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The Duty to Defend

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Overview

- Basic principles – the ground rules
- The "eight-corners rule" – analyzing the duty to defend
- Extrinsic evidence – *GuideOne*
- Damages – *Lamar Homes*
- Emerging duty-to-defend issues
  - Cell phone cases
  - Fortuity doctrine

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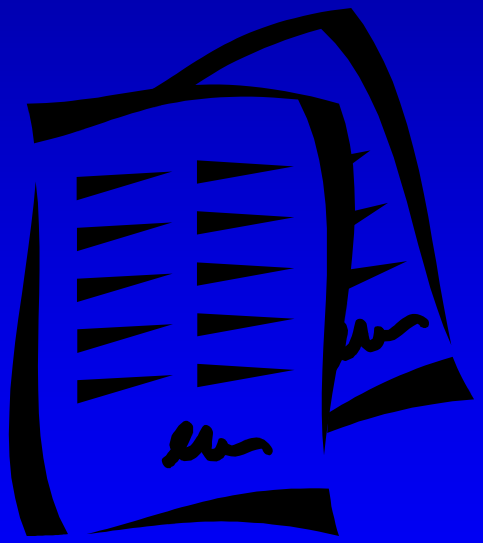
Ground Rules

Insurance Policy Construction



- Insurance policies are contracts governed by the general rules of contract construction.
- If more than one reasonable interpretation exists → the policy is ambiguous.
- If an insurance policy is ambiguous, the court must adopt the construction that most favors the insured.
- If unambiguous, the insurance contract must be enforced as written.

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Ground Rules

Burdens of Proof

With respect to the duty to defend:

- The insured bears the initial burden of proving that the underlying lawsuit potentially falls within the policy's coverage. Once the insured meets this burden,
- the insurer bears the burden of proving applicability of an exclusion.
- Then, the burden shifts back to the insured to prove the applicability of an exception to an exclusion.

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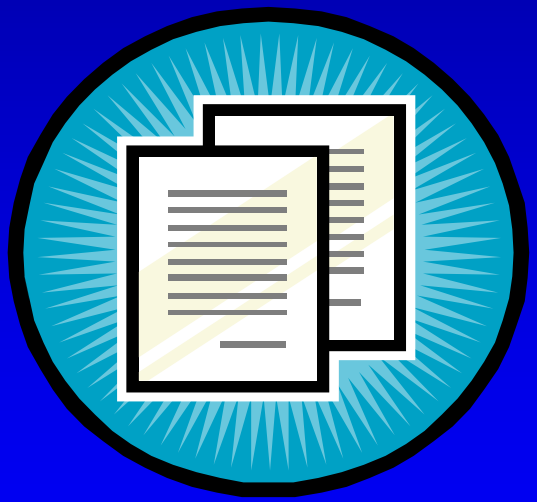
The Eight-Corners Rule
(a/k/a The Complaint-Allegation Rule)



Under Texas law, the duty to defend is typically determined based solely on the terms of the policy (the first "four corners") and the complaint in the underlying lawsuit (the second "four corners"). This is known as the "eight-corners" rule, or "complaint-allegation" rule.

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The Eight-Corners Rule
(a/k/a The Complaint-Allegation Rule)

- Under the eight-corners rule, the duty to defend arises when the facts alleged in the underlying pleading, taken as true, potentially state a cause of action falling within the terms of the policy.
- If the pleading does not allege facts even potentially within the scope of coverage under the policy → no duty to defend.
- Extrinsic facts, or facts outside of the "eight corners," (even easily ascertained facts) are ordinarily not material to a determination of the duty to defend.

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Duty to Defend v. Duty to Indemnify

Duty to Defend

Eight-corners analysis – "Facts ascertained before suit, developed in the process of litigation or determined by the ultimate outcome of the suit do not affect the duty to defend." *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 528 (5th Cir. 2004) (applying Texas law).

Duty to Indemnify

Actual facts – "The duty to indemnify is triggered by the actual facts establishing liability in the underlying suit." *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821 (Tex. 1997).

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Duty to Defend v. Duty to Indemnify

- The duty to defend may be determined by the court at the outset of the claim – because the actual facts are not typically material.
- The duty to indemnify may not be justiciable until the underlying lawsuit is resolved.
- **Exception:** Where the same facts that defeat the duty to defend also preclude the duty to indemnify, courts have held that the duty to indemnify may be adjudicated before resolution of the underlying case.

