There and Back Again: The *Frank's Casing* Saga

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INTRODUCTION

The Texas Supreme Court recently reconsidered the insurance industry's Hobbesian choice between settling a potentially uncovered claim without a right of reimbursement versus not settling and being liable for a sum greater than the policy limits.

The Court previously dealt with the reimbursement question nearly three years ago, when it issued the first *Frank's Casing* opinion ("*Frank's Casing I*"), which held that insurers are entitled to reimbursement in some circumstances. *Excess Underwriters At Lloyd's, London and Certain Companies Subscribing Severally but not Jointly to Policy No. 548/TA4011FO1 v. Frank's Casing Crew & Rental Tools, Inc.*, 2005 Tex. LEXIS 418 (Tex. May 27, 2005). The Court granted a petition for review in 2006 and withdrew the prior opinion, replacing it with *Frank's Casing* ("*Frank's Casing II*"). *Excess Underwriters at Lloyd's v. Frank's Casing Crew & Rental Tools, Inc.*, 2008 Tex. Lexis 92 (Tex. 2008). Thus, the Court put insurers back into the recoupment dilemma and decided that there is no implied right of reimbursement when an insurance company settles a claim later determined not to be covered. *Id* at *1.

The Court re-examined this issue in light of its holding in *Texas Association of Counties County Government Risk Management Pool v. Matagorda County*. 52 S.W.3d 128 (Tex. 2000). There, the Court decided that absent an express provision in the policy, the only way an insurer could seek reimbursement for paying a claim that is later determined not to be covered is when the insured agrees to the settlement *and* to the insurer's right to seek reimbursement. *Id* at 136. The first *Frank's Casing* opinion purported to clarify the *Matagorda County* holding by allowing reimbursement in some circumstances. However, the second *Frank's Casing* opinion found this clarification unpersuasive and returned the reimbursement law to the post *Matagorda County* state. 2008 Tex. LEXIS 92.

This paper will examine these three major reimbursement opinions and explore the Court's rationale for its original and recent holdings as well as its foray into reimbursement rights in *Frank's Casing I*. Section I will discuss the factual backgrounds of the *Matagorda County* and *Frank's Casing* decisions and the meaningful distinctions between them. Sections II and III will examine the reasons each Court came to its respective holdings, focusing on the Justices' treatment of public policy, contract law, and legal precedent. Finally, Section IV will explore how this decision may affect insurers' settlement obligations and practices.

I. EVENTS LEADING TO THE REIMBURSEMENT CASES

A. Matagorda County

In 1993, three prisoners sued Matagorda County ("County") when they were physically and sexually assaulted by inmates armed with razor blades. 52 S.W.3d at 129. The County demanded that the Texas Association of Counties County Government Risk Management Pool ("TAC") defend and indemnify them under a law-enforcement-liability insurance policy. TAC initially denied coverage pursuant to an endorsement on its policy excluding coverage for any claim "arising out of jail." *Id*. Eventually, TAC agreed to pay defense costs of the attorney hired by the County, subject to a reservation or rights to deny coverage. Two years after the prisoners filed suit, they offered to settle for $300,000, which was within the County's policy limits. The County's lawyer advised TAC that the settlement was reasonable, but the County refused to contribute because it insisted that the claim was covered. TAC issued a second letter reserving its rights to continue to deny coverage and to seek reimbursement from the County in the event the claim was determined to be not covered. The County ignored the second letter. The insurance agreement between the County and TAC allowed the latter to unilaterally settle any claim. TAC settled the prisoners' claims for $300,000, and the County did not object. TAC then amended a declaratory action it had already filed seeking a determination of the coverage to include a request for reimbursement of the settlement funds.

The trial court ruled that the claim was not covered and TAC was entitled to a $300,000 reimbursement from the County. The court of appeals reversed, stating that no equitable remedy allowed recovery of the funds, and the County never agreed either to be bound by the settlement or to reimburse TAC. *Id*. As noted above, the Texas Supreme Court agreed with the appeals court and held that "when coverage is disputed and the insurer is presented with a reasonable settlement demand within policy limits, the insurer may fund the settlement and seek reimbursement only if it obtains the insured's clear and unequivocal consent to the settlement and the insurer's right to seek reimbursement." *Id* at 135.

