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## Insurance Law

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# INSURANCE LAW

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## I. INTRODUCTION

During this Survey period,<sup>1</sup> the Texas Supreme Court clarified that the “fully adversarial trial” requirement established in *State Farm Fire & Casualty Co. v. Gandy*<sup>2</sup> requires that the insured bear an actual risk of liability for the damages awarded against it or agreed upon to be binding upon its insurer. The supreme Court also evaluated whether an insured can recover policy benefits as “damages” for an insurer’s violation of the Texas Insurance Code, absent evidence that the insured had a contractual right to benefits under the policy. In seeking to “clarify” precedent, the supreme court established “five rules addressing the relationship between contract claims under an insurance policy and tort claims under the Insurance Code.”<sup>3</sup> The Texas legislature also made significant legislative changes to the Texas Insurance Code with the passage of House Bill 1774 and promulgation of Chapter 542A of the Texas Insurance Code. The new statutes modify an insurer’s liability for certain first-party weather-related losses under the Insurance Code. In addition to addressing extra-contractual claims, Texas state and federal courts also evaluated various contractual issues, including the extent of an insurer’s subrogation rights, scope of “personal and advertising injury” under a commercial general liability policy, and coverage for additional insureds.

## II. THE “FULLY ADVERSARIAL TRIAL” REQUIREMENT

In *Great American Insurance Co. v. Hamel*, the Texas Supreme Court revisited its decision in *State Farm Fire & Casualty Co. v. Gandy*<sup>4</sup> to determine whether an underlying judgment against an insured was the result of a “fully adversarial trial.”<sup>5</sup> The underlying case stemmed from

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1. This article encompasses opinions issued between December 1, 2016, and November 30, 2017.

2. 925 S.W.2d 696, 714 (Tex. 1996).

3. *USAA Texas Lloyds Company v. Menchaca*, 545 S.W.3d 479, 484 (Tex. 2018) (The cited opinion was substituted for an earlier opinion which was published during this Survey period).

4. 925 S.W.2d 696, 714 (Tex. 1996).

5. *Great Am. Ins. Co. v. Hamel*, 525 S.W.3d 655, 658 (Tex. 2017).

water damage allegedly caused by the improper installation of exterior stucco on a home owned by Glen and Marsha Hamel (the Hamels).<sup>6</sup> The Hamels hired Terry Mitchell Builders, Inc. (Mitchell Builders) to finish construction of their home after the initial contractor abandoned the project.<sup>7</sup> Mitchell Builders was insured under multiple commercial general liability policies issued by Great American Insurance Company (Great American).<sup>8</sup> After noticing signs of water damage to their home, the Hamels sued Mitchell Builders, alleging that the water damage was attributable to either improper construction or, alternatively, the home's exterior stucco.<sup>9</sup>

Mitchell Builders notified Great American of the suit, but Great American denied coverage, citing an exclusion in the policy.<sup>10</sup> Shortly before the trial, Mitchell Builders entered into a Rule 11 agreement with the Hamels, which restricted the Hamels' right to recover only to those assets in the company's name (except for the owner's truck and tools) in exchange for Mitchell Builders' agreement to appear at the scheduled trial and not request a continuance.<sup>11</sup> As Mitchell Builders had no other assets, the net effect of this agreement was to restrict recovery to the Great American policy proceeds. The day before trial, Mitchell Builders and the Hamels executed stipulations of fact wherein Mitchell Builders abandoned its defenses that the water damage resulted from defective work by the original contractor and instead conceded that Mitchell Builders had failed to properly inspect and repair its defective work.<sup>12</sup> After a brief bench trial, the court awarded the Hamels \$365,089 in damages.<sup>13</sup> Mitchell Builders then "assigned most of its rights against Great American to the Hamels."<sup>14</sup> A subsequent coverage action against Great American resulted in a judgment for the Hamels of \$355,838.<sup>15</sup> Great American appealed, citing *State Farm Fire & Casualty Co. v. Gandy*<sup>16</sup> as authority for the proposition that judgments issued in favor of an insured's assignee are not enforceable against an insurer absent a fully adversarial trial.<sup>17</sup> In particular, Great American argued that the appellate court erred in finding that the bench trial satisfied the "fully adversarial trial" requirement as required by *Gandy*.<sup>18</sup>

In evaluating Great American's appeal, the supreme court sought to harmonize its previous holdings in *Employers Casualty Co. v. Block*,<sup>19</sup>

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6. *Id.* at 659.

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.* at 659–60.

11. *Id.* at 660.

12. *Id.*

13. *Id.* at 661.

14. *Id.*

15. *Id.* at 662.

16. 925 S.W.2d 696, 714 (Tex. 1996).

17. *Hamel*, 525 S.W.3d at 662.

18. *Id.* at 662, 665–66.

19. 744 S.W.2d 940, 942–43 (Tex. 1988).

*Gandy*,<sup>20</sup> and *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*<sup>21</sup> Whereas the court in *Block* had adopted the reasoning that an insurer's breach of its duty to defend rendered any resulting judgment binding against the insurer, *Gandy* and *ATOFINA* both focused their analysis on whether "the underlying judgment accurately reflect[ed] the plaintiff's damages."<sup>22</sup>

Initially, the supreme court cautioned that in evaluating whether there was a "fully adversarial trial," an appellate court should not second guess trial strategy, as this "often produces an inaccurate and unreliable result."<sup>23</sup> In particular, "[e]very trial presents unique challenges, requiring subjective judgment calls that may seem in hindsight to have been ill-advised. But determining whether and when those calls destroy the 'adversarial' nature of the proceeding is simply not possible."<sup>24</sup> Instead, the supreme court held that "the controlling factor is whether, at the time of the underlying trial or settlement, the insured bore an actual risk of liability for the damages awarded or agreed upon" or, otherwise, had some incentive to seek an accurate judgment.<sup>25</sup> The supreme court stated that this holding is consistent with its decision in *ATOFINA*. Applying this principle to the facts in *Hamel*, the supreme court noted that the pretrial agreement not to enforce any judgment against the personal assets of Mitchell Builders removed all incentive for the insured to defend itself at trial.<sup>26</sup> As a result, the supreme court held that an adversarial defect in the underlying trial could be remedied by a fully adversarial insurance trial, but that had not taken place in the case at bar.<sup>27</sup>

The supreme court also found that the determination of the actual damages suffered by the Hamels was not addressed in the coverage litigation at the trial or appellate level.<sup>28</sup> Accordingly, the court determined that the proper remedy under the circumstances was to remand the matter for a new insurance trial, which would provide both the Hamels and Great American with an opportunity to litigate whether and to what extent Mitchell Builders had covered liability.<sup>29</sup>

In our 2015 article, we recognized that litigation and uncertainty existed in Texas regarding the scope and interplay among *Block*, *Gandy*, and *ATOFINA*. Although some commentators interpreted *ATOFINA* as overruling or limiting *Gandy*, we suggested that *ATOFINA* did not overrule *Gandy* and that the two opinions were not in conflict. *ATOFINA* was distinguishable from *Gandy* because, in *ATOFINA*, the insured paid the settlement amount and brought suit against its insurer to recover the

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20. 925 S.W.2d 696, 714 (Tex. 1996).

21. 256 S.W.3d 660, 673–74 (Tex. 2008).

22. *Hamel*, 525 S.W.3d at 665.

23. *Id.* at 666.

24. *Id.*

25. *Id.*

26. *Id.* at 667.

27. *Id.* at 669.

