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TEXAS INSURANCE LAW NEWSBRIEF

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TEXAS SUPREME COURT ARTICULATES NEW BAD FAITH STANDARDS

Those who follow Texas insurance cases have seen the pattern of policyholders' counsel seeking the contract benefits as the sole measure of extra-contractual damages. The biggest unresolved legal question in the Texas bad faith world which fueled this strategy was whether a breach of contract was necessary for an insured to recover common law or statutory bad faith damages. Last Friday, the Supreme Court of Texas addressed these issues in detail in a decision where it reversed both the court of appeals and trial court judgment for the insured in *USAA v. Menchaca*, No. 14-0721 (Tex. April 7, 2017). In a dense and thorny 37-page opinion, the high court crafted a new and somewhat byzantine set of rules for determining when a policyholder may and may not recover statutory EC damages from a carrier in an insurance case. In light of the significance of this opinion to the future of insurance coverage litigation, we provide an in-depth review here, and also wanted to provide a link to the full opinion: Full Opinion

The Supreme Court of Texas began by stating: ***"Today's case presents an opportunity to provide clarity regarding the relationship between claims for an insurance policy breach and Insurance Code violations."*** The court then set forth five "distinct but interrelated rules that govern the relationship between contractual and extra-contractual claims in the insurance context." Carriers who get sued in Texas for bad faith must now understand these parameters from the Texas Supreme Court

Trial History. At the trial of this first party property case (which Chris Martin from our firm handled as lead counsel), the jury in Conroe, Texas (north of Houston) found the claimed damages were below the deductible and no policy benefits were owed. As such, the jury found USAA did not breach the contract. The trial court also found the carrier did not violate five provisions of the Texas Insurance Code. Curiously, the jury did find the carrier violated one other provision of the Insurance Code by not "reasonably investigating" the claim. The jury then awarded the insured nothing for contract benefits (because there was there was no breach of contract), $11,350 for actual damages on her unfair-practices claim and $130,000 in attorney fees. USAA moved for post-judgment verdict in its favor arguing the jury's finding that the policy was not breached precluded bad faith or other extra-contractual liability. The trial court denied that motion. In a curious case of appellate docket equalization, the historically conservative Houston Court of Appeals then transferred the case to the historically liberal Corpus Christi Court of Appeals. The Corpus Christi Court of Appeals ultimately agreed there was no error and affirmed the judgment for Menchaca. Last Friday, the Supreme Court of Texas reversed and remanded the case for a new trial "consistent with the rules we have clarified today."

Brief Holdings by the Supreme Court:

The court summarized its holdings essentially as follows:

- An insured cannot recover policy benefits as damages for a statutory violation if the policy does not provide a right to those benefits (i.e. if the contract isn't breached).
- An insured can recover policy benefits as actual damages under the Insurance Code even if the insured has no contractual right to those benefits, ***if*** the statutory violation causes the loss of the benefits or the insurer's conduct caused the insured to lose that right. *Some conceivable hypothetical examples might be a wrongful cancellation, a misrepresentation at the time of sale that caused the insured to forego an available optional coverage, or requiring the insured to sign a certain kind of release in exchange for improper consideration.*
- 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 independent injury even if the insured is not entitled to receive policy benefits.
    - But if the policy does entitle the insured to benefits, the insurer's statutory violation does not permit the insured to recover any actual damages beyond those policy benefits unless the violation causes an injury independent from the loss of benefits.
- An insured cannot recover any damages based on an insurer's statutory violation if the insured had no right to receive policy benefits and sustained no injury independent of the right to policy benefits. *By the court's own description, this is essentially a corollary to the other rules, and could be seen as merely a restatement of the first rule.*

The heart of the *Menchaca* case can be boiled down to the two types of scenarios where the court allowed for possible extra-contractual damages in the absence of a covered and compensable loss: (a) when an act of the carrier causes the insured to lose contractual rights it would otherwise have had (in this type of scenario, the erstwhile policy benefits may be the proper measure), or (b) the insured proves an independent injury beyond the loss of benefits (the "independent injury" rule). In all other case situations, the court appears to be endorsing the rule advocated by carriers and their counsel for many years: "no coverage = no extra-contractual damages."

Discussion of The Court's Five Rules:

The principal issue before the Supreme Court was "whether the insured can recover policy benefits based on findings the insurer violated the Texas Insurance Code, and the violation resulted in the insured's loss of benefits the insurer "should have paid" under the policy, **even though the jury failed to find that the insurer breached its policy obligations.** It was this question the court considered so complex as to require a 37-page opinion, culminating in remand of the case to the trial court "in the interest of justice" for a new trial consistent with the five rules outlined below.

