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Insurance Law

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I. INTRODUCTION

During the last Survey period, the Texas Supreme Court issued *USAA Texas Lloyds Co. v. Menchaca*, which was a significant opinion addressing extra-contractual claims against insurers under Chapter 541 of the Texas Insurance Code.[1] The supreme court set forth five rules applicable to claims brought under Chapter 541.[2] During this Survey period, several opinions were issued by Texas appellate and federal courts applying the *Menchaca* rules. Below the authors discuss several examples showing how courts have applied these rules. Also of significance are several cases involving application of the "eight-corners" rule in determining the duty to defend, and whether or to what extent exceptions to the eight-corners rule should apply.

II. DUTY TO DEFEND

Whether an insurer is obligated to provide a defense to its insured is a question of law to be decided by the courts.[3] In Texas, the insurer's duty to defend is determined based on a review of the four corners of the

1. USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 484 (Tex. 2018).
2. *Id.*
3. *See* Myers v. Hall Columbus Lender, LLC, 437 S.W.3d 632, 637–38 (Tex. App.—Dallas 2014, no pet.) (citing Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., 279 S.W.3d 650, 655 (Tex. 2009)).

insurance policy and the four corners of the pleading against the insured.[4] Generally, only these "eight corners" of these two documents are relevant to the determination of the insurer's obligation to defend its insured.[5] While this rule is relatively simple, its simplicity can present challenges for courts when applying the eight-corners rule. A strict application of the rule in some circumstances could yield a result inconsistent with the intent of the parties to the insurance contract. Also, application of this simple rule can be difficult when allegations in the pleading lack sufficient specificity to determine whether the claim falls within the coverage afforded by the policy. As a result, Texas courts have struggled with whether the eight-corners rule should be subject to any exceptions. While the Texas Supreme Court has never officially recognized that an extrinsic-evidence exception exists,[6] the U.S. Court of Appeals for the Fifth Circuit has recognized that a narrow exception exists.[7] Accordingly, until the Texas Supreme Court squarely addresses this issue, there will remain uncertainty among Texas state courts as to whether, or to what extent, any exception exists that would permit a court to look to extrinsic evidence to resolve the question of an insurer's duty to defend.

A. Federal Court Relies on Extrinsic Evidence About Dates of Construction in Concluding That Duty to Defend is Precluded by a "Prior Injury Or Damage Exclusion"

In *Evanston Insurance Co. v. Kinsale Insurance Co.*, the U.S. District Court for the Southern District of Texas determined that reliance on extrinsic evidence as to the date "property damage" occurred was permissible because the pleading was silent as to the date of any property damage and the date of property damage was determinative as to coverage under the applicable policy.[8] In the underlying lawsuit, a general contractor sued a school district for non-payment, prompting the school district to file counterclaims against the contractor for defective construction work by it and its subcontractors. The contractor then asserted claims against its subcontractors, alleging property damage due to defective work.[9] One of the subcontractors was insured under commercial general liability insurance policies issued by both Evanston Insurance Company (Evanston) and Kinsale Insurance Company (Kinsale), covering different policy

4. GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church, 197 S.W.3d 305, 308 (Tex. 2006) (citing King v. Dallas Fire Ins. Co., 85 S.W.3d 185, 187 (Tex. 2002)).

5. *See Pine Oak*, 279 S.W.3d at 655.

6. *See GuideOne Elite*, 197 S.W.3d at 308 ("[T]his Court has never expressly recognized an exception to the eight-corners rule . . . .").

7. *See* Ooida Risk Retention Grp., Inc. v. Williams, 579 F.3d 469, 476 (5th Cir. 2009); *see also* Star-Tex Res., LLC v. Granite State Ins. Co., 553 F. App'x 366, 371 (5th Cir. 2014) (per curiam) ("We conclude that there is a limited exception to the eight-corners rule that, under the circumstances of this appeal, allows us to consider extrinsic evidence.").

8. Evanston Ins. Co. v. Kinsale Ins. Co., No. 7:17-CV-327, 2018 WL 4103031, at *11 (S.D. Tex. Jul. 12, 2018).

9. *Id.* at *1.

periods.[10]

Kinsale's policies included a "Prior Injury or Damage Exclusion" provision that barred coverage for damage "which begins or takes place before the inception date of [the] policy. . . ."[11] Although both insurers initially provided a defense to the subcontractor, Kinsale subsequently denied coverage and withdrew its defense, contending that it did not owe a duty to defend because the property damage first began prior to the inception of its policies. Evanston challenged Kinsale's position and filed a declaratory judgment action in federal court.[12]

Kinsale's policies provided coverage for the policy period beginning August 6, 2013, and ending August 6, 2014.[13] The underlying lawsuit was filed on March 18, 2016. The school district's counterclaim against the general contractor specifically alleged that construction for one project began on April 26, 2011, and continued through September 24, 2012, and that construction on the other project began on May 19, 2009, and continued through March 9, 2011.[14] However, the general contractor's claim against the subcontractor insured by Kinsale was silent as to the dates of any alleged property damage.[15] Despite the absence of any allegations regarding the dates of property damage in the pleading against the subcontractor, Kinsale nevertheless concluded that evidence of damage beginning prior to the inception of its policy precluded a duty to defend based on its "Prior Injury or Damage Exclusion" clause.

Because the claim by the general contractor against Kinsale's insured was silent as to when the alleged property damage occurred,[16] Kinsale urged the district court to consider the allegations in the underlying counterclaim by the school district against the general contractor.[17] Conversely, Evanston argued that Kinsale had a duty to defend because the allegations in the pleading against the insured subcontractor did "not specifically rule out the possibility of a [potentially covered] claim . . . ."[18] The district court noted that, under Evanston's reasoning, the fact that a pleading "does not specifically rule out the possibility of a claim then that means there is a potential claim."[19] In rejecting this reasoning, the district court explained that "[w]hile a potential claim gives rise to a duty to defend, courts may not 'read facts into the pleadings,' and '[a] duty to defend should not be allowed to spring into existence based on artful or inartful pleading.'"[20] The district court concluded that accepting Evans-

10. *Id.* at *1–2.
11. *Id.* at *2.
12. *Id.*
13. *Id.*
14. *Id.* at *1.
15. *Id.*
16. *Id.* at *10.
17. *Id.* at *9.
18. *Id.* at *10.
19. *Id.*
20. *Id.* (citing Weingarten Realty Mgmt. Co. v. Liberty Mut. Fire Ins. Co., 343 S.W.3d 859, 869 (Tex. App.—Houston [14th Dist.] 2011, pet. denied)).

ton's argument "would undermine the Court's driving aim which is to give effect to the intention in the underlying insurance policy."[21] The district court found that Evanston had not met its burden to "plead and prove" that there was coverage under the Kinsale policies that would trigger its duty to defend.

