Texas Supreme Court: Breach of Contract Not Required to Prevail on Statutory Bad Faith Claim

In <u>USAA Texas Lloyds Company v. Menchaca</u>,[1] the Supreme Court of Texas clarified long-standing confusion regarding whether damages for bad faith are recoverable in the absence of a breach of contract under Texas law. The Menchaca case takes an in-depth dive into decades' worth of Texas precedent and concludes that, under certain circumstances, an insured can recover policy benefits as damages for bad faith without finding that the insurer was in breach of contract.

The story of this case begins with Hurricane Ike in September 2008. Homeowner Gail Menchaca contacted her homeowner's insurance company, USAA Texas Llloyds Company ("USAA") to report that the storm had damaged her home. USAA sent an adjuster to investigate the claim, and USAA determined that although the policy covered some of the damage, no benefits would be paid under the policy because the repair estimate did not exceed the policy deductible. Five months later, at Ms. Menchaca's request, another USAA adjuster inspected the property and reached the same conclusion.

Ms. Menchaca filed a lawsuit against USAA for breach of contract and unfair settlement practices in violation of the Texas Insurance Code. As damages, she sought insurance benefits under the policy, plus court costs and attorney's fees. The case was tried to a jury, and the jury was presented with three questions: 1) was USAA in breach of contract for failure to pay the claim; 2) did USAA engage in various unfair or deceptive practices under the statute, including refusal to pay a claim without a reasonable investigation; and 3) the amount of damages that resulted from either Question 1 or 2, calculated as the difference between the amount of insurance policy benefits USAA "should have paid" and the amount that was actually paid. The jury answered No to Question 1, Yes to Question 2, and $11,350 to Question 3. The court of appeals affirmed the jury verdict, and the Supreme Court of Texas granted USAA's petition for review.

On appeal, USAA argued that Ms. Menchaca could not recover any policy benefits because there was no finding that USAA breached its obligations under the policy, despite the fact that the jury did find that USAA violated the Insurance Code. Ms. Menchaca countered that she was entitled to recover policy benefits because although she lost her breach of contract claim, the jury found that USAA violated the statute and that the violation resulted in damages in the amount of policy benefits that USAA should have paid. Thus, the issue was "whether an insured can recover policy benefits as 'actual damages' caused by an insurer's statutory violation absent a finding that the insured had a contractual right to the benefits under the insurance policy." The Supreme Court noted that there had been confusion amongst Texas courts on this very issue and seized the opportunity to clarify the principles of Texas bad faith law, setting forth five "distinct but interrelated" rules.

I.   The General Rule

Under Texas law, "[t]he general rule is that an insured cannot recover policy benefits for an insurer's statutory violation if the insured does not have a right to those benefits under the policy." This is because the Insurance Code only permits the recovery of actual damages "caused by" the violation. The Court clarified the meaning of this rule: an insured has no claim for bad faith when their insurer promptly denies a claim that is not covered.

USAA argued that the general rule applies to this case; therefore, Ms. Menchaca could not recover policy benefits based on a violation of the Insurance Code because the jury found that USAA did not breach the contract. However, the Supreme Court noted an important distinction: for purposes of the bad faith statute, what matters is whether the insured was entitled to receive benefits under the policy, not whether the insured prevailed on a breach of contract claim. Thus, "if the insured was entitled to the benefits and the insurer's statutory violation caused the insured to lose those benefits, the statute authorizes the insured to recover those benefits as 'actual damages ... caused by' the statutory violation, even if the insured does not submit a separate breach-of-contract claim."

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1.   No. 14-0721, 2018 WL 1866041 (Tex. Sup. Ct. April 13, 2018).

II.   The Entitled-to-Benefits Rule

The second rule is that an insured who is entitled to policy benefits can recover those benefits under the bad faith statute only if it was the violation of the statute that caused the loss of benefits. At first glance, this seems to be a straightforward and logical extension of the general rule; however, there was some confusion amongst Texas courts as to how to apply seemingly inconsistent precedent addressing this issue. The Texas Supreme Court took this opportunity to clarify that if an insurer wrongfully denies a valid insurance claim in violation of the bad faith statute, the resulting damages include the amount of wrongfully withheld policy benefits.

III.   The Benefits-Lost Rule

Pursuant to the Benefits-Lost Rule, "an insured can recover benefits as actual damages under the Insurance Code even if the insured has no right to those benefits under the policy, *if the insurer's conduct caused the insured to lose that contractual right*."[2] For example, an insurer may misrepresent that a policy provides coverage when in reality, it does not. The insurer's misrepresentation doesn't create coverage under the policy, but it does constitute a violation of the statute, with damages being the amount of policy benefits the insured reasonably believed they were entitled to receive. The Court concluded that "[p]ut simply, an insurer that commits a statutory violation that eliminates or reduces its contractual obligations cannot then avail itself of the general rule."

IV.   The Independent-Injury Rule

The fourth rule discussed by the Court is the Independent-Injury Rule, which posits that an insurer's liability for bad faith is separate and distinct from its liability for benefits under the policy. This leaves open the possibility that an insurer can deny a claim that is not covered, yet in doing so commit a bad faith act so extreme that it causes injury independent from the claim for coverage. In such a case, the insured can recover damages for their injury even though they are not entitled to benefits under the policy. However, the bad faith damages must be truly separate from the claim for coverage; that is, they cannot be based on an improper denial of a claim for policy benefits. Additionally, pursuant to the Independent-Injury Rule, violation of the bad faith statute "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." The Court acknowledged that the circumstances under which violation of the bad faith statute could give rise to a successful independent-injury claim would so rare that the Court could not even speculate as to what such a claim might entail.

V.   The No-Recovery Rule

"The fifth and final rule is simply the natural corollary to the first four rules: An insured cannot recover *any* damages based on an insurer's statutory violation unless the insured establishes a right to receive benefits under the policy or an injury independent of a right to benefits." That is, if there is no coverage under the policy for the claim, and the insurer's conduct in handling the claim causes no harm (other than the justified denial of policy benefits), the insured cannot recover any damages under the Insurance Code.

VI.   The Menchaca Claim

Having set forth these rules, the Court applied them to Ms. Menchaca's claim. First, the Court noted that USAA's position ignored the fact that an insured need not prove a breach of contract in order to prevail on a statutory bad faith claim; under either the Entitled-to-Benefits Rule or the Benefits-Lost Rule, the insured need only establish that the insurer violated the statute, and that violation resulted in loss of benefits the insured was entitled to.

However, the conundrum here was that the jury's answers to Questions 2 and 3 conflicted with its answer to Question 1. If USAA should have paid policy benefits, but failed to do so, then the jury should have answered "yes" to Question 1. The trial court's solution was to side-step the issue and disregard the jury's answer to Question 1, which the Supreme Court deemed to be an error. Given the confusing precedent on the issue of whether policy benefits can be awarded for statutory bad faith in the absence of a breach of contract, the Supreme Court remanded the case for a new trial in the interest of justice.

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2.   Emphasis in original.