28. *Id.* at 670.

29. *Id.* at 671.

amount it actually paid. *Gandy*, on the other hand, involved an agreed judgment and assignment of rights, pursuant to which the insured had no obligation to pay the amount of the agreed judgment. Further, in *Gandy*, the underlying plaintiff—as the insured’s assignee—sued the insurer to recover the agreed amount.

In *Hamel*, the Texas Supreme Court expressly confirmed that the holdings from *Gandy* and *ATOFINA* can be harmonized. Thus, remaining in effect is the rule in *Gandy* that “[i]n no event . . . is a judgment for plaintiff against defendant, rendered without 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.”<sup>30</sup> However, pursuant to *ATOFINA*, this rule is tempered by the equitable principle of estoppel. To date, the only recognized basis to estop an insurer from contesting the amount of a settlement is when the insurer refused to participate in settlement negotiations and the insured incurs actual liability for payment of the settlement. Although *Hamel* answered the questions as to whether *ATOFINA* overruled *Gandy* in the negative, we anticipate that litigation will continue regarding whether and to what extent *Gandy* should be further limited.

### III. EXTRA-CONTRACTUAL LIABILITY

#### A. CHAPTER 541 AND THE DUTY OF GOOD FAITH AND FAIR DEALING

Insurers have argued that an insured is prohibited from recovering extra-contractual damages under Chapter 541 of the Texas Insurance Code (Chapter 541) absent the insured demonstrating it sustained an “independent injury” separate and apart from the loss of the policy benefits. In *USAA Texas Lloyds Co. v. Menchaca*, the Texas Supreme Court appears to have rejected this broad “independent injury” prerequisite to bringing a claim under Chapter 541. Rather, in an attempt to clarify years of what it admits was confusing precedent, the supreme court promulgated five rules for evaluating when an insured can recover statutory extra-contractual damages from an insurer.<sup>31</sup>

After her home was struck by Hurricane Ike, Gail Menchaca (Menchaca) filed a claim for coverage with her homeowners’ insurer, USAA Texas Lloyds (USAA).<sup>32</sup> USAA determined that the damage to Menchaca’s home was covered but did not exceed the policy’s deductible.<sup>33</sup> USAA declined to pay for the damage, and Menchaca sued for breach of the insurance policy and violations of the Texas Insurance Code, claiming as damages the benefits due under the policy plus court costs and attorney’s fees.<sup>34</sup> The jury determined that USAA complied

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30. *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996).

31. *USAA Texas Lloyds Co. v. Menchaca*, 545 S.W.3d 479, 484 (Tex. 2018).

32. *Id.* at 484–86.

33. *Id.* at 485.

34. *Id.* at 485–86.

with the terms of the policy, but that it failed to pay a claim without conducting a reasonable investigation in violation of the Insurance Code. The jury calculated Menchaca's damages based on what it believed USAA *should have* paid under the policy.<sup>35</sup> According to USAA, "Menchaca could not recover for 'bad faith or extra-contractual liability as a matter of law'" because the jury found that USAA had not breached the policy.<sup>36</sup>

On appeal, the Texas Supreme Court acknowledged that both USAA and Menchaca could cite precedent in their favor: *Provident American Insurance Co. v. Castañeda*<sup>37</sup> for USAA; *Vail v. Texas Farm Bureau Mutual Insurance Co.*<sup>38</sup> for Menchaca.<sup>39</sup> Recognizing that courts and commentators had opined that these decisions potentially stood at odds with one another, the supreme court explained that the case at bar "presents an opportunity to provide clarity regarding the relationship between claims for an insurance-policy breach and Insurance Code violations. In light of the confusing nature of our precedent in this area, we begin by returning to the underlying governing principles."<sup>40</sup> According to the supreme court, the initial underlying governing principle "is that an 'insurance policy is a contract' that establishes the respective rights and obligations to which an insurer and its insured have mutually agreed."<sup>41</sup> However, an insurance contract presents unique circumstances, "because an insurer generally 'has exclusive control over the evaluation, processing[,] and denial of claims,' and it can easily use that control to take advantage of its insured."<sup>42</sup> Thus, according to the supreme court, there is justification for imposing a common law duty of good faith and fair dealing upon an insurer. The second principle is that Chapter 541 imposes certain statutory requirements in addition to common law requirements under which an insurer must "review and resolve an insured's claim for policy benefits."<sup>43</sup> While a claim for breach of the policy is distinct and independent from claims that an insurer breached its extra-contractual common law and statutory duties, the supreme court recognized that these are "largely interwoven."<sup>44</sup> Thus, "[t]he primary question in this case [was] whether an insured can recover policy benefits as actual damages caused by an insurer's statutory violation absent a finding that the insured had a contractual right to the benefits under the insurance policy."<sup>45</sup>

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35. *Id.* at 486.

36. *Id.*

37. 988 S.W.2d 189, 198 (Tex. 1998).

38. 754 S.W.2d 129, 136 (Tex. 1988).

39. *Menchaca*, 545 S.W.3d at 487.

40. *Id.* at 488.

41. *Id.* (quoting *RSUI Indem. Co. v. The Lynd Co.*, 466 S.W.3d 113, 118 (Tex. 2015)).

42. *Id.* (quoting *Arnold v. Nat'l Cty. Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987)).

43. *Id.*

44. *Id.* at 489.

45. *Id.* (internal quotations omitted).

To address this question, the supreme court set forth “five distinct but interrelated rules that govern the relationship between contractual and extra-contractual claims in the insurance context.”<sup>46</sup> “First, as a general rule, an insured cannot recover policy benefits as damages for an insurer’s statutory violation” if the insured does not have a right to those benefits under the policy.<sup>47</sup> Citing the language of the Insurance Code itself, the supreme court observed that an insured may recover actual damages only if “caused by” the insurer’s statutory violation. Explaining further, the supreme court stated that, in general, if an insurer violates a statutory provision, that violation cannot cause damages in the form of policy benefits that the insured has no right to receive under the policy.<sup>48</sup>

The second rule outlined by the supreme court is the “Entitled-to-Benefits” Rule: “An insured who establishes a right to receive benefits under the insurance policy can recover those benefits as actual damages under the Insurance Code if the insurer’s statutory violation causes the loss of the benefits.”<sup>49</sup> This rule reconciles *Castañeda*, *Republic Insurance Co. v. Stoker*, and *Vail*:

In short, *Stoker* and *Castañeda* stand for the general rule that an insured cannot recover policy benefits as damages for an insurer’s extra-contractual violation if the policy does not provide the insured a right to those benefits. *Vail* announced a corollary rule: an insured who establishes a right to benefits under the policy can recover those benefits as actual damages resulting from a statutory violation.<sup>50</sup>

In other words, the insured is not limited to breach of contract damages for the policy benefits. Those contractual benefits can constitute actual damages under Chapter 541 if the damages resulted from an insurer engaging in conduct that constitutes a statutory violation. Thus, if the insurer breaches the insurance policy by engaging in conduct that constitutes a statutory violation, the insured can recover its contractual benefits as “damages” under Chapter 541. For example, this occurs when an insurer wrongfully denies a claim without proper investigation or fails to settle a claim when liability is reasonably clear.

The third rule is the “Benefits-Lost Rule.” Under this rule, “even if the insured cannot establish a present contractual right to policy benefits, the insured can recover benefits as actual damages under the Insurance Code *if the insurer’s statutory violation caused the insured to lose that contractual right.*”<sup>51</sup> For instance, if an insurer misrepresents that the policy provides coverage when the policy actually does not provide coverage, the insurer can be liable under the statute for benefits to the extent that the insured is adversely affected or injured by its reliance on the insurer’s misrepresentation. Moreover, if a statutory violation prejudices an in-

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46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.* at 497.