The district court justified its reliance on the school district's pleading against the general contractor (which was evidence extrinsic to the eight corners of the insurance policy and pleading against the subcontractor) because that document provided the "relevant factual background" of the claims at issue in the lawsuit, which was necessary to understand whether those claims would implicate coverage for the subcontractor.[22] This was a circumstance that warranted application of an extrinsic-evidence exception, as "[t]he alleged date of construction goes solely to a fundamental issue of coverage and does not implicate the merits or depend on the truth of the facts alleged."[23] Based on the allegations in the counterclaim, the district court determined that Kinsale did not owe a duty to defend its insured.[24]

This case is illustrative of the fact that federal courts have embraced exceptions to the eight-corners rule in certain circumstances, while Texas state appellate courts appear to still be reluctant to recognize the existence of any exceptions to the rule. For example, in *Gehan Homes, Ltd. v. Employers Mutual Casualty Co.* and *Summit Custom Homes, Inc. v. Great American Lloyds Insurance Co.*, the Dallas Court of Appeals held that if a pleading is silent as to the date of loss, the insurer is obligated to defend unless other bases exist to deny coverage.[25] In *Gehan*, the court specifically noted that it could not "look outside the pleadings to determine when the injury manifested itself" in determining whether coverage was potentially triggered under an insuring agreement.[26] By contrast, the federal court in *Evanston* relied on extrinsic evidence in determining whether the exclusion in Kinsale's policy relieved Kinsale of a duty to defend in order to "give effect to the intention in the underlying insurance policy."[27]

B. State Court Declines to Consider Extrinsic Evidence That a Vehicle was Operated by an Excluded Driver in Evaluating the Duty to Defend

In *Avalos v. Loya Insurance Co.*, the San Antonio Court of Appeals evaluated whether deposition testimony of an insured that directly con-

21. *Id.* at *11.
22. *Id.*
23. *Id.*
24. *Id.*
25. Gehan Homes, Ltd. v. Emp'rs Mut. Cas. Co., 146 S.W.3d 833, 845 (Tex. App.—Dallas 2004, pet. denied); Summit Custom Homes, Inc. v. Great Am. Lloyds Ins. Co., 202 S.W.3d 823, 828 (Tex. App.—Dallas 2006, pet. withdrawn).
26. *Gehan Homes, Ltd.*, 146 S.W.3d at 845–46.
27. *Evanston Ins. Co.*, 2018 WL 4103031, at *11.

tradicted the allegations in the pleading was relevant to the duty-to-defend analysis.[28] Significantly, the insured's deposition testimony directly contradicted the specific allegations in the pleading in the liability lawsuit as to the identity of the driver of the vehicle at issue.[29]

Karla Flores Guevara (Guevara) was insured under an auto policy issued by Loya Insurance Company (Loya). Guevara was the only named insured on the policy. The policy included a named driver exclusion identifying Guevara's husband, Rodolfo Flores, as an excluded driver. A collision occurred between an automobile operated by Flores and an automobile occupied by Osbaldo Hurtado Avalos and Antonio Hurtado (the Hurtados). Although Flores was the driver at fault, Guevara, Flores, and the Hurtados reported to the police and Loya after the accident that Guevara, rather than Flores, was driving the vehicle that collided with the Hurtados.[30]

The Hurtados sued Guevara, alleging that her negligence caused the accident. Loya appointed defense counsel to defend Guevara. Guevara identified herself as the driver during initial stages of discovery. However, Loya thereafter discovered that Flores was actually driving the vehicle at the time of the accident and subsequently denied coverage and withdrew from defending Guevara. A judgment was ultimately rendered against Guevara. The Hurtados, as assignees of Guevara, then filed suit against Loya and alleged that Loya breached its duty to defend Guevara.[31] Loya counterclaimed for breach of contract, fraud, and a declaration that it had no duty to defend Guevara because of the policy's named driver exclusion. Loya moved for summary judgment and, in support of its motion, provided Guevara's deposition testimony in the coverage lawsuit against Loya in which Guevara admitted that Flores was driving the car at the time of the accident.[32] The trial court granted Loya's motion for summary judgment.

On appeal, the Hurtados contended that summary judgment was improper because the trial court failed to evaluate Loya's duty to defend pursuant to the eight-corners rule.[33] In response, Loya argued that reference to the deposition testimony established that Guevara materially breached the policy by falsely reporting that she was the driver. As such, this precluded a duty to defend. The court rejected this argument, explaining that under the general eight-corners rule, the only documents relevant to the determination of the duty to defend are the insurance policy and the pleadings.[34] Moreover, facts that contradict the pleading or that are discovered during the course of litigation do not affect the duty

28. Avalos v. Loya Ins. Co., No. 04-17-00070-CV, 2018 WL 3551260, at *5 (Tex. App.—San Antonio Jul. 25, 2018, pet. filed) (mem. op.).
29. *Id.* at *2.
30. *Id.* at *1.
31. *Id.*
32. *Id.* at *2.
33. *Id.*
34. *Id.* at *4.

to defend.[35] Similarly, facts that overlap with liability issues are generally not considered. Because the Hurtados' petition contained no allegations that Flores was the negligent driver of the vehicle, the court found that this was not a situation where evaluation of the deposition testimony to determine the duty to defend was proper.[36] Rather, the court found that the deposition testimony contradicted the allegations in the pleading and overlapped with the liability issues.[37] Moreover, the court found that if Loya knew that the allegations in the pleading were untrue, it had a duty to establish such facts in defense of its insured, as that is a valuable bargained-for benefit of the insurance policy.[38]

Interestingly, one justice issued a concurring opinion where she pointed out that while the Texas Supreme Court has never recognized an exception to the eight-corners rule, "it indicated that an exception may be appropriate where collusion or fraud exists."[39] In noting that the summary judgment evidence established fraud and collusion between the Hurtados, Guevara, and Flores, the concurring justice opined that this should be a situation where extrinsic evidence should be allowed to determine the duty to defend.[40] However, she concurred in the judgment "[b]ecause the supreme court has not yet recognized an exception to the eight-corners rule."[41]

Because the pleading against Guevara specifically alleged that Guevara was driving the vehicle, it appears that the court of appeals correctly applied the eight-corners rule. However, this is an example of when a strict application of the rule can "bind insurance companies to defend claims that are clearly outside of the *bounds* of their policy."[42] In *Evanston*, discussed above, the court noted that such a rule undermines the driving aim of giving effect to the intention of the policy.[43] Moreover, in *Avalos*, the strict application of the eight corners-rule appears to have allowed the plaintiffs and the insured to impose an obligation on the insurer through a deliberate misrepresentation of the actual facts in the underlying pleading. Such an inequitable result could be avoided by a reasonable exception to the eight-corners rule.

35. *Id.* (citing Zurich Am. Ins. Co. v. Nokia, Inc., 268 S.W.3d 487, 491 (Tex. 2008)).
36. *Id.* at *5.
37. *Id.*
38. *Id.*
39. *Id.* at *6 (Angelini, J., concurring).
40. *See id.* at *6–7.
41. *Id.* at *7.
42. Evanston Ins. Co. v. Kinsale Ins. Co., No. 7:17-CV-327, 2018 WL 4103031, at *11 (S.D. Tex. Jul. 12, 2018) (emphasis added).
43. *Id.*

C. Fifth Circuit Holds Duty to Defend Owed to an Additional Insured Based on Inferences Drawn From Pleading and Policy

In *Lyda Swinerton Builders, Inc. v. Oklahoma Surety Co.*, the U.S. Court of Appeals for the Fifth Circuit evaluated whether a general contractor was entitled to defense as an additional insured under a commercial general liability policy.[44] Lyda Swinerton Builders, Inc. (Lyda), the general contractor, hired subcontractor Willis Company, Inc. (Willis) to assist in the construction of an office building. The subcontract agreement between Lyda and Willis required Willis to maintain a general liability insurance policy designating Lyda as an additional insured.[45]

In the underlying lawsuit, the plaintiff asserted claims against Lyda for breach of contract due to alleged delays in construction and material deficiencies.[46] The plaintiff alleged that Lyda was responsible for numerous construction defects, including deficiencies in "the roof" and structures on or near the roof. However, in its original petition, the plaintiff did not name Willis as a defendant, did not include any allegations that Willis was responsible for any of the construction defects, and did not identify Willis as the roofing contractor.[47]

Oklahoma Surety Company (Oklahoma Surety) issued Willis a commercial general liability insurance policy identifying Willis as a "COMMERCIAL ROOFING CONTRACTOR."[48] The policy included an endorsement naming Lyda as an additional insured, "but only with respect to liability directly attributable to [Willis'] performance of '[Willis'] work' for [Lyda]."[49] Moreover, coverage for Lyda applied only if Willis had agreed in a "written 'insured contract' to designate [Lyda] as an additional insured."[50] The policy defined "insured contract" to include "'[t]hat part of any other contract or agreement pertaining to [Willis'] business . . . under which [Willis] assume[s] the tort liability of another party . . . .'"[51] Lyda requested a defense and an indemnity from Oklahoma Surety as an "additional insured" under the policy issued to Willis. Oklahoma Surety denied that request.[52]

1. The "Written Insured Contract" Requirement

The first part of the Fifth Circuit's additional-insured analysis was whether Willis had agreed in a "written 'insured contract'" to name Lyda as an additional insured.[53] Oklahoma Surety made two arguments that

44. Lyda Swinerton Builders, Inc. v. Okla. Sur. Co., 903 F.3d 435, 445 (5th Cir. 2018).
45. *Id.* at 440.
46. *Id.* at 442.
47. *Id.* at 442–43.
48. *Id.* at 441.
49. *Id.*
50. *Id.*
51. *Id.* at 441–42.
52. *Id.* at 443.
53. *Id.* at 445.

this "written 'insured contract'" requirement was not met. First, Oklahoma Surety argued that there was no written contract because the subcontract between Willis and Lyda was never signed by Willis.[54] Second, Oklahoma Surety argued that the agreement between Willis and Lyda did not constitute an "insured contract" as defined in the policy.

