PROMPT PAYMENT OF CLAIMS, THE UNANSWERED QUESTION: SHOULD ARTICLE 21.55 APPLY TO THE DUTY TO DEFEND

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I. APPLYING ARTICLE 21.55 TO BREACH OF DUTY TO DEFEND

Increasingly, savvy policyholders are adding Texas Insurance Code article 21.55[1] claims to their litigation arsenals. Article 21.55 imposes an 18% penalty on insurance carriers who drag their feet in paying claims beyond a statutory deadline, whether they ultimately *do* pay those claims or deny them altogether. Policyholders have found article 21.55 to be a valuable tool in holding carriers accountable for paying valid claims on time, or paying the consequences for their delay. Because of Article 21.55's rising popularity, there is an ongoing debate in Texas whether article 21.55 applies to an insured's claim for defense under a liability policy. **i.**

Federal courts applying Texas law hold that article 21.55 applies to an insured's claim for defense under a liability policy because it is a first-party claim under article 21.55. Texas state courts are divided regarding whether a claim for defense under a liability policy is a first-party claim for purposes of article 21.55. The main issue is whether an insured seeking legal defense from its insurer, under the policy, asserts a "claim" for purposes of article 21.55. The Fifth Circuit, in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, certified to the Texas Supreme Court whether article 21.55 and its statutory penalties applies to a commercial general liability insurer's breach of the duty to defend. 428 F.3d 193, 201 (5th Cir. 2005).

This article first explores how Article 21.55 works and the deadlines imposed on carriers and the penalties imposed for missing those deadlines. Next this article examines each side to the argument regarding the applicability of article 21.55 to a carrier's duty to defend under a liability policy. This article discusses the argument that article 21.55 does not apply to the request for defense on the basis that the claim is a third-party claim and is not a request for payment under the statute. The authors address various defenses that may be asserted by an insurer in response to an insured's action for damages under article 21.55 of the Texas Insurance Code based on the insurer's breach of the duty to defend under a third-party liability policy. Finally, this article explores the argument that article 21.55 applies to a request for defense because it is a first-party claim for purposes of the statute.

A. How Article 21.55 Works

Article 21.55 of the Texas Insurance Code was enacted by the Texas Legislature in 1991 for the purpose of obtaining prompt payment of claims made pursuant to policies of insurance. TEX. INS. CODE ANN. art. 21.55 (Vernon Supp. 2004-2005). Article 21.55 imposes strict deadlines on carriers for (a) notifying policyholders of the carrier's coverage position; and (b) paying viable claims. Carriers who miss these deadlines face penalties prescribed by the statute.

1. Deadlines

a. Notice of Claim

A carrier has **15 days** from receiving notice of a claim to do three things: (a) acknowledge receipt of the claim in writing; (b) begin investigation; and (c) request all documents from the policyholder necessary to secure final proof of loss. *See* TEX. INS. CODE ANN. art. 21.55 § 2(a). A telephone call from the insurer to the policyholder will not satisfy the insurer's obligation under this provision, as the statute expressly requires notice in writing. *See Daugherty v. American Motorists Ins. Co.*, 974 S.W.2d 796, 799 (Tex. App.—Houston [1st Dist.] 1998, no writ) (insurer's telephone call to insured who made claim for stolen vehicle notifying insured of amount of loss will not satisfy requirement of Article 21.55 § 2(a)).

b. Accept or Deny Claim

As a general rule, within **15 days** from receiving all necessary documents from the policyholder, the carrier must inform the policyholder in writing of its acceptance or rejection of the claim. If the carrier rejects the claim, the written notice must state the reason the claim was rejected. *See* TEX. INS. CODE ANN. art. 21.55 § 3.

c. Extension of Deadline When Carrier Needs More Time to Investigate

The exception to the general rule stated above is when the carrier needs more time to determine whether to accept or reject a claim. To get an extension of time to investigate the claim, the carrier must inform the policyholder in writing, *within the 15-day deadline imposed by article 21.55,* that it needs additional time. The written notice must state the *reason(s)* why the carrier needs additional time. TEX. INS. CODE ANN. art. 21.55 § 3(d). This notice gives a carrier an **additional 45 days** from the date of the notice in which to accept or deny a claim. No further extensions are available under the statute.

d. Deadline to Pay Valid Claim

[1] Codified as Texas Insurance Code § 542.051-.061 (West 2006) during the 78th Legislative session. Chapter 542 did not become effective until April 1, 2005. The authors will refer to *Texas Insurance Code* § 542.051-.061 as article 21.55.

If a carrier notifies an insured that it will pay a claim (or part of a claim), it must pay the claim within **5 days** after giving that notice. TEX. INS. CODE ANN. art. 21.55 § 4. If payment is conditioned upon some action by the insured, the carrier must pay within 5 days of the insured's performance of the required action. *Id.* The statute does not identify the types of actions a carrier may require of an insured as conditions to payment.

A carrier who initially notifies its insured that it will pay a claim may *withdraw* that notice if it subsequently learns facts that would justify denial of the claim. *See Daugherty*, 974 S.W.2d at 799 (insurer withdraws "notice of payment" after learning facts indicating that auto theft claim not covered). A carrier who timely withdraws its notice of payment under these circumstances can effectively stop the 5-day deadline of article 21.55 from running. *See id.*

2. Penalties

If a carrier delays payment of a valid claim for more than **60 days** after receiving all necessary documents from the insured, it is liable for penalties under the statute. This 60-day period is a default provision; if another statute requires payment of a certain type of claim within a shorter time period, that provision governs for purposes of Article 21.55). TEX. INS. CODE ANN. art. 21.55 § 4. A carrier who delays payment past this deadline must pay, in addition to the claim, **a penalty of 18.% per annum** of the amount of the claim **plus attorney's fees**. TEX. INS. CODE ANN. art. 21.55 § 6.

