Alert

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COZEN O'CONNOR

Fifth Circuit: Covenant Not to Execute is a Settlement — Relieves Primary Insurer of Duty to Defend

On November 11, 2019, the U.S. Court of Appeals for the Fifth Circuit ruled in *Aggreko, L.L.C. v. Chartis Specialty Ins. Co.*, No. 18-40325, 2019 WL 5866880 (5th Cir. Nov. 11, 2019) that, under both Texas and Louisiana law, a covenant not to execute — under which a primary insurer paid policy limits in a wrongful death action in exchange for the plaintiffs' promise not to collect any judgment they obtained against the insured except from other insurance — constituted a "settlement" sufficient to relieve the primary insurer of its duty to defend the insured, where the plaintiffs' damages exceeded the policy limit, and the primary insurer could not obtain a full release with its policy limit alone.

The litigation arose out of fatal injuries suffered by James Andrew Brenek, II, when he was electrocuted by an allegedly faulty generator housing cabinet on a rig in Jefferson County, Texas. At the time of his accident, Brenek was working for Guichard Operating Company, LLC, a drilling subcontractor in Crowley, La. Guichard had leased the generator involved in the incident from Aggreko, LLC, a company doing business in both Louisiana and Texas. The rental agreement between Guichard and Aggreko required Guichard to maintain a liability policy during the lease period that would cover damages arising out of use of the leased equipment and recognize Aggreko as an additional insured.

On the date of Brenek's accident, Guichard had a primary liability policy from Gray and Aggreko had a primary policy from Indian Harbor. Due to the rental agreement, the Indian Harbor policy was excess of the Gray policy relative to Aggreko.

Gray initially defended Aggreko against the Breneks' suit but later paid the family $950,000 in exchange for them agreeing to collect any judgment only against Aggreko's other insurer. The agreement was without Aggreko's involvement or permission. Gray's $1 million policy had been eroded by a prior $50,000 settlement.

As a result, Gray stopped defending Aggreko.

At issue on appeal was whether U.S. District Court Judge Marcia A. Crone correctly applied Texas law instead of Louisiana law and found that Gray's contractual obligations under the policy were fulfilled when it paid the limit of the $1 million policy, and whether the "covenant not to execute" agreement could be considered a settlement.

The three-judge panel ruled unanimously that Texas law did apply and that the payment could be considered a settlement for purposes of policy exhaustion. Because the court found no Texas precedent that could be applied to the case, it made an *Erie* guess as to how the Texas Supreme Court would rule.

"Our review of pertinent Texas jurisprudence leaves us convinced that, if presented with the issue before us, the Texas Supreme Court would conclude that a settlement occurred, as required by the Gray policy," the judges wrote.

The panel rejected Indian Harbor's argument that the payment cannot be considered a settlement because there was no release of liability against Aggreko. "Aggreko clearly received as a result of

Joseph A. Ziemianski

Co-Chair, Global Insurance Department

jziemianski@cozen.com
Phone: (832) 214-3920
Fax: (832) 214-3905

Bryan P. Vezey

Member

bvezey@cozen.com
Phone: (832) 214-3940
Fax: (866) 715-0543

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the covenant not to execute the benefit of the Breneks' agreement not to execute any judgment directly against Aggreko," the court said. "We conclude that the lack of a release of Aggreko's liability is not dispositive of whether Gray's obligations to Aggreko under the Gray policy were exhausted."

The court also made an *Erie* guess as to how the Louisiana Supreme Court would rule on the case and found it too would have considered the payment a settlement or a "compromise." Because both states would likely consider the payment a settlement, the panel said there was no conflict, and therefore Texas law applied.

The appellate court's ruling is significant for both primary and excess insurers. The ruling makes way for a primary insurer to reach a similar agreement with tort plaintiffs and terminate its defense obligation despite the lack of a full release of the insured. Primary insurers seeking to take advantage of this ability should, however, take heed of the Fifth Circuit's warning in the opinion's final paragraph:

> [W]e recognize that, in some instances, insurers may be compelled to improperly and hastily hand over their policy limits to rid themselves of the duty to defend their insured. We reiterate that such a situation is not before us, as there is no suggestion or indication in the record that the Breneks' damages do not exceed the Gray policy limit or that Gray did not properly investigate the Breneks' claim on behalf of Aggreko. Thus, our decision should not be construed as in any way limiting remedies to insureds under Texas or Louisiana law against insurers who have improperly or in bad faith handled their claims.

The warning clarifies that primary insurers must still investigate properly, ascertain that the damages exceed the primary limits and otherwise handle suits in good faith before they may safely obtain a similar agreement.

Excess insurers must now be more wary of inheriting a defense obligation, possibly with little or no notice, and for an insured who, by the very nature of the agreement, has lost all financial incentive to cooperate. To avoid this result, an excess insurer — including primary insurers in an excess position like Indian Harbor in the Aggreko suit — should carefully monitor all suits with potential impact on the excess layer, even if the potential impact is low. Depending on the particular exposure, the excess insurer may wish to exercise its right to associate additional defense counsel so it will be ready to take over the defense if the need arises. Settlement opportunities must also be evaluated with an eye toward the primary insurer's newly buttressed ability to cut the excess insurer out of a settlement.

Unaddressed by the Fifth Circuit, and by Indian Harbor in its brief, is the effect, if any, of Indian Harbor's own policy language on whether that insurer's obligations commenced upon entry of the covenant not to execute, or upon Gray's payment or defense cessation. That may be because Indian Harbor's policy was issued as a primary policy and lacked any language that would have made a difference. True excess insurers may fare better than Indian Harbor in future cases if they have helpful policy language including, for example, insuring-agreement wording or conditions requiring that underlying insurance exhaust only by the insurer's own payment toward a full release. See *Martin Res. Mgmt. Corp. v. AXIS Ins. Co.*, 803 F.3d 766, 772 (5th Cir. 2015) (rejecting, based on excess policy language, that exhaustion occurred where the primary insurer settled for less than its limits and insured "filled the gap"). Excess insurers in future similar cases should take this possibility into account and consult their own policy language.