By Laura Grabouski

ARE POLICY PROCEEDS ACTUAL DAMAGES FOR VIOLATIONS OF THE INSURANCE CODE? THE TEXAS SUPREME COURT IN *MENCHACA* SAYS: "YES—IF CLAIM IS COVERED."

I. Introduction

The question of whether an insured can recover actual damages under the Texas Insurance Code without showing that he or she suffered damages independent of the policy proceeds was answered back in 1988. In *Vail v. Texas Farm Bureau Mutual Insurance Company*, 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."[1] State courts relied on this holding to award treble damages based on findings of a covered claim and an unfair claim settlement practice knowingly committed, despite lack of evidence of independent damage.[2] The Fifth Circuit, however, viewed the 1998 *Castañeda* decision[3] as having overruled *Vail* and required insureds to show "injury separate and apart from the denial of benefits" to maintain claims for breach of the duty of good faith and fair dealing or statutory violations.[4] As such, litigants faced differing results based on whether a suit was pending in state or federal court.

The Texas Supreme Court recently resolved the issue in a lengthy opinion, which sought to clarify the confusion: *USAA Texas Lloyds Co. v. Menchaca*.[5] Following a trial on the Menchaca's claim for damage to their home allegedly caused by Hurricane Ike, the jury found that USAA Texas Lloyds did not fail to comply with the policy but did fail to pay the claim without conducting a reasonable investigation in violation of section 541.060(a)(7).[6] As damages for the statutory violation, the jury awarded policy benefits.[7] Relying on *Castañeda*, USAA argued that Menchaca could not obtain policy benefits based solely on failure to reasonably investigate.[8] Menchaca relied on *Vail* to assert that the unfair refusal to pay the claim caused damages in at least the amount of the benefits wrongly withheld.[9]

In its opinion, the Texas Supreme Court reaffirmed *Vail*—"We did not reject the *Vail* rule in *Stoker* or in *Castañeda*"—but conceded that "we could have made the point more clearly."[10] To avoid further confusion, the court outlined five rules for overlapping contract and statutory causes of action. This paper examines the history of the *Vail/ Castañeda* divide, the court's clarification in *Menchaca*, and the five rules the court articulated to guide future cases.

II. Trebling Provisions of the Insurance Code and DTPA

One major significance of the "*Vail* rule" is the trebling provision found in both the Texas Insurance Code and the Deceptive Trade Practices-Consumer Protection Act (DTPA). Both statutes authorize recovery of up to treble damages based on evidence of intentional or knowing violations. The DTPA refers to "economic" and "mental anguish" damages and allows potential trebling of both:

> (b) In a suit filed under this section, each consumer who prevails may obtain:
>
> (1) the amount of economic damages found by the trier of fact. If the trier of fact finds that the conduct of the defendant was committed knowingly, the consumer may also recover damages for mental anguish, as found by the trier of fact, and the trier of fact may award not more than three times the amount of economic damages; or if the trier of fact finds the conduct was committed intentionally, the consumer may recover damages for mental anguish, as found by the triter of fact, and the trier of fact may award not more than three times the amount of damages for mental anguish and economic damages.[11]

Section 541.152 of the Insurance Code refers to "actual damages" but similarly authorizes up to treble actual damages as follows:

> (a) A plaintiff who prevails in an action under this subchapter may obtain:
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> 1) the amount of *actual damages*, plus court costs and reasonable and necessary attorney's fees;
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> 2) an order enjoining the act or failure to act complained of; or
>
> 3) any other relief the court determines is proper.

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> (b) Except as provided by Subsection (c), on a finding by the trier of fact that the defendant knowingly committed the act complained of, *the trier of fact may award an amount not to exceed three times the amount of actual damages.*
>
> (c) Subsection (b) does not apply to an action under this subchapter brought against the Texas Windstorm Insurance Association.[12]

Thus, if an insured is entitled to recover policy benefits as economic or actual damages based on a violation of either statute, and establishes that the insurer's violation was knowing and/or intentional, the statutes expressly authorize recovery of up to an additional two times the amount of its claim. The *Vail* case presented this scenario.