The 18% per annum penalty is simple interest, not compounded annually. *See Cater v. United Servs. Auto. Ass'n*, 27 S.W.3d 81, 83-84 (Tex. App.–San Antonio 2000, pet. denied). The interest calculation begins on the sixtieth day after the carrier (1) receives all necessary documents from the insured or (2) acknowledges its obligation to pay, and runs until the date of judgment. *See American National Property and Casualty Co. v. Patty*, No. 05-00-01171-CV, 2001 WL 914990, at *4 (Tex. App.–Dallas, August 15, 2001, no pet. h.). Courts have calculated the 18% penalty by using the following formula: "i = p r t," where "i" is interest, "p" equals the principal, "r" equals the rate of interest, and "t" equals the time over which the interest is to be calculated. *See Texas Farmers Ins. Co. v. Cameron*, 24 S.W.3d 386, 400 (Tex. App.–Dallas 2000, pet. denied). Because the penalty is punitive in nature, prejudgment interest may not be assessed on article 21.55's 18% per annum penalty. *See Cameron*, 24 S.W.3d at 398; *Dunn v. Southern Farm Bureau Cas. Ins. Co.*, 991 S.W.2d 467, 479 (Tex. App.–Tyler 1999, pet. denied); *but see Bekins Moving & Storage Co. v. Williams*, 947 S.W.2d 568, 584 (Tex. App.–Texarkana 1997, no writ).

II. ARTICLE 21.55 DOES NOT APPLY TO THE DUTY TO DEFEND

A. Plain Language of Article 21.55 Includes Only First-Party Claims

When a statute is clear and unambiguous, courts need not resort to rules of construction or extrinsic aids to construe it, but should give the statute its common meaning and should determine the Legislature's intent based on the plain and common meaning of the words used. *See St. Luke's Episcopal Hosp. v. Agbor*, 952 S.W.2d 503, 505 (Tex.1997) (citing *Bridgestone/Firestone, Inc. v. Glyn-Jones*, 878 S.W.2d 132, 133 (Tex.1994); *One 1985 Chevrolet v. State*, 852 S.W.2d 932, 935 (Tex.1993)).

Article 21.55 defines "claim" 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. art. 21.55, § 1(3) (Vernon Supp. 2004-2005) (emphasis added).

First-party insurance requires the insurer to perform its **duty to indemnify** directly to the insured for the insured's direct loss. *See* ERIC MILLS HOLMES & MARK S. RHODES, APPLEMAN ON INSURANCE 2d § 3.2 (1st ed. 1996). All insurance other than liability can be classified as first-party insurance. *See id.* Commentators explain:

> The classic example of first-party insurance is property insurance. In first-party property insurance, the damage to the insured's property (say, e.g., your house or your airplane) is an *immediate, direct diminution of the insured's assets*. The insurance proceeds are then paid by the first-party insurer directly to the insured to redress ("indemnify") the insured's actual, direct loss.

Id.

Conversely, third-party insurance requires that the insurer perform its duty to indemnify not directly to the insured but directly, on the insured's behalf, to a third-party claimant injured by the insured's conduct. *See id.* § 3.3. In contrast to first-party insurance, third-party insurance involves payment of proceeds for the insured's ***indirect*** loss:

> [I]f an insured negligently injures a person not in privity of the insurance contract, that third party has a claim usually in tort against the insured. The third party's claim is not a contract claim under the liability insurance contract. But if the third party reduces its claim to a judgment (or a settlement between

> the insured, insurer and third party), the insured will suffer a loss. ***However, the insured's loss is "indirect" and the third party's loss is "direct." The liability insurer reimburses ("indemnifies") its insured for the insured's indirect loss, but payment in practical effect runs directly to the third-party claimant.*** The liability insurer essentially reimburses its insured for any liability it may have to the third party by paying the third party on the insured's behalf and benefit. The insured is only a conduit for transferring the insurance proceeds from the liability insurer to the third party.

Id. (emphasis added).

Article 21.55's definition is clear: "claim" means a first-party claim made by the insured; that is, a claim for which the insurer has the duty to pay (indemnify) the insured for the insured's direct loss to the insured's insurable interest under the terms of the policy. TEX. INS. CODE ANN. art. 21.55, § 1(3); APPLEMAN ON INSURANCE 2d §§ 3.2, 3.3. Accordingly, the insurer's first argument that article 21.55 does not apply to a claim for defense is that the plain language of article 21.55 expressly limits the statute's applicability to first-party claims. Thus, no liability exists under article 21.55 for an insurer's breach of the duty to defend under a third-party liability policy.

B. Plain Language of Article 21.55 Requires Payment Directly to the Insured, Thus Precluding Statute's Applicability to the Duty to Defend

As stated above, under article 21.55, a "claim" is a first-party claim that "**must be paid by the insurer directly to the insured or beneficiary**." TEX. INS. CODE ANN. art. 21.55, § 1(3) (emphasis added). Generally, when the insurer provides a defense under its duty to defend under a third-party liability policy, the money is paid directly to the persons providing the legal services, not directly to the insured. Consequently, under its plain language, article 21.55 is not applicable to a breach of the duty to defend under a third-party liability policy.

C. Article 21.55 Requires a "Claim" for Which the Insurer May Be Liable Under the Policy

Article 21.55 damages are recoverable only for the insurer's failure to timely pay any "claim" for which the insurer might be liable under the policy. TEX. INS. CODE ANN. art. 21.55, § 6. In interpreting article 21.55, courts may look to its statutory predecessor, article 3.62 of the Texas Insurance Code. *See Higginbotham v. State Farm Mut. Auto. Ins. Co.*, 103 F.3d 456, 461 (5th Cir. 1997). Under former article 3.62, the **type of loss** controlled the applicability of that provision. *See Cantu v. Western Fire & Cas. Ins. Co., Ltd.*, 716 S.W.2d 737, 741 (Tex. App.–Corpus Christi 1986), writ ref'd n.r.e., 723 S.W.2d 668 (Tex. 1987) (concluding that nature of article 3.62 is death, disability or injury to persons, not damage to property, thus, suit to recover property damage not a "loss" anticipated or covered by provision); *see also National Educators Life Ins. Co. v. Morgan*, 295 S.W.2d 713, 717 (Tex. Civ. App.–Amarillo 1956, writ ref'd n.r.e.) (emphasizing "loss" was $983.50, representing hospitalization expenses insured under policy at issue).

