Texas Legal Liability Advisor

INFORMATION TO AVOID LIABILITY FALL 2009

SUBROGATION - TEXAS STYLE

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Introduction

Subrogation is an area that has seen a lot of activity in the Texas courts over the last several years including three major decisions from the Texas Supreme Court. One of those decisions, *Mid-Continent v. Liberty Mutual*, is an important decision because it affects all cases where multiple primary insurers have co-existing defense or indemnity obligations to a single insured. All adjusters who handle such cases in Texas, especially those in the areas of mass and toxic torts, and environmental and construction claims, need to be aware of this decision. This article explores recent developments in the area of insurance subrogation in Texas.

Subrogation Basics

Subrogation refers to the right of one who has paid an obligation which another should have paid to be indemnified by the other.[1] There are three recognized types of subrogation in Texas: 1) equitable or legal subrogation; 2) contractual subrogation; and 3) statutory subrogation.[2] Although most often used in the insurance context, equitable subrogation applies to all situations where a party shows that it involuntarily paid a debt primarily owed by another which in equity should have been paid by the other party.[3] Contractual subrogation is created by a written agreement that grants a right to pursue reimbursement from a third party in exchange for payment of a loss.[4] Under both equitable or contractual subrogation, the insurer stands in the shoes of the insured, and may assert only those rights held by the insured subject to any defenses of the third party against the insured.[5] While equitable and contractual subrogation rest on common principles, they are not coequal in that express contractual subrogation terms trump equitable principles.[6] For example, in a recently decided Texas Supreme Court case, the Court held that the equitable "made whole" doctrine, a common defense raised against health insurers trying to recover medical expenses paid on behalf of an injured plaintiff, does not prohibit those health insurers from enforcing clear and specific contractual subrogation rights which entitle them to recover the amount of health care benefits paid on behalf of the plaintiff.[7]

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Subrogation against your own Insured?

The general rule is that absent a contractual right or statutory authority, an insurer cannot subrogate against its own insured for sums paid out under an insurance policy.[8] This rule, known as the antisubrogation rule, provides that an insurer has no right of subrogation against its own insured for a claim arising from the very same risk for which the insured was covered.[9] The prohibition against an insurer subrogating itself against its insured is based on, among other things, the public policy considerations which are raised due to the fiduciary type relationship between the insurer and its insured.[10] One court indicated that "the situation where an insurer attempts to subrogate and sue its own insured, whom it is obligated to defend, gives rise to so many opportunities for conflict of interests or misrepresentation of the insured that public policy dictates that the insurer be denied the right to do so."[11] Moreover, Texas courts have recognized a "special relationship" between an insurance company and its insured, giving rise to duties of good faith and fair dealing.[12] Allowing an insurer to unilaterally settle uncovered claims and then step into the shoes of the claimant and sue its own insured runs counter to this relationship and to public policy interests which promote trust and eliminate conflicts of interests between insurer and insured.[13] This issue was most recently considered in the 2008 Texas Supreme Court case of *Excess Underwriters at Lloyd's London v. Frank's Casing Crew & Rental Tools, Inc.*[14] That case, discussed extensively in the 2008 summer edition of the Texas Legal Liability Advisor, reaffirms Texas law that without a specific contract provision providing a right of reimbursement, an insurer which settles a claim against its insured when coverage is disputed and is later determined not to exist, may only seek reimbursement from the insured if the insurer obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to reimbursement.[15] The Court reasoned that an insurer, rather than the insured, is best positioned to assess the viability of its coverage defense and determine what course of action is appropriate on the coverage issue because the insurer is in the business of analyzing and allocating risk.[16] Accordingly, insurers are encouraged to do everything they can to promptly resolve coverage issues before they are put in the situation of having to decide whether they should fund the settlement of a claim that may not be covered.

