

**SETTLEMENTS, ASSIGNMENTS, AND AGREEMENTS BETWEEN  
PLAINTIFFS AND INSURED/DEFENDANTS: WHAT CAN AND  
CAN'T BE DONE**

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**CHAPTER 7**



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**Settlements, Assignments, and Agreements Between Plaintiffs and Insured/Defendants:  
What Can and Can't Be Done**

Mark L. Kincaid<sup>1</sup>

**I. Overview**

When an insured under a liability policy believes the insurer has breached its duty to defend, negligently failed to settle, is going to refuse to indemnify, or has committed some other unfair insurance practice, when and to what extent can the insured protect himself by making an agreement with the plaintiff?

**II. Introduction**

In a tort lawsuit where liability insurance is involved, the interests of the plaintiff, insured defendant, and insurer collide, change, and sometimes coincide on the issues of liability and insurance coverage. The plaintiff wants to succeed in holding the defendant liable, and is opposed on liability by both the defendant and the insurer. If the plaintiff succeeds on liability, then, in most cases, the plaintiff and defendant both want the judgment to be covered by insurance – both are adverse to the insurer, which would like to avoid paying.

This shifting of interests may be triggered or aggravated by other events in the course of the suit. The insurer may refuse to defend, leaving the defendant with no ally to help contest liability. The insurer may defend while reserving the right later to deny coverage, leaving the plaintiff and defendant uncertain about a source of recovery if the plaintiff wins on liability. The insurer may mishandle or interfere with the defense. The insurer may fail to settle, thus exposing the defendant to a loss that exceeds or is outside of coverage. Any of these circumstances in turn may motivate the defendant to find other ways to protect himself, such as trying to induce the plaintiff to pursue the insurer.

One approach that once was fairly common was for the defendant to agree to a judgment in favor of the plaintiff and agree to assign to the plaintiff all claims against the insurer. In return, the plaintiff would agree not to execute on the judgment against the defendant and to pursue only the insurer.

Although this arrangement was called by the pejorative-sounding name, “sweetheart deal,” it actually provided many of the same benefits as the original insurance policy. Like a liability policy, the agreement protected the defendant from personal liability by shifting to the insurer the obligation to pay the plaintiff. Like a liability policy, the agreement provided to the plaintiff a source of recovery from the insurer. The potential for plaintiffs and defendants to

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make these agreements also gave insurers a strong incentive not to prejudice the insured by failing to defend, settle, or indemnify.

Defendants liked this, because it gave them what they had bargained for under the insurance policy – protection from personal liability.

Plaintiffs liked this, because it gave them what they hoped for from the insurance policy – a source of recovery for the defendant's liability.

Insurers hated this, because they found themselves facing the asserted binding effect of a judgment in the underlying case, for huge damages, based on an agreement between parties who did not have the same interests as the insurer, or based on an uncontested "trial."<sup>2</sup>

In *State Farm Fire & Casualty Co. v. Gandy*,<sup>3</sup> the Texas Supreme Court declared such agreements void as against public policy, based on the factors present in that case. The court's overarching concerns were that the assignment skewed the resulting coverage litigation by causing the plaintiff and defendant to alter their positions. The court also disapproved the practice of plaintiffs and defendants attempting to establish the amount of the insurer's liability by an agreed judgment between them, or by any other means that fell short of a "fully adversarial trial."

The *Gandy* decision did not categorically forbid assignments and covenants not to execute. At the same time, the court did not commit to any circumstances when such agreements would be upheld. Thus, plaintiffs, defendants, and insurers are left with uncertainty about what options are available to a defendant that is denied, or loses confidence in, the insurer's protection. Uncertainty exists about the legal tools that are available to protect the insured, to compensate the plaintiff, and to punish an insurer that wrongly refuses to defend, settle, or pay.

After a decade of uncertainty, the supreme court decided *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*,<sup>4</sup> and brought great clarity to the limits of *Gandy* and the options available to defendant/insureds to protect themselves from insurers' breaches.

### **III. The State Farm v. Gandy decision**

#### **A. Factual background of Gandy**

Understanding how the issues arose in *State Farm v. Gandy* sheds some light on the court's holdings.

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<sup>2</sup> For further discussion of the dilemma of balancing the interests of the insured and insurer, the need to protect the insured, the need to deter insurer misconduct, and the benefits of and problems with these arrangements, see Chris Wood, *Assignments of Rights and Covenants Not to Execute in Insurance Litigation*, 75 Tex. L. Rev. 1373, 1376-89 (1997).

<sup>3</sup> 925 S.W.2d 696 (Tex. 1996).

<sup>4</sup> 51 Tex. Sup. Ct. J. 460, 2008 WL 400394, (Tex. Feb. 15, 2008).



Julie Gandy sued Pearce, her step-father, alleging that he had repeatedly abused her sexually. Pearce requested that State Farm defend him. State Farm provided homeowner's insurance to Pearce, and Gandy alleged that some of the sexual abuse occurred at his home. Pearce hired Andrews to act as his attorney in the civil suit. Andrews specialized in criminal law and was defending Pearce in the criminal prosecution that had been filed because of Gandy's allegations. State Farm was notified of the suit about six months after Gandy's suit was filed. State Farm advised Pearce that it had decided to defend him, but reserved its right to deny coverage based on the policy exclusion for intentional conduct. State Farm later sent Andrews a letter directing him to send his bills to it and to keep it advised of the progress of the lawsuit.<sup>5</sup>

Andrews later filed a motion to withdraw as Pearce's attorney after he improperly answered interrogatories and failed to appear at a hearing on a motion to compel. The new attorney persuaded the trial court not to sanction Pearce, and thereafter Pearce, who had by that time concluded that State Farm had refused to do anything except pay Andrews's bill, decided to settle the case.<sup>6</sup>

Pearce and Gandy then entered into an agreed judgment awarding her actual and punitive damages of over \$6 million. At the same time, Pearce assigned Gandy all of his rights and causes of action that he had against State Farm or any other insurer. Gandy executed a covenant to limit execution on the judgment in return for Pearce's assignment of his rights to her. State Farm was not a party to the settlement discussions and was completely unaware of the agreed judgment until a copy of it arrived in the mail.<sup>7</sup>

As assignee of Pearce, Gandy filed suit against State Farm on the basis that State Farm had failed to provide Pearce an adequate defense. Although the trial court rendered summary judgment that State Farm's policy did not cover Gandy's injuries from Pearce's intentional acts, the jury found that State Farm was negligent in handling Pearce's defense and that State Farm violated the DTPA. The jury found Pearce's actual damages to be \$200,000 and set attorney's fees at 15% of that amount.<sup>8</sup>

The trial court rendered the judgment based on the verdict in favor of Gandy, and the court of appeals affirmed.<sup>9</sup>

## **B. The reasoning and holdings of the court in *Gandy***

The supreme court reversed and rendered a take-nothing judgment.<sup>10</sup> The basis for the court's decision was its conclusion that Pearce's assignment to Gandy of his rights against State Farm was invalid, and thus Gandy had no right to recover from State Farm.<sup>11</sup>

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<sup>5</sup> 925 S.W.2d at 697-700.

<sup>6</sup> *Id.* at 700.

<sup>7</sup> *Id.* at 700-02.

<sup>8</sup> *Id.* at 703-04.

<sup>9</sup> *Id.* at 704.

After expounding on the history of law relating to the assignability of causes of action, the court noted that, although the law originally prohibited such assignments, the modern rule is that, generally, the assignment of a cause of action is permissible.<sup>12</sup> However, the court found that exceptions to the general rule exist when the assignment tends to increase and distort litigation. The court gave four examples of impermissible assignments:

- (1) causes of action for legal malpractice arising out of litigation (*Zuniga v. Groce, Locke & Hebdon*, 878 S.W.2d 313 (Tex. App.–San Antonio 1994, writ ref'd));
- (2) Mary Carter agreements (*Elbaor v. Smith*, 845 S.W.2d 240 (Tex. 1992));
- (3) the assignment of a tort claim to one tortfeasor so that tortfeasor can prosecute the claim against another tortfeasor (*International Proteins Corp. v. Ralston-Purina Co.*, 744 S.W.2d 932 (Tex. 1988)); and
- (4) the assignment of an interest in an estate (*Trevino v. Turcotte*, 564 S.W.2d 682 (Tex. 1978)).<sup>13</sup>

According to the court, Pearce's settlement with Gandy did not terminate the litigation but prolonged it because Gandy wanted to recover against State Farm rather than Pearce.<sup>14</sup> The court also found that the settlement "greatly distorted" the litigation against State Farm.<sup>15</sup>

As an example, the court noted that in her lawsuit against Pearce, Gandy had claimed that she suffered \$50,000 in damages each time Pearce abused her (325 times). However, at the time of settlement, Gandy's lawyer claimed that \$12,500 per incident fairly compensated for Gandy's injuries. In the lawsuit against State Farm, Gandy took the position that her damages were actually far less than the judgment amount in order to establish that Pearce was damaged by State Farm's negligent handling of his defense. The court explained that this last change in position was necessary in order to create damages for Pearce because, if the damages were as those in the agreed judgment, then Pearce would not have been damaged by State Farm's mishandling of his defense.<sup>16</sup>

The court also mentioned the change in Pearce's position. Pearce, when Gandy's suit was first filed, denied ever abusing her. Then he agreed to a \$6 million judgment that stated he abused her 325 times in two years. Later, in the lawsuit against State Farm, Pearce again denied

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<sup>10</sup> *Id.* at 720.

<sup>11</sup> *Id.* at 705.

<sup>12</sup> *Id.* at 705-07.

<sup>13</sup> *Id.* at 707-11.

<sup>14</sup> *Id.* at 711-12.

<sup>15</sup> *Id.* at 712.

<sup>16</sup> *Id.*

that he abused Gandy at all and claimed that he could have proven his innocence if State Farm had provided him with competent counsel.<sup>17</sup>

While taking inconsistent positions is not generally prohibited, the court found the change suspect because both Gandy and Pearce took positions contrary to their natural interests so that a judgment might be secured against State Farm. Thus, the court found the agreed judgment was a sham and held the assignment invalid.<sup>18</sup>

The court, however, did not conclude that all settlements involving an assignment of rights in exchange for a covenant not to execute are invalid. Rather, the court held that an assignment of an insured's claim against his or her insurer to the plaintiff is invalid if:

- (1) it is made prior to an adjudication of plaintiff's claim against defendant in a fully adversarial trial,
- (2) defendant's insurer has tendered a defense, and
- (3) either:
  - (a) defendant's insurer has accepted coverage, or
  - (b) defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim.<sup>19</sup>

The "fully adversarial trial" requirement was very important to the court. The court stated, "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 by plaintiff as defendant's assignee."<sup>20</sup> The court disapproved any contrary language in *Employers Casualty Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), and *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 F.2d 949, 954 (5th Cir. 1990).<sup>21</sup>

The court felt that requiring an adjudication of the plaintiff's claim in a fully adversarial trial would insure a fair determination of the value of such a claim rather than allowing the parties to place a value on the claim and thereby forcing the possibility of having to take positions inconsistent with their interests.<sup>22</sup> The court did say that if the plaintiff and insured

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<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 712-13.

<sup>19</sup> *Id.* at 714.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 713-14.

settle after a fully adversarial trial, “the value of the [plaintiff’s] claim can be taken to be the amount of the judgment obtained.”<sup>23</sup>

What if these elements are not all present? We do not know. The court said, “We do not address whether an assignment is also invalid if one or more of these elements is lacking.”<sup>24</sup>

While the court did not give guidance on what type of agreement would be valid, the court did not say that all similar agreements would be bad. The court noted that these types of settlements frequently arise in situations where the defendant has asked the insurer to provide a defense and the insurer has refused or has provided a qualified defense. In those cases, the settlement is designed to protect the defendant from personal liability, which the court recognized as a legitimate concern.

However, the court felt that this concern could be better addressed by resolving the issue of the insurer’s obligation to defend before the plaintiff’s claim is adjudicated, such as by a declaratory judgment action. This provided the rationale for the court’s requirement that the insurer make a good faith effort to adjudicate coverage issues prior to the resolution of the plaintiff’s claim.

The *Gandy* decision created such great uncertainty, that defendant/insureds and plaintiffs were at great peril in trying to guess what agreements could be made when an insurer breached its obligations. The decision was greeted as a tremendous win for insurers.<sup>25</sup>

### C. Problems with the *Gandy* elements

#### 1. *Requiring the insurer to make a good faith effort to determine coverage*

In *State Farm Fire & Casualty Co. v. Gandy*,<sup>26</sup> the court upset the established constitutional rules regarding declaratory relief. The court cited as one factor for voiding the agreement whether the insure made a good faith effort to determine coverage before the underlying suit was resolved. The court even speculated that it may be in everyone’s interest to know if there is coverage before litigating liability.<sup>27</sup>

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<sup>23</sup> *Id.* at 713.

<sup>24</sup> *Id.* at 714.

<sup>25</sup> See, e.g., Michael J. Huddleston, *An Affair to Forget – Texas Supreme Court Drives A Stake Into Sweetheart Deals*, 6 COVERAGE 3 (1996) (Mike Huddleston was one of the lawyers who successfully represented the insurer in *Gandy*, so he was entitled to crow a bit.); David L. Plaut, *Gandy Busts Up Sweetheart Deals For Good*, 60 TEX. BAR J. 1112 (1997); Timothy D. Howell, *So Long “Sweetheart” – State Farm Fire & Casualty Co. v. Gandy Swings the Pendulum Further to the Right As the Latest In A Line of Setbacks for Texas Plaintiffs*, 29 ST. MARY’S L. J. 47 (1997).

<sup>26</sup> 925 S.W.2d 696 (Tex. 1996).

<sup>27</sup> *Id.* at 714.

The problem is that the court encouraged the insurer to do something that was impossible under the law. Prior to *Gandy*, Texas law permitted a declaratory judgment on the duty to defend. Normally, it did not permit a declaratory judgment on the duty to indemnify, while the underlying tort suit was pending. The rationale was that such a determination would be an advisory opinion, which was precluded by the Texas Constitution, as the court held in *Firemen's Insurance Co. v. Burch*.<sup>28</sup> In *Gandy*, the supreme court ignored *Burch* and this constitutional mandate. Directly contrary to *Burch*, the *Gandy* court stated that a liability insurer should attempt to determine its duty to indemnify before the underlying tort suit is decided. This language – dicta or holding – cannot be reconciled with *Burch*, but the court did not overrule or distinguish *Burch's* constitutional interpretation. Thus, insurers and insureds were left not knowing whether a declaratory judgment must be sought on the duty to indemnify, or whether such a declaration is forbidden.

The court then attempted to clarify matters in *Farmers Texas County Mutual Insurance Co. v. Griffin*.<sup>29</sup> In *Griffin*, the insured drove a vehicle from which gunshots were fired, injuring a pedestrian. The driver's insurer filed suit seeking a declaration that it had no duty to defend its insured and no duty to indemnify him. The policy covered liability for bodily injury resulting from an "auto accident."

The court recognized the conflict between *Gandy* and *Burch* on the ability to use a declaratory judgment suit to litigate coverage when the underlying suit has not been resolved. The court recognized that the duties to defend and indemnify are separate. The court held that the constitutional language upon which *Burch* was grounded had been modified – even though this wasn't mentioned in *Gandy* – so that under *Gandy*, "parties may secure a declaratory judgment on the insurer's duty to indemnify before the underlying tort suit proceeds to judgment."<sup>30</sup> The court now concluded:

It may sometimes be necessary to defer resolution of indemnity issues until the liability litigation is resolved. In some cases, coverage may turn on facts actually proven in the underlying lawsuit. For example, the plaintiff may allege both negligent conduct and intentional conduct; a judgment based upon the former type of conduct often triggers the duty to indemnify, while a judgment based on the latter usually establishes the lack of a duty. In many cases, however, the court may appropriately decide the rights of the parties before judgment is rendered in the underlying tort suit.

We now hold that the duty to indemnify is justiciable before the insured's liability is determined in the liability lawsuit when the insurer has no duty to defend *and the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify*. Based on the facts and the rule we announce today, Farmers has no duty to indemnify Royal. No facts

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<sup>28</sup> 442 S.W.2d 331, 333-35 (Tex. 1968).

<sup>29</sup> 955 S.W.2d 81 (Tex. 1997).

