Mid-Continent v. Liberty Mutual
"Fiendishly Difficult High-Stakes Insurance Law Questions"

Dottie Sheffield
Raymond Fischer
COOPER & SCULLY, P.C.
Founders Square
900 Jackson Street
Suite 100
Dallas, Texas 75202
(214) 712-9500
(214) 712-9540 (fax)

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INTRODUCTION

In *Mid-Continent Insurance Co. v. Liberty Mutual Insurance Co.*, 236 S.W.3d 765 (Tex. 2007), the underlying case arose from a 1996 auto accident that occurred in a construction zone of a state highway project. Kinsel Industries ("Kinsel") was working for the State of Texas as the general contractor on the project. Crabtree Barricades (Crabtree") was Kinsel's subcontractor, who was responsible for signage. *Id.* at 769.

The section of the highway involved is ordinarily four lanes but at the time of the accident, Kinsel had closed the two eastbound lanes. Traffic was diverted onto one of the two westbound lanes. A head-on collision occurred when a young driver named Tony Cooper crossed the center line into oncoming traffic in an attempt to pass the vehicle in front of him. Cooper struck the Boutin family auto and caused serious injuries to the entire family. *Id.* at 769.

Liberty Mutual insured Kinsel with $1 million in primary coverage under a general liability policy and an additional $10 million in coverage under a separate excess policy. Mid-Continent provided $1 million in coverage to Crabtree under a general liability policy. Both the Liberty Mutual and Mid-Continent general liability policies had identical "Other Insurance" provisions. *Id.* at 769.

After suit was filed, both insurers assumed the defense of their respective insureds. Liberty Mutual then demanded that Mid-Continent participate in the defense of Kinsel on the basis that Kinsel was identified as an additional insured under the Mid-Continent policy issued to Crabtree. Mid-Continent agreed and the insurers entered into a cost-sharing agreement relating to the defense.

The sole area of disagreement between the insurers related to the settlement value of the case. At mediation, Liberty Mutual had an opportunity to settle the claims against Kinsel for a total of $1.5 million. It asked Mid-Continent to contribute half of this amount. Mid-Continent valued the claim at $300,000 and so refused to contribute more than $150,000. Liberty Mutual agreed to settle the case against Kinsel for $1.5 million and the settlement was funded with Liberty Mutual paying $1.35 million and Mid-Continent contributing $150,000. Mid-Continent later settled the claims against Crabtree for $300,000. *Id.* at 770.

I. CASE HISTORY

After a failed mediation, Liberty Mutual sued Mid-Continent in state district court in Dallas County in 2001, seeking to recover Mid-Continent's pro rata share of the sum paid to settle the claims against Kinsel. Mid-Continent removed the case to federal court where it eventually proceeded to a bench trial before United States District Judge Kinkeade in the spring of 2003. In June of 2003, Judge Kinkeade concluded that Liberty Mutual was entitled through subrogation to recover $550,000 from Mid-Continent. *Liberty-Mutual Ins. Co. v. Mid-Continent Ins. Co.*, 266 F.Supp.2d 533, 544, 546 (N.D. Tex. 2003). Relying on *General Agents Insurance Co. of America v. Home Insurance Co.* 21 S.W.3d 419 (Tex. App.—San Antonio 2000, pet. Dism'd by agr), the district court determined that each insurer owed a duty to act reasonably in exercising its rights under the CGL policies. *Liberty Mut. Ins.*, 266 F.Supp.2d at 542. It found that Mid-Continent was objectively unreasonable in assessing Kinsel's share of liability, and that Liberty Mutual was reasonable in assessing the same and in accepting the settlement offer. *Id.* at 543-44. Therefore, the district court concluded that, whether apportioned pro rata or in equal shares, Mid-Continent was liable in subrogation for $750,000, one-half of the $1.5 million settlement with Kinsel. *Id.* at 546. Mid-Continent appealed, and the Fifth Circuit certified questions of law to the Supreme Court. *Id.* at 771.

