



EXTRA-CONTRACTUAL DAMAGES FOR BREACH OF THE DUTY TO DEFEND

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New court decisions have blurred the lines between contractual and extra-contractual liability claims in the third-party claim context. What was once a purely contractual claim—breach of the duty to defend—has recently evolved into a claim for tort damages in Texas. Other states also recognize tort damages for denial of defense, including recovery of punitive damages.

How did a contract claim expand to a tort? Some states, such as California, have expansively interpreted the common law duty of good faith and fair dealing to apply to first- and third-party claims alike. On the other hand, states that allow extra-contractual damages have not expressly adopted a tort rationale for breach of the duty to defend; rather, liability is typically pre-

mised on breach of the separate duty to accept an in-limits settlement demand. In Texas, the law developed through the interaction between the common law and statutory claim-handling schemes.

Duty of Good Faith and Fair Dealing First Recognized in First-Party Claims in Texas

The duty of good faith and fair dealing has been recognized in a majority of jurisdictions. *See Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48, 52 (Tex. 1997) (observing Texas in the mainstream in recognizing bad-faith tort in context of first-party claims). Texas first adopted the duty in a first-party case involving uninsured/underinsured motorist benefits. *See Arnold v. National Cty. Mut. Fire Ins. Co.*, 725

S.W.2d 165 (Tex. 1987). Texas courts did not immediately recognize a tort claim of common law bad faith stemming from breach of the duty to defend. Cases decided after adoption of the new duty of good faith continued to limit breach of the duty to defend to contractual remedies. *See, e.g., United Services Auto. Ass'n. v. Pennington*, 810 S.W.2d 777, 783-84 (Tex. App.—San Antonio 1991, writ denied) (claim sounded purely in contract where pleading alleged wrongful failure to defend).

Subsequently, the Texas Supreme Court expressly declined to recognize a duty of good faith and fair dealing in the context of third-party liability claims. *See*

Maryland Ins. Co. v. Head Indus. Coatings & Serv., Inc., 938 S.W.2d 27, 28-29 (Tex. 1996) (insured fully protected by *Stowers* rights and contractual rights against insurer's erroneous refusal to defend).

Similarly, Texas law has not adopted the estoppel principle recognized by some jurisdictions in which a carrier that breaches the duty to defend forfeits coverage defenses. *See, e.g., Santa's Best Craft, LLC v. St. Paul Fire & Marine Ins. Co.*, 353 F. Supp. 2d 966, 971 (N.D. Ill. 2005) (citing *Employers Ins. of Wausau v. Ehlco Liquidating Tr.*, 708 N.E.2d 1211 (Ill. 1999) (insurer who denies defense may be estopped from raising coverage defenses). Instead, Texas law holds that an insurer that erroneously denies a duty to defend may be estopped from contesting the amount and reasonableness of an arm's-length settlement. *See Evanston Ins. Co. v. Atofina Petrochems., Inc.*, 256 S.W.3d 660, 674 (Tex. 2008); *but see Great American Insurance Company v. Hamel*, 525 S.W.3d 655 (Tex. 2017) (discussing exceptions for agreed judgments). However, liability is contractually circumscribed by the terms and limits of coverage. *See Willcox v. American Home Assurance Co.*, 900 F. Supp. 850, 856 (S.D. Tex. 1995) (insurer's liability for breach of duty to defend does not include damages in excess of policy limits; and damages are generally limited to reasonable attorney's fees incurred in defense, reasonable and necessary attorney's fees to enforce the judgment or settlement, and indemnity up to policy limits, subject to terms of coverage).



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Implementation of Statutory Unfair Claim Settlement Practices

Over time, however, enhanced liability for breach of the duty to defend evolved pursuant to the interplay between the Unfair Settlement Practices and Prompt Payment provisions of the Insurance Code and common law causes of action. For example, soon after recognition of the common law duty of good faith and fair dealing, the Texas Supreme Court adopted the statutory formulation of “bad faith” as the standard for both common law and statutory claims. *See Giles*, 950 S.W.2d at 56 (adopting statutory formulation of bad faith as “failing to attempt in good faith to effectuate a prompt, fair, and equitable settlement of a claim with respect to which the insurer’s liability has become reasonably clear” pursuant to Insurance Code).

