The Liability Insurer’s Dilemma.
Should a Good Faith But Mistaken Belief There Is No Coverage Absolve An Insurer of “Stowers” Liability?

By Randall L. Smith and Fred A. Simpson

Introduction

Liability insurers frequently face “Stowers” demands with strong beliefs their policies do not cover allegations in lawsuits brought against their insureds. Stowers demands create real dilemmatic situations for insurers, as proved by the 2002 holding in Excess Underwriters at Lloyd’s v. Frank’s Casing Crew & Rental Tools, Inc. However, the dilemma can be eliminated by the Supreme Court of Texas when it rules on Frank’s, now that the court has given the green light for review of the Fourteenth Court’s decision in that case.

The object of this article is to show how the Supreme Court could provide insurers some much needed equitable relief without placing any undue burden on Texas insureds.

What is the dilemma?

The dilemma is explained in the Fourteenth Court’s holding in Frank’s:

We recognize this case carries Matagorda County to a logical conclusion that is somewhat disquieting—Frank’s [the insured] was able to resolve the parties’ coverage dispute in its own favor simply by sending a Stowers demand to the Underwriters [the insurer]. Thereafter, the Underwriters had to pay if Arco’s allegations were within the policy, but also had to pay if they are not within the policy because there was no right to reimbursement. But this is a matter that the Underwriters must take up with the superior court.

The Frank’s intermediate appellate court used this language to affirm summary judgment in favor of the insured after its “excess” insurer paid $7.5 Million to settle a tort lawsuit rather than risk a judgment against its insured that might exceed policy limits and the
insurer’s own liability for any such excess judgment under Stowers. The Frank’ excess insurer paid its money to settle the underlying lawsuit and then sought declaratory relief on the coverage dispute, also requesting the trial court to order the insured to reimburse the $7.5 Million. “No way!,” said the trial court, 7 and so did Chief Justice Scott Brister of the Fourteenth Court, harking back to the holding in Texas Ass’n of Counties County Government Risk Management Pool v. Matagorda County.

The status of Texas law

Frank’s confirms the reality of Texas law. When insurers believe in good faith there is no coverage for allegations in lawsuits that underly Stowers demands, insurers have no fair chance to have those beliefs safely tested. When coverage is disputed and insurers are presented with reasonable settlement demands within policy limits, insurers may fund the settlement and seek reimbursement only if insurers first obtain their insureds’ clear and unequivocal consent to settlement, along with the insureds’ consent to insurers’ rights to seek reimbursement.8

Insurers appear to have absolutely no right to be wrong about whether there is coverage if they fail to honor Stowers demands. The only salvation for insurers is to gamble (1) that no judgments in excess of policy limits will emerge from the underlying tort lawsuits, or (2) if there are excess judgments and their insureds (or their assignees) bring Stowers lawsuits, there will be no jury findings that the insurers were negligent by failing to settle within policy limits when the insurers had the chance.

In other words, the lack of specific Texas case law on point at this moment denies insurers their day in court for advance tests of their good faith beliefs that there is no
coverage for allegations raised in pleadings of lawsuits that are the subject of *Stowers* demands. Unless insurers are willing to assume extracontractual risks of unknown magnitudes, insurers typically pay the *Stowers* demands and move on. Does all this have any material impact on Texas liability insurance premiums?

**How did things get as they are in Texas?**

The *Stowers* doctrine has been on the books in Texas for almost 75 years. Requiring insurers to use ordinary care in settling lawsuits arises from insurers’ contractual control of the defense and their exclusive right to settle.\(^9\) Texas law provides insurers two options when tort plaintiffs present *Stowers* settlement demands that reasonable and prudent insurers would accept (tainted as that tenuous choice may be as a result of the harshness of being proved wrong on the coverage issue). Insurers may (1) give their insureds complete control of the defense and settlement process, or (2) retain control of the defense and pay the *Stowers* demands.

Insurers preferring to debate questions of coverage and, accordingly, refusing to accept and pay reasonable settlement demands, encounter an obvious jeopardy. Under current rules, insurers expose themselves to heavy penalties if they refuse to defend their insureds and ignore *Stowers* demands they receive on grounds of no coverage. If trial courts later determine coverage issues in favor of their insureds, the losing insurers who took on the defense of their insureds are liable for the full resulting judgments against their insureds in the underlying tort actions, even for judgments in amounts that exceed policy limits.