A. Certified Questions From the Fifth Circuit

1. Two insurers, providing the same insured applicable primary insurance liability coverage under policies with $1 million limits and standard provisions (one insurer also providing the insured coverage under a $10 million excess policy), cooperatively assume defense of the suit against their common insured, admitting coverage. The insurer also issuing the excess policy procures an offer to settle for the reasonable amount of $1.5 million and demands that the other insurer contribute its proportionate part of that settlement, but the other insurer, unreasonably valuing the case at no more than $300,000, contributes only $150,000, although it could contribute as much as $700,000 without exceeding its remaining available policy limits. As a result, the case settles (without an actual trial) for $1.5 million funded $1.35 million by the insurer which also issued the excess policy and $150,000 by the other insurer.

In that situation is any actionable duty owed (directly or by subrogation to the insured's rights) to the insurer paying the $1.35 million by the underpaying insurer to reimburse the former respecting its payment of more than its proportionate part of the settlement?

2. If there is potentially such a duty, does it depend on the underpaying insurer having been negligent in its ultimate evaluation of the case as worth no more than $300,000, or does the duty depend on the underpaying insured's evaluation having been

sufficiently wrongful to justify an action for breach of the duty of good faith and fair dealing for denial of a first party claim, or is the existence of the duty measured by some other standard?

3. If there is potentially such a duty, is it limited to a duty owed the overpaying insurer respecting the $350,000 it paid on the settlement under its excess policy?

Liberty-Mutual Ins. Co. v. Mid-Continent Ins. Co., 405 F.3d 296, 310 (5th. Cir. 2005). The Supreme Court answered the first question in the negative, and therefore did not reach the second and third questions.

B. Arguments to the Supreme Court

At the Texas Supreme Court, Liberty Mutual argued that upon payment of the settlement amount, it was subrogated to its insured's contractual right to enforce language in the Mid-Continent policy, under which it was an additional insured, to pay an equal or pro-rata share of settlement. Liberty also argued that it is subrogated to the common law right of Kinsel to have Mid-Continent act reasonable when handling an insured's defense-including reasonable negotiation and participation in settlement. *Id.* at 771.

Mid-Continent contended that it did not breach any contractual or common law duty to Kinsel to which Liberty Mutual may be subrogated. Mid-Continent complied with its contractual duty to timely assume Kinsel's defense, and therefore Liberty Mutual has no contractual claim against Mid-Continent. Mid-Continent relied on the voluntary payment and no-action clauses in its policy to limit its liability to the amounts it consents to pay. Mid-Continent argued that its only common law duty to Kinsel was the *Stowers* duty to accept a reasonable settlement offer within its policy limits. There was never an offer within the policy limits, so *Stowers* cannot apply. *Id*. at 771.

Mid-Continent further argued that it owed no direct duty to Liberty Mutual upon which reimbursement may be based. There is no direct action exists between co-insurers in *Texas Traders & General Insurance Co. v. Hicks Rubber Co.*, 169 S.W. 2d 142 (Tex. 1943); *American Centennial Insurance Co. v. Canal Insurance Co.*, 843 W.W.2d 480 (Tex. 1992). Liberty Mutual is not entitled to reimbursement because there is no direct duty of reimbursement between co-primary insurers when their policies contain other insurance clauses. *General Insurance* at 148. *Id.* at 771-72.

The Supreme Court examined the two possible scenarios argued by Liberty Mutual. One involving any ability of a co-primary insurer to compel another co-primary insurer to proportionately participate in the settlement of a third-party claim, and a second involving an insured's ability to compel an insurer's proportionate participation in settlement of a third-party claim. *Id.* at *12.

C. Supreme Court Holding

The Supreme Court held that there is no right of reimbursement in this case. Kinsel had no common law cause of action against Mid-Continent. Because Kinsel was fully indemnified, Kinsel has no contractual rights against Mid-Continent. Because Kinsel has no rights to which Liberty Mutual may be subrogated, Liberty Mutual has no right of reimbursement through subrogation. The Court came to this conclusion by going through the following analysis. *Id.* at 772.

