Martin, Disiere, Jefferson & Wisdom

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SUPREME COURT REVISITS GANDY, "FULLY ADVERSARIAL TRIAL" REQUIREMENTS

In an important recent decision, the Supreme Court of Texas re-examined the scope of *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996), and its "fully adversarial trial" requirement in determining the binding effect of a judgment against a liability insurer in an action by the insured's assignee. In *Great American Lloyds Ins. Co. v. Hamel*, --- S.W.3d ---, No. 14-1007 (June 16, 2017) (slip op.), the carrier refused to defend a builder against a homeowner's construction defect suit involving EIFS damage. The carrier later conceded that its refusal to defend the builder had been made in error.

Having no funds to defend the suit and no significant assets, the builder did little to defend itself and entered into a pretrial agreement under which the builder's owner would appear at trial, and the homeowner would not attempt to enforce any judgment against his personal assets or tools of his trade (he later admitted the company had no other assets). The builder made damaging pretrial stipulations admitting liability. After a bench trial, the trial court rendered a large judgment against the builder based on the homeowner's findings of fact. The builder then assigned its claims against the carrier to the homeowner, who sued the carrier to recover the judgment. In the resulting insurance litigation, both the trial court and the court of appeals concluded the underlying judgment was binding on the carrier, despite the carrier's arguments that it violated *Gandy*.

The Texas Supreme Court first noted that this case did not fall within the classic *Gandy* parameters because unlike *Gandy*, the assignment of the builders' claims was made after the trial, the carrier had breached its duty to defend, and the carrier had neither accepted coverage nor made a good faith attempt to adjudicate coverage before the trial of the underlying suit. Therefore, there was no doubt that the assignment of claims from the builder to the homeowner was valid. Rather, the crux of the suit was *Gandy's* pronouncement that ***"in no event… is a judgment for plaintiff against defendant, rendered without a fully adversarial trial, binding on defendant's insurer or admissible as evidence of damages in an action against defendant's insurer by plaintiff as defendant's assignee."*** *Gandy* at 714. The court observed that by imposing the fully adversarial trial requirement, it "shifted focus toward whether the underlying judgment accurately reflects the plaintiff's damages and thus the insured's covered loss."

In attempting to answer the question of whether a given trial was "fully adversarial," the court noted the inherent difficulty of critiquing trial strategy after the fact, and declared a focus on the trial details to be "misplaced." The court clarified that **"the controlling factor is whether, at the time of the underlying trial or settlement, the insured bore an actual risk of liability for the damages awarded or agreed upon, or had some other meaningful incentive to ensure that the judgment or settlement accurately reflects the plaintiff's damages and thus the defendant-insured's covered liability loss."** The court went on to rephrase it for the hard of hearing: **"Stated another way, proceedings lose their adversarial nature when, by agreement, one party has no stake in the outcome and thus no meaningful incentive to defend itself."** Here, the parties' pretrial agreement eliminated any meaningful incentive the builder had to contest the judgment, and the declared the resulting judgment not binding on the carrier.

The court then went on to hold that **"while we will not hold an insurer to a judgment that was not the result of an adversarial proceeding, we will not preclude the parties from properly litigating the underlying liability issues in a subsequent coverage suit."** Naturally, the parties to this case had considered the underlying liability to be largely a closed issue and had not fully litigated it in the coverage suit. Therefore, the court remanded for a new trial to fully explore the liability issues – in essence, a re-trial of the underlying suit, with the carrier filling the role of the fully adverse defendant.

Editor's Note: A major lesson of this case is that a claimant cannot stick the insurer with a large judgment by making a "sweetheart" deal with the defendant-insured, even if all the *Gandy* red flags are carefully avoided. The claimant will have to truly prove its damages in a fully adversarial trial in which the defendant has a genuine stake, but that trial may be either against the insured, or, ultimately, the carrier itself. Re-litigating liability issues years after the fact comes with its own set of disadvantages, including fading memories, lost evidence, and dead or disappeared parties and witnesses, and they can cut both ways. Therefore, it is in the interest of all parties to try liability once and get a reliable answer the first time.

