UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS
AUSTIN DIVISION

WINDERMERE OAKS WATER SUPPLY CORPORATION; DANA MARTIN; WILLIAM EARNEST; THOMAS MICHAEL MADDEN; ROBERT MEBANE; PATRICK MULLIGAN; JOE GIMENEZ; DAVID BERTINO; MIKE NELSON; DOROTHY TAYLOR; and NORMAN MORSE,	§	**CIVIL ACTION NO.: 1:21-CV-258-RP**
Plaintiffs,	§	
v.	§	
ALLIED WORLD SPECIALTY INSURANCE COMPANY	§	
Defendant,	§	

PLAINTIFFS' RESPONSE TO DEFENDANT'S CROSS-MOTION FOR SUMMARY JUDGMENT AND REPLY TO RESPONSE TO PLAINTIFFS' MOTION FOR PARTIAL SUMMARY JUDGMENT ON THE DUTY TO DEFEND

Pursuant to Rule 56(b) of the Federal Rules of Civil Procedure and in accordance with this Court's Local Rules, Windermere Oaks Water Supply Corporation ("WSC"), and Dana Martin, William Earnest, Thomas Michael Madden, Robert Mebane, Patrick Mulligan, Joe Gimenez, David Bertino, Mike Nelson, Dorothy Taylor, and Norman Morse (collectively, the "Directors") (collectively with WSC, the "Plaintiffs") file this Response to the Cross-Motion for Summary Judgment Regarding the Duty to Defend filed by Defendant Allied World Specialty Insurance Company ("Allied World"). This also serves as Plaintiffs' Reply to Allied World's Response to Plaintiffs' Motion for Partial Summary Judgment on the Duty to Defend. Plaintiffs respectfully would show this Court as follows:

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A. Summary of the Argument in Response / Reply

In Allied World Specialty Insurance Company's Cross-Motion for Summary Judgment Regarding the Duty to Defend and Brief in Support and Response to Plaintiffs' Motion for Partial Summary Judgment Regarding the Duty to Defend [Doc. #12] (the "Cross-Motion"), Allied World concedes that the insuring agreement of policy number 5105-0560-03 (the "Policy") is satisfied based on the factual allegations made in the underlying lawsuit styled *Rene Ffrench, et al. v. Friendship Homes & Hangars, LLC, et al.*; Cause No. 48292, pending in the 33rd Judicial District Court of Burnet County, Texas (the "Underlying Lawsuit"). Rather, in trying to avoid its obligation to provide a defense for its insureds based on the allegations in the Third Amended Original Petition filed in the Underlying Lawsuit, Allied World relies upon various exclusions in the Policy. Allied World cannot, however, establish that any exclusions in the Policy bar defense coverage. Thus, Allied World has breached its contractual duty to defend Plaintiffs in the Underlying Lawsuit. Moreover, because Allied World has breached the duty to defend, it is liable for breach of contract and for statutory damages under the Texas Prompt Payment of Claims Act, the amount of which will be determined at a later time.

B. Allied World Improperly Characterizes the Nature of the Claims in the Underlying Lawsuit

In the Cross-Motion, Allied World attempts to characterize the Underlying Lawsuit simply as a dispute arising "out of the sale of the Airport Tract by WSC to Dana Martin."[1] To the contrary—and as established by the actual factual allegations asserted in the pleading—the Underlying Lawsuit is much more complex and involves the purported breach of fiduciary duties and alleged *ultra vires* wrongful acts, errors, and omissions by the Directors of WSC *prior to* and

[1] Cross-Motion, p. 7.

leading up to the sale of the Airport Tract to Martin.[2] This distinction represents the essence of the parties' dispute over the proper interpretation of the Policy. The appropriate evaluation of the duty to defend must take into account all the factual allegations regarding the Directors' conduct leading up to the ultimate decision to sell the Airport Tract. These purported actions represent the risks for which WSC and the Director Defendants purchased insurance.

Further, in a footnote, Allied World asserts that "[o]nly the allegations set forth in the Third Amended Petition will be discussed herein since it is the 'live' pleading in the Underlying Lawsuit, and, as conceded by Plaintiffs in their motion, 'the document relevant to whether Allied World has an ongoing duty to defend.'"[3] This is incorrect. Plaintiffs timely tendered the Underlying Lawsuit to Allied World on May 31, 2019, requesting defense and indemnity.[4] This request was denied. On November 8, 2019, Plaintiffs again submitted to Allied World a request for defense and indemnity under the Policy based on the allegations in the Second Amended Original Petition.[5] By letter dated December 19, 2019, Allied World—through its authorized third-party claims administrator, Network Adjusters, Inc.—wrongfully denied coverage.[6] Plaintiffs then submitted the Third Amended Original Petition to Allied World on August 25, 2020.[7] That tender was also denied.

While the Third Amended Original Petition is the "live" pleading filed in the Underlying Lawsuit, Allied World's obligation to defend was implicated prior to the time when that pleading

[2] Ex. B to Plaintiffs' Motion for Partial Summary Judgment on the Duty to Defend and Brief in Support [Doc #11] ("Plaintiffs' Motion"), WSC00163; Ex. C, WSC00221.

[3] Cross-Motion, p. 7 n.24.

[4] Ex. A to Plaintiffs' Motion, Document 2.

[5] Ex. A. to Plaintiffs' Motion.

[6] Ex. F. to Plaintiffs' Motion.

[7] Ex. H. to Plaintiffs' Motion.

was filed. Particularly, Plaintiffs, in their Motion for Partial Summary Judgment, explained as follows:

> [B]ecause there is at least a *potential* for coverage based on the factual allegations in both the Second Amended Original Petition and the Third Amended Original Petition (which is the live pleading in the Underlying Lawsuit) and terms of the Policy, Allied World—as a matter of law—had and continues to have a duty to defend Plaintiffs in the Underlying Lawsuit. Allied World cannot meet its burden to show that any exclusions bar coverage as a matter of law; therefore, it owed and continues to owe Plaintiffs a *complete* defense in the Underlying Lawsuit.[8]

Allied World, however, has limited its argument in its Cross-Motion (and Response to Plaintiffs' Motion) to the allegations in the Third Amended Original Petition. Thus, Allied World does not contest that it had and breached a duty to defend Plaintiffs based on the allegations in the Second Amended Original Petition tendered on November 8, 2019. Therefore, the Plaintiffs are entitled to a ruling, as a matter of law, that Allied World owed a duty to defend the Plaintiffs following the tender of the Second Amended Original Petition, breached the duty to defend, and violated the Prompt Payment of Claims Act. Thus, in an amount to be determined later, Plaintiffs are entitled to a judgment in the amount of their defense costs, plus an award of penalty interest at the rate of 18% per annum and an award of attorneys' fees incurred in pursuit of this claim.

C. The Contractual Liability Exclusion Does Not Preclude the Duty to Defend

Based on its faulty characterization of the factual allegations in the Third Amended Original Petition in the Underlying Lawsuit,[9] Allied World's primary argument in the Cross-Motion is that

[8] Plaintiffs' Motion, p. 26 (emphasis in original).