Exceptions to the Antisubrogation Rule

Contractual and statutory subrogation are the main exceptions to the antisubrogation rule. However, there are other narrow exceptions to the general rule as well, including: 1) equitable subrogation claims of an excess insurer for legal malpractice against an insured's defense attorneys or negligence against the primary insurer when the excess insurer has to pay more than it should have due to the attorney's or primary insurer's negligence;[17] 2) an insurer subrogation claim against the insured under a separate insurance policy;[18] and 3) insurer subrogation against a third-party tortfeasor.

Subrogation Against a Third-Party Tortfeasor

In the *Frymire Engineering* case, the Texas Supreme Court looked at whether an insurer which paid to settle a contractual liability claim against the insured could subrogate against a third-party tortfeasor responsible for causing the damages that required the payment.[19] The tortfeasor argued that because the payment was required by contract, the insurer's settlement

payment was not voluntary, and therefore, equitable subrogation was not applicable.[20] The Court confirmed the general rule that equitable subrogation applies in every instance in which one person, not acting voluntarily, has paid a debt for which another is primarily liable and which in equity should be paid by the latter.[21] The Court held that the insurer, in the name of its insured, could pursue claims against the alleged third-party tortfeasor under the doctrine of equitable subrogation because it had shown: 1) that it paid a debt primarily owed by the tortfeasor; 2) that it made the payment involuntarily; and 3) that it sought subrogation in a situation where the tortfeasor would be unjustly enriched if the insured was not allowed to pursue the claims.

MULTIPLE INSURERS OWING DUTIES TO THE SAME INSURED

Perhaps the most surprising development in the last few years in the subrogation context is the rule established in *Mid-Continent v. Liberty Mutual.* In this 2007 case, the Texas Supreme Court considered whether one co-primary insurer had a reimbursement claim against another co-primary insurer covering the same loss for the same insured when there was a disproportionate amount paid by the first insurer to the settle the claim.[22] The case arose out of a serious highway motor vehicle accident in a construction zone. The injured plaintiffs sued the project's general contractor, Kinsel Industries, and the subcontractor responsible for signs and barricades, Crabtree Barricades.[23] Kinsel was insured by its own carrier, Liberty Mutual, with a $1 million primary CGL and $10 million excess policy.[24] Kinsel was also an additional insured under Crabtree's $1 million CGL policy with Mid-Continent.[25] Importantly both CGL polices contained identical "other insurance" clauses that provided for equal or pro rata sharing up to the co-insurers respective policy limits if the loss is covered by other primary insurance.[26] While both carriers did not dispute that they each owed a portion of Kinsel's defense and indemnification, the carriers disagreed over the settlement value of the case.[27] Mid-Continent evaluated the case value against Kinsel at $300,000 and refused to pay anything more than 50% of this value.[28] Liberty Mutual believed the risk was closer to $2-3 million.[29] Ultimately, Liberty Mutual agreed to settle the case for $1.5 million, using Mid-Continent's $150,000 and itself funding the difference.[30] Liberty Mutual later sued Mid-Continent for failing to act reasonably in evaluating the risk against the insured and in failing to reasonably exercise its rights under the CGL policy. The trial court found for Liberty Mutual, finding a right of subrogation against the other co-insurer and awarding it its proportionate share.[31] On appeal, the Fifth Circuit Court of Appeals certified the question to the Texas Supreme Court.[32]

Contrary to the then developing law among some lower Texas courts, the Texas Supreme Court found in favor of Mid-Continent and held that there is no direct duty of reimbursement between co-primary insurers with identical "other insurance" clauses, and that there are no contribution or subrogation rights available to Liberty Mutual.[33] The Court based its holding on a case it decided back in 1943, *Hicks Rubber*.[34] While both this Court and the Court in *Hicks Rubber* recognized the general rule that, if two or more insurers bind themselves to pay the entire loss insured against, and one insurer pays the whole loss, the one so paying has a right of contribution against the co-insurer for the disproportionate amount paid, they also found that such right is extinguished when the policies contain "other insurance" or "pro rata" clauses.[35] The Court opined that the pro rata clause operates to ensure that