A DAY LATE, $6 MILLION SHORT: TEXAS SUPREME COURT ENFORCES STRICT COMPLIANCE WITH CANCELLATION NOTICES

Recently, the Supreme Court of Texas ruled against a premium finance company in a policy cancellation dispute, reversing a favorable summary judgment by the trial court and potentially exposing the premium finance company to liability for a $6 million dollar loss that occurred four days after the attempted cancellation of the policy. *BankDirect Capital Finance, LLC v. Plasma Fab, LLC*, 2017 WL 1968024 (Tex. May 12, 2017) (slip op.) involved an insured, Plasma Fab, who was habitually late paying its premiums. Its liability policy had previously been cancelled and reinstated twice due to late premium payments. The Texas Insurance Code requires a premium finance company to mail a notice of cancellation to the insured ten days before the cancellation date stated in the notice.

The third time Plasma Fab was late paying its premium, BankDirect, the premium finance company, issued a notice of intention to cancel dated November 24, which stated an effective cancellation date ten days later, on December 4. But the notice was not actually mailed until the next day, November 25, giving only nine days' notice between mailing and the stated cancellation date. Plasma Fab did not pay the premium by December 4, and a notice confirming the cancellation was issued that day. Four days later, a fire occurred which resulted in a claim against Plasma Fab. Plasma Fab paid the overdue premium the day after the fire and requested reinstatement of the policy. The carrier refused, citing internal rules prohibiting reinstatement after three cancellations for failure to pay premiums. The carrier denied the claim resulting from the fire, and Plasma Fab ultimately became liable for a $6 million judgment.

Plasma Fab sued the carrier and BankDirect, asserting that because the notice was not mailed in compliance with the Insurance Code's ten-day notice requirement, the cancellation was not valid. The case was defended on a "substantial compliance" theory. The trial court agreed with this theory and granted summary judgment in favor of the carrier and BankDirect. The court of appeals reversed as to BankDirect only, and the issue then reached the supreme court.

BankDirect argued that failure to give ten days' notice did not render its notice of intent to cancel completely ineffective, but merely pushed the effective date back to the earliest allowable date that would provide ten days of actual notice. In other words, because the notice was not mailed until November 25, the cancellation did not become effective until December 5, rather than December 4 as stated on the notice. The court agreed this position had an internal logic, but stated it could not be upheld by anything in the statute.

In a majority opinion authored by Justice Willett, the court observed that when the Legislature deems substantial compliance adequate, it can enact statutes which expressly allow for substantial compliance, and cited numerous examples where the Legislature had done exactly that. It also observed that a statutorily fixed time limit is generally not subject to the notion of "substantial compliance," stating, "The essential requirement of a deadline is the deadline, and, as with a missed statute of limitations, the *degree* of delay matters not: A miss is as good as a mile."

The majority also looked to the Code Construction Act and relied on it to conclude that the notice requirement at issue required BankDirect to mail the written notice of cancellation to the insured, and simultaneously prohibited BankDirect from stating a date in the notice that was less than ten days after the date of mailing. BankDirect violated the clear requirement of the statute by mailing a notice which stated a cancellation date only nine days after the date of mailing. Because the notice requirement is clear and unambiguous, the majority concluded it must enforce it as written, and declined to look to extrinsic factors such as the legislative history, the object of the statute, or the public policy implications of enforcing or not enforcing it. The court noted, "Statutes that impose timelines naturally burden those who miss them," and urged that courts must resist the temptation to alter a statute to realign perceived inequities.

Justice Guzman filed a concurring opinion which gave more credence to the idea of substantial compliance, but concluded that in this case, the only way to *substantially* comply with the specific and express ten-day notice requirement was to *fully* comply with it.

Justices Johnson and Hecht dissented, noting the absence in the statute of any penalty for failing to comply with the ten-day notice requirement and concluding the statute should be construed as merely directory rather than mandatory. The dissent looked to *Hines v. Hash*, in which the supreme court examined a pre-suit notice requirement under the DTPA. There, the statute required 30 days' notice, but did not specify a penalty for non-compliance. The court concluded that the purpose of the statute could be accomplished by merely abating the lawsuit until the notice period had elapsed. This abatement remedy is now well known and has been codified in more recent versions of the statute. The dissent argued for a similar result here, pushing back the effective date of cancellation until the ten days had elapsed. The dissent further argued that as long as an insured has at least until the tenth day after the date of mailing to cure the default, then the essential requirement of the deadline has been met, and the concept of substantial compliance can still be meaningful.

