THE DUTY TO DEFEND

AMY E. STEWART
REBECCA M. ALCANTAR
WILSON, ELSER, MOSKOWITZ, EDELMAN & DICKER LLP
5000 Renaissance Tower
1201 Elm Street
Dallas, Texas 75270
214.698.8000 – Telephone
214.698.1101 – Facsimile
www.wilsonelser.com

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ABOUT THE AUTHORS

Rebecca M. Alcantar is a partner in the Dallas office of Wilson, Elser, Moskowitz, Edelman & Dicker LLP. She has extensive experience handling a variety of litigation matters in practice areas such as health care liability claims, insurance disputes, premises liability, construction, environmental/toxic tort claims and product liability. Ms. Alcantar's practice also includes providing risk management assessments to transportation clients on the prevention and management of catastrophic casualty claims. Additionally, she represents domestic and international clients and insurers at trials, hearings, depositions, mediations and arbitrations. Ms. Alcantar maintains an active trial docket, with the balance of her practice consisting of the defense of litigation matters in state and federal courts. She earned her B.A. degree from The University of Texas at Austin and a J.D. degree from Texas Tech University School of Law, where she was associate editor of the *Texas Tech University Law Journal*.

Amy E. Stewart is a partner in the Dallas office of Wilson, Elser, Moskowitz, Edelman & Dicker LLP. Her litigation practice encompasses business and commercial litigation, insurance coverage and bad faith litigation, managed care litigation, construction disputes and appellate matters. Ms. Stewart has successfully represented clients in both state and federal court litigation, as well as in arbitration and mediation. Her practice includes representation of clients in both state and federal appellate courts, including the Texas Supreme Court, on a wide variety of matters. Ms. Stewart dedicates a significant portion of her practice to the representation of liability insurers, serving as insurance coverage and monitoring counsel for claims under directors and officers liability, fiduciary liability, employee benefits errors and omissions, and professional liability policies. She earned a B.S. degree from Liberty University and her J.D. degree from the University of Virginia School of Law.

The authors would like to express their appreciation to **Amber Pickett** for her assistance in the preparation of these materials. Ms. Pickett is an associate in the Dallas office of Wilson, Elser, Moskowitz, Edelman & Dicker LLP. She practices with the insurance coverage and litigation sections of the firm. Ms. Pickett earned her B.A. degree from Rice University and a J.D. degree from University of Texas School of Law.

THE DUTY TO DEFEND

Amy E. Stewart
Rebecca M. Alcantar

In recent years, insurance cases have seen substantial activity in the Texas Supreme Court, resulting in several key decisions that have made a significant impact on issues relating to liability insurance policies. Most notably on duty to defend issues, the supreme court declined to recognize an exception to the eight-corners rule in *GuideOne*, a case involving "mixed" extrinsic evidence relating to both coverage and the merits of the underlying case. Although debate persists regarding whether the supreme court would recognize a more narrow exception if presented with the issue, most courts seem to be applying the exception acknowledged in the *GuideOne* decision for extrinsic evidence that relates only to coverage and does not challenge the merits of the underlying case.

Lamar Homes was an important decision last year, in which the supreme court applied the Texas prompt-payment statute to claims for breach of a liability insurer's duty to defend, resulting in the imposition of penalty interest on unpaid defense costs. Also relevant to the duty to defend, the supreme court has been asked to consider, in *Warrantech*, whether the fortuity doctrine may be applied in an eight-corners analysis to defeat the duty to defend or whether a complete departure from the traditional rule is warranted for fortuity cases.

This article provides a review of the general guidelines for determining the existence of an insurer's duty to defend under Texas law, focusing on recent cases, key principles and significant issues currently before the supreme court.

A. THE EIGHT-CORNERS RULE – AN OVERVIEW

Under Texas law, courts generally analyze an insurer's duty to defend under an insurance policy pursuant to the "eight-corners" rule, also known as the "complaint-allegation" rule.[1] This well-established doctrine mandates a comparison solely of the factual allegations in the underlying petition (the first "four corners") with the language of the insurance policy (the second "four corners").[2] As expressed by the Texas Supreme Court:

> The eight-corners rule provides that when an insured is sued by a third party, the liability insurer is to determine its duty to defend solely from terms of the policy and the pleadings of the third-party claimant. Resort to evidence outside the four corners of these two documents is generally prohibited.[3]

Facts outside the pleadings (even easily ascertained facts) are ordinarily not material to the determination of whether the insurer has a duty to defend.[4]

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[1] *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 308 (Tex. 2006).

[2] *GuideOne*, 197 S.W.3d at 308. *See Nat'l Union Fire Ins. Co. v. Merchs. Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Liberty Mut. Ins. Co. v. Graham*, 473 F.3d 596, 599-600 (5th Cir. 2006) (applying Texas law). *See also King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 187 (Tex. 2002) (duty to defend is determined "solely by the allegations in the pleadings and the language of the insurance policy").

[3] *GuideOne*, 197 S.W.3d at 307.

[4] *GuideOne*, 197 S.W.3d at 308.

In this regard, "[f]acts ascertained before suit, developed in the process of litigation, or determined by the ultimate outcome of the suit do not affect the duty to defend."[5]

The duty to defend arises when the facts alleged in the underlying pleading, taken as true, potentially state a cause of action falling within the terms of the policy.[6] "[A]n insurer is required to defend its insured if and only if a cause of action asserted in a petition is within the policy coverage."[7] Conversely, if the petition does not allege facts within the scope of coverage, an insurer is not required to defend.[8] As such, an insurer is absolved of the duty to defend if it is shown, within the confines of the eight-corners rule, "that the plain language of a policy exclusion or limitation allows the insurer to avoid coverage of *all* claims."[9]

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[5] *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 528 (5th Cir. 2004) (applying Texas law). *See Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 829 (Tex. 1997) (quoting *Am. Alliance Ins. Co. v. Frito-Lay, Inc.*, 788 S.W.2d 152, 154 (Tex. App.—Dallas 1990, writ dism'd)).

[6] *Northfield*, 363 F.3d at 528 (*citing Canutillo Indep. Sch. Dist. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 99 F.3d 695, 701 (5th Cir. 1996) (applying Texas law).

[7] *State Farm Fire & Cas. Co. v. Wade*, 827 S.W.2d 448, 451 (Tex. App.—Corpus Christi 1992, writ denied); *see also Fidelity & Guar. Ins. Underwriters, Inc. v. McManus*, 633 S.W.2d 787, 788 (Tex. 1982).

[8] *King*, 85 S.W.3d at 187; *see also Cowan*, 945 S.W.2d at 821; *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848 (Tex. 1994); *Merchs. Fast Motor Lines*, 939 S.W.2d at 141; *McManus*, 633 S.W.2d at 788; *Guar. Nat'l Ins. Co. v. Azrock Indus. Inc.*, 211 F.3d 239, 251 (5th Cir. 2000) (applying Texas law) (if complaint does not allege facts covered by the plain language of the policy, the court "should not impose a duty to defend"). *See also Northfield*, 363 F.3d at 528 (if the petition *only* alleges facts excluded by the policy, the insurer is not required to defend).

[9] *Northfield*, 363 F.3d at 528.

1. Ordinary Contract Principles Apply

Insurance policies are contracts controlled by general rules of contract construction.[10] Interpretation of an insurance policy to analyze the existence of a duty to defend is a question of law for the court.[11] The court's primary concern is to give effect to the intention of the parties as expressed by the policy language.[12]

If the insurance policy language is susceptible to more than one reasonable interpretation, it is deemed ambiguous and the court must resolve the uncertainty by adopting the construction that most favors the insured.[13] Not every difference in the interpretation of a contract or an insurance policy amounts to an ambiguity, however.[14] "Both the insured and the insurer are likely to take conflicting views of coverage, but neither conflicting expectations nor disputation is sufficient to *create* an ambiguity."[15] Policy language that can be given only one reasonable construction is not

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[10] *See Mid-Continent Cas. Co. v. Swift Energy Co.,* 206 F.3d 487, 491 (5th Cir. 2000) (applying Texas law); *Nat'l Union Fire Ins. Co. v. CBI Indus., Inc.,* 907 S.W.2d 517, 520 (Tex. 1995).

[11] *See Forbau v. Aetna Life Ins. Co.,* 876 S.W.2d 132, 133 (Tex. 1994); *Nat'l Union Fire Ins. Co. v. Hudson Energy Co.,* 811 S.W.2d 552, 555 (Tex. 1991); *Barnett v. Aetna Life Ins. Co.,* 723 S.W.2d 663, 665-66 (Tex. 1987); *Coker v. Coker,* 650 S.W.2d 391, 393-94 (Tex. 1983).

[12] *CBI Indus.,* 907 S.W.2d at 520; *Forbau,* 876 S.W.2d at 133. *See also Mid-Continent Cas. Co.,* 206 F.3d at 491.

[13] *Hudson Energy Co.,* 811 S.W.2d at 555 (citing *Barnett,* 723 S.W.2d at 667; *Ramsay v. Md. Am. Gen. Ins. Co.,* 533 S.W.2d 344, 349 (Tex. 1976); *Brown v. Palatine,* 89 Tex. 590, 35 S.W. 1060, 1061 (1896)).

[14] *State Farm Life Ins. Co. v. Beaston,* 907 S.W.2d 430, 433 (Tex. 1995) (quoting *Forbau*, 876 S.W.2d at 134).

[15] *Id.* (quoting *Forbau,* 876 S.W.2d at 134).

ambiguous[16] and must be enforced as written – a court may not vary the terms of an unambiguous policy.[17] The question of whether a policy is ambiguous is one of law for the court.[18]

2. Burdens of Proof

To establish an insurer's duty to defend, the insured bears the initial burden of proving that the claim is potentially within the policy's coverage.[19] Once the insured has proven that the claim falls within the scope of the insuring agreement, the insurer must prove the applicability of a policy exclusion.[20]

> After the insured meets his burden to show that the alleged facts in the petition state a potential claim against him, to defeat the duty to defend, the insurer bears the burden of showing that the plain language of a policy exclusion or limitation allows the insurer to avoid coverage of *all* claims, also within the confines of the eight corners rule.[21]

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[16] *Hudson Energy Co.,* 811 S.W.2d at 555; *Puckett v. U.S. Fire Ins. Co.,* 678 S.W.2d 936, 938 (Tex. 1984).

[17] *Am. Nat'l Gen. Ins. Co. v. Ryan,* 274 F.3d 319, 329 (5th Cir. 2001) (applying Texas law).

[18] *Mid-Continent Cas. Co.,* 206 F.3d at 491.

