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## Insurance Law

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# INSURANCE LAW

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## I. EXTRACONTRACTUAL LIABILITY

### A. NO TORT LIABILITY FOR INSURER'S PAYMENT OF ALLEGEDLY INVALID WORKERS COMPENSATION CLAIMS

IN *Wayne Duddlesten, Inc. v. Highland Insurance Co.*, the First District Court of Appeals refused to recognize causes of action by an employer against its workers compensation carrier for breach of fiduciary duty and negligence arising from the carrier's payment of allegedly invalid workers compensation claims.<sup>1</sup> The insured employer obtained workers' compensation insurance from the same workers compensation carrier for three consecutive years beginning July 1, 1991. These policies were subject to a "retrospective premium payment," pursuant to which a standard annual premium amount was adjusted according to the amount of claims paid under the policies.<sup>2</sup> The employer complained that the carrier inappropriately paid a number of claims that should have been contested, thereby unnecessarily increasing its premiums. The employer asserted numerous causes of action, including breach of fiduciary duty and negligence. The court rejected all of the employer's liability theories, but of particular interest was the court's treatment of the fiduciary duty and negligence causes of action.

#### 1. *No Fiduciary Duty*

The court held that the trial court correctly granted summary judgment on the pleadings with respect to the breach of fiduciary duty cause of action. The court noted that "there is no general fiduciary duty between

1. *Wayne Duddlesten, Inc. v. Highland Ins. Co.*, 110 S.W.3d 85, 97 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

2. *Id.* at 88-89.

an insurer and its insured.”<sup>3</sup> The employer failed to plead facts demonstrating that an informal, confidential relationship existed between the employer and the insurer prior to and apart from the insurance contracts. Mere allegations that the employer “trusted the insurer to correctly administer its workers’ compensation claims” was insufficient to support the existence of an informal fiduciary duty.<sup>4</sup>

## 2. No Cause of Action for Negligent Claims Handling

The employer claimed that its insurer was negligent in settling, rather than contesting, allegedly invalid workers’ compensation claims. As a result of this alleged negligence, the employer was subject to higher premiums under a retrospective premium payment plan. The employer further contended that, because the insurer would get paid more premiums under the retrospective premium plan, it “had less of an incentive to dispute invalid claims.”<sup>5</sup> The employer argued that the Texas Supreme Court’s decision in *Ranger County Mutual Insurance Co. v. Guin*<sup>6</sup> extended the *Stowers* duty to the claims handling process. “The court in *Ranger* stated that an insurer’s duty . . . ‘extends to the full range of the agency relationship,’ and includes the investigation [of claims] and the defense of . . . lawsuits.”<sup>7</sup> However, the *Duddleston* court determined that this case was distinguishable from *Ranger* because *Ranger* involved the insurer’s negligent failure to settle cases *within policy limits*. Here, the employer’s complaint was based on the insurer’s decision to settle claims, rather than the failure to settle as in *Ranger*. The court concluded that Texas law does not permit claims against “insurers, outside the scope of *Stowers*, for the negligent handling of claims.”<sup>8</sup>

### B. 5TH CIRCUIT EXTENDS DUTY OF GOOD FAITH TO D&O LIABILITY POLICY

In *Medical Care America, Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania*,<sup>9</sup> shareholders of Medical Care America, Inc. (“Medical Care”) brought securities claims against the directors and officers (“D&O”) of Medical Care for alleged misrepresentation and material nondisclosures in connection with a merger which resulted in a decline in stock value. Medical Care obtained a D&O liability policy which provided coverage beginning the date of the merger. Medical Care sought indemnification under the D&O policy for amounts paid to settle the claims against its directors and officers, but coverage was denied. Medical Care sued alleging, among other things, breach of contract and

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3. *Id.* at 96.

4. *Id.*

5. *Id.* at 97.

6. *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d 656, 659 (Tex. 1987).

7. *Duddleston*, 110 S.W.3d at 97 (quoting *Ranger*, 723 S.W.2d at 659).

8. *Id.*

9. *Med. Care Am., Inc. v. Nat’l Union Fire Ins. Co.*, 341 F.3d 415 (5th Cir. 2003).

bad faith.<sup>10</sup>

The coverage provided under the D&O policy was limited to “[l]oss arising from claims for alleged Wrongful Acts occurring on or after [the date of the merger].”<sup>11</sup> The policy provided that losses “arising out of the same or related Wrongful Act(s) shall be deemed to arise from the first such same or related Wrongful Act.”<sup>12</sup> The coverage question at issue was whether the policy covered the directors and officers post merger wrongful acts that were the same or related to their pre-merger wrongful acts. A jury determined that the claims against the directors and officers were not covered by the policy. Medical Care appealed.<sup>13</sup>

The Fifth Circuit affirmed the trial court’s judgment on the verdict, finding that the evidence was sufficient to support the jury’s verdict. What is significant about this case is the court’s analysis of Medical Care’s bad faith claim. Citing *Maryland Insurance Co. v. Head Industrial Coatings & Services, Inc.*,<sup>14</sup> the court recognized that, under Texas law, an insurer is not liable for bad faith premised on the insurer’s investigation or defense of a claim brought against the insured by a third party since the insured is fully protected by his contractual and *Stowers* rights. However, although the D&O policy provided liability coverage for losses resulting from claims brought by third parties, the court treated Medical Care’s claim as a first party claim to which the duty of good faith and fair dealing applies. The court stated:

In this case, Medical Care does not allege that National Union acted in bad faith in investigating or defending the shareholders’ claims of loss. Indeed, it admits that National Union had no duty to defend the shareholder suit. Medical Care alleges instead that National Union acted in bad faith in handling its own claim of loss (i.e., reimbursement of its indemnification of the \$10 million allocated to its directors and officers following the settlement of the shareholder suit). Its allegation concerns the relationship between it and National Union—not between National Union and the shareholders. Thus, we will treat Medical Care’s claim as a first-party claim to which the duty of good faith applies.<sup>15</sup>

The court ultimately determined that Medical Care’s bad faith claim was invalid because “the evidence overwhelmingly shows that there was a bona fide coverage dispute, which National Union subsequently won.”<sup>16</sup> However, the court’s analysis of the issue may signal an effort to limit the applicability of the Texas Supreme Court’s holding in the *Head* case.

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10. *Id.* at 417-19.

11. *Id.* at 419 (quoting Endorsement \*7 of the D&O Liability Policy).

12. *Id.*

13. *Id.* at 420.

14. *Md. Ins. Co. v. Head Indus. Coatings & Servs., Inc.*, 938 S.W.2d 27, 27 (Tex. 1996).

15. *Med. Care Am., Inc.*, at 425.

16. *Id.* at 426.

C. EFFECT OF RELEASE OF CONTRACTUAL CLAIMS FOR COVERAGE  
ON EXTRACTIONAL CLAIMS

In *Vaughan v. Hartford Casualty Insurance Co.*,<sup>17</sup> the United States District Court for the Northern District of Texas provided a reminder of the importance of paying attention to detail when drafting settlement documents in coverage disputes. In this case, Vaughan was injured in an automobile accident in July of 2000. The driver of the other vehicle was at fault, but only had \$20,000 in liability coverage. Vaughan notified Hartford, the uninsured motorist carrier for the car in which he was a passenger, of the accident and his injuries in October of 2000 and again in November of 2000.<sup>18</sup> On or about March 21, 2002, Vaughan reached an agreement with Hartford to settle the uninsured/underinsured motorist claim for \$200,000.<sup>19</sup> Hartford sent Vaughan a release that Vaughan returned, adding language specifically stating that he was not releasing any claims for breach of the duty of good faith and fair dealing, violation of Insurance Code Article 21.21, and of Article 21.55. Hartford rejected Vaughan's revisions to the release.<sup>20</sup> On April 4, 2002, Vaughan signed a release containing the original language proposed by Hartford, which released Hartford

from any and all claim, demands and causes of action, of whatever nature, whether in contract or in tort, for bodily injury and property damage which have accrued or may ever accrue to me. . . *for and on account of the incident/auto accident which occurred on or about July 8, 2000, involving the [Escalade].*<sup>21</sup>

The release further stated that the \$200,000 of consideration "is accepted by [Vaughan] in full compromise and settlement of all claims and causes of action being asserted by me or which might have been asserted by me, whether for property damages, personal injury or other loss or damage, and said claim shall be dismissed with prejudice."<sup>22</sup> Lastly, the release "acknowledge[s] *full satisfaction and discharge of all claims and demands against [Hartford] under the [UM/UIM Coverage] attached to [the Policy].*"<sup>23</sup>

Subsequent to the execution of the release, Vaughan sued Hartford for breach of the common-law duty of good faith and fair dealing, as well as violations of Insurance Code Article 21.21, § 4(10) and Insurance Code article 21.55.<sup>24</sup> The threshold issue in this appeal was whether the scope of the release precluded Vaughan from asserting extracontractual claims against Hartford. The court noted that, generally, "an insured may not prevail on [extracontractual] claim[s] without first showing that the in-

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17. *Vaughan v. Hartford Cas. Ins. Co.*, 277 F. Supp. 2d 682 (N.D. Tex. 2003).