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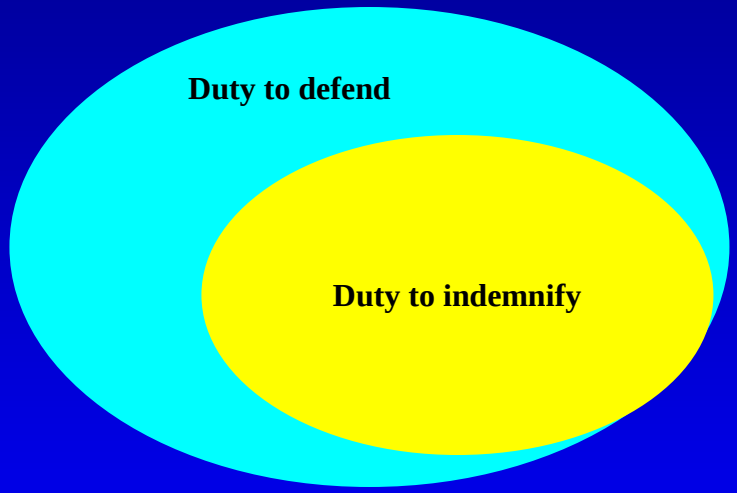
Duty to Defend v. Duty to Indemnify



- The duty to defend is broader than the duty to indemnify. If the facts alleged in the underlying lawsuit potentially state a cause of action falling within coverage, the duty to defend is triggered.
- The duty to indemnify, on the other hand, is triggered only when the actual facts establish that the claim is covered.

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Eight-Corners Analysis

Facts Alleged, Not Legal Theories

- Focus is on the facts alleged, which show the origin of damages, not the cause of action or legal theories.

  Example: *Adamo v. State Farm Lloyds*, 853 S.W.2d 673 (Tex. App.—Houston [14th Dist.] 1993, writ denied)

  – Faced with a criminal investigation, Joseph Marino sought advice from long-time friend and attorney, Sam Adamo. Adamo advised Marino to turn his property and business over to a friend and leave the country until the investigation was over. Marino followed this advice and, when he returned to the United States, discovered the friend had sold his property and stolen his business.

  – Marino sued Adamo, alleging causes of action for, *inter alia*, legal malpractice and breach of fiduciary duty.

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Eight-Corners Analysis

Facts Alleged, Not Legal Theories

Example: *Adamo v. State Farm Lloyds*, 853 S.W.2d 673 (Tex. App.—Houston [14th Dist.] 1993, writ denied)

(*continued*)

- Adamo demanded a defense from his homeowner's insurer.
  - Conceded that legal malpractice was not covered under homeowner's policy.
  - Argued that the lawsuit alleged a fiduciary relationship based on the long-time friendship with Marino, which created a possibility that the claims arose out of the personal relationship (potentially covered) rather than the professional relationship (not covered).
- Based on the facts alleged, the court concluded that all of the damages stemmed from the professional relationship. The lawsuit was therefore excluded from coverage and the insurer had no duty to defend.

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Eight-Corners Analysis

Facts Alleged, Not Legal Theories

- Conclusory allegations are insufficient – without specific factual allegations, the claim is "nothing more than a conclusory statement," which is insufficient to trigger the duty to defend.
- On the other hand, where the facts alleged are sufficient to support a cause of action for an offense covered under the policy, it may not be necessary that the pleading specifically name the covered offense.

  Example: *St. Paul Fire & Marine Ins. Co. v. Green Tree Fin. Corp.-Tex.*, 249 F.3d 389 (5th Cir. 2001) (applying Texas law).

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Eight-Corners Analysis

Facts Alleged, Not Legal Theories

Example: *St. Paul Fire & Marine Ins. Co. v. Green Tree Fin. Corp.-Tex.*, 249 F.3d 389 (5th Cir. 2001)

- The insured faced counterclaims for wrongful debt collection practices, breach of an installment agreement and breach of warranties (*i.e.*, the legal theories).
- The pleading alleged that the insured bombarded claimants with harassing and abusive phone calls.
- These facts supported a cause of action for invasion of privacy (although no such cause of action was alleged), which was covered under the policy.
- The court found a duty to defend.

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Eight-Corners Analysis

Facts Alleged, Taken as True

- The facts alleged in the underlying pleading control the duty-to-defend analysis, without regard to their truth or falsity.