[19] *Canutillo,* 99 F.3d at 701 (insured must show "that the claim against it is potentially within the policy's coverage"); *Lincoln Gen. Ins. Co. v. Reyna*, 401 F.3d 347, 350 (5th Cir. 2005) (applying Texas law) (insured party bears the initial burden of showing that there is coverage). *See also Employers Cas. Co. v. Block,* 744 S.W.2d 940, 944 (Tex. 1988), *overruled on other grounds by State Farm Fire & Cas. v. Gandy,* 925 S.W.2d 696 (Tex. 1996).

[20] *Canutillo,* 99 F.3d at 701 ("insurer bears the burden of establishing that an exclusion in the policy constitutes an avoidance of or affirmative defense to coverage") (citing TEX. INS. CODE ANN. art. 21.58(b) (Vernon 2005)); *Reyna*, 401 F.3d at 350 (insurer bears the burden of showing that any exclusion in the policy applies).

[21] *Northfield*, 363 F.3d at 528 (citing TEX. INS. CODE ANN. art. 21.58(b)).

Finally, "[o]nce the insurer proves that an exclusion applies, the burden shifts back to the insured to show that the claim falls within an exception to the exclusion."[22]

3. Facts Alleged, Not Legal Theories

The focus of the duty-to-defend inquiry is on the facts alleged in the underlying petition which show the origin of the damages, not on the cause of action or legal theories asserted.[23] "It is not the cause of action alleged that determines coverage but the *facts* giving rise to the alleged actionable conduct."[24]

Conclusory allegations are likewise insufficient to trigger the duty to defend. "Texas courts do not look to conclusory assertions of a cause of action in determining a duty to defend."[25] Rather, "they look to see if the facts giving rise to the alleged actionable conduct, as stated within the eight corners of the complaint, constitute a claim potentially within the insurance

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[22] *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 723 (5th Cir. 1999) (applying Texas law) (footnotes omitted). *See Guar. Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 193 (5th Cir. 1998) (applying Texas law) (once the insurer demonstrates the applicability of an exclusion, the burden re-shifts to the insured to establish an exception to the exclusion).

[23] *Merchs. Fast Motor Lines, Inc.*, 939 S.W.2d at 141; *Reyna*, 401 F.3d at 350. *See Urethane Int'l Prods. v. Mid-Continent Cas. Co.*, 187 S.W.3d 172, 176 (Tex. App.—Waco 2006, no pet.) ("The Texas Supreme Court has repeatedly held that it is the facts alleged in the underlying case, not the legal theories asserted, that determine whether or not there is coverage under the policy and/or a duty to defend."). *See also Northfield*, 363 F.3d at 528; *St. Paul Fire & Marine Ins. Co. v. Green Tree Fin. Corp.-Tex.*, 249 F.3d 389, 392 (5th Cir. 2001) (applying Texas law).

[24] *Adamo v. State Farm Lloyds Co.*, 853 S.W.2d 673, 676 (Tex. App.—Houston [14th Dist.] 1993, writ denied).

[25] *Cornhill Ins. PLC v. Valsamis, Inc.*, No. 95-20898, 1997 U.S. App. LEXIS 12773, *8-9 (5th Cir. 1997) (applying Texas law).

coverage."[26] In the absence of specific factual allegations, the claim becomes "nothing more than a conclusory statement, which cannot be used as a basis to decide whether [the insurer] has a duty to defend."[27]

Where the underlying pleading alleges a sufficient factual basis to support a cause of action for a covered offense, it may not be necessary that the pleading specifically name the particular covered offense to trigger a duty to defend.[28] In *Green Tree*, the insured faced counterclaims alleging causes of action for wrongful debt collection practices, breach of an installment contract and breach of warranties.[29] In support of the wrongful debt collection claim, the pleading alleged that the insured bombarded claimants with harassing and abusive phone calls.[30] Because the facts that formed the basis for the wrongful debt collection claim supported a cause of action for invasion of privacy covered under the policy, the court concluded that the insurer had a duty to defend the counterclaims.[31]

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[26] *Cornhill Ins. PLC*, 1997 U.S. App. LEXIS 12773, at *9 (citing *Adamo*, 853 S.W.2d at 673).

[27] *See St. Paul Guardian Ins. Co. v. Centrum G.S. Ltd.*, No. 3:97-CV-1478-L, 2000 WL 1639345, *8 (N.D. Tex. Oct. 31, 2000), *aff'd in part, rev'd in part on other grounds by* 238 F.3d 709 (5th Cir. 2002) (analyzing a claim for defamation, where the court noted that the plaintiff must, at a minimum, "identify the alleged defamatory statements, the maker of the statements, the approximate dates the statements were made, and to whom the statements were made") (citing *Cornhill Ins. PLC*, 106 F.3d at 85).

[28] *See Green Tree*, 249 F.3d at 393.

[29] *Id.* at 390-91.

[30] *Id.*

[31] *Green Tree*, 249 F.3d at 393-95. *See Md. Cas. Co. v. S. Tex. Med. Clinics*, No. 13-06-089-CV, 2008 Tex. App. Lexis 279, *17 n. 11 (Tex. App.—Corpus Christi Jan. 10, 2008, pet. filed) (although the petition did not state a claim for false imprisonment, court found a duty to defend based on facts alleged that satisfied the elements of false imprisonment).

Conversely, as discussed above, the mere mention of a particular covered offense, without specific supporting facts, is not sufficient to trigger a duty to defend. As one court observed:

> While *Green Tree* holds that it is not *necessary* for an underlying pleading to specifically name a covered offense to trigger an insurer's duty to defend, it notably does not stand for the proposition that an offhand mention of a covered offense in an underlying pleading is *sufficient* to trigger coverage. The touchstone remains whether the factual allegations support a claim for a covered offense.[32]

Regardless of the legal theories or causes of action alleged, the inquiry is whether the facts alleged in the underlying pleading give rise to any claim triggering coverage under the policy at issue.

4. Facts Alleged Taken as True

The insurer's duty to defend depends on whether the factual allegations in the underlying pleading, without regard to their veracity, would potentially state a claim that falls within the policy's coverage.[33] Facts alleged against an insured in the underlying petition are presumed to be true when gauging the insurer's duty to defend.[34]

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[32] *See Federal Ins. Co. v. CMI Lloyds Ins. Co.*, Civil Action No. 3:06-CV-0103, *12 (N.D. Tex. Mar. 9, 2007) (memorandum order) (emphasis in original). *See also C.O. Morgan Lincoln-Mercury, Inc. v. Vigilant Ins. Co.*, 521 S.W.2d 318, 321 (Tex. Civ. App.—Fort Worth 1975, no writ) (in suit for conversion, allegations regarding slanderous comments that were not the basis of the recovery sought, insurer had no duty to defend).

[33] *GuideOne*, 197 S.W.3d at 308 (factual allegations against the insured are taken as true); *Graham*, 473 F.3d at 600.

[34] *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.,* 146 S.W.3d 833, 838 (Tex. App.—Dallas 2004, pet. denied) (citing *Heyden Newport Chem. Corp. v. S. Gen. Ins. Co.,* 387 S.W.2d 22, 24 (Tex. 1965)).

5. Doubts Resolved in Favor of Duty

When applying the eight-corners rule, courts give the facts alleged in the petition a liberal interpretation.[35] Doubts about the insurer's duty to defend are resolved in favor of the duty.[36] More specifically, "[i]n case of doubt as to whether or not the allegations of a complaint against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in insured's favor."[37]

> Where the complaint does not state facts sufficient to clearly bring the case within or without the coverage, the general rule is that the insurer is obligated to defend if there is, potentially, a case under the complaint within the coverage of the policy. Stated differently, in case of doubt as to whether or not the allegations of a complaint against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in the insured's favor.[38]

In *Merchants Fast Motor Lines*, the supreme court provided guidance regarding the application of this principle.[39] The only facts alleged in the underlying case were that the tortfeasor was operating a truck owned by the

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[35] *See GuideOne*, 197 S.W.3d at 308; *Merchs. Fast Motor Lines*, 939 S.W.2d at 141 ("When applying the eight corners rule, we give the allegations in the petition a liberal interpretation.").

[36] *King*, 85 S.W.3d at 187 ("[W]e resolve all doubts regarding the duty to defend in favor of the duty."). *See Graham*, 473 F.3d at 600.

[37] *Merchs. Fast Motor Lines*, 939 S.W.2d at 141 (quoting *Heyden*, 387 S.W.2d at 26); *Northfield*, 363 F.3d at 528.

[38] *Heyden*, 387 S.W.2d at 26 (quoting C.T. Drechsler, *Allegations in Third Person's Action Against Insured as Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458, 504 (1956)).

[39] 939 S.W.2d 139.

insured when he negligently discharged a firearm injuring the underlying plaintiff. Analyzing the facts alleged, the court concluded, "Given their most liberal interpretation, these allegations do not suggest that [the plaintiff]'s injury resulted from the use of the truck."[40] Although the allegation that the tortfeasor "was operating the tractor-trailer" was sufficient to allege "use of a covered auto," the pleadings did not allege that the plaintiff's injury was "caused by an accident *resulting from* the . . . use of a covered auto," as required by the policy at issue.[41]

Under an eight-corners analysis, the court found that the mere fact an automobile was the situs of an accident is insufficient to establish the necessary nexus between the use and the accident to warrant the conclusion that the accident resulted from such use.[42] "Because the facts alleged in the pleadings do not suggest even a remote causal relationship between the truck's operation and [the plaintiff]'s injury, they do not create that degree of doubt which compels resolution of the issue for the insured."[43]

The court's analysis in *Merchants* demonstrates that the "degree of doubt which compels resolution of the issue for the insured" is more than mere metaphysical doubt. Although the pleadings are strictly construed

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[40] *Id.* at 141-42.

[41] *Id.*

[42] *Id.* at 142.

[43] *Id.* at 142 (citing *Heyden*, 387 S.W.2d at 26).

against the insurer with any doubt resolved in favor of coverage, "not every doubt requires resolution of the duty to defend in favor of the insured."[44]

6. Actual Allegations, Not Imagined or Implied

Finally, as the rule itself suggests, the duty to defend is not limitless, but rather is bounded by the facts actually alleged in the pleading.[45] In analyzing the petition, the court may not read facts into the pleadings, look outside the pleadings or "imagine factual scenarios that might trigger coverage."[46]

B. Exceptions – Consideration of Extrinsic Evidence

Although the duty to defend is generally governed by the eight-corners rule, limited exceptions permitting consideration of extrinsic evidence on fundamental coverage issues have been recognized by both state and federal courts applying Texas law.[47] Because the supreme court has not expressly adopted an exception, however, the decisions of other courts applying exceptions have spawned substantial debate.

