Martin, Disiere, Jefferson & Wisdom

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FIFTH CIRCUIT COURT OF APPEALS DELINEATES EXCEPTION FOR INSURANCE POLICY PROCEEDS IN BANKRUPTCY PROCEEDINGS

Recently, the Fifth Circuit in *In re OGA Charters, L.L.C.*, No. 17-40920, addressed a previously unresolved issue of bankruptcy law regarding the proceeds of a liability insurance policy. In policies where the proceeds are payable to the insured/debtor, such as property & casualty policies, the proceeds of such policies have been held to be property of the bankruptcy estate. Because the proceeds of a liability policy are not payable to the insured/debtor, however, they were historically held not to be property of the bankruptcy estate in the Fifth Circuit. *In re OGA Charters, L.L.C.* has now recognized an exception to the general rule, and has held, in certain circumstances, that proceeds of a liability policy will be deemed property of the bankruptcy estate. This ruling has potentially far-reaching implications on a liability insurer's rights under the *Soriano* doctrine to enter into settlements with some claimants and not others.

OGA Charters operated tour buses in the Rio Grande Valley. OGA was insured by New York Marine and General Insurance Company ("NYM") under a $5 million liability policy. While transporting a group to the Kickapoo Indian Lucky Eagle Casino near Laredo, Texas, an OGA bus overturned and killed 9 people and injured several others. In all, there were approximately 65 wrongful death, personal injury, and survivor claims arising out of the accident and the aggregate value of the various settlement demands exceeded $400 million.

Following a failed attempt to convene a global mediation in which all claimants would be required to participate, NYM advised counsel for the various claimants that it would entertain reasonable individual settlement offers. As a result, defense counsel was able to negotiate settlements with 14 of the claimants, including some of the wrongful death claims, which exhausted the policy proceeds. Before any of the settlements could be funded, however, the non-settling claimants filed a bankruptcy petition to place OGA into involuntary Chapter 7 bankruptcy. The non-settling claimants further obtained an injunction prohibiting the funding of any of the settlements. NYM ultimately placed the $5 million policy proceeds into the registry of the bankruptcy court.

The settling claimants argued that the settlements were valid under the *Soriano* doctrine, in which the Supreme Court of Texas held that "when faced with a settlement demand arising out of multiple claims and inadequate proceeds, an insurer may enter into a reasonable settlement with one of the several claimants even though such settlement exhausts or diminishes the proceeds available to satisfy other claims." *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 316 (1994).

The non-settling claimants argued that the equitable considerations in bankruptcy should prevail, and that it was unfair for such a large number of claimants to be left without a remedy. The non-settling claimants sought to have the bankruptcy court take possession of the policy proceeds, manage the numerous claims, and arrive at an equitable settlement of all claims. To do so, however, would require the bankruptcy court to find that the proceeds of the NYM liability policy were property of the bankruptcy estate.

Prior to this case, the law in the Fifth Circuit was that proceeds of a liability insurance policy generally are not property of the debtor's bankruptcy estate, because the proceeds are not payable to the debtor. One of the leading cases in the Fifth Circuit was *In re Edgeworth*, 993 F.2d 51, 55-56 (5th Cir. 1993), in which the Court had held:

The overriding question when determining whether insurance proceeds are property of the estate is whether the debtor would have a right to receive and keep those proceeds when the insurer paid on a claim. When a payment by the insurer cannot inure to the debtor's pecuniary benefit, then that payment should neither enhance nor decrease the bankruptcy estate. In other words, when the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.

Under this framework, the policy itself was property of the Chapter 7 estate, but the proceeds of the policy were not. See also, *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir. 1987).

The non-settling claimants argued that the proceeds of the NYM insurance policy should be considered property of the bankruptcy estate in this specific instance. Although the issue was not before the Court for decision in *Edgeworth*, the Fifth Circuit recognized that under certain fact-specific circumstances, such as where the policy proceeds were not sufficient to cover all of the claims, the policy proceeds might be deemed property of the estate.

