LLC[272] involved a failed asset purchase agreement for the sale of assets of a car dealership located in Waxahachie, Texas. In 2008, the car dealership, BP Automotive, L.P. (Bossier Dodge), "experienced financial difficulties and began looking for a potential buyer for its assets."[273] In 2009, a group of RML entities (RML) executed an asset purchase agreement, under which Bossier Dodge would sell its dealership assets.[274] As a condition of the deal, RML needed to seek the approval of Chrysler Motor, L.L.C. (Chrysler).[275] Thereafter, Chrysler filed for bankruptcy and rejected Bossier Dodge's franchise agreement as part of the bankruptcy proceed-

264. *Id.*
265. *Id.* at *16–17.
266. *Id.* at *17.
267. *Id.* at *17–18.
268. *Id.* at *18.
269. *See id.* at *12–18.
270. *See id.* at *13–17.
271. *See id.* at *15–18.
272. 448 S.W.3d 562 (Tex, App.—Houston [1st Dist.] 2014, pet. denied).
273. *Id.* at 566.
274. *Id.*
275. *Id.*

ings.[276] Subsequently, "the reorganized Chrysler awarded RML [a franchise agreement] in Waxahachie."[277]

Bossier Dodge then sued the potential buyer, RML, for breach of contract, tortious interference with an existing contract, tortious interference with a prospective business relationship, and several other causes of action.[278] RML moved for a no-evidence summary judgment on the tortious interference claims, which the trial court granted.[279] The First Houston Court of Appeals determined that the lower court properly granted the no-evidence motion as to the tortious interference with an existing contract claim, but erred in granting RML's motion as to the tortious interference with prospective business relationship claim.[280]

In Texas, there are four the elements to a cause of action for tortious interference with an existing contract: "(1) an existing contract subject to interference, (2) a willful and intentional act of interference with the contract, (3) that proximately caused the plaintiff's injury, and (4) caused actual damage or loss."[281] "Bossier Dodge argue[d] that '[RML] [had] induced Chrysler to breach its franchise agreement with Bossier Dodge after Chrysler's bankruptcy so that RML would be awarded'" the Waxahachie franchise.[282] As to this claim, the court of appeals determined that "Bossier Dodge presented no evidence that Chrysler was bound to continue the franchise agreements that existed prior to its bankruptcy."[283] Indeed, the record showed that acceptance or rejection of the previously existing franchises was a requirement of the bankruptcy proceeding.[284] Thus, the court of appeals found that there was "no evidence of an existing contract that was subject to interference."[285] In addition, there was also no evidence of any willful or intentional act since the act complained of was "RML's filing of an application for the Chrysler franchise, presumably in competition with Bossier Dodge's own application."[286] Such competition was not a prohibited act.[287] Because there was no evidence of an existing contract subject to interference or of a willful and intentional act of interference by RML, "the trial court properly granted the no-evidence motion for summary judgment" on Bossier Dodge's tortious interference with an existing contract claim.[288]

By contrast, the court of appeals determined that the trial court erred in granting summary judgment on Bossier Dodge's claim for tortious in-

276. *Id.*
277. *Id.*
278. *Id.* at 567.
279. *Id.* at 567–68.
280. *Id.* at 570–71.
281. *Id.* at 570.
282. *Id.*
283. *Id.* at 571.
284. *Id.*
285. *Id.*
286. *Id.*
287. *Id.*
288. *Id.*

terference with prospective business relations.[289] In Texas, there are four elements to a tortious interference with prospective business relationship claim:

> (1) a reasonable probability that the plaintiff would have entered into a business relationship; (2) an independently tortious or unlawful act by the defendant that prevented the relationship from occurring; (3) the defendant did such act with a conscious desire to prevent the relationship from occurring or the defendant knew the interference was certain or substantially certain to occur as a result of the conduct; and (4) the plaintiff suffered actual harm or damages as a result of the defendant's interference.[290]

RML asserted that Bossier Dodge failed to establish any of these four elements.[291] The court of appeals found that the affidavit testimony presented by Bossier Dodge contained more than a scintilla of evidence in support of its claim for tortious interference with prospective business relations.[292] In this affidavit, one of Bossier Dodge's limited partners testified that a potential buyer of Bossier Dodge's assets approached the limited partner about buying Bossier Dodge's assets. The limited partner testified that when the potential buyer attempted to view the assets, RML incorrectly told the potential buyer that the assets had already been sold to RML.[293] Because Bossier Dodge had presented more than a scintilla of evidence in support of its claim for tortious interference with prospective business relationship, the court of appeals concluded that the trial court erred in granting RML's no-evidence motion for summary judgment on this claim.[294]

In *Williamson-Dickie Manufacturing Co. v. Apparel Ltd.*, previously discussed, the U.S. District Court for the Northern District of Texas determined that a duty of good faith and fair dealing did not exist in a licensor-licensee relationship.[295] The district court also dismissed the licensee's claims that a licensor tortiously interfered with its prospective business relationships but upheld the licensee's claims that the licensor tortiously interfered with the licensee's existing business relationships.[296] As discussed above, the license agreement at issue gave Apparel the exclusive right to sell Williamson-Dickie branded products using Williamson-Dickie's trademarks through "authorized channels," including mass merchandisers such as Wal-Mart, in the United States.[297] Apparel asserted tortious interference counterclaims based on the theory that Williamson-Dickie sold products directly to mass merchandisers, and those

289. *Id.*
290. *Id.*
291. *Id.*
292. *Id.*
293. *Id.*
294. *Id.*
295. Williamson-Dickie Mfg. Co. v. Apparel Ltd., No. 4:15-CV-164-A, 2015 U.S. Dist. LEXIS 75227, at *5–7 (N.D. Tex. June 10, 2015).
296. *Id.* at *7–8.
297. *Id.* at *2.

sales tortiously interfered with its existing business relationships with its buyer as well as with its prospective customers.[298]

First, the district court determined that Apparel had adequately pled a cause of action for tortious interference with its existing business relationships.[299] Williamson-Dickie challenged the claim on the ground that Apparel failed to plead that Williamson-Dickie's conduct was unlawful.[300] The district court, however, found that Apparel had properly pleaded a claim for tortious interference with existing contact because the conduct need not be unlawful.[301] Because Apparel pleaded that there was an existing contract and that Williamson-Dickie intentionally and willfully interfered with it, which proximately caused injury, Apparel had properly pleaded a claim for tortious interference with an existing contract.[302]

On the other hand, the district court dismissed Apparel's claim for tortious interference with prospective business relationship, which requires that the interference was independently tortious or unlawful, as discussed above.[303] Apparel relied on its allegations that Williamson-Dickie's conduct was unlawful because it was in breach of the implied covenant of good faith and fair dealing.[304] However, because there is no implied duty of good faith and fair dealing in a licensor-licensee relationship, the district court concluded that Apparel had failed to establish a tortious interference with prospective business relationship claim.[305]

V. STATUTORY CLAIMS

A. Texas Deceptive Trade Practices—Consumer Protection Act

In *Yumilicious II*, discussed above for its statute of limitations issues, the U.S. District Court for the Northern District of Texas determined that allegations of a technical violation of the Federal Trade Commission's Franchise Act (Franchise Rule), without more, cannot support a DTPA claim based on the theory of representations or omissions.[306] In this case, the franchisor filed suit against the franchisee, alleging that the franchisee breached two franchise agreements.[307] The franchisee then asserted counterclaims for, *inter alia*, DTPA violations, alleging that the franchisor had violated the Franchise Rule by providing a materially deficient franchise disclosure agreement with an earlier date.[308] The franchisor

298. *Id.* at *7–8.
299. *Id.* at *8.
300. *Id.*
301. *Id.*
302. *Id.* at *8–9.
303. *Id.* at *9–10.
304. *Id.* at *9.
305. *Id.* at *9–10.
306. *Yumilicious II*, No. 3:13-CV-4841-L, 2015 WL 1822877, at *6 (N.D. Tex. Apr. 22, 2015).
307. *Yumilicious I*, No. 3:13-CV-4841-L, 2014 WL 4055475, at *1 (N.D. Tex. Aug. 14, 2014).
308. *Id.* at *4, *8.

moved to dismiss the DTPA claim, which the district court initially granted on statute of limitations grounds.[309] When the franchisee moved for reconsideration of the order, the district court, instead, examined the sufficiency of the franchisee's DTPA allegations under §§ 17.46(b)(5) and 17.46(b)(24) of the Texas Business and Commerce Code.[310]

The franchisee alleged that the franchisor had made assurances that the franchise could expand nationally and that the franchisor was negotiating a contract for such expansion with a national distributor (but the franchisor ultimately did not consummate the deal).[311] The district court denied the franchisee's motion for reconsideration, finding that the franchisee had failed to allege that the franchisor knowingly made false statements or that the franchisee had detrimentally relied on those statements.[312] As it stood, the franchisee could only establish that the franchisor had committed a technical violation of the Franchise Rule when it failed to include all of the financial performance information previously given to the franchisee—allegations that were not sufficient to state a DTPA claim.[313] The holding in *Yumilicious II* serves as a reminder that "mere nondisclosure of material information is not enough to establish an actionable DTPA claim," and technical violations of the Franchise Rule, without evidence of intent or detrimental reliance, cannot support a DTPA claim.[314]

B. Bankruptcy Issues

In *Pizza Patron Inc. v. Saenz* (*In re Saenz*), the U.S. District Court for the Southern District of Texas considered indemnification and subrogation fraud claims under the statutory provisions related to non-dischargeable debt.[315] Here, Saenz, the franchisee who claimed to be a franchise representative, sold a Pizza Patron franchise to Gomez without Pizza Patron's permission.[316] Gomez eventually sued Saenz and Pizza Patron, alleging that Saenz acted as Pizza Patron's agent while committing fraud and other torts.[317] In response, Pizza Patron filed a Complaint for Determination of Non-dischargeable Debt under 11 U.S.C. §§ 523(a)(2) and 523(a)(4), seeking indemnification and subrogation from Saenz if it was found liable for Saenz's fraud.[318]

Pizza Patron pled direct fraud against Saenz, but the district court found that Pizza Patron had failed to allege sufficient facts to support the

309. *Id.* at *3–4.
310. *Yumilicious II*, 2015 WL 1822877, at *3–6; *see also supra*, Section II.G. Statute of Limitations.
311. *Yumilicious II*, 2015 WL 1822877, at *4.
312. *Id.* at *5, *7.
313. *Id.* at *6.
314. *Id.* at *4, *6 (quoting Century 21 Real Estate Corp. v. Hometown Real Estate Co., 890 S.W.2d 118, 126 (Tex. App.—Texarkana 1994, writ denied) (alteration in original).
315. Pizza Patron Inc. v. Saenz (*In re* Saenz), 515 B.R. 521, 523 (S.D. Tex. 2014).
316. *Id.* at 524.
317. *Id.* at 526.
318. *Id.* at 524, 526.

claim.[319] In addition, Pizza Patron alleged claims for derivative fraud based on Gomez's fraud claims against Saenz.[320] Saenz countered that Pizza Patron failed to state a claim because the movant creditor must have been the target of the alleged fraud.[321] The district court disagreed, finding that such an interpretation of the law would violate the underlying purpose of the Bankruptcy Code to prevent debtors from discharging any debts arising from their own fraud.[322] Instead, the district court ruled that Pizza Patron could assert a claim based on fraud committed against another person.[323] However, because Pizza Patron's derivative fraud claims were based on Gomez's fraud claims, the district court would allow Pizza Patron to amend its claim under § 523(a)(2) only if Gomez successfully pled his claim under the same section.[324] Because Gomez had already successfully stated a claim under § 523(a)(4), the district court upheld Pizza Patron's indemnification and subrogation claim under this section.[325]

Although Pizza Patron was ultimately dismissed from the suit,[326] *Pizza Patron* shows that claims for indemnification or subrogation may qualify as a non-dischargeable debt even when the debt is based on a liability resulting from a third party's fraud claim. In such cases, the statute does not require that the fraud be committed against the movant.[327] While this issue seems to have been scarcely considered in this district before this case, the court's holding falls in line with bankruptcy law's policy of protecting the "honest but unfortunate debtor."[328]

Next, *In re Simbaki, Ltd.* explored the statutory deadline for a creditor to file Chapter 11 plans of reorganization and the consequences of a court's failure to confirm such a plan within the statutory deadline.[329] *Simbaki* involved a small business debtor who filed a voluntary petition for Chapter 11 relief and entered a plan of reorganization.[330] When numerous parties filed objections, Simbaki withdrew the proposed plan.[331] Later, Simbaki's primary secured creditor asked for a continuance to propose an alternate plan.[332] Several parties opposed the continuance and moved to dismiss the case, arguing that because the statutory deadline for filing and confirming any plan of reorganization had passed, cause existed

319. *Id.* at 526.
320. *Id.*
321. *Id.*
322. *Id.* at 527–28 (quoting Cohen v. de la Cruz, 523 U.S. 213, 217 (1998)).
323. *Id.* at 528.
324. *Id.* at 528, 532; *see also id.* at 532 (noting that the district court had previously granted Gomez leave to amend his claim under § 523(a)(2)).
325. *Id.* at 529.
326. Gomez v. Saenz, 534 B.R. 276, 281 (S.D. Tex. 2015).
327. *See Pizza Patron*, 515 B.R. at 526.
328. *See id.* at 526–28 (quoting *Cohen*, 523 U.S. at 217).
329. *See generally In re* Simbaki, Ltd., 522 B.R. 917 (Bankr. S.D. Tex. 2014).
330. *Id.* at 918–19.
331. *Id.* at 919.
332. *Id.*

under § 1112 to dismiss or convert the case.[333]

The U.S. Bankruptcy Court for the Southern District of Texas rejected this contention, holding that the 300-day deadline for filing a plan applied only to plans proposed by a debtor, not plans proposed by a creditor.[334] The bankruptcy court found that a review of the statute's legislative history and Congress' intent in amending the statute suggested that the statutory deadline was intended to apply only to plans offered by a debtor.[335]

Further, the bankruptcy court found that cause to dismiss the case did not exist based on the court's failure to confirm a plan within the 45-day statutory deadline.[336] Although the bankruptcy court acknowledged a nationwide split on the issue, the bankruptcy court rejected the contention that the plain language of the statute mandated dismissal or conversion if a plan was not confirmed before the deadline passed.[337] The bankruptcy court reasoned that while "[d]ismissing or converting the debtor's case in a situation where it failed to comply with a deadline is appropriate[, i]mposing a penalty on a debtor when a court did not approve their plan is a different proposition."[338]

The holding in *Simbaki* signals a reluctance to dismiss Chapter 11 cases where creditors participate in the reorganization process, even if debtors have missed a statutory deadline to file a reorganization plan and the court has missed its deadline to confirm. Other jurisdictions, however, mandate a dismissal after the confirmation deadline has passed, and the 300-day deadline for filing a plan is an ambiguous statute that is subject to different interpretations.[339] Thus, it is important for debtor and creditor parties alike to recognize the applicable law during the reorganization process.