Texas courts have never ruled on whether a potential lack of coverage is a defense to a *Stowers* action, although one Texas case came close to this issue. In *Riggs v. Sentry, Ins.*,\(^{10}\)
the Fourteenth Court rejected a jury instruction telling the jury that insurers must assume that coverage exists when tort plaintiffs make reasonable policy limit settlement offers.

The 2000 holding by the Supreme Court of Texas in *Matagorda County* was an issue of first impression in Texas.\footnote{11} *Frank’s* differs from *Matagorda County* for reasons shown in “Subissue 2” to the Petition for Review submitted in *Frank’s*:

The *Matagorda* ruling was limited to its facts and cannot properly be extended beyond them. This Court held in the *Matagorda* case that a primary insurer on a Texas policy, that defends and settles a case, cannot be reimbursed for funds paid to settle noncovered claims without the insured’s consent. The Excess Underwriters here had no authority to settle, no duty to defend, and did not control the defense or settlement, but settled at Frank’s insistence. Frank’s controlled the defense, solicited settlement, and acknowledged coverage issues reserved between Frank’s and Excess Underwriters.\footnote{12}

Thus, new issues are presented with the potential for a new set of reasoning. Although it is entirely possible for the higher court to simply agree with the Fourteenth Court’s decision in *Frank’s* by applying the same ruling as in *Matagorda County*, we foresee a more rational outcome which will put to rest the issue of reimbursement and remove the insurers’ dilemma.

**There is a rational solution.**

We propose an evidentiary exclusion rule that would give insurers the up front chance to disprove coverage without jeopardy of extracontractual damages. The rule would operate in the following manner. Once an insurer determines, in good faith, that its policy may not potentially cover allegations in the underlying lawsuit, the insurer would assume the insured’s defense under a reservation of rights. The insurer would then immediately file a declaratory judgment action to quickly resolve the coverage dispute. Any offer to settle
submitted by the tort plaintiff after the filing of the action for declaratory relief, and before
the court resolves coverage issues in that action, would not be admissible as proof in a later
Stowers action.

This proposed evidence preclusion rule would operate much like the court-created
“complaint allegation rule” the Supreme Court of Texas established in 1965. Our
proposed Stowers evidentiary rule would deny insureds the second element of the Stowers
doctrine, a necessary element before insurers can be nailed with extracontractual liability,
\textit{i.e.}, the rule would render as a nullity any demands on insurers to settle within the policy
limits if those demands are made before coverage issues are resolved in the insurers’ actions
for declaratory relief.

\textbf{How would insurers prove their good faith belief of no coverage?}

Insurers’ good faith beliefs would be questions for triers of fact. However, evidence
that insurers reasonably interpreted and compared policy coverage with allegations of the
complaints or petitions in the underlying tort lawsuits would be supportable in part by
opinions of competent coverage counsel. Ideally, such legal opinions would already be part
of the insurers’ basis to contest coverage, along with other parts of the insurers’ investigation
and claim files.

\textbf{How could the Supreme Court of Texas adopt the new rule?}

The dominant issue in \textit{Frank’s} is whether insurers can recoup from their insureds
indemnity dollars paid to settle potentially non-covered lawsuits against their insureds. In its
review of \textit{Frank’s}, the Supreme Court of Texas could rehash the reimbursement issue
resolved in \textit{Texas Ass’n of Counties County Government Risk Mgmt. Pool v. Matagorda}
County, and simply agree with the Fourteenth Court. However, that would overlook the opportunity to resolve the insurer’s dilemma. A better solution would be for the supreme court to harmonize existing insurance law and provide insurers an equitable solution for the Stowers dilemma.

The Supreme Court of Texas would first have to find proper rationale to reopen the issues of Matagorda County in order to avoid an advisory opinion. This could be done by remanding the case to the trial court and allowing the Frank’s excess insurer to have its coverage issues decided. The reasoning would be based on the fact that the Frank’s excess insurer did not control the defense or settlement processes. The court could then define the exclusionary rule that would prevent the insured from “Stowerizing” that insurer on remand until after the basic issue of coverage is decided.

If the Supreme Court of Texas allows insurers to reject reasonable settlement offers, provided they have good faith beliefs (even though erroneous) that there is no coverage for the underlying tort lawsuits, Frank’s will provide a nonconflicting adjunct to the Matagorda County decision. Why so? Because Matagorda County merely denies reimbursement, it does not preclude actions for declaratory relief to determine coverage.

