IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

HOUSTON CASUALTY COMPANY	§	
	§	
Plaintiff,	§	
	§	
VS.	§	**CIVIL ACTION NO. H-05-1804**
	§	
LEXINGTON INSURANCE COMPANY	§	
	§	
Defendant.	§	

HOUSTON CASUALTY COMPANY'S OBJECTION TO MAGISTRATE'S JUNE 25, 2007 MEMORANDUM AND RECOMMENDATION

Plaintiff, Houston Casualty Company ("HCC"), timely files this Objection to Magistrate Judge Stephen Smith's Memorandum and Recommendation, filed on June 25, 2007, recommending that Defendant, Lexington Insurance Company's ("Lexington"), Motion for Partial Summary Judgment Regarding HCC's Article 21.55 Claim be granted and that HCC's Cross-Motion for Summary Judgment be denied.

A. OBJECTION.

HCC objects to the Magistrate's June 25, 2007 Memorandum and Recommendation on the grounds that it wrongfully concludes that HCC's claim for coverage is a third party claim and not a first party claim to which Article 21.55 applies.[1]

B. SUMMARY OF ARGUMENT.

The Magistrate erred in granting Lexington's Motion for Partial Summary Judgment Regarding HCC's Article 21.55 claim and in denying HCC's Cross-Motion for Summary Judgment because:

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[1] Article 21.55 was repealed in 2003 and recodified at §§ 542.051-542.061 of the Texas Insurance Code effective April 1, 2005.

- HCC's claim is a first party claim because it is one in which HCC seeks recovery for its own loss rather than for injuries to a third party.
- HCC's claim is a first party claim because the proceeds of the Lexington policy are payable directly to HCC rather than to a third party.
- The Magistrate erred in concluding that HCC's claim is a third party claim by (1) improperly focusing the first/third party claim determination on the risk insured by the original insurance policy between Seagram and Gulfstream rather than the risk insured by the HCC-Lexington reinsurance contract and (2) ignoring the fact that the HCC-Lexington contract is a first party indemnity policy, not a third party liability policy.
- The "follow the settlements of the reinsured" doctrine does not speak to whether HCC's claim is a first or third party claim.

C. FACTUAL BACKGROUND.

The facts of this claim are established by a Stipulated Record and are generally set forth in (1) the Magistrate's Memorandum and Recommendation issued June 15, 2006 adopted by the District Court on July 11, 2006 (the "2006 Memorandum") and (2) the Magistrate's Memorandum and Recommendation issued on June 25, 2007 (the "2007 Memorandum").[2] Briefly restated, Lexington issued HCC a reinsurance policy (the "Lexington Policy"). HCC made a claim under the Lexington Policy. Lexington denied coverage and HCC filed this lawsuit for breach of contract and a statutory penalty available under Article 21.55 based upon Lexington's failure to promptly pay HCC's claim. 2007 Memorandum at pp. 1-2.

This Court, in adopting the Magistrate's 2006 Memorandum, recommending that HCC be granted summary judgment on its breach of contract claim, determined that Lexington's denial of coverage was wrongful. The parties subsequently filed cross-motions for summary

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[2] In order not to unduly burden this Court, HCC will not attach the Stipulated Record and prior summary judgment rulings to this filing, but instead incorporates each by reference. *See*, FED. R. CIV. P. 72. These are on file with this Court. References to exhibits contained within the Stipulated Record are cited as: SR, Ex. ___, p. ___.

judgment as to whether Lexington's wrongful denial of coverage subjected it to liability under Article 21.55. The Magistrate recommended that Lexington's summary judgment motion be granted and that Plaintiffs' motion be denied. HCC objects to that recommendation.

D. ARGUMENT.

1. HCC's Claim is a First Party Claim.

The Magistrate concluded that Article 21.55 did not apply to HCC's claim under the Lexington Policy because it was not a first party claim. 2007 Memorandum at pp. 1, 7-12. As a preliminary matter, this conclusion is at odds with the Texas Supreme Court's definition of such a claim. A first party claim is one in which an insured seeks recovery for its own loss. *Universal Life Ins. Co. v. Giles*, 950 S.W.2d 48, 53 n. 2 (Tex. 1997). HCC suffered such a loss. It was forced to come out of pocket in order to pay the claim of its insured, Gulfstream Insurance (Ireland), Limited ("Gulfstream"). 2007 Memorandum at p. 1. Its claim is thus a first party claim.

2. The Tests Set Forth by the Magistrate for Distinguishing Between First and Third Party Claims Also Support the Conclusion That HCC's Claim is a First Party Claim.

The Magistrate distinguished between first and third party claims as:

> [A first-party claim is one in which] [t]he insurance proceeds are paid by a first-party insurer directly to the insured to cover the insured's actual, direct loss.
>
> By contrast, a third-party claim is one in which an insured seeks coverage for injuries to a third party. The insured will suffer a loss only if the third-party reduces its claim to a judgment or settlement. In such a case the insured's loss is "indirect" while the third-party's loss is "direct." The payment of proceeds in practical effect runs directly to the third-party claimant, not to the insured.

