

Absent Duty to Defend, Insurer Does Not Have to Determine Coverage Until after Judgment or Settlement

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A Texas appellate court has held that an errors and omissions insurer who did not have a duty to defend, but only a right to defend, was not required to decide coverage under the policy until a reasonable time after settlement, rather than within a reasonable time after tender of the claim. *Comsys Info. Tech. Svcs., Inc. v. Twin City Fire Ins. Co.*, 2003 WL 22901017 (Tex. App. Ct. Dec. 4, 2003). The court also held that where parts of the underlying settlement were covered by the policy, and parts were not, the policyholder had the burden of segregating damages.

The insured computer contractor purchased an E&O policy that had a limit of \$5 million and a retention of \$250,000. The policy provided that the insurer would pay "all sums which the insured shall become legally obligated to pay as damages." Further, the policy provided that:

- The "insured against whom a 'claim' is made shall have the duty to defend any 'suit' seeking damages; "
- The "insured will...have the obligation of paying any defense counsel selected by or on behalf of the insured and all defense costs" and
- The insurer "shall not be obligated to assume charge of, participate in, or pay for the investigation or defense of any 'claim' or 'suit.'"

However, the policy also provided that if the suit is "reasonably likely" to result in damages in excess of the retention, the insurer has "the right but not the duty to assume control of the defense."

A company that had retained the contractor to develop and implement a project sued the contractor in 1997 for negligence and negligent misrepresentation in failing to properly perform and supervise work on its computer system. The contractor filed a counterclaim against the company for unpaid work. In 2000, the parties settled the lawsuit for \$275,000, plus forgiveness of the \$114,000 in unpaid work. A month and a half after the contractor tendered the claim to the insurer for \$139,000 (the amount of settlement in excess of the retention), the insurer denied coverage because the contractor had settled the suit without first obtaining the insurer's consent and because coverage was barred by certain exclusions in the policy. Coverage litigation

ensued and, in that litigation, the contractor sought to recover both the settlement amount, as well as additional damages, including loss of good will and the additional costs it incurred in completing the project.

As an initial matter, the court rejected the contractor's argument that the insurer had waived the settlement-without-consent provision in the policy by waiting a month and a half to deny coverage or, alternatively, that it was estopped from doing so. The court reasoned that because the policy did not require the insurer to defend and the insurer did not exercise its right to defend, the insurer was only obligated to determine whether the suit was covered within a reasonable time after judgment or settlement and therefore did not waive its right to deny coverage by waiting two years to determine coverage.

However, the court also reasoned that because the insurer had been invited to the mediation more than a week before it occurred and declined to attend, a factual question existed as to whether the delay in deciding to consent to the settlement or assume the defense was reasonable once the insurer was invited to the mediation. Nevertheless, the court held that even if the delay was reasonable, the insurer would need to demonstrate that it had been prejudiced by not being given the opportunity to consent to the settlement. The court therefore remanded for a determination as to whether the insurer had waived its right to rely on the consent provision and, if so, whether it had been prejudiced.

The court then evaluated a number of exclusions on which the insurer had relied to deny coverage. Among other things, the court held that allegations of overcharging by the contractor were excluded by the provision in the policy precluding coverage for "[a]ny injury or damage arising out of the failure to...[m]eet the terms of cost estimates or guarantees, or any delays in the performance of any contract or agreement...." The court held that the policy precluded coverage for loss of goodwill on the part of the contractor, noting that the policy contained an exclusion barring coverage for "[a]ny injury or damage arising out of loss of customer faith or acceptance or any cost incurred to regain customer approval." The court also agreed that the contractor was not entitled to recover \$100,000 it spent to repair the computer system, reasoning that the expense was part of the cost of doing business and was precluded by the policy provision precluding coverage for "your costs of doing business. This includes the costs or expenses of performing additional services to correct deficiencies in the original services you performed."

The court found that there was a factual issue as to whether the allegations of loss of revenue by the company for whom the contractor was performing work were excluded by the policy provision precluding coverage for "[a]ny injury or damage claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of [your product, work, or any property of which your product or work forms a part] if such product, work, or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it." The court reasoned that it was unclear from the record whether the losses of revenue were caused by system downtime or delays when the system was running. The court found that the allegations of breach of express and implied warranties were not excluded by the policy because the exclusion for breach of warranties carved out "representations made at any time with respect to fitness, quality, durability, performance or use of 'your work' or 'your product'" and the allegations at issue were for breach of warranties concerning its services, goods, or workmanship.

The court then explained that because some of the allegations were covered and others were not, it would be necessary to segregate the damages in order to determine if the retention had been exceeded. The court explained that, under the doctrine of concurrent causation, "when covered and non-covered perils combine to create a loss, the insured is entitled to recover that portion of the damage caused solely by the covered peril." It also explained that the policyholder has the burden of proof on this issue. The court remanded for a factual determination as to the appropriate segregation of damages.

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