Regarding the requirement that the agreement be "written," the Fifth Circuit rejected Oklahoma Surety's argument, noting that the policy language did not require all parties to sign the subcontract, just that the parties "agree" in a written contract that one of the parties is added as an additional insured.[55] Moreover, the term "written," according to the Fifth Circuit, did not impose any requirement that all parties sign the written agreement.[56]

Oklahoma Surety's second argument was that the subcontract did not constitute a "written '*insured contract*.'" Under the policy, to constitute an "insured contract," the contract required Willis to assume the tort liability of Lyda. The subcontract included an indemnification provision which, in part, stated: "TO THE FULLEST EXTENT PERMITTED BY LAW, SUBCONTRACTOR AGREES TO DEFEND, HOLD HARMLESS AND UNCONDITIONALLY INDEMNIFY CONTRACTOR AND OWNER . . . ."[57] Willis executed and returned the subcontract to Lyda with handwritten amendments, striking the portion of the provision which stated Willis would indemnify Lyda for "ANY NEGLIGENT ACT OR OMMISSION OR CLAIM INVOLVING STRICT LIABILITY OR NEGLIGENCE PER SE OF CONTRACTOR OR OWNER [and their employees]."[58]

Oklahoma Surety argued that Willis' handwritten changes to the indemnity provision eliminated Willis' obligation to indemnity Lyda, thus disqualifying the contract as an "insured" contract. However, the Fifth Circuit disagreed.[59] The Fifth Circuit concluded that "additional insured" status depended not upon whether Willis actually "assume[d] the tort liability of another party" in an enforceable indemnity agreement, but rather on whether Willis "*agreed*" to assume that tort liability in the subcontract.[60] Thus, even though the language stricken by the handwritten notes arguably made the indemnity provision unenforceable, the court found that the subcontract "still state[d] that Willis agree[d] to 'unconditionally indemnify' [Lyda] 'to the fullest extent permitted by law' for 'all liability' that [Lyda] incurs for damages 'in any manner arising out of or resulting from [Willis'] performance or failure to perform' under the subcontract."[61] Accordingly, the Fifth Circuit found that the subcontract was

54. *Id.*
55. *Id.* at 445–46.
56. *Id.* at 445.
57. *Id.* at 440.
58. *Id.* at 441 (strikethrough omitted).
59. *Id.* at 446.
60. *Id.*
61. *Id.*

a "written 'insured contract'" as required by the additional insured provision.[62]

2. Liability Attributable to Willis' Work Requirement

Next, the court evaluated whether the allegations in the underlying litigation implicated the scope of coverage under the additional insured provision.[63] The additional insured coverage applied under Willis' policy only "'with respect to liability [Lyda has] directly attributable' to Willis' performance of its work for [Lyda]."[64] Restricting its analysis of this issue to the eight corners, the court noted that Willis was identified in the declarations pages of the policy as a "COMMERCIAL ROOFING CONTRACTOR."[65] While Willis was not specifically identified in the original petition, the court explained:

> The original petition alleged that [Lyda] was responsible for numerous "material deficiencies" affecting various portions of the project, including "the roof" and structures on or near the roof. In addition, the [original] petition alleged that [Lyda] failed to "adequately supervise work performed by subcontractors; to supply sufficient skilled workers and suitable materials necessary to complete the [w]ork in accordance with the contract documents; [and] to take adequate protective measures to prevent damage to the [w]ork resulting from exposure to the elements." . . . . Reading the original petition liberally, and resolving any doubts in [Lyda's] favor, there was at least a *potential* that [the underlying] suit fell within the policy's scope of coverage. That was sufficient to trigger [Oklahoma Surety's] duty to defend under the eight-corners rule. And since [the] amended petitions contained *more* factual detail than the original petition, [Oklahoma Surety] had a duty to defend [Lyda] against them as well.[66]

Because the pleading contained allegations that Lyda and its subcontractors caused property damage, including damage to the roof, and the policy identified Willis as a commercial roofing contractor, the Fifth Circuit inferred that the allegations in the pleading of defects in the roof potentially referred to Willis' work.[67] As a result, the Fifth Circuit found that the additional insured coverage was triggered for purposes of the duty to defend.[68]

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62. *Id.*
63. *Id.*
64. *Id.* at 447.
65. *Id.*
66. *Id.* (emphasis in original).
67. *Id.* at 448.
68. *Id.*

D. Federal District Court Holds Tender of Limits in Exchange for Covenant Not to Execute Against Insured's Assets Terminates Insurer's Duty to Defend Obligation

In *Aggreko, LLC v. Chartis Specialty Insurance Co.*, the U.S. District Court for the Eastern District of Texas evaluated whether an insurer's duty to defend terminated upon tender of its limits in exchange for a covenant not to execute against its insured's assets by the underlying plaintiffs.[69] In the underlying case, an employee of Guichard Operating Company (Guichard) died after being "electrocuted when his arm [ ] touched an electrically-energized generator housing cabinet at a well site" in Texas.[70] In January 2015, suit was filed against multiple entities, including Aggreko, LLC (Aggreko), who manufactured the generator housing cabinet. Aggreko sought coverage for the lawsuit as an additional insured under the liability policy that Gray Insurance Company (Gray) issued to Guichard. The policy issued by Gray had limits of $1,000,000 per occurrence and stated that Gray's "'right and duty to defend ends when [it has] used up the applicable limit of insurance in the payment of judgments or settlements . . . .'"[71] Gray accepted coverage and agreed to provide Aggreko with an unqualified defense in the underlying lawsuit.

In February 2017, Gray reached an agreement with the plaintiffs from the underlying suit titled "Covenant Not To Execute Agreement" (the Covenant).[72] Pursuant to the Covenant, Gray paid the underlying plaintiffs $950,000 for their agreement to provide Aggreko with a covenant not to execute on any judgment obtained by the underlying plaintiffs. The Covenant stated, in relevant part, that the underlying plaintiffs

> "jointly and severally, promise[d], agree[d,] and covenant[ed] that they shall not seek to and will not execute on any Judgment obtained in their favor against Aggreko in the [underlying lawsuit] save and except to the extent they can recover the Judgment from any insurance company which provides coverage to Aggreko." The Covenant . . . further state[d] that the [underlying plaintiffs] "promise[d], agree[d,] and covenant[ed] that they [would] enforce any and all such Judgment against the available insurance only, and not against the assets of Aggreko or its respective present or former directors, officers, employees, parent companies."[73]

Thereafter, Gray notified Aggreko that it was withdrawing its defense in the underlying lawsuit filed by the decedent's estate against Aggreko. Aggreko's primary insurer, Indian Harbor Insurance Company (Indian Harbor), sued Gray, asserting, in part, that Gray had an ongoing duty to defend Aggreko in the underlying lawsuit. Gray argued it had no further