B. *Frank's Casing*

ARCO/Vastar sued Frank's Casing Crew & Rental Tools, Inc. after a drilling platform fabricated by the latter collapsed on site in the Gulf of Mexico. Frank's Casing carried a primary liability policy with a $1 million limit and excess coverage up to $10 million from Certain Companies Subscribing Severally But Not Jointly To Policy No. 548/TA4011F01 ("Underwriters"). This policy did not require the

Underwriters to assume control of the defense or the settlement of any claims; however, they could associate with defense counsel if it was reasonably likely that the excess coverage layer would be reached. 2008 Tex. Lexis 92, *2-3. The Underwriters issued reservation of rights letters asserting that certain of ARCO's claims were not covered. The primary carrier retained defense counsel for Frank's Casing. Several settlement demands were made by ARCO; both Frank's Casing and the Underwriters rejected them. By close of the second day of trial, Frank's Casing's in-house counsel contacted ARCO and suggested that it make a settlement demand of about $7 million, which was within the excess policy limits. ARCO quickly demanded $7.5 million, and Frank's Casing communicated the offer to the Underwriters with a demand that *Stower*ized them. *Id* at *4; *See G.A. Stowers Furniture Co. v. Am. Indemn. Co.*, 15 S.W.2d 544, 547 (Tex. Comm'n App. 1929, holdings approved). In this letter, Frank's Casing reiterated its disagreement with the Underwriters' coverage position and stated that Frank's Casing expected the Underwriters to fund the entire settlement. The Underwriters agreed the case should be settled and offered to fund it if Frank's Casing agreed to reserve the coverage issues for later. Frank's Casing rejected this proposal and insisted that the Underwriters were responsible for the settlement. In response to this final letter, the Underwriters wrote that they would fund the $7.5 million settlement, less contributions from the primary carrier, and then seek reimbursement from Frank's Casing. A few hours after sending this letter, the Underwriters orally accepted the settlement offer. *Id* at *5. A written settlement agreement between the parties preserved "any claims that exist presently" between the Underwriters and Frank's Casing. The Underwriters filed a lawsuit to determine the coverage and reimbursement questions before executing the settlement agreement. *Id*.

The trial court granted the Underwriters' motions for summary judgment on the coverage issue and their right to reimbursement. However, before final judgment was entered, the Texas Supreme Court issued the *Matagorda County* decision, and Frank's Casing filed a motion for new trial on the reimbursement issue. The trial court withdrew its previous opinion and signed a take-nothing judgment in Frank's Casing's favor. The court of appeals affirmed. *Id* at *6.

C. A Matter of Distinction

The Underwriters clung to the distinctions between the cases, claiming "Frank's is not the County and Excess Underwriters are not TAC." *Excess Underwriters At Lloyd's, London and Certain Companies Subscribing Severally but not Jointly to Policy No. 548/TA4011FO1 v. Frank's Casing Crew & Rental Tools, Inc.*, 2002 TX S.Ct. Briefs 730, *1-2 (Petitioner's Brief in Reply, 2003). This strategy proved prescient, as the Court in *Frank's Casing I* pointed out that the factual differences prompted its decision to recognize a right of reimbursement in two circumstances. The first circumstance is when the insured has demanded that its insurer accept a settlement offer within policy limits. 2005 Tex. LEXIS 418, *12. The other is when an insured expressly agrees that the settlement offer should be accepted. *Id*. If either of these two situations exists, and the insurer asserted its reservation of rights, notified the insured it intends to seek reimbursement, and paid to settle claims that were not covered, then the insurer has a right of reimbursement.

II. A PUBLIC POLICY DEBATE

The fundamental concern in *Matagorda County* was that allowing implied reimbursement rights places the insured in a position where it has to choose between rejecting a settlement within policy limits and accepting a possible financial obligation to pay an amount that may be beyond its means, at a time when it is most vulnerable. *Matagorda County*, 52 S.W.3d at 135. The Court in *Frank's Casing I* decided that the distinctions between the cases ameliorated this concern. 2005 Tex. LEXIS 418, *11. In *Frank's Casing II*, the Court disagreed with its predecessor, holding that the differences did nothing to alter the *Matagorda County* analysis.