In 2006, the supreme court was confronted with an opportunity to address the issue of extrinsic evidence in *GuideOne Elite Ins. Co. v. Fielder*

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[44] *D.R. Horton-Texas, Ltd. v. Markel International Insurance Co., Ltd.,* No. 14-05-00486-CV, 2006 Tex. App. LEXIS 9346, *8 (Tex. App.—Houston [14th Dist.] Oct. 26, 2006, pet. filed).

[45] *St. Paul Ins. Co. v. Tex. Dep't of Transp.*, 999 S.W.2d 881, 884 (Tex. App.—Austin 1999, pet. denied).

[46] *Tex. Dep't of Transp.*, 999 S.W.2d at 885; *Merchs. Fast Motor Lines*, 939 S.W.2d at 141. *See also Azrock Indus.*, 211 F.3d at 243 (applying Texas law).

[47] *See GuideOne*, 197 S.W.3d at 308 n. 1.

Rd. Baptist Church. Although it offered some guidance regarding the situations in which extrinsic evidence should not be considered, the supreme court declined to issue a bright-line rule that extrinsic evidence may never be considered in the duty-to-defend context.[48] Until the issue is squarely presented to the supreme court, therefore, courts and litigants must discern the circumstances in which extrinsic evidence may be considered in determining the duty to defend from the decisions of the federal courts and intermediate courts of appeal who have considered the issue. At the outset of this discussion, it is worth noting that the eight-corners rule and the common law defining whatever exceptions may exist will not uniformly favor one side or the other – insureds v. insurers. The rule, whatever it is, will sometimes benefit the insured and, at other times, will result in a win for the insurer. The segment that follows focuses on *GuideOne* and subsequent decisions that have analyzed existing Texas law in an effort to ascertain whether and when extrinsic evidence may be considered in determining the duty to defend.

1. *GuideOne*

In *GuideOne*, the supreme court was asked to create an exception to the eight-corners rule to permit consideration of "mixed" extrinsic evidence –

[48] *See Hermitage Ins. Co. v. Times Square Dallas, Ltd.*, Civil Action No. 3:05-CV-0785-N, slip op. at 4-6 (N.D. Tex. Mar. 9, 2007) (citing *GuideOne* as "persuasive authority" that the supreme court would find a narrow exception for coverage-only extrinsic evidence if the question were squarely presented).

i.e., evidence that is relevant both to coverage and to the merits of the underlying case.[49]

a. The Coverage Dispute

The coverage lawsuit involved a commercial general liability policy issued by GuideOne Elite Insurance Company ("GuideOne") to Fielder Road Baptist Church for the policy period March 31, 1993 to March 31, 1994. The policy provided coverage, in pertinent part, for "damages because of bodily injury, excluding any sickness or disease, to any person arising out of sexual misconduct which occurs during the policy period."[50]

In 2001, Jane Doe filed an underlying lawsuit against the church and one of its former youth ministers, Charles Patrick Evans. The pleadings alleged that "[a]t all times material herein from 1992 to 1994, Evans was employed as an associate youth minister and was under Fielder Road's direct supervision and control when he sexually exploited and abused Plaintiff."[51] The church demanded that GuideOne defend it in the lawsuit and indemnify it for any judgment or settlement. GuideOne provided a defense, subject to a reservation of rights, and later initiated coverage litigation, seeking a

[49] 197 S.W.3d 305 (Tex. 2006).

[50] *Id*. at 307.

[51] *Id*.

declaration that it had no duty to defend or indemnify the church in the sexual misconduct lawsuit.[52]

Through discovery in the coverage litigation, GuideOne obtained evidence that the youth minister's employment with the church ended in December 1992, several months before the policy incepted. The trial court granted GuideOne's motion for summary judgment, concluding that GuideOne had no duty to defend the church in the underlying lawsuit. The court of appeals reversed on grounds that the trial court improperly considered extrinsic evidence in determining whether GuideOne had a duty to defend and GuideOne petitioned the supreme court for review.[53]

b. Arguments on Appeal

On review, GuideOne argued that it had no duty to defend the church against the sexual misconduct claim because the youth minister left his job with the church before the policy's effective date.[54] Since the plaintiff's allegations against the church involved Evans' conduct while a youth minister, GuideOne suggested, the extrinsic evidence of when that relationship ended established that no coverage existed for Evans' acts during the policy period.[55] Recognizing the eight-corners rule as an

[52] *Id.*

[53] *Id.*

[54] *Id.* at 308.

[55] *Id.*

impediment to its position, however, GuideOne advanced several arguments in support of its contention that extrinsic evidence regarding Evans' employment status be considered as an exception to the rule:

> 1. an exception should apply because the extrinsic evidence was primarily relevant to the issue of coverage, rather than the merits of the plaintiff's underlying claim;
>
> 2. extrinsic evidence is needed to supplement the plaintiff's allegations because those allegations alone are insufficient to determine coverage or the duty to defend; and
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> 3. if the Court concludes that the employment evidence is relevant both to coverage and liability, an exception to the eight-corners rule should nevertheless be recognized for this type of "mixed" or "overlapping" extrinsic evidence.[56]

c. The Court's Analysis

Before analyzing the parties' arguments, the *GuideOne* court considered the decisions of other Texas courts permitting consideration of extrinsic evidence to determine an insurer's duty to defend where "fundamental" policy coverage questions are resolved by "readily determined facts."[57] According to the court, a "pure coverage question" is one which is "relevant to an independent and discrete coverage issue, not touching on the merits of the underlying third-party claim."[58] A pure coverage question may

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[56] *Id.*

[57] *Id.* at 309 n. 2.

[58] *GuideOne,* 197 S.W.3d at 308.

not overlap with the facts pled in the underlying case.[59] The key element in reviewing the use of extrinsic evidence is whether the evidence contradicts allegations in the underlying lawsuit or whether the evidence relates solely to coverage questions.[60]

Concluding that the evidence regarding Evans' employment was relevant to both coverage and the merits of the underlying case, the supreme court observed that this type of "mixed" evidence did not fit within the narrow exception applied by other courts – "when it is initially impossible to discern whether coverage is potentially implicated *and* when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case."[61] Contrary to this recognized exception, the extrinsic evidence adduced by GuideOne "directly contradict[ed] the plaintiff's allegations that the [c]hurch employed Evans during the relevant coverage period."[62]

On these facts, the court declined to recognize a broader exception to the eight-corners rule for the use of overlapping evidence, noting that "very

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[59] *Id.* at 309.

[60] *Fair Operating, Inc. v. Mid-Continent Cas. Co.*, 193 Fed. Appx. 302, 305, M 05-50917, 2006 U.S. App. LEXIS 19382, at *8-9 (5th Cir. Aug. 1, 2006) (applying Texas law); *B. Hall Contracting, Inc. v. Evanston Ins. Co.*,, 447 F. Supp. 2d 634, 646 (N.D. Tex. 2006); *Nautilus Ins. Co. v. Nevco Waterproofing, Inc.*, Civil Action No. H-04-2986, 2005 U.S. Dist. LEXIS 30939, at *33-34 (S.D. Tex. July 11, 2005).

[61] *Northfield*, 363 F.3d at 531.

[62] *GuideOne*, 197 S.W.3d at 310.

little support exists for this position."[63] First, the Fifth Circuit had previously rejected a similar use of overlapping facts for this purpose. In *Gulf Chemical & Metallurgical Corp. v. Associated Metals & Minerals Corp.*,[64] the underlying tort plaintiffs alleged that Gulf was strictly liable because it sold or shipped molyoxide. The petition alleged that the plaintiffs had suffered injures from exposure to molyoxide between 1946 and 1990, but did not specifically allege when Gulf had shipped the toxin. Extrinsic evidence would have established that Gulf did not ship any molyoxide until three days after the expiration of the policy in question. Because the evidence in question concerned both the merits of the underlying case and coverage, the Fifth Circuit, applying Texas law, rejected the use of extrinsic evidence under these circumstances.[65]

The court further observed that an exception for "mixed" extrinsic evidence would pose "a significant risk of undermining the insured's ability to defend itself in the underlying litigation"[66] and stressed the problem with conflating the insurer's defense and indemnity obligations, which are distinct and separate. The duty to defend applies even to groundless claims, while

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[63] *Id.* at 309.

[64] 1 F.3d 365 (5th Cir. 1993) (applying Texas law).

[65] *Id.* at 371.

[66] *GuideOne*, 197 S.W.3d at 309 (citing Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty to Defend in Texas*, 31 Tex. Tech L. Rev. 869, 891-95 (2000) (discussing risks associated with using overlapping evidence as an exception to the eight-corners rule)).

the duty to indemnify applies only to meritorious claims. Rejecting GuideOne's argument that it should not have to defend because it *knew* that Evans was not in fact an employee of the church during this period, the court emphasized that the duty to defend does not turn on the truth or falsity of the plaintiff's allegations.[67]

d. Looking Ahead

Although the *GuideOne* court declined to recognize an exception for "mixed" extrinsic evidence, it left unanswered the question of whether "coverage-only" evidence might be admissible in a duty to defend case. While the issue continues to spawn debate, the *GuideOne* decision appears to have left the door open for application of the narrow exception for "pure coverage" evidence.

First, the *GuideOne* court observed that, in determining an insurer's duty to defend, "[r]esort to evidence outside [the eight corners] is *generally* prohibited"[68] – the court could have, but did not, articulate a bright-line rule that extrinsic evidence is strictly prohibited.

Second, the court noted that it had never expressly recognized any exception to the eight-corners rule, but acknowledged that other courts have "drawn a very narrow exception, permitting the use of extrinsic evidence only when relevant to an independent and discrete coverage issue, not touching on

[67] *Guide One*, 197 S.W.3d at 311.

[68] *Id.* at 307 (emphasis added).

the merits of the underlying third-party claim."[69] In particular, the court identified six decisions recognizing an exception for coverage-only extrinsic evidence, describing the standard applied and the pertinent circumstances.[70] Although the supreme court did not expressly adopt the rules articulated by these courts, the holdings were recited without criticism.

Third, the court noted the Fifth Circuit's observation in *Northfield Insurance Co. v. Loving Home Care, Inc.* – that if it were to recognize an exception to the eight-corners rule, it would likely do so "when it is initially impossible to discern whether coverage is potentially implicated *and* when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts

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[69] *Id.* at 308.