<sup>30</sup> 955 S.W.2d at 83.

can be developed in the underlying tort suit that can transform a drive-by shooting into an “auto accident.” Farmers has no duty to defend, and, for the same reasons, has no duty to indemnify Royal.<sup>31</sup>

Thus, in many cases the coverage issue is not ripe until the underlying liability issues are resolved.<sup>32</sup>

Naturally, if insurers are commanded to resolve coverage issues before the underlying case is resolved, the failure to do so could be a waiver of the right to dispute coverage. However, the insurer can't waive a right it doesn't have.<sup>33</sup>

Another problem with requiring the insurer to litigate coverage is that the plaintiff, under existing case law, is not considered a proper party to that suit.<sup>34</sup> While a plaintiff may choose to participate, if he does not the insurer may have to relitigate coverage against the plaintiff.

Insurers face trouble in federal court as well. While federal courts have the power to declare whether there is a duty to indemnify, they will typically abstain from doing so until the underlying issues are resolved so as to avoid conflicting findings.<sup>35</sup>

Thus, *Gandy* encourages insurers to always file declaratory judgment suits to determine the duty to indemnify, before the underlying suit is resolved. Yet *Griffin* holds that only in certain narrow circumstances will coverage be justiciable by a Texas court. As illogical and inefficient as it seems, insurers will be tempted to file a declaratory judgment suit anyway, to better position themselves to take advantage of *Gandy*'s protections, whatever they are, against a deal between the plaintiff and the defendant.

Despite recognizing in *Griffin* that the ability to litigate coverage issues is very narrow, the court has continued to essentially require insurers to do so. As the court – incorrectly – said in the *Matagorda* case, rejecting the insurer's effort to seek reimbursement after settling a non-covered claim:

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<sup>31</sup> *Id.* at 84 (emphasis by the court); see also *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 528 (5th Cir. 2004).

<sup>32</sup> See, e.g., *State Farm Lloyds v. C.M.W.*, 53 S.W.3d 877, 893 (Tex. App.–Dallas 2001, pet. denied).

<sup>33</sup> In *State Farm Lloyds v. C.M.W.*, 53 S.W.3d 877, 892-93 (Tex. App.–Dallas 2001, pet. denied), the plaintiff argued that the insurer waived its coverage defenses by failing to follow *Gandy*'s mandate to resolve those issues before the underlying case was resolved. Relying on *Burch* and *Griffin*, the court of appeals rejected this argument.

<sup>34</sup> See, e.g., *State & County Mut. Fire Ins. Co. v. Walker*, 228 S.W.3d 404, 411 & nn. 15-16 (Tex. App.–Fort Worth 2007, no pet.). If the insurer does sue the plaintiff, and the plaintiff does not object, then the insurer cannot argue that the plaintiff lacks standing to litigate coverage. *Spruiell v. Lincoln Ins. Co.*, No. 07-97-0336-CV, 1998 WL 174722, at \*1 (Tex. App.–Amarillo 1998, no pet.).

<sup>35</sup> See, e.g., *Wilton v. Seven Falls Co.*, 515 U.S. 277, 283 (1995); *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 536-37 (5th Cir. 2004); *Admiral Ins. Co. v. Little Big Inch Pipeline Co.*, 523 F.Supp.2d 524, 545-46 (W.D. Tex. 2007).

We recognize that, however the issue is resolved, either the insurers or insureds will face a difficult choice when coverage is questioned. But an insurer in such a situation that cannot obtain the insured's consent may, among other options, seek prompt resolution of the coverage dispute in a declaratory judgment action, a step we have encouraged insurer's in TAC's position to take. ... In *Gandy*, we required insurers either to accept coverage or make a good-faith effort to resolve coverage before resolving the underlying claim. ... TAC's position undermines *Gandy* by reducing the insurer's incentive to seek early resolution of coverage disputes.<sup>36</sup>

The court has now twice penalized insurers that don't file declaratory judgment suits to litigate coverage while the underlying case is pending, even though that was prohibited by *Burch* and only narrowly allowed by *Griffin*. *Gandy* says the failure to do so may be a factor in enforcing an agreement between the insured and plaintiff that is adverse to the insurer. *Matagorda* says the failure was a justification for denying the insurer's reimbursement claim.

Having made up this ability in *Gandy*, the court now believes it is true.

The court repeated its position in the decision on rehearing in *Frank's Casing*, saying that "an insurer may seek prompt resolution of its coverage dispute, a course we have encouraged insurers in this position to take."<sup>37</sup> The court in *Frank's Casing* did recognize that the insurer has other options when it has a coverage dispute. The insurer may refuse to participate in a settlement and rely on the coverage action, leaving the insured to settle with its own resources; or, if the coverage position is difficult to assess, the insurer can leverage the coverage dispute during settlement negotiations to lower the plaintiff's demand.<sup>38</sup>

The court has not explained what insurers are to do when the coverage issue is not ripe or overlaps the issues to be litigated in the underlying suit. How can an insurer make a good faith effort to litigate the coverage issue? Unfortunately, it is easier for counsel representing an insurer to follow *Gandy*'s blandishment and file a declaratory judgment suit in all cases – thereby earning *Gandy*'s indicia of "good faith" as a protection against an assignment – than to thoughtfully decide whether a declaratory judgment suit is proper. Cautious counsel for the insurer may reason it is better for the declaratory judgment court to reject the attempt than for the insurer to take the risk that by failing to make the attempt the insurer makes the potential for a deal between the insured and the plaintiff more viable.

The needless encouragement of ineffective declaratory judgment suits has disadvantages for everyone. The insurer incurs additional cost. The defendant/insured, who already has been sued by the plaintiff and hoped to be protected by insurance, now faces its insurer as an

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<sup>36</sup> *Texas Ass'n of Counties County Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 135 (Tex. 2000) (citing *Gandy* and *Griffin*). The court chided TAC for filing a declaratory judgment suit and then failing to get it resolved before the underling case was settled. 52 S.W.3d at 135 n. 6.

<sup>37</sup> *Excess Underwriters at Lloyd's London v. Frank's Casing Crew & Rental Tools*, No. 02-0730, 2008 WL 274878, at \*4 (Tex. Feb. 15, 2008) (citing *Gandy* and *Griffin*).

<sup>38</sup> *Frank's Casing*, at \*4.

adversary in a second suit. The plaintiff now faces the dilemma of joining or not joining the declaratory judgment suit, which may affect his ability to recover. Further, both the defendant and plaintiff are now presented the challenge of getting adequate representation in the coverage suit, at their own expense, which may not be possible.

The court needs to fix this problem – either by dropping the good-faith-attempt-to-litigate-coverage element, or by adapting it to what is actually possible.

2. **Holding that assignment is invalid if insurer accepts coverage or makes effort to adjudicate coverage**

The *Gandy* decision is replete with dicta. In fact, the majority opinion goes on for twelve pages in the reported decision before West's editors found a holding to mark with a head note.<sup>39</sup> A concurring justice noted that substantial portions of the opinion were not needed to decide the case, and he was "not confident that the conclusions implicit in these discussions are correct."<sup>40</sup>

Nevertheless, despite its sweeping dicta, the *Gandy* decision did explicitly set out certain holding, including the following:

Balancing the various considerations we have mentioned, we hold that a defendant's assignment of his claims against his insurer to a plaintiff is invalid if (1) it is made prior to an adjudication of plaintiff's claim against defendant in a fully adversarial trial, (2) defendant's insurer has tendered a defense, and (3) either (a) defendant's insurer has accepted coverage, or (b) defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim. We do not address whether an assignment is also invalid if one or more of these elements is lacking. . . .<sup>41</sup>

The problem is that the court voided the assignment even though the insurer had *not* accepted coverage or made a good faith effort to adjudicate coverage. State Farm did not accept coverage; it defended Pearce under a reservation of rights, as the court repeatedly noted.<sup>42</sup>

State Farm said it was going to file a declaratory judgment action to resolve coverage issues.<sup>43</sup> But State Farm did not. As the court noted, State Farm did not attempt to litigate the coverage issues until after the agreement was entered into and Gandy sued State Farm to collect.<sup>44</sup> The court even complained that it was doubtful Gandy and Pearce ever would have

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<sup>39</sup> See 925 S.W.2d at 697-709.

<sup>40</sup> 925 S.W.2d at 720 (Enoch, J., concurring). Others have questioned the breadth and accuracy of the decisions. See *Scottsdale Ins. Co. v. Sessions*, 331 F.Supp.2d 479, 488 (N.D. Tex. 2003) (dicta in *Gandy* announces questionable principles).

<sup>41</sup> *Id.* at 714 (emphasis added).

<sup>42</sup> 925 S.W.2d at 699-700, 703.

<sup>43</sup> *Id.* at 699. The court noted that the insurer sent a letter stating, "Also, please be advised State Farm will be filing a Declaratory Relief Action, asking the court to resolve issues of coverage in this matter."

<sup>44</sup> *Id.* at 703-04.



entered into their agreement if the coverage issue had been resolved early on in Gandy's litigation against Pearce.<sup>45</sup>

Thus, even the court's "holding" was dicta, because the insurer did not satisfy the elements the court held justified voiding the assignment.

**3. Holding that insurers are deterred from wrongfully denying defense and refusing to pay**

As previously noted, the potential for an agreement between the plaintiff and defendant had the desirable effect of giving the insurer an incentive not to abandon the defendant. To the extent the *Gandy* court removed this threat, and offered no equivalent protection, the court left insurers in a position to abandon their insureds, with little or no risk to the insurer.

At one point, the court said that if the insurer lost a declaratory judgment on coverage, then the defendant could recover attorney's fees and a statutory penalty of 18% of the claim.<sup>46</sup> The court further opined that, "An insurer has ample disincentives to deny coverage or a defense without good reason: it will be liable for its own attorney fees in litigating the dispute and may be liable for the insured's attorney fees, a statutory penalty [presumably the 18%], and even bad faith damages."<sup>47</sup> Problems with these statements are that they were questionable when made, and the court hasn't stood by them.

Despite saying in *Gandy* that a defendant/insured was protected by the threat of "a statutory penalty, and even bad faith damages," shortly after that the court refused to apply the common law duty of good faith and fair dealing to liability claims, and refused to allow treble damages or a statutory penalty to a defendant/insured complaining of the insurer's bad faith refusal to defend and pay a claim.<sup>48</sup>

It took a decade of litigation that split the intermediate courts before a divided supreme court in *Lamar Homes v. Mid-Continent* upheld the principle *Gandy* announced that an insurer that breached its duty to defend would be liable for an 18% penalty under the prompt payment of claims statute.<sup>49</sup> Significantly, Justice Hecht, who had authored the *Gandy* opinion, which was unanimous on this point, reneged in *Lamar Homes*, joining a dissent that argued that insurers shouldn't have to pay after all.<sup>50</sup> Another point undermining the protections is that the 18% penalty in *Lamar Homes* only applies to the defendants unpaid fees, not to the amount of "the claim," as *Gandy* had boasted.

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<sup>45</sup> *Id.* at 712.

<sup>46</sup> 925 S.W.2d 714.

<sup>47</sup> *Id.*

<sup>48</sup> See *Maryland Ins. Co. v. Head Indus. Coatings & Serv., Inc.*, 938 S.W.2d 27, 29 (Tex. 1996).

<sup>49</sup> *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 16-19 (Tex. 2007).

<sup>50</sup> *Id.* at 25-29 (Brister, J., dissenting, joined by Hecht, J.) (on rehearing).

One factor that motivated the *Gandy* court to void the agreement was the fact that the insurer had tendered a defense. The court did not address the facts that the tendered defense was alleged to be a bad defense. The insured alleged and offered proof that the defense lawyer who was paid by the insurer had no competence to defend the case and was mishandling the case, but the insurer never advised the defendant that the insurer would pay for another lawyer, despite his repeated complaints.<sup>51</sup>

Defendants do have meaningful common law and statutory remedies if the insurer refuses to settle a liability claim.<sup>52</sup> The statutory cause of action recognized in *Rocor* for failing to settle once the insurer's liability was reasonably clear would also apply to an insurer's unreasonable failure to pay. Nevertheless, except for the 18% penalty on defense costs recognized in *Lamar Homes*, there is no meaningful disincentive to keep a liability insurer from refusing to defend. An unscrupulous insurer may be tempted to wrongfully deny a defense, knowing that the defendant cannot seek protection in a deal with the plaintiff and has no other effective options.

The *Gandy* court pointed out that the holding voiding the assignment was based, in part, on the fact that the insurer had tendered a defense. The court left open the question whether such an agreement would be void if the insurer wrongly refused to defend. In a case where the insurer did fail to defend, leaving the defendant to fend for himself, perhaps a later court will take the invitation *Gandy* extended and will allow an assignment of the defendant's claim.

#### 4. *Uncertainty about options for defendant/insureds and plaintiffs*

The biggest problem created by *Gandy* was that it provided no guidance for how defendant/insureds could protect themselves, and what rights a plaintiff could obtain and how.

*Gandy* held that the assignment was invalid in the circumstances of that case – i.e., it was made prior to an adjudication of the plaintiffs' claim in a fully adversarial trial; the insurer tendered a defense; and the insurer either accepted coverage or made a good faith effort to determine coverage.<sup>53</sup> Other factors the court emphasized were that the settlement did not end the litigation and distorted the litigation that followed.<sup>54</sup>

The court left open the possibility that a similar settlement might be valid in other circumstances. The court said:

Not every settlement involving an assignment of rights in exchange for a covenant to limit the assignor's liability has the problems we have described. For example, as we have said, if the settlement follows an adversarial trial, the

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<sup>51</sup> See 925 S.W.2d at 704.

<sup>52</sup> See *American Phys. Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849-51 (Tex.1994) (recognizing common law cause of action for negligent failure to settle); and *Rocor Int'l, Inc. v. Nat'l Union Fire Ins. Co.*, 77 S.W.3d 253, 260 (Tex. 2002) (recognizing statutory cause of action for unfair refusal to settle).

<sup>53</sup> 925 S.W.2d at 714.

<sup>54</sup> *Id.* at 711-12.

difficulties in evaluating *P*'s claim are no longer present. That value has been fairly determined. We should not invalidate a settlement that is free from this difficulty simply because it is structured like one that is not.<sup>55</sup>

Further, the court stated: "As we have said, we do not address whether an assignment is invalid when any element of the rule is lacking, such as when an insurer has not tendered a defense of its insured."<sup>56</sup>

However, the court warned that it wasn't committing to upholding any deal, either. The court said:

We do not address whether an assignment is also invalid if one or more of these elements is lacking. 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 by plaintiff as defendant's assignee. We disapprove the contrary suggestion in dicta in *Employers Casualty Company v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), and *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 S.W.2d 949, 954 (5th Cir. 1990).<sup>57</sup>

The disapproved decisions in *Block* and *Olympia Wings* said that when an insurer wrongly refused to defend, the insurer could not challenge an agreed judgment between the plaintiff and the defendant/insured. Thus, the *Gandy* decision appeared to foreclose the option of an agreed judgment, even if the insurer refused to defend.

The *Gandy* court gave insurers a "heads-I-win, tails-you-lose" victory. If an insurer defended, the defendant/insured could not make an agreement that bound the insurer. If the insurer refused to defend, the defendant/insured still could not make an agreement that bound the insurer. So defendants were left with nothing to offer and nothing to protect themselves. Plaintiffs were left with no alternative but to attempt to litigate – in a fully adversarial trial – the defendant/insured's liability, even if the defendant had been abandoned by the insurer and left, literally, defenseless.

The safest course for a plaintiff was to attempt to litigate the defendant/insured's liability in a "fully adversarial trial" (whatever that is). Then, by turnover order or assignment, the plaintiff would attempt to pursue the defendant/insured's rights against the insurer. Having litigated liability against the defendant, the plaintiff had no incentive to give a covenant not to execute, so the defendant remained exposed.

The insurer, even one that wrongly abandoned the defendant/insured, could then relitigate damages, by showing that what happened before was not a "fully adversarial trial." Having

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<sup>55</sup> *Id.* at 714.

<sup>56</sup> *Id.* at 719.