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69. Aggreko, LLC v. Chartis Specialty Ins. Co., No. 1:16-CV-297, 2018 WL 4050498, at *5 (E.D. Tex. Mar. 7, 2018).
70. *Id.* at *1.
71. *Id.* (alteration in original).
72. *Id.* at *2.
73. *Id.*

duties to Aggreko because Gray's policy limits exhausted from the agreements with and payment of a total of $1,000,000[74] to the underlying plaintiffs.[75]

After determining that the Covenant and Gray's policy should be construed by Texas law, the district court examined whether the Covenant constituted a full release or settlement.[76] While the Gray policy did not define the term "settlement," it did define the term "agreed settlement" as a "settlement and release of liability, signed by [Gray], the insured, and the claimant or the claimant's legal representative."[77] Gray argued that the Covenant insulated Aggreko's assets from any risk of judgment by the decedent's estate. Relying on U.S. Court of Appeals for the Fifth Circuit[78] and state court[79] precedent, the district court explained that "although the [decedent's estate] cannot enforce any judgment directly against Aggreko's assets, [the estate] can still assert claims and obtain a judgment against Aggreko, looking for recovery only from any insurance carriers that provide coverage to Aggreko."[80] Nevertheless, the district court found that the Covenant "is sufficient to exhaust Gray's duty to defend, despite the fact that not every claim against Aggreko has been terminated."[81] To support this finding, the district court explained that the critical question was not whether all potential claims against Aggreko were extinguished, but instead whether the decedent estate's claims against Aggreko's assets have been fully resolved.[82] The district court noted that the underlying plaintiffs can only execute any judgment obtained against Aggreko by looking to Aggreko's other insurance policies, if any.[83] Thus, the district court concluded that "by paying its policy limits and obtaining a covenant not to execute in favor of its insured, an insurer can fulfill its duty to defend and indemnify without securing a release or terminating all pending or potential claims against the insured."[84] Accordingly, the district court found that although there was no express release of Aggreko, the Covenant coupled with payment of the policy proceeds exhausted the policy's limits and extinguished any further duties owed by Gray to Aggreko.[85]

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74. *Id.* Gray also entered into a separate agreement with the underlying plaintiffs, agreeing to pay $50,000 in exchange for a full and final release of another defendant (and presumably another additional insured under Gray's policy) in the lawsuit. *Id.* at *3.

75. *Id.*

76. *Id.* at *5–6.

77. *Id.* at *11 (alteration in original).

78. *Id.* at *12 (citing Judwin Properties, Inc. v. U.S. Fire Ins. Co., 973 F.2d 432, 436 (5th Cir. 1992) (per curiam)).

79. *Id.* at *13 (citing Kings Park Apartments Ltd. v. Nat'l Union Fire Ins. Co., 101 S.W.3d 525, 533–34 (Tex. App.—Houston [1st Dist.] 2003, pet. denied)).

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.*

III. BREACH OF NOTICE CONDITION

A. Plaintiff Could Not Enforce Default Judgment Against Insured Where Insured Failed to Provide Notice to Insurer

In *United Automobile Insurance Services v. Rhymes*, the Dallas Court of Appeals evaluated whether an insurer was required to satisfy a default judgment against its insured when the insured failed to provide notice of the claim to the insurer.[86] Old American Country Mutual Fire Insurance Company (Old American) issued a personal auto policy through its managing agent United Automobile Insurance Services (UAIS), which provided coverage to Maria Hernandez (Hernandez). Alvin Rhymes (Rhymes) was involved in an automobile accident with Hernandez. Prior to the entry of the default judgment, UAIS attempted without success to contact Hernandez. During that time, Rhymes's counsel remained in communication with UAIS in efforts to settle Rhymes's claim against Hernandez. Hernandez, however, failed to contact either USAI or Old American, and neither requested a defense from UAIS nor submitted suit papers to UAIS.[87]

Six months after obtaining the default judgment, Rhymes's attorney sent a copy of the judgment to UAIS and demanded payment. Eventually, Rhymes sued UAIS and Old American to collect on his judgment against Hernandez. He asserted a breach of contract claim in his status as a third-party beneficiary of the policy. The trial court ruled that Rhymes was entitled to coverage under Hernandez's policy for the judgment.[88]

On appeal, the issue was whether "[Hernandez's] complete failure to give [Old American and UAIS] notice of Rhymes'[s] suit, coupled with the default judgment against her, defeats Rhymes'[s] claim under the policy."[89] In holding that Rhymes had no claim under the policy, the appellate court noted that an injured person generally "cannot sue the tortfeasor's liability insurer directly until the tortfeasor's liability has been determined by agreement or judgment."[90] The injured person can only sue the insurer after judgment because, "[a]s a third-party beneficiary, Rhymes therefore 'steps into the shoes' of [Hernandez] and is bound by the policy's conditions precedent."[91]

The policy required that Old American "must be notified promptly of how, when and where the accident or loss happened" and "[n]otice should also include the names and addresses of any injured persons and

86. United Auto. Ins. Servs. v. Rhymes, No. 05-16-01125-CV, 2018 WL 2077561, at *2 (Tex. App.—Dallas May 4, 2018, no pet.) (mem. op.).

87. *Id.* at *1.

88. *Id.* at *2.

89. *Id.* at *3.

90. *Id.* (citing Ohio Cas. Ins. Co. v. Time Warner Entm't Co., 244 S.W.3d 885, 888 (Tex. App.—Dallas 2008, pet. denied)).

91. *Id.* (citing Martinez v. ACCC Ins. Co., 343 S.W.3d 924, 929 (Tex. App.—Dallas 2011, no pet.)).

of any witnesses."[92] Additionally, the policy stated that if the insured's "failure to provide notice prejudices [Old American's] defense, there is no liability coverage under the policy."[93] The policy also included a provision requiring that the insured "[p]romptly send [Old American] copies of any notices or legal papers received in connection with the accident or loss."[94]

Relying on authority from the Texas Supreme Court, the court held that Old American and UAIS were entitled to summary judgment because they had conclusively proven that Hernandez did not give notice of the suit or make a request for a defense in the suit.[95] The court also found that Old American and UAIS proved as a matter of law that they were prejudiced by the default judgment.[96] The court specifically rejected Rhymes's argument that Old American and UAIS failed to show prejudice.[97] In support of that argument, Rhymes cited *PAJ, Inc. v. Hanover Insurance Co.*,[98] in which "the supreme court held that the insured's failure to timely notify the insurer of a claim or suit does not defeat coverage if the delay did not prejudice the insurer."[99] The court found that *PAJ* was inapplicable because "(i) *PAJ* involved late notice while this case involves a complete lack of notice and (ii) the parties in that case stipulated that there was no resulting prejudice."[100]

Moreover, the court rejected Rhymes's argument that notice provided by his attorney was sufficient to satisfy the notice requirement of the Hernandez policy.[101] Citing *National Union Fire Insurance Co. v. Crocker*,[102] the court held that it is "clear that the insurer's duties are triggered when the *insured* gives notice and requests a defense," but that "[n]otice given by a third party does not trigger the insurer's duty to defend and does not estop the insurer from asserting the insured's breach as a bar to liability."[103]

Thus, the court found that the notice provided by Rhymes's own counsel was "irrelevant."[104] Furthermore, the court found that "[t]he default judgment not only deprived [Old American and UAIS] of the opportu-

92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.* at *5.
96. *Id.*
97. *Id.*
98. 243 S.W.3d 630, 636–37 (Tex. 2008).
99. *Rhymes*, 2018 WL 2077561, at *5.
100. *Id.*
101. *Id.*
102. 246 S.W.3d 603, 608–09 (Tex. 2008).
103. *Rhymes*, 2018 WL 2077561, at *6 (emphasis in original) (citing *Crocker*, 246 S.W.3d at 608 ("Mere awareness of a claim or suit does not impose a duty on the insurer to defend under the policy . . . .")); *see also Crocker*, 246 S.W.3d at 608 (stating insurer does not have to "gratuitously subject[ ] itself to liability" before insured gives notice of suit); Hoel v. Old Am. County Mut. Fire Ins. Co., No. 01-16-00610-CV, 2017 WL 3911020 at *1, *3–5 (Tex. App.—Houston [1st. Dist] Sept. 7, 2017, no pet.) (mem. op.) (stating insured did not give notice of suit, even though injured party gave insurer several notices about suit)).
104. *Rhymes*, 2018 WL 2077561, at *5.