18. *Id.* at 683.

19. *Id.* at 686.

20. *Id.*

21. *Id.* at 688 (quoting App. to Mot. at 47-48) (emphasis in original).

22. *Id.* (quoting App. to Mot. at 48).

23. *Id.* (quoting App. to Mot. at 48) (emphasis in original).

24. *Id.* at 683.

surer breached [its] contract.”<sup>25</sup> Vaughan could not establish breach of contract because the release discharged this claim. However, the court stated that because of the independent nature of the tort and contract claims, in some cases an insured can succeed on its bad faith tort claim despite its failure demonstrate a breach of the insurance contract.<sup>26</sup>

1. *Release of Contractual Claims Did Not Bar Common Law Bad Faith and DTPA Claims*

The release did not specifically include extracontractual claims. As a result, the court held that the scope of the release did not preclude Vaughan from bringing his claims for bad faith and violations of the DTPA. Hartford argued that the fact that Vaughan signed the release after Hartford had rejected Vaughan’s attempt to expressly reserve his extracontractual claims from the release was evidence that the parties intended for the extracontractual claims to be included within the scope of the release. However, the court noted that Vaughan may have signed the release because he determined that the scope of the release was sufficiently narrow that it was unnecessary to expressly reserve the extracontractual claims. Thus, Vaughan was not precluded by the release from asserting his bad faith and DTPA claims since these claims were of a different nature than the released contract claim.<sup>27</sup>

2. *Article 21.55 Claim Was Precluded by Release of Contract Claim*

The court took a different view concerning Vaughan’s claims under Article 21.55 of the Texas Insurance Code. The court recognized that Article 21.55 defines the obligations of an insurer “under an insurance policy[,] extends the rights of an insured under [the policy, and] is limited to ‘a first party claim made by an insured or a policyholder under an insurance policy or contract or by a beneficiary named in the policy or contract that must be paid by the insurer directly to the insured or beneficiary.’”<sup>28</sup> Thus, the court concluded that Vaughan’s Article 21.55 claim was discharged by the release, since the release was in full satisfaction and discharge of all claims under the policy.<sup>29</sup>

3. *Release of Contractual Claim did not Necessarily Preclude Article 21.21 Claim*

The court did not reach a conclusion as to whether Vaughan’s Article 21.21 claim was discharged by the release; however, the court recognized that there might be the basis for an argument that the Article 21.21 claim should be treated in the same manner as the common law bad faith and

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25. *Id.* at 689 (citing *Liberty Nat’l Fire Ins. Co. v. Akin*, 927 S.W.2d 627, 629 (Tex. 1996)).

26. *Id.*

27. *Id.*

28. *Id.* (quoting TEX. INS. CODE ANN. art. 21.55, § 1(3) (Vernon Supp. 2003)).

29. *Id.* (quoting App. to Mot. at 48).

DTPA claims. The court determined that it need not decide this issue because Vaughan had failed to establish any damages beyond those damages that were released. As a result, the court ultimately determined that Vaughan's bad faith, DTPA, and Article 21.21 claims could not be sustained.<sup>30</sup>

Although the court ultimately resolved this dispute in favor of the insurer, the court's analysis demonstrates that insurers seeking to discharge both contract and tort claims when resolving disputed claims should ensure that their settlement documentation specifically release both contractual and extracontractual claims.

#### D. DUTY TO INVESTIGATE, NEGOTIATE AND SETTLE CLAIMS LIMITED TO STOWERS DUTY

In *Gulf Insurance Co. v. Jones*,<sup>31</sup> the Northern District of Texas addressed the extent of an insurer's duty to investigate, negotiate, and settle third party liability claims against its insured. Donald R. Blum ("Blum") was a podiatrist who had obtained a professional liability policy from the Fidelity and Casualty Company of New York, which was reinsured by Gulf Insurance Company (collectively "Gulf"). Sonia Jones sued Blum for medical malpractice based on events that occurred during the effective dates of the policy. Gulf defended Blum. The case was tried in February of 1999, resulting in a \$2,125,000 verdict, later lowered by remittitur to \$1,100,000, plus prejudgment and postjudgment interest. Gulf agreed to indemnify Blum for the judgment, but only up to the "per person" liability limit of \$500,000. Gulf filed a declaratory judgment action seeking a determination that it was not obligated to indemnify Blum in excess of the \$500,000 per person liability limit and that it had no extracontractual liability for its handling of the claim. Blum counterclaimed for breach of contract, violations of the Texas Insurance Code, and negligence.<sup>32</sup>

After determining that Gulf was not contractually obligated to indemnify Blum beyond the \$500,000 per person liability limit, the court addressed Blum's extracontractual claims. Blum complained that Gulf failed to investigate, negotiate, and settle Jones's claim. As a threshold matter, the court held that while the insurance contract gave Gulf the *right* to investigate, negotiate and settle any suit or claim Gulf believed appropriate, the contract did not impose a corresponding contractual *duty* on Gulf.<sup>33</sup>

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30. *Id.* at 690.

31. *Gulf Ins. Co. v. Jones*, No. CIV.A.300CV0330L, 2003 WL 22208551 (N.D. Tex. Sept. 24, 2003).

32. *Id.* at \*1.

33. *Id.* at \*3-4.



### 1. *No Stowers Duty to Negotiate*

Blum asserted that Gulf acted negligently by refusing to negotiate and settle Jones's claim. The court noted that there was a pretrial settlement demand of \$500,000; however, the court pointed out that Blum was adamant that he did not want to settle the lawsuit and that he communicated this to Gulf. Despite Blum's opposition to settlement, Blum argued that his consent to settlement was not required under the policy and blamed Gulf's insurance adjuster for failing to settle the lawsuit. First, he claimed that the adjuster failed to appreciate the weakness in his defense; however, the court pointed out that the record demonstrated the adjuster considered the evidence in the case and that Blum himself testified in his deposition that it was reasonable for the insurer to believe that the claim was defensible. Blum further complained that the adjuster did not actively attempt to settle the case, but the court stated that an insurer has no *Stowers* duty to make or solicit settlement offers.<sup>34</sup> Second, he blamed the adjuster for allegedly hiring an inexperienced attorney. Although, Blum admitted he was satisfied with his defense, he claimed that, but for defense counsel's inexperience, he might have been convinced to settle the lawsuit. The court rejected this argument completely, recognizing that an insurer is not vicariously liable for the conduct of defense counsel and, thus, could not support a *Stowers* claim based on defense counsel's alleged conduct.<sup>35</sup>

### 2. *Duty Under Article 21.21 is the Same As Stowers*

Blum contended that Gulf's failure to negotiate and settle Jones' claim was a violation of Article 21.21. Gulf countered that Blum was not entitled to assert a cause of action under 21.21 in light of the Texas Supreme Court's holding in *Head* "that the insured's rights against its insurer regarding the insurer's settlement practices were limited to the rights under the *Stowers* doctrine."<sup>36</sup> The court responded that "*Head*, however, is not [sic] longer applicable."<sup>37</sup> This broad statement should be viewed in context, as the court was addressing the viability of an Article 21.21 cause of action. The court pointed out that the statute has been amended subsequent to the *Head* decision and now "permits an insured to bring a cause of action against an insurer for unfair settlement practices."<sup>38</sup> Citing the Texas Supreme Court decision in *Rocor International Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pennsylvania*,<sup>39</sup> the court recognized that the elements necessary to establish liability under Article 21.21

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34. *Id.* at \*4 (citing *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 851 (Tex. 1994)).

35. *Id.* at \*4.

36. *Id.* at \*9 (citing *Md. Ins. Co. v. Hear Indus. Coatings & Servs., Inc.*, 938 S.W.2d 27, 28-29 (Tex. 1996)).