<sup>57</sup> *Id.* at 714.

failed to defend its insured, the insurer now had a chance to litigate on its own behalf, with no penalty for its prior breach.<sup>58</sup>

#### IV. Post-Gandy: Continued hostility towards assignments

If anyone was tempted to find a way to craft an effective settlement and assignment that would survive supreme court review, that temptation would be chilled by a non-insurance decision by the supreme court that appeared to foreshadow how the court would decide whether, and to what extent, an insured may assign to a third-party claimant the insured's claims against an insurer.

In *PPG Industries, Inc. v. JMB/Houston Centers Partners Ltd.*<sup>59</sup> a buyer of a commercial building sued the manufacturer of defective windows under the DTPA for breach of warranty. The buyer asserted its right to sue based on a general assignment by the original owner of all warranties. The court held that the DTPA claim was not assignable.<sup>60</sup>

Relying on the decision in *State Farm v. Gandy*, the court held that a more important reason not to allow assignment of the DTPA claim was because an assignment might "increase or distort litigation." The court stated that it had "prohibited assignments that may skew the trial process, confuse or mislead the jury, promote collusion among nominal adversaries, or misdirect damages from more culpable to less culpable defendants."<sup>61</sup>

The court reasoned that juries would be confused by assessing the mental anguish suffered by the consumer and the punitive damages based on the situation and sensibilities of the parties, only to have that money go to an assignee.<sup>62</sup> The court also feared that an assignment would give the seller and purchaser "a strong incentive to direct the suit elsewhere for relief" and would cause the litigation to continue with the parties in different roles – "precisely the results that have led us to prohibit assignments in other contexts."<sup>63</sup> Assignability, the court opined, "may encourage some buyers to cooperate – if not collude – with a seller who may have been the one that actually misled them."<sup>64</sup>

So, because of concerns about naïve consumers being misled into assigning their claims, and then cunningly colluding with their assignees to confusingly obtain mental anguish and punitive damages against less culpable product sellers, the court held DTPA claims aren't assignable – in a case where the sophisticated consumer was not duped into making the

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<sup>58</sup> As discussed below in part V, the recent decision in *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, No. 03-0647, 2008 WL 400394 (Tex. Feb. 15, 2008), offers some hope.

<sup>59</sup> 146 S.W.3d 79 (Tex. 2004).

<sup>60</sup> *Id.* at 92.

<sup>61</sup> *Id.* at 90.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 91.

assignment, did not and could not seek mental anguish damages, and recovered treble damages under a version of the statute repealed twenty years ago, all with no evidence of any collusion.

The four dissenting justices would have held the DTPA claim was assignable, for the most part, because the assignment did not present the concerns that led to voiding assignments in other cases. The dissenters distilled the twofold concerns as: first, prolonging the suit rather than resolving the litigation; and, second, distorting the litigation by causing the parties to take positions that appeared contrary to their natural interests.<sup>65</sup>

A particularly inexplicable aspect of the majority's reasoning is its view that an assignment should be voided if it prolongs the litigation and directs the litigation elsewhere. Why would there be an assignment if not to pursue it? Does the court seriously mean the only valid way to assign a right to sue is if the assignee doesn't use it?

And what of the concern about the suit being directed elsewhere? Isn't that exactly why there is an assignment – so the assignee will pursue the claim against someone besides the assignor? Isn't that the value the assignor gets?

While this was not an insurance case, the analysis of both the majority and the dissenters appears likely to fuel arguments in future insurance cases about whether, and to what extent, an insured defendant can assign to a plaintiff his claims under Texas Insurance Code chapter 541 (a companion to the DTPA) and other claims against his insurer.

*Gandy* voided the assignment based on the circumstances in that case. The *PPG* case broadly prohibits assignment of DTPA claims. Nevertheless, claims generally are assignable, so unless the court is in full retreat from this position, there must be circumstances where assignments – that somehow navigate the court's evolving policy concerns – are valid.

## V. Limiting *Gandy* - an apparent solution: *Evanston v. ATOFINA*

The supreme court had an opportunity to clarify the limits of *Gandy*, and the rights and remedies of defendant/insureds, in *Evanston Insurance Co. v. ATOFINA Petrochemicals, Inc.*<sup>66</sup> ATOFINA was sued over the death of a worker who was employed by another company. ATOFINA contended that it was an additional insured under an excess policy issued by Evanston. Evanston refused to provide coverage, contending that ATOFINA's sole negligence was the cause of the loss and was excluded. ATOFINA then settled with the plaintiffs and sought to collect from Evanston.

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<sup>65</sup> *Id.* at 107 (O'Neill, J., dissenting).

<sup>66</sup> No. 03-0647, 2008 WL 400394 (Tex. Feb. 15, 2008). This case had an arduous path. It was decided per curiam by the Beaumont Court of Appeals in April 2003. *See* 104 S.W.2d 247 (Tex. App.–Beaumont 2003). Review was granted by the supreme court in March 2005, and the case was argued April 13, 2005. The supreme court originally decided the case May 5, 2006, granted rehearing October 27, 2006, and handed down the revised decision February 15, 2008.

The court first found that ATOFINA was covered by the Evanston policy as an additional insured. The court then considered the insurer's argument that it was not bound by the settlement because ATOFINA failed to show the settlement was reasonable. ATOFINA responded that the insurer's wrongful denial of coverage barred it from challenging the reasonableness of the settlement.

The court reached back to – and revived – its decision in *Employers Casualty Co. v. Block*<sup>67</sup> to hold that the insurer's denial of coverage barred it from challenging the reasonableness of the settlement.

The ATOFINA court reaffirmed the holding in *Block* that the insurer “was barred from collaterally attacking the agreed judgment by litigating the reasonableness of the damages recited therein . . . [.]”<sup>68</sup> The *Block* decision bound the insurer to an amount set by an agreed judgment, which was not the result of a fully adversarial trial. The ATOFINA court extended this reasoning to include a settlement agreement between the plaintiffs and the defendant/insured [ATOFINA].

In addition to *Block*, the ATOFINA court cited with approval the Fifth Circuit decisions in *Western Alliance Insurance Co. v. Northern Insurance Co.*<sup>69</sup> and *Enserch Corp. v. Shand Morahan & Co.*,<sup>70</sup> which held that an insurer that breaches its duty to defend cannot contest the defendant/insured's liability or the reasonableness of the amount of the underlying settlement or judgment.

The ATOFINA court held that the equitable principles of estoppel and waiver found in *Block* were triggered by the insurer's denial of coverage by letter and by its assertion of no coverage in its pleadings throughout the coverage suit.<sup>71</sup>

The ATOFINA court further held that an insurer would be estopped to challenge the settlement whether it attempted to rely on a policy provision or to assert that the amount was unreasonable.<sup>72</sup>

In *Block*, the insurer was estopped to challenge the judgment, because the insurer had violated its duty to defend. In ATOFINA, the excess insurer had no duty to defend, but had wrongfully denied coverage. The ATOFINA court held this distinction was unimportant. What was important, and justified barring the insurer's ability to challenge the settlement, was that the insurer had notice and an opportunity to participate in the settlement discussion.<sup>73</sup>

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<sup>67</sup> 744 S.W.2d 940 (Tex. 1988).

<sup>68</sup> 2008 WL 400394, at \*8.

<sup>69</sup> 176 F.3d 825, 830 (5th Cir. 1999).

<sup>70</sup> 952 F.2d 1485, 1495-96 (5th Cir. 1992).

<sup>71</sup> 2008 WL 400394, at \*8 & n. 60.

<sup>72</sup> 2008 WL 400394, at \* 8.

<sup>73</sup> *Id.*

The court cited with approval the court of appeals decision in *Ranger Insurance Co. v. Rogers*<sup>74</sup> for the proposition that “[h]ad [the insurer] accepted the defense, it would have had, of course, the opportunity to conduct the defense in a manner most likely to have defeated the plaintiff’s claim or at least to have reduced the amount of damages.”<sup>75</sup> The *ATOFINA* court reasoned that if the insurer, Evanston, had not denied coverage it would have been able to influence the amount of the settlement.<sup>76</sup>

The *ATOFINA* court also reaffirmed the decision in *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*,<sup>77</sup> which it cited for the proposition that an insurer that flatly refuses to defend cannot contest the reasonableness of a consent judgment agreed to between the defendant/insured and the plaintiff, while an insurer that offers a defense under a reservation of rights can contest the reasonableness of a settlement.<sup>78</sup>

But wait! What about the *Gandy* court’s admonition that “in no event” could the plaintiff and defendant/insured bind the insurer to a judgment amount without a “fully adversarial trial”? What about *Gandy* disapproving contrary suggestions in “dicta” in *Block* and *Olympia Wings*?

The court in *Evanston v. ATOFINA* found *Gandy* was not controlling. The *ATOFINA* court found that *Gandy*’s holding was “explicit and narrow, applying only to a specific set of assignments with special attributes”<sup>79</sup> and that *Gandy*’s invalidation applies only to cases that present its “five unique elements.”<sup>80</sup>

First, this case did not fall within *Gandy*’s holdings, because the “key factual predicate” of an assignment was missing. This removed the case from the “formal bounds of *Gandy*.”<sup>81</sup>

Second, the court reasoned that *Gandy* was concerned about assignments that made evaluating the merits of the plaintiff’s claim difficult by prolonging disputes and distorting trial litigation motives, but not all cases implicate those concerns.<sup>82</sup> Invoking *Gandy*’s own language,

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<sup>74</sup> 530 S.W.2d 162, 167 (Tex. Civ. App.–Austin 1975, writ ref’d n.r.e.).

<sup>75</sup> 2008 WL 400394, at \* 9 & n. 63.

<sup>76</sup> 2008 WL 400394, at \* 9 & n. 64. The concurring justice put it more bluntly, saying: “An insurer that wrongly refuses to defend a claim, leaving its insured to defend himself, can hardly be allowed to argue that it would have done a better job.” *Id.* at \* \_\_\_ (Hecht, J., concurring).

<sup>77</sup> 896 F.2d 949 (5th Cir. 1990).

<sup>78</sup> 2008 WL 400394, at \* 9 & n. 65.

<sup>79</sup> 2008 WL 400394, at \* 9 & n. 68.

<sup>80</sup> 2008 WL 400394, at \* 9 & n. 69. It isn’t entirely clear what the *ATOFINA* court meant by the “five unique elements.” The court may mean the elements that the agreement (1) prolonged and (2) distorted the litigation, and (3) was made prior to an adjudication of the plaintiff’s claim, (4) the insurer tendered a defense, and (5) the insurer (a) accepted coverage or (b) made a good faith effort to adjudicate coverage. See *Gandy*, 925 S.W.2d at 711-12, 714.

<sup>81</sup> 2008 WL 400394, at \* 9.

<sup>82</sup> 2008 WL 400394, at \* 9 & n. 71.

the *ATOFINA* court noted, “We should not invalidate a settlement that is free from this difficulty [of fairly evaluating a plaintiff’s claims] simply because it is structured like one that is not.”<sup>83</sup>

The *ATOFINA* court found that barring the insurer from challenging the settlement shortened litigation, instead of prolonging it. Further, the settlement did not distort the litigation. Because *ATOFINA* settled without knowing if the claim was covered, it had an incentive to minimize the settlement in case it had to pay.<sup>84</sup> The court concluded that the insurer was liable for the settlement amount.<sup>85</sup>

So it appears that *Gandy* is limited to cases where the insurer has tendered a defense, while *ATOFINA* – and the revived *Block* – will control whenever the insurer breaches its duty to defend or duty to pay. Logically, the court might also extend the reasoning of *ATOFINA* to other breaches by an insurer, such as breach of the duty to settle.<sup>86</sup>

## VI. Issues to consider

The *Gandy* court identified several concerns that justified voiding the agreement in that case. The court held the assignment was invalid because, first, it did not end the litigation but instead prolonged it, and, second, the assignment greatly distorted the litigation that followed, by causing the parties to change their positions.<sup>87</sup> Additional factors the court relied on to invalidate the assignment were if “(1) it is made prior to an adjudication of plaintiff’s claim against

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<sup>83</sup> 2008 WL 400394, at \* 9 & n. 72.

<sup>84</sup> 2008 WL 400394, at \* 10 & n. 73.

<sup>85</sup> Remarkably, the concurring justice, Justice Hecht, authored *Gandy*. He wrote in *Gandy* that in “no event” would the insurer be bound by a judgment that was not the result of a fully adversarial trial. 925 S.W.2d at 714. Now, in *ATOFINA* he wrote: “An insurer that breaches its duty to defend a claim cannot later be heard to complain that the amount the insured paid in settlement was unreasonable, absent evidence of collusion. This is what we held in *Employers Casualty Co. v. Block*, and as far as I can tell, it is uniformly the rule throughout the country.” 2008 WL 400394, at \*\_\_\_ (footnotes omitted). Justice Hecht then would allow an insurer that breached its duty to defend to be held liable for an amount agreed to in settlement, without a fully adversarial trial, but he would have remanded to determine the fact question of whether the settlement was reasonable.

<sup>86</sup> One commentator compared the *Gandy* decision and its “tort reform” mindset to a defense-oriented swing of the pendulum. He invoked the metaphor of Edgar Allan Poe’s *The Pit and the Pendulum*. There, a victim of the Spanish Inquisition finds himself facing death as a razor-sharp pendulum swings back and forth. He escapes the pendulum only to face death again as the walls of the chamber close in to crush him. (Any Texas plaintiff in the past twenty years can relate.) He escapes at the last moment when trumpets herald the arrival of a rescuing army and the fall of the Inquisition. See Timothy D. Howell, *So Long “Sweetheart” – State Farm Fire & Casualty Co. v. Gandy Swings the Pendulum Further to the Right As the Latest In A Line of Setbacks for Texas Plaintiffs*, 29 ST. MARY’S L. J. 47, 103-04 (1997).

Pushing the analogy further invites a few comments, in decreasing order of optimism. First, maybe the decision in *Evanson v ATOFINA* is the trumpet blast heralding the end of the Inquisition. Second, in the story each swing of the pendulum threatened to kill the man caught in the middle – no swing favored; all threatened. Third, in real life, the Inquisition ended mainly because it ran out of suspected heretics to torture. See *Spain*, ENCYCLOPÆDIA BRITANNICA (2008) available at <http://search.eb.com.ezproxy.lib.utexas.edu/eb/article-70389>. This comparison suggests that the law may not so much improve as run out of ways to get worse.

<sup>87</sup> 925 S.W.2d at 711-12.



defendant in a fully adversarial trial, (2) defendant's insurer has tendered a defense, and (3) either (a) defendant's insurer has accepted coverage, or (b) defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim."<sup>88</sup> Any agreement between a defendant/insured and a plaintiff should be measured against these factors.

**A. Timing of an agreement**

One factor the *Gandy* court cited in holding the assignment invalid was that it was "made prior to an adjudication of [the] plaintiff's claim against [the] defendant in a fully adversarial trial."<sup>89</sup> It seems this factor does not go so much to the validity of the agreement as to the effect. The agreement may be valid but will not bind the insurer to liability and damages that were not adjudicated. If the issues were adjudicated, they should be binding on the insurer.

An initial consideration should be the timing of an agreement. An agreement after an insurer has breached or refused to perform and obligation is more likely to be upheld as being necessary to protect the defendant/insured. Similarly, if the agreement is reached after the parties have litigated liability and damages, then the agreement is not subject to the attack that it causes the parties to change their positions. Also, a judgment in that instance would bind the insurer if it was rendered after a fully adversarial trial.

For a plaintiff with a strong claim who is simply trying to move past an insolvent defendant to collect from a solvent insurer, waiting does not pose any additional burden. Absent any form of assignment or other agreement, the plaintiff would have to acquire judgment creditor status before pursuing the insurer.

For the plaintiff with a weak claim that he hopes to bolster by getting an agreed judgment that otherwise would be unlikely, waiting may not be a viable option. Of course, this is not a legitimate interest that needs to be protected.

**B. Nature of the insurer's misconduct**

**1. In general**

Liability insurers have three basic duties: (1) the duty to defend; (2) the duty to settle; and (3) the duty to indemnify. There is a fourth type of misconduct, which may be considered a fourth duty or an obligation that arises from the other three duties – that is, (4) the duty not to interfere with coverage or defense of the claim.<sup>90</sup> Breach of any of these duties by the insurer

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<sup>88</sup> *Id.* at 714.