III. *Vail*

Vail involved a dispute over a homeowners' fire claim.[13] Texas Farm Bureau Mutual Insurance Company denied the Vails' claim after a fire destroyed their home.[14] The Vails sued for the full policy proceeds and for damages under the Deceptive Trade Practices–Consumer Protection Act and the Unfair Claim Settlement Practices Act of the Texas Insurance Code.[15]

The trial court awarded the Vails treble the amount of the policy proceeds as well as prejudgment interest and attorney's fees.[16] The appellate court reversed the treble actual damages portion of the judgment and reduced the judgment to include a single policy limit amount. The Texas Supreme Court reversed and reinstated the trebled policy limits.[17]

The court first affirmed the jury's findings that Texas Farm Bureau had violated then article 21.21-2 of the Insurance Code by failing to promptly and fairly settle the Vails' claim when its liability had become reasonably clear. The court also held that the Vails had proved a cause of action for unfair settlement practices under section 17.50(a)(4) of the DTPA.[18] Because the jury found that Texas Farm Bureau's conduct was intentional, the Vails were entitled to treble damages under the DTPA.[19]

The court then addressed Texas Farm Bureau's argument that because the Vails' only damages were the policy proceeds that were recoverable for breach of contract, such damages did not constitute "actual damages" in relation to a claim of unfair claims settlement practices.[20] The court squarely rejected the argument, stating that *"[w]e hold 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."*[21] The court continued:

> The Vails suffered a loss at the time of the fire for which they were entitled to make a claim under the insurance policy. It was not until Texas Farm wrongfully denied the claim that the Vails' loss was transformed into a legal damage. That damage is, at minimum, the amount of policy proceeds wrongfully withheld by Texas Farm.
>
> The fact that the Vails have a breach of contract action against Texas Farm does not preclude a cause of action under the DTPA and article 21.21 of the Insurance Code. Both the DTPA and the Insurance Code provide that the statutory remedies are cumulative of other remedies. . . . It would be incongruous to bar an insured—who has paid premiums and is entitled to protection under the policy—from recovering damages when the insurer wrongfully refuses to pay a valid claim. Such a result would be in contravention of the remedial purposes of the DTPA and the Insurance Code.[22]

Finally, the court stated that because the policy set the value of the insured property, the Vails were not required to prove actual damages.[23] Insureds have relied on *Vail* to seek recovery of up to treble the amount of the claim under the policy (based on a knowing and/or intentional violation of section 541.060 of the Insurance Code) without evidence of damages independent of the unpaid claim.

IV. *Castañeda*

In its 1998 *Castañeda* decision, the Texas Supreme Court made statements that have been construed to conflict with the "policy benefits as actual damages" holding of *Vail*.[24] The facts of *Castañeda* were distinguishable from those of *Vail*, notably that Castañeda did not allege a claim covered by the policy.[25] Nonetheless, the decision created uncertainty with regard to the evidentiary standard for recovery of additional damages, particularly in the Fifth Circuit.

Denise Castañeda sued her health insurer, Provident American Insurance Company, for alleged violations of the Insurance Code and Deceptive Trade Practices Act.[26] The jury found that Provident American had violated then article 21.21 of the Insurance Code by denying or delaying Castañeda's claim without a reasonable basis.[27] Castañeda did not seek or obtain any jury finding awarding relief *under the policy*.[28] The trial court awarded actual damages, treble damages, attorney's fees, and penalty interest; the appellate court affirmed except as to penalty interest.[29] The Texas Supreme Court reversed and held that the evidence was legally insufficient to support the jury's verdict for Insurance Code violations.[30]

Ms. Castañeda argued that the jury's findings that Provident American had engaged in "unfair settlement practices" (under then subsection 2(b)(5) of article 21.21-2) by making a deficient settlement offer, failing to acknowledge communications regarding the claim, and failing to adopt reasonable standards for investigation of claims authorized recovery of damages "equivalent to policy benefits."[31] The court rejected the argument based on the holding in *Stoker* that the failure to properly investigate a claim was not a basis for an award of policy benefits.[32] The court acknowledged the "*Stoker* exception" for liability for mishandling a claim which caused damages "other than policy benefits."[33] "We said: 'We do not exclude, however, the possibility that in denying the claim, the insurer may . . . cause injury independent of the policy claim.'"[34]