VI. REMEDIES: DAMAGES AND INJUNCTIVE RELIEF

A. Punitive Damages

In *Yumicilious III*, discussed earlier for its fraud and misrepresentation claims, the U.S. District Court for the Northern District of Texas held that the defendants could not recover consequential and punitive damages because they had waived their right to recover those damages by signing guaranty agreements supporting franchise agreements that contained such a waiver.[340] Relying on a damages waiver provision in the franchise agreements signed by the defendant-franchisee, which the individual defendants personally guaranteed, Yumilicious argued an affirmative defense of waiver against defendants' request for consequential and

333. *Id.*
334. *Id.* at 920–21.
335. *Id.* at 921–22.
336. *Id.* at 923–24.
337. *Id.* at 924.
338. *Id.*
339. *See id.* at 921, 923.
340. *Yumilicious III*, No. 3:13-CV-4841-L, 2015 WL 1856729, at *8 (N.D. Tex. Apr. 23, 2015).

punitive damages.[341] Defendants maintained that the waiver provision did not apply to the individual defendants, because the provision was not conspicuous and the individual defendants were not parties to the franchise agreements.[342]

The district court determined that the damages waiver provision applied to both the defendant-franchisee and the individual defendants, even those defendants who had not signed both agreements.[343] The district court considered the conspicuousness of the waiver provision based on whether "a reasonable person against whom a clause is to operate ought to have noticed it."[344] The waiver provision contained a heading that appeared in all capitals, bold, and underlined typeface as well as text that appeared in all capitals and bold typeface.[345] The provision also stated in all capitals and boldface letters that the provision applied to the franchisee and the franchisee's principals.[346] Further, the guaranty agreements, signed by the individual defendants, referenced the specific subsection containing the waiver provision on the same page as language stating that the guarantors personally agreed to obligate themselves to the franchisee's agreements.[347] The district court also noted that one of the franchisee's principals and guarantors signed both the franchise and guaranty agreements.[348] Based on the language of the franchise and guaranty agreements, the court held that the damages waiver provision was conspicuous as a matter of law and that all the individual defendants, along with the franchisee, were bound to that provision through the terms of the guaranty agreements.[349]

Based on this holding, personal guarantors of a franchisee should take care in reviewing and signing franchise and guaranty agreements, especially with regards to waiver provisions. In particular, individual non-signatories of a franchise agreement may find themselves subject to all of the agreement's provisions even where only one principal-guarantor was a party and signatory to both the franchise and guaranty agreements.

B. Compensatory & Injunctive Relief

In *Choice Hotels International, Inc. v. Goldmark Hospitality, LLC*, the U.S. District Court for the Northern District of Texas denied Choice Hotels's summary judgment motions for monetary and injunctive relief despite having granted summary judgment on all claims against a party who

341. *Id.*
342. *Id.*
343. *Id.*
344. *Id.* at *9 (quoting Dresser Indus., Inc. v. Page Petroleum, Inc., 853 S.W.2d 505, 511 (Tex. 1993)).
345. *Id.*
346. *Id.*
347. *Id.*
348. *Id.* at *9–10.
349. *Id.* at *10.

was not directly involved in the franchise agreement.[350] Franchisor Choice Hotels entered into a franchise agreement with a franchisee that later defaulted and filed for bankruptcy.[351] Around the time that Choice Hotels terminated the franchise agreement, defendant Goldmark became owner of the franchisee's hotel property as the beneficiary of a deed of trust.[352] Goldmark then began to operate the hotel property under a new name but continued to display certain Choice Hotels trademarks and signs.[353] When Goldmark failed to remove two Choice Hotels signs, Choice Hotels sued Goldmark under the Lanham Act as well as under Texas law for common law trademark infringement and unfair competition.[354]

Although the district court granted Choice Hotels's motion for summary judgment for liability on all its claims, the district court rejected Choice Hotels' request for a permanent injunction, finding that certain disputed issues of material fact still existed.[355] To obtain permanent injunctive relief, Choice Hotels had to establish each of the following factors:

> (1) a substantial likelihood that it will prevail on the merits; (2) a substantial threat that it will suffer irreparable injury if the injunction is not granted; (3) that the threatened injury to Choice Hotels outweighs the threatened harm . . . to Goldmark; and (4) that granting the preliminary injunction would not disserve the public interest.[356]

While Choice Hotels could establish actual success on the merits (as evidenced by the court's earlier findings), the district court found that Choice Hotels could not carry the heavy burden of supporting its request for a permanent injunction.[357] The district court held that Choice Hotels failed to prove that it faced a substantial threat of irreparable injury because Goldmark had covered up the disputed signs, removed other signs or paraphilia containing Choice Hotels's marks, and generally presented itself as an establishment not owned by Choice Hotels.[358] The district court found that these issues precluded Choice Hotels's summary judgment request for injunctive relief.[359]

Similarly, the district court held that Choice Hotels was not entitled to monetary damages because disputed issues of material fact remained.[360] While Choice Hotels sought Goldmark's profits during the time of infringement, Choice Hotels disputed the loss and accounting statement

350. Choice Hotels Int'l, Inc. v. Goldmark Hosp., LLC, No. 3:12-CV-0548-D, 2014 WL 642731, at *1 (N.D. Tex. Feb. 19, 2014).
351. *Id.*
352. *Id.*
353. *Id.*
354. *Id.* at *1–2.
355. *Id.* at *10–12.
356. *Id.* at *11.
357. *Id.* at *12.
358. *Id.*
359. *Id.*
360. *Id.* at *12–13.

that summarized Goldmark's profits.[361] Choice Hotels also sought actual damages in the form of reasonable royalties due under the franchise agreement.[362] Contrary to Goldmark's arguments, the district court held that Choice Hotels could obtain royalty payments from Goldmark, despite the fact that Goldmark had not previously entered into a licensing agreement with Choice Hotels.[363] The district court, however, ultimately held that Choice Hotels was not entitled to actual damages because it had not clearly established the royalty rate that should be used.[364]

Choice Hotels stands as another example of a case in which the court granted summary judgment as to liability, but denied summary judgment as to the remedies because it found that disputed issues of material fact remain.[365] Further, *Choice Hotels* is notable because the defendant was not a former franchisee, but rather the owner of a foreclosure deed on a property previously operated under a franchise. In this situation, where a defendant violates infringement statutes as a matter of circumstance and without intending to do so, a franchisor may face difficulties in obtaining injunctive or monetary remedies on summary judgment.

C. Attorneys' Fees

Meltzer/Austin Restaurant Corp. v. Benihana National Corp. addressed the question of whether a franchisor could recover attorneys' fees based on a provision requiring that the franchisee pay for costs incurred in enforcing the franchise agreement.[366] This case involved three separate suits based on Meltzer's franchise agreements with Benihana, which were later consolidated in the Western District of Texas.[367] Only one set of claims by Meltzer's San Antonio business survived until trial, where a jury ruled in Benihana's favor.[368] Benihana then sought to recover attorneys' fees incurred in bringing suit against Meltzer in Florida as well as defending against Meltzer's suit in Texas.[369] Benihana relied on a provision in the franchise agreement that obligated Meltzer to pay all costs, including attorneys' fees, incurred by Benihana "in connection with the enforcement" of certain sections of the agreement related to the franchisee's covenants and to the use of Benihana's intellectual property and confidential information.[370] Whether such contractual language obligated Meltzer to pay Benihana's attorneys' fees in the initiation and defense of

361. *Id.* at *13.
362. *Id.* at *13–14.
363. *Id.* at *14; *see also id.* (citing Bos. Prof'l Hockey Ass'n, Inc. v. Dall. Cap & Emblem Mfg., Inc., 597 F.2d 71 (5th Cir. 1979)) ("[A] prior licensing arrangement is not a prerequisite to using a reasonable royalty method to calculate damages.").
364. *Id.*
365. *See also* Choice Hotels Int'l, Inc. v. Patel, 940 F. Supp. 2d 532 (S.D. Tex. 2013).
366. Meltzer/Austin Rest. Corp. v. Benihana Nat'l Corp., No. A-11-CV-542-AWA, 2014 WL 7157110, at *2 (W.D. Tex. Dec. 15, 2014). Haynes and Boone, LLP served as counsel for Benihana National Corporation in this matter.
367. *Id.* at *1.
368. *Id.*
369. *Id.* at *2.
370. *Id.*

suits depended on the definition of "enforcement," which the franchise agreement did not define.[371]

The U.S. District Court for the Western District of Texas held that Meltzer was not required to pay Benihana's attorneys' fees incurred in defending against Meltzer's suit, pointing to various cases in which courts interpreted similar contractual language.[372] Specifically, the district court pointed to cases that drew a distinction between a proactive stance (e.g. suing to compel a covenant or enforce a right) and a defensive stance (e.g. defending against a claim based on an agreement) and held that enforcement of an agreement fell only into the former category.[373] Ultimately, because enforcement did not include defense of a suit and Benihana had failed to include explicit language stating, the district court found that Benihana could not recover the attorneys' fees incurred in defending itself against Meltzer's suit.[374] The district court, however, held that Benihana was entitled to attorneys' fees incurred in bringing suit against Meltzer in Florida because that action sought to enforce certain provisions of the franchise agreement.[375]

The *Meltzer/Austin Restaurant* holding emphasizes the importance of drafting contractual language in a precise manner. In cases where courts have expanded the definition of "enforcement" to include the defense of an action, they have relied on other language in the agreement to guide their interpretation.[376] For example, one federal district court awarded attorneys' fees incurred in defense of a suit where the agreement required payment for attorneys' fees incurred in connection with the enforcement and protection of the agreement, because the court interpreted "protection" to include defense of a suit.[377] Because drafters are capable of writing clauses that explicitly award attorneys' fees in certain situations, courts generally do not interpret enforcement to mean anything beyond "to enforce."[378]

VII. CONCLUSION

This Survey period not only witnessed the Texas courts continuing to define procedural and substantive issues in the franchising context, but it also saw the Texas Legislature take affirmative steps to limit a franchisor's exposure to vicarious liability under the joint employer doctrine in response to recent National Labor Relations Board decisions.

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371. *Id.* at *3.
372. *Id.* at *2–4 (citing Hous. Auth. of Champaign Cnty. v. Lyles, 918 N.E.2d 1276 (Ill. App. Ct. 2009); Carr v. Enoch Smith Co., 781 P.2d 1292 (Utah Ct. App. 1989); Gadsy v. Am. Golf Corp. of Cal., No. 2:10-cv-680-FtM-38CM, 2014 WL 5473555, at *5 (M.D. Fla. Oct. 28, 214)).
373. *See id.* at *3–4.
374. *Id.* at *4.
375. *Id.* at *4–5.
376. *Id.* at *3.
377. *Id.* (citing Bank of Am., N.A. v. Oberman, Tivoli & Pickert, Inc., 12 F. Supp. 3d 1092 (N.D. Ill. Jan. 22, 2014)).
378. *Id.* at *4.

Procedurally, *Great American* and *SGIC* remind franchisors that the requirements to establish personal jurisdiction over a defendant remain relatively stringent, and *Aguayo* and *Pacheco* provide worthwhile distinctions for applying the relatively low requirements for certifying a proposed class. *Gator Apple*, *Pritchett*, *Yumilicious I*, and *Yumilicious II* emphasize the importance of timing and intent behind franchise agreements as it relates to choice-of-law, forum selection clauses incorporated by reference, jury waivers in guaranty agreements, and statute of limitation issues related to DTPA counterclaims. In addition to cautioning franchisors that arbitration exemptions should be explicitly identified and should include specific language in the franchise agreement, *DXP* and *Allee* demonstrate Texas courts' inclination to enforce arbitration clauses that are reasonably broad in scope.

Although *New York Pizzeria* appears, at first glance, to weaken a franchisor's trademark protection of distinctive food flavors and trade dress protection for plating of dishes, the case underscores the importance of protecting recipes and other cooking secrets through effective nondisclosure and confidentiality agreements.

Texas law imposes extra-contractual duties of good faith and fair dealing where there is a special relationship between the parties. But Texas courts have found no special relationship between parties to a franchise agreement. *Williamson-Dickie* further notes that the implied covenant does not exist in a trademark license agreement since a licensor-licensee relationship is substantially similar to the franchisor-franchisee relationship. Accordingly, there can be no claim for tortious interference with prospective business when the conduct complained of is an alleged breach of the implied covenant of good faith and fair dealing.

Further, in the tort context, *Yumilicious III* stands for the proposition that the economic loss rule precludes recovery for fraud and misrepresentation claims tied directly to a franchise agreement. *BP Automotive* holds that filing an application for a franchise, presumably to compete with a competitor's application, does not constitute a prohibited act. Nor is the application an "existing contract" sufficient for a claim of tortious interference with existing contract.

Most notably, the Texas Legislature limited a franchisor's exposure to liability for claims made by a franchisee's employees. By restricting a franchisor's status as an employer or joint employer over those employees, a franchisor will be liable only if it exercises direct control over the employees beyond what is necessary to protect its brand. In *Domino's*, the court of appeals fleshed out the "control" element for analyzing vicarious liability in the franchising context and focused specifically on the franchise agreement. In addition, *EEOC v. Simbaki* makes it clear that franchisors should pay particular attention to any Title VII allegations because the named-party requirement may not ultimately be a defense to liability.

Yumilicious II reminds franchisors that the mere nondisclosure of material information does not give rise to an actionable DTPA claim and that technical violations of the Franchise Rule will not support a DTPA without evidence of intent or detrimental reliance. And in the bankruptcy context, *Pizza Patron* suggests indemnification or subrogation claims may qualify as non-dischargeable debt even if the debt is based on liability from a third-party's fraud claim, a holding that adheres to the general policy of protecting an honest but unfortunate debtor. Furthermore, *In re Simbaki* highlights how bankruptcy courts in this jurisdiction are reluctant to dismiss a Chapter 11 case if creditors participate in the reorganization process, even if the debtor and the court miss statutory deadlines to file and confirm the reorganization plan.

Finally, with respect to remedies, *Yumilicious III* serves as a reminder to personal guarantors of a franchise to carefully review both the franchise and guaranty agreements for waiver provisions because the right to recover consequential or punitive damages can be waived. *Choice Hotels* clarifies that summary judgment as to liability does not automatically result in summary judgment as to remedies where disputed issues of material fact remain, and injunctive relief may be especially difficult in the foreclosure context where a defendant has no intent to violate an infringement statute. Franchise attorneys should thoroughly examine *Meltzer* and its implicit instruction to precisely draft attorneys' fees provisions in franchise agreements. By avoiding seemingly ambiguous phrases, such as the "enforcement of the franchise agreement," drafters can ensure that attorneys' fees are awarded in specific situations.

INSURANCE LAW

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I. INTRODUCTION

During this Survey period,[1] both the Texas Supreme Court and U.S. Court of Appeals for the Fifth Circuit were particularly active in addressing questions of insurance law. Some of the more significant topics addressed by these courts related to whether an insured must demonstrate independent injury to recover under Chapter 541 of the Texas Insurance Code; the scope of the *Stowers* doctrine; whether the scope of additional insured coverage can be limited by reference to an underlying contract; whether an exception exists to the "eight-corners" rule in determining the duty to defend; application of the vacancy clause and anti-concurrent-causation exclusion in a commercial property policy; and the scope of the contractual liability exclusion in commercial general liability policies. Courts continued to evaluate issues regarding the necessary and proper parties to coverage litigation. Moreover, the Texas Supreme Court provided guidance on the scope of discovery permissible in assessing whether an insurer properly adjusted a property claim.

II. EXTRA-CONTRACTUAL LIABILITY

A. TEXAS INSURANCE CODE CHAPTER 541—UNFAIR METHODS OF COMPETITION AND UNFAIR OR DECEPTIVE ACTS OR PRACTICES (CHAPTER 541)[2]

1. Whether Insured Must Show Independent Injury to Maintain a Chapter 541 Claim

During this Survey period, several courts addressed whether an insured is required to show an injury independent from the denial of policy benefits to prevail on a cause of action under Chapter 541. Chapter 541 provides for a private cause of action by an insured against an insurer for "actual damages" caused by an insurer's "unfair method of competition

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1. This Article encompasses opinions issued between November 1, 2013 and October 31, 2015.