<sup>89</sup> *Id.*

<sup>90</sup> For example, an insurer may be estopped to deny liability if it allows the defense lawyer to develop evidence that prejudices the defendant/insured's coverage. See *Employers Cas. Co. v. Tilley*, 496 S.W.2d 552, 558 (Tex. 1973). An insurer may also incur liability if it interferes with the defense lawyer's exercise of his or her independent judgment on behalf of the defendant/insured. See *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998).

may justify allowing the defendant/insured and plaintiff options that protect their interests at the expense of the insurer.

One crucial factor in determining a defendant/insured's options is to consider the nature of the insurer's misconduct, or whether there has been any misconduct.<sup>91</sup>

When an insurer abandons the defendant/insured, then the defendant/insured is entitled to take steps to protect himself. Conversely, if the insurer is performing its obligations, then there is no need to equip the defendant/insured with alternatives. That seems to have been one of the problems in *Gandy*. It wasn't clear that the insurer breached any of its duties. The insurer defended under a reservation of rights. There was no coverage for the conduct, so there was no breach of the duty to indemnify. The court did not discuss any breach of the duty to settle. The arguable misconduct by the insurer was that it mishandled the defense by agreeing to pay a lawyer who apparently did a very poor job.

## 2. *Breach of the duty to defend*

An insurer that breaches its duty to defend cannot insist on compliance with policy conditions and cannot collaterally attack the reasonableness of a settlement between the plaintiff and defendant/insured, as the supreme court reiterated in *Evanston v. ATOFINA*.<sup>92</sup> In so holding, the court disapproved broad dicta in *Gandy* and reaffirmed the holdings of numerous Texas and Fifth Circuit decisions that an insurer that breaches its duty to defend cannot challenge a settlement or agreed judgment.<sup>93</sup> One of the important policy conditions the insurer loses is the right to rely on the "no action" clause, which provides that it will not be liable unless the

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<sup>91</sup> The *Gandy* court recognized that the relief available to a plaintiff in a subsequent suit against the insurer would vary depending on the nature of the insurer's breach. If the issue was coverage, the plaintiff would be entitled to recover from the insurer the amount he should have recovered from the defendant. If the insurer failed to settle, the plaintiff might recover the excess judgment. If the insurer mishandled the defense, the plaintiff's recovery would be the difference between the damages and the damages that would have been recovered had there been a proper defense. 925 S.W.2d at 713.

<sup>92</sup> *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, No. 03-0647, 2008 WL 400394 (Tex. Feb. 15, 2008).

<sup>93</sup> See *Employers Cas. Co. v. Block*, 744 S.W.2d 940 (Tex. 1988); *Gulf Ins. Co. v. Parker Prods., Inc.*, 498 S.W.2d 676, 679 (Tex. 1973); *Ranger Ins. Co. v. Rogers*, 530 S.W.2d 162, 167 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.); *Western Alliance Ins. Co. v. Northern Ins. Co.*, 176 F.3d 825, 830 (5th Cir. 1999); *Enserch Corp. v. Shand Morahan & Co.*, 952 F.2d 1485, 1495-96 (5th Cir. 1992); *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 F.2d 949, 954-55 (5th Cir. 1990); *Transportation Ins. Co. v. Heiman*, 1999 WL 239917, at \*3 (Tex. App.—Dallas April 26, 1999, no pet.); see also 1 Allan D. Windt, *Insurance Claims & Disputes: Representation of Insurance Companies & Insureds* §§ 3:10, 3:11 (4th ed. 2007).

One of the clearest statements of this general principle is that, "The company cannot refuse to perform its part and demand anything of the assured." *Royal Indem. Co. v. Schwartz*, 172 S.W. 581, 584 (Tex. Civ. App.—El Paso 1914, writ dismissed w.o.j.). This chestnut was uncovered by Chris Martin in his excellent article, *Insurance Issues Every Trial Lawyer Must Master*, in State Bar of Texas, Annual Meeting; Litigation: What's Hot and What's Not ch. 3, at 3 (June 23, 2005).

judgment is the result of an “actual trial.”<sup>94</sup> The defendant/insured and plaintiff thus are able to enter into a settlement agreement, enter in an agreed judgment, or allow a default judgment.

At least one court has held that an assignment was valid, when the insurer failed to tender a defense.<sup>95</sup>

Because a breach of the insurer’s duty to defend affects the rights of the parties, an initial consideration is to make sure the defendant/insured has invoked the duty to defend. If the defendant has not effectively triggered the insurer’s duty, he may have nothing to offer the plaintiff to avoid personal liability. The plaintiff as judgment creditor is subject to all contract defenses the insurer has against the defendant/insured. Thus, if the defendant/insured did not trigger the insurer’s duty, that will preclude recovery by the plaintiff against the insurer.

The plaintiff and defendant/insured should make sure the defendant/insured has given the insurer notice of the claim and has demanded a defense and coverage. Without notice of the claim and a demand for a defense and coverage, the insurer will not be liable, so the plaintiff seeking to assert the defendant/insured’s rights will get nothing.<sup>96</sup>

If the insurer has been given notice, it is then important to consider whether the duty to defend has been triggered. Obviously, if the insurer is defending, this is not a problem. If, however, the insurer has refused to defend, it is important first to determine whether the denial was proper.<sup>97</sup>

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<sup>94</sup> See, e.g., *Gulf Ins. Co. v. Parker Prods., Inc.*, 498 S.W.2d 676, 679 (Tex. 1973); see generally 5 Elaine A. Grafton Carlson, *McDonald & Carlson Texas Civil Practice* § 30:16[b] & n. 158 (2d. ed. 2003) (citing cases).

<sup>95</sup> *Reyna v. Safeway Managing Gen. Agency*, 27 S.W.3d 7, 17-18 (Tex. App.–San Antonio 2000, pet. granted, j. rev’d and remanded by agreement).

<sup>96</sup> See *Nat’l Union Fire Ins. Co. v. Crocker*, 51 Tex. Sup. Ct. J. 518, 2008 WL 400398 (Tex. Feb. 15, 2008); *Weaver v. Hartford Accident & Indem. Co.*, 570 S.W.2d 367, 370 (Tex. 1978).

<sup>97</sup> An insurer’s duty to defend is determined by the allegations in the pleadings and the language of the insurance policy. This is the “eight-corners” or “complaint allegation rule.” *GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 307-08 (Tex. 2006); *Nat’l Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997). The allegations of the complaint should be considered in light of the policy provisions, without reference to the truth or falsity of the allegations, and without reference to what the parties know or believe the true facts to be. *Argonaut Sw. Ins. Co. v. Maupin*, 500 S.W.2d 633, 635 (Tex. 1973). A court resolves all doubts regarding the duty to defend in favor of finding the duty. *Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965). When applying the eight-corners rule, a court will give the allegations in the petition a liberal interpretation. The supreme court explained:

Where the complaint does not state facts sufficient to clearly bring the case within or without the coverage, the general rule is that the insurer is obligated to defend if there is, potentially, a case under the complaint within the coverage of the policy. Stated differently, in case of doubt as to whether or not the allegations of a complaint against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in the insured’s favor.

*Heyden Newport*, 387 S.W.2d at 26 (quoted in *National Union v. Merchants*, 939 S.W.2d at 141).

If the denial of a defense, and hence coverage, was improper then the defendant/insured may be entitled to settle with the plaintiff to protect his interests. If the denial of a defense appears proper, it may be in the interest of both the defendant/insured and the plaintiff for the plaintiff to amend his pleadings to state a claim that would be covered, if the facts support it.<sup>98</sup>

An insurer that offers a “qualified defense” – that is, offers to defend under a reservation of its right later to deny coverage – does not breach its duty to defend, so the defendant/insured cannot reach an agreement with the plaintiff, without violating policy conditions that will relieve the insurer of liability.<sup>99</sup> The defendant/insured may, however, hire his own lawyer, control the defense, and require the insurer to pay the defense costs.<sup>100</sup> When the insurer offers a qualified defense, it retains the right to challenge the reasonableness of a settlement between the defendant/insured and the plaintiff.<sup>101, 102</sup>

### 3. Breach of the duty to indemnify

The supreme court in *Evanston Insurance Co. v. ATOFINA* made clear that an insurer's breach – including an anticipatory breach – of its duty to indemnify will allow the defendant/insured to take steps to protect his interests, including entering into a settlement, which the insurer will be estopped to challenge. The court relied on the reasoning of *Employers Casualty v. Block*, which held that an insurer that breaches its duty to defend cannot challenge an agreed judgment entered into by the defendant/insured. The *ATOFINA* court extended this to hold that an insurer that wrongfully denied coverage is likewise estopped to challenge a settlement entered into by the defendant/insured.<sup>103</sup>

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<sup>98</sup> See generally Ellen S. Pryor, *The Stories We Tell: Intentional Harm & The Quest For Insurance Funding*, 75 TEX. L. REV. 1721, 1734 (1997); Mark L. Kincaid, *How to Plead the Case for Coverage – Coverage: What It Is And What It Should Be*, in STATE BAR OF TEXAS INSURANCE LAW SECTION, 2D ANN. ADV. INSURANCE LAW COURSE, ch. 2 (2005); Beth D. Bradley, *Pleading Traps & Tricks: Pleading In & Out of Coverage*, in STATE BAR OF TEXAS INSURANCE LAW SECTION, *Insurance, Litigation and You: The Impact of Insurance In Litigation*, tab 3 (2004).

<sup>99</sup> See *State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38, 40 (Tex. 1998); *Motiva Enterp., LLC v. St. Paul Fire & Marine Ins. Co.*, 445 F.3d 381, 385 (5th Cir. 2006); *First Gen. Realty Corp. v. Maryland Cas. Co.*, 981 S.W.2d 495, 501 (Tex. App.–Austin 1998, pet. denied).

<sup>100</sup> See *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Aries Marine Corp.*, 932 F.2d 442, 445 (5th Cir. 1991); *American Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 173-74 (Tex. App.–El Paso 1996 writ denied); *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713, 716 (Tex. Civ. App.–San Antonio 1965, writ ref'd n.r.e.); *Housing Auth. of City of Dallas v. Northland Ins. Co.*, 333 F.Supp.2d 595, 600-01 (N.D. Tex. 2004).

<sup>101</sup> *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 F.2d 949, 954-55 (5th Cir. 1990); *Transportation Ins. Co. v. Heiman*, 1999 WL 239917, at \*4-\*5 (Tex. App.–Dallas April 26, 1999, no pet.).

<sup>102</sup> Prof. Ellen Pryor has written an excellent article detailing the remedies that are available when an insurer refuses to defend. See Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty to Defend in Texas*, 31 Tex. Tech. L. Rev. 869, 897 (2000). A shorter version appeared as *Declaratory Judgments; Remedies for Breach of the Duty to Defend* (1997).

<sup>103</sup> No. 03-0647, 2008 WL 400394 at \*8.

This holding is the flip side of the *Gandy* factor considering whether the insurer “accepted coverage.”<sup>104</sup> Under *ATOFINA*, if the insurer rejects coverage then the insurer is estopped to challenge a resulting agreement between the defendant/insured and the plaintiff. Under *Gandy*, the insurer’s acceptance of coverage is a factor that justifies voiding an agreement between the defendant/insured and the plaintiff.

One wonders why the defendant/insured would want or need to enter into an agreement if the insurer accepted coverage. The *Gandy* court did not elaborate. One instance is where the insurer accepts coverage but then fails to settle, resulting in a judgment against the defendant/insured that exceeds the policy limits. That is the next topic.

#### 4. *Breach of the duty to settle*

This circumstance avoids certain concerns of *Gandy*. Because a failure-to-settle claim usually comes after a trial and excess judgment, the requirement that an insurer will only be bound after a “fully adversarial trial” should be satisfied. The insurer should be hard-pressed to argue that a defense it controlled wasn’t adversarial enough.

There should be no concern that the position of the parties will be distorted. The plaintiff would have argued in the underlying suit that the defendant was liable, and now will argue that the defendant was so obviously liable that the insurer was unreasonable in failing to settle.

A plaintiff should consider what position the defendant took. If the defendant, through private counsel or otherwise, demanded that the insurer settle the underlying suit, then the defendant’s position in the coverage suit will be consistent. On the other hand, there may be a problem if the defendant opposed settlement but now would have to argue that the insurer should have settled. Not only would this change of positions raise the concern noted in *Gandy*, the defendant’s prior opposition could be cited by the insurer as evidence it was reasonable in refusing to settle.

Of course, an insured’s opposition to a settlement should not be determinative. If the defendant/insured was relatively unsophisticated, a more experienced insurer could not reasonably rely on the defendant/insured’s assessment of whether the case presented such risk that it should be settled. After all, insurers don’t necessarily heed their insured’s demand *to* settle, so why should they be allowed to follow the insured’s demand *not to*?

One other complexity that may arise is when the insurer got bad advice from the defense lawyers not to settle, or bad advice undervaluing the exposure. The defense lawyer may be liable to the defendant/insured for malpractice, but that claim is not assignable.<sup>105</sup> In this type of case, the defendant/insured may need to pursue the claim to obtain a source of funding to satisfy the plaintiff’s judgment.

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<sup>104</sup> 925 S.W.2d at 714.

<sup>105</sup> *Gandy*, 925 S.W.2d at 707-08 (citing *Zuniga v. Groce, Locke & Hebdon*, 878 S.W.2d 313, 317-18 (Tex. App.—San Antonio 1994, writ ref’d).

5. *Did the insurer engage in other misconduct that prejudiced the insured?*

A fourth type of misconduct was mentioned above – conduct by the insurer that prejudices the defense or coverage. Cases in this category pose the greatest uncertainty. Because the duties aren't as clearly defined, a breach of the duties also may be unclear. One problem in *Gandy*, as noted, was that it wasn't clear that the insurer breached any duty. From the procedural history, it appeared that the defendant/insured lost confidence in the conduct of his defense, but it wasn't clear whether that was because of the conduct of the insurer, the defense lawyer, or both.<sup>106</sup> The absence of a clear breach by the insurer certainly must have influenced the court's analysis.

In contrast, in *ATOFINA*, where the insurer clearly breached its duty to pay, the court had no problem holding the insurer accountable for the resulting settlement by the defendant/insured.<sup>107</sup> Thus, a defendant/insured and plaintiff seeking to reach an agreement that will be upheld need to be able to articulate clear misconduct by the insurer that makes it reasonable for the defendant/insured to take steps to protect himself.

C. Issues regarding assignments

The *Gandy* court invalidated an assignment to the plaintiff of the defendant/insured's claims against the insurer because, first, the assignment did not end the litigation but instead prolonged it, and, second, by causing the parties to change their positions the assignment greatly distorted the litigation that followed.<sup>108</sup> In subsequent decisions, the court has emphasized the importance of these considerations.<sup>109</sup>

1. Concerns about prolonging the litigation

The concern that an assignment will “prolong the litigation” does not help the analysis. Of course the assignment prolongs the litigation – that is the whole point. If there wasn't litigation to be continued, there would be nothing to assign. The court has recognized the general rule that choses in action – that is legal claims – are freely assignable.<sup>110</sup> In every one of those cases, by virtue of the assignment, the litigation would continue and thus be prolonged.

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<sup>106</sup> See *Gandy*, 925 S.W.2d at 698-700.

<sup>107</sup> *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, No. 03-0647, 2008 WL 400394, at \*7-\*10 (Tex. Feb. 15, 2008).

<sup>108</sup> 925 S.W.2d at 711-12.

<sup>109</sup> In *PPG Industries, Inc. v. JMB/Houston Centers Partners Ltd. Partnership*, 146 S.W.3d 76 (Tex. 2004), the majority and dissent disagreed over whether DTPA warranties were assignable, but both sides agreed that *Gandy* disapproves of assignments that prolong and skew the litigation. Compare 146 S.W.3d at 90, with 146 S.W.3d at 107 (O'Neill, J., dissenting). The court emphasized the same points in *Interstate Contracting Corp. v. City of Dallas*, 135 S.W.3d 605, 616 (Tex. 2004).

<sup>110</sup> *Gandy*, 925 S.W.2d at 707.

The *Gandy* court elaborated that “as Gandy’s counsel freely testified, the entire purpose of the arrangement was to find a way to recover against State Farm.”<sup>111</sup> Well, of course it was.

Isn’t a plaintiff’s fundamental purpose in a personal injury suit to assign legal responsibility to a solvent defendant? That legitimate goal does not make the means employed correct or incorrect. So why would the court bother to point that out?