  Example: *GuideOne v. Fielder Rd. Baptist Church*, 197 S.W.3d 305 (Tex. 2006)

  – Policy covered damages because of bodily injury arising out of sexual misconduct that occurred during the policy period – March 31, 1993 to March 31, 1994.

  – Underlying petition alleged that Charles Patrick Evans was employed as a youth minister of Fielder Road Baptist Church from 1992 to 1994 and was under the church's direct supervision and control when he sexually exploited and abused the plaintiff.

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Eight-Corners Analysis

Facts Alleged, Taken as True

Example: *GuideOne v. Fielder Rd. Baptist Church*, 197 S.W.3d 305 (Tex. 2006)

(*continued*)

- Based on these alleged facts, without regard to their veracity, the lawsuit alleged sexual misconduct occurred during the policy period.
- The undisputed evidence demonstrated that Evans' employment with the church ended in December 1992, several months before policy incepted.
- Based on the facts alleged in the petition, the supreme court held that the insurer had a duty to defend the church, notwithstanding the true facts which demonstrated that the alleged sexual misconduct could not have occurred during the policy period.

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Eight-Corners Analysis

Doubts Resolved in Favor of Duty

- Facts alleged are liberally construed. In case of doubt as to whether or not the allegations of a complaint state a cause of action covered by the policy, such doubt will be resolved in the insured's favor.
- Not every "doubt" is sufficient to compel a resolution in favor of the insured. Silence in the pleading does not trigger the duty to defend.
- Consider the following cases –

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Eight-Corners Analysis

Doubts Resolved in Favor of Duty

Example 1: *Nat. Union Fire Ins. Co. v. Merchs. Fast Motor Lines*, 939 S.W.2d 139 (Tex. 1997)

- The underlying pleading alleged that the tortfeasor was operating a truck owned by the insured when he negligently discharged a firearm, injuring the underlying plaintiff. No other facts were alleged.
- Although the pleading alleged use of a covered auto, it did not allege an accident resulting from use of the covered auto, as required by the policy. The mere fact that a covered auto was the site of the accident was insufficient to establish that the accident resulted from the use of the auto.
- Because the facts alleged did not "suggest even a remote causal relationship between the truck's operation and [the plaintiff's] injury, they do not create that degree of doubt which compels resolution of the issue for the insured."

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Eight-Corners Analysis

Doubts Resolved in Favor of Duty

Example 2: *D.R. Horton-Texas, Ltd. v. Markel International Ins. Co., Ltd.*, No. 14-05-00486-CV, 2006 Tex. App. LEXIS 9346 (Tex.App.–Houston [14th Dist.] Oct. 26, 2006, pet. filed)

- In 2002, James and Cicely Holmes filed suit against homebuilder D.R. Horton, alleging that their home contained latent defects that led to the propogation of toxic mold, making the home uninhabitable.
- D.R. Horton was an additional insured on an insurance policy issued to a subcontractor, Rosendo Ramirez, but only for liability arising out of Ramirez's work.
- The underlying lawsuit did not mention Ramirez and did not allege that the plaintiffs were damaged by the conduct of any person or entity other than D.R. Horton.

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Eight-Corners Analysis

Doubts Resolved in Favor of Duty

"Although we strictly construe the pleadings against the insurer and resolve any doubt in favor of coverage, not every doubt requires resolution of the duty to defend in favor of the insured."

- Given their most liberal interpretation in favor of coverage, the allegations in the underlying lawsuit could not be interpreted to state a claim for damages arising out of Ramirez's work.
- Although extrinsic evidence would have established that Ramirez performed masonry work on the Holmes home, the court declined to consider the extrinsic evidence and concluded that the insurer had no duty to defend.
- D.R. Horton is seeking review in the supreme court.

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Eight-Corners Analysis

Actual Allegations, Not Imagined or Implied

- The duty to defend is not limitless, but is bounded by the facts actually alleged in the pleadings.
- The court may consider those inferences that logically flow from the facts alleged. The court may not read facts into the pleadings, look outside the pleadings or "imagine factual scenarios that might trigger coverage."

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Exceptions to the Eight-Corners Rule?

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Exceptions to the Eight-Corners Rule?

