RECENT DEVELOPMENTS

INSURANCE

SURETYSHIP, AS HISTORICALLY UNDERSTOOD IN THE INSURANCE AND SURETYSHIP FIELDS, DOES NOT CONSTITUTE THE BUSINESS OF INSURANCE UNDER ARTICLE 21.21

Dallas Fire Ins. Co. v. Texas Contractors Surety and Casualty Agency, ____ S.W.3d ____ (Tex. 2004).

FACTS: Bond agent, Texas Contractors Surety and Casualty Agency ("TCSCA") signed an Agency-Company agreement in late 2003 to issue surety, performance, and bid bonds on behalf of Dallas Fire Insurance Company ("Dallas Fire"). As part of the agreement, for each bond sold by TCSCA, Dallas Fire agreed to pay a straight commission, plus a contingency profit commission based on premiums collected adjusted by a loss ratio reflecting losses and expenses.

During 1994 and 1995, Dallas Fire calculated the contingency using direct expenses incurred in handling bond claims and paid TCSCA on that basis. In 1996 it calculated the contingency commission to include indirect expenses as well, preventing TCSCA from receiving contingency commissions. Dallas Fire also demanded reimbursement for previously paid excess commission on this basis.

TCSCA filed suit for breach of the Agency-Company Agreement and deceptive acts violation of Tex. Ins. Code. Art. 21.21 § 16(a). The jury found for TCSCA awarding damages under the Insurance Code, but denied its recovery under the breach of contract claim. Dallas Fire appealed arguing that TCSCA had no claim under Article 21.21. The court of appeals affirmed. Dallas Fire appealed.

HOLDING: Reversed.

REASONING: According to *Great American Insurance Co., v. North Austin Utility District No. 1*, 908 S.W.2d 415 (Tex. 1995), suretyship is not included in the scope of Article 21.21, which provides a cause of action for unfair or deceptive acts or practices in the business of insurance. The court held that the appeals court read the Great American ruling too narrowly and also incorrectly relied on evidence that Dallas Fire's primary line of business was commercial liability insurance and its surety bonds were insurance products for the purpose of licensing under article 21.02. The interpretation was irrelevant because all that was involved was a commission dispute involving the sale of surety bonds and TCSCA's claims arose in the business of suretyship, not the business of insurance.

The court pointed out the unique characteristics of suretyship, particularly that insurance involves spreading risks with no right of indemnity, while suretyship involves risks of initial payment with full right of indemnity. Given the unique character, rights, and obligations of suretyship, and the complexities that would result by the imposition of liability under 21.21, the court could not conclude that the Legislature intended to include suretyship in the definition of the business of insurance under article 21.21. Absent a clear legislative directive, suretyship, as historically understood in the insurance and suretyship fields, does not constitute the business of insurance under article 21.21.

FIFTH CIRCUIT CERTIFIES QUESTION TO TEXAS SUPREME COURT: DOES THE ENSUING LOSS PROVISION CONTAINED IN SECTION I EXCLUSIONS, PART 1 (f) OF THE HOMEOWNERS FORM B (HO-B) INSURANCE POLICY AS DESCRIBED BY THE TEXAS DEPARTMENT OF INSURANCE, EFFECTIVE JULY 8, 1992 (REVISED JANUARY 1, 1996), WHEN READ IN CONJUNCTION WITH THE REMAINDER OF THE POLICY, PROVIDE COVERAGE FOR MOLD CONTAMINATION CAUSED BY WATER DAMAGE THAT IS OTHERWISE COVERED UNDER THE POLICY?

Fiess v. State Farm Lloyds, 392 F.3d 802 (5th Cir. 2004).

