STRATEGIES FOR DEFENDING AGAINST CLAIMS UNDER THE TEXAS PROMPT PAYMENT OF CLAIMS STATUTE

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I. INTRODUCTION[1]

For years the focus of statutory insurance litigation in Texas has been on the application of Texas' "bad faith" statute, Chapter 541 of the Texas Insurance Code (formerly known as Art. 21.21). Over the past decade, however, policyholders in increasing numbers are turning to long-ignored provisions of the Texas Prompt Payment of Claims Statute, Chapter 542 of Texas Insurance Code (formerly known as Article 21.55) (the "statute," "Chapter 542" or "Art. 21.55").

Unlike its better-known sibling, Chapter 541/Article 21.21, case law regarding Chapter 542 and its predecessor statutes has not been well-developed. Since the Texas Supreme Court's landmark decision in *State Farm Fire and Casualty Co. v. Gandy*, 925 S.W.2d *696* (Tex. 1996), however, a growing movement among policyholders has been to use Art. 21.55, and later Chapter 542, as an offensive tool to supplant or supplement traditional bad faith litigation with regard to an insurer's duty to defend.

The question of whether the statute applied to an insurer's duty to defend dominated the Texas courts in the past decade, with splits of authority between Texas state appellate courts and federal courts attempting to interpret Texas law. In 2005, the U.S. Court of Appeals for the Fifth Circuit certified the question to the Texas Supreme Court, which resolved the issue in *Lamar Homes, Inc. v. Mid-Continent Cas. Co*., 242 S.W.3d 1 (Tex. 2007). *Lamar Homes* resolved the split among the courts in favor of policyholders; but, *Lamar Homes* raised many more issues regarding the application of the statute, how to handle claims within the confines of the statute, and how to preserve the insurer's right to contest coverage in the appropriate case.

This paper opens with a general analysis of the claims handling procedures required by the statute. The paper also discusses various landmark decisions that affect application of the statute in practice, including *Lamar Homes*. The paper then discusses amendments to the statute, new cases, and issues that arise for insurers defending against a Chapter 542 claim.

II. CLAIMS HANDLING PROCEDURES AND REQUIREMENTS UNDER CHAPTER 542

Chapter 542 of the Texas Insurance Code sets forth deadlines for insurers to: (a) inform insureds regarding the acceptance or rejection of the claim tendered; and (b) make payment on valid claims. Moreover, Section 542.060 imposes penalties for insurers that fail to meet the statutory deadlines.

A. Insurer's Acknowledgement of Receipt of Claim:

Under Texas law, an insurer has 15 days from its receipt of notice of a claim to: (a) acknowledge receipt of the claim in writing; (b) begin to investigate the claim; and (c) request all necessary documents from the policyholder. TEX. INS. CODE ANN. § 542.055(a). The acknowledgement of the claim must be in writing to satisfy Section 542.055. *Daugherty v. American Motorists Ins. Co.*, 974 S.W.2d 796, 799 (Tex.App.—Houston [1st Dist.] 1998, no writ).

B. Insurer's Deadline to Accept or Reject Claim:

Under Section 542.056(a) of the Texas Insurance Code, the carrier must notify the insured in writing of its acceptance or rejection of the claim tendered not later than the 15th business day after it receives of all necessary documents requested from the insured to secure final proof of loss. *See* TEX. INS. CODE ANN. §542.056(a). Any rejection of the claim must be in writing and must state the reason the claim was rejected. *Id.* § 542.056(c).

Section 542.056(d) provides for an extension of forty-five days to the fifteen-day deadline if the carrier requires additional time to render a decision regarding the acceptance of the claim. *See* TEX. INS. CODE ANN. § 542.056(d). To take advantage of this extension, the insurer must notify the insured in writing prior to the expiration of the fifteen-day deadline and must specify the reasons the insurer requires additional time. *Id.*

C. Insurer's Deadline to Promptly Pay Accepted Claim:

After the insurer notifies an insured that it will pay a claim (in whole or in part), it must pay the claim within five business days after it gives the notice. TEX. INS. CODE ANN. § 542.057(a). If the insurer conditions payment upon some action by the insured (such as signing a release), the insurer must pay within five days of the insured's performance of the required action. *Id.*

However, the carrier can withdraw the notice if it receives new information upon which it can validly deny the claim. *Daugherty*, 974 S.W.2d at 799.

