2013 YEAR IN REVIEW

SIGNIFICANT DECISIONS IN 2013: INSURANCE LAW UPDATE

By Jennifer Kelley

SUPREME COURT OF TEXAS

***Lennar Corp. v. Markel American Ins. Co.*, No. 11-0394, 2013 Tex. LEXIS 597 (Tex. Aug. 23, 2013).**

In *Lennar*, the Supreme Court of Texas held that an insurer is responsible for the costs of a settlement that it does not consent to if the insurer is not prejudiced. The supreme court also held that, under the terms and conditions of the subject policy, the insurer was responsible for the insured's remediation costs.

Trial Court and Court of Appeals Proceedings

From 1992 to 1998, Lennar Corporation ("Lennar") and its predecessor built homes using an imitation stucco siding called an Exterior Insulation and Finish System ("EIFS"). It was later discovered that the EIFS trapped moisture, which resulted in damage to the EIFS and to the building materials beneath it.

After a national television program televised a story on the moisture problems caused by EIFS, Lennar began receiving phone calls from concerned homeowners. In response, Lennar developed a "voluntary business plan" to inspect and repair the EIFS on many of the homes. When the repairs failed to solve the moisture problems, Lennar decided to remove the EIFS on all of the homes and replace it with conventional stucco, regardless of whether any particular home had suffered water damage.

Lennar filed suit against its liability insurers, including Markel American Insurance Company ("Markel"), which issued excess coverage. The trial court granted summary judgment in favor of Markel, holding that coverage did not exist for Lennar's losses. The Houston [14th Dist.] Court of Appeals, however, reversed the judgment in part holding that the costs to repair water damage and the costs to remove EIFS to repair underlying water damage were covered, but also holding that the costs to remove and replace EIFS as a preventative measure on homes that had not yet suffered water damage were not covered. The appellate court remanded the case to the trial court, and specifically instructed Lennar to apportion its loss among those costs that were covered and those that were not.

On remand to the trial court, Lennar argued that it could not determine if water damage had occurred without first removing the EIFS. It asked the jury to award damages for the costs to remove the EIFS on all homes, without regard to whether any home had actually sustained damage. Lennar did not offer any evidence of the costs it incurred to remove EIFS solely from the damaged portions of homes. After a jury trial, the trial court awarded Lennar nearly $3 million in actual damages. Markel appealed, arguing that it did not owe coverage for any of the damages because Lennar failed to apportion the covered portion of the judgment from the uncovered portion.

The Houston [14th Dist.] Court of Appeals agreed with Markel's argument, reasoning that because Lennar bore the burden to establish the amount of covered damages under the Markel policy, it had the burden of presenting evidence from which the jury could allocate between covered and uncovered damages at trial. Thus, because Lennar failed to do so, it failed to meet its burden to prove what damages were covered. Consequently, the appellate court held that coverage was barred for the entire claim.

The appellate court also held that Lennar had failed to establish that any of the costs it incurred fell within the definition of "ultimate net loss" under the Markel policy. The policy defined "ultimate net loss" as "the total amount of damages for which the insured is legally liable in payment of . . . 'property damage.'" The policy provided that "ultimate net loss" could be established "by adjudication, arbitration, or a compromise settlement to which we [Markel] have previously agreed in writing." Because there had not been any adjudication or arbitration of any claims, and because Lennar had settled the claims without Markel's written consent, the appellate court held that the payment of the losses did not satisfy the definition of "ultimate net loss." Accordingly, the appellate court held that the losses were not covered on this basis too.

Notably, the appellate court had earlier held in the prior appeal that Markel would need to establish prejudice in order to prevail on a coverage defense based on a breach of the voluntary payment clause in the conditions section of the policy. The court of appeals, however, held that prejudice was not required to be shown when an insurer challenges whether the claim falls within the grant of coverage to begin with—that is, whether the losses fell within the definition of "ultimate net loss." The appellate court concluded that injecting a prejudice requirement into the analysis of "ultimate net loss" would require the court to rewrite the policy, which Texas law prohibits.

The Houston [14th Dist.] Court of Appeals reversed the trial court's judgment and the Texas Supreme Court granted petition for review.

<u>Supreme Court of Texas Proceedings</u>

At issue before the Supreme Court of Texas was whether Markel was responsible for: (1) costs when Lennar settled without Markel's consent and (2) costs to determine whether or not the property was damaged and costs to remediate damage that began before and continued after the policy period.

With regard to an insurer's responsibility for settlement costs, the supreme court noted that an insurer must suffer a material prejudice in order to excuse coverage. Markel argued that Lennar's remediation settlements were prejudicial, largely because Lennar offered remediation to homeowners that never would have sought redress. Further, Markel maintained that Lennar's unilateral settlement was a material breach of the insurance policy because it significantly impaired Markel's position to adjust claims, provide a defense, or be involved in negotiating a settlement. The supreme court disagreed, observing that the jury did not find Markel's arguments persuasive, and concluding that the jury was entitled to credit evidence that, had Lennar not proceeded with its remediation process, the damages would have worsened with the deterioration of EIFS and the remediation costs increased.

