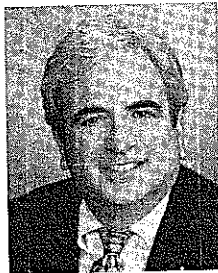


## Liability Insurers and Rights of Reimbursement



BY MICHAEL SEAN QUINN

**In December of 2000 the Texas Supreme court made a very important ruling in Texas Association of Counties vs. Matagorda County.**

Liability insurers face three especially difficult litigation problems. One of them arises when an insurance contract provides that an insurer has a duty to defend, and it is not clear from the plaintiff's petition whether that duty is triggered. The second one arises when the plaintiff sues an insured on all sorts of theories, but there is coverage for only one of them. The third problem arises when it is unclear whether there is any duty-to-pay coverage under a liability policy, but the plaintiff offers to defend for a sum that is reasonable (given what happened to him) and less than policy limits, but not clearly covered under the policy.

These are difficult questions, in part, because standard liability insurance contracts do not specify who is to do what when, in this contexts. Various courts have fashioned procedures. Usually, courts say that insurance companies must take their chances, since they have been paid their money.

### The California Solution

Several years ago the Supreme Court of California tried a different approach. It said that a liability insurer that stepped up to the plate could obtain reimbursement from their policyholders under some circumstances. A case in California arose when a policyholder was sued

for what was essentially contractual breaches and intentional business torts. There were nearly two dozen theories propounded, none of which was covered. At the end of the plaintiff's pleadings, however, there was one small claim for which there was potential coverage, and therefore a duty to defend. That duty extended to the whole case.

In most states, the insurance company would have not only a duty to defend the entire case but a duty to pay for the whole defense. In California, however, it had become strictly required for plaintiffs in business litigation to include one claim for negligence, slander, or something of the sort

which would "steal" defense coverage by the defendant. Both sides then cooperated to squeeze settlement money out of the insurer that was paying through the nose for the defense.

Naturally enough, California insurers were outraged by this manipulation and asked the California Supreme Court for help. That court said that where actions are clearly separable, insurance companies have to pay for a whole defense, but then they can recover defense expenses for theories of recovery that can be blocked off and separated.

Thus, in California, insurers now have a right of reimbursement with respect to segregable defense expenses for uncovered claims. Naturally, insurers that wish to utilize this right must reserve it explicitly. In other words, the right to reimbursement must be set forth in a reservation of rights letter.

### New Texas case

No Texas court has ever adopted this approach. A similar problem, however, came up recently. This time, the right of reimbursement pertained to an indemnity payout in the context of a settlement.

The problem arose in *Texas Association of Counties: County Government Risk Management Pool v. Matagorda County*. This case, as it developed, has been a topic of continuing discussion among insurance lawyers, risk managers, and agents for several years. The Texas Supreme Court decided it at long last on Dec. 21, 2000.

Texas Association of Counties provided liability insurance for county jails. There was a knife fight and some rapes in the Matagorda County jail in 1993. The injured inmates sued. Their case settled in 1995.

Matagorda County indicated to TAC that the settlement was reasonable, asserted that TAC had coverage and proclaimed that the county would—"by Zeus!"—not contribute one thin dime to settlement. As everyone knows, if an insurer unreasonably refuses a covered settlement offer within policy limits, and there is subsequently a covered judgment in excess of policy limits, then the liability insurer will probably have to pay the entire judgment, even the sums that are in excess of policy limits. This prospect worries—and sometimes even frightens—sensible insurers.

TAC wanted to protect its policyholders, but it also wanted to protect other counties, which were very much like stockholders.

### Highlights from Texas Association of Counties: *County Government Risk Management Pool v. Matagorda County*:

- Insurers may not create new rights by reservation-of-rights letters.
- Only rights specified or implied in the insurance contract of arising out of the insurer-insured course of dealing can be reserved.
- Insurers may not unilaterally reserve the right to get reimbursed for settlement payments made.
- Insurers are entitled to the reimbursement of settlement payments only if the insured agrees in a clear and unequivocal way.
- Insurers may not subrogate against their own insureds.

Consequently, TAC settled the case for the demanded sum "subject to" a reservation of rights.