Section 542.058 overlays the deadline in Section 542.057. Section 542.058 provides that, if an insurer fails to pay a valid claim for more than sixty days after

[1] Many thanks to Wes Johnson of Cooper & Scully, P.C., who wrote the original version of this paper.

receiving all requested documentation from the insured, it will be liable for the statutory penalties in Section 542.060. TEX. INS. CODE ANN. § 542.058(a).

III. PENALTIES FOR VIOLATIONS OF CHAPTER 542

A. Statutory Penalties for Violations of Chapter 542:

Section 542.060 provides that, if an insurer that is liable for a claim under an insurance policy is not in compliance with the deadlines imposed by Chapter 542, the insurer is liable to pay the holder of the policy or the beneficiary, in addition to the amount of the claim, a penalty of 18% per year in damages and the insured's reasonable attorney's fees. TEX. INS. CODE ANN. §542.060(a).

B. Partial Payment of Valid Claim Does Not Protect Carrier From Statutory Penalties:

In *Republic Underwriters Ins. Co. v. Mex-Tex, Inc.*, 150 S.W.3d 423 (Tex. 2004), the insured sought payment for the destruction of its roof during a hail storm. While the insurer was investigating the matter, the insured had the roof replaced. The insurer sent a $145,460 check for the amount that it believed was the true cost of the roof work, which was less than the insured had paid. The insured refused the check, claiming that the insurer conditioned a full release in exchange for the payment.

The Texas Supreme Court held that the insured failed to prove its allegation that the insurer conditioned a full release of the claim with the partial payment. At the conclusion of the trial, 75 days after the insurer tendered payment of $145,460, the jury awarded the insured damages for the roof totaling $179,000, a $33,540 difference.

Therefore, the Texas Supreme Court held the insured was entitled to the statutory 18% per annum delay penalty only on the $33,540 difference between the tendered payment and the claim amount, as determined by the trial court.

C. Insurer's Failure to Meet Prompt Payment Deadlines Demonstrates an Unfair Settlement Practice Under Section 541:

At least one Texas court has concluded that, in addition to the statutory penalties provided by Section 542.060, the failure to comply with Chapter 542's imposed deadlines is also the basis for a cause of action under Section 541 for the engagement in unfair claims settlement practices. *See Colonial County Mut. Ins. Co. v. Valdez*, 30 S.W.3d 514, 522-23 (Tex. App. – Corpus Christi 2000, no pet.).

Based on this decision, the policyholder has the opportunity to recover from the insurer, in addition to the statutory 18% penalty and attorneys' fees for violation of Chapter 542, its actual damages, policy benefits, attorney's fees, and potential treble damages under the Insurance Code and/or DTPA if the conduct was knowing.

IV. APPLICATION OF CHAPTER 542

A. Chapter 542 Applies Only to First Party Claims:

The plain language of Chapter 542 limits the application of the Prompt Payment of Claims Act to a first-party claim brought by the insured against the insurer. Specifically, the statute defines a "claim" under Chapter 542 as "a first party claim made by an insured or policyholder under an insurance policy or contract or by a beneficiary named in the policy or contract [that] must be paid by the insurer directly to the insured or beneficiary." TEX. INS. CODE ANN. § 542.051(2).

B. Types of Policies Excluded by the Statute:

The statute itself specifically excludes the following types of insurance from the deadlines and penalties: (1) workers' compensation insurance; (2) mortgage guaranty insurance; (3) title insurance; (4) fidelity, surety, or guaranty bonds; (5) certain marine insurance; and (6) a guaranty association created and operating under chapter 2602 of the Insurance Code. TEX. INS.CODE ANN. § 542.053(a).