Subsequently, the Texas Supreme Court extended the Prompt Payment Act—which imposes deadlines for carriers to investigate and settle first-party claims and penalties for noncompliance—to breach of the duty to defend third-party liability actions. *See Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 5 (Tex. 2007). Policyholders could now seek, in addition to reimbursement of defense costs, interest calculated at 18 percent annually, together with reasonable and necessary attorney’s fees. *See Tex. Ins. Code* §§ 542.051–.061.

Nonetheless, while such damages are “extra-contractual,” they are not imposed for “bad faith.” The Prompt Payment Act

is a strict liability statute that does not encompass a reasonableness element, either as a basis for imposition of liability or as a defense thereto. *See Hinojos v. State Farm Lloyds*, 619 S.W.3d 651, 658 (Tex. 2021) (rejecting defense of “reasonable” partial payment to Prompt Payment liability claims).

Recovery of Covered Benefits as Statutory Damages without Proof of Breach

It was not until the Texas Supreme Court’s seminal *Menchaca* decision that the tort of wrongful failure to defend was arguably conceived. *See USAA Texas Lloyd’s Co. v. Menchaca*, 545 S.W.3d 479, 498 (Tex. 2018). *Menchaca* involved a first-party claim for property damage under a homeowner’s policy. The Court held that the policyholder’s statutory claim for the carrier’s failure to pay covered benefits without conducting a reasonable investigation allowed her to recover covered damages *irrespective* of breach of contract. *Id.* at 495. As a corollary, the Court affirmed that denial of a covered claim may give rise to “actual damages,” which may include mental anguish damages and up to three times economic damages for a knowing or intentional violation of the statute along with court costs and reasonable and necessary attorney’s fees. *See id.*

The Fifth Circuit Court of Appeals almost immediately applied *Menchaca*’s actual damage holding to a policyholder’s suit for breach of the duty to defend. *See Lyda Swinerton Builders, Inc. v. Okla-*

homa Surety Co., 903 F.3d 435 (5th Cir. 2018). The policyholder alleged that, in denying a defense, the insurer misrepresented material facts relative to coverage, which is actionable pursuant to section 541.061 of the Texas Insurance Code. The Court agreed that breach of the duty to defend may be actionable as a statutory misrepresentation of the policy allowing recovery of up to three times actual defense costs as damages. *Id.* at 435.¹

Prior to *Menchaca* and *Lyda Swinerton Builders*, breach of the duty to defend could subject an insurer to liability for covered damages, consisting of both defense costs and indemnity. Now an insurer may face potential extra-contractual liability based on the failure to defend a covered claim in the form of additional attorney's fees and actual damages (*i.e.*, trebling and, in certain scenarios, mental anguish damages). See Tex. Ins. Code § 541.152; *State Farm Life Ins. Co. v. Beaston*, 907 S.W.2d 430, 435–36 (Tex. 1997) (mental anguish damages conditioned on knowing finding). Further, penalty interest continues to be

¹The *Lyda Swinerton* decision did not explicitly endorse a duty to defend claim based on other enumerated provisions in Texas Insurance Code section 541.060, e.g., 541.060(a)(7): refusing to pay a claim without conducting a reasonable investigation—the claim at issue in *Menchaca*—or 541.060(a)(3): failing to promptly provide to a policyholder a reasonable explanation of the basis of the policy, in relation to the facts or applicable law, for the insurer's denial of a claim. See, e.g., *Tejas Specialty Grp., Inc. v. United Specialty Ins. Co.*, 2021 Tex. App. LEXIS 4360 (Tex. App.—Fort Worth, June 3, 2021, no pet.) (insured alleged failure to defend and indemnify, and violations of Texas Ins. Code 541.060(a)(2)A, (3), and Prompt Payment Act claims).

available under the Prompt Payment Act. All of these claims add up.