Id. at p. 8 (citations omitted). These tests compel the conclusion that HCC's claim is a first party claim.

First, as the Magistrate recognized but apparently failed to consider in his analysis of the Article 21.55 issue, the proceeds of the various reinsurance policies were each payable directly to the reinsureds not to the alleged third party, Seagram, the original insured. 2006 Memorandum at pp. 2-3; 2007 Memorandum at pp. 1-2 (establishing that HCC paid Gulfstream and in turn sought coverage from Lexington).

Second, HCC's claim did not seek coverage for injuries to a third party, nor did a third party reduce a claim against HCC to a judgment or settlement. Significantly, had Lexington abided by its contract and paid HCC, the proceeds of the Lexington Policy would have been paid to HCC, *not* Seagram; the injuries sustained by the alleged third party, Seagram, were paid by its insurer, Gulfstream, not HCC or Lexington.

HCC's claim thus seeks coverage for its own direct loss – the amount it was required to pay to cover the claim of its insured, Gulfstream. Its claim is thus a first party claim under the tests adopted by the Magistrate.

3. A Claim for Indemnity Under an Indemnity Policy is a First Party Insurance Claim.

The Lexington Policy is an indemnity policy. SR, Ex. 8, p. HCC/Gulf 000762 ("The reinsurers hereby agree . . . to indemnify the Reassured . . . against Loss . . . ."). An insured's demand for indemnification under an indemnity policy, like HCC's demand in this case, constitutes a first party claim under Article 21.55. For example, a property insurance policy is an indemnity policy, and Article 21.55 applies to a claim for indemnity under a property policy. *See, e.g., Cater v. United Services Auto. Assoc.*, 27 S.W.3d 81, 83-85 (Tex. App. – San Antonio 2000, pet. denied). Certain professional liability policies are also indemnity policies, and this Court has found Article 21.55 applicable to such policies. *See, e.g., HCC Employer Svcs., Inc. v. Westchester County Surplus Lines Ins. Co.*, 2006 WL 1663343 at *8 (S.D. Tex. 2006) (Article

21.55 applied to insured's first-party claim for indemnification under a professional liability policy not containing a defense obligation); *Westcott Holdings, Inc. v. Monitor Liability Managers, Inc.*, 2005 WL 2206196 at *7 (S.D. Tex. 2005) (Article 21.55 applied to insured's first-party claim for indemnification under a D&O policy). *See also*, *Medical Care America, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 341 F.3d 415, 425 (5th Cir. 2002) (treating an insured's request for indemnification under a D&O policy as a first party claim for purposes of determining whether a common law bad faith claim, which claim is inapplicable in the context of a third party claim, would lie).

The Magistrate largely ignored this critical distinction between liability and indemnity policies, improperly treating the Lexington Policy as a liability policy.[3] The flaw in the Magistrate's reasoning is aptly demonstrated by the following passage:

> The critical factor [in determining whether a claim is a first or third party claim] is whether the claim originates with the claimant or with another party. When the claimant seeks reimbursement for compensating another's loss, the claimant is pursuing a third-party claim.

2007 Memorandum at pp. 10-11. This test may apply in connection with an insured's claim under a liability policy seeking coverage for a loss sustained by a third party claimant against the insured following the insurer's declination of coverage. It has no applicability, however, to an indemnity policy such as the Lexington Policy in which the insured is seeking recovery for its own direct loss. That is a first party claim. *See, e.g.*, *Westchester*, 2006 WL 163343 at *8; *Westcott*, 2005 WL 2206196 at *7.

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[3] The Magistrate simply concluded that any discussion of the distinction recognized in *Medical*, *Westchester* and *Westcott* between indemnity and liability policies *vis-à-vis* whether such policies constitute first or third party insurance was "unproductive." 2007 Memorandum at p. 11.

4. Lexington's Claim is Not a Third Party Claim.

The Magistrate properly recognized that a third party claim is one in which the insurer's duty to indemnify does not run directly to the insured, but to a third party claimant injured by the insured. 2007 Memorandum at p. 8. *See, also, Giles*, 950 S.W.2d at 53 n. 2; *Hartman v. St. Paul Fire and Marine Ins. Co.*, 55 F.Supp.2d 600, 603 (N.D. Tex. 1998). The Magistrate erred, however, in applying this definition. The Lexington Policy is not a third party liability policy. The proceeds of the policy are not payable to any third party. Instead, Lexington's obligations under the Lexington Policy run directly and solely to HCC. SR, Ex. 8, p. HCC/Gulf 000762 ("The reinsurers hereby agree . . . to indemnify the Reassured . . . against Loss . . . ."). Indeed, Seagram, the alleged "third party," has no claim to the proceeds of the Lexington Policy. *See, State and County Mut. Fire Ins. Co. v. Miller*, 52 S.W.3d 693, 697 (Tex. 2001) (recognizing that, in the absence of contractual provision to the contrary, an insured has no claim against its insurer's reinsurer). HCC's claim, therefore, does not satisfy the definition of a third party claim. *See, e.g., Giles*, 950 S.W.2d at 53 n. 2.