Whether an insured has suffered a "loss" under a policy contemplates a determination of indemnity. Under a liability policy, an insurer agrees to pay for losses to third parties–hence, an indirect loss to the insured. *See* APPLEMAN ON INSURANCE 2d § 3.3. Article 21.55 applies only to first-party claims, that is, those claims for which the insurer has assumed the risk of loss to the insured's own insurable interest, whether that be medical bills, loss of life, or property damage. Losses to those interests are direct losses to the insured. Conversely, an insured's "claim" for breach of the duty to defend does not constitute a "loss" based on a first-party claim. Rather, the insured's claim is based on defense costs resulting from a third-party suit. It is only the third party's damages that constitute a "loss" for which the insurer owes the duty to indemnify. Stated differently, an insured's request for a defense is not a "loss" for which an insurer would be liable for **coverage** under the express terms of the policy.

For example, under a commercial general liability policy, coverage is provided for "bodily injury" or "property damage" caused by an "occurrence," as well as "personal injury" and "advertising injury." An insured's own breach of contract "damages" in the form of reasonable attorneys' fees or settlements paid are neither "bodily injury" or "property damage" caused by an "occurrence," nor are they "personal injury" or "advertising injury," as defined under standard general liability policies and as interpreted under Texas law. Consequently, damages for breach of the duty to defend under a third-party general liability insurance contract are not a "first-party" loss within coverage under the policy. Because defense costs are not a covered "loss" under the policy, they do not constitute a "claim" for which the insurer would be liable to pay, as required under article 21.55.

D. Inherent Features of Article 21.55 Preclude Its Applicability to the Duty to Defend

Several features of article 21.55 demonstrate that this statute is inapplicable to a claim for breach of the duty to defend under a third-party liability policy. First, article 21.55 provides that if the insurer is unable to accept or reject the claim within 15 business days after the date the insurer receives all items, statements, and

forms, the insurer may receive up to an additional 45 days to accept or reject the claim. TEX. INS. CODE ANN. art. 21.55, § 3(d), (e). Thus, assuming *arguendo* that article 21.55 does apply to the duty to defend, the insurer would have **15 business days plus an additional 45 days** to determine whether it will provide a defense. Such a scenario is simply unworkable given that a defendant must file its answer by 10:00 a.m. on the Monday next after the expiration of **20 days** from the date the defendant is served. *See* TEX. R. CIV. P. 99(b). Such a scenario would often result in a default judgment being entered against the insured during the time the insurer is investigating whether to accept or reject the claim for a defense.

Second, the plain language of article 21.55 requires an insurer to either **accept or reject** a claim no later than the 15th business day after the date the insurer receives all items, statements, and forms required by the insurer. TEX. INS. CODE ANN. art. 21.55, § 3(a). However, the insurer, when presented with a claim for a defense, often does not outright accept or reject the claim, but instead provides a defense under a reservation of rights. Under this scenario, the insurer who provides a defense subject to a reservation of rights would be in violation of article 21.55 because it would not have accepted or rejected the claim.

The fact that the application of article 21.55 to claims for a defense under a third-party liability policy creates conflicts in the law and unworkable scenarios further supports the insurer's argument that the Legislature did not intend for article 21.55 to apply to such claims.

E. Legislative Scheme Supports Argument That Article 21.55 Does Not Apply to Third-Party Liability Policies

Article 21.55 was enacted in 1991 as part of an insurance reform package known as the Omnibus Insurance Reform Act. 72d Leg., R.S., ch. 242, § 11.03(a), 1991 Tex. Gen. Laws 939, 1043. Article 21.56 was enacted as part of this same insurance reform package. TEX. INS. CODE ANN. art. 21.56 (Vernon Supp. 2004-2005). While article 21.55 applies to first-party claims, article 21.56 applies to third-party casualty insurance policies and establishes deadlines for an insurer to notify the insured in writing of an initial offer to compromise or settle a claim against the insured and of any settlement of a claim against the insured. TEX. INS. CODE ANN. art. 21.55, § 1(3); art. 21.56(a)-(c).

The plain language of these statutes evidences the Legislature's intent to enact companion statutes that would provide greater protection to insureds – one statute (article 21.55) to govern first-party claims, and one statute (article 21.56) to govern third-party claims. This legislative scheme supports the insurer's argument that article 21.55 applies only to a first-party claim and not to a claim for defense costs under a third-party liability policy.

F. The Texas Department of Insurance Does Not Require Notice of Prompt Payment of Claims for General Liability Policies

The Texas Administrative Code title on insurance, as promulgated by the Texas Department of Insurance (TDI), provides guidance on the proper interpretation of "claim" under article 21.55. The Texas Administrative Code defines "claim" as a "request or demand reduced to writing and filed by a Texas resident with an insurer for payment of funds or the providing of services under the terms of a policy, certificate, or binder of insurance." 28 TEX. ADMIN. CODE § 21.202(2). "First-party coverage" is defined as "[b]enefits and other rights provided by an insurance contract **to an insured**," while "third-party coverage" is defined as "[b]enefits and other rights provided by an insurance contract **to any person other than the insured**." *Id.* § 21.202(5), (8) (emphasis added). Thus, under the TDI's definition, a first-party claim includes only benefits and rights provided to the insured.

Further, the TDI has promulgated requirements for property and casualty forms that includes a Summary of Statutory Requirements for Form Filings, listing lines of insurance and the statutory requirements for each policy form. *See* TEXAS DEPARTMENT OF INSURANCE PROPERTY & CASUALTY FILINGS MADE EASY MANUAL (12-05 ed.), *available at* http://www.tdi.state.tx.us/company/documents/pccpfme1a.doc. The TDI expressly indicates that an article 21.55 notice of prompt payment of claims provision is **not** required for general liability policies; commercial multi-peril policies; fidelity, surety and guaranty bonds; medical professional liability policies; miscellaneous professional liability policies; personal casualty policies; and mortgage guaranty policies. *See id.* Because the TDI is the administrative agency charged with interpreting the Texas Insurance Code, its promulgation concerning article 21.55 provides authority concerning the Legislature's intent that article 21.55 not apply to third-party general liability policies.

