Blurring the Line Between First-Party and Third-Party Insurance: *Time Warner Enter. Co., L.P. v. Ohio Cas. Ins. Co.*

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BLURRING THE LINE BETWEEN FIRST-PARTY AND THIRD-PARTY INSURANCE

By Michelle E. Robberson[1]

I. INTRODUCTION

Those involved with the insurance industry have long heard the maxims that first-party insurance is insurance paid directly to an insured or beneficiary for the insured's own loss (*e.g.*, property insurance), and that third-party insurance is insurance paid to a third party to compensate it for injuries or damages caused by an insured (*e.g.*, liability insurance). The Texas Supreme Court has upheld these rules for decades. *Compare Heyden Newport Chem. Co. v. S. Gen'l Ins. Co.*, 387 S.W.2d 22 (Tex. 1965), *with Evanston Ins. Co. v. ATOFINA Petrochem., Inc.*, __ S.W.3d __, 2008 Tex. LEXIS 575 (Tex. 2008).

Likewise, with respect to a third-party claim under a liability insurance policy, it is axiomatic that the insurer does not owe indemnity until the insured has been adjudicated legally responsible in a lawsuit or via settlement with the third-party claimant. *See, e.g., Heyden*, 387 S.W.2d at 25. Dozens of cases recognize that the facts actually established in the underlying suit control the duty to indemnify under a liability policy. *E.g., GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 310 (Tex. 2006).

Yet, in a case pending before the Texas Supreme Court, Time Warner Entertainment Company, L.P. is asking the high court to do away with these canons of insurance law, at least with respect to additional insureds. Time Warner asks the high court to hold instead that an additional insured under a commercial general liability policy is entitled to indemnity from the liability carrier for out-of-pocket costs it incurred in repairing allegedly defective work of the named insured, even though Time Warner has no judgment against the named insured, and even though Time Warner has never been sued by any third party for damages arising from that allegedly defective work. Time Warner claims the CGL policy insuring agreement does not impose any "suit requirement" before a party can obtain indemnity for a covered loss. These arguments are blurring the line between first-party and third-party insurance.

The case is No. 08-0223, *Time Warner Entertainment Company, L.P. v. Ohio Casualty Insurance Company and West American Insurance Company*. The supreme court has shown some interest in the case, as it has requested the parties file briefs on the merits (the second set of full briefs filed after the initial, shorter petition for review). These briefs have been filed, and the parties are waiting to hear whether the court will grant or deny review. You can read the briefs on the supreme court's website, www.supreme.courts.state.tx.us; search by the case number under "electronic briefs."

II. TRIAL COURT PROCEEDINGS

The alleged defective work arose during a fiber optic cable project in Plano, Texas, on which Time Warner was the general contractor and Signal Images Telecommunications, Inc. was the subcontractor. Time Warner claimed Signal laid the cable too shallow and out of easement, in violation of their contract. Time Warner claimed it faced liability to the "owner" of the project (another Time Warner company) and to property owners where the cable was buried outside existing easements. Time Warner had no evidence, however, of any claim or threatened claim from any of these third parties arising out of Signal's allegedly defective work.

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Time Warner claimed it asked Signal to repair the defective work but that Signal was "unwilling or unable" to do so in a timely manner. Time Warner claimed it then spent roughly $1.6 million to re-bury the cable.

In 2002, Signal sued Time Warner in state district court because Time Warner had refused to pay Signal under their contract. Time Warner filed a counterclaim in that suit, alleging Signal breached their contract and made negligent misrepresentations about the depth and locations of the fiber optic cable. This is what the parties refer to as the "underlying suit."

In 2004, before any judgment or settlement in the underlying suit, Time Warner sued the insurers directly for indemnity under Signal's CGL policy in the same state district court as the underlying suit. The parties refer to this suit as the "coverage suit." Although the insurers moved for abatement of the coverage suit to allow the underlying suit to proceed to trial, the state district court judge denied the motion and, instead, abated the underlying suit.

With the underlying suit abated, Time Warner and the insurers filed cross-motions for summary judgment on coverage. Although Time Warner had no judgment against or settlement with the named insured, Signal, and no third party had made a claim against or sued Time Warner for damages arising out of Signal's allegedly defective work, Time Warner claimed it was entitled to indemnity under Signal's CGL policy for the $1.6 million it spent to re-bury the cable. The insurers argued that Time Warner lacked standing and/or that its claim for indemnity was not yet ripe under the terms and conditions of the CGL policy.

