

# TEXAS INSURANCE LAW NEWSBRIEF

JUL 3, 2018

## FIFTH CIRCUIT REVERSES AND REMANDS JUDGMENT ON PLEADINGS AND DISMISSAL OF SPEC'S SUIT AGAINST HANNOVER INSURANCE FOR CREDIT CARD HACKER DEFENSE

Last week, the United States Court of Appeals, Fifth Circuit issued its opinion in *Spec's Family Partners, Limited v. Hannover Insurance Company*, No. 17-20263, 2018 WL 3120794 (5th Cir. Jun. 25, 2018). Spec's sued Hannover Insurance for refusing to pay its attorney's fees and expenses in defense of a suit relating to the hacking of Spec's credit card networks between 2012 and 2014. The Fifth Circuit found, based on the underlying insurance policy, that the trial court erred in rendering judgment on the pleadings and dismissing Spec's suit against Hannover, remanding the case back to the Southern District of Texas.

Spec's is a well-known retail chain based in Houston, Texas who fell victim to credit card hackers between 2012 and 2014. Spec's used First Data Merchant Services, LLC to process its credit cards pursuant to a Merchant Agreement between the two companies. As a result of the breach, First Data was required to reimburse banks the costs associated with the fraudulent transactions. In December 2013, First Data sent a demand letter to Spec's claiming Spec's breached the "cardholder environment" and alleged Spec's failed to abide by the Payment Card Industry Data Security standard requirements. As a result of case management fees, fines, and reimbursement costs, First Data set a reserve account in the amount of \$7,624,846.21 and demanded documents from Spec's reflecting its security compliance. In March 2015, First Data sent another demand letter repeating its allegations from the first letter and notified Spec's of an additional reserve account in the amount of \$1,978,019.49. First Data alleged that both reserve amounts reflected Spec's indemnification obligations under the Merchant Agreement.

Spec's provided its insurance carrier, Hannover Insurance, with timely notice of the demand letters and Hannover eventually agreed to defend Spec's under a reservation of rights—entering into a "defense funding agreement" to hire counsel and reimburse Spec's for costs previously incurred in defending the claims. To recover the money First Data withheld in the reserve accounts, Spec's sued First Data in Federal court in Tennessee. Hannover refused to pay the expenses associated with the Tennessee suit, claiming they were not "defense expenses." As a result, Spec's sued Hannover in the underlying matter for: (1) breach of the insurance policy; (2) breach of the Defense Funding Agreement, (3) violation of Section 542 of the Texas Insurance Code and (4) sought a declaratory judgment that Hannover has an ongoing duty to pay defense costs. Hannover moved for judgment on the pleadings claiming a policy exclusion (Exclusion-"N")—providing that the underlying policy does not apply to a loss resulting from a claim based upon liability under a written or oral contract or agreement—foreclosed Hannover's duty to defend or indemnify Spec's since the liability arose from the Merchant Agreement between Spec's and First Data. The district court granted Hannover's motion and dismissed all of Spec's claims based on the insurance policy's Exclusion-N. Spec's appealed.

The Fifth Circuit reviewed the underlying policy considering Hannover's obligations under both the duty to defend and duty to indemnify. The Court noted that Hannover's duty to defend turned on whether First Data's demand letters contained at least one claim that fell within the scope of coverage under Spec's insurance policy. The Court concluded that this obligation was triggered if the Claim from First Data included the potential for liability on a non-contractual ground, even if the claim also included contractual liability that would have been excluded by Exclusion-N.

The Court found that the demand letters from First Data included references to Spec's alleged non-compliance with duties outside of the Merchant Agreement. Because claims were made that fell outside of the exclusion, the Court found the District Court erred in rendering judgment on the pleadings. Furthermore, the Fifth Circuit also found the District Court erred in entering judgment on the pleadings on Spec's claims of Hannover's breach of the Defense Funding Agreement as Hannover never mentioned the agreement in its motion for judgment on the pleadings—arguing only that the Policy excluded its obligation from defending Spec's.

As a result, the Fifth Circuit reversed and remanded the district court's judgment.

## UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TEXAS FINDS DEFAULT JUDGMENT AGAINST INSURED NOT BINDING AGAINST INSURER IN FIRST PARTY SUIT DUE TO LACK OF ADVERSARIAL PROCEEDING

Last week, the United States District Court for the Western District of Texas addressed the binding nature against an insurer of a less than fully adversarial proceeding against its insured in *CBX Resources, LLC v. Ace American Insurance Company and Ace Property and Casualty Insurance Company*, No. 5:17-CV-17-DAE, 2018 WL 3203153 (W.D. Tex. Jun. 28, 2018). The original state suit stemmed from an oil and gas operation in Zavala County, Texas in 2011. CBX leased the mineral tract and hired Espada Operating, LLC for drilling and operation. Espada drilled and installed a fracking system into the production casing, however months later when

Espada tried to pull the production casing out, it discovered a fracture of 3,400 feet in the well and determined that the production casing below the fracture could not be recovered. As a result, the well was plugged and abandoned. Espada was insured under a policy issued by Ace American and an umbrella policy issued by Ace Property.