G. The Texas Supreme Court Distinguishes First-Party and Third-Party Claims

The Texas Supreme Court had the opportunity in *Northern County Mutual Insurance Co. v. Davalos*, 140 S.W.3d 685 (Tex. 2004), to determine whether or not article 21.55 applies to an insurer who fails to promptly accept of reject its insured's defense. In *Davalos,* the parties disputed whether article 21.55 applies only to first party claims and whether the request for defense is only a third party claim and not within article 21.55. *Id.* at 690. The court held that the insurer did not violate

article 21.55 and subsequently declined to determine whether or not article 21.55 applied to an insurer's decision to accept or reject its insured's defense. *Id*. at 691.

Although the Texas Supreme Court has not specifically answered this issue of whether article 21.55 applies to an insured's claim for defense costs under a third-party policy, it has issued two opinions that are instructive on the issue. In *Maryland Ins. Co. v. Head Indus. Coatings & Servs. Inc*., 938 S.W.2d 27 (Tex. 1996), the supreme court addressed whether a claim for attorneys' fees under a liability policy was a first-party or third-party claim. The *Head* court held that the claim was a third-party claim. In reaching this holding, the supreme court considered whether the breach of the duty to defend a third-party liability claim also constituted a breach of the duty of good faith and fair dealing to investigate and defend the insured against claims by third parties. *Id*. The court held that no duty of good faith and fair dealing exists in the context of third-party liability policies. *Id*. at 28-29. Thus, the court also held that the breach of the duty to defend is not a first-party claim. *See id*.

Further, the supreme court's definition of "first-party claim" in *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 53 (Tex. 1997), is predictive of the court's definition of "first-party claim" as used in article 21.55. The *Giles* court explained that a "first-party claim is one in which an insured seeks recovery for the insured's *own loss*." *Id*. at 53 n.2 (emphasis added). Although *Giles* does not involve issues relative to article 21.55, it does involve a policy of first-party insurance. *See id*. (explaining that bad-faith tort only available in "first-party context"). Accordingly, *Giles* provides guidance concerning the Texas Supreme Court's interpretation of "claim" as used in article 21.55, and supports the insurer's assertion that article 21.55's definition of "claim" is a first party claim made by the insured; that is, a claim for which the insurer has the duty to pay (indemnify) the insured for the insured's direct loss to the insured's insurable interest under the terms of the policy.

1. State Farm Fire & Casualty Company v. Gandy

Insureds often cite the Texas Supreme Court's opinion in *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996) as support for their argument that article 21.55 applies to third-party liability policies. However, *Gandy* contains no holding to that effect.

Gandy sued her uncle, Pearce, for abusing her as a child. Pearce's insurer, State Farm, agreed to defend Pearce against Gandy's claims. Without State Farm's knowledge, and before a trial on the merits, Pearce agreed to a judgment of $6,000,000 in Gandy's favor. Pearce then assigned his claims against State Farm to Gandy, in exchange for Gandy's promise not to enforce the judgment against Pearce himself. Gandy then sued State Farm to collect the $6,000,000 judgment she obtained against Pearce.

The Texas Supreme Court denounced the "sweetheart deal" assignment at issue in *Gandy*, in part because the merits of Gandy's claims against Pearce were never tested through litigation. However, the Court quickly added that not <u>all</u> assignments of an insured's claims against its insurer violate public policy. *See Gandy*, 925 S.W.2d at 714.

The language relied on by insureds states:

> Disputes between *I* and *D* can often be expeditiously resolved in an action for declaratory judgment while *P's* claim is pending. If successful, *D* should be entitled to recover attorney fees. TEX. CIV. PRAC. & REM. CODE § 37.009; TEX. INS. CODE art. 21.55 § 6. *D* <u>*may*</u> also be entitled to recover a penalty against *I* equal to eighteen percent of the claim. TEX. INS. CODE art. 21.55 § 6.

Gandy, 925 S.W.2d at 714 (emphasis added).

None of the issues facing the *Gandy* court included whether, under a third-party liability policy, an insured may assert a first-party claim for defense costs, out of which a violation of article 21.55 could arise. In fact, no breach of the duty to defend was even alleged in *Gandy*. Rather, the *Gandy* court considered whether the insured's prejudgment assignment of claims against a liability insurer violated public policy and was invalid. *See id*. at 707-11. Consequently, the above language is merely dicta. Dictum, which includes expressions of opinion on a point or issue not necessarily involved in the case, will not create binding precedent under stare decisis. *Lester v. First Am. Bank, Bryan, Texas*, 866 S.W.2d 361, 363 (Tex. App.–Waco 1993, writ denied) (citing *Boswell v. Pannell*, 107 Tex. 433, 180 S.W. 593, 597 (1915); *Grisgby v. Reib*, 105 Tex. 597, 153 S.W. 1124, 1126 (1913)).

Currently pending before the Texas Supreme Court, as certified by the Fifth Circuit, is the issue of whether the remedies under article 21.55 are available to an insured when its insurer refuses a request for defense. *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 428 F.3d 193, 201 (5th Cir. 2005). Several Texas courts of appeal have held that the "Prompt Pay Statute" only applies to first-party claims. *See Service Lloyd's Insurance Co. v. J.C. Wink, Inc.*, 182 S.W.3d 19 (Tex. App.–San Antonio 2005, pet. pending); *TIG Ins. Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232 (Tex. App.–Dallas 2004, pet. denied).

