

No. 96 -

In the Supreme Court of the United States

OCTOBER TERM, 1996

VEREX ASSURANCE, INC., *Petitioner*

v.

NANCY ABSHIRE PALMA, *Respondent*

**Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Fifth Circuit**

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether, consistent with *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), a federal court sitting in diversity may disregard state intermediate court decisions that are squarely on point and recognize a cause of action for a group of litigants never before countenanced under the law of that State.

2. Whether, at a minimum, the Court should grant the petition, vacate the judgment below, and either certify the state law question to the state supreme court or remand the case to the court of appeals for further consideration in light of an intervening state court decision that confirms that state law does not recognize the new cause of action created by the federal court.

**PARTIES TO THE PROCEEDING AND
RULE 29.6 STATEMENT**

All parties are listed in the caption. The petitioner in this case is Verex Assurance, Inc., which is a wholly owned subsidiary of G.E. Capital Mortgage Corporation, which in turn is a subsidiary of General Electric Corporation.

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PETITION FOR A WRIT OF CERTIORARI

Verex Assurance, Inc. respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit (App., *infra*, 1a-24a) is reported at 79 F.3d 1453. The opinions of the magistrate judge (App., *infra*, 39a-59a, 62a-85a), which were adopted by the United States District Court for the Southern District of Texas (App., *infra*, 25a-26a, 37a-38a, 60a-61a), are unreported.

JURISDICTION

The court of appeals entered its judgment on April 16, 1996. App., *infra*, 1a. A timely petition for rehearing was denied on July 17, 1996 (App., *infra*, 87a-88a), and the petition for a writ of certiorari is accordingly due on October 15, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The Rules of Decision Act, 28 U.S.C. § 1652 (1988), provides:

The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply.

Article 21.21(16)¹ of the Texas Insurance Code provides in pertinent part:

¹ In 1995, the relevant provisions of Article 21.21(16) were amended without substantive change. The decisions of the courts below address Article 21.21(16) as codified before those 1995 amendments, and thus this petition uses the statutory language employed in those decisions. The provision, as amended, is set forth in the Appendix at 112a.

Any person who has sustained actual damages as a result of another's engaging in an act or practice declared in Section 4 or in rules or regulations lawfully adopted by the Board under this Article to be unfair methods of competition or unfair or deceptive acts or practices in the business of insurance or in any practice defined by Section 17.46 of the Business and Commerce Code as an unlawful trade practice may maintain an action against the person or persons engaging in such acts or practices.

STATEMENT

This case arises out of a charge by respondent Nancy Abshire Palma, a borrower, that petitioner Verex Assurance, Inc., a mortgage insurance company, violated Article 21.21(16) of the Texas Insurance Code when it sought to recover a mortgage loan deficiency following Palma's default. In pressing her claims, Palma invoked a provision in the mortgage insurance contract between petitioner and City Federal Savings & Loan ("City Federal"), Palma's lender — a contract to which Palma was not a party. Purporting to apply Texas law, the Fifth Circuit recognized a cause of action for an entirely new class of litigants, holding that borrowers are third-party beneficiaries of mortgage insurance contracts between lenders and their insurers and therefore have standing to bring an action under Article 21.21(16) of the Texas Insurance Code against insurers based on their handling of those contracts.

The Fifth Circuit's decision in this case, creating a new cause of action for litigants where none previously existed under state law, has aligned that circuit with one side of a split of authority in the Courts of Appeals concerning a federal diversity court's authority, under principles first enunciated in *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), to create new state law. The Fifth Circuit refused to apply the settled law of Texas, as established by consistent intermediate appellate court decisions, which plainly instructs that borrowers

like Palma lack standing to bring claims under Article 21.21(16) of the Texas Insurance Code against lenders' insurers.

The Fifth Circuit thus far has remained steadfast in its refusal to apply Texas law. Petitioner recently filed with the Fifth Circuit a Motion to Recall Mandate, a Second Petition for Panel Rehearing, and a Second Suggestion for Rehearing *En Banc*, informing the court of a subsequent Texas intermediate appellate court decision that plainly rejects the Fifth Circuit's view of Texas law. If the Fifth Circuit refuses to recall its mandate and conform its order to the state law of Texas, the court will be in violation of *Huddleston v. Dwyer*, 322 U.S. 232 (1944), and *Vandenbark v. Owens-Illinois Co.*, 311 U.S. 538 (1941). And as a consequence, the availability of a cause of action for borrowers under Texas law would depend solely — and improperly — on whether the plaintiff files suit in state or federal court.

A. Legal Framework

Article 21.21(16) of the Texas Insurance Code provides in relevant part that “[a]ny person who has sustained actual damages as a result of another’s * * * unfair or deceptive acts or practices in the business of insurance * * * may maintain an action against the person * * * engaging in such acts or practices.” Although “any person” would appear to provide standing to a wide range of litigants, Texas state courts construe the phrase quite narrowly. Indeed, Texas courts have recognized only three categories of plaintiffs who may bring an action under Article 21.21(16): the insured, intended third-party beneficiaries of the underlying contract, and persons who rely to their detriment on the words or deeds of the insurer. See, e.g., *Shelton Ins. Agency v. St. Paul Mercury Ins. Co.*, 848 S.W.2d 739, 744 (Tex. Ct. App. 1993, writ denied); *Hermann Hosp. v. National Standard Ins. Co.*, 776 S.W.2d 249, 252 (Tex. Ct. App. 1989).