each insurer is not liable for any greater proportion of the loss than the proportion of its coverage to the total coverage available for the loss.[36] The effect of the pro rata clause, the Court held, precludes a direct claim for contribution among insurers because the clause makes the insurance contracts several and independent of each other.[37] The co-insurer that pays more than its contractually agreed proportionate share does so voluntarily, that is, without a legal obligation to do so and without a remedy for reimbursement.[38] The Court also determined that since in subrogation the insurer takes only those rights the insured had, and because the insured had already been fully indemnified by the settlement, it had no right to give to the subrogating insurer.[39] Accordingly, Liberty Mutual did not have a claim for subrogation against Mid-Continent.

The *Mid-Continent* case involved a claim for reimbursement of funds spent to indemnify the insured, but the same outcome results when the case principles are applied to the duty to defend.[40] For example, in a recent case decided by a Federal District Court in Houston, a co-primary insurer brought a claim against another co-primary insurer for reimbursement of defense costs incurred on behalf of the shared insured.[41] Based on the holding in *Mid-Continent,* the claim was denied. The Court held that because the paying co-primary insurer stood in the place of the insured it had no damages and no right to subrogation since the insured's defense costs had already been paid by that same paying co-primary insurer. While the paying co-insurer could not get reimbursed for previously paid defense costs, the Court did determine that the non-paying co-primary insurer had coverage, a duty to defend and from that time forward had to participate in the defense.[42]

Effect of *Mid-Continent* Decision

The *Mid-Continent* case could easily have been decided differently, and is an unfortunate decision for Texas insurance law. The Court's rationale that an insurer has no subrogation claim because it stands in the shoes of its insured who has been fully paid by that insurer makes little common sense in the subrogation context. Indeed, that is the whole point of subrogation in the first place. Moreover, there is no public policy served by this decision and it does nothing to promote the prompt resolution of liability cases against insureds. It certainly does not encourage or reward proactive insurers wanting to resolve cases on behalf of their insureds. Rather, the decision discourages a co-primary insurer from settling any claim where there is a dispute over the value of the claim between the multiple primary insurers. The practical effect is that co-primary insurers will be limited to the pro-rata share of the lowest settlement value determined by any one of them. That is not a recipe for resolving cases promptly. It will be interesting to see how this concept plays out when a policy limits demand is made on an insured and one insurer refuses to pay its share. Does that mean the recalcitrant co-primary insurer will again get the benefit of doing nothing? The other unfortunate effect of this decision is that it discourages co-primary insurers from participating in the insured's defense when at least one other primary carrier has already stepped forward to defend. As long as the defense is being provided by one carrier, under these decisions, the other carrier can simply wait until sued and a judgment is entered requiring it to defend before it will have any obligation to do anything. Under at least one court decision, a carrier that delays like this is not liable for past defense costs, and only has to start paying its share of defense costs incurred

thereafter. Given these cases, in situations where a co-primary insurer refuses to defend, the other primary insurer is well advised to secure a declaratory judgment as soon as possible so that the recalcitrant insurer will be forced to participate. Insurers are also advised not to pay more than any agreed pro rata share of any settlement since anything paid in excess of that amount may be a volunteer payment for which there is no chance of reimbursement absent a specific agreement providing for such recovery from the other insurer.

RECOMMENDATIONS

Subrogation is an indispensable part of the insurance process and is generally permitted by Texas courts. The most significant recent development for insurers is the elimination of claims that were available between co-primary insurers when faced with co-existing defense and indemnity obligations for a single insured. In any case where there is more than one primary liability carrier for a single insured, carriers must pay special attention as to whether all primary insurers are participating in the defense of the insured. If one is not, then serious consideration should be given as to whether suit needs to be filed immediately to compel participation by the other insurer. As for indemnity payments, an insurer needs to be aware that if it pays a disproportionate share, it will not likely have any recourse to sue any other primary insurer for reimbursement. Given the pressure that a carrier may be put under to fulfill its duties to the insured, having a conflict with another co-primary insurer over the value of a claim certainly makes this area of law more complex than ever. Consultation with Texas coverage counsel for guidance regarding the appropriate action is certainly needed and recommended.