The supreme court next addressed whether the policy's consent-to-settlement requirement excused coverage as a matter of law. The supreme court held that Lennar's failure to comply with the policy's consent-to-settle provision did not excuse Markel's liability under the policy unless it was prejudiced by the remediation settlements. Because the issue of whether Markel suffered prejudice from Lennar's remediation efforts was resolved by the jury in Lennar's favor, no prejudice was established and Markel was not excused from providing coverage.

As to the issue of an insurer's responsibility to pay for costs to determine if property is damaged, the supreme court noted that the policy obligated Markel to pay "the total amount" of Lennar's loss "because of" property damage that "occurred during the policy period". The supreme court reiterated that the "because of" language "is susceptible to a broad definition". Thus, "[u]nder no reasonable construction of the phrase can the cost of finding EIFS property damage in order to repair it not be considered to be 'because of' the damage." In reaching its conclusion, the supreme court emphasized that it "was not confronted with a situation in which the existence of damage was doubtful."

Finally, on the issue of an insurer's responsibility to pay for remediation costs for damage that began before and continued after the policy period, the supreme court reaffirmed its decision in *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994), in which it held:

> If a single occurrence triggers more than one policy, covering different policy periods, then different limits may have applied at different times. In such a case, the insured's indemnity limit should be whatever limit applied at the single point in time during the coverage periods of the triggered policies when the insured's limit was highest. The insured is generally in the best position to identify the policy or policies that would maximize coverage. Once the applicable limits is identified, all insurers whose policies are triggered must allocate funding of the indemnity limit among themselves according to their subrogation rights.

The supreme court, therefore, concluded that Markel was responsible for Lennar's entire remediation costs and not just its pro rata share.

<u>THE FIFTH CIRCUIT</u>

***Starr Indem. & Lia. Co. v. SGS Petroluem Servs. Corp.*, 719 F.3d 700 (5th Cir. 2013).**

In *Star Indem. & Liability Co.*, one of the issues before the court was whether or not an insurer must show prejudice before denying coverage based on late notice on an occurrence based policy. The insured did not report the triggering incident until 59 days after it learned of the incident. The insurer sought a declaratory judgment that it was not required to show prejudice before denying coverage to the insured for liability arising out of a pollution occurrence, which the insured did not report within thirty days as required by the policy. Plaintiff, on the other hand, argued that the insurer did not suffer any prejudice from Plaintiff's failure to provide notice to the insurer within the required 30 days. Drawing parallels from an earlier decision, the Fifth Circuit explained that to extend the 30 day notice period would have exposed the insurer "to a risk broader than the risk expressly insured against the policy." The court noted that both the insured and the insurer were sophisticated commercial parties with comparable bargaining power, that the language in the policy was plain, and that timely reporting of the claim was one of the events necessary to trigger coverage. The Fifth Circuit concluded that the notice provision of the policy was an essential part of the bargained-for exchange under the occurrence-based policy and was specifically negotiated, and therefore held that the insurer was not required to show prejudice before denying coverage.

***Materials Evaluation and Technology Corporation v. Mid-Continent Casualty Company*, No. 12-40186, 2013 U.S. App. LEXIS 5323 (5th Cir. 2013).**

The United States Court of Appeals for the Fifth Circuit, construing Texas law, affirmed the district court's ruling granting an insurer's summary judgment regarding an insurer's duty to defend under a commercial general liability policy.

In *Materials Evaluation and Technology*, the insured renewed its coverage on an annual basis through at least 2004. The 2002 policy, effective from July 2002 to July 2003, provided for an Employer's Liability Exclusion. Through the Exclusion, the 2002 policy provided coverage for employee injuries arising from third-party contractual relationships.

The insured renewed its policy for the period of July 2003 to July 2004. While the coverage for the 2003 policy contained the Employer's Liability Exclusion, it also contained an endorsement excluding liability arising out of third-party relationships.

In 2003, the insured executed an agreement to provide various testing services at a DuPont facility in Beaumont, Texas. The agreement included an indemnity clause, requiring the insured and DuPont to indemnify each other. In 2004, two of the insured's employees sustained bodily injuries while working at the DuPont facility. DuPont settled with the injured employees and sought indemnity from the insured. The insured refused and was subsequently sued for breach of contract. The insured tendered defense to Mid-Continent Casualty Company. Mid-Continent determined that the Endorsement in the 2003 policy precluded coverage and the District Court agreed.

The Fifth Circuit rejected the insured's argument that the 2003 policy was on the same terms as the 2002 policy because Texas law generally provides that a policy renewal is on the same terms as the original. The Court carefully distinguished the case law the insured relied upon and then stressed that the cases were limited to their particular circumstances and did not "stand for the blanket proposition that a policyholder has a right to assume that a renewal policy is on the same terms as the original." Thus, because the 2003 Policy language with the endorsement specifically excluded liability arising from third party contracts, the Court determined the 2003 Policy specifically negated Mid-Continent's duty to defend the insured.

***Mid-Continent Casualty Company v. Eland Energy, Inc. and Sundown Energy LP*, 709 F.3d 515 (5th Cir. 2013).**

The United States Court of Appeals for the Fifth Circuit reaffirmed that Texas law does not recognize a cause of action for breach of the duty of good faith and fair dealing by an insurance company for the handling of third-party tort claims against its insured.