51. *Id.* at 489 (emphasis added).

sured, the insurer may be estopped from denying benefits. The amount the insured can recover based on estoppel could be “actual damages” if the conduct creating the estoppel constitutes a violation of the statute.

As a fourth rule, the supreme court stated that “if an insurer’s statutory violation causes an injury independent of the loss of policy benefits, the insured may recover damages for that injury even if the policy does not grant the insured a right to benefits.”<sup>52</sup> This rule has two aspects. First, “if an insurer’s statutory violation causes an injury independent of the insured’s right to recover policy benefits, the insured may recover damages for that injury even if the policy does not entitle the insured to receive benefits.”<sup>53</sup> Second, “an insurer’s statutory violation does not permit the insured to recover *any* damages beyond policy benefits unless the violation causes an injury that is independent from the loss of the benefits.”<sup>54</sup>

Finally, under the fifth rule, which the supreme court explained is the “No-Recovery Rule,” an insured cannot recover any damages based on an insurer’s statutory violation if the insured had no right to receive benefits under the policy and sustained no injury independent of a right to benefits.<sup>55</sup> The supreme court stated that this rule is “simply the natural corollary to the first four rules.”<sup>56</sup>

In light of this framework, the supreme court held that remand was proper “in the interest of justice” given the confusing nature of the legal precedent.<sup>57</sup> Interestingly, the supreme court recognized that due to the confusion of the prior legal opinions, both parties had relied on incomplete analyses of statutory liability.<sup>58</sup>

The goal of the supreme court was to establish a clear framework for both insurers and insureds as to the application of the Texas Insurance Code. Even though the supreme court explicitly sought “to clarify”<sup>59</sup> precedent with five rules, whether it was able to provide actual clarification to the insurance bar remains to be seen and will likely involve post-*Menchaca* litigation.

#### B. TEXAS INSURANCE CODE CHAPTER 542 PROCESSING AND SETTLEMENT OF CLAIMS (CHAPTER 542)

In *Mainali Corp. v. Covington Specialty Insurance Co.*, the U.S. Court of Appeals for the Fifth Circuit evaluated whether an insurer who timely pays an appraisal award is subject to extra-contractual penalties under the Prompt Payment of Claims Act.<sup>60</sup> A fire damaged a gas station owned by Mainali Corp (Mainali) and insured by Covington Specialty

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52. *Id.*

53. *Id.* at 499.

54. *Id.* at 500.

55. *Id.* at 500–01.

56. *Id.* at 500.

57. *Id.* at 521.

58. *Id.*

59. *Id.* at 489.

60. *Mainali Corp. v. Covington Specialty Ins. Co.*, 872 F.3d 255, 257 (5th Cir. 2017).



Insurance Company (Covington).<sup>61</sup> After Mainali reported the incident and requested coverage, Covington sent an independent adjuster to inspect the risk.<sup>62</sup> Over the course of the next six months, Covington paid Mainali installments totaling \$389,255.59, representing the “actual cash value” for the loss.<sup>63</sup> Mainali disputed Covington’s loss calculations, and two months after the final payment, filed suit against Covington and its adjuster.<sup>64</sup> Covington removed the suit to federal court and invoked its right to an appraisal under the policy.<sup>65</sup> The appraisal panel issued an appraisal award of \$387,925.49, “inclusive of all FIRE damages sustained to the insured property.”<sup>66</sup> According to the Fifth Circuit, “[a]lthough Covington had already paid more than the total amount the appraisal panel said it owed, [Covington] paid an additional \$15,175.82 for the building allocation after the panel announced its award.”<sup>67</sup>

Covington moved for summary judgment after the announcement of the award on the basis that its timely payment of the appraisal precluded Mainali’s contract and extra-contractual claims. In response, Mainali argued that the appraisal award was incomplete because it did not account for certain covered damages. Mainali further contended that Covington owed interest penalties under Chapter 542 because the appraisal payment was made more than sixty days after Covington had received necessary documentation for which to evaluate the claim.<sup>68</sup> The district court granted summary judgment in favor of Covington and Mainali appealed.

The Fifth Circuit noted the strong presumption under Texas law in favor of the validity of appraisal awards except in circumstances where the award was either made without authority, resulted from fraud or accident, or was otherwise “not in compliance with the requirements of the policy.”<sup>69</sup> Reasoning that the award stated that it was inclusive of all fire damages sustained at the property, the court observed that Mainali failed to meet its burden to show some evidence that the appraisal award was incomplete.<sup>70</sup>

The court then turned to Mainali’s claim that the appraisal award should be subject to statutory interest for prompt payment violations, explaining that

under Chapter 542 of the Texas Insurance Code . . . the statute requires the insurer to pay the policyholder’s claim within 60 days of receiving all documentation needed to resolve the claim. If the insurer does not do so, it is liable for an 18% penalty on the amount

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61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.* at 257–58.

69. *Id.* at 258.

70. *Id.*

that was not timely paid, plus attorney's fees.<sup>71</sup>

The court observed: "[w]e must decide whether a payment made to comply with an appraisal award, which in most if not all cases is going to be paid after the 60-day window, is subject to this penalty. No reported Texas case has ever subjected such a payment to the statute."<sup>72</sup>

Mainali cited one case in support of its prompt payment claims, *Graber v. State Farm Lloyds*.<sup>73</sup> However, the Fifth Circuit noted that ample authority exists that timely payment of an appraisal award precludes statutory penalties.<sup>74</sup> Moreover, the Fifth Circuit reasoned that "[t]he most fundamental problem with *Graber* is that it did not recognize [a court's *Erie*] duty to follow state courts' interpretation of state law rather than the interpretation the federal court thinks makes the most sense."<sup>75</sup> According to the court, "the primary authority *Graber* relied on was the rejection of a 'good faith' defense to the Prompt Payment of Claims Act in a nonappraisal case."<sup>76</sup> In sum, the court found:

The different situation in which that ruling [in *Graber*] arose is not enough to divine that the Supreme Court of Texas would disagree with all the lower courts in the state that have addressed the issue in the context of postappraisal payments. Covington was not trying to avoid payment of the claim; it was invoking a contractually agreed to mechanism for assessing the amount it owed.<sup>77</sup>

As a result, the Fifth Circuit determined that Covington satisfied the statutory prompt payment requirement as set forth in Chapter 542 of the Texas Insurance Code and was therefore not subject to statutory penalties because Covington timely paid the appraisal award.<sup>78</sup>

If an insurer and insured cannot reach an agreement regarding the value of a covered loss, the appraisal provision generally provides a mechanism for determination of an agreed valuation. As shown by the holding in *Mainali*, if an insurer timely pays an appraisal award, the insured would promptly receive the benefits to which the insured is entitled under the policy. This holding comports with the purpose of Chapter 542, which is to "promote the prompt payment of insurance claims," pursuant to policies of insurance.<sup>79</sup>

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71. *Id.* (citing TEX. INS. CODE § 542.060 (West Supp. 2017)).

72. *Id.*

73. 2015 WL 3755030, at \*10 (N.D. Tex. June 15, 2015) (mem. op.).

74. *Mainali Corp.*, 872 F.3d at 258–59.

75. *Id.* at 259.