37. *Id.*

38. *Id.*

39. *Rocor Int'l Inc. v. Nat'l Union Fire Ins. Co.*, 77 S.W.3d 253, 262 (Tex. 2002).

are essentially the same as under the *Stowers* doctrine.<sup>40</sup> Accordingly, having found no *Stowers* violation, the court granted summary judgment for Gulf on Blum's Article 21.21 claim.<sup>41</sup>

#### E. COURT FINDS ARTICLE 21.55 APPLIES TO PAYMENT OF DEFENSE COSTS UNDER LIABILITY POLICY

The Southern District of Texas addressed whether damages under Insurance Code Article 21.55 would be appropriate in a third-party liability action in *Luxury Living, Inc. v. Mid-Continent Casualty Co.*<sup>42</sup> Luxury Living sought defense and indemnification under a commercial general liability ("CGL") policy issued by Mid-Continent. Mid-Continent denied coverage and Luxury Living filed a declaratory action. Luxury Living also alleged that it was entitled to damages under Article 21.55 for Mid-Continent's failure to provide a defense. Mid-Continent argued that Luxury Living was not entitled to Article 21.55 damages because this was a third-party liability claim, not a first-party claim. Article 21.55 applies only to first-party claims.<sup>43</sup> Recognizing that Texas case law is not unanimous on this issue, the court stated that "most courts in Texas have concluded that a 'claim for the duty to defend is a first party claim asserted against [the insurer] under Article 21.55 of the Texas Insurance Code, and the statutory penalty will apply to such sums.'"<sup>44</sup>

## II. CONTRACTUAL LIABILITY

### A. MOLD CLAIMS UNDER HOMEOWNERS POLICIES

#### 1. Mold Exclusion

In *Fiess v. State Farm Lloyds*,<sup>45</sup> United States Magistrate Judge Marcia A. Crone, in the Southern District of Texas, Houston Division, determined that the mold exclusion in a standard Texas homeowner's policy precluded coverage for the homeowners' mold claim.<sup>46</sup> After discovering mold in their home, Richard and Stephanie Fiess made a claim under their homeowner's insurance policy with State Farm Lloyds. The mold resulted at least in part from water intrusion into the home. "State Farm maintain[ed] that the Fiesses' claim for mold damage was expressly excluded from coverage under the policy. The Fiesses, however, assert[ed] that the mold damage was covered as an 'ensuing loss' under the Pol-

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40. *Gulf*, 2003 WL 22208551 at \*9 ("The *Rocor* court adopted the common-law *Stowers* standard in determining the statutory liability standard [under article 21.21 post *Head*]").

41. *Id.* at \*10.

42. *Luxury Living, Inc. v. Mid-Continent Cas. Co.*, No. CIV.A.H-02-3166, 2003 WL 22116202 (S.D. Tex. Sep. 10, 2003).

43. *Id.* at \*20 (quoting art. 21.55 § 1(3)).

44. *Id.* (quoting *Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc.*, 215 F. Supp. 2d 783, 794 (E.D. Tex. 2002)) (alterations in original).

45. *Fiess v. State Farm Lloyds*, No. CIV.A.H-02-1912, 2003 WL 21659408 (S.D. Tex. June 4, 2003).

46. *Id.* at \*9.

icy.”<sup>47</sup> The policy provided:

- f. We [State Farm] do not cover loss caused by:
- (1) wear and tear, deterioration or loss caused by an quality in property that causes it to damage or destroy itself.
  - (2) rust, rot, mold or other fungi.
  - (3) dampness of atmosphere, extremes of temperature.
  - (4) contamination.
  - (5) rats, mice, termites, moths or other insects.

We do cover ensuing loss caused by collapse of building or any part of the building, water damage or breakage of glass which is part of the building if the loss would otherwise be covered under the policy.<sup>48</sup>

The court determined that this exclusion explicitly removed from coverage any loss caused by mold, regardless of the cause of the mold. However, the Fiesses argued that their mold damage fell within the “exception to the exclusion as an ‘ensuing loss caused by . . . water damage’ under the Policy.”<sup>49</sup> The court found that “‘ensuing loss caused by . . . water damage’ refers to water damage which is the result, rather than the cause, of one of the types of damage enumerated in [the] exclusion . . . in this case mold.”<sup>50</sup> The court noted that the “opinion relied upon by the Fiesses, *Home Ins. Co. v. McClain*,<sup>51</sup> . . . departs from the long line of authority in Texas and is contrary to the interpretation given the ensuing loss clause in other jurisdictions.”<sup>52</sup> Because it was undisputed that the water damage was not caused by the mold, but instead, the mold was caused by the water damage, the court held that the mold damage was excluded and did not fall within the ensuing loss exception.<sup>53</sup>

In *Flores v. Allstate Texas Lloyd’s Co.*,<sup>54</sup> United States District Judge Crane, for the Southern District of Texas, McAllen Division, reached the opposite conclusion from the *Fiess* decision. Like *Fiess*, this case involved mold claims submitted by homeowners Oscar and Graciela Flores under a Texas standard homeowners policy. The policy contained the same mold exclusion and ensuing loss exception as the policy addressed in *Fiess*. The court expressly declined to follow the reasoning of the *Fiess* case and, instead, concluded that mold damage is covered if it ensues from an otherwise covered loss under the Policy.<sup>55</sup>

47. *Id.* at \*6.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Home Ins. Co. v. McClain*, No. 05-97-01479-CV, 2000 WL 144115, at \*3 (Tex. App.—Dallas Feb. 10, 2000, no pet.) (not designated for publication).

52. *Fiess*, 2003 WL 21659408, at \*9.

53. *Id.*

54. *Flores v. Allstate Tex. Lloyd’s Co.*, 278 F. Supp. 2d 810 (S.D. Tex. 2003).

55. *Id.* at 815.

## 2. Notice Requirement

After determining that the Floreses' mold claim was not excluded by the mold exclusion, the court addressed Allstate's argument that the Floreses failed to comply with the notice requirement in the policy, which required prompt written notice in the event of loss to covered property. The court recognized that Texas follows the manifestation trigger of coverage for property damage claims; that is, "[u]nder Texas law, a party cannot be said to sustain actual property damage until such damage becomes manifest."<sup>56</sup> The Floreses did not submit a claim for the initial water event, only for the subsequent mold damage. The court stated that "there can be no duty to notify until damage is apparent."<sup>57</sup> The court further stated that:

[A] homeowner cannot sit back and watch mold grow in his home, or observe an obvious mold-instigating event—such as the flooding of a room in which the baseboards and walls are saturated for several days, or a continuous leak that saturates a surface—and not notify his insurers. But not every water event will cause mold to ensue. Consequently, an insured is not expected to notify his insurance company each time the toilet overflows or the sink drips, where the insured takes prompt remedial action appropriate to the circumstances.<sup>58</sup>

The court next considered whether an insurer is required to demonstrate prejudice in order to avoid coverage under the notice requirement of a homeowner's policy. The court acknowledged that the Fifth Circuit has recognized "a 'trend' toward Texas courts requiring a showing of prejudice to prevail in untimely notice cases, [but] no Texas cases have yet held that such demonstration of prejudice is required in homeowner's policies."<sup>59</sup> As a result, the court declined to impose a prejudice requirement.<sup>60</sup>

Interestingly, in determining the late notice issue, the court did not take a single manifestation approach. Instead, the court found that coverage was precluded for a portion of the mold damage because there was sufficient summary judgment evidence that the Floreses were aware of this damage, but unreasonably delayed reporting the damage to Allstate. However, with respect to the rest of the mold damage in the house, the court found that fact questions existed with respect to whether the Floreses' were sufficiently aware of that damage such that they were obligated to report it to Allstate earlier.<sup>61</sup>

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56. *Id.* (citing *Am. Home Assurance Co. v. Unitramp Ltd.*, 146 F.3d 311, 313 (5th Cir. 1998)).

57. *Id.* at 816.

58. *Id.*

59. *Id.* (footnote omitted).

60. *Id.*

61. *Id.* at 817-20.

B. LIABILITY COVERAGE FOR CONSTRUCTION DEFECTS—THE  
“OCCURRENCE” DEBATE

Insurers, insureds, and courts continue to struggle with analyzing coverage for construction defect claims under general liability policies. *Luxury Living, Inc. v. Mid-Continent Casualty Co.*,<sup>62</sup> and *Jim Johnson Homes, Inc. v. Mid-Continent Casualty Co.*,<sup>63</sup> are two examples from the Survey period of how courts struggling with this analysis can reach inconsistent conclusions. The difficulty in analyzing coverage for construction defect cases under Texas jurisprudence generally involves the “occurrence” requirement of general liability policies.