C. Application of Chapter 542 to Uninsured Motorist/Underinsured Motorist Claims

The question of whether the Prompt Payment of Claims statute applied in the context of an uninsured/underinsured motorist claim was explored in a recent case, *Mid-Century v. Daniel* 223 S.W.3d 586 (Tex. App. – Amarillo 2007, writ denied).

In *Daniel*, the plaintiff was injured in an automobile accident. Mid-Century was Daniel's underinsured motorist carrier, and it failed to participate in settlement negotiations, prompting Daniel to join Mid-Century as a defendant in the litigation. The claim against Mid-Century was severed and abated pending the outcome of the liability trial. *Id.* at 588.

Daniel received a judgment against the other driver at trial for a total of $75,562.55, after reduction for the proportionate responsibility of Daniel. Because the defendant driver's liability carrier, State Farm, had policy limits of $25,000 for the occurrence, Mid-Century paid the balance of the judgment to Daniel two days after the judgment was signed. *Id.*

Based on this payment, Mid-Century filed a motion for summary judgment on Daniel's claims against it for violations of Art. 21.55, which the trial court denied. However, the trial court granted Daniel's subsequent motion for summary judgment, holding that Mid-Century had violated Art. 21.55 because it failed to pay Daniel's claim within sixty days of receiving the claim. The trial court awarded statutory damages and attorney's fees against Mid-Century. *Id*.

On appeal, the Amarillo Court of Appeals held that, unlike many first-party insurance contracts, the UIM contract is unique because benefits are conditioned upon the insured's legal entitlement to receive damages from a third party. *Id*. at 589 (citing *Brainard v. Trinity Universal Ins. Co.*, 216 S.W.3d 809, 818 (Tex. 2006)). The court further stated that Mid-Century's obligation to pay benefits did not arise until liability and damages were determined, which did not occur until the trial court rendered judgment. *Id*. As such, Mid-Century's payment of $50,562.55 within two days of the judgment against the third party precluded the award of attorney's fees and statutory penalties under the Prompt Payment of Claims statute. *Id*.

D. Chapter 542 Claims Are Applicable in Interpleader Actions:

In *State Farm Ins. Co. v. Martinez*, 216 S.W.3d 799 (Tex. 2007), the Texas Supreme Court recently addressed the novel question of whether an Art. 21.55 claim can arise in connection with an interpleader action.

In *Martinez*, the parties disputed the proper beneficiary of a life insurance policy because of provisions of a divorce decree and a subsequent attempt by the policyholder to alter the beneficiary in contravention of the terms of that decree. *Martinez*, 216 S.W.3d at 800-01. Because of conflicting claims to the policy proceeds, the insurer filed an interpleader action 72 days after receipt of the wife's (Martinez's) claim to the proceeds, depositing the policy benefits into the registry of the court. *Id*.

Martinez asserted that the insurer's failure to tender the proceeds of the policy within 60 days of her claim constituted a violation of Art. 21.55. *Id.* at 803. The insurer argued that the common law had always excepted application of prompt payment statutes in the case of interpleader and, as such, the Art. 21.55 claim was not valid upon application of common law to the statute. *Id.* at 803.

The Supreme Court rejected the insurer's argument that the common law abrogated Art. 21.55 by holding the converse: that the 1991 enactment of Art. 21.55 overruled the common law. *Id.* at 804-05. Because the text of the statute itself declares that the statute should be "liberally" construed, the Court determined that the statute should apply in an interpleader action. *Id*.

The Court also provided guidance to insurers in those cases by holding State Farm responsible only for statutory penalties for the 12 days beyond the 60-day deadline. *Id.* The tender to the registry of the court constituted payment of the claim under Art. 21.55, which terminated the running of the statutory penalties beyond the date of the interpleader. *Id.*

Thus, while the Court held that Art. 21.55/Chapter 542 applied to interpleader actions, the Court also held that the interpleading of funds satisfied the payment requirements of the statute. As such, if the insurer files an interpleader action prior to the end of the statutory period, the insurer could avoid application of the statutory penalties. If the filing occurs after the 60-day period, the statutory penalties would apply for the period from the 61st day until the date of the interpleader filing.