In *Eland Energy, Inc.*, Sundown's oil and gas production facility in Louisiana was severely damaged by Hurricane Katrina, causing storage tanks with crude oil to spill into the surrounding area. Sundown filed a claim under its CGL policy with Mid-Continent for reimbursement of government-mandated clean-up costs. At the same time, surrounding property owners and commercial fisherman filed multiple lawsuits against Sundown and Eland, which Sundown tendered to Mid-Continent for defense. One property owner not in a lawsuit contacted Mid-Continent directly to make a third-party claim and tried to negotiate a settlement, which Mid-Continent unsuccessfully attempted to do without Sundown's knowledge.

Mid-Continent agreed to defend the lawsuits and eventually paid to Sundown the $1 million dollar primary policy limit and the $5 million umbrella policy limit for clean-up costs. With policy limits exhausted, Mid- Continent withdrew from defending the lawsuits. Sundown, however, refused to accept the $6 million, advised Mid-Continent it wished to hold the clean-up claim "in abeyance," and asked Mid-Continent to continue defending the lawsuits. Mid-Continent filed a declaratory judgment seeking to clarify its duties and responsibilities under the policies, and Sundown filed counterclaims for bad faith, Insurance Code violations and other counter- claims.

The district court granted summary judgment to Mid-Continent for some of the relief it sought, and the case went to trial on Sundown's remaining counter-claims, including a claim that Mid-Continent breached a duty of good faith and fair dealing by attempting to settle the claim of one property owner without Sundown's knowledge or consent. The jury returned a verdict in favor of Sundown, but the district court granted Mid-Continent's motion for judgment as a matter of law overturning the jury verdict.

Sundown complained on appeal that Mid-Continent's offer of settlement to a third-party claimant was bad faith, relying on *State Farm v. Traver* and *Republic Ins. Co. v. Stoker*. Sundown argued both *Traver* and *Stoker* expanded an insurer's liability in the third-party context if it "consciously undermined" the insured's defense, or committed some act, so extreme, that it would cause injury independent of the policy claim. The 5th Circuit said neither of the passages taken from *Traver* and *Stoker* established Texas law, and, in the seventeen years since *Stoker*, the 5th Circuit noted no Texas court had ever held that recovery was available under Texas law for an insurer's allegedly "extreme act" causing injury independent of the policy claim in the first-party context, let alone in the third-party context. The 5th Circuit refused to do so here and affirmed the district court's final judgment.

***Pride Transportation v. Continental Casualty Company*, No. 11-10892, 2013 U.S. App. LEXIS 2575 (5th Cir. Feb. 6, 2013) (unpublished opinion).**

The United States Court of Appeals for the Fifth Circuit, construing Texas law, affirmed the district court's ruling granting two insurers summary judgment in a case where the insurers, a primary carrier and an excess carrier, settled for the policy limits for an additional insured, leaving the named insured without coverage.

In *Pride Transportation*, an employee of Pride Transportation (an interstate motor carrier) was involved in an accident in which the employee rear-ended a pick-up truck driven by Wayne Hatley. Mr. Hatley was rendered a paraplegic. Pride was insured under a $1 million primary policy and a $4 million excess policy. The primary insurer undertook the defense of both the employee and Pride.

The Hatleys made a time limit settlement demand to the employee alone to settle their claims for the combined $5 million limits of both policies. The demand did not include their claims against Pride. Pride's counsel demanded that the primary insurer tender its policy limits to the excess insurer, which it did. The excess insurer then took over the settlement negotiations. The excess insurer attempted to respond to the Hatleys' offer by seeking permission to make a counteroffer settling all claims against both defendants for the limits of both policies. The Hatleys, however, refused to include Pride in the settlement. The employee's counsel demanded that the excess insurer accept the offer on behalf of the employee. The excess insurer accepted the offer on the employee's behalf. The Hatleys signed a formal settlement agreement containing a release of all of the Hatleys' claims against the employee. Because its policy limits were now exhausted, the excess insurer withdrew from further defense of Pride. Pride then settled the Hatleys' claims for an additional $2 million.

Pride then sued its primary and excess insurers for breach of contract and violation of the Unfair Claims Settlement Practices Act. The Northern District of Texas held that despite the problems the settlement created for Pride, the insurers acted reasonably in accepting the Hatleys' demand for policy limits, which had been directed to one, but not both, of the insureds. Pride, therefore, had no claim against its insurers.

On appeal, the Fifth Circuit declined to extend the *Stowers* duty to insurers *accepting* demands, noting that the *Stowers* duty imposes liability on insurers who *reject* reasonable demands covered under their policies. With regard to Pride's argument that the settlement was unreasonable, the court noted that due to "the likelihood and degree of potential exposure to excess judgment for [the employee], the Settlement was reasonable as a matter of law and did not result in a breach of the insurance contracts." As to Pride's statutory claims, the Fifth Circuit concluded that Pride's speculations as to what the insurers' motives were in settling, were insufficient to create a fact issue.