Texas courts have also addressed the specific question considered by the Fifth Circuit in the present case, *i.e.*, whether a borrower has standing to sue the lender's insurer directly under

Article 21.21(16) of the Insurance Code for claims arising from the lender's insurance contract, consistently and repeatedly holding that borrowers lack standing to bring such claims. See, e.g., *First Am. Title Ins. Co. v. Willard*, No. 12-93-00290-CV, 1996 WL 495583 (Tex. Ct. App. Aug. 29, 1996)²; *Pineda v. PMI Mortgage Ins. Co.*, 843 S.W.2d 660, 673 (Tex. Ct. App. 1992); see also *Chaffin v. Transamerica Ins. Co.*, 731 S.W.2d 728, 732 (Tex. Ct. App. 1987) ("We are aware of no Texas case providing a statutory remedy for an injured third party against the insurance carrier of an insured."). This is because, as a matter of equally well-established Texas law, borrowers are neither named insureds nor third-party beneficiaries of the contracts between lenders and their insureds. See, e.g., *Pineda*, 843 S.W.2d at 673; *Shields v. Atlantic Fin. Mortgage Corp.*, 799 S.W.2d 441, 442, 444 (Tex. Ct. App. 1990); see also *Chaffin*, 731 S.W.2d at 730-731 (homeowner neither insured nor third-party beneficiary of subcontractor's liability policy). This is true regardless of whether the borrower pays the mortgage insurance premiums, *Willard*, 1996 WL 495583, App., *infra*, at 98a; *Pineda*, 843 S.W.2d at 664, 673; *Hunt v. Jefferson Savs. & Loan Ass'n*, 756 S.W.2d 762, 765 (Tex. Ct. App. 1988), cert. denied, 489 U.S. 1079 (1989), or would benefit from the enforcement of the insurance contract, *Willard*, 1996 WL 495583 (App., *infra*, at 99a).

B. Proceedings Below

1. In 1983, Palma obtained a loan from City Federal to purchase a condominium. As a condition of the loan, Palma was required to fund an escrow account, from which City Federal purchased mortgage insurance from petitioner for protection against loss in the event Palma defaulted on the loan. App., *infra*, 1a.

² The opinion in *Willard* is reproduced in the Appendix. See App., *infra*, at 89a-111a.

In 1988, Palma defaulted on her obligation to repay the note, and City Federal foreclosed on the condominium. After foreclosure, there remained a balance due City Federal on the note. Petitioner paid City Federal the amount owing under the mortgage insurance contract, and City Federal assigned to petitioner the balance due on the loan after foreclosure. Petitioner then sent a letter to Palma demanding that the deficiency be paid. App., *infra*, 2a.

2. Rather than pay her debt, Palma filed suit in state court and sought certification for a class of borrowers, alleging numerous state law claims arising out of petitioner's pursuit of the deficiency. Palma's claims included an allegation that, by pursuing the deficiency, petitioner disregarded the terms of its mortgage insurance contract with City Federal and in so doing violated Article 21.21(16) of the Texas Insurance Code. Palma asserted that she had standing to raise the claim because she was a third-party beneficiary of the contract between petitioner and City Federal. App., *infra*, 2a-3a.

Petitioner removed the suit to the United States District Court for the Southern District of Texas and filed a counterclaim for the deficiency and attorneys fees. The case was referred to a magistrate judge (App., *infra*, 86a), who concluded that Palma was not a third-party beneficiary of the insurance contract between petitioner and City Federal and thus lacked standing to bring claims based on that underlying contract (*id.* at 67a-68a, see *id.* at 3a). The district court adopted the magistrate's memorandum and recommendations. *Id.* at 60a-61a; see *id.* at 3a.

Palma's remaining claim and petitioner's counterclaims were tried before the bench. App. *infra*, 3a. The district court entered a final judgment in favor of petitioner. *Id.* at 25a-26a.

3. By a divided vote, the court of appeals reversed, holding that Palma had standing to sue under Article 21.21(16) of the Texas Insurance Code. App., *infra*, 1a-24a. In the majority's view, Palma was a “third-party beneficiary of the contract for mortgage insurance entered into between [petitioner] and City Federal” (*id.* at 10a), and accordingly could bring an action against petitioner, the insurer, based on its handling of that contract. The majority acknowledged that a 1992 Texas intermediate appellate court had squarely rejected standing in virtually identical circumstances. *Id.* at 7a n.4 (citing *Pineda*, 843 S.W.2d at 665). Nevertheless, in light of *Allstate Ins. Co. v. Watson*, 876 S.W.2d 145 (Tex. 1994) — in which the Texas Supreme Court had *rejected* third-party standing under Article 21.21(16) — the court was “convinced” that the Texas Supreme Court would *find* standing in cases like this. App., *infra*, 7a n.4. In particular, the court identified three “factors” discussed in *Watson* that weighed against standing in that case, but favored standing here: (1) “Palma had a contract with the insured, City Federal”; (2) “Palma paid the premiums for the mortgage insurance”; and (3) “Palma is designated by name in the certificate of insurance issued by [petitioner] to City Federal.” App., *infra*, 6a.³

Judge Davis dissented. App., *infra*, 22a-24a. He concluded that Palma lacked standing to assert the claims against petitioner because Palma “is not a third-party beneficiary” of the mortgage insurance contract and, among other things, “the Texas cases interpreting mortgage guaranty insurance policies unanimously hold that a borrower is not a party to such contracts.” *Id.* at 24a.

³ The court of appeals reached this conclusion even while recognizing that the *Watson* court “did not expressly state that these factors were to be used when deciding whether a party was entitled to standing under [the Insurance Code].” App., *infra*, 6a.