V. APPLYING CHAPTER 542 TO THE DUTY TO DEFEND

A. Background and History:

The question of whether the Prompt Payment of Claims statute applied to a carrier's duty to defend its insured arose from dicta in *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex.1996), where the Texas Supreme Court commented that the prompt-payment statute might hypothetically apply to an insured's claim for a defense under a liability policy. This dicta by the Court was non-binding and did not set precedent; but, it created a decade-long dispute over whether Art. 21.55/Chapter 542 applied to the duty to defend.

One line of cases held that an insured's claim for defense costs under a liability policy is not a "first-party claim" within the meaning of the prompt-payment statute. These cases generally follow the reasoning of *TIG Insurance Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232 (Tex.App.-Dallas 2004, pet. denied). See also *Summit Custom Homes, Inc. v. Great Am. Lloyds Ins. Co.*, 202 S.W.3d 823 (Tex.App.-Dallas 2006, no pet.); *Serv. Lloyd's Ins. Co. v. J.C. Wink, Inc.*, 182 S.W.3d 19, 32-33 (Tex.App.-San Antonio 2005, pet. withdrawn).

Dallas Basketball and its progeny concluded that an insured's claim for defense costs was "fundamentally different than first-party claims for

payment based on a loss suffered by the insured." *Id.* at 242. *Dallas Basketball* explained that an insured's claim for defense costs was not a first-party claim because (1) "[a] demand for a defense under a liability policy is not a claim for payment" as the statute requires, but rather a demand for services, *Id.* at 239; (2) a defense claim is not typically payable to the insured, but rather to the insured's attorney, thus it is not a claim "paid by the insurer directly to the insured or beneficiary" as the statute requires, *Id.* (quoting former art. 21.55, § 1(3), now TEX. INS. CODE ANN. § 542.051(2)(B)); (3) an insured's claim for defense costs is not a policy claim but rather a breach of contract claim; and (4) the cost of defending the insured is not a statutory "claim" because the structure and deadlines imposed by the prompt-payment statute do not work with this type of claim. *Id.* at 240-41.

A conflicting line of authority (from mostly federal courts interpreting Texas law) held that the insured's claim for defense costs is "a first-party claim" and that the prompt payment statute does apply when an insurer wrongfully refuses to pay for the insured's defense. See *Rx.Com, Inc. v. Hartford Fire Ins. Co.*, 364 F. Supp.2d 609, 611-20 (S.D. Tex. 2005) (holding insured's request for a defense from liability insurer was first-party claim for purposes of article 21.55); *Hous. Auth. of Dallas v. Northland Ins. Co.*, 333 F. Supp.2d 595 (N.D. Tex. 2004) (same); *Travelers Indem. Co. v. Presbyterian Healthcare Res.*, 313 F. Supp.2d 648 (N.D. Tex. 2004) (same); *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F. Supp.2d 601, 632 n. 19 (E.D. Tex. 2003) (same); *Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc.*, 215 F. Supp.2d 783, 794 (E.D. Tex. 2002) (same); *N. County Mut. Ins. Co. v. Davalos*, 84 S.W.3d 314, 319 (Tex. App.—Corpus Christi 2002), *rev'd on other grounds*, 140 S.W.3d 685 (Tex.2004).

This line of cases reasoned that an insured's claim for defense costs is a first-party claim because it concerns a direct loss to the insured; that is, the claim does not belong to a third party. *See Rx. Com, Inc.*, 364 F. Supp.2d at 614-19 (rejecting the court's analysis in *Dallas Basketball*, 129 S.W.3d 232).

Based on the distinct split in authority between these two lines of cases, the U.S. Fifth Circuit Court of Appeals, when faced with the direct question of whether the Prompt Payment of Claims statute applied to the duty to defend, certified the question to the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 428 F.3d 193 (5th Cir. 2005), which the Texas Supreme Court accepted.

B. *Lamar Homes* Resolves the Split in Authority:

Lamar Homes was one of the most anticipated insurance law decisions in recent memory. In addition to the important question regarding application of the Prompt Payment of Claims statute, *Lamar Homes* also dealt with the issue of whether construction defects could constitute an accident or occurrence and whether allegations of property damage was sufficient enough to trigger an insurer's duty to defend under a CGL policy. As such, both the insurance and construction industry waited for the *Lamar Homes* opinion.