H. Texas Appellate Courts Stand Divided

1. Hartman v. St. Paul Fire & Marine Insurance Company

The first case to actually address the applicability of article 21.55 in the context of the duty to defend under a third-party liability policy was *Hartman v. St. Paul Fire & Marine Ins. Co.*, 55 F. Supp. 2d 600 (N.D. Tex. 1998). In this case, Hartman sought the 18% penalty and attorneys' fees for St. Paul's alleged violation of article 21.55 through its alleged untimely payment of a judgment against it, after mandate issued by the Fifth Circuit. *Id.* at 602. The judgment involved the trial court's finding that St. Paul owed coverage for claims brought in a lawsuit filed against Hartman by a former employee, and the Fifth Circuit's affirmance of that finding and the jury's finding of the amount of $333,000 and reasonable attorneys' fees incurred by Hartman in handling his defense. *Id.*

St. Paul contended that article 21.55 was inapplicable, asserting many of the arguments set forth in this paper, including that (1) Hartman's claim was not a first-party claim, but rather a third-party claim under general liability policies, thereby making 21.55 inapplicable because St. Paul agreed to indemnify Hartman only for amounts he became legally obligated to pay as damages to third parties; (2) the Texas Department of Insurance maintains that a notice of prompt payment of claims is not a statutory requirement for general liability policies, *i.e.*, article 21.55 does not apply; and (3) because the relationship of the parties at the time of the alleged "untimeliness" was no longer that of insured, but that of judgment creditor/judgment debtor, article 21.55 was not available to Hartman because he was not making a first-party claim against his insurer pursuant to a policy of insurance, but instead sought a penalty for his judgment debtor's purported tardiness in paying adjudicated contract damages. *Id.* at 603-04.

The *Hartman* court stated that it found all these arguments persuasive, thereby providing support for the insurer's position that article 21.55 does not apply to a claim for defense costs under a third-party liability policy. *Id.* at 604. Ultimately, however, the court based its conclusion that article 21.55 afforded no relief to Hartman on its determination that Hartman was not presenting a "claim" for acceptance or rejection as contemplated by article 21.55, but instead an action pursuant to his execution of an adjudicated right. *Id.* The court further emphasized that, even assuming *arguendo* that Hartman presented St. Paul with the type of claim contemplated by article 21.55, St. Paul complied with article 21.55 by tendering a defense subject to a reservation of rights. *Id.*

2. TIG Insurance Co. v. Dallas Basketball, Ltd.

The Dallas Court of Appeals is the first appellate court to definitively hold that article 21.55 does not apply to an insured's request for defense. In *TIG Insurance Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232, 240 (Tex. App.–Dallas 2004, pet.denied), the Dallas Court of Appeals held that the interest penalty in Article 21.55 of the Texas Insurance Code does not apply to an insurer's wrongful failure to defend its insured. The Dallas Mavericks contended that TIG violated article 21.55 when it refused the request for defense. TIG defended that article 21.55 does not apply to claims for defense, but applies only to first-party claims for payment to an insured or beneficiary. *Id*. at 239.

The court determined that a request for a defense under a liability policy is not a "claim" for payment and noted the statute is entitled "Prompt Payment of Claims." *Id*. "It is a demand that the insurance company provide a legal defense to the insured as required by the policy. The insurance company is not required to send a payment to the insured, prompt or otherwise, in response to a claim for a defense." *Id*. The court held that when an insurer provides a defense for its insured, the insurer "controls the defense and pays the attorneys' fees associated with the case to the attorney engaged to represent the insured." *Id*.

The court characterized a claim for defense costs as a common law claim for damages, rather than as a claim under the policy. *Id*. at 240 (citing *Hartman v. St. Paul Fire & Marine Ins. Co.*, 55 F. Supp. 2d 600, 604 (N.D. Tex. 1998)). The court stated its conclusion that:

> a claim for a defense is not a "claim" to which article 21.55 was intended to apply is further supported by the fact that both the statute's deadlines and its consequences for failing to meet those deadlines presume that the insured's claim is one for compensation for a covered loss rather than for a defense.

Id. The court noted that the statutory penalties of article 21.55 do not have any meaning when applied to claims for a defense.

In holding that the penalty does not apply to an insurer's defense duty, the court held that article 21.55 applies only to claims that trigger an insurer's duty under the policy to pay the insured. The court noted that its holding is contrary to that of other Texas appellate court and federal court decisions.[2]

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[2]*See Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202 (S.D. Tex. 2003); *Primrose Operating Co. v. Nat'l Am. Ins. Co.*, 2003 WL 21662829 (N.D. Tex. 2003); *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F.Supp.2d 601 (E.D. Tex. 2003); *Mt.*

3. Service Lloyd's Insurance Co. v. J.C. Wink, Inc.

In *Service Lloyd's Insurance Co. v. J.C. Wink, Inc.*, the San Antonio Court of Appeals determined whether an insurer owed a duty to defend to its insured and whether the insurer was subject to penalties and attorneys' fees under article 21.55. 182 S.W.3d 19 (Tex. App.–San Antonio 2005, pet. pending). The appellate court concluded that article 21.55 does not apply to a duty to defend. *Id*. at 31. The *Wink* court followed the reasoning of the Dallas Court of Appeals in *Dallas Basketball* that a request for a defense is not a first-party claim for money to be paid directly to the insured. *Id*. (citing *TIG Insurance Co. v. Dallas Basketball, Ltd.*, 129 S.W.3d 232, 239 (Tex. App.–Dallas 2004, pet.denied)). Therefore, article 21.55 does not apply to claims for a defense. The court reasoned that:

> the entire structure of article 21.55 presumes a tangible, measurable loss suffered by the insured for which he seeks payment from the insurance company. Any attempt to apply the statute's structure to a claim for a defense is unworkable and, based on the language of the statute, clearly unintended by the legislature.

Id. (quoting *Dallas Basketball, Ltd.*, 129 S.W.3d at 239)).

The *Wink* court then considered the argument that, due to the insurer's refusal to provide a defense, the insured is forced to pay for their own legal representation and their claim for reimbursement of the defense costs is a first-party claim to be paid directly to them. *Id*. The *Wink* court agreed that this is merely a common law claim for breach of contract damages. The court held that an insured's claim for defense costs is not a first-party claim as that term is used in article 21.55. *Id*. at 32.

III. ARTICLE 21.55 SHOULD APPLY TO A CARRIER'S DUTY TO DEFEND AN INSURED UNDER A LIABILITY INSURANCE POLICY

As previously discussed, by its own terms, Article 21.55 only applies to "first party claims." *See* TEX. INS. CODE ANN. art. 21.55 § 1(3). For that reason, carriers routinely contend that the statute does not apply to "third-party insurance," such as a liability policy. However, a determination must be made whether a liability policy is, as carriers contend, "third-party insurance"—or whether liability policies encompass first party claims and are therefore both "third-party insurance" and "first-party insurance."

