FirstLook

Issues and Developments in Insurance Law

## Letter from the Insurance Company Team

This past year, the Insurance Company Team recently welcomed six new team members from The Woodlands, Texas office of Steptoe & Johnson PLLC. The combined experience of the new members brings decades of Texas focused experience to the Team in the areas of insurance coverage, claim investigation, claim handling, and bad faith defense.

This edition of First Look focuses on three hot button insurance topics currently trending in the State of Texas. Any carrier writing coverage in the State of Texas or adjusting claims under Texas law should be familiar with these evolving issues and potential traps for bad faith exposure.

The first article revisits the *Stowers* Doctrine and provides practical instruction concerning under what circumstances a carrier's failure to settle a third party liability claim within policy limits may expose the carrier to liability for an excess judgment. The next article discusses the evolving body of case law addressing statutory bad faith claims, and specifically, whether an insured may recover policy benefits as actual damages caused by a carrier's statutory violations, absent a breach of the insurance policy. The last article instructs carriers on the impact of recent Texas case law regarding additional insured coverage when dealing with an underlying service contract.

We hope our readers enjoy this Texas focused edition of First Look, and encourage you to contact any of our Texas Team members with additional questions.

## INSIDE THIS EDITION:

# *"Not our First Rodeo: Navigating Insurance Law in Texas"*

## IN THIS ISSUE

# *Extra-Contractual Liability For Failure To Settle Within Liability Policy Limits Is Not Automatic - Revisiting the Stowers Doctrine*

## By: Ed Wallison

**An adjuster is assigned a new third party liability claim arising out of an automobile collision. Liability may be in issue. She receives a settlement demand from an aggressive Plaintiff's attorney for currently undisclosed "policy limits" just three weeks after the incident. The attorney warns the adjuster of the application of the *"Stowers"* doctrine.**

**The adjuster has limited information concerning the nature and extent of the third party claim. She is concerned that if she fails to settle within the liability policy limits as requested, the carrier will have unlimited exposure should there be an excess judgment entered against the insured at trial.**

**This is a common misconception. The *Stowers* doctrine never created automatic extra-contractual exposure should the carrier decline to settle the third party claim within the insured's liability policy limits.**

### *Background on G.A. Stowers Furniture Co. v. American Indemnity Co.*

**The phrase "*Stowers* demand" is derived from the Court of Commission of Appeals of Texas (now the Texas Supreme Court) decision in *G.A. Stowers Furniture Co. v. American Indemnity Co.*, 15 S.W.2d 544 (Tex. 1929).**

**Stowers Furniture Company had an auto liability insurance policy with American Indemnity Company. The policy limit was $5,000. Under the policy, Stowers Furniture gave full control of the settlement process to American Indemnity.**

**On January 23, 1920, a Stowers Furniture employee was driving a truck in Houston. The truck became disabled. The employee left the truck on the road without turning on any lights to warn oncoming traffic. Mamie Bichon collided with the disabled truck. She sued Stowers Furniture for personal injury damages of $20,000.**

**Prior to trial, Miss Bichon offered to settle her claim against Stowers Furniture for $4,000. Under the policy, American Indemnity exercised complete control over the claims process. It refused to accept Miss Bichon's offer.**

**Ms. Bichon was awarded $14,107.14 after a jury verdict. The verdict was in excess of the $5,000.00 policy limits.**

**Stowers Furniture then sued American Indemnity claiming that it should have settled when Ms. Bichon offered to settle for $4,000. It asked the court to rule that American Indemnity was responsible for the amount of the verdict in excess of the policy limits in addition to the $5,000 it was contractually obligated to pay.**

**The trial court directed a verdict in favor of American Indemnity. The Court of Appeals affirmed the decision in favor of American Indemnity. The Court of Commission of Appeals of Texas reversed.**

**Contrary to popular belief, the high court did not require American Indemnity to pay a judgment in excess of the insured's policy limits. It simply remanded the case to the lower court for a new trial to determine whether the carrier had acted reasonably in not settling the case within those policy limits. The case subsequently settled.**

**This *Stowers* decision is widely misinterpreted as creating some type of automatic extra-contractual liability on the part of a carrier that fails to settle a claim within an insured's liability policy limits, regardless of the circumstances. To the contrary, the Stowers holding simply creates a duty on the part of the insurance carrier to act reasonably when evaluating the ability to settle a claim within the insured's liability policy limits.**

### The *Stowers* Duty

**As is typical in Texas law, liability follows control. The *Stowers* court found that the indemnity policy made the carrier the sole and exclusive agent of the insured, with complete control over the claims process/litigation. With such complete control, the failure to act reasonably in settling the claim would constitute negligence. As the sole and exclusive agent with complete control, the carrier would be:**