In the OGA Charters matter, the Court adopted as the law in the Fifth Circuit the hypothetical exception it had discussed in *Edgeworth* regarding circumstances where the proceeds of a liability policy could be property of the estate, even though the debtor has no right to those proceeds:

We now make official what our cases have long contemplated: In the 'limited circumstances,' as here, where a siege of tort claimants threaten the debtor's estate over and above the policy limits, we classify the proceeds as property of the estate. Here, over $400 million in related claims threaten the debtor's estate over and above the $5 million policy limit, giving rise to an equitable interest of the debtor in having the proceeds applied to satisfy as much of those claims as possible.

Editorial Notes: It remains to be seen whether the settling claimants will seek en banc consideration of the case. Assuming that the OGA Charters opinion is now the law in the Fifth Circuit, it potentially has long-term implications that may impact a liability insurer's ability to settle claims early and to enter into settlements with fewer than all claimants. The opinion contains very little discussion as to how the holding reconciles with the *Soriano* doctrine, and provides no guidance as to how insurers should approach future settlements involving multiple claims and potentially inadequate insurance proceeds to satisfy all claims. The fallout from this case is that insurers who work diligently to reach settlements and avoid litigation run the risk of a recalcitrant, non-settling claimant simply undoing the settlements by putting the insured/defendant into involuntary bankruptcy.

In addition, the opinion does not discuss the *Stowers* doctrine and the obligations of an insurer to accept reasonable settlement demands within policy limits. Because the 14 claimants who reached settlements had made demands within policy limits that were deemed to be reasonable, NYM entered into those settlements to fulfill its *Stowers* duties to its insured, OGA Charters.

FIFTH CIRCUIT ADDRESSES INSURER'S DUTY TO DEFEND IN THE WAKE OF MENCHACA

Recently, in *Lyda Swinerton Builders, Inc. v. Oklahoma Surety Co.*, 2018 WL 411 3795; No. 16-20195 (5th Cir. Aug. 29, 2018), the Fifth Circuit addressed both an insurer's duty to defend and the damages an insured may recover when the duty is breached in light of the Supreme Court of Texas' opinion in *Texas Lloyds Co. v. Menchaca*.

Lyda Swinerton Builders served as the general contractor for the construction of a College Station, Texas, office building in which Swinerton engaged A.D. Willis Company as a subcontractor. As a condition to the subcontract, Willis obtained a commercial policy with Oklahoma Surety Company in which it named Swinerton as an additional insured. The office building owner assigned their interest in the agreement with Swinerton to Adam Development Properties who sued Swinerton for breach of contract alleging, among other things, that Swinerton failed to meet contractual deadlines, provided work with material deficiencies and consistently failed to comply with contractual obligations. Swinerton filed a third party petition against various other companies including Willis, and Adam Development amended its petition to include Willis as a third party defendant.

Swinerton requested defense from Oklahoma Surety based on its status as an additional insured under Willis' policy, which Oklahoma Surety denied. Swinerton further requested defense from other insurers who similarly denied the request. One insurer went so far to file a declaratory action in Federal court naming Adam Development, Swinerton and another party. Swinerton filed a third-party complaint in the declaratory action, seeking damages and relief against Oklahoma Surety for breach of contract based on their failure to defend in the state suit, violation of the Texas Insurance Code and violation of the Prompt Payment of Claims Act.

Ultimately, all claims settled with the exception of those between Swinerton and Oklahoma Surety. The district court ultimately found Oklahoma Surety had a duty to defend Swinerton, that the duty was breached and Oklahoma Surety owed Swinerton damages.