In February 2013, CBX sued several defendants (not including Espada) for damages arising from the total loss of the use of the well in the 293<sup>rd</sup> Judicial District Court of Zavala County, Texas. CBX later added Espada as a defendant who was represented by counsel retained by Ace American. In August 2013 Espada filed a third-party petition alleging that a catastrophic failure in the casing occurred down the well hole and the well could not be repaired. In September 2015, CBX served a *Stowers* demand on Espada seeking a full and unconditional release of its claims in exchange for an amount within the limits of the policies issued by Ace American and Ace Property. Less than a month later however, Ace American pulled Espada's defense and the state court granted withdrawal of Espada's counsel approximately 71 days before trial. Espada failed to appear at a pre-trial hearing and the court ordered judgment to be entered in favor of CBX. Just over a week later, the court held a hearing addressing damages where CBX put forth witnesses and evidence. The court entered a judgment finding Espada was negligent and awarded CBX damages and post-judgment interest. The court thereafter entered an Order for Turnover Relief transferring ownership of Espada's causes of actions against its insurers, Ace American and Ace Property, to CBX.

In January 2017, CBX sued Ace American and Ace Property (together "Ace") in Federal court asserting causes of action for breach of Ace's *Stowers* duty to reasonably settle, bad faith, breach of contract, deceptive insurance practices, and declaratory judgment regarding Ace's duty to defend and indemnify Espada in the state court matter. Both CBX and Ace filed cross motions for partial summary judgment on Ace's duty to defend and the Court granted Ace's motion and denied CBX's, the Court found the underlying insurance policy did not apply to the type of property damage alleged by CBX. Accordingly, Ace did not have a duty to defend.

In this matter, Ace proceeded to file a declaratory judgment seeking declaration that the underlying judgment CBX obtained against Espada is not binding against Ace or admissible in the instant suit as evidence of damages.

The primary issue the Court considered was whether the underlying judgment against Espada was the result of a fully adversarial proceeding. The Court looked to the recent Texas Supreme Court opinion in *Great American Insurance Co. v. Hamel* issued in 2017 for guidance on the issue of whether an insurer can be bound or damages be admitted against an insurer without a fully adversarial trial. The *Hamel* court interpreted the phrase "fully adversarial" as "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..." Accordingly, the measurement against Espada was whether Espada breached any actual risk of liability for damages at the time of judgment or whether Espada had some other meaningful incentive to ensure the judgment accurately represented CBX's damages in the state court case.

Although the Texas Supreme Court in *Hamel* noted that a court should normally apply the presumption that the lack of any pretrial agreement suggests that at the underlying judgment was the result of a fully adversarial proceeding, the court here distinguished *Hamel* in several respects. Unlike the present case, the defendant in *Hamel* attended the damages hearing where here, after Espada's counsel withdrew, Espada did not appear at trial. The court took the facts that Espada wholly failed to appear at docket call and the damages hearing, that only CBX appeared at the damage hearing, and Ace's evidence that Espada was financially unstable and unable to hire counsel, among others, indicated that the trial and the underlying judgment were not fully adversarial and therefore cannot be used as evidence against Ace.

## SOUTHERN DISTRICT OF TEXAS CLARIFIES "LIVE CONTROVERSY" FOR PURPOSES OF AN INSURER'S DUTY TO DEFEND

Last week, the United States District Court for the Southern District of Texas clarified the determination of what constitutes a "live controversy" in light of an insurer's duty to defend an insured in *Federal Insurance Company v. Northfield Insurance Company v. Bryan C. Wagner, et al.*, No. 4:14-CV-0262, 2018 WL 3122092 (S.D. Tex. Jun. 26, 2018) (slip. op.). The longstanding litigation involves various insurers' duty to defend or indemnify the Wagner Parties in an underlying state court matter. In state court, ExxonMobil alleged that the Wagner Parties have a contractual duty to defend and indemnify Exxon in two lawsuits in Louisiana relating to "environmental damages" to two properties of which the Wagner Parties purchased the mineral rights from Exxon.

This matter specifically addressed various insurers' duty to defend and indemnify. Defendant Northfield Insurance Company filed a third-party complaint against other Third-Party Insurers regarding those insurers' duty to defend and indemnify the Wagner Parties in the underlying state court matter. In a previous order, the court concluded that under the Northfield Policy issued to the Wagners, Northfield had a duty to defend the Wagners in the state court matter. The Third-Party Insurers filed a counterclaim against Northfield and a cross-claim against the Wagners seeking a declaratory judgment that the Third-Party Insurers have no duty to defend or indemnify the Wagners relating to the state suit. Here, the Wagners filed a motion to dismiss the Third-Party Insurers' cross-claim based on lack of subject jurisdiction as no justiciable controversy exists between the Wagners and the Third-Party Insurers. The Wagners asserted that because they are not seeking defense or indemnity from the Third-Party Insurers and no final judgment was issued in the state suit, the claims are not ripe.

The Court noted in adjudicating a duty to defend, the Fifth Circuit has held that a justiciable controversy can exist between an insurer and its insured regarding a duty to defend so long as an underlying lawsuit for which the insured might seek defense is pending. *See Ironshore Specialty Ins. Co. v. Tractor Supply Co.*, 624 F. App'x 159, 163 (5th Cir. 2015). Accordingly, because: (1) the Wagners have a contingent right to defense from Northfield (based on the ongoing state suit); (2) the Wagners refuse to abandon claims for defense costs against the Third-Party Insurers; (3) the issue of what rights the Wagners have from the Third-Party insurers is still ripe;

and (4) the court has substantial discretion to decide or dismiss the action; the court concluded that a live controversy exists and denied the Wagners' motion.

Addressing the Wagners' dismissal of the Third-Party Insurers' cross-claims for declaratory judgment that the insurers have no duty to indemnify, the Court reiterated that indemnification is determined by the facts established in the underlying suit and because no final judgment was entered in the state suit, the determination was not ripe. Accordingly, the Court stayed the Third-Party Insurers' cross-claim.