A. The Differences Make All the Difference

In *Matagorda County*, the County's attorney advised TAC that it considered reasonable the claimants' settlement offer of $300,000. In *Frank's Casing*, the insured procured the settlement demand and communicated it to its insurer. (*Frank's Casing I* and *Frank's Casing II* recited slightly different versions of events on this point. The former stated that Frank's Casing's communication of the $7.5 million settlement offer was "accompanied by a demand that the underwriters accept this offer." 2005 Tex. LEXIS 419, *4. *Frank's Casing* II recalled this same incident as Frank's Casing forwarding the settlement offer to the Underwriters "with a letter suggesting that the settlement offer was a reasonable one that the underwriters should accept." 2008 Tex. LEXIS 92, *4.) Texas Supreme Court Justice Priscilla Owen, writing for the majority in *Frank's Casing I*, decided that this distinction was crucial, because an insured who *Stower*izes its insurer no longer needs the *Matagorda County* protection. She reasoned that once *Stower*ized, the insurer does not have a duty to accept a settlement offer within policy limits unless "an ordinarily prudent person, in the exercise of ordinary care, as viewed from the standpoint of the assured, would have." *Stowers*, 15 S.W.2d 544, 547. In other

words, the Underwriters decision to accept the settlement offer was no different than if Frank's Casing accepted it. And, in fact, Frank's Casing considered the offer reasonable and told the Underwriters they should accept it.

The law requires an insurer faced with a settlement demand from its insured to make an objective assessment of the insured's potential liability. *Frank's Casing*, 2005 Tex. LEXIS 418, *13. That happened in *Frank's Casing*, and accordingly, the Court said it makes no sense to suggest that the insured chose to accept an obligation to pay an amount that might be beyond its means if it turns out the claims against it are not covered. The insured benefited from the settlement by reducing its exposure to a judgment that was potentially larger than the settlement. And, the Court decided, because the settlement was considered reasonable based solely on the insured's potential liability, the insured is in the same position it would have been in were there no coverage at all. Thus, the insurer, who paid the settlement under a mistaken belief that there was coverage, should be entitled to a reimbursement from its insured.

Frank's Casing I also deemed dispositive the Underwriters' claim that they could not settle without Frank's Casing's consent. In *Matagorda County*, the insurance agreement between the parties allowed the insurer to settle any claims at its own discretion, without the insured's consent. This distinction matters, according to *Frank's Casing I*, because the insured could have decided to continue the litigation at this point rather than accepting the settlement agreement. The insured made this decision with the knowledge that the insurer planned to pursue coverage issues and to seek reimbursement. Because of this, "an insured who agrees to the settlement and benefits by having claims against it extinguished cannot complain that it must reimburse its insurer if the claims against the insured were not covered by the policy." *Frank's Casing*, 2005 Tex. LEXIS 418, *18-19.

B. Everything Is the Same as Always

The analysis in *Frank's Casing II* makes no explicit mention of the position taken in *Frank's Casing I*. For example, the *Frank's Casing I* Court used the insured's demand that the Underwriters settle the claim as the basis for its public policy argument that an insured should not be able to take inconsistent positions regarding a settlement's reasonableness. The *Frank's Casing II* Court reserved the bulk of its discussion about the demand distinction for its holding that there was no 11th-hour implied agreement that the insurer could seek reimbursement. Nevertheless, when the majority in *Frank's Casing II* weighed the public policy equities, the scale tipped considerably in the favor of no reimbursement right.

> Both *Matagorda County* and *Frank's Casing* II recognized the difficult decision insurers are forced to make when they are not entitled to reimbursement. The insurer who rejects a reasonable offer within policy limits risks incurring exponentially larger liability for bad-faith insurance practices if it loses in its coverage contest. This situation creates coverage in cases where coverage is determined not to exist. However, the Court quickly added, if an extra-contractual reimbursement obligation exists, insureds are placed in the highly untenable position that formed the basis for the *Matagorda County* decision: "The insured is forced to choose between rejecting a settlement within policy limits or accepting a possible financial obligation to pay an amount that may be beyond its means, at a time when the insured is most vulnerable." *Frank's Casing*, 2008 Tex. LEXIS 92, *9-10 (quoting *Matagorda County*, 57 S.W.2d at 135).