FACTS: Richard and Stephanie Fiess brought suit against their homeowner's insurance carrier, State Farm Lloyds ("State Farm"), seeking coverage for losses incurred as a result of mold contamination in their house. When the Fiesses were removing damaged sheetrock in their house after Tropical Storm Allison, they found the house was contaminated with a large amount of mold that was not related to the tropical storm. Believing the insurance award to be inadequate to cover damages caused by mold attributable to pre-flood water leaks, the Fiesses asserted claims under the DTPA, breach of contract, fraud, intentional misrepresentation, breach of warranty, and violations of the Texas Insurance Code. The district court granted State Farm's motion for summary judgment on all claims. The Fiesses appealed claiming their ensuing loss provision provided coverage for mold contamination caused by otherwise covered water damage. The provision stated, "We do not cover loss caused by: …rust, rot, mold or other fungi. We do cover ensuing loss caused by collapse of building or any part of the building, water damage…if the loss would otherwise be covered under this policy."

HOLDING: Question certified to the Supreme Court of Texas.

REASONING: The Supreme Court of Texas is empowered to answer "questions of law certified to it by any federal appellate court if the certifying court is presented with determinative questions of Texas law having no controlling Supreme Court precedent." Tex.R.App. P. 58.1. The court could identify no binding Texas Supreme Court case law addressing the question of whether the ensuing loss provision at issue in this case provided coverage for mold contamination resulting from otherwise covered water damage. The cases that have addressed the issue of the proper interpretation of the ensuing loss provision can be grouped into two categories. One group of cases provides for a general exclusion for "rust, rot, mold or other fungi" but includes an exception for mold contamination resulting or ensuing from a covered water damage event. The other group of cases denies coverage for mold contamination caused by a covered water event unless a preceding cause, a proximate cause, and an ensuing loss are shown. A preceding cause is one enumerated in the exclusion list, such as "rust, rot, mold or other fungi." A proximate cause must be one of the

forms of damage listed in the ensuing loss provision, including otherwise covered water damage. The issue was submitted to the Supreme Court of Texas to resolve.

FAILURE TO INDEPENDENTLY ADJUST HAIL DAMAGES DOES NOT CONSTITUTE FAILURE TO CONFIRM OR DENY COVERAGE, OR BAD FAITH

Harris v. American Protection Ins.Co., 158 S.W.3d 614 (Tex. App.—Fort Worth 2005).

The court found that American attempted, in good faith, to effectuate a prompt, fair and equitable settlement of a claim.

FACTS: Southwest Portfolio, Inc. ("Southwest") owned a building with a roof damaged in a hailstorm. Southwest had insurance policies on the building from both Aetna Life and Casualty ("Aetna") and American Protection Insurance Company ("American"). Each policy covered fifty percent of the loss. Southwest, however, only placed a claim with Aetna, which was unaware of American's liability. Aetna agreed to pay $712,613.40, $268,445.90 immediately for actual cash value of the loss ("ACV") and $444,167.50 for repairs as incurred. Before repair costs were incurred, but after Southwest was reimbursed for the loss in value, the insurance broker who sold both policies notified American of the claim. American's adjuster then contacted the Aetna adjuster who asked American to reimburse Aetna for one half of the ACV. American subsequently paid half of the ACV. Soon thereafter, Southwest sold the building to G.L. Harris. The sales agreement gave Harris credit for amounts paid or payable on the insurance claims from the building.

Harris then hired a contractor who did not repair the roof properly, and Harris received in total $680,260 for the repair costs Although Harris represented to Aetna that he had paid $690,000 to replace the roof, he had actually paid only $375,000. American reimbursed Aetna for half of the amount. Later, the roof sustained further damage due to the faulty replacement, and Harris filed a claim for $1.8 million. Both American and Aetna rejected the claim. Harris filed suit against Aetna. Aetna added American as a necessary party and Harris sued American for breach of insurance contract by failing to pay policy benefits and under article 2155 and section 4(10) of article 21.21 of the Texas Insurance Code. American counterclaimed against Harris for fraud for the misrepresentation of the amount of the repairs. Aetna settled, and the trial proceeded between Harris and American.

The trial court found for American on the hail damage breach of contract and insurance claims as a matter of law. In addition, the court found for Harris on American's counterclaim for fraud as a matter of law.

HOLDING: Affirmed.

