

**REVISITING THE TEXAS PROMPT PAYMENT OF CLAIMS
STATUTE**

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15th Annual Insurance Symposium
March 28, 2008
Dallas, Texas

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I. INTRODUCTION

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 of the Texas Insurance Code). However, over the course of the past decade, policyholders have turned in greater numbers to long ignored provisions of the Texas Prompt Payment of Claims Statute, Section 542 of Texas Insurance Code (formerly known as Art. 21.55 of the Texas Insurance Code.) (Hereafter, referred to as 'the statute,' 'Section 542' or ('Art. 21.55'.)

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

However, the question of whether the statute applied to an insurer's duty to defend has dominated the past decade, with fundamental splits of authority between Texas state appellate courts and federal courts attempting to interpret Texas law. The fundamental dispute of whether the statute applied to the duty to defend is based upon the insurers' contention that the statute does not apply to "third party insurance," and the contention that the duty to defend against a third party claim is derivative of the third party claim itself – thus, the claim for defense is itself a third party claim.

Obviously, policyholders argued the converse – that a claim for defense is brought directly by the insured to the insurer, thus, it is a first party claim in nature.

Over the years, various courts sided with insurers and policyholders, creating a difficult environment for both insurer and policyholder to gauge risk and recovery. So significant was the distinction in the lines of cases that the U.S. Court of Appeals for the Fifth Circuit submitted a certified question to the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007). Through the certified question, the Fifth Circuit requested that the Texas Supreme Court render an opinion on the issue of whether Sec. 542/Art. 21.55 applied to an insurer's duty to defend. The *Lamar Homes* decision has resolved this dispute in favor of policyholders, but has raised many more issues regarding the application of the statute.

This paper will explore the claims handling procedures required by the statute. In addition, it will

explore the significance of the *Lamar Homes* decision on Sec. 542/Art. 21.55 jurisprudence, along with an update on other important cases that are related to applying the statute.

II. CLAIMS HANDLING PROCEDURES AND REQUIREMENTS UNDER SECTION 542

Section 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. The acknowledgement of the claim must be in writing to satisfy Section 542.055 of the Texas Insurance Code. *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 of the Texas Insurance Code, the carrier must notify the insured in writing of its acceptance or rejection of the claim tendered before the expiration of 15 days from its receipt of all necessary documents requested from the insured. Any rejection of the claim must be in writing and must state the reason the claim was rejected. *See* TEX. INS. CODE ANN. §542.056.

Section 542.056 does provide an additional extension of forty-five days to the fifteen day deadline in the event that 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 such notice must specify the reasons the insurer requires additional time. *Id.*

C. Statutory 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 days after such notice is given. TEX. INS. CODE ANN. § 542.057. If the insurer conditions payment upon some action by the insured, the insurer must pay within 5 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.

The deadline in Section 542.057 is overlaid by another deadline imposed by Section 542.058, which states that an insurer must pay a valid claim within sixty days upon receiving all requested documentation from the insured or face the statutory penalties. TEX. INS. CODE ANN. § 542.058.

III. PENALTIES FOR VIOLATIONS OF SECTION 542

A. Statutory Penalties for Violations of Section 542:

Section 542.060 provides that if the insurer is not in compliance with the deadlines imposed by Section 542, then the insurer is liable to pay the holder of the policy, in addition to the amount of the claim, a penalty of 18% per annum in damages and the insured's attorney's fees. TEX. INS. CODE ANN. §542.060.

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 found 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 insured was awarded damages for the roof totaling \$179,000, a \$33,540 difference.

Therefore, the Texas Supreme Court held that 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. Proving Your Insurer Failed 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 542.060, the failure to comply with Section 542's imposed deadlines is also the basis for a cause of action under Section 541 for the engagement of unfair

settlement practices. See *Colonial County Mut. Ins. Co. v. Valdez*, 30 S.W.3d 514, 522023 (Tex. App. – Corpus Christi 2000, no pet.).

Thus, in addition to the statutory 18% penalty for violation of Section 542, the policyholder has the opportunity to recover its actual damages, policy benefits, attorney's fees and potential treble damages under the DTPA.

IV. APPLICATION OF SECTION 542

A. Section 542 Applies Only to First Party Claims:

The plain language of Section 542 limits the application of the prompt payment of claims statute to a first party claim brought by the insured against the insurer. Specifically, the statute defines a "Claim" under Section 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.

C. Application of Section 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 context was explored in a recent case, *Mid-Century v. Daniel* 223 S.W.3d 586 (Tex. App. – Amarillo 2007, no pet.).

In *Daniel*, the plaintiff was injured in an automobile accident. Mid-Century was Daniel's underinsured motorist carrier, whom 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. Since 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 was denied. However, Daniel's subsequent motion for summary judgment was granted by the trial court, which held that Mid-Century had violated Art. 21.55 since 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, according to its terms, 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 after judgment was rendered. *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. Section 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 dealt with the novel question of the application of an Art. 21.55 claim in an interpleader action.

In *Martinez*, there was a dispute over the proper beneficiary of a life insurance policy due to the provisions of a divorce decree and a subsequent attempt by the policyholder to alter the beneficiary in contravention of the terms of the divorce decree. *Martinez*, 216 S.W.3d at 800-01. Due to conflicting claims on 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's benefit into the registry of the court. *Id.*

Martinez asserted that the insurer's failure to tender the proceeds of the policy constituted a violation of Art. 21.55, by failing to pay her within 60 days of her claim. *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 21.55 claim was not valid upon application of common law to the statute. *Id.* at 803.