The state district court judge agreed with Time Warner and granted summary judgment declaring the insurers owed the duty to indemnify. Time Warner then filed a second motion for summary judgment to establish the amount of its indemnity claim and its attorneys' fees. The trial court also granted this motion. The insurers appealed to the Dallas Court of Appeals.

III. COURT OF APPEALS' OPINION

The Dallas Court of Appeals rejected Time Warner's arguments in its Opinion. *See Ohio Cas. Ins. Co. v. Time Warner Enter. Co., L.P.*, 244 S.W.3d 885 (Tex. App.—Dallas 2008, pet. filed). The Court of Appeals recognized that Time Warner could obtain indemnity under Signal's liability policies in two ways: first, as a judgment creditor of Signal, and second, as an additional insured if it established it had been held responsible for covered damages caused by the named insured, Signal.

A. Whether Time Warner Had Standing to Seek Indemnity Based on Signal's Alleged Liability

On the first theory, the Court of Appeals focused on whether Time Warner had standing to seek recovery under the CGL policy at the time it sought summary judgment. The Court ultimately held that Time Warner lacked standing because (a) Texas is not a direct action state, (b) Time Warner failed to plead or prove that Signal's liability to Time Warner had been determined by judgment or settlement of the underlying suit. *Id.* at 888-89. Without being a judgment creditor of Signal, Time Warner lacked standing to sue the insurers directly for indemnity under the policies.

The Court rejected Time Warner's argument that, unlike most cases involving direct action against insurers by a third party "stranger" to the insurance policy, Time Warner was an additional insured under the policy who, apparently, was entitled to a different rule. The Court disagreed, finding that if Time Warner was relying on the CGL policy's coverage of Signal to pay damages for Signal's liabilities, Time Warner must obtain a judgment against or settlement with Signal to trigger any duty to indemnify. *Id.* at 889.

B. Whether Time Warner's Status as Additional Insured Gave it a Right to Sue Directly for Indemnity

Under its second theory, Time Warner claimed it was entitled to coverage because of its status as an additional insured. On this theory,

the Court focused on the policy language in the additional insured endorsement and the CGL and umbrella insuring agreements. The Court recognized that the policies were "standard" in the sense that they gave rise to two distinct duties to insureds: the duty to defend and the duty to indemnify. *Id.* at 890. Time Warner had never been sued by any third party, so it was not seeking coverage for the duty to defend.

On the duty to indemnify, the Court noted that the policies only required the insurer to pay sums that the "insured becomes legally obligated to pay as damages," with certain other qualifications. The Court interpreted this language to provide, unambiguously, that the duty to indemnify arises only after an insured's legal responsibility for covered damages has been established by judgment or settlement. *Id.* The Court cited several cases and a commentator (Allan Windt) in support of its holding.

The Court noted that Time Warner had failed to establish its right to indemnity "at this time." *Id.* at 891. In other words, Time Warner could still obtain indemnity if it showed in the future either (a) it has become legally obligated to pay damages covered by the policies, or (b) it has a judgment against Signal that legally obligates Signal to pay damages covered by the policies.

C. Conclusions

The Court of Appeals concluded that, on its first theory, Time Warner did not prove it held a judgment against or settlement with the named insured, Signal. *Id.* Thus, it lacked standing to sue Signal's insurers directly for indemnity under Signal's policies. *Id.* On Time Warner's second theory, Time Warner did not prove it had been held "legally obligated to pay" covered damages, as was necessary to trigger coverage under the policies as an additional insured. *Id.* Therefore, Time Warner was not entitled to summary judgment for indemnity. The Court reversed both the declaratory summary judgment and the monetary summary judgment and remanded the case for further proceedings.

The Court declined to address the substantive coverage issues raised by the parties (*i.e.*, whether Time Warner's claim was an "occurrence," whether Time Warner suffered "property damage," and whether certain exclusions barred Time Warner's claim). The Court found that, because Time Warner's claim for indemnity was, essentially, not yet ripe, the Court could not declare the parties' rights under the policies. *Id.* at 892.

IV. TEXAS SUPREME COURT

Time Warner filed a Petition for Review in the Texas Supreme Court, complaining of the Court of Appeals' ruling. In the supreme court, Time Warner is *not* challenging the first half of the Court of Appeals' Opinion, in which it held Time Warner lacked standing to sue for indemnity based on Signal's liability. Time Warner *only* challenges the second half of the Opinion.

