

# **TEXAS INSURANCE LAW SYMPOSIUM**

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## ***STOWERS UPDATE: 2007***

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# STOWERS UPDATE: 2007

## I. STOWERS BASICS

Under Texas law, an insurer may be liable for negligently failing to settle within policy limits claims made against its insured. *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 314 (Tex. 1994); *G.A. Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544, 547-48 (Tex. Comm'n App.1929, holding approved). A *Stowers* duty is triggered by a settlement demand when: (1) the claim against the insured is within the scope of coverage; (2) the demand is within the policy limits; and (3) the terms of the demand are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment. *State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38, 41 (Tex. 1998); *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994). A *Stowers* claim is not a "bad faith" claim. *Maryland Ins. Co. v. Head Indus. Coatings and Services, Inc.*, 938 S.W.2d 27, 28 (Tex. 1996); *Garcia*, 876 S.W.2d at 847.

Evidence concerning claims investigation, trial defense, and conduct during settlement negotiations is "necessarily subsidiary to the ultimate issue of whether the claimant's demand was reasonable under the circumstances, such that an ordinarily prudent insurer would accept it." *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994). An insurer has no duty to make settlement proposals and, in fact, the insurer is not even obligated to solicit settlement offers from a third-party plaintiff. *American Physicians*, 876 S.W.2d at 849, 850 n. 17; *Insurance Corp. of Am. v. Webster*, 906 S.W.2d 77, 79 (Tex. App.–Houston [1st Dist.] 1995,

writ denied). Thus, the *Stowers* standard focuses solely on the reasonableness of the claimant's offer. *American Physicians*, 876 S.W.2d at 849.

Whether an insurer has satisfied the reasonableness standard will depend on issues of fact. The *Stowers* standard, like the traditional negligence standard, is inherently fact specific and will usually require fact-finder consideration. *See Westchester Fire Ins. Co. v. Admiral Ins. Co.*, 152 S.W.3d 172, 197 (Tex. App.–Ft. Worth 2004, pet. filed) (whether an ordinarily prudent insurer would have settled the underlying case within policy limits was question of fact for jury); 14 Couch on Ins. § 206:13. *See also Bailey, Vaught, Robertson and Co. v. Remington Investments, Inc.*, 888 S.W.2d 860, 867 (Tex. App.–Dallas 1994, no pet.) ("Reasonableness is generally a fact question.").

The reasonableness of an insurer's rejection of a *Stowers* demand depends, in part, on the potential exposure to an excess judgment. A question that comes up frequently is whether or not the insurer has to consider the insured's exposure to a potential award of punitive damages. *See, e.g., St. Paul Fire and Marine Ins. Co. v. Convalescent Services, Inc.*, 193 F.3d 340 (5<sup>th</sup> Cir. 1999) (holding under Texas law that insured could not recover from insurer portion of excess judgment attributable to punitive damages when policy specifically excluded coverage for punitive damages). The insurability of punitive damages is currently being litigated before the Texas Supreme Court. Obviously, if punitive damages are not insurable, either under policy language or because such coverage is against public policy, insurers will not be required to consider the risk of punitive damages in their evaluations of

Stowers demands and whether or not the insured reasonably fears a judgment in excess of policy limits. The question of the insurability of punitive damages is addressed below.

*American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994) is an important decision addressing the *Stowers* doctrine. *Garcia* addressed *Stowers* in the context of a situation where a plaintiff in a medical malpractice case tried to stack separate policies from consecutive years to achieve a greater policy limit for purposes of determining whether his settlement demand was within the policy limit and thereby invoking the *Stowers* doctrine. *Id.* at 843-45. The Texas Supreme Court announced several *Stowers* principles restricting the doctrine's application. Post-*Garcia*, the determination of whether *Stowers* duties are owed is, for the most part, a question of law. In addition, the plaintiff bears the burden of making a proper *Stowers* demand. *Id.* at 851 (“[c]onsidering the negotiating incentives for each party, we conclude that the public interest favoring early dispute resolution supports our decision not to shift the burden of making settlement offers under *Stowers* on to insurers”); *see also Birmingham Fire Ins. Co. v. American Nat'l Fire Ins. Co.*, 947 S.W.2d 592 (Tex. App.—Texarkana 1997, no writ) (noting that *Stowers* liability is premised purely on negligent failure to accept a reasonable settlement offer, it cannot arise from a “failure to negotiate” because the insurer has no duty to undertake actions often required for negotiation, such as make a counteroffer). *Garcia* also held that “[g]enerally, a *Stowers* demand must propose to release the insured fully in exchange for a stated sum of money, but may substitute ‘the policy limits’ for a sum certain.” *Id.* at 848-49. Additionally, *Garcia* stated there is no duty to settle uncovered claims. *Id.* at 848.

The Texas Supreme Court decided another “nuts and bolts” *Stowers* issue in *State*

*Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625 (Tex. 1998). *Traver* involved a situation where defense counsel retained by State Farm to represent its insured allegedly committed malpractice, thereby exposing the insured to damages in excess of policy limits. Accordingly, the insured sued State Farm for breach of its *Stowers* duties and argued that State Farm was vicariously liable for the malpractice of its appointed defense counsel. *Id.* at 626-28. The Texas Supreme Court reversed, holding “a liability insurer is not vicariously responsible for the conduct of an independent attorney it selects to defend an insured.” *Id.* at 628.

## II. SORIANO AND STOWERS LIABILITY IN THE MULTIPLE CLAIMANT CONTEXT

The application of the *Stowers* doctrine in the “multiple claimant” context was squarely presented in *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312 (Tex. 1994). The issue in *Soriano* was whether the insurer was negligent for failing to settle certain claims that were filed against its insured as a result of a car accident. Two sets of claimants, the Medinas and the Lopezes, sought recovery from the insured. The insured had only the minimum insurance coverage of \$20,000 per occurrence, and the insurer offered the full policy limits of \$20,000 to the Medinas, but the offer was refused. Subsequently, the Lopez's claim was settled for \$5,000. The insurer then offered the remaining \$15,000 to the Medinas, who demanded the original offer of \$20,000. The case went to trial, and the jury awarded the Medinas \$172,187 in damages.

Soriano assigned his rights against the insurer to the Medinas, who sued the insurer for its negligent handling of the Medinas' claims. The jury found that the insurer was negligent for failing to settle and awarded \$520,577.24 in

actual damages. The court of appeals affirmed the award, finding that there was some evidence that the Lopez settlement was unreasonable and negligent. The Texas Supreme Court reversed, holding that “an insurer may enter into a reasonable settlement with one of ... several claimants even though such settlement exhausts or diminishes the proceeds available to satisfy other claims.” 881 S.W.2d at 315. Put another way, when determining whether to accept a settlement demand in a case involving multiple claims and inadequate proceeds, an insurer may consider only the merits of that particular claim and the corresponding potential liability of its insured. The Texas Supreme Court explained that “[t]his standard is nothing more than what is required of an insurer under *Stowers*.” *Id.* See also *Travelers Indem. Co. v. Citgo Petroleum Corp.*, 166 F.3d 761 (5<sup>th</sup> Cir. 1999) (under Texas law, an insurer is not subject to liability for proceeding, on behalf of a sued insured, with a reasonable settlement once a settlement demand is made, even if the settlement eliminates or reduces to a level insufficient for further settlement coverage for a coinsured as to whom no *Stowers* demand has been made); *Kings Park Apartments, Ltd. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 101 S.W.3d 525 (Tex. App.–Houston Dist.] 2003, pet. denied) (in a case involving approximately 300 plaintiffs seeking more than \$100 million for health problems allegedly caused by the chlordane exposure, holding that National Union’s \$5 million payment exhausted its policy limits on behalf of Kings Park to settle the chlordane plaintiffs bodily injury claims. Because the policy had been exhausted, bad faith and Insurance Code violations could not have arisen from National Union’s failure to defend and settle future lawsuits); *Carter v. State Farm Mut. Auto. Ins. Co.*, 33 S.W.3d 369, 371 (Tex. App.–Fort Worth 2000, no pet.) (in the UM/UIM context, holding State Farm did not act unreasonably in settling with the two remaining claimants who were still willing to

negotiate the settlement of their claims – an insurer will not be liable in bad faith claims under Soriano for settling reasonable claims with one of several claimants even if such settlement exhausts or diminishes the proceeds, when faced with settlement demands arising out of multiple claims and inadequate proceeds).

### **III. STATE FARM V. MALDONADO AND BIFURCATED STOWERS DEMANDS**

In *State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38 (Tex. 1998), the Texas Supreme Court considered whether State Farm breached its *Stowers* duty to the insured by refusing to pay a \$1.3 million demand when policy limits were only \$300,000. The claimant had argued that the insured’s offer to pay \$1 million above policy limits converted the \$1.3 million demand into a \$300,000 policy limits demand. *Id.* at 41. The Texas Supreme Court found in favor of State Farm rendering a take-nothing judgment against the insured and the claimant. *Id.*

#### **A. Factual Overview**

In January 1991, Curtis Robert told a Brooks County district judge and the county auditor that his former bookkeeper, Adela Maldonado, had stolen \$500 from his safe deposit box and that she was a prostitute. Maldonado had worked for Robert before going to work for the county auditor. Because of Robert’s statements, Maldonado was passed over for a promotion to county auditor. Robert’s statements seriously damaged Maldonado’s reputation in the community. Robert ultimately confessed, however, that his charges of Maldonado’s being a thief and a prostitute were “completely false.”

As a result of Robert’s statements, Maldonado sued him for defamation. Robert

was insured by State Farm under a CGL policy covering up to \$300,000 in personal injury damages. State Farm defended Robert under a reservation of rights, hiring Roland Leon as Robert's counsel. As he investigated the claim, Leon became concerned that Maldonado's case against Robert appeared strong not only because of the harshness of the slander, but also because of Robert's lack of credibility. In fact, at one point Leon told State Farm that Robert's case was "horrible," that a "high dollar verdict can be expected," and finally that from a liability standpoint, it was the worst case he had ever seen.

In October 1991, Maldonado made a settlement demand to State Farm of \$1.3 million, open until November 15<sup>th</sup>. When State Farm did not accept the demand by the deadline, Maldonado and Robert entered into an agreement whereby Robert agreed to pay Maldonado \$1 million from his personal assets in return for Maldonado's promise not to collect on any later judgment against Robert. The agreement further provided that after Robert later recovered his \$1 million from State Farm in a bad faith lawsuit, he and Maldonado would split any remaining recovery.

The defamation case proceeded to a "trial" of sorts, although there was no jury, no testimony from Robert, and no evidence presented on behalf of the defense. Leon did not cross-examine any witnesses and did not present opening or closing arguments. Essentially, the entire trial consisted of Maldonado's witnesses' testimony. The judge rendered a \$2 million verdict for Maldonado. The appellate record, which the Court did not cite, indicated that Leon did not participate at "trial" because he did not want to do anything that would interfere with his client's settlement. According to Leon, "it wasn't really an adversarial situation."