> **held to that degree of care and diligence which an ordinarily prudent person would exercise in the management of his own business; and if an ordinarily prudent person, in the exercise of ordinary care,**

> as viewed from the standpoint of the assured, would have settled the case, and failed or refused to do so, then the agent, which in this case is the indemnity company, should respond in damages. *Id.* at 547. The insurance company was found to be "duty bound to exercise ordinary care to protect the interest of the assured up to the amount of the policy." *Id.*

In remanding the case to the lower court for a new trial to determine whether the carrier had acted reasonably in not settling the case within the insured's policy limits, the court noted that:

> knowledge on the part of the indemnity company is also an issue. The facts and circumstances surrounding the original injury, and the extent of same, would not raise the issue of negligence on the part of the indemnity company unless it had knowledge thereof, or by the exercise of ordinary care could have had such knowledge.

*Id.* at 548. Accordingly, *Stowers* liability is determined by the facts and circumstances presented to the liability carrier at the time the opportunity to settle the case within the insured's policy limits occurs.

*Stowers* liability has withstood challenges since 1929. In 1994, the Texas Supreme Court reaffirmed the *Stowers* decision and clarified the exact requirements in the case of *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842 (Tex.1994). The Court found that in order to prove a *Stowers* claim, the insured must establish that:

> (1) the claim against the insured is within the scope of coverage; (2) the demand [was] within policy limits; and (3) the terms of the demand [were] such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment.

*Id.* at 849.

## Full and Final Release Required

In the case of *Trinity Universal Ins. Co.v. Bleeker*, 966 S.W.2d 489 (Tex.1998), the Texas Supreme Court determined that a valid *Stowers* demand must include the offer of a full and final release of the insured from further liability.

### *What Are the Practical Requirements of a Stowers Demand?*

Accordingly, based on the above cited cases, a proper *Stowers* demand has five requirements:

1. The demand must be within the policy limits;
2. Liability must be reasonably clear;
3. A reasonable insurer would accept the demand;
4. The demand must be unconditional; and
5. The demand must offer a full release.

## How a Stowers Claim Is Prosecuted

The *Stowers* claim does not exist prior to a trial. It is created when the trial results in a judgment entered in excess of the insured's liability policy limits.

Further, the potential *Stowers* claim is owned by the insured, not the third party claimant.

Assume the liability carrier had the opportunity to settle the claim prior to or during trial within the liability policy limits and did not do so for whatever reason. After a trial, a judgment is entered against the insured in excess of his liability policy limits. The Plaintiff's attorney would 1) normally ask the insured to voluntarily assign his *Stowers* claim to the Plaintiff in return for a covenant not to seek to collect the judgment against the insured personally; or 2) ask the court to compel the insured to assign the *Stowers* claim as an asset to satisfy the judgment. Either way, the Plaintiff pursues the *Stowers* claim directly against the carrier standing in the shoes of the insured as his assignee.

## The "Reasonableness" Factor

The question of whether an insurance company acted reasonably when presented with an unconditional demand to settle within an insured's liability policy limits is to be viewed in light of the information available to the carrier at the

time of the demand.

The obvious drawbacks in seeking an answer to this "reasonableness" factor are that:

> a) reasonableness is always a factual issue in the hands of a future trier of fact; and
> b) the future trier of fact must make this reasonableness determination in hindsight while trying not to be influenced by the knowledge that an excess judgment actually occurred.

Regardless, an error in judgment is not a failure to use ordinary care that dictates liability. In *Highway Ins. Underwriters v. Lufkin-Beaumont Motor Coaches*, 215 S.W.2d 904, 928 (Tex. Civ. App.- Beaumont 1948), the court noted:

> Only *due care* is required of Insurer, and therefore we agree with Insurer that Insurer did not become liable to Insured merely because a decision to reject Alexander's offers proved to be wrong. *Due care* leaves room for an error of judgment, without liability necessarily resulting.

Consistent with this principal, a jury charge in a *Stowers* case would include an instruction similar to:

> You are instructed that under the law in Texas, an insurer is required to exercise ordinary care in considering whether an offer of settlement should be accepted, but an insurer does not necessarily become liable merely because the decision to reject an offer of settlement proves to be wrong.

**Always Act "Reasonably"**

It is therefore critical to act "reasonably" when faced with a *Stowers* demand. Always timely respond. If more information is necessary before an intelligent evaluation of the claim can be made, respond that the demand is premature and detail the additional information needed. Avoid making requests for information immaterial to the claim (for example, there is no need to require five years of past medical if the claim is for a broken leg). If the time for response is too short because of the need to proceed through several layers of management authority, ask for a reasonable amount of additional time to respond. Always be cordial in your correspondence and keep the lines of communication open.

In short, if someone is going to appear unreasonable, let it be Plaintiff's attorney.