In fairness, the court recognized that arrangements like this one are not unusual when the plaintiff’s claims arguably are covered by the defendant’s insurance.<sup>112</sup> The court noted that not every settlement involving an assignment of rights has the problems the court described.<sup>113</sup> Every settlement involving an assignment of rights would in fact prolong the litigation, so that must not be the problem. Further, the court recognized that one consideration to be balanced was the advantage of the defendant having a means to avoid personal liability.<sup>114</sup> Obviously, an assignment that lets the plaintiff recover from the insurer – even the “prolonged litigation” against the insurer – does that.

In insurance cases, there usually is an underlying suit between the defendant/insured and the plaintiff, where the insurer cannot be a party, followed by a coverage suit where the insurer necessarily is a party. It is hard to see how an assignment to the plaintiff would prolong the litigation, considering that the plaintiff may already have standing to sue as a judgment creditor or may acquire the defendant’s contract rights by a turnover order. An assignment of a claim to the plaintiff neither prolongs nor terminates the coverage suit; it just changes who is seeking the relief.

In fact, the assignment limits the dispute by resolving at least some of the disagreement between the defendant/insured and the plaintiff.

If the “prolongs the litigation” concern is viewed as an independent element, it is a make-weight argument that adds nothing to the court’s analysis, and is flat wrong. The court’s logic would be:

- Choses in action allow one party to assign a claim to be pursued in litigation by another.
- Choses in action are generally assignable.
- However, when an assignment of a chose in action “prolongs the litigation” by allowing one party to assign a claim to be pursued in litigation by another it is an exception to the general rule and the assignment is void.

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<sup>111</sup> *Id.* at 712.

<sup>112</sup> *Id.* at 713.

<sup>113</sup> *Id.* at 714.

<sup>114</sup> *Id.*

If we are to assume that the court did not intend such an illogical syllogism, the real concern must be whether the assignment distorts or skews the litigation by causing the parties to change their positions. In other words, the assignment is invalid when it prolongs the litigation *and* skews that litigation. This is our next point.

## 2. Concerns about distorting the litigation

It seems that when the *Gandy* court voided the assignment because it prolonged the litigation, that concern was inseparably tied to the court's other concern that the assignment "greatly distorted the litigation that followed."<sup>115</sup> When the court cited other instances where it voided settlements, the court felt that all the settlements distorted the litigation.

In *Zuniga v. Groce, Locke & Hebdon*,<sup>116</sup> the court approved the court of appeals decision voiding an assignment of a legal malpractice claim, which would "cause a reversal of the positions taken by each set of lawyers and clients, which would embarrass and demean the legal profession."<sup>117</sup> The court voided Mary Carter agreements in *Elbaor v. Smith*<sup>118</sup> because, by giving the settling defendant a stake in the recovery, such agreements "distort the trial against the nonsettling defendants" as the settling defendant moved over to the plaintiffs side to point the finger at the others.<sup>119</sup> Finally, in *International Proteins Corp. v. Ralston-Purina Co.*,<sup>120</sup> the court voided a settlement where one defendant took an assignment that allowed it to pursue the plaintiff's claim against a joint tortfeasor, because the trial made it appear the plaintiff was present, when he was not, and "the settling defendant's unusual posture as surrogate plaintiff, co-defendant and cross-plaintiff will confuse a jury and possibly prejudice the remaining parties."<sup>121</sup>

Similarly, in *Gandy* for the assigned claims to have any value, the court noted, the parties had to drastically change their positions. Julie Gandy originally sued Pearce seeking at least \$1 million in actual damages, plus punitive damages for his repeated acts of abuse. Her attorney took the position in the agreed judgment that Pearce could be liable for up to \$15 million. Pearce denied all this. After the assignment, because Julie Gandy was asserting Pearce's assigned rights, she had to change her position and argue that if State Farm had done a better job, she could not have recovered as much, otherwise Pearce wasn't harmed by State Farm's conduct because he got what was coming to him anyway. Pearce initially denied any misconduct, then changed his position in the agreed judgment to admit liability, then changed back to deny liability so he could argue that he could have won if State Farm provided him with competent counsel.<sup>122</sup>

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<sup>115</sup> 925 S.W.2d at 712.

<sup>116</sup> 878 S.W.2d 313 (Tex. App.–San Antonio 1994, writ ref'd).

<sup>117</sup> *Id.* at 317, quoted in *Gandy*, 925 S.W.2d at 708.

<sup>118</sup> 845 S.W.2d 240 (Tex. 1992).

<sup>119</sup> *Id.* at 246-47, quoted in *Gandy*, 925 S.W.2d at 709.

<sup>120</sup> 744 S.W.2d 932 (Tex. 1988).

<sup>121</sup> *Gandy*, 925 S.W.2d at 710 (quoting *Beech Aircraft Corp. v. Jenkins*, 739 S.W.2d 19, 22 (Tex. 1987)).

<sup>122</sup> *Gandy*, 925 S.W.2d at 712-13.



The court concluded, “In these circumstances, we have no hesitation in holding that the assignment was invalid.”<sup>123</sup>

Other courts have focused on this element of *Gandy* to void agreements that distorted the litigation.<sup>124</sup> In contrast, courts have upheld assignments that do not have this problem.<sup>125</sup> One court upheld an assignment that involved some degree of prolonging the litigation and altering positions, where other *Gandy* elements were not present.<sup>126</sup>

Obviously then, to have a viable assignment, it is crucial that the parties not switch positions as a result and thereby skew or distort the ensuing litigation.

This requirement should not prove difficult in most cases. If the insurer breaches its duty to defend, *Evanston v. ATOFINA* allows the parties to settle and precludes the insurer challenging the reasonableness of that settlement. There is no need to change positions. Both the plaintiff and defendant/insured can consistently maintain that, aside from the merits of the litigation, the abandoned defendant/insured had no choice but to seek protection from a settlement.

When the insurer breaches its duty to settle, the parties do not need to change positions. The plaintiff argued at the time of the settlement demand that the defendant/insured's liability is so clear that the insurer should settle. After the excess judgment and an assignment to the plaintiff, the plaintiff maintains the same position. A problem arises, however, if the defendant/insured took the position that the insurer should not settle. That could create problems. If the defendant/insured maintains that position, the insurer can point to that as proof it was reasonable not to settle, thus undermining the plaintiff's assigned claim. If the defendant/insured changes positions, that runs afoul of *Gandy* and could void the assignment. On the other hand, if the defendant/insured demanded that the insurer settle, or at least didn't oppose a settlement, there is no need to change positions.

If the insurer breaches its duty to indemnify, there should be no need for the plaintiff or defendant/insured to change positions. While they were adverse on liability, presumably neither

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<sup>123</sup> *Id.* at 713.

<sup>124</sup> See *Sage Street Assoc. v. Federal Ins. Co.*, 43 S.W.3d 100, 105 (Tex. App.–Houston [1st Dist.] 2001, pet. denied); *Transportation Ins. Co. v. Heiman*, 1999 WL 239917, at \*8 (Tex. App.–Dallas April 26, 1999, no pet.); see also *PPG Industries, Inc. v. JMB/Houston Ctrs. Partners Ltd. P'ship*, 146 S.W.3d 76, 90 (Tex. 2004) (DTPA warranty claim held not assignable, inter alia, because of concern of “serious risk of skewing the adversarial process”).

<sup>125</sup> See *Reyna v. Safeway Managing Gen. Agency*, 27 S.W.3d 7, 17-18 (Tex. App.–San Antonio 2000, pet. granted, j. rev'd and remanded by agreement); *Burns Motors, Inc. v. Gulf Ins. Co.*, 975 S.W.2d 810, 815-16 (Tex. App.–Corpus Christi 1998), reversed on other grounds, 22 S.W.3d 417 (Tex. 2000); see also *Esposito v. CPM Ins. Serv., Inc.*, 50 Conn.Supp. 283, 922 A.2d 343, 352, 40 Conn. L. Rptr. 787 (Superior Ct. Conn. 2006) (noting *Gandy* concerns and allowing assignment of claim against negligent insurance agent, where “role reversal” was not sufficiently problematic).

<sup>126</sup> *Polinard v. United Serv. Auto. Ass'n*, 1996 WL 460040, at \*5-\*6 (Tex. App.–San Antonio Aug. 14, 1996, no writ).

one took a position that would negate coverage; thus, the pursuit of coverage is consistent with – or at least not inconsistent with – their earlier positions.

The trouble arose in *Gandy*, and will arise again, when the defendant/insured complains about the quality of the defense. The plaintiff and defendant/insured will be forced to argue the inconsistent that the defendant/insured wouldn't be as liable as he was found to be, but for the insurer's misconduct.

### 3. General form of assignment

Assuming that you can navigate the difficulties of an assignment, a form is available.<sup>127</sup>

### 4. Alternatives to an assignment

With these concerns about assignments, it is worth considering whether an assignment is needed. There are several alternatives.

#### a. Defendant/insured pursues claim

First, the defendant/insured can pursue the claim against the insurer itself. This is the path that was successfully taken in *Evanston v. ATOFINA*. After the insurer made clear it would not indemnify ATOFINA, the defendant/insured settled with the plaintiff and then sued the insurer to be paid back. Because there was no assignment, the court held that by its own terms the *Gandy* decision was inapplicable.<sup>128</sup> This approach is available with a solvent defendant that has the resources to pay the plaintiff and pursue the coverage litigation on its own. This approach offers little help when the defendant/insured is insolvent and the only viable source of recovery is the insurance proceeds. In that instance, the plaintiff may be the only one in a position to pursue the litigation, because they at least have a contingent fee lawyer who won't get paid unless there is a recovery. Even then, an assignment may not be needed.

#### b. Plaintiff pursues claim as judgment creditor

A second option is for the plaintiff to pursue the insurer based on his standing as a judgment creditor. An injured party has the right, once a judgment is rendered against the defendant/insured, to sue the insurer as judgment creditor and may collect up to the policy limits.<sup>129</sup> Where this approach was taken courts have concluded that the *Gandy* concerns about assignments were inapplicable. In two cases where the insurers refused to defend, and the

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<sup>127</sup> See Stephen S. Ashley, *Bad Faith Actions, Liability & Damages* § 12:12 (2004) (available on Westlaw as BFA § 12:12). For a general discussion, see Annot., *Assignability of Insured's Right to Recover Over Against Liability Insurer for Rejection of Settlement Offer*, 12 A.L.R.3d 1158 (2004) (available on Westlaw at 12 A.L.R.3d 1158).

<sup>128</sup> *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, No. 03-0647, 2008 WL 400394, at \*9 & nn. 68-71 (Tex. Feb. 15, 2008); see also *Crocker v. Nat'l Union Fire Ins. Co.*, No. SA-04-CA-0389-RF, 2005 WL 1168429, at \*5-\*6 (W. D. Tex. May 12, 2005) (*Gandy* inapplicable, absent assignment).

<sup>129</sup> E.g., *Seaton v. Pickens*, 126 Tex. 271, 273, 87 S.W.2d 709, 710 (1935).

plaintiffs sought recovery as judgment creditors under default judgments, the courts upheld recovery, despite the absence of a fully adversarial trial.<sup>130</sup>

Suing as judgment creditor is sufficient when the plaintiff seeks only the policy benefits. If the plaintiff seeks to assert extracontractual claims – such as a claim under *Stowers* or *Rocor* for failure to settle – and recover damages beyond the policy limits, an assignment or some other means of acquiring the defendant/insured's rights will be required. The plaintiff's status as judgment creditor is not sufficient to allow the plaintiff to assert these extracontractual claims.<sup>131</sup>

**c. Plaintiff acquires claim by turnover order**

A third option is for the plaintiff to acquire the defendant's right to sue by seeking a turnover order. The turnover statute allows a court to order the defendant/insured to deliver or "turnover" an asset to a creditor. The defendant/insured's cause of action against the insurer is the asset that is sought once the plaintiff becomes a judgment creditor.<sup>132</sup> The turnover statute allows an order turning over the cause of action, attorney's fees, and authorizes the trial court to order affirmative action by the judgment debtor to assist the judgment creditor in subjecting the asset to satisfaction of the underlying judgment.<sup>133</sup>

By avoiding a voluntary assignment, the parties may avoid the concerns in *Gandy*, considering that the supreme court case has limited *Gandy* to cases involving assignments.<sup>134</sup> However, one court of appeals has held that public policy concerns that bar an assignment would also bar a turnover order.<sup>135</sup>

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<sup>130</sup> *Crocker v. National Union Fire Ins. Co.*, 2005 WL 1168429, at \*1, \*5-\*6 (W. D. Tex. May 12, 2005); *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 2005 WL 1123759, at \*8-\*9 (W.D. Tex. April 21, 2005). The Texas Supreme Court disagreed with the *Crocker* court on other grounds. *National Union Fire Ins. Co. v. Crocker*, 51 Tex. Sup. Ct. J. 518, 2008 WL 400398 (Tex. Feb. 15, 2008) (answering certified question regarding notice and prejudice).

<sup>131</sup> *See Whatley v. City of Dallas*, 758 S.W.2d 301, 307 (Tex. App.–Dallas 1988, writ denied); 5 Elaine A. Grafton Carlson, *McDonald & Carlson Texas Civil Practice* § 30:16[b] & nn. 175-178 (2d. ed. 2003).

One gray area is the plaintiff's right as judgment creditor to pursue statutory extracontractual claims for unfair insurance practices. *See Allstate Ins. Co. v. Watson*, 876 S.W.2d 145, 150-51 (Tex. 1994) (Spector, J., concurring) (would grant standing to judgment creditor). No later decision has embraced this position, so it may be necessary, or at least wise, to get an assignment.

<sup>132</sup> *See* Tex. Civ. Prac. & Rem. Code § 31.002. Prof. Dorsaneo's always excellent treatise provides a detailed discussion of the turnover statute, the procedure for using it, and forms. *See* 9 William V. Dorsaneo, III, & Fred D. Nation, Jr., *Texas Litigation Guide* §§ 132.05, 132.50, 132.121 (Matthew Bender 2008); *see also Main Place Custom Homes, Inc. v. Honaker*, 192 S.W.3d 604, 627-28 (Tex. App.–Fort Worth 2006, pet. denied) (reversing turnover order where party did not follow required procedural steps); *Charles v. Tamez*, 878 S.W.2d 201, 205 (Tex. App.–Corpus Christi 1994, writ denied).

<sup>133</sup> *Schultz v. Fifth Judicial Dist. Court of Appeals*, 810 S.W.2d 738, 740 (Tex. 1991).

<sup>134</sup> *See Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, \_\_\_ S.W.3d \_\_\_, 2008 WL 400394, at \*9 (Tex. Feb. 15, 2008) (limiting *Gandy* to cases involving assignments); *see also Great West Cas. Co. v. Omniflight Helicopters, Inc.*, 2006 WL 328174, at \*4 (N.D. Tex. 2006) (*Gandy* did not apply where plaintiff received cause of action by turnover order after refusal to defend resulted in default judgment).

<sup>135</sup> *Charles v. Tamez*, 878 S.W.2d 201, 206 (Tex. App.–Corpus Christi 1994, writ denied).

Courts have recognized that claims against an insurer for failure to settle generally are subject to assignment and turnover.<sup>136</sup>

In *Charles v. Tamez*, the court of appeals held that public policy barred the turnover of a cause of action to the plaintiff for an insurer's unreasonable failure to settle, when the defendant/insured repeatedly stated that he was satisfied with the insurer's representation of him and would not have allowed the insurer to settle.<sup>137</sup> The court did not address whether an asserted or ignored cause of action against the insurer could be turned over.<sup>138</sup> In a later case, the same court of appeals limited *Charles v. Tamez*, and rejected an insurer's attempt to set aside a turnover order, where the defendant/insured never opposed the turnover order and did not indicate the same level of agreement with his insurer.<sup>139</sup>

One aspect of the reasoning of the court in *Charles v. Tamez* is questionable. Whether an insurer was negligent or acted unfairly in failing to settle is an objective standard measured by what a reasonable person would have done. The defendant/insured's satisfaction with the insurer's conduct is not conclusive proof that the insurer acted reasonably, just as his dissatisfaction would not establish the insurer's liability. Furthermore, the defendant/insured could have been misinformed.