nity to litigate the claim's merits but also imposed 'a new burden of proof on new issues' in order to set the default judgment aside."[105] Thus, the court held that the default was prejudicial as a matter of law. This holding is significant in that the court found that the entry of a default judgment against an insured constitutes prejudice as a matter of law, even if the default judgment is still susceptible to being set aside. In other words, the fact that a judgment might ultimately be set aside on a motion for new trial does not eliminate the prejudice to the insurer, because the entry of the default judgment imposed "a new burden of proof on new issues" required to overturn the judgment.[106]

IV. LANDSCAPE OF EXTRA-CONTRACTUAL LIABILITY POST *MENCHACA*

As noted in the authors' article last year, insurers previously argued "that an insured is prohibited from recovering extra-contractual damages under Chapter 541 of the Texas Insurance Code (Chapter 541) absent the insured demonstrating it sustained an 'independent injury' separate and apart from the loss of the policy benefits."[107] The Texas Supreme Court rejected a "broad 'independent injury' prerequisite to bringing a claim under Chapter 541" in *USAA Texas Lloyds Co. v. Menchaca* and, "in an attempt to clarify years of what it admitt[ed] was confusing precedent, the supreme court promulgated five rules for evaluating when an insured can recover statutory extra-contractual damages from an insurer."[108] In the wake of the *Menchaca* opinion, courts have begun evaluating how those rules should be applied. The rules outlined by *Menchaca* are as follows:

> First, as a general rule, an insured cannot recover policy benefits as damages for an insurer's statutory violation if the policy does not provide the insured a right to receive those benefits. Second, an insured who establishes a right to receive benefits under the insurance policy can recover those benefits as actual damages under the Insurance Code if the insurer's statutory violation causes the loss of the benefits. Third, even if the insured cannot establish a present contractual right to policy benefits, the insured can recover benefits as actual damages under the Insurance Code if the insurer's statutory violation caused the insured to lose that contractual right. Fourth, if an insurer's statutory violation causes an injury independent of the loss of policy benefits, the insured may recover damages for that injury even if the policy does not grant the insured a right to benefits. And fifth, an insured cannot recover *any* damages based on an insurer's statutory violation if the insured had no right to receive benefits under the policy and sustained no injury independent of a right to

105. *Id.* at *6 (quoting *Hoel*, 2017 WL 3911020, at *5).

106. *See id.* at *4; *see also* Coastal Ref. & Mktg., Inc. v. U.S. Fidelity and Guar. Co., 218 S.W.3d 279, 287–88 (Tex. App.—Houston [14th Dist.] 2007, pet. denied) (discussing the prejudicial effect of a default judgment against an insured creates upon the insurer).

107. J. Price Collins et al., *Insurance Law*, 4 SMU ANN. TEX. SURV. 217, 220 (2018).

108. *Id.* (citing USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 484 (Tex. 2018)).

benefits.[109]

During the Survey period, several opinions were issued that illustrate how courts have applied the *Menchaca* rules under various factual scenarios. The authors discuss a few of these examples below.

A. Fifth Circuit Holds That Defense Costs Owed to an Additional Insured are Recoverable Under Chapter 541, Pursuant to the Entitled-to-Benefits Rule

In *Lyda Swinerton v. Oklahoma Surety Co.*, the U.S. Court of Appeals for the Fifth Circuit addressed two of the rules outlined in *Menchaca*.[110] As noted above, the case involved analysis of whether Oklahoma Surety wrongfully refused to defend Lyda as an additional insured in an underlying lawsuit. Lyda sued Oklahoma Surety for breach of contract, and also for violations of Chapter 541 of the Insurance Code. Although the district court found that Oklahoma Surety breached its contract by refusing to defend Lyda, the district court determined that Lyda was not entitled to recovery under Chapter 541 because Lyda failed to establish that it sustained an injury independent of the injuries it sought under the insurance contract.[111]

On appeal, the Fifth Circuit recognized that at the time the district court rendered its opinion the Texas Supreme Court had not yet issued its holding in *Menchaca*.[112] In light of the rules outlined in that opinion, the Fifth Circuit concluded that the "independent-injury" rule did not preclude Lyda's statutory claim under Chapter 541.[113] The Fifth Circuit recognized that the Texas supreme court had found that there are actually two aspects of the independent-injury rule:

> The first is that, if an insurer's statutory violation causes an injury independent of the insured's right to recover policy benefits, the insured may recover damages for that injury even if the policy does not entitle the insured to receive benefits . . . . The second aspect of the independent-injury rule is that an insurer's statutory violation does not permit the insured to recover *any* damages beyond policy benefits unless the violation causes an injury that is independent from the loss of the benefits.[114]

The Fifth Circuit stated that the phrase "beyond policy benefits" indicates that the "independent-injury rule does not restrict the damages an insured can recover under the entitled-to-benefits rule" but instead "limits the recovery of *other* damages that 'flow' or 'stem' from a mere denial

109. *Menchaca*, 545 S.W.3d at 489 (emphasis in original).
110. Lyda Swinerton Builders, Inc. v. Okla. Sur. Co., 903 F.3d 435, 451–52 (5th Cir. 2018).
111. *Id.* at 451, 453.
112. *Id.* at 451.
113. *Id.* at 453.
114. *Id.* at 452 (quoting *Menchaca*, 545 S.W.3d at 499–500) (emphasis in original).

of policy benefits," such as emotional distress.[115] As a result, the Fifth Circuit found that because Lyda established that it was entitled to a defense from Oklahoma Surety, the defense was a benefit owed to Lyda under the policy.[116] Thus, if Lyda was able to establish on remand that Oklahoma Surety's "alleged misrepresentations caused it to be deprived of that benefit, [Lyda] can recover the resulting defense costs it incurred as actual damages under Chapter 541—without limitation from the independent-injury rule. Furthermore, if [Lyda] proves that [Oklahoma Surety] committed the statutory violation 'knowingly,' it may recover treble that amount."[117]

In short, the Fifth Circuit found that if Lyda can show that Oklahoma Surety committed a violation of Chapter 541 in refusing to provide a defense to Lyda, the damages resulting from that breach can be recoverable under Chapter 541.[118] Significantly, the mere breach of the contractual duty to defend is not sufficient to constitute a violation of Chapter 541.[119] Accordingly, the Fifth Circuit remanded the case to the district court for further proceedings in order to determine whether Oklahoma Surety violated Chapter 541 by refusing to defend Lyda.[120]

B. Texas Appellate Court Holds That Bona Fide Coverage Dispute Does Not Provide Basis For Extra-Contractual Damages

In *State Farm Lloyds v. Webb*, the Beaumont Court of Appeals evaluated whether the evidence presented by an insured was sufficient to support a finding that the insurer violated Chapter 541.[121] The matter involved a coverage dispute between State Farm Lloyds (State Farm) and its insured David Webb (Webb) over the scope and amount of covered damages resulting from a plumbing leak at Webb's home.[122] The jury found that State Farm breached the contract and knowingly violated Chapter 541. The jury awarded Webb contract damages of $15,000. Separately, the jury awarded $20,000 in actual damages for violations of Chapter 541 and $60,000 in additional damages based on their finding that State Farm's statutory violations were committed knowingly.[123] The jury found that State Farm (1) failed to settle the claim once liability had become reasonably clear; and (2) failed to conduct a reasonable investigation.[124]