Both *Luxury Living* and *Jim Johnson* involve claims against home builders for faulty construction. In *Luxury Living*, purchasers of a custom home built by Luxury Living noticed substantial problems with the home several years after the home was completed. The problems with the home included “significant areas of water penetration around doors, windows, and other locations, including a large accumulation of water in the crawl space under the House.”<sup>64</sup> The homeowners asserted causes of action against Luxury Living “for negligence, negligent misrepresentation, violations of RCLA, breach of express warranty, breach of implied warranty of merchantability, breach of implied warranty of good and workmanlike construction, breach of warranty of habitability, violations of the Texas Deceptive Trade Practices Act, and fraud.”<sup>65</sup>

Luxury Living’s insurer, Mid-Continent, denied coverage for the claim, contending that the claim did not involve property damage caused by an “occurrence” and that the claim was excluded by several business risk exclusions in the policy. Luxury Living then sued Mid-Continent for defense costs and indemnity for the claim. Mid-Continent argued that the liability policy is not a performance bond meant to guarantee that the insured did the job correctly, rather, the risk that the workmanship may be faulty and will require repairs to a business risk that should be borne by the insured rather than a general liability insurer. Mid-Continent argued that the claim did not constitute an “occurrence,” which is defined under the policy as an accident, because the claim was based on “harm to the insured’s own work caused by the insured’s failure to do his job properly.”<sup>66</sup> Luxury Living, on the other hand, argued that Mid-Continent owed a defense obligation because the claim included “a garden-variety negligence claim that contains factual allegations of damages which were undesigned and unexpected by Luxury Living,” and which constitutes an accident and, therefore, an “occurrence.”<sup>67</sup>

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62. *Luxury Living, Inc. v. Mid-Continent Cas. Co.*, No. CIV.A.H-02-3166, 2003 WL 22116202 (S.D. Tex. Sep. 10, 2003).

63. *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706 (N.D. Tex. 2003).

64. *Luxury Living*, 2003 WL 22116202 at \*1.

65. *Id.* at \*3.

66. *Id.* at \*13.

67. *Id.*

The court's analysis addresses numerous court opinions addressing the "occurrence" issue under Texas law and attempts to harmonize these varying decisions. In the end, the court simply concludes that the "general allegations of negligence" by the homeowners constituted allegations of property damages caused by an accident.<sup>68</sup> The court did not directly address Mid-Continent's argument that general liability policies are not intended to guarantee the quality of the insured's work.

In contrast, the court in *Jim Johnson* rejected the concept that the mere assertion of a general negligence theory as an alternative basis of recovery is sufficient to satisfy the "occurrence" requirement of a general liability policy.<sup>69</sup> The underlying claim in *Jim Johnson* arose from a construction contract between the Jeters and Jim Johnson, pursuant to which the Jeters hired Jim Johnson to build them a custom home. During the construction of the home, the Jeters encountered problems with the construction work, including problems with the foundation. After a dispute arose between the Jeters and Jim Johnson over the problems with the construction, the Jeters terminated the contract with Jim Johnson and stopped the construction project. Ultimately, it was determined that the foundation was defective and, as a result, the entire foundation and the partial framing that had been constructed had to be demolished so that the foundation could be rebuilt. The Jeters sued Jim Johnson for "(1) breach of contract, (2) violations of the Texas Deceptive Trade Practices Act, and (3) fraud."<sup>70</sup> Alternatively, the Jeters alleged that "[Jim Johnson] . . . was negligent in [(1)] designing and constructing [the home, and in] [(2)] retaining, employing and supervising its designers, employees, engineers and subcontractors."<sup>71</sup>

The *Jim Johnson* court held that that the Jeter's claim was not covered under Jim Johnson's general liability policy. The court noted that "as a general proposition, the purpose of comprehensive liability insurance coverage for a builder is to protect the insured from liability resulting from property damage (or bodily injury) caused by the insured's product, but not for the replacement or repair of that product."<sup>72</sup> The court also suggested that the "better reasoned authorities hold that claims such as the Jeters are making . . . are not claims of accidental damage to property."<sup>73</sup> The court determined that "there is no reading of . . . any Texas court decision the court has found that reasonably would lead to a conclusion that the mere characterization, alternatively made, that a contractor's failure to properly perform a building contract was negligent is sufficient to convert claims based on breach of express and implied covenants and warranties in a building contract into a claim for recovery of

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68. *Id.* at \*16

69. *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706, 716 (N.D. Tex. 2003).

70. *Id.* at 711.

71. *Id.*

72. *Id.*

73. *Id.* at 715.

property damages caused by an accident within the meaning of a liability insurance policy.”<sup>74</sup>

While the factual distinctions and analytical nuances involved in *Luxury Living* and *Jim Johnson* will likely be debated by insureds and insurers in future coverage disputes as each attempts to support its respective position, these cases demonstrate the need for the Texas Supreme Court to articulate more definitive guidelines for determining whether a construction defect case involves allegations of property damage caused by an “occurrence.” Without a more clearly defined rule, insureds and insurers (such as Mid-Continent in these two cases) potentially face conflicting interpretations of their insurance policies.

### C. SCOPE OF AUTO EXCLUSION NOT LIMITED BY “SEPARATION OF INSURED” CLAUSE

In *Bituminous Casualty Corp. v. Maxey*,<sup>75</sup> the Houston Court of Appeals, First District, analyzed whether the “separation of insureds” clause, also called the severability clause, limits the scope of the automobile exclusion in a general liability policy. In this case, two companies, L&R Timber Co., Inc. (“L&R”) and Triple L Express, Inc. (“Triple L”), were insured under the same CGL policy. Employees of both companies were “insureds” under the policy. An employee of Triple L was involved in an automobile accident with another motorist while he was operating a truck. At the time of the accident, the truck the employee was operating was pulling a trailer owned by L&R. An L&R employee was responsible for the braking system on the truck, the failure of which appeared to be a partial cause of the accident. The injured motorist sued Triple L, its employee, L&R, and its employee.<sup>76</sup>

The liability insurer filed a declaratory judgment action seeking to establish that it did not owe Triple L or L&R a defense or indemnity pursuant to the automobile exclusion in the policy, which excluded coverage for “[b]odily injury” or “property damage” arising out of the ownership, maintenance, use or entrustment to others of any . . . ‘auto’ . . . owned or operated by or rented or loaned to any insured.”<sup>77</sup> The policy contained a severability clause which provided that the insurance applies “[a]s if each Named Insured were the only Named Insured; and . . . separately to each insured against whom claim is made or ‘suit’ is brought.”<sup>78</sup>

“The severability clause serves to provide coverage when there is an ‘innocent’ insured who did not commit the conduct excluded by the policy.”<sup>79</sup> Thus, the issue before the court was whether the severability provision limited the scope of the auto exclusion to only those damages

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74. *Id.* at 716 n.13.

75. *Bituminous Cas. Corp. v. Maxey*, 110 S.W.3d 203 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

76. *Id.* at 207.

77. *Id.* at 209.

78. *Id.* at 210.

79. *Id.*

attributable to the specific insured seeking coverage. In addressing this issue of first impression,<sup>80</sup> the court noted that in *King v. Dallas Fire Insurance Co.*,<sup>81</sup> the Texas Supreme Court applied the severability clause to an expected or intended injury exclusion which excluded coverage for injury expected or intended from the standpoint of “*the insured*.”<sup>82</sup> The *Bituminous* court found it significant that the auto exclusion applied to autos owned or operated by or rented or loaned to “*any insured*.”<sup>83</sup> The court refused to apply the severability clause to the auto exclusion, noting that “to hold that the term ‘*any insured*’ in an exclusion means ‘*the insured* making the claim’ would collapse the distinction between the terms ‘*the insured*’ and ‘*any insured*’ in an insurance policy exclusion clause, making the distinction meaningless.”<sup>84</sup> Accordingly, the court held that coverage was precluded by the auto exclusion.<sup>85</sup>

#### D. ANTITRUST CLAIM BARRED BY FORTUITY DOCTRINE

In *RLI Insurance Co. v. Maxxon Southwest, Inc.*,<sup>86</sup> the United States District Court for the Northern District of Texas refused to find coverage under a commercial general liability policy for antitrust claims involving alleged conduct beginning prior to the purchase of the policy. The court decision was based on the principle enunciated by the Southern District that a party “may not ‘voluntarily engag[e] in an activity that gives rise to an accusation of wrongdoing and potential legal liability, and then purchas[e] insurance so that it may shift financial responsibility for its conduct.’”<sup>87</sup>

Maxxon Southwest, Inc. (“MSI”), Gypsum Floors, Raymond Brekke, and the Maxxon Corporation were sued “for violations of the Robinson-Patman Act and conspiracy to violate federal antitrust laws” based on their establishment of a discriminatory pricing scheme to gain a price advantage over the competition.<sup>88</sup> The allegations stated that this began before 1996. RLI had issued a CGL policy to MSI, Gypsum Floors, and Brekke for the first time on or before April 1, 2000 and the policy was in effect between April 1, 2000 and April 1, 2001. The underlying defendants sought a defense from RLI, who undertook the defense at first, but later withdrew. RLI then sought a declaratory judgment in this action that it had no duty to defend. “RLI argue[d] that the activities alleged in

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80. *Id.* at 211 (“This is apparently a case of first impression under Texas law regarding the application of a separation of insureds clause to a policy provision that refers to ‘any insured.’”).