### 5. Effect of void assignment

What happens if the assignment is void? *Gandy* doesn't tell us. The court reversed the judgment in favor of the plaintiff and rendered judgment that she take nothing, but the court doesn't explain why. That may have been the correct result. Julie Gandy acquired no rights against State Farm, because the court held that the assignment of those claims to her was void. The court did not address what rights, if any, Pearce – the defendant/insured – had. Logically it would seem that when an assignment is voided, that restores the status quo ante; the defendant/insured again becomes the owner of the claim against the insurer. However, that may not be the case.

According to the Restatement of Contracts, section 197, with certain exceptions “a party has no claim in restitution for performance that he has rendered under or in return for a promise

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<sup>136</sup> *Hartrick v. Great American Lloyds Ins. Co.*, 62 S.W.2d 270, 273 n. 4 (Tex. App.–Houston [1st Dist.] 2001, no pet.); *Charles v. Tamez*, 878 S.W.2d 201, 205, 208 (Tex. App.–Corpus Christi 1994, writ denied); *Republic Ins. Co. v. Millard*, 825 S.W.2d 780, 784 (Tex. App.–Houston [14th Dist.] 1992, no pet.); *Garcia v. American Physicians Ins. Exch.*, 812 S.W.2d 25, 33-34 (Tex. App.–San Antonio 1991), *rev'd on other grounds* 876 S.W.2d 842 (Tex. 1994); *La Joya Gardens, L.L.C.*, 2007 WL 1461449, at \*4 (N.D. Tex. May 17, 2007); *Great West Cas. Co. v. Omniflight Helicopters, Inc.*, 2006 WL 328174, at \*2 (N.D. Tex. Nov. 13, 2006).

<sup>137</sup> *Charles v. Tamez*, 878 S.W.2d at 208; *see also* *Nationwide Mut. Ins. Co. v. Chaney*, 202 WL 31178068, at \*4 n. 5 (N.D. Tex. Sept. 30, 2002).

<sup>138</sup> *Id.* at 208-09.

<sup>139</sup> *Trinity Univ. Ins. Co. v. Bleeker*, 944 S.W.2d 672, 677 (Tex. App.–Corpus Christi 1997), *rev'd on other grounds* 966 S.W.2d 489 (Tex. 1998).

that is unenforceable on grounds of public policy unless denial of restitution would cause disproportionate forfeiture.<sup>140</sup> The rationale is that:

In general, if a court will not, on grounds of public policy, aid a promisee by enforcing the promise, it will not aid him by granting him restitution for performance that he has rendered in return for the unenforceable promise. Neither will it aid the promisor by allowing a claim in restitution for performance that he has rendered under the unenforceable promise. It will simply leave both parties as it finds them, even though this may result in one of them retaining a benefit that he has received as a result of the transaction.<sup>141</sup>

No Texas case has adopted this section of the Restatement.<sup>142</sup> The general principles under Texas law have been stated as follows:

The general rule that denies relief to a party to an illegal contract is expressed in the maxim, *In pari delicto potior est conditio defendantis*. ... The rule is adopted, not for the benefit of either party and not to punish either of them, but for the benefit of the public. ... In many cases relief is granted to the party who is not in *pari delicto*. ... It has been said that even where the parties are in *pari delicto* relief will sometimes be granted if public policy demands it. ... There is often involved, in reaching a decision as to granting or withholding relief, the question whether the policy against assisting a wrongdoer outweighs the policy against permitting unjust enrichment of one party at the expense of the other. The

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<sup>140</sup> *Restatement (Second) of the Law of Contracts* § 197 (1981).

<sup>141</sup> *Id.* Comment a. The *Restatement* further explains:

Exceptions to the rule denying restitution are made in favor of a party who is excusably ignorant or is not equally in the wrong (§ 198) and in favor of a party who has withdrawn or where the situation is contrary to public policy (§ 199). These exceptions are dealt with in the two sections that follow. In addition, the rule is subject to the exception stated in this Section that allows restitution in favor of a party who would otherwise suffer a forfeiture that is disproportionate in relation to the contravention of public policy involved. Account will be taken of such factors as the extent of the party's deliberate involvement in any misconduct, the gravity of that misconduct, and the strength of the public policy. See § 178(3). The exception is especially appropriate in the case of technical rules or regulations that are drawn so that their strict application would result in such forfeiture if restitution were not allowed. Here, as elsewhere in this *Restatement*, the term "forfeiture" is used to refer to the denial of compensation that results when the obligee loses his right to the agreed exchange after he has relied substantially, as by preparation or performance, on the expectation of that exchange. See Comment *b* to § 227 and Comment *b* to § 229. Whether the forfeiture is "disproportionate" for the purposes of this Section will depend on the extent of that denial of compensation as compared with the gravity of the public interest involved and the extent of the contravention. If the claimant has threatened grave social harm, no forfeiture will be disproportionate. Restitution under this Section is subject to the rules of §§ 370-77.

*Id.* Comment b.

<sup>142</sup> See *Penny v. Orthalliance, Inc.*, 2003 WL 21640570, at \*2 (N.D. Tex. July 9, 2003) (citing section to allow claim for unjust enrichment).

solution of the question depends upon the peculiar facts and the equities of the case, and the answer usually given is that which it is thought will better serve public policy. ...

A test, sometimes used in determining whether a demand connected with an illegal transaction can be enforced, is whether the plaintiff requires any aid from the illegal transaction to establish his case. ...<sup>143</sup>

While there are Texas cases holding that a court will leave parties to an unenforceable agreement where they have placed themselves,<sup>144</sup> that can't really be done with a void assignment. If the assignment is voided, the plaintiff no longer has the right to sue, so the question becomes, "What happens to the claim?" Does it disappear or does it revert to the defendant/insured?

A defendant/insured might successfully argue that he should be able to pursue that claim after the assignment was voided, because the insurer otherwise would be unjustly enriched.

Another rule of Texas law that might allow the defendant/insured to pursue the now unassigned claim is the principle that "the defense of illegality is confined to the parties to the contract and is not available to third parties to defeat a just claim against themselves."<sup>145</sup> While the assignment was unenforceable, that would not affect the insurer's liability.

One concern is whether, even if the defendant/insured could assert the now unassigned claim, that suit likely would be barred by limitations.<sup>146</sup> But it may be that the original suit, while defective, would toll limitations.<sup>147</sup>

Nevertheless, it may not be worth taking the risk.

#### **D. Binding effect, or not, of judgment against defendant/insured**

A critical, and contentious, issue has been the extent to which a judgment against the defendant/insured binds the insurer. If the defendant/insured feels prejudiced by the insurer's conduct and attempts to reach an agreement with the plaintiff, the value of any agreement is greatly diminished if the insurer is not bound and gets to challenge or relitigate every issue. Another factor on this side is the unfairness of allowing an insurer that failed to defend its insured to nevertheless contest the same issues to protect itself. On the other hand, an insurer may be severely – and some would say unfairly – prejudiced if it is bound by every finding

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<sup>143</sup> *Lewis v. Davis*, 145 Tex. 468, 476, 199 S.W.2d 146, 151 (Tex. 1947) (citations omitted)..

<sup>144</sup> *Herrmann v. Lindsey*, 136 S.W.3d 286, 290-91 (Tex. App.–San Antonio 2004, no pet.).

<sup>145</sup> *Hartford Fire Ins. Co. v. Galveston, H. & S.A. Ry. Co.*, 239 S.W. 919, 923 (Tex. Comm'n App. 1922, holding approved).

<sup>146</sup> Actually, Mike Huddleston raised this concern.

<sup>147</sup> "If the nature of the suit against the defendants remains unchanged, the substitution of parties-plaintiff does not constitute a new suit." *Foust v. Estate of Walters*, 21 S.W.3d 495, 501 (Tex. App.–San Antonio 2000, pet. denied).

against, or agreement by, the defendant/insured, when the defendant/insured has little incentive or ability to contest those issues.

### 1. **Binding effect of judgments pre-Gandy**

Before *Gandy*, the law was fairly-well settled. As a general rule, the insurer was bound by liability and damage findings against the defendant/insured because the insurer and defendant/insured were in privity on those issues – i.e., both want the defendant/insured to win and the plaintiff to lose.<sup>148</sup> The insurer was not bound with respect to coverage issues, either because they were not litigated, or because if they were litigated the insurer and defendant/insured were not in privity – i.e., the defendant/insured wants there to be coverage and the insurer does not.<sup>149</sup>

Moving away from these initial principles, courts prior to *Gandy* also held that if the insurer breached its duty to defend, it would be bound by liability and damage findings against its defendant/insured, even if those findings came in the form of a consent judgment or settlement, instead of resulting from an adversarial contest.<sup>150</sup> Courts reached this conclusion by holding that an insurer that breached its contractual obligation could not rely on the insurance policy provision requiring an “actual trial” before the insurer could be bound. As another basis for binding insurers, courts held that consent judgments and default judgments satisfied the requirement of an “actual trial.”<sup>151</sup>

### 2. **Gandy requires a “fully adversarial trial” for a judgment to bind the insurer**

The *Gandy* court seemed to clearly intend to restrict this ability of the defendant/insured and plaintiff to bind an insurer. The supreme court agreed with the court of appeals decision, which was “very critical” of the settlement between the parties. The court of appeals said that the judgment, by agreement “perpetrates a fraud on the court,” because the covenant not to execute meant that the defendant/insured would not have to pay the judgment.<sup>152</sup> The court of appeals stated that such a result should be against public policy because it allowed a “sham”

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<sup>148</sup> The general rule is stated in *Massachusetts Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396 (Tex.1967), that “when a person is responsible over to another, either by operation of law or by express contract, and he is duly notified of the pendency of the suit and has actually assumed management of the proceeding or defense, the judgment in such suit will be conclusive as to the issues litigated therein.” *Id.* at 400.

<sup>149</sup> See *Employers Cas. Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988); *Gulf Ins. Co. v. Parker Prods., Inc.*, 498 S.W.2d 676, 679 (Tex. 1973).

<sup>150</sup> *Block*, at 943.

<sup>151</sup> See *Scottsdale Ins. Co. v. Sessions*, 331 F.Supp.2d 479, 488 (N.D. Tex. 2003) (citing *Pioneer Cas. Co. v. Jefferson*, 456 S.W.2d 410, 413 (Tex. App.–Houston [14th Dist.] 1970, writ ref’d n.r.e.); *Gulf Ins. Co. v. Vela*, 361 S.W.2d 904, 908 (Tex. Civ. App.–Austin 1962, writ ref’d n.r.e.)).

<sup>152</sup> *Gandy*, 925 S.W.2d at 705.

judgment by agreement, without any trial or evidence on the merits, encourages fraud and collusion, and corrupts the judicial process.<sup>153</sup>

The supreme court in *Gandy* stated: “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 by plaintiff as defendant’s assignee.”<sup>154</sup> To make doubly sure, the court disapproved the “contrary suggestion in dicta” in prior decisions.<sup>155</sup> To make triply sure, the court said again:

In no event should a judgment agreed to between plaintiff and defendant be binding on defendant’s insurer. If an insurer’s liability is to be litigated in an action by a plaintiff as a defendant’s assignee after such a judgment is rendered, it should be done on the strength of plaintiff’s claims rather than the generosity of defendant’s concessions.<sup>156</sup>

### 3. *ATOFINA* limits, or overrules, the “fully adversarial trial” requirement

As discussed above, the decision in *Evanston v. ATOFINA* rejected this absolute position be allowing a non-adversarial judgment to be binding in certain instances and by reaffirming decisions *Gandy* had disapproved. Thus, there is a dichotomy.

If the insurer breaches the duty to defend or the duty to indemnify, under the court’s holdings in *Evanston v. ATOFINA* and *Employers Casualty v. Block*, the defendant/insured and plaintiff can agree to a judgment that will bind the insurer. *Gandy*’s “fully adversarial trial” requirement may still matter if the insurer breaches its duty to settle or breaches its duty by mishandling the defense. This isn’t because *Gandy* says so, but because those are the two areas not controlled by *ATOFINA*.

If the insurer breaches its duty to settle, the fully adversarial trial requirement most likely will be satisfied. In such cases, the most common pattern is that after the insurer fails to settle the plaintiff obtains a verdict and judgment against the defendant/insured after a trial on the merits. In that instance, *Gandy*’s requirement – if it still is a requirement – is satisfied. Of course, the reasoning in *ATOFINA* supports the argument that an insurer that breaches its duty to settle also is estopped to challenge an agreed judgment that was not the result of a fully adversarial trial. It seems the *Gandy* concerns about “sham” judgments aren’t implicated in a duty-to-settle case. For the plaintiff to win, the plaintiff must show that her claim was so strong that a reasonable person would have settled, so even the insurer gets to contest the reasonableness of the resulting judgment by litigating that issue.

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.* at 714.

<sup>155</sup> *Id.* (“We disapprove the contrary suggestion in dicta in *Employers Casualty Company v. Block*, 744 S.W.2d 940, 943 (Tex. 1988), and *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 S.W.2d 949, 954 (5th Cir. 1990).”).

<sup>156</sup> *Gandy*, at 719.



It may be that the logic of *ATOFINA* overrules *Gandy* on the fully adversarial trial issue, or limits it to cases involving an insurer's breach by interfering with the defense. As the *Gandy* court noted, these cases are particularly problematic, because the defendant/insured and plaintiff must argue that the defendant was liable but would have been less liable if properly defended. This type of argument makes it tempting to establish liability by concessions instead of proof, because the proof is difficult or nonexistent.

#### 4. Satisfying the requirement of a "fully adversarial trial"

Whatever the continuing scope and vitality of the fully adversarial trial requirement, a review of how courts have applied this requirement may be helpful.

Despite the clear language in *Gandy* requiring a fully adversarial trial, not all courts respected this holding. One court said this portion of the opinion announced "questionable principles," and that court relied on prior cases to hold that an insurer was bound by a default judgment.<sup>157</sup> In addition to *ATOFINA*, other courts held that a fully adversarial trial was not required when the insurer breaches its duty to defend, so the insurer was bound by a default judgment.<sup>158</sup>

It seems that the *Gandy* court used the phrase "fully adversarial trial" to denote something more than the "actual trial" required by the policies. But what is an "actual trial"? The supreme court has held:

An "actual trial" contemplates a genuine contest of issues. *See Wright v. Allstate Ins. Co.*, 285 S.W.2d 376, 379-80 (Tex. Civ. App.-Dallas 1955, writ ref'd n.r.e.) (" 'judgment following [an] actual trial' relates to ... a contest of issues leading up to a final determination by court or jury, in contrast to a resolving of the same issues by agreement of the parties; i.e., without a contest.") (emphasis in original); *see also Emscor Mfg., Inc. v. Alliance Ins. Group*, 879 S.W.2d 894, 908 (Tex. App.-Houston [14th Dist.] 1994, writ denied). Although Maldonado presented evidence to a judge who later made findings of fact and conclusions of law, this evidence was uncontested. Robert did not appear at trial. His attorney did not cross-examine any witnesses or put on any of his own. Robert's attorney made no argument to the court contesting liability or damages and at one point even referred to the trial as a "hearing." In sum, there was no real contest of issues.<sup>159</sup>

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<sup>157</sup> *Scottsdale Ins. Co. v. Sessions*, 331 F.Supp.2d 479, 488 (N.D. Tex. 2003).

<sup>158</sup> *Minter v. Great American Ins. Co. of New York*, 423 F.3d 460, 472-73 (5th Cir. 2005); *Crocker v. National Union Fire Ins. Co.*, 2005 WL 1168429, at \*1, \*5-\*6 (W. D. Tex. May 12, 2005); *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 2005 WL 1123759, at \*8-\*9 (W.D. Tex. April 21, 2005); *see also Reyna v. Safeway Managing Gen. Agency*, 27 S.W.3d 7, 16-18 (Tex. App.-San Antonio 2000, pet. granted, j. rev'd and remanded by agreement) (declining to apply "fully adversarial trial" requirement in suit against insurance agent).

<sup>159</sup> *State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38, 40 (Tex. 1998).

