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TEXAS INSURANCE LAW NEWSBRIEF

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HOUSTON COURT OF APPEALS AFFIRMS COMMERCIAL IKE DAMAGE AWARD & FINDING OF KNOWING CONDUCT

In the wake of a policyholder verdict which included findings of Insurance Code violations and knowing conduct by the insurer, Houston's Fourteenth Court of Appeals affirmed the verdict in most respects last Thursday. This result will very likely be appealed to the Supreme Court of Texas and there is a good chance the Supreme Court will accept the petition, paving the way for potential reversal. In *United Nat'l Ins. Co. v. AMJ Investments, LLC*, ---S.W.3d ---, No. 14-12-00941-CV, 2014 WL 2895003 (Tex. App.—Houston [14th Dist.] June 26, 2014, no. pet. h.), AMJ alleged that United had knowingly underpaid its claim for hurricane Ike damage to a seven-story office building. At trial, AMJ presented evidence that United's adjuster, Sheffield, retained an expert building consultant, UBS, who prepared a repair estimate, with which AMJ's adjuster agreed. But instead of relying on that estimate, Sheffield prepared his own lower estimate based on an engineering report from Rimkus and used it as the basis of United's payment.

The jury found both breach of contract and Insurance Code violations, but awarded identical damages of $300,000 for both causes of action, and AMJ elected to recover the Insurance Code damages. The jury also awarded treble damages of $600,000[1] based on a finding of knowing conduct, 18% interest under Insurance Code Chapter 542, and attorney fees totaling approximately $160,000. On a legal and factual sufficiency challenge, the Court of Appeals concluded that evidence in the record supported the jury's finding because reasonable jurors could have concluded the parties agreed the claim would be paid based on the UBS estimate, but United then refused and paid based on Sheffield's lower estimate.

Relying on the general rule that reliance on an expert is not evidence of bad faith, United argued it could not have committed bad faith because it relied on the causation findings of the Rimkus engineering report. The Court of Appeals disagreed and pointed out that in some circumstances use of an expert will not necessarily shield an insurer from a finding of bad faith. The court held the jury could have concluded that United agreed to pay based on the UBS repair estimate, and that choosing the contrary opinion of Rimkus over UBS was bad faith.

United also argued that AMJ had not sufficiently proven its damages because it relied solely on Xactimate estimates, and no witness testified that the figures in those estimates were reasonable and necessary repair costs. Although this argument has previously persuaded the Supreme Court of Texas,[2] the Court of Appeals disagreed because both parties relied on Xactimate and there was some evidence the parties had agreed that Xactimate would be the method of determining the cost of repair. Additionally, the jury was not asked to find the "reasonable and necessary" cost of repair, and neither party requested the phrase "reasonable and necessary" be included in the jury charge.

United also argued there could be no extra-contractual liability without a showing of an independent injury apart from the plaintiff's claim for policy proceeds. Thus, because the jury awarded identical amounts for the contract cause of action and the Insurance Code cause of action, United asserted AMJ could not recover on its statutory claim. However, the Court of Appeals disagreed, relying on one of Texas's seminal bad faith opinions, *Vail v. Texas Farm Bur. Mut. Ins. Co.*[3] for the proposition that a policyholder may elect to recover its damages under a breach of contract theory or a statutory violation theory. The court flatly rejected arguments that more recent opinions of the Supreme Court of Texas in fact require a showing of an independent injury.

On the other hand, the Court of Appeals reversed the verdict in two respects. The court held that the 18% "enhanced interest" under Insurance Code Chapter 542 had been improperly calculated based on a trigger date that was too early, and the interest began to accrue after United received all items needed to secure final proof of loss, ***not*** after the first date that AMJ asserted United should have paid the entire loss. This resulted in a reduction of the interest accrual period by about six months, eliminating approximately $45,000 in awarded interest.

Second, the Court of Appeals held that AMJ's attorney fees were not supported by sufficient evidence. AMJ calculated its claimed attorney fees based on the "lodestar" method, which calls for the reasonable number of hours spent by the attorney to be multiplied by the attorney's reasonable hourly rate. The court initially pointed out that the lodestar method is only *required* in cases decided under the Texas Commission on Human Rights Act, and AMJ's counsel chose to use the lodestar method even though it was not required here.[4] However, the lodestar method still requires the attorney to present specific evidence of the time expended on specific

tasks. The court concluded that AMJ's counsel did not present adequately detailed evidence of the time spent on specific phases of the litigation, and remanded the attorney fee award for further fact-finding by the trial court.

In a ten-page dissent, Justice Donovan argued that the verdict should have been reversed and AMJ should have taken nothing because *McGinty v. Hennen*, distinguished by the majority, in fact controlled the standards AMJ must meet to prove its damages. Because AMJ did not prove the figures in the Xactimate estimate were reasonable and necessary, Justice Donovan argued there was no evidence to support AMJ's actual damages, and thus no basis for any other aspect of the award. Justice Donovan pointed out that the jury charge did in fact incorporate the "reasonable" standard in its statement, "What sum of money… would *fairly and reasonably* compensate AMJ for its damages…" Additionally, Justice Donovan opined that widespread use of Xactimate in the industry, and by both these parties, does not establish by itself that the figures in an Xactimate estimate are reasonable or necessary.