- To date, the Texas Supreme Court has not recognized any exception to the eight-corners rule.
- In *GuideOne* (2006), the supreme court refused to recognize an exception for "mixed" extrinsic evidence – *i.e.*, evidence relevant to both coverage and to the merits of the underlying case.
  - Policy covered damages because of bodily injury arising out of sexual misconduct during the policy period – March 1993 to March 1994.
  - Petition alleged that a youth minister sexually abused and exploited the plaintiff while he was under the church's supervision and control from 1992 to 1994. Extrinsic evidence established that the youth minister left the church in December 1992, several months before the policy incepted.
  - Court refused to consider extrinsic evidence, and insurer had duty to defend.

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Exceptions to the Eight-Corners Rule?

- In *GuideOne*, the court left unanswered the question of whether "coverage-only" evidence might be admissible, leaving some clues that suggest it might recognize a more limited exception:
  - First, while it could have created a bright-line rule that extrinsic evidence may never be considered in the duty-to-defend context, the court did not do so.
  - Second, the court closely analyzed the decisions of other Texas courts permitting extrinsic evidence to determine an insurer's duty to defend where "fundamental" coverage questions are resolved by "readily determined facts." Although the court did not adopt the rules articulated by these courts, the holdings were recited without criticism.
  - Third, the court's analysis of *Northfield* seems to approve the more limited exception articulated in that case.

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Exceptions to the Eight-Corners Rule?

- In *Northfield*, the Fifth Circuit made an *Erie* guess that the Texas Supreme Court would not recognize any exception to the eight-corners rule and that, if it recognized any exception, it would likely do so –

The *Northfield* Exception

"when it is initially impossible to discern whether coverage is potentially implicated and when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case."

Northfield Ins. Co. v. Loving Home Care, Inc., 363 F.3d 523 (5th Cir. 2004) (applying Texas law).

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Exceptions to the Eight-Corners Rule?

- Since *GuideOne*, several courts applying Texas law have issued well-reasoned opinions applying the *Northfield* exception.
  - *Liberty Mut. v. Graham*, 473 F.3d 596 (5th Cir. 2006)
    - Issue → whether defendant was a permissive driver of the vehicle involved in an accident.
    - District court admitted extrinsic evidence to establish driver was not permissive user and was intoxicated.
    - Fifth Circuit reversed, concluding that the proffered evidence did not meet the criteria for consideration of extrinsic evidence because it overlapped with allegations in the underlying lawsuit.

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Exceptions to the Eight-Corners Rule?

- *Hermitage v. Times Square Dallas*
  - Issue → whether underlying plaintiff's injuries were caused by an assault and therefore excluded from coverage.
  - The plaintiff initially pled himself out of coverage by alleging conduct squarely within the assault exclusion.
  - The plaintiff subsequently attempted to plead himself back into coverage by excising from the pleading any reference to how his injuries occurred. The amended pleading was silent with respect to the facts necessary to determine applicability of the assault exclusion.
  - Based on the amended pleading, how the plaintiff sustained his injuries was irrelevant to the underlying case. As such, the extrinsic evidence regarding the assault did not overlap with the facts alleged in the underlying lawsuit, fitting within the exception.

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Exceptions to the Eight-Corners Rule?

- *Mary Kay v. Federal*
  - Issue → whether a particular entity was a subsidiary of the insured when the policy incepted (which the court called a "temporal issue").
  - Because the underlying lawsuit contained no allegations regarding ownership of the entity at the time the policy incepted, the court concluded that the issue of subsidiary status when the policy incepted fell within the *Northfield* exception.
  - The extrinsic evidence was a bankruptcy court order cancelling all of the entity's stock several months before the policy incepted, which conclusively established that any equity interest the insured may have held in the entity was terminated before the policy was issued and the entity could not have been a subsidiary.

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Exceptions to the Eight-Corners Rule?

- *Boss Mgmt. Services v. Acceptance*
  - Issue → whether underlying lawsuits alleged property damage occurring during the policy periods, which could not be determined from the imprecise allegations in the complaints. The insured suggested that the court consider certificates of occupancy in order to establish the earliest date after which the damage appeared.
  - Court noted that *GuideOne* "favorably cited," in dicta, the *Northfield* exception and "hinted that a more narrow exception may be appropriate in some cases" – where it is initially impossible to determine whether coverage is implicated and the extrinsic evidence relates solely to coverage, not overlapping with the merits.
  - Based on the certificates of occupancy proffered by the insured, the court concluded that coverage was potentially implicated, triggering the duty to defend.