4. The court of appeals thereafter denied rehearing, as well as rehearing *en banc*. App., *infra*, 87a-88a. Some 42 days after rehearing was denied, the Court of Appeals for the Twelfth District of Texas at Tyler decided an essentially identical issue of Texas law in *First American Title Insurance Co. v. Willard*, No. 12-93-00290-CV, 1996 WL 495583 (Aug. 29, 1996). App., *infra*, 89a-111a (reprinting *Willard* opinion). There, as in this case, a borrower sought to sue his lender's insurer under Article 21.21(16) based on the insurer's administration of an insurance contract between the lender and the insured. The Texas court, like every other Texas intermediate appellate court that had previously considered the issue⁴ and unlike the Fifth Circuit, held that a borrower does not have standing to raise such claims. App., *infra*, 99a. The court reached this result even though *Willard*, like *Palma*, (1) had a contract with the insured and (2) had paid the premiums for the insurance policy. *Id.* at 98a-99a. (The *Willard* opinion does not state whether the plaintiff was designated by name in the certificate of insurance, although there would have to have been a reference to either *Willard* or the property to identify the risk for which the insurance was purchased.) The court cited *Watson* as authority for its decision denying standing. *Id.* at 98a.

The present case is on all fours with *Willard*, except as to result. In *Willard*, the court, relying on *Watson*, expressly held that a borrower did *not* have standing to bring a direct cause of action under Article 21.21(16) of the Insurance Code against its lender's insurer based on the insurer's handling of the lender's insurance contract. App., *infra*, 98a-99a. The Fifth Circuit — also citing *Watson* — concluded that a borrower *did* have standing to bring that same claim against its lender's insurer. See *id.* at 4a-10a.

⁴ *Pineda*, 843 S.W.2d at 673; *Chaffin*, 731 S.W.2d at 730-731; see *Shields*, 799 S.W.2d at 444; *Hunt*, 756 S.W.2d at 765.

6. When petitioner learned of *Willard*, it promptly called the decision to the attention of the Fifth Circuit by filing a Motion for Recall of Mandate, a Second Petition for Panel Rehearing, and a Second Suggestion for Rehearing *En Banc*. The motion and petitions are pending before the court.

REASONS FOR GRANTING THE PETITION

This case calls for the exercise of this Court's supervisory authority over the administration of federal diversity jurisdiction. The Fifth Circuit's decision presents the Court with an opportunity to resolve an important and recurring split among the Courts of Appeals regarding their authority under *Erie* to forge new state law.

If the Court elects not to use this case as the vehicle by which to address the schism among the federal appellate courts, the Court, at a minimum, should grant certiorari, vacate the judgment below, and either certify the state law question to the Texas Supreme Court or remand with instructions that the Fifth Circuit reconsider its decision in light of *Willard*. Court action is necessary here — just as it was in *Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas*, 488 U.S. 920 (1988), and *National Union Fire Ins. Co. v. American Medical International, Inc.*, 116 S. Ct. 510 (1995), two cases in which the Court ordered courts of appeals to reconsider their decisions in diversity cases in light of subsequent state court authority. See also *Huddleston v. Dwyer*, 322 U.S. 232 (1944); *Vandenbark v. Owens-Illinois Co.*, 311 U.S. 538 (1941). Court action is required in the present case to resolve the current intrastate conflict in Texas as a result of which the availability of a cause of action depends solely on whether the case is in state or federal court, in violation of *Fidelity Union Trust Co. v. Field*, 311 U.S. 169, 180 (1940).

I. A FEDERAL COURT SITTING IN DIVERSITY EXCEEDS ITS *ERIE* AUTHORITY WHEN IT CREATES STANDING FOR A CLASS OF LITIGANTS TO BRING CLAIMS, WHEN SUCH STANDING HAS BEEN REJECTED BY THE COURTS AND LEGISLATURE OF THE STATE.

A. The Courts Of Appeals Are Divided On The Important And Recurring Question Whether Federal Courts Can Make New State Law

This case presents the Court with an opportunity to resolve a persistent conflict among the federal courts of appeals by rejecting an unjustifiable — but widely invoked — interpretation of a federal court's authority under *Erie* to forge new state law. The question demands the Court's review as it concerns a fundamental issue with which federal courts sitting in diversity must contend on a daily basis.

Federal diversity courts must follow and apply state substantive law. *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). Where there is no state law authority directly on point, the federal court must make an “*Erie* guess,” predicting how the state supreme court would apply settled state law to a new factual situation. This type of interstitial decision making is the daily grist of the federal courts' mill.

The more problematic question posed by this petition arises when a federal court is asked not simply to apply settled state law to situations previously unconsidered by the state courts, but rather to make new state law. In such cases, may federal courts expand, modify, or revoke settled state law principles as a state supreme court might do? The answer to this question, which implicates fundamental issues about the proper role of federal courts in our federal system, differs depending on which court of appeals is being asked.

In this case, the Fifth Circuit recognized standing for Palma, a borrower, to bring a claim under Article 21.21(16) of the Texas Insurance Code against petitioner, the lender's insurer, based on

petitioner's handling of the mortgage insurance contract.⁵ App. *infra*, 21a-22a. In so ruling, the Fifth Circuit essentially created a new cause of action for an entire class of litigants — a result all courts in Texas had previously rejected. See pp. 3-4, *supra*. In reaching its novel result, the Fifth Circuit explicitly disavowed the well-settled and heretofore unquestioned law in Texas that borrowers, as neither insureds nor beneficiaries, do not have standing to bring claims under Article 21.21(16) of the Insurance Code against the lenders' insurance companies. App., *infra*, at 7a n.4 (citing *Pineda*, 843 S.W.2d at 665). In at least five other circuits, Palma's innovative argument to overturn Texas' settled law of standing would not have been seriously entertained, much less adopted.