Ultimately, *Matagorda County* and *Frank's Casing II* agreed that the insurer is best positioned to handle this problem. It makes no difference whether the insurer is an excess carrier, receives a settlement demand from its insured, or has no unilateral settlement rights, because the insurer always has the following options:

> (1) If the insurer assesses its coverage position as strong, it can rely on that and refuse to participate in settlement;
>
> (2) The insurer may seek prompt resolution of its coverage dispute;
>
> (3) If the coverage position is difficult to assess, the insurer can leverage the coverage dispute during negotiations to lower the claimant's demand;
>
> (4) The insurer can accept the settlement offer and subsequently eliminate bad faith liability, save defense costs, and avoid protracted coverage litigation with its insured;
>
> (5) The insurer may include a reimbursement right in the policy at the outset, which may yield a lower premium.

Id at *10-11 (citing *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996) and *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex. 1997)).

From the insured's perspective, an extra-contractual reimbursement right creates several potential problems. First, it is bad public policy to allow an insurer to settle claims and then sue its

policyholder as a creditor. This fosters conflict and distrust in a fiduciary relationship, which courts seek to avoid. *Id* at *11 (citing *Medina v. Herrera*, 927 S.W.2d 597, 604 (Tex. 1996) and *Phoenix Ins. Co. v. Erie & W. Transp. Co.*, 117 U.S. 312, 320-25 (deciding that insurers are precluded from seeking equitable subrogation against their insureds). Additionally, recognizing an implied reimbursement right hinders defense counsel's ability to conduct frank settlement discussion. If an insured's acknowledgment that settlement was reasonable exposed it to a reimbursement action, then the insured's own defense counsel would be advancing the insurer's interest. Insurers and insureds may feel compelled to hire separate coverage counsel and settlement counsel. Another negative consequence of an implied reimbursement right is that it may weaken the insurer's incentive to negotiate the best possible settlement for the insured. The insurer's knowledge that the insured will likely bear the payment obligation might motivate it "to curtail attorney's fees and litigation expenses early in the proceedings by negotiating a quick settlement, with the added benefit of extinguishing any risk of *Stowers* liability. The insured now faces coverage and reimbursement litigation, which is precisely why it purchased insurance in the first place – to hedge the risk of future litigation. *Id* at *14.

With these public policy concerns in mind, *Frank's Casing II* chose to weigh the varying risks and decided that the Underwriters and Frank's Casing were indeed no different than TAC and the County. The insurers can handle it.

III. CONTRACT LAW

The policy arguments provided the respective courts an opportunity to delineate which side they felt the reimbursement question should fall. Fundamental concepts of contract law provided the courts with the necessary legal reasoning to support their decisions. The Underwriters claimed that a reimbursement right should be recognized as either an implied-in-fact contractual agreement or an implied-in-law extra-contractual obligation. *Matagorda County* rejected both of these claims under its factual scenario. *Frank's Casing I* ignored the implied-in-fact claim but strenuously attacked *Matagorda County's* rationale for rejecting the implied-in-law argument. *Frank's Casing II* rehabilitated the *Matagorda County* implied-in-law analysis and held that no agreement existed between the Underwriters and Frank's Casing under any theory.

A. In Fact, No Agreement Existed

An implied-in-fact contract differs from an express contract in that the mutual assent required for the former is inferred from the circumstances. The parties' conduct and course of dealing creates the offer and acceptance. This implied consent to be bound requires a meeting of the minds and is an essential element of an implied-in-fact contract.