1. **No Direct Claim for Contribution between Co-Insurers**

Although Liberty Mutual did not expressly argue for the right of contribution, the Court addressed it anyway. The Supreme Court reaffirmed its 38 year old decision in *Employer's Cas. Co. v. Transport Ins. Co.*, 444 S.W.2d 606 (Tex. 1969). In so doing the Court held that where several insurers share a common obligation or burden and one has made a compulsory payment or other discharge of more than its fair share, a right of contribution exists. However, the Supreme Court stated that this direct claim for contribution between co-insurers disappears when the insurance policies contain "other insurance" or "pro rata" clauses. 169 S.W.2d at 148. The court held that the effect of the pro rata clause precludes a direct claim for contribution among insurers because the clause makes the contracts several and independent of each other. *Id*. With independent contractual obligations, the co-insurers do not meet the common obligation requirement of a contribution claim-each co-insurer contractually agreed with the insured to pay only its pro rata share of a covered loss; the co-insurers did not contractually agree to pay each other's pro rata share. *Employers* at 609. In addition, the co-insurer paying more than its contractually agreed upon proportionate share does so voluntarily; without a legal obligation to do so. *Id.* at 609-10. Therefore, a co-insurer paying more than its proportionate share cannot recover the excess from the other co-insurers. *Id.* at 772.

The Court stated that this decision is contrary to the holding in *General Agents Ins. Co. of America, Inc. v. Home Ins. Co. of Illinois*, 21 S.W.3d 419 (Tex. App.—San Antonio, 2000), which appeared to premise a right of reimbursement on a direct duty between co-insurers to act reasonably in exercising their policy rights. *General Agents* at 426. The

Supreme Court disagreed with General Agents and found that there is no common law duty between co-primary insurers to act reasonably in exercising policy rights. *Id*. at 773.

2. **No Subrogation Rights**

Acknowledging that a right of contribution did not exist, Liberty Mutual sought reimbursement through contractual or equitable subrogation to the rights of Kinsel. Beginning its discussion of subrogation as a possible basis for recovery, the Court stated that the mere fact that a general right of subrogation may exist does not answer the questions of when the insurer is actually entitled to subrogation or how much it should receive. *Id*. at 774.

There are two types of subrogation-contractual subrogation which is created by an agreement that grants the right to pursue reimbursement from a third party in exchange for payment of a loss, while equitable subrogation arises where a party, not acting voluntarily has paid a debt for which another was primarily liable and which in equity should have been paid by the latter. In either case, Liberty Mutual must step into Kinsel's shoes to assert only those rights held by Kinsel against Mid-Continent. Liberty argued that it was subrogated to the contractual right of Kinsel to enforce Mid-Continent's policy language which imposed a duty on Mid-Continent to defend and indemnify Kinsel and to pay a pro rata share of settlement. *Id.* at 774. The Court found that Liberty could not recover under subrogation based on a breach of contract theory because an insureds contractual right of indemnity under an insurance policy is limited to the actual amount of the loss. The Court found that the duty of both insurers to pay a pro rata share of covered losses up to their policy limits could not be viewed apart from the actual purpose of the pro rata clause or of the rule that once the insured has been fully indemnified, an insurer's duty to pay pro-rata shares of a loss is unenforceable. *Id.* The Court pointed out that the insured's right of indemnity under a policy is limited to actual amount of loss, and that when two policies provide coverage for losses, "the pro rata clause does not create an exception to the principle of indemnity, but rather implements that principle by eliminating the potential for double recovery by the insured." *Id.* at 774. The Court went on to hold that equity does not demand a different result here. The Court held, therefore, that a fully indemnified insured has no right to recover an additional pro rata portion of settlement from an insurer regardless of that insurer's contribution to the settlement. Having fully recovered its loss, Kinsel had no contractual rights that a co-insurer could have asserted against another co-insurer in subrogation. *Id.* at 775.

3. **<u>No Common Law Rights</u>**

Liberty also argued that it was subrogated to the common law right of Kinsel to enforce Mid-Continent's duty to act reasonably when handling an insured's defense-including reasonable negotiation and participation in settlement. The Court reiterated its long standing position that an insurer's common law duty in this third party context is limited to the *Stowers* duty to protect the insured by accepting a reasonable settlement offer within policy limits. The court stated that Mid-Continent did not breach a *Stowers* duty to Kinsel because a settlement demand was never made within Mid-Continent's policy limits. *Id.* Finally, the Court held that Liberty's dual status in the case as a primary and excess carrier negated the fundamental requirement of subrogation that a subrogee must have paid a debt for which another is primarily liable. Id.; see also 16 *Couch on Insurance* §223:1; 44 *Am. Jur. 2d Insurance* §1787, at 256 (2003)("The doctrine of subrogation is inapplicable if the liability insurer seeking subrogation is the one primarily liable; and the doctrine is inapplicable if the effect of the respective policies is to establish equal liability.")