1. The rule in at least five circuits is that a federal court sitting in diversity may not make new state law. These courts hold that to usurp state lawmaking authority in this manner is inconsistent with principles of federal-state comity and the proper role of the federal courts as enunciated in *Erie*.

The First Circuit, for example, perceives its *Erie* role as applying state law, not making it.

Absent some authoritative signal from the legislature or the [state courts], we see no basis for even considering the pros and cons of innovative theories * * *. We must apply the law of the forum as we infer it presently to be, not as it might come to be.

Dayton v. Peck, Stow & Wilcox Co., 739 F.2d 690, 694 (1984) (footnoted omitted).

⁵ The reach of the majority's opinion may even be broader. If borrowers are held to be third-party beneficiaries of their lenders' insurance contracts, then borrowers may be able to bring numerous other statutory and common law claims against their lenders' insurers, as Palma attempted to do here. See App., *infra*, 42a.

The Third Circuit has explained the important notions of federalism that underlie this rule:

In a diversity case * * * federal courts may not engage in judicial activism. Federalism concerns require that we permit state courts to decide whether and to what extent they will expand state common law * * *. Our role is to apply the current law of the appropriate jurisdiction, and leave it undisturbed.

City of Phila. v. Lead Indus. Ass'n, 994 F.2d 112, 123 (1993). Concerns of federalism — and responsible jurisprudence — also feature prominently in another Third Circuit opinion, which rejected an invitation to interpret a divided Pennsylvania Supreme Court decision as creating new state law:

For a federal court to predict that a majority of a seven-judge court with three new members would overrule a long established doctrine of Pennsylvania law would be to engage in reckless speculation. If a change in the basic Pennsylvania tort law is to be forthcoming it should emerge from a majority of [the Pennsylvania supreme] court and not from the Court of Appeals for the Third Circuit.

Vargus v. Pitman Mfg. Co., 675 F.2d 73, 76 (1982).

The D.C. Circuit likewise adheres to a policy of judicial restraint when sitting in diversity. In *American Institute of Architects v. Interstate Fire & Casualty Co.*, 986 F.2d 1455 (1993), for example, the court considered an invitation from the claimant, the AIA, to “follow the ‘modern trend’ of excusing any delay in the absence of prejudice” in determining whether, under Illinois law, the AIA had given timely notice of a claim to a fire and casualty insurer. A unanimous panel, including then-Judge Ginsburg, rejected the AIA's entreaty, stating succinctly that “[it] is not our place * * * to break new ground for the Illinois courts.” *Id.* at 1458.

The Fourth and Seventh Circuits are in accord with the D.C. Circuit's understanding of a federal court's role under *Erie*. See, e.g., *Burris Chem., Inc. v. USX Corp.*, 10 F.3d 243, 247 (4th Cir. 1993) (“Under *Erie Railroad v. Tompkins*, the federal courts sitting in diversity rule upon state law as it exists and do not surmise or suggest its expansion.”); *Trembath v. St. Regis Paper Co.*, 753 F.2d 603, 605 (7th Cir. 1985) (noting that “the District Court properly refused to speculate that there might be a ‘trend’ in Wisconsin toward regulating unilateral pronouncements * * * as contractual obligations, or toward abrogation of the employment-at-will doctrine”) (footnotes omitted).

2. By contrast, the Second, Sixth, Eighth, and Ninth Circuits have adopted a self-consciously more activist role in fashioning state law under *Erie*. According to the Second Circuit, for example, a federal court sitting in diversity is free to consider “all the resources that the [state's highest court] could use” in making the state law determination, including the State's “policies” and the law of other jurisdictions. *DeWeerth v. Baldinger*, 836 F.2d 103, 108 (1987), cert. denied, 486 U.S. 1056 (1988).

Like the Second Circuit, the Sixth Circuit takes an activist approach in making state law under its *Erie* authority. In *Johnson v. Honeywell Information Systems, Inc.*, 955 F.2d 409 (1992), for example, the Sixth Circuit anticipated that the Michigan Supreme Court would allow a defense to a claim of wrongful termination of employment based upon employee misconduct discovered after termination. The Court predicated its guess, in part, on “common sense” and “the dearth of Michigan case law to the contrary.” *Id.* at 413.

Neither the Second nor the Sixth Circuit's creative approach would have been permitted in those federal circuits that will not “even consider[] the pros and cons of innovative theories,” *Peck, Stow & Wilcox Co.*, 739 F.2d at 694 (1st Cir.), that decline “to decide whether and to what extent they will expand state common law,” *Lead Indus. Ass'n*, 994 F.2d at 123 (3d Cir.), that “refuse[]

to speculate” on state law “trend[s],” *St. Regis Paper Co.*, 753 F.2d at 605 (7th Cir.), that “do not surmise or suggest [the] expansion” of state law, *Burriss Chem., Inc.* 10 F.3d at 247 (4th Cir.), or that refuse “to break new ground” in areas of state law, *American Inst. of Architects*, 986 F.2d at 1458 (D.C. Cir.). Those two Circuits — like the Fifth — plainly adhere to a different understanding of their obligations under *Erie*.

The Eighth Circuit also has shown little reluctance about spinning new state law out of whole cloth. In *Hazen v. Pasley*, 768 F.2d 226 (1985), for example, that court concluded that the Missouri Supreme Court would recognize a right of action arising out of an alleged “wrongful domination” over property by Missouri law enforcement authorities. The Eighth Circuit justified its conclusion solely on the basis of certain regulatory policies of Missouri law enforcement agencies that appeared consistent with plaintiff’s theory of recovery. *Id.* at 229. The Eighth Circuit essentially converted an internal regulatory policy into an implied right of action — precisely the type of “judicial activism” that circuits on the other side of the split categorically reject.