2. TEX. INS. CODE ANN. ch. 541 (West 2015).

or an unfair or deceptive act or practice in the business of insurance."[3] In *In re Deepwater Horizon*, the insured appealed the district court's dismissal of the Chapter 541 claim where it sought only the policy benefits and the attorney's fees incurred for the coverage litigation.[4] The insured argued that the district court should have followed *Vail v. Texas Farm Bureau Mutual Insurance Co.*,[5] where the Texas Supreme Court held that an insured "need not show any injury independent from the denied policy benefits."[6]

On appeal, the U.S. Court of Appeals for the Fifth Circuit emphasized that subsequent decisions "arguably cast doubt on *Vail*'s continued vitality."[7] The Fifth Circuit noted that it had previously relied on "a more recent case from the Supreme Court of Texas," *Provident American Insurance Co. v. Castaneda*,[8] "as setting out the opposite rule from *Vail*."[9] Recent decisions from Texas intermediate appellate courts, however, have indicated that *Vail*, not *Castaneda*, controls and have rejected the independent injury requirement.[10] Recognizing that there is a split of authority on this important question of Texas state law, the Fifth Circuit certified the following question to the Texas Supreme Court: "Whether, to maintain a cause of action under Chapter 541 . . . against an insurer that wrongfully withheld policy benefits, an insured must allege and prove an injury independent from the denied policy benefits?"[11]

B. Texas Insurance Code Chapter 542—Processing and Settlement of Claims (Chapter 542)[12]

1. Fifth Circuit Ruled That Violation of Any Chapter 542 Deadline Triggers the Accrual of Statutory Interest

For the stated purpose of "promot[ing] the prompt payment of insurance claims," Chapter 542 sets forth deadlines governing an insurer's handling of first-party claims.[13] Section 542.058 provides that if any insurer delays payment for more than sixty days "after receiving all items, state-

3. *Id.* §§ 541.003, 541.151.
4. *In re* Deepwater Horizon, 807 F.3d 689, 697 (5th Cir. 2015).
5. 754 S.W.2d 129 (Tex. 1988).
6. *In re Deepwater Horizon*, 807 F.3d at 697 (emphasis omitted).
7. *Id.* at 698.
8. 988 S.W.2d 189, 198–99 (Tex. 1998).
9. *In re Deepwater Horizon*, 807 F.3d at 698 (citing Great Am. Ins. Co. v. AFS/BEX Fin. Servs., Inc., 612 F.3d 800, 808 & n.1 (5th Cir. 2010)).
10. *Id.* (citing United Nat'l Ins. Co. v. AMJ Invs., LLC, 447 S.W.3d 1, 11 (Tex. App.—Houston [14th Dist.] 2014, pet. dism'd) (independent injury not required); USAA Tex. Lloyd's Co. v. Menchaca, No. 13-13-00046-CV, 2014 Tex. App. LEXIS 8250, at *35 (Tex. App.—Corpus Christi July 31, 2014, pet. filed) (mem. op.) (relying on *Vail*, 754 S.W.2d 129)). *But see* Admiral Ins. Co. v. Petron Energy, Inc., 1 F. Supp. 3d 501, 503–04 (N.D. Tex. 2014) (applying independent injury requirement and granting summary judgment for insurer where insured sought only policy benefits and expenses incurred in the coverage litigation).
11. *In re Deepwater Horizon*, 807 F.3d at 698, 701.
12. Tex. Ins. Code Ann. ch. 542 (West 2015).
13. *Id.* §§ 542.054–542.057.

ments, and forms reasonably requested and required . . . the insurer shall pay damages and other items as provided by Section 542.060."[14] Section 542.060 makes the insurer liable for 18 percent annual interest on the amount of the claim and for the insured's reasonable attorney's fees.[15]

In *Cox Operating, L.L.C. v. St. Paul Surplus Lines Insurance Co.*, the U.S. Court of Appeals for the Fifth Circuit addressed whether the penalties under § 542.060 can be imposed only for a violation of § 542.058 or for any violation of the statutory deadlines.[16] The insured sought coverage for costs it incurred in cleaning up from damage due to Hurricane Katrina. After reimbursing the insured for $1.4 million, the insurer filed suit "seeking a declaration that the remainder of [the] costs" were not covered.[17] The jury found that the insurer "failed to commence an investigation or request [items from the insured] within 30 days" of the insured's notice of the claim, in violation of § 542.055.[18] Reasoning that the insurer's failure to request information signaled to the insured that the initial notice was all that was necessary, the district court concluded that the statutory interest began accruing sixty days after the notice date. Judgment was entered against the insurer for around $9.5 million in contractual damages and around $13.1 million in penalty interest.[19]

On appeal, the insurer challenged only the determination of the accrual date, arguing that because only § 542.058, and none of the other deadlines, imposes penalty interest under § 542.060, interest does not begin to accrue on a particular cost until sixty days after the date the insurer received the invoice supporting that cost.[20] In rejecting this argument, the Fifth Circuit acknowledged the absence of express language in any of the other statutory sections tying a violation of its deadline to the penalty interest under § 542.060, but dismissed this as a "disturbing inconsistency" in the statute.[21] The Fifth Circuit instead reasoned that reading the statute as imposing interest only for a violation of § 542.058, but not for violation of other statutory deadlines, would render the other deadlines toothless and inoperative.[22] The Fifth Circuit therefore concluded that, "[n]otwithstanding § 542.058's specific reference to penalty interest . . . [Chapter 542] as a whole is clear: a violation of any of the Act's deadlines . . . triggers the accrual of statutory interest under § 542.060."[23]

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14. *Id.* § 542.058.

15. *Id.* § 542.060.

16. Cox Operating, L.L.C. v. St. Paul Surplus Lines Ins. Co., 795 F.3d 496, 505–09 (5th Cir. 2015).

17. *Id.* at 498.

18. *Id.* at 506.

19. *Id.* at 498.

20. *Id.* at 506.

21. *Id.* at 507 (quoting Devonshire Real Estate & Asset Mgmt., L.P. v. Am. Ins. Co., No. 3:12-CV-2199-B, 2014 WL 4796967, at *2 (N.D. Tex. Sept. 26, 2014)).

22. *Id.* at 507–08 (quoting *Devonshire*, 2014 WL 4796967, at *21; City of San Antonio v. City of Boerne, 111 S.W.3d 22, 29 (Tex. 2003)).

23. *Id.* at 508.

C. *Stowers* Liability[24]

1. Stowers Does Not Require Insurer to Accept Settlement Demand That Does Not Fully Release Insured from All Claims

The First Houston Court of Appeals revisited the requirements for a settlement demand to trigger an insurer's duty to settle under *Stowers*.[25] The claimant sued the insured for the wrongful death of his wife, and during the course of the litigation, he sent the insured's liability insurer two settlement demands—the first for the insurer to pay its policy limits to the children of the claimant and the deceased, and the second for the insurer to pay its policy limits to the claimant.[26] The insurer declined both proposals, interpleaded its limits, and was granted a release and discharge. The claimant and the insured subsequently entered into a settlement agreement, under which the claimant agreed not to execute on a judgment against the insured in exchange for the insured's assignment of its claims against the insurer.[27] Following a post-answer default judgment against the insured, the claimant sued the insurer under *Stowers*, alleging that it had negligently failed to settle the wrongful death suit.

Under *Stowers*, "insurers have a common-law duty to exercise ordinary care in the settlement of claims to protect their insureds against judgments in excess of policy limits."[28] To trigger the *Stowers* duty to settle, the settlement offer must be unconditional and must propose to fully release the insured.[29] The court of appeals explained that the claimant's two settlement offers "did not propose to fully release [the insured], as [the insured] would still have been liable to an excess judgment to either [the claimant], his children, or his wife's estate, whichever was not named in the settlement demand."[30] The court of appeals further reasoned that had the insurer paid the policy to settle with only one of the claimants, it "could have potentially exposed [the insured] to an excess judgment by one of the other claimants."[31] The court of appeals therefore held that the "settlement offers did not trigger [the insurer's] *Stowers* duty to settle" and affirmed the grant of summary judgment in favor of the insurer.[32]

Interestingly, the court of appeals's analysis did not mention *Texas Farmers Insurance Co. v. Soriano*,[33] in which the Texas Supreme Court held that an insurer which enters into a reasonable settlement with one

24. G.A. Stowers Furniture Co. v. Am. Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929, no writ.).

25. Patterson v. Home State Cnty. & Mut. Ins. Co., No. 01-12-00365-CV, 2014 Tex. App. LEXIS 4460, at *18–27 (Tex. App.—Houston [1st Dist.] Apr. 24, 2014 2014, pet. denied) (mem. op.).

26. *Id.* at *1–2.

27. *Id.* at *5.

28. *Id.* at *18.

29. *Id.* at *23.

30. *Id.* at *23–24.

31. *Id.* at *24.

32. *Id.* at *24, *28.

33. 881 S.W.2d 312 (1994).

claimant does not violate *Stowers*, even if insufficient limits are left to resolve other claims.[34] The current rule thus appears to be that an insurer is permitted, but is not required, to accept a settlement demand that does not release the insured from all liability as to all claimants.

III. CONTRACTUAL LIABILITY

A. Contract Interpretation

1. Texas Supreme Court Holds Additional Insured Endorsement Incorporates Limitations on the Scope of Coverage Within Underlying Contract

The Texas Supreme Court addressed whether coverage for an additional insured can be limited in scope and to amounts designated in an underlying contract between the named insured and additional insured. *In re Deepwater Horizon* arose out of the April 2010 sinking of the Deepwater Horizon drilling rig in the Gulf of Mexico.[35] BP sought coverage for the resulting personal injury and property damage claims under the primary and excess liability policies issued to Transocean, who was the drilling-rig owner. Transocean's insurer did not dispute whether BP was an additional insured; rather, the dispute centered on whether "BP is entitled to coverage for liabilities it expressly assumed in the [drilling contract it has with Transocean]."[36]

Transocean was required to procure liability insurance for BP only "for liabilities assumed by [Transocean] under the terms of [the drilling contract]."[37] Responsibility for pollution-related liabilities at or above the water surface was allocated to Transocean under an indemnity provision in the drilling contract. In another indemnity provision in the drilling contract, BP assumed responsibility for any pollution liabilities not assumed by Transocean.

The additional insured provisions in the policies expanded the definition of "Insured" to anyone whom Transocean was "obliged by any oral or written 'Insured Contract' . . . to provide insurance."[38] The insurers argued that this policy language required reference to the drilling contract for the scope of additional insured coverage, and that because Transocean had not assumed liability for subsea pollution, BP was not insured for that liability. BP argued the existence and scope of additional insured coverage must be evaluated exclusively from the policies' terms, and that no limitation existed on the scope of coverage for the pollution claims.

The supreme court found that while its initial analysis must begin with the language from the policies, that language required reference to the

34. *Id.* at 315.
35. *In re* Deepwater Horizon, 470 S.W.3d 452, 456 (Tex. 2015).
36. *Id.*
37. *Id.* at 457.
38. *Id.* The parties did not dispute that Transocean was obliged to procure insurance for BP under the terms of the drilling contract. *Id.* at 458.

underlying drilling contract to determine the status and scope of additional insured coverage.[39] Thus, the coverage for BP was limited to the amounts and type required by the drilling contract because its status as an additional insured was "inextricably intertwined with limitations on the extent of coverage to be afforded under the Transocean policies."[40] Because BP had assumed responsibility for the subsea pollution, Transocean was not required under the drilling contract to provide additional insured coverage to BP for that liability.[41] As a result, the supreme court held that BP was not an additional insured with respect to the claims and damages related to the subsea pollution.[42]

2. Texas Supreme Court Finds that EPA Notice Letters Can Constitute "Suit"

In *McGinnes Industrial Maintenance Corp. v. Phoenix Insurance Co.*, the Texas Supreme Court analyzed the meaning of the term "suit" in the commercial general liability context.[43] In 2009, the Environmental Protection Agency (EPA) notified the insured via special notice letter that the insured was responsible for site cleanup and reimbursement costs based on the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) resulting from dumping activities the insured committed in the 1960s. The EPA eventually issued a unilateral order directing the insured to perform its own investigation of remedial steps in accordance with EPA specifications. The EPA also warned that a failure to comply would subject the insured to civil penalties and punitive damages.[44] The insured sought coverage from its insurers.

The policies required the insurer "to defend any suit against [an] insured seeking damages on account of . . . property damage."[45] Unlike most modern general liability (GL) policies, the policies at issue did not define the term, suit. The insurers denied coverage, claiming that the EPA letters and CERCLA proceeding did not constitute a suit in the traditional sense of the term.[46] The insured filed a coverage lawsuit, which ultimately reached the Fifth Circuit, who certified the following question to the supreme court: "Whether the EPA's [notice] letters and/or unilateral administrative order, issued pursuant to CERCLA, constitute a 'suit' within the meaning of the CGL policies, triggering the duty to

39. *Id.* at 455, 460, 462.

40. *Id.* at 455–56.

41. *See id.* at 464–65.

42. *Id.* at 467–68; *see also* Ironshore Specialty Ins. Co. v. Aspen Underwriting, Ltd., 788 F.3d 456, 457 (5th Cir. 2015) (applying *In re Deepwater Horizon* and holding that the amount of insurance oil well service company was obligated to provide for oil rig owner was limited to that amount identified in the master service agreement between the parties).

43. McGinnes Indus. Maint. Corp. v. Phoenix Ins. Co., 477 S.W.3d 786, 787 (Tex. 2015).

44. *Id.* at 790.

45. *Id.*

46. *Id.*

defend."[47]

Though agreeing with the insurers and conceding that the term, suit, usually refers to a proceeding in court, the supreme court answered the certified question "yes" for three reasons.[48] First, at the time the policies were written, which was in an era before the existence of the EPA or CERCLA, lawsuits were required to enforce pollution laws.[49] Under modern laws, however, the supreme court reasoned that EPA letters and proceedings are, "in actuality, . . . the suit itself."[50] The supreme court identified parallels between the EPA proceedings and actual litigation, including the similarities between the PRP letters and pleadings, the EPA's use of discovery to obtain information, use of mediation to attempt settlement, administrative orders that resemble summary judgments, and fines and penalties that function in a similar manner to sanctions in civil litigation.[51] The supreme court also rejected the notion that its ruling would impose a duty to defend in response to every demand letter to an insured.[52]

Second, the supreme court noted that "relatively well-settled" law exists that CERCLA cleanup costs constitute damages as contemplated by the policies at issue.[53] The supreme court added that "To interpret the policies as covering the damages incurred as a result of pollution cleanup proceedings without giving the Insurers the right and duty to defend those proceedings creates perverse incentives and consequences for insurers and insureds alike."[54]

Finally, the supreme court decided—in an effort to "strive for uniformity as much as possible"[55]—to join the thirteen other state high courts that have adopted this broad interpretation of the term, suits, explaining that "insureds in Texas should not be deprived the coverage insureds have in [those] states."[56] Nevertheless, the supreme court recognized in its opinion that high courts in California, Illinios, and Maine have actually sided with the interpretation of suits put forward by the insurer, meaning that complete uniformity was impossible.[57]

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47. *Id.*

48. *Id.* at 791.

49. *Id.*

50. *Id.* The supreme court noted that potentially responsible parties (PRPs) have no practical hope for relief in light of CERCLA, and that the PRPs have essentially no choice but to comply with the EPA. *Id.* at 789.

51. *Id.* at 791.

52. *Id.* at 792.

53. *Id.*

54. *Id.* Seemingly at odds with this statement, under Texas law an insurer can have a duty to indemnify even if it has no duty to defend. D.R. Horton-Tex., Ltd. v. Markel Int'l Ins. Co., Ltd., 300 S.W.3d 740, 741 (Tex. 2009) ("We hold that the duty to indemnify is not dependent on the duty to defend and that an insurer may have a duty to indemnify its insured even if the duty to defend never arises.").

55. *McGinnes*, 477 S.W.3d at 794 (quoting Trinity Universal Ins. Co v. Cowan, 945 S.W.2d 819, 824 (Tex. 1997)).

56. *Id.* at 793–94.

