By Stephen Gibson

***Liability Insurance*: To support the refusal of a duty to defend its insured, a liability insurer may rely on undisputed extrinsic evidence of collusion between the claimant and insured to fraudulently create coverage for an excluded risk.**

The typical liability insurance contract obligates the insurer to defend all suits against the insured seeking damages covered under the policy. The typical liability policy used to explicitly state this obligation existed even if the suit was "groundless, false or fraudulent." With or without this phrase, the obligation to defend a suit was governed by the "complaint allegation rule" under which the insurer's duty to defend turned solely on whether the liberally construed allegations against the insured, if true, would have resulted in a covered liability. Because the wording limited the defense obligation to the allegations of the petition, regardless of their veracity, the Texas Supreme refused to allow the duty to defend to turn on consideration of factors other than those alleged in the pleading against the insured, even if those "extrinsic facts" were undisputedly true.

The court's rationale was the proper role of extrinsic evidence at variance with the allegations against the insured was to contest the insured's liability, not the insurer's defense obligation as written in the policy. The court had, however, previously hinted that it *might* recognize a narrow exception to the complaint allegation rule for deciding the insurer's duty to defend. However, any such exception would be narrowly tailored to apply only if (1) the allegations would not show whether the liability would be covered and (2) the extrinsic facts are relevant only to coverage, not the insured's liability to the claimant. However, the court never actually recognized this or any other exception to the complaint allegation rule.

Until now.

After steadfastly rejecting consideration of extrinsic evidence, a unanimous court in *Loya Insurance Co. v. Avalos* decided to allow it under the peculiar circumstances this case presented. In *Avalos*, the evidence was undisputed the husband was driving when the auto collision occurred. The husband, however, was an excluded driver under the auto liability policy. Presumably, insurance proceeds would have been the only funds readily available to pay any judgement. To evade the exclusion, the wife and the claimants concocted the story that the wife was driving.

The parties did not dispute that their collusion was intended to manufacture liability coverage that did not otherwise exist. Justice Busby's unanimous opinion reasoned the insurer's promise to defend a claimant's allegations against the insured even if fraudulent did not include "fraudulent allegations brought about *by the insured*." The opinion did not, however, identify any language in the insuring agreement that justified excepting from the insurer's obligation to defend fraudulent pleadings according to who participated in the fraud. Indeed, the exception appears to have been based, not on the language of the policy, but instead on the undisputed – albeit extrinsic – evidence of collusion by the claimant and the insured.

In other words, there is a fraud exception to the agreement to defend fraudulent pleadings. The opinion explains that when the evidence of collusion is conclusively established so that the extrinsic evidence may be considered, the insurer need not seek a declaratory judgment excusing it from further defending the insured. The opinion suggests, but does not explicitly hold, that there is likely no justiciable controversy when the facts are undisputed. In this writer's opinion, this observation must be limited to the context in which it was made. A controversy may be justiciable even without a factual dispute if there is a dispute about the manner in which the law applies to those undisputed facts.

Excusing the insurer from the usual requirement of seeking declaratory relief before withdrawing from the insured's defense is limited to "clear cut" cases. The exception being recognized presents, according to the opinion, no undue risk of wrongful refusal to defend the insured. Insureds retain their statutory and common law remedies against insurers which allow for recovery of more than actual damages if the insurer wrongfully refuses to defend the insured or engages in an unfair claim settlement practice. The court reasoned that should be enough to discourage unscrupulous insurers from refusing to defend in questionable cases.

Franchise Taxes: Military goods delivered to the U. S. government in Texas for resale to a foreign government is not a Texas sale for purposes of franchise tax calculation because the requirement of distribution through the U. S. government is a "condition of sale" the applicable version of the franchise tax statute says does not control.

Lockheed Martin in Fort Worth builds the F-16 fighter. This plane is used by both U.S. and foreign militaries. By statute, manufacturers of certain U. S. military equipment, including the F-16, cannot sell it directly to foreign governments. Instead, the equipment must be sold to the U.S. government which in turn resells it to the foreign government under a separate contract.

Under the law in effect at the time, Texas franchise taxes were calculated as a ratio of in-state to total sales receipts. A sale was in-state if the goods were delivered or shipped to a buyer in Texas, regardless of the contractually specified FOB point or other condition of sale.

A U. S. government pilot took delivery of the aircraft at Lockheed Martin's Fort Worth factory. The U. S. government, again using its pilots, later ferried the planes to the foreign government to fulfill the U. S. government's separate contract with the foreign government.