Based on the record, the court held that Provident American's conduct was not "the producing cause of any damage *separate and apart from* those that would have resulted from a wrongful denial of the claim."[35] The court observed that the only damages awarded that did not constitute policy benefits were for loss of credit reputation, which resulted from Provident American's denial of the claim, not the failure to communicate or investigate.[36]

The conclusion of the opinion reinforces the factual underpinning of the holding that recovery of damages under the Insurance Code is premised on a covered claim:

> In sum, there is no support in the evidence for any of the extra-contractual claims on which Denise Castañeda obtained findings. *Castañeda did not plead and did not obtain a determination from the trial court that Provident American was liable for breach of the insurance contract.* Accordingly, there is no basis on which Castañeda may recover based on this record.[37]

V. Fifth Circuit Post-*Castañeda*: Independent Injury Required

Four years later, in *Parkans International, L.L.C. v. Zurich Insurance Company*, the Fifth Circuit interpreted *Castañeda* as requiring proof of independent injury as a prerequisite to all extra-contractual damages.[38] Parkans sued Zurich Insurance Company for breach of contract, breach of the duty of good faith and fair dealing, and violations of the Insurance Code and DTPA.[39] The trial court held that Parkans' claim was covered on cross-motions for summary judgment; the jury was instructed that the loss was covered and that Zurich's failure to pay breached the policy.[40] The jury then awarded $1.34 million for breach of contract, $1.29 million on the extra-contractual claims, and attorney's fees; however, the trial court entered judgment solely for the contractual damages and attorney's fees.[41]

On appeal, the Fifth Circuit reversed the summary judgment in favor of coverage under the primary policy.[42] The court also held that Zurich's summary judgment on Parkans' claims for unfair settlement practices should have been granted because it had a reasonable basis for its denial; i.e., there was a *bona fide* coverage dispute.[43] Although the good faith dispute was dispositive of the issue, the court added, "the jury essentially found no tort injuries independent of the contract damages."[44] The court stated: "There can be no recovery for extra-contractual damages for mishandling claims unless the complained of actions or omissions caused injury independent of those that would have resulted from a wrongful denial of policy benefits."[45]

The decision comports with Texas law that a bona fide coverage dispute, without more, precludes extra-contractual damages. The rationale, however, is not the lack of independent damage to the insured, but rather the insurer's right to reject a claim so long as its acts reasonably in doing so, even if it subsequently is proven to have been mistaken as to its denial.[46]

Further, the decision imposed a requirement not found in *Vail* for recovery of extra-contractual damages in cases in which the claim was covered. Although not an issue in *Parkans*, the *AFS/IBEX* case squarely presented this conflict.[47] In that case, the district court ruled on summary judgment that coverage was provided by two successive crime protection policies, but the issue of damages was tried to the jury.[48] The district court dismissed AFS's extra-contractual claims at the close of evidence because AFS's damages "all potentially flowed from [Great American's] breach of its insurance contract [and] the same damages could not, as a matter of law, satisfy the damage element for AFS's extra-contractual claims."[49]

On cross-appeal, the Fifth Circuit affirmed the district court's judgment in favor of coverage.[50] It rejected AFS's assertion that it was not required to prove a separate injury to maintain its extra-contractual claims as inconsistent with "this court's case law," citing *Parkans*.[51]

VI. Foreshadowing *Menchaca's* Holding, State Courts Continue to Apply *Vail*.

In a recent case decided before *Menchaca*, the Houston Fourteenth Court of Appeals recognized the conflict presented by the *Parkans/AFS* line of cases in *AMJ Investments*, but reconciled *Castañeda* with *Vail* based on the existence of a covered claim.[52] Accordingly, the court affirmed the judgment for trebling of policy proceeds up to the statutory maximum without the need for damages independent of the benefits.[53] The same court in another Hurricane Ike-related suit also rejected, in dicta, a bright-line rule that would eliminate extra-contractual damages when the insured failed to recover on the contract.[54] Citing the appellate court decision in *Menchaca* and others, the

court noted that "the interplay of contractual and extra-contractual claims depends heavily on the particular circumstances of particular cases."[55] In other words, as the Texas Supreme Court's opinion in *Menchaca* would later explain, it's "complicated."[56]