Maldonado, as a judgment creditor and third-party beneficiary, and Robert then sued State Farm for negligence, gross negligence, violations of the Insurance Code, breach of contract, and breach of the duty of good faith and fair dealing. The jury found State Farm liable under each theory except gross negligence. Based on those findings, the trial court awarded Robert over \$6 million and Maldonado over \$1.5 million. The court of appeals affirmed in part and reversed in part.

#### **B. No *Stowers* Demand Within Policy Limits**

Examining Robert's *Stowers* claim, the Texas Supreme Court reiterated that a *Stowers* duty is triggered by a settlement demand when: (1) the claim against the insured is within the scope of coverage; (2) the demand is within the policy limits; and (3) the terms of the demand are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment. (Citing *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994)). "A demand above policy limits, even though reasonable, does not trigger the *Stowers* duty to settle." *Id.* Robert was thus required to show that Maldonado's demand of \$1.3 million was somehow transformed into an unconditional offer to settle within the policy limits of \$300,000. *Id.*

It was undisputed that Maldonado never made a settlement demand of less than \$1.3 million. Moreover, the court emphasized that State Farm did not know that Robert made "an unconditional offer to pay the \$1 million excess" and so it was not confronted with the question – left open in *APIE v. Garcia* – of whether a *Stowers* duty is triggered if an insured provides notice of his or her willingness to accept a reasonable demand above policy limits and to fund the settlement. Although

Maldonado claimed “it was understood” that the \$1.3 million settlement offer was bifurcated – \$300,000 from State Farm and \$1 million from Robert – the Court found no evidence that State Farm knew, at a point when it had a reasonable amount of time to respond, that Robert had made an unconditional offer to pay the excess. *Id.* Because Maldonado never made a demand within the policy limits, State Farm had no duty to respond to the demand in excess of policy limits; its failure to settle in response to that demand was not negligent. The Texas Supreme Court thus concluded that Maldonado’s settlement demand did not impose a *Stowers* duty on State Farm and there was no breach of its obligations to Robert. Accordingly, Robert could not recover from State Farm in tort. *Id.*

#### **IV. TRINITY v. BLEEKER: NO STOWERS LIABILITY WITHOUT A “FULL RELEASE” OF THE INSURED**

In *Trinity Universal Insurance Co. v. Bleeker*, 966 S.W.2d 489 (Tex. 1998), the Texas Supreme Court addressed the question of whether there can be a valid *Stowers* claim<sup>1</sup> when a third-party claimant does not offer to release the insured fully. Not surprisingly, the Court found that an insurer has no *Stowers* duty to settle when a claimant’s attorney never offers to fully release the insured as part of his settlement demand. *Id.* at 491. The facts of *Trinity v. Bleeker* are somewhat convoluted but are summarized, in relevant part, below.

##### **A. Facts and Procedure**

The insured, Bleeker, was involved in an automobile accident while under the influence of alcohol. In the accident, he struck a pick-up

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<sup>1</sup>*G.A. Stowers Furniture Co. v. American Indemn. Co.* 15 S.W.2d 544, 547 (Tex. Comm’n App. 1929, holding approved).

truck in which two separate families were traveling, killing one person and injuring thirteen others. *Id.* Bleeker had minimum insurance coverage with \$40,000 per occurrence limits. *Id.* Villegas, an attorney, was initially hired to represent five of the fourteen claimants; he made repeated oral offers to settle his clients’ claims that were rejected. *Id.* Villegas subsequently wrote to Trinity demanding that Trinity pay the \$40,000 policy limits into the registry of the court for distribution to his five clients and the other nine claimants whom he did not represent at the time. Trinity refused to pay the policy limits into the court registry without a full release from Bleeker. *Id.* Villegas would not promise to “fully release” the insured for a policy-limits settlement because hospital liens against his clients alone exceeded the \$40,000 policy limits.

The case was later tried to judgment, resulting in a damage award against the insured exceeding \$11 million. *Id.* The plaintiffs acquired the insured’s rights against his insurance company by assignment, and filed suit against Trinity, which resulted in a \$77,000,000.00 judgment based on DTPA and Insurance Code violations, common-law bad faith, and *Stowers* liability for negligently failing to settle. *Id.* The court of appeals reversed and rendered judgment for *Trinity* on all claims except the *Stowers* award, which it affirmed and one DTPA claim for unconscionable conduct that the trial court had refused to submit to the jury.

##### **B. The *Stowers* Claim Failed as a Matter of Law**

In rendering judgment that the insured and claimants take nothing, the Texas Supreme Court emphasized as a “threshold matter” that a settlement demand “must promise to release the insured fully in exchange for a stated sum of money.” *Id.* at 491 (citing *Texas Farmers Ins.*

*Co. v. Soriano*, 881 S.W.2d 312, 314 (Tex. 1994); *APIE v. Garcia*, 876 S.W.2d 842, 848-49, (Tex. 1994)). Assuming without deciding that Villegas' letter was in fact a settlement offer, and further assuming that a *Stowers* demand may be made on behalf of only some of a total pool of potential plaintiffs, Villegas' *Stowers* demand still did not meet the requirement that he offer to release those claims fully. *Id.*

Trinity never had a *Stowers* duty to settle because Villegas never offered a full release even of his five clients' claims. Villegas made one written and several oral offers to settle, but none of these offers included or even mentioned hospital liens that exceeded the \$40,000 policy limits. In fact, when Villegas had contacted the hospitals, they had refused to release their liens. *Id.* at 491. As a result, Villegas could not possibly have fully settled the case against the insured, even for his five clients. *Id.* Accordingly, the *Stowers* claim failed as a matter of law.

### **C. The DTPA Claims also Failed as a Matter of Law**

The Court also held that there was no evidence that Trinity's failure to inform the insured of the claimant's settlement demand was a producing cause of damages, because there was no evidence that the insured or his attorney would have been inclined to meet the claimants' demands. As a result, the insured's DTPA "failure to inform" and unconscionability claims both failed as well. *Id.* at 492. Both DTPA claims depended on one allegation: that Trinity failed to inform Bleeker and his attorney of Villegas' letter. Because there was no evidence of producing cause, the Court did not consider Trinity's assertion that the insured could not state a DTPA claim based on Trinity's handling of a third-party settlement demand. *Id.*

## **V. ROCOR RECOGNIZES ARTICLE 21.21 CAUSE OF ACTION IN THE THIRD-PARTY LIABILITY CONTEXT**

In a recent decision *Rocor International Inc. v. National Union Fire Insurance Co.*, 77 S.W.3d 253 (Tex. 2002) – the Texas Supreme Court recognized a cause of action under article 21.21 of the Insurance Code for an insurer's failure to attempt settlement of a third-party claim when liability has become reasonably clear. In recognizing a cause of action in the third-party context for failing to settle when liability is "reasonably clear," the court appears to have revised its thinking since *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994), which refused to recognize an Insurance Code claim in this context. *Id.* at 847 ("[b]reach of the *Stowers* duty does not constitute a violation of article 21.21 or the DTPA"). The *Rocor* majority emphasized that *Garcia* does not limit an insured's statutory claims against its own insurer for unfair claim settlement practices to first-party insurance claims. 77 S.W.3d at 260. Unable to identify a "principled basis upon which to draw a distinction between first-party and third-party claims" for unfair claim settlement practices," the *Rocor* court recognized the cause of action, but entered a "take nothing" judgment against plaintiffs because there was no evidence of a proper settlement offer. *Id.* at 265.

### **A. Background Facts**

An insured trucking company, *Rocor*, had primary liability policy limits of \$1 million, a \$1 million self-insured retention, and an \$8 million excess liability policy with National Union when one of its drivers ran off the road and killed two police officers. *Id.* at 256. Because the driver was intoxicated, attempted to flee the scene, and offered an implausible

explanation for the accident, *Rocor* and its attorney concluded that *Rocor* faced significant liability and put National Union on notice its excess coverage would probably be reached. *Id.* National Union assumed control of settlement negotiations, canceled a scheduled mediation, and directed that no offer be made to plaintiffs. *Id.* Over the next 14 months, the parties exchanged a number of settlement propositions “for widely varying amounts.” *Id.* Plaintiffs subsequently orally demanded \$4.5 million but, it was unclear whether this demand was intended to settle the claims for everyone, adults and children. *Id.* at 256-57. Plaintiffs’ attorney later testified that he considered the demand \$6.3 million to settle all of the plaintiffs’ claims. Shortly after this oral demand, plaintiffs made their only formal written settlement offer for \$10 million, which all parties agreed was merely an attempt to “*Stower-ize*” National Union and pressure them for a counteroffer. *Id.* at 257. After two mediations and continued negotiation, the claims eventually settled for \$6.4 million. *Id.*

*Rocor* filed suit to recover attorneys’ fees and expenses it incurred in continued trial preparation as a result of National Union’s alleged failure to promptly effectuate settlement, under both common-law negligence and Article 21.21. The jury found in favor of *Rocor* on both theories, but the trial court granted judgment n.o.v. in favor of National Union, which argued that *Rocor* was not entitled to maintain either action and, alternatively, that no evidence supported the findings. *Id.* A divided court of appeals reversed and rendered judgment in favor of *Rocor* on the negligence theory. *Id.* at 257-58.

A sharply divided Texas Supreme Court reversed the court of appeals. The five-justice majority and two-justice concurring opinions agreed that there was no evidence of a concrete demand to indicate that settlement could have

occurred before it did. *Id.* at 263; Hecht, J., concurring op. at 265. Concurring in the judgment only, Justice Hecht emphasized that prior cases clearly reject any statutory duty under article 21.21 to third-party claims.<sup>2</sup> The *Rocor* majority, however, holds that an insured may have an article 21.21 cause of action against its insurer in the context of both first and third-party claims “when the insured has been directly injured as a result of its insurer’s unfair claim settlement practices,”<sup>3</sup> based on article 21.21’s liability standard that an insurer must “attempt in good faith to effectuate prompt, fair, and equitable settlement of claims submitted . . . in which liability has become reasonably clear.”<sup>4</sup>

## **B. Elements of the Article 21.21 Cause of Action in the Third-Party Context**

*Rocor* recognized that an insurer has a statutory duty to reasonably attempt settlement of a third-party claim against its insured when a claimant has presented the insurer with “a proper settlement demand within policy limits that an ordinarily prudent insurer would have accepted.” A “proper settlement demand”

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<sup>2</sup>*Maryland Ins. Co. v. Head Indus. Coatings and Services, Inc.*, 938 S.W.2d 27, 28 (Tex. 1996) (precluding “bad faith” liability in the third-party context); *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 847 (Tex. 1994) (“[b]reach of the *Stowers* duty does not constitute a violation of article 21.21 or the DTPA”).