After the release of the *Lamar Homes* opinion, the focus was on the Court's holding that construction defects can constitute an accident and/or occurrence and that allegations of property damage can trigger the duty to defend under a CGL policy. The Court's holding on the prompt payment issue was almost an afterthought. In fact, the initial dissent in the case failed to even mention the Court's holding on the Art. 21.55 issue. (The dissenting justices did provide an amended dissent addressing the 21.55 claim in Dec. 2007).

However, in considering the impact of *Lamar Homes* on Texas insurance law, it is the prompt payment issues that appear to be the more far-reaching and that have the greater potential to impact the entire insurance industry. The Texas Supreme Court essentially adopted the *Gandy* line of cases by determining that a claim for defense under a policy constitutes a first-party claim.

In reaching this holding, the Court relied heavily on the definition of first-party claim contained in *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 54 n. 2 (Tex.1997). The Court noted that the statute itself does not define "first-party claim" but that the *Giles* opinion distinguished first-party and third-party claims on the basis of the claimant's relationship to the loss. *Lamar Homes*, 242 S.W.3d at 17. Thus, the Court concluded that "an insured seeks recovery for the insured's own loss," whereas a third-party claim is stated when "an insured seeks coverage for injuries to a third party." *Id*. (citing *Giles*, 950 S.W.2d at 54 n. 2). Based upon that distinction, a claim for a defense is a first-party claim because it relates solely to the insured's own loss.

The Court also reasoned that, without the defense benefit provided by a liability policy, the insured alone would be responsible for these defense costs. Unlike the loss incurred in satisfaction of a judgment or settlement, the Court held that such loss belongs only to the insured and is in no way derivative of any loss suffered by a third party. *Id.* at 17-18. Thus, the

claim for defense costs is a first-party claim because the insured is the only party who will suffer the loss or benefit from the claim.

The Court rejected the argument that, given the complexities of the defense obligation, Art. 21.55 was simply unworkable in the CGL context. *Id.* at 18-19. The Court acknowledged *Dallas Basketball's* observation about the difficulty in applying this procedure to an insured's claim for a defense, because, at the time of the claim, the insured typically has not yet suffered any actual loss. *Id.* Instead of adopting *Dallas Basketball's* reasoning that this quandary made the statute unworkable with respect to defense costs, the Court held: "when the insurer wrongfully rejects its defense obligation, the insured has suffered an actual loss that is quantified after the insured retains counsel and begins receiving statements from legal services." *Id.* (emphasis added).

The Court did note that the insured would have to submit his legal bills to the insurance company, as received, to mature its rights under the prompt-payment statute. *Id*. (citing *Primrose Operating Co. v. Nat'l Am. Ins. Co.*, 382 F.3d 546, 565 (5th Cir.2004)). As such, it is not enough for the insured to retain counsel and incur attorney's fees and legal expenses to perfect a claim under the statute; instead, the insured must tender the bills to the carrier to start the statutory timetables.

C. Impact of *Lamar Homes* – Pandora Revisited?

Without question, *Lamar Homes*' decision regarding the application of Chapter 542 affects each and every insurer writing a policy not specifically excluded by the statute itself. The real debate is no longer about the law but about the practical impact of the Court's determination that the insurer has the information necessary to "quantify the insured's loss" under Section 542.056(a) when the insurer receives statements or invoices for legal services rendered on behalf of the insured. *Id.* at 19.

Thus, in theory, once the insurer receives an invoice for attorney's fees or legal expenses from the insured's attorney, the clock begins to tick on the statutory deadlines for prompt payment of claims. The logical implication of *Lamar Homes* is that, if an insurer denies a defense to its insured based upon a viable coverage defense, the insured still can mature its right to Chapter 542 damages, penalty, and reasonable attorney's fees by tendering to the insurer invoices for legal services in defending the non-covered claim. *Id.* at 19.