In contrast, where the insurer failed to defend and there was no evidence of collusion, a default judgment is a judgment entered after an “actual trial.”<sup>160</sup>

An agreed judgment that was not based on evidence presented to the trial court is what the *Gandy* court held was not a “fully adversarial trial.”<sup>161</sup> Later courts have held that when the insurer offers to defend under a reservation of rights, it will not be bound by an agreed judgment, because that judgment was not the result of a fully adversarial trial.<sup>162</sup> An excess carrier that did not have a duty to defend was not bound by a default judgment taken against the insured after the primary insurer was placed in receivership.<sup>163</sup>

The Fifth Circuit relied on the “fully adversarial trial” requirement to hold that an insurer that had no duty to defend was not bound by a default judgment after a bankrupt defendant/insured failed to defend itself.<sup>164</sup>

Where two new trials were granted before the parties agreed to reinstate the original judgment, which had been set aside, the court held that judgment was not the result of a fully adversarial trial.<sup>165</sup>

Two cases have held that the requirement of an adversarial trial can be satisfied by someone other than the defendant/insured. In *Minter*, the Fifth Circuit held that trial of the issues by a pro se co-defendant was sufficient to constitute an “actual trial” and distinguish *Gandy*.<sup>166</sup> Similarly, the district court in *Crocker* held there was an actual trial involving a real contest of the issues where the insurer provided a defense for a co-defendant.<sup>167</sup>

Another court held that having an “actual trial” while being in a “fully adversarial relationship” was not enough to satisfy *Gandy*. The court held that when the judgment is agreed or by default, or when the defendant’s participation was so minimal as to not be adversarial, the *Gandy* requirement was not satisfied.<sup>168</sup> Interestingly, the court concluded there was a *fact question* whether there was a fully adversarial trial, based on evidence that in the underlying suit the defendant/insured was not represented by counsel, made no opening or closing statements,

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<sup>160</sup> *Scottsdale Ins. Co. v. Sessions*, 331 F.Supp.2d 479, 488 (N.D. Tex. 2003) (citing *Pioneer Cas. Co. v. Jefferson*, 456 S.W.2d 410, 413 (Tex. App.–Houston [14th Dist.] 1970, writ ref’d n.r.e.); *Gulf Ins. Co. v. Vela*, 361 S.W.2d 904, 908 (Tex. Civ. App.–Austin 1962, writ ref’d n.r.e.)).

<sup>161</sup> *Gandy*, 925 S.W.2d at 703, 714.

<sup>162</sup> *First Gen. Realty Corp. v. Maryland Cas. Co.*, 981 S.W.2d 495, 500 (Tex. App.–Austin 1998, pet. denied); *American Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 177 (Tex. App.–El Paso 1996 writ denied).

<sup>163</sup> *Vang v. Delta Lloyds Ins. Co.*, 2001 WL 722279, at \*3 (Tex. App.–Dallas June 28, 2001, no pet.). June 28, 2001

<sup>164</sup> *Ace Prop. & Cas. Ins. Co. v. Dorismond*, 88 Fed.Appx. 695, 697-98 (5th Cir. 2004).

<sup>165</sup> *Burney v. Odyssey Re(London) Ltd.*, 2005 WL 81722, at \*4 (N.D. Tex. Jan. 14, 2005), *affirmed*, 169 Fed.Appx. 828, 829 (5th Cir. 2006) (per curiam).

<sup>166</sup> *Minter v. Great American Ins. Co. of New York*, 423 F.3d 460, 42-73 (5th Cir. 2005).

<sup>167</sup> *Crocker v. National Union Fire Ins. Co.*, 2005 WL 1168429, at \*1, \*4 (W. D. Tex. May 12, 2005)

<sup>168</sup> *Yorkshire Ins. Co. v. Seger*, 2007 WL 1771614, at \*13-\*14 (Tex. App.–Amarillo, June 20, 2007, pet. filed).

offered no evidence, and conducted no cross-examination of the plaintiffs' witnesses.<sup>169</sup> It is hard to imagine how a jury would decide what seems like a legal question in this case.

Whatever uncertainty there is about the meaning of fully adversarial trial and whether one is required, it seems clear that, if the plaintiff did not have a fully adversarial trial against the defendant/insured, he may have one against the insurer. The *Gandy* court meant to give the insurer a fair opportunity to have liability and damages determined, now a way to avoid that determination. The *Gandy* court specifically envisioned that the plaintiff might litigate the issues in the suit against the insurer, saying: "If an insurer's liability is to be litigated in an action by a plaintiff as a defendant's assignee after such a judgment is rendered, it should be done on the strength of plaintiff's claims rather than the generosity of defendant's concessions."<sup>170</sup>

For this reason, the decision of the court of appeals in *Stroop v. Northern County Mutual Insurance Co.*<sup>171</sup> is questionable. In *Stroop*, after the insurer refused to defend or indemnify, the plaintiff and defendant/insured settled and entered into an agreed judgment. The plaintiff then got a turnover order assigning to him the insured's rights against the insurer, sued the insurer, and got a jury verdict in the suit against the insurer determining the defendant/insured's liability as a basis for holding the insurer liable.<sup>172</sup> The court of appeals held this was insufficient and did not constitute a fully adversarial trial. The court held that the settlement had distorted the positions of the parties to the point where the resulting verdict was not the result of a "fully adversarial trial." For example, no live witnesses were called on behalf of the defendant trucking company, and the court found the attempt to reconstruct a defense of the trucking company was ineffective.<sup>173</sup>

In light of *Evanston v. ATOFINA*, the *Stroop* decision was wrong, because the insurer's breach of its duty to defend estopped the insurer to contest the settlement. But beyond that, the *Stroop* court seems to have misapplied *Gandy*. The *Stroop* court allowed the insurer to wrongly refuse to defend its insured and then to hide behind that denial to argue that no adversarial trial could be had.

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<sup>169</sup> *Id.* at \*14. The *Yorkshire* decision is difficult to apply. If the claim was covered, then under the holding in *Evanston v. ATOFINA* the insurer would be estopped to deny coverage, with or without a fully adversarial trial. If the claim was *not* covered, then the insurer would not be liable for the underlying judgment, with or without a fully adversarial trial.

<sup>170</sup> *Gandy*, 925 S.W.2d at 719.

<sup>171</sup> 133 S.W.2d 844 (Tex. App.—Dallas 2004, pet. denied).

<sup>172</sup> *Id.* at 846-47.

<sup>173</sup> *Id.* at 849-50.

### 5. Effect of fraud or collusion

Many of the cases that enforce an agreed judgment or default judgment note there was no evidence of fraud or collusion between the plaintiff and defendant/insured.<sup>174</sup> This suggests that if there were such evidence, that would give the insurer a basis to avoid liability.

So what is “collusion”? It would seem that the types of false recitations in the judgment that were excoriated as a “sham” and “fraud on the court” in *Gandy* would qualify.

This issue was addressed in *Britt v. Cambridge Mutual Fire Insurance Co.*<sup>175</sup> The court found sufficient evidence that the judgment against the insured was obtained by fraud and collusion, so the insurer was not collaterally estopped to challenge the judgment. Unfortunately, the *Britt* court did not point out what evidence it found of fraud or collusion.<sup>176</sup>

The *Gandy* court discussed “fraud and collusion” as a basis for challenging a settlement, offering this particularly confounding quote: “The principles of fraud and collusion are self-evident and require no extended discussion. The facts and circumstances which will lead a court to conclude that either are present are limited only by the imagination of those who would cheat and deceive.”<sup>177</sup>

Obviously, the fact of an agreement between the defendant/insured and the plaintiff cannot alone be evidence of collusion.<sup>178</sup> The *Gandy* court recognized that the defendant/insured may be placed in a position where he is entitled to make an agreement to protect himself.

An interesting case from 1955 discusses the concepts of fraud and collusion in the context of the cooperation clause. Mr. New, the defendant/insured, tire had a tire blowout, causing a crash that killed his mother-in-law and injured his father-in-law, Frazier, who became the plaintiff. New was advised by the lawyer who later represented Frazier. The insurer asserted that the defendant/insured breached the cooperation clause by helping the plaintiff. The court stated the following principles:

Besides the affirmative duty on the part of New to make a full, frank and fair disclosure of the facts, he owed certain negative duties to the Company. He was obliged to refrain from any fraudulent or collusive act which might operate as a means of prejudice to the Company in the conduct of the defense against, or

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<sup>174</sup> See, e.g., *Minter v. Great American Ins. Co. of New York*, 423 F.3d 460, 473 (5th Cir. 2005); *Scottsdale Ins. Co. v. Sessions*, 331 F.Supp.2d 479, 488 (N.D. Tex. 2003).

<sup>175</sup> 717 S.W.2d 476, 483 (Tex. App.–San Antonio 1986, writ ref'd n.r.e.).

<sup>176</sup> The “fraud and collusion” concept is discussed, in not particularly helpful terms in *Dallas Postal Credit Union v. Southtrust Bank Nat. Ass’n*, 2001 WL 804467, at \*5 (Tex. App.–Dallas, July 18, 2001, no pet.).

<sup>177</sup> 925 S.W.2d at 719 (quoting *Pruyn v. Agricultural Ins. Co.*, 36 Cal.App.4th 500, 42 Cal.Rptr.2d 295, 313.14 (1995)).

<sup>178</sup> *Old Republic Sur. Co. v. Bonham State Bank*, 172 S.W.3d 210, 219 (Tex. App.–Texarkana 2005, no pet.) (insured’s agreement to default judgment does not necessarily indicate that the parties colluded, absent additional evidence).

settlement of, the claim Frazier made against him. Cooperation with Frazier would not constitute a breach of the cooperation clause of the policy so long as fraud played no part therein.

New desired that Frazier collect the greatest possible amount from the Company. This state of mind constituted no breach of contract. New could cooperate with Frazier and the Company at one and the same time. Cooperation with the one would not necessarily foreclose cooperation with the other. The making of statements to Frazier by New was proper if they were true statements. Even had they been false, no breach would be involved absent some prejudice to the Company. New's demands upon the Company to settle Frazier's claims were proper demands if made in good faith. This is true even though it were conclusive that because thereof the Company's interests were actually prejudiced. Fraud or collusion must be a factor, and prejudice must result.

Shortly after the occurrence of the accident, New employed an attorney to represent him and advise him in connection with the policy of insurance. Frazier subsequently employed the same attorney to prosecute his claim for damages against New. It was after the attorney became counsel for Frazier that New gave him the statements of himself and his wife, and accepted his aid and assistance in writing letters, etc., to the Company demanding that it settle the claims of Frazier.

Even when we assume that the attorney in question represented both New and Frazier at one and the same time, whereby inconsistency in the attorney's position would appear, – we do not perceive where inconsistency would be the only possible conclusion, – or even if it should be, that fraud or collusion was necessarily involved on the part of New and Frazier in respect to the means whereby they hoped to 'open the till' of the Company for the benefit of Frazier.<sup>179</sup>

The court concluded that whether there was a breach of the duty to cooperate was a fact question.<sup>180</sup>

#### **E. Extent to which judgment establishes amount of damages**

A basic measure of damages is the amount necessary to place the wronged party in the same economic position he would have been in had the contract not been breached.<sup>181</sup> Instead of

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<sup>179</sup> *Frazier v. Glens Falls Indem. Co.*, 278 S.W.2d 388, 392 (Tex. Civ. App.–Fort Worth 1955, writ ref'd n.r.e.).

<sup>180</sup> *Id.* See also *Siddall v. Goggan*, 68 Tex. 708, 711, 5 S.W. 668, 671 (1887) (agreed judgment on just claim was not evidence of fraud and collusion); *Torrington Co. v. Stutzman*, 36 S.W.3d 511, 523 (Tex. App.–Beaumont 1999) (closing argument admitting defect, which was supported by evidence, was not collusion), *aff'd in part, rev'd in part, on other grounds*, 46 S.W.3d 829 (Tex. 2000); *U.S. Fidelity & Guar. Co. v. Pressler*, 185 S.W. 326, 329 (Tex. Civ. App.–Texarkana 1916, writ dis'm'd) (after insurer refused to defend, insured was not required to stubbornly resist just claim for damages, and fact that parties were near relatives did not make inference of fraud and collusion irresistible). See generally Allan D. Windt, *Insurance Claims & Disputes* § 6:24 (4th ed. 2004) (available on Westlaw at INCD § 6:24).

trying to measure the harm from the judgment, which is speculative, it is proper to award the face amount of the judgment as the cost of removing that harm, and which is certain. That measure at least partially restores the defendant/insured to the position he would have been in had the contract not been breached by satisfying the judgment.

**F. Issues regarding covenants not to execute**

One aspect of the typical arrangement prior to *Gandy* was that in return for an agreed judgment and assignment of the defendant/insured claims against the insurer, the plaintiff would agree not to execute on the judgment against the defendant/insured and would only look to the insurer for payment. A “covenant not to execute” is attractive to the defendant/insured, obviously, because it shields him from personal liability. Historically, a plaintiff might be willing to give such a covenant to induce the defendant not to oppose the claim and agree to a judgment, or at least to induce the defendant to cooperate by assigning his claims.<sup>182</sup>

For reasons to be discussed, it does not appear wise for a plaintiff to give the defendant/insured a covenant not to execute.

If the plaintiff agrees not to execute against the assets of the defendant, the insurer may argue that it has no liability. A liability policy requires the insurer to pay sums the insured is legally obligated to pay; hence, the insurer may argue that it has no liability because the defendant is no longer obligated to pay.<sup>183</sup>

This was the argument the insurer made in *YMCA v. Commercial Standard Insurance Co.*<sup>184</sup> The court of appeals held that the covenant by the plaintiff that he would not execute against the defendant’s assets did not relieve the insurer of liability. The court reasoned that with a liability policy, as contrasted with an indemnity policy, the insured did not have to pay before the insurer was obligated to pay. The insurer’s obligation to pay attached at the time judgment was rendered against its insured.<sup>185</sup> The court further held:

We next consider the effect of the “covenant not to execute” on the liability of Commercial Standard under the terms of the “legal obligation to pay” and “no-action” clauses in the insuring agreement.

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<sup>181</sup> See, e.g., *Doss v. Homecoming Financial Network, Inc.*, 210 S.W.3d 706, 713 (Tex. App.–Corpus Christi 2006, pet. denied); *Anderson, Greenwood & Co. v. Martin*, 44 S.W.3d 200, 219 (Tex. App.–Houston [14 Dist.] 2001, pet. denied); *Armendariz v. Mora*, 553 S.W.2d 400, 406 (Tex. Civ. App.–El Paso 1977, writ ref’d n.r.e.).

<sup>182</sup> See generally 5 Elaine A. Grafton Carlson, *McDonald & Carlson Texas Civil Practice* § 30:16[b] (2d. ed. 2003) (discussing reasons for covenant not to execute).

<sup>183</sup> See *State Farm Lloyds, Inc. v. Williams*, 960 S.W.2d 781, 789 nn. 14-15 (Tex. App.–Dallas 1997, writ dism’d by agr.).

<sup>184</sup> 552 S.W.2d 497, 501 (Tex. Civ. App.–Fort Worth 1977), writ ref’d n.r.e. per curiam, 563 S.W.2d 246 (Tex. 1978).

<sup>185</sup> 552 S.W.2d at 504.

In *First National Indemnity Company v. Mercado*, 511 S.W.2d 354 (Tex. Civ. App. Austin, 1974 no writ), an insurance carrier refused to defend the insured. In order to protect itself, the insured secured a covenant in which the claimants agreed not to execute except upon the policy. The court held that if the insured, under those circumstances, is left to defend himself, it is reasonable that he covenant against his own liability and hold the costs of his defense to a minimum. That court further pointed out the well-established rule that although an insurance company ordinarily may insist upon compliance with the condition found in the “no-action” clause, the company may not do so after it is given the opportunity to defend the suit or to agree to the settlement, and refuses to do either on the erroneous ground that it has no responsibility under the policy. The court relied upon *Gulf Insurance Company v. Parker Products, Inc.*, 498 S.W.2d 676, 679 (Tex.1973); *Womack v. Allstate Insurance Company*, 156 Tex. 467, 296 S.W.2d 233, 237 (1956).

It is our opinion and we hold that the same reasoning and results would apply, had the case been decided under the “legal obligation to pay” provision of the insurance policy.