Finally, the Court held that Liberty's dual status in the case as a primary and excess carrier negated the fundamental requirement of equitable subrogation where an excess insurer's recovery against a primary insurer is allowed to prevent a primary insurer from taking advantage of an excess insurer, when a potential judgment approaches the primary insurer's policy limits. *Canal* 843 S.W.2d at 483. The excess insurer would be forced to pay for a debt for which another insurer was primarily liable. In the present case, the Court found that Liberty Mutual seemed to have been motivated by concern for its excess insurance policy. Mid-Continent can not be required to agree to a settlement that requires payment in excess of its remaining coverage to protect Liberty Mutual's excess insurance interests. *Id*. at 776.

D. How does this Decision affect the discharge of the Duty to Defend

Justice Willett in his concurring opinion stated that the result in Mid-Continent might have different if Mid-Continent had refused to defend the insured. *Id.* at 777. Under *Gulf Ins. Co. v. Parker Products, Inc.* 498 S.W.2d 676 (Tex. 1973), the court held that once an insurer breaches the policy by denying a defense, they are estopped from relying on any of the conditions contained in the policy. In *Gulf v. Parker Products*, Parker Products sued its insurer, Gulf

Insurance Company, on its general liability policy for the amount and expenses of a settlement made between Parker and a third party claimant, Gulf Insurance, denied that the claim was covered by the policy due to an exclusion in the policy. Gulf furthered contended that Parker violated the following condition of the policy:

> No action shall lie against the company unless, as a condition precedent thereto, there shall have been full compliance with all of the terms of this policy, nor until the amount of the insured's obligation to pay shall have been finally determined either by judgment against the insured after actual trial or by written agreement of the insured, the claimant and the company.

By settling the claim rather than litigating it to a final judgment, Gulf alleged that Parker breached this provision of the policy. *Id* at 679. Parker plead that Gulf Insurance waived compliance with the conditions of the policy by unconditionally refusing to defend or to assume any liability under the policy. It was shown that Gulf Insurance reiterated their denial of coverage when advised by Parker of the need and opportunity for settlement of the claim. The court held that an insurance company can ordinarily insist upon compliance with conditions of the policy for its own protection, but it may not do so after it is given the opportunity to defend the suit and refuses to do so on the erroneous ground that it has no responsibility under the policy. *Id.* at 679; also see *Womack v. Allstate Ins. Co.,* 296 S.W.2d 233 (Tex. 1956); *Travelers Indemnity Co. v. Equipment Rental Co.,* 345 S.W.2d 831 (Tex. App.—1961, writ ref'd n.r.e.); 67 A.L.R.2d 1086.

Justice Willet in his concurring opinion recognized the distinction between the facts in the Gulf case and the facts in Mid-Continent. Justice Willett states:

> "Here, the body of precedent presenting similar but not identical issues deserves our respect and most careful analysis, but with an appreciation of the factual differences between those cases and the one before us now. We should start with the principle that Mid-Continent's primary, if not exclusive, contractual and common-law duty is to its insured, Kinsel Industries. Mid-Continent did not deny coverage or sit idly on the sidelines; it participated in the defense, but disputed Liberty Mutual's subjective assessment of what the case was worth. I see no basis for concluding that Mid-Continent, by taking a hard line in negotiations, breached a duty to Kinsel—to defend, to exercise good faith, to settle within the policy limits, or any other contractual or common-law duty an insurer might owe its insure. Kinsel purchased insurance and got what it paid for, a legal defense of the claim against it and a settlement within policy limits, both funded by its insurers. Not surprisingly, Liberty Mutual, with Kinsel as its named (as opposed to additional) insured and vastly greater exposure because of its excess policy, paid most of the settlement."

Id. at 777.

Clearly, the Mid-Continent decision does not apply to co-insurers who breach the policy by denying a defense to their insureds and then rely on any of the conditions contained in the policy such as the voluntary payment clause which provides, "no insureds will, except at their own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without the insurers consent", to discharge their duty to defend. The rationale in Mid-Continent would not apply to operate as a bar for an insurer's duty to defend.