[9] Because the allegations in the Second Amended Original Petition and the Third Amended Original Petition are sufficiently similar, and in the unlikely event this Court finds that Allied World has *not* conceded its obligations and associated breaches associated with defense of the Plaintiffs in connection with the Second Amended Original Petition, any and all arguments asserted herein with respect to responding to Allied World's arguments associated with the Third Amended Original Petition apply equally to the Allied World's obligations with respect to the Second Amended Original Petition.

the Contractual Liability Exclusion (Exclusion 11.) in the Policy bars defense coverage for the Plaintiffs.[10] That exclusion precludes coverage for:

> "Damages," "defense expenses," costs or loss based upon, attributed to, arising out of, in consequence of, or in any way related to any contract or agreement to which the insured is a party or a third-party beneficiary, including, but not limited to, any representations made in anticipation of a contract or any interference with the performance of a contract.[11]

To support its flawed and over-broad interpretation of the Contractual Liability exclusion in the Policy, Allied World relies on *Carolina Casualty Insurance Co. v. Sowell*.[12] In *Sowell*, Judge Sidney A. Fitzwater of the United States District Court for the Northern District of Texas evaluated a similar (but not exact) exclusion in the context of a coverage dispute appertaining to four lawsuits involving a leased property that was damaged by Hurricane Katrina.[13] At the time of the hurricane, Doussan Properties, L.L.C. ("Doussan Properties") had leased the property to Union Industrial Gas & Supply, Inc.; DGS, L.L.C.; and Gas Holdings, Inc.[14] Doussan Properties filed separate lawsuits against those entities. In one suit, referred to by the court as the "*Federal Lawsuit*," Doussan Properties alleged that the entities "failed to secure sufficient insurance for the Leased Property, as they were required to do under the lease."[15] Doussan Properties claimed that, because of the breach of the lease, it was entitled to the difference between the amount received under the insurance in effect at the time of the loss and the insured value of the property.[16] In the *Federal Lawsuit*, Doussan Properties also alleged that the lessees refused to remove their personal property from the

[10] Cross-Motion [Doc #12], pp. 12–15.

[11] Ex. A to Plaintiffs' Motion, Document 1, WSC00122.

[12] Cross-Motion, pp. 12–14, 20.

[13] *Carolina Cas. Ins. v. Sowell*, 603 F. Supp. 2d 914, 919–20, 922 (N.D. Tex. 2009).

[14] *Id*. at 920.

[15] *Id.*

[16] *Id.*

Leased Property, as required under the lease, and that the lessees failed to return the Leased Property in the condition in which they took possession, as required by the lease agreement.[17]

In the second lawsuit, identified by the court as the "*Orleans Parish Lawsuit*," Doussan Properties made the same allegations, but added an alternative claim "that the lessees' failure to secure adequate insurance for the Leased Property constitute[d] negligence."[18] In the third lawsuit, identified by the court as the "*Jefferson Parish Lawsuit*," DGS, L.L.C. filed a declaratory judgment action seeking to have its rights and status determined under the lease agreement with Doussan Properties.[19] As to the fourth lawsuit, the "*Dallas County Lawsuit*," the court explained:

> [D]efendant [James E.] Sowell filed a shareholder derivative action on behalf of [DGS, L.L.C.] against Leonard Doussan III ("Doussan III"), Leonard Doussan, Jr. ("Doussan Jr."), [Jeffrey] Ellis, and [DGS, L.L.C.] . . . . Sowell allege[d], in relevant part, that Doussan III, Doussan Jr., and Ellis breached fiduciary duties owed to [DGS, L.L.C.]. The claims concern[ed] the failure to provide adequate insurance for the Leased Property and [DGS, L.L.C.]'s mismanagement of the litigation concerning the Leased Property. Subsequently, another [DGS, L.L.C.] shareholder, Robert Welsh ("Welsh"), intervened in the *Dallas County Lawsuit*, also alleging a breach of fiduciary duty by Ellis.[20]

The court initially found that the *Jefferson Parish Lawsuit* did not trigger the insuring agreement and granted summary judgment in favor of the insurer as to that claim.[21] With respect to the *Federal Lawsuit* and the *Orleans Parish Lawsuit*, the issue was whether the policy's Contract Exclusion was applicable.[22] The Contract Exclusion at issue in *Sowell* stated that there was no coverage for:

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[17] *Id.*

[18] *Id.*

[19] *Id*. at 921.

[20] *Id.*

[21] *Id*. at 924.

[22] *Id*. at 925.

> any payment for Loss in connection with a Claim made against any insured . . . based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving any oral or written contract or agreement. This exclusion shall not apply to Coverage A. or Coverage C., in the event that such liability would have attached to an Insured in the absence of the oral or written contract or agreement, or in the event a claimant alleges a breach of implied contract.[23]

In a lengthy discussion, Judge Fitzwater distinguished *Admiral Insurance Co. v. Briggs* (as correctly noted by Allied World in the Cross-Motion), but the holding from the opinion actually *supports* Plaintiffs' interpretation of the Contractual Liability Exclusion in the Policy. In particular, Judge Fitzwater explained that, in *Briggs*, the insured's former landlord sued the insured for stock fraud, alleging that the insured made material misrepresentations concerning its future success in order to convince the landlord to accept the insured's stock instead of cash for payment on the lease.[24] The insurer in *Briggs* contended that the stock fraud claim fell within the contract exclusion because it "involved" the lease contract.[25] Judge Godbey rejected the insurer's argument and found that the "involving" language, required a "causal relationship between the contract and the claim."[26] Judge Godbey concluded in *Briggs* that "[t]he lease contract did not cause the stock fraud claim, it simply provided the context in which the stock fraud took place."[27]

In *Sowell*, Judge Fitzwater explained that, while the stock fraud claim in *Briggs* could exist independent from the lease, the claims asserted in the *Federal Lawsuit* and the *Orleans Parish Lawsuit* were "based on the lease itself."[28] Particularly:

> The first claim [Doussan Properties] asserts . . . is for money damages for failing to secure adequate insurance on the Leased Property. [Doussan

[23] *Id.* at 922.

[24] *Id*. at 926–27 (citing *Admiral Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 462–63 (N.D. Tex. 2003)).

[25] *Id*. at 926 (citing *Briggs*, 264 F. Supp. 2d at 462).

[26] *Id*. (citing *Briggs*, 264 F. Supp. 2d at 463).

[27] *Id*. at 926–27 (quoting *Briggs*, 264 F. Supp. 2d at 463).

[28] *Id*. at 927.

> Properties] alleges that the lessees were contractually liable under the terms of the lease when Hurricane Katrina damaged the Leased Property. [Doussan Properties] avers that the lease required that they insure the Leased Property against fire, flood, and windstorm damage for an amount not less than 90% of the value of the building and improvements on the Leased Property, but that the lessees failed to obtain the required amount of insurance. This is a breach of contract claim that is clearly based on the lease and falls within the Contract Exclusion.[29]

As to the "related and alternative claim" asserted by Doussan Properties for negligence in failing to obtain the proper insurance, Judge Fitzwater concluded that "[t]he duty to obtain insurance on the Leased Property arises directly and exclusively from the terms of the lease. The fact that [Doussan Properties] framed its claim as one for 'negligence' is not determinative."[30] Judge Fitzwater then concluded that all other claims by Doussan Properties against the lessees in the *Federal Lawsuit* and the *Orleans Parish Lawsuit* were based upon and dependent upon the existence of the lease.[31]

The court specifically recognized:

> As indicated above, this claim is inherently different from the stock fraud claim at issue in [*Briggs*, where] Judge Godbey held that the lease merely provided the context for the stock fraud claim. [citation omitted]. The insured had a duty not to commit stock fraud regardless of whether the victim was its landlord. Here, the lease is not merely contextual; it provides the basis for the claim. There can be no claim . . . unless there is a lease. It is the existence of the lease that imposes the statutory obligations on the lessee.[32]

With respect to the *Dallas County Lawsuit*, which contained various allegations of breach of fiduciary duty against the directors of DGS, L.L.C. for failing to acquire the appropriate insurance and for mismanagement of the pending litigation against DGS, L.L.C., the insurer did

[29] *Id.*

[30] *Id*. at 927–28.

