INDEPENDENT INJURY: WHAT INSURERS AND CLAIMANTS NEED TO KNOW ABOUT *MENCHACA* AND ACTUAL DAMAGES IN CONNECTION WITH BAD FAITH CLAIMS

There has long been confusion regarding the damages that are recoverable for violations of the Texas Insurance Code (the "Insurance Code"). The statute allows claimants to recover their "actual damages" for an insurer's violation, but decades of convoluted precedent blurred the distinction between the denial of policy benefits and separate injury, leaving an uncertain landscape in this area. However, in *USAA Tex. Lloyds Co. v. Menchaca*, 545 S.W.3d 479 (Tex. 2018), the Texas Supreme Court made it a point to set forth guiding principles with respect to insurance coverage and bad faith claims in an attempt to clear up the quagmire of law that had baffled attorneys and judges in Texas for some time. Literally, the court circulated five interrelated rules, each supported by extensive citations to caselaw, to resolve the noted "confusion over our decisions in this area." *Id.* at 487. The rules set forth in the *Menchaca* opinion have already had, and will continue to have, a profound impact on the landscape of insurance coverage and bad faith litigation, especially with respect to the insured who either is not entitled to benefits under their applicable insurance policy or is seeking damages in addition to the denial of policy benefits.

The Basics—Coverage v. Chapter 541 *etc.*

At the outset, it is worth recapping the distinction between claims for coverage under an insurance policy and claims based on a violation of the common law or statutes that deal with the handling of insurance claims. An insurance policy, after all, is simply a contract and is "generally governed by the same rules of construction as all other contracts." *RSUI Indem. Co. v. The Lynd Co.*, 466 S.W.3d 113, 118 (Tex. 2015). However, insurance policies are different from ordinary arms-length transactions because of the "unequal bargaining power and the nature of insurance contracts which would allow unscrupulous insurers to take advantage of their insureds' misfortunes[.]" *Arnold v. Nat'l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987). Because of this "special relationship," courts even the scale by construing policies in a way that most favors the insured when both sides offer competing, reasonable constructions. *Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738, 741 (Tex. 1998). In any event, a claim that an insurer wrongfully denied an insured policy benefits is a claim that sounds in contract, and is actionable as a breach of contract.

In addition to the obligations that may be imposed on an insurer under an insurance policy, Texas courts have also held that the "special relationship" between the insurer and insured justifies the imposition of additional duties on the insurer, namely a duty of good faith and fair dealing. *Arnold*, 725 S.W.2d at 167. This is a common law duty, which might be implicated when an insurer refuses to reasonably investigate a claim or delays in paying a claim. *Id.* Further, the Insurance Code augments the duties insurers owe to their insureds by proscribing various categories of conduct deemed to be "unfair" or

"deceptive." *See e.g.*, Tex. Ins. Code § 541.060(a)(1) (declaring it to be an unfair or deceptive practice to misrepresent to a claimant a material fact or policy provision relating to coverage). Violations of the Insurance Code give rise to a "private action" for the recovery of "actual damages," separate and apart from the insurer's obligations under the policy. Tex. Ins. Code § 541.151. Insurers would do well to pay careful attention to potential Insurance Code claims, because the insured can recover attorney's fees and costs, in addition to their damages, if they prevail on such a claim, and may even recover treble damages if the violation was committed knowingly. Tex. Ins. Code § 541.152.

Therefore, the relationship between insurer and insured can give rise to two different types of claims; one based on the actual policy and others based on the conduct of the insurer (*i.e.*, extra-contractual claims). *Menchaca* dealt with the interplay (or distinction) between these types of claims and explained what damages are recoverable for violations of the Insurance Code.

Menchaca and the 5 Rules

While the legal principles laid out by the Supreme Court in *Menchaca* are weighty, the underlying dispute was relatively mundane. In 2008, Gail Menchaca made a claim with her homeowner's insurance company, USAA Texas Lloyds, to report the damage that her home sustained during Hurricane Ike. *Menchaca*, 545 S.W.3d at 485. After an investigation, Mrs. Menchaca was denied benefits because the cost to repair the damage supposedly did not exceed her deductible. *Id.* After a second denial of her claim, Mrs. Menchaca filed suit against USAA. *Id.* Crucially, while she alleged both a breach of contract claim and violations of the Insurance Code, she only sought to recover benefits under her policy.

At trial, the jury found that USAA complied with its obligations under the insurance policy. *Id.* at 486. But, the jury also found in favor of Mrs. Menchaca by finding that USAA violated the Insurance Code when it failed to pay the claim without conducting a reasonable investigation. *Id.* The jury awarded Mrs. Menchaca approximately $11,000 in damages calculated as the amount that should have been paid under the policy by USAA. *Id.* USAA nevertheless moved for judgment in its favor based on the finding that it complied with its obligations under the policy. *Id.* The trial court disagreed with USAA and entered a final judgment in Mrs. Menchaca's favor, which was affirmed on appeal and then brought before the Texas Supreme Court. *Id.*

All parties agreed that the jury awarded Mrs. Menchaca policy benefits, but USAA and Mrs. Menchaca disagreed in terms of the efficacy of this award, each relying on apparently conflicting precedent to support their respective positions. *Id.* at 486-87. The key issue was whether Mrs. Menchaca, who was not entitled to benefits under her homeowner's insurance policy, could nevertheless recover policy benefits from USAA based on USAA's violation of the Insurance Code. *Id.* In order to clarify the precedent bearing on this issue, the Texas Supreme Court set forth the following interrelated rules:

> Rule 1—**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**. *Id.* at 490.
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> Rule 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 violation causes the loss of those benefits.** *Id.* at 495.
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> Rule 3—**Even if the insured cannot establish a present right to policy benefits, it can recover those benefits as actual damages if the insurer's statutory violation caused the insured to lose that contractual right**. *Id.* at 497.
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> Rule 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 it did not have a right to receive policy benefits**. *Id.* at 499.
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> Rule 5—**An insured cannot recover any damages based on an insurer's violation of the Insurance Code if the insured is not entitled to receive policy benefits and did not sustain an injury independent of the right to receive policy benefits**. *Id.* at 500.

