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March 25, 2020

Texas Supreme Court Answers Certified Question Regarding an Insurer's Duty to Defend

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In *Richards v. State Farm Lloyds*, --- S.W.3d ---, 2020 WL 1313782 (Tex. Mar. 20, 2020), the Texas Supreme Court answered a certified question from the Fifth Circuit Court of Appeals about the scope of an insurer's duty to defend its insured against third-party claims. In determining whether an insurer has a duty to defend, Texas generally uses the "eight corners rule," under which an insurer's duty to defend is determined by comparing the claims alleged within the four corners of the petition with the coverage provided within the four corners of the policy. If the allegations in the petition—*taken as true*—give rise to any claim potentially covered by the policy, the insurer has a duty to defend.

But what if the policy does not have language requiring the insurer to defend "groundless, false, or fraudulent claims" (a "groundless-claims clause")? And what if extrinsic evidence shows that the facts alleged in the petition are incorrect—and the true facts negate coverage? Under these circumstances, a federal district court concluded that the eight-corners rule does not apply and, therefore, it could consider extrinsic evidence negating the duty to defend.

On appeal, the Fifth Circuit asked the Texas Supreme Court whether the district court's exception to the eight-corners rule—a so-called "policy-language exception" that applies whenever a policy *omits* a groundless-claims clause—is permissible under Texas law. In answering that question "no," the Texas Supreme Court reaffirmed settled law about the eight-corners rule—but left the door open for future recognition of more widely used exceptions that could play a significant role in reducing the rule's reach.

Background: The underlying personal-injury action arose after ten-year-old Jayden Meals died in an all-terrain vehicle (ATV) that allegedly occurred "[o]n or near" his grandparents residence while Jayden was under his grandparents' "supervision." Jayden's mother sued the grandparents, who asked State Farm to provide a defense. In response, State Farm filed suit against the grandparents seeking a declaration that it had no duty to defend or indemnify them in the underlying suit.

State Farm moved for summary judgment on the ground that the policy did not cover the underlying claims. Using extrinsic evidence to show that the accident occurred *off* the insured premises (not "on or near"), State Farm argued that the policy's "motor-vehicle exclusion" negated the duty to defend. (The policy's exclusion of claims for bodily injury arising from the use of a "motor vehicle" only applies to ATVs when used "off an insured location.") State Farm also introduced extrinsic evidence showing that the defendant-grandparents were not merely Jayden's supervisors; they were his joint managing conservators. Given these additional facts, State Farm argued that the policy's "insured exclusion" also negated the duty to defend.

The United States District Court for the Northern District of Texas concluded that, because the policy did not include a "groundless-claims clause" requiring State Farm to defend "all actions against its insured no matter if the allegations of the suit are groundless, false or fraudulent," the eight corners rule did not prohibit the court from considering extrinsic evidence. Based on that evidence, the court granted State Farm's motion for summary judgment.

On appeal, the Fifth Circuit asked the Texas Supreme Court "whether the district court's 'policy-language exception' to the eight-corners rule is 'a permissible exception under Texas law.'" *Richards*, 2020 WL 1313782, at *1.

Key holdings: In answering the certified question, the Texas Supreme Court began with the principle that "[i]nsurance policies are controlled by rules of interpretation and construction which are applicable to contracts generally." *Id.* at *4. Thus, the duty to defend is a contractual matter that "depends on the language of the policy setting out the contractual agreement between insurer and insured." *Id.* Although the Court recognized that "parties can contract around the eight-corners rule," it held that they do not do so by omitting a groundless-claims clause from the policy. *Id.* After reviewing the history of the eight-corners rule, the Court noted that the rule has never been "contingent on a groundless-claims clause." *Id.* at *5. Instead, it has been consistently applied without regard to whether the policy has such a clause. *Id.* Accordingly, the Court held that the "policy-language exception" applied by the district court—"under which the eight-corners rule does not apply unless the policy contains a groundless-claims clause—is not a permissible exception under Texas law." *Id.* at *6.

Potential impact: For jurisdictional reasons, the Court declined to opine on questions other than the one certified. For example, the Court acknowledged that the Fifth Circuit has "consistently applied" a different exception based on its opinion in *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 531 (5th Cir. 2004). The "*Northfield* exception," which has been adopted by several Texas courts of appeals (but rejected by others), allows a court to consider extrinsic evidence in determining 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 Court observed that it "has never had occasion to address the so-called '*Northfield* exception,' although we have twice [now three times] acknowledged its widespread use." Hinting that this might be a permissible exception, the Court noted that "courts applying Texas law will employ the eight-corners rule, subject possibly to exceptions such as that found in the Fifth Circuit's *Northfield* decision."

The Court also left open the possibility of parties contracting around the eight-corners rule by including policy language that is "inconsistent with" the rule's application. *Richards*, 2020 WL 1313782, at *4. Omitting a groundless-claims clause is not enough; what policy language might be sufficient to avoid the eight-corners rule is another issue for another case. As for other possible exceptions, the Court could not opine—but it did say that "[t]he varied circumstances under which such arguments for the consideration of evidence may arise are *beyond imagination*." *Id.* at *6. Clearly, in answering the certified question and eliminating one possible exception to the eight-corners rule, the Court has opened the door to recognizing other exceptions in future cases.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the author.

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