

THOUGHT LEADERSHIP

News

FIFTH CIRCUIT ADDRESSES INSURER'S DUTY TO DEFEND IN THE WAKE OF MENCHACA

Newsbrief

11 SEP 2018

Recently, in *Lyda Swinerton Builders, Inc. v. Oklahoma Surety Co.*, 2018 WL 411 3795; No. 16-20195 (5th Cir. Aug. 29, 2018), the Fifth Circuit addressed both an insurer's duty to defend and the damages an insured may recover when the duty is breached in light of the Supreme Court of Texas' opinion in *Texas Lloyds Co. v. Menchaca*.

Lyda Swinerton Builders served as the general contractor for the construction of a College Station, Texas, office building in which Swinerton engaged A.D. Willis Company as a subcontractor. As a condition to the subcontract, Willis obtained a commercial policy with Oklahoma Surety Company in which it named Swinerton as an additional insured. The office building owner assigned their interest in the agreement with Swinerton to Adam Development Properties who sued Swinerton for breach of contract alleging, among other things, that Swinerton failed to meet contractual deadlines, provided work with material deficiencies and consistently failed to comply with contractual obligations. Swinerton filed a third party petition against various other companies including Willis, and Adam Development amended its petition to include Willis as a third party defendant.

Swinerton requested defense from Oklahoma Surety based on its status as an additional insured under Willis' policy, which Oklahoma Surety denied. Swinerton further requested defense from other insurers who similarly denied the request. One insurer went so far to file a declaratory action in Federal court naming Adam Development, Swinerton and another party. Swinerton filed a third-party complaint in the declaratory action, seeking damages and relief against Oklahoma Surety for breach of contract based on their failure to defend in the state suit, violation of the Texas Insurance Code and violation of the Prompt Payment of Claims Act.

Ultimately, all claims settled with the exception of those between Swinerton and Oklahoma Surety. The district court ultimately found Oklahoma Surety had a duty to defend Swinerton, that the duty was breached and Oklahoma Surety owed Swinerton damages.

Addressing Oklahoma Surety's duty to defend, the Court analyzed the duty in three parts: (1) whether Swinerton was a named insured under the Oklahoma Surety policy; (2) whether a duty to defend arose under the eight corner rule; and (3) whether the anti-stacking rule applied. Addressing Swinerton's status under the Oklahoma Surety policy, the court noted that the policy obligates Oklahoma Surety to defend Willis and any additional insured against suits covering property damage. The Court found that the subcontract between Swinerton and Willis constituted an insured contract despite Swinerton's failure to countersign. Under the eight corners rule—in which Texas courts

FIFTH CIRCUIT ADDRESSES INSURER'S DUTY TO DEFEND IN THE WAKE OF MENCHACA

measure the four corners of the petition against the language within the four corners of the policy—the Court found that Oklahoma Surety had a duty to defend Swinerton against Adam Development's petition. Specifically, the Court found that, based on the factual allegations including material deficiencies in the work and failure to follow the contract, there was a potential that the suit fell within the underlying policy's scope of coverage therefore triggering Oklahoma Surety's duty to defend. Finally, the Court addressed the applicability of the anti-stacking rule—prohibiting an insured from stacking coverage limits of multiple policies when a single claim involves an indivisible injury extended across several distinct policy periods. In such instances, the insured's indemnity limit is whatever the highest limit was at the single point in time during the policy periods. Here, the court found the rule had no application. The court rejected Oklahoma Surety's assertion that another insurer's policy (and defense) applied instead, noting that if Swinerton sought defense from the other insured following denial by Oklahoma Surety, application of the rule would reward Oklahoma Surety for shirking its legal duty.

The Court further addressed Swinerton's cross-appeal denying its claim for extra contractual damages in light of the recent Supreme Court of Texas Opinion in *USAA Texas Lloyds v. Menchaca*. Swinerton claimed Oklahoma Surety violated the insurance code by knowingly misrepresenting the policy coverage to avoid its duty to defend. The *Menchaca* court distilled several rules including the "entitled-to-benefits rule" and the "independent injury rule." The entitled-to-benefits rule states an insured who establishes a right to receive benefits under the policy can recover the benefits as actual damages if the insurer's statutory violation caused the loss. The independent injury rule provides that if an insurer's statutory violation causes an injury independent of the right to recover benefits, the insured can recover damages for that injury even if the policy does not entitle the insured to receive the benefits. Further, an insurer's statutory violation does not permit the insured to recover any damages beyond the policy benefits unless the violation causes an injury independent from the loss of benefit. Because Swinerton was entitled to the benefit of defense, if, on remand, Swinerton can establish the misrepresentation caused deprivation of the benefit, Swinerton can recover the defense costs incurred as actual damages including treble damages upon a showing that the statutory violation was made knowingly.

Lastly, the court addressed Oklahoma Surety's appeal of the district court's damage ruling and found no error in awarding Swinerton defense costs. On the damages relating to the prompt payment statute, because of the remand of Swinerton's claims under Chapter 541 of the Insurance Code, if Swinerton prevails and elects to recover defense costs as actual damages rather than breach of contract damages, it will be entitled to the penalties under the prompt payment act.