57. *Id.*

The majority opinion drew a scathing dissent, authored by Justice Boyd, which began as follows:

> If you do not like your insurance policy, the Supreme Court of Texas can now change it for you. Never mind all those times the Court has said "we may neither rewrite the parties' contract nor add to its language." Forget that we have repeatedly said "[i]f an insurance contract uses unambiguous language, we will . . . enforce it as written." Ignore our former commitment to interpreting insurance policies by relying on the "ordinary, everyday meaning of its words to the general public." Disregard our prior conviction that a contract's language is the best representation of what the parties mutually intended. Those are just rules of construction, and we have only followed them because they support freedom of contract, promote transactional stability and predictability, and facilitate industry and commerce. As it turns out, those objectives are now provisional, and like a contract, the Court's precedential opinions are just words on paper, so you cannot assume we really meant what we chose to say.
>
> At times, the Court's members have characterized other members' opinions as ignoring these rules while claiming to follow them. The Court makes no such pretentions today. Instead, it flatly abandons the rules and openly superimposes a meaning onto the term "suit" that the Court concedes to be outside the term's ordinary meaning, unsupported by the context, and indisputably beyond what the contracting parties actually contemplated. Today the Court demonstrates that it can and will rewrite your insurance policy if it wants to. We may look beyond the policy's words to decide what we think you must (or should) have meant. We will even make up our own definitions so your words can mean something completely new. Why would the Court do this, in spite of everything we've always said about construing insurance policies? Because it seems like a good thing to do here (and on top of that, everyone else is doing it). My law professors (and my momma) taught me better. I respectfully dissent.[58]

Interestingly, the majority candidly recognized that the EPA letters did not fit within the ordinary meaning of the term suit.[59] The supreme court also recognized that the policies at issue were written prior to CERCLA.[60] Thus, the insurer could not have contemplated the existence—much less the scope—of such proceedings at the time of drafting the policy language.[61] Accordingly, it appears that extending the meaning of "suit" to such proceedings exceeds the scope of insurance actually contemplated by the parties.[62]

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58. *Id.* at 794–97 (Boyd, J., dissenting) (internal citations omitted).
59. *See id.* at 797.
60. *See id.* at 800.
61. *See id.* at 801–02.
62. *See id.*

3. Fifth Circuit Evaluates the Effect of Ambiguity in Policy Language and Whether Sophisticated Insured Exception Exists to Rule of Contra Proferentem

In *Certain Underwriters at Lloyd's London v. Perraud*, the U.S. Court of Appeals for the Fifth Circuit evaluated issues with respect to a possible sophisticated insured exception to the long-standing doctrine of *contra proferentem*.[63] Underwriters issued a directors' and officers' liability policy to Stanford Financial Group Company (SFGC). SFGC employees Bruce Perraud and Thomas Raffanello sought reimbursement of their attorneys' fees and costs following successful defense to criminal charges. The underwriters denied coverage based on an exclusion, prompting coverage litigation in federal court. The district court found the exclusion ambiguous and, after applying the doctrine of *contra proferentem*,[64] held that coverage applied under the policy. In doing so, the district court refused to adopt a sophisticated-insured exception to that doctrine. On appeal, the underwriters challenged only whether the sophisticated-insured exception should apply.[65]

The Fifth Circuit recognized that courts around the country have taken various approaches to the application and scope of this exception.[66] Some courts apply it only when "the insured actually negotiated the *particular* provision at issue."[67] Other courts have adopted a broad exception, noting that it applies if "the insured is a sophisticated business entity, regardless of whether the insured, or someone on the insured's behalf, actually negotiated or drafted portions of the policy."[68] Most courts, however, apply the exception only "where the insured—or a broker acting on the insured's behalf—actually negotiates, drafts, or proposes *portions* of the policy."[69] The Fifth Circuit declined to opine whether Texas courts would

63. Certain Underwriters at Lloyd's London v. Perraud, 623 F. App'x 628, 630 (5th Cir. 2015).

64. *See* Nat'l Union Fire Ins. Co. v. Willis, 296 F. 3d 336, 339 (5th Cir. 2002) (noting that if a policy is susceptible to more than one reasonable interpretation, "Texas law requires an insurance policy to be construed against the insurer and in favor of the insured.").

65. The underwriters did not challenge whether the exclusion was ambiguous. Moreover, the underwriters did not argue that Texas *actually* recognizes a sophisticated-insured exception. Rather, the underwriters "assumed that the Supreme Court of Texas would answer" this issue on certified question from the Fifth Circuit in *In re Deepwater Horizon*, 470 S.W.3d 452 (Tex. 2015). *Perraud*, 623 F. App'x at 631–32. The supreme court found it unnecessary in that case to address this argument. The Fifth Circuit thus found that the underwriters waived this issue on appeal. *Id.* at 632.

66. *Id.* at 630–31.

67. *Id.* at 630 (emphasis supplied) (citing Commercial Union Ins. Co. v. Walbrook Ins. Co., 7 F.3d 1047, 1053 n.8 (1st Cir. 1993); McDermott Int'l, Inc. v. Lloyds Underwriters of London, 944 F.2d 1199, 1207 (5th Cir. 1991); AIU Ins. Co. v. Superior Court, 799 P.2d 1253, 1265 n.9 (Cal. 1990); Ogden Corp. v. Travelers Indem. Co., 681 F. Supp. 169, 174 (S.D.N.Y. 1988)).

68. *Id.* at 630–31 (citing Eagle Leasing Corp. v. Hartford Fire Ins. Co., 540 F.2d 1257, 1261 (5th Cir. 1976); St. Paul Mercury Ins. Co. v. Grand Chapter of Phi Sigma Kappa, Inc., 651 F. Supp. 1042, 1045 (E.D. Pa. 1987); Owens-Illinois, Inc. v. United Ins. Co. 650 A.2d 974, 991 (N.J. 1994)).

69. *Id.* at 631 (emphasis added).

actually recognize any exception.[70] Assuming, *arguendo*, that they would, the Fifth Circuit evaluated whether Underwriters offered sufficient "evidence to create a genuine dispute of material fact as to whether they have satisfied that exception if it did exist."[71] The Fifth Circuit found that Underwriters put forth insufficient evidence to warrant application of the narrow or middle-ground approaches recognized by courts.[72] The Fifth Circuit also concluded that there was no reason to conclude that Texas would adopt the broad application of the exception.[73] Accordingly, the Fifth Circuit found that "[t]he district court did not err by declining to apply the exception even if, *arguendo*, it were applicable in Texas."[74] Applying the well accepted doctrine of *contra proferentum* and observing Texas's strong policy in favor of finding coverage, the Fifth Circuit affirmed summary judgment for the insureds finding coverage under the policy.[75]

4. Insurer not Required to Show Prejudice to Deny Coverage Based on Late Notice Under Claims-Made-and-Reported Policy

In *Prodigy Communications Corp. v Agricultural Excess & Surplus Insurance Co.*, the Texas Supreme Court held that an insured's breach of a notice condition must result in a material breach of the policy for the insurer to deny coverage.[76] This ruling, however, was limited to the facts of the case because the supreme court specifically recognized that while late, the notice was provided by the insured during the extended reporting deadline.[77] Thus, the insured's delay was not a material breach because the insurer "was not denied the benefit of the claims-made nature of its policy as it could not 'close its books' on the policy until . . . after the discovery period expired."[78] *Prodigy*, when read in conjunction with *PAJ, Inc. v. Hanover Insurance Co.*[79] and *Financial Industries Corp. v. XL Specialty Insurance Co.*[80] left open an inference that an insurer need not show prejudice to deny coverage when an insured provides notice of a claim under a claims-made policy *after* the policy period or other report-

70. *Id.* at 631–32 (declining to address this issue because the underwriters waived it on appeal).

71. *Id.* at 632.

72. *Id.* at 633.

73. *Id.* at 632.

74. *Id.* at 633.

75. *Id.* at 632–33.

76. Prodigy Commc'ns Corp. v Agric. Excess & Surplus Ins. Co., 288 S.W.3d 374, 375 (Tex. 2009).

77. *See id.*

78. *Id.* at 382.

79. 243 S.W.3d 630, 636–37 (Tex. 2008) (holding insurer must show prejudice before denying coverage on late notice because notice provision is not an essential part of the bargained-for exchange in an "occurrence" policy).

80. 285 S.W.3d 877, 879 (Tex. 2009) (holding insurer must show prejudice before denying coverage on late notice under claims-made policy when notice received during the policy period).

ing deadline.[81]

The Dallas Court of Appeals addressed this issue recently in *Nicholas Petroleum, Inc. v. Mid-Continent Casualty Co.*[82] In that case, the policies at issue required the insured to provide notice of a claim "as soon as practicable but in any event no later than thirty (30) days after the receipt of the Claim by the Insured."[83] The initial policy period was from September 17, 2007 to September 17, 2008, and was renewed for the policy period from September 17, 2008 to September 17, 2009.[84]

The Texas Commission on Environmental Quality (TCEQ) notified the insured on May 10, 2006, of alleged pollution from the insured's tanks at its facility.[85] The TCEQ sent additional letters to the insured on August 23, 2006; July 12, 2007; September 12, 2007; February 5, 2008; and July 13, 2008. In August 2006, the owner of the building next to the insured's property retained counsel and sent a letter to the insured seeking damages resulting from the pollution. The building owner eventually filed suit against the insured on August 4, 2008.

The insured argued that "it did not receive notice of a claim . . . until the TCEQ sent a letter on February 5, 2009 stating it had become aware that a release has occurred from a storage tank system [on the insured's property]" and that the insured was the responsible party.[86] On April 10, 2009, the insured notified the insurer of the ongoing litigation with its neighbor. The insured eventually settled and sought coverage from the insurer, who denied based on late notice.

Though the insured conceded it failed to provide notice of the lawsuit within the thirty day reporting provision of the 2008-2009 policy, the insured argued that the insurer was required to show prejudice to deny coverage because the insured had provided notice within the policy period. The court of appeals noted that the notice provision at issue contained additional restrictive language that notice be provided to the insurer "no later than thirty (30) days after receipt of the Claim by the Insured."[87] Based on the specificity of the policy language at issue, the court of appeals concluded that the "notice provision is a material part of the bargained-for exchange in this policy, and [the insured's] failure to comply with the notice provision was a material breach."[88] Because the insured failed to provide notice within thirty days after receipt of the claim, the court of appeals found that the policy did not provide coverage

81. *See, e.g.*, Pennzoil-Quaker State Co. v. Am. Int'l Specialty Lines Ins. Co., 653 F. Supp. 2d 690, 698 (S.D. Tex. 2009) (holding insurer not required to show prejudice by insured's failure to provide notice to insurer within extended reporting period of a claims-made-and-report policy).

82. No. 05-13-01106-CV, 2015 Tex. App. LEXIS 7489, at *9 (Tex. App.—Dallas July 21, 2015, no pet.) (mem. op.).

83. *Id.* at *3.

84. *Id.* at *1.

85. *Id.* at *3–4.

86. *Id.* at *10.

87. *Id.* at *14–15.

88. *Id.* at *15.

for the settlement.[89]

5. *Texas Supreme Court Recognizes Insurer May Have Contractual Right of Reimbursement from Its Insured for Breach of a Policy Requirement, Even in the Absence of a Reimbursement Provision in the Policy*

In *Gotham Insurance Co. v. Warren E&P, Inc.*, the Texas Supreme Court also addressed the scope of an insurer's right to seek reimbursement from its insured, specifically the "role of equity claims when a contractual provision addresses the matter in dispute."[90] The insured sought coverage for expenses incurred in regaining control of an oil well blowout. The insurer sued the insured under contract and equity theories for reimbursement of amounts it had paid, alleging that the insured misrepresented its ownership interest in the well. The supreme court relied on its prior holding that "[w]here a valid contract prescribes particular remedies or imposes particular obligations, equity generally must yield unless the contract violates positive law or offends public policy."[91] The supreme court determined that because the contractual provisions relied on by the insurer did not violate the law or public policy, the insurer was limited to contractual claims and could not proceed on its equity claims.[92] Then addressing the contract claims, the supreme court emphasized that the absence of an express reimbursement clause in the policy "does not necessarily foreclose an insurer's ability to recover [from the insured] if the insured has breached the policy," and recognized that an insurer may still pursue a claim against the insured to recover damages proximately caused by the insured's breach.[93]

B. Duty to Defend

1. *Federal and State Courts Reach Conflicting Results Regarding Whether an Exception to Eight-Corners Rule Exists*

Liability insurance policies typically impose two separate and distinct duties on an insurer: (1) the duty to defend; and (2) the duty to indemnify. To determine whether an insurer has a duty to defend, Texas courts follow the "eight-corners" rule, so called because "only two documents are ordinarily relevant to the determination . . . the policy and the pleadings of the third-party claimant."[94] The Texas Supreme Court has yet to

89. *Id.* at *15–16; *see also* Netspend Corp. v. Axis Ins. Co., No. A-13-CA-456-SS, 2014 U.S. Dist. LEXIS 97656, at *21 (W.D. Tex. July 18, 2014), *aff'd*, 609 F. App'x 268 (5th Cir. 2015) (holding an insurer need not demonstrate prejudice because the insured did not provide notice in compliance with the reporting period requirement of the policy).

90. Gotham Ins. Co. v. Warren E&P, Inc., 455 S.W.3d 558, 559 (Tex. 2014).

91. *Id.* at 563 (quoting Fortis Benefits v. Cantu, 234 S.W.3d 642, 648–49 (Tex. 2007)).

92. *Id.* at 563–66.

93. *Id.* at 566–67.

94. GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church, 197 S.W.3d 305, 308 (Tex. 2006) (citing King v. Dall. Fire Ins. Co., 85 S.W.3d 185, 187 (Tex. 2002)).

officially recognize that any exception to the eight-corners rule exists.[95] Federal courts have consistently recognized that an exception *may* exist that would allow use of extrinsic evidence in certain circumstances to determine the duty to defend. Their state court counterparts, however, have been inconsistent and less willing to apply, much less even recognize, any such exception. Litigation over this issue will likely continue until the Texas Supreme Court provides additional guidance.

In *Star-Tex Resources, L.L.C. v. Granite State Insurance Co.*, the U.S. Court of Appeals for the Fifth Circuit again addressed this issue and held that an insurer could rely on undisputed extrinsic evidence to establish that it had no duty to defend.[96] The underlying plaintiff's complaint included a brief factual statement regarding the incident at issue: "On or about June 29, 2010, [underlying plaintiff] was seriously injured in an automobile collision caused by the negligence of Defendant Esquivel, an employee of Star-Tex Resources. Defendant Esquivel was under the influence of alcohol and/or drugs at the time of the collision."[97] The insurer denied coverage, arguing that an exclusion barred coverage for injury arising out of the use of an auto owned or operated by any insured. Coverage litigation ensued.

The insurer argued that it was reasonable to infer from the vague pleading that an employee of the insured was operating a vehicle at the time of the incident, meaning that there was no duty to defend based on the exclusion.[98] Alternatively, the insurer argued that extrinsic evidence within the initial notice of the claim should be admissible in establishing that there was no duty to defend based on the exclusion.[99]

The Fifth Circuit noted that the pleading supported multiple reasonable inferences. Accordingly, the Fifth Circuit found that it was not possible to determine from the pleadings alone whether a potentially covered claim was alleged.[100] The Fifth Circuit then evaluated whether to recognize an exception to the eight-corners rule based on the two-part test established in *Northfield Insurance Co. v. Loving Home Care, Inc.*[101] Based on the brief one-sentence description of the facts of the accident in the underlying complaint, the Fifth Circuit found that the first part of the test was met because it was impossible to determine whether coverage was implicated.[102] Although the auto exclusion was potentially implicated

95. *See id.* ("[T]his Court has never expressly recognized an exception to the eight-corners rule.").