76. *Id.*

77. *Id.*

78. *Id.*

79. TEX. INS. CODE § 542.054 (West 2009 & Supp. 2017).

## IV. CONTRACTUAL LIABILITY

## A. COMMERCIAL GENERAL LIABILITY (CGL) INSURANCE

In *Longhorn Gasket & Supply Co. v. United States Fire Insurance Co.*, the U.S. Court of Appeals for the Fifth Circuit evaluated whether asbestos qualified as a “pollutant” under a CGL policy. Longhorn manufactured and sold gaskets which contained asbestos during the 1980s and 1990s and was consequently the defendant in a number of asbestos liability lawsuits.<sup>80</sup> Trinity Lloyd’s Insurance Company and Trinity Universal Insurance Company (collectively, Trinity) were the primary insurers during the period at issue and had expended considerable sums both in defending and settling a number of the claims.<sup>81</sup> In 2007, Longhorn filed suit against its excess insurer, U.S. Fire, for breach of contract and insurance code violations arising out of U.S. Fire’s denial of coverage.<sup>82</sup> Trinity intervened in the lawsuit, contending that it had exhausted the limits of the primary policy and seeking reimbursement from U.S. Fire for defense and indemnity costs paid on behalf of Longhorn.<sup>83</sup> Before the case was concluded, Longhorn settled with U.S. Fire, and dismissed its claims with prejudice.<sup>84</sup> A district court ultimately determined that Trinity was entitled to \$903,638.52 in settlement costs and an additional \$1,564,334.47 in defenses costs from U.S. Fire.<sup>85</sup>

U.S. Fire appealed, arguing that the district court had erred in a number of its rulings.<sup>86</sup> The Fifth Circuit, however, focused on the application of the pollution exclusion in the U.S. Fire policy.<sup>87</sup> Specifically, the policy contained an exclusion that barred coverage for the “discharge, dispersal, release or escape” of “irritant[s], contaminant[s] or pollutant[s],” but it did not apply “if such discharge, dispersal, release or escape is sudden and accidental.”<sup>88</sup> The parties differed on whether asbestos could be a “pollutant” under the exclusion, and the Fifth Circuit noted that there was no dispositive ruling by the Texas Supreme Court on the matter.<sup>89</sup> Surveying other jurisdictions, the Fifth Circuit noted that the case law “slightly favor[ed]” treating asbestos as a pollutant, particularly where, as with the U.S. Fire policy, coverage was excluded for “irritant[s], contaminant[s] or pollutant[s].”<sup>90</sup> The court went on to observe that asbestos also apparently satisfied the plain language meaning of irritant as anything “causing irritation; esp. physical irritation.”<sup>91</sup> Accordingly, the court held

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80. *Longhorn Gasket & Supply Co. v. U.S. Fire Ins. Co.*, 698 F. App’x 774, 775 (5th Cir. 2017) (per curiam).

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at 776.

85. *Id.*

86. *Id.* at 776–77.

87. *Id.* at 778–79.

88. *Id.*

89. *Id.* at 779.

90. *Id.* at 780.

91. *Id.* at 779.

that U.S. Fire had met its burden in establishing that asbestos triggered the exclusion in its policy and remanded the case to the district court for further determination of whether the exclusion's "sudden and accidental" exception applied.<sup>92</sup>

## B. PROPERTY INSURANCE

In *Nassar v. Liberty Mutual Fire Insurance Co.*, the Texas Supreme Court evaluated whether a fence attached to a home falls within the scope of dwelling coverage under a homeowners' insurance policy.<sup>93</sup> Hurricane Ike damaged the Nassars' home and fence, prompting the Nassars to file a claim with their homeowners' insurer, Liberty Mutual.<sup>94</sup> The policy included both "dwelling" coverage, with a \$247,200 limit, and an "other structures" coverage subject to a much lower limit of \$24,720.<sup>95</sup> The damage to the home totaled \$20,090.61, while damage to the fencing alone totaled \$58,665.<sup>96</sup> As a result, a dispute arose between Liberty Mutual and the Nassars regarding whether the damage to the fence fell within the "dwelling" or "other structures" coverage of the policy.

The supreme court agreed with the Nassars that, under the policy terms, the fence was covered as part of the dwelling. While the policy did not define what constitutes a "structure," the policy did indicate that "dwelling" includes structures *attached* to it.<sup>97</sup> Citing the Black's Law Dictionary definition of a "structure" as "[a]ny construction, production, or piece of work artificially built up or composed of parts purposefully joined together" and "attach" as "[t]o annex, bind, or fasten," the supreme court held that the policy language was unambiguous and that the fence, which was either bolted or cemented onto the house, was clearly a structure attached to the house.<sup>98</sup> The supreme court rejected the analysis of the appellate court and arguments by Liberty Mutual that such a reading of the policy might allow for ambiguity.<sup>99</sup> Rather, the supreme court opined that to have read the policy otherwise would have been to make an impermissible guess about the intent of the policy's drafters as opposed to a determination based on the plain language of the contract.<sup>100</sup>

## C. COMMERCIAL CRIME INSURANCE

In *Cooper Industries, Ltd. v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania*, the U.S. Court of Appeals for the Fifth Circuit evaluated whether a commercial crime policy provides coverage for pension fund assets invested in what was later determined to be a Ponzi

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92. *Id.* at 781.

93. *Nassar v. Liberty Mut. Fire Ins. Co.*, 508 S.W.3d 254, 258 (Tex. 2017) (per curiam).

94. *Id.* at 255.

95. *Id.* at 256.

96. *Id.*

97. *Id.* at 258.

98. *Id.*

99. *Id.* at 258–59.

100. *Id.* at 260.

scheme.<sup>101</sup> Cooper Industries (Cooper) was a publicly traded company and offered a pension plan to its employees. Cooper contracted with and “invested more than \$140 million of its equity-fund assets and \$35 million of its bond-fund assets” through Westridge Capital Management and its two related companies (collectively the Westridge Entities).<sup>102</sup>

It was later discovered that the Westridge Entities were running a Ponzi scheme. After government regulators filed an enforcement action against the Westridge Entities, a receiver was appointed to collect and liquidate whatever assets remained in the Westridge Entities. The receiver ultimately determined that each investor in the Ponzi scheme was entitled to return of approximately eighty-five percent of its net investment. After Cooper obtained a distribution from the receiver, it submitted to its commercial crime insurer National Union Fire Insurance Company of Pittsburgh (National Union) “a proof of loss, estimating that it could ultimately experience a loss of between \$15 million and \$57 million.”<sup>103</sup> National Union denied coverage and Cooper filed suit in federal district court.

The policy issued by National Union provided coverage for loss of funds resulting from fraudulent or dishonest acts, but limited coverage to property that was owned or leased by the insured.<sup>104</sup> The policy also contained exclusions that barred coverage for loss that resulted from trading and indirect loss that resulted from an occurrence.<sup>105</sup> The district court entered a take-nothing judgment against Cooper, explaining first that “Cooper did not ‘own’ its lost earnings within the meaning of the Policy,” and second, “that Cooper suffered no ‘loss’ under the Policy when it loaned funds to [the Westridge Entities] because it gave up ownership of the principal at the moment it made the loan.”<sup>106</sup>

On appeal, Cooper argued that it owned the lost principal and interest it had invested with the Westridge Entities.<sup>107</sup> The Fifth Circuit rejected this argument, noting that although the word “own” was not defined in the policy, under its common meaning “own” implied some level of possession or control.<sup>108</sup> Rather, the Fifth Circuit explained that when Cooper invested the pension funds with the Westridge Entities, it gave up possession or control of the funds in exchange for promissory notes.<sup>109</sup> While Cooper cited to cases where courts had construed the term “own” to include a more equitable definition of ownership, the Fifth Circuit observed that in insurance disputes like the one before the court, the general trend was to adopt the everyday meaning of the term rather than a

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101. *Cooper Indus., Ltd. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Penn.*, 876 F.3d 119, 123 (5th Cir. 2017).