Editor's Note: The trial court's summary judgment in favor of the carrier, Scottsdale Insurance Company, was not appealed, and the absence of Scottsdale from this appeal may have changed the way these issues were addressed by the court. Cancellation notices issued by carriers and those issued by premium finance companies are governed by two different sections of the Texas Insurance Code. Section 651.161, governing notices issued by premium finance companies, and which was at issue in this case, reads,

"The insurance premium finance company must mail to the insured a written notice that the company will cancel the insurance

contract because of the insured's default in payment unless the default is cured at or before the time stated in the notice. The stated time may not be earlier than the 10th day after the date the notice is mailed."

In contrast, Section 551.053, governing cancellation by an insurer, reads,

"Not later than the 10th day before the date on which the cancellation of a liability insurance policy takes effect, an insurer must deliver or mail written notice of the cancellation to the first-named insured under the policy at the address shown on the policy."

The wording of the second appears more flexible than the first. The court's interpretation of the first provision in this case focused heavily on the interplay of the words "must" and "may not," and held that BankDirect had violated the "may not" in the second sentence. Section 551.053 contains no equivalent provision, and focuses more on the amount of notice given to the insured than on what the cancellation notice says. This difference, combined with the arguments made by the dissent, leaves open the possibility that had BankDirect been an insurer and not a premium finance company, its argument that cancellation became effective on the 10th day after mailing might have worked, and the outcome might have been quite different.

Additionally, had Scottsdale remained in the case, more substantive coverage concerns likely would have been at issue, such as the fortuity doctrine, which prohibits insurance coverage from attaching for a loss that has already occurred. Therefore, while this opinion is certainly a cautionary tale on the importance of mailing notices on time and being ready to prove up proof of mailing when required, it may not be the last word on a notice mailed one day late by an insurer rather than a premium finance company.

DISCOVERING A BALANCE: TEXAS SUPREME COURT PROVIDES PROPORTIONALITY-BASED GUIDANCE FOR DECIDING DISPUTES OVER ELECTRONICALLY STORED INFORMATION

In a decision that will impact the discovery process in all Texas lawsuits, the Texas Supreme Court recently issued new guidance for e-discovery practice in the context of a dispute between insureds and insurers over the discovery of electronically stored information in native format. In *In re State Farm Lloyds* 2017 WL 23223099 (Tex. 2017), State Farm sought mandamus relief from a trial court order directing State Farm to produce claim file documents in native or near-native format. At the trial and intermediate appellate level, the insureds prevailed by arguing that the requesting party has the right to dictate the production format of electronically stored information in the responding party's possession.

The discovery dispute erupted in the context of claims asserted by homeowners that State Farm underpaid hail damage claims. The insureds and their counsel demanded production of claims information in native format, but State Farm objected to producing the documents in that format because its central database for storing claims information kept the documents in a searchable static format. The insureds argued that native format was essential because it would show metadata about the produced files, enabling the insureds to see who worked on documents, tracked changes, speaker notes in PowerPoint, photo captions, and other information not available via searchable static format. In response, State Farm argued that production of the documents in native format would be too expensive because a brand new internal system for storing claims information would have to be created. After the trial court ordered production in native format and the court of appeals upheld, State Farm sought relief from the Texas Supreme Court.

In ruling on the dispute, the Texas Supreme Court focused on the proportionality analysis trial courts must undertake once a responding party objects to the requested format of production. Importantly, the Supreme Court specifically noted that the requesting party cannot dictate the form of discovery, undercutting a requesting party's ability to fish for irrelevant information or force settlement by driving discovery expenses ever higher. Rather than leaving the form of production solely at the discretion of the requesting party, the supreme court placed the decision on format in the trial court's discretion as mandated by the plain language of the rules of civil procedure. In exercising this discretion, the trial court is to evaluate 7 factors: (1) the likely benefit of the requested discovery, (2) the needs of the case, (3) the amount in controversy, (4) the parties' resources, (5) the importance of issues at the in the litigation, (6) the importance of the proposed discovery in resolving the litigation, and (7) any other factor bearing on rules of civil procedure.