A closer look at liability insurance reveals that it imposes two distinct types of coverage: defense and indemnity. A carrier's duty to indemnify is clearly third-party coverage, as it is payable from the insurer to a third party—i.e., a judgment creditor or settling claimant. In contrast, a claim for defense is arguably a first-party claim because it is often paid by the insurer directly to the insured, or it is paid to lawyers thereby benefitting the insured. This argument that article 21.55 applies to a carrier's duty to defend is based on the language of the statute itself, as well as on recent case authorities applying Texas law.

A. Plain Language of Article 21.55 Includes a Claim for Defense

In determining whether article 21.55 should apply to a carrier's duty to defend, the statute itself is the place to start. If the statute's own language determines its applicability to a given situation, it is improper to look to extrinsic evidence. As the Texas Supreme Court has observed, "[t]he resolution of an issue of statutory construction must begin with an analysis of the statute." *Cail v. Serv. Motors, Inc.*, 660 S.W.2d 814, 815 (Tex. 1983). Moreover, "[i]f the meaning of the statute is clear and unambiguous, extrinsic aids and rules of construction are inappropriate." *Id.*; *see also Minton v. Frank*, 545 S.W.2d 442, 445 (Tex. 1976) ("Where the intent is apparent from the words of the statute, it is not necessary for this Court to make an analysis of the extrinsic evidence of legislative intent").

B. Liability Insurance Is Not Excluded from Article's Scope

Policyholders can viably argue that the plain language of article 21.55 indicates that it **is** applicable to a claim for defense under a liability insurance policy. First, Section 5 of article 21.55 identifies certain types of policies that are excepted from the article's application. *See* TEX. INS. CODE ANN. art. 21.55 § 5. The standard commercial general liability policy is not listed among the exceptions. *See id.* As the Texas Supreme Court has observed, "'It is a familiar rule of statutory construction that an exception makes plain the intent that the statute should apply in all cases not excepted.'" *Insurance Co. of N. Am. v. Morris*, 981 S.W.2d 667, 681 (Tex. 1998) (quoting *State v. Richards*, 301 S.W.2d 597, 600 (Tex. 1957). Because liability insurance is not listed as an exception to the statute, policyholders may argue, article 21.55's plain intent is to apply to liability insurance. *See id*.

Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc., 215 F.Supp.2d 783 (E.D. Tex. 2002); *E & R Rubalcava Constr., Inc. v. Burlington Ins. Co.*, 148 F.Supp.2d 746 (N.D. Tex. 2001); *N. County Mut. Ins. Co. v. Davalos*, 84 S.W.3d 314 (Tex. App.–Corpus Christi 2002, pet. granted).

C. Term "Insurer" Implicitly Encompasses Liability Carriers

The definition of the term "Insurer" in article 21.55 would also encompass carriers that issue liability insurance policies. *See* TEX. INS. CODE ANN. art. 21.55 § 1(4). Many, if not all, of the types of insurers listed issue liability insurance policies, and are therefore within the scope of the statute's applicability.

D. Term "Claim" Arguably Applies to Insured's Claim for Defense

Moreover, article 21.55 defines the term "Claim" as "a first party claim made by an insured or a policyholder under an insurance policy . . . ***that must be paid by the insurer directly to the insured or beneficiary***." *See* TEX. INS. CODE ANN. art. 21.55 § 1(3) (emphasis added). As noted above, liability insurance imposes two primary obligations on an insurer: a duty to indemnify and a duty to defend. In contrast to a claim for indemnity, a claim for defense is arguably a first-party claim because, as article 21.55 clarifies, it is "paid by the insurer directly to the insured or beneficiary." *Id.* A claim for defense may therefore be considered a "Claim" within the scope of Article 21.55.

As discussed earlier, carriers respond to this reading of the statute by noting that it requires a payment "directly" to the insured or beneficiary. *See* TEX. INS. CODE ANN. art. 21.55 § 1(3). Because carriers often pay defense costs directly to defense counsel rather than to the insured itself, carriers may argue, a claim for defense does not meet this statutory definition of "Claim." Policyholders may offer four arguments in response. First, they may argue that this is an overly restrictive, mechanical reading of the statute—especially since the statute is to be "liberally construed," as discussed below. Although money may not actually pass from the carrier's hand to the insured's, the payment directly *benefits* the insured and not a third party, distinguishing a claim for defense from a third-party claim. Surely, the legislative intent behind the requirement of a "direct" payment was to distinguish claims **by an insured**, who has a contractual relationship with the insurer to be held accountable, from claims by a third party who is a stranger to the contract. A claim for defense is clearly a "first-party claim" in this regard.

A second, related argument is that there is no meaningful distinction between payment directly to an insured and payment to an insured's attorney for the insured's benefit. The result is the same regardless of whether defense costs are paid directly to defense counsel, or are rather paid directly to the insured who then passes them on to defense counsel.

Third, the actual policy benefit at issue is the **defense** of a lawsuit, not payment of defense **costs**. Regardless of whether fees are paid directly to the insured or its attorneys, the **insured** receives the defense. Thus, the policy benefit of a defense is paid directly to the insured, regardless of how defense costs are routed for payment.

Finally, policyholders may argue that the definition of "Claim" also encompasses payment "by the insurer directly to the . . . beneficiary." *See id.* The term "beneficiary" is not defined in the statute, even though the statute does contain a list of definitions. *See* TEX. INS. CODE ANN. art. 21.55 § 1. Terms not defined in insurance policies are construed according to their plain and ordinary meanings. The ordinary meaning of the term "beneficiary" is simply "one who benefits from the act of another." *See* BLACK'S LAW DICTIONARY 157 (6th ed. 1990). The defense counsel to whom the defense costs are directly paid is arguably a "beneficiary" within that broad definition, particularly given a liberal construction of the statute.

1. Statute to Be Liberally Construed

Finally, article 21.55 provides, "This article shall be liberally construed to promote its underlying purpose which is to obtain prompt payment of claims made pursuant to policies of insurance." *See* TEX. INS. CODE ANN. art. 21.55 § 8. Policyholders may argue that the statute's "underlying purpose" applies to the "prompt payment of claims" for defense costs, no less than to other types of claims.