The Ninth Circuit has recognized the sharp inter-circuit conflict on this issue and apparently has sided with those circuits willing to make new state law:

We note that the rule in other circuits is that the federal courts have limited discretion in a diversity case “to adopt untested legal theories brought under the rubric of state law.”

Torres v. Goodyear Tire & Rubber Co., 867 F.2d 1234, 1238 n.1 (1989) (quoting *Affiliated FM Ins. Co. v. Trane Co.*, 831 F.2d 153, 155 (7th Cir. 1987)). “For better or for worse,” the court continued, “this circuit has not seen fit to assume such a posture of restraint when it comes to deciding novel questions of state law.” *Ibid.* (citing *Paul v. Watchtower Bible & Trust Soc’y*, 819 F.2d 875, 879 (9th Cir.), cert. denied, 484 U.S. 926 (1987)).

The Tenth Circuit appears to be internally divided on the issue. Some panels have attempted to divine how a State supreme court might rule on a novel theory on the basis of “doctrinal trends indicated by * * * policies.” *Weiss v. United States*, 787 F.2d 518, 525 (1986). Others have indicated great reluctance to create new law where none existed before. See, e.g., *Taylor v. Phelan*, 9 F.3d 882, 887 (1993) (“As a federal court, we are generally reticent to expand state law without clear guidance from its highest court; but where the expansion directly affects state finances and functions, we should take extra care.”); see also *Mares v. Conagra Poultry Co.*, 773 F. Supp. 248, 252 (D. Col. 1991) (“a federal court sitting in diversity should not anticipate a change in existing state law”), *aff’d*, 971 F.2d 492 (10th Cir. 1992).

3. In this case, the Fifth Circuit cast its lot with the activist approach of the Second, Sixth, Eighth, and Ninth Circuits, directly contravening the rule in five other Courts of Appeals. The Fifth Circuit here adopted a theory of Texas law — consistently rejected by Texas courts — that a borrower has standing to bring an action under Article 21.21(16) of the Texas Insurance Code directly against its lender's insurer based on the insurer's handling of the lender's insurance contract. (The Fifth Circuit may have been driven to judicial activism in order to achieve the particular result it desired in this case; the court apparently was concerned about, *inter alia*, the “astonishing amount” of attorneys fees awarded to petitioner. App., *infra*, 3a.)⁶

⁶ In this connection, the court of appeals failed to appreciate that the majority of the attorneys fees resulted from collateral litigation brought on by Palma herself. As Palma conceded at trial, “the facts necessary to support [petitioner's] case [were] admitted from the very inception of the case.” Trial Tr. 104; see *id.* at 82-94, 98-102, 114-118.

The Fifth Circuit purported to find support for its new cause of action in dicta from a 1994 Texas Supreme Court decision, which *rejected* the argument that, under Article 21.21(16) of the Insurance Code, a third-party claimant could sue another party's insurer for the insurer's administration of the insurance contract. *Allstate Ins. Co. v. Watson*, 876 S.W.2d 145 (Tex. 1994). *Nowhere* in *Watson*, however, did the State Supreme Court discuss — much less disavow — the long line of intermediate appellate court authority holding that, in Texas, borrowers lack standing to bring such claims against the lenders' insurers. Moreover, as of the date the case was pending before the Fifth Circuit, there were (to our knowledge) *no* state court decisions in Texas that had held, as the Fifth Circuit did, that, under Article 21.21(16) of the Insurance Code, a borrower has standing to sue a lender's insurer based on the insurer's handling of the lender's insurance contract. (Nor are we aware of any since.) Indeed, all state court decisions have gone the other way. See pp. 3-4, *supra*.

In essence, the Fifth Circuit read *Watson* to signal a new direction in Texas jurisprudence that, *some day, might* result in the Texas Supreme Court overruling a well-established doctrine of state law. But rather than, in the interim, “apply[ing] the current law of [Texas], and leav[ing] it undisturbed,” *Lead Indus. Ass'n*, 994 F.2d at 123 (3d Cir.), the Fifth Circuit decided that *it* was the appropriate court to extend *Watson* to what, in its view, was *Watson's* logical conclusion. That is precisely the type of “reckless speculation,” *Vargus*, 675 F.2d at 76 (3d Cir.), reliance on “trend[s],” *St. Regis Paper Co.*, 753 F.2d at 605 (7th Cir.), “expansion” of law, *Burris Chem., Inc.*, 10 F.3d at 247 (4th Cir.), and “ground [breaking]” jurisprudence, *American Inst. of Architects*, 986 F.2d at 1458 (D.C. Cir.), that is abjured in the more judicially conservative circuits.

4. Not only did the court of appeals boldly go where no Texas State court had gone before, it also *declined* to follow well-settled Texas decisions, apparently because they were rendered only by *intermediate* appellate courts. But absent state supreme court authority, the decisions of intermediate appellate courts *are* a state's law. As the Court recognized in *West v. AT&T*, 311 U.S. 223, 236-237 (1940):

A state court is not without law save as its highest court has declared it. There are many rules of decision commonly accepted and acted upon by the bar and inferior courts which are nevertheless laws of the state although the highest court of the state has never passed upon them. In those circumstances a federal court is not free to reject the state rule merely because it has not received the sanction of the highest state court, even though it thinks the rule is unsound in principle or that another rule is preferable.