TAC tried to reserve the right to obtain reimbursement from Matagorda County in case it was ever determined that there was no coverage. Naturally enough, there was a declaratory judgment action percolating along at a leisurely pace.

Matagorda County received the reservation of rights letter TAC dispatched. It did not respond, however. At the same time, it did not prevent TAC from settling the case. In other words, it acquiesced in TAC's settlement and received the benefit of it. Of course, as with many liability policies, the insurer had the right to settle.

### Texas issue

The Matagorda County case presents a novel and important question. It has not been litigated around the country much. Thus, the Texas Supreme Court is now in the forefront.

The issue is quite simple. When a liability insurer accepts an offer to settle and makes a payment within policy limits which is not covered, may it recover that sum from its insured, assuming it has explicitly reserved its right to do so?

Many fair-minded people have thought it reasonable for liability insurers to have some right of reimbursement. After all, why should an insurer have to make a hard choice of that kind when the insured better knows what happened and can read the insurance contract for itself. Why should an insured receive the benefit of a payment, which is not authorized by the insurance contract? Perhaps the answers to both questions are the same: It shouldn't.

### The Texas answer

**Contractual Issues:** A seven person majority of the Texas Supreme Court went the other way. The policyholder won. The court examined the insurance contract closely. Nothing in it expressly gave the liability insurer the rights to seek reimbursement. That right cannot even be found, as it were, hidden between the lines of the contract. (Virtually all liability policies are like this.)

Moreover, there was nothing in the course of dealing between TAC and Matagorda County that gave TAC that right. Hence, said the majority, the right of reimbursement is neither implicit in the contract nor implied by any feature of the relationship between the insurer and the insured.

TAC suggested that it had reserved right to reimbursement. But the majority observed that an insurer has to have a right before it can hold back a right. One cannot reserve what one does not already have. One cannot create rights by reserving them. If neither a contract nor a course of dealing creates such a right, it

cannot be reserved.

A reservation of rights letter, as opposed to a reimbursement agreement, that tries to reserve a right which does not already exist, is nothing more than an offer to modify an insurance contract. If the insured responds with silence, the offer has not been accepted, said the majority.

**Subrogation:** TAC argued that it stepped into the shoes of the claimants. After all, it had paid the claimant, so it automatically acquired rights of the claimants. This idea is the essence of subrogation. However, inherent in the legal principle of subrogation is the rule that insurers may not subrogate against their own insureds. The Supreme Court applied that rule broadly and boldly in this case. Henceforth, under Texas law, it will be almost impossible for insurers to subrogate against their own insureds. Formerly, it was only very difficult.

**Unjust Enrichment:** The law recognizes the remedy of restitution for unjust enrichments. If the Good Samaritan in Luke had inadvertently assisted a wealthy man, he would have been entitled to recover from the person he helped upon a theory of unjust enrichment. The law also calls this theory "quasi-contract."

TAC attempted to utilize this theory against Matagorda County. In effect, the insurer contended that it was the "Good Samaritan" in connection with its policyholder. Writing for the court, Justice Harriet O'Neill held that per-

mitting insurers to obtain restitution under these circumstances would encourage unfortunate strategic shenanigans by insurers.

In the end, the majority held that "when coverage is disputed and the [liability] insurer is presented with a reasonable settlement demand within policy limits, the insurer may fund the settlement and seek reimbursement only if it obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement."