## *Confusion Amongst Texas Courts: When Can Insureds Recover Policy Benefits for Statutory Violations?*

### By: Dawn S. Holiday

While first-party bad faith claims may appear to be a dying notion in other jurisdictions, the tort-based claim in Texas is alive and well. Throughout the years, courts have continued to search for ways to define the common-law standard and balance it with public interest due to the unequal bargaining power in the insured-insurer relationship.[1] For this reason, the law of bad faith in Texas is constantly evolving.

Texas imposes a common law duty on insurers to "deal fairly and in good faith with their insureds."[2] A breach of the duty of good faith and fair dealing gives rise to a tort cause of action that is separate from any action for breach of the underlying insurance policy.[3] If an insurer breaches its duty of good faith and fair dealing, in addition to interest, court costs and attorney's fees, the insured can recover actual, i.e. extra-contractual, damages for economic or personal injuries and exemplary damages if: (1) actual damages were awarded for an injury independent of the loss of policy benefits and (2) the insurer's conduct was fraudulent, malicious, intentional or grossly negligent.[4] Exemplary damages are within the jury's discretion and "must be reasonably proportioned to actual damages."[5]

Texas also provides a statutory scheme for bad-faith claims that allows recovery of extra-contractual damages through a private cause of action against an insurer. The statutory bad-faith tort is governed by Chapter 541 of the Texas Insurance Code ("Code").[6] The statutory claim is in addition, and a supplement, to the contractual cause of action against an insurer for breach of an insurance policy. Similar to the common law claim, for Code violations the insured may recover economic damages, but only up to three times the amount of economic damages, i.e. treble damages, for violations committed "knowingly."[7]

**It is not uncommon in first party bad-faith cases for the insured to assert a breach of contract claim against the insurer for breaching the insurance policy *and* a tort cause of action against the insurer for violations of the Code. However, extra-contractual tort claims brought pursuant to the Code require the same predicate for recovery as a bad faith claim under a good faith and fair dealing violation.[8] Because the frameworks of the statutory and common law claims are so similar, most Texas courts have treated common law claims as redundant.**

**When considering the damages available under the policy and under the statute, there have been some inconsistencies amongst Texas courts regarding the recovery of policy benefits when there have been statutory violations of the Code. As such, in *USAA Texas Lloyds Company v. Gail Menchaca*, the Texas Supreme Court seized the opportunity clear up the confusion by addressing the issue of whether an insured can recover policy benefits for Code violations when there has been no breach of the insurance policy.[9]**

## *USAA v. Menchaca*

**In *Menchaca*, the Texas Supreme Court acknowledges, "When our decisions create such uncertainties, 'it is our duty to settle conflicts in order that the confusion will as nearly as possible be set at rest.'"[10] Thus, the goal in *Menchaca* was "to provide clarity regarding the relationship between claims for an insurance policy breach and Insurance Code violations."[11] The primary question 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."[12]**

**Following Hurricane Ike in September 2008, Gail Menchaca contacted her homeowner's insurance company, USAA Texas Lloyds ("USAA"), and reported storm damage to her home.[13] The USAA adjuster who inspected Menchaca's claim found only minimal damage.[14] USAA determined that the damage was covered under Menchaca's policy but declined to pay benefits because the total repair costs did not exceed the deductible under Menchaca's policy.[15] Five months later, at Menchaca's request, another USAA adjuster re-inspected Menchaca's home.[16] The second adjuster confirmed the first adjuster's findings and again USAA declined to pay any policy benefits.[17] Menchaca filed suit against USAA for breach of the insurance policy and for unfair settlement practices in violation of the Texas Insurance Code. Menchaca sought policy benefits for both claims.[18] For the alleged breach of the insurance policy, she sought benefit of the bargain damages, i.e. the amount of her claim for policy benefits and attorney's fees. For the statutory violations, she sought actual damages, i.e. the loss of the benefits that should have been paid pursuant to the policy, court courts and attorney's fees.[19]**

**The case proceeded to a jury trial and three questions were submitted to the jury.[20] Question 1 addressed Menchaca's breach of contract claim and asked whether USAA failed "to comply with the terms of the insurance policy with respect to the claim for damages filed by Gail Menchaca resulting from Hurricane Ike" and the jury answered "No." Question 2 addressed Menchaca's claim for statutory violations and asked "whether USAA engaged in various unfair or deceptive practices, including whether USAA refused to "pay a claim without conducting a reasonable investigation with respect to that claim" and the jury answered "Yes." Question 3 asked the jury to determine Menchaca's damages that resulted from either USAA's failure to comply with the policy or its statutory violations, calculated as "the difference, if any, between the amount USAA should have paid Gail Menchaca for her Hurricane Ike damages and the amount that was actually paid" and the jury answered "$11,350."[21]**

