THE TEXAS PROMPT PAYMENT OF CLAIMS STATUTE AND ITS APPLICATION TO THE DUTY TO DEFEND

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I. INTRODUCTION

The purpose of this article is to provide the insurance claims handler with the basic underpinnings of Section 542.051, et. seq of the Texas Insurance Code (formerly Article 21.55 and also known as the Texas Prompt Payment of Claims Statute) and its practical application to the handling of third party claims. On August 31, 2007, the Texas Supreme Court held that the Prompt Payment of Claims Statute applies to an insurer's duty to defend thereby resolving a split between intermediate state and federal courts on the statute's applicability to at least one aspect of third party claims. The article will discuss the requirements and the potential pitfalls unique to third party claims under the Prompt Payment of Claims Statute.

II. *LAMAR HOMES*: THE PROMPT PAYMENT OF CLAIMS STATUTE APPLIES TO DUTY TO DEFEND CLAIMS

In *Lamar Homes, Inc., v. Mid-Continent Casualty Company*, 2007 WL 2459193 (Tex. Aug. 31, 2007), in addition to outlining the scope of the term "occurrence" in general liability policies involving construction defect claims, the Texas Supreme Court made a surprising and mostly unexpected finding that the Texas Prompt Payment of Claims Statute applies to an insurer's duty to defend under a liability policy. [1] Prior to *Lamar Homes*, intermediate state and federal courts had been split as to the applicability of the statute to an insurer's duty to defend or indemnify in third party claims. The statute does not separately define "a first-party claim," and these courts were divided as to its meaning. 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, while another held that the insured's claim for defense costs is "a first-party claim" and that the prompt-payment statute is applicable.

The Texas Supreme Court resolved the dispute, holding that a defense claim is a first-party claim because it relates solely to the insured's own loss. Without the defense benefit provided by a liability policy, the insured alone would be responsible for those costs. Thus, unlike the loss incurred in satisfaction of a judgment or settlement, the loss belongs only to the insured and is in no way derivative of any loss suffered by a third party.

The court went on to hold that in order to mature the insured's rights under the prompt-payment statute, the insured has to submit his legal bills to the insurance company, as received. 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 for legal services. These statements or invoices are the last piece of information needed to put a value on the insured's loss. When the insurer, who owes a defense to its insured, fails to pay within the statutory deadline, the insured's right to reasonable attorney's fees and the eighteen percent interest penalty specified by the statute is mature.

III. THE STATUTORY DEADLINES

Given that carriers have previously not considered the Prompt Payment of Claims Statute to apply to liability policies, carriers have not followed or been conscious of the timelines and

[1] Motion for rehearing has been denied.

duties imposed by the statute, nor paid attention to the potential penalties for failure to comply. The following is an outline of the duties and timelines set out in the relevant statutory provisions.

A. RECEIPT OF NOTICE OF CLAIM

An insurer has fifteen (15) actual days after receiving written notice of a claim (or, if the insurer is an eligible surplus lines insurer, thirty (30) *business* days after the date an insurer receives written notice of a claim) to: (1) acknowledge receipt of the claim; (2) begin an investigation of the claim; and (3) request all documentation from the policyholder necessary to secure final proof of loss. If the carrier does not acknowledge the claim in writing, it must "make a record of the date, means and content of the acknowledgment." TEX. INS. CODE § 542.055.

The *Lamar* decision did not address whether the timelines under the Prompt Payment of Claims Statute are triggered merely by a tender of a defense by an insured to a claim or lawsuit. Instead, a reasonable reading of the statutory language suggests that a written request for reimbursement of specific defense costs is required. Nevertheless, we recommend that in the context of a request for a duty to defend, the carrier should acknowledge the request for a defense and specifically ask for all items, statements and forms which may be related to the tender. While the statute permits a carrier to do this orally, the carrier must make a record of the date, manner, and content of the non-written acknowledgment. Typically, a log entry note confirming the adjuster called the insured constitutes adequate acknowledgement, but oftentimes, the adjuster may not send a letter requesting necessary information to investigate the claim. The better course is to acknowledge the claim in writing, request all necessary information, and reserve rights on any coverage defenses, if applicable.