<sup>3</sup>77 S.W.3d at 260. This holding is significant because it establishes potential for liability in the third-party context in addition to *Stowers* liability, thereby resolving the debate that has occurred since the court’s decision in *Head*. However, the holding raises new questions regarding the availability of double or treble damages in appropriate *Stowers* cases when article 21.21 is pled as an alternate theory of liability.

<sup>4</sup>*Id.* at 264. With regard to *Rocor*’s alternate theories of misrepresentation and negligence, the court refused to consider the legal validity of the claims and simply affirmed the judgment n.o.v. based on “no evidence.”

generally must propose to release the insured fully in exchange for a stated sum, and at a minimum, the settlement demand must clearly state a sum certain and propose to fully release the insured. 77 S.W.3d at 261.

*Rocor* specifically holds that an insured may assert a cause of action against its insurer under article 21.21 for failure to attempt settlement of a third-party claim, once liability has become reasonably clear. Slip op. at 16. To establish liability, the insured must show:

- (1) the policy covers the claim;
- (2) the insured's liability is reasonably clear;
- (3) the claimant has made a proper settlement demand within policy limits; and
- (4) the demand's terms are such that an ordinarily prudent insurer would accept it.

*Id.*

### **C. Plaintiffs "Take Nothing" Despite *Rocor's* Recognition of Article 21.21 Cause of Action in the Third-Party Context**

Applying this standard, the *Rocor* majority concluded that although the first two elements were satisfied, the plaintiffs failed to make a proper settlement demand with terms a prudent insurer would accept. 77 S.W.3d at 262-63. Furthermore, while the court acknowledged that a "formal settlement demand [i.e., written] is not absolutely necessary," the demand's terms must, at a minimum, be "clear and undisputed," which was not so in this case. *Id.* at 263. Finally, the court also held that duties under *Stowers* and article 21.21 not only do not depend on a contractual duty to defend, but also attach when the insurer exercises control over settlement.

In dissent, Justice Baker argued that the

majority impermissibly grafts a common-law standard on the statute when a standard is already present. Baker, J., dissenting op. at 269. The dissent argues that the "attempting in good faith" language of the statute requires the insurer "to take good faith affirmative steps to effectuate a settlement" once liability is clear. *Id.* Citing the varying purposes served by the *Stowers* and statutory duties, Justice Baker argues that using the same standard is inappropriate: "reasonably clear liability" triggers the statutory duty to prevent an insurer from prolonging a dispute's resolution and causing the insured to sustain damages but is irrelevant to the *Stowers* duty, which may be triggered even for meritless claims that still expose the insured to significant liability because of the particular circumstances. *Id.* at 271. Justice Baker would hold that an insured establishes liability under article 21.21 if the insurer fails to initiate settlement discussions when the insured's liability – irrespective of damages – is "reasonably clear." *Id.* In Justice Baker's view, there was more than a scintilla of evidence supporting the jury's conclusion that National Union failed to attempt, in good faith, to effectuate a prompt, fair, and equitable settlement once liability became reasonably clear. *Id.* at 272.

### **D. *Rocor* and Excess/Primary Insurance Issues**

*Rocor* has not yet generated a suit based on subrogation to an insured's *Stowers* action. Prior to *Rocor*, in *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 485 (Tex. 1992), Justice Hecht wrote a concurring opinion indicating a subrogating excess carrier may recover only the difference between what it was required to pay and what it would have paid but for the primary carrier's negligent handling of the action, plus interest; is not entitled to damages in its own right, or statutory or punitive damages. *Id.* (citing *InterFirst Bank*

*Dallas v. United States Fidelity & Guar. Co.*, 774 S.W.2d 391, 399 (Tex. App.–Dallas 1989, writ denied) (subrogee limited to recovery of amount paid); *McAllen State Bank v. Linbeck Constr. Corp.*, 695 S.W.2d 10, 24 n. 5 (Tex. App.–Corpus Christi 1985, writ ref’d n.r.e.) (subrogee not entitled to statutory damages under Texas Deceptive Trade Practices-Consumer Protection Act). The Houston court of appeals followed Justice Hecht’s lead, holding that an excess carrier, who brings suit based on the doctrine of equitable subrogation, cannot recover statutory or punitive damages from the primary carrier or the insured’s defense counsel, thus barring a 21.21 claim. *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Insurance Co. of North America*, 955 S.W.2d 120 (Tex. App.–Houston [14<sup>th</sup> Dist.] 1997), *aff’d sub. nom.*, *Keck, Mahin & Cate v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 20 S.W.3d 692 (Tex. 2000). This holding was not appealed to the Supreme Court. 20 S.W.3d at 696 n. 1.

In several cases, the Texas Supreme Court has indicated that an insurer has a duty of ordinary care that includes “investigation, preparation for defense of the lawsuit, trial of the case and reasonable attempts to settle.” *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d 656, 659-660 (Tex. 1987) (judgment against insurer, was supported by evidence of, among other things, insurer’s linking together the settlements of multiple insureds even though the demand was severable, insurer’s failed to inform its insureds of the terms of the demand); *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 485 (Tex. 1992) (plurality and concurring opinions) (citing *Ranger* for standard of reasonableness in “investigating, preparing to defend, trying or settling the third party action”); *American Physicians Ins. Exchange v. Garcia*, 876 S.W.2d 842, 847 n. 11 (Tex. 1994). Texas courts have recognized that the failure to disclose the existence of a settlement offer may

constitute a violation of the DTPA. *American Physicians*, 876 S.W.2d at 847 n. 11; *Ecotech Int’l, Inc. v. Griggs & Harrison*, 928 S.W.2d 644, 649 (Tex. App.–San Antonio 1996, writ denied). *See also Allstate Ins. Co. v. Kelly*, 680 S.W.2d 595, 598, 200, 608-609 (Tex. App.–Tyler 1984, writ ref’d n.r.e.) (Allstate may have violated the DTPA by, in addition to refusing to settle, seeking to pay its policy limits into the court registry and leave its insured exposed in the event of an excess judgment, encouraging its insured not to hire counsel, and neglecting to inform its insured of the settlement demand or its reasons for rejecting the demand until over two months after the demand had expired). However, these cases generally involve affirmative misconduct by the insurer to subvert or terminate settlement negotiations. *American Physicians*, 876 S.W.2d at 850 n. 17. *See Birmingham Fire Ins. Co. of Pennsylvania v. American Nat. Fire Ins. Co.*, 947 S.W.2d 592, 598-99 (Tex. App.–Texarkana 1997, writ denied) (declining to hold that *American Physicians* creates an “affirmative misconduct” exception to the *Stowers* requirement of a “within limits” settlement demand).

Even if such a failure to disclose settlement offers constitutes a DTPA violation, however, the insured must show that informing them of the settlement offer would have led to the offer’s being accepted. Failure to do so precludes the DTPA action as a matter of law. *Trinity Universal Ins. Co. v. Bleeker*, 944 S.W.2d 672, 679 (Tex. App.–Corpus Christi 1997), *aff’d in part*, *Trinity Universal Ins. Co. v. Bleeker*, 966 S.W.2d 489 (Tex. 1998).

## **VI. EXCESS v. PRIMARY INSURER ISSUES IN THE STOWERS CONTEXT**

Any *Stowers* claim brought by an excess insurer arises out of its right to subrogate to the rights of the primary carrier’s insureds.

Subrogation is the substitution of one person in the place of another with reference to a lawful right or claim. *Cockrell v. Republic Mortgage Ins. Co.*, 817 S.W.2d 106, 113 (Tex. App.—Dallas 1991, no writ). Subrogation can arise from contract or from equity. *Liberty Mut. Ins. Co. v. General Ins. Corp.*, 517 S.W.2d 791, 797 (Tex. Civ. App.—Tyler 1974, writ ref'd n.r.e.). Once an excess insurer shows itself entitled to contractual or equitable subrogation, it is considered to have “standing” to bring a *Stowers* action against the primary insurer, but it must still prove all the elements of the *Stowers* action. See *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, — S.W.3d —, 2004 WL 2793239, \*6 (Tex. App.—Ft. Worth, Dec. 2, 2004, pet. filed) (en banc).

Equitable subrogation permits an excess insurer “to maintain any action that the insured may have against the primary carrier for mishandling the claim.” *Am. Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 483 (Tex. 1992). Since the excess insurer stands in the shoes of the insured, equitable subrogation permits the primary insurer to raise in the *Stowers* action any defenses it would have had against the insured itself, including the refusal to settle and the failure to cooperate. *Id.* Generally, contractual subrogation is examined within the framework of equitable subrogation and conforms with its principles, unless the contract indicates otherwise. See *Foremost County Mut. Ins. Co. v. Home Indem. Co.*, 897 F.2d 754, 762 (5<sup>th</sup> Cir.1990).

Thus, whether an insurer pursues equitable or contractual subrogation, the excess carrier may rely on the insured’s arguments, e.g., that the primary insurer waived defenses by failing to reserve rights. The primary insurer, on the other hand, may raise coverage defenses it would have had against the insured, such as failure to cooperate or that punitive damages were not insurable.

**A. Equitable Subrogation Requires that the Excess Carrier’s Payment be Involuntary.**

The two key elements of equitable subrogation are: (1) that the party on whose behalf the claimant discharged the debt was primarily liable on the debt, and (2) that the claimant paid the debt involuntarily. *Argonaut Ins. Co. v. Allstate Ins. Co.*, 869 S.W.2d 537, 542 (Tex. App.—Corpus Christi 1993, writ denied). Voluntariness is usually the major issue. An excess insurer’s settlement of a case is involuntary – even if the excess carrier’s own policy did not provide coverage – if, at the time of the settlement, the excess carrier made the payment in good faith and reasonably believed the payment was necessary for its protection. *Keck, Mahin & Cate v. National Union Fire Insurance Co. of Pittsburgh, PA*, 20 S.W.3d 692, 702-03 (Tex. 2000). Texas courts are liberal in finding that such payments by excess insurers are involuntary, and presume the involuntary character of such payments. *Id.* at 702. E.g., *Argonaut Ins. Co. v. Allstate Ins. Co.*, 869 S.W.2d 537 (Tex. App.—Corpus Christi 1993, writ denied) (reversing summary judgment finding excess insurer’s payment was voluntary because a fact issue existed).

**B. *Keck, Mahin* Addresses Primary/Excess Issues in *Stowers* Context.**

In *Keck, Mahin & Cate, Grant, Cook v. National Union Fire Insurance Co.*, 20 S.W.3d 692 (Tex. 2000), an excess insurer brought an equitable subrogation suit against a primary insurer and the insured’s attorneys to recover for the mishandling of the defense. The primary carrier argued that the excess carrier bore some comparative responsibility for the entry of the excess judgment because a reasonably prudent excess carrier would have done more to protect itself from liability. 20 S.W.3d at 702.