While the factors articulated are broad and will vary on a case by case basis, the supreme court embedded some statements that may help limit the discoverability of information in native format in future cases. For example, the court noted that native format metadata sometimes has no relevance at all, meaning that "hypothetical needs, surmise, and suspicion should be afforded no weight" by a trial court in considering whether to order production in that format. Instead, native format and metadata must be shown to be relevant to the claims and defenses at issue and cannot be discovered simply because helpful information *might* be discovered if native format documents are overturned. Finally, in a move hinting how the Court thinks the trial court should rule given the new guidance in its opinion, the Court approvingly cited *Dizdar v. State Farm Lloyds*, a case in which a federal district court denied an insured plaintiff's request for native format documents from State Farm because State Farm's production was in a reasonably usable format already. In conclusion, the Court denied State Farms petitions for writ of mandamus and sent the case back to the trial court for determination considering the guiding principles in its opinion.

Fifth Circuit Finds Subrogation Clause Allows Subrogee to Seek Reformation of Insurance Contract

In a matter of first impression under Texas law, the Fifth Circuit recently held that an excess insurer can seek reformation of an underlying co-insurer's policy to secure additional coverage for the insured. In *Associated International Insurance Co. v. Scottsdale Insurance Co.*, 2017 WL 2889078 (5th Cir. Tex. July 7, 2017), an assault occurred at an apartment complex and the injured party sued the property manager and the company that owned the apartments. Scottsdale insured the property manager but the apartment complex was not listed on the policy as required, so coverage was denied. The property owner's primary insurer and Associated, the excess insurer, settled the underlying claim. Associated then sought recovery from Scottsdale, asserting the insured's subrogation rights. Associated claimed that the property was not listed on the Scottsdale policy due to a mutual mistake between the property manager and Scottsdale. The district court concluded that Associated had no standing as a subrogee, to seek reformation of the contract between a third party, the property manager, and its insurer Scottsdale, because it was not in privity with that separate agreement. This appeal followed.

The Fifth Circuit, as a matter of first impression under Texas law, noted longstanding efforts by Texas Courts to recognize insurer's subrogation rights and then, examined whether those rights include the right to seek reformation of the contract. The court determined that the subrogation clause in Associated's policy with its insured, provided the necessary connection to establish privity and standing to seek reformation, as could its insured who would be an additional insured under the reformed Scottsdale policy. Because the reformation claim was dismissed at the pleading stage, and there was no evidence to evaluate it, the court reversed and remanded the case to the district court for further proceedings to address the reformation claim on its merits.

Southern District Finds Timely Payment of Appraisal Award Precludes Extra-Contractual Liability, Even Under Texas Supreme Court's Recently Articulated Bad Faith Standards

In granting summary judgment in an insurer's favor, the Southern District of Texas rejected arguments that the Texas Supreme Court's recent efforts to clarify standards for insurer's extra-contractual liability, in *USAA Tex. Lloyds Co. v. Menchaca*, 2017 WL 1311752 (Tex. April 7, 2017) (*See* Texas Insurance Law Newsbrief April 10, 2017, http://www.mdjwlaw.com/newsroom-news-TIN-20170410-item1.html) should allow the lawsuit to proceed despite timely payment of an appraisal award. In *Losciale v. State Farm Lloyds*, 2017 WL 3008642 (S.D.Tex. July 14, 2017), the insured claimed storm damage to their residence. State Farm investigated the claim and because damage less than the deductible, no payment was issued. The insured ultimately filed suit and the parties agreed to abate the case pending completion of the appraisal process. An award was entered in excess of the deductible and State Farm issued timely payment of the award in compliance with the policy and the Texas Insurance Code. Both parties then filed motions for summary judgement.

State Farm asserted that its timely payment of amounts owed under the appraisal award, precluded the breach of contract and extra-contractual claims asserted against it. The insured argued that the recent Texas Supreme Court's decision in *Menchaca*, overruled the cases State Farm relied upon in seeking summary judgment of the extra-contractual claims. The court analyzed recent case law and, applying the *Menchaca* standards, the court concluded that there was no loss of benefits under the policy and, no independent-injury to support the extra-contractual claims. The court held that well established Texas case law was not changed by *Menchaca*, and that by issuing timely payment based on the appraisal award, the insured's contractual and all extra-contractual claims were precluded as a matter of law.