Available Damages in Other Jurisdictions

Texas is not alone in providing enhanced remedies for a breach of contract. Many jurisdictions have recognized claims for additional damages stemming from breach of the duty to defend. In the majority of cases, extra-contractual damages for breach of the duty to defend actually represent indemnity for an excess judgment or settlement against the insured, akin to a *Stowers'* claim in Texas jurisprudence.² Further, many decisions hew to the contractual damages line, authorizing additional damages as consequential damages for breach of contract rather than tort damages. Some of the representative states in this category include the following:

- **Alaska:** *U.S. v. CNA Financial Corp.*, 214 F. Supp. 2d 1044, 1047 (D. Alaska 2002) (breach of duty to defend exposes insurer to damages in excess of policy limits)
- **Illinois:** *Conway v. Country Cas. Ins. Co.*, 442 N.E.2d 245 (Ill. 1982) (insurer liable for full amount of judgment or settlement including in excess of policy limits only if insurer acted in bad faith by refusing to defend); *Knoll Pharm. Co. v. Automo-*

²See *G.A. Stowers Furniture Co. v. American Indemnity Co.*, 15 S.W.2d 544, 547–48 (Tex. Comm'n App. 1929, holding approved).

- bile Ins. Co. of Hartford*, 210 F. Supp. 2d 1017 (N.D. Ill. 2002) (insurer who breached duty to defend liable estopped from denying coverage and has duty to indemnify for insured's settlement up to policy limits, as well as reasonable expenses incurred in defending suit and pre-judgment interest; declining to find liability for sanctions pursuant to Illinois Insurance Code section 155 due to lack of vexatious conduct)
- **Iowa:** *Dairyland Ins. Co. v. Hawkins*, 292 F. Supp. 947, 952 (S.D. Iowa 1968) (Iowa law) (opining Iowa Supreme Court would hold that insurer's breaching duty to defend in bad faith liable for excess settlement)
 - **Kansas:** *Coleman v. Holecek*, 542 F.2d 532, 537-39 (10th Cir. 1976) (Kansas law) (insurer's breach of duty to defend rendered it liable for full amount of judgment against insured, including amount in excess of policy limits and attorney's fees incurred by third-party claimant in garnishment action); *see also Glickman, Inc. v. Home Ins. Co.*, 86 F.3d 997, 998 (10th Cir. 1996) (observing Kansas statute K.S.A. sec. 40-256, which "punishes insurance companies that refuse, without just cause or excuse, to pay the full amount of an insured loss, by requiring them to pay plaintiff's attorney's fees incurred in a coverage action against the insurer ... has been judicially extended to cover refusals to defend")
 - **Massachusetts:** *Premier Homes, Inc. v. Lawyers Title Ins. Corp.*, 76 F. Supp. 2d 110, 118 (D. Mass. 1999) (Mass. Law) ("An insurer who unjustifiably refuses or fails to defend its insured, even in good faith, assumes the consequential risks of that breach of its insurance contract, including liability for the expense of a reasonable settlement of the underlying claim as well as the cost of the defense to that time.")
 - **Missouri:** *Sprint Lumber, Inc. v. Union Ins. Co.*, 627 S.W.3d 96, 116, 119 (Mo. Ct. App. 2021) (once insurer unjustifiably refuses to defend, insured may settle without insurer's consent and insurer liable for limits of policy plus attorney's fees, expenses, and other damages and, if denial of defense in bad faith, for entire amount of judgment beyond policy limits)
 - **Montana:** *J&C Moodie Props., LLC v. Deck*, 384 P.3d 466, 472 (Mont. 2016) ("Where an insurer refuses to defend a claim and does so unjustifiably, that insurer becomes liable for defense costs and judgments."); *accord, Nielsen v. TIG Ins. Co.*, 442 F. Supp. 2d 972, 980-81 (D. Mont. 2006) (insurer who breaches duty to defend liable for all damages flowing from breach including judgments against insured, including damages in excess of policy limits)