[70] *Id.* at 309 n. 2 (citing *W. Heritage Ins. Co. v. River Entm't,* 998 F.2d 311, 313 (5th Cir. 1993) (applying Texas law) ("However, when the petition does not contain sufficient facts to enable the court to determine if coverage exists, it is proper to look to extrinsic evidence in order to adequately address the issue."); *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F. Supp. 2d 601, 621-22 (E.D. Tex. 2003) (extrinsic evidence admissible in deciding the duty to defend where fundamental policy coverage questions can be resolved by readily determined facts that do not engage the truth or falsity of the allegations in the underlying petition, or overlap with the merits of the underlying suit); *Wade*, 827 S.W.2d at 452-53 (extrinsic evidence could be admitted in deciding the duty to defend when the facts alleged are insufficient to determine coverage and "when doing so does not question the truth or falsity of any facts alleged in the underlying petition"); *Gonzales v. Am. States Ins. Co.*, 628 S.W.2d 184, 187 (Tex. App.—Corpus Christi 1982, no writ) (facts extrinsic to the petition relating only to coverage, not liability, may be considered to determine a duty to defend, where such evidence does not contradict any allegation in the petition); *Cook v. Ohio Cas. Ins. Co.*, 418 S.W.2d 712, 715-16 (Tex. Civ. App.—Texarkana 1967, no writ) ("[T]he Supreme Court draws a distinction between cases in which the merit of the claim is the issue and those where the coverage of the insurance policy is in question. In the first instance the allegation of the petition controls, and in the second the know or ascertainable facts are to be allowed to prevail."); *Int'l Serv. Ins. Co. v. Boll*, 392 S.W.2d 158, 161 (Tex. Civ. App.—Houston [1st Dist.] 1965, writ ref'd n.r.e.) (considering extrinsic evidence of identity of driver of insured vehicle by stipulation, "which went strictly to the coverage issue" and "did not contradict any allegation in the third-party claimant's pleadings material to the merits of that underlying claim")).

alleged in the underlying case."[71] In *Northfield*, the Fifth Circuit actually made an *Erie* guess that the supreme court would not recognize any exception to the eight-corners rule and that, if it recognized any exception, it would apply only to pure coverage facts unrelated to the merits of the underlying case.[72] In its reference to *Northfield*, the *GuideOne* court clearly had the opportunity to affirm the Fifth Circuit's *Erie* guess, which it did not do – choosing instead to cite the narrow exception the Fifth Circuit thought might be adopted.

2. *Graham*

After the supreme court decided *GuideOne*, the Fifth Circuit considered the admissibility of extrinsic evidence to determine an insurer's duty to defend in *Liberty Mutual Insurance Co. v. Graham*.[73] The disputed issue was whether the defendant in an underlying lawsuit was a permissive user of a vehicle involved in an accident.[74] The district court admitted extrinsic evidence offered by the insurer to establish that the driver was not a permissive user of the vehicle and that he was intoxicated.[75]

On appeal, the insured argued that the insurer owed him a defense because, under the eight-corners rule, a liability insurer's duty to defend is

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[71] *Northfield*, 363 F.3d at 531.

[72] *Id.*

[73] 473 F.3d 596 (5th Cir. 2006) (applying Texas law).

[74] *Id.* at 598-99.

[75] *Id.* at 599.

determined solely from the terms of the policy and the pleading in the underlying lawsuit.[76] Because the underlying complaint alleged permission and the policy covered permissive drivers, the insured argued that the duty to defend was triggered.[77] The insurer countered that the complaint did not allege permissive use of the vehicle and that, even if it did, an exception to the eight-corners rule was justified and considering extrinsic evidence was appropriate because the evidence related solely to a coverage determination.[78]

The Fifth Circuit agreed with the insured and reversed the district court's order granting summary judgment in favor of the insurer, holding that the admission of extrinsic evidence on the duty to defend issue was error after *GuideOne* (issued after the district court's decision). In its analysis, the court referred to "the limited exception to the eight corners rule applied by some Texas appellate courts and approved in the *GuideOne* decision's dicta."[79] The insurer argued that the evidence in question fit the limited exception because it related solely to the driver's status as an insured.[80] While the evidence may have contradicted the merits of the plaintiffs' claims

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[76] *Id.*

[77] *Id.*

[78] *Id.* at 598-99.

[79] *Id.* at 602.

[80] *Id.*

against other defendants, the insurer maintained it did not challenge the merits of the plaintiffs' case against the driver.[81]

The court determined that the complaint against Graham contained allegations sufficient to support the conclusion that the underlying plaintiffs alleged permissive use of the vehicle.[82] The court distinguished *Boll*[83] "and other Texas intermediate court decisions allowing extrinsic evidence to establish a lack of coverage" because those cases "involved explicit policy coverage exclusion clauses, the applicability of which could not be established under the allegations of the complaint but rather required reference to unrelated but readily ascertainable facts."[84] Although the Fifth Circuit acknowledged the exception approved by the supreme court in *GuideOne*'s dicta, it concluded that the facts of the *Graham* case did not meet the criteria for consideration of extrinsic evidence.[85]

3. Other Courts

Since *GuideOne* and *Graham*, several other courts have analyzed "the narrow exception to the 'eight corners' rule that permits consideration of

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[81] *Id.*

[82] *Id.* at 603.

[83] *Boll*, 392 S.W.2d at 158.

[84] *Graham*, 473 F.3d at 603 (footnote omitted).

[85] *Id.*

extrinsic evidence applicable solely to coverage."[86] Applying the principles articulated in *GuideOne* and *Graham*, the United States District Court for the Northern District of Texas (Godbey, J.) concluded in two cases decided last year that extrinsic evidence relating to coverage did not overlap with the facts alleged in the underlying complaint and could therefore be considered in determining whether the insurer had a duty to defend.[87] These opinions carefully analyzed "the state of Texas law regarding an exception to the eight corners rule in certain limited circumstances" after *GuideOne*:

> In [*GuideOne*], the Texas Supreme Court decided not to create an exception to the eight corners rule for extrinsic evidence that is "mixed," i.e., that is relevant both to coverage and to the merits of the underlying case. In so holding, the court cited with approval a Fifth Circuit case predicting that if the Texas Supreme Court ever adopted any exception, it would be narrow and limited to "coverage only" extrinsic evidence. Thus, although the Texas Supreme Court did not expressly hold that Texas law has such a narrow exception for extrinsic evidence, it is persuasive authority that the Court would find one if the question were squarely presented.
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> The Court concludes from *GuideOne* and *Liberty Mut. v. Graham* that, under Texas law, there is an exception to the eight corners rule "when it is initially impossible to discern whether coverage is potentially implicated *and* when the extrinsic evidence goes solely to a fundamental issue of coverage

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[86] *Mary Kay Holding Corp. v. Fed. Holding Co.*, No. 3:06-CV-896, 2007 U.S. Dist. LEXIS 88583, at *11 (N.D. Tex. Aug. 14, 2007), *appeal docketed*, No. 07-10951 (5th Cir. Sept. 10, 2007) (quoting *Hermitage,* Civil Action No. 3:05-CV-0785-N, slip op. at 4–6).

[87] *See Mary Kay*, 2007 U.S. Dist. LEXIS 88583 at *16; *Hermitage,* Civil Action No. 3:05-CV-0785-N, slip op. at 1.

> which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case."[88]

In both cases, the court concluded that extrinsic evidence was admissible under the narrow exception recognized in *GuideOne* and *Graham*.

The *Hermitage* case presented "difficult and subtle issues regarding the duty to defend under a contract of insurance."[89] The plaintiff in the underlying case initially pled himself out of coverage by alleging conduct squarely within the policy's assault exclusion. He then attempted to plead back into coverage by excising from his petition any facts regarding how his injuries occurred. The court was faced with the situation in which the underlying facts apparently precluded the duty to defend, but the latest pleading in the case was silent with respect to facts needed to determine the applicability of the assault exclusion.

The court concluded that the criteria for the exception were met. It was impossible to discern whether coverage was potentially implicated without extrinsic evidence of the assault. According to the amended petition (which contained no facts regarding the assault), *how* the plaintiff ended up on the ground with a subdural hematoma was irrelevant to the merits of the underlying case. Because nothing in the amended petition addressed how the

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[88] *Mary Kay*, 2007 U.S. Dist. LEXIS at *12-14 (quoting *Hermitage,* Civil Action No. 3:05-CV-0785-N, slip op. at 4-6) (internal citations omitted).

[89] *Hermitage,* Civil Action No. 3:05-CV-0785-N, slip op. at 1.

plaintiff was injured, the extrinsic evidence did not "engage the truth or falsity of any facts alleged in the underlying case."[90]

In *Mary Kay*, the court determined that the coverage dispute required, in part, resolution of a temporal issue – whether a particular entity was a subsidiary of the insured when the policy incepted.[91] Because the underlying lawsuit contained no allegations regarding ownership of the entity at the time the policy incepted, the court concluded that the issue of subsidiary status as of the policy inception date fell within the narrow exception acknowledged in *GuideOne* and *Graham*.

> Because the temporal focus is different for liability than for coverage, this case fits nicely within the exception. …[E]vidence of subsidiary status as of [the policy inception date] "does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case."[92]

The evidence in question was a bankruptcy court order approving the entity's plan of reorganization, which cancelled all of the entity's stock prior to the inception of the policy.[93] This evidence conclusively established that any equity interest the insured may have had in the entity was terminated before the policy incepted, such that the entity could not have been a subsidiary of

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[90] *Hermitage,* Civil Action No. 3:05-CV-0785-N, slip op. at 10 (quoting *Northfield*, 363 F.3d at 531).

[91] *Mary Kay*, 2007 U.S. Dist. LEXIS 88583, at *14-15.

[92] *Id.* at *16.

[93] *Id.* at *11.

the insured.[94] Accordingly, the insurer had no duty to defend based on the allegations relating to the non-subsidiary entity.[95] The *Mary Kay* case is currently on appeal to the Fifth Circuit.

Other courts have likewise concluded that *GuideOne* did not foreclose the possibility of an exception to the eight-corners rule. In *Bayou Bend Homes*, the United States District Court for the Southern District of Houston observed:

> Although the Texas Supreme Court explicitly rejected the use of extrinsic evidence that was relevant both to coverage and to the merits of the underlying action, it did not rule on the validity of a more narrow exception that would allow extrinsic evidence solely on the issue of coverage. In fact, the language of the opinion hints that the court views the more narrow exception favorably. For example, the court specifically acknowledged that other courts recognized a narrow exception for extrinsic evidence that is relevant to the discrete issue of coverage and noted that the Fifth Circuit had opined that, were any exception to be recognized by the Texas high court, it would likely be such a narrow exception.[96]

The United States District Court for the Southern District of Texas analyzed the impact of the *GuideOne* decision on the eight-corners rule in *Boss Management Services, Inc. v. Acceptance Insurance Company*.[97] The coverage issue in dispute was whether the underlying lawsuits alleged

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[94] *Id.* at *17.