In *Matagorda County*, the insurer maintained that the insured's decision to ignore its reservation-of-rights letter coupled with its acknowledgment of the settlement's reasonableness created an implied-in-fact reimbursement obligation. The Court disagreed with TAC because a unilateral reservation of rights letter cannot create rights not contained in the insurance policy, and there was no meeting of the minds. Specifically, *Matagorda County* held that the County's silence and inaction to TAC's reservation-of-rights letter cannot be construed as an assent to an offer. *Matagorda County*, 52 S.W.3d at 132. It also stated that no meeting of the minds existed because the County consistently contested TAC's coverage position and insisted that TAC pay under the policy. The County never consented, by either its conduct or its course of dealing, to be bound by an implied-in-fact reimbursement obligation.

The Underwriters argued that Frank's Casing impliedly agreed to reimbursement by procuring the settlement offer, demanding its acceptance, and participating in its creation and negotiation. The Court in *Frank's Casing II* again was unmoved by these distinctions because they had no effect and were not really even that different than the situation in *Matagorda County*. In the end, Frank's Casing made it just as clear that it disagreed with the insurer's coverage position and would seek recourse against the Underwriters if the case were not settled. According to the Court, "[t]his is a far cry from impliedly consenting to reimbursement" and negates the necessary meeting of the minds. *Frank's Casing*, 2008 Tex. LEXIS 92, *16-18.

Noticeably absent from the analysis in *Frank's Casing I* is a discussion about an implied-in-fact reimbursement right. Instead, that opinion focused on the quasi-contractual, implied-in-law agreement.

B. Equitable Theories

Courts occasionally enforce contractual rights in the absence of an express or implied-in-fact contract when a failure to do so would unjustly enrich a party. These quasi-contractual rights do not depend on the mutual assent of the parties because they are implied in law "for reasons of justice, honesty, and fair dealing without any expression of assent and sometimes even against a clear expression of dissent." 2-21A Dorsaneo, Texas Litigation Guide § 21A.01. The Underwriters made their biggest push for reimbursement rights under an equitable theory, and the Court in *Frank's Casing I* was adequately moved to agree with them. Nevertheless, the *Frank's Casing II* Court had the final word and remained unconvinced.

Justice Owen in *Frank's Casing I* launched a direct attack on *Matagorda County's* treatment of

quasi-contractual rights. In the opinion, she stopped just short of saying the majority in *Matagorda County* was being disingenuous by misconstruing several foreign decisions to support its holding.

In *Matagorda County*, the Court dismissed TAC's equitable subrogation claim and then turned its attention to quantum meruit and unjust enrichment. Specifically, it cited its agreement with three foreign cases and a law review article and noted, "the few courts that have considered the settlement-reimbursement question have generally opted to recognize a reimbursement right only if the insured has authorized the settlement and agreed to reimburse the insurer should the insurer prevail on its defense. *See Medical Malpractice Joint Underwriting Association of Massachusetts v. Goldberg*, 680 N.E.2d 1121 (Mass. 1997); *Mt. Airy Insurance Co. v. Doe Law Firm*, 668 So.2d 534 (Ala. 1995); *Val's Painting & Drywall, Inc. v. Allstate Insurance Co.*, 126 Cal. Rptr. 267 (Cal. Ct. App. 1975); Robert H. Jerry, II, *The Insurer's Right to Reimbursement of Defense Costs*, 42 ARIZ. L. REV. 13, 70 n.220 (2000). *Frank's Casing I* pointed out that only one of the cases cited by *Matagorda County* was consistent with the latter Court's opinion. The other three sources supported an implied-in-law right of reimbursement.

Frank's Casing II made short work of the Underwriters' equitable claims and completely ignored *Frank's Casing I*'s tacit disagreement with *Matagorda County's* interpretation of persuasive sources on the issue. In short, the Court held in *Frank's Casing II* that the insured's settlement demand and the insurer's status as excess insurers with no duty to defend does nothing to "allay[] the concerns underlying our analysis in *Matagorda County*." *Frank's Casing*, 2008 Tex. LEXIS 92, *20. Additionally, the Court decided, the Underwriters were not entitled to a reimbursement right on a quasi-contractual basis because a valid agreement already addressed the matter and the equitable theory would be inconsistent. In other words, the insurance policy governed the parties' rights and obligations, and there was no right to reimbursement in there.