**Both parties moved for judgment in their favor. USAA argued that Menchaca was not entitled to recover for bad faith or extra-contractual liability because the jury found that it did not breach the insurance policy. Menchaca argued that the jury answered Questions 2 and 3 in her favor and neither were dependent on a favorable answer to Question 1. The trial court disregarded Question 1 and entered judgment in Menchaca's favor. The court of appeals affirmed and the Texas Supreme Court granted USAA's petition for review.[22]**

**In analyzing 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 benefits under the insurance policy, the Court set forth "five distinct but interrelated rules that govern the relationship between contractual and extra-contractual claims in the insurance context."[23] Following the Court's analysis of these rules, it determined that the court of appeals erred by affirming the trial court's decision to disregard the jury's answer to Question 1. The Court further stated, "In light of the parties' obvious and understandable confusion over our relevant precedent and the effect of that confusion on their arguments in this case, we conclude that a remand is necessary here in the interest of justice."[24] The rules outlined by the Court are as follows:**

***Rule 1: General Rule:*** **An insured cannot recover policy benefits for an insurer's statutory violation if the insured does not have a right to those benefits under the policy.[25] This rule is derived from the Court's rule in *Republic Ins. Co. v. Stoker* that "there can be no claim for bad faith when an insurer has promptly denied a claim that is in fact not covered."[26] Although the fact pattern in *Stoker* was limited to the bad faith denial of a claim, the Court has since applied the general rule to other types of extra-contractual violations, i.e. failing to properly pay a claim, failing to fairly investigate a claim and failing to effectuate a prompt and fair settlement of the claim.[27] The general rule is derived from the fact that Code "only allows an insured to recover actual damages 'caused by' the insurer's statutory violation."[28] In determining whether the insured has to establish a right to benefits and then a breach of the policy to recover policy benefits for statutory violations, the Court stated, "While an insured cannot recover policy benefits for a statutory violation unless the jury finds that the insured had a right to the benefits under the policy, the insured does not also have to establish that the insurer breached the policy by refusing to pay those benefits."[29]**

***Rule 2: Entitled to Benefits Rule:*** **An insured who establishes a right to receive benefits under an insurance policy can recover policy benefits as "actual damages" under the statute if the insurer's statutory violation causes the loss of the benefits.[30] "If an insurer's 'wrongful' denial of a 'valid' claim results from or constitutes a statutory violation, the resulting damages will necessarily include 'at least the amount of the policy benefits wrongfully withheld.'"[31]**

***Rule 3: Benefits Loss Rule:*** **An insured can recover policy benefits as actual damages under the Insurance Code even if the insured has no right to those benefits under the policy, *if the insurer's conduct caused the insured to lose that contractual right.*[32] The Court has recognized this principle in cases alleging claims against an insurer for misrepresenting a policy's coverage, statutory violations by the insurer which prejudice the insured by waiving its right to deny coverage or is estopped from doing so, and statutory violations that cause the insured to lose a contractual right to benefits that it otherwise would have been entitled to.[33] "[A]n insurer that commits a statutory violation that eliminates or reduces its contractual obligations cannot then avail itself of the general rule."[34]**

***Rule 4: Independent Injury Rule:*** **The first aspect of the rule is that 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.[35] This rule takes into account that there may be some extra-contractual claims that may not "relate to the insurer's breach of contractual duties to pay covered claims" and recognizes that there may be compensatory damages different from policy benefits that result from the tort of bad faith under common law.[36]**

**The second aspect of the independent-injury rule is that an insurer's violation does not allow the insured to recover any damages beyond policy benefits unless the violation causes an injury that is independent from the loss of the benefits.[37] For instance, the Court held in *Twin City Fire Ins. Co. v. Davis* that "an insured who prevails on a statutory claim cannot recover punitive damages for bad-faith conduct in the absence of independent actual damages arising from that conduct.[38] Notably, as it relates to the independent-injury rule, the Court states that an independent-injury claim would be rare, they have yet to encounter one, and "have no occasion to speculate what would constitute a recoverable independent injury."[39]**

***Rule 5: No-Recovery Rule:*** **An insured cannot recover any damages based on an insurer's statutory violation unless the insured establishes a right to receive benefits under the policy or an injury independent of a right to benefits.[40.]**

***Conclusion***

**"It is the beginning of wisdom when you recognize that the best you can do is choose which rules you want to live by, and it's persistent and aggravated imbecility to pretend you can live without any."[41] The Texas Supreme Court has attempted to clear up the confusion caused by its precedent by adopting five rules on the issue of recovery of policy benefits for statutory violations. While the rules appear fairly simplistic and undoubtedly will provide guidance, it remains to be seen whether the opinion actually brings clarity to the situation or simply a lesser degree of confusion for the courts to follow. In any event, the rules in *Menchaca* appear to weigh in favor of insurers because the law is settled, i.e. there must be a right to receive benefits or a (rare, but possible) independent injury to receive policy benefits for statutory violations.**