Specifically, the primary carrier suggested that the excess carrier should have explored coverage issues more diligently, reserved its rights against the insured, investigated the merits of the third-party claim more thoroughly, hired independent counsel to monitor the third-party claim, supervised its claims adjuster more closely, and demanded to settle the claim months before trial. *Id.* The court disagreed, holding that the excess carrier could not have been negligent in failing to take the suggested actions because it had no duty to act before the primary carrier tendered its limits. Prior to such tender, the excess carrier was not required to supervise the insured's defense and had no duty to anticipate that the carrier and its attorneys were not performing appropriately. *Id.*

Texas courts are liberal in finding that such payments by excess insurers are involuntary, and presume the involuntary character of such payments. *Id.* at 702. At best, primary insurers will have an opportunity to convince a jury that the excess insurer did not reasonably believe a given payment was necessary for its own protection. *E.g., Argonaut Ins. Co. v. Allstate Ins. Co.*, 869 S.W.2d 537 (Tex. App.–Corpus Christi 1993, writ denied) (reversing summary judgment finding excess insurer's payment was voluntary because a fact issue existed).

### **C. The Volunteer Doctrine does not Apply to Contractual Subrogation.**

Contractual subrogation arises from express agreement, as in the subrogation clause of an insurance policy. *Employers Cas. Co. v. Transp. Ins. Co.*, 444 S.W.2d 606, 610 (Tex. 1969). Contracts that give insurers the right to subrogation “confirm, but [do] not expand, the equitable subrogation rights of insurers.” *Esparza v. Scott & White Health Plan*, 909 S.W.2d 548, 552 (Tex. App.–Austin 1995, writ denied). “While an insurance contract providing

expressly for subrogation may remove from the realm of equity the question of whether the insurer has a right to subrogation, it cannot answer the question of when the insurer is actually entitled to subrogation or how much it should receive.” *Id.* at 551. *See Foremost County Mut. Ins. Co. v. Home Indem. Co.*, 897 F.2d 754, 762 (5<sup>th</sup> Cir.1990) (“Unless the contract indicates otherwise contractual subrogation is examined within the framework of the doctrine of equitable subrogation and is subject to conformity with its principles.”).

The volunteer doctrine does not apply to contractual subrogation. *Employers Cas. Co.*, 444 S.W.2d at 610 (when a claim is asserted under a policy through a contractual subrogation provision, whether a payment is more than required by the policy or made voluntarily is immaterial); *Dawson v. Chicago Title Ins. Co.*, 2002 WL 80162 (Tex. App.–Dallas 2002, no pet.); Allan D. Windt, INSURANCE CLAIMS AND DISPUTES § 10:10 (4<sup>th</sup> Ed. 2005). An excess insurer can avoid the volunteer doctrine if it secures an assignment from the insureds of all claims against the primary insurer. *Id.*

### **D. Westchester Fire v. Admiral Insurance Raises Issues Relating to the Insurability of Punitive Damages and Stowers in the Excess Context**

*Westchester Fire Insurance Company v. Admiral Insurance Co.*, 152 S.W.3d 172 (Tex. App.–Ft. Worth 2004, pet. filed) involved an excess insurer's (Westchester) equitable subrogation action against the primary insurer (Admiral) of a nursing home (owned by PeopleCare). Westchester brought a *Stowers* action against Admiral for negligently failing to settle a claim against the nursing home within policy limits. PeopleCare had a \$1 million primary policy with “eroding, burning, or wasting” limits that were reduced by the expenditure of attorney's fees and costs. The

Westchester excess policy provided \$10 million of excess insurance above the primary limits.

### **1. Overview of the Underlying *Cagle* Action**

In 1994, PeopleCare (the owner of a nursing home) was sued by Beulah Cagle and her daughter for negligence, gross negligence, and DTPA violations in the treatment of Beulah at the nursing home. Beulah was repeatedly left in a “urine soaked bed” and developed decubitus ulcers and all the complications such inadequate nursing care entails. 152 S.W.3d at 176. Admiral hired Gardere & Wynn to defend PeopleCare. After a bench trial, the Court found that PeopleCare was grossly negligent in its treatment of Beulah, and that it knowingly misrepresented the nature of Beulah’s injuries to her daughter. As a result, the trial court awarded compensatory damages, prejudgment interest, mental anguish damages, treble damages, and attorney’s fees in the amount of \$2 million. The trial court then scheduled a hearing on exemplary damages. Before that hearing, Westchester settled the underlying action for \$4 million, with Admiral tendering its policy limits and Westchester contributing the remainder.

### **2. Overview of the Equitable Subrogation/*Stowers* Action**

Westchester subsequently filed suit against Admiral alleging that Admiral failed to settle the Cagles’ claims against PeopleCare within the limits of the primary insurance policy. Before trial of the underlying action, the trial court ruled that insurance coverage for punitive damages violates public policy. *Id.* at 176.<sup>5</sup> Westchester also sued Gardere & Wynn

for negligence in defending PeopleCare in the underlying action. Before Admiral completed its case-in-chief, Westchester settled with Gardere & Wynn for an amount greater than the amount by which the Cagles’ compensatory damages exceeded Admiral’s settlement contribution. Accordingly, on Admiral’s motion, the trial court granted Admiral a directed verdict on the ground that Admiral was entitled to a credit in the amount of Gardere & Wynn’s settlement with Westchester, and the amount of the credit exceeded the damages Westchester could recover from Admiral. *Id.* at 177.

### **3. Holding of the Court of Appeals**

On appeal, Westchester argued that punitive damages were covered under the Admiral policy and should have been considered in Admiral’s assessment of risk. Westchester also emphasized that its payment as an excess insurer of \$4 million to settle the underlying action was “involuntary,” because that payment was made in good faith and Westchester reasonably believed the settlement was necessary for its own protection. *Id.* at 179.

The Fort Worth Court of Appeals determined that: (1) public policy at the time the *Cagle* case was decided did not preclude coverage under Admiral’s policy for amounts attributable to punitive damages; and (2) the Admiral policy and professional malpractice endorsement did not exclude punitive damages from coverage. *Id.* at 197. The court thus reversed the part of the trial court’s partial summary judgment determining that public policy at the time the *Cagle* case was tried and settled precluded coverage under Admiral’s policy for punitive damages, and excluding

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<sup>5</sup>Westchester did not challenge the trial court’s directed verdict denying Westchester recovery from Admiral for amounts attributable to treble damages and

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attorney’s fees awarded to Lola Cagle for PeopleCare’s DTPA violations on the basis that those damages were not within coverage of the Admiral policy. *Id.* at 177.

from Westchester's potential damages recovery of the amount of Westchester's settlement contribution attributable to punitive damages on Beulah's claim. *Id.* Because Admiral's settlement credit was less than the amount of Westchester's potential recovery (i.e., the portion of Westchester's settlement contribution attributable to the Cagles' compensatory damages and punitive damages on Beulah's claim), the Fort Worth court reversed the trial court's directed verdict in Admiral's favor and remanded the case for a new trial on Westchester's *Stowers* claim.

#### **4. "Gross Negligence" Claim Against the Nursing Home Was Covered under the Policy**

Admiral's primary policy provided both commercial general liability coverage and professional medical liability coverage. Admiral claimed that the policy precluded coverage because "grossly negligent" behavior could never reflect accidental error or omission. *Id.* at 181. The medical liability portion of the Admiral policy, however, broadly covered any liability because of bodily injury arising out of "nursing treatment." *Id.* The Fort Worth Court of Appeals found that the medical liability provision covered Peoplecare's "gross negligence" related to its failure to render appropriate care to Beulah Cagle. *Id.* In so holding, the court emphasized that Admiral itself believed punitive damages were not excluded from the policy. *Id.* at 182.

#### **5. Public Policy Did Not Preclude Coverage for Punitive Damages**

While declining to address Admiral's argument that punitive damages are *currently* uninsurable in Texas, the Fort Worth Court of Appeals held that at all relevant times in the *Cagle* suit (between 1993-1995) punitive damages *were insurable* under a professional

medical liability policy. *Id.* at 189-90. In 1993 (when the policy originally issued), 1994 (at the time of the occurrence in question), and 1995 (when the suit was filed and settled), the legislature had authorized the imposition of punitive damages as "an example to others."<sup>6</sup> The appellate court thus found that the trial court's imposition of punitive damages would not have violated one of the express statutory purposes then in effect.

The court noted that in response to the *Moriel* decision,<sup>7</sup> the legislature had revised the statutory provisions regarding exemplary damages during the 1995 legislative session,<sup>8</sup> deleting the words "as an example to others," and leaving the definition of exemplary damages as "any damages awarded as a penalty or by way of punishment." *Id.* at 108-09. It was not until 2001 that the legislature added for-profit nursing homes to the list of entities prohibited from obtaining coverage for punitive damages under a primary insurance policy, but at the same time the legislature included them in the list of entities that could obtain a specific endorsement for such coverage.

#### **6. Proper *Stowers* Demand Within Policy Limits?**

On appeal, Admiral asserted that there was no evidence the Cagles made a settlement demand that triggered Admiral's duty to settle under *Stowers*. The court of appeals disagreed finding there was some evidence of a proper *Stowers* demand, and holding that the trial court

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<sup>6</sup>Act of June 13, 1987, 70<sup>th</sup> Leg., 1<sup>st</sup> C.S., Ch. 2 § 212 1987, Tex. Gen. Laws 37, 44.

<sup>7</sup>*Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10 (Tex. 1994) clarified that in Texas "punitive damages are levied for the public purpose of punishment and deterrence."

<sup>8</sup>See Act of April 11, 1995, 74<sup>th</sup> Leg. R.S., Ch. 19 § 1, 1995 Tex. Gen. Laws 108, 108-13.

erred by granting a motion for directed verdict in Admiral's favor. The evidence regarding the plaintiffs' *Stowers* demand was convoluted at best.

Counsel apparently first discussed settlement of the case in February 1995 after a pretrial conference. At that time, plaintiffs' counsel indicated he would be seeking the nursing home's "policy limits." *Id.* at 192. Later that month, defense counsel forwarded the declarations page of the policy to plaintiffs showing the Admiral policy had "eroding" limits.<sup>9</sup> In such a policy, the limits are diminished by defense costs and expenses. Plaintiffs' counsel orally communicated to defense counsel on at least one other occasion that he was seeking the nursing home's policy limits. On April 25, 1995, defense counsel wrote Admiral indicating that plaintiff was "basically . . . willing to settle for the full policy limits." Defense counsel indicated that she did not see any of these conversations with plaintiffs' counsel as including firm settlement offers, but viewed them as more exploratory and positioning in nature. *Id.* at 192.

