

# TEXAS INSURANCE LAW NEWSBRIEF

SEPTEMBER 30, 2014

## TEXAS APPEALS COURT FINDS THAT DESTRUCTION AND FABRICATION OF MATERIAL EVIDENCE DOES NOT WARRANT TRIAL COURT'S DEATH-PENALTY SANCTIONS OR MILLION DOLLAR FEE AWARD AGAINST INSURED

Last week in in *Knoderer v. State Farm Lloyds* (06-13-00027-CV), the Texarkana Court of Appeals reversed a \$1 million award of attorneys' fees and "death penalty" sanctions assessed against a couple whom the trial court found intentionally fabricated photos of flooding damage to collect insurance money from State Farm and then later destroyed evidence relating to these fabricated photographs because the appellate court found the penalties "excessive."

The sanctions were issued after William and Susan Knoderer allegedly pried a water valve fitting from a pipe causing their house to flood in 2008 and then later fabricated six photographs in an attempt to discredit State Farm's analysis of the leak. The trial court also found they later destroyed evidence relating to the photographs in violation of a specific court order that it be preserved.

The court-described "ill will" between the parties which went back several years when the Knoderers sued State Farm on a mold claim and lost. They later added specific mold coverage to their policy but State Farm determined the mold coverage should not have been issued and, pursuant to the applicable policy provisions, notified the insureds the coverage would be rescinded.

In January of 2008, State Farm sent the Knoderers a letter advising that their mold coverage would cease effective March 6, 2008. On the evening of February 20, 2008, a supply line allegedly separated from a brass fitting inside the wall of a utility closet, flooding the Knoderers' residence. An investigator determined the pipe was possibly pried loose with a screwdriver and was unlikely to have been caused by water pressure alone. State Farm demanded access to the home and The Knoderers agreed. After the Knoderers granted State Farm access to the house, the cabinets, countertops, fixtures, appliances, doors, trim, flooring, and bottom four feet of sheetrock were removed from the house by them.

The Knoderers then filed suit claiming State Farm used deception to increase their damages by misrepresenting in their letters to the Knoderers that State Farm would pay for the demolition and restoration of the house. As discovery progressed, six photographs admitted into evidence by the Knoderers in an effort to prove State Farm had fabricated evidence were themselves determined to have been fabricated by the Knoderers, after investigators found a number of discrepancies in the pictures' metadata. The Knoderers were later found to have disobeyed a specific court order to preserve them.

In addition to granting the death penalty sanction and striking the Knoderers' claims, the trial court awarded the insurance company \$1,000,000 in attorney fees, \$142,339 in expert fees and \$33,474 in costs.

On appeal, the Knoderers argued the death penalty sanctions were inappropriate because the fabrication and destruction of evidence did not "go to the heart of the case." The unanimous appeals panel said it deferred to the factual record developed in the trial court indicating the Knoderers fabricated the six photographs and destroyed evidence, they weren't sufficient to issue sanctions essentially allowing State Farm to prevail in the underlying suit. The appellate court explained: "Here, the destroyed evidence could have supported or undercut only the argument that the six photographs were fabricated, not the ultimate issues in the lawsuit." It continued: "Therefore, the destruction of the data related to the six photographs does not justify a conclusion that the Knoderers' claims lack merit."

At the heart of the court's analysis was the issue of whether the misconduct justified the required implied finding that the Knoderers caused the February 2008 leak. The Court also held the record from the trial court was insufficient to show the required consideration of lesser sanctions before imposing a case-determinative sanction.

As for the monetary sanctions, the appeals court found the fee award was excessive and said fees awarded should be proportional to the misconduct in question only and not the fees incurred in the entire litigation. The court explained: "The award in this case is for essentially the total of State Farm's attorneys' fees in the case—not the attorneys' fees incurred due to the sanctionable conduct." It concluded: "Only the attorneys' fees, expert fee, and costs related to the six fabricated photographs should be included in the sanctions."

Finally, the Court found the sanctions against Mrs. Knoderer were inappropriate because there was no evidence that she directly participated in the misdeeds or whether she was an agent of her husband. The Court cited the Family Code for the proposition that a spouse may not be held liable for the torts of the other spouse.

The Court rendered judgment deleting all sanctions against Mrs. Knoderer and remanded the case to the trial court for further proceedings, including an assessment of lesser sanctions, against Mr. Knoderer.

## FIFTH CIRCUIT COURT OF APPEALS CERTIFIES QUESTION TO TEXAS SUPREME COURT REGARDING COMMONLY USED TERMS IN COMMERCIAL GENERAL LIABILITY POLICIES

Last week, the Fifth Circuit Court of Appeals in New Orleans asked the Texas Supreme Court for help in determining if commonly used terms in commercial general liability policies are ambiguous under Texas law in U.S. Metals' suit seeking liability coverage for a \$6.3 million settlement with Exxon over allegedly defective refinery equipment.

