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How Extra-Contractual Damages Can Protect Insureds From Obstinate Insurance Companies

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The Texas Supreme Court first recognized a cause of action against insurance companies for improper handling of an insurance claim in 1987. The court noted that because of the unequal bargaining power between insured and insurer, “unscrupulous insurers [could] take advantage of their insureds’ misfortunes in bargaining for settlement or resolution of claims” and that “without such an action insurers can arbitrarily deny coverage and delay payment of a claim with no more penalty than interest on the amount owed.” The case was *Arnold v. National County Mutual Insurance*.

Over the next 30 years since *Arnold*, the pendulum in Texas swung from large and frequent verdicts against insurers for their “unscrupulous” behavior to practitioners lamenting that bad faith was effectively dead in Texas. After *Arnold*, insurers worked hard to defang the common law bad faith claim through a series of court decisions. As a result, insureds have turned their attention to two Texas statutes that provide powerful protection against an insurer’s improper handling of claims: Chapters 541 and 542 of the Texas Insurance Code.

Chapter 541 of the Texas Insurance Code sets forth a laundry list of prohibited acts or practices by an insurance company in handling claims. For example, insurance companies cannot misrepresent material facts or policy provisions relating to coverage, refuse to settle claims when the insurer’s liability is reasonably clear, fail to affirm or deny coverage within a reasonable period of time, or fail to conduct a reasonable investigation of a claim. When the insurance company violates one of the prohibited acts, the insured can sue and recover their “actual damages” for that violation, and the damages are trebled if the insurer’s violation was a knowing one.

For years, insureds and insurance companies argued over what the Texas legislature meant by “actual damages” in this statute. Insureds argued unpaid policy benefits represented their “actual damages.” Insurance companies, on the other hand, argued that any unpaid policy benefits were only contractual damages, and that the statute required an “independent injury” aside from the unpaid policy benefits. Insureds noted that an “independent injury” requirement would eviscerate the protections afforded under Chapter 541 for corporate policyholders, which typically do not suffer “independent injuries” such as mental anguish or damaged credit.

The case law on this issue was all over the map. The Texas Supreme Court itself acknowledged “substantial confusion” by the courts on this issue. Therefore, the Texas Supreme Court sought to clarify the scope of extra-contractual damages available under Chapter 541 last year in *USAA v. Menchaca*, 60 Tex. Sup. Ct. J. 672 (2017). In April 2017, the Texas Supreme Court ruled that unpaid policy benefits constituted “actual damages” when an insurer’s violation of the prohibited acts or practices causes that loss. A year later, on April 13, the Texas Supreme Court issued a second opinion after a rehearing which confirmed this pro-insured rule.

This ruling represents a major victory for insureds and especially corporate insureds. Not only are policy benefits recoverable as actual damages under Chapter 541, but an insured can recover trebled damages once it shows the insurer’s violation was knowing. With the Texas Supreme Court’s latest pronouncement in *Menchaca*, statutory bad faith under Chapter 541 is officially alive and well in Texas.

Chapter 542 provides a second important source of extra-contractual recovery for insureds. Known as the Prompt Pay Act, this statute sets out various timelines that an insurance company must meet for handling first-

party claims. The statute's objective is to encourage prompt payment of claims. When the insurance company fails to meet these statutory deadlines, insureds are entitled to recover 18 percent statutory interest on the late or unpaid amounts, attorneys fees, and any other remedies available under the law.

For years, insureds have relied on the Prompt Pay Act to ensure that their insurers make timely claim payments. Last year, the insurance industry pushed for the passage of the so-called "Hail Bill," which would dramatically reduce the statutory interest rate, introduce onerous pre-suit requirements, and alter the way attorneys fees are calculated under the Prompt Pay Act. Introduced under the auspices of curbing alleged abuses for hail claims, the initial version of the bill was expansive and targeted all insurance claims within the scope of Chapter 542, not just hail claims.

Insured-side advocates fought against the passage of the Hail Bill. While the Hail Bill would ultimately pass, it did so on much narrower terms. The new provisions in the Hail Bill only apply to claims involving "forces of nature." As a result, there are now two different tracks for recovering under the Prompt Pay Act. For claims that do not involve "forces of nature," insureds can still proceed as usual under Chapter 542. However, for claims that do involve "forces of nature," insureds must go through a new provision, Chapter 542A, which involves navigating a more complicated pre-claim process and provides the insured with more limited remedies.

Extra-contractual damages provide crucial protection for insureds dealing with obstinate insurance companies who fail to uphold their end of the special relationship. Texas insureds are fortunate to have the protections afforded under Chapters 541, 542, and even 542A to curb potential abuses by unscrupulous insurers. However, given the ever-changing landscape of this area of the law, insureds must be mindful of the insurance industry's ongoing efforts to roll back these statutory protections through both the judicial and legislative process.

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