Notes

1. *Employers Cas. Co. v. Dyess,* 957 S.W.2d 884, 886 (Tex. App.--Amarillo 1997, pet. denied).

2. *State Farm Mut. Auto. Ins. Co. v. Perkins,* 216 S.W.3d 396, 400 (Tex. App. – Eastland 2006, no pet.).

3. *Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co*., 236 S.W.3d 765, 774 (Tex. 2007); *Frymire Eng'g Co. v. Jomar Intern., Ltd.*, 259 S.W.3d 140, 142, 144-46 (Tex. 2008).

4. *Mid-Continent Ins.*, 236 S.W.3d at 774.

5. *Id.*

6. *Fortis Benefits v. Cantu,* 234 S.W.3d 642, 648-649 (Tex. 2007).

7. *Id.* at 651.

8. *Matagorda County v. Texas Ass'n of Counties Government Risk Management Pool*, 975 S.W.2d 782, 786 (Tex. App.– Corpus Christi,1998) *aff'd*, 52 S.W.3d 128 (Tex. 2000); *AGIP Petroleum Co. v. Gulf Island Fabrication, Inc.*, 920 F.Supp. 1318, 1326 (S.D. Tex.1996); *Stafford Metal Works, Inc. v. Cook Paint & Varnish Co.*, 418 F. Supp. 56, 58 (N.D. Tex.1976).

9. *State Farm Mut. Auto. Ins. Co. v. Perkins*, 216 S.W.3d at 401.

10. *Stafford*, 418 F.Supp. at 58-59.

11. *Stafford*, at 62.

12. *Crim Truck & Tractor Co. v. Navistar Intern. Transp. Corp*., 823 S.W.2d 591, 593-94 (Tex.1992); *Aranda v. Insurance Co. of N. Am.*, 748 S.W.2d 210, 212-13 (Tex.1988); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex.1987).

13. *Matagorda County v. Texas Ass'n of Counties Government Risk Management Pool,* 975 S.W.2d 782, 786 Tex. App.– Corpus Christi,1998, *aff'd* 52 S.W.3d 128 (Tex. 2000).

14. 246 S.W.3d 42 (Tex. 2008).

15. *Excess Underwriters at Lloyd's London v. Frank's Casing Crew & Rental Tools, Inc.*, 246 S.W.3d at 45 (Decision reaffirms rule set out in *Texas Ass'n. of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 135 (Tex. 2000)).

16. *Id.* at 47-48.

17. *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 Sw2d 480 (Tex. 1992); *Keck, Mahin & Cate, Grant Cook v. Nat'l Union Fire Ins. Co*., 20 SW3d 692, 703 (Tex. 2000).

18. *State Farm Mut. Auto. Ins. Co. v. Perkins*, 216 S.W.3d 396, 399 (Tex. App. – Eastland 2006, no pet.).

19. *Frymire Engineering Co., Inc. v. Jomar Int'l, Ltd.*, 259 S.W.3d 140, 141 (Tex. 2008).

20. *Id.* at 145.

21. *Id.* at 142.

22. *Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co.*, 236 S.W.3d 765, 768 (Tex. 2007).

[23] *Id.* at 768-769.
[24] *Id.* at 769.
[25] *Id.*
[26] *Id.*
[27] *Id.* at 770.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.* at 771.
[33] *Id.* at 772.
[34] *Traders & General Ins. Co. v. Hicks Rubber Co.*, 169 S.W.2d 142 (Tex 1943).
[35] *Mid-Continent* at 771 (citing *Traders & General Ins. Co. v. Hicks Rubber Co.*, 169 S.W.2nd at 148.).
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.* at 774-776.
[40] *Trinity Univ. Ins. Co. v. Employers Nat'l Cas. Co.*, 586 F. Supp 2d 718 (S.D. Tex. 2008).
[41] *Id.*
[42] *Id.*

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