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[1] Universal Life Ins. Co. v. Giles, 950 S.W.2d 48, 53 (Tex. 1997).
[2] Arnold v. Nat'l Cty. Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).
[3] Viles v. Sec. Nat'l Ins. Co., 788 S.W.2d 566, 567 (Tex. 1990).
[4] Pena v. State Farm Lloyds, 980 S.W.2d 949, 958 (Tex. App.—Corpus Christi 1998, no pet.); Giles, 950 S.W.2d at 54. See also Arnold, 757 S.W.2d at 168 (stating, "[E]xemplary damages and mental anguish damages are recoverable for a breach of the duty of good faith and fair dealing under the same principles allowing recovery of those damages in other tort actions.").
[5] Pa Preston Carter Co. v. Tatum, 708 S.W.2d 23, 25 (Tex. App.—Dallas 1985, no writ). ere is no set rule or ratio between the amount of actual damages and exemplary damages which will be considered reasonable and the determination is made on a case-by-case basis. Alamo Nat'l Bank v. Kraus, 616 S.W.2d

908, 910 (Tex. 1981).
[6] Texas does not adhere to the Uniform Deceptive Trade Practices Act adopted by many other states, but has its own set of laws, known as the Texas Deceptive Trade Practices Act ("DTPA"). Chapter 541 of the Texas Insurance Code addresses the protection of consumer interests against deceptive, unfair, and prohibited practices within the context of insurance. Chapter 17.50(a)(4) of the DTPA incorporates Chapter 541 of the Texas Insurance Code in its entirety.
[7] TEX. INS. CODE § 541.152.
[8] National Sec. Fire & Cas. Co. v. Hurst, 523 S.W.3d 840, 840 (Tex. App.—Houston 14th Dist. 2017, no pet.).
[9] No. 14-0721, 2017 WL 1311752, at *1 (Tex. 2017).
[10] 2017 WL 1311752, at *1.
[11] Id. at *3.
[12] Id. at *1.
[13] Id.
[14] Id.
[15] Id.
[16] Id.
[17] Id.
[18] Id.
[19] Id. at *3.
[20] Id. at *2.
[21] Id.
[22] Id.
[23] Id. at *4.
[24] Id. at *14.
[25] TEX. INS. CODE § 541.151; Stoker, 903 S.W.2d at 341.
[26] Republic Ins. Co. v. Stoker, 903 S.W.2d 338, 341 (Tex. 1995).
[27] Menchaca, 2017 WL 1311752, at *5.
[28] Id. (citing TEX. INS. CODE § 541.151).
[29] Menchaca, 2017 WL 1311752, at *7.
[30] Id.
[31] Id. (citing Vail v. Texas Farm Bureau Mut. Ins. Co. v. Castaneda, 988 S.W.2d 189, 188 (Tex. 1998).
[32] Menchaca, 2017 WL 1311752, at *10 (emphasis in original).
[33] Id.
[34] Id.
[35] Id. at *11.
[36] Id.. ; see also Twin City Fire Ins. Co. v. Davis, 904 S.W.2d 663, 666 (Tex. 1995) (identifying mental anguish damages as an example).
[37] Menchaca, 2017 WL 1311752, at *11 (emphasis added).
[38] 904 S.W.2d 663, 666 (Tex. 1995) (citing Federal Express Corp. v. Dutschmann, 846 S.W.2d 282, 284 (Tex. 1993) (stating that "[r]ecovery of punitive damages requires a finding of an independent tort with accompanying actual damages."). Therefore, insurers are not liable for punitive damages if there is not an independent injury resulting in extra-contractual damages.
[39] Menchaca, 2017 WL 1311752, at *12.
[40] Menchaca, 2017 WL 1311752, at *12; Casteneda, 988 S.W.2d at 198.
[41] WALLACE STEGNER, ALL THE LITTLE LIVE THINGS (PENGUIN BOOKS 1991).

## *Does the Insurance Policy Incorporate the Service Contract by Reference? An Examination of In Re Deepwater Horizon*

### By: Leah M. Homan

**In 2015, the Texas Supreme Court issued a ruling that changed the way additional insured coverage under an insurance policy is analyzed when there is an underlying drilling contract limiting the additional insured coverage to the scope of the liability assumed in the service contract. In *In re Deepwater Horizon*, the court faced the issue of whether a drilling contract limits the scope of coverage extended to an additional insured.[1] This article discusses *Deepwater Horizon*, which governs allocation of risk, assumed liabilities, and the granting of additional insured status in underlying service contracts, and the precedent the case established.**