Timely Payment of Appraisal Award Precludes Contractual and Extra-Contractual Claims

Recently, the Fourteenth Court of Appeals reversed a Galveston trial court and rendered a take nothing judgment on all claims after the insurer timely paid an appraisal award. In *Ozier Hurst v. National Security Fire & Casualty, et al.*, No. 14-15-00714-CV (Tex.App.—Houston [14th Dist.] May 23, 2017), National Security sought to reverse a trial court denial of a motion for directed verdict based on the payment of an appraisal award.

Ozier Hurst filed a claim with his insurer National for Hurricane Ike damage. National assigned the claim to an independent adjuster who inspected the home and prepared an estimate. National paid Hurst based on the estimate, but he did not use any of the money to repair his property or request a re-inspection or inspection of additional property. Instead, Hurst filed suit.

After litigation began, counsel for Hurst invoked the appraisal provision of the Policy. Both parties selected appraisers but they could not agree on the amount of the loss. The Court appointed an umpire and he issued an award. National promptly issued a check to Hurst and his counsel for payment of the award. Hurst did not move to set aside the award or cash the check, but continued pursuing his lawsuit. At trial, National moved for a directed verdict based on the payment of the appraisal award and no independent injury. The trial court denied the motion. The jury eventually returned a verdict for Hurst on breach of contract, and the statutory and common-law bad faith causes of action.

On appeal, National argued the directed verdict should have been granted because payment of the appraisal award precludes Hurst's claims. Hurst argued his refusal to accept the tendered payment allowed him to maintain his breach of contract claim and that National's inclusion of a release with the tender made it a conditional. Hurst further argued that National breached the policy by conditioning its tender of the appraisal award on a release of extra-contractual claims.

The Court disagreed with Hurst and found that tendering payment for an appraisal award estops an insured from bringing a breach of contract claim against an insurer, and that the trial court erred in denying the directed verdict on the breach of contract claim. As to the extra-contractual claims, the Court found that prompt payment claims were precluded by the timely payment of the appraisal award.

Hurt's additional extra-contractual claims were similarly precluded because he received the benefits to which he was entitled under the policy and did not allege any act so extreme as to cause independent injury.
The Court concluded by noting that the appraisal process is an extra-judicial means designed to avoid litigation on the issue of damages and that an insured cannot defeat an appraisal award simply by refusing to accept payment or by asserting extra-contractual claims that are derivative of the policy claim. The Court reversed the trial court's decision and rendered a take nothing judgment in favor of the insurer.

Court Examines Attorney-Client Privilege Protection for Insurer's Claim File – Conditionally Grants, In-Part, Insured's Request for Claim File Documents

The Texarkana Court of Appeals recently examined attorney-client privilege assertions by an insurer seeking to protect certain claim file documents from production and found that certain documents were not protected. In *In re Goin*, 2017 WL 2961478 (Tex. App. Texarkana, July 12, 2017), Goin was driving a pickup truck owned by his employer and insured under a commercial insurance policy issued by Travelers Property Casualty Company of America. The vehicle was involved in a rollover accident and Goin's passenger was rendered a paraplegic. She filed suit against Goin and the employer. Travelers initially defended subject to a reservation of rights. The passenger nonsuited the first lawsuit and filed a second in another county. Travelers did not tender a defense for eighteen months in that lawsuit, by which time most pre-trial deadlines has passed. The matter proceeded to trial and the passenger secured a damage award in excess of $10 million.
Goin then filed suit against Travelers alleging extra-contractual claims and sought discovery of the claim file. Travelers asserted the attorney-client privilege was applicable to internal communications on coverage between the adjuster and an in-house attorney employed by Travelers. The trial court ruled that the documents sought were protected by the attorney-client privilege. Goin then filed this mandamus proceeding seeking to compel production of the documents.
The Texarkana Court of Appeals examined Texas Rule of Evidence 503, which governs attorney-client privilege, and the evidence provided by Travelers in support. The court found that while the affidavit provided by Travelers did not meet the evidentiary standards, the trial court's in-camera review of the documents themselves could have supported their finding as to certain communications between in-house counsel and the adjuster. But there were certain pages of documents that listed documents transmitted, that "does not otherwise indicate that it is in any way privileged." Accordingly, the Texarkana court directed the trial court to order Traveler's to produce un-redacted versions of those pages.
The insured also asserted that Traveler's waived the attorney-client privilege by allowing the adjuster to review the claim file in preparation for his deposition. The court examined Texas Rule of Evidence 612 and a decision by a sister court that held the attorney-client and work-product privileges were waived when a witness was allowed to review documents to refresh recollection. In distinguishing that case, the court noted that the adjuster in the present case, reviewed the file in advance of the deposition, and not while testifying. So even if they were to adopt the sister court's ruling, waiver was not supported under the facts of the present case. Accordingly, mandamus was conditionally granted, in part, to require production of certain pages noted above, but otherwise the trial court's ruling was upheld.