VII. *Menchaca*

In *Menchaca*, USAA argued that because the jury found no breach of contract, the damages awarded for unreasonable investigation failed as a matter of law based on *State Farm Lloyds v. Page*, wherein the court stated: "There can be no liability under . . . the Insurance Code if there is no coverage under the policy."[57] The appellate court rejected USAA's argument for two reasons. First, the court reasoned that section 541.060(a)(7) imposed an independent duty to conduct a reasonable investigation prior to denying a claim. "It follows that USAA could have fully complied with the contract even if it failed to reasonably investigate Menchaca's claim."[58] Second, the court disagreed that the jury's answer to the breach of contract question definitively established that there was no coverage where USAA did not assert lack of coverage but rather that the amount of covered damage did not exceed the deductible.[59]

The Texas Supreme Court disagreed with both statements. Although it accepted the premise that "USAA could have complied with the policy even if it failed to reasonably investigate the claim," it rejected the conclusion that Menchaca could collect policy benefits based solely on that finding and without proving that benefits were owed under the policy.[60] Such a premise falls squarely within the "general rule" recognized in *Castañeda* and *Stoker*: "If the insurer violates a statutory provision, that violation—at least generally—cannot cause damages in the form of policy benefits that the insured has no right to receive under the policy."[61]

The court also disagreed, however, with USAA's position that an insured may never recover policy benefits as actual damages for a statutory violation.[62] In so doing, the court reaffirmed the *Vail* (or "entitled to benefits") rule[63] on the same premise recognized by the earlier state court decisions: "While we could have made the point more clearly, the distinction between the 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."[64]

The court also disagreed that the insured had to obtain a finding that the insurer "breached" the policy. While "breach" and "coverage" are often used interchangeably, a breach of contract finding is not a prerequisite to statutory damages assuming that the evidence establishes a covered claim.[65]

Against this backdrop, the court held the trial court had improperly disregarded the jury's answer to the breach question where USAA provided some evidence that damages were less than the deductible.[66] Accordingly, the court reversed the judgment in favor of Menchaca, but remanded for a new trial in light of the parties' "obvious and understandable confusion over our relevant precedent and the effect of that confusion on their arguments in this case."[67]

VIII. Beyond *Menchaca*: The Five Rules applicable to Coverage and Extra-contractual Claims

First, the "**general rule**" is that an insured cannot recover policy benefits as actual damages if there is no right to the benefits.[68]

Second, the "**entitled-to-benefits rule**" announced in *Vail* remains viable. As a corollary to the general rule, where an insured establishes that the insurer has unreasonably withheld covered benefits, those benefits are recoverable as actual damages under the Insurance Code.[69]

Third, policy benefits may be recoverable as actual damages under the "**benefits-lost rule**" if an insurer, through a misrepresentation of coverage,[70] waiver and/or estoppel,[71] or statutory violation,[72] causes the loss of benefits.[73]

Fourth, the **"independent-injury rule"** announced in *Stoker* remains viable, although extremely limited in application.[74] This is because the insured's statutory claim must be independent of the duty to pay contractual benefits,[75] *and* it must cause injury that is independent of the loss of such benefits.[76] It is worth repeating that the court has yet to find an independent injury in the twenty-two years since it issued the *Stoker* decision.

Fifth, the "**no-recovery rule**" is a natural corollary to rules one through four and holds that an insured cannot recover damages for a statutory violation absent a right to benefits or independent injury.[77]

IX. Conclusion

Post-*Menchaca*, the evidence needed to prevail on an extra-contractual claim should no longer depend on whether the suit is litigated in state court or federal court. If the insured proves that the claim for policy benefits is covered, it can assert those benefits as damages for a violation of the Insurance Code, and, if it proves that the violation was knowing or intentional, seek trebling of same.