**The insurance coverage dispute arose from the 2010 explosion and sinking of the Deepwater Horizon drilling rig in the Gulf of Mexico.[2] BP, the oil-field developer, and Transocean, the drilling-rig owner entered into a drilling agreement for a mobile offshore drilling unit ("Drilling Contract").[3] The issue was whether the insurance provisions in the Drilling Contract limited the scope of insurance coverage extended to BP as an additional insured.**

**The Drilling Contract had standard "knock-for-knock" or mutual indemnity obligations for personal injury and property damage.[4] Pollution liabilities were allocated between Transocean and BP based upon the source and conveyance of the subject pollution.[5] Transocean agreed to indemnify BP for pollution occurring above the surface, regardless of fault, and BP agreed to assume and/or retain liability for all other pollution.[6] As is standard in the industry,**

Transocean was required to carry insurance policies that named BP as an additional insured for liabilities assumed under the terms of the Drilling Contract. Transocean's policies extended insured status to any "person or entity to whom the 'Insured' is obliged by oral or written 'Insured Contract' … to provide insurance such as afforded by [the] Policy."[7] The parties did not dispute that BP was an additional insured under the Transocean policies or that the Drilling Contract was an "Insured Contract" triggering coverage. Rather, the parties focused on the scope of the policy coverage; specifically, the extent to which the Drilling Contract's risk allocations could limit BP's coverage, as an additional insured, under Transocean's insurance policies.[8]

BP argued that under *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*,[9] the extent of coverage should be ascertained exclusively from the four corners of the Transocean insurance policies and not from the terms and conditions of the Drilling Contract.[10] BP contended that, as an unconditional additional insured, its worldwide operations are automatically covered for all "liability imposed by law," which includes subsurface pollution from the explosion.[11]

Challenging BP's broad interpretation, Transocean and its insurers[12] argued that BP's analysis disregarded that BP is an "Insured" only by the status conferred by the Drilling Contract, and, thusly, the coverage extended is limited to the risks assumed in the Drilling Contract.[13] Transocean and the insurers relied on *Urrutia v. Decker,*[14] in which the Texas Supreme Court held that "Texas law has long provided that a separate contract can be incorporated into an insurance policy by an explicit reference clearly indicating the parties' intention to include the contract as part of their agreement."[15] Applying the *Urrutia* exception to BP's four-corner analysis, Transocean and its insurers contended that the Drilling Contract was incorporated into the Transocean insurance policies by the policy language that limited additional insured status to "where required" and as "obliged."[16] Stated simply, Transocean and its insurers argued that the Drilling Contract required Transocean to name BP as an additional insured only for the above-surface pollution risk that Transocean assumed, and, as a result, BP lacked additional insured status for subsurface pollution.[17]

The court incorporated the Drilling Contract into the insurance policy by using Texas contract law which looks to the parties' intent as expressed by the words that they chose to effectuate their agreement.[18] The court then examined the policy language and found that BP is not named in any of the insurance policies, nor was there any evidence that expressly included BP as a blanket additional insured in the insurance endorsement or certificate.[19] Nonetheless, the court went on to find that the policies conferred coverage by reference to the Drilling Contract, in which "(1) Transocean assumed some liability for pollution that might otherwise be imposed on BP (making that contract an "Insured Contract") and (2) Transocean is "obliged" to procure insurance coverage for BP as an additional insured (making BP an "Insured")."[20] The court agreed with Transocean and the insurers that the use of "where required" and "as obliged" in the additional insurance coverage sections of the insurance policies referenced the Drilling Contract's additional insured clause, thereby limiting the scope of coverage.

The additional insured provision in the Drilling Contract read as follows,

> [BP], its subsidiaries and affiliated companies, co-owners, and joint venturers, if any, and their employees, officers, and agents shall be named as additional insureds in each of [Transocean's] policies, *except Workers' Compensation for liabilities assumed by [Transocean] under the terms of this contract.*[21]

The court reasoned that the plain language of the provision makes it apparent that BP's status as an insured is "inexorably linked" to the extent of Transocean's indemnity obligations. The real issue from the provision was whether (a) the italicized portion was intended to be narrow and specific, thus applying only to workers' compensation policies covering Transocean's employees; or (b) the provision exempted only workers' compensation policies from the general additional insured obligation and imposed a limitation on the general insurance obligation that is contiguous with all of Transocean's contractual indemnity duties.[22]

Regarding the limitation of additional insured status to liabilities assumed in the contract, BP's argument focused on a missing comma. BP argued that the missing comma following the word "compensation" suggested that its coverage as an additional insured extended to the full limit of the policy and was not limited by liabilities assumed by Transocean, except with respect to workers' compensation coverage. The Texas Supreme Court found BP's construction "unreasonable," as such an interpretation would render the words "for liabilities assumed by [Transocean] under the terms of this contract" meaningless.