**The rule would be no burden to Texas insureds.**

The proposed rule would not be unfair or inequitable to Texas insureds who bargained only for coverage described in the policy, not for windfalls arising from Stowers, a court-created rule. As exemplified in Frank’s, insureds can now easily seize control of the Stowers windfall, creating the unfair dilemma for insurers. The rule would substantially eliminate
Stowers as a plaything used by tort plaintiffs to coerce insureds into seeking benefits not bargained for in their insurance contracts.

Rewriting liability insurance policies, as suggested in Franks, misses the point. Reimbursement from insureds need never be an issue if the supreme court adopts our proposed rule. Furthermore, the rewriting of liability insurance policies would provide no real solution if insureds lack the financial resources to repay settlements. Rewritten insurance policies would discriminate against solvent insureds and would foster litigation over money rather than promote quick and equitable justice under actions for declaratory relief, most of which can be resolved by summary judgment rather than requiring full-blown trials.

If the Supreme Court of Texas ignores the problem, liability insurance coverage may tend to dry up, just as homeowners’ and medical malpractice coverage suffered under uncured economic pressures.

**How do other jurisdictions handle the question of coverage and the duty to settle?**

Contrary to the course of Texas insurance law, the California Supreme Court created the reimbursement mess by holding that the question of coverage is an irrelevant factor when insurers respond to policy limit settlement demands. Over the course of more than forty years, the California Supreme Court lessened the harshness of that rule by allowing insurers to seek reimbursement from their insureds in several different situations. First, where insurers provide the funds to settle lawsuits when there is absolutely no coverage under their policies; second, where allegations in tort lawsuits are only partially covered by their policies; and, third where insurers incur and pay defense costs where allegations in the underlying lawsuits are only partially covered.
The California Supreme Court developed a series of rules about recovery from insureds of defense costs and settlement payments:

1. Insurers may not seek reimbursement of defense costs from their insureds where there is a potential for policy coverage of the allegations in the lawsuits.

2. However, in certain instances insurers may seek reimbursement for defense costs from their insureds for noncovered allegations, but insurers bear the burden of proving proper allocation of those defense costs by a preponderance of the evidence.\(^{18}\)

3. Insurers may obtain reimbursement from their insured for settlement payments allocated solely to allegations for which there is no policy coverage.

The California Supreme Court considered whether insurers act in bad faith if they refuse to accept reasonable, policy limit settlement offers, based on their good faith belief that their policies do not cover the underlying tort lawsuits. As framed by one commentator, the California Supreme Court ultimately concluded that:

the insurer’s belief that the policy does not provide coverage cannot be allowed to affect the insurer’s decision as to whether a policy limit settlement offer should be accepted. Instead, the insurer should evaluate the settlement offer as if there was no doubt about coverage and reserve the defense of non-coverage if necessary. In a separate action, the insurer may then seek reimbursement from the insured if it should succeed in establishing a lack of coverage.\(^{19}\)

Thus, under California law, because insurers contractually control the settlement process (the same rationale as in Texas), insurers assume the full risk of improper failures to settle within policy limits. The fact that liability policies do not cover allegations in the underlying lawsuits, in whole or in part, is not an allowable defense. The California test requires insurers to (1) presume their policies cover allegations in the underlying lawsuits, and (2) to settle if reasonable insurers would do so. If there turns out to be no coverage or
only partial coverage, insurers get the chance to recover both defense costs and indemnity dollars from their insureds under principles of restitution or unjust enrichment.

A matter of California public policy arises because insurers contractually assume complete control of the defense of their insureds’ under contracts of adhesion. Under California law, insurers must subordinate their disputes over coverage in absolute favor of their insureds’ interests, leaving insurers with exclusive authority to respond to reasonable policy limit settlement offers. If insurers wish to dispute coverage, they must first accept reasonable settlement offers, reserve their rights to reimbursement from their insureds, and file lawsuits to have courts determine whether there was coverage for allegations settled by the insurers. Approximately 19 jurisdictions follow the “California Rule.”

There are also approximately 19 jurisdictions that favor a rule similar to the one we advocate here for Texas. Sometimes called the “Wisconsin Rule,” this rule generally agrees with our hypothesis that good faith, but mistaken, refusals to accept reasonable settlement offers due to coverage defenses should insulate insurers from excess judgments.

A few jurisdictions apply a variety of multi-factor tests to measure the reasonableness of insurers’ refusals to pay settlement demands, generally favoring the advocated position presented here for Texas.