The language of the holding, however, is not limited specifically to cases where the insurer actually denies the defense. The holding states: "And when the insurer, who owes a defense to its insured, fails to pay within the statutory deadline, the insured matures its right to reasonable attorney's fees and the eighteen percent interest rate specified by the statute." *Id.* (emphasis added). The holding seems to apply the statute to all cases where a defense is *owed*.

This sentence could very well amount to a "Pandora's box" for insurers, as it could expand the scope of the *Lamar Homes* holding beyond what any observer contemplated. Insureds can argue that Chapter 542 applies even in cases where the insurer provides a defense subject to reservation of rights, or even an unqualified defense, if the attorney's fees are not paid by the statutory deadlines after the bills were submitted to the carrier.

In other words, the *Lamar Homes* opinion could be read to hold that each invoice received for attorney's fees rendered on behalf of an insured (even if the defense is being paid by the carrier) constitutes a "claim" under Chapter 542, which must be paid in advance of the statutory deadlines to avoid the application of 18% penalty and the imposition of potential attorney's fees in an enforcement action against the carrier brought on behalf of the insured.

Obviously, this could have a far-reaching impact on the insurance industry, as many insurers have payment arrangements with defense counsel that are paid out annually, semi-annually, and quarterly, all of which would fall outside of the 60-day deadline imposed by Chapter 542.

D. Further Defining "First-Party Claim" – *Evanston v. Atofina:*

In the wake of *Lamar Homes*, it appeared that the scope of what constituted a first-party claim on a prompt payment issue could encompass a vast array of cases. However, the Texas Supreme Court did apply the *Giles* standard relied upon by *Lamar Homes* to the detriment of the policyholder in *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.*, __ S.W.3d __, 2008 Tex. LEXIS 575 (Tex. 2008).

Evanston dealt with the issue of an excess umbrella policy that was issued to a contractor that performed maintenance and construction work at a refinery owned by Atofina. *Evanston*, 2008 Tex. LEXIS 575 at *1-4. The policy included Atofina as an additional insured. An employee of the contractor was killed in an accident while working at the refinery. The primary insurer tendered its policy limits, and Evanston denied coverage. *Id*. Atofina eventually settled for an amount well in excess of the primary policy limits and brought a bad faith action

against Evanston, including a claim for damages for violation of the Prompt Payment of Claims statute. *Id.*

In *Evanston*, the Court held that the claim presented by Atofina for reimbursement of its settlement payment was not a first-party claim. *Id.* at *38-40. In reaching this conclusion, the Court applied the *Giles* standard used in *Lamar Homes.* The Court held that the deceased employee was an employee of the contractor, not of Atofina. Thus, because the loss was incurred in satisfaction of a settlement that belongs to a third party for his injuries, it was a "classic third-party claim." *Id*. at *39. Thus, Atofina was not entitled to the statutory penalty or attorneys' fees under Art. 21.55. *Id.* at *40.

In the recent Supreme Court case, *Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co*., 279 S.W.3d 650 (Tex. 2009), the Texas Supreme Court applied *Lamar Homes* in (a) declaring that a claim of faulty workmanship against a homebuilder was a claim for "property damage" caused by an "occurrence" under a CGL policy that was "identical" to the one construed in *Lamar Homes*, and (b) the claim for a breach of the insurer's duty to defend is a first-party claim subject to the deadlines in Chapter 542. *Id.* at 652.

VI. RECENT AMENDMENTS AND CASES

A. Amendment of Section 542.058

Effective June 19, 2009, the Legislature revised Section 542.058 of the Prompt Payment of Claims statute to include the following new paragraph:

> (c) A life insurer that receives notice of an adverse, bona fide claim to all or part of the proceeds of the policy before the applicable payment deadline under Subsection (a) shall pay the claim or properly file an interpleader action and tender the benefits into the registry of the court not later than the 90th day after the insurer receives all items, statements, and forms reasonably requested and required under Section 542.055. A life insurer that delays payment of the claim or the filing of an interpleader and tender of policy proceeds for more than 90 days shall pay damages and other items as provided by Section 542.060 until the claim is paid or an interpleader is properly filed.