81. *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185 (Tex. 2002).

82. *Bituminous Cas. Corp.*, 110 S.W.3d at 212 (citing *King*, 85 S.W.3d at 188) (emphasis added).

83. *Id.* at 211.

84. *Id.* at 214.

85. *Id.* at 215.

86. *RLI Ins. Co. v. Maxxon Southwest, Inc.*, 265 F. Supp. 2d 727 (N.D. Tex. 2003).

87. *Id.* at 730 (quoting *Franklin v. Fugro-McClelland (Southwest), Inc.*, 16 F. Supp. 2d 732, 736 (S.D. Tex. 1997)).

88. *Id.* at 728.



the underlying complaint constituted a 'loss in progress,' which [precluded] coverage under the fortuity doctrine."<sup>89</sup>

The fortuity doctrine precludes insurance coverage "where the insured is, or should be, aware of an ongoing progressive loss or known loss at the time the policy is purchased."<sup>90</sup> The doctrine is based on "the premise that, because insurance policies are designed to insure against fortuities, insuring a certainty constitutes fraud."<sup>91</sup> The court stated that

[t]he key factor in determining coverage under the fortuity doctrine is not, as defendants contend, whether the insureds had actual knowledge of the underlying loss and potential liability, . . . but rather if they knew at the inception of coverage "*that they were engaging in activities* for which they could possibly be found liable."<sup>92</sup>

The court determined that the risk of potential injury to their competition due to the formulation of price lists was or should have been apparent.<sup>93</sup> Thus, the fortuity doctrine precluded MSI, Gypsum, and Bekke from receiving coverage and, consequently, a defense from RLI.<sup>94</sup>

#### E. COMPETING OTHER INSURANCE CLAUSES—THE INDEMNITY EXCEPTION

*American Indemnity Lloyds v. Travelers Property & Casualty Insurance Co.*<sup>95</sup> involved a dispute between two liability insurers regarding the application of their respective other insurance clauses. In resolving the issue, the Fifth Circuit Court of Appeals recognized an exception to the general rule that conflicting other insurance clauses in multiple liability policies covering the same loss are to be disregarded and the co-insurers are to share the loss. In this case, Elite Masonry, Inc. ("Elite") agreed to provide masonry services pursuant to a subcontract with Caddell Construction Company, Inc. ("Caddell"), the general contractor. Under the subcontract, Elite agreed to indemnify Caddell for all claims, demands, liabilities, losses, expenses, suits, and actions for or on account of injuries arising out of the work done in connection with the subcontract. The subcontract further required Elite to procure liability insurance naming Caddell as an additional insured. Elite obtained the required insurance from American Indemnity Lloyds ("AIL") with primary limits of \$1,000,000. Caddell was also the named insured under its own general liability insurance policy issued by Aetna Casualty & Surety Company (subsequently assumed by Travelers Property & Casualty Ins.

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89. *Id.* at 729.

90. *Id.* at 730 (quoting *Two Pesos, Inc. v. Gulf Ins. Co.*, 901 S.W.2d 495, 501 (Tex. App.—Houston [14th Dist.] 1995, no writ) (citations omitted in original)).

91. *Id.* (citing *Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App.—Dallas 2001, pet. denied)).

92. *Id.* at 731 (quoting *Franklin v. Fugro-McClelland (Southwest), Inc.*, 16 F. Supp. 2d 732, 736 (S.D. Tex. 1997)).

93. *Id.* at 732.

94. *Id.*

95. *Am. Indem. Lloyds v. Travelers Prop. & Cas. Ins. Co.*, 335 F.3d 429 (5th Cir. 2003).

Co.)("TPC") with primary limits of \$1,000,000. Both policies contained identical other insurance clauses.<sup>96</sup>

An employee of Elite sued Elite and Caddell for injuries he received while performing work pursuant to Elite's subcontract with Caddell. Caddell's insurer, TPC, initially provided Caddell with a defense, but subsequently withdrew when AIL assumed Caddell's defense in response to a demand by TPC. AIL ultimately settled the lawsuit. AIL demanded that TPC reimburse it for a portion of the settlement and defense costs, but TPC refused. AIL filed a declaratory judgment action against TPC seeking a declaration that it was entitled under the "other insurance" clauses of the policies to recover from TPC half of the amount paid to settle and defend Caddell.<sup>97</sup>

The court acknowledged the general rule that

[W]here each of two liability insurance policies issued by different insurers provides primary coverage to the same insured in respect to the claim in question and contains mutually consistent 'other insurance' provisions similar to those in the policies here, the insurer paying more than its share (generally either one half or the fraction that the limits of its policy is of the total of the limits of both policies) of the claim is ordinarily entitled to recover from the other insurer for the excess so paid.<sup>98</sup>

However, the court found that this "general rule is subject to an equally widely recognized exception for cases in which the policy of the insurer seeking to invoke the 'other insurance' clauses also covers another insured who is liable to indemnify the insured in the policy of the other insurer."<sup>99</sup> This rule is based on the "potential circuitry of action" that would potentially result in "wasteful litigation."<sup>100</sup> For example, in this case, had TPC been required to reimburse AIL for half of the settlement and defense costs, TPC, standing in the shoes of its insured, Caddell, presumably would have asserted a subrogation claim against Elite, AIL's insured, for contractual indemnity under the subcontract and AIL ultimately would have been required to defend and indemnify Elite against this claim. In that event, the result would have been the same: AIL would have borne all the costs of defending and settling the claim.

#### F. CGL COVERAGE B—"PERSONAL INJURY" AND "ADVERTISING INJURY" COVERAGE

##### 1. No Coverage for Patent Infringement

In *Pennsylvania Pulp & Paper Co. v. Nationwide Mutual Insurance*

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96. *Id.* at 432.

97. *Id.* at 431-34.

98. *Id.* at 435.

99. *Id.* at 436.

100. *Id.* at 437 (quoting *Wal-Mart Stores, Inc. v. RLI Ins. Co.*, 292 F.3d 583, 594 (8th Cir. 2002)).

Co.,<sup>101</sup> the Houston Court of Appeals, Fourteenth District, determined that a patent infringement claim was not covered under a CGL policy's coverage for "advertising injury," which is defined as "injury arising out of one or more of the following offenses: . . . [m]isappropriation of advertising ideas or style of doing business."<sup>102</sup> In this case, the insured sued the manufacturer of holographic imaging machines alleging breach of contract and violations of the Texas Deceptive Trade Practices Act ("DTPA"). The manufacturer filed a counterclaim alleging, among other things, patent infringement, misappropriation of trade secrets, and groundless DTPA claims.<sup>103</sup>

The court determined that because the manufacturer did not allege any facts related to, or injury from, advertising activity, the claim did not fall within the policy's advertising injury coverage.<sup>104</sup>

### 2. *No Coverage for Counterclaim of Groundless DTPA Claim*

As stated above, the manufacturer's counterclaim also sought damages for the insured's alleged filing of a groundless DTPA claim. The insured argued that this claim fell within the policy's "personal injury" coverage, which expressly included coverage for malicious prosecution, but did not define "malicious prosecution." The insured argued that the DTPA counterclaim was covered because it constituted "malicious prosecution."<sup>105</sup> However, the court disagreed, holding that this term referred to the specific legal claim of malicious prosecution under the Texas common law and was intended to have the technical meaning and elements of that claim as provided under the common law.<sup>106</sup>

### 3. *Courts Disagree Over Whether Insurer Must Demonstrate Prejudice To Deny Coverage for "Personal Injury" Claims Based on Late Notice*

Two Federal District Courts in Texas addressed the issue of whether a CGL insurer must show prejudice in order to deny coverage for "personal injury" claims based on the insured's failure to provide timely notice in accordance with the policy.<sup>107</sup> However, the courts reached opposite conclusions.

*St. Paul Guardian Insurance Co. v. Centrum G.S. Ltd.* involved a suit against an insured building owner by a former employee, Perdue, for various causes of action arising out of an allegedly wrongful termination.