B. COVERAGE DECISION DEADLINE

The insurer must then notify the insured in writing whether it accepts or rejects the claim within 15 *business* days of the receipt of all necessary information required to investigate the claim (i.e., the petition or complaint and invoices from defense counsel). If the insurer rejects the claim, the written notice must state the "reasons for the rejection." However, if for any reason the insurer is unable to accept or reject the claim within 15 days after receiving the documentation, the insurer is entitled to explain to the insured why it is not able to do so in that period in writing and it then it has 45 days to accept or reject the claim. TEX. INS. CODE § 542.056.

In *Lamar Homes*, the court held that the time for triggering the statute was the receipt of the defense invoices. Specifically, the court raised the question, "Whether the insured would have to submit its legal bills to the insurance company, as received, to mature its rights under the Prompt Payment Statute. The statute's apparent answer is, yes." In other words, as the statute requires that "an insurer shall notify a claimant, in writing, of the acceptance or rejection of a claim not later than the fifteenth business day after the date the insurer receives all items, statements and forms required by an insurer to secure final proof of loss." The key document that triggers the statute with respect to the duty to defend is the receipt of the invoice from defense counsel.

Another court that has provided some guidance on the application of the statute to a tender of defense is *Sentry Ins. Co. v. Greenleaf Software, Inc.*, 91 F.Supp.2d 920 (N.D. Tex. 2000). In that case, the suit against the insured was filed in 1997. The insured tendered its defense by giving notice to the insurer on April 21, 1998. The insurer subsequently denied a defense. On May 17, 1999, the insured submitted to the insurer a demand for reimbursement with copies of the attorney's fees and costs paid to defend the case. The court held that the insured's submission of its attorney's invoices on May 17, 1999 triggered the timelines under the Prompt Payment Statute. *Id.* at 924-25.

An issue that frequently arises that may present a problem for the insurer is when an insured submits its attorney's fee invoices that are block billed or fail to adequately separate out services related to clearly non-covered claims under the policy. Federal courts have held that block billed invoices are not proper to ascertain whether fees are reasonable or necessary. Additionally, the Fifth Circuit has held that an insurer may apportion defense costs between covered and non-covered claims if the insurer can clearly distinguish between those fees incurred for non-covered fees and those incurred for covered claims. *Lafarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 385 (5th Cir. 1995). For example, an insurer would not be responsible for payment of fees related to prosecution of an insured's affirmative claims against a party, if they are capable of being apportioned with certainty. Where the insured submits invoices for reimbursement that contain fees for both defending covered claims and prosecuting counter-claims and they are block billed, there are two possible options for an insurer. First, the insurer can take the position that all required information necessary to investigate the claim has not been provided under Section 542.056 and therefore the 15 day deadline to accept or reject the claim is thereby tolled. The insurer should request that the insured provide invoices that are not block billed so that they can be properly reviewed. A second option is to inform the insured that the insurer is not able to accept or reject the claim pursuant to Section 542.056 and to request that the insured provide invoices that are not block billed. However, the insurer must still accept or deny the fees within 45 days after that date whether or not the insured has complied with the request. The more prudent approach is option one. Unfortunately, there is no guidance from the courts on this issue.

C. PAYMENT DEADLINE

If an insurer notifies a policyholder that it will pay a claim (or a portion of the claim), the claim must be paid within five (5) business days. (If the insurer is an eligible surplus lines insurer, the insurer must pay the claim not later than the 20th business day after the date of notice of payment by the insurer or the date of performance by the insured.) If payment is conditioned on some action by the policyholder, the insurer must pay within five (5) business days of the policyholder's performance of the required action. TEX. INS. CODE § 542.057. The statute is silent as to the types of action that may be required of a policyholder.

Given this provision, if an insurer agrees to pay an invoice for legal fees, or some part of the invoice, the insurer must pay the invoice within five (5) business days (20 business days for a surplus lines insurer) after accepting the invoice.

An insurer who initially notifies its policyholder that it will pay a claim is able to *withdraw* that decision upon learning facts that would justify denial of the claim. *See Daugherty v. American Motorists Insurance Company*, 974 S.W.2d 796, 799 (Tex.App.-Houston [14th

Dist.] 1998, no pet.) (insurer withdrew notice of payment after learning facts indicating that auto theft claim not covered). However, the withdrawal of a decision to issue payment must occur within five (5) actual days of the initial notice of payment.