IV. CONCLUSION

A. Inconsistent State Laws

The Underwriters' also argued that the Court should follow California's lead in recognizing an implied reimbursement right. In *Blue Ridge v. Jacobsen*, the California Supreme Court considered the reimbursement question under nearly identical underlying facts. 22 P.3d 313 (Cal. 2001). The *Blue Ridge* Court held that "an insurer may be reimbursed for a reasonable settlement payment made over the objection of its insureds." While the factual scenarios between *Frank's Casing* and *Blue Ridge* were similar, the laws of Texas and California are not.

California insurers face something akin to a *Stowers* duty when presented with a settlement demand, as they can be held liable for an entire judgment if they failed to accept a reasonable settlement offer within policy limits. However, in California, insurers may not consider the issue of coverage in determining whether a settlement offer is reasonable. *Johansen v. California State Auto Assn. Inter-Ins. Bureau*, 538 P.2d 744 (Cal. 1975). Additionally, California courts are prone to stay declaratory judgment actions until after the underlying suit is tried to avoid the possibility of inconsistent factual determinations. *Blue Ridge*, 22 P.3d at 323. Thus, in California, an insurer is in a terrible position without the right to seek reimbursement. It cannot consider its coverage position in assessing the settlement demand, and it cannot adjudicate its coverage position in a declaratory action. Every time an insured objects to a reservation of rights, coverage would be created regardless of whether it was contemplated in the insurance policy.

In Texas, an insurer's *Stowers* duty is not triggered every time it faces a demand to settle a lawsuit on behalf of its insured. Rather, the *Stowers* duty attaches only when all of the following exist: (1) the claim is covered; (2) the settlement offer is within the policy limit; (3) the settlement fully releases the insured; and, (4) the terms of the offer are such that "an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment." *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848-49 (Tex. 1994); *Tex. Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 314 (Tex. 1994). Texas insurers can consider their coverage position when deciding whether to settle and they can adjudicate coverage positions as well. *Frank's Casing II* found the different legal landscapes reason enough not to follow the California decision.

B. Keeping *Stowers* Alive

The recognition of an implied reimbursement right would emasculate the *Stowers* doctrine. Suppose an insured gets sued and the coverage position is difficult to assess. Early in the litigation, the claimant makes a settlement offer within the policy limit and the terms are such that an ordinarily prudent insurer would accept it. What happens if the insurer decides to accept the settlement offer? If it is later determined that the claim was covered, then the insurer benefitted by avoiding *Stowers* liability, which would have attached at that point. On the other hand, if the claim was determined not to be covered, then the insurer could simply recoup the settlement funds. In other words, any time an insurer is not 100 percent certain of its coverage position, it will be motivated to settle.

Injured third parties benefit from this because they get their recovery, and the court system may benefit because it promotes prompt, out-of-court resolution. The insured, however, loses much of the protection afforded it by *Stowers*.

Another complication that arises between an implied right of reimbursement and the *Stowers* doctrine deals with time constraints. How long does the insurer have to consider a settlement offer that might or might not trigger its *Stowers* duty? Texas courts are rightfully reluctant to establish a bright line rule, although at least one court suggested that an offer that expires within a couple of days is not a reasonable amount of time. *State Farm Lloyds Ins. Co. v. Maldonado*, 935 S.W.2d 805, 826 (Tex. App. 1996) (Rickhoff, J., concurring and dissenting). Most courts would probably answer this question with reference to the reasonableness standard that accompanies a *Stowers* demand. A flexible standard works well because the time necessary to consider prudently a settlement demand will vary according to circumstances. But once again, recognizing an implied reimbursement right may incentivize an insurer to settle as quickly as possible in order to reduce attorney's fees and litigation expenses. If there is a three-day window to accept the settlement and potential liability is unclear and complicated, then an insurer's default position may be to settle. It can spend the money and time saved on settling the underlying suit in the subsequent coverage and reimbursement actions. The insured comes up short again, as the insurer may have settled for an amount that the insured could not have afforded.

Stowers attempts to balance the inherent conflict between the insurer and insured during settlement negotiations. An implied right of reimbursement tips this delicate balance toward the insurer, who is in the business of analyzing risk, drafting insurance policies, and assessing coverage positions.