[31] *Id*. at 928–32.

[32] *Id*. at 929.

not even attempt to argue that the Contract Exclusion applied. Rather, the insurer relied upon the Insured v. Insured Exclusion to avoid coverage for the claims made in that lawsuit.[33]

A recent decision (coincidentally also issued by Judge Fitzwater) demonstrates the limitation of *Sowell* and why the Contractual Liability Exclusion in the Policy does not preclude the duty to defend based on the facts alleged in the Underlying Lawsuit. In *RLI Insurance Co. v. Interstate Battery System International, Inc.*, the following exclusion was at issue:

> The Insurer shall not be liable for Loss on account of any claim made against any Entity based upon, arising out of, directly or indirectly resulting from or in consequence of . . . for any actual or alleged obligation under or breach of any written, oral, express, or implied contract or agreement except to the extent that the Entity would have been liable in absence of such contract or agreement.[34]

PowerFX, LLC ("PowerFX") sued Interstate Battery System International, Inc. ("Interstate Battery System") and PowerCare and Service Solutions, Inc. ("PowerCare") on claims for fraudulent inducement and negligent misrepresentation.[35] PowerFX alleged that PowerCare and PowerFX entered into a "Master Services Agreement" (the "MSA") under which PowerCare "'was obligated to deliver [to PowerFX] and provide maintenance' for its cloud-based battery rejuvenation and management solution product named 'Battery Medic.'"[36] In return, PowerFX agreed that it would market the product and "'perform[] demonstrations and obtain[] commitments from multiple entities who could benefit from the Battery Medic.'"[37]

The Battery Medic machines that PowerFX sent to customers failed to function and even caught fire. To respond to these problems, the parties signed a another agreement, but shortly

[33] *Id*. at 932.

[34] No. 3:20-CV-1888-D, 2021 WL 5164937, at *2 (N.D. Tex. Nov. 5, 2021).

[35] *Id*. at *2.

[36] *Id*.

[37] *Id.*

thereafter, PowerCare and Interstate Battery System terminated their dealings with PowerFX.[38] As a result, PowerFX was left "'without [its] past time and financial investments and without the ability to generate the massive profits promised'" by PowerCare and Interstate Battery System.[39] PowerFX alleged in its lawsuit that much of its behavior—including entering into the MSA—resulted because of misrepresentations made by Power Care and Interstate Battery System regarding the performance of the Battery Medic.[40] The court recognized that "[m]ost of the misrepresentations were made . . . before the [MSA] was signed."[41] The misrepresentations related primarily to the quality of the Battery Medic product, including:

> that Interstate Battery System had a full-time staff for training (which it did not) and that the Battery Medic worked on all batteries (which it did not); Interstate Battery System owned the intellectual property to the computers to operate Battery Medic (which it did not); the Battery Medic could stream data to the cloud or could be exported to any file type (neither of which it could do); Interstate Battery System had set aside capital for the project (which it had not); and the Battery Medic was being used by companies (like Amazon) who did not actually use the product.[42]

PowerFX alleged that "'[e]very dollar and minute that PowerFx spent on Battery Medic was due solely to the Defendants' false statements.'"[43] Based on these misrepresentations regarding the functionality and features of Battery Medic, PowerFX purportedly created its business model, obtained investments, and made agreements with partners in the field.[44]

Judge Fitzwater ruled that the "scope of the phrase 'arising out of' requires a causal and incidental relationship between the contractual obligation or breach, and the claim" at issue in the

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.* at *3.

[44] *Id.*

underlying lawsuit.[45] In evaluating the applicability of the exclusion, Judge Fitzwater framed the issue as follows:

> There is a causal, incidental relationship when the claims at issue depend on the breach of contract or obligation under the contract. *See Sowell*, 603 F. Supp. 2d at 928. In *Sowell*[,] a lease between a company and a lessor required the company to obtain adequate insurance for the leased property—which the company failed to do. *Id*. The lessor asserted a negligence claim against the company for failing to obtain insurance. *Id*. But the duty for the negligence claim arose from an obligation under the contract to maintain insurance. *Id*. The court therefore held that the negligence claim "arose from" the contract. *Id*.
>
> There is no causal, incidental relationship if the claims do not depend on the breach of contract or obligation under the contract. *See Admiral Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 463 (N.D. Tex. 2003) (Godbey, J.). In *Briggs* a corporation made misrepresentations regarding its future success to a lessor. *Id*. The corporation's misrepresentations persuaded the lessor to accept stock instead of cash for payment of a lease. *Id*. The lessor sued the corporation for securities fraud in the underlying lawsuit. *Id*. In deciding that the insurer had a duty to defend (the insurer had issued a policy to the corporation that excluded claims arising out of contract), the court held that the lease was irrelevant because the claim asserted (securities fraud) occurred independently of the lease at the moment the company made the misrepresentations to the lessor. *Id*. at 462–63. In other words, "[t]he lease contract did not cause the stock fraud claim, it simply provided the context in which the stock fraud took place." *Id*.[46]

The defendants argued that there was no causal relationship because the purported misrepresentations occurred before any contract was formed.[47] The defendants further argued that, had there been no breach of the MSA, PowerFX would still have a claim based on statements made before the MSA was entered into—because the misrepresentations themselves caused harm.[48] Finally, the defendants argued that the insurer's interpretation of the phrase "'arising out of' would

[45] *Id*. at *5.

[46] *Id.*

[47] *Id*. at *6.

[48] *Id.*

expand the definition too far and make insurance coverage 'illusory' because contracts are so pervasive throughout business and would be involved in some way in every suit."[49]

Judge Fitzwater agreed with the defendants, finding that the exclusion was inapplicable: "Liberally construing the allegations in the Underlying Lawsuit in favor of coverage and resolving all doubts regarding the duty to defend in favor of the duty, the court concludes from its reading of the Policy and PowerFX's petition that PowerFX's claims for fraudulent inducement and negligent misrepresentation do not arise from an obligation or breach of the contract."[50] The court ruled that the underlying petition did not "plead obligations under the [MSA] that gave rise to the claims," because "[t]he fraudulent inducement and negligent misrepresentation claims . . . [did] not depend on (*i.e.*, 'arise out of') obligations or duties under the [MSA] (which relate[d] to delivering the product) but instead from misrepresentations (which relate[d] only to the quality of the product)."[51]

Resolving all doubts in favor of the insured, the court found that the "pleading simply contains no facts for the court to conclude (beyond the doubts it must resolve in Defendants' favor) that . . . the claims arise from obligations under the [MSA]."[52] In reaching its holding, the court looked to *Church Mutual Insurance Co. v. United States Liability Insurance Co.*[53] and *McPeek v. Travelers Casualty and Surety Co. of America*,[54] which the court found stood for the following "three propositions":[55]

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[49] *Id.*

[50] *Id*.

[51] *Id.*

[52] *Id*. at *7.

[53] 347 F. Supp. 2d 880 (S.D. Cal. 2004).

[54] No. 2:06-cv-114, 2006 WL 1308087 (W.D. Pa. May 10, 2006).

[55] *Interstate Battery System Int'l, Inc.*, 2021 WL 5164937, at *8.

- that tort claims "arise out of" a contract when the fraudulent representations giving rise to those claims are memorialized in the contract,
- that when the duty for the tort comes from the contract, the tort claims arise out of the contract, and
- that tort claims based on fraudulent misrepresentations that do not fit in these categories do not arise out of contract.[56]

The court found that the fraud claims based on misrepresentations were not intertwined with the contract, that the duties for these claims did not arise from the contract, and that the misrepresentations were not memorialized in the contract.[57] Rather, like in *Briggs* and *McPeek*, the claims at issue and the tort duties identified in the underlying lawsuit did not arise out of obligations set forth in the MSA or for breach of the MSA.[58] As in *Briggs* and *McPeek*, "misrepresentations were made before the plaintiff entered into the contract, and the duties giving rise to claims based on those misrepresentations were independent from the contract."[59] As a result, the court found that the insurer had a duty to defend, because the contract exclusion did not apply.