E. How does this Decision Impact *Stowers*

Insurers are faced with a difficult decision where there is a demand made by a plaintiff which is within the policy limits of concurrent policies. In this situation, the insurer would have the ability to settle the case. However, under the contractual terms of the policy, it is only obligated to pay its pro rata share of the judgment or settlement. There has been no guidance provided by the Supreme Court in this situation. However, the Texas Supreme Court touched on this issued in footnote 13 of American Physicians Ins. Exchange v. Garcia, 876 S.W.2d 842 (Tex. 1994), in which the Court stated:

> A liability policy requires an insurance company to indemnify an insured only up to the insured's contractual limits with that company. Thus, insurers have no duty to accept over-the-limit

> demands. We do not reach the question of when, if ever, a *Stowers* duty may be triggered if an insured provides notice of his or her willingness to accept a reasonable demand above the policy limits, and to fund the settlement, such that the insurer's share of the settlement would remain within the policy limits. Nor do we address the *Stowers* duty when a settlement requires funding from multiple insurers and no single insurer can fund the settlement within the limits that apply under its particular policy.

In such a situation where a demand is made within the policy limits of concurrent policies, it appears that a prudent course of conduct for the insurer would be to go ahead and pay the limits to settle a case and seek subrogation against the other insurer who was recalcitrant. Unfortunately, the holding in *Mid-Continent* will make this option less desirable.

Mid-Continent is not technically a *Stowers* case as the Supreme Court properly ruled that no demand was ever made within the policy limits of either primary policy. However, the Court discarded any idea that one primary carrier owes any direct duty to another when both policies contain "other insurance" provisions. When that is the case, the carriers' duty to contribute is contractually limited to their proportionate share of the loss. Only if the insured has a right of action against the recalcitrant insurer can the paying insurer step into the shoes of the insured and seek reimbursement for any amount paid beyond its contractually agreed upon proportion. But once a settlement demand is paid and the insured is fully indemnified, the insured will never have a claim against the recalcitrant insurer and no claim for equitable subrogation will ever arise.

This creates an uncomfortable *Stowers* scenario for a carrier faced with a reasonable settlement demand that is less than the limits of both its policy limits and the limits of the recalcitrant insurer and the recalcitrant insurer is unwilling to pay its proportionate share.

Can the paying insurer escape *Stowers* liability simply by tendering its proportionate share of such a *Stowers* settlement demand while refusing to pay any portion of the other carrier's obligation? And, if the paying insurer does do just that, would only the recalcitrant insurer face exposure under the *Stowers* doctrine or would the paying insurer also face such exposure to an excess judgment? The *Mid-Continent* case is problematic because it does not appear to recognize any mechanism in which the paying insurer can protect its insured and also be reimbursed for its payment of sums greater than its proportionate share. If the Supreme Court's answer is that the paying insurer escapes liability under *Stowers* by tendering payment of its proportionate share, even though that will not accomplish a settlement, then the Court appears to be placing a strong burden on the insured to have to go to trial and face an excess judgment just so that it can later sue the recalcitrant insurer for the excess amount.

Although *Mid-Continent* does not present pure *Stowers* issues and the Supreme Court does state that it must be read in the context of the facts of that case, the rulings in the case appear to create a situation in which an insurer, willing to pay its share of a reasonable *Stowers* demand, will be forced to make a difficult decision on how to respond to a *Stowers* demand with little guidance from the Supreme Court regarding its rights and obligations.

F. Did the Supreme Court End Pay and Chase

The decision in the Mid-Continent case raises very significant questions for any carrier facing the settlement of tort claims where the insured has multiple primary carriers with policies that contain other insurance pro rata provisions. If one carrier plays hard ball, the settling carrier probably cannot sue this carrier unless the insured contributes to the settlement and still possesses a claim against the recalcitrant insurer. Such a claim may also exist if the reluctant carrier is subject to a valid *Stowers* claim for failing to settle within limits. Otherwise, liability carriers may force more cases to trial due to the reluctance of co-carriers to fund tort settlements for their insureds. This means more lawsuits will be filed and third parties will have to wait longer for any settlements. This is a slippery slope which undoubtedly will create much fodder for litigation in the future.