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101. *Pa. Pulp & Paper Co., Inc. v. Nationwide Mut. Ins. Co.*, 100 S.W.3d 566 (Tex. App.—Houston [14th Dist.] 2003, pet. denied).

102. *Id.* at 568-69 (quoting the policy).

103. *Id.* at 569.

104. *Id.* at 575.

105. *Id.* at 573.

106. *Id.* at 575.

107. *See St. Paul Guardian Ins. Co. v. Centrum G.S. Ltd.*, No. CIV.A. 3:97CV1478-L, 2003 WL 22038321 (N.D. Tex. Aug. 29, 2003); *New Era of Networks, Inc. v. Great N. Ins. Co.*, No. H-01-1841, 2003 U.S. Dist. LEXIS 14259 (S.D. Tex. Aug. 1, 2003).

The insurer filed a declaratory judgment action against the insured seeking a judicial determination that it has no duty to defend or indemnify the insured or any other defendant in the action and that the insured's late notice of Perdue's claims and suit relieved it of its obligations under the CGL policy.<sup>108</sup>

First, the insurer argued that the terms of the policy itself do not require a showing of prejudice because the prejudice requirement was limited to "bodily injury" and "property damage" claims.<sup>109</sup> They argued that "personal injury" liability is not mentioned in the clause requiring prejudice, thus they can, by implication, deny coverage for a personal injury claim because of late notice without showing prejudice.<sup>110</sup> The court disagreed, stating that the "policy [did] not expressly state that the prejudice requirement applie[d] only to bodily injury and property damage claims" and that such an interpretation "would render the insurance policy ambiguous."<sup>111</sup> The court determined that the insurer had the duty to set forth expressly and in unambiguous terms the circumstances under which forfeiture of coverage for personal injury claims would occur, but failed to do so. As such, it could not manipulate the policy and argue that the policy did not require the insurer to show prejudice.<sup>112</sup>

Furthermore, the court interpreted the Fifth Circuit's decision in *Hanson Production Co. v. Americas Insurance Co.* and concluded that insurance companies cannot "deny coverage on the basis of untimely notice under [a CGL] 'occurrence' policy unless [they] can show actual prejudice from the delay."<sup>113</sup> The court refused to accept the insurer's argument that *Hanson's* prejudice requirement was limited to claims for bodily injury and property damage under a general liability policy based on precedent holding that the impact untimely notice has on coverage depends on the type of insurance policy issued, not on the type of coverage provided under the policy.<sup>114</sup>

The insurer argued that it was prejudiced by the late notice because it lost the opportunity to investigate the case and to manage the defense for eighteen to twenty-four months and that it lost the opportunity to participate in early settlement negotiations and obtain a settlement for less than \$20,000. The court disagreed, finding that no Texas case has held that an insurer's inability or failure to obtain a smaller or more favorable settlement constitutes prejudice sufficient to relieve an insurer of its duty to defend or indemnify its insured.<sup>115</sup> Therefore, the court found that there

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108. *Centrum*, 2003 WL 22038321 at \*2.

109. *Id.* at \*4.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.* at \*7 (citing *Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 678 (5th Cir. 1999)).

114. *Id.* at \*6-8.

115. *Id.* at \*9. The court noted that there were only four circumstances where courts have in fact found prejudice as a result of late notice: (1) when the insurer receives notice after entry of default judgment against the insured; (2) where the insurer receives notice of

was no prejudice as a result of the late notice.<sup>116</sup>

However, the Southern District of Texas addressed the prejudice requirement for the late notice of "personal injury" claims and came to a different determination in *New Era*.<sup>117</sup> This case involved a trademark infringement case against an insured for the use of the name "NEON." The insured sought coverage for the claim under its CGL and umbrella policies that provided coverage for personal injuries and advertising injuries.<sup>118</sup>

The court found that the decision in *Hanson* requiring a showing of prejudice to the insurer in order to deny coverage for late notice of claims was limited to claims for bodily injury or property damage liability and, thus, insurers issuing a CGL policy do not have to show prejudice to deny coverage for claims of advertising injuries due to a late notice of the claim.<sup>119</sup> The court also held that an insurer was not precluded from raising a late notice defense because they would deny coverage anyway for claims such as "prior acts, first publication, fortuity, known loss, or loss in progress."<sup>120</sup>

#### G. TEXAS SUPREME COURT RECOGNIZES BROAD MEANING OF "ARISING OUT OF"

In *Utica National Insurance Co. of Texas v. American Indemnity Co.*,<sup>121</sup> the Texas Supreme Court addressed the scope of a professional liability exclusion in a CGL policy, which excluded coverage for "'bodily injury' . . . due to rendering or failure to render any professional service"<sup>122</sup> The court declined to read the exclusion as broadly as the insurer proposed, instead finding that the exclusion applied "only when the . . . injury is caused by the breach of a professional standard of care."<sup>123</sup> Significant to the court's analysis was the use of the phrase "due to" in the exclusion rather than the broader phrase "arising out of," which was used in other parts of the policy.<sup>124</sup>

Because the phrase "arising out of" is frequently used in almost all types of insurance policies, the court's comments regarding this phrase are noteworthy. The court stated that "'aris[ing] out of' means that there is simply a 'causal connection or relation,' which is interpreted to mean

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the suit and the trial date is so close to that date that it deprives the insurer of an opportunity to investigate the claims or mount an adequate defense; (3) the insurer receives notice after trial and judgment against the insured; and (4) when the insurer receives notice of a default judgment against the insured after it has become final and non-appealable. *Id.*

116. *Id.* at \*11.

117. *New Era of Networks, Inc. v. Great N. Ins. Co.*, No. H-01-1841, 2003 U.S. Dist. LEXIS 14239 (S.D. Tex. Aug. 1, 2003).

118. *Id.* at \*2-8.

119. *Id.* at \*14-22.

120. *Id.* at \*24 (citation omitted).

121. *Utica Nat'l Ins. Co. v. Am. Indem. Co.*, No. 02-0090, 2003 WL 21468776 (Tex. June 26, 2003), *reh'g granted* (Dec. 19, 2003).

122. *Id.* at \*2 (emphasis added).

123. *Id.* at \*4.

124. *Id.*

that there is but-for causation, though not necessarily direct or proximate causation.”<sup>125</sup> Since the policy provision at issue used the phrase “due to,” rather than “arising out of,” the court concluded that a more direct type of causation was required.<sup>126</sup>

#### H. AUTO POLICIES: NO COVERAGE FOR “DIMINISHED VALUE” AFTER REPAIRS

During the 2002 Survey period, several cases were decided by Texas appellate courts addressing the issue of whether a standard automobile policy provides coverage for the diminished value of a covered auto after the automobile has been fully repaired. These decisions perpetuated a preexisting split in Texas authority on this issue.<sup>127</sup> During the 2003 Survey period, the Texas Supreme Court finally resolved this issue in *American Manufacturers Mutual Insurance Co. v. Schaefer*.<sup>128</sup>

In *Schaefer*, the policyholder submitted a claim under his Texas Standard Personal Auto Policy for damage to his covered automobile sustained in an automobile accident. The insurer elected to repair the vehicle and the insured did not dispute the quality or adequacy of these repairs, but maintained that the value of the automobile decreased by \$2,600 due to market perceptions that a damaged and subsequently repaired vehicle is worth less than one that has never been damaged.<sup>129</sup> Thus, the insured sought the diminished value of the car under the policy and filed suit claiming that the insurer’s “refusal to compensate him for his vehicle’s diminished market value violated the Texas Insurance Code and breached the insurance contract.”<sup>130</sup>

The court determined “that the policy’s plain language . . . [was] unambiguous and [did] not require payment for diminished value when [the] vehicle has been fully and adequately repaired.”<sup>131</sup> First, the “Limit of Liability” section of the policy limited the insurer’s liability “to the damaged vehicle’s ‘actual cash value’ or the amount needed ‘to repair or replace’ the vehicle, whichever is less.”<sup>132</sup> The court noted that “repair” means something tangible such as the removal of dents or replacing or fixing parts, but did not include compensation “for the market’s perception that a damaged but fully and adequately repaired vehicle has an in-

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125. *Id.* (citation omitted).