In sum, in *Sowell*, the court ruled that the Contract Exclusion at issue was implicated as to the claims for failing to acquire the proper insurance for the Leased Property, as those claims' existence was based upon and entirely dependent upon the obligations set forth in the lease agreement (*i.e.*, a contract). To the contrary, in *Interstate Battery System International, Inc.*, the pre-contract misdeeds and tort duties were not related to the contract but were independent of any duties imposed by the contract.

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[56] *Id.*

[57] *Id*. at *9.

[58] *Id.*

[59] *Id*. at *10 (citing *Briggs*, 264 F.Supp.2d at 463; *McPeek*, 2006 WL 1308087, at *4).

Here, this case aligns with the holdings from *Interstate Battery System International, Inc.*, *Briggs*, and *McPeek*. Under Texas law, "[i]t is well settled . . . that officers and directors owe a corporation the fiduciary 'duties of obedience, loyalty, and due care.'"[60] According to the Fifth Circuit, "[t]he duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation."[61] The duty of loyalty and care dictates that a corporate officer or director must act in good faith and must not allow his personal interests to prevail over the interest of the corporation."[62] This duty requires "an extreme measure of candor, unselflessness, and good faith on the part of the officer or director" to act in a manner that confers a benefit on the corporation.[63] In other words, the fiduciary duties purportedly breached by the Directors do not exist because of any contract or agreement, but rather are established at law. This is the key distinction between this matter and the decision from *Sowell*, where the court found that the claims were based upon and dependent upon the existence of the lease agreement.[64] Thus, the Contractual Liability Exclusion simply does not apply to preclude the duty to defend under the Policy.

Contrary to Allied World's assertion, the focus of the Underlying Lawsuit is, in fact, on the purported breach by the Defendants of these fiduciary duties, by way of *ultra vires* acts and *pre*-contract misdeeds. The prohibition on such conduct does not originate in the contract associated with the Airport Tract transaction or any contract (like in *Sowell*); rather, the prohibition on such

[60] *Hui Ye v. Xiang Zhang*, No. 4:18-CV-4729, 2020 WL 2521292, at *15 (S.D. Tex. May 15, 2020) (citing *Gearhart Indus., Inc. v. Smith Int'l Inc.*, 741 F.2d 707, 719 (5th Cir. 1984)).

[61] *Gearhart Indus.*, 741 F.2d at 719.

[62] *Hui Ye*, 2020 WL 2521292, at *17.

[63] *Id.*

[64] *Carolina Cas. Ins. v. Sowell*, 603 F. Supp. 2d 914, 931–32 (N.D. Tex. 2009).

conduct is created as a matter of common and statutory law.[65] In fact, the Fifth Circuit has specifically recognized that the "fiduciary duties of corporate officers and directors . . . are creatures of state common law."[66]

Based on the foregoing, the purported conduct (or misconduct) by the Directors falls outside the scope of the Contractual Liability Exclusion. Within the pleadings, there are multiple allegations that the Directors engaged in "wrongful acts" unrelated to a contract or for any representations made in anticipation of a contract.[67] These purported "wrongful acts" include the alleged failure to market, advertise, and sell the Airport Tract for the best price available.[68] The Underlying Claimants allege in the Underlying Lawsuit that obtaining the best price for the Airport Tract was a key component for WSC being able to upgrade the wastewater treatment plant.[69] According to the Underlying Claimants, the Directors were required (but failed) to take steps to obtain the most value out of selling the Airport Tract, and the failure to do so directly resulted in the inability to retire debt, an increase in rates and assessments, and a loss to the Underlying Claimants and other Members of the "Cooperative" of at least $1 million.[70] In other words, the Directors purportedly breached their fiduciary duties to the WSC, completely ***independent*** of any contract or agreement.

In this regard, the Underlying Claimants specifically assert in each pleading that the decision to sell the Airport Tract was made ***years*** before the purported sale occurred.[71] These *pre-*

[65] *Gearhart Indus.*, 741 F.2d at 719.

[66] *Id.*

[67] *See* Ex. A to Plaintiffs' Motion, Document 1, WSC00122.

[68] Ex. B to Plaintiffs' Motion, WSC00170, 174; Ex. C to Plaintiffs' Motion, WSC00229, 233.

[69] Ex. B to Plaintiffs' Motion, WSC00169; Ex. C to Plaintiffs' Motion, WSC00228.

[70] Ex. B to Plaintiffs' Motion, WSC00181–82; Ex. C to Plaintiffs' Motion, WSC00241–42.

[71] *See, e.g.*, Ex. B to Plaintiffs' Motion, WSC00169; Ex. C to Plaintiffs' Motion, WSC00228 (allegations that the Board of WSC voted in 2013 to upgrade the wastewater treatment facilities and sell the Airport Tract).

contractual misdeeds relate to the Directors' failure to market and advertise the sale of the Airport Tract. Had the Directors and WSC properly marketed the Airport Tract and not breached their fiduciary duties to obtain the highest and best use and most profit, then there would be no loss. Thus, any contract or agreement conveying the Airport Tract and other real estate "simply provided the context in which the [breach of fiduciary duties and other misdeeds] took place."[72] Applying the Contractual Liability Exclusion in this manner is consistent with Texas law (particularly *RLI Insurance Co. v. Interstate Battery System International, Inc.*) and courts around the country as it relates to pre-contact misdeeds and purported breaches of common law fiduciary duties.[73]

As in *Briggs*, the contract of sale was the context or "vehicle" in which the claims for the *pre*-contract misdeeds and breaches of fiduciary duty were asserted, as evidenced by the following factual allegations in the pleading:

> 7.12 Had the Airport Tract been properly marketed and sold for what it was worth in March 2016, the WSC and its Member Owners would have netted well over $1,000,000. They could have extinguished the outstanding debt, acquired needed equipment, made a healthy allocation to the reserve fund and received a respectable dividend, all in furtherance of the legitimate business of a water supply and sewer service Cooperative. Instead, the Cooperative's unfaithful fiduciaries caused the WSC to give away valuable property interests for next to nothing, devalued other property interests, and now have acted to keep those losses largely intact and to make it worse by giving away the Piper Lane taxiway. The Member Owners have been burdened with unnecessary debt service and higher rates and fees, and the Cooperative still doesn't have needed equipment and facilities. The WSC

[72] *See Admiral Ins. Co., Inc. v. Briggs*, 264 F. Supp. 2d 460, 463 (N.D. Tex. 2003).

[73] *See, e.g.*, *RLI Ins. Co. v. Interstate Battery Sys. Int'l, Inc.*, No. 3:20-CV-1888-D, 2021 WL 5164937, at *7 (N.D. Tex. Nov. 5, 2021) (explaining that its holding that the contract exclusion was inapplicable was "consistent with the holdings of other courts"); *Clark Sch. For Creative Learning, Inc. v. Philadelphia Indem. Ins. Co.*, No. 12-10475-DJC, 2012 WL 6771835, at *5 (D. Mass. Dec. 26, 2012) (holding that breach of contract exclusion was inapplicable to "pre-contract misdeeds" because they were based on conduct independent of the contracts), *aff'd*, 734 F.3d 51 (1st Cir. 2013); *Church Mut. Ins. Co. v. U.S. Liab. Ins. Co.*, 347 F. Supp. 2d 880, 888–89 (S.D. Cal. 2004) (finding that a contractual liability exclusion did not apply to claims that an insured was involved in a pattern and practice of defrauding contractors by entering into contracts without intending to pay).