The Fifth Circuit was aware of the Texas precedent (see App., *infra*, 7a n.4), but refused to accept the intermediate appellate court decisions as the law of Texas. Purportedly it did so because the Texas Supreme Court's opinion in *Allstate Ins. Co. v. Watson*, 876 S.W.2d 145 (Tex. 1994), provided "persuasive data" that the law in Texas had abruptly changed. App., *infra*, 7a n.4. But *Watson* does not provide the credible evidence necessary for a federal court to overturn well-settled state law.

Watson held that an automobile accident victim, as a third-party claimant, lacks standing under Article 21.21(16) of the Insurance Code to sue the tortfeasor's insurer for the insurer's administration of the insurance contract. 876 S.W.2d at 150. The Texas court explained:

The obligations imposed by art. 21.21 of the Insurance Code and *Vail* [*v. Texas Farm Bureau Mut. Ins. Co.*, 754 S.W.2d 129 (Tex. 1988)]⁷ are engrafted onto the contract between the insurer and insured and are extra-contractual in nature. A third party claimant has no contract with the insurer or the insured, has not paid any premiums, has no legal relationship to the insurer or special relationship of trust with the insurer, and in short, has no basis upon which to expect or demand the benefit of the extra-contractual obligations imposed on insurers under art. 21.21 with regard to their insureds.

Id. at 149. *Nowhere* in the *Watson* opinion does the Texas Supreme Court mention — much less question — *Pineda* or its predecessors.

Nonetheless, the Fifth Circuit latched onto the *Watson* court's explanation of why third-party claimants lack standing under the Insurance Code, elevated that explanation to the level of “factors,” and concluded that, in the case of a borrower, those factors militate *in favor of* standing to sue the lender's insurer under Article 21.21(16) of the Insurance Code. App., *infra*, 6a. The Fifth Circuit reached that conclusion even though, as the court itself acknowledged, the *Watson* court “did not expressly state that these factors were to be used when deciding whether a party was entitled to standing under [the Insurance Code]” (*ibid.*) and in doing so reversed long-settled Texas law (*id.* at 7a n.4). The Fifth Circuit's “data” are far too meager to base a conclusion that otherwise binding precedent is no longer good law.

⁷ *Vail* concerned the obligations owed by an insurer to its insured.

B. The Fifth Circuit's Approach In Establishing New State Law Is Inconsistent With The Principles Established In *Erie*

The sharp division among the circuits on the question presented by this petition arises because federal diversity courts often have difficulty delineating the limits of their authority under *Erie*. On the one hand, *Erie* and its progeny have established that federal diversity courts may not on their own authority alter existing state law:

A federal court in a diversity case is not free to engraft onto those state rules exceptions or modifications which may commend themselves to the federal court, but which have not commended themselves to the State in which the federal court sits.

Day & Zimmerman, Inc. v. Challoner, 423 U.S. 3, 4 (1975) (per curiam); see *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 71 (1938) (rejecting rule that diversity courts are “free to exercise an independent judgment as to what the common law of the State is — or should be”); *United States v. Standard Oil Co.*, 332 U.S. 301, 313 (1947) (“in the federal scheme our part * * *, and the part of the other federal courts, outside the constitutional area is more modest than that of state courts, particularly in the freedom to create new common-law liabilities”).

On the other hand, federal courts must apply state law in diversity cases even when that law is uncertain. Courts sitting in diversity have a duty to determine what a state supreme court would do in cases in which there is no state authority directly on point:

Erie R. Co. v. Tompkins [] did not free the federal courts from the duty of deciding questions of state law in diversity cases. Instead it placed on them a greater responsibility for determining and applying state laws in all cases within their jurisdiction in which federal law does not govern. Accepting this responsibility, as was its duty, this Court has not hesitated

to decide questions of state law when necessary for the disposition of a case brought to it for decision, although the highest court of the state had not answered them, the answers were difficult, and the character of the answers which the highest state courts might ultimately give remained uncertain.

Meredith v. City of Winter Haven, 320 U.S. 228, 237 (1943). Unfortunately, the only guidance that this Court gave to the lower federal courts in divining issues of state law is that the law is to be decided “with the aid of such light as was afforded by the materials for decision at hand, and in accordance with the applicable principles for determining state law.” *Id.* at 238.

Tension between the obligation to apply state law in uncertain cases and the constitutional limitations on federal authority to make state law becomes acute when, as here, a federal court is asked not simply to make an “*Erie* guess,” but to expand state law in a manner not contemplated, or indeed already rejected, by the state courts. As indicated above, some courts, like the Fifth Circuit, see their obligation as only to “stand in the shoes” of the state courts — authorized to forge new state law without restraint. Other courts apply state law, but heed the federalism and comity concerns that *Erie* and our constitutional system impose. Those courts recognize that their role is “more modest than that of state courts,” *Standard Oil Co.*, 332 U.S. at 313, and refuse to expand state law. Only this latter rule resolves the tension in a manner consistent with the constitutional limitations that govern a federal court applying state law.⁸

⁸ The difference is not one of semantics. The innovative state lawmaking engaged in by the Fifth Circuit here, for example, would plainly be rejected in the First, Third, Fourth, Seventh, and District of Columbia Circuits. See pp. 10-12, *supra*.

The present case is a good illustration of the dangers of federal judicial activism in the application of state law. The Fifth Circuit essentially overruled an accepted and long-established rule of Texas law (see pp. 3-4, *supra*) based on nothing more than its judgment that dicta in a Texas Supreme Court opinion presaged a sea change in Texas law governing the relationship between borrowers and their lenders' insurers. To recognize what it perceived as the emerging state law, however, the Fifth Circuit had to abandon the current state law. And, when a federal court indulges in such a progressive and unguided exercise of lawmaking, it should not be surprising that it often will arrive at the wrong answer — as the Fifth Circuit did here. See Part II, *infra*.