The court further reasoned that Transocean and the insurers' construction of the provision was the most reasonable because it is "in harmony with the allocation of liabilities in the contract, gives meaning to all the language the parties

employed, and is consistent with the standard use of such language and the purpose of such clauses."[23] Further, the court stated that additional insured provisions are commonly phrased in terms that extend coverage to insurance policies while exempting workers' compensation from coverage.[24] The court also opined that "a manifest purpose of an additional insured clause is to provide supplemental protection when the additional insured may be sued for conduct within the contractor's scope of risk."[25] After applying this reasonableness construction to the additional insured provision in the Drilling Contract, the court held that BP is an additional insured only as to liabilities assumed by Transocean under the Drilling Contract.[26] Additionally, because Transocean did not assume liability for the risk of subsurface pollution, Transocean had no obligation to name BP as an additional insured for subsurface pollution.[27]

Not wanting to lose a good fight, BP further argued that the provision cannot limit its additional insured status to the extent of Transocean's indemnity obligations because the Drilling Contract's indemnity and insurance provisions are separate and independent.[28] Disagreeing with BP's argument, the court stated that BP was consolidating duty with scope and Texas courts have long recognized that "contractual duties to indemnify and to maintain insurance may be separate and independent."[29] The court found that the Drilling Contract required Transocean to name BP as an additional insured only for the liability Transocean assumed under the contract; thus, Transocean had separate duties to indemnify and insure BP, but the scope of indemnity and insurance only extended to pollution above the surface, as specifically allocated or assumed in the Drilling Contract.[30.]

The court concluded by stating that:

> Texas law has long allowed insurance policies to incorporate other documents by reference, and policy language dictates the extent to which another document is so incorporated. The policies here provide additional-insured coverage automatically where required and as obligated by written contract in which an insured has agreed to assume the tort liability of another party. Because BP is not named as an insured in the Transocean policies or any certificates of insurance, the insurance policies direct us to the additional-insured provision in the Drilling Contract to determine the existence and scope of coverage. Applying the only reasonable construction of that provision, we conclude that, as it pertains to the damages at issue, BP is an additional insured under the Transocean policies only to the extent of the liability Transocean assumed for above-surface pollution.[31]

After *Deepwater Horizon*, if the language of an insurance policy incorporates by reference another contract that dictates the status and scope of coverage, the court will give that contract effect, but only to the extent allotted for by the insurance policy. Moving forward, the precedent established by Deepwater Horizon should reduce disputes among operators and contractors alike who seek additional insured status subject to limiting language in the insurance policy that incorporates an underlying services contract. The parties should pay particular attention to the policy's language to determine the extent to which a court will look to the underlying services contract to ascertain the scope of coverage as an additional insured.

Select Cases after *Deepwater Horizon*

In 2017, the Fifth Circuit of the United States Court of Appeals was tasked with resolving a dispute between ExxonMobil ("Exxon") and its contractor, Electrical Reliability Services ("ERS").[32] An employee of a subcontractor of ERS was injured and filed suit against Exxon and ERS.[33] Exxon settled the suit and sought reimbursement from ERS and its insurer based on a theory that ERS had a contractual obligation to indemnify Exxon because Exxon was an additional insured under ERS' insurance policy.[34] In 2012, the district court held that ERS' insurer breached its obligation by failing to provide coverage and reimbursement to Exxon.[35] Thus, the district court awarded Exxon over $3 million.[36] On appeal, the Fifth Circuit vacated and remanded the district court's holding in light of the Texas Supreme Court's decision in *Deepwater Horizon*.[37]

On remand, the district court determined that Deepwater Horizon had no effect on its decision and reinforced its prior ruling.[38] In a second appeal the Fifth Circuit agreed with the district court and held that *Deepwater Horizon* did not interfere with the original judgment because there was no language in the insurance policy or the contract that suggested the parties intended the scope of the indemnity provision to govern or limit the scope of the insurance provision in the policy.[39] Thus, the parties' intent "as expressed in the writing itself" differed from the parties' intent in *Deepwater Horizon* because the contract Exxon and ERS executed focused on the duty of indemnification and not the scope of liability.[40.]