The essence of these rules is that an insured cannot use an insurer's violation of the Insurance Code to create coverage where none exists, unless it was the statutory violation that resulted in the loss of coverage in the first place. But, if the insured never had a right to recover policy benefits and the insurer's actions did not result in a loss of that right, the insured can only recover damages based on a statutory violation if the damages flow from something other than the denial of benefits. An insurer cannot be made to pay what it was never obligated to pay under the insurance policy, unless its actions deprived the insured of policy benefits. *Id.* at 490 ("[T]here can be no bad faith claim when an insurer has promptly denied a claim that is not in fact covered"). The reason for this limitation is because the Insurance Code only allows recovery of damages "caused by" an insurer's conduct. *Id.* at 490 (quoting Tex. Ins. Code § 541.151)). An insured's "actual damages" cannot be caused by a statutory violation if the damages flow from a policy that does not afford any benefits. *Id.* at 492 ("Actual damages are the common-law damages the insured sustains as a result of the statutory violation") (internal quotations omitted).

The foregoing *Menchaca* rules should sound familiar, as they appear to be a Chapter 541 iteration of the "economic loss rule." This rule precludes recovery in tort for economic losses resulting from a party's failure to perform under a contract when the harm consists only of the economic loss of the contractual expectancy. *Chapman Custom Homes, Inc. v. Dallas Plumbing Co.*, 445 S.W.3d 716, 718 (Tex. 2014). In other words, if a party to a contract only seeks damages calculated as the benefit of the bargain the party expected

under the contract, then that party cannot also recover in tort. *Id.* "But the [economic loss] rule does not bar all tort claims arising out of a contractual setting; instead, a party states a tort claim when the duty allegedly breached is independent of the contractual undertaking and the harm suffered is not merely the economic loss of a contractual benefit." *Shellnut v. Wells Fargo Bank, N.A.*, 02-15-00204-CV, 2017 WL 1538166, at *11 (Tex. App.—Fort Worth Apr. 27, 2017, pet. denied). Carrying this idea over into the insurance policy and bad faith context makes sense, especially because an insurance policy is nothing more than a contract and Chapter 541 is just a statutory extension of common law bad faith torts.

What does an Independent Injury look like?

The Texas Supreme Court in *Menchaca* ultimately reversed and remanded the case for a new trial. *Menchaca*, 545 S.W.3d. at 521. In sum, the court held that there was a fatal conflict between the jury's answers to question 1 of the jury charge (that USAA complied with its obligations under the policy) and question 3 (awarding Mrs. Menchaca damages calculated as the amount of policy proceeds that should have been paid). *Id.* These answers could not both be correct given the new guidance set forth by the court. *Id.* But, if insureds like Gail Menchaca cannot recover policy benefits as damages based on the insurer's violation of the Insurance Code (because they have no right to those benefits), then what sort of situations could lead to independent recovery? The court in *Menchaca* went out of its way to not answer this question, stating: "although we reiterate our statement in *Stoker* that such a claim could exist, we have no occasion to speculate what would constitute a recoverable independent injury." *Id.* at 500.

It is difficult to image what a truly independent injury might look like because the most common disputes between insurers and insureds concern whether policy benefits are available. In other words, is there coverage or not? In most cases, insureds only seek the benefit of the bargain they believe they are entitled to under the policy. But, in *State Farm Lloyds v. Fuentes*, 597 S.W.3d 925 (Tex. App.—Houston [14th Dist.] 2020, no pet.), the Fourteenth Court of Appeals in Houston had occasion to examine a potential independent injury. There, like Gail Menchaca, Candelario and Maria Fuentes filed a claim with their homeowner's insurer, State Farm, for storm damage that resulted from Hurricane Ike. *Id.* at 929. The adjuster that responded to the claim wrote the Fuenteses a meager check and did nothing to address the interior water damage in their home. *Id.* The Fuenteses eventually sued State Farm for breach of contract and violations of the Insurance Code. *Id.* Interestingly, the Fuenteses sought and recovered mental anguish damages at trial based on State Farm's statutory and common-law violations (*i.e.*, they suffered mental injury because State Farm did not deal with them in good faith). *Id.* at 930. The Court of Appeals held that this award met the *Menchaca* independent injury rule, because the mental anguish damages that the Fuenteses sought from State Farm were separate from their right to receive the benefit of the bargain under their policy. *Id.* at 941. The Fuenteses even obtained a separate jury finding relating to their mental anguish damages and were awarded additional damages based on State Farm's "knowing" violation of the Insurance Code. *Id.*

The bright-line rule from *Menchaca* and *Fuentes* is that, if an insured who is not entitled to benefits under a policy (or who seeks damages in addition to policy benefits) wishes to recover damages based on an insurer's bad faith conduct, the insured cannot exclusively seek the benefit of the bargain from their insurance contract. The damages they sustain must flow from the insurer's conduct. In other words, if the insurer had not violated the Insurance Code or common law duty of good faith, would the insured have an injury? If the payment of policy benefits would make the insured whole, then he has no independent injury. Insurers should be watching for these issues from the outset of litigation in case an opportunity presents itself to dispose of an insured's Chapter 541 claims because the insured has no independent damages. Insureds similarly need to think carefully about bringing potential 541 claims, because, when the insured does not have coverage, the statute will only afford relief in limited circumstances.

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