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Exceptions to the Eight-Corners Rule?

- *Pine Oak Builders & D.R. Horton*
  - In both cases, the insured sought to introduce extrinsic evidence to trigger a duty to defend.
  - *Pine Oak Builders* – the insured relied on extrinsic evidence to establish that all of the work on plaintiffs' house was performed by subcontractors, bringing the case within the subcontractor exception to the "your work" exclusion.
  - *D.R. Horton* – the insured proffered extrinsic evidence to provide that it was an additional insured under a subcontractor's insurance policy.
  - In both cases, the Houston Court of Appeals applied a strict eight-corners analysis and declined to consider the evidence.
  - Both insureds sought review in the supreme court.

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Undertaking the Defense

- Before undertaking the defense, the insurer must set forth all known coverage defenses in a reservation of rights letter.
- The reservation of rights preserves policy defenses.

Warning: An ambiguous reservation of rights may be construed against the insurer.

- Control of the defense is a matter of contract.
- The insured has a right to independent counsel only if "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends."

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Consequences for Breach

- Under Texas law, the reasonable attorney's fees incurred by the insured in litigation with a third party are recoverable as actual damages for breach of the duty to defend.
- In addition, an insurer who breaches its duty to defend may face liability for interest on unpaid defense costs under the Texas prompt-payment statute.
- In *Lamar Homes v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007), the supreme court ruled last year that the prompt-pay statute applies to a liability insurer's breach of the duty to defend.

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Consequences for Breach

- Formerly codified as article 21.55 of the Texas Insurance Code and recodified without substantial change as sections 542.051-.061 (effective April 1, 2005), the statute authorizes an award of "interest on the amount of the claim at the rate of eighteen percent per year as damages, together with reasonable attorney's fees."
- Reasoning that an insurer's duty to defend is a "first party" claim because it involves a direct loss to the insured, the supreme court rejected the argument that the statute was not intended to apply to third-party insurers.

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Consequences for Breach

- The court also rejected arguments that the statute is unworkable in the context of an insured's claim for a defense.
- Rather, these statutory requirements apply:
  - Written notice of claim triggers insurer's duty to investigate and acknowledge the claim.
  - After receiving notice, the insurer has 15 days to (1) acknowledge receipt; (2) commence an investigation and (3) request all items, statements and forms the insurer reasonably believes will be required.
  - The statutory deadlines for accepting and paying the claim do not begin until the insurer has "receive[d] all items, statements and forms required by the insurer to secure final proof of loss."

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Consequences for Breach

- Applying the statutory provisions to an insured's claim for a defense, the court determined that an insured would need to submit its legal bills to the insurer, as they are received, in order to mature its rights under the statute.
- "These statements are the last piece of information needed to put a value on the insured's loss."

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Consequences for Breach

- On December 14, 2007, the supreme court denied rehearing in *Lamar Homes*, prompting a vigorous dissent from three justices.
- The dissent focused on the history of the statutory provisions, which have never applied to all insurance claims.
- The dissent further criticized the court's definition of "first-party claim" as being unrecognizable to the insurance industry and at odds with the use of the term by courts "around the nation."

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Consequences for Breach

- Dissent → a decision to extend the provisions of the prompt-payment statute to third-party liability insurers is "a decision for the people of Texas to make through legislative proposals and debate, not for this Court to make out of whole cloth."

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Cell Phone Cases

- *Nokia*, *Samsung* and *Cellular One*
- Issue → do lawsuits alleging damage to human cells or "biological injury" trigger a duty to defend under CGL policies providing coverage for bodily injury?
- All three cases were appealed to the Dallas Court of Appeals, which answered the duty-to-defend question, "yes"
- All three insurers sought review in the Texas Supreme Court, where the cases are now pending

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The Fortuity Doctrine

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The Fortuity Doctrine in Texas

- Fortuity is an inherent requirement in all insurance policies.
- An insurance agreement is a "contract in which a promise is conditioned on the happening of a fortuitous event, an event of chance."
- As a matter of public policy, the purpose of insurance is to protect against unknown, fortuitous risks – not known losses or risks.

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The Fortuity Doctrine in Texas

- The fortuity doctrine precludes insurance coverage for losses that are foreseen or that should have been foreseen by a policyholder at the time the policy incepts.
- Under Texas law, the fortuity doctrine precludes coverage for two types of losses:
    1. known losses; and
    2. losses in progress.