The dispute in *Lockheed Martin Corp. v. Hegar* was about who was the buyer where the delivery to that buyer occurred for franchise tax purposes. If the U.S. was the "buyer," the planes were delivered in Fort Worth so the sale increased the portion of Lockheed Martin's total sales subject to the franchise tax. If, however, the foreign government was the "buyer," the sale would be deemed outside Texas excluded from franchise taxes. The trial court and the court of appeals both agreed that, in view of the federal statute only permitting foreign distribution of the aircraft through re-sale by the U. S. government, the relevant "sale" was the one to the U. S. and, therefore, it was a delivery in Texas that must have been included in the franchise tax calculation.

A majority of the Texas Supreme Court in an 8:1 opinion by Justice Lehrmann sided with Lockheed Martin. The majority ruled that the relevant sale for franchise tax purposes was not the one by Lockheed Martin to the U. S. government. Instead, the sale that counted for franchise taxation was the re-sale from the U. S. to the foreign government so that the proceeds from the sale of the planes were not subject to franchise taxation. The opinion reached this remarkable result by pointing to a provision in the since-amended version of the franchise tax law that said the in-state or out-of-state character of the transaction was controlled by where the goods were delivered or shipped to the buyer, regardless of the contractually specified FOB point or other condition of the sale.

The majority opinion treated the federally mandated sale from Lockheed to the U. S. government as but a "condition of sale" that must be disregarded under the applicable version of the franchise tax. The majority acknowledged that, as a general rule, domestic intrastate sales to effectuate an interstate re-sale is a Texas sale for franchise tax purposes. However, the majority reasoned that "because the sale … could not occur without [the U. S. government's] involvement, the federal mandate is a statutory "condition of the sale" that we disregard for franchise-tax purposes." The court justified this conclusion because the particular F-16's were built to the foreign government's specifications, and that the payment was made with funds the foreign government deposited with the U. S. government. Thus, in the view of the majority, the foreign government was always the intended recipient. The sale to the U. S. government was deemed a mere formality. Because the planes were delivered to the foreign buyer outside Texas, the sale was not a Texas sale for purposes of franchise tax calculations.

The majority did not appear to consider, however, that the purpose of the Texas statute's directive was to prevent the parties from manipulating the formalities of the transaction to avoid franchise taxes. Nor did the majority appear to consider that the requirement of sale to the U.S. government was not one imposed by the parties and was not imposed for any reason related to state franchise taxation.

Less-than-subtly suggesting the majority's decision was result-oriented, Justice Boyd, dissented "because the Court believes the sales should not generate Texas receipts in these 'unique circumstances'" without any statutory basis for such an exception. He maintained the franchise tax statute, instead of permitting disregard of the specified delivery point, *required* the delivery point to control *regardless* of any condition of sale, including the condition that the U. S. government resell the aircraft to a foreign government. After all, the delivery point both as a matter of contractual specification and as a matter of fact was in Fort Worth. Justice Boyd pointed to the statutory reference to delivery to "*a* buyer" means *any* buyer, not just the ultimate buyer. In his view, the sale should have been included in of Lockheed Martin's Texas revenue for purposes of its franchise tax calculation.

Sovereign Immunity and Agreements to Binding Arbitration**: Local Gov't Code chapter 271 permits governmental entities to arbitrate disputes under goods and services contracts. Claims of sovereign immunity from arbitration is a jurisdictional issue for the court, not the arbitrator, to decide. Chapter 271 waived the authority's sovereign immunity even though the contracted repairs primarily benefitted a third party and did not discharge a duty owed directly by the authority itself.**

Earlier this term, the Supreme Court of Texas ruled in *Robinson v. Home Owners Management Enterprises, Inc.*, that arbitrability of class actions is a gateway issue for the court to decide unless the parties "clearly and unmistakably" agree to permit the arbitrator to resolve it. In *San Antonio River Authority v Austin Bridge & Road*, the court tackled the questions of whether a governmental entity is authorized to agree to arbitrate contractual disputes and, if so, whether court or arbitrator decides whether the governmental entity waived its sovereign immunity. Spoiler alert: a narrowly divided court ruled 5:4 in an opinion by Justice Bland that governmental entities are authorized under Texas Local Government Code chapter 271 to agree to the arbitration of contractual disputes and that assertions of sovereign immunity were jurisdictional threshold questions that courts, not arbitrators, must decide.

Governmental entities are permitted to agree to arbitrate disputes under goods and services contracts.

The San Antonio River Authority and a contractor disagreed about the scope of work and payment under a contract to repair the Medina dam. The contractor invoked the contract's arbitration clause, but the authority resisted by asserting that it was not authorized to agree to arbitrate such contractual disputes and, therefore, continued to enjoy sovereign immunity. The contractor argued the authority had waived its immunity and the parties disputed whether that issue should be decided by the courts or the arbitrator.