126. *Id.*

127. Compare *Schaefer v. Am. Mfrs. Mut. Ins. Co.*, 65 S.W.3d 806, 808-10 (Tex. App.—Beaumont 2002), *rev’d* 124 S.W.3d 154 (Tex. 2003) (finding that the policy provided coverage for diminished value) and *Bailey v. Progressive County Mut. Ins. Co.*, 78 S.W.3d 708, 710-11 (Tex. App.—Dallas 2002), *rev’d* No. 02-0778, 2004 WL 326707 (finding that the policy provided coverage for diminished value) with *Smither v. Progressive County Mut. Ins. Co.*, 76 S.W.3d 719, 725 (Tex. App.—Houston [14th Dist.] 2002, *pet. denied*) (finding that the policy did not provide coverage for diminished value).

128. *Am. Mfrs. Mut. Ins. Co. v. Schaefer*, 124 S.W.3d 154 (Tex. 2003).

129. *Id.* at 156.

130. *Id.*

131. *Id.* at 158.

132. *Id.*

trinsic value less than that of a never-damaged car.”<sup>133</sup>

Second, the court determined that to interpret “repair or replace language to include diminished value . . . would render other provisions of the policy meaningless.”<sup>134</sup> For example, the language of the policy stating that the insured is entitled to “the lesser of” actual cash value or the cost to repair or replace the vehicle would be rendered meaningless if the court allowed diminished value damages because insurer would have to pay both to repair or replace the car *and* pay the cash value of the car under Schaefer’s interpretation, thus undermining the insurer’s option to choose the appropriate compensation. Also, the “Payment of Loss” provision that allows the insurer to pay loss in money *or* repair *or* replacement would be rendered meaningless by requiring the insurer to pay diminished value because it would turn those “ors” into “ands.”<sup>135</sup>

Third, the court determined that the language of the “Limitation of Liability provision” of the policy referring to the “[a]mount necessary to repair or replace the property with other *of like kind and quality*” does not require the insurer to pay diminished value, but means that if the insurer elects to repair a vehicle, it must do so using parts of like kind and quality, or if the insurer elects to replace the vehicle, it must do so with a vehicle of like kind and quality.<sup>136</sup>

Finally, the court rejected Schaefer’s argument that the policy covers diminished-value damages because it is not expressly included in the “Exclusions” section of the policy. The court stated, “Absence of an exclusion cannot confer coverage.”<sup>137</sup> The policy language did not require coverage for diminished value to begin with, so an exclusion was not necessary.<sup>138</sup>

Thus, the court determined that an automobile insurer was not required to pay for the diminished value of the automobile.<sup>139</sup>

## I. COVERAGE FOR PUNITIVE DAMAGES NOT AGAINST PUBLIC POLICY

During this Survey period, the Fort Worth Court of Appeals and the United States District Court for the Northern District of Texas, Abilene Division, concluded that coverage for punitive damages under liability policies does not violate Texas public policy.<sup>140</sup> These decisions contradict an earlier opinion from the United States District Court for the Northern District of Texas.<sup>141</sup>

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133. *Id.* at 158-59.

134. *Id.* at 159.

135. *Id.* at 159-60.

136. *Id.* at 160.

137. *Id.*

138. *Id.*

139. *Id.* at 162.

140. *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, No. 2-01-227-CV, 2003 WL 21475423 (Tex. App.—Fort Worth, Jun. 26, 2003), *reh’g granted* (Sept. 22, 2003); *Fairfield Ins. Co. v. Stephens Martin Paving, L.P.*, No. CIV.A. 1:03-CV-037-C, 2003 WL 22005877 (N.D. Tex. Aug. 25, 2003).

141. *Hartford Cas. Ins. Co. v. Powell*, 19 F. Supp. 2d 678 (N.D. Tex. 1998).

In *Westchester Fire Insurance Co. v. Admiral Insurance Co.*,<sup>142</sup> the Fort Worth Court of Appeals determined that punitive damages were covered under a liability policy and that such coverage did not violate public policy. This case involved claims under primary and excess professional liability policies for a malpractice claim against the insured nursing home. At a bench trial on the underlying claims, the court granted the complainant compensatory damages, prejudgment interest, mental anguish damages, and treble damages, but before the court could determine punitive damages, the insured settled the suit with the claimants “for an amount exceeding the [claimants’] compensatory damages.”<sup>143</sup> The primary insurer tendered its policy limits, less defense costs and the insured’s deductible, leaving the excess insurer to contribute the remaining amount. After this, the excess insurer filed suit against the primary insurer for negligent failure “to settle the claimants’ claims against the insured within the limits of the primary insurance policy.”<sup>144</sup>

The court addressed the trial court’s summary judgment issue of whether insurance coverage for punitive damages is considered void as against public policy. They noted that “[n]either the Texas Legislature nor the Supreme Court of Texas has addressed whether insurance coverage for punitive damages violates the public policy of Texas.”<sup>145</sup> In a previous decision, the Northern District of Texas made an “Erie guess” as to how the Texas Supreme Court would resolve the issue, “hold[ing] that, at least in the context of third-party coverage for automobile insurance claims, insurance coverage for punitive damages [was] void as against public policy.”<sup>146</sup> Because this case was not binding precedent, the court continued its analysis, examining the various policy sources in this context. The court noted that several cases providing coverage for “sums” or “all sums” an insured becomes required to pay as a result of bodily injury or property damages covers punitive damages if not otherwise excluded.<sup>147</sup> Beginning in 1994, Texas courts of appeals began to move towards considering insurance coverage for punitive damages as void against public policy specifically in the context of uninsured motorist claims. However, the court noted that those decisions were based on the fact that the aims of punitive damages in Texas, punishment and deterrence, were not involved in uninsured motorist cases since the wrongdoer was not even present in the case, which is consistent with other courts that held insurance coverage for punitive damages is void as against public policy because “wrongdoers should not be shielded from the consequences of their acts.”<sup>148</sup>

The Insurance Code has specifically addressed “coverage for punitive

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142. *Westchester Fire Ins. Co.*, 2003 WL 21475423.

143. *Id.* at \*1.

144. *Id.*

145. *Id.*

146. *Id.* (discussing *Hartford*, 19 F. Supp. 2d at 696).

147. *Id.* at \*4.

148. *Id.*



damages under professional medical liability policies.”<sup>149</sup> In 1977, the legislature [inserted a clause] which provided that [n]o policy . . . [could] include coverage for punitive damages . . . against [a] health care provider or physician.”<sup>150</sup> At that time, the definition of “health care provider” did not include for-profit nursing homes. The legislature amended these provisions in 1987 to allow endorsements providing “coverage for punitive damages to be used on a policy of medical professional liability insurance issued to a hospital.”<sup>151</sup> “The legislature extended the ability to obtain an endorsement for punitive damages to not-for-profit nursing homes in 1997.”<sup>152</sup> In 2001, the legislature added for-profit nursing homes to the list of entities prohibiting coverage for punitives under a primary insurance policy and the list allowing an endorsement granting coverage for punitive damages. Thus, the court noted that, under the current law, a “for-profit nursing home . . . may not obtain insurance coverage for punitive damage awards under a professional medical liability insurance policy unless the nursing home specifically obtains an endorsement for such coverage.”<sup>153</sup> However, those provisions did not apply here because the events giving rise to the claims occurred between January and May of 1994 and the case was determined in 1995, before many of these developments. Also, the court noted that this case is distinguishable from those cases where the court found coverage for punitive damages violated public policy because the wrongdoers, here the insured would still face punishment and deterrence because the payment of punitive damages would be reflected in higher future premiums they would have to pay their insurers as a result of such payment. Thus, the court held that coverage for punitive damages under the excess policy was not void as against public policy.<sup>154</sup>

Furthermore, the court found that punitive damages for gross negligence were not precluded as expected or intended injuries because the court could conceive of acts or omissions which could cause serious harm that would rise to the level of grossly negligent behavior, thus leading to punitive damages, but where the actor would “not anticipate or consider it probable that the harm would actually occur.”<sup>155</sup>

Accordingly, this court held that the trial court had erred in finding that coverage for punitive damages was void as against public policy under this policy and that the excess carrier’s recovery from the primary carrier “should not have been limited to amounts attributable to excess

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149. *Id.* at \*7 (citing TEX. INS. CODE ANN. art. 5.15-1 (Vernon 1981 & Supp. 2003)).

150. *Id.* (quoting Medical Liability and Insurance Act, 65th Leg., R.S., ch. 817, § 31.01, 1977 Tex. Gen. Laws 2039, 2056 (amended 1987, 1997 & 2001) (current version at TEX. INS. CODE ANN. art. 5.15-1, § 8 (Vernon Supp. 2003)).

151. *Id.* at \*81 (quoting Act of June 3, 1987, 70th Leg., 1st C.S., ch. 1, § 7.01, 1987 Tex. Gen. Laws 1, 36 (amended 1997 & 2001)).