D. THE PENALTY

If an insurer delays payment of a claim for more than sixty (60) days after receiving all required information pursuant to Section 542.055, it is liable for penalties under the statute. This time period may be trumped by other statutes that require payment in a shorter period of time. TEX. INS. CODE § 542.058. An insurer who delays payment past this deadline must pay, in addition to the claim, a penalty of eighteen (18) percent per annum of the amount of the claim plus attorney's fees. TEX. INS. CODE § 542.060. The eighteen (18) percent per annum penalty is to be calculated as simple non-compounding interest from the date of the violation. *Teate v. Mutual Life Insurance Company of New York*, 965 F.Supp. 891, 894 (E.D. Tex. 1997). The penalty is also calculated on the amount of the claim ultimately determined to be owed. *Republic Underwriters Ins. Co. v. Mex-Tex, Inc*., 150 S.W.3d 423 (Tex. 2004). If partial payment has been made by the insurer, then the insurer receives a credit toward the ultimate amount owed, and the eighteen (18%) percent penalty is not calculated on the amount partially paid. *Id.*

E. DELAY OR DENY=SAME OUTCOME?

An insurer who wrongfully denies payment of a claim will be liable for the eighteen (18) percent penalty assessed by Section 542.060. The penalty starts to accrue sixty (60) days after the insurer receives all required information to investigate the claim. This penalty is cumulative of other available remedies. *See, e.g., Higginbotham v. State Farm Mut. Auto. Ins. Co.*, 103 F.3d 456 (5th Cir. 1997); *Sentry Ins. Co. v. Greenleaf Software, Inc.*, 91 F.Supp.2d 920 (N.D. Tex. 2000); *Teate v. Mutual Life Ins. Co. of New York*, 965 F. Supp. 891 (E.D. Tex. 1997); *Oram v. State Farm Lloyds*, 977 S.W.2d 163 (Tex. App.—Austin 1998, no pet.). Several courts have reasoned that an insurer who wrongfully denies a claim should not be in a better position under the statute than an insurer who delays, but ultimately pays, the claim. *Id.* There is no "good faith" exception to the rule. An insurer who wrongfully denies payment is subject to the statutory penalty even if it had a reasonable, good faith basis for the denial. *Atofina Petrochemicals, Inc. v. Evanston Ins. Co.*, 104 S.W.3d 247 (Tex. App.–Beaumont 2003, *rev'd on other grounds*.), __ S.W.3d __, 2006 WL 1195330 (Tex., May 5, 2006, *reh'g granted*)[2]

F. EFFECT OF INSURED'S DELAY

In *Allison v. Fire Ins. Exchange*, 98 S.W.3d 227 (Tex. App.—Austin 2002, no pet.), the court found that the adjuster's request for an additional forty-five (45) days, when no additional information was actually needed (the adjuster simply needed to gain proper authority), constituted a misrepresentation under Article 21.21. The court also found that the insurer failed to timely make payments under the terms of Article 21.55. In calculating the penalty and interest, however, the court attributed part of the delay to the insured. Therefore, the court remanded that issue to the district court for recalculation.

[2] The applicability of the Prompt Payment of Claims Statute to the duty to indemnify claims is pending before the Texas Supreme Court in the *Atofina* case.

G. IF NO COVERAGE EXISTS, THERE CAN BE NO VIOLATION OF THE PROMPT PAYMENT OF CLAIMS STATUTE

In *Allstate Ins. Co. v. Bonner*, 51 S.W.3d 289 (Tex. 2001), the Texas Supreme Court held that an insurer cannot be held liable under the Prompt Payment of Claims Statute if no coverage exists under the policy for the claim made by the insured. This is true even if the insurer is in violation of the statute's deadlines for acknowledging and rejecting claims. Since *Bonner*, the Prompt Payment of Claims Statute has been amended to state that if it is determined after arbitration or litigation the claim is not valid, there is no claim for damages under the statute.