- **New Jersey:** *Fireman's Fund Ins. Co. v. Imbesi*, 826 A.2d 735, 749-50 (N.J. Super. Ct., App. Div. 2003) (insurer liable for amount of judgment or settlement after wrongful denial of defense, subject to reasonableness of amount and that payment made in good faith)
- **New York:** *Gordon v. Nationwide Mut. Ins.*, 285 N.E.2d 849, 854 (N.Y. Ct. App. 1972) (measure of damage for breach of duty to defend cost of defense and amount of recovery against insured within policy limits); *accord*, *East Ramapo Cent. Sch. Dis. V. N.Y. Sch. Ins. Reciprocal*, 2017 NYLJ LEXIS 3688, *8 (Supreme Ct. N.Y. 2018) (measure of damages for breach of duty to defend cost of defense and amount of recovery against insured; absent express limit on attorney's fees, insured's damages not limited by policy limits)
- **Oregon:** *See, cf. Warren v. Farmers Ins. Co.*, 838 P.2d 620, 624 n.2 (Or. 1992) (declining to recognize tort theory for breach of duty to defend, but indicating insurer may have liability for default judgment in excess of policy limits for breach of contractual duty)
- **South Carolina:** *Hodges v. State Farm Mut. Auto. Ins. Co.*, 488 F. Supp. 1057, 1063 (D.S. Car. 1980) (S. Car. law) (insurer's failure to defend may make it liable for damages in excess of policy limits)
- **Wisconsin:** *Charter Oak Fire Ins. Co. v. Hedeem & Cos.*, 280 F.3d 730, 738 (7th Cir. 2002) (WI law) (under Wisconsin law, when insurer breaches duty to defend, insured can recover damages naturally flowing from that breach including costs and attorney's fees incurred by insured in defending suit)

Jurisdictions Allowing Additional Damages

However, a handful of courts have allowed a claim for tort damages, such as mental anguish and even punitive damages, for breach of the duty to defend. *See, e.g.:*

- **California:** *Century Sur. Co. v. Polisso*, 139 Cal. App. 4th 922, 949 (Cal. Ct. App. 2006) (in breach of duty to defend alleging breach of duty of good faith and fair dealing, insured can recover punitive damages); *accord*, *Campbell v. Superior Ct.*, 44 Cal. App. 4th 1308, 1320-22 (Cal. Ct. App. 1996) ("Limiting an insured to contract damages for breach of the duty to defend would result in inequitable treatment of insureds based upon their financial status."); *Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370 (9th Cir. 1985) (Cal. law) (compensatory and punitive damages awarded for breach of duty to defend)
- **Delaware:** *See Oliver B. Cannon & Son Inc. v. Fidelity & Cas. Co.*, 484

F. Supp. 1375 (D. Del. 1980) (Penn. and Del. law) (discussing availability of punitive damages for breach of duty to defend)

- **North Dakota:** *Smith v. American Family Mut. Ins. Co.*, 294 N.W.2d 751, 759 (N.D. 1980) (adopting rule refusal to defend can give rise to tort liability including emotional distress and punitive damages)
- **Pennsylvania:** *Mark I Restoration SVC v. Assurance Co. of Am.*, 248 F. Supp. 2d 397, 406 (E.D. Penn. 2003) (insured stated cause of action under Pennsylvania's bad faith statute, 42 Pa. Cons. Stat. Ann. 8731, but failed as matter of law where insurer properly determined no duty to defend)

Conclusion and Takeaways

A number of jurisdictions have addressed damages outside of policy limits involving breach of the duty to defend, mostly within the context of liability for excess judgments or settlements. However, a minority of jurisdictions, including Texas, authorize recovery of non-economic damages for breach of the duty to defend.

Such cases are not a cause for alarm. While the threat of additional damages theoretically increases the stakes for a legit-

imate denial of coverage, a properly drafted reservation of rights or declination of coverage should not contain a misrepresentation. Likewise, insurers may prevail on a *bona fide* coverage dispute or other safe harbor. See, e.g., *U.S. Fire Ins. Co. v. Williams*, 955 S.W.2d 267 (Tex. 1997); *Wells v. Minnesota Life Ins. Co.*, 885 F.3d 885, 897 (5th Cir. 2018) (*bona fide* dispute over coverage does not give rise to bad faith); *National Cas. Co. v. South Shore Iron Works, Inc.*, 341 F. Supp.3d 884 (N.D. Ill. 2018) (insurer has option to either defend under reservation of rights or timely initiate declaratory judgment action); *Wilson v. 21st Century Ins.*, 171 P.3d 1082, 1088-89 (Cal. 2007) (discussing genuine dispute defense). In other words, denial of a defense may not be a breach *or* a tort.



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