> and its Board have no power to manage the Cooperative's assets in this manner.[74]
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> * * *
>
> 7.23 The Director Defendants have no authority to engage in breaches of fiduciary duty, constructive fraud or other misconduct, and such acts and omissions confer no lawful authority. As they have acknowledged in the past, the Director Defendants stand in a fiduciary capacity vis-à-vis the WSC and its Member Owners. In particular, they act as agents in connection with their management of property held in the name of the WSC for the benefit of the Member Owners. As such, the Directors' actions must be fair and equitable to the WSC and its Member Owners, the Directors must make reasonable use of the confidence placed in them, they must act in utmost good faith and exercise the most scrupulous honesty, they must place the interests of the WSC and its Member Owners ahead of their own interests and not use the advantage of their position to gain any benefit for themselves at the expense of the WSC or its Member Owners, and they must fully and fairly disclosed all important information to the WSC and its Member Owners.[75]

Simply put, when liberally construing the Contractual Liability Exclusion in favor of coverage—as required by Texas law—Allied World cannot meet its heavy burden[76] to establish that, under these factual allegations, that the true nature of the underlying dispute rests in contract law. Rather, when stripped to its core, the Underlying Claimants assert that the Director Defendants breached their common-law fiduciary duties in the management of the WSC. Any doubt regarding the application of the exclusion must be resolved in favor of coverage.[77] While the Director Defendants continue to wholeheartedly disagree with the assertions by the Underlying Claimants, these factual assertions implicate Allied World's duty to defend under the Policy. Allied World has breached and continues to breach this duty.

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[74] Ex. C to Plaintiffs' Motion, WSC00246–247.

[75] Ex. C to Plaintiffs' Motion, WSC00249.

[76] For Allied World to avoid providing a defense, it has the burden to show that an exclusion applies *See Guaranty Nat'l Ins. Co. v. Vic Mfg. Co.*, 143 F.3d 192, 193 (5th Cir. 1998); TEX. INS. CODE ANN. § 554.002 (West 2021).

[77] *Interstate Battery Sys. Int'l, Inc.*, 2021 WL 5164937, at *7.

Allied World asserts in the Cross-Motion that, "[w]ithout the WSC entering into that agreement [to sell the Airport Tract] and the board subsequently ratifying that agreement, there would be no claims against the defendants."[78] This is, however, an incorrect statement of law. Rather, the breach of fiduciary claims alleged in each pleading in the Underlying Lawsuit can stand on their own and are independent of any contract or agreement.[79] Again, this is exemplified by the relationship of a director to a corporation and the numerous allegations regarding the Directors' *ultra vires* acts, which are imposed not because of the contract to sale the Airport Tract, but rather—as discussed above—imposed at law.[80] Moreover, there are no factual allegations that these purported breaches of fiduciary duties involved "any representations made in anticipation of a contract"; rather, these alleged pre-contract misdeeds related to the overall management of the WSC's resources and the marketing and conduct of the Directors related to the Airport Tract itself.[81] As such, contrary to Allied World's position, the "plain language of the exclusion" does not support its proffered interpretation of the Contractual Liability Exclusion.[82]

Further, the exclusion itself applies only with respect to "any contract or agreement to which *the* insured is a party or a third-party beneficiary."[83] Allied World can point to no factual

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[78] Cross-Motion, p. 15.

[79] *See Interstate Battery Sys. Int'l, Inc.*, 2021 WL 5164937, at *8–9; *Am. Chem. Soc. v. Leadscope, Inc.*, No. 04AP–305, 2005 WL 1220746, at *10 (Ohio Ct. App. May 24, 2005) (finding that claims of conversion of trade secrets was not excluded by a contractual liability exclusion because the claims could be maintained "without regard" to any contract and the "claim for conversion neither necessarily arises from nor is based upon contractual liability").

[80] *See Gearhart Indus., Inc. v. Smith Int'l Inc.*, 741 F.2d 707, 719 (5th Cir. 1984)

[81] *See Interstate Battery Sys. Int'l, Inc.*, 2021 WL 5164937, at *8–9. *See*, *e.g.*, *Clark Sch. For Creative Learning, Inc. v. Philadelphia Indem. Ins. Co.*, No. 12-10475-DJC, 2012 WL 6771835, at *5 (D. Mass. Dec. 26, 2012), *aff'd*, 734 F.3d 51 (1st Cir. 2013) (similar exclusion was inapplicable as to "pre-contract misdeeds" because these misdeeds were based on conduct independent of the contracts); *Church Mut. Ins. Co. v. U.S. Liab. Ins. Co.*, 347 F. Supp. 2d 880, 888–89 (S.D. Cal. 2004) (finding that a contractual liability exclusion did not apply to claims that an insured was involved in a pattern and practice of defrauding contractors by entering into contracts without intending to pay). *See also, e.g.*, *Leadscope, Inc.*, 2005 WL 1220746, at *10.

[82] *See* Cross-Motion, pp. 15–16

[83] Ex. A to Plaintiffs' Motion, Document 1, WSC00122 (emphasis added).

allegations that the Directors (except Martin) are even parties to or third-party beneficiaries of any contract or agreement used to convey the Airport Tract.[84] This exclusion utilizes "the insured" as opposed to "any insured" or "an insured."[85] Pursuant to the "Separation of Insureds" provision, the Policy applies "[s]eparately to each insured against whom 'claim' is made."[86] Thus, as it relates to the Directors, the Contractual Liability Exclusion is inapplicable on its face, as there is no indication that any Directors (except Martin) were parties to any contract at issue.

Oddly, Allied World asserts in the Cross-Motion that the "Separation of Insureds" provision is not applicable because *King v. Dallas Fire Ins. Co.* (cited by Plaintiffs in their Motion) was decided in the context of whether an "occurrence" had taken place.[87] As an initial matter, Allied World appears to be suggesting that this Court should simply ignore a provision found in the Policy, which is improper under Texas law.[88] Rather, courts construe insurance policies in an "attempt to give effect to all contract provisions, so that none will be rendered meaningless."[89] Additionally, the holding from *King* was never intended to be so limited, as Allied World suggests, given the subsequent decision in *Chrysler Insurance Co. v. Greenspoint Dodge of Houston, Inc.*, where the Supreme Court of Texas cited *King* and found that the "separation of insureds" provision was applicable in evaluating the scope of a known-falsity exclusion.[90] Moreover, Texas appellate

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[84] *See McPeek*, 2006 WL 1308087, at *4 (noting that an additional reason a similar exclusion was not applicable is because the individual officer insureds were not parties to the contracts at issue).

[85] *Ooida Risk Retention Group, Inc. v. Williams*, 579 F.3d 469, 472–73 (5th Cir. 2009) (separation of insureds provision operates to give "effect to the separate coverage promised each insured by using the term 'the insured' to refer to the particular insured seeking coverage").

[86] Ex. A to Plaintiffs' Motion, Document 1, WSC00131; *see also King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 189 (Tex. 2002) (finding that when a policy contains a similar "separation of insureds" clause, the intentional conduct of one insured could not be imputed to another insured for purposes of determining an occurrence).

[87] Cross-Motion, p. 19.

[88] *See Kelley-Coppedge, Inc. v. Highlands Ins. Co.*, 980 S.W.2d 462, 464 (Tex. 1998).

[89] *Id*. at 464.