96. Star-Tex Resources, L.L.C. v. Granite State Ins. Co., 553 F. App'x 366, 372–73 (5th Cir. 2014).

97. *Id.* at 367.

98. *Id.* at 370.

99. The General Liability Notice of Occurrence/Claim provided to the insurer stated that the insured's employee "put car in motion pinning [the underlying plaintiff] between t[w]o cars causing injury." *Id.*

100. *Id.* at 370.

101. *Id.* at 371–73 (citing Northfield Ins. Co. v. Loving Home Care, Inc., 363 F.3d 523, 531 (5th Cir. 2004)).

102. *Id.* at 372 (citing *Northfield*, 363 F.3d at 531).

in the complaint's description of the facts of the collision, the material fact of whether the underlying defendant was driving the vehicle was omitted.[103] Second, the Fifth Circuit "consider[ed] whether '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.'"[104] The Fifth Circuit found the extrinsic evidence of whether the underlying defendant was operating the vehicle applied only to the issue of coverage, and not to the negligence of the underlying defendant or plaintiff.[105] The Fifth Circuit additionally found the extrinsic evidence also did not go to the truth or falsity of the underlying complaint's alleged facts, especially "given the paucity of facts contained in [the underlying plaintiff's] terse complaint."[106] Accordingly, the Fifth Circuit determined that the insurer could rely on the extrinsic evidence exception to the eight-corners rule to deny the duty to defend.[107]

In a subsequent opinion, the U.S. Court of Appeals for the Fifth Circuit again analyzed this issue—this time where an insured sought to introduce extrinsic evidence that would arguably trigger the duty to defend.[108] In *Evanston Insurance Co. v. Lapolla Industries, Inc.*, the insured sought to introduce evidence that the underlying injuries at issue resulted from the mere presence of insulation, as opposed to the release of vapors from that insulation during the installation process.[109] The insured argued that if the extrinsic evidence was allowed, the pollution exclusion was inapplicable because the product itself caused the injuries as opposed to the vapors emitting therefrom. The Fifth Circuit found that the detailed factual allegations in the complaint established that the underlying plaintiff sought damages resulting from vapors.[110] As a result, the Fifth Circuit held that the insured could not introduce extrinsic evidence "because it [was] not impossible to discern whether coverage [was] potentially implicated."[111]

During the Survey period, federal courts in the Northern District and Southern District of Texas recognized that an exception to the eight-corners rule exists, but they refused to allow the use of extrinsic evidence in evaluating the duty to defend because that evidence touched on the merits of the underlying lawsuit.[112] However, in *Texas Farm Bureau Under-*

103. *Id.*
104. *Id.* (quoting *Northfield*, 363 F.3d at 531).
105. *Id.* at 372–73.
106. *Id.* at 373.
107. *Id.*
108. Evanston Ins. Co. v. Lapolla Indus., Inc., No. 15-20213, 2015 U.S. App. LEXIS 22552, at *1, *4 (5th Cir. Dec. 23, 2015). The Fifth Circuit's analysis mirrors that of the district court, which released its opinion on Feb. 23, 2015. *See generally* Evanston Ins. Co. v. Lapolla Indus., 93 F. Supp. 3d 606 (S.D. Tex. 2015).
109. *Evanston Ins. Co.*, 2015 U.S. App. LEXIS 22552, at *11.
110. *Id.* at *12.
111. *Id.* (internal quotation marks omitted).
112. Selective Ins. Co. v. ICI Constr., Inc., No. G-14-110, 2015 U.S. Dist. LEXIS 47000, at *2–5 (S.D. Tex. Mar. 13, 2015) (refusing to allow evidence that additional insured's liability was caused by the named insured's ongoing operations); Acadia Ins. Co. v. Jacob & Martin, Ltd., No. 4:13-cv-798-O, 2014 U.S. Dist. LEXIS 72901, at *9 (N.D. Tex. May 28,

writers v. Graham, the Texarkana Court of Appeals[113] flatly refused to even recognize that an exception to the eight-corners rule exists.[114] The insured sought to introduce evidence that, in his opinion, demonstrated that the shooting at issue in the underlying lawsuit was the result of an accident thereby triggering the insurer's duty to defend. The court of appeals stated that "[r]eliance on this kind of extrinsic evidence violates the eight corners rule."[115] The court of appeals then went further: "To date, neither the Texas Supreme Court nor the Tyler Court of Appeals has officially embraced any exception to the eight corners rule, and our sister courts have declined to apply the exception referenced in *Pine Oak Builders, Inc.*"[116] Despite the court of appeals's refusal to even recognize or evaluate whether an exception to the eight-corners rule exists, multiple Texas state courts have recognized and applied an extrinsic evidence exception to determine whether an insurer has a duty to defend.[117]

2. Duty to Defend Not Triggered by Threatened Litigation

Although the duty to defend is broad, the U.S. District Court for the Northern District of Texas recently held that this duty is not implicated by the *threat* of imminent litigation.[118] In *American Construction Benefits Group, LLC v. Zurich American Insurance Co.*, the insured had a claims-made policy covering it for losses caused by claims made for "wrongful acts committed by [its] directors, officers, or employees."[119] The insured settled a claim resulting from a purported wrongful act of its president, and, in turn, sought coverage for the settlement from its insurer. Thereafter, members of the insured organization purportedly threatened to file a derivative action against the insured's directors relating to the settlement. The insured filed a declaratory judgment, seeking to have the court determine whether the insurer has a duty to defend the insured against the imminent derivative suit. Relying on the principles of the eight-corners rule, the district court held that it could not decide on the duty to defend

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2014) (refusing to allow extrinsic evidence that underlying plaintiff's death potentially resulted from covered cause as opposed to excluded cause alleged in pleading)).

113. Originally in the Tyler Court of Appeals, the case was transferred by the Texas Supreme Court as part of its docket equalization efforts. Tex. Farm Bureau Underwriters v. Graham, 450 S.W.3d 919, 921 n.1 (Tex. App.—Texarkana 2014, pet. denied).

114. *Id.* at 925.

115. *Id.*

116. *Id.* (citing Burlington N. & Santa Fe Ry. Co. v. Nat'l Union Fire Ins. Co., 394 S.W.3d 228, 235 (Tex. App.—El Paso 2012, pet. denied); AccuFleet, Inc. v. Hartford Fire Ins. Co., 322 S.W.3d 264, 273 (Tex. App.—Houston [1st Dist.] 2009, no pet.)).

117. *See, e.g.*, Weingarten Realty Mgmt. Co. v. Liberty Mut. Fire Ins. Co., 343 S.W.3d 859, 869 (Tex. App.—Houston [14th Dist.] 2011, pet. denied); State Farm Fire & Cas. Co. v. Wade, 827 S.W.2d 448, 452–53 (Tex. App.—Corpus Christi 1992, writ denied); Gonzales v. Am. States Ins. Co. of Tex., 628 S.W.2d 184, 187 (Tex. App.—Corpus Christi 1982, no writ); Cook v. Ohio Cas. Ins. Co., 418 S.W.2d 712, 715–16 (Tex. Civ. App.—Texarkana 1967, no writ); Int'l Serv. Ins. Co. v. Boll, 392 S.W.2d 158, 160–61 (Tex. Civ. App.—Houston 1965, writ ref'd n.r.e).

118. Am. Constr. Benefits Grp., LLC v. Zurich Am. Ins. Co., No. 3:12-CV-2726-D, 2014 WL 144974, at *3 (N.D. Tex. Jan. 15, 2014).

119. *Id.* at *1.

issue because a necessary component (i.e., the pleading) to make such an evaluation was missing.[120]

C. Commercial Property Insurance

1. Texas Supreme Court Holds Vacancy Clause Not Subject to Anti-Technicality Statute or Prejudice Requirement

The Texas Supreme Court recently upheld the application of the vacancy clause within a homeowners' policy as a basis for denial of coverage.[121] In *Greene v. Farmers Insurance Exchange*, the homeowner/insured moved from her home that was insured by Farmers Insurance Exchange (Farmers) under the Texas Homeowners-A Policy (HOA) coverage form. More than four months after the insured moved, her home was damaged by fire. Farmers subsequently denied coverage for the loss, citing a vacancy provision, which states: "If the insured moves from the dwelling . . . the dwelling will be considered vacant. Coverage that applies under Coverage A (Dwelling) will be suspended effective 60 days after the dwelling becomes vacant. This coverage will remain suspended during such vacancy."[122]

The insured argued that § 862.054 of the Texas Insurance Code (the Anti-Technicality Statute) and prior Texas Supreme Court case law prohibited the insurer from relying on the vacancy condition because (1) the vacancy did not cause or otherwise contribute to the loss; and (2) the vacancy did not prejudice the insurer. The supreme court addressed the insured's arguments regarding the Anti-Technicality Statute first.[123] That statute provides as follows:

> Unless the breach or violation contributed to cause the destruction of the property, a breach or violation by the insured of a warranty, condition, or provision of a fire insurance policy or contract of insurance on personal property, or of an application for the policy or contract:
> (1) does not render the policy or contract void; and
> (2) is not a defense to a suit for loss.[124]

The supreme court found that the Anti-Technicality Statute is applicable only to a breach—that is, failure "to perform an act that [a party] has contractually promised to perform."[125] The vacancy clause in the policy contained no such "promise by or obligation on behalf of [the insured] to occupy the house."[126] Rather, "[t]he vacancy clause [was] substantively an agreement between the insured and [the insurer] that [the insurer] will continue insuring the house for sixty days after it no longer is her resi-

120. *Id.* at *3.
121. Greene v. Farmers Ins. Exch., 446 S.W.3d 761, 762–63 (Tex. 2014).
122. *Id.* at 763.
123. *Id.* at 764.
124. *Id.* at 764–65 (quoting Tex. Ins. Code. Ann. § 862.054 (West 2014)).
125. *Id.* at 765.
126. *Id.*

dence."[127] Thus, the supreme court rejected the insured's argument that triggering the vacancy clause was the same as breaching a warranty, condition, or provision as contemplated by the Anti-Technicality Statute.[128]

The supreme court also rejected the insured's argument that the insurer was required to show prejudice.[129] The analysis on this issue focused on the fact that because there was no breach of any condition (as established by the discussion in the first portion of the opinion), prejudice was not at issue.[130] Finally, the supreme court rejected the insured's arguments that public policy precluded application of the vacancy condition.[131] The vacancy clause could not be characterized as a mere technicality under the Anti-Technicality Statute because it was contained in a coverage form approved by the Texas Department of Insurance, which has authority from the legislature to make decisions regarding whether provisions violate public policy.[132]

2. Texas Supreme Court Holds that the Anti-Concurrent-Causation Exclusion Bars Coverage for Loss That Resulted from Both Covered and Excluded Causes of Loss

In *JAW The Pointe, L.L.C. v. Lexington Insurance Co.*, the Texas Supreme Court considered for the first time the applicability of the anti-concurrent-causation exclusion under Texas law.[133] The insured owned an apartment complex in Galveston that was damaged by Hurricane Ike. During the rebuilding and adjusting process, the insured learned of a city ordinance requiring any apartment that sustained damage at fifty percent or more of its market value to be "brought into compliance with current code requirements."[134] Because the ordinance applied to the properties, the insured was required to demolish and rebuild the structures at substantial cost.

The policy provided coverage on an "all risk" basis.[135] Moreover, it contained an endorsement covering the increased cost of repairs or replacement as a result of an ordinance, but only if the policy covers the property damage that triggers the enforcement of the ordinances. The damage to the apartment complex was caused by a combination of wind (which is covered) and flooding (which is specifically excluded). Nevertheless, an exclusion in the policy barred coverage for "loss or damage caused directly or indirectly by any [excluded cause or event], *regardless of any other cause or event that contributes concurrently or in any se-*

127. *Id.*
128. *Id.* at 765–66.
129. *Id.* at 767.
130. *Id.* at 768.
131. *Id.* at 769–70 (distinguishing Puckett v. U.S. Fire Ins. Co., 678 S.W.2d 936 (Tex. 1984)).
132. *Id.* at 770.
133. JAW The Pointe, L.L.C. v. Lexington Ins. Co., 460 S.W.3d 597, 607 (Tex. 2015).
134. *Id.* at 600.
135. *Id.* at 604.

quence to the loss."[136] Thus, the issue before the supreme court was whether a covered loss caused the enforcement of the ordinance.[137]

The insurer argued that because the damages triggering the application of the ordinance were caused by both wind and flood, the anti-concurrent-causation exclusion precluded coverage. The insured argued "that because [the policy was] an all-risks policy" and a single covered cause of loss occurred, "the burden shifted to [the insurer] to show the damage that caused the enforcement of the ordinances was damage that the policy excluded."[138] The supreme court noted as follows:

> Under these facts, and the contractual anti-concurrent-causation clause, . . . the relevant inquiry is what in fact triggered enforcement of the ordinances, not what in theory was sufficient to do so. Here, [the insured] does not seek to recover losses caused by wind damage—[the insurer] has already paid . . . for those losses—or losses caused by flood damage—[the insured] concedes that the policy excludes coverage for those losses. Instead, [the insured] seeks to recover losses caused by the city's enforcement of the ordinances against [the apartments]. The question, therefore, is what caused the city to enforce the ordinances.[139]

The supreme court found "that the evidence conclusively establishe[d] that . . . both wind and flood damage, in a sequence of events, . . . combined to cause the city to enforce the ordinances."[140] Thus, because an excluded cause of loss resulted in the application of the ordinances against the property, the anti-concurrent-causation exclusion applied.[141] In reaching this holding, the supreme court rejected the insured's argument that application of the anti-concurrent-cause exclusion would conflict with the common law concurrent-cause doctrine previously recognized by Texas courts.[142] The supreme court stated that reliance on the common law was inappropriate because the specific policy language at issue in the policy before the supreme court was determinative.[143]

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136. *Id.* at 607 (emphasis added).
137. *Id.* at 606.
138. *Id.* at 606–07.
139. *Id.* at 608.
140. *Id.* at 609.
141. *Id.* at 610.
142. With respect to the common law concurrent-cause doctrine, the supreme court has held the following:

> [W]hen excluded and covered events combine to cause a loss and the two causes cannot be separated, concurrent causation exists and the exclusion is triggered such that the insurer has no duty to provide the requested coverage. But when a covered event and an excluded event each independently cause the loss, separate and independent causation exists, and the insurer must provide coverage despite the exclusion.