In addition to the language of the statute itself, six recent opinions shed some light on whether article 21.55 should apply to a carrier's duty to defend.

E. Texas Courts Applying Article 21.55 to the Duty to Defend

Several federal district courts have recently held that article 21.55 does apply to claims for a defense. *See Rx.com, Inc. v. Hartford Fire Ins. Co.*, 364 F. Supp. 2d 609 (S.D. Tex. 2005); *Housing Authority of City of Dallas v. Northland Ins. Co.*, 333 F. Supp. 2d 595 (N.D. Tex. 2004). Other cases applying Texas law have touched on, to a greater or lesser degree, the issue of whether article 21.55 should apply to a claim for defense under a liability policy. *See E & R Rubalcava Constr., Inc. v. Burlington Ins. Co.*,148 F. Supp. 2d 746, 750 (N.D. Tex 2001); *Sentry Ins. Co. v. Greenleaf Software, Inc.*, 91 F. Supp. 2d 920 (N.D. Tex. 2000), *vacated* 2000 WL 33254495 (N.D. Tex. April 18, 2000); *Hartman v. St. Paul Fire & Marine Ins. Co.*, 55 F. Supp. 2d 600 (N.D. Tex. 1998); *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996). An examination of these cases provides insight into how the Texas Supreme Court should resolve this issue as certified by the Fifth Circuit in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 428 F.3d 193, 201 (5th Cir. 2005).

1. State Farm Fire & Casualty Company v. Gandy

As previously discussed, the *Gandy* opinion is about whether, and under what circumstances, an insured defendant can assign its claims against its insurer to a tort plaintiff in exchange for a release of personal liability. It is not about article 21.55. Nonetheless, the *Gandy* opinion alludes to article 21.55 in a context that is relevant to the present issue.

The language relied on by insureds states:

> Disputes between *I* and *D* can often be expeditiously resolved in an action for declaratory judgment while *P's* claim is pending. If successful, *D* should be entitled to recover attorney fees. TEX. CIV. PRAC. & REM. CODE § 37.009; TEX. INS. CODE art. 21.55 § 6. *D* may also be entitled to recover a penalty against *I* equal to eighteen percent of the claim. TEX. INS. CODE art. 21.55 § 6.

Gandy, 925 S.W.2d at 714 (emphasis added). As article 21.55 was not even at issue in *Gandy*, this quote is clearly dicta. Nonetheless, it indicates the Texas Supreme Court's opinion that an insured who prevails on a duty to defend claim **would** be entitled to the statutory penalty imposed by article 21.55. Thus, the *Gandy* opinion offers at least **some** support for the contention that article 21.55 should apply to a claim for defense under a liability policy.

2. Sentry Insurance Company v. Greenleaf Software, Inc. and E & R Rubalcava Construction, Inc. v. Burlington Insurance Company

The first case to directly address, and rule upon, the issue of whether article 21.55 applies to a claim for defense under a liability policy was decided on March 25, 2000. *Sentry Ins. Co. v. Greenleaf Software, Inc.*, 91 F. Supp. 2d 920 (N.D. Tex. 2000), *vacated* 2000 WL 33254495 (N.D. Tex. April 18, 2000). Although the Court subsequently vacated the *Sentry* opinion pursuant to a Joint Motion to Vacate, this article examines the opinion, as an insured seeking to recover under article 21.55 for defense costs may still gain insight from the *Sentry* court's analysis.

Underlying the *Sentry* opinion was a dispute over rights to computer software. Greenleaf allegedly violated certain intellectual property rights of a competitor, Frontline. Frontline sued Greenleaf, who sought coverage from its liability carrier, Sentry. Greenleaf submitted a demand for reimbursement of defense costs to Sentry, along with supporting invoices. Sentry refused to defend Greenleaf in the Frontline suit, which led to the coverage litigation at issue in the *Sentry* opinion.

Sentry argued that a claim for defense is not a first party claim within the ambit of article 21.55. In unusually strong language, the court rejected Sentry's argument:

> Sentry suggests that Greenleaf's letter of May 17, 1999 [i.e., the demand for payment of defense costs] was not a first party claim. This is a ludicrous statement. Greenleaf is the insured party. It did not submit this claim for reimbursement "for its health." Greenleaf clearly intended for Sentry to come to its aid and defend this lawsuit. Sentry failed to do so. Consequently, Greenleaf submitted its claim for reimbursement. Clearly this is a first party claim.

Sentry, 91 F. Supp. 2d at 925. Based on this rationale, the Court held Sentry liable to Greenleaf for the 18 percent penalty imposed by article 21.55. *See id.*

The Northern District of Texas again ruled that a liability carrier's wrongful denial of its duty to defend is subject to the penalty imposed by article 21.55 in *E & R Rubalcava Constr., Inc. v. Burlington Ins. Co.*, 148 F. Supp. 2d 746, 750 (N.D. Tex 2001). There, homeowners sued general contractors for defective homes. The general contractors then asserted third-party claims against Rubalcava, the subcontractor that provided foundations for the homes at issue. Rubalcava tendered the defense of these claims to its general liability insurer, Burlington, which denied coverage.

Rubalcava then sued Burlington on several theories, including breach of the duty to defend and the consequent violation of article 21.55. Upon concluding that Burlington had violated its duty to defend, the court addressed Rubalcava's article 21.55 claim. The court concluded:

> Here, Burlington has refused to pay defense costs for which it is liable to Rubalcava. The amount of such costs is not before the Court and presumably will be presented to the factfinder. ***This claim is now a first party claim and the statutory penalty under Art. 21.55 will apply to such sums.***

Id. (citing *Sentry*, 91 F. Supp. 2d at 920) (emphasis added).