102. *Id.*

103. *Id.* at 125.

104. *Id.*

105. *Id.*

106. *Id.* at 125–26.

107. *Id.* at 128.

108. *Id.* at 129.

109. *Id.*

legalistic interpretation.<sup>110</sup>

Cooper also argued that it had suffered a “loss” under the policy when it transferred the fund principal to the Westridge Entities.<sup>111</sup> The court noted: “[a]ccording to Cooper, a ‘loss’ occurs at the moment a borrower fraudulently induces a loan.”<sup>112</sup> The Fifth Circuit rejected this argument as well, reasoning that while loss was not defined in the policy, it generally required “some action which reduced the available assets . . . as against its liabilities to depositors, creditors, and stockholders.”<sup>113</sup> The court concluded:

Whether Cooper is entitled to recover the principal depends on whether a “loss” occurred before or after title passed to [the Westridge Entities’ agents]. Under Texas law, a fraudulently induced loan is voidable, not void. [citations omitted]. Even though [the Westridge Entities’ agents] procured the loan through fraud, title to the funds still passed to [the Westridge Entities]. [citations omitted]. The “loss,” however, did not occur when Cooper loaned the funds to [the Westridge Entities], but when [the Westridge Entities’ agents] stole them after the loan had been made. By that time, title had passed, and Cooper no longer owned the funds. Moreover, Cooper’s substantial profit on its equity-fund investment belies any argument that it sustained a “loss” when it funded the loan. Cooper ultimately recovered all of its equity-fund principal, as well as roughly \$30 million in earnings. It makes no sense to say that it nonetheless suffered a “loss” of the principal when it funded the loan because the loan actually yielded a substantial profit for Cooper. Cooper may have ultimately earned less on the equity-fund investment than it would have had it invested with honest money managers, but that opportunity cost is a purely theoretical loss not covered by the Policy.<sup>114</sup>

Accordingly, the Fifth Circuit held that Cooper was “not entitled to recover its principal investment because it did not suffer a ‘loss’ of that principal [amount] until after title had passed to [the Westridge Entities].”<sup>115</sup>

## V. CONTRACT INTERPRETATION

### A. DUTY TO DEFEND AND DUTY TO INDEMNIFY

#### 1. *Fifth Circuit Evaluates the Meaning of “Advertising Idea” Under Coverage B of a CGL Policy*

In *Laney Chiropractic & Sports Therapy, P.A. v. Nationwide Mutual Insurance Co.*, the U.S. Court of Appeals for the Fifth Circuit considered whether an insured’s advertisement of another’s product triggered a duty to defend under a policy which provided coverage for use of another’s

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110. *Id.* at 130.

111. *Id.* at 131.

112. *Id.*

113. *Id.* at 131–32.

114. *Id.*

115. *Id.* at 132.

advertising idea, trade dress infringement, or slogan infringement.<sup>116</sup> Beginning in 2004, Laney provided “Active Release Techniques” (ART) treatments to customers under a licensing agreement with ART Corporate Solutions, Inc. and Active Release Technologies, LLC.<sup>117</sup> By 2011, it was offering these services directly to customers with no licensing agreement, while still referring to ART on its website.<sup>118</sup> In 2014, Laney changed its website to describe “soft tissue techniques,” or “STT,” and “500 unique deep tissues protocols,” which was language used by the ART companies to describe their treatments.<sup>119</sup> Thereafter, Laney changed its website yet again, describing its treatments as a “Fascial Distortion Model,” or “FDM,” but retained the same verbiage as its previous description of ART licensed techniques.<sup>120</sup> The ART companies sued Laney for “trademark infringement, false and/or misleading advertising, deceptive business practices, unfair competition, breach of contract, and breach of the duty of good faith and fair dealing.”<sup>121</sup> Laney sought coverage under Coverage B of its CGL policy from Nationwide.<sup>122</sup> Nationwide denied coverage on the basis that the allegations in the underlying pleading failed to trigger the insuring agreement. In a subsequent declaratory judgment action brought by Laney, a trial court agreed with Nationwide that there was no coverage and Laney appealed to the Fifth Circuit.<sup>123</sup>

On appeal, Laney argued that the ART suit was one for “personal and advertising injury,” which the policy defined, in relevant part, as either the use of another’s “advertising idea” in your “advertisement” or “infringing upon another’s copyright, trade dress or slogan in your ‘advertisement.’”<sup>124</sup> The court rejected this argument. The court first recognized that the policy does not define the term “advertising idea.” Moreover, neither the Fifth Circuit nor Texas state courts have evaluated what that term means in the context of a commercial general liability policy. However, other jurisdictions have examined that term and found that under the plain and ordinary meaning, an “advertising idea” is something used as a marketing or advertising device.<sup>125</sup> Accordingly, the court found that the allegations regarding the use of ART products in Laney’s advertisements did not qualify as the use of an “advertising idea.”<sup>126</sup> Specifically, the court found that trademarks are not an advertising idea “because under Texas law, a trademark is not a marketing or advertising

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116. *Laney Chiropractic & Sports Therapy, P.A. v. Nationwide Mut. Ins. Co.*, 866 F.3d 254, 258 (5th Cir. 2017).

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.* at 259–60.

126. *Id.* at 260.

device.”<sup>127</sup> Thus, because the use of a trademark is not the use of an advertising idea, “Laney’s use of trademarked phrases, such as ‘ART’ or ‘Active Release Techniques,’ is not the use of another’s advertising idea.”<sup>128</sup> Conflating the two concepts would run afoul of the traditional distinction between advertisement and the product being advertised.<sup>129</sup>

The court also rejected Laney’s argument that the underlying complaint potentially stated a trade dress claim. Noting that “trade dress protection extends only to incidental, arbitrary or ornamental product features which identify the source of the product,” the court found that there could be no trade dress claims based on the allegations that Laney copied ART’s entire products.<sup>130</sup> The allegations did not concern any purely aesthetic aspect of Laney’s advertising or allege any required element of a trade dress claim.<sup>131</sup> The allegations also did not concern the look or feel of Laney’s website, but rather that the website used specific words meant to describe products.<sup>132</sup>

Finally, the court rejected Laney’s contention that the underlying complaint potentially involved slogan infringement, reasoning that terms allegedly used were not slogans, but rather were brand or product names.<sup>133</sup> As with “advertising idea,” the court looked to other jurisdictions for guidance on how to define “slogan” as used in the policy. The court determined that Laney’s proffered definition was in direct conflict with the trend of construing “slogan” to be a short catchy phrase.<sup>134</sup> Finding that the allegations did not implicate coverage under the policy, the Fifth Circuit affirmed the decision of the district court.