[90] *Chrysler Ins. Co. v. Greenspoint Dodge of Houston, Inc*., 297 S.W.3d 248, 253 (Tex. 2009).

courts have recognized that *King* extends to the context of an exclusion, as set forth in *Bituminous Casualty Corp. v. Maxey*, where the Houston Court of Appeals (1st. District) explained:

> To hold that the term "*any* insured" in an exclusion clause means "*the* insured making the claim" would collapse the distinction between the terms "the insured" and "any insured" in an insurance policy exclusion clause, making the distinction meaningless. It would also alter the plain language of the clause, frustrating the reasonable expectations of the parties when contracting for insurance. We should not adopt an unreasonable construction of an insurance contract."[91]

Thus, Allied World's suggestion that the "Separation of Insureds" provision is inapplicable to the Contractual Liability Exclusion is wholly without merit.

Finally, Allied World refutes Plaintiffs' position that the Contractual Liability Exclusion is ambiguous.[92] Contrary to Allied World's position, simply because the court in *Briggs* did not find that a similar exclusion was ambiguous or because the court in *Sowell* found that a similar exclusion was unambiguous does not mean that the Contractual Liability Exclusion in the Policy is not ambiguous. First, the exclusions are not identical, and, in fact, they utilize different language. Thus, the decisions from *Briggs* and *Sowell* as to other versions of similar exclusions is not binding on this Court as to whether the language of Allied World's exclusion and the terms of the Policy are ambiguous. Rather, a policy term is ambiguous if the "language . . . is subject to two or more reasonable interpretations."[93] If the Court finds an ambiguity in this particular contract, the Court must construe the policy strictly against the insurer.[94] Accordingly, if an ambiguity exists, a Court must adopt the insured's interpretation as long as it is reasonable, even where the insurer's

[91] *Bituminous Cas. Corp. v. Maxey*, 110 S.W.3d 203, 214 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (emphasis in original).

[92] Cross-Motion, pp. 19–20.

[93] *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. CBI Indus., Inc.*, 907 S.W.2d 517, 520 (Tex. 1995); *see Valmont Energy Steel, Inc. v. Commercial Union Ins. Co.*, 359 F.3d 770, 774 (5th Cir. 2004).

[94] *Valmont*, 359 F.3d at 774.

interpretation is a more reasonable interpretation.[95] Plaintiffs' interpretation that the Contractual Liability Exclusion does not apply to pre-contract misdeeds or common law fiduciary duty obligations is reasonable. Thus, the exclusion is ambiguous and should be interpreted narrowly in a way that it does not apply to the Underlying Lawsuit. Any broader interpretation would eviscerate coverage for the risks that WSC intended to cover through the purchase of the Policy.[96]

For the above reasons, Allied World cannot meet its burden to establish that the Contractual Liability Exclusion bars defense coverage for Plaintiffs in the Underlying Lawsuit. Thus, the Court should deny Allied World's Cross-Motion and grant Summary Judgment in favor of Plaintiffs on their claims.

D. The Criminal Acts and Violation of Laws Exclusions are Inapplicable to the Duty to Defend

Allied World maintains in the Cross-Motion that the Criminal Acts (Exclusion 12.) and Violation of Laws (Exclusion 19.) exclusions bar coverage. Pursuant to the Criminal Acts Exclusion, the insurance does not apply to:

> "Damages," "defense expenses," costs or loss arising out of or contributed to by any fraudulent, dishonest, criminal or malicious act of the insured . . . , or the willful violation of any statute, ordinance or regulation committed by or with the knowledge of the insured. However, we will defend the insured for covered civil action subject to the other terms of this Coverage Form until either a judgment or final adjudication establishes such an act, or the insured confirms such act.[97]

[95] *Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738, 741 (Tex. 1998).

[96] *See*, *e.g., Church Mut. Ins. Co. v. U.S. Liab. Ins. Co.*, 347 F. Supp. 2d 880, 884–85 (S.D. Cal. 2004) (noting that the insurer's "expansive interpretation" of a similar breach of contract exclusion "is at odds with the coverage provision of the . . . Policy, which provides coverage for 'Wrongful Acts'" that include "any actual or alleged act, error, omission, misstatement, misleading statement, neglect or breach of duties").

[97] Ex. A to Plaintiffs' Motion, Document 1, WSC00122.

Exclusion 19. precludes coverage for "'Damages,' 'defense expenses,' costs, or loss arising from an insured's willful violation of any federal, state, or local law, rule, or regulation."[98] Allied World's analysis misses the mark. The primary basis for reliance on these exclusions are the purported violations of the Texas Open Meetings Act (the "TOMA") as it relates to the negotiation and sale of the Airport Tract.

Allied World fails to address the fact that these exclusions have absolutely no application to the multiple allegations against the WSC and the Directors involving "claims" for "wrongful acts" that do not relate, in any form or fashion to a "fraudulent, dishonest, criminal or malicious act of the insured," "the willful violation of any statute, ordinance or regulation committed by or with the knowledge of the insured," or "an insured's willful violation of any federal, state, or local law, rule, or regulation." These alleged "wrongful acts" include, but are not limited to, the failure to obtain the "highest price obtainable" for the Airport Tract;[99] failure to engage a real estate professional to market the Airport Tract;[100] failure to list, advertise, or market the Airport Tract;[101] failure to retire outstanding debt of WSC;[102] postponing needed repairs and acquisition of equipment needed to comply with regulations;[103] and failure to provide reserve funds for the "legitimate business of a water supply and sewer" entity.[104] Under Texas law, "'[i]f *any* allegation in the [underlying] complaint is even *potentially* covered by the policy then the insurer has a duty

[98] Ex. A to Plaintiffs' Motion, Document 1, WSC00123.

[99] *See* Ex. B to Plaintiffs' Motion, WSC00165; Ex. C to Plaintiffs' Motion, WSC00226.

[100] *See* Ex. B to Plaintiffs' Motion, WSC00170, 174, 187; WSC00229–30, 233, 246.

[101] *See* Ex. B to Plaintiffs' Motion, WSC00170, 174, 187; WSC00229–30, 233, 246.

[102] Ex. B to Plaintiffs' Motion, WSC00179; Ex. C to Plaintiffs' Motion, WSC00239.

[103] Ex. B to Plaintiffs' Motion, WSC00181; Ex. C to Plaintiffs' Motion, WSC00241.

[104] Ex. B to Plaintiffs' Motion, WSC00187; Ex. C to Plaintiffs' Motion, WSC00246

to defend its insured.'"[105]For this reason alone, Allied World cannot meet its burden to show that these exclusions preclude defense coverage for all claims asserted in the Underlying Lawsuit.

Even if the Criminal Acts or the Violation of Laws Exclusions are broad enough to encompass *all* the factual allegations in the Underlying Lawsuit—which is expressly denied—there is no indication from the pleading that there was a "willful violation of any statute, ordinance or regulation committed by or with the knowledge of the insured;" or a "willful violation of any federal, state, or local law, rule, or regulation." Allied World asserts:

> The gravamen of the Underlying Lawsuit is that the defendants agreed to sell the Airport Tract to Martin and FHH for "pennies on the dollar" even though that agreement allegedly ran afoul of the financial interests of the Cooperative. Given this, the fact that the WSC board held a closed meeting without posting that the agenda of the meeting would include the discussion of the sale of the Airport Tract, falls squarely in the definition of "willful," since the board stubbornly did what it wanted (discuss the sale of the Airport Tract to Martin) regardless of the consequences (a violation of TOMA or any damage to the Cooperative as a result of the sale).[106]

Unsurprisingly, Allied World can cite to no case law or authority to support its contention that these allegations (or any allegations in the entire Underlying Lawsuit for that matter) rise to the level of "willful," which is generally understood to be "intentional; deliberate" or "having or showing a stubborn and determined intention to do as one wants, regardless of the consequences or effects."[107] Again, it is Allied World's burden of proof to show that the terms of its exclusions are met. And the pleading is simply devoid of factual allegations that there was any intentional, deliberate, or stubborn conduct by the Directors. Allied World has also not cited to any authority that establishes that there is an intent element to TOMA, which is a statute appearing at Section

[105] *Landry's, Inc. v. Ins. Co. of the State of Pa.*, 4 F.4th 366, 370 (5th Cir. 2021).