After issuing the *Rubalcava* opinion, the Northern District Court acknowledged in a Supplemental Order that the *Sentry* decision, which the Court had cited in *Rubalcava*, was later vacated. *Id.* at 750-51. Nonetheless, the Court advised that it remained of the view that *Rubalcava* involved a first party claim subject to article 21.55. *Id.*

3. Housing Authority of the City of Dallas v. Northland Insurance Co.

The Northern District of Texas in *Housing Authority of the City of Dallas v. Northland Insurance Co.*, 333 F. Supp. 2d 595 (N.D. Tex. 2004), held that an insured's demand for defense under its liability policy was a first-party claim within the meaning of article 21.55. The Dallas Housing Authority alleged Northland's refusal to pay its defense costs constituted a violation of article 21.55. *Id*. at 602. Northland argued that article 21.55 only applied to first-party claims and that a demand for defense is a third-party claim.

The federal court noted that the Texas Supreme Court has yet to determine this issue and instead relied on the language of *Gandy* which alludes that when disputes regarding coverage and the duty to defend arise between an insured and an insurer that the insured may be entitled to recover a penalty against the insurer equal to 18% of the claim pursuant to article 21.55. *Id*. The court noted that the Texas Supreme Court's decision not to reverse the appellate court decision in *Northern County Mutual Insurance Co. v. Davalos*, 83 S.W.3d 314 (Tex. App.–Corpus Christi 2002), *rev'd on other grounds*, 140 S.W.3d 685 (Tex. 2004), and the dicta of *Gandy* demonstrate the Supreme Court of Texas's belief that article 21.55 is applicable to defense claims. *Housing Authority of the City of Dallas*, 333 F. Supp. 2d at 603. The Northern District of Texas court concluded that "the Texas Supreme Court would likely decide that claims for defense are first party claims for purposes of Article 21.55." *Id*.

The court in *Housing Authority* concluded that the insurer's failure to pay defense costs was a first-party claim and subject to the statutory penalties under article 21.55. *Id*.

4. Meritage Corporation v. Clarendon National Insurance Co.

In *Meritage Corporation v. Clarendon National Insurance Co.*, 2004 WL 2254215, *5 (N.D. Tex. 2004), the federal court addressed whether the insurer's failure to defend claims asserted against its insured was a violation of article 21.55 and subject to penalties. The court recognized that, although not unanimous on the subject, most federal district courts in Texas have concluded that a "claim for the duty to defend is a first party claim asserted against [the insurer] under Article 21.55 of the Texas Insurance Code, and the statutory penalty will apply to such [claims]." *Id*. (citations omitted). The court noted several Texas federal court decisions which held that article 21.55's statutory penalties apply to claims made by an insured against a liability insurer for defense costs.

Clarendon argued Meritage failed to state a viable cause of action under article 21.55. The court reasoned as follows:

> When Clarendon failed to defend the Underlying Claims, Meritage spent its own funds and submitted its claim for reimbursement. As a result, Meritage's claims for defense costs under its liability policy should be viewed as a first party claim. Second, Clarendon suggests that to the extent Meritage sought a defense from Clarendon for the Underlying Claims, the claims did not seek payment by the insurer directly to the insured as required by Article 21.55. *Id.* Because Clarendon failed to pay for Meritage's defense, however, Clarendon is now obligated to pay the cost of that defense directly to Meritage. It follows that Meritage's claim is a first party claim falling under the provisions of Article 21.55.

Id. at *6. The court reasoned it was inclined to follow the great weight of federal authority that article 21.55 applies to duty to defend claims. The court agreed that this type of claim–a duty to defend claim–fits within the definition of a first party claim for purposes of article 21.55.

5. Rx.com Inc. v. Hartford Fire Insurance Co.

In *Rx.com v. Hartford Fire Insurance*, a prescription retailer brought action against its liability insurer, alleging breach of duty to defend. 364 F. Supp. 2d 609 (S.D. Tex. 2005). Rx.com argued that article 21.55 applied when an insured tenders a lawsuit to its insurer for a defense. Hartford argued that article 21.55 applies only to first-party claims not to the duty to defend an insured against a third-party lawsuit. *Id*. at 611. The court noted that several Texas state courts and federal court, interpreting Texas law, have addressed this issue and differ in their answers.

Rx.com relied on *Gandy* and *Davalos* to support its argument that article 21.55 applies to an insured's claim for defense. *Id*. at 612. The court noted that Texas federal district courts have consistently agreed that article 21.55 applies to an insured's claim for a defense. "In the last five years alone, over ten federal court decisions have held, with varying levels of analysis, that article 21.55 applies to claims such as Rx.com's allegation that its CGL insurer breached the duty to defend." *Id*.

After a thorough examination of both sides of the argument, the federal district court in *Rx.com* held that the duty to defend is a first party claim for purposes of article 21.55. *Id.* at 617. Further, in response to Rx.com's argument that defense fees are not paid "directly to the insurer" as required by article 21.55, the court held that article 21.55's requirement that claims be paid directly to the insured only means that the statute applies to first-party claims, not third party claims. *Id.* at

618. Because the right to a defense is a first-party right, article 21.55 applies. *Id.*

In response to the insurer's last argument that article 21.55 is unworkable as applied to claims for defense, the court noted "Courts that have applied article 21.55 to insurers who refuse to pay defense costs have not encountered difficulty with "workability." *Id.* at 619. The federal district court in *Rx.com* concluded that "the Texas Supreme Court would apply article 21.55 to an insured's demand for a defense".

6. Nautilus Insurance Co. v. International House of Pancakes, Inc.

In *Nautilus Insurance Co. v. International House of Pancakes, Inc.*, 2006 WL 148900 (S.D. Tex. Jan. 18, 2006), the court determined whether an insured's demand for defense of a third-party suit is subject to article 21.55's statutory penalties. *Id*. at *1. The Southern District of Texas abstained from making its decision regarding article 21.55 because of the Fifth Circuit's certified question to the Texas Supreme Court in *Lamar Homes* of that very issue.

IV. CONCLUSION

This paper explored Texas appellate court decisions and federal court decisions applying Texas law interpreting whether article 21.55 applies to an insurer's duty to defend. As it stands, the majority of courts hold article 21.55 applies to an insurer's duty to defend. Most of these courts are federal district courts that are simply predicting how they believe the Texas Supreme Court would decide the issue. While the Texas Supreme Court has dodged the issue in the past, the Fifth Circuit's certification in *Lamar Homes* will force the court to finally speak on this issue.