If an insurer misses the 15 day deadline for acknowledging receipt of an insured's submission of defense fee invoices, there is no violation of the statute if a determination is made that insurer did not owe a defense. Similarly, if defense costs submitted by the insured are incurred before tender of the defense to the carrier, statutory penalties should not apply since the costs are not covered.

H. STATUTE OF LIMITATIONS APPLIES TO STATUTE

The courts are in conflict as to whether the two or four year statute of limitations applies to a claim under the Prompt Payment of Claims Statute. In *Ericsson, Inc. v. St. Paul Fire and Marine Ins. Co.*, 423 F.Supp.2d 587 (N.D.Tex. 2006), the federal district court held, without much discussion, that the two year statute of limitation applies. On the other hand, in *Rx.com Inc. v. Hartford Fire Ins. Co.*, 426 F.Supp.2d 546, 563 (S.D.Tex. 2006), another federal district court held that the four year statute of limitation applies reasoning that the statute is based on a breach of contract.

V. PRACTICAL APPLICATION

1. If a defense attorney is appointed to represent the insured and the attorney has a strong relationship with the carrier (such as panel counsel), the statutory deadlines should not present a problem for the insurer. Because of the tri-partite relationship, the attorney may have a conflict in pursuing a claim directly against the carrier, and as long as the defense of the case is not impaired, the insured is unlikely to care whether the attorney is paid in accordance with the statutory deadlines.

2. If counsel is chosen by the insured, such as in cases in which the reservation of rights is rejected, an attempt should be made to work out a reasonable timeframe for the review and audit of invoices. If such agreements are in writing and agreed to by defense counsel, this should also insulate the carrier from any Prompt Payment of Claims Statute risks.

3. If defense counsel is antagonistic to the carrier, they may strictly impose these timelines to create a benefit for the insured, as well as to create leverage in settlement negotiations or gain other advantages depending upon the circumstances. Strict compliance with the timelines imposed by the statute in this scenario is critical. Also, the insurer should document all requests for supporting information to justify any potential delays.

4. Under *Lamar*, even if the carrier denies coverage, the insured should be required to submit invoices to "mature" the Prompt Payment claim. Arguably, if the insured/defense counsel do not submit the invoices after denial, the statute does not apply.

5. The application of the Prompt Payment statute creates a new extra-contractual risk for incorrect denials of the duty to defend. Indeed, one policyholder firm immediately sent a blast e-mail to its clients following the decision telling them they now had the leverage to obtain a defense in almost all cases. Simply put, even though there is no duty of good faith and fair dealing in the third party context, and insurers have had no risk of extra-contractual exposure, if a good faith basis for a denial of coverage exists, a carrier may be faced with an 18% interest penalty even when it makes a reasonable decision to deny a duty to defend but a court disagrees. For example, if a duty to defend is denied and $100,000 in defense costs are incurred over 2 years, the policyholder may be able to recover the $100,000 in defense costs, up to $36,000 in interest penalties, as well as the attorneys fees expended in recovering those defense costs. Further, if the litigation over the duty to defend takes 2 years, presumably the 18% penalty continues to run.

6. Some policyholder attorneys have already indicated that the risks of application of the statute will be used to leverage not only defense obligations, but to attempt to obtain indemnity dollars in cases in which there has either been an untimely payment or a questionable denial of the duty to defend. This may be true, but should be of limited impact except in special circumstances.

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PROMPT PAYMENT STATUTE FLOW CHART

1. Acknowledge claim within 15 days of receipt of defense bills and begin investigation (30 business days if surplus lines insurer).

    - include request for "all items, statements or materials" that evidence or support claim.

    - obtain policies / underwriting files.

    - document in your notes that you began investigation promptly.

2. Within 15 business days of receipt of all information required to pay claim must:

    A. Accept defense; or

    B. Deny defense; or

    C. Request further information.

3. If you accept defense, you must pay bills within 5 business days (20 business days if surplus lines insurer) of accepting them.

4. If you deny defense, you must explain why in writing.

5. If unable to accept or reject within 15 business days, must notify (not necessarily in writing, but make sure it is documented) insured why more time needed.

    - Must then accept or reject claim within 45 days.

6. If accept part of bill, but reject part (e.g., improperly documented invoice, wrong file, etc.) must pay accepted portion within 5 business days (20 business days if surplus lines insurer).