Id. at 608 (internal citations and quotation marks omitted).
143. *Id.*

D. Workers' Compensation Coverage

1. Texas Supreme Court Clarifies and Expands on Scope of Ruttiger

In 1988, the Texas Supreme Court extended the common law duty of good faith and fair dealing to workers' compensation insurers.[144] In 2012, however, the supreme court overruled its 1988 decision and held in *Texas Mutual Insurance Company v. Ruttiger* that when the Texas Legislature substantially amended the Workers' Compensation Act in 1989, the legislature sufficiently addressed the deficiencies that led to the creation of the common law remedy.[145] Specifically, the supreme court found that because the legislature created detailed procedures and remedies in the amended Workers' Compensation Act (the Act), there was no longer "any need for a judicially imposed cause of action."[146] Rather, the Act now provides the exclusive remedy in *all* workers' compensation claims and the sole recourse to challenge most insurer misconduct.[147] Therefore, the supreme court ruled that an injured employee may not sue a workers' compensation carrier for common-law bad faith or for unfair settlement and investigation practices under the Texas Insurance Code.[148] Nevertheless, the supreme court recognized that its opinion did not bar all common law and statutory remedies available in the workers' compensation context.[149]

The Texas Supreme Court further explained the *Ruttiger* holding in *In re Crawford*.[150] Following an injury while working for his employer and beginning the administrative process for receiving benefits, the employee and his wife simultaneously filed suit against the workers' compensation carrier, alleging wrongful denial of benefits, misrepresentation of benefits and coverage, "fail[ing] to provide required notices," "repeatedly agree[ing] to pay for benefits . . . but then refus[ing] to do so," "perform[ing] inadequate and misleading investigations" into their claims, and false accusations "leading to [a] wrongful arrest[ ]" for insurance fraud.[151] Although the employee and his wife acknowledged that the administrative process provided the exclusive procedure for obtaining comp benefits, they argued that "additional, independent, and 'unrelated' damages" could be tried in civil courts.[152]

The specific issue in *Crawford* not addressed in *Ruttinger* was "whether the Division ha[d] exclusive jurisdiction over a claim for misrepresentation[s] . . . [in a] claims-settlement context."[153] The supreme court found

144. Aranda v. Ins. Co. of N. Am., 748 S.W.2d 210, 212–13 (Tex. 1988), *overruled by* Tex. Mut. Ins. Co. v. Ruttiger, 381 S.W.3d 430, 451 (Tex. 2012).
145. *Ruttiger*, 381 S.W.3d at 447.
146. *Id.* at 451.
147. *Id.* at 451, 462.
148. *Id.* at 451.
149. *Id.* at 445–46.
150. 458 S.W.3d 920, 923–25 (Tex. 2015) (per curiam).
151. *Id.* at 921–22.
152. *Id.* at 922.
153. *Id.* at 927.

that all claims at issue in *Crawford* should have been dismissed by the trial court for lack of jurisdiction.[154] The allegations based on deception, fraud, and misrepresentation were without jurisdiction because the Workers Compensation Act specifically prohibited carriers from making misrepresentations, including misrepresentations regarding the Act's provisions and reasons for not paying benefits.[155] Similarly, the supreme court determined that the "claims for negligence, gross negligence, breach of contract, quantum meruit, breach of the duty of good faith and fair dealing, and statutory violations" were all without jurisdiction because they arose "out of [the] investigation, handling, and settling of the" claims by the employee and his wife.[156] Moreover, the "claims for malicious prosecution and intentional infliction of emotional distress" were without jurisdiction because they arose out of the carrier's "investigation, handling, and settling of the . . . claims for workers' compensation benefits."[157] Finally, the supreme court found that the argument by the employee's wife that her claims were independent of the Act because she was not an employee were without merit.[158] Thus, the supreme court dismissed all the claims by the employee and his wife against the carrier pending final resolution of the administrative adjudication.[159]

2. Availability of Lifetime Income Benefits Requires Actual Loss of Use of Member of Body Itself

In *Dallas National Insurance Co. v. De La Cruz*, the Texas Supreme Court considered whether an employee, who fell in 2004 and injured her knee and back, was entitled to lifetime income benefits (LIBs).[160] The employee, who was a cook for the insured, underwent back and arthroscopic knee surgery but "continued to experience pain and numbness in her legs."[161] In 2009, she filed a claim for LIBs on the basis that her "2004 injury caused the total loss of use of both her feet at or above the ankle, the loss of use was permanent, and she was entitled to LIBs pursuant to [the Texas Labor Code.]"[162] Thus, at issue was whether the worker actually suffered "total loss of use of both feet at or above the ankle."[163]

The supreme court noted that "[f]or total loss of use of a member to be compensable," there must be loss of use of the member itself "as opposed to the loss of use resulting from injury to another part of the body."[164] Although there was "evidence that the injury to [the worker's] back affected her lower extremities, including her feet," this evidence did not

154. *See id.* at 923, 929.
155. *Id.* at 926.
156. *Id.*
157. *Id.* at 927.
158. *Id.* at 928.
159. *Id.* at 928–29.
160. Dall. Nat'l Ins. Co. v. De La Cruz, 470 S.W.3d 56, 57 (Tex. 2015) (per curiam).
161. *Id.*
162. *Id.*
163. *Id.* at 58 (citing TEX. LAB. CODE ANN. § 408.161(a)–(b) (West 2015)).
164. *Id.*

foreclose the possibility that this condition resulted from "reflecting injury to the nerve roots in [the worker's] back."[165] Without further evidence of actual damage or harm to the physical structure of the worker's back or feet and evidence that the injury caused the "permanent total loss of use" of them, the supreme court held that the evidence was legally insufficient to meet statutory requirements for LIBs.[166] This decision, combined with the supreme court's previous holding from *Insurance Company of State of Pennsylvania v. Muro*[167] and language from the Texas Labor Code, reinforce the intent that LIBs are available only when there is total loss of use of a body member that results from injury to the physical structure of the member itself.

3. Travelling to and from Work Considered to be in the Course and Scope of Employment

In *Seabright Insurance Co. v. Lopez*, the Texas Supreme Court examined whether an employee was acting in the course and scope of his employment while traveling to a job site.[168] The employer had its primary office in Odessa, Texas, but provided services and assigned the employee to remote job sites, where he would usually stay in a motel and receive a per diem for food and expenses.[169] The employee was killed in an automobile accident while using a company provided vehicle and transporting two of his co-workers to a work site more than 450 miles from his home.[170] The insurer denied coverage for death benefits, claiming the employee was not in the course and scope of his employment at the time of his death.[171]

The supreme court conceded that travel to and from work is not usually considered in the course and scope of employment, which requires that an activity be related to or originate in the employer's business and occur in the furtherance of that business.[172] The supreme court, however, explained that an exception applied if "the relationship between the travel and the employment is so close that it can fairly be said that the injury had to do with and originated in the work, business, trade or profession of the employer."[173] The supreme court concluded that the evidence demonstrated that the employee's injury was so closely related to his job that it had to do with and originated in his employer's work.[174] The supreme court noted that the employer's business model called for employing crews who would constantly shift from one remote assignment

165. *Id.* at 59.
166. *Id.*
167. 347 S.W.3d 268, 271–72 (Tex. 2011).
168. Seabright Ins. Co. v. Lopez, 465 S.W.3d 637, 639 (Tex. 2015).
169. *Id.* at 640.
170. *Id.*
171. *Id.*
172. *Id.* at 641 (citing Leordeanu v. Am. Prot. Ins. Co., 330 S.W.3d 239, 241 (Tex. 2010)).
173. *Id.* at 642 (citing Shelton v. Standard Ins. Co., 389 S.W.2d 290, 292 (Tex. 1965)).
174. *Id.* at 644.

to another.[175] Moreover, the employer provided a per diem, hotel money, a company vehicle, fuel, insurance, and expected co-workers to carpool; and the travel to and from remote sites was both dictated by the employer and an essential part of the employment.[176]

4. Texas Supreme Court Addresses Allocation of Benefits Among Multiple Beneficiaries

In *State Office of Risk Management v. Carty*, the Texas Supreme Court answered the Fifth Circuit's certified question regarding "[h]ow . . . a workers' compensation carrier's right . . . to treat a recovery as an advance of future benefits [should] be calculated in a case involving multiple beneficiaries."[177] A state worker died in a training accident; afterward, the workers' compensation carrier for state employees paid medical, funeral, and death benefits to his wife and children.[178] In addition to those benefits, the deceased's wife filed suit in federal court against two companies, Ringside, Inc. and Kim Pacific Martial Arts. Following settlement with the defendants, the workers' comp carrier intervened to assert its right to reimbursement.[179]

The trial court apportioned the settlement among the claimants into four different categories, not as a collective group, but instead based on the ratio of benefits they had already received.[180] The carrier challenged this allocation on the grounds that it misapplied the relevant section of the Texas Labor Code governing carrier reimbursement from third-party recoveries.[181] Under the Texas statutory scheme, "amount[s] recovered by a claimant in a third-party action shall be used to reimburse the insurance carrier for benefits, including medical benefits, that have been paid[.]"[182] If there is money left over, that amount is "treated as an advance against future benefits, including medical benefits, that the claimant is entitled to receive."[183] If there is not enough money to fully compensate the claimants for all future benefits, the carrier "shall resume the payment of benefits when the advance is exhausted."[184] The carrier argued that multiple beneficiaries in a single settlement should be treated as a single group for purposes of determining when the carrier's obligations to resume benefit payments; when the total amount of suspended benefits reached the total amount of money allocated as advance pay-

175. *Id.*

176. *Id.* The supreme court also found that because the employee was using transportation furnished by the employer, an exception to the statutory "course and scope" limitations applied. *Id.* at 645 (citing TEX. LAB. CODE ANN. § 401.011(12)(A) (West 2015)).

177. State Office of Risk Mgmt. v. Carty, 436 S.W.3d 298, 299–300 (Tex. 2014).

178. *Id.* at 300.

179. *Id.* at 300–01.

180. *Id.*

181. *See id.*; *see also* TEX. LAB. CODE ANN. § 417.002.

182. TEX. LAB. CODE ANN. § 417.002(a).

183. *Id.* § 417.002(b).

184. *Id.* § 417.002(c).

ments, the carrier would resume payments.[185] The beneficiaries, on the other hand, argued that the point at which benefit payments should resume was best determined on a beneficiary-by-beneficiary basis.[186]

The supreme court sided with the carrier, noting that the beneficiaries' interpretation would require treating the award of future benefits differently from the award of past benefits.[187] The supreme court noted that the legislature designed the statutory reimbursement scheme to give the carrier "the first money a worker receives from a tortfeasor"; it went on to point out that attempting to allocate future payments on a beneficiary-by-beneficiary basis would only lead to further disputes over the proper apportionment.[188] Moreover, the statutory description of the carrier's subrogation interest did not distinguish between past or future interests, and nothing in the language of the statute indicated that past and future interests should be treated differently.[189] Finally, apportionments like the one imposed by the trial court "undermine[d] the goal of reducing carrier costs."[190] Thus, "a workers' compensation carriers right under section 417.002 to treat a third-party recovery as an advance of future benefits in a case involving multiple beneficiaries of the same covered employee should be determined on a collective-recovery basis."[191]

E. Commercial General Liability Coverage

1. Courts Clarify the Scope and Application of Gilbert and the Contractual Liability Exclusion

In 2010, the Texas Supreme Court issued its decision in *Gilbert Texas Construction, LP v. Underwriters at Lloyd's London*, in which it analyzed the proper application of the contractual liability exclusion in commercial general liability policies.[192] Shortly thereafter, in *Ewing Construction Co., Inc. v. Amerisure Insurance Co.*, the U.S. Court of Appeals for the Fifth Circuit certified questions to the Texas Supreme Court regarding the scope and application of *Gilbert*.[193] Since these decisions, the Fifth Circuit has wrestled with the proper application of the contractual liability exclusion.

In *Gilbert*, the insured was sued for damages sustained by a third party's building, which was adjacent to the insured's work site.[194] After defeating all potential tort liability through summary judgment, the only

185. *Carty*, 436 S.W.3d at 302–03.
186. *Id.* at 302.
187. *Id.* at 303.
188. *Id.* at 303–04.
189. *Id.* The supreme court relied on the fact that both the section describing the payment of past benefits and the section describing the allocation of future benefits referred to "the claimant." *Id.*
190. *Id.* at 306.
191. *Id.* at 307.
192. Gilbert Tex. Constr., LP v. Underwriters at Lloyd's London, 327 S.W.3d 118, 121 (Tex. 2010).
193. Ewing Constr. Co., Inc. v. Amerisure Ins. Co., 690 F.3d 628, 633 (5th Cir. 2012).
194. *Gilbert*, 327 S.W.3d at 122.

remaining theory of liability arose from the insured's contract with DART. Following settlement of the remaining claim, the insured "sought indemnity from its insurers," arguing a narrow reading should be given to the exclusion and that "assumption" in the exclusion's terms referred only to the assumption of "liability of *another* such as in hold-harmless or indemnity agreements."[195] The supreme court held that "assumption of liability" means that the insured has assumed a liability for damages that exceeds the liability it would have under general law.[196] Therefore, the contractual liability exclusion applies to exclude coverage for claims where "the insured assumes liability for damages in a contract" that it would not have otherwise had under the law.[197] The supreme court determined that the insured had assumed liability for damage to property of a third party that it would not have had under general law and that the only relevant exception, "the exception for liability the insured would have [in the] absen[ce] [of a] contract," did not apply.[198] Accordingly, it held that the contractual liability exclusion barred coverage for the insured's claim.[199]

In *Ewing*, the U.S. Court of Appeals for the Fifth Circuit struggled to apply *Gilbert*.[200] The Fifth Circuit originally determined that the contractual liability exclusion applied when an insured entered into a contract, and, by doing so, has assumed liability for its own performance under that contract.[201] But less than two months after issuing its original opinion, the Fifth Circuit withdrew its opinion and certified the following question[202] to the Texas Supreme Court:

> 1. Does a general contractor that enters into a contract in which it agrees to perform its construction work in a good and workmanlike manner, without more specific provisions enlarging this obligation, "assume liability" for damages arising out of the contractor's defective work so as to trigger the Contractual Liability Exclusion.[203]

The facts were relatively straight forward: a school district sued the insured and sought damages for allegedly defective construction of a tennis court.[204] The school district alleged that the insured failed to (1) "properly prepare for and manage . . . construction"; (2) "retain and oversee subcontractors"; (3) "perform in a good and workmanlike manner"; (4) complete construction in accordance with the contract terms and specifi-

195. *Id.* at 121, 125 (emphasis in original).
196. *Id.* at 127.
197. *Id.* at 128, 131–32.
198. *Id.* at 123, 133–36.
199. *Id.* at 131–32.
200. Ewing Constr. Co., Inc. v. Amerisure Ins. Co., 690 F.3d 628, 632 (5th Cir. 2012).
201. Ewing Constr. Co., Inc. v. Amerisure Ins. Co., 684 F.3d 512, 519 (5th Cir. 2012), *withdrawn by* 690 F.3d 628 (2012).
202. The Fifth Circuit certified two questions. The supreme court, however, did not address the second question because it answered the first "no." Ewing Constr. Co., Inc. v. Amerinsure Ins. Co., 420 S.W.3d 30, 31 (Tex. 2014).
203. *Id.* at 31.
204. *Id.*

cations; and (5) "use ordinary care in the performance of its contract," proximately causing damages to Plaintiff.[205]

Quoting *Gilbert*, the insurer first contended that the contractual liability exclusion "means what it says: it excludes claims when the insured assumes liability for damages in a contract or agreement, except when the insured would be liable absent the contract or agreement."[206] It then argued that the exclusion applied because the insured contractually assumed liability for damages arising from its failure to construct the tennis courts in a good and workmanlike manner.[207] The insured argued that, pursuant to *Gilbert*, the contractual liability exclusion is triggered only when the liability assumed under contract "enlarge[s] its obligations beyond any general common-law duty it might have."[208] The supreme court agreed with the insured and concluded:

> [A] general contractor who agrees to perform its construction work in a good and workmanlike manner, without more, does not enlarge its duty to exercise ordinary care in fulfilling its contract, thus it does not 'assume liability' for damages arising out of its defective work so as to trigger the Contractual Liability Exclusion.[209]

Therefore, it answered the certified question "no."[210]

The same year the Texas Supreme Court answered *Ewing*, the U.S. Court of Appeals for the Fifth Circuit was once again faced with determining the scope of the contractual liability exclusion. In *Crownover v. Mid-Continent Casualty Co.*,[211] the insured entered into a construction contract to build a home for the Crownovers.[212] The contract included a warranty-to-repair clause that required the insured to promptly correct work that did not conform to the requirements of the contract. After the work was completed, the Crownovers noticed various defects. When the insured refused to correct the deficiencies, the Crownovers initiated arbitration. The arbitrator determined that that the insured was liable for breach of the construction contract's warranty-to-repair clause.[213] The Crownovers demanded that the insurer pay the arbitration award, but the insurer denied coverage.[214]

The Fifth Circuit initially found that the insured's obligation to perform its work in a workmanlike manner was based solely on the construction contract.[215] The Crownovers petitioned for rehearing because that ruling conflicted with *Gilbert* and *Ewing*. On rehearing, the Fifth Circuit first