The Supreme Court of Texas also has a practice of considering public policy

The rule we propose is entirely consistent with the views of the Supreme Court of Texas. Examples of how the proposed exclusionary rule harmonizes nicely with the balancing practices of court-created Texas insurance law are these:

1. The proposition that insurers have no duty to settle alleged claims that are not covered under their policies.
2. The proposition that the *Stowers* remedy of shifting the risk of excessive judgments to insurers is inappropriate without proof that insurers were presented with a “reasonable opportunity” to prevent the excess judgment by settling within policy limits.\(^{24}\)

3. The court’s decision not to burden insurers with a duty to make settlement offers under *Stowers*, supported by the public interest that favors early dispute resolution.\(^{25}\)

4. The proposition that insureds and plaintiffs are not entitled to enter agreements that prevent insurers from litigating coverage defenses.\(^{26}\)

5. The court’s abhorrence of arrangements that present “tremendous incentive” for insureds and plaintiffs to conspire against insurers, resulting in “confused and distorted” litigation.\(^{27}\)

6. The proposition that a judgment against an insured without a fully adversial trial is not binding on an insurer, nor is it admissible as evidence of damages in later lawsuits against insurers.\(^{28}\)

**Conclusion**

The Supreme Court of Texas refused to recognize a right of reimbursement in *Matagorda County*. We urge the court to perpetuate that decision. When the court fairly disposes of *Frank’s*, the court should observe that a good faith, but mistaken belief that the policy does not cover the tort plaintiff’s suit creates an absolute defense to a *Stowers* suit. If the Texas Supreme Court makes such a pronouncement in *Frank’s*, it would fairly bridge the gap between the lack of insurers’ rights to seek reimbursement of defense and settlement costs under Texas law and the perception that insurers must settle lawsuits against their insureds, when appropriate and to avoid excess judgments, even though coverage may not exist. Such an outcome in *Frank’s* would strike a proper balance in Texas law between the *Matagorda County* decision of no insurer right to reimbursement and the use of “no coverage” as a defense to a *Stowers* lawsuit. Although that balance would be dissimilar to the solution in California, given the holding in *Matagorda County* which bars
reimbursement, there are few other reasonable alternative solutions for the dilemma faced by Texas liability insurers.

1 G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm’n App. 1929, holding approved) (insurers must accept settlement offers within policy limits if allegations are covered and ordinarily prudent persons would accept them, considering the likelihood and degree of insureds’ potential exposure to judgments in excess of policy limits).

2 The word “allegations” is used in this article in deference to the “complaint allegation rule,” and is intended to mean the “claims” against the liability insurance policy that are potentially raised by the pleadings in the underlying tort lawsuit brought against the insured.


5 Texas Ass’n of Counties County Government Risk Management Pool v. Matagorda County, 52 S.W.2d 128 (Tex. 2000).

6 93 S.W. 3d at 180. (Emphasis in the original).

7 The trial court initially held in favor of the insurer on cross-motions for summary judgment, but reversed its course after the supreme court decided the referenced Matagorda County case. Texas Ass’n of Counties County Government Risk Management Pool v. Matagorda County, 52 S.W. 2d 128 (Tex. 2000).

8 Texas Ass’n of Counties County Government Risk Management Pool v. Matagorda County, 52 S.W.2d 128, 135 (Tex. 2000).


10 821 S.W.2d 701, 706 (Tex. App.--Houston [14th Dist.] 1991, writ denied). The contested instruction in Riggs, provided as follows:

  You are further instructed that any question at SENTRY whether or not there was coverage for RIGGS’ claim against SAMUEL RAMIREZ must not be considered in deciding Question No. [5 or 6]. That is, you must consider Question No. [5 or 6] and the above instruction as though there was no question at SENTRY that such coverage existed when RIGGS made his offer to settle.

11 Texas Ass’n of Counties County Government Risk Management Pool v. Matagorda County, 52 S.W. 2d 128, 131 (Tex. 2000).


American Physicians Ins. Exchange v. Garcia, 876 S.W.2d 842, 848 (Tex. 1994) (Stowers duty not activated unless the claim against the insured is within the scope of coverage; settlement demand is made within policy limits, and the terms of the demand must be such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured’s potential exposure to an excess judgment).

52 S.W.3d 128 (Tex. 2000).


28 State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696, 714 (Tex. 1996).