[95] *Id.*

[96] *Bayou Bend Homes, Inc. v. Scottsdale Ins. Co.*, No. H-05-1544, 2006 WL 2037564, at *5, 2006 U.S. Dist. LEXIS 48887, at *16–19 (S.D. Tex. July 18, 2006) (citations and footnote omitted) (citing *GuideOne*, 197 S.W.3d at 305). *See also Evanston*, 447 F. Supp. 2d at 646.

[97] No. H-06-2397, 2007 U.S. Dist. LEXIS 69666 (S.D. Tex. Sept. 19, 2007).

property damage occurring during the policy periods, which could not be determined from the imprecise allegations in the complaints.[98] The insured suggested that the court consider the certificates of occupancy in order to establish the earliest date after which the damage appeared.[99]

The court agreed that this was a proper use of extrinsic evidence.[100] Although the supreme court was "steadfast in its rejection of the use of overlapping evidence," the high court "favorably cited," in dicta, the exception recognized in *Northfield* and "hinted that a more narrow exception may be appropriate in some cases" – where it is initially impossible to determine whether coverage is potentially implicated and the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of the case.[101] The certificates of occupancy provided undisputed evidence of the dates on which the buildings were completed and occupied, which enabled the court to determine that coverage was potentially implicated.[102] Accordingly, the court denied the insurers' motions for summary judgment.[103]

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[98] *Id.* at *37.

[99] *Id.* at *38.

[100] *Id.*

[101] *Id.* at *24-25.

[102] *Id.* at *38.

[103] *Id.* at *44.

Finally, in *Pine Oak Builders, Inc. v. Great American Lloyds Insurance Company*[104] and *D.R. Horton-Texas, Ltd. v. Markel International Insurance Co., Ltd.,*[105] the Houston Court of Appeals (Fourteenth District) followed a strict eight-corners analysis, refusing to consider extrinsic evidence in determining the duty to defend. In both cases, the insured proffered extrinsic evidence to establish a duty to defend that was not triggered by the facts alleged in the pleadings. In *Pine Oak Builders*, the insured sought to establish that all of the work performed on the plaintiffs' house was performed by subcontractors, bringing the case within the subcontractor exception to the "your work" exclusion in the policy.[106] Similarly, in *D.R. Horton*, the defendant home builder adduced extrinsic evidence to prove that it was an additional insured under a subcontractor's insurance policy.[107] Concluding that the extrinsic evidence related to both coverage and liability, the court applied a strict eight-corners analysis in both cases and declined to consider the evidence. Both of these cases are currently pending before the supreme court.

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[104] No. 14-05-00487-CV, 2006 Tex. App. LEXIS 5950 (Tex. App.—Houston [14th Dist.] July 6, 2006), pet. granted, 2007 Tex. LEXIS 741 (Tex. Aug. 31, 2007) (No. 06-0867).

[105] No. 14-05-00486-CV, 2006 Tex. App. LEXIS 9346.

[106] *Pine Oak Builders*, No. 14-05-00487-CV, 2006 Tex. App. LEXIS 5950 at *18.

[107] *D.R. Horton*, No. 14-05-00486-CV, 2006 Tex. App. LEXIS 9346 at *16.

C. DUTY TO DEFEND – BROADER THAN THE DUTY TO INDEMNIFY

Under Texas law, the duty to defend and the duty to indemnify are distinct and separate duties.[108] The duty to defend is triggered by the facts alleged in the underlying petition, while the duty to indemnify is triggered by the actual facts establishing liability in the underlying suit.[109] Since the duty to indemnify is determined based upon actual facts, it may not be justiciable in some cases until after the conclusion of the underlying lawsuit.[110]

The duty to defend is, however, broader than the duty to indemnify.[111] When "the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify," therefore, the duty to indemnify may be determined before resolution of the underlying case.[112] As some courts have recognized, "[l]ogic and common sense dictate that if there is no duty to defend, then there must be no duty to indemnify."[113]

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[108] *Cowan,* 945 S.W.2d at 821-22 (citations omitted); *see also King,* 85 S.W.3d at 187.

[109] *Id.* (citing *Heyden,* 387 S.W.2d at 25).

[110] *Northfield,* 363 F.3d at 529 (quoting *Farmers Texas County Mut. Ins. Co. v. Griffin,* 955 S.W.2d 81, 84 (Tex. 1997) (where court cannot state with certainty that all possibility is negated that the insurer will ever have a duty to indemnify, question of indemnity may not be justiciable before resolution of underlying lawsuit). *See Westport Ins.,* 267 F. Supp. 2d at 634 (ruling on the duty to indemnify may be premature and "might very well conflict with findings yet to be made in the state court"); *Admiral Ins. Co. v. Little Big Inch Pipeline Co., Inc.*, 523 F. Supp. 2d 524, 545-46 (W.D. Tex. 2007) (although insurer had no duty to defend, neither party presented evidence that any facts had been conclusively established in the underlying lawsuit; possible that facts later alleged and proven at trial may establish damages that do not fall within any exclusion, which may potentially trigger duty to indemnify).

[111] *Am. States Ins. Co. v. Bailey*, 133 F.3d 363, 368 (5th Cir. 1998) (applying Texas law); *Gulf Chem. & Metallurgical Corp.*, 1 F.3d at 369.

[112] *Northfield,* 363 F.3d at 529 (quoting *Griffin,* 955 S.W.2d at 84).

[113] *Bailey*, 133 F.3d at 368. *See River Entm't*, 998 F.2d at 315.

D. UNDERTAKING THE DEFENSE

1. Reservation of Rights

Before an insurer undertakes the defense of a lawsuit against its insured, any defenses to coverage known to the insurer should be set forth in a reservation of rights letter. If an insurer has knowledge of facts indicating a lack of coverage and assumes the insured's defense without obtaining a reservation of rights or non-waiver agreement, the insurer waives all policy defenses, including defenses of non-coverage, or the insurer may be estopped from asserting such defenses.[114] When coverage is in doubt, an insurer defending its insured under a reservation of rights preserves its policy defenses in the event the insured is subsequently found liable, suspending operation of the doctrines of waiver and estoppel.[115] This rule is based on the "apparent conflict of interest that might arise when the insurer represents the insured in a lawsuit against the insured and simultaneously formulates its defense against the insured for noncoverage."[116] Finally, the reservation of rights should be clearly stated. An ambiguous reservation of rights may be construed strictly against the insurer and liberally in favor of the insured.[117]

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[114] *Farmers Tex. County Mut. Ins. Co. v. Wilkinson*, 601 S.W.2d 520, 521-22 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.). *See Tex. Farmers Ins. Co. v. McGuire*, 744 S.W.2d 601, 603 n.1 (Tex. 1988).

[115] *Wilkinson*, 601 S.W.2d at 522.

[116] *Id.* (quoting *Pac. Indem. Co. v. Acel Delivery Serv., Inc.*, 485 F.2d 1169 (5th Cir. 1973)).

[117] *Id.* at 523.

2. Control of the Defense

"Whether an insurer has the right to conduct its insured's defense is a matter of contract."[118] Many insurance policies that impose a duty to defend give the insurer the right to conduct the defense, which includes the authority to select the attorney who will defend the claim and to make other decisions that would normally be vested in the insured as the named party in the case.[119] When certain conflicts of interest exist, however, an insurer may not insist upon its contractual right to control the defense.

Not every reservation of rights creates a conflict of interest allowing an insured to select independent counsel.[120] If it did, the insured, not the insurer, could control the defense by merely disagreeing with the insurer's proposed actions.[121] Rather, the existence of a conflict depends on the nature of the coverage issue as it relates to the underlying case.

More specifically, if the insurance policy gives the insurer the right to control the defense of a case the insurer is defending on the insured's behalf, the insured cannot choose independent counsel and require the insurer to reimburse the expenses unless "the facts to be adjudicated in the liability

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[118] *N. County Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex. 2004).

[119] *Id.* (citing *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 627 (Tex. 1998)).

[120] *Rx.com, Inc. v. Hartford Fire Ins. Co.*, 426 F. Supp. 2d 546, 559-560 (S.D. Tex. 2006) (rejecting insured's contention that an insured may choose its own counsel at the insurer's expense any time the insurer agrees to defend subject to a reservation of rights).

[121] *Davalos*, 140 S.W.3d at 689.

lawsuit are the same facts upon which coverage depends."[122] If the issue on which coverage turns is independent of the issues in the underlying case, counsel selected by the insured is not required. A conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim.[123]

This rule allows insurers to control costs while permitting insureds to protect themselves from an insurer-hired attorney who may be tempted to develop facts or legal strategy that could ultimately support the insurer's position that the underlying lawsuit fits within a policy exclusion.[124]

3. "Mixed" Actions

In many instances, "[i]f an insurer has a duty to defend any portion of a suit, the insurer must defend the entire suit."[125] The rationale behind this common law rule is that the contract obligates the insurer to defend its

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[122] *Rx.com*, 426 F. Supp. 2d at 559 (quoting *Davalos*, 140 S.W.3d at 689). *See Hous. Auth. of the City of Dallas, Tex. v. Northland Ins. Co.*, 333 F. Supp. 2d 595, 602 (N.D. Tex. 2004) ("Because the liability facts and coverage facts were the same and because a potential conflict of interest was created by the issuance of the reservation of rights letter, a disqualifying conflict existed; therefore [the insurer] could not conduct the defense of the [underlying] lawsuit.").

[123] *Rx.com*, 426 F. Supp. 2d at 559; *Davalos*, 140 S.W.3d at 689.

[124] *Rx.com*, 426 F. Supp. 2d at 559-560 (citing *Northland Ins. Co.*, 333 F. Supp.2d at 601).

[125] *Green Tree*, 249 F.3d at 395. *See St. Paul Ins. Co. v. Tex. Dept. of Transp.* 999 S.W.2d 881, 884 (Tex. App.—Austin 1999, pet. denied) ("[o]nce coverage is found for any portion of a suit, an insurer must defend the entire suit"); *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466, 474 (5th Cir. 2001) (holding that the insurer "must defend [the insured] against the entire suit including causes of action that would not alone trigger the duty to defend, regardless whether the complaint is pled in the alternative or not because the [underlying plaintiffs'] factual allegations of negligence are sufficient to trigger the duty to defend").

insured, not to provide a partial or pro rata defense.[126] The principle is most often applied in cases involving general liability policies, which typically require that the insurer defend any "suit" brought against insureds.[127] For example, the standard commercial general liability policy form requires insurers to "pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies" and gives the insurer the "right and duty to defend any 'suit' seeking those damages."[128]

Other types of policies, like directors and officers liability policies, may impose a duty to defend covered "claims." A "claim" may be defined to include, *inter alia*, a civil proceeding, a written notice, or a monetary demand. One court has interpreted a "claim" to mean each separate cause of action asserted in a lawsuit, as opposed to the entire lawsuit.[129] In particular, the

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[126] *Tex. Dept. of Transp.*, 999 S.W.2d at 884; *Tex. Prop. & Cas. Ins. Guar. Ass'n v. Sw. Aggregates*, 982 S.W.2d 600, 606-607 (Tex. App.—Austin 1998, no pet.) (consecutive insurers were required to provide a "full" defense, and were not permitted to share the defense pro rata based upon their "time on the risk" for damages partially within and partially outside of the respective policy periods).