## *2. Fifth Circuit Evaluates Duty to Defend and Priority of Coverage Issues Between Co-Insurers*

Carothers Construction (Carothers) acted as general contractor for a project and retained subcontractors Premier Constructors (Premier) and Self-Concrete.<sup>135</sup> United Fire & Casualty Company (United) insured Self-Concrete; Colony National Insurance Company (Colony) insured Premier. Both policies identified Carothers as an additional insured.<sup>136</sup> Gordon Bonner (Bonner) was employed by Premier and sustained injuries when a tilt wall panel swung out and hit him.<sup>137</sup> He sued Carothers, Premier, one of Premier’s subcontractors, and Self-Concrete.<sup>138</sup>

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127. *Id.* (citing *Sport Supply Grp., Inc. v. Columbia Cas. Co.*, 335 F.3d 453, 464 (5th Cir. 2003)).

128. *Id.*

129. *Id.* at 261.

130. *Id.*

131. *Id.*

132. *Id.* at 262.

133. *Id.*

134. *Id.* at 263.

135. *Colony Nat’l Ins. Co. v. United Fire & Cas. Co.*, 677 F. App’x 941, 943 (5th Cir. 2017).

136. *Id.*

137. *Id.*

138. *Id.*



Carothers tendered a request for defense and indemnity as an additional insured to both Colony and United. Colony accepted the tender but United declined.<sup>139</sup> After the underlying lawsuit settled, Colony sued United in subrogation for breach of contract. United also asserted claims for contribution stemming from United's refusal to participate in defending Carothers in the underlying suit.<sup>140</sup> Both insurers moved for summary judgment. The district court held that based upon the factual allegations in the underlying pleading, United had breached its duty to defend and was responsible for half of the defense costs.<sup>141</sup>

United's policy language required that the additional insured have potential "LIABILITY WHICH MAY BE IMPUTED TO [THE ADDITIONAL INSURED] DIRECTLY ARISING OUT OF [SELF-CONCRETE'S] ONGOING OPERATIONS PERFORMED FOR [THE ADDITIONAL INSURED]." <sup>142</sup> United argued on appeal that additional insured coverage did not apply because the underlying pleading contained "no facts or theories that support[ed] imputed liability" against Carothers.<sup>143</sup> In particular, United argued that the allegations did not implicate Self-Concrete's scope of work "because the accident was caused by an out of control tilt wall panel, and the contract between Self-Concrete and Carothers specifically excluded lifting tilt wall panels from the scope of Self-Concrete's work."<sup>144</sup>

Rejecting this argument, the Fifth Circuit explained that because the underlying pleading contained allegations

that Carothers retained authority over the jobsite and plans for the tilt wall panels and further failed to ensure that its subcontractors abided by the requirements and standards contained in the subcontracts[, t]his [was] sufficient to find liability on the part of Self-Concrete, which may be imputed to Carothers, giving rise to a duty to defend.<sup>145</sup>

Relying on law developed in the employer/employee context, the court recognized that an employer is not usually liable for the acts of negligence of an independent contractor. However, the court explained that such liability may exist if the employer retains control of "operative details" of the subcontractor's work.<sup>146</sup> The court focused on the specific allegations by Bonner and held that there was at least the potential that Carothers maintained "operative control" over the details of Self-Concrete's work sufficient to trigger the additional insured coverage and

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139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.* at 945.

143. *Id.*

144. *Id.*

145. *Id.* at 945–46.

146. *Id.* at 946. According to the court, under applicable Texas law for an employer to have control of "operative details," the employer must have "the right to control the means, methods, or details of the independent contractor's work to the extent that the independent contractor is not entirely free to do the work his own way." *Id.*

United's duty to defend.<sup>147</sup> Specifically, the court observed:

Bonner alleged that Carothers provided plans for the tilt wall panel formation to Self-Concrete. Providing "plans" may be typical of a general contractor and may not rise to the level of imputing liability to a general contractor for the purposes of tort liability. However, Bonner alleged that Carothers's control over the "plans" included much more than simply furnishing the plans. Moreover, Bonner's petition set forth the detailed level of control that Carothers exercised over the jobsite and Self-Concrete's work, which, in addition to following the terms of its contracts, included having the right and duty to enforce regulations of the U.S. Army Corps of Engineers, OSHA, and Carothers's own Safety Policy/Accident Prevention Plan, which were incorporated into Carothers and Self-Concrete's subcontract. This level of control over Self-Concrete's actions amounts to "operative control" . . . .<sup>148</sup>

Having found that United had a duty to defend Carothers, the court then considered the issue of priority of coverage between the United policy and Colony policy. With respect to coverage for additional insureds, each policy had language that purported to make it excess to the other. Because these clauses were mutually repugnant, the court found that they cancelled each other out. As a result, Colony and United were obligated to share equally the costs of defending Carothers.<sup>149</sup> In reaching its holding, the court specifically rejected United's argument that the "Primary and Non-Contributing Insurance Endorsement" in Colony's policy negated United's duty to defend.<sup>150</sup>

3. *Fifth Circuit Evaluates Whether Misrepresentation of Patent Rights Can Constitute a Coverage B Offense for Purposes of the Duty to Defend Under CGL Policy*

In *Uretek (USA), Inc. v. Continental Casualty Co.*, Uretek (USA), Inc. (Uretek) was a roadway maintenance and repair company insured under a commercial general liability policy by Continental Casualty Company (Continental).<sup>151</sup> Uretek sued a competitor, Applied Polymeric (Applied), for patent infringement. In response, Applied filed a counterclaim against Uretek.<sup>152</sup> According to the counterclaim, Uretek:

engaged in a pattern or practice of misrepresenting the scope of [Uretek's] patent in a concerted effort to intimidate and coerce [Uretek's] competitors into refraining from proper and lawful bidding on, and to intimidate contracting bodies in the selection and award of bids for, construction projects for which the scope of work

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147. *Id.*

148. *Id.*

149. *Id.* at 947.

150. *Id.*

151. *Uretek (USA), Inc. v. Cont'l Cas. Co.*, 701 F. App'x 343, 344 (5th Cir. 2017) (per curiam).

152. *Id.*

does not involve processes covered by [Uretek's] Patent.<sup>153</sup>

Applied alleged that Uretek engaged in its conduct with "knowledge that [its] patent [was] not valid or enforceable."<sup>154</sup> Applied also asserted in its counterclaim that it had contracted with the Virginia Department of Transportation (VDOT) to perform work on Interstate 664, and that Uretek "falsely misrepresented to general contractors, VDOT, and other roadway-owning government authorities that the VDOT contract for I-664 . . . and/or other contracts let for bid are covered by [Uretek's] patent."<sup>155</sup> Additionally, Allied alleged in its counterclaim that Uretek's misrepresentations "deceived or had a tendency to deceive a substantial segment of Applied's roadway-owning government authority customers, general contractor customers, and potential customers and that Allied received fewer contracts for pavement lifting work."<sup>156</sup> According to Allied, Uretek "inhibited competition by representing to government agencies and others that certain pavement lifting work—including work performed under the VDOT contract—fell within the scope of Uretek's . . . patent."<sup>157</sup> Applied also asserted that Uretek violated state unfair competition law due to its "illegal and anti-competitive acts."<sup>158</sup>

Uretek tendered the counterclaim to Continental for coverage.<sup>159</sup> After Continental denied coverage, Uretek filed a declaratory judgment action. The Coverage B insuring agreement in the Continental policy stated, in relevant part, that Continental would defend Uretek against suits seeking damages for an "injury . . . arising out of . . . [the] [o]ral or written publication, in any manner, of material that . . . disparages a person's or organization's goods, products or services."<sup>160</sup>

The district court granted summary judgment for Continental, finding that the terms of the Coverage B insuring agreement of the policy were not triggered. According to the district court, "Allied had not alleged [in its counterclaim] that Uretek told customers that Applied had infringed the . . . patent."<sup>161</sup>

The U.S. Court of Appeals for the Fifth Circuit disagreed. First, the court explained that the plain, ordinary, and generally accepted meaning of disparage is "'to lower in rank or reputation; degrade' or 'speak slightly about.'"<sup>162</sup> After detailed recitation of the factual allegations from the counterclaim, the court surmised that "[a] statement to a competitor's customer that the competitor is undertaking work that it has no legal right to undertake disparages that competitor and the services it offers by

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153. *Id.* at 346.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at 344.