A. Time Warner's Arguments

On appeal, Time Warner argued that the plain language of the policies does not require that an additional insured's liability be established via settlement or lawsuit before the insurer's duty to indemnify arises. Instead, the insured's "legal obligation to pay" can arise by other means. Time Warner relied on two Texas cases for this proposition: *Venture Encoding Serv., Inc. v. Atlantic Mut. Ins. Co.*, 107 S.W.3d 729 (Tex. App.—Fort Worth 2003, pet. denied), and *Acceptance Ins. Co. v. S&S Telecom, Inc.*, 2001 WL 844749 (Tex. App.—San Antonio 2001, no pet.) (not designated for publication). Time Warner said it was "obligated" to the "owner" of the fiber optic project to repair and replace defective work on the project by subcontractors like Signal, making it "legally obligated to pay" and thereby triggering the liability policies.

Accordingly, Time Warner claimed, the Court of Appeals misinterpreted the language of the policies' insuring agreements by requiring a lawsuit to trigger the duty to indemnify. This holding, Time Warner said, promotes litigation and conflicts with Texas's "strong public

policy" that encourages settlements to resolve disputes.

1. *"Legally Obligated to Pay"*

The typical CGL insuring agreement, like the one at issue here, provides:

> We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. However, we will have no duty to defend the insured against any "suit" seeking damages for "bodily injury" or "property damage" to which this insurance does not apply.

Time Warner claimed that, because the CGL insuring agreement only uses the word "suit" in connection with the duty to defend, and not in the first sentence discussing the sums the insured becomes "legally obligated to pay," the policy does not require a lawsuit to trigger the insurer's duty to indemnify. Therefore, the Court of Appeals erred in interpreting the policy to only trigger if Time Warner becomes legally obligated to pay damages via a judgment or settlement (*i.e.*, in imposing a "suit requirement" on the duty to indemnify).

Time Warner asserted a distinction exists between being "legally obligated to pay" and being "judicially obligated to pay" damages. It claimed a "legal obligation" can arise via tort, contract, or statute, whereas a "judicial obligation" does not arise until a court issues a judgment. Time Warner asserts the insurers could have written their policies more clearly if they only intended to pay indemnity on the latter obligation.

According to Time Warner, the *Venture Encoding* case held that costs incurred to correct a printing error under the insured's contract with a third party were sums the insured was "legally obligated to pay" as damages under a printer's errors and omissions rider to a CGL policy, without the necessity for a lawsuit. In other words, according to Time Warner, the "legal obligation" allegedly arose under the contract between the insured and the third party. Thus, the insurer owed indemnity.

It is noteworthy, however, that the *Venture Encoding* opinion does not discuss long-standing Texas law holding that the duty to indemnify arises only upon the insured's liability for a judgment or settlement. Also, the *Venture Encoding* opinion does not mention whether the third party made a claim against the printer that was, in turn, submitted to the insurer, or whether the printer "settled" with the third party by agreeing to make the corrections without having to resort to litigation.

Also, the opinion characterized the printer's errors & omissions rider as coverage for a "specific risk" – that is, the insuring agreement stated the insurer would pay "those sums that the insured becomes legally obligated to pay as damages arising out of any negligent act, error or omission committed by . . . the insured in the course of providing or failing to provide 'printing services.'" This type of coverage was different, the court said, from the general liability coverage provided by a CGL policy. Thus, as with every good legal argument, the *Venture Encoding* case has two "sides" or interpretations.

In further support of its construction of "legally obligated to pay," Time Warner also relied on the unpublished *Acceptance* case mentioned above, as well as *Lennar Corp. v. Great American*, a Fifth Circuit case (*SnyderGeneral v. Century*), and three out-of-state cases. In addition, Time Warner submitted some quotes from insurance treatises, which it claimed support a no-lawsuit-required interpretation of a liability policy insuring agreement.

2. *Public Policy Argument*

Time Warner next argued that the Court of Appeals' interpretation of the policies' insuring agreements – as purportedly requiring a "suit" to trigger the duty to indemnify – violates Texas's strong public policy in favor of settlements. To

follow the Court of Appeals' ruling, according to Time Warner, means insureds must wait around to get sued to get coverage, instead of being proactive by attempting to mitigate their damages and avoid litigation.

Time Warner also asserted that the insurers ought to be required – before they can deny indemnity – to show prejudice from Time Warner's proactive conduct in resolving its legal obligation short of litigation, analogizing to the case of *Hernandez v. Gulf Group Lloyds.* Its proactive conduct, Time Warner said, inured to the benefit of everyone, including the insurers, because everyone avoided the costs of litigation.

