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Texas – Supreme Court Issues Two Major Rulings About the Duty to Defend and the Eight-Corners Rule

BY: Jeremy S. Macklin

The Texas Supreme Court has now issued two major rulings this year regarding the scope of an insurer's duty to defend: *Richards v. State Farm Lloyds* and *Loya Ins. Co. v. Avalos*. Both decisions address the "eight-corners rule" Texas courts use to determine a liability insurer's duty to defend its insured. The eight-corners rule gets its name from the fact that only two documents are ordinarily relevant to the determination of the duty to defend, each of which has four corners: the pleadings against the insured and the insurance policy.

Generally, facts outside the pleadings, even those easily ascertained, are not material to the determination of an insurer's duty to defend. Additionally, under Texas law, allegations against the insured are liberally construed in favor of coverage. The Fifth Circuit Court of Appeals, applying Texas law, and various Texas courts of appeal have adopted an exception to the eight-corners rule derived from *Northfield Ins. Co. v. Loving Home Care, Inc.* The *Northfield* exception allows consideration of extrinsic evidence bearing on the duty to defend when: (1) it is initially impossible to discern whether coverage is potentially implicated and (2) the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the merits of or engage the truth or falsity of any facts alleged in the underlying case. The Texas Supreme Court, however, has not had occasion to address the *Northfield* exception, although has twice acknowledged its widespread use.

In *Richards v. State Farm Lloyds*, the Fifth Circuit Court of Appeals certified an eight-corners exception case to the Texas Supreme Court. Janet and Melvin Richards were the defendants in a personal injury lawsuit brought by Amanda Meals. Meals, the Richards' daughter, sued them for the death of her son Jayden who died in an ATV accident while under the Richards' supervision. The underlying complaint alleged that Jayden was under the defendant-grandparents' "supervision" and alleged the accident occurred "[o]n or near the Defendants' residence." The Richards asked their insurer, State Farm, to defend (and if necessary, indemnify) them. State Farm refused and sought a declaration in federal court that it had no duty to defend or indemnify. In doing so, State Farm argued two exclusions barred coverage and relied on extrinsic evidence.

The first exclusion, the "motor-vehicle exclusion," barred coverage for bodily injury arising from the use of an ATV *while off an insured location*. Although the complaint was silent as to the location of the accident, State Farm attached a vehicle crash report showing that the accident occurred away from the Richards' premises, as well as the Richards' admissions that the accident occurred off an insured location. The other exclusion – the "insured exclusion" – barred coverage for bodily injury to any insured, which includes "you" and "your" relatives *if residents of your household*. State Farm attached the Richards' admission that they were Jayden's grandparents, as well as an order appointing them as joint-managing conservators, to show that the boy was a "resident of [the Richards'] household." Again, the complaint was silent as to the boy's residency.

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The narrow issue addressed by the Texas Supreme Court was an issue of policy interpretation. While some liability policies agree to defend an insured even if the allegations of the lawsuit are “groundless, false, or fraudulent,” the State Farm policy at issue did not contain that language. State Farm argued that the eight-corners rule does not apply unless the policy includes the “groundless, false, or fraudulent” language. The Texas Supreme Court rejected that argument, holding that State Farm did not contract away the eight-corners rule altogether merely by omitting from its policy an express agreement to defend claims that are “groundless, false or fraudulent.”

The *Richards* holding is limited to rejection of the policy language exception raised by State Farm. Interestingly, the Texas Supreme Court did not reject possible exceptions to the eight-corners rule under *Northfield* or similar decisions. In fact, the court seemed to recognize that these may be legitimate exceptions to the eight-corners rule.

In *Loya Ins. Co. v. Avalos*, the Texas Supreme Court was again presented with an eight-corners exception issue. Loya Insurance Company (the insurer) sold an automobile liability insurance policy to Karla Flores Guevara. Guevara’s husband, Rodolfo Flores, was explicitly excluded from the policy’s coverage. While moving Guevara’s car, Flores collided with another car carrying Osbaldo Hurtado Avalos and Antonio Hurtado (collectively, “the Hurtados”). The Hurtados, Guevara, and Flores agreed to tell both the responding police officer and the insurer that Guevara was driving the car rather than Flores.

The Hurtados sued Guevara claiming damages resulting from Guevara’s negligent operation of her vehicle. Loya agreed to defend Guevara in the lawsuit. Early in the discovery process, Guevara disclosed the lie to her attorney and identified Flores as the driver. Loya responded to this information by canceling Guevara’s scheduled deposition and denying her both a defense and coverage.

The Texas Supreme Court was tasked with determining whether Loya’s duty to defend was bound by the allegation in the pleading that Guevara was operating the car at the time of the accident (triggering a duty to defend) or whether Loya could rely on the statement from Guevara contradicting the pleadings (implicating the policy exclusion for operation of the vehicle by Flores). The Texas Supreme Court stated that the court has never before recognized an exception to the eight-corners rule, but acknowledged that other courts have and that the court’s prior decisions “left open the question whether to do so in an appropriate case.”

In *Avalos*, the court held that “[t]his is such a case” to recognize an exception to the eight-corners rule. The court held that the eight-corners rule “does not bar courts from considering such extrinsic evidence regarding collusive fraud by the insured in determining the insurer's duty to defend.” While the duty to defend in liability insurance policies applies to fraudulent allegations against the insured by third parties, insurers do not agree to undertake (and the insured has not paid for) a duty to defend the insured against fraudulent allegations brought about by the insured itself. In other words, while fraudulent allegations by a third-party claimant must still be analyzed under the eight-corners rule, the insured’s involvement in creating those allegations is what triggers the exception.

The *Avalos* decision is significant for two reasons. First, it provides guidance to insurers faced with an eight-corners issue like *Avalos*: insurers are encouraged to seek a favorable declaratory judgment before withdrawing a defense. Second, while the *Avalos* decision is narrow in scope, the Texas Supreme Court is open to recognizing exceptions to the eight-corners rule in the appropriate case. Whether the Texas Supreme Court will adopt the *Northfield* exception, however, remains to be seen.

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