160. *Id.*

161. *Id.* at 345.

162. *Id.*

clear implication.”<sup>163</sup> The Fifth Circuit rejected Uretex’s reliance on *KLN Steel Products Co. v. CNA Insurance Cos.*, in which the San Antonio Court of Appeals held that an insurer had no duty to defend where the insured allegedly overstated its qualifications in conversation with contracting officers.<sup>164</sup> The court noted that while *KLN* involved the insured overstating its qualifications to a potential customer, Applied’s counterclaim involved actual disparagement of a competitor’s work.<sup>165</sup> The court also rejected Continental’s argument that the suit needed to consist of a “covered disparagement offense”—specifically business disparagement—reiterating that absent a definition of the term “disparagement” in the policy, it would rely on the commonly understood meaning of the word.<sup>166</sup> The court also determined that two of the policy’s exclusions, which barred coverage for material published with knowledge of its falsity or for injury caused with knowledge that the act would inflict personal and advertising injury, were inapplicable as Applied’s counterclaim merely alleged that Uretex “knew or should have known” that its patent did not prevent its competitors from bidding on public contracts.<sup>167</sup> The court recognized that the Lanham Act does not require intentional conduct. Accordingly, the court found that the duty to defend was triggered because Applied could at least potentially prevail on its claims based on its factual allegations in the counterclaim.<sup>168</sup>

#### B. NOTICE CONDITION

A frequent topic of coverage litigation is whether the notice provision of an insurance policy provides an insurer a basis to deny coverage if an insured fails to provide timely notice of a lawsuit. In *PAJ, Inc. v. The Hanover Insurance Co.*, the Texas Supreme Court held that to deny coverage on this basis, an insurer must show that it was prejudiced by the late notice.<sup>169</sup> According to the supreme court, prejudice is required because an insured’s obligation to provide timely notice was not “an essential part of the bargained-for-exchange” under the policy.<sup>170</sup>

Generally, prejudice is a fact issue. However, some Texas courts have recognized that situations exist where an insurer can demonstrate that it is prejudiced as a matter of law by an insured’s failure to provide timely notice. One such situation is when a notice is not provided until after entry of judgment against the insured.<sup>171</sup>

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163. *Id.* at 346.

164. *Id.* at 347.

165. *Id.*

166. *Id.*

167. *Id.* at 348.

168. *Id.*

169. *PAJ, Inc. v. The Hanover Ins. Co.*, 243 S.W.3d 630, 631 (Tex. 2008).

170. *Id.* at 636.

171. *See Liberty Mut. Ins. Co. v. Cruz*, 883 S.W.2d 164, 166 (Tex. 1993) (per curiam) (“We agree that an insurer that is not notified of suit against its insured until a default judgment has become final, absent actual knowledge of the suit, is prejudiced as a matter of law.”); *Berkley Reg’l Ins. Co. v. Phila. Indem. Ins. Co.*, 690 F.3d 342, 350 (5th Cir. 2012);

The Fifth Circuit again addressed this issue in *Nautilus Insurance Co. v. Miranda-Mondragon*, reaffirming that notice provided after a default judgment constitutes a material breach of an insurance policy and prejudices an insurer as a matter of law.<sup>172</sup> Irma Miranda-Mondragon (Miranda-Mondragon) was working as a waitress at a nightclub when gunmen entered and shot her, patrons, and several other employees.<sup>173</sup> She sued and subsequently obtained a default judgment against Houston Star Security Patrol (Houston Star).<sup>174</sup> Despite being served, Houston Star never made an appearance in the lawsuit. Miranda-Mondragon eventually obtained a default judgment against Houston Star.<sup>175</sup> Thereafter, Miranda-Mondragon sent a letter and a copy of the default judgment to Houston Star's insurer, Nautilus Insurance Company (Nautilus), and demanded payment for the judgment.<sup>176</sup>

Nautilus filed a declaratory judgment action and obtained summary judgment that the notice provided was untimely and precluded coverage under its policy.<sup>177</sup> On appeal, the Fifth Circuit affirmed, stating: "[t]he first notice Nautilus received of the lawsuit came from Miranda-Mondragon's counsel 41 days after the state court entered default judgment against Houston Star. The delayed notice prejudiced Nautilus as a matter of law and relieved Nautilus of liability under the policy."<sup>178</sup>

### C. SUBROGATION

In a matter of first impression, the U.S. Court of Appeals for the Fifth Circuit evaluated in *Associated International Insurance Co. v. Scottsdale Insurance Co.* whether a subrogation clause would "allow an insurer to seek reformation of a contract between its insured and a third party."<sup>179</sup> Associated International (Associated) was an excess insurer for VDC-Matthew Ridge, Ltd. (Matthew Ridge).<sup>180</sup> Because of an assault on the premises of a property owned by Matthew Ridge and managed by Alpha-Barnes Real Estate Services (Alpha), Associated was eventually forced to contribute to a settlement on behalf of Matthew Ridge and Alpha.<sup>181</sup>

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C.L. Thomas, Inc. v. Lexington Ins. Co., 2014 WL 4494516, at \*5 (Tex. App.—Corpus Christi Sept. 11, 2014, no pet.) (mem. op.) (concluding that insurer established prejudice as matter of law when insured provided notice after arbitration award against it); Wash. Mut. Bank v. Commonwealth Land Title Ins. Co., 2010 WL 135685, at \*2 (Tex. App.—Corpus Christi Jan. 14, 2010, pet. denied) (mem. op.) (insurer prejudiced as a matter of law due to insured not providing notice until after judgment); Md. Cas. Co. v. Am. Home Assur. Co., 277 S.W.3d 107, 118–19 (Tex. App.—Houston [1st Dist.] 2009, no pet.) (holding same).

172. *Nautilus Ins. Co. v. Miranda-Mondragon*, 711 F. App'x 214, 216 (5th Cir. 2017) (per curiam).

173. *Id.* at 215.

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.* at 216 (citing *Berkley Reg'l Ins. Co. v. Phila. Indem. Ins. Co.*, 690 F.3d 342, 350 (5th Cir. 2012); *Liberty Mut. Ins. Co. v. Cruz*, 883 S.W.2d 164, 165 (Tex. 1993)).

179. *Associated Int'l Ins. Co. v. Scottsdale Ins. Co.*, 862 F.3d 508, 509 (5th Cir. 2017).