Resolution of whether the authority was bound by the arbitration clause depended on the interpretation of chapter 271. Before chapter 271 became law, local governmental entities enjoyed immunity, even for its contractual obligations. When Local Gov't Code §271.152 was enacted, the erstwhile immunity of local governmental entities from contractual liability was abrogated for contracts governed by chapter 271. That chapter further allowed enforcement of arbitration provisions in such contracts, Texas Local Gov't Code § 271.154, because the definition of "adjudication" under chapter 271 includes arbitration proceedings.

Chapter 271 grants all the permission necessary for governmental entities to agree to arbitrate disputes under goods and services contracts.

Nevertheless, the authority argued that simply because arbitration agreements in goods and services contracts with local governments could be enforced, its agreement with the contractor in this case was not binding because the authority had not been granted the necessary consent to do so by statute or resolution. The court rejected this contention. After deciding that chapter 271 authorized bringing civil suits and that bringing civil suits included arbitration proceedings, the majority determined that, by permitting these actions, the legislature had granted all the permission necessary for the authority to be bound to its agreement to arbitrate its contract dispute.

Claims of sovereign immunity are jurisdictional and must be decided by the court, not the arbitrator.

Having decided the agreement to arbitrate was enforceable, the court turned to the issues of whether the arbitrator or the courts decide arbitrability when the governmental entity asserts sovereign immunity. As a contest to the court's jurisdiction to act, including referral to arbitration, the issue is one that the courts must decide. "[T]he judiciary retains the duty to decide whether a local government has waived its immunity, . . . the parties' agreement to arbitrate notwithstanding" because "it is the non-delegable role of the judiciary to determine whether governmental immunity exists, whether such immunity has been waived, and to what extent."

Chapter 271 waived immunity even though the authority did not have a direct duty to perform the contracted services.

Because the arbitration was permitted under chapter 271, the authority's sovereign immunity was expressly waived with respect to that agreement under §271.152. Under a separate agreement, the authority agreed to manage the project for repairs by the contractor for the benefit of another governmental entity who was directly responsible for maintaining the dam that was the subject of the contract. Nevertheless, the contractor’s services incidentally discharged some of the authority’s responsibilities to the third party. That was enough to make the agreement one that provided goods or services to the authority to which chapter 271 applied to waive the authority’s immunity.

Claims for additional work actually performed are direct, not consequential, damages for which Chapter 271 waives immunity.

The Chapter 271 waiver is limited, however, to sums due under the contract and any change orders, attorney's fees and interest as allowed under the Government Code. The waiver of immunity does not extend to consequential damages other than sums due under the contract and any change orders for work delays or accelerations. The court rejected the authority's argument that the damages sought were "consequential damages" not within the scope of the immunity waiver.
Consequential damages are those that naturally, but not necessarily, result from the defendant's breach and are not the usual result of the wrong. Although the evidence and arguments on that issue had not been fully developed, the majority was satisfied that at least part of the sums claimed by the contractor were for work actually performed and that such claims were within the scope of the waiver.

The question unanswered by the majority, however, is what part of the case is arbitrable and what part is not. If waiver of immunity is a jurisdictional impediment that the court must decide, then it would seem to follow that the court would need to delineate which issues can be decided by the arbitrator and those that cannot. Further concerns presented are whether and how the proceedings must be commenced. For example, parties cannot confer subject-matter jurisdiction by agreement or acquiescence. Should the contractor initiate judicial proceedings to force the government's hand in asserting sovereign immunity? If the contractor simply refers the matter to arbitration, does the governmental entity enjoy an effective "King's X" that allows it to challenge the arbitrator's jurisdiction if it is displeased with the arbitral outcome?

The dissent questions the basis for the majority's conclusion that the authority had the necessary permission to agree to binding *arbitration.*

The dissent by Justice Boyd, joined by the Chief Justice and two other Justices, challenges the majority's conclusion that the legislature granted permission to the authority to agree to *binding* arbitration. The dissent posits that the majority's conclusion that the statute granted permission to agree to binding arbitration by blurring the distinction between an arbitration *procedure* and an arbitration *proceeding* recognized in sections 271.151 and 271.154 when it considered both to be permitted under the definition of "adjudication." According to the dissent, the reference to certain proceedings that occur in an arbitration unless they conflict with other parts of that subchapter, cannot be read to authorize a binding arbitration proceeding. The dissent reasons that authorizing certain procedures that may be part of a permissible arbitration does not necessarily authorize the arbitration itself. The dissent points out the Governmental Dispute Resolution Act in §§ 2009.001–.055 of the Government Code withholds authorization of *binding* arbitration. The dissenters reason when it is understood that chapter 271 refers to procedures that also apply to non-binding arbitration, chapter 271 does not necessarily or fairly imply that the legislature granted the authority the power to agree to binding arbitration.