The effect of this new provision is to clarify that the existence of a competing claim to life insurance proceeds is not enough, by itself, to justify a delay in payment. A carrier must either determine who is entitled to receive the benefits within 90 days of receipt of all documents reasonably requested or file an interpleader action and tender the benefits to the court within that 90-day period.

B. *GuideOne Lloyds Insurance Co. v. First Baptist Church of Bedford*, 268 S.W.3d 822 (Tex.App.—Fort Worth 2008, no pet.).

Although this case involved a number of litigation issues, the main issue involving Art. 21.55 concerned the application of the statutory 18% penalty. The insurer and insured disagreed over the value of a claim for hail damage to the roof of the insured church. At a point midway between the initial presentment of the claim and trial, the insurer offered an unconditional payment of $155,000 for the damage to the church. At trial, the jury awarded damages of $286,596.63 for the breach of contract claim.

The trial court awarded the statutory 18% penalty on the entire breach of contract award, despite the jury's finding that the tender of the $155,000 was an unconditional tender (and despite the Texas Supreme Court's opinion in *Republic v. Mex-Tex*). The appellate court applied the tender as a credit against the breach of contract amount, but allowed the offset only from the date of the tender until the date of the judgment. Prior to the tender, the 18% penalty for delay in payment was levied against the full amount of the damage to the roof. The appellate court then reduced the amount of the statutory penalty interest so it did not get awarded on the amount unconditionally tendered by the insurer from the date of the tender to the date of judgment.

Clearly, if the insurer does not contest a portion of the amount owed to an insured, it is in the best interests of the insurer to unconditionally tender that amount as early in the dispute process as possible to avoid or reduce the statutory penalty, even if the insurer continues to dispute a greater sum claimed by the insured.

C. *Nautilus Insurance Co. v. International House of Pancakes*, 622 F. Supp.2d 470 (S.D.Tex. 2009).

In the *Nautilus* case, an insurer filed a declaratory judgment action seeking a declaration that it did not owe a duty to defend or to indemnify the International House of Pancakes ("IHOP") and one of its franchise owners in two underlying state court actions. In each of the suits, a woman alleged that a manager employed by the franchise restaurant had sexually

harassed and raped her. The court held that Nautilus had no duty to defend or indemnify IHOP and the owner of the franchise in one case, but owed a duty to defend IHOP and the owner in the other lawsuit.

After that ruling, Nautilus filed a motion of summary judgment seeking a ruling that it had no duty to pay the 18% penalty interest and attorneys' fees under Article 21.55 of the Texas Insurance Code, contending that the Prompt Payment of Claims statute did not apply to an insurer's denial of a defense involving a third-party claimant's suit. Further, Nautilus contended that the statute was both facially unconstitutional and void for vagueness as applied to the claim for a defense a third-party suit. IHOP filed a cross-motion for summary judgment, seeking the 18% penalty and attorneys' fees.

Based on the ruling of the Texas Supreme Court in *Lamar Homes*, the Southern District federal court denied the constitutionality challenge of Nautilus and granted the cross-motion for summary judgment of IHOP. Even though the Texas Supreme Court had not addressed the constitutionality argument in *Lamar Homes*, Nautilus had raised it by amicus brief filed in that case. The federal court found that the statute was not facially invalid, as that requires a showing that no set of circumstances exist under which the law would be valid. *Nautilus*, 622 F. Supp.2d at 477. This is an incredibly difficult burden to meet.

The statute also was not unconstitutionally vague as applied to Nautilus because the statute provides fair warning to insurers that they could be liable for any delay in paying a covered claim, including a claim for defense costs. *Id.* at 480. Even if the statute were "strictly construed," as penal statutes frequently are, the court found that application of the statute was "reasonably foreseeable" to Nautilus was not unconstitutionally vague. *Id.* at 482.

Because this case is a federal district court case, it is possible that the constitutional arguments in the case could be made again until the Texas Supreme Court rules definitively on the issue.