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205. *Id.* at 33–34.
206. *Id.* at 36.
207. *Id.*
208. *Id.*
209. *Id.* at 68.
210. *Id.*
211. 772 F. 3d 197 (5th Cir. 2014).
212. *Id.* at 199.
213. *Id.*
214. *Id.*
215. Crownover v. Mid-Continent Cas. Co., 757 F. 3d 200, 208 (5th Cir. 2014), *withdrawn by* 772 F.3d 197 (2014).

determined that the insured's defective work was an occurrence under the policy that caused property damage to the Crownovers' HVAC system and the foundation.[216] The Fifth Circuit then explained that to trigger the contractual liability exclusion, the insurer was required to show that "the source of the adjudicated liability—the express duty to repair—expanded [the insured's] obligations" under common law.[217] In determining whether the insurer had met its burden, the Fifth Circuit identified three elements in the construction contract that "could potentially have triggered the contractual-liability exclusion: (1) it constituted an *express* rather than implied warranty; (2) it was a duty to *repair* rather than construct; (3) it referred to performance in conformity with the *contract* documents rather than simple competent performance."[218] The Fifth Circuit determined that none of these factors "extended [the insured's] liability beyond its liability under general law" because there is a general law duty to perform the terms of a contract with reasonable care and to repair work that is not performed work in a good and workmanlike manner.[219] Because the insured's "adjudicated liability reflected a duty no broader than that required by general law," the Fifth Circuit held that contractual liability exclusion did not apply.[220] The Fifth Circuit rendered summary judgment in favor of the Crownovers and remanded the case to the district court for calculation of attorneys' fees.[221]

2. Fifth Circuit Analyzes Scope of "Advertisement" and "Advertising Injury" Under Coverage B

The U.S. Court of Appeals for the Fifth Circuit recently applied a broad interpretation of the term "advertisement" as used in the context of general liability policy. In *Mid-Continent Casualty Co. v. Kipp Flores Architects, LLC*, the underlying-plaintiff architectural firm Kipp Flores Architects, LLC (KFA) licensed eleven distinct home designs to the insured.[222] Under the license agreement, the insured was authorized to build one home per design for a total of eleven homes. If the insured desired to build additional homes using a licensed design, it was required to compensate KFA in advance for the use of that design. The insured built the original eleven houses, but then built hundreds of other houses using the same design plans without paying additional licensing fees. KFA sued and obtained a large judgment against the insured for copyright infringement.[223]

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216. *Crownover*, 772 F. 3d at 206–07.
217. *Id.* at 207.
218. *Id.* (emphasis in original).
219. *Id.* at 207–08.
220. *Id.* at 209–10.
221. *Id.* at 213.
222. Mid-Continent Cas. Co. v. Kipp Flores Architects, LLC, 602 F. App'x 985, 987 (5th Cir. 2015).
223. *Id.* at 988.

The insurer filed a declaratory judgment action, arguing "that the . . . judgment [against the insured] was not for a covered 'advertising injury' because the infringement did not take place in an 'advertisement' as defined in the policies."[224] The policies at issue provide coverage for damages because of "personal and advertising injury," which is defined, in part, as "injury . . . arising out of . . . infringing upon another's copyright . . . in [the insured's] 'advertisement.'"[225] Advertisement is defined as "a notice that is broadcast or published to the general public or specific market segments about [the insured's] goods, products or services for the purpose of attracting customers or supporters."[226]

According to the insurer, an infringing house cannot—under the language of the policy and common sense—be "notice" that is "broadcast or published," and therefore the house itself can never be an advertisement.[227] The Fifth Circuit rejected this argument, noting initially that the policy does not restrict that notice must be in a particular form.[228] Rather, prior case law has construed "notice" broadly, finding that "publish" is a comprehensive term meaning "'to make public or generally known' or 'to make generally accessible or available for acceptance or use . . . [or] to present to or before the public.'"[229] Moreover, the term "advertisement" has an expansive definition under Texas law, with the Texas Supreme Court finding that an "advertising" is a "'marketing device[ ] designed to induce the public to patronize' a particular establishment."[230] Because the undisputed facts demonstrated that the insured's "primary means of marketing" consisted of the use of the homes themselves, both through the use of model homes and yard signs on the various properties, the Fifth Circuit found that infringing houses were advertisements under the terms of the policies.[231]

F. Excess Coverage

In a recent decision, the U.S. Court of Appeals for the Fifth Circuit held that an insured could not trigger an excess policy by making a "fill the gap" payment to exhaust a primary policy after the primary insurer made settlement payments that did not exceed the primary policy limits.[232] The insured obtained an excess insurance policy from AXIS Insurance Company (AXIS), which stated that AXIS had no obligation to provide coverage until "after all applicable Underlying Insurance . . . has been exhausted by actual payment under such Underlying Insurance."[233] After settling a lawsuit, the insured sued its three insurers, alleging it was

224. *Id.*
225. *Id.* at 990.
226. *Id.*
227. *Id.* at 992–93.
228. *Id.* at 993.
229. *Id.*
230. *Id.* at 993–94 (quoting Smith v. Baldwin, 611 S.W.2d 611, 614–15 (Tex. 1980)).
231. *Id.* at 994.
232. Martin Res. Mgmt. Corp. v. AXIS Ins. Co., 803 F.3d 766, 773 (5th Cir. 2015).
233. *Id.* at 769.

entitled to coverage under a primary policy issued by Zurich American Insurance Company (Zurich) and two excess policies (including the first excess AXIS policy), with each policy having a $10 million limit.[234]

The insured eventually settled with Zurich for $6 million. Thereafter, AXIS moved for summary judgment, arguing the primary policy was not exhausted because the primary insurer had not paid its full policy limits.[235] The insured argued that the AXIS policy allows the insured to "fill the gap" by paying the difference between the limit of the primary insurance and the below-limit settlement, thereby triggering the AXIS policy.[236] The Fifth Circuit held that "the AXIS policy unambiguously precludes exhaustion by below-limit settlement," noting that the language of the AXIS policy makes it clear that exhaustion requires "actual payment under [the Zurich Policy]" of its entire $10 million limit.[237] The Fifth Circuit also found that the AXIS policy prohibited the insured from "paying the difference between the underlying limit of liability and the below-limit settlement," including the "Reduction or Exhaustion of Underlying Limits" and "Limits of Liability" provisions.[238] Moreover, the Fifth Circuit held that even if the primary insurer's below-limit settlement constituted an actual payment, Martin's argument that its own gap payments also were "actual payments under [the primary policy]" was not reasonable.[239]

The Eastland Court of Appeals in *Plantation Pipe Line Co. v. Highlands Insurance Co.* reached a different conclusion, relying on the specific policy language at issue.[240] The underlying dispute arose out of a $12 million remediation undertaken by the insured as required by North Carolina pollution control laws. The insured had four layers of liability policies to cover such losses, with the "special risk policy" issued by Highlands Insurance Company (Highlands) attaching at $8 million.[241] The insured sued the three underlying insurers in Georgia state court (the insured did not initially sue Highlands), which ultimately resulted in a settlement in which the underlying insurers settled for less than their respective policy limits. The insured "paid the remaining balance of the loss."[242] Thereafter, the insured notified Highlands that the total losses exceeded $8 million and demanded that it indemnify it for the excess of that amount.[243] Highlands responded to the demand arguing that its policy was not impli-

234. *Id.* at 767. The second excess policy, issued by Arch Insurance Company, was not at issue on appeal.

235. *Id.* at 768.

236. *Id.*

237. *Id.* at 769–70.

238. *Id.* at 772–73.

239. *Id.* at 770.

240. Plantation Pipe Line Co. v. Highlands Ins. Co., 444 S.W.3d 307, 309, 311 (Tex. App.—Eastland 2014, pet. denied).

241. *Id.* at 310.

242. *Id.*

243. *Id.*

cated because the underlying limits were not fully exhausted. Coverage litigation ensued.

The court of appeals held that the Highlands policy attached based on its terms despite the fact that the underlying settlements were for amounts less than full policy limits.[244] The court of appeals initially explained that the Highlands policy directed it to look to an underlying umbrella policy for the definition of "ultimate net loss."[245] Then, the court of appeals integrated into the "Exhaustion Clause" of the Highlands policy that definition of "ultimate net loss."[246] The result, according to the court of appeals, was the following "Limit of Liability" provision in the Highlands policy:

> It is expressly agreed that liability shall attach to [Highlands] only after the Underlying Umbrella Insurers have paid or have been held liable to pay the full amount of all sums which the insured or any organization as his insurer, *or both*, become legally obligated to pay as damages, whether by reason of adjudication *or settlement*, because of personal injury, property damage or advertising liability.[247]

Based on what it determined to be specific unambiguous language at issue permitted exhaustion via payments by the insured or the underlying insurers, meaning that the Highlands policy attached at $8 million.[248]

IV. DISCOVERY AND PROCEDURAL ISSUES

A. Discovery for Insurer's Claim Files for its Other Insureds was Overbroad

In *In re National Lloyds Insurance Co.*, the Texas Supreme Court ended the uncertainty regarding whether discovery of other policyholders' claim file is permissible by holding that such discovery will almost always be considered overbroad.[249] The insured's home in Cedar Hill, Texas was damaged by two hail storms—one in September 2011 and another in June 2012. The trial court ordered the insurer to produce all claim file materials for all claims adjusted by the two adjusting firms that adjusted the insured's claims, but only for claims for properties in Cedar Hill that arose from those particular storms.[250] On mandamus review, the supreme court agreed with the insurer that the requested discovery was necessarily overbroad and stated, "[W]e fail to see how National Lloyds' overpayment, underpayment, or proper payment of the claims of unrelated third parties is probative of its conduct with respect to Plaintiff's undervaluation claims at issue in this case."[251] The supreme court further opined,

244. *Id.* at 312.
245. *Id.*
246. *Id.*
247. *Id.* at 313 (emphasis added by court).
248. *Id.*
249. *In re* Nat'l Lloyds Ins. Co., 449 S.W.3d 486, 489 n.2 (Tex. 2014) (orig. proceeding) (per curiam).
250. *Id.* at 487.
251. *Id.* at 489–90.

"scouring claim files in the hopes of finding similarly situated claimants whose claims were evaluated differently from [those of the insured] is at best an impermissible fishing expedition."[252] The supreme court therefore directed the trial court to vacate its discovery order.[253]

B. Proper Parties to Coverage Litigation

1. An Underlying Claimant Appears to Be a Proper Party to a Declaratory Judgment Action by an Insurer

In bringing a declaratory judgment action, an insurer must evaluate whether the underlying claimant is a proper or necessary party to the litigation. With respect to declaratory judgments in federal court brought pursuant to the Federal Declaratory Judgment Act, case law is (relatively) clear that a third-party claimant is a proper party to the declaratory judgment action.[254] The U.S. District Court for the Northern District of Texas recently examined this issue again in *Vanliner Insurance Co.v. Dermargosian*.[255] The underlying tort action in *Dermargosian* involved claims against the insured for negligently packing a firearm in the underlying plaintiff's moving boxes, which resulted in the underlying plaintiff being charged with a crime in Dubai. After the insured sought coverage, the insurer commenced coverage litigation in federal court against both the insured and the underlying plaintiff.[256] The underlying plaintiffs moved to dismiss the action under various legal and procedural theories, arguing that "there [was] no actual controversy between the parties."[257] In particular, the underlying plaintiffs argued that there was no contractual privity with the insurer, that the insurer did not sell them a policy, and that the insurer did not appear to be making claims against them in the declaratory judgment action. Noting that "[a] declaratory judgment action among an insurer, an insured, and a plaintiff in a pending lawsuit against the insured constitutes a 'controversy' within the meaning of the [federal court declaratory judgment action statute] and Article III of the Constitution," the district court held that the underlying claimants failed to establish that the suit should be dismissed.[258] The district court also specifically noted that an individual injured by an insured party is considered a third-party beneficiary of the liability insurance policy; thus, the

252. *Id.* at 489.
253. *Id.* at 490.
254. *See* Century Sur. Co. v. Hardscape Constr. Specialties, No. 4:05-CV-285-Y, 2006 WL 1948063, at *5 (N.D. Tex. July 13, 2006) ("This court's determination that [the insurer] does not have a duty to indemnify [its insureds] is binding on [the injured party], as well, due to the derivative nature of its right to recovery."); Nat'l Am. Ins. Co. v. Breaux, 368 F. Supp. 2d 604, 621 (E.D. Tex. 2005) ("[U]nder Texas law, a declaratory judgment action brought by an insurer is binding upon a third-party beneficiary to a liability insurance policy if properly joined as a party to such action."); Bituminous Cas. Corp. v. Garcia, 223 F.R.D. 308, 311 (N.D. Tex. 2004); Ohio Cas. Ins. Co. v. Cooper Mach. Corp., 817 F. Supp. 45, 46–47 (N.D. Tex. 1993).
255. No. 3:12-CV-5074-D, 2014 WL 113595, at *3 (N.D. Tex. Jan. 13, 2014).
256. *Id.* at *1.
257. *Id.* (citing Fed. R. Civ. P. 12(b)(1), (6)).
258. *Id.* at *2, *4.

declaratory judgment action is binding against a properly joined third-party beneficiary.[259]

With respect to declaratory judgments brought in state court pursuant to the Texas Declaratory Judgment Act in the Texas Civil Practice and Remedies Code, the law remains unsettled. Some Texas state courts have held that the underlying claimant is not a proper party on the basis that no justiciable controversy exists between it and the insurer.[260] These courts based their analysis on a 1968 opinion issued by the Texas Supreme Court, *Fireman's Insurance Company of Newark, N.J. v. Burch*, in which the supreme court found that the duty to indemnify was not justiciable until a final judgment was rendered against the insured.[261] Despite *Burch*, the Texas Supreme Court held in its 1983 decision, *Dairyland County Mutual Insurance Co. v. Childress*, that if the underlying plaintiff is not a party to coverage litigation, the underlying plaintiff is free to relitigate issues regarding potential indemnity.[262] Thus, if the insurer did not include the underlying claimant (which courts had concluded was proper due to lack of a justiciable controversy), any adjudication in the declaratory judgment action was potentially inapplicable to the underlying claimant.

After the above cases were decided, the Texas Supreme Court issued an opinion in which it held that "duty to indemnify is justiciable" in certain circumstances *prior* to the time that a judgment is rendered in an underlying tort suit.[263] In *Griffin*, the Texas Supreme Court specifically stated that after *Burch*, the Texas Constitution was amended to give district court's broader jurisdiction, which includes jurisdiction over "all actions, proceedings, and remedies."[264]

2. Texas Supreme Court Reaffirms Texas is a no "Direct-Action" State

While an underlying claimant appears to be a proper party to a declaratory judgment action by an insurer, "an injured party cannot sue the tortfeasor's insurer directly until the tortfeasor's liability has been finally determined by agreement or judgment."[265] The Texas Supreme Court recently reaffirmed that Texas remains a "no direct action" state in *In re Essex Insurance Co.*[266] In that case, the underlying claimant argued that it could pursue the insured's insurer because its direct action was for declar-

259. *Id.* at *3

260. *See* Safeway Managing Gen. Agency for State & Cnty. Mut. Fire Ins. Co. v. Cooper, 952 S.W.2d 861, 868–69 (Tex. App.—Amarillo 1997, no writ); Providence Lloyds v. Blevins, 741 S.W.2d 604, 606–07 (Tex. App.—Austin 1987, no writ); Nat'l Sav. Ins. Co. v. Gaskins, 572 S.W.2d 573, 574–76 (Tex. Civ. App.—Fort Worth 1978, no writ).

