Fifth Circuit Rules that Settlements in Underlying Action Consitute "Other Insurance" if Used to Compensate for Covered Losses

The Fifth Circuit ruled that settlements between an insured and its subcontractors qualified as "other insurance" to the extent those settlements were used to pay for damages covered by an excess insurance policy. Policyholders should note the outcome of this case as it demonstrates the significant impact that settlements can have on coverage.

Satterfield & Pontikes Construction, Inc. v. Amerisure Mutual Ins. Co.[1] was the result of a construction project gone wrong. Zapata County, Texas hired Satterfield & Pontikes ("S&P") as a general contractor for the construction of a courthouse building. When the project did not go as planned, Zapata County terminated S&P, hired new subcontractors to complete the project, and sued S&P.

S&P, in turn, sought indemnification from its subcontractors, who were contractually obligated to indemnify S&P and procure insurance for any damage the subcontractors caused at the project. S&P also sought coverage from its own primary insurers, American Guarantee and Liability Insurance Company ("AGLIC") and Amerisure Mutual Insurance Company ("Amerisure"), and its excess insurer, U.S. Fire Insurance Company ("U.S. Fire") who provided liability coverage for S&P's potential liabilities at the project. The policies contained exclusions for losses arising from mold and did not provide coverage for attorney's fees or similar legal costs.

An arbitration panel found S&P liable for its failure to supervise its subcontractors and its failure to "build the courthouse in a good and workmanlike manner." The arbitration panel awarded Zapata County approximately $8 million in damages, comprised of $2.8 million for mold remediation and dome reconstruction, $860,000 for roof replacement, $2.4 million for fireproofing replacement, window repairs, and cleaning, $430,000 for prejudgment interest, and $1.5 million for attorney's fees and arbitration costs.

To pay for the damages, S&P received approximately $4.5 million in settlement from multiple subcontractors. This amount was not allocated to any particular categories of damage. Additionally, Amerisure contributed approximately $1 million and AGLIC $2 million, which exhausted both of S&P's primary policies. Thus, S&P was left to fund the balance of approximately $500,000. S&P sought to recover this balance from U.S. Fire because, as its excess insurer, S&P believed U.S. Fire was obligated to pay covered damages above the limits of its primary policies. U.S. Fire refused, and S&P sued U.S. Fire.

U.S. Fire contended that only $2.5 million of the total damages award was potentially covered under its policy and the remaining amounts were not, including the mold remediation damages, prejudgment interest, attorney's fees, arbitration costs, and the amount covered by the followed policy (the AGLIC policy). Even though $2.5 million was potentially recoverable, U.S. Fire did not believe it owed anything due to the manner in which the award had been funded by other parties. In looking at the details of S&P's $4.5 million settlement with its subcontractors, the waterproofing subcontractor, who presumably was responsible for the mold damage, contributed $1.75 million. As mold was excluded under the U.S. Fire policy, U.S. Fire explained that this contribution constituted excluded damages. U.S. Fire argued that the remaining settlement amount that S&P received from its subcontractors, $2.75 million, was for covered damages; however, U.S. Fire argued that it owed nothing to S&P because allowing recovery from both U.S. Fire and the subcontractors would result in double recovery or unjust enrichment.

[1] 898 F.3d 574 (5th Cir. 2018).

The Fifth Circuit agreed with U.S. Fire. In determining this outcome, it considered the issue of whether the settlement funds received from S&P's subcontractors constituted "other insurance" as defined in the U.S. Fire policy. S&P argued that the settlement funds functioned as "contractual risk mechanisms," which did not qualify as insurance coverage but instead were the product of indemnity agreements intended to apply to gaps in coverage. However, the court explained that the settlements fell under the plain language of the policy's definition of "other insurance," namely, "a mechanism by which an Insured arranges funding of legal liabilities for which the [U.S. Fire] policy also provides coverage." The court stated that S&P provided no authority for its argument or to depart from the plain language of the policy.

Additionally, S&P argued that it should be entitled to allocate settlement proceeds to covered or uncovered damages as it sees fit because S&P, as the insured, is in the best position to determine how to maximize coverage. In other words, S&P believed that it should be able to allocate the settlement amounts received from subcontractors towards the excluded portions of the damages and seek coverage for the remaining covered damages under its policies.

The court disagreed and held that S&P bore the burden of proving that it appropriately allocated the settlement amounts with its subcontractors to covered or uncovered damages. If S&P failed to meet this burden, under Texas law, then it must be assumed that the settlement amounts are allocated to covered damages. In coming to this result, the court considered analogous decisions made by the Texas Supreme Court and concluded that a "non-settling party should not be penalized for events under which it had no control" because it did not have the ability to structure the settlements to allocate the amounts to one kind of damage or another.

This case demonstrates the impact that the settlement of an underlying action has on coverage. S&P may have avoided spending hundreds of thousands of dollars had they included terms within the settlement agreement that specified the allocation of the settlements to the total damages award. Policyholders should involve coverage counsel as early as possible in the litigation and dispute resolution of underlying matters to assess any impact on coverage before it's too late.

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