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115. *Id.* (quoting *Menchaca*, 545 S.W.3d at 500) (emphasis in original).
116. *Id.* at 453.
117. *Id.* (noting that the Texas Insurance Code "provides for the trebling of 'actual damages' if the insurer 'knowingly committed the act complained of' ").
118. *Id.*
119. *Id.*
120. *Id.*
121. *See* State Farm Lloyds v. Webb, No. 09-15-00408-CV, 2017 WL 1739763, at *1 (Tex. App.—Beaumont May 4, 2017, pet. denied) (mem. op.).
122. *Id.*
123. *Id.*
124. *Id.*

On appeal, State Farm argued that the evidence was legally and factually insufficient to support the jury's findings that State Farm had committed an insurance code violation. The appellate court agreed with State Farm.[125] Beginning its analysis, the court noted:

> In determining whether the insurer had a reasonable basis to deny a claim, we review the facts available to the insurer at the time of the denial. Evidence that merely shows a bona fide dispute about the insurer's liability on the contract does not rise to the level of bad faith. Thus, a disagreement among experts concerning whether the cause of the loss is covered by the policy will not support a judgment for bad faith.[126]

Guided by the above principles, the court declined to find that State Farm acted in bad faith when its denial of Webb's claim was grounded upon reasonable reliance on its expert's report.[127] The court reasoned that disagreement among the experts on their findings coupled with the fact that liability on Webb's claim was unclear, provided a reasonable basis for State Farm to deny the claim. Accordingly, the court concluded that neither a bona fide dispute about State Farm's liability on the contract nor evidence that it was incorrect about the factual basis for its denial of the claim can be evidence of bad faith.[128]

Therefore, with respect to the $15,000 that the jury determined represented the benefits Webb was due under the policy, the court determined State Farm's failure to pay those benefits was not the result of an insurance code violation, even if it constituted a breach of contract.[129] In other words, Webb was not entitled to recovery under the entitled-to-benefits rule of *Menchaca*. Therefore, in order for the jury's $20,000 award to stand, these damages would have to be recoverable under the independent-injury rule. However, Webb "failed to produce evidence of an injury independent of the denial of insurance policy benefits."[130] Accordingly, the court held that the evidence was legally insufficient to support the jury's award of damages under Chapter 541.[131]

C. Fifth Circuit Holds That Insured's Claim Under the *Menchaca* Independent Injury Rule Could Not Include Damages That Stem From Policy Benefits

In *Moore v. Allstate Texas Lloyds*, Glen Moore (Moore) sued Allstate Texas Lloyds (Allstate) for breach of contract and violations of the Insurance Code.[132] The district court found "that [the insured] failed to plead

125. *Id.* at *9.
126. *Id.* at *8.
127. *Id.* at *9.
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.* at *10.
132. Moore v. Allstate Tex. Lloyds, 742 F. App'x 815, 817 (5th Cir. 2018) (per curiam).

sufficient facts to state a viable breach of contract claim," and dismissed that claim.[133] Additionally, the district court dismissed the insured's "extra-contractual claims, stating '[t]here can be no recovery for extra-contractual damages for mishandling claims unless the complained of acts or omissions caused an injury independent of those that would have resulted from a wrongful denial of policy benefits.' "[134]

On appeal, the U.S. Court of Appeals for the Fifth Circuit affirmed the district court's dismissal of the breach of contract claim. With respect to the dismissal of his extra-contractual claims, Moore argued that he had pleaded sufficient facts to state violations of the insurance code. He further argued that, under *Menchaca*, he was entitled to recovery if "violations cause an injury that is independent from breach of contract . . . even if the [contract] does not provide benefits."[135]

The court recognized that Moore was relying on the fourth rule (i.e., the independent-injury rule) from *Menchaca*: " 'if an insurer's statutory violation causes an injury independent of the loss of policy benefits, the insured may recover damages for that injury even if the policy does not grant the insured a right to benefits.' "[136] In rejecting this position, the court stated the following:

> [The insured] . . . omits the [supreme] court's explanation that this independent-injury rule applies "only if the damages are truly independent of the insured's right to receive policy benefits." That is, the independent-injury rule "does not apply if the insured's statutory or extra-contractual claims 'are predicated on [the loss] being covered under the insurance policy' . . . or if the damages 'flow' or 'stem' from the denial of the claim for policy benefits." The [supreme] court further explained that "[w]hen an insured seeks to recover damages that 'are predicated on,' 'flow from,' or 'stem from' policy benefits, the general rule applies and precludes recovery unless the policy entitles the insured to those benefits."[137]

Finding that the bad faith claims were predicated on his loss being covered by his contract, the Fifth Circuit held that the independent-injury rule did not apply.[138] Instead, Moore's claims were governed by the general rule: "an insured cannot recover policy benefits as damages for an insurer's statutory violation if the policy does not provide the insured a right to receive those benefits."[139] The Fifth Circuit affirmed the district court's dismissal of Moore's extra-contractual claims.

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133. *Id.*
134. *Id.* at 818.
135. *Id.* at 818–19.
136. *Id.* at 819 (quoting USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 489 (Tex. 2018)).
137. *Id.* (citations omitted).
138. *See id.*
139. *Id.* (quoting *Menchaca*, 545 S.W.3d at 489).

V. APPRAISAL AND LOSS PAYMENT

A. Federal District Court and State Appellate Court Hold That Prompt Payment of Appraisal Award Preclude Insureds' Extra-Contractual Claims

In *Kezar v. State Farm Lloyds*, Thomas G. and Sylva Shroyer Kezar (the Kezars) filed a claim under their homeowners' policy issued by State Farm Lloyds (State Farm) after their home was damaged by a fire.[140] The parties could not agree on the scope of damages owed under the policy, so State Farm invoked the policy's appraisal clause. Following the appraisal process, State Farm paid the appraisal award amount. Nevertheless, the Kezars alleged that although State Farm paid the claim, it was in breach of contract because it did not pay the claim in a timely manner. The Kezars also alleged fraud, negligence, breach of the duty of good faith and fair dealing, and unfair settlement practices.[141]

With respect to the contract claim, the U.S. District Court for the Western District of Texas evaluated whether the payment by State Farm, after the appraisal award, was timely.[142] The disagreement centered on what event actually triggered State Farm's contractual obligation to pay the Kezars within five business days.[143] The relevant "Loss Payment" provision in the policy stated:

> If we notify you that we will pay your claim, or part of your claims, we must pay within 5 business days after we notify you. If payment of your claim or part of your claim requires the performance of an act by you, we must pay within 5 business days after the date you perform the act.[144]

The district court held that the unambiguous language required "payment within five business days only if State Farm notifies the Kezars that it will pay some or all of a claim—or, if payment is conditioned on some action by the Kezars, five days from that action."[145] Because the Kezars did not dispute that State Farm made payment within five days of notifying the Kezars that the claim would be paid, the district court found that State Farm had not breached the contract.[146]

In support of their cause of action for breach of the duty of good faith and fair dealing, the Kezars "allege[d] that State Farm had no reasonable basis for denying or delaying payment of their claim."[147] The district court noted that under Texas law, an insurer owes its insured the duty of good faith and fair dealing and breaches such duty "'if the insurer knew

140. Kezar v. State Farm Lloyds, No. 1:17-CV-389-RP, 2018 WL 2271380, at *1 (W.D. Tex. May 17, 2018).
141. *Id.* at *1.
142. *Id.* at *2.
143. *Id.*
144. *Id.*
145. *Id.* at *3.
146. *Id.*
147. *Id.* at *4.

or should have known that it was reasonably clear that the claim was covered,' but denies or unreasonably delays payment of the claim."[148] To prevail on a bad faith claim, the insured must "'first show[ ] that the insurer breached the contract.'"[149] However, citing *Menchaca*, the district court noted that there are several exceptions to this rule, for example, "if the insurer [were to] commit some act, so extreme, that would cause injury independent of the policy claim."[150]