261. Fireman's Ins. Co. of Newark, N.J. v. Burch, 442 S.W.2d 331, 332–33 (Tex. 1968), *superseded by constitutional amendment*, TEX. CONST. art. V, § 8, *as recognized in* Farmers Tex. Cnty. Mut. Ins. v. Griffin, 955 S.W.2d 81, 83 (Tex. 1997).

262. Dairyland Cnty. Mut. Ins. Co. v. Childress, 650 S.W.2d 770, 774 (Tex. 1983).

263. *Griffin*, 955 S.W.2d at 84.

264. *Id.* (quoting TEX. CONST. art V, § 8).

265. *See* Angus Chem. Co. v IMC Fertilizer, Inc. 939 S.W.2d 138, 138 (Tex. 1997) (per curiam).

266. 450 S.W.3d 524, 526 (Tex. 2014).

atory judgment and not money damages. The supreme court summarily rejected this argument, stating, "Whether stated as claims for damages or for declaratory relief, [third-party beneficiaries] claims against [insurer] must fail."[267] The supreme court first pointed out that the insurer would be faced with a conflict of interest if, in the same suit, it must both establish it has no duty to defend in addition to providing a vigorous defense to the insured.[268] Second, the supreme court surmised evidence of liability insurance would be admitted in a combined suit in violation of Rule 411 of the Texas Rules of Evidence.[269] Accordingly, because both of these policy reasons apply both to a "plaintiff . . . seeking declaratory relief or money damages from the insurer," the supreme court rejected the arguments that the Texas Declaratory Judgment Act provides a basis to avoid the no direct action rule.[270]

3. Fifth Circuit Allows Direct Action against Insurer Based on Compulsory Counterclaim Rule of Civil Procedure

Despite the no direct-action rule, the U.S. Court of Appeals for the Fifth Circuit recently allowed an underlying claimant to sue the insured's insurer directly.[271] In *National Liability and Fire Insurance Co. v. R&R Marine, Inc.*, the underlying tort action involved a bailment between the underlying claimant (bailee) and the insured (bailor) for the repair of two of the claimant's vessels. While one of the vessels was in the custody of the insured, it sank as a result of taking on water during a tropical storm. Thereafter, the insurer initiated a declaratory action, which resulted in the counterclaim by the claimant against the insurer arguing that it must cover all claims and damages the claimant had against its insured.[272] Relying on the no direct action rule, the insurer argued that a final judgment had not been entered against insured and therefore the predicate to the insurer's liability had not been met.[273] The claimant argued that it was required to assert its compulsory counterclaim against the insurer by the Federal Rules of Civil Procedure.[274]

Following, an *Erie* analysis, the Fifth Circuit determined that the principles of no direct action and compulsory counterclaims are in direct conflict.[275] The Fifth Circuit found that the counterclaim was compulsory under Rule 13(a) because it and the insurer's declaratory action arose out of the same occurrence.[276] Further, the Fifth Circuit aptly noted that because the insurer joined both the insured and the claimant in the initial

267. *Id.* at 526.
268. *Id.*
269. *Id.* at 526–27.
270. *Id.* at 527.
271. Nat'l Liab. & Fire Ins. Co. v. R&R Marine, Inc., 756 F.3d 825, 834–35 (5th Cir. 2014).
272. *Id.* at 828.
273. *Id.* at 833.
274. *Id.* at 834.
275. *Id.* at 835.
276. *Id.*

declaratory action, no additional parties were necessary to join.[277] Finally, the Fifth Circuit, in finding that a direct conflict between the state and federal laws exists, was required to determine whether application of the federal procedural rule would violate either the U.S. Constitution or the Rules Enabling Act.[278] The Fifth Circuit found that application of Rule 13(a) did not violate any constitutional rights, nor was the Rules Enabling Act violated because the underlying claimant's "counterclaim [did] not 'abridge, enlarge or modify any substantive right' under Texas law."[279] Citing *Hanna v. Plumer*, the Fifth Circuit concluded its discussion by noting the goal of uniformity in federal courts and their efficient administration of legal proceedings.[280] Following the principles established by *Hanna*, the Fifth Circuit determined that it could resolve the lawsuit in a single action by combining all potential disputes between the parties.[281] Accordingly, the Fifth Circuit held that the underlying claimant "had standing to bring its counterclaim" against the insured under Rule 13(a).[282]

Although *R&R Marine* appears to be limited to the specific facts and circumstances presented by that particular case, we suspect that claimants will rely on that holding to make arguments based on procedural rules or *res judicata* principles in their attempts to sue the tortfeasor's insurers directly. In light of the holding from *In re Essex*, however, it seems clear that Texas will remain a no direct action state until the legislature takes action to change this approach.

4. Federal Courts Address Arguments Related to Improper Joinder in Evaluating Jurisdiction for Coverage Litigation

Frequently an initial subject of coverage litigation is whether a non-diverse defendant is improperly joined in an attempt to defeat federal court jurisdiction. According to the U.S. Court of Appeals for the Fifth Circuit, the doctrine of improper joinder represents "a 'narrow exception' to the rule of complete diversity, and the burden of persuasion on the party claiming improper joinder is a 'heavy one.'"[283] Federal courts prefer for state court jurisdiction in these matters, noting that "doubts regarding whether removal jurisdiction is proper should be resolved against federal jurisdiction."[284] Additionally, "the Court must resolve all ambiguities of state law in favor of the non-removing party."[285] With these standards in mind, courts analyze improper joinder claims under the two potential circumstances. First, improper joinder may be established by the

277. *Id.*
278. *Id.*
279. *Id.* (citing 28 U.S.C. § 2072(b) (2012)).
280. *Id.* at 835–36 (citing Hanna v. Plumer, 380 U.S. 460 (1965)).
281. *Id.*
282. *Id.*
283. Campbell v. Stone Ins., Inc., 509 F.3d 665, 669 (5th Cir. 2007) (citing McDonal v. Abbott Labs., 408 F.3d 177, 183 (5th Cir. 2005)).
284. Acuna v. Brown & Root Inc., 200 F.3d 335, 339 (5th Cir. 2000).
285. *Campbell*, 509 F.3d at 669.

removing party through a showing of "(1) actual fraud in the pleading of jurisdictional facts, or (2) [the] inability of the plaintiff to establish a cause of action against the non-diverse defendant in state court."[286] A majority of cases turn on the second basis for showing improper joinder, which can be stated differently in that "there is no reasonable basis for the district court to predict that the plaintiff might be able to recover against an in-state defendant."[287] Several federal district courts call this inquiry a "Rule 12(b)(6)-type analysis" in that the defendant must show that the plaintiff has no possibility of recovery.[288] This standard often requires courts to enter into a fact-intensive inquiry considering the plaintiff's complaint in light of relevant state law. As a result, during this Survey period, various courts found that joinder was proper when the plaintiff established a valid cause of action against a non-diverse defendant,[289] whereas other courts found joinder improper where the plaintiff was unable to articulate a valid cause of action against the non-diverse defendant.[290]

C. The "Fully Adversarial Trial" Requirement

Texas courts continue to address the scope of *State Farm Fire and Casualty Co. v. Gandy*, which involved issues of whether an insurer is bound by an insured's settlement and assignment.[291] In *Gandy*, the Texas Supreme Court held:

> a defendant's assignment of his claims against his insurer to a plaintiff is invalid if (1) it is made prior to an adjudication of plaintiff's claim against defendant in a fully adversarial trial, (2) defendant's insurer has tendered a defense, and (3) either (a) defendant's insurer has accepted coverage, or (b) defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim. We do not address whether an assignment is also invalid if one or more of these elements is lacking. In no event, however, is a judgment for plaintiff against defendant, rendered without

286. McKee v. Kan. City S. Ry. Co., 358 F.3d 329, 333 (5th Cir. 2004).
287. Smallwood v. Ill. Cent. R.R. Co., 385 F.3d 568, 573 (5th Cir. 2004).
288. *Id.*
289. Celanese Corp. v. OneBeacon Am. Ins., Co., No. 3:14-CV-3981-L, 2015 WL 3939399, at *8 (N.D. Tex. June 25, 2015); Linron Props. v. Wausau Underwriters Ins. Co., No. 3:15-CV-00293-B, 2015 U.S. Dist. LEXIS 77357, at *12 (N.D. Tex. June 16, 2015); W. Ohio St. Condo Ass'n v. Allstate Ins. Co., No. 2:15-CV-192, 2015 U.S. Dist. LEXIS 77522, at *8 (S.D. Tex. June 16, 2015); Garza v. Scottsdale Ins. Co., No. 2:15-CV-149, 2015 U.S. Dist. LEXIS 77525, at *13 (S.D. Tex. June 16, 2015); Garza v. Geovera Specialty Ins. Co., No. 7:13-CV-525, 2014 U.S. Dist. LEXIS 1975, at *5 (S.D. Tex. Jan. 8, 2014); Rocha v. Geovera Specialty Ins. Co., No. 7:13-CV-589, 2014 U.S. Dist. LEXIS 1990, at *15 (S.D. Tex. Jan. 8, 2014).
290. Michels v. Safeco Ins. Co. of Ind., 544 F. App'x 535, 539–40 (5th Cir. 2013); Calvary United Pentecostal Church v. Church Mut. Ins. Co., No. 4:15-CV-365, 2015 U.S. Dist. LEXIS 122192, at *4 (E.D. Tex. Sept. 14, 2015); Davis v. State Farm Lloyds, No. 3:15-CV-0596-B, 2015 WL 4475860, at *6–7 (N.D. Tex. July 21, 2015); Mainali Corp. v. Covington Specialty Ins. Co., No. 3:15-CV-1087-D, 2015 U.S. Dist. LEXIS 115191, at *6 (N.D. Tex. Aug. 31, 2015); Struder v. State Farm Lloyds, No. 4:13CV413, 2013 U.S. Dist. LEXIS 183915, at *4–5 (E.D. Tex. Dec. 18, 2013).
291. *See* State Farm Fire & Casualty Co. v. Gandy, 925 S.W.2d 696, 698 (Tex. 1996).

> a fully adversarial trial, binding on defendant's insurer or admissible as evidence of damages in an action against defendant's insurer by plaintiff as defendant's assignee.[292]

Two Texas state appellate courts addressed the "fully adversarial trial" issue identified in *Gandy* during the Survey period, reaching differing results. In *Vela v. Catlin Specialty Insurance Co.*, the insured, a construction contractor, sued the general contractor for breach of contract, alleging he was owed money for work he performed.[293] The general contractor counterclaimed for breach of contract and negligence, asserting that the insured's work was "junk," requiring demolition and rebuilding at a cost of $100,000. The insurer initially denied coverage, but later "agreed to defend . . . under a reservation of rights."[294] The insured rejected this defense and proceeded with personal counsel. The insured and general contractor eventually agreed to waive their rights to a jury trial, that the insured would non-suit his claims, and that any sums adjudicated in subsequent litigation against the insurer would be divided between them.[295] At the bench trial, the trial court rendered judgment in favor of the general contractor of $312,204 plus $122,500 in attorneys' fees.[296] Thereafter, the insured filed suit against the insurer.

After finding that various "business risk" exclusions in the policy precluded the duty to defend, the Corpus Christi Court of Appeals then evaluated whether the insurer had a duty to indemnify the insured for the unpaid judgment.[297] According to the court of appeals, the parties' agreement, subsequent bench trial, minimal participation by the insured's counsel during the bench trial, and the insured's denial that he knew the proceeding took place[298] amounted to a "'sham of adversity' to the trial court and distorted the trial process."[299] The court of appeals concluded that the agreement tended to promote additional litigation, as opposed to providing a means to end the litigation, which is a practice expressly disapproved by the Texas Supreme Court for public policy reasons.[300] Thus, the court of appeals found that there was no "fully adversarial trial," that the insurer was not bound by the judgment, and that it owed no duty to indemnify the insured.[301]

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292. *Id.* at 714.

293. Vela v. Catlin Specialty Ins. Co., No. 13-13-00475-CV, 2015 Tex. App. LEXIS 3743, at *4 (Tex. App.—Corpus Christi Apr. 16, 2015, pet. denied) (mem. op.).

294. *Id.* at *5.

295. *Id.* at *7.

296. *Id.* at *9–10.

297. *Id.* at *19.

298. During his deposition, the insured stated that he did not believe or did not understand that a judgment was entered against him. He also testified that he had no knowledge of the bench trial and believed that he was still pursuing the general contractor for damages. *Id.* at *26–27.

299. *Id.* at *30. The court of appeals also found that the exclusions applicable to the duty to defend also barred indemnity coverage. *Id.* at *20.

300. *Id.* at *30.

301. *See id.* at *30 n.10; *see also* Nautilus Ins. Co. v. Villalta, 558 F. App'x 404, 405 (5th Cir. 2014) (per curiam) (holding an assignment by insured to underling plaintiffs was inva-

On the other hand, in *Great American Insurance Co. v. Hamel*, the El Paso Court of Appeals found a valid assignment that resulted from what it determined to be a fully adversarial trial.[302] The insured was sued for allegedly failing to construct a home "in a good and workmanlike manner."[303] The insurer refused to defend. Thereafter, the underlying parties entered into various agreements and stipulations relating to the claims at issue before trying the case to the bench. Both sides introduced extensive testimony during the trial regarding the work and damages at issue. Following entry of judgment against the insured, the insured assigned its claims against the insurer to the underlying plaintiffs, who filed suit against the insurer "for breach of contract, declaratory relief, and Texas Insurance Code violations."[304] The trial court in the coverage case eventually found that the insurer was liable for the damages the underlying plaintiffs recovered against the insured, and an appeal followed.

In rejecting the insurer's argument that the judgment against the insured "did not result from an 'actual trial,'" the court of appeals first determined that the insurer could not rely on this argument because it "breached its duty to defend."[305] Turning to the insurer's argument that the assignment violated *Gandy*, the court of appeals noted that this case was readily distinguishable from the facts in that case.[306] While *Gandy* involved a pre-trial assignment, the assignment in this case at bar followed a trial on the merits.[307] Second, the court of appeals found that none of the *Gandy* elements were at issue.[308] The court of appeals recognized that in considering the validity of an assignment against an insurer, "*Gandy* requires a 'fully adversarial trial,'" which is undefined in the case law.[309] However, noting that both parties were active participants in the underlying litigation, introducing extensive evidence, and engaging in cross-examination of witnesses, the court of appeals found that the trial court had been well-engaged and that the verdict resulted from a fully adversarial trial.[310] Thus, the court of appeals held that the assignment was proper.[311]

The Texas Supreme Court is set to address in *Seger v. Yorkshire Insurance Co., Ltd.*[312] the interplay between the *Gandy* "fully adversarial trial" requirement and its holding from *Evanston Insurance Co. v. Atofina Pet-*

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lid as a matter of law based on *Gandy* because there was no judgment or agreement that the insured had a legal obligation to pay damages to the underlying plaintiff).

302. Great Am. Ins. Co. v. Hamel, 444 S.W.3d 780, 803–04 (Tex. App.—El Paso 2014, pet. filed).

303. *Id.* at 785.

304. *Id.* at 787.

305. *Id.* at 798–99, 801.

306. *Id.* at 802.

307. *Id.*

308. *Id.*

309. *Id.*

310. *Id.* at 803, 804.

311. *Id.* at 804.

312. No. 13-0673, 2016 Tex. LEXIS 503 (Tex. June 17, 2016). When this article was drafted, the Texas Supreme Court had yet to address this issue.

rochemicals Inc., where it found that a liability insurer that wrongfully denies coverage to its insured cannot later challenge the reasonableness of the amount of the insured's settlement with a third-party claimant.[313] In doing so, the supreme court will hopefully provide practitioners with additional guidance on the requirements for an underlying judgment or settlement to be binding on a liability insurer.

313. *See* Evanston Ins. Co. v. Atofina Petrochemicals Inc., 256 S.W.3d 660, 674 (Tex. 2008).