Conversely, a finding of no coverage will preclude any damages unless the insured presents evidence sufficient to warrant the *Stoker* exception, which has proven elusive. In practice, courts should continue to grant motions to dismiss extra-contractual claims following a finding of lack of coverage where the insured has no evidence of damages independent of the policy.

Further, even assuming that the insured proves that the insurer failed to conduct a reasonable investigation, policy benefits cannot be awarded as actual damages for an Insurance Code violation unless the factfinder also finds that the claim was covered, which does not necessarily equate with a finding that the insurer "breached" the contract.

Alternatively, under the other rules outlined in *Menchaca*, an insured may concede lack of coverage but assert a claim based on a misrepresentation or a waiver/estoppel theory if the evidence supports it. In sum, the *Menchaca* opinion has provided needed guidance on the actual damages controversy and is a helpful manual for litigating coverage cases more generally.

1 754 S.W.2d 129, 136–37 (Tex. 1988).

2 *See, e.g., United Nat'l Ins. Co. v. AMJ Inv., LLC*, 447 S.W.3d 1, 11 (Tex. App.—Houston [14th Dist.] 2014, pet. denied).

3 *Provident Am. Ins. Co. v. Castañeda*, 988 S.W.2d 189, 198 (Tex. 1998).

4 *See Great Am. Ins. Co. v. AFS/IBEX Fin. Servs., Inc.*, 612 F.3d 800, 808 n.1 (5th Cir. 2010).

5 *USAA Texas Lloyd's Co. v. Menchaca*, No. 14–0721, 2017 WL 1311752 (Tex. Apr. 7, 2017).

6 *Menchaca*, 2017 WL 1311752, at *2.

7 Specifically, the jury awarded $11,350, "the difference . . . between the amount USAA should have paid Gail Menchaca for her Hurricane Ike damages and the amount that was actually paid." *Id.*

8 *Id.*

9 *Id.*

10 *Id.* at *8.

11 Tex. Bus. & Com. Code Ann. § 17.50(b).

12 Tex. Ins. Code § 541.152 (emphasis added). The Texas Supreme Court has unified recovery of mental anguish damages under the Insurance Code with the DTPA requirement of a knowing or intentional finding. *See State Farm Life Ins. Co. v. Beaston*, 907 S.W.2d 430, 435–36 (Tex. 1995) (construing pre-1995 DTPA and observing Insurance Code provisions governing unfair and deceptive acts in business of insurance and DTPA are interrelated).

13 *See Vail*, 754 S.W.2d at 130.

14 The Act formerly was codified article under 21.21, and currently is codified in sections 541.051-061.

15 *See Vail*, 754 S.W.2d at 130.

16 *Id.*

17 *Id.*

18 *See id.* at 133–34.

19 *Id.* at 135.

20 *See id.* at 136.

21 *Id.* at 136 (emphasis added, internal citations omitted).

22 *Id.* (citations omitted).

23 *Id.* at 137.

24 *See Castañeda, supra.*

25 *See AMJ Investments, LLC*, 447 S.W.3d at 11 (distinguishing *Castañeda*).

26 *Castañeda,* 988 S.W.2d at 193.

27 *See id.*

28 *See id.* at 196.

29 *Id.* at 192.

30 *Id.* at 195–96.

31 *See id.* at 198.

32 *See id.* (citing *Republic Ins. Co. v. Stoker,* 903 S.W.2d 338, 341 (Tex. 1995)).

33 *Id.*

34 *Id.* (citing *Stoker*, 903 S.W.2d at 341).

35 *Id.* (emphasis added).

36 *See id.* at 199.

37 *Id.* at 201 (emphasis added).

38 *Parkans Int'l, L.L.C. v. Zurich Ins. Co.*, 299 F.3d 514, 519 (5th Cir. 2002).

39 *Id.* at 515.

40 *Id.* at 516.

41 *Id.*

42 *Id.* at 517.

43 *Id.* at 519. *See, e.g., State Farm Fire & Cas. Co. v. Simmons*, 963 S.W.2d 42, 44 (Tex. 1998) (evidence of mere *bona fide* dispute over coverage does not establish bad faith).

44 *Id.* (noting in n.5