1. 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."
The court 'clarified' this general rule in a detailed recitation of the historic rulings on the issue and concluded:
"If the insurer violates a statutory provision, that violation—at least generally—cannot cause damages in the form of policy benefits that the insured has no right to receive under the policy." ***But…*** "…if the jury finds that the policy entitles the insured to receive the benefits *and* that the insurer's statutory violation caused the insured to not receive those benefits, the insured can recover the benefits as "actual damages . . . caused by" the statutory violation. ***Therefore…***"Because an insurer's statutory violation permits an insured to receive only those "actual damages" that are "caused by" the violation, we clarify and affirm the general rule that an insured cannot recover policy benefits as actual damages for an insurer's statutory violation if the insured has no right to those benefits under the policy."

2. The Entitled-to-Benefits Rule. "…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."
The court clarified and affirmed this rule with this comment: "In short, *Stoker* and *Castañeda* stand for the general rule that an insured cannot recover policy benefits as damages for an insurer's extra-contractual violation if the policy does not provide the insured a right to those benefits. *Vail* announced a corollary rule: an insured who establishes a right to benefits under the policy can recover those benefits as actual damages resulting from a statutory violation." The Court's recognition of *Vail*, decided more than 30 years ago, does seem to make it clear that if the jury finds a breach of contract, those damages can also constitute statutory EC damages. By itself, this isn't remarkable because a successful plaintiff would still have to make an election of remedies if the same damages were awarded for the contract and EC violation, but it does open the door to the possibility of the insured also seeking to have those same EC damages "trebled" for any "knowing" violation of the Insurance Code

3. The Benefits-Lost Rule. "...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."
This scenario could occur, according to the Court, in three instances;

- "an insurer that violates the statute by misrepresenting that its policy provides coverage that it does not in fact provide can be liable under the statute for such benefits if the insured is "adversely affected" or injured by its reliance on the misrepresentation."
- "where an insurer's statutory violations prejudice the insured, the insurer may be estopped "from denying benefits that would be payable under its policy as if the risk had been covered…Under such circumstances, the insured may recover "any damages it sustains because of the insurer's actions," even though the policy does not cover the loss."
- "when the insurer's statutory violation actually caused the policy not to cover losses that it otherwise would have covered."

4. The Independent Injury Rule. "…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."
The court "clarified" the rule saying:

1. "…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." ***But…***
2. "…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."

5. The No Recovery Rule. "…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 benefits."
The court considered this 'simply a corollary to the first four rules" and affirmed several prior holdings in favor of carriers because:

- The policy did not cover the claim and the insureds "have not alleged any act so extreme as to cause an injury independent of [the denial of their claim]"
- The policy did not cover the claim and the insureds demonstrated no "independent injury arising from" statutory violations);
- There was no coverage [for the claim] or breach [of the policy] and the insured put forth no evidence of "extreme conduct or of damages suffered independent of those that would have resulted from an alleged wrongful denial of his claim."

The high court's ruling *Menchaca* endorses, in most factual scenarios, the well-established general rule of "no coverage = no extra-contractual damages" as well as the "independent injury" rule. But, it has also unintentionally created a "gray area" in which there may exist a narrow spectrum of possible fact scenarios in which an insured might have no contractual right to policy benefits, but yet still argue for their entitlement to recover extra-contractual damages without proving any independent injury. The language of the opinion appears to create a very narrow gap between the general "no coverage = no EC" rule and the "independent injury" rule into

which only a very limited class of wrongful acts could potentially fall. Possible hypothetical examples might possibly include a wrongful cancellation of a policy, a misrepresentation causing the insured not to buy coverage that would have covered the loss, estoppel scenarios preventing the carrier from enforcing a particular policy term or condition, or an unconventional release situation.

Menchaca is likely to stand in the Texas legal lexicon with *Vail, Moriel, Stoker, Casteneda*, and their brethren. Unfortunately, it is unlikely to be celebrated for its clarity or conciseness. The rules crafted by this opinion appear somewhat unwieldy and fact-intensive, and how the lower courts will apply them obviously remains to be seen. It also remains to be seen how large the gray area will ultimately prove to be once trial courts and lower appellate courts begin to apply *Menchaca*. Thus, practitioners across the state, on both sides of the bar, may not able to build a full understanding of their clients' prospects without several more years of follow-up litigation on this still-evolving issue. It does, however, seem to be a step in the right direction and it was a huge victory to have the high court of Texas reject the policyholders' overly simplistic and potentially dangerous positions regarding the bad faith issues on appeal in this case.

[**Editor's Note**: MDJW was privileged to represent USAA in this case as lead counsel in the trial court and as co-counsel through the intermediate appeal and ultimately to the Supreme Court of Texas. We wish to congratulate USAA for having the fortitude to take this case all the way to the high court in order to get these critical issues clarified.]