152. *Id.*

153. *Id.* at \*9.

154. *Id.* at \*10.

155. *Id.*

compensatory damages only.”<sup>156</sup>

In *Fairfield Insurance Co. v. Stephens Martin Paving, L.P.*, the Abilene Division of the Northern District of Texas determined that coverage for punitive damages under an employer’s liability policy did not violate Texas public policy.<sup>157</sup> Roy Edward Bennett was an employee of Stephens Martin Paving. On December 20, 2002, while Bennett was acting in the scope and course of his employment, he died when a brooming machine he was operating rolled over him. Carrie Bennett, Bennett’s widow, brought suit on January 24, 2003 against Stephens Martin claiming gross negligence. She alleged in the lawsuit that Stephens Martin “was aware of the lack of properly functioning seat belts on a brooming machine which [Bennett] was operating at the time of his death.”<sup>158</sup> She further alleged that Stephens Martin failed to provide properly functioning brakes on the brooming machine; failed to assure the mechanical soundness of the equipment; failed to follow, enforce, and properly train its employees concerning appropriate safety rules and regulations; and failed to warn Bennett of the hazards of his employment. Bennett sought punitive damages in the suit.<sup>159</sup>

Fairfield Insurance Company issued Stephens Martin a two-part policy: Part One being a Workers’ Compensation Policy and Part Two being an Employer’s Liability Policy. Coverage under the Workers’ Compensation part of the policy was not in question in this decision. The case instead looked at coverage under the Employer’s Liability part of the policy. Stephens Martin sought coverage under this part of the policy. However, Fairfield argued that there was no coverage in this case seeking declaratory judgment regarding the parties’ rights under the Employer’s Liability Policy.<sup>160</sup>

Fairfield’s first argument was that there was no coverage for Bennett’s gross negligence claims because of an exclusion stating, “[t]his insurance does not cover . . . bodily injury intentionally caused or aggravated by you.”<sup>161</sup> The court disagreed, first finding that Bennett’s gross negligence claims based on improper maintenance of brakes and seatbelts, and failure to enforce industry safeguards and practices presented sufficient claims to bring forth a duty to defend and to indemnify. They also noted that Texas courts recognize a difference between intentional misconduct and gross negligence.<sup>162</sup> The court quoted *Westchester* stating that, “a person could know that an act or commission was likely to cause serious harm for purposes of gross negligence, but not anticipate it or consider it

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156. *Id.*

157. *Fairfield Ins. Co. v. Stephens Martin Paving, L.P.*, No. CIV.A. 1:03-CV-037-C, 2003 WL 22005877, at \*8-10 (N.D. Tex. Aug. 25, 2003).

158. *Id.* at \*1.

159. *Id.*

160. *Id.*

161. *Id.* at \*4 (quoting Part Two—Employers Liability Insurance, at subsections A-C).

162. *Id.* at \*6-8.

probable that the harm would actually occur.”<sup>163</sup> Because of this distinction, the exclusion did not apply to preclude coverage.<sup>164</sup>

The court next turned to the question of whether the policy could cover punitive damages under Texas law. They found no specific guidance from the Texas Supreme Court or the Texas Legislature. However, they turned to two cases: *Ridgway v. Gulf Life Insurance Co.*<sup>165</sup> from the Fifth Circuit and *Westchester*<sup>166</sup> from the Fort Worth Court of Appeals. In both of those cases, the courts had held that coverage for punitive damages did not violate Texas public policy. The courts determined that until the Texas Supreme Court was willing to change its approach to punitive damages covered by liability insurance, the cases above were controlling. Accordingly, the Employer’s Liability Policy provided coverage for punitive damages arising as a result of Stephens Martin’s gross negligence.<sup>167</sup>

### III. SCOPE OF EVIDENCE ADMISSIBLE IN COVERAGE LITIGATION

In *Swicegood v. Medical Protective Co.*,<sup>168</sup> United States District Judge Fitzwater for the Northern District of Texas, Dallas Division, addressed the issue of the scope of evidence admissible in a coverage trial. Specifically, the court considered whether the evidence must be limited to evidence introduced during the underlying liability trial or whether new evidence may be admitted when the underlying liability trial does not resolve all the coverage issues.<sup>169</sup>

As a threshold question, the court considered whether the insurer could be “obligated to indemnify the [insured for the underlying judgment] in the absence in the judgment or verdict that apportioned or allocated the damages between covered and non-covered claims.”<sup>170</sup> The insurer cited several cases for the proposition that the insured is obligated to obtain findings in the underlying lawsuit that apportioned or allocated damages between covered and non-covered claim. However, the court determined that these cases only stood for “the propositions that the apportionment or allocation must be made at some point and that the judgment or verdict in the underlying suit may in some instances completely resolve the coverage question.”<sup>171</sup> The court specifically relied on language in a Texas Supreme Court decision stating, “[i]t may sometimes be necessary to defer resolution of indemnity issues until the liability litiga-

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163. *Id.* at \*8 (quoting *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, No. 2-01-227-CV, 2003 WL 21475423, at \*13 (Tex. App.—Fort Worth Jan. 26, 2003), *reh’g granted* (Sept. 22, 2003)).

164. *Id.*

165. *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026 (5th Cir. 1978).

166. *Westchester*, 2003 WL 21475423.

167. *Fairfield*, 2003 WL 2205877, at \*9-10.

168. *Swicegood v. Med. Protective Co.*, No. CIV.A. 3:95-CV-0335-D, 2003 WL 22234928 (N.D. Tex. Sept. 19, 2003).

169. *Id.* at \*11.

170. *Id.* at \*4.

171. *Id.* at \*5.

tion is resolved. In some cases, coverage may turn on facts actually proven in the underlying lawsuit."<sup>172</sup> The court considered the contrast in these two statements to be significant and determined that coverage issues that cannot be resolved in the underlying third-party case can be subject to further factual development in the subsequent coverage case.<sup>173</sup>

Next, the court considered the argument that the insurer was "collaterally estopped from contesting coverage because the jury in the underlying lawsuit allocated or apportioned 100% of the damages to covered malpractice claims."<sup>174</sup> However, the court determined that there remained a question of material fact whether the damages are based on conduct covered under the policy. This collateral estoppel was based on the jury charge and its use of the terms "negligence" and "ordinary care."<sup>175</sup> Nothing in the definitions used by the court limited the jury's consideration to only covered conduct; the jury could have considered evidence of excluded conduct in reaching its finding of negligence. Furthermore, the court reasoned that the plaintiff in the underlying lawsuit only had to establish that the insured's negligence was a proximate cause of her injuries, and that there could have been multiple proximate causes of an event. The court also noted that the jury was asked to determine the amounts that would compensate the plaintiff for injuries "resulting from the occurrence in question," without defining the term "occurrence in question."<sup>176</sup> Without a definition, the court determined that the term could mean any event enabling the plaintiff to sue the defendant and, in this case, the plaintiff relied on both covered and non-covered events. Based on these determinations, the court held that nothing in the jury's "charge excluded the possibility of an award of compensatory damages for non-covered claims."<sup>177</sup>

Having determined that the underlying lawsuit did not resolve the coverage dispute, the court addressed the scope of the evidence that would be admissible in the coverage litigation. The court first noted that case law indicated that "new evidence is admissible [in a coverage trial] when the coverage question turns on a matter that was not adjudicated in the liability suit."<sup>178</sup> The court further stated that it "located no case that suggests that a coverage suit should consist of a retrial of all or even substantial parts of an [underlying] indemnity suit that has been fully tried."<sup>179</sup> Thus, the court made an "Erie-guess" that the Texas Supreme Court would hold that new evidence may be introduced in a coverage trial where such proof is necessary to resolve an issue relevant to cover-

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172. *Id.* at \*6 (quoting *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 995 S.W.2d 81, 84 (Tex. 1997) (per curiam)).

173. *Id.* at \*6.

174. *Id.*

175. *Id.* at \*7.

176. *Id.* at \*8.

177. *Id.*

178. *Id.* at \*12.

179. *Id.* at \*13 (footnote omitted).

age not conclusively decided in the underlying indemnity suit. However, the court held "that if the coverage question is one of law that can be decided on the record of the underlying suit, no new evidence is admissible."<sup>180</sup> Applying its "*Erie*-guess," the court stated that it would admit "historical evidence from the [u]nderlying [l]awsuit and expert testimony [that would] assist the jury in allocating or apportioning . . . damages" amongst covered and non-covered conduct.<sup>181</sup>

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180. *Id.* at \*14.

181. *Id.* \*15.