[127] *See, e.g. Md. Cas. Co. v. Moritz,* 138 S.W.2d 1095, 1097 (Tex. Civ. App.—Austin 1940, writ ref'd) (requiring the insurer to "defend . . . any *suit* against the insured"); *Admiral Inc. Co. v. Rio Grande Heart Specialists of S. Tex., Inc.* 64 S.W.3d 497, 501, 503 (Tex. App.—Corpus Christi 2001, pet. dism'd by agrm't).

[128] 1 SUSAN J. MILLER & PHILIP LEFEBVRE, MILLER'S STANDARD INSURANCE POLICIES ANN. 401.3, form: CGGL1 (4th ed. 2007) (industry standard policy forms prepared by the Insurance Service Office, Inc.).

[129] *Executive Risk Indem., Inc. v. Integral Equity, L.P., et al.,* No. 3:03-CV-0269-G, 2004 U.S. Dist. LEXIS 3742, *28-30 (N.D. Tex. Mar. 10, 2004).

court observed that the term "proceeding" in the policy's definition of "claim" could mean "anything from an entire lawsuit to one act within a lawsuit."[130]

It must be recognized that the duty to defend is created by contract; it is not implied or imposed by law. Absent a contractual requirement to defend, the insurer has no duty to defend.[131] As such, an insurer may have a basis for apportioning defense costs between covered and non-covered claims based on allocation clauses or other policy language that limits the scope of the duty to defend to covered claims.

In *Lafarge Corp. v. Hartford Cas. Ins. Co.*,[132] the Fifth Circuit was asked to apportion defense costs in a "mixed" action, a lawsuit comprised of both covered and non-covered allegations. Although certain allegations of damage in the underlying lawsuit may not have been covered, the court determined that other allegations were potentially covered, triggering the insurer's duty to defend. On appeal, the insurer argued that it was not responsible for all the defense costs incurred, but only for those costs attributable to the defense of covered claims. The Fifth Circuit reached the following conclusion:

> Hartford first claims that, despite the general rule that an insurer who has a duty to defend as to one claim must defend as to all claims, it should have been allowed to apportion defense

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[130] *Id.* at *27 n.8 (*citing* BLACK'S LAW DICTIONARY 1221 (7th ed. 1999)).

[131] *See Wheelways Ins. Co. v. Hodges*, 872 S.W.2d 776, 786 (Tex. App.—Texarkana 1994, no writ).

[132] 61 F.3d 389 (5th Cir. 1995) (applying Texas law).

> costs between covered and non-covered claims. It is true that, when there is a clear distinction between covered and non-covered claims, an insurer may apportion defense costs. However, even though some of the claims were not covered under the policy, apportionment of costs would be not be feasible in this case because the claims all arose from a single accident.[133]

Apportionment of costs was not feasible in *LaFarge* because the separate claims all arose out of a single accident. The Fifth Circuit suggests, however, that if defense costs incurred as a result of covered claims are distinct from those incurred in the defense of non-covered claims, an insurer may be entitled to apportion defense costs between covered and non-covered matters – even when the insurer has a duty to defend.

E. CONSEQUENCES FOR BREACH – STATUTORY INTEREST

Texas courts have held that attorney's fees incurred involving litigation with a third party are recoverable as actual damages for breach of the duty to defend.[134] As discussed below, the breaching insurer may also face interest on unpaid defense costs under the Texas prompt-payment statute.

In a decision significantly impacting liability carriers, the supreme court ruled last year that the Texas prompt-payment statute applies to an

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[133] *Id.* at 398 (internal citations omitted).

[134] *Rx.com*, 426 F. Supp. 2d at 559 (citing *Am. Home Assur. Co. v. United Space Alliance, LLC*, 378 F.3d 482, 490 (5th Cir. 2004) (applying Texas law)).

insurer's breach of the duty to defend under liability policies.[135] Resolving the split in authority among Texas state and federal courts, the supreme court concluded in *Lamar Homes* that the prompt-payment statute may be applied when an insurer wrongfully refuses to pay promptly a defense benefit owed to the insured. Formerly codified as article 21.55 of the Texas Insurance Code and recodified without substantial change as sections 542.051-.061 of the Texas Insurance Code (effective April 1, 2005), the statute authorizes an award of "interest on the amount of the claim at the rate of eighteen percent per year as damages, together with reasonable attorney's fees."[136] "Claim" is defined in the statute as a first-party claim made by an insured that must be paid by the insurer directly to the insured. "First-party claim" is not separately defined.

In reaching its conclusion, the court explained that it had previously distinguished first-party and third-party claims based upon the claimant's relationship to the loss. A first-party claim is stated when an insured seeks recovery for the insured's own loss, whereas a third-party claim is presented when an insured seeks coverage for injuries to a third party. The court adopted the reasoning that an insured's claim for defense costs is a first-party claim because it involves a direct loss to the insured.

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[135] *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007) (on certified questions from the United States Court of Appeals for the Fifth Circuit).

[136] TEX. INS. CODE § 542.060(a).

> Without the defense benefit provided by a liability policy, the insured alone would be responsible for these costs. Unlike the loss incurred in satisfaction of a judgment or settlement, this loss belongs only to the insured and is in no way derivative of any loss suffered by a third party. The claim for defense costs then is a first-party claim because the insured is the only party who will suffer the loss or benefit from the claim.[137]

The court concluded that this reasoning more accurately reflects the Legislature's purpose in enacting the prompt-payment statute. The court rejected the argument that, by applying the statute to "first-party claims," the Legislature intended to eliminate third-party insurers from the ambit of the statute. In support of its position, the court determined that the term "first-party" modifies "claim" – and does not limit the particular types of policies or insurers to which the statute applies. On the contrary, the court observed that the statute does exempt certain types of insurance, but liability or third-party insurance is not expressly exempt.

The court further rejected the notion that the statute is "unworkable" in the context of an insured's claim for a defense. In this regard, the court observed that the statute requires that the insured submit a written notice of claim, which triggers the insurer's duties to investigate and acknowledge the claim.[138] After receiving notice of the claim, the insurer has fifteen days to: (1) acknowledge receipt; (2) commence an investigation; and (3) "request from the claimant all items, statements and forms that the insurer reasonably

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[137] *Lamar Homes*, 242 S.W.3d at 43.

[138] TEX. INS. CODE §§542.051(4), 542.055.

believes, at that time, will be required from the claimant."[139] The statutory deadlines for accepting and paying the claim do not begin to run until the insurer has "receive[d] all items, statements, and forms required by the insurer to secure final proof of loss."[140]

Applying these provisions to an insured's claim for a defense, the court concluded that the insured would need to submit its legal bills to the insurance company, as they are received, in order to mature its rights under the prompt payment statute. "These statements or invoices are the last piece of information needed to put a value on the insured's loss."[141] Then, when the insurer who owes a defense fails to pay within the statutory deadline, "the insured matures its right to reasonable attorney's fees and the eighteen percent interest rate specified by the statute."

On December 14, 2007, the supreme court denied rehearing in *Lamar Homes*, sparking a vigorous dissent from three justices.[142] The dissent observes that the Texas prompt-payment statutes have never applied to all insurance claims, tracking the evolution of the statutory provisions.[143] Consistent with the Code Construction Act, the dissent posits, the phrase

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[139] TEX. INS. CODE §542.055.

[140] TEX. INS. CODE §§542.056(a), 542.058.

[141] *See* TEX. INS. CODE §542.056(a).

[142] *Lamar Homes*, 242 S.W.3d 1, 2007 Tex. LEXIS 1176, *1 (Tex. 2007) (Brister, J., Hecht, J., Willet, J., dissenting).

[143] *Id.* at *1-2.

"first-party claim" must be given its technical or particular meaning customarily used with respect to insurance policies. "We cannot adopt a definition of 'first-party claim' that those in the insurance industry would not recognize."[144]

Defining the phrase "first-party claim" to include liability policies is at odds with the use of the term in courts "around the nation," according to the dissent, and does not comport with the provisions of the prompt-payment statute itself. First, the statute applies to claims "that must be paid by the insurer."[145] While first-party insurers promise to pay life, auto or health claims, liability insurers promise a service – to defend covered claims.[146] Second, a claim for reimbursement of defense costs is a damages claim for breach of contract, not a claim "under an insurance policy."[147] Third, the dissent takes issue with the court's determination that defense costs are claims "that must be paid by the insurer directly to the insured," noting that an insured under a third-party liability policy cannot simply demand that defense costs be paid directly to it.[148] On the contrary, "how defense costs are paid is entirely up to the insurer."[149] Fourth, the dissent argues that "the

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[144] *Id.* at *5.

[145] *Id.* at *9.

[146] *Id.*

[147] *Id.* at *9-10.

[148] *Id.* at *10.

[149] *Id.*

very operation of the statute precludes applying it to the duty to defend," criticizing the court's decree that "final proof of loss is unnecessary: the [statutory] deadlines now run seriatim as each legal bill is received by the carrier."[150]

Finally, the dissent challenges the court's "novel, even revolutionary" distinction between first-party claims and first-party insurance, noting "big problems" with the court's logic. The dissent closes with the observation that a decision to extend the provisions of the prompt-payment statute to third-party liability insurers is "a decision for the people of Texas to make through legislative proposals and debate, not for this Court to make out of whole cloth."[151]

F. EMERGING ISSUES

1. *Nokia*, *Samsung* and *Cellular One*

Three cases out of the Dallas Court of Appeals involve the insurer's duty to defend a series of class action lawsuits brought against cell phone manufacturers – *Nokia, Inc. v. Zurich American Insurance Company*,[152]

[150] *Id*. at *11.

[151] *Id*. at *15.

[152] *Nokia, Inc. v. Zurich Am. Ins. Co.*, 202 S.W.3d 384 (Tex. App.—Dallas 2006), *pet. granted*, 2007 Tex. LEXIS 1022 (Tex. Nov. 30, 2007) (No. 06-1030).