MINIMUM FACTUAL ALLEGATIONS SUFFICIENT TO DEFEAT REMOVAL IN NORTHERN DISTRICT PROPERTY DAMAGE CLAIM

Recently, the United States District Court for the Northern District of Texas ruled that an insured plaintiff's new allegations against an insurance adjuster were sufficient to mandate remand back to state court despite the fact the court previously concluded that the adjuster had been improperly joined. In *Hutchins Warehouse Limited Partners v. American Automobile Insurance Company*, 2017 WL 2691315 (N.D. Tex. 2017), the insured sued AAIC and its adjuster in Texas state court after a tornado caused damage to its property. AAIC promptly removed the action to federal court. In response, the insured filed a motion to remand the action to state court, but AAIC successfully argued that its adjuster McMillan had been improperly joined solely to defeat diversity jurisdiction. Based on the facts in the insured's original petition, the court agreed. As a result, the lawsuit remained in federal court.

Undaunted, the insured filed an amended petition containing new allegations and new causes of action against AAIC's adjuster. The court then examined whether the new facts were sufficient to state a viable claim against the in-state defendant adjuster, mandating remand back to state court. In doing so, the court used a plaintiff-friendly standard, noting that it "need not decide whether [the insured] has sufficiently pleaded each cause of action; rather, if the court finds a reasonable basis to predict that it can potentially recover on any of these causes of action, the court must remand the entire case." With that principle in mind, the court found the new petition stated potentially viable claims. Specifically, the court found allegations that the adjuster "misrepresented material facts related to the coverage at issue," conducted an outcome-oriented investigation, and refused to provide an estimate for certain damages sufficient to show potential violations of Chapter 541 of the Texas Insurance Code. The feasible claims against the in-state defendant adjuster defeated diversity jurisdiction and caused the judge to remand the lawsuit back to state court.

HOUSTON COURT OF APPEAL GRANTS SECOND MANDAMUS FOR USAA ON NEW TRIAL ORDER

In *In re USAA*, ---S.W.3d ---, No. 01-17-00048-CV, 2017 WL 2545075 (June 13, 2017), the Houston Court of Appeals recently reminded us that it means what it says in its opinions, and its rulings on questions of law will continue to bind the parties in later proceedings. After a carrier won a judgment that it did not breach its contract and prevailed on most of the extra-contractual claims

against it, the trial court granted the plaintiffs' motion for new trial in 2013. After a three-year mandamus battle going up to the Supreme Court of Texas, the order granting new trial was vacated in 2016. We reported on that proceeding here: http://www.mdjwlaw.com/newsroom-news-TIN-20160429-item1.html. After the case was remanded to the trial court for compliance with the supreme court's directive, the plaintiffs again moved for new trial, and the trial court once again granted the motion, on three grounds which were the same as those stated (and rejected by the appellate courts) in the original new trial order.

On a new writ of mandamus, the court of appeals applied the "law of the case" doctrine and compared the 2016 new trial order with its previous analysis of the original 2013 new trial order. The court concluded that each reason given for granting new trial in the 2016 order was contrary to the existing law of the case, as explained in the court of appeals' 2014 mandamus opinion. The court rejected the argument that "law of the case" doctrine did not apply because the original 2013 new trial order and the 2016 new trial order were not identical – in essence, holding that re-wording an order already held invalid cannot escape the law of the case.

Editor's Note: USAA was represented by Levon Hovnatanian and Robert Owen in the court of appeals and in the Supreme Court of Texas. Martin, Disiere, Jefferson, & Wisdom congratulates them on their victory and appreciates the continued opportunity to represent USAA.