Later, on July 19, 1995 plaintiffs' counsel specifically asked "what amount of insurance is left out of the aggregate, of this primary policy?" *Id.* Defense counsel responded that she thought the entire \$2 million aggregate was still in place, and noted that the "insurance policies are sufficient to cover [plaintiffs'] claims." *Id.* On August 1, 1995, plaintiffs' counsel sent two letters stating that plaintiffs' settlement demands would exceed coverage limits for the primary policies, and noting that Westchester (the excess carrier) should receive notice. On August 9, 1995, plaintiffs' counsel sent a written settlement

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<sup>9</sup>Policies with "eroding" limits are sometimes referred to as "burning," "exhausting," or "wasting" policies.

demand stating "[w]e are willing at this time to settle this case for the policy limits of the primary insurance policy: \$1,000,000.00. I trust that you will apprise the excess carrier of the fact that this case can be settled at this time within the limits of the primary insurance policy." *Id.* at 193. At the time he made this demand, plaintiffs' counsel understood primary limits to be \$1 million. *Id.* He testified that he was basically "tricked" into not making a *Stowers* demand within policy limits. Some of the testimony indicated that at mediation, plaintiffs were aware of the eroding nature of the policy, and demanded \$1 million or whatever was left. *Id.*

At mediation, the nursing home made an opening offer of \$40,000. The mediator said the offer needed to be in a \$500,000 range or the mediation would end immediately. The attorneys then spoke outside the presence of the mediator and plaintiffs were told the nursing home could not settle for \$1 million even if it wanted to because the policy was a "wasting" policy. Defense counsel allegedly said "if you don't have \$1,000,000 then you're going to need to get up just as close to \$1,000,000 as you can come . . . ." *Id.* at 194. The mediation ended without a settlement. *Id.* at 195.

On August 17, 1995, the insured informed Admiral that "the demand for settlement is currently within the basic insured amount," and requested that Admiral "attempt to get this account settled as soon as possible." *Id.* On August 24, 1995, Admiral confirmed receipt of plaintiffs' "\$1,000,000" demand. On September 21, 1995, in response to a structured settlement offer, plaintiffs increased their demand to \$1,750,000 for Beulah and \$150,000 for her daughter. Plaintiffs emphasized that defendants had been "given an opportunity to settle [the] case within the primary policy limits at mediation." *Id.* at 195. On this record, the Fort Worth Court of Appeals held there was a

fact question as to whether plaintiffs had made a settlement demand within policy limits. The court also determined that Admiral had failed to establish conclusively that an ordinarily prudent insurer would not have accepted plaintiffs' policy limits demand. The directed verdict in favor of Admiral on this ground was thus improper.

### **E. *Royal Insurance v. Caliber One* Addresses the Excess Carrier's Equitable Subrogation Rights**

In *Royal Insurance Co. of Am. v. Caliber One Indem. Co.*, 465 F.3d 614 (5<sup>th</sup> Cir. 2006) an excess carrier (Royal) sued two primary carriers, Caliber One and Hartford to recover \$1,000,000 paid on behalf of an insured nursing home (Methodist) in settling wrongful death and survival claims arising out of the care of a nursing home resident (Trevino). Methodist's policy with Hartford provided \$1,000,000 for each "medical incident" or "occurrence" between April 1, 1997 and April 1, 1999. Caliber One provided the same type of coverage for April 1, 1999 to April 1, 2000. Royal provided excess coverage for April 1, 1999 to July 1, 2000. Hartford and Caliber One had agreed to share the cost of defending Methodist, while reserving their rights to deny coverage. 465 F.3d at 616.

#### **1. The Underlying Settlement**

In the wrongful death action, Trevino's family offered to settle for \$3,000,000 and Methodist sent a "*Stowers*" demand letter to Hartford, Caliber One, and Royal requesting that they accept the offer. At the time, Methodist believed it had \$1,000,000 in primary coverage. *Id.* at 616. Royal took the position that limits of both policies were available because there was more than one occurrence. *Id.* After negotiations, the Trevino family settled for \$2,000,000. Caliber One contributed

\$800,000 and Hartford contributed \$200,000, and Royal contributed \$1,000,000 under protest. Royal then sued Hartford and Caliber One to recoup the \$1,000,000 it had paid.

#### **2. Summary Judgment Ruling**

On cross motions for summary judgment, the trial court ruled in favor of the primary insurers and against Royal (the excess carrier). The court ruled as follows:

- an excess carrier has an equitable subrogation claim against a primary insurer "only when it is predicated on the violation of a tort duty owed the insured";
- neither of the primary carriers had been negligent;
- the insured had indicated it had only \$1,000,000 in primary coverage and this was a binding admission;
- there was only one occurrence or medical incident within the meaning of the policies because Trevino's death stemmed from an ongoing course of care and treatment;
- under such circumstances, Texas law does not allow an insured to "stack" coverage, and the highest limits under any one policy apply, even if the negligence spanned multiple policy periods; and
- the trial court concluded that Hartford and Capital One had tendered the full limits: \$1,000,000.

*Id.* at 617-18.

### 3. Fifth Circuit Finds Liability for One Primary Insurer and Not the Other

Affirming the summary judgment in favor of Hartford, and reversing the summary judgment in favor of Caliber One, the Fifth Circuit held that Hartford's policy did not apply to acts and omissions after April 1, 1999, and so Royal could not look to Hartford for payment. In so holding, the Fifth Circuit emphasized that although Methodist's employees were negligent during the period the Hartford policy was in effect, this negligence caused only "relatively minor" injuries to Trevino. *Id.* at 623.<sup>10</sup> These injuries were divisible from the alleged acts of negligence that occurred a year later (during the Caliber One policy period) that caused pneumonia, and a massive, infected Stage IV pressure sore and resulting sepsis, leading to Trevino's death. *Id.*

The trial court also erred in concluding that Royal could not pursue a claim against the primary carriers simply because the insured believed policy limits were only \$1,000,000. *Id.* at 620. The appellate court noted that because the insured had little incentive to enforce the primary carrier's duties, the excess carrier should be permitted to do so. *Id.* Citing Justice Hecht's opinion in *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 485 (Tex. 1992), the Fifth Circuit noted that when a primary carrier "negligently investigat[ed], prepar[ed] to defend, tr[ie]d or settl[ed] the third-party action and the amount of the judgment or cost to settle was thereby increased," the excess carrier could recover the extra amounts it had to pay an insured as a

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<sup>10</sup>These injuries included a failure to clean Trevino properly that lead to rashes and a urinary tract infection. Failure to supervise Trevino and to secure her wheelchair caused bruises on her hands. Her stomach pain was ignored, and nurses massaged damaged skin causing skin abrasions and pain. *Id.* at 623.

result. *Id.* at 618. *But see Wayne Duddleston, Inc. v. Highland Ins. Co.*, 110 S.W.3d 85, 97 (Tex. App.—Houston [1<sup>st</sup> Dist.] 2003, rev. denied) (noting that *APIE v. Garcia* limited the broad language used in *Ranger* regarding an insurer's duties, and noting the absence of authority from the Texas Supreme Court that expressly permits plaintiffs to sue insurers outside the scope of *Stowers* for the negligent handling of claims).

### F. Fifth Circuit Certifies Issue of Settlement Duties of Co-Primary Insurers in *Liberty Mutual v. Mid-Continent*

In *Liberty Mutual Ins. Co. v. Mid-Continent Ins. Co.*, 405 F.3d 296 (5<sup>th</sup> Cir. 2005) the Fifth Circuit certified to the Texas Supreme Court the question of when a settlement requires funding from multiple insurers where no single insurer can fund the settlement within the limits that apply under its particular policy. *Id.* This *Stowers* issue was left open in *APIE v. Garcia*. See 876 S.W.2d at 849 n. 13.

#### 1. Overview of *Liberty Mutual v. Mid-Continent*

*Liberty Mutual v. Mid-Continent* involved a situation in which the CGL insurer (Liberty Mutual) of a highway construction contractor brought suit against a co-insurer (Mid-Continent) seeking further contribution for settlement of a negligence suit arising from an automobile collision at a construction site. Each insurer assumed the defense of Kinsel Industries ("Kinsel"), a covered insured under each of their respective \$1 million CGL policies. *Id.* at 298. Although the case against Kinsel ultimately settled for \$1.5 million, Mid-Continent contributed only \$150,000, so Liberty Mutual (which also had a \$10 million excess policy) paid the remaining \$1,350,000 and then brought suit against Mid-Continent for what it contended

Mid-Continent was obligated to pay as its proportionate share of the \$1.5 million settlement. *Id.*

Following a bench trial, the district court awarded Liberty Mutual \$550,000. Mid-Continent appealed that judgment contending it had no duty to Liberty Mutual as a primary co-insurer defending the underlying action. Mid-Continent argued it had not been negligent, and asserted there was never a *Stowers* demand within its policy limits.

## 2. Facts of the Underlying Action

Mid-Continent insured Crabtree Barricades (“Crabtree”), Kinsel’s subcontractor responsible for signs and dividers on the project. The Mid-Continent \$1 million CGL policy issued to Crabtree also identified Kinsel as an additional insured for liability arising out of Crabtree’s work under the contract. The case involved an automobile accident in a construction zone covered by Kinsel’s contract with the State of Texas. *Id.* at 299. A westbound driver (Cooper) crossed into the lane assigned to eastbound traffic and collided head-on with an eastbound car driven by James Boutin, and carrying his wife and their two children. *Id.* at 300. The Boutin family suffered serious injuries, and they all sued Cooper (the westbound driver), the State, Kinsel, and Crabtree. *Id.*

In April 1998, Mid-Continent agreed to share with Liberty Mutual the costs of defending and indemnifying Kinsel. *Id.* Although Liberty Mutual and Mid-Continent agreed to share these costs they differed in their assessments of the settlement value of the case against Kinsel. Mid-Continent believed Kinsel’s percentage of fault was 10% to 15%, but Liberty Mutual assessed Kinsel’s liability at 60%. Liberty Mutual agreed to pay \$1.5 million on behalf of Kinsel and demanded half from

Mid-Continent which calculated the *total* settlement value for Kinsel at \$300,000 and agreed to pay only \$150,000 toward that settlement. Liberty Mutual funded the remaining \$1,350,000 and then filed suit against Mid-Continent.

After a bench trial, the court concluded that Liberty was entitled to recover \$550,000 from Mid-Continent. Mid-Continent’s liability was capped at \$550,000 because its policy limits were \$1 million and it had already paid \$450,000 (\$150,000 for the Kinsel settlement, and \$300,000 to settle the claims against Crabtree). Relying on *General Agents Ins. Co. of Am., Inc. v. Home Ins. Co. of Ill.*, 21 S.W.3d 419 (Tex. App.–San Antonio 2000, pet. dism’d by agr.), the trial court held that each insurer “owed a duty to act reasonably in exercising rights under the CGL policy.” *Id.* at 301. The court found that Mid-Continent’s assessment of Kinsel’s liability was objectively unreasonable. *Id.* The trial court and Liberty both relied on *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d 656 (Tex. 1987) for the proposition that there can be a subrogation action related to a co-insurer’s duty of “reasonable negotiation and participation in settlement.”

The Fifth Circuit has certified to the Texas Supreme Court the question of whether Mid-Continent (as a primary insurer) had any duty to Liberty Mutual (its co-insurer) either as an equitable subrogee of their common insured (Kinsel) or otherwise. The Texas Supreme Court has also been asked to address the question of whether the liability standard in this case is one that requires a showing that the underpaying insurer was negligent or acted in “bad faith.