REASONING: The main issue settled by this case was whether American's failure to have its own adjuster calculate hail damages was a failure to confirm or deny coverage or bad faith under section 4(10) of article 21.21 of the Texas Insurance Code.

Section 4(10) of article 21.21 of the Texas Insurance Code prohibits insurance companies from unfair settlement practices and failing to affirm or deny coverage of a policyholder's claim within a reasonable time. Neither Southwest nor Harris made a claim for hail damage under the American policy. In addition, Southwest deliberately settled directly with Aetna and instructed American to settle its liability for the claim directly with Aetna. Finally, American then appropriately confirmed its coverage with Aetna and complied with Aetna's request and right under subrogation to be reimbursed for American's share of the hail damage claim. As a result, the court found there was no failure to affirm or deny coverage of the claim to the policy holder within a reasonable time.

Section 4(10) of article 21.21 of the Texas Insurance Code also prohibits failure to attempt in good faith to effectuate a prompt, fair and equitable settlement of a claim with respect to which an insurer's liability has become reasonably clear. Promptly after getting notice of hail damage, American sent its adjustor out to inspect the roof, reviewed documentation relied upon by Aetna's adjustor, and talked with Aetna's adjuster. American then acknowledged coverage and timely reimbursed Aetna for half of the ACV payment. In addition, American reimbursed Aetna for the remainder of the repair costs after Aetna's request and after additional fact gathering. Since Aetna was subrogated, and the insured instructed American to settle its liability with Aetna, payment to Aetna for settlement of the claim was reasonable. Therefore, the court found that American attempted, in good faith, to effectuate a prompt, fair, and equitable settlement of a claim with respect to which an insurer's liability had become reasonably clear.

COURT AFFIRMS BAD FAITH PUNITIVE DAMAGES THAT ARE 75 TIMES ACTUAL DAMAGES

Willow Inn, Inc. v. Pub. Serv. Mut. Ins. Co., 399 F.3d 224 (3d Cir. 2005).

FACTS: A tornado caused extensive damage to the Willow Inn, a bar/restaurant and residence in Willow Grove, Pennsylvania. Willow Inn hired a public adjusting firm to assist it in submitting its insurance claim to Public Service Mutual Insurance Company ("PSM"), its real and personal property insurance carrier. The adjuster forwarded its initial claim estimate of $216,000 to PSM's adjuster. PSM's adjuster provided an estimate of $90,000. At Willow Inn's request PSM advanced a $75,000 payment to its insured. Because of the variance between their estimates, the two parties' adjusters retained a contractor to evaluate the loss to Willow Inn and agreed to a claim amount of $126,810. PSM's adjuster recommended this amount to PSM. Willow Inn then submitted a sworn Proof of Loss for $127,810, an amount that after the $1000 deductible was the same as that agreed upon by the adjusters. Willow Inn also claimed an additional $2000 for preparations costs, the maximum allowed under a separate policy provision. PSM rejected the Proof of Loss and did not respond to the $2000 claim. PSM offered another estimate of loss of $91,312. Willow Inn rejected this offer, withdrew

its adherence to its earlier proposed settlement and, per the policy, requested an appraisal within 20 days. PSM initially refused the appraisal request and only after 8 months submitted to an appraisal, relying on documents it originally averred were insufficient. The appraisal umpire fixed the claim at $117,000, which, less the $75,000 dollar advance, PSM paid. PSM did not pay the $2000 preparations costs claim.

Willow Inn filed suit and the parties agreed to a bench trial. The district court awarded Willow Inn $2000 on the breach of contract claim, $150,000 in punitive damages, $128,075 in attorney fees and $7,372 in costs. PSM appealed, claiming *inter alia* that the punitive damages assessment was constitutionally excessive. The court vacated and remanded that award to the district court with instructions to apply the guideposts outlined in *BMW of N. American, Inc. v. Gore*, 517 U.S. 559 (1996). On remand the district court declared its $150,000 punitive damages award not to be constitutionally excessive.

HOLDING: Affirmed.