In *Langdeau v. Pittman*, 337 S.W.2d 343 (Tex. Civ. App. Austin, 1960 writ ref'd n.r.e.), the court had before it an action against the receiver appointed for Highway Insurance Underwriters, for personal injuries sustained by a claimant as a result of a collision between a truck it had insured, and an automobile. In that case the claimants agreed they would satisfy their claim against the insurer only. They also agreed to indemnify and hold harmless the defendants to the extent of the amount of any judgment which might be rendered in favor of the plaintiffs against defendants in excess of what is actually collected from the insurance carrier. That court held the covenant not to execute did not release the insurance carrier of liability under the policy. The language of that covenant not to execute is very similar to the one here before us.

The general principle of law is stated in 7 Tex.Jur.2d Rev. Part 1, *Automobile Insurance*, § 43, at 308, “Judgment against insured as prerequisite.” (1975), “. . . after the injured party has secured a favorable judgment against the insured in a court of competent jurisdiction, the liability of the insurer to pay the judgment to the extent of its bond or policy attaches. Such judgment is the basis of the injured third party’s suit and permits the judgment creditor of the insured to institute an action in the nature of a third-party beneficiary action against the insurer to the extent of its policy limits.”

If this had been an indemnity policy rather than a liability policy there would have been no legal obligation to pay until the YMCA had paid the judgment. But this policy specifically gives the claimants, who are judgment creditors, the right of direct action against the insured’s liability carrier before judgment is satisfied.

As applied to the facts in this case, we agree with the language of the Arizona Supreme Court in *Rager v. Superior Coach Sales & Service of Arizona*, 110 Ariz. 188, 516 P.2d 324, 327 (1973), which states:

A covenant not to execute is certainly not a satisfaction, nor is it the same as a release. Its legal effect is similar to a covenant not to sue, in that it does not extinguish the plaintiff's cause of action and does not operate to release other joint tortfeasors. *Pellett v. Sonotone Corp.*, 26 Cal.2d 705, 160 P.2d 783, 160 A.L.R. 863 (1945); *Whittlesea v. Farmer*, 86 Nev. 347, 469 P.2d 57 (1970).<sup>186</sup>

To the same effect is the court of appeals decision in *Garcia v. American Physicians Insurance Exchange*.<sup>187</sup> The court of appeals rejected the argument that a covenant not to execute negated the defendant's damages. The court of appeals stated:

APIE argues that there was no possibility of an excess judgment against Dr. Garcia because of the Non-Execution Agreement which provides that Cardenas will execute only against the proceeds of the insurance policies and not against Dr. Garcia's other assets. APIE contends that Dr. Garcia "could not be held responsible" for any excess judgment in *Cardenas v. Garcia*, and APIE is not therefore required to indemnify him.

APIE cites *Whatley v. City of Dallas*, 758 S.W.2d 301, 310 (Tex. App.-Dallas 1988, writ denied), which held that a covenant not to enforce a judgment against an insured individually will prevent recovery against an insurer in excess of policy limits. That case, however, is distinguishable. There were no findings in *Whatley*, as there are here, that the insurer acted negligently or in bad faith. *Whatley* did not decide whether an insurer is liable for damages in excess of policy limits for which the insured is not personally liable when the insurer has acted negligently or in bad faith. *Id.* at n. 6.

APIE also cites several out-of-state cases holding that a nonexecution agreement relieves the insured of an obligation to pay an excess judgment, and likewise relieves the insurer of an obligation to pay. ...

These cases are decided on two theories. First, the nonexecution agreements made the insureds not legally obligated to pay damages in excess of policy limits, therefore, the "legally obligated to pay" language in the insurance policies shields the insurers from liability. Second, because the non-execution agreement protects the insureds from any liability to judgment creditors, the insureds have suffered no damage compensable by the insurers.

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<sup>186</sup> 552 S.W.2d 504-05.

<sup>187</sup> 812 S.W.2d 25, 32-33 (Tex. App.-San Antonio 1991), *rev'd on other grounds*, 876 S.W.2d 842 (Tex. 1994).



We do not agree either that the insured is no longer “legally obligated to pay” or that he has suffered no damage. A covenant not to execute is merely a contract and not a release. ... Therefore, the underlying tort liability remains and a breach of contract action lies if the injured party seeks to collect the judgment in violation of the contract. The tortfeasor is still “legally obligated” to the injured party, and the insurer is still bound by its contractual promise to pay. The insured’s claim against the insurer for breach of contract is not extinguished by the covenant. ...

Likewise, the covenant does not “blot out” the personal judgment. ... In this state the personal judgment could affect Dr. Garcia’s credit and cloud his title to real estate. ... The judgment in *Cardenas v. Garcia* established the damages in this case. ... The covenant not to execute did not eliminate those damages. So it cannot reasonably be asserted that a covenant which does not release the judgment but merely limits execution to specific assets negates all damages the judgment debtor may suffer. We hold that the Non-Execution Agreement does not affect APIE’s liability to Dr. Garcia.<sup>188</sup>

The reasoning of the courts of appeals in *YMCA* and *Garcia* is consistent with the holding of the supreme court in *Hernandez v. Great American Ins. Co. of New York*,<sup>189</sup> which held that a

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<sup>188</sup> 812 S.W.2d at 32-33 (citations partially omitted). For other authorities holding that a covenant not to execute against the insured does not release the insurer, see *Langdeau v. Pittman*, 337 S.W.2d 343 (Tex. Civ. App.—Austin 1960, writ ref’d n.r.e.); *First Nat’l Indem. Co. v. Mercado*, 511 S.W.2d 354, 358 (Tex. Civ. App.—Austin 1974, no writ); 5 Elaine A. Grafton Carlson, *McDonald & Carlson Texas Civil Practice* § 30:16 & n. 153 (2d. ed. 2003) (covenant not to execute does not extinguish underlying judgment or release insurer from policy obligation); *Garcia v. American Physicians Ins. Exch.*, 812 S.W.2d 25, 33-34 (Tex. App.—San Antonio 1991), *rev’d on other grounds*, 876 S.W.2d 842, 855 n. 25 (Tex. 1994); 6 Elaine A. Grafton Carlson, *McDonald & Carlson Texas Civil Practice* § 14:3 & nn. 49-51 (2d. ed. 2003); *see also American Phys. Ins. Exch. v. Garcia*, 876 S.W.2d 842, 867-72 (Tex. 1994) (Hightower, J., dissenting); *Foremost Co. Mut. Ins. Co. v. Home Indem. Co.*, 807 F.2d 754, 757-60 (5th Cir. 1990); *Texas Farmers Ins. Co. v. Soriano*, 844 S.W.2d 808, 825-26 (Tex. App.—San Antonio 1992), *rev’d on other grounds*, 881 S.W.2d 312 (Tex. 1994); *Horton v. State Dept. of Ins. Receiver J. Robert Hunter*, 905 S.W.2d 59, 62 (Tex. App.—Austin 1995, no writ) (covenants should be encouraged as part of policy favoring settlement that minimizes insured’s liability); *Franco v. Selective Ins. Co.*, 184 F.3d 4, 10 (1st Cir. 1999); *Glenn v. Fleming*, 247 Kan. 296, 799 P.2d 79, 92 (1990); *see generally* William V. Dorsaneo, III, et al., *Getting the Case Settled: The Insurer and Insured’s Role in Settling the Underlying Suit*, in State Bar of Texas, 1st Ann. Adv. Ins. Law Course, ch. 7, at 11 (2004).

Another court rejected the argument that a covenant to limit execution negated the damages from the judgment, but the court held the face amount of the judgment did not conclusively fix the amount of damages. *State Farm Lloyds, Inc. v. Williams*, 960 S.W.2d 781, 786-87, 789-90 (Tex. App.—Dallas 1997, writ dism’d by agr.); *see also Reyna v. Safeway Managing Gen. Agency*, 27 S.W.3d 7, 18 (Tex. App.—San Antonio 2000, pet. granted, j. rev’d and remanded by agreement) (default judgment with covenant not to execute did not conclusively set amount of damages, but raised fact question). In *Head Indus. Coatings & Services, Inc. v. Maryland Ins. Co.*, 981 S.W.2d 305, 310 (Tex. App.—Texarkana 1998, pet. denied), the court held that an agreement limiting the insured’s liability did not inure to the benefit of the insurer.

<sup>189</sup> 464 S.W.2d 91, 94 (Tex. 1971).

defendant was not required to pay an excess judgment before being able to sue the insurer for failing to settle.<sup>190</sup>

On the other hand, several courts have held, or stated in dicta, that a covenant not to execute or other agreement limiting execution of the judgment against the defendant/insured does reduce or negate the damages.<sup>191</sup> The supreme court has not decided the effect of a covenant not to execute on the defendant/insured's damages and the plaintiff's claim.<sup>192</sup>

If the agreement not to execute in return for an assignment of the claims had the effect of destroying the value of the assigned claims, that would seem to be a clear failure of consideration that should return the parties to their prior positions.<sup>193</sup> Alternatively, there would be a mutual mistake about the value and validity of the agreement that should allow the plaintiff to avoid it.<sup>194</sup> Under either rationale, the deal would be undone, the plaintiff would again have a judgment, the defendant would again be legally obligated to pay, and so the insurer would still face liability.

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<sup>190</sup> An excellent discussion on the effect of a covenant not to execute appears in *Christiansen v. Holiday Rent-A-Car*, 845 P.2d 1316 (Utah App. 1992). The court held that the insureds nonpayment of the judgment did not relieve the insurer of liability. The court stated that this "nonpayment" view was supported by three considerations:

(1) [S]uch view prevents an insurer from benefiting from the impecuniousness of an insured who has a meritorious claim but cannot first pay the judgment imposed upon him; (2) such view negates the possibility that the insurer would be "... less responsive to its trust duties where the insured is [un]able to pay the excess judgment. Were payment the rule, an insurer with an insolvent insured could unreasonably refuse to settle, for, at worst, it would only be liable for the amount specified by the policy. To permit this would be to impair the usefulness of insurance for the poor man"...; (3) such view recognizes that the fact of entry of the judgment itself against the insured constitutes a real damage to him because of the potential harm to his credit rating.

*Id.* at 1323. The *Christiansen* court recognized, "Insureds and injured parties alike may need the possibility of an assignment and covenant not to execute as a weapon against insurer misconduct surrounding claims made under the policy.' . . . Such misconduct has been found to include an insurer's refusal to defend an insured, a failure to promptly notify an insured that its coverage is being cancelled, and a refusal to pay a valid claim." *Id.*

<sup>191</sup> *Whately v. City of Dallas*, 758 S.W.2d 301, 310 (Tex. App.–Dallas 1988, writ denied); *Williams M. Mercer, Inc. v. Woods*, 717 S.W.2d 391, 398 (Tex. App.–Texarkana 1986), *aff'd in part, rev'd in part on other grounds*, 769 S.W.2d 515 (Tex. 1988). Another court rejected the argument that a covenant to limit execution negated the damages from the judgment, but the court held the face amount of the judgment did not conclusively fix the amount of damages. *State Farm Lloyds, Inc. v. Williams*, 960 S.W.2d 781, 786-87, 789-90 (Tex. App.–Dallas 1997, writ dismissed by agr.).

<sup>192</sup> See *State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38, 39 n. 4 (Tex. 1988); see also *American Phys. Ins. Exch. v. Garcia*, 876 S.W.2d 842, 855 n. 25 (Tex. 1994) (because assignment held invalid on other grounds, court did not reach this issue). Justice Hightower dissented in *Garcia*, and would have held that a covenant not to execute did not negate damages. He was joined by three other justices. *Garcia*, 876 S.W.2d at 855, 867-72. It bears noting that the dissenters' position had been the majority opinion. See 39 Tex. Sup. Ct. J. 406, 409-10, 1992 WL 387406 (Dec. 31, 1992).

<sup>193</sup> See *Restatement (Second) of Contracts* §§ 261, 265; *Centex Corp. v. Dalton*, 840 S.W.2d 952, 954-55 (Tex. 1992).

<sup>194</sup> See *Restatement (Second) of Contracts* § 152; *Williams v. Glash*, 789 S.W.2d 261, 263-64 (Tex. 1990).

In *Gandy*, the parties attempted to draft around this problem. Instead of agreeing not to execute against any asset of the defendant, the parties agreed that the plaintiff would limit any execution solely to the claims against the insurer.<sup>195</sup> They also expressly agreed that the agreement was merely a contract to limit the scope of execution and was not a release.<sup>196</sup> Because the court voided the assignment, the effectiveness of this approach was not tested.

While the approach taken in *Gandy* should be valid, there is a better way to avoid the issue. Once the plaintiff has obtained a judgment against the defendant after a fully adversarial trial, the defendant is in no position to bargain for a covenant not to execute or a covenant to limit execution. The plaintiff may proceed to execute on the judgment, or may obtain by turnover order the defendant's cause of action against his insurer. Obviously, the plaintiff does not need to give the defendant a covenant as an inducement to agree to a judgment, once the plaintiff has obtained a judgment. At most, to obtain the defendant's cooperation in assigning the causes of action against the insurer, the plaintiff might agree to first attempt to collect from the insurer.

A covenant not to execute is bad for the plaintiff. It takes away one source of recovery – the defendant. It also lets the insurer argue that the defendant is not really damaged, because he faces no liability, so the insurer has nothing to indemnify. Leaving aside the merits of this argument, why give the insurer this attack?

If the plaintiff just won a fully adversarial trial, the defendant has little room to bargain. His best shot is to assign everything to the plaintiff and hope the plaintiff gets paid by the insurer. If the plaintiff gets paid, the defendant benefits to that extent, which beats immediate proceedings to collect on the judgment.

One reason not to give a covenant not to execute is because the plaintiff doesn't have to. The plaintiff can get the defendant's rights against the insurer by using the "turnover" statute, as noted above, without offering any inducement to the defendant/insured.

#### **G. Who should pursue the suit against the insurer?**

Another thing to consider is who should pursue the litigation against the insurer – the plaintiff, the defendant, or both? If the defendant has resources to fund the litigation it may make sense for the plaintiff to let the defendant do more of the work. If the defendant has limited resources, it may be necessary for the plaintiff's attorney to take the lead because, otherwise, neither the lawyer or client will get paid.

#### **H. Disqualification of attorneys in underlying suit as material witnesses in suit against insurer**

Consideration should be given to the dual roles the attorneys in the underlying case have as witnesses and advocates in the coverage suit against the insurer. While it may be permissible,

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<sup>195</sup> 925 S.W.2d at 701.

<sup>196</sup> *Id.* at 702.

and cost effective, for the same lawyers to continue representing their respective clients, at some point they likely will be material witnesses. For example, both lawyers may need to testify about settlement opportunities missed by the insurer. It makes sense to plan ahead for this transition. The attorneys also should consider their ability to fairly advise the client regarding events where the attorneys were key participants and will be key witnesses.

One court has rejected the argument the lawyers from the underlying suit should have been disqualified, where there was no showing of harm to the insurer.<sup>197</sup>

## VII. Recommendations

So what is one to make of all this? Some strategies are fairly obvious from *Gandy's* prohibitions, and some are less obvious. Here is a recap.

- Consider the nature of the insurer's misconduct. If the insurer breached its duty to defend or indemnify, it may be estopped to challenge an agreed judgment. If the insurer breached its duty to settle, then presumably the plaintiff will proceed to take an excess judgment, which, if the result of a fully adversarial trial, will bind the insurer. If the insurer committed other conduct, then the *Gandy* considerations are more likely to apply.
- Make sure that the insurer is made aware of the demand for a defense, indemnity, or settlement. The more awareness the insurer has, the harder it will be to avoid being estopped to challenge the resulting agreement or judgment.
- If possible, the plaintiff should not take an assignment of the defendant/insured's claim, and should instead let the defendant proceed to collect, or seek a turnover order or sue as judgment creditor.
- If an assignment is necessary, do not enter into any agreement that will distort the subsequent litigation by causing the parties to change their positions.
- There isn't much you can do about the agreement prolonging the litigation. If you hope to collect from the insurer, that is unavoidable.
- To avoid arguments that damages are negated or reduced, a plaintiff should not agree to a covenant not to execute. If a covenant not to execute is needed, there are many cases that hold the agreement does not relieve the insurer of liability.

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<sup>197</sup> *Yorkshire Ins. Co. v. Seger*, 2007 WL 1771614, at \*15 (Tex. App.—Amarillo, June 20, 2007, pet. filed).

- Don't engage in fraud or collusion – no funny business. For example, if the judgment says the court heard evidence, make sure that is true.

### VIII. Selected Bibliography

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