## **VII. WHETHER PUBLIC POLICY PRECLUDES INSURING PUNITIVE DAMAGES**

### **A. Overview**

Texas appellate courts have split on the question of whether punitive damages are insurable, but the Fifth Circuit recently certified that question to the Texas Supreme Court in *Fairfield Insurance Co. v. Stephens Martin Paving, L.P.*, 381 F.3d 435 (5<sup>th</sup> Cir. Aug. 11, 2004). The court stated the question as follows:

Does Texas public policy prohibit a liability insurance provider from indemnifying an award for punitive damages imposed on its insured because of gross negligence?

*Id.* at 437. The Supreme Court accepted the question and on November 9, 2004, the court heard oral argument and the case was submitted. (Supreme Court Case No. 04-0728.) A short survey of the pre-*Fairfield* cases follows.

Prior to *Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10 (Tex. 1994), in which the Supreme Court refined the standards for awarding punitive damages for gross negligence, several Texas courts had followed the majority rule<sup>11</sup> and held that punitive

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<sup>11</sup>The majority rule rejects insurance coverage for punitive damages against an individual as against public policy. See Michael A. Rosenhouse, Annot., *Liability Insurance Coverage as Extending to Liability for Punitive or Exemplary Damages*, 16 A.L.R.4th 11, 17, 1982 WL 198924 (1982); *Powell* 19 F.Supp.2d at 691-692 (citing cases from other jurisdictions). However, many of these same jurisdictions recognize an exception in cases of vicarious liability, which usually includes corporate liability for acts of an agent. See 16 A.L.R. 4<sup>th</sup> at § 4. See also *American Home Assurance Co. v. Safeway Steel Prods. Co.*, 743 S.W.2d 693, 704 (Tex. App.–Austin 1987, writ denied) (denying coverage for punitive damages against a corporation served no purpose because

damages were insurable. See, e.g., *Mariquez v. Mid-Century Insurance Company of Texas*, 779 S.W.2d 482, 484 (Tex. App.–El Paso 1989); *American Home Assurance Co. v. Safeway Steel Products Company, Inc.*, 743 S.W.2d 693, 703-05 (Tex. App.–Austin 1987, writ denied); *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026, 1030 (5<sup>th</sup> Cir.1978); *Dairyland County Mutual Insurance Co. v. Wallgren*, 477 S.W.2d 341, 343 (Tex. App.–Fort Worth 1972, writ ref'd n.r.e.); *Home Indemnity Company v. Tyler*, 522 S.W.2d 594, 597 (Tex. App.–Houston 1975, writ ref'd n.r.e) (uninsured motorist coverage).

However, in uninsured/underinsured motorist cases, Texas appellate courts had departed from this view, holding punitive damages were not insurable in that context because the purpose of punishing the wrongdoer could not be served by requiring the injured motorist's insurer to pay for the wrongdoing of the uninsured motorist. E.g., *Government Employees Ins. Co. v. Lichte*, 792 S.W.2d 546, 549 (Tex. App.–El Paso 1990), writ denied per curiam, 825 S.W.2d 431 (Tex. 1991) (uninsured motorist coverage); *State Farm Mut. Auto. Ins. Co. v. Shaffer*, 888 S.W.2d 146, 149-150 (Tex. App.–Houston [1<sup>st</sup> Dist.] 1994, writ denied); *Vanderlinden v. United Servs. Auto. Ass'n Property & Cas. Ins. Co.*, 885 S.W.2d 239 (Tex. App.–Texarkana 1994, writ denied).

*Moriel*, however, likened punitive damages to “criminal punishment” and held that “punitive damages are levied for the public purpose of punishment and deterrence.” 879 S.W.2d at 16-17.<sup>12</sup> This stricter standard for

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“the cost of paying the judgment will be borne not by the culpable corporate agents, but by the corporation's customers.”)

<sup>12</sup>In response to *Moriel*, the legislature revised the statutory provisions regarding exemplary damages during the 1995 legislative session. See Act of April 11, 1995, 74th Leg., R.S., ch. 19, § 1, 1995 Tex. Gen. Laws 108, 108-13. Importantly, the definition of exemplary

awarding punitive damages for gross negligence launched a debate among the intermediate courts over the question of insurability. Compare *Milligan v. State Farm Mut. Auto. Ins. Co.*, 940 S.W.2d 228, 232 (Tex. App.–Houston [14th Dist.] 1997, writ denied) (punitive damages were uninsurable) and *Hartford Cas. Ins. Co. v. Powell*, 19 F. Supp.2d 678, 696 (N.D. Tex. 1998) with *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, – S.W.3d –, 2004 WL 2793239, \*6 (Tex. App.–Ft. Worth, 2004, rule 57.3 motion granted) (en banc).

In *Powell*, the district court concluded the Texas Supreme Court would find punitive damages uninsurable after *Moriel*. The *Powell* court focused on *Moriel*'s declaration that the objective of a punitive damages award is "punishment and deterrence," which, the court held, weighed against the insurability of such damages. 19 F.Supp.2d at 683. The *Powell* court also distinguished earlier cases relying on the compensatory aspect of punitive damages as a justification for coverage, finding no such compensatory aspect acknowledged in *Moriel*. *Id.*

More recently, however, the Fort Worth Court of Appeals, sitting en banc, held that insuring punitive damages does not violate public policy and therefore punitive damages could be considered in connection with a *Stowers* claim between an excess insurer and a primary insurer. *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, 152 S.W.3d 172 (Tex. App.–Ft. Worth 2004, pet. filed) (en banc). The court held that, at the time of the underlying case,

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damages was revised. The 1995 legislation deleted the words "as an example to others," leaving the definition of exemplary damages as "any damages awarded as a penalty or by way of punishment." See Act of April 11, 1995, 74th Leg., R.S., ch. 19, § 1, 1995 Tex. Gen. Laws 108, 109. The 1995 amendments apply only to a cause of action accruing on or after September 1, 1995. Act of April 11, 1995, 74th Leg., R.S., ch. 19, § 2, 1995 Tex. Gen. Laws 108, 113.

exemplary damages could have been assessed to make an example of others, not solely to punish the wrongdoer, and thus militated in favor of insurability because "the mere fact that the damages are assessed . . . sets the example to the public and other similarly situated parties." Slip op. at \*14. The court declined to address whether punitive damages became uninsurable when the legislature removed the "as an example to others" rationale. *Id.* at 15.

The *Westchester* court nevertheless found that whether the primary insurer's settlement was reasonable raised issues of fact. *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, – S.W.3d –, 2004 WL 2793239, slip op. at 6. Interestingly, two justices dissented, finding that the primary insurer did not have standing to challenge the insurability of punitive damages because neither of the insureds was involved in the case. *Id.* at 24.

#### **B. Whether Punitive Damages are Covered by the Policy Language.**

The Texas Supreme Court has not addressed the issue of whether the language of general liability or auto liability policies extend coverage for punitive damages. The certified question in the *Fairfield* case does not specifically present this question, but the Supreme Court might consider it before reaching the public policy issue.

Some intermediate appellate courts have found that, depending on the facts, such provisions as the "bodily injury/property damage" requirement, the "occurrence" requirement and the "intentional injury" exclusion preclude coverage for punitive damages awarded against the insured. *E.g.*, *Comsys Information Technology Services, Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 192 (Tex. App.–Houston [14<sup>th</sup> Dist.] 2003, pet. filed) (in misrepresentation suit, coverage for

insured's alleged liability for punitive damages was barred by intentional acts, exclusion of errors and omissions policy and exclusion applicable to malicious acts applied to insured's alleged liability for punitive damages supported by malice); *Certain Underwriters at Lloyd's London v. Oryx Energy Co.*, 142 F.3d 255, 260 (5<sup>th</sup> Cir.1998) (holding insurer was entitled to reimbursement from insured for amounts paid to settle punitive damage claims that were not covered by the policy).

Other Texas courts, however, have found the language of general liability policies covers punitive damages. *E.g.*, *Waffle House, Inc. v. Travelers Indem. Co. of Illinois*, 114 S.W.3d 601, 612 (Tex. App.–Ft. Worth 2003, pet. denied) (punitive damages “arose out of” or “resulted from” insured’s defamatory statements and insurer had a duty to indemnify insured for those damages.); *American Home Assur. Co. v. Safway Steel Products Co., Inc.*, 743 S.W.2d 693, 702 (Tex. App.–Austin 1987, writ denied) (the term “damages” encompassed both punitive and compensatory damages, and gross negligence liability for punitive damages was not excluded by intentional injury exclusion); *Philadelphia Indem. Ins. Co. v. Stebbins Five Companies*, 2004 WL 210636, \*3 (N.D. Tex. 2004) (CGL and Professional Liability policies unambiguously provided coverage for an award of punitive damages).

Other Texas courts have held that auto policy language covers punitive damages. *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Shaffer*, 888 S.W.2d 146, 149 (Tex. App.–Houston [1<sup>st</sup> Dist.] 1994, writ denied) (language of uninsured motorist coverage extended to punitive damage, but such coverage was contrary to the purpose of UM coverage). *Government Employees Ins. Co. v. Lichte*, 792 S.W.2d 546, 549 (Tex. App.–El Paso 1990), writ denied per curiam, 825 S.W.2d 431 (Tex. 1991) (uninsured motorist coverage); *Manriquez v. Mid-Century Ins. Co.*

*of Texas*, 779 S.W.2d 482, 484 (Tex. App.–El Paso 1989) (auto policy covered punitive damages, excepting those for intentional conduct, where policy covered “damages for bodily injury or property damage for which any covered person becomes legally responsible because of an auto accident.”); *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026, 1030 (5<sup>th</sup> Cir. 1978) (insuring clause necessarily included both punitive and actual damages and extension of coverage to punitive damages did not violate public policy).

Several courts from other jurisdictions have held that the words “all sums an ‘insured’ legally must pay as damages because of ‘bodily injury’ or ‘property damage’” refer only to compensatory damages, not punitive damages. *See Braley v. Berkshire Mut. Ins. Co.*, 440 A.2d 359, 361-62 (Me. 1982) (collecting cases); *Crull v. Gleb*, 382 S.W.2d 17 (Mo. App. 1964); *Laird v. Nationwide Ins. Co.*, 243 S.C. 388, 134 S.E.2d 206 (1964). *See also Annot., Liability Insurance Coverage as Extending to Liability for Punitive or Exemplary Damages*, 16 A.L.R.4th 11.

