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TEXAS SUPREME COURT ALTERS DUTY TO DEFEND ANALYSIS

Texas Supreme Court Alters Duty to Defend Analysis (PDF Client Alert)

MONROE GUARANTY INSURANCE CO. V. BITCO GENERAL INSURANCE CORP.,

No. 21-0232, 2022 WL 413940, — S.W.3d — (Tex. Feb. 11, 2022)

It has long been Texas law that the duty to defend is determined by comparing the allegations in the underlying petition (complaint)—without regard to their truth or falsity and without reference to facts known or proven—with the terms of the insurance policy. Under this "eight-corners rule," if the plaintiff's allegations, taken as true, state a potentially-covered claim under the policy, the insurer has to defend the entire underlying suit regardless of extrinsic evidence that would establish a lack of coverage.

In 2004, the U.S. Court of Appeals for the Fifth Circuit issued a ruling in *Northfield Insurance Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 (5th Cir. 2004), predicting the Texas Supreme Court would recognize an exception to the eight-corners rule and allow extrinsic evidence to be considered in determining an insurer's duty to defend in situations where:

1. It is initially impossible to discern whether coverage is potentially implicated;
2. The extrinsic evidence goes solely to a fundamental issue of coverage; and
3. The extrinsic evidence does not overlap with the merits of or engage the truth or falsity of any facts alleged in the four corners of the petition.

Ever since *Northfield*, numerous courts applying Texas law have utilized the "*Northfield* exception" to resolve difficult duty-to-defend issues. Yet the Texas Supreme Court did not directly address the *Northfield* exception until last week. While the Court could have resolved this issue in *Loya Insurance Co. v. Avalos*, 610 S.W.3d 878, 882 (Tex. 2020), the Court recognized only a narrow exception to the eight-corners rule for extrinsic evidence showing the insured committed fraud in connection with the insurance claim. This left unsettled whether the Court would recognize a broader exception to the rule, like the *Northfield* exception. Thus, the Fifth Circuit certified questions to the Texas Supreme Court last year concerning whether extrinsic evidence can be considered in accordance with *Northfield*. The Texas Supreme Court answered these questions in a February 11, 2022 decision, ***Monroe Guaranty Insurance Co. v. BITCO General Insurance Corp.***

Facts: During the summer of 2014, a Texas landowner contracted with 5D Drilling & Pump Service, Inc. ("5D") to drill a 3,600-foot commercial irrigation well. BITCO provided two consecutive one-year CGL policies to 5D covering the period from October 2013 to October 2015. Monroe issued a CGL policy for the period from October 2015 to October 2016. The landowner sued 5D in 2016, alleging breach of contract and multiple acts of negligence resulting in property damage, but the petition failed to allege when those acts and damages occurred.

BITCO defended 5D under a reservation of rights. Monroe declined coverage, contending the property damage occurred before its policy period and 5D knew prior to the policy's inception that the property damage had occurred. BITCO paid to settle the underlying lawsuit, and then filed suit in federal district court seeking a declaration that Monroe owed 5D a defense. BITCO and Monroe stipulated that one of the events causing property damage, 5D's drill bit getting stuck in the bore, occurred "in or around November 2014," well before Monroe's policy incepted. BITCO and Monroe both sought summary judgment. The district court granted summary judgment in favor of BITCO, holding that the stipulation was extrinsic evidence that could not be considered in determining the duty to defend. Monroe appealed to the Fifth Circuit, which certified questions to the Texas Supreme Court.

Holding: The Texas Supreme Court adopted the *Northfield* exception to the eight-corners rule with several important modifications discussed below. Nevertheless, in this case, the Court ruled that the extrinsic evidence as to the date of property damage could not be used in determining the duty to defend because such evidence overlaps with the merits of the underlying lawsuit. Significantly, the Court held: "A dispute as to *when* property damage occurs also implicates *whether* property damage occurred on that date, forcing the insured to confess damages at a particular date to invoke coverage, when its position may very well be that no damage was sustained at all." *Monroe*, 2022 WL 413940, at *7 (emphasis included).

The Court observed that the stipulation only proved that the drill bit became stuck in the well-bore in November 2014, not that any property damage also occurred on that date. *Id.* at *8. While Monroe argued that its duty to defend was relieved by this stipulation because it proved property damage occurred at that time (prior to Monroe's policy period), the Court assumed that 5D likely would have sought to prove in the underlying lawsuit that the sticking of the drill bit was not the cause of any damage. *Id.* Thus, the Court held the stipulation could not be used to determine whether Monroe had a duty to defend because the use of the stipulation in the manner urged by Monroe would overlap with the merits of liability in the underlying lawsuit. *Id.*

How this holding could impact insurers: Insurers and insureds have long awaited meaningful guidance from the Texas Supreme Court on whether extrinsic evidence exceptions to the eight-corners rule exist in Texas. In *Monroe*, the Court finally adopted what appears to be a relatively-broad exception to the eight-corners rule and articulated a fairly straightforward test for its application.

While the eight-corners rule remains the initial inquiry to determine whether a duty to defend exists, the Texas Supreme Court held that if the underlying petition states a claim that could trigger the duty to defend and, after applying the eight-corners rule, there is a gap in the plaintiff's pleading such that the "eight corners" are not determinative of whether coverage exists, Texas law permits consideration of extrinsic evidence provided it:

1. Goes solely to an issue of coverage and does not overlap with the merits of liability;
2. Does not contradict facts alleged in the pleading; and
3. Conclusively establishes the coverage fact to be proved.

Id. at *7.

The Texas Supreme Court mostly agreed with the *Northfield* decision, but there are three key exceptions. First, the Court rejected the *Northfield* exception to the extent it is limited to situations where it is "initially impossible" to discern whether coverage is "potentially" implicated. *Monroe* at *6. The Court viewed this standard as an invitation for courts to "read facts into the pleadings" or "imagine factual scenarios which might trigger coverage," which the Court has long disallowed. *Id.* Rather, the Court determined that the proper inquiry is: "does the pleading contain the facts necessary to resolve the question of whether the claim is covered?" *Id.* Second, *Northfield* requires that the extrinsic evidence pertain to a "fundamental" coverage issue, such as whether the person sued or the property damaged is covered under the policy, which the Court eliminated as an unnecessary consideration. *Id.* Third, the Court held that, unlike in *Northfield,* the extrinsic evidence must conclusively prove the coverage fact issue, although such extrinsic evidence "need not be the subject of a stipulation" and "[o]ther forms of proof may suffice." *Id.* at *7.

As with any such development, disputes are certain to arise. Issues that are likely to be litigated in the future include: (i) what constitutes a sufficient "gap in the plaintiff's pleading"; (ii) whether extrinsic evidence "goes solely" to coverage and does not "overlap with the merits of liability"; (iii) whether extrinsic evidence "contradicts facts alleged in the pleading"; and (iv) whether extrinsic evidence "conclusively establishes" a coverage fact.

Nonetheless, *Monroe* is a significant development in Texas law that will provide experienced coverage counsel new bases for resolving duty-to-defend disputes when coverage is unclear from the allegations in the underlying lawsuit.