Also in 2017, in *North American Capacity Insurance Co. v. Colony Specialty Insurance Co.*, the U.S. District Court of

**the Southern District of Texas held that the insurer's argument that a separate contract can be incorporated into an insurance policy by reference to that document in light of *Deepwater Horizon* was unpersuasive. The court noted that the policies that the insurer referenced did not contain any specific references to the separate contract.[41]**

**In 2016, The Fifth Circuit was faced with an umbrella insurer's argument that pursuant to *Deepwater Horizon*, a subcontract that accounts for "additional insureds" should be incorporated into the policy.[42] In *EMJ Corp. v. Hudson Specialty Insurance Co.*, the Fifth Circuit rejected the insurer's argument by finding that Texas law was not applicable because the case was in diversity and Mississippi law applied.[43] The Fifth Circuit stated that "[t]he Texas Supreme Court arguably modified the traditional rule when it decided *Deepwater Horizon*" and a Mississippi court reaffirmed the traditional rule in 2014.[44] The traditional rule in Mississippi is that "mere references to extrinsic documents in a contract do not incorporate the terms of that document into the contract."[45]**

**In another 2016 decision, the United States District Court in the Southern District of Texas determined that *Deepwater Horizon* "does not present an intervening change in the controlling law; it does not expressly overrule any previous case law."[46] In *Lexington Insurance Co. v. ACE American Insurance Co.*, the court followed the traditional construction principles in *Urrutia* and *ATOFINA* after reinforcing the court's language in *Deepwater Horizon* that "[o]ur application of these foundational principles in *Urrutia* and *ATOFINA* guides our analysis of the policies and Drilling Contract at issue here."[47]**

**In 2015, the Fifth Circuit held that based on the precedent set by *Deepwater Horizon*, insurance policies that incorporated a $5 million limit as referenced in a master service could be used to determine the scope of coverage. In *Ironshore Specialty Insurance Co. v. Aspen Underwriting, Ltd.*, the "Insured Contract" provision was essentially the same as Transocean's in *Deepwater Horizon*.[48] The Fifth Circuit was asked to determine what effect the Texas Supreme Court gave to the "Insured Contract" provision because Transocean's provision had language that added additional insureds "where required by written contract."[49] Ultimately, the Fifth Circuit found that the "best reading" of *Deepwater Horizon* is that "each provision standing alone was an independent basis for the decision."[50] Like in *Deepwater Horizon*, the Fifth Circuit held that the "Insured Contract" provision at issue in *Ironshore Specialty Insurance Co.* was sufficient to incorporate the master service agreement's coverage limitation to risks assumed.[51]**

**Conclusion**

**The law surrounding additional insured coverage in underlying service contacts is evolving in Texas. Some courts have interpreted the *Deepwater Horizon* holding narrowly and have attempted to distinguish the case by using the specific language from the Transocean policy. Other courts have continued applying the traditional principles set forth in *Urrutia* and *ATOFINA*. As a final takeaway, it should be noted that indemnity and additional insurance clauses in oil and gas service contracts are not always harmonious. Additional insurance clauses in an insurance policy may afford more protection than an indemnity clause in a service contract obligates a party to provide. Carriers may want to ensure congruity in the two documents to avoid a dispute like that in *Deepwater Horizon* .**

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[1] 470 S.W.3d 452 (Tex. 2015).
[2] Id. at 455
[3] Id.
[4] Id. at 456-457.
[5] Id.
[6] Id.
[7] Id. at 457.
[8] Id. at 458.
[9] Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc. 256 S.W.3d 660 (Tex. 2008).
[10] Id.
[11] Id. at 459.
[12] The insurers were Ranger Insurance, Ltd. (primary policy) and "four layers of excess insurance from a multitude of additional insurers." Id. at 457.
[13] Id at 459.
[14] 992 S.W.2d 440 (Tex. 1999).
[15] Id. at 442.
[16] In re Deepwater Horizon, 470 S.W.3d at 459.
[17] Id.
[18] Id. at 464; Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London, 327 S.W.3d 118, 126 (Tex. 2010).
[19] Id.
[20] Id.
[21] Id. at 465 (emphasis added).
[22] Id.
[23] Id. at 466.
[24] Id.

[25] Id. at 467.
[26] Id.
[27] Id.
[28] Id.
[29] Id. at 468.
[30] Id.
[31] Id. at 469.
[32] ExxonMobil Corp. v. Elec. Reliability Servs., Inc., 868 F.3d 408 (5th Cir. 2017).
[33] Id. at 411.
[34] Id.
[35] Id.
[36] Id.
[37] Id.
[38] Id.
[39] Id. at 417.
[40] Id. at 417-418.
[41] N. Am. Capacity Ins. Co. v. Colony Specialty Ins. Co., 2017 WL 3447107 at 5 (S.D. Tex. 2017).
[42] EMJ Corp. v. Hudson Specialty Ins. Co., 833 F.3d 544, 555 (5th Cir. 2016).
[43] Id.
[44] Id.
[45] Id.; citing Woodru v. ames, 143 So.3d 546, 555-55 (Miss. 2014).
[46] Lexington Ins. Co. v. ACE Am. Ins. Co., 192 F. Supp. 3d 712, 715 (S.D. Tex. 2016).
[47] Id.
[48] Ironshore Specialty Ins. Co. v. Aspen Underwriting, Ltd., 788 F.3d 456, 462 (5th Cir. 2015).
[49] Id.
[50] Id.
[51] Id.

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