There are significant costs to such federal court forays into state lawmaking. Here, for example, as a result of the Fifth Circuit's incorrect ruling, there now is one rule of Texas law for litigants in state courts and another rule for litigants who bring the same question of state law before federal courts sitting in diversity. As a result, whether future borrowers, such as Palma, will have standing to bring an action against lenders' insurers under Article 21.21(16) of the Texas Insurance Code will depend entirely on the courthouse in which the complaint is filed. Such discrepancies are intolerable under *Erie*. See *Fidelity Union Trust Co. v. Field*, 311 U.S. 169, 180 (1940) (it is impermissible “that there should be one rule of state law for litigants in the state courts and another rule for litigants who bring the same question before the federal courts owing to the circumstance of diversity of citizenship”); see also *Baldwin v. Alabama*, 472 U.S. 372, 374 (1985) (resolving “significant conflict” between the Eleventh Circuit and the Supreme Court of Alabama). Such a result is flatly inconsistent with the purpose of the Rules Enabling Act, which “is to avoid the maintenance within a state of two divergent or conflicting systems of law, one to be applied in state courts, the other to be availed of in federal courts, only in cases of diversity of citizenship.” *West*, 311 U.S. at 236. See

generally *Guaranty Trust Co. v. York*, 326 U.S. 99, 109 (1945) (“In essence, the intent of [*Erie*] was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same, so as far as legal rules determine the outcome of a litigation, as it would be if tried in a State court.”) The Court’s review is necessary to correct the conflict between federal and state courts in Texas.⁹

⁹ It must be added that the question presented has substantial practical consequences for the mortgage insurance and housing industries in Texas. Until this decision, the relationship between borrower, lender, and the private mortgage insurer had been clear: The borrower is the lender’s customer, the lender is the insurer’s customer, private mortgage insurance protects the lender against the risk of default by the borrower, and the borrower is not a third-party beneficiary of the lender’s insurance. See, e.g., *Pineda*, 843 S.W.2d at 665; *Chaffin*, 731 S.W.2d at 730-731. As a result of the decision below, insurers now cannot be sure to whom they owe duties.

This is no trivial matter. The Fifth Circuit’s opinion puts mortgage insurers in the hopeless position of owing duties to two parties who, if a claim is actually made, will likely be adverse to each other. Indeed, it was this fact, in part, that persuaded the *Watson* court that third-party claimants do *not* have standing to bring claims under the Insurance Code against another’s insurer for the insurer’s handling of an insurance contract. As that court explained:

Were we to extend to third party claimants the same duties insurers owe to their insured, insurers would be faced with owing coextensive and conflicting duties. An insurer owes to its insured a duty to defend the insured *against* the claims asserted by a third party. * * *. [I]t is conceivable that in attempting to settle claims pursuant to the demands of a third party claimant, insurers may be liable to the insured for settling too quickly.

II. AT A MINIMUM, THIS COURT SHOULD GRANT THE PETITION, VACATE THE JUDGMENT, AND EITHER CERTIFY THE STATE LAW QUESTION TO THE STATE SUPREME COURT OR REMAND TO THE FIFTH CIRCUIT FOR FURTHER CONSIDERATION IN LIGHT OF AN INTERVENING TEXAS INTERMEDIATE APPELLATE COURT DECISION

Although petitioner believes that the Fifth Circuit's decision is wrong as a matter of federal law under the principles enunciated in Part I, *supra*, at the very least the decision also is wrong as a matter of state law. In particular, just days after rehearing was denied in this case, another Texas intermediate appellate court specifically rejected the very rule adopted by the Fifth Circuit. *First Am. Title Ins. Co. v. Willard*, No. 12-93-00290-CV, 1996 WL 495583 (Aug. 29, 1996). App., *infra*, 89a-111a. In light of this intervening decision, *Vandenbark v. Owens-Illinois Co.*, 311 U.S. 538 (1941), and *Huddleston v. Dwyer*, 322 U.S. 232 (1944), instruct that the Court, pursuant to its authority under 28 U.S.C. § 2106, should grant, vacate, and either certify the state law question to the Texas Supreme Court or remand the case so that the Fifth Circuit may “conform [its] order[] to the State law.” *Vandenbark*, 311 U.S. at 543. Because the *Willard* decision — which completely contradicts the Fifth Circuit's “*Erie* guess” — was rendered after the court of appeals issued its opinion in this case, a GVR order is entirely appropriate. See *Lawrence v. Chater*, 116 S. Ct. 604, 607 (1996) (per curiam).

876 S.W.2d at 150 (emphasis in original). The precise conflicting duties warned of in *Watson* are the inevitable byproduct of the Fifth Circuit's decision here.

In *Willard*, a borrower obtained money from a savings and loan to build a home on a tract of land and entered into a lien contract with the construction contractor, which duly assigned the contract to the lender. To protect its loan collateral, the lender obtained title insurance, which, as a condition of the loan, it required the borrower to pay. *Id.* at 90a. During construction of the home, the parties discovered that the dwelling was being built over a pipeline, for which the pipeline owner had a valid easement. The title insurer acknowledged its responsibility for losses due to the easement, and offered to pay to relocate the pipeline. The pipeline company refused the offer, and no agreement was reached. After the house was completed, the borrower sued the title insurer, alleging, inter alia, that the insurer had engaged in unfair claim settlement practices in violation of Article 21.21(16) of the Texas Insurance Code. The trial court rendered judgment for the borrower, and the insurer appealed. See App., *infra*, 91a-92a.