[**Editor's Note**: AMJ was represented by Gravely & Pearson of San Antonio at trial. United National was represented by Tucker, Taunton, Snyder & Slade of Houston in the trial court, and by Strasburger & Price on appeal. The appellate court rulings on the "independent injury" issue and the "knowing" finding are both very significant. We presume the case will now proceed to the Texas Supreme Court. Given the lower court's efforts to distinguish prior supreme court precedent on several key issues, we are hopeful the high court will take the case and use it to further clarify Texas law regarding the extra contractual claims. This case will certainly be watched carefully as the anticipated appeal to the Supreme Court of Texas proceeds and, as always, we will keep our readers updated on any further development.]

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[1] The jury attempted to award $1 million in treble damages for knowing conduct, but this amount was reduced to the statutory cap of two times economic damages.

[2] *See McGinty v. Hennen*, 372 S.W.3d 625 (Tex. 2012).

[3] 754 S.W.2d 129 (Tex. 1988).

[4] In fact, the Supreme Court of Texas has held in a more broadly applicable opinion that a contingent fee agreement, standing alone, cannot support an award of attorney fees, and the reasonable fee must be determined in light of a non-exclusive list of factors which were not considered here. *See Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812 (Tex. 1997).

FIFTH CIRCUIT UPHOLDS INSURER'S RIGHT TO CHOOSE COUNSEL WHEN DEFENDING UNDER A RESERVATION OF RIGHTS

Last Tuesday, the Fifth Circuit applied the rule of *Northern County Mut. Ins. Co. v. Davalos*,[1] which holds that an insurer who defends an insured under a reservation of rights retains the right to control the defense by selecting counsel, unless the facts to be adjudicated in the liability suit are the same facts on which coverage depends. In *Graper v. Mid-Continent Cas. Co.*, --- F.3d---, 2014 WL 2870553, No. 13-20099 (5th Cir. June 24, 2014), the insured was sued for an alleged copyright infringement. Mid-Continent agreed to defend, but reserved its rights. The coverage questions included whether the infringement took place during the policy period, and whether the infringement was knowing. The insured rejected the tender of counsel and defended itself with its own counsel, then sued Mid-Continent for its defense costs.

One of the insured's major defenses in the liability suit was statute of limitations, and the insured argued it was based on the same facts that would determine the coverage question of whether the loss occurred during the policy period. The court made a nuanced distinction between the date the infringement *occurred*, which would control coverage, and the date the claimant's cause of action for infringement *accrued*, which would control the limitations defense. Although these two facts are similar, they are not the same. While adjudication of the accrual date would generally signal that the occurrence must have preceded it in time, it would not actually establish the date of the occurrence.

The insured also argued it was entitled to its own counsel because of the allegation that its infringement was "willful," which overlapped the policy's exclusion for "knowing" conduct. Again the court made a careful distinction between the legal standards to be determined. "Willful," as construed under the Copyright Act, is a lower standard than "knowing" and may be based solely on a finding of recklessness.

Therefore, in a "close but no cigar" opinion, the Fifth Circuit affirmed Mid-Continent's right to appoint defense counsel for the insured and held it was not obligated to pay for the insured's own chosen counsel. The Fifth Circuit has now signaled several times that it will apply the *Davalos* rule strictly.

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[1] 140 S.W.3d 685 (Tex. 2004).

FIFTH CIRCUIT HOLDS UMBRELLA COVERAGE MAY BE TRIGGERED BY PAYMENT OF NON-COVERED CLAIMS

Last Monday, the Fifth Circuit examined the relationship between primary and umbrella insurance policies, and held that under the specific language of the policies in question, exhaustion of the primary insurance triggered the umbrella policy even though the claims which exhausted the primary coverage were not covered under the umbrella policy. In *Indemnity Ins. Co. of N. America v. W&T Offhsore, Inc.*, --- F.3d---, 2014 WL 2853586, No. 13-20512 (5th Cir. June 23, 2014), the insured purchased a primary CGL policy, a primary "Energy Package" policy, and an umbrella policy. The Energy Package policy covered property damage and "operators' extra expenses," incurred by the insured itself, but the umbrella policy only covered claims made against the insured by third parties.

After Hurricane Ike, the insured submitted claims for property damage and extra expense for over 150 offshore drilling platforms, which exceeded $150 million. The insured was also legally required to remove the debris of the damaged platforms, for which it incurred another $50 million. After exhausting its total limits under the Energy Package policy with the $150 million in property damage and extra expense claims, the insurer tendered the debris removal claims to the umbrella carrier. The umbrella carrier refused the debris removal claims, asserting its coverage was not triggered because the claims which were paid by the underlying insurance were first-party claims, which are not covered by the umbrella policy.

