



Insurer's Knowing Violation of Texas Insurance Code May Entitle Insured to Treble Damages

The Fifth Circuit's recent opinion in *Lyda Swinerton Builders, Inc. v. Oklahoma Sur. Co.*¹ includes policyholder-friendly holdings on Texas law concerning the duty to defend and the potential to recover treble damages for an insurer's knowing violation of Texas Insurance Code.

The case arose out of a construction project in College Station, Texas. The general contractor, Lyda Swinerton Builders, Inc. ("LSB") hired A.D. Willis Company, Inc. ("Willis") as a roofing subcontractor. The subcontract, which was never signed by LSB, required Willis to maintain commercial general liability insurance designating LSB as an additional insured.

Several years later, before the project was completed, LSB was sued for breach of contract. The lawsuit alleged various deficiencies in LSB's work, including deficiencies in the roof. The lawsuit was later amended to state that LSB's negligence caused property damage to the project.

LSB sought coverage for the lawsuit as an additional insured under a policy issued to Willis by Oklahoma Surety Company ("OSC"). The OSC Policy included an additional insured endorsement for LSB, which provided coverage to LSB "only with respect to liability directly attributable" to Willis' work for LSB, and only if Willis had "agreed by written 'insured contract'" to provide additional insured coverage for LSB. OSC denied coverage and became involved in a declaratory judgment action with LSB. The District Court for the Southern District of Texas ruled that OSC breached its duty to defend LSB as an additional insured, and in doing so, violated the provisions of the Texas Prompt Payment of Claims Act (the "Prompt Pay Act"). However, the court declined to rule that LSB could also recover damages under Chapter 541 of the Texas Insurance Code, as LSB had not proven that it suffered any injury separate and apart from the denial of benefits under the OSC policy. The Fifth Circuit addressed each of these issues on appeal.

1. Duty to Defend

In determining the duty to defend, Texas courts follow the "eight corners rule;" they look at the facts alleged in the underlying complaint, measure them against the policy language, and determine if the allegations could potentially be covered. With this rule in mind, the Fifth Circuit began its analysis by confirming that LSB was an additional insured under the OSC policy. Although the policy specifically designated LSB as an additional insured, the coverage only applied if Willis had "agreed by written 'insured contract'" to provide such coverage for LSB, and Willis' contract was never signed by LSB, making it unenforceable. The Fifth Circuit held that the contract need not be enforceable to satisfy the additional insured endorsement, and found that the contract's obligation that Willis indemnify LSB satisfied the "written 'insured contract'" requirement.

The Fifth Circuit then determined that the allegations in the underlying complaint triggered OSC's duty to defend LSB, even before the allegations of negligence were added. The original complaint alleged that LSB was responsible for numerous deficiencies on the project, including the roof. The complaint did not contain any direct reference to Willis, only a vague reference to LSB's subcontractors; however, the court inferred that there was a potential that the claims of deficiencies in the roof resulted from Willis' work, as the policy expressly identified Willis as a "Commercial Roofing Contractor." The Fifth Circuit also noted that although the complaint sought to recover for breach of contract, the determining factor is the facts giving rise to the claim and not the cause of action alleged, and the factual allegations regarding the various deficiencies were clearly allegations of property damage.

¹ 903 F.3d 435 (5th Cir. 2018)

2. The Prompt Pay Act

Under the Prompt Pay Act, an insurer that fails to promptly respond to or pay a covered claim is liable for the amount of the claim plus interest and reasonable attorney's fees. "To recover under the PPCA, an insured must establish that: '(1) a claim was made under an insurance policy, (2) the insurer is liable for the claim, and (3) the insurer failed to follow one or more sections of the prompt-payment statute with respect to the claim.'" Having already concluded that OSC had a duty to defend LSB as an additional insured, the Fifth Circuit held that OSC's improper denial of a defense to LSB was in violation of the Prompt Pay Act.

3. Texas Insurance Code

Chapter 541 of the Texas Insurance Code prohibits insurers from engaging in certain unfair or deceptive acts or practices. If an insurer engages in such acts or practices and the insured sustains actual damages as a result, the insured can recover the amount of the damages plus costs and attorney's fees. In addition, the insured can also recover treble damages if the insurer committed the unfair or deceptive conduct knowingly. LSB argued that OSC violated Chapter 541 by knowingly misrepresenting the scope of the policy's coverage to avoid its duty to defend, causing LSB to incur defense costs as damages.

The District Court held that LSB had not offered any evidence that it suffered injury separate and apart from the denial of benefits, and that an independent injury was necessary to obtain extra-contractual damages under Chapter 541. However, during the course of the appeal, the Texas Supreme Court issued an opinion in *USAA Texas Lloyds Co. v. Menchaca*,² which included an in-depth analysis of how Texas law applies to extra-contractual claims in the context of insurance. OSC urged the Fifth Circuit to affirm the District Court's holding that LSB was not entitled to recover under Chapter 541 pursuant to one of the rules discussed in *Menchaca* – the "independent-injury rule," which stands for the proposition that bad faith damages must be truly separate from a claim for coverage; that is, they cannot be based on improper denial of a claim. However, the Fifth Circuit noted that another rule was also relevant – the "entitled-to-benefits rule," which provides that an insured who is entitled to policy benefits can recover those benefits under the bad faith statute if it was the violation of the statute that caused the loss of benefits. The Fifth Circuit held that LSB was entitled to a defense from OSC as a policy benefit, and if LSB established that OSC's misrepresentations caused it to be deprived of that benefit, LSB could recover damages under Chapter 541, along with treble damages if the misrepresentation was knowingly committed. Accordingly, the Fifth Circuit reversed the District Court's decision and remanded the case for further proceedings consistent with the *Menchaca* case.

This case is an excellent example of how courts should approach the analysis of the duty to defend. The eight-corners rule can be limiting in that it does not permit the additional insured to offer extrinsic evidence that the loss was caused by the named insured. However, the Fifth Circuit did justice to the broad scope of the duty to defend, making inferences from the complaint and the policy about Willis' involvement to find a potential of coverage for LSB. This case should also serve as a warning to insurers, reinforcing that courts applying Texas law are readily willing to impose treble damages for an insurer's knowing violations of the Texas Insurance Code.

For more information contact [Bethany Barrese](mailto:Bethany.Barrese@sdvllaw.com) at 203.287.2113 or blb@sdvllaw.com.

² See SDV's [case alert](#) for full analysis of the *Menchaca* case