3. *Policy Conditions*

Time Warner last argued that the CGL policy conditions, such as the no-action clause, do not apply to it based on a fairly technical interpretation of the clause. The no-action clause provides:

> No person or organization has a right under this Coverage Part:
>
> a. to join us as a party or otherwise bring us into a "suit" asking for damages from an insured; or
>
> b. to sue us on this Coverage Part unless all of its terms have been fully complied with.
>
> A person or organization may sue us to recover on an agreed settlement or on a final judgment against an insured; but we will not be liable for damages that are not payable under the terms of this Coverage Part or that are in excess of the applicable limit of insurance. An agreed settlement means a settlement and release of liability signed by us, the insured and the claimant or the claimant's legal representative.

Time Warner asserted that, because it is an additional insured under the policies, it is not a "person or organization" seeking damages "from an insured" and, thus, the clause does not apply to it. It theorized the no-action clause only applies to third-party "strangers" to the policy. Therefore, no judgment or settlement is required to trigger the insurer's duty to indemnify an additional insured.

B. Insurers' Arguments

As you would expect, the insurers responded in their briefing to all these arguments. The insurers urged the high court to deny review of the Court of Appeals' Opinion because it correctly applied decades of Texas law squarely on point with the facts of this case.

1. *Stare Decisis*

The insurers opened by discussing the purpose of liability insurance, which is to provide coverage to the insured for accidental injuries it allegedly caused to a third party. Case law, as well as treatises and even the Texas Department of Insurance's website, echo this purpose.

Given the purpose of liability insurance, the insurers argued that the Texas Supreme Court should follow the numerous cases – including several from its own Court – which have held for at least 50 years that the duty to indemnify under a liability policy only arises upon the determination of the insured's liability via judgment or settlement. Principles of *stare decisis* – the Latin term for the doctrine under which courts adhere to precedent on questions of law to insure certainty, consistency, and stability in the administration of justice – require the court to follow its long-standing precedent in interpreting liability insurance policies.

2. *Court of Appeals Did Not Impose a "Suit Requirement"*

Next, while not conceding that a "suit" has to be filed to trigger indemnity (*e.g.*, an insurer can owe indemnity for an agreed settlement reached prior to litigation), the insurers also noted that a "suit requirement" as a prerequisite to insurance coverage is not foreign to Texas law. In *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996), the high court practically mandated the use of a fully

adversarial trial to determine an insured's liability for covered damages, stating: "In no event, however, 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." *Gandy*, 925 S.W.2d at 714.

Likewise, the supreme court has required a lawsuit to trigger the insurer's liability in underinsured motorist cases. In *Henson v. Southern Farm Bureau Casualty Insurance Co.*, 17 S.W.3d 652 (Tex.2000), for example, the court held an auto insurer was under no contractual duty to pay underinsured motorist benefits until the insured obtained a judgment establishing the liability and underinsured status of the other motorist. *Id.* at 653-54. The *Henson* court also recognized that neither requesting underinsured motorist benefits nor filing suit against the insurer triggered the insurer's contractual duty to pay. *Id.*; *see also Trinity Universal Ins. Co. v. Brainard*, 216 S.W.3d 809, 818 (Tex. 2006).

Thus, even if some form of litigation is, on occasion, a predicate to triggering the duty to indemnify, such a requirement is not inconsistent with Texas law or Texas public policy.

3. *Policy Conditions*

The insurers next argued that the long line of cases interpreting the liability insuring agreement as requiring a determination of the insured's liability via judgment or settlement finds support in the no-action clause of the CGL policy. Courts and commentators (including Malecki and Couch) recognize that this clause must be satisfied by any insured before it can seek indemnity under a liability policy.

The insurers suggested that, under Texas rules of policy construction, the high court must read the policy as a whole – including the insuring agreement, the additional insured endorsement, the no-action clause, and any other relevant provisions – in construing the policy and declaring the insurers' obligations to an additional insured. Time Warner, on the other hand, had improperly focused only on the first sentence of the insuring agreement (arguing it did not contain the word "suit" or any "suit requirement") in asserting its interpretation of the policies.

Time Warner had asserted the Court of Appeals had "rewritten" the policies by inserting a "suit requirement" into the sentence providing for the duty to indemnify. The insurers argued that a suit was not the only method by which a person or organization could trigger their duty to indemnify (*i.e.*, claims or settlements also trigger the duty). The focus with a liability insurance policy must be on the insured's *liability to a third party* for damages that are covered by the policy, not for a loss personally sustained.[2] In this case, Time Warner has not yet been held responsible to anyone for damages in the sense contemplated by the phrase "legally obligated to pay."