180. *Id.*

181. *Id.*

Associated sought reimbursement from Scottsdale, which issued an umbrella policy to Alpha, despite the fact that the property where the assault occurred was not listed on the schedule of covered properties in the Scottsdale policy.<sup>182</sup>

Associated argued that, although the property was not listed as a covered property on the policy, it had been omitted by mutual mistake between Alpha and Scottsdale, and thus Associated, as subrogee of Alpha, had standing to seek reformation of the policy.<sup>183</sup> The district court rejected Associated's position, concluding "that Associated had no standing to seek reformation because it was not in privity with the Alpha-Scottsdale 'agreement.'"<sup>184</sup> After outlining the general rationale for allowing the subrogation of insurers, the Fifth Circuit observed that the district court erred in holding that Associated was not in privity with the agreement.<sup>185</sup> Rather, under the generally accepted principles of subrogation, Associated stepped into the shoes of Alpha and thus was in privity through the rights of Alpha.<sup>186</sup> The court rejected Scottsdale's argument that allowing reformation would run afoul of recognized subrogation rights under Texas law.<sup>187</sup> Rather, Associated sought reformation only as an avenue to recover amounts it had paid as opposed to a windfall from its insured. As a result, no equitable basis existed to deny the claim.<sup>188</sup> Finally, the court rejected Scottsdale's argument that reformation would potentially put Associated at odds with Alpha's best interest. The court explained that this argument was unresponsive to Scottsdale's position, noting that "an insured's displeasure with its insurer's litigation decisions is a not infrequent consequence of the subrogee getting to step into its shoes."<sup>189</sup>

## VI. HOUSE BILL 1774 AND CHAPTER 542A OF THE TEXAS INSURANCE CODE

During this Survey period, the Texas Legislature passed and Texas Governor Greg Abbott signed into law House Bill 1774 (the Bill). This bill addressed multiple insurance-related issues aimed at simplifying first party liability cases with respect to certain weather-related losses. As a result of the Bill, Chapter 542A was added to the Texas Insurance Code.

### A. SCOPE OF APPLICATION

Chapter 542A codifies certain pre-suit notice and inspection requirements and imposes limitations on interest penalties and attorney's fees. Chapter 542A is limited to a first-party claim that (a) "is made by an

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182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.* at 510.

186. *Id.* at 511.

187. *Id.*

188. *Id.*

189. *Id.*

insured under an insurance policy providing coverage for real property or improvements to real property”; (b) “must be paid by the insurer directly to the insured”; and (c) “arises from damage to or loss of covered property caused, wholly or partly, by forces of nature, including an earthquake or earth tremor, a wildfire, a flood, a tornado, lightning, a hurricane, hail, wind, a snowstorm, or a rainstorm.”<sup>190</sup> These reforms are also limited to actions against an insurer for “breach of contract . . . negligence, misrepresentation, fraud, or breach of a common law duty,” or actions brought under Subchapter D of Chapter 541, Subchapter B of 542, or Subchapter E of the DTPA.<sup>191</sup>

#### B. LIABILITY FOR AGENTS AND PROPER PARTIES TO COVERAGE LITIGATION

One significant provision within Chapter 542A relates to liability of adjusters and other agents. Under the new statute, an “agent”—as defined in the subchapter—may avoid liability if an insurer elects “to accept whatever liability the agent might have to the claimant for the agent’s acts or omissions related to the claim.”<sup>192</sup> Further, this liability is not merely limited to adjusters, but may apply to *any* employee, agent, representative, or adjuster who performs any act on behalf of an insurer. Where an insurer accepts liability on behalf of its agent for acts related to a claim prior to the filing of a suit, any subsequent suit brought against that agent will be dismissed with prejudice. Likewise, where an insurer accepts the agent’s liability after filing of a suit, any action against the agent will be dismissed. The election cannot be conditioned to allow the insurer to avoid liability for the agent’s acts, and is irrevocable. Finally, an insurer’s election to accept the agent’s liability may not be made known to the jury, and any judgment against the insurer must include any liability that would have been assessed against the agent.

We recognized in previous articles that the subject of frequent coverage litigation is whether a non-diverse defendant (typically the insurance adjuster) is improperly joined in an attempt to defeat federal court jurisdiction. The fact-intensive nature of this evaluation led at times to inconsistent results.<sup>193</sup> In light of the passage of the Bill and statutes promulgated within Chapter 542A, it appears that this issue may be moot in future storm-related damage litigation.

#### C. PRE-LITIGATION NOTICE AND INSPECTION REQUIREMENTS

The Bill also addressed notice requirements for filing suit against an insurer. Specifically, not later than the sixty first day prior to the filing of

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190. TEX. INS. CODE § 542A.001 (West Supp. 2017).

191. *Id.* § 542A.002.

192. *Id.* § 542A.006.

193. See generally J. Price Collins et. al., *Insurance Law*, 2 SMU ANN. TEX. SURV. 199 (2016).

a lawsuit, a claimant must give written notice to its insurer specifically identifying:

- “[T]he acts or omissions giving rise to the claim”;
- The amount allegedly owed by the insurer; and
- “[T]he amount of reasonable and necessary attorney’s fees . . . calculated by multiplying the number of hours actually worked by claimant’s attorney . . . by an hourly rate that is customary for similar legal services.”<sup>194</sup>

The notice is admissible as evidence in a civil action, but may not be required where doing so would cause the claim to be barred under the statute of limitations. An insurer who receives pre-suit notice may request an inspection of the property at issue within thirty days of receipt of the notice. Such an inspection should be completed not later than sixty days after receipt of the pre-suit notice.<sup>195</sup>

Under Chapter 542A, insurers may file a plea in abatement within thirty days of filing an original answer where pre-suit notice was either not received or pre-suit inspection was requested but no reasonable opportunity to inspect was provided.<sup>196</sup> Absent a response affidavit by the insured, the suit will be automatically abated without a court order eleven days after the filing of a verified plea and abatement will continue until either the sixtieth day after proper pre-suit notice is given or the fifteenth day after the requested property inspection is completed, whichever is later.<sup>197</sup>

Significantly, the Texas Legislature also took steps to reign in the award of attorney’s fees for first party cases. For instance, where a defendant pleads and proves that pre-suit notice was not properly given, the court may not award attorney’s fees to the claimant incurred after the date the defendant files its pleading with the court.<sup>198</sup>

Likewise, where such notice is proven to be unreasonably inflated, a court may limit attorney’s fees. If less than twenty percent of claimed pre-suit damages are awarded, no fees are recoverable. If the amount awarded is between twenty and seventy-nine percent of claimed pre-suit damages, a corresponding percentage of attorney’s fees is likewise recoverable. If eighty percent or more are recovered, full recovery of attorney’s fees is permissible.<sup>199</sup> These limiting provisions do not apply in the event an insurer accepts liability on behalf of an agent but fails to reasonably make the agent available for deposition testimony, unless a court subsequently determines that it was impracticable to make the agent available for testimony, or the agent would not have been a proper party to the action, or their testimony was not warranted under the law.

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194. TEX. INS. CODE § 542A.003 (West Supp. 2017).

195. *Id.* § 542A.004.

196. *Id.* § 542A.005.

197. *Id.* § 542A.005(c).

198. *Id.* § 542A.007(d).

199. *Id.* § 542A.007.



#### D. PENALTY INTEREST FOR PROMPT PAYMENT VIOLATIONS

Finally, Chapter 542A amends Texas Insurance Code § 542.060 to provide a new calculation for statutory penalty interest for prompt payment violations.<sup>200</sup> Specifically, in an action where Chapter 542A applies, penalty interest will now be determined by adding five percent to the Federal Reserve's prime rate, down to a floor of five percent and up to a ceiling of fifteen percent. In other words, where the prime rate drops below five percent, penalty interest will be calculated by adding five percent to a base of five percent, for a minimum penalty interest of ten percent. Where the prime rate rises about fifteen percent, fifteen percent will be used instead of the prime rate for a maximum penalty interest of twenty percent. This new rate will only apply to claims made after September 1, 2017.

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200. *Id.* § 542.060(c).