The Fifth Circuit appeal arose from a dispute between U.S. Metals and Liberty Mutual regarding coverage of certain damages pursuant to two exclusions in a commercial general liability insurance policy. The coverage case ended up in Federal Court in Houston and was resolved in Liberty's favor by summary judgment. The insured appealed and the Fifth Circuit panel found this case involves important questions of Texas law regarding the interpretation of terms within common exclusions of commercial general liability policies, as to which there is no controlling Texas Supreme Court precedent. They determined the resolution of this case turns on two questions of Texas law, neither of which has been directly addressed by the Supreme Court of Texas: (1) whether the terms "physical injury" and "replacement" found in the common "your product" and "impaired property" exclusions are ambiguous; and (2) if not, what do these terms mean pursuant to Texas law? The panel declined to make an "Erie guess" and certified four questions to the Supreme Court of Texas.

The following questions of law were certified to the Supreme Court of Texas:

1. In the "your product" and "impaired property" exclusions, are the terms "physical injury" and/or "replacement" ambiguous?
2. If yes as to either, are the aforementioned interpretations offered by the insured reasonable and thus, must be applied pursuant to Texas law?
3. If the above question 1 is answered in the negative as to "physical injury," does "physical injury" occur to the third party's product that is irreversibly attached to the insured's product at the moment of incorporation of the insured's defective product or does "physical injury" only occur to the third party's product when there is an alteration in the color, shape, or appearance of the third party's product due to the insured's defective product that is irreversibly attached?
4. If the above question 1 is answered in the negative as to "replacement," does "replacement" of the insured's defective product irreversibly attached to a third party's product include the removal or destruction of the third party's product?

The panel said they could find no controlling Texas case law discussing the meaning of "replacement" within the commonly used impaired property exclusion, but noted a Texas federal court interpreted replacement to include the cost of tearing down other injured components, even if the other components were physically injured upon the installation of defective equipment.

The panel further noted a Texas appeals court said the incorporation of a defective product is not "property damage" to the defective product itself, but the panel also noted that that opinion doesn't discuss whether damage to other integrated components would be considered property damage.

In explaining its rationale for certification, the panel found the Texas Supreme Court's interpretation of these terms will have "far-reaching implications due to the commonality of these exclusions within CGL policies." It further noted: "the answer to our certified questions will affect a large number of litigants. No Texas court or any other state or circuit court has determined whether the terms "physical injury" or "replacement" found within the "your property" and "impaired property" exclusions are ambiguous."

Late last week, the Texas Supreme Court accepted the case and issued a briefing schedule to allow the parties to address the precise questions raised by the Fifth Circuit. We will keep our readers updated regarding any further developments in this important case.

[Editor's Note: Liberty Mutual is represented in this case by Chris Martin, Levon Hovnatanian and Bruce Ramage of MDJW.]

## HOUSTON COURT OF APPEALS AFFIRMS SUMMARY JUDGMENT IN FAVOR OF THE INSURER BECAUSE THE INSURED REJECTED PIP AND UIM COVERAGE IN WRITING WHEN THE INSURER ISSUED THE FIRST AUTO LIABILITY POLICY

Recently, the Houston Court of Appeals [14th Dist], in *Cain v. Progressive Cty. Mut. Ins. Co.*, Cause No. 14-12-00954-CV, 2014 WL 4638923, (September 18, 2014), affirmed summary judgment in favor of Progressive because the Insured rejected PIP and UIM coverage in writing before Progressive issued the first auto liability policy.

In May 2003, Corliss Madison obtained an auto policy from Progressive. At that time, Madison rejected in writing UIM and PIP coverage. Madison and Larry Bradford were named insureds under the policy. After the initial policy expired, Madison entered into seven more successive insurance policies every six months over the next four years. In December 2005, Madison's son ("Coleman") was added to the existing policy for one month and then again in April 2007 through the applicable policy period. Madison was involved in a vehicular accident in July 2007, which allegedly resulted in her death in February 2012. Madison's husband ("Cain") made a claim under the policy and sought UIM and PIP coverage. Progressive denied the claim.

Cain then filed suit alleging Progressive breached the insurance contract and violated the Texas Insurance Code when it denied Cain's claim.

Progressive filed a motion for summary judgment in the trial court asserting that Madison's written rejection in May 2003 of UIM and PIP coverage was valid and enforceable; therefore there was no UIM or PIP coverage. Further, Progressive asserted the policies entered into with Progressive after the initial policy were "renewal policies" and unless Madison requested PIP or UIM coverage in writing, Progressive was not required to provide either coverage. The trial court granted Progressive's Motion for Summary Judgment.

In Texas, UIM and PIP coverage is mandated unless any insured named in the insurance policy rejects the coverage in writing. Further, Texas law mandates that an insurer is not required to provide either coverage in or supplemental to a "renewal insurance policy" after such coverage had previously been rejected in writing. The issue presented to the Court of Appeals was whether the addition of a named insured under the policy constituted a "material change" that created a "new policy" requiring the insurer to obtain *another* written rejection of UIM and PIP coverage.

Relying on several sister courts of appeals in other states, the Court found that Madison's eighth successive policy was a "renewal insurance policy," as it was a successive policy in an unbroken chain of coverage going back to the initial policy to which UIM and PIP was rejected in writing by Madison. The Court found that the addition and removal of vehicles from the policies and the addition and removal of Coleman as a named insured did not preclude the applicable policy from being a renewal insurance policy. The court therefore affirmed the underlying summary judgment in favor of Progressive.