In response to Time Warner's technical interpretation of the no-action clause, the insurers pointed out that the policies in several places define an "insured" as any "person or organization" qualifying under "Who is an Insured" (including the preamble and the additional insured endorsement). Therefore, Time Warner is a "person or organization" who is an "insured" subject to the no-action clause. The language of the no-action clause is broad because its intent was to bar anyone from suing the insurer directly, including the insured, until the policy conditions have been met.

4. *"Legally Obligated to Pay"*

On the meaning of this clause, the insurers cited to a number of opinions in which Texas courts found this phrase meant an obligation imposed by law through judgment or settlement

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[2] *See, e.g., Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 17, 18 (Tex. 2007); Rowland Long, 1-1 LAW OF LIABILITY INSURANCE § 1.02; *Montrose Chem. Corp. v. Admiral Ins. Co.*, 913 P.2d 878, 886 (Cal. 1995); Lantz, C., *Triggering Coverage of Progressive Property Loss: Preserving the Distinctions Between First- and Third-Party Insurance Policies,* 35 WM. & MARY L. REV. 1801, 1812 (1994).

or, possibly, a statute. The insurers also pointed the Court to *Lennar Corp. v. Great American*, in which the court discussed what was *not* meant by "legally obligated to pay." There, the Houston Fourteenth Court of Appeals held that Lennar's out-of-pocket expenses incurred to comply with its home building contracts, as well as expenses Lennar incurred to prevent future claims by other homeowners, were not damages that Lennar was "legally obligated to pay as damages" to a third-party claimant. Consequently, the out-of-pocket expenses were not covered by the CGL policy insuring agreement, and the insurer owed no duty to indemnify Lennar for those costs. *See also Data Specialties, Inc. v. Transcontinental Ins. Co.*, 125 F.3d 909 (5th Cir. 1997) (Texas law).

5. *Public Policy*

The insurers' arguments showed that the Court of Appeals' interpretation of the liability policies, consistent with long-standing Texas law, did not conflict with Texas public policy. Moreover, the Court of Appeals' Opinion fostered another important Texas public policy – the freedom to contract. Under Texas law, courts must exercise judicial restraint in deciding whether to hold a contract void on public policy grounds. Typically, courts are reluctant to deny the right to preservation of contractual freedom because it promotes certainty in enforcement and effectuates the reasonable expectations of the parties.

C. A Few Thoughts on "Blurring the Line"

In the author's view, Time Warner essentially is asking the Texas Supreme Court to eliminate the "liability" component of general liability insurance and hold that an additional insured under a CGL policy can get direct benefits for its own out-of-pocket loss, much like it would under a first-party property insurance policy. This approach eliminates the whole third-party and fault-based components of liability insurance.

Also, Time Warner is asking the supreme court to excuse it from the CGL policy requirements that apply to every other insured, including the named insured, Signal. Signal, for example, would not be able to obtain indemnity from the insurers just by spending money out of its own pocket to repair some sub-subcontractor's work and then asking its insurer for reimbursement. The same rules that apply to named insureds must apply to additional insureds seeking coverage under a general liability policy.

From a business perspective, if insureds got to decide which of their claimed "damages" were covered by their insurance policies (instead of courts and insurers), the insurance industry would likely fold from having to pay so many claims. Premiums would be so sky-high that the average person would not be able to afford liability insurance. Here, Time Warner asserts it is entitled to indemnity simply by alleging Signal did something wrong, paying out of its own pocket to make repairs to Signal's allegedly defective work, and holding out its hand to Signal's liability insurers. This has never been the law of Texas, and Time Warner must convince the Court to overturn multiple and ingrained precedents to achieve this result.

Admittedly, however, the current Texas Supreme Court in its most recent opinions has favored the insured much more than past incarnations of the court. And, another recent trend of the high court in insurance cases is to make very plain language interpretations of the policies. *See, e.g., United States Fid. & Guar. Co. v. Goudeau*, 272 S.W.3d 603 (Tex. 2008) (construing meaning of "occupying" in auto policy); *Don's Bldg. Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20 (Tex. 2008) (construing when "property damage" "occurs" under a CGL policy). These cases also have generated a number of separate opinions, concurring and dissenting, which reflects in some cases a philosophical split among the Justices on whether insurance policies really are being applied as written or whether the Court is taking too activist of a stance and "rewriting" insurance policies. Thus, how the Court will decide the issue presented by Time Warner cannot be predicted with any certainty.