Samsung Electronics America, Inc. v. Federal Insurance Company[153] and *Trinity Universal Insurance Company v. Cellular One Group*.[154]

In the underlying lawsuits, the class plaintiffs allege the defendants knew or should have known that cell phones emit harmful radiation that potentially causes injury to human cells when the cell phones are used without a headset. The class plaintiffs allege that they were exposed to radiation and its biological effects each time they used their cell phones without a headset and that this exposure caused an "adverse cellular reaction" or "cellular dysfunction."[155] The class plaintiffs seek compensatory damages (the cost to purchase a cell phone headset), an order to provide each class member with a cell phone headset with instructions regarding how and why to use the headset, punitive damages, injunctive relief preventing the future sale of cell phones without headsets, attorneys' fees and costs.

Nokia, Samsung and Cellular One each forwarded the lawsuits to their commercial general liability carriers, demanding a defense and indemnity. In the coverage lawsuits that ensued, the parties moved for summary judgment on the duty to defend. The trial court granted the insurers' motions for summary judgment in *Nokia* and *Samsung*; in *Cellular One*, the

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[153] *Samsung Elec. Am., Inc. v. Federal Ins. Co.*, 202 S.W.3d 372 (Tex. App.—Dallas 2006), *pet. granted*, 2007 Tex. LEXIS 1023 (Tex. Nov. 30, 2007) (No. 06-1040).

[154] *Trinity Universal Ins. Co. v. Cellular One Group*, No. 05-04-01641-CV, 2007 Tex. App. LEXIS 96 (Tex. App.—Dallas Jan. 9, 2007), *pet. granted*, 2007 Tex. LEXIS 1025 (Tex. Nov. 30, 2007) (No. 07-0140).

[155] *Samsung*, 202 S.W.3d at 380-381; *Nokia*, 202 S.W.3d at 390-392; *Cellular One*, 2007 Tex. App. LEXIS at *7.

trial court found that Trinity had a duty to defend and granted summary judgment in favor of the insured. All three cases were appealed to the Dallas Court of Appeals.

In each case, the insurers argued that the complaints in the underlying lawsuits failed to allege damages from "bodily injury" as required by the policies, but only the potential for bodily injury. The insurers further argued that the complaints sought only economic losses (*i.e.*, the cost of a headset), not damages "because of bodily injury." One of the lawsuits (*Dahlgren*) asserted only claims for false and misleading misrepresentations regarding the potential risks associated with cell phone use and alleged that the plaintiffs were injured by paying for cell phones that did not comport with the description provided. The court found that this complaint did not allege bodily injury and that the insurers did not have a duty to defend in that case.[156] With respect to the remaining lawsuits, the Dallas Court of Appeals disagreed with the insurers' arguments, finding a duty to defend.

First, the court observed that the plaintiffs alleged they were exposed to radiation and its adverse biological effects each time they used their cell phones without a headset. The court concluded these allegations of injury to human cells potentially alleged a covered claim for bodily injury under the

[156] *Samsung*, 202 S.W.3d at 383; *Nokia*, 202 S.W.3d at 391.

policies.[157] The court reasoned that "to exclude biological injury to human cells from the definitions of 'bodily injury' would require us to read language into the policy that was not there."[158] Next, the court determined that the complaints in the underlying lawsuits actually alleged that the plaintiffs suffered "bodily injury" and sought damages "because of bodily injury."[159] Accordingly, the court concluded that the insurers had a duty to defend the class action lawsuits (except the *Dahlgren* case). All three cases are before the Texas Supreme Court on review.

2. *Warrantech* – Fortuity and the Duty to Defend

It is well-established that fortuity is an inherent requirement in <u>*all*</u> insurance policies.[160] Questions have arisen, however, regarding what exactly "fortuity" means under Texas law, when the fortuity doctrine applies and whether it precludes a duty to defend based on an eight-corners analysis. The issue of whether the fortuity doctrine may preclude an insurer's duty to defend is presently before the supreme court in *Warrantech Corp. v. Steadfast*

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[157] *Samsung*, 202 S.W.3d at 380; *Nokia*, 202 S.W.3d at 390; *Cellular One*, 2007 Tex. App. LEXIS at *7.

[158] *Nokia*, 202 S.W.3d at 390. *See Samsung*, 202 S.W.3d at 380.

[159] *Samsung*, 202 S.W.3d at 383; *Nokia*, 202 S.W.3d at 391; *Cellular One*, 2007 Tex. App. LEXIS at *8-9.

[160] *See, e.g., RLI Ins. Co. v. Maxxon Sw., Inc.*, 265 F. Supp. 2d 727, 730 (N.D. Tex. 2003), *aff'd*, 108 Fed. Appx. 194 (5th Cir. 2004) (applying Texas law); *Certain Underwriters at Lloyd's Subscribing to Policy No. WDO-10000 v. KKM Inc.*, 215 S.W.3d 486, 495 (Tex. App.—Corpus Christi-Edinburg 2006, pet. denied); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 687 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).

Ins. Co.[161]

a. The Fortuity Doctrine

An insurance agreement is a "contract in which a promise is conditioned on the happening of a fortuitous event, an event of chance."[162] Texas law recognizes the "fortuity doctrine" as a matter of public policy, because the purpose of insurance is to protect against unknown, fortuitous risks.[163] The fortuity doctrine precludes coverage for two types of losses – (1) known losses and (2) losses in progress.[164] "A 'known loss' is a loss the insured knew had occurred prior to making the insurance contract."[165] "A 'loss in progress' occurs when the insured is, or should be, aware of an ongoing progressive loss at the time the policy is purchased."[166] Simply put, an insured cannot insure against something that has already begun and which is known to have begun[167] – the proverbial burning building.

Under the fortuity doctrine, therefore, insurance coverage is precluded not only for known losses, but also for losses of which an insured is, or should

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[161] *Warrantech Corp. v. Steadfast Ins. Co.*, 210 S.W.3d 760 (Tex. App.—Fort Worth 2006, pet. filed), *appeal docketed*, No. 07-0016 (Tex. Jan. 10, 2007).

[162] *In re Texas Ass'n of School Boards, Inc.*, 169 S.W.3d 653, 658 (Tex. 2005).

[163] *See Scottsdale Ins. Co. v. Travis*, 68 S.W.3d 72, 75 (Tex. App.—Dallas 2001, pet. denied); *Two Pesos, Inc. v. Gulf Ins. Co.*, 901 S.W.2d 495, 501-2 (Tex. App.—Houston [14th Dist.] 1995, no writ) (op. on reh'g).

[164] *Warrantech*, 210 S.W.3d at 766; *Scottsdale Ins. Co.*, 68 S.W.3d at 75.

[165] *Scottsdale Ins. Co.*, 68 S.W.3d at 75.

[166] *Id.*

[167] *Two Pesos*, 901 S.W.2d at 501.

be, aware at the inception of the policy.[168] As the Fifth Circuit has stated: "[i]f an insured knows, or should have known, at the time it purchased the insurance policy, that its current behavior is wrongful and could result in liability, it effectively removes the risk element inherent in insurance, and therefore a Texas court will not require the insurer to pay."[169] More specifically, "[t]he [loss in progress] doctrine precludes a party from voluntarily engaging in an activity that gives rise to an accusation of wrongdoing and potential legal liability, and then purchasing insurance so that it may shift financial responsibility for its conduct[.]"[170] "The relevant inquiry is whether [the insureds] knew at the time they entered the insurance policy that they were engaging in activities for which they could possibly be found liable."[171]

b. Application to the Duty to Defend

Courts that have considered the issue under Texas law have consistently analyzed an insurer's fortuity defense under the traditional eight-corners rule and have concluded that the fortuity doctrine, if applicable, precludes the duty to defend.[172]

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[168] *Id.*; *see also Scottsdale Ins. Co.*, 68 S.W.3d at 75.

[169] *RLI Ins. Co. v. Maxxon Sw. Inc.*, 108 Fed. Appx. 194, 198, No. 03-10660, 2004 WL 1941757, at *3 (5th Cir. Sept. 1, 2004) (applying Texas law).

[170] *Franklin v. Fugro-McClelland (Sw.), Inc.,* 16 F. Supp. 2d 732, 736 (S.D. Tex. 1997).

[171] *Id.* at 737.

[172] *See, e.g., Scottsdale Ins. Co.*, 68 S.W.3d at 73 ("Because we conclude the terms of the policy and the fortuity doctrine exclude coverage, we reverse the trial court's judgment and render judgment

i. RLI

In *RLI Ins. Co. v. Maxxon Southwest Inc.,*[173] for example, a competitor of the insureds sued them, alleging wrongful behavior that began approximately four years prior to the purchase of the insurance policy at issue. The complaint alleged that the insureds intentionally and knowingly engaged in discriminatory price fixing to gain an advantage over their competition and engaged in an unlawful conspiracy to violate federal antitrust laws.[174] The court found that those allegations sufficiently reflected that the insureds "knowingly engaged in conduct … which they knew or should have known could reasonably be expected to expose them to legal liability."[175] Based on the allegations in the complaint, therefore, the court held that the insurer had no duty to defend or indemnify the insureds in the underlying lawsuit.[176]

ii. Matagorda Ventures

Similarly, in *Matagorda Ventures, Inc. v. Travelers Lloyds Ins. Co.*,[177] the insureds sought a declaratory judgment that their insurer owed them a

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that Scottsdale has no duty to defend [the insureds] in [the underlying lawsuit]."); *Two Pesos*, 901 S.W.2d at 495, 501-02 (where "risk of liability was no longer unknown," claim constituted known loss or loss in progress and trial court did not err in finding no duty to defend).

[173] 108 Fed. Appx. 194, No. 03-10660, 2004 WL 1941757.

[174] *Id.* at 196, 2004 WL 1941757, at *1.

[175] *Id.* at 199, 2004 WL 1941757, at *3.

[176] *Id.* 201, 2004 WL 1941757, at *5.

[177] 208 F. Supp. 2d 687, 687-88 (S.D. Tex. 2001).

defense in an ongoing trademark and copyright infringement lawsuit. The court granted summary judgment in favor of the insurer, and the insured filed a motion for reconsideration, arguing that the fortuity doctrine "protects against previously incurred losses, not potentially previously incurred, and not yet legally adjudicated or even legally pursued, claims."[178] The court rejected this argument, stating that the relevant inquiry is *not* whether liability had already been adjudicated at the inception of the policy, but whether the insureds "knew at the time they entered the insurance policy that they were engaging in activities for which they could possibly be found liable."[179] The insureds had begun the activities for which they claimed liability coverage before the inception of the insurance policy, had been warned of potential liability, and then purchased the policy without disclosing their underlying activities to the insurer.[180] Based on these facts, the court denied the insureds' request for reconsideration.

iii. Warrantech

In *Warrantech*, the Fort Worth Court of Appeals analyzed a fortuity defense under the eight-corners rule to determine whether the insurer had a duty to defend its insured in litigation arising from the administration of a

[178] *Id.* at 690.