"State Farm argue[d] that no exception to the general rule applies and that it is therefore not liable in tort because it did not breach its contract with the Kezars."[151] According to State Farm, the Kezars "failed to allege[ ] any facts which would give rise to an independent injury claim."[152] However, the Kezars argued that "State Farm's intentional delay in settling their claims [through appraisal] caused them injuries independent of the policy claim."[153] The district court summarized the Kezars' further contention as follows:

> Specifically, the Kezars identify three acts of allegedly intentional delay: (1) State Farm's agent initially estimated the loss at a value approximately $200,000 lower than the ultimate appraisal award; (2) State Farm appointed its appraiser 28 days late; and (3) State Farm's appraiser took seven months to submit his estimate. The Kezars state that these delays injured them by increasing their construction costs, diminishing their health and quality of life, requiring them to spend money to convert their office into a residential space, and delaying their claim to their appraisal award.[154]

The district court found that these alleged instances of delay were neither sufficiently independent nor sufficiently extreme to trigger the independent-injury rule.[155] Reiterating the foundation of the independent-injury rule set out by the *Menchaca* court, the court restated that "[t]he independent-injury applies 'only if the damages are truly independent of the insured's right to receive policy benefits.'"[156] Accordingly, any alleged extra-contractual claims cannot be "predicated on the loss being covered under the insurance policy" and the damages cannot "'flow or stem' from the denial of the claim."[157] In interpreting the substance of the injuries contained in the Kezars' own allegations, the district court found that each alleged injury was "caused by State Farm's allegedly bad-faith delays in fully resolving their claim."[158] The district court found that

148. *Id.* (quoting Garcia v. Lloyds, 514 S.W.3d 257, 276 (Tex. App.—San Antonio 2016, pet. denied)).
149. *Id.*
150. *Id.* (quoting USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 499 (Tex. 2018)) (alteration in original).
151. *Id.*
152. *Id.* (alteration in original).
153. *Id.*
154. *Id.* (internal citations omitted).
155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.* at *5.

these "injuries flow from the denial of the Kezars' claim" and therefore the independent-injury rule did not apply.[159] Accordingly, the court held that the Kezars' "recovery for this extra-contractual cause of action is barred by their failure to establish a breach of contract."[160]

In *Turner v. Peerless Indemnity Insurance Co.*, William Turner (Turner) sued Peerless Indemnity Insurance Company (Peerless) for breach of contract and extra-contractual damages resulting from a dispute over coverage under a homeowners' insurance policy.[161] Following Turner's tender of the claim, Peerless and Turner could not agree as to the amount of the loss. Following suit by Turner, Peerless invoked the appraisal clause, subsequently paid the amount of the appraisal award, and moved for summary judgment on Turner's contract and extra-contractual claims.[162] The trial court granted Peerless's motion.

The Amarillo Court of Appeals next considered the extra-contractual claims after first determining that the trial court's judgment on the breach of contract claims was supported by the evidence.[163] Peerless argued that Turner provided no evidence of the requisite independent injury in support of those claims.[164] In other words, Peerless argued, "[Turner] had no evidence of suffering damages aside from those represented by supposedly lost policy benefits."[165] To rebut this contention, Turner posited that the lost benefits provide sufficient evidence of an independent injury.[166] The court, however, disagreed with Turner's position.[167]

Citing *Menchaca*, the court declared that "[t]he independent injury rule is alive and well."[168] Recall that an insured's cause of action for extra-contractual damages pursuant to the independent injury rule holds that extra-contractual liability "is 'distinct' from its liability for benefits under the insurance policy."[169] The court then reiterated the "two aspects" of the independent injury rule established by the Texas Supreme Court in *Menchaca*.[170] First, "an insurer's statutory violation causes an injury independent of the insured's right to recover policy benefits, the insured may recover damages for that injury even if the policy does not entitle the insured to receive benefits."[171] Second, "an insured can recover actual damages caused by the insurer's bad-faith conduct if the damages 'are

159. *Id.*
160. *Id.*
161. Turner v. Peerless Indem. Ins. Co., No. 07-17-00279-CV, 2018 WL 2709489, at *1 (Tex. App.—Amarillo Jun. 5, 2018, no pet.) (mem. op.).
162. *Id.*
163. *Id.* at *3.
164. *Id.* at *4.
165. *Id.*
166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.* (quoting USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 499 (Tex. 2018)).
170. *Id.*
171. *Id.* (quoting *Menchaca*, 545 S.W.3d at 499).

separate from and . . . differ from benefits under the contract.'"[172]

With respect to the second aspect, the supreme court has explained that an insured may only recover damages if the statutory violation causes an independent injury that is separate from the loss of benefits.[173] The court interpreted the *Menchaca* decision to "have particular application to situations where a claim falls outside the coverage provided by the insurance policy and the insured nonetheless sues for damages."[174] The court opined that some admittedly rare situations may arise where an insured may recover "damages unrelated to the supposed policy benefits."[175] However, the court noted that this was not such a situation because "there was coverage and full payment was made timely once the parties completed the appraisal process as established by the insurance policy."[176]

Here, the court found that Turner received the benefit that was afforded under the insurance policy.[177] However, the court noted that *Menchaca* seems to indicate that in rare circumstances, extra-contractual damages may be available to the insured despite the lack of a breach of contract.[178] In such situations, the extra-contractual claim must not be "predicated on [the loss] being covered under the insurance policy."[179] The court surmised that "[t]his suggests that when benefits are paid per the contract and the insurer performed its contractual obligation (i.e., has not breached the contract), an insured may still pursue extra-contractual causes of action but only when they are not founded upon the loss or injury allegedly covered by the policy."[180] In other words, the extra-contractual claims must be based "on an act that caused injury independent of the policy claim."[181]

The court held that Turner's extra-contractual claims were not based on an act that caused him an independent injury of the policy claim.[182] Moreover, the court noted that Turner did not even make such an argument; rather, he posited that if his claim was covered, then Peerless was bound by its statutory duties.[183] Turner further proposed that if Peerless breached its duties, then the resulting lost benefits are transformed into "legal damage," which is not recoverable under the policy but is recover-

172. *Id.* (quoting *Menchaca*, 545 S.W.3d at 499).
173. *Id.* (citing *Menchaca*, 545 S.W.3d at 500).
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.* (alteration in original); *see also* USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 500 (Tex. 2018) (stating that the independent-injury rule "does not apply if the insured's statutory or extra-contractual claims 'are predicated on [the loss] being covered under the insurance policy' . . . or if the damages 'flow' or 'stem' from the denial of the claim for policy benefits").
180. *Turner*, 2018 WL 2709489, at *4.
181. *Id.*
182. *See id.* at *4–5.
183. *Id.* at *5.

able pursuant to the bad faith statute.[184] However, applying its "perception" of the independent-injury rule as explained in *Menchaca*, the court determined that Turner's injury cannot be predicated on his theory of "legal damage."[185] Instead, the court found that Turner's injury must "be independent of what he claims he lost 'out on' under the policy."[186] Therefore, the court concluded that it must overrule Turner's issue and affirmed the summary judgment.[187]

B. State Appellate Court Holds That Timely Payment of Appraisal Award Precludes Prompt Payment Act Claims Under Chapter 542 of the Texas Insurance Code

In *Marchbanks v. Liberty Insurance Corp.*, the Fourteenth Houston Court of Appeals evaluated whether timely payment of an appraisal award precluded claims against an insurer under Chapter 542 of the Texas Insurance Code (the Prompt Payment Act).[188] The insured's residence purportedly sustained hail damage, prompting the insured to submit a claim to his insurer, Liberty Insurance Corporation (Liberty). Following multiple inspections, Liberty determined that the only covered damage was for an amount below the deductible and advised that it would not be issuing payment. The insured filed suit and Liberty invoked the appraisal provision in its policy. Liberty then paid the appraisal award to the insured.