### **C. To the Extent the Defense is Based on Public Policy it is not Waivable.**

In an early case finding that insurance coverage for punitive damages contravened public policy, the Fifth Circuit held that waiver/estoppel does not apply to coverage defenses based on public policy. *Northwestern Nat. Cas. Co. v. McNulty*, 307 F.2d 432, 442 (5<sup>th</sup> Cir. 1962) (“since public policy forbids an insurer and an insured to enter into an insurance contract covering punitive damages, public policy forbids the accomplishment of the result by an estoppel”). *See also Westwood v. Continental Cas. Co.*, 80 F.2d 494, 497 (5<sup>th</sup> Cir. 1935) (defense to contract on grounds it was

void as against public policy could not be waived).<sup>13</sup>

**D. To the Extent it Relies on Policy Language, an Insurer Must Still Reserve Rights Before Assuming the Defense.**

Generally, waiver and estoppel will not enlarge the risks covered by an insurance policy. *Minnesota Mut. Life Ins. Co. v. Morse*, 487 S.W.2d 317, 320 (Tex. 1972); *State Farm Lloyds, Inc. v. Williams*, 791 S.W.2d 542, 550 (Tex. App.–Dallas 1990, writ denied); *Farmers Texas County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 521 (Tex. Civ. App.–Austin 1980, writ ref'd n.r.e.). See *Republic Insurance Company v. Stoker*, 903 S.W.2d 338, 341 (Tex. 1995) (holding that “[a]s a general rule there can be no claim for bad faith when an insurer has promptly denied a claim that is in fact not covered.”); *Arkwright-Boston Mfr. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5<sup>th</sup> Cir.1991).

An exception to this rule holds that “[i]f an insurer assumes the insured’s defense without obtaining a reservation of rights or a non-waiver agreement and with knowledge of the facts indicating non-coverage, all policy defenses, including those of non-coverage, are waived, or the insurer may be estopped from

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<sup>13</sup>In *Westchester Fire Ins. Co. v. Admiral Ins. Co.*, – S.W.3d –, 2004 WL 2793239, \*6 (Tex. App.–Ft. Worth 2004) (en banc), the court relied on certain facts bearing on waiver in holding that punitive damages are insurable, but did not specifically find a waiver. The court noted the primary insurer assumed the defense without a reservation of rights as to punitive damages, never challenged coverage until after the excess insurer had settled the suit and sued the primary, that the primary insurer was aware of its insured’s exposure to punitive damages and, therefore, its own and apparently believed its policy covered both the negligence and gross negligence claims as it considered and made settlement offers.

raising them.” *Williams*, 791 S.W.2d at 550; *Wilkinson*, 601 S.W.2d at 521-22 (emphasis in original). This rule is based on the conflict of interest created by the insurer’s incentive to formulate a coverage defense while simultaneously defending the insured in the underlying lawsuit. *Wilkinson*, 601 S.W.2d at 522.

Thus, to prove waiver or estoppel, an insured must show: “(1) that the insurer had sufficient knowledge of the facts or circumstances indicating non-coverage but (2) assumed or continued to defend its insured without obtaining an effective reservation of rights or non-waiver agreement and, as a result, (3) the insured suffered some type of harm.” *Pennsylvania Nat’l Mut. Ins. Co. v. Kitty Hawk Airways, Inc.*, 964 F.2d 478, 481 (5<sup>th</sup> Cir.1992). Harm to the insured usually arises as a matter of law from the inherent conflict of interest. *Williams*, 791 S.W.2d at 551; *Hertz Corp. v. Pap*, 923 F.Supp. 914 918-919 (N.D. Tex. 1995). Waiver is justified by the fact that the insured is deprived of the right to completely control his defense, a situation that is inherently prejudicial to the insured in the absence of a reservation of rights. *Williams*, 791 S.W.2d at 551. Thus, the insured is insulated from any such harm if he is represented by counsel independent of the insurer and controls his own defense. *Id.* A failure to establish any one of the three essential elements will defeat a waiver or estoppel defense. *Certain Underwriters at Lloyds, London v. Oryx Energy Co.*, 957 F. Supp. 930, 934 (S.D. Texas 1997).<sup>14</sup>

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<sup>14</sup>Thus, if the insurer’s participation in the underlying suit does not amount to assumption of the insured’s defense, the insurer does not waive policy defenses, even if it participates in settlement negotiations. *Comsys Information Technology Services, Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181, 192 (Tex. App.–Houston [14<sup>th</sup> Dist.] 2003, ) (liability insurer did not waive reliance on exclusions where insurer did not assume the defense); *Arkwright-Boston Mfr. Mut. Ins. Co.*

## **VIII. DAL-WORTH RECOGNIZES A “NEGLIGENT CLAIMS-HANDLING” CAUSE OF ACTION**

*St. Paul v. Dal-Worth Tank*, 974 S.W.2d 51 (Tex. 1998) involved a propane truck rollover accident and St. Paul’s duty as Dal-Worth’s insurer to defend Dal-Worth (the truck manufacturer) from the claims of Mission Butane Gas Co. (“Mission”). Mission had purchased a propane truck that had been assembled by Dal-Worth from a Chevrolet truck chassis with a liquid propane tank. This propane truck rolled over in San Antonio injuring its driver. Mission sued Dal-Worth and Dal-Worth sought a defense from St. Paul, its liability insurer. A default judgment for \$794,100 was eventually entered against Dal-Worth.

### **A. Overview of Claims-Handling Facts**

Dal-Worth received a DTPA demand notice from Mission reflecting an intent to sue for several thousand dollars in damages. Dal-Worth sent the notice to its insurer, St. Paul Surplus Lines Insurance Co., which opened a claim file. *Id.* at 52. Mission’s insurer also

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*v. Aries Marine Corp.*, 932 F.2d 442, 445-446 (5<sup>th</sup> Cir.1991) (excess did not waive coverage defenses, even though it participated in settlement negotiations where the insured’s independent counsel controlled the defense and settlement of the case and also noted that Aries raised no objection to the settlement at the time it was consummated. *See also Certain Underwriters at Lloyds, London v. Oryx Energy Co.*, 957 F. Supp. 930, 934 (S.D. Texas 1997) (liability insurer did not waive and was not estopped from contesting coverage by its pre-settlement conduct in waiting until one year after filing of litigation to assert reservation of rights where insurer did not assume or control additional insured’s defense; insurer’s participation in negotiations that led to ultimate settlement of litigation did not constitute assumption of defense, nor did fact that insurer was kept advised of litigation by additional insured’s private counsel).

notified St. Paul of Mission’s intention to sue Dal-Worth if Mission’s claim was not satisfied. After discussing the claim with Dal-Worth, St. Paul concluded that Dal-Worth was not liable and refused to pay. *Id.*

Mission then sued Dal-Worth. There was evidence that the suit papers were forwarded to St. Paul, although St. Paul disputed having received them. St. Paul heard conflicting accounts from Mission’s insurer’s employees about whether Mission had filed suit but concluded suit had not been filed. Even after Dal-Worth called St. Paul to ask about “the suit,” St. Paul did not inquire whether suit had actually been filed.<sup>15</sup>

Dal-Worth did not answer Mission’s suit, and eventually Mission obtained a default judgment against Dal-Worth for \$794,100. Dal-Worth received notice of the judgment from the court but did not realize its significance and did not send it to St. Paul. *Id.* St. Paul first learned of the judgment seventy-eight days after it was signed and decided to determine whether it was covered by the policy before initiating a writ of error appeal. St. Paul advised Dal-Worth of the existence of the judgment but did not say that it was exploring coverage issues. Mission would have settled the case at this point for \$17,000, but neither Mission, Dal-Worth, nor St. Paul made any settlement overtures. *Id.*

Four weeks later St. Paul denied

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<sup>15</sup>St. Paul’s agent assured Dal-Worth that St. Paul was “handling” the matter and, in reliance thereon, Dal-Worth did not hire an attorney to defend the lawsuit. During the thirteen months from the opening of the claim file in St. Paul’s office, Dal-Worth was assured that St. Paul was “investigating” the claim, and it was not until the default judgment was taken that St. Paul offered a defense with reservation of rights. *St. Paul Surplus Lines Ins. Co. v. Dal-Worth Tank Co., Inc.*, 917 S.W.2d 29, 58 (Tex. App.–Amarillo 1995), *aff’d in part, rev’d in part*, 974 S.W.2d 51 (Tex. 1998).

coverage but offered to pay an attorney of Dal-Worth's choice to appeal by writ of error. Dal-Worth accepted the offer and appealed, but when St. Paul would not supersede the judgment, Dal-Worth was forced into bankruptcy. *Id.*

#### **B. Opinion of the Court of Appeals in *Dal-Worth***

The opinion of the Amarillo Court of Appeals provides the backdrop for the Texas Supreme Court's conclusion that St. Paul was "negligent" in its handling of the claims against Dal-Worth and for its finding of insurer "misconduct." Reviewing a jury verdict in favor of Dal-Worth against St. Paul, the court of appeals found sufficient evidence that St. Paul, with knowledge through its agent, assumed the defense of the lawsuit without any reservation of rights, and thereby waived all policy defenses, including that of non-coverage, and was estopped from raising them. *St. Paul Surplus Lines Ins. Co. v. Dal-Worth Tank Co., Inc.*, 917 S.W.2d 29, 58 (Tex. App.—Amarillo 1995), *aff'd in part, rev'd in part*, 41 TEX. SUP. CT. J. 380 (Feb. 13, 1998). The court of appeals determined that St. Paul had waived its right to contest coverage, and was thus bound by the default judgment, because St. Paul had knowledge of Mission's lawsuit before the default judgment was taken.

The jury's findings of estoppel and waiver were reinforced by the expert testimony at trial, which was especially critical of St. Paul's failure to notify Dal-Worth of coverage problems until well after the default judgment was discovered. Even then, the claims adjuster informed Dal-Worth that St. Paul was analyzing the situation and would get back to Dal-Worth, but admittedly did not mention any concerns over coverage. Although the adjuster testified she informed Dal-Worth the DTPA claims might not be covered, she did not document that

disclosure, and Dal-Worth personnel testified she "never" told them St. Paul might deny coverage. Dal-Worth did not know of any problems with coverage until some five weeks later when St. Paul notified Dal-Worth that it had denied coverage.

#### **C. Opinion of the Texas Supreme Court in *Dal-Worth***

The Texas Supreme Court reversed a jury finding of a "knowing" DTPA/Insurance Code violation (which would have permitted treble damages), but held that St. Paul acted negligently and in violation of the DTPA and the Insurance Code in its handling of the claim against Dal-Worth. The Court did not set out this claims-handling "misconduct" in any detail, but simply noted that there was some evidence supporting the jury's finding that St. Paul acted negligently and violated the DTPA and Insurance Code. The Court noted there was evidence that although St. Paul had received "suit papers" reflecting a claim, St. Paul did not inform its insured of its coverage position but simply allowed a default judgment to be taken. The Texas Supreme Court essentially validated the jury's finding of "waiver" and penalized St. Paul for not doing all it could have done to determine that Dal-Worth had been sued and for failing to communicate pertinent information to Dal-Worth about the status of Mission's lawsuit. 41 TEX. SUP. CT. J. at 382. The opinion of the court of appeals in this case addresses St. Paul's "misconduct" more specifically.