Addressing Oklahoma Surety's duty to defend, the Court analyzed the duty in three parts: (1) whether Swinerton was a named insured under the Oklahoma Surety policy; (2) whether a duty to defend arose under the eight corner rule; and (3) whether the anti-stacking rule applied. Addressing Swinerton's status under the Oklahoma Surety policy, the court noted that the policy obligates Oklahoma Surety to defend Willis and any additional insured against suits covering property damage. The Court found that the subcontract between Swinerton and Willis constituted an insured contract despite Swinerton's failure to countersign. Under the eight corners rule—in which Texas courts measure the four corners of the petition against the language within the four corners of the policy—the Court found that Oklahoma Surety had a duty to defend Swinerton against Adam Development's petition. Specifically, the Court found that, based on the factual allegations including material deficiencies in the work and failure to follow the contract, there was a potential that the suit fell within the underlying policy's scope of coverage therefore triggering Oklahoma Surety's duty to defend. Finally, the Court addressed the applicability of the anti-stacking rule—prohibiting an insured from stacking coverage limits of multiple policies when a single claim involves an indivisible injury extended across several distinct policy periods. In such instances, the insured's indemnity limit is whatever the highest limit was at the single point in time during the policy periods. Here, the court found the rule had no application. The court rejected Oklahoma Surety's assertion that another insurer's policy (and defense) applied instead, noting that if Swinerton sought defense from the other insured following denial by Oklahoma Surety, application of the rule would reward Oklahoma Surety for shirking its legal duty.

The Court further addressed Swinerton's cross-appeal denying its claim for extra contractual damages in light of the recent Supreme Court of Texas Opinion in *USAA Texas Lloyds v. Menchaca*. Swinerton claimed Oklahoma Surety violated the insurance code by knowingly misrepresenting the policy coverage to avoid its duty to defend. The *Menchaca* court distilled several rules including the "entitled-to-benefits rule" and the "independent injury rule." The entitled-to-benefits rule states an insured who establishes a right to receive benefits under the policy can recover the benefits as actual damages if the insurer's statutory violation caused the loss. The independent injury rule provides that if an insurer's statutory violation causes an injury independent of the right to recover benefits, the insured can recover damages for that injury even if the policy does not entitle the insured to receive the benefits. Further, an insurer's statutory violation does not permit the insured to recover any damages beyond the policy benefits unless the violation causes an injury independent from the loss of benefit. Because Swinerton was entitled to the benefit of defense, if, on remand, Swinerton can establish the misrepresentation caused deprivation of the benefit, Swinerton can recover the defense costs incurred as actual damages including treble damages upon a showing that the statutory violation was made knowingly.

Lastly, the court addressed Oklahoma Surety's appeal of the district court's damage ruling and found no error in awarding Swinerton defense costs. On the damages relating to the prompt payment statute, because of the remand of Swinerton's claims under Chapter 541 of the Insurance Code, if Swinerton prevails and elects to recover defense costs as actual damages rather than breach of contract damages, it will be entitled to the penalties under the prompt payment act.

SOUTHERN DISTRICT OF TEXAS INTERPRETS FEDERAL QUESTION JURISDICTION REGARDING NFIA PREEMPTION FOR HURRICANE HARVEY CLAIMS

Last week, the United States District Court addressed a key jurisdictional issue regarding National Flood Insurance Act preemption of claims stemming from Hurricane Harvey. In *Alexander v. Woodlands Land Development Co. L.P., et. al*, 2018 WL 4242451, H-18-2291 (S.D. Tex., Sep. 6, 2018), 486 plaintiffs sued the Woodlands Land Development Company L.P., The Howard Hughes Corporation, LJA Engineering, Inc. and James R. Bowls for negligence, gross negligence and violations of the Texas Deceptive Trade Practices resulting from the design and development of the residential community of Timarron Park in Tomball, Texas. Plaintiffs allege that when the development was planned, it was located within a FEMA 500 year floodplain and, despite a 1994 storm exceeding the 500 year floodplain, the developers did not reduce the likelihood of flooding. Plaintiffs contend that, as a result, following Hurricane Harvey in the summer of 2017, they were displaced from their homes and will endure months and years of repairs.

Defendants removed the matter to Federal court asserting federal question jurisdiction in that Plaintiffs' claims were preempted by federal law or raise disputed and substantial federal issues based on FEMA's determination of flood plains. Plaintiffs moved to remand the case back to state court on the basis that their claims did not invoke federal question jurisdiction.