The Supreme Court rejected the argument of the insurer that the common law abrogated Art. 21.55 by holding that older common law precepts were overridden by the 1991 enactment of Art. 21.55. *Id.* at 804-05. Since the text of the statute itself declares that the statute should be "liberally" construed, the

Court determined that the statute should apply in the instance of interpleader. *Id.*

However, the Court also provided guidance to insurers in such cases by only holding State Farm responsible for statutory penalties for the 12 days beyond the 60 day deadline, holding that the tender of interpleader to the registry of the court constituted payment of the claim under 21.55, which cut off the application of statutory penalties beyond the date of the filing of the interpleader. *Id.*

Thus, while the Court held that the mere filing of interpleader did not erase the application of 21.55/Section 542, the Court did clearly state that the filing of interpleader funds did suffice the payment requirements of the statute. As such, provided that the interpleader was filed prior to the end of the statutory deadlines period, an insurer could preclude application of the statute against it. In the case that the filing occurred after the 60 day period, the statutory penalties would apply until such date the interpleader is filed.

V. APPLYING SECTION 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 a dicta comment contained in *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex.1996), that the prompt-payment statute might hypothetically apply to an insured's claim for a defense under a liability policy.

This suggestion by the Texas Supreme Court was non-binding and did not set precedent, but it certainly created a decade long dispute over whether the Prompt Payment of Claims statute 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, pet. pending); *Ulico Cas. Co. v. Allied Pilots Ass'n*, 187 S.W.3d 91, 104 (Tex.App.-Fort Worth 2005, pet. pending); *Serv. Lloyd's Ins. Co. v. J.C. Wink, Inc.*, 182 S.W.3d 19, 32-33 (Tex.App.-San Antonio 2005, pet. pending).

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 (quoting statute’s title “Prompt Payment of Claims”); (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 § 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 indeed 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).

These cases principally stemmed from the suggestion in *Gandy* that the prompt-payment statute might hypothetically apply to an insured’s claim for a defense under a liability policy. This line 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 the case of *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 428 F.3d 193 (5th Cir. (Tex.) 2005) – accepted by the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 239 S.W.3d 236 (Tex. 2007).

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 under a construction and whether allegations of property damage was sufficient enough to trigger an insurer’s duty to defend. *Lamar Homes*, 239 S.W.3d at 4-5. As such, both the insurance and construction industry was focused on the *Lamar Homes* opinion.

In fact, after the release of the opinion in *Lamar Homes*, it seemed the focus was on the impact of 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. It almost seemed that the Court’s holding on the prompt payment issue was 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, as one studies the impact of *Lamar Homes*, it is the prompt payment issues that appear to be the more far reaching and have the greater potential impact on the entire insurance industry.

The Texas Supreme Court 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*, 239 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 defense claim is a first-party claim because it relates solely to the insured’s own loss.

In addition, 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 Court held that the claim for defense costs then is a first-party claim because the insured is the only party who will suffer the loss or benefit from the claim.

Moreover, the Court rejected the argument that, given the complexities of the defense obligation, Article 21.55 was simply unworkable in the CGL context. *Id.* at 18-19. In addition, the Court recognized *Dallas Basketball's* observation which recognized the difficulty in applying this procedure to an insured's claim for a defense, since 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 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 to simply retain counsel and incur attorney's fees and legal expenses to perfect a claim under the statute, the insured must tender the bills to the carrier to start the statutory timetables. Thus, earlier is obviously better than later.

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

Without question, the decision in *Lamar Homes* regarding the application of Section 542 affects each and every insurer writing a policy not specifically excluded by the statute itself.

The Court has resolved the decade long dispute of whether or not the statute applied to a claim for a defense. However, the real debate is now the practical impact of the Court's determination that the insurer had 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, upon receipt of an invoice for attorney's fees or legal expenses the clock begins to tick on the statutory deadlines for prompt payment of claims. As such, it is absolutely clear that *Lamar Homes* holds that if an insurer denies a defense to its insured that the insured matures its right to reasonable attorney's fees and the eighteen percent interest rate specified by the statute by tendering invoices for legal services. *Id.* at 19.

However, the language of the holding is not limited specifically to cases where the insurer actually denies the defense. The holding states "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).

Note that the holding does not specifically limit its application to matters where the insurer has denied a defense to the insured; 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. It can now be argued (quite convincingly) that Section 542 is applicable even in cases where a defense is being tendered and that the attorney's fees are simply not paid in advance of the statutory deadlines after the bills were submitted to the carrier.

In other words, a reasonable interpretation of the *Lamar Homes* opinion could conclude 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 Section 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 incredibly 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 Section 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 the recent holding in *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.*, 51 Tex. Sup. J. 460, 2008 Lexis 122 (Tex, Feb. 15, 2008).

Atofina 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*. *Atofina*, 2008 Lexis 122 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 policy limits were tendered, and the excess policy denied coverage. *Id.* *Atofina* eventually settled for an excess of the policy limits and brought a bad faith action against the excess carrier, including a claim for damages for violation of the Prompt Payment statute. *Id.*

In this case, the Court held that the claim presented was not a first party claim. 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, since the loss was incurred in satisfaction of a settlement that belongs to a third party for his injuries, then this is a classic third-party claim. *Id.* at 40.

VI. CONCLUSION

Needless to say, *Lamar Homes* has changed the scope of claims under the Prompt Payment of Claims statute. Even before the *Lamar Homes* decision, policyholders were beginning to rely upon the statute as an offensive tool in classic 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.

However, it seems clear that *Lamar Homes* has left some questions unresolved, particularly with the scope of its holding regarding violations of the statute for non-payment of attorney's fees. These issues will likely have to be addressed by the Court to clarify its holding, and it will likely need to occur soon. As mentioned above, the potential application of the statute even in cases where a defense is being tendered could lead to unforeseen consequences. Such matters will need to be clarified by the Court in the coming months.