

Texas Supreme Court Clarifies Whether Bad Faith Liability May Exist in Absence of a Policy Breach



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In *Menchaca v. USAA Texas Lloyds Company*, Cause No. 14-0721 (Tex.2018) the Texas Supreme Court replaced its prior 2017 opinion. The court continues to hold that where there has been no breach of the insurance policy, **generally** but not always, extracontractual causes of action are not available. In articulating five separate rules, the Texas Supreme Court focused on the nexus between the alleged misconduct and the alleged damages, “clarifying” the procedural steps a court should follow in determining which rule applies and what damages apply.

Case Overview

Menchaca arises from a Hurricane Ike first-party property claim. Gail Menchaca (Menchaca) insured her home through USAA Texas Lloyds Company (USAA). After Hurricane Ike, Menchaca submitted a claim for damage to USAA, which opened a file and commenced an investigation. USAA’s investigation concluded that Menchaca suffered damages as a result of the hurricane, but that the damages were less than Menchaca’s deductible. Accordingly, USAA made no payment. Menchaca disagreed and filed suit, alleging that USAA breached its policy obligations by not paying the full extent of her loss and that it violated the unfair settlement practices provisions of the Texas Insurance Code, in part, by failing to conduct a reasonable investigation into her loss.

After trial, the jury returned a verdict that found: (1) that USAA did not breach its policy obligations; (2) that USAA refused to pay a claim without conducting a reasonable investigation; and (3) that Menchaca’s damages totaled \$11,350. Both Menchaca and USAA argued that the jury verdict was clear and requested that judgment be entered in their favor. The trial court disregarded the jury’s finding that USAA did not breach its contractual obligations and entered judgment in favor of Menchaca.

Result Overview

The Texas Supreme Court concluded unanimously that while statutory bad faith claims could exist in the absence of a carrier’s breach of its policy obligations, the exceptions to the “general rule” precluding statutory bad faith when a carrier complied with its contractual obligations are narrow. Additionally, in considering the jury’s verdict and the actions of the trial court, the court unanimously concluded that the trial court erred in disregarding the jury finding of no breach by USAA. But the court was not unanimous in the procedural effect of applying the five rules applicable to a breach of contract with extracontractual claims, to the actual *Menchaca* jury findings. For three of the seven justices (one abstained), the jury’s findings resulted in a decision that judgment should be rendered in favor of USAA. For the other four justices, the jury verdict contained a fatal contradiction that ultimately required a remand to the trial court for a new trial. Thus, based on a plurality, the case has been remanded to the trial court.

Statutory Bad Faith Law in Texas

In reaching its holding that a claim for statutory bad faith could exist independently of an actual breach of the policy obligations, the Texas Supreme Court examined the history of the Texas Insurance Code, and its own prior precedent, to “provide clarity regarding the relationship between claims for an insurance-policy breach and Insurance Code violations.” In doing so, the Texas Supreme Court announced that “five distinct but interrelated rules govern the relationship between contractual and extra-contractual claims in the insurance context.”

First, the Texas Supreme Court stated that, as a 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.” Thus, in most cases, the failure to show that a carrier breached its obligations under a policy will end any claim that a carrier engaged in statutory bad faith conduct. Although the Texas Supreme Court acknowledged that an insurer’s duties under the Texas Insurance Code were separate and distinct from the insurer’s duties under a policy, recovery for a statutory violation flows only from the existence of actual damages. Stated differently, statutory bad faith conduct generally cannot cause “actual damage” to the policyholder, when the policyholder has no rights under the policy in the first place.

The second rule considers the case where a policyholder secures a finding that a carrier did fail to pay benefits as required under the policy. The Texas Supreme Court pointed out that, by its terms, the remedies provided under the Texas Insurance Code were cumulative of other available remedies. Thus, in this situation, the policyholder can recover both damages for the carrier’s breach of its policy obligations and damages when the enumerated statutory bad faith conduct **caused** the insurer to breach its obligations under a policy. Here, the Texas Supreme Court focused on the causal relationship between the alleged statutory misconduct and the reasons why a claim was not paid or underpaid. For example, a carrier that underpays a claim **because of** an inadequate investigation would be liable for actual damages in at least the amount of the unpaid policy benefits. Thus, the statutory violation caused the insured to suffer a loss of policy benefits, and the insured may elect the liability theory under which it recovers.

The third rule, identified as the “Benefits-Lost Rule,” describes an exception to the general rule. The Benefits-Lost Rule provides that a policyholder can recover policy benefits as actual damages “if the insurer’s statutory violation caused the insured to lose” its rights under the policy. As examples, the Texas Supreme Court referred to: (1) the situation where a carrier misrepresents that a policy provides coverage that is not, in fact, existent, and the policyholder suffers injury as a result of its reliance on such a misrepresentation; and (2) the situation where an insurer’s conduct caused the policy not to cover losses that the policy otherwise would have covered, as where the carrier improperly pays out benefits, thereby exhausting the policy limits for another claim. The Texas Supreme Court also reiterated the rule that waiver and estoppel cannot be used to rewrite a policy to create coverage. But, the Texas Supreme Court noted that where an insurer’s statutory violations prejudice the insured’s right to coverage, the insurer may be estopped from denying benefits that would exist but for the insurer’s conduct.

The fourth rule holds that an insurer can be liable for damages when its conduct causes a policyholder to suffer damage independent of the loss of policy benefits. The “independent injury” must be distinct from the claimed policy benefit. Such an injury could be mental anguish, so long as that injury flowed from the insurer’s conduct, and not simply from the denial of a claim. Damages that are predicated on a loss being covered by a policy do not count as independent injuries. The Texas Supreme Court noted that it had never yet encountered a successful independent injury claim.

The fifth rule announced by the Texas Supreme Court confirms that “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.”

Submitting Claims for Policy Benefits and Bad Faith Claims

The Texas Supreme Court noted that problems arose at the trial court level due to confusion over how a case alleging both a loss of policy benefits and statutory bad faith claims should be submitted to a jury. While noting that it was not providing an advisory opinion, it did state that for claims involving statutory bad faith claims, a proper jury submission would first ask whether the insurer engaged in improper conduct that caused damage to an insured, with a second question asking the jury to determine the amount of damage caused by the improper conduct. In doing so, the Texas Supreme Court stressed that the jury response must find that the violation in question caused the insured to lose benefits to which the insured was otherwise entitled, with any instructions needed to establish the critical causation element.

Conclusions

Menchaca removes some of the confusion created by the original opinion issued by the Texas Supreme Court but leaves open other questions. And, it is unclear whether this opinion applies

only to first-party claims, or also encompasses third-party matters. Insurers and practitioners faced with statutory bad faith claims are encouraged to examine closely the nexus between the alleged improper conduct and the alleged damages suffered to determine which rule applies to the given fact pattern. At the very least, practitioners and carriers should scrutinize carefully the charge and questions submitted to a jury to ensure they follow the pronouncements set forth in *Menchaca*.

To discuss any questions you may have regarding the issues addressed in this Alert, or how they may apply to your particular circumstances, please contact Gregory S. Hudson at (832) 214-3909 or ghudson@cozen.com.