

TEXAS LAW★ALERT

THE TEXAS SUPREME COURT "CLARIFIES" THE LAW REGARDING RECOVERY OF DAMAGES IN FIRST PARTY BAD FAITH CLAIMS

Prior to last Friday, courts in Texas, both at the state and federal level, had been struggling with the apparent discrepancy between the Texas Supreme Court's holding in *Vail v. Texas Farm Bureau Mut. Ins. Co.*, 754 S.W.2d 129 (Tex. 1988), wherein the court held that an insurer's unfair refusal to pay the insured's claim causes damages as a matter of law in at least the amount of the policy benefits wrongfully withheld, and the holding in *Provident Am. Ins. Co. v. Castaneda*, 988 S.W.2d 189 (Tex. 1998), wherein the court held that an insurance company's failure to properly investigate a claim is not a basis for obtaining policy benefits. Many courts had taken the position that *Castaneda* effectively overruled *Vail*.

The Texas Supreme Court now believes that it has "clarified" the issues in *USAA Tex. Lloyds Co. v. Menchaca*, 2017 WL 1311752 (Tex. Apr. 7, 2017), a case in which the court, while recognizing that its prior language could have been clearer, recognized no concern with the rules stated in *Vail* and *Castaneda* standing side by side. In this case, an insured's home suffered damage when Hurricane Ike struck Galveston. She contacted her carrier and reported the damage. An adjuster investigated the claim and determined that the damage did not exceed her policy's deductible so the claim was denied. Five months later, another adjuster re-inspected the property and confirmed the first adjuster's findings. The insured then sued the carrier for breach of contract and for unfair claim settlement practices. As damages for both claims, she sought only the insurance benefits under the policy. The jury held that the carrier did not breach the insurance contract, but did find that the carrier failed to conduct a reasonable investigation. The damages question asked the jury to determine insured's damages that resulted from either the carrier's failure to comply with the policy or its statutory violations, calculated as the difference, if any, between the amount the carrier should have paid for the damages and the amount that was actually paid. The jury answered in favor of the insured in the amount of \$11,350.

The question presented to the Texas Supreme Court was whether an insured can recover policy benefits as actual damages for insurance code violations absent a finding that the insured had a contractual right to the benefits under the policy? In responding to this question, the court noted that the case "presents an opportunity to provide clarity regarding the relationship between claims for an insurance policy breach and Insurance Code violations." The court went on to outline five interrelated rules that govern the relationship between contractual and extra-contractual claims in the insurance context.

1. As a general rule, an insured cannot recover policy benefits as damages for an insurer's statutory violation if the policy does not provide a right to receive those benefits;
2. 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;
3. 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 statutory violation caused the insured to lose that contractual right;
4. 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; and
5. An insured cannot recover any damages based on a statutory violation if the insured had no right to receive benefits under the policy and sustained no injury independent of a right to benefits.

While these rules seem relatively straightforward, it is not necessarily clear that the court has once and for all clarified anything. In order to try and understand these rules, a brief analysis of each is necessary.

The general rule derives from the fact that the Insurance Code only allows an insured to recover actual damages caused by the insurer's statutory violation. If an insurer violates a statutory provision, that violation, at least generally, cannot cause damage in the form of policy benefits that the insured has no right to receive under the policy.

The second rule, "the entitled to benefits rule," is, according to the court, a logical corollary to the general rule. In discussing this rule, the court found that it did not reject *Vail* in *Castaneda*. Recognizing that it could have made the point clearer, the court noted that the distinction between the two cases is that the parties in *Vail* did not dispute the insured's entitlement to the policy benefits and the only issue was whether the insured could recover those benefits as statutory damages. By contrast, in *Castaneda*, the insured did not establish and the insurer did not concede (once again proof that a carrier should never concede an argument) that the insured had a right to benefits under the policy. In fact, the insured never sought and did not receive any contractual relief and never alleged that the carrier was liable for breach of the insurance contract. Instead, the insured sought only to recover damages equivalent to policy benefits based on her statutory claims. The court ultimately concluded that it clarified and affirmed both of the rules stated in *Vail* and *Castaneda*.

Examples of the third rule, the "benefits lost rule," can be found in claims alleging that an insurer misrepresented a policy's coverage and the insured is adversely affected or injured by its reliance on the misrepresentation, waived its right to deny coverage or is estopped from doing so, or committed a violation that caused the insured to lose a contractual right to benefits it otherwise would have had. In each of these contexts, the insured can recover the policy benefits as damages because the benefits are actual damages caused by the statutory violation.

The fourth rule, entitled the "independent injury rule," is the most problematic for the court. The court noted that there are two aspects to this rule. First, if an insurer's statutory violation causes an injury independent of the right to recovery policy benefits, the insured may recover damage for that injury even if the claim is not covered. This aspect of the rule applies only if the damages are truly independent of the right to recover policy benefits. The second aspect of the rule is that the statutory violation does not permit the insured to recover any damages beyond policy benefits unless the violation causes an injury independent from the loss of benefits. The court noted that the possibility that a statutory violation could cause an independent injury is a rare one, and that it had yet to encounter such an injury. The court refused to even speculate what would constitute a recoverable independent injury.

The final rule, the "no recover rule," is, according to the court, the natural corollary to the first four rules.

Interestingly, the court remanded the case for a new trial given the newly minted rules.

We do not yet know what the result of this case will be. However, what is clear is that carriers can no longer simply argue that the mere fact that no coverage exists under the policy necessarily precludes a claim for statutory damages. Those damages may be the equivalent of policy benefits, depending upon which rule the insured can fight his or her facts under. We are sure that this case will result in more claims for first party bad faith.

We apologize for the lengthy e-mail. It could have been much longer. This was a long opinion. If you have any questions, please do not hesitate to reach out to the firm's appellate and coverage section for additional clarity.

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Craig Reese leads the Firm's appellate and coverage practice group. He has 23 years practice experience including appeals at the federal and state level, insurance coverage/defense, and commercial litigation. He has represented clients in a wide variety of litigation including insurance coverage, general insurance defense, bad faith litigation, and commercial matters. His appellate experience includes cases before every level of the state courts of appeals and appeals to the Fifth Circuit Court of Appeals. In addition, he is a former briefing attorney to the Honorable H.M. Lattimore for the Second Court of Appeals in Fort Worth.

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