

Texas Supreme Court Clarifies Viability of Statutory Extracontractual Claims in Absence of Coverage

On Friday, April, 7, 2017, the Texas Supreme Court issued its opinion in *USAA Texas Lloyds Company v. Menchaca*, describing its ruling as clarifying much of the confusion that has existed among the courts in Texas with respect to whether, absent a finding the insured had a contractual right to policy benefits, the insured can recover actual damages caused by an insurer's violation of the Texas Insurance Code¹. In doing so, the court set forth five "distinct but interrelated rules" that govern the relationship between contractual and extracontractual claims at least in the first party insurance context, focusing also on what the term "actual damages" means. Finding that both the trial court and appellate court had erred, the Texas Supreme Court remanded the case in the interest of justice for a new trial consistent with its clarified rules.

As with any opinion, the factual and procedural background is important. Gail Menchaca (Menchaca) filed a first party insurance claim with her insurer, USAA Texas Lloyds Company (USAA) claiming that her home sustained damage as a result of Hurricane Ike. The adjuster that investigated Menchaca's home found only minimal damage and although USAA relied on the adjuster's findings determining that there were some covered damages because the amount of those damages was less than the policy's deductible it did not pay any amount under the policy. Menchaca complained of the adjustment and USAA sent a second adjuster to re-inspect the home. After the second adjuster confirmed the first adjuster's findings, USAA again declined to pay any policy benefits. Menchaca sued USAA for breach of the insurance policy and for unfair settlement practices in violation of the Texas Insurance Code.

The matter was tried before a Montgomery County jury. Jury Question 1 asked whether USAA failed to comply with the terms of the policy, to which the jury answered "no." Without conditioning Jury Question 2 with a "yes" answer to Jury Question 1, Jury Question 2 asked whether USAA engaged in various unfair or deceptive practices, including whether USAA refused to pay a claim without conducting a reasonable investigation. The jury answered "yes," to Jury Question 2. Jury Question 3 was a damages question. It asked the jury to determine Menchaca's damages that resulted from either USAA's failure to comply with the policy or its statutory violations, calculated as "the difference, if any, between the amount USAA should have paid Menchaca for her Hurricane Ike damages and the amount that was actually paid." The jury awarded \$11,350. In post-judgment argument, USAA argued that the answer to Jury Question 1 was issue determinative while Menchaca argued that the two questions could each stand on their own. The trial court resolved the parties' dispute by disregarding the jury's answer to Jury Question 1 as immaterial. Relying instead on the answers to Questions 2 and 3, it entered a final judgment in Menchaca's favor for \$11,350².

On appeal to the Court of Appeals of Texas, Thirteenth District, Corpus Christi, USAA argued that the jury's answer to Jury Question 1 was outcome determinative because there was no finding of a breach of the insurance policy. In rebuttal, Menchaca argued that the jury's answer to Jury Question 2 that USAA violated the Texas Insurance Code was, in effect, a finding that had USAA conducted a thorough investigation it would have paid Menchaca the benefits due under her policy. The court of appeals affirmed the trial court's decision to disregard Jury Question 1 and, although for different reasons than expressed by the trial court, affirmed the judgment.

On appeal to the Texas Supreme Court, the court concluded that the trial court and the court of appeals erred by disregarding the jury's answer to Jury Question 1 concerning whether there was a breach of contract because a jury question can only be disregarded if it is unsupported by the evidence or if the issue is immaterial — neither of which was the case in the instant lawsuit. It then concluded that the arguments of both parties had some support in existing Supreme Court case



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law, and there was confusion in the case law on the issues before the court. The court therefore remanded the case for trial “in the interest of justice” based upon the Supreme Court’s clarification of the confusion surrounding whether a jury finding of no breach is the end of the inquiry or whether an insured can prevail if an insurer’s violation of the Texas Insurance Code causes non-breach of contract damages, establishing the following five rules to guide the parties’ new trial.

Rule One: the court noted that it first announced the general rule in *Republic Ins. Co. v. Stoker*, 903 S.W.2d 338 (Tex. 1995) that if the policy does not provide the insured a right to receive the claimed benefits, i.e., no coverage under the policy, generally an insured has no statutory right of recovery for actual damages, even if there was a statutory violation of the Texas Insurance Code. But the court clarified this rule, stating that it actually addresses a denial of a claim and not “any kind” of bad faith conduct, holding that a more accurate statement of the *Stoker* rule is: “there can be no claim for bad faith [denial of an insured’s claim for policy benefits] when an insurer has promptly denied a claim that is in fact not covered.” Further, and more importantly, the court confirmed that an insured who sues an insurer for statutory violations can only recover damages “caused by” those statutory violations.

Rule Two: the court reiterated the “Entitled-to-Benefits” Rule expressed in *Vail v. Texas Farm Bureau Mutual Insurance Co.*, 754 S.W.2d 129 (Tex. 1988), that an insured who establishes a right to receive benefits under the policy can recover those benefits as actual damages under the Texas Insurance Code if the insurer’s statutory violations cause the loss of the policy benefits. The court noted that the Texas Insurance Code provides that statutory remedies are cumulative of other remedies and allows an insured to elect between statutory remedies or breach of contract remedies.