Other constitutional challenges could also be made to the statute, including challenges based on violation of due process rights, of the takings clause (no taking of property without just compensation), of the right to access to the courts, and other rights. These are premised on the argument that the statute unfairly restricts the right of an insurer to contest a claim for a valid reason and forces it to pay the claim, the penalty, and reasonable attorneys' fees while it litigates the coverage defenses.

VII. TRIAL OF THE CHAPTER 542 CLAIM

A. Submission of the Jury Charge

Texas federal courts have addressed the issue of how to submit a claim for violation of Chapter 542, although the opinion from the Fifth Circuit is unpublished. In *Salinas v. State Farm Lloyds*, 267 Fed. Appx. 381 (5th Cir. 2008), the plaintiffs complained on appeal that the trial court abused its discretion in refusing to submit their claim for State Farm's violation of the acknowledgment provisions of the statute. The Fifth Circuit held that the plaintiffs had pleaded and produced evidence to support their claim and were entitled to a submission. However, the plaintiffs arguably did not preserve error because the Court held that their requested question did not correctly state the law. *Id.* at 388.

The Court held, essentially, that any jury question inquiring whether an insurer violated Chapter 542 must track the statute. A proper question would inquire: (a) whether the plaintiff made a claim under an insurance policy, (b) whether the insurer was liable for the claim (*i.e.*, the claim was covered), and (c) whether the insurer failed to comply with one or more sections of the statute with respect to the claim. *Id.* (citing section 542.060(a) and *Allstate Ins. Co. v. Bonner*, 51 S.W.3d 289, 291 (Tex. 2001)). Under this standard, the Court held that the trial court's failure to submit a jury question on the Chapter 542 violation was harmless error because the jury had found State Farm was not liable for the claim and, thus, plaintiffs could not have proven one of the elements of the claim. *Id.* at 389.

Nonetheless, this case provides some guidance on how to submit a claim under Chapter 542 to a jury. If the insurer is accused of violating more than one section of Chapter 542, the question should include a separate blank for each provision alleged to be violated. This will allow for proper review of any adverse jury finding on appeal.

B. Challenging the Reasonableness of Attorneys' Fees

One of the elements of the Chapter 542 recovery is "reasonable attorneys' fees." TEX. INS. CODE ANN. § 542.060(a). As a result, one of the factual battles in a lawsuit involving a Chapter 542 claim likely will be over the "reasonableness" of the insured's attorneys' fees. A federal district court addressed these issues in considerable detail in *Great Am. Ins. Co. v. AFS/IBEX Fin. Svcs., Inc.*, 2009 U.S. Dist. LEXIS 11648 (N.D. Tex. 2009). The court considered the insured's request for fees within the framework of Texas substantive law on the reasonableness and necessity of attorneys' fees and considered evidence such as

affidavits from the lawyers and legal fee bills. The insurer should consider designating an attorneys' fees expert in the appropriate case.

C. Discovery in Chapter 542 Cases

Discovery on the prompt payment claim may be relatively limited. The only factual issues might be whether the insurer violated the statute (*i.e.*, issues regarding the timing or form of notice, timing of payment, requests for extensions) and the reasonableness of the insured's attorneys' fees. In *Owen v. Employers Mut. Cas. Co.*, 2008 U.S. Dist. LEXIS 24893 (N.D. Tex. 2008), the federal district court indicated it would allow the insurer to conduct limited discovery in a UM case involving a Chapter 542 claim; but, the court said it was "hard pressed to believe" that the insurer had not had sufficient time to properly investigate the underlying claim and prepare its defense. *Id.* at *11-12.

VIII. CONCLUSION

Lamar Homes undeniably altered the landscape for claims under the Prompt Payment of Claims statute. Texas case law has yet to conclusively determine how insurers can and must handle claims, including claims for breach of the duty to defend, in their day-to-day business so as to avoid violation of Chapter 542 and assessment of the penalty and attorneys' fees while still exercising their rights to contest uncovered claims.

Even before the *Lamar Homes* decision, policyholders were beginning to rely upon the statute as an offensive tool in bad faith litigation. Considering that claims may remain in litigation for years following a denial of coverage, the prospect of recovery of 18% per annum penalties is a formidable weapon in the policyholder's arsenal.