On appeal, the insurer argued, inter alia, that pursuant to *Allstate Ins. Co. v. Watson*, 876 S.W.2d 145 (Tex. 1994), the borrower lacked standing to sue the insurer directly under Article 21.21(16) of the Insurance Code for a claim based on the mortgage contract. The borrower responded that *Watson* was distinguishable, inter alia, “because [the borrower] had paid the premium for the insurance policy.”¹⁰ App., *infra*, 98a. The court rejected the distinction, reasoning:

¹⁰ The borrower also argued that he had standing because “he would directly benefit from the payment by the insurer” to remove the pipeline. App, *infra*, 99a. The court rejected this argument, observing that “the insured * * * would benefit from [the insurer's] indemnification of the claim against it” and, “[a]s in *Watson*, a benefit to a third party does not thrust that party into a contractual relationship between the two other parties or confer upon [the borrower] a direct cause of action against [an insurer] for unfair claim settlement practices.” *Ibid.*

Customarily, the home builder/borrower pays this expense, because a lending institution must require that the borrower has title to the real property on which its loan proceeds will be expended. Rather than require the borrower to incur the expense of a title examination, a title insurance policy in favor of the lender is an inexpensive means of assuring the validity of its title * * *. We disagree that the borrower's act of paying the premium for the title insurance injects the borrower into the insurance contract as a party to the policy.

Id. The appellate court concluded that “[w]e do not agree that Willard’s posture in this transaction circumvents the supreme court’s opinion in *Watson*.” *Id.* at 99a.

Willard and this case are factually indistinguishable, but legally irreconcilable. In *Willard*, the court, relying on *Watson*, expressly held that a borrower *did not have* standing to bring a direct cause of action against a lender’s insurer under Article 21.21(16) of the Insurance Code based on an insurer’s handling of a lender’s insurance contract. Here, the Fifth Circuit — also purportedly interpreting *Watson* — concluded that a borrower *did have standing* to bring a direct cause of action against a lender’s insurer under Article 21.21(16) of the Insurance Code for the insurer’s handling of a lender’s insurance contract.

When petitioner became aware of the *Willard* decision, it promptly filed with the Fifth Circuit a Motion for Recall of the Mandate, a Second Petition for Panel Rehearing, and a Second Suggestion for Rehearing *En Banc*, all of which currently are pending. A refusal by the Fifth Circuit to recall its mandate and conform its judgment with what plainly is the controlling law of Texas would conflict with this Court’s guidance in *Huddleston*, 322 U.S. at 236-238, and *Vandenbark*, 311 U.S. at 543, and practice in *National Union Fire Ins. Co. v. American Medical International, Inc.*, 116 S. Ct. 510 (1995), and *Exxon Co., U.S.A. v. Banque de Paris et des Pay-Bas*, 488 U.S. 920 (1988). See also *Braniff*

Airways, Inc. v. Curtiss-Wright Corp., 424 F.2d 427 (2d Cir.), cert. denied, 400 U.S. 829 (1970) (granting petition for rehearing, after petition for certiorari was filed, in light of subsequent change in state law); *Scott v. Singletary*, 38 F.3d 1547, 1551 (11th Cir. 1994) (noting that court of appeals “ha[s] the power to recall its mandate if there has been a supervening change in the law”). As the Court observed in *Vandenbark*, 311 U.S. at 543 (footnoted omitted):

[T]he dominant principle is that *nisi prius* and appellate tribunals alike should conform their orders to the state law as of the time of the entry. Intervening and conflicting decisions will thus cause the reversal of judgments which were correct when entered. * * * [U]ntil such time as a case is no longer *sub judice*, the duty rests upon federal courts to apply state law under the Rules of Decision statute in accordance with the then controlling decision of the highest state court. Any other conclusion would but perpetuate the confusion and injustices arising from inconsistent federal and state interpretations of state law.

The Court applied these principles — ironically in another Fifth Circuit case — in *Exxon Co., U.S.A.*, 488 U.S. at 920. There, the Fifth Circuit decided a issue involving a question of Texas law. Thereafter, a state intermediate appellate court, in a different case, decided the question contrary to the Fifth Circuit's understanding of Texas law. The losing party before the Fifth Circuit petitioned the Court for a writ of certiorari, which the Court granted. After briefing on the merits, the Court vacated the Fifth Circuit judgment and remanded for further consideration in light of the intervening state court decision.

If the Fifth Circuit refuses to adhere to the law of Texas in the present case, that decision will be more troubling than its earlier unwillingness to do so in *Exxon*. Here — unlike in *Exxon* — the subsequent intermediate appellate court decision was completely predictable; it was entirely consistent with a long line of unquestioned

intermediate appellate court decisions. See pp. 3-4, *supra*. The Fifth Circuit disregarded those decisions because it was convinced that the *Watson* case — *rejecting* third-party standing — presaged a reversal of well-established state law. But *Watson* is hardly the harbinger of a *change* in Texas law, as *Willard* now confirms. In short, if the Court does not grant review and consider the case on the merits, it should at a minimum vacate and either certify the state law question to the Texas Supreme Court or remand to the court of appeals for further consideration in light of *Willard*.¹¹

¹¹ The alternative of certifying the question to the Texas Supreme Court makes particularly good sense in light of the majority's refusal in the decision below to apply well-settled decisions of the intermediate state courts of Texas.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted. In the alternative, the petition should be granted, the judgment vacated, and either the state law question certified to the Texas Supreme Court or the case remanded to the court of appeals for further consideration in light of the decision in *First American Title Insurance Co. v. Willard*.

Respectfully submitted.

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