In concluding that HCC's claim was a third party claim, the Magistrate improperly focused on the perils reinsured by the Lexington Policy rather than the risks insured by the policy, reasoning that the loss at issue in this case was the interruption to Seagram's business, a loss sustained by an alleged "third party" to the Lexington policy. 2007 Memorandum at pp. 9-10. The Lexington Policy, however, insured the risk that HCC would have to pay Gulfstream under the HCC-Gulfstream reinsurance policy, not the risk that Seagram would sustain a loss. SR, Ex. 8, p. HCC/Gulf 000762 ("The reinsurers hereby agree . . . to indemnify the Reassured . . . against Loss . . . ."). Indeed, here, the alleged third party, Seagram, was paid for its losses by its insurer, Gulfstream, despite Lexington's failure to pay. 2006 Memorandum at p.

2. The "loss" at issue here is thus HCC's loss under the Lexington Policy, not the loss sustained by Seagram. As between HCC and Lexington, the parties to the Lexington Policy, HCC's claim is a first party claim in which it seeks to recover for its own direct loss. *See, e.g., Giles*, 950 S.W.2d at 53 n.2.

The Magistrate also reasoned that the "derivative nature" of HCC's claim compelled the conclusion that HCC's claim was a third party claim. 2007 Memorandum at p. 11. If anything, the derivative nature of HCC's claim compels the opposite conclusion. The Magistrate properly recognized that "[a]s between Seagram and its original insurer (Gulfstream), Seagram's is a first-party claim to be made whole for its own covered loss." *Id.* at p. 9. Thus, to the extent the reinsurers' liability is "derivative of the original insured's loss," which loss is a first party one, the reinsurers' liability to their reinsureds must likewise be considered first, not third, party in nature.

The facts of the case bear this out. None of the reinsurers insured Seagram, and none of the reinsurance proceeds ran directly to Seagram. Instead, each reinsurer in the chain insured the risk that its reinsured would be called upon to pay, and each reinsured recovered its own direct loss from its reinsurer. 2006 Memorandum at pp. 2-3. The claim of each insurer seeking recovery of its own loss from its reinsurer falls squarely within the definition of a first party claim. *See, e.g., Giles*, 950 S.W.2d at 53 n. 2.

5. The Authority Cited by the Magistrate is Distinguishable.

The decisions in *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 703-04 (Tex. App.—Houston [14th Dist.] 2006, pet. filed) and *American Nat'l Fire Ins. Co. v. Hammer Trucking, Inc.*, 2006 WL 3247906 (Tex. App.—Fort Worth 2006, pet. filed) cited by the Magistrate do nothing to change the conclusion that Article 21.55 applies. 2007 Memorandum at

p. 12. Both cases involve insureds seeking coverage under a liability policy in connection with third party claims. *See Lennar*, 200 S.W.3d at 703-704; *American*, 2006 WL 3247906 at *1 - *2. Here in contrast, the alleged third party, Seagram, made no claim against HCC. Nor is HCC seeking coverage under a liability policy for injuries to a third party. As such, there is no settlement or judgment in favor of a third party claimant which could be said to constitute an indirect loss to HCC and the proceeds of the Lexington Policy are not payable to any third party, including Seagram. HCC, instead, seeks coverage for its own direct loss under an indemnity policy – a first party claim to which Article 21.55 applies. *See, e.g., HCC Employer Svcs., Inc.* 2006 WL 1663343 at *8; *Westcott*, 2005 WL 2206196 at *7.

6. The "Follow-the-Settlements" Doctrine Has No Applicability to the Determination of Whether HCC's Claim is a First or Third Party Claim.

Finally, the Magistrate cited the follow-the-settlements condition in the Lexington Policy as further support for the conclusion that HCC's claim was derivative in nature and thus a third party claim. 2007 Memorandum at p. 10. As pointed out by the Magistrate, however, the follow-the-settlements doctrine ". . . provides that a reinsurer must indemnify its reinsured for payments the reinsured makes in settlement of claims against it without second-guessing the reinsured's liability determination." *Id.* (citations omitted). That doctrine, while relevant to HCC's breach of contract claim, has no bearing on the question of whether HCC's claim is a first or third party claim under Article 21.55. *See, e.g., Giles*, 950 S.W.2d at 53 n. 2 (defining first and third party claims without resort to the follow-the-settlements doctrine).

E. CONCLUSION.

For these reasons, and those provided in HCC's Response to Lexington's Motion for Partial Summary Judgment and Cross-Motion for Partial Summary Judgment, Lexington's Motion for Partial Summary Judgment should have been denied, and HCC's Cross-Motion for

Partial Summary Judgment should have been granted. Accordingly, this Court should reject the Magistrate's Recommendation and enter partial summary judgment in favor of HCC:

(1) awarding HCC $589,977.00 plus a penalty of 18% per annum from the date Lexington wrongfully denied its claim under Texas Insurance Code § 21.55; and

(2) for such other relief the Court deems just and equitable under the circumstances.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing instrument was served on the following parties in accordance with the Federal Rules of Civil Procedure on July 9, 2007.

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