[179] *Id.* at 691 (emphasis added) (quoting *Franklin*, 16 F. Supp. 2d at 737).

[180] *Id.*

consumer warranty program.[181] The court based its analysis on the allegations in the underlying petition. As administrator of the program, Warrantech was in charge of processing the warranty claims. When a claim was made, Warrantech was responsible for validating the warranty in question before authorizing a repair and paying the repair costs. To cover the cost of the warranty claims it was required to pay under the program, Warrantech obtained insurance from Houston General Insurance Company ("Houston General") and Houston General obtained reinsurance for the program. In essence, Houston General and the reinsurers paid for the warranty repairs that were authorized by Warrantech.[182]

Because the program was entirely paperless, however, warranty information existed only in a computer database that was incomplete and inaccurate. Many of the electronic warranty records failed to provide even basic information to identify the customer, the product or the type of warranty sold.[183] In 1996, Warrantech began haphazardly matching unvalidated warranty repair claims to incomplete "shell" warranty contracts in a deliberate attempt to turn unvalidated, uninsured claims into validated, insured claims. Warrantech automated that process with linking software in 1997. Warrantech then denied the existence of the linking software during

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[181] 210 S.W.3d 760.

[182] *Id.* at 763.

[183] *Id.* at 763.

the arbitration proceeding and deliberately destroyed the second version of the software.[184]

As a result of an audit in 1998, Houston General accused Warrantech of overpaying claims and demanded reimbursement of $19 million. When the reinsurers subsequently refused to reimburse Houston General for Warrantech claims, an arbitration ensued. Warrantech was aware of and involved in the arbitration between Houston General and the reinsurers over the disputed claims. All of this happened before the policy's inception date of July 30, 2002. The only significant event to occur after the policy incepted was the arbitration panel's $ 39 million award to Houston General in August 2002,[185] after which the reinsurers sued Warrantech.

The court reiterated that "[a]pplication of the fortuity doctrine in the duty-to-defend context is resolved by the eight-corners rule; 'we focus only on those facts that are alleged in the pleadings in the underlying lawsuit.'"[186] Based on its analysis of the petition, the court concluded succinctly:

> The Reinsurers' petition compels one conclusion: Warrantech knew of the loss caused by its mispayment of warranty claims long before the inception date of Steadfast's policy. This is true regardless of whether Warrantech made the mispayments intentionally or merely negligently as alternatively alleged by the Reinsurers in the underlying suit. As of July 30, 2002, the policy's inception date, the only unknown was whether Houston

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[184] *Id.* at 767.

[185] Id. at 767.

[186] *Warrantech*, 210 S.W.3d at 766 (quoting *Burlington Ins. Co. v. Tex. Krishnas, Inc.*, 143 S.W.3d 226, 230 (Tex. App.—Eastland 2004, no pet.)).

> General or the Reinsurers would bear the brunt of the loss upon resolution of the arbitration proceeding.[187]

In the coverage litigation that followed, Warrantech advanced several creative, but unfounded arguments in an effort to overcome the fortuity doctrine and secure a defense from its insurer – all of which were rejected by the court. First, Warrantech argued that "loss" in "known loss" and "loss in progress" means a judgment against the insured; a loss is uncertain and cannot be known until a judgment is rendered on the underlying claim. The court concluded that Warrantech's position was unsupported by Texas law, citing several cases applying the fortuity doctrine where the insured's liability was not yet fixed by judgment.[188]

Second, Warrantech argued that "the very nature of a claims-made policy anticipates the possibility of losses occurring before the policy's inception date, and to apply the fortuity doctrine to a claims-made policy would render the contract of insurance illusory because there would never be coverage for losses occurring before the inception date."[189] Noting that fortuity is a requirement in all insurance policies, the court emphasized that it is not the existence of a loss but the insured's knowledge of the loss that

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[187] *Id.* at 767-68.

[188] *Id.* at 766 (citing *Roman Catholic Diocese of Dallas ex rel. Grahmann v. Interstate Fire & Cas. Co.*, 133 S.W.3d 887, 889 (Tex. App.—Dallas 2004, pet. denied); *Scottsdale Ins. Co.*, 68 S.W.3d at 74). Indeed, the court noted that at least one court applying Texas law has rejected the same argument made by Warrantech. *See Franklin,* 16 F. Supp. 2d at 735.

[189] *Warrantech*, 210 S.W.3d at 767.

triggers the fortuity doctrine.

> Application of the fortuity doctrine to a claims-made policy will preclude coverage for losses of which the insured knows but will not preclude coverage for losses of which the insured is ignorant at the policy's inception. Thus, the fortuity doctrine does not render claims-made insurance illusory but merely restricts coverage to unknown losses.[190]

Third, Warrantech argued that the policy's fraud exclusion precluded application of the fortuity doctrine. Again, the court rejected Warrantech's analysis, explaining that application of the fortuity doctrine does not hinge on whether the insured knew a particular act was wrongful, but on whether the insured knew before the inception of coverage that an act – knowingly wrongful or otherwise – resulted in a loss. "The question is not whether Warrantech caused the loss knowingly, but whether it knew of the loss before the policy's inception."[191]

Applying the fortuity doctrine under the constraints of the eight-corners rule, therefore, the court held that the insurer had no duty to defend Warrantech against the reinsurers' claims.[192] Warrantech is seeking review in the supreme court.

iv. Sentry *and* South Texas Medical Clinics

Since the Fort Worth Court of Appeals issued its opinion in *Warrantech*, two other Texas courts have decided fortuity cases – each

[190] *Id.* (citing cases where courts have applied the fortuity doctrine to claims-made policies).

[191] *Id.* at 768.

[192] *Id.*

applying the well-established principle of fortuity within the framework of the eight-corners rule to determine the insurer's duty to defend. In *Sentry Ins. v. DFW Alliance Corp.*,[193] the United States District Court for the Northern District of Texas considered whether, under the known loss doctrine, the insurer had a duty to defend its insured in litigation allegedly covered by liability insurance for advertising injury. The insurer argued that the conduct alleged in the underlying complaint occurred long before the inception of the policies and was known to have begun, barring coverage.[194] The court observed that under the known loss and loss in progress doctrines, "insurance coverage is precluded where the insured is, or should be, aware of an ongoing progressive loss or known loss at the time the policy is purchased."[195]

In evaluating whether the known loss doctrine applies, moreover, the court determined that the relevant inquiry is whether the insureds "knew at the time they entered the insurance policy that they were engaging in activities for which they could possibly be found liable."[196] According to the underlying complaint, the insureds "embarked on a program of subterfuge to prepare themselves to unfairly compete" with the underlying plaintiff before

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[193] No. 3:04-CV-1043-D, 2007 WL 507047 (N.D. Tex. Feb. 16, 2007).

[194] *Id.* at *6.

[195] *Id.* (quoting *Franklin*, 16 F. Supp. 2d at 734-35).

[196] *Id.* at *7 (quoting *Matagorda*, 203 F. Supp. 2d at 724).

June 30, 2000.[197] The complaint alleged that the infringing activity began before June 2000 (almost two years before the beginning of the policy period) and described the specific activities that were allegedly undertaken, when they started, and by whom.[198] Based on these allegations, the court determined that the insurer did not have a duty to defend its insured in the underlying litigation under the known loss doctrine.[199]

Most recently, in *Maryland Casualty Company v. South Texas Medical Clinics*,[200] the Corpus Christi Court of Appeals applied the eight-corners rule, analyzing the insurers' fortuity defense in light of the facts alleged in the underlying petition. The coverage lawsuit arose from an underlying lawsuit against South Texas Medical Clinics ("STMC") for sexual discrimination, negligence, intentional infliction of emotional distress and invasion of privacy.[201] The lawsuit alleged that the plaintiff (a former STMC employee) was willfully detained by STMC's president and chief surgeon and forced to participate in unwanted "closed door" hypnotic sessions while on the job.[202] The petition alleged that these forced hypnotic sessions took place over a

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[197] *Id.*

[198] *Id.*

[199] *Id.*

[200] No. 13-06-089-CV, 2008 Tex. App. Lexis 279 (Tex. App.—Corpus Christi Jan. 10, 2008, pet. filed).

[201] *Id.* at *3

[202] *Id.* at *3-4 n. 3.

period of nine years and that the former employee was routinely belittled and intimidated if she refused to participate.[203] The insurers argued, *inter alia*, that coverage for the underlying lawsuit was precluded by the fortuity doctrine.[204]

Evaluating the applicability of the fortuity doctrine, the court recognized that it was bound by the eight-corners rule and based its analysis on the underlying petition and the language of the policies. The court concluded that:

- the petition did not conclusively establish that STMC was aware of the alleged wrongful conduct in 1986, when STMC purchased the first policy from the insurers;
- the petition was not clear regarding the president's role in purchasing the insurance policies; and
- the petition did not provide a date reflecting when the plaintiff first began complaining about the alleged wrongful conduct, thus putting STMC on notice.[205]

Based on this analysis, the court held that the insurers could not conclusively establish, based solely on the petition, that STMC sought to insure a known or ongoing loss as a matter of law.[206] Because the pleading contained insufficient facts from which to conclude that the insured sought to insure a

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[203] *Id.*

[204] 2008 Tex. App. Lexis 279 at *20.

[205] *Id.* at *22-23.

[206] *Id. at *23* (citing *Burch,* 450 S.W.2d at 840-41; *Scottsdale Ins. Co.,* 68 S.W.3d at 75; *see also Warrantech,* 210 S.W.3d at 768 ("Application of the fortuity doctrine does not hinge on whether the insured knew a particular act was wrongful. Rather, it hinges on whether the insured knew before the inception of the coverage that an act--knowingly wrongful or otherwise--resulted in a loss.")).

known risk, the court concluded that the insurer had a duty to defend.

3. Counter-Arguments

Against the weight of the applicable authority, some insureds have proposed substantial modifications of Texas jurisprudence on the duty to defend, claiming that the eight-corners rule and the fortuity doctrine are incompatible and, therefore, that fortuity may never defeat the duty to defend. Rather than taking the allegations in the underlying complaint as true, some argue that the insurer should be required to prove the insured knew or should have known about the loss or risk of liability before the policy incepted – in essence, that insurers should be held to the fraud-based standard applicable in rescission cases. These issues, and others, are presently before the Texas Supreme Court in the *Warrantech* case.