The umbrella policy's insuring agreement covered claims in excess of the Retained Limit, which was defined to mean the limits of the underlying insurance or SIR. Nothing in the definition of the Retained Limit required that it be spent on claims which would be covered under the umbrella policy. On the other hand, the umbrella carrier argued that the policy contained a drop-down clause which stated its obligations if the Retained Limit was exhausted "by payment of one or more claims that would be insured by our Policy," and this clause showed that only covered claims could exhaust the underlying limits.

After a careful parsing of the language, the court held the policy was unambiguous and the insuring agreement required the umbrella carrier to pay otherwise covered claims anytime the Retained Limit was exhausted, regardless of the type of claim that resulted in the exhaustion. The court concluded the existence of the drop-down clause did not limit liability, but outlined additional duties in the event the retained limit was exhausted by claims which were covered under the umbrella policy.

This holding is not as broad as it may at first seem because it was based on a word-by-word parsing of highly specific policy language. The court contrasted this result with another case, *Westchester Fire Ins. Co. v. Stewart & Stevenson Services, Inc.*, 31 S.W.3d 654 (Tex. App.—Houston [1st Dist.] 2000, pet. denied) which involved different policy language and a different outcome. Nevertheless, all carriers who provide excess/umbrella coverage in Texas should study both opinions carefully.

FEDERAL COURT STRIKES PLAINTIFF'S EXPERTS IN BASTROP FIRE CASE HOLDING "EYEBALL" ESTIMATING METHOD DEEMED UNRELIABLE

Federal District Court Judge David Ezra of the Western District of Texas recently considered several expert witnesses retained by the insured and his counsel to address claimed smoke damage to an insured residence following the 2011 Bastrop wildfire and found the testimony offered was unreliable, stating at one point: "from a common sense perspective, this is absurd." The Court accordingly struck the expert's testimony. In *Falcon v. State Farm Lloyds*, 2014 WL 2711849 (W.D. Tex., June 16, 2014), the insured claimed smoke damage to the insured residence as a result of the 2011 wildfire in Bastrop County, Texas. State Farm inspected the property and found minor fire damage around the property and paid for that damage as well as to clean the residence and personal property and paid roughly $20,000 for the cleaning and other covered losses. Later, State Farm received a letter from the insured's attorney claiming attaching an estimate from the insured's public adjuster, Stephen Hadhazi, seeking $112,766.59 to remediate the property entirely. State Farm's re-inspection revealed that initial cleaning efforts by Service Master were successful. This lawsuit followed.

State Farm moved to strike expert testimony offered by plaintiff's experts James fields, Stephen Hadhazi and Marion Armstrong. The court's well-reasoned twenty-seven page opinion provides a thorough analysis of the court's gatekeeper role under the rules of evidence "to ensure that any and all scientific evidence is not only relevant, but reliable." Addressing the qualifications of James Fields, the insured's expert on smoke contamination who took samples for testing, the court found that his lack of formal education, his reported self-education by learning what he could from the internet, "do not qualify him as an expert in smoke contaminate sampling and testing procedures." And, the Court found Fields "course of study" which he claims qualifies him as an expert in smoke contaminant testing "is woefully inadequate." The court carefully reviewed Fields opinions on smoke contamination's impact on property values, disclosure obligations, diminution in the property value and other issues and likewise held Fields was not qualified and that his opinions were unreliable. Lastly, the court found his method of sampling for smoke contamination was unreliable, with unreliable techniques and handling procedures.

The samples taken by James Fields were sent to Armstrong Labs for analysis. The court found that while plaintiff's expert Marion Armstrong is well qualified as an industrial hygienist, having found that Field's samples were unreliable, the court likewise rejected any opinions that relied solely on them. The impact was to greatly limit those topics on which Armstrong would be allowed to testify.

Lastly, the court reviewed the qualifications and opinions offered by plaintiffs damage and bad faith expert, Stephen Hadhazi. The court observed serious questions regarding his experience, qualifications and background. State Farm challenged the reliability of Hadhazi's estimating methods and his experience, asserting that he has never estimated a wildfire case as a public adjuster and his experience comes from preparing fifty to one hundred estimates in other cases for the plaintiff's attorney. The court found that Hadhazi's methods for coming up with his damage estimate were unreliable and his testimony would be excluded. The court noted "Hadhazi can point to no actual method he used, other than "eyeballing" what he perceived to be damage in the home. The court also observed Hadhazi had no documentation of his methods, performed no quantifiable test for his damage estimate or to support his conclusion that the roof needed to be replaced. The court found Hadhazi's experience was "not enough to render his testimony reliable when all of his opinions are based on guesswork." And in addressing Hadhazi's position that insurance companies should always replace a damaged item without first trying to clean it, the court astutely noted: "From a common sense perspective, this is absurd." Similarly, the court found Hadhazi was not qualified to opine on bad faith, and was not even able to offer a cogent definition of it. Accordingly, Hadhazi's testimony was excluded.

[**Editor's Note**: Christopher Lewis and Richard Grigg of Spivey & Grigg in Houston, Rick Leeper of the Law Offices of Dicky Grigg in Austin and Robert Collins of Houston represented Plaintiffs. Richard South of Wright & Greenhill in Austin represented State Farm. Congratulations to Mr. South and State Farm for this great win.]