[106] Cross-Motion, pp. 20–21.

[107] *Apache Corp. v. Castex Offshore, Inc.*, 626 S.W.3d 371, 381 (Tex. App.—Houston [14th Dist.] 2021, no pet.) (quoting NEW OXFORD AMERICAN DICTIONARY 1978 (Angus Stevenson & Christine Lindberg eds., 3d ed. 2010)).

551.001 *et seq*. of the Texas Government Code. If Allied World is suggesting that an intent element can be inferred from the pleading, this argument is without merit, as it is just as reasonable to infer that the Directors had *no* intent to violate TOMA or engage in any conduct that would be considered "stubborn." Such a broad proffered interpretation of these exclusions simply runs afoul of Texas law.[108] Allied World cannot meet its burden to show that there was any "willful" violation of TOMA.

Allied World's position on the Criminal Acts Exclusion (Exclusion 12.) is even more tenuous. That exclusion—by its express terms—*does not* apply to the duty to defend *until* "either a judgment or final adjudication establishes such an act, or the insured confirms such act."[109] Contrary to Allied World's position, the "judgment or final adjudication" phrase under Texas law means that the exclusion applies ***only*** if there is a finding of a *willful* violation (which, as noted above, Plaintiffs dispute is even met) through final judgment or settlement in the Underlying Lawsuit, ***not*** in a parallel coverage action *or* parallel lawsuit.[110] Specifically, the Fifth Circuit noted:

> When a D&O policy requires a "final adjudication" to trigger an exclusion, "courts have consistently held that the adjudication must occur in the underlying D&O proceeding," rather than in a parallel coverage action or other lawsuit. The distinction is important because under a "final adjudication" clause, some courts bar insurers, after settlement of the underlying case, from litigating "whether the settled claims were in fact attributable to defendants' dishonest acts." Read this way, a final adjudication exclusion limits the insurer's recourse if the parties settle—the

[108] *See Landry's, Inc.*, 4 F.4th at 370.

[109] Ex. A, Document 1, WSC00122.

[110] *See e.g.*, *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 600 F.3d 562, 573 (5th Cir. 2010); *also Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Brown*, 787 F. Supp. 1424, 1429 (S.D. Fla. 1991), *aff'd sub nom.* 963 F.2d 385 (11th Cir. 1992) ("Pursuant to [a similar criminal acts] exclusion, National Union is not liable to make payment for losses arising out of claims made against the Insureds for fraud, dishonesty or criminal acts. The exclusion does not apply unless there is a final adjudication adverse to the Insureds that establishes fraud, dishonesty or criminal acts. The allegations in the civil and criminal actions appear to fall within the scope of the exclusion in Clause 4(d). However, the exclusion does not apply at this time because there has been no final adjudication establishing that the Insureds engaged in fraud, dishonesty or criminal acts.").

> most likely outcome—or if the insured is otherwise absolved of liability or guilt in the underlying action. As the district court in the [*In re Enron Corp. Sec., Derivatives & "ERISA" Litig.*, 391 F.Supp.2d 541, 573 (S.D.Tex.2005).] case explained, "the 'final adjudication' requirement of [the] exclusions implies that where the insured is not found guilty, there is coverage for his costs and expenses in defending himself in a criminal action."[111]

The decision from *Pendergest-Holt* represents Texas law and—more importantly—is binding on the district courts within the Circuit.[112] No state court decision or statutory amendment has occurred that would render the Fifth Circuit's decision in *Pendergest-Holt* "clearly wrong" and, therefore, the rationale applies here.

Allied World's reliance on the "related" lawsuit also contravenes the well-established "eight corners" rule, as reliance on the "related" lawsuit constitutes evidence that is extrinsic to the factual allegations in the live pleading.[113] Allied World has attached the following documents as its "evidence" in support of its Cross-Motion on the issue of the duty to defend:

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[111] *Id*. at 572–73.

[112] *See*, *e.g., United States v. AMC Entm't, Inc.*, 549 F.3d 760, 771 (9th Cir. 2008) (noting that, when the "Ninth Circuit or any of its coequal circuit courts issue an opinion, the pronouncements become the law of that geographical area"). *See also Ridglea Estate Condo. Ass'n v. Lexington Ins. Co.*, 309 F. Supp. 2d 851, 855 (N.D. Tex. 2004), *overruled on other grounds*, 398 F.3d 332 (5th Cir. 2005), *vacated and remanded*, 415 F.3d 474 (5th Cir. 2005) (reasoning that, "if a panel of the Fifth Circuit has settled on the state law to be applied in a diversity case, that precedent should be followed 'absent a subsequent state court decision or statutory amendment that rendered the [the Fifth Circuit's] prior decision clearly wrong'").

[113] *Richards v. State Farm Lloyds*, 597 S.W.3d 492, 500 (Tex. 2020) ("The eight-corners rule merely acknowledges that, under many common duty-to-defend clauses, only the *petition* and the *policy* are relevant to the initial inquiry into whether the petition's claim fits within the *policy's* coverage.") (emphasis in original); *Pine Oak Bldrs., Inc. v. Great Am. Lloyds Ins. Co.*, 279 S.W.3d 650, 655 (Tex. 2009) (holding that in deciding the duty to defend, the court should not consider extrinsic evidence from either the insurer or the insured but rather must rely on the language of the policy and allegations in the underlying pleading).

ALLIED WORLD'S EXHIBIT	DESCRIPTION
A	First Amended Petition filed in the TOMA Lawsuit
B	Trial court's Final Judgment entered in the TOMA Lawsuit dated November 13, 2018
C	June 21, 2019 decision of the Court of Appeals Sixth Appellate District of Texas at Texarkana issued in connection with the appeal of the November 13, 2018 Final Judgment issued in the TOMA Lawsuit and the Court of Appeals Judgment entered in connection with that decision

These Exhibits[114] are not relevant to the determination of the duty to defend and must be ignored. Texas courts apply the "eight corners" rule to determine whether an insurer has a duty to defend.[115] Allied World recognizes this, but asserts that it is entitled to rely on these Exhibits from the TOMA Lawsuit based on a "a narrow exception" where courts "will allow extrinsic evidence when determining whether or not an insurer has a duty to defend, when such evidence is relevant to an independent and discrete coverage issue, not touching on the merits of the underlying third-party claim."[116]

First, Allied World has not even set forth the proper standard for potentially evaluating extrinsic evidence as established by the Fifth Circuit. Rather, the actual standard is as follows:

> [I]f the four corners of the petition allege facts stating a cause of action which potentially falls within the four corners of the policy's scope of coverage, resolving all doubts in favor of the insured, the insurer has a duty to defend. If all the facts alleged in the underlying petition fall outside the scope of coverage, then there is no duty to defend. However, in the unlikely situation that the Texas Supreme Court were to recognize an exception to the strict eight corners rule, we conclude any exception would only apply in very limited circumstances: when it is initially impossible to discern whether coverage is potentially implicated *and* when the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with

[114] Cross-Motion, pp. 22–23; Allied World Ex. B; Allied World Ex. C.

[115] *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207, 212 (5th Cir. 2009).

