Expert Commentary

Contract Bars Coverage? Reform the Contract!

Can parties reform the contract even if it means an insurer must pay for defense costs or damages that would not be covered under the contract as written?

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Defense and Settlement

In a case that may have implications beyond its underlying facts, the Fifth Circuit Court of Appeals recently affirmed a district court's reformation of an oil field master services agreement that resulted in extending coverage for indemnity payments that otherwise would not have been covered under the indemnitor's liability policy. *See Raylin Richard v. Anadarko Petroleum Corp.*, No. 16-30216 (5th Cir. Mar. 2, 2017).

Many liability coverage questions, particularly concerning an insurer's duty to defend, may be resolved by reading two documents—the insurance policy and the underlying complaint. In Texas and other states, this is called the "Eight Corners Rule," although it goes by other names elsewhere. There are, however, at least two common scenarios where liability coverage issues require reference to other documents, such as a contract between the named insured and a third party.

Additional insured endorsements, for example, often extend coverage to parties for which the named insured has agreed in writing to provide such coverage. Another scenario is when the named insured seeks coverage for its defense or indemnification of third parties through an "insured contract." In each of these situations, the language of the "other" contract is generally dispositive. *See, e.g.*, *In re Deepwater Horizon*, 470 S.W.3d 452 (Tex. 2015) (drilling contract limited scope of additional insured coverage); *Gilbane Bldg. Co. v. Admiral Ins. Co.*, 664 F.3d 589 (5th Cir. 2011) (Gilbane was additional insured by virtue of an "insured contract" with named insured); *St. Paul Fire & Marine Ins. Co. v. American Int'l Spec. Lines Co.*, 365 F.3d 263 (4th Cir. 2004) (policy covered named insured's indemnification of third party under "insured contract"). "Twelve Corners Rule," anyone?

But what if the parties to the "other" contract insist its written terms do not accurately reflect their agreement? Can they reform the contract, even if it means an insurer must pay for defense costs or damages that would not be covered under the contract as written? This is the question addressed by the courts in *Anadarko*.

Facts of the Case

Although at its heart a coverage dispute, the primary substantive issue in *Anadarko* was the meaning and effect of a "two-part chain of contractual indemnifications."

Anadarko and Offshore Energy Services (OES) had a longstanding master services agreement (MSA) under which OES provided casing and other services for Anadarko's drilling projects and agreed to indemnify Anadarko and its indemnitees (defined as including Anadarko's subcontractors). In connection with a project on a drill ship, Anadarko indemnified other contractors, including Dolphin Drilling and Smith International.

When Raylin Richard, a casing supervisor for OES on that project, was injured, he filed tort claims against all of the above. Dolphin and Smith sought indemnity from Anadarko, which in turn sought indemnity from OES. Considering itself bound to indemnify the other three companies, OES spent almost $470,000 defending the lawsuit and ultimately paid $2.5 million for a full release of all four companies.

OES sought to recover its defense costs and its $1 million policy limit from its commercial general liability carrier, Liberty Mutual. The insurer denied coverage for OES's expenditures related to Dolphin and Smith on the grounds that they were not encompassed by OES's indemnity agreement with Anadarko.

The district court granted summary judgment for Liberty, holding that Dolphin and Smith "were Anadarko's 'contractors,' which the MSC's indemnity provisions did not cover, rather than 'subcontractors,' which the MSC's indemnity provisions would cover."

On OES's motion for reconsideration, the court declined to revisit its construction of the indemnity agreement as not extending to Dolphin and Smith but permitted Anadarko and OES to reform their MSC "to reflect a mutually intended 'knock for knock indemnity scheme that would require … OES to indemnify Anadarko, Smith, and Dolphin.'" Liberty was, therefore, required to compensate OES for its defense costs, in addition to paying the policy limits (less the deductible).

The Appeal

Liberty appealed, and the Fifth Circuit devoted the bulk of its opinion addressing the propriety of the reformation order. First, the court confirmed the MSC was subject to federal maritime law, which was not disputed. Under that law, parol evidence was admissible to prove a mutual mistake, and the Fifth Circuit agreed OES and Anadarko had proven "a mutual error by clear-and-convincing evidence." Because maritime law did not clearly resolve whether reformation could be granted when the interests of a third party (here, Liberty) were adversely affected, the court referred to state law to answer that question. As to which state's law was applicable, the court held there was no conflict between Texas and Louisiana law on the issue, so applied the law of its forum, Louisiana.

Although Liberty argued it should be protected from reformation because it "assumed obligations based on the original contract language," it was undisputed that Liberty "did not study, review, or rely on the language of the [MSC] prior to issuing its policy to OES." Distinguishing two previous cases in which it had affirmed a district court's denial of reformation in similar scenarios, the Fifth Circuit held Liberty did "not stand on equal footing" with the insurers in those cases. It, therefore, affirmed the district court's order requiring Liberty to reimburse OES for defense costs incurred in the underlying lawsuit. It reversed, however, the order that Liberty pay all the defense costs, holding the policy unambiguously required reimbursement of only a pro-rata share of those costs. It then modified the judgment to require payment of $169,000 rather than $469,000.

Conclusion

What, if anything, does *Anadarko* portend for other coverage cases? In most cases, the parties to the "other" contract have divergent interests in allocating policy proceeds and are unlikely to agree to "reform" their contract to increase coverage for one of the parties. In *Deepwater Horizon*, for example, the named insured

bitterly objected to the additional insured's claim to be covered for its own negligence. As *Anadarko* demonstrates, however, there are circumstances where the interests of the contracting parties are aligned in pursuit of insurance recovery. If they discover the language of their contract does not trigger the insurance coverage they anticipated, they might want to consider reformation.

Contemplate, for example, this scenario: A property owner-developer regularly retains a closely aligned general contractor, and the two companies structure their relationship to include mutual indemnifications and insurance requirements. The owner creates a different entity for each project, and the form contract is modified for each project to require the contractor to include the specific owner entity as an additional insured on its liability policy. On one of the projects, an accident at a worksite injures several employees and bystanders, and a lawsuit ensues.

The construction contract on this project, however, inadvertently named the wrong entity as the owner entitled to additional-insured protection. (Any business that uses a form contract for a series of different projects knows how easily such a mistake can happen.) The owner entity tenders its defense to the contractor's liability carrier, the insurer looks to the contract for this project, and it determines the insurance provision does not satisfy the additional-insured endorsement. When the insurer denies coverage of the owner entity on this ground, the owner and contractor insist the misnomer in their contract was the result of a mutual mistake and does not accurately reflect their actual agreement.

The reformation approved in *Anadarko* gives the contracting parties a mechanism by which they might be able to correct their mistake and salvage coverage that would otherwise be lost. The burden of proving a right to reformation, of course, is heavy, and situations in which this equitable remedy is appropriate are rare. But in desperate circumstances, policyholders may want to request it.