REASONING: The court found the $150,000 punitive damages to approach but not cross the constitutional line after it considered the district court's application of the three *Gore* guideposts.

The court recognized that perhaps the most important indicum of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant's conduct and explained that the critical input to the reprehensibility calculus in this case was whether the delay in settling the claim was due to legitimate differences of opinion over its value, or rather to PSM's dilatoriness and inertia. The court examined the district court's findings regarding the subfactors of the reprehensibility analysis and agreed that the plaintiff was financially vulnerable as Willow Inn was a modest family-run business. The court disagreed that the various stonewalling tactics employed by PSM in processing Willow Inn's claim satisfied the "repeated conduct" reprehensibility subfactor because "repeated conduct" in *Gore* involved not merely a pattern of contemptible conduct within one extended transaction, but rather specific instances of similar conduct by the defendant in relation to other parties. The court further held that the delay in settling the claim was due to intentional stonewalling. PSM repeatedly asked Willow Inn for documentation that had already been submitted or was unnecessary. PSM also unreasonably asserted that no dispute warranting an appraisal existed and froze the appraisal process. The court concluded that the punitive damages award was not out of proportion to the reprehensibility of PSM's conduct.

The Court next examined the ratio of the punitive damages award to the actual harm inflicted on the plaintiff. In determining the figure that comprised the second term of the ratio the court rejected the amount the district court used: "Willow Inn's claim under the policy and the payment that it belatedly received," approximately $125,000. As Willow Inn's main insurance claim had been settled before this case was brought, and because the $2000 contract claim award was only incidental to the bad faith thrust of the litigation, the court concluded that attorney fees and costs awarded was the proper term to compare to the punitive damages award for ratio purposes. These awards totaled $135,000, resulting in approximately a 1:1 ratio, which is indicative of constitutionality under *Gore*.

The court found the district court was mistaken to consider attorney fees to be a "civil penalty" when applying the third *Gore* guidepost. The court held the most applicable civil penalty to compare with the punitive damages amount was a penalty of up to $5000 contained in Pennsylvania's Unfair Insurance Practices Act. The court also noted that PSM's conduct arguably could have resulted in the revocation of one's license to issue insurance policies. The court recognized the lack of Supreme Court guidance on this issue and the difficulty in measuring civil penalties against punitive damages. While unsure as to how to apply this guidepost, the court was reluctant to overturn the punitive damages award on this basis alone. Finding the punitive damages award not constitutionally excessive, the court affirmed the judgment of the district court.

DEBT COLLECTION

DEBT COLLECTOR WAS NOT LIABLE UNDER FEDERAL LAW FOR CONTACTING THE DEBTOR DIRECTLY WHEN THE COLLECTOR WAS UNAWARE THAT THE DEBTOR WAS REPRESENTED BY COUNSEL

Schmitt v. FMA Alliance, 398 F.3d 995 (8th Cir. 2005).

FACTS: Schmitt incurred a debt to First Bank U.S.A ("First Bank"). He failed to pay the debt and he retained an attorney. The attorney informed First Bank that he represented Schmitt and that Schmitt was unable to pay the debt. After receiving the attorney's notice, First Bank transferred Schmitt's account to FMA Alliance ("FMA") to collect from Schmitt. Thereafter, FMA sent a letter directly to Schmitt seeking immediate payment, warning of accruing interest and naming First Bank as the creditor.

Schmitt filed a complaint charging that the letter from FMA violated the Fair Debt Collection Practices Act ("FDCPA"), which prohibits a debt collector from contacting a debtor where the collection agency "knows" the consumer is represented by an attorney. Schmitt's complaint premised FMA's liability on the theory that a creditor's actual knowledge of a debtor's representation is imputed to its agent (i.e., the debt collection agency). The magistrate judge construed the FDCPA to require actual knowledge by the debt collector and reasoned that although First Bank knew of Schmitt's representation, FMA did not. The district court adopted the magistrate's recommendation and dismissed the complaint. Schmitt appealed.

A distinction between creditors and debt collectors is fundamental to the FDCPA.