[116] Cross-Motion, p. 25.

> the merits of or engage the truth or falsity of any facts alleged in the underlying case.[117]

Thus, under the so-called "*Northfield* Exception," it must first be "impossible to discern whether coverage is potentially implicated."[118] Allied World's duty to defend *can* be determined from the face of the complaint in the Underlying Lawsuit. As noted above, Allied World concedes that the insuring agreement is satisfied. There are no factual allegations in the pleading itself that establish any "willful" violation of law or statute. Thus, any reference in determining the duty to defend on the extrinsic evidence from the TOMA Lawsuit is simply improper under the *Northfield* Exception. The court must also reject the suggestion by Allied World that judicial notice of ancillary proceedings represents an exception to the "eight corners" rule, as Allied World has presented no authority (and likely cannot find any because none exists) that judicial notice presents a valid exception to the "eight corners" rule.[119]

Even if this Court were to allow Allied World to rely upon this extrinsic evidence, there was no "judgment or final adjudication" or—much less—even any allegation within the TOMA Lawsuit that WSC or the Directors committed a *willful* violation of TOMA or any statute. In fact, in the Memorandum Opinion issued by the Texarkana Court of Appeals, the court noted that, while WSC "posted notices of a public meeting at which Windermere's board authorized the sale of a portion of Windermere's property to a third party," WSC violated Section 551.041 of the Texas Government Code by failing "to include the subject of the prospective sale."[120] The plaintiff in the

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[117] *Northfield Ins. Co. v. Loving Home Care, Inc*., 363 F.3d 523, 531 (5th Cir. 2004) (emphasis in original).

[118] *Id*. at 531.

[119] Cross-Motion, p. 25.

[120] Exhibit C to Cross-Motion, ALLIED WORLD 011.

TOMA Lawsuit made no allegations of any willful violation of law. Thus, this extrinsic evidence and these Exhibits provide no support for Allied World as to these exclusions.

As neither of these exclusions operates to deny coverage to Plaintiffs, Allied World cannot escape its obligation to defend the Plaintiffs. Accordingly, Allied World's Cross-Motion should be denied, and Plaintiffs' Motion should be granted in its entirety.

E. Allied World Violated the Prompt Payment of Claims Act by Failing to Defend

Because Allied World breached the duty to defend and has breached the terms of the Policy, it is liable under the Prompt Payment of Claims Act within the Texas Insurance Code. In fact, as noted above, Allied World's blatant failure to even *address* its obligations under the Second Amended Original Petition constitutes an obvious breach of the duty to defend. This statute states that an insured is entitled to additional damages when an insurer improperly refuses or delays payment of a claim.[121] An insurer's breach of the duty to defend constitutes a *per se* violation of the Prompt Payment of Claims Act.[122] The Fifth Circuit recently reaffirmed that the Prompt Payment of Claims Act is a "strict liability" statute.[123] Thus, by breaching the duty to defend, as set forth above, Allied World has violated the Prompt Payment of Claims Act.[124] The Court should reject Allied World's argument that it has no exposure under the Prompt Payment of Claims Act and, instead, enter a ruling that Allied World violated the Prompt Payment of Claims Act based on

[121] *See* TEX. INS. CODE ANN. § 542.060 (West 2021).

[122] *See Pine Oak Builders, Inc.*, 279 S.W.3d at 652 (applying the Prompt Payment of Claims statute to an insurer's breach of its defense obligation); *Lamar Homes, Inc. v. Mid-Continent Cas. Co*, 242 S.W.3d 1, 20 (Tex. 2007) (holding that the right to a defense benefit under a liability insurance policy is a "first-party" claim within the meaning of the Prompt Payment of Claims statute); *see also Trammell Crow Residential Co. v. Virginia Sur. Co., Inc.*, 643 F. Supp. 2d 844 (N.D. Tex. 2008).

[123] *Agredano v. State Farm Lloyds*, 975 F.3d 504, 507 (5th Cir. 2020) (citing *Barbara Techs. Corp. v. State Farm Lloyds*, 589 S.W.3d 806, 819 (Tex. 2019); *Ortiz v. State Farm Lloyds*, 589 S.W.3d 127, 135 (Tex. 2019) ("[A]n insurer's payment of an . . . award does not as a matter of law bar an insured's claims under" the TPPCA.)).

[124] The Prompt Payment of Claims Act provides for an 18% penalty per annum plus attorneys' fees. *See* TEX. INS. CODE ANN. § 542.060 (West 2021). At this point, Plaintiffs seeks only a ruling that Allied World breached the duty to defend and, in doing so, violated the Prompt Payment of Claims Act.

its wrongful denial of coverage. Plaintiffs should then be awarded penalty interest on their damages at the rate of 18% per annum, as well as attorneys' fees incurred in prosecuting this coverage lawsuit, in amounts that will be calculated later.[125]

F. Conclusion

In sum, because there is at least a *potential* for coverage based on the factual allegations in the pleadings and terms of the Policy, Allied World—as a matter of law—had and continues to have a duty to defend Plaintiffs in the Underlying Lawsuit. Allied World wholly failed to even attempt to meet its burden to show that any exclusions bar coverage as a matter of law with respect to the Second Amended Original Petition and cannot meet that same burden with respect to the Third Amended Original Petition; therefore, it owed and continues to owe Plaintiffs a *complete* defense in the Underlying Lawsuit. For these reasons, Allied World's Cross-Motion for Summary Judgment should be denied, and Plaintiffs' Motion for Partial Summary Judgment should be granted. Allied World has also violated the Texas Prompt Payment of Claims Act based on its improper denial of defense coverage.

WHEREFORE, PREMISES CONSIDERED, Plaintiffs pray that the Court deny Allied World's Cross-Motion, grant Plaintiffs' Motion for Partial Summary Judgment on the Duty to Defend, decree and order that, because Allied World had and continues to have a duty to defend Plaintiffs in the Underlying Lawsuit, Allied World has breached the contract by refusing to defend, and, by not providing a defense, violated the Prompt Payment of Claims Act in the Texas Insurance Code. Plaintiffs further pray for all such further relief to which they may show themselves justly entitled.

[125] As set forth in Plaintiffs' Motion, the total *amount* of fees and the calculation of the penalty amount are not at issue at this time. Rather, these will be determined after the Court rules that Allied World had and breached the duty to defend.

Respectfully submitted,

SHIDLOFSKY LAW FIRM PLLC

/s/ Blake H. Crawford

Blake H. Crawford
Lead Attorney to be Noticed
State Bar No. 24065096
blake@shidlofskylaw.com
Douglas P. Skelley
State Bar No. 24056335
doug@shidlofskylaw.com
SHIDLOFSKY LAW FIRM PLLC
7200 N. Mopac Expy., Ste. 430
Austin, Texas 78731
512-685-1400
866-232-8412 (Fax)

ATTORNEYS FOR PLAINTIFFS WINDERMERE OAKS WATER SUPPLY CORPORATION, DANA MARTIN, WILLIAM EARNEST, THOMAS MICHAEL MADDEN, ROBERT MEBANE, PATRICK MULLIGAN, JOE GIMENEZ, DAVID BERTINO, MIKE NELSON, DOROTHY TAYLOR, and NORMAN MORSE

CERTIFICATE OF SERVICE

I hereby certify that, on January 31, 2022, I electronically filed under seal the foregoing document with the clerk of court for the U.S. District Court, Western District of Texas, Austin Division, using the electronic case filing system of the court. The electronic case filing system sent a "Notice of Electronic Filing" to attorneys of record for all parties who have consented in writing to accept service by electronic means.

/s/ Blake H. Crawford
Blake H. Crawford