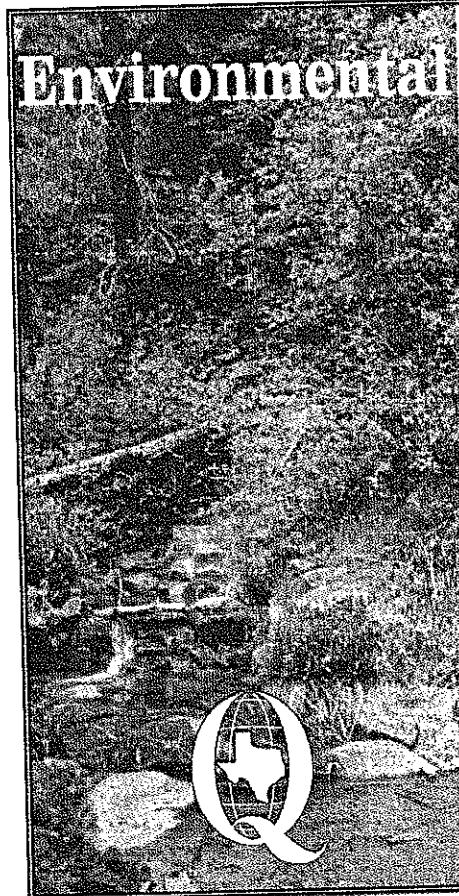
### Texas public policy

The majority's position rests upon the idea that insurance companies are in the business of analyzing and allocating risk and are therefore in a better position than insureds to assess the ins-and-outs of coverage disputes. (Silently, the majority included even wealthy and sophisticated insureds. Can this be right?)

Also, said the majority, insurers are in the business of drafting insurance policies. If they want a right to reimbursement, they should insert it in their insurance policies. Finally, the majority pointed out that it has repeatedly encouraged insurers to bring declaratory judgment actions designed to resolve coverage actions at an early date.

### Dissent

There were two dissenters. They believe that the insured was unjustly enriched and



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hence that the insurer should be able to obtain restitution. "An obligation of reimbursement should be imposed when an insurer pays an amount that the insured agrees is reasonable to settle a claim that is not covered. This rule of law would preserve the respective rights and obligations of the parties to the insurance contract." As a result of the majority's decision, "Matagorda County is receiving a benefit for which it did not bargain—payment of a claim that was not covered under its agreement." Thus, the dissenters raise high the banner of the sanctity of contract.

In addition, the dissenters held that in a

situation where an insurer offers to pay a settlement upon a condition, if the insured accepts the offer and lets the settlement go through it accepts the condition. This second point is clearly revisionary with respect to orthodox contract law.

Justice Priscilla Owen, dissenting, makes a profound point about the nature of relational contracts. Her deep point is that where a contract lasts over time and the two contracting parties have to interact with each other to administer the contract, they may acquire obligations to respond to what orthodox contract theory would classify as mere offers to

which no response is necessary. In other words, relational contracts are different from one-shot deals. Justice Owen's contention here is a very important one. Surely most insurance contracts are relational.

### Evaluation

The majority and the minority are only a hair's breath apart on the unjust enrichment issue. The only difference between them is that the majority is worried that insurers might manipulate a right of reimbursement if they had one. Perhaps so. Is the best way to police a sensible right to deny its existence? The decision in this case may have two important consequences. One of them is certain to happen. One of them is more speculative.

*The Certain Consequence:* The Texas Supreme Court could not make the point more plain. Insurers should file declaratory judgment actions early and file them often. The court has virtually instructed trial courts not to slow them down. This is a full employment for insurance coverage lawyers decision.

Similarly, policyholders run risks if they try to slow them down. They may lose the rights they acquired under Matagorda County if they succeed in retarding the progress of a coverage "dec" action. It would not be surprising henceforth to see coverage issues resolved well before underlying torts issues are determined. Of course, such decisions may also impact the results in the underlying tort actions.

*A Speculative Consequence:* There is a very intriguing situation. What happens if an insurer is defending; coverage is uncertain; and plaintiff makes a settlement demand within policy limits? The legal rule in precisely this situation is that insurers may be liable for sums in excess of policy limits, unless they act reasonably.

But what are the determinants of reasonable conduct here? Up to now, the concept of reasonableness ranged over two factors: first, the amount of the settlement offer, in comparison to the victim-plaintiff's damages and second, the alleged tortfeasors conduct.

Only those two factors counted. Matagorda County suggests (but no more than suggests) that insurers may also look at a third. They may look at the probabilities as to whether there is coverage in determining how to act reasonably. In other words, perhaps, from now on, if an insurer reasonably but mistakenly concludes there is no coverage and refuses a settlement, it will not owe beyond policy limits.

If so, this is a revolution in Texas law. ■

*Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He litigates and testifies on insurance related problems and is currently the chair of the Insurance Section of the State Bar of Texas. He also is a Visiting Professor of Law at the University of Texas-Austin.*

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