Following payment of the appraisal award, Liberty moved for summary judgment against the insured on his claims, including his claims that Liberty violated the Prompt Payment Act. In response, the insured "contended that Liberty violated two sections of the Prompt Payment . . . Act before Liberty invoked appraisal" because it failed "to request items, statements, and forms that it reasonably believed were required," and failed "to accept or reject [the insured's] claim within 15 business days of receiving all items, statements, and forms required."[189] The focus of the insured's claims was on the pre-appraisal conduct of Liberty. Rejecting the insured's argument, the court held that "full and timely payment of the amount owed under the policy based on an appraisal award precludes as a matter of law a recovery on a claim under the [Prompt Payment

184. *Id.*
185. *Id.*
186. *Id.*
187. *Id.*
188. Marchbanks v. Liberty Ins. Corp., 558 S.W.3d 308, 310 (Tex. App.—Houston [14th Dist.] 2018, pet. filed). The relevant provision in the Prompt Payment Act states:

> If an insurer that is liable for a claim under an insurance policy is not in compliance with this subchapter [the Prompt Payment of Claims Act], the insurer is liable to pay the holder of the policy or the beneficiary making the claim under the policy, in addition to the amount of the claim, interest on the amount of the claim at the rate of 18 percent a year as damages, together with reasonable and necessary attorney's fees.

Tex. Ins. Code Ann. § 542.060(a).
189. *Marchbanks*, 558 S.W.3d at 311.

Act]."[190] The court also declined to recognize that, according to the insured, the rationale for the Prompt Payment Act is to impose a penalty upon an insurer that breaches its contract by not making timely payment of covered claims.[191] If the insured cannot establish that the insurer breached any provision of the policy, there is no basis for imposing an extra-contractual penalty.[192] The "appraisal award does not resolve whether the insurer is liable under the insurance policy"; rather, the appraisal simply states the amount of the loss.[193] Thus, if an insurer pays the full amount of the appraisal, there is no breach and no basis to impose the statutory penalty.[194]

VI. UNDERINSURED/UNINSURED MOTORIST LIABILITY—COURT OF APPEALS FINDS TRIAL COURT ABUSED ITS DISCRETION IN FAILING TO ABATE EXTRA-CONTRACTUAL CLAIMS PENDING RESOLUTION OF CONTRACT CLAIM FOR UIM COVERAGE

In *In re State Farm Mutual Automobile Insurance Co.*, the plaintiffs "were involved in an automobile accident" allegedly "caused by the negligence of [another] driver."[195] After the accident, the negligent driver's insurer "tendered the full per person liability policy limit" to each plaintiff.[196] The plaintiffs subsequently filed a claim for uninsured motorist benefits with their insurer State Farm Mutual Automobile Insurance Company (State Farm). After State Farm allegedly failed to respond to their demand, the plaintiffs filed suit against State Farm and its two adjusters, alleging causes of action for breach of contract and extra-contractual claims for violations of the Texas Insurance Code.[197] The trial court severed the plaintiffs' extra-contractual claims from the contract claims, but did not abate the extra-contractual claims pending resolution of the breach of contract claims. State Farm and its two adjusters thereafter filed a petition for mandamus relief and asserted that "State Farm is under no contractual [obligation] to pay underinsured motorist ('UIM') benefits" until the plaintiffs obtain a judgment establishing the breach of contract claims.[198]

In *Brainard v. Trinity Universal Insurance Co.*, the Texas Supreme Court held that under the Texas Insurance Code, "the UIM insurer is under no contractual duty to pay benefits until the insured obtains a judgment establishing the liability and underinsured status of the other mo-

190. *Id.* at 312.
191. *Id.* at 315.
192. *Id.* at 313.
193. *Id.*
194. *Id.* at 313–14.
195. *In re* State Farm Mut. Auto. Ins. Co., 553 S.W.3d 557, 559 (Tex. App.—San Antonio 2018, orig. proceeding).
196. *Id.*
197. *Id.*
198. *Id.*

torist."[199] Because State Farm's contractual liability had not yet been determined, State Farm argued that the extra-contractual claims should have been abated. However, the plaintiffs argued that *Menchaca* "nullified the need for abatement in cases involving first-party claims because breach of contract claims and extra-contractual claims are separate causes of action that exist independent of each other."[200] The plaintiffs contended that, post-*Menchaca*, an insured is not required to rely on a breach-of-contract finding to pursue statutory violation claims.[201] Additionally, plaintiffs posited a public policy argument that *Menchaca* shifts the "long-standing pattern of inequitable outcomes favoring insurers under *Brainard*."[202]

The San Antonio Court of Appeals, however, disagreed and "[observed that] the plaintiffs read *Manchaca* [sic] too broadly."[203] Notably, the court noted that *Menchaca* neither overrules *Brainard* nor mentions *Brainard*.[204] Because the Texas supreme court did not overrule its decision in *Brainard*, the court reasoned that it is bound by the applicable precedent.[205] Additionally, the court noted that *Menchaca* neither involved a UIM claim nor addressed "whether contract and extra-contractual claims should be severed and abated."[206] The court then distinguished *Menchaca* from *Brainard*, noting that "*Menchaca* stated that a breach of contract claim is 'distinct and independent' from extra-contractual claims, while *Brainard* set forth the test an insured must satisfy before pursuing extra-contractual claims in an UIM case."[207] The court further elaborated that the holdings in *Menchaca* and *Brainard* are consistent with each other and there is no indication that "*Menchaca* nullified *Brainard*'s holding that a '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.'"[208] Moreover, the court highlighted that *Menchaca* "'clarifi[ed] and affirm[ed]' the general rule that an insured cannot recover policy benefits as actual damages for

199. *Id.* (quoting Brainard v. Trinity Universal Ins. Co., 216 S.W.3d 809, 818 (Tex. 2006)).

200. *Id.* at 560.

201. *Id.*

202. *Id.* at 561.

203. *Id.*

204. *Id.*

205. *Id.* (noting that "[i]t is the prerogative of the Texas Supreme Court to overrule its own decisions and, until it expressly does so, we are bound by the caselaw that directly applies").

206. *Id.* (noting "[i]nstead, [*Menchaca*] involved a first-party claim by the insured against her insurer for storm damage to the insured's home").

207. *Id.* at 562 (noting that in *Menchaca*, the Texas Supreme Court noted "An insured's claim for breach of an insurance contract is 'distinct' and 'independent' from claims that the insurer violated its extra-contractual common-law and statutory duties. . . . A claim for breach of the policy is a 'contract cause of action,' while a common-law or statutory bad-faith claim 'is a cause of action that sounds in tort.' But the claims are often 'largely interwoven,' and the same evidence is often 'admissible on both claims.'").

208. *Id.* (quoting Brainard v. Trinity Universal Ins. Co., 216 S.W.3d 809, 818 (Tex. 2006)) (emphasis in original).

an insurer's statutory violation if the insured has no right to those benefits under the policy."[209] The court reconciled this notion with the distinction discussed in *Brainard* between first-party insurance contract claims and UIM contracts, which held that "the insurer's contractual obligation to pay benefits does not arise until liability and damages are determined."[210] As such, the court explained that the holdings in *Menchaca* and *Brainard* were consistent.[211] Ultimately, the court concluded that "*Menchaca*'s 'distinct and independent' holding does not inevitably lead to the conclusion that abatement of extra-contractual claims is no longer required in a UIM case when the UIM claim is disputed."[212]

The court observed that, "because of their unique nature, UIM extra-contractual claims can be rendered moot if the insured does not obtain a judgment against the underinsured motorist."[213] Accordingly, the court held that "abatement is necessary to avoid litigation expense and conserve judicial resources."[214]

209. *Id.* (quoting USAA Tex. Lloyds Co. v. Menchaca, 545 S.W.3d 479, 495 (Tex. 2018)).
210. *Id.* (quoting *Brainard*, 216 S.W.3d at 818).
211. *Id.*
212. *Id.* at 564.
213. *Id.*
214. *Id.* at 564–65.