The court noted that the presence of a federal question is measured under the well-pleaded complaint rule—considering if the federal question is presented on the face of plaintiffs' properly pleaded complaint. However, an exception to the rule is the complete preemption doctrine which converts a state law claim into a federal claim when the federal statute "so forcibly and completely displace[s] the state law that plaintiff's cause of action is either wholly federal or nothing at all."

Addressing preemption, the Court rejected defendants' arguments that plaintiffs were actually challenging FEMA's statutorily-mandated floodplain determinations, and because the National Flood Insurance Act is the sole basis to challenge the determinations, plaintiffs' claims were preempted. Instead, the Court observed that plaintiffs' claims did not arise out of the handling or disposition of federal flood insurance policies and found no authority that the NFIA creates a cause of action that replaces and protects state tort claims, thereby preempting plaintiffs' claims of negligence, gross negligence and DTPA violations.

Lastly the Court addressed the issue of substantial federal question, concluding that since plaintiffs' allegations were failure to conform to the standard of care applicable to professional engineers and developers (which are duties under state law), it was unnecessary to resolve any federal issues to decide the causes of action. Furthermore, because plaintiffs attacked the issues of the engineers/developers' judgment and representations and not the FEMA floodplain determinations, the Court found that there was no disputed and substantial federal issue. Finally, the Court concluded that Texas courts have an interest in deciding professional negligence and Texas DTPA claims.

Because plaintiffs did not allege federal causes of action under the NFIA and plaintiffs' negligence and DTPA claims were created by state law, the court granted plaintiffs' motion to remand.

FIFTH CIRCUIT CONFIRMS LEGAL STATUTE OF LIMITATIONS TOLLING RULE FOR LEGAL MALPRACTICE DOES NOT APPLY TO PUBLIC ADJUSTERS

This week, the United States Court of Appeals for the Fifth Circuit addressed the issue of whether the special tolling rule articulated in Hughes v. Mahaney applied to public adjusters. In Bloom v. Aftermath Public Adjusters, Inc., 2018 WL 4203601, No. 17-41087 (5th Cir. Sep 4, 2018), Gracie Reese's Galveston, Texas property was damaged by Hurricane Ike. Unsatisfied with Fidelity National Property and Casualty Company's damage assessment, Reese hired Aftermath Public Adjusters, Inc. to assist them with the claim. Aftermath inspected the property and prepared both a proof of loss and repair estimate with higher calculations than Fidelity. Thereafter, Reese's claim was denied by Fidelity who claimed no proof of loss was submitted. Reese sued Fidelity who filed summary judgment on the basis Reese failed to submit any documentation. Reese failed to respond and Fidelity's summary judgment was granted. Two years later, Reese filed the underlying suit against Aftermath and its adjuster alleging negligence and breach of contract. Aftermath moved for summary judgment based on the relevant two and four years statute of limitations since seven years had passed since Fidelity's denial of Reese's claim. Reese responded that, under the Texas rule articulated in Hughes v. Mahaney, the statute of limitations was tolled until the conclusion of her suit against Fidelity. The court rejected the claim and Reese's representatives appealed.

The Court recited the Hughes rule from the Texas Supreme Court which states that when an attorney commits malpractice in the prosecution or defense of a claim resulting in litigation, the statute of limitations on the malpractice action is tolled until all appeals for the underling suit are exhausted. Although the Fifth Circuit has previously clarified this rule is exclusive to attorney malpractice actions, Reese's representatives argued the rule's applicability as there was a time when Texas prohibited non-lawyers from engaging in public adjusting and therefore—although defendants are technically non-lawyers—they are "lawyers in disguise." The Fifth Circuit swiftly rejected the expansion of the rule and reaffirmed clear Texas law that the rule is exclusive to attorney malpractice. Accordingly, the Fifth Circuit affirmed the lower court.