An Insurer had a Duty to Defend a Claim Alleging the Negligent Transfer of the Claimant's Money to an Email Scammer.

But No Duty To Indemnify Because The Insured Settled The Claim After The Statute Of Limitations Expired.

A Texas federal District Court recently reconsidered its denial of cross-motions for summary judgment on the duty to defend, and ruled that a directors & officers liability insurer breached its duty to defend against a demand that the insured corporation pay amounts the claimant lost when the insured transferred money out of the claimant's bank account in response to a scammer's e-mail purporting to be from the claimant (this is sometimes referred to as a "social engineering" scam).

The case involved several closely held corporations relating to a food processing business. The entity seeking coverage provided financial services for individuals connected with the business. One of the issues was whether the claimant was an insured under the policy due to his connection with the business. Indeed, the case initially included claims under both the policy's D&O coverage and its first-party crime coverage. The first-party claims were voluntarily dismissed.

The policy covered a "claim" for a "wrongful act" and included a duty to defend a "claim." "Claim" was defined to include "a written demand for monetary damages" and "wrongful act" was defined to mean an actual or alleged "error, misstatement, misleading statement, act, omission, neglect, or breach of duty." The insurer raised three exclusions, barring coverage for: (i) claims "by or on behalf of any Insureds;" (ii) claims arising from "any services for or on behalf of others for a fee;" and (iii) claims arising from "liability under any contract or agreement" but not if the liability would have been incurred in the absence of the contract.

The Court did not revisit its prior ruling that there was no duty to indemnify the insured because the insured settled the potentially-covered negligence claim (the demand letter also encompassed an excluded breach of contract claim) after the statute of limitations on the negligence claim had expired. The settlement payment was not an amount for which the insured was legally liable (a requirement for coverage), the Court reasoned, and therefore did not fall within the policy's indemnity coverage. The Court rejected the insured's argument that the insurer's breach of its duty to defend barred it from contesting any liability determination against the insured, noting that there was no determination of liability for negligence because no suit was filed within the limitations period.

However, the Court determined that it had erred when it denied the insured's motion for summary judgment on the duty to defend in reliance on a narrow exception to Texas' "eight corners" rule, which limits the analysis of the duty to defend to the policy and the complaint (or in this case the demand letter). The exception permits the consideration of extrinsic evidence when it is initially impossible to determine whether coverage is implicated and the extrinsic evidence goes solely to a fundamental issue of coverage which does not overlap with the facts of the underlying case. (The existence and scope of the exception is a murky issue. As the Court notes, the exception has been recognized by the Fifth Circuit, but not adopted by the Texas Supreme Court, and is the subject of a question recently certified by the former to the latter. To further complicate matters, there is case law suggesting that the exception, if there is one, might not apply to a policy requiring the insurer to defend even if the claim is "groundless, false or fraudulent" – language that was in the policy before the Court in this case.)

The Court had applied the exception to deny the insured summary judgment on the duty to defend because the extrinsic evidence with respect to the applicability of the three exclusions showed that there were disputed issues of fact that precluded a determination as to the applicability of the exclusions on summary judgment. On reconsideration, the Court held that the demand letter alleged a potentially covered claim triggering the duty to defend, and the duty was not negated by exclusions where the extrinsic evidence concerning the exclusions was disputed and their applicability could not be determined. Put another way, it appears that the decision on reconsideration acknowledges that because the insured is entitled to a defense when there is a potential for coverage, factual disputes concerning the applicability of one or more exclusions will not preclude summary judgment on the duty to defend.

The Court's decision supports the proposition that the negligent transfer of funds of another in response to a scam email may be a wrongful act potentially covered under a D&O liability policy. Because of its unusual facts, and in particular the dispute as to the nature of the claimant's relationship to the insured entity and his potential status as an insured, the case may be distinguishable from a typical social engineering coverage case. However, in addition to highlighting the issue of the exception to Texas' "eight corners" rule, the case does provide a clear warning that even where the insurer has breached the duty to defend, it may not be required to indemnify the insured for a settlement the insured was not legally obligated to pay.

The case is *Quality Sausage Company, Inc.* v. *Twin City Fire Ins. Co.*, U.S.D.C. for the Southern District of Texas No. 4:17-CV-111 (Order of September 18, 2019).