#### **D. *Dal-Worth, Ranger v. Guin*, and Other Cases Addressing "Negligent Claims Handling"**

Plaintiffs and insureds in the future are likely to argue that *Dal-Worth* is both a recognition of the viability of a "negligent claims handling" cause of action and an extension of the protections afforded by *Ranger*

*County Mutual Insurance Co. v. Guin*, 723 S.W.2d 656 (Tex. 1987). It is important to note that the court of appeals in *Dal-Worth* specifically found that the insurer had a duty to handle the claim against the insured in a non-negligent manner. 917 S.W.2d at 54 (emphasizing that *Pennington* does not preclude a cause of action for negligent claims handling in the third-party context). The court of appeals recognized a duty to handle third-party claims in a non-negligent manner based “on the special relationship between an insured and an insurer” which imposes upon the insurer “a duty to investigate claims thoroughly and in good faith.” *Id.* at 54 (citing *Viles v. Security Nat’l Ins. Co.*, 788 S.W.2d 566, 568 (Tex. 1990)).

Future plaintiffs and insureds will cite *Ranger v. Guin* as the case in which the Texas Supreme Court recognized an insurer’s duty of ordinary care in the “investigation, preparation for defense of the lawsuit, trial of the case and reasonable attempts to settle.” 723 S.W.2d at 659. There are, in fact, a number of cases which broadly opine that an insurer must act with ordinary care when investigating and settling third-party claims. See *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994) (reiterating *Ranger v. Guin* but emphasizing that in a *Stowers* lawsuit, evidence “concerning claims investigation, trial defense, and conduct during settlement negotiations” is “subsidiary” to the ultimate issue of whether the claimant’s demand was reasonable under the circumstances such that an ordinarily prudent insurer would accept it); *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 485 (Tex. 1992) (citing *Ranger v. Guin* and a standard of reasonableness for insurers in “investigating, preparing to defend, trying or settling the third party action”); *Birmingham Fire Ins. Co. of Pa. v. American Nat. Ins. Co.*, 947 S.W.2d 592 (Tex. App.–Texarkana 1997, writ filed) (citing *Ranger v. Guin* for the proposition that an insurer’s duty of ordinary

care includes investigation, preparation for the defense of the lawsuit, trial of the case and reasonable attempts to settle”); *Wheelways Ins. Co. v. Hodges*, 872 S.W.2d 776, 780 (Tex. App.–Texarkana 1994, no writ) (describing *Ranger* as extending the *Stowers* doctrine to impose liability on an insurer to its insured “for a judgment in excess of the policy limits when caused by the insurer’s negligent handling of the claim”).

#### **E. Responding to a “Negligent-Claims Handling” Theory after *Dal-Worth***

In response to any “negligent claims handling” theory, insurers can argue that the *Dal-Worth* and *Ranger v. Guin* line of cases simply does not apply in the absence of coverage. This is not a spurious distinction and relies on a number of cases – including *Republic Insurance v. Stoker* and *Maryland Insurance v. Head* – which appear to indicate that there can be no “tort” duty flowing from the special relationship of insured and insurer in the absence of coverage. In other words, when there is no contractual obligation to defend, in the third-party context the insured cannot manufacture coverage by focusing on some purportedly “negligent” aspect of the insurer’s claims handling. (The obvious rejoinder to any such argument is that under *Viles* insurers have a duty to investigate reasonably in all circumstances, whether or not a particular claim is covered.)

#### **1. *Republic Insurance v. Stoker* Holds no Bad Faith Without a Covered Claim.**

In *Republic Insurance Company v. Stoker*, 903 S.W.2d 338 (Tex. 1995), the Texas Supreme Court held that “[a]s a general rule there can be no claim for bad faith when an insurer has promptly denied a claim that is in fact not covered.” *Id.* at 341 (emphasis added). As long as an insurer determines in a timely

manner that there is a reasonable basis for denying a claim, it can make “the right decision for the wrong reason.” *Id.* The Texas Supreme Court noted that all of the Stokers’ causes of action were based on their bad faith allegations and held that they were not entitled to recover against their insurer. *Stoker* thus predicates recovery in a bad faith case – in the absence of some “extreme” act that causes injury independent of a policy claim – on an initial showing of contractual liability. *Id.* at 341; *North Am. Shipbuilding, Inc. v. Southern Marine & Aviation Under., Inc.*, 930 S.W.2d 829, 834 (Tex. App.–Houston [1<sup>st</sup> Dist.] 1996, no writ).

Related to this no coverage/no bad faith argument is the recognition in *APIE v. Garcia* that an insurer’s duty of ordinary care in the *Stowers* situation is based on the existence of a contractual obligation and right to control the insured’s defense. 876 S.W.2d at 846 (citing *Stowers*). Arguably, when there is no coverage (no contractual obligation to defend), an insurer has no duty of ordinary care in the handling of a third-party claim. Future insureds and plaintiffs are sure to point out, however, that *Stoker* is a first-party and not a third-party case.

## **2. *Maryland Insurance v. Head* Holds no “Bad Faith” in the Third-Party Liability Context but *Rocor* Creates Problems.**

With *Maryland Insurance Co. v. Head Industrial Coatings and Services, Inc.*, 938 S.W.2d 27 (Tex. 1996), the Texas Supreme Court concluded unequivocally that there is no common-law duty of good faith and fair dealing in the third-party liability context. The question remaining is under what circumstances, if any, an insured may bring statutory causes of action and/or a claim for negligent claims handling after insurer misconduct in failure to defend and failure to settle cases (the third-party liability

context).

In a brief per curiam opinion, the Texas Supreme Court held that the insurer did not owe its insured a duty of good faith and fair dealing for failure to settle or defend a third-party claim. The court reasoned that “the insured is fully protected against his insurer’s refusal to defend or mishandling of third-party claim by his contractual and *Stowers* rights. Imposing an additional duty on insurers in handling third-party claims is unnecessary and therefore inappropriate.” *Id.* at 28-29 (emphasis added).

What the court achieved in brevity it lost in clarity. As many commentators have noted, it is impossible to discern whether the supreme court intended to eliminate only the insured’s common-law action for bad faith in a failure to defend/failure to settle context, or whether the court eliminated all statutory causes of action as well. Insurers certainly have an argument that the Texas Supreme Court intended to eliminate all statutory causes of action along with common-law bad faith and “negligent claims handling” in the third party context by pointing to the court’s sanctioning of “only one tort duty in this context” and its position that “an insured is *fully protected*” by these rights against a refusal to defend or failure to settle a third-party claim. *See Head*, 938 S.W.2d at 28-29. Absent some conduct in addition to the refusal to defend that would trigger duties under 21.21 or the DTPA, *see American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 847 n.11 (Tex. 1994), an insured is likely limited to its breach of contract and *Stowers* claims in refusal to defend/failure to settle cases. In response, plaintiffs and insureds may cite *Allstate v. Kelly*, 680 S.W.2d 595 (Tex. App.–Tyler 1984, writ ref’d n.r.e.), a case in which the insurer “potentially violated the DTPA” by encouraging its insured not to hire counsel and by leaving the insured exposed to a potential judgment in excess of policy limits. *But see APIE*, 876

S.W.2d at 847 n.10 & n.11 (insurer in *Kelly* did not contest application of article 21.21 or DTPA).

A good case for insurers on the scope of *Maryland Insurance v. Head* is *Dear v. Scottsdale Insurance Co.*, 947 S.W.2d 908, 914, 15 (Tex. App.–Dallas 1997, writ denied). In *Dear v. Scottsdale*, the Dallas Court of Appeals reiterated *Maryland Insurance v. Head* and barred an insured’s bad faith and negligence claims in the third party liability context. The insured (a private investigator) had been sued by a client (and her parents and others) for overcharging, fraud, and inadequate services. The insured tendered the suit to his professional liability insurer for a defense. After several mediations, the insurer settled the suits that were pending against the insured. The insured subsequently sued his insurer for negligently investigating and handling the claims and lawsuits against him, because the insurer’s negligence allegedly made it more difficult and expensive for him to obtain professional liability insurance. The Dallas Court of Appeals refused to recognize a claim for “negligent investigation” in this context and limited *Ranger v. Guin* to pure *Stowers* situations. 947 S.W.2d at 908 n.2.

In *Rocor*, the San Antonio Court of Appeals indicated that “[t]o the extent that *Dear* suggests that an insured may not recover damages for an insurer’s negligent settlement practices, we disagree with this holding.” *Rocor Int’l Inc. v. National Union Fire Ins. Co. of Pitt.*, 995 S.W.2d 804, 813 (Tex. App.–San Antonio 1999), *aff’d in part, rev’d in part*, 77 S.W.3d 253 (Tex. 2002); *see also Ecotech Intern’l, Inc. v. Griggs & Harrison*, 928 S.W.2d 644 (Tex. App.–San Antonio 1996, writ denied).

### 3. ***Pennington* and Other Cases Barring “Negligent Claims Handling” May no Longer be Good Law.**

The pre-*Dal-Worth* line of state and federal cases, which appeared to bar any cause of action for “negligent claims handling” in Texas, are now of decidedly uncertain precedential value.<sup>16</sup> Insurers may cite these cases in opposition to “negligent claims handling” theories, but plaintiffs and insureds will undoubtedly argue that these cases are out of line with *Dal-Worth* and thus not controlling. Again, the court of appeals in *Dal-Worth* specifically rejected St. Paul’s “sweeping statement” based on *Pennington* that Texas law does not impose upon insurers the duty to handle claims in a non-negligent manner. In light of the fact that the Texas Supreme Court affirmed the jury’s finding of negligence in the handling of *Dal-Worth*’s claims, it would appear that *Pennington* is more limited than previous state and federal cases in Texas have indicated.

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<sup>16</sup>*See Higginbotham v. State Farm Mut. Auto. Ins. Co.*, 103 F.3d 456, 460 (5<sup>th</sup> Cir. 1997); *Robinson v. State Farm Fire & Cas. Co.*, 13 F.3d 160, 163 (5<sup>th</sup> Cir. 1994); *Jimenez v. State Farm Lloyds*, 968 F. Supp. 330 (W.D. Tex. 1997); *French v. State Farm Ins. Co.*, 156 F.R.D. 159, 161 (S.D. Tex. 1994); *Muniz v. State Farm Lloyds*, 1998 WL 62872 (Tex. App.–San Antonio 1998, no writ) (recognizing that “the only tort that arises from the handling of insurance claims arises from breach of the duty of good faith and fair dealing, or the duty to exercise ordinary care and prudence in considering an offer to settle within policy limits”); *Willcox v. American Home Assur. Co.*, 900 F. Supp. 850, 863 (S.D. Tex. 1995); *United Serv. Auto. Ass’n v. Pennington*, 810 S.W.2d 777, 783 (Tex. App.–San Antonio 1991, writ denied) (emphasizing that “[i]f the defendant’s conduct would impose liability on him only because it breaches the parties’ agreement, the claim is contractual”).