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The Fortuity Doctrine in Texas

- A "known loss" is a loss the insured knew had occurred prior to making the insurance contract. *Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex.App.—Dallas 2001, pet. denied).
- A "loss in progress" occurs when the insured is, or should be, aware of an ongoing progressive loss at the time the policy is purchased. *Id.*

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The Fortuity Doctrine in Texas

- "If an insured knows, or should have known, at the time it purchased the insurance policy, that its current behavior is wrongful and could result in liability, it effectively removes the risk element inherent in insurance …" *RLI Ins. Co. v. Maxxon Sw., Inc.*, 108 Fed. Appx. 194 (5th Cir. Sept. 1, 2004).
- An insured may not voluntarily engage in an activity that gives rise to an accusation of wrongdoing and potential legal liability, then purchase insurance to shift financial liability to the insurer.

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The Fortuity Doctrine in Texas

Simply put, an insured cannot insure against something that has already begun and which is known to have begun …

. . .the proverbial burning building.

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Fortuity & The Duty to Defend

- Courts that have considered the issue under Texas law have uniformly analyzed an insurer's fortuity defense under the traditional eight-corners rule and have concluded that the fortuity doctrine, if applicable, precludes the duty to defend. *Warrantech v. Steadfast, Ins. Co.*, 210 S.W.3d 760 (Tex. App.—Fort Worth 2006, pet. denied.)
- Here are some cases that illustrate the fortuity doctrine –

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Fortuity & The Duty to Defend

- *RLI Ins. Co. v. Maxxon Southwest, Inc.*
  - A competitor of the insureds sued them, alleging wrongful behavior that began four years before the insurance policy was purchased, including discriminatory price fixing and an unlawful conspiracy.
  - Court found that the insureds knowingly engaged in conduct they knew could reasonably be expected to expose them to liability.
  - No duty to defend or indemnify.

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Fortuity & The Duty to Defend

- *Matagorda Ventures, Inc. v. Travelers Lloyds Ins. Co.*
  - Insureds were sued for trademark and copyright infringement.
  - Court rejected insureds' argument that fortuity protects against "previously incurred losses, not potentially previously incurred losses."
  - Relevant inquiry is not whether liability had already been adjudicated at policy inception, but whether insureds knew, when the policy was issued, that they had been engaging in activities for which they could possibly be found liable.
  - No duty to defend where insureds had begun the activities for which they claimed coverage before policy inception, had been warned of potential liability, then purchased the policy without disclosing the activities to their insurer.

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Fortuity & The Duty to Defend

- *Warrantech v. Steadfast*
  - Warrantech administered a computer warranty program and was alleged to have fraudulently or haphazardly matched unvalidated warranty repair claims to incomplete shell warranty contracts through use of linking software.
  - As a result of an audit, Houston General accused Warrantech of overpaying claims and demanded reimbursement of $19 million.
  - Warrantech denied the existence of the linking software and arbitration ensued among the Reinsurers and Houston General. Houston General won the arbitration.
  - Petition alleged that whomever lost the arbitration (Reinsurers) would look to Warrantech for payment.

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Fortuity & The Duty to Defend

- *Warrantech v. Steadfast*

  (*continued*)

  – Court analyzed the insurer's fortuity defense based on the allegations in the underlying complaint to determine the existence of a duty to defend under the eight-corners rule.

  – The court focused on the facts alleged in the pleadings, without regard to their truth or falsity.

  – Based upon these well-established principles, the court determined that the Reinsurers' petition compelled one conclusion – Warrantech knew of the loss caused by its mispayments of warranty claims long before the inception date of the policy, regardless of whether the mispayments were intentional or merely negligent.

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Fortuity & The Duty to Defend

- *Sentry Ins. v. DFW Alliance Corp.*
  - Under the known loss doctrine, insurer did not have a duty to defend insured because underlying complaint alleged that the insureds embarked on a program of subterfuge to prepare themselves to unfairly compete with the underlying plaintiff before the policies' inception.
- *Maryland Casualty Co. v. South Texas Medical Clinic*
  - Analyzing the insurer's fortuity defense under the eight-corners rule, court of appeals held that the facts alleged did not conclusively establish that STMC sought to insure a known or ongoing loss as a matter of law.

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Thank you!