Rule Three: calling it “The Benefits-Lost Rule,” the court confirmed that even if an insured cannot establish a current right to policy benefits, it can still recover those policy benefits as actual damages under the Texas Insurance Code if the insurer’s statutory violation(s) causes the insured to lose its contractual rights. The court cited three possible scenarios: (1) where the insurer had misrepresented what the policy did and did not cover, holding that an insured would be entitled to recover its damages and loss of policy benefits citing *Royal Globe Ins. Co. v. Bar Consultants, Inc.*, 577 S.W.2d 688 (Tex. 1979); (2) where the insurer’s statutory violations “prejudice the insured, the insurer may be estopped ‘from denying benefits that would be payable under its policy if the risk had been covered’” citing *Kennedy v. Sale*, 689 S.W.2d 890 (Tex. 1985); and (3) in those circumstances where the insurer’s statutory violation “actually caused the policy not to cover losses that it otherwise would have covered citing *JAW the Pointe, LLC. v. Lexington Insurance Co.*, 460 S.W.3d 597 (Tex. 2015). In concluding its discussion of Rule Three, the court stated: “Put simply, an insurer that commits a statutory violation that eliminates or reduces its contractual obligations cannot then avail itself of the general rule” that “waiver and estoppel cannot be used to re-write a policy so that it provides coverage it did not originally provide.” The court indicated that an example of the Benefits-Lost Rule could include the situation where a health insurer’s agent represented that a policy “offered full coverage without qualification” for preexisting medical conditions, the insured reasonably relied on that representation, but the policy actually limited such coverage to a specific, maximum amount. In that case, the insured would have the right to full coverage even though coverage under the policy was limited.

Rule Four: identified as “the Independent-Injury Rule” and relying on *Tex. Mut. Ins. Co. v. Ruttiger*, 381 S.W.3d 430 (Tex. 2012) and *Transportation Insurance Co. v. Moriel*, 879 S.W.2d 10 (Tex. 1994), the court confirmed that if an insurer’s statutory violation(s) 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 but only if the insurer’s acts are so extreme that its conduct causes an injury independent of the policy claim. The court identified two aspects to this rule. The first aspect is the requirement that the statutory violation must cause “an injury independent to the insured’s right to recover policy benefits” The court made it clear, however, that an insured’s damages must be separate and distinct from a mere denial of policy benefits and cannot merely “flow from” or “stem from” a denial of policy benefits. The second aspect of the Independent-Injury Rule is that an “insurer’s statutory violation does not permit the insured to recovery **any** damages beyond policy benefits unless the violation causes an injury that is independent from the loss of the benefits.” The court noted, however, that no Texas court has ever found such an extreme act sufficient to allow such a recovery under this rule.

Rule Five: under the court’s “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 the insured did not sustain an injury independent of its right to policy benefits, citing *Castaneda and Lundstrom v. United Servs. Auto Ass’n – CIC*, 192 S.W.3d 78 (Tex.App. – Houston [14th Dist.] 2006, pet. denied). The court noted that “[t]he fifth and final rule is simply the natural corollary to the first four rules.” Simply put, the court held that if there is no coverage under the policy for the alleged claim and the conduct of the insurer in adjusting the non-covered claim does not cause any harm other than a denial of policy benefits, the insured has no statutory claim against its insurer under the Texas Insurance Code.

To prevail in a new trial, Menchaca will have to prove whether or not it was owed policy benefits, whether USAA conducted a proper investigation or committed some other statutory violation, and the actual damages, if any, resultant from either.

This opinion is a worthwhile read because it not only summarizes 30 plus years of Texas bad faith law but, more importantly, the court clarifies the differences between decisions from various courts of appeals and the Fifth Circuit on the more subtle issues involving extracontractual law. It also focuses on the proper measure of damages when insurance breach of contract and extracontractual claims are asserted. As with any Texas Supreme Court decision, whether it actually eliminates the confusion, will play out in the court opinions that follow.

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Alicia Curran at (214) 462-3021 or acurran@cozen.com or Ron Tigner at (832) 214-3935 or rtigner@cozen.com.

¹ The court, while discussing several opinions, couched this opinion as an opportunity to provide clarity regarding the relationship between claims for an insurance policy breach and Texas Insurance Code violations, and to settle the conflicts created by the confusion of precedents including that created by the opinions in *Provident American Insurance Co. v. Casteneda*, 988 S.W.2d 189, 198 (Tex. 1998) and *Vail v. Texas Farm Bureau Mutual Insurance Co.*, 754 S.W.2d 129, 136 (Tex. 1988).

² The jury also found that Menchaca’s reasonable and necessary attorney’s fees “for representation in the trial court” totaled \$13,000, and did not find that Menchaca failed to mitigate her damages or that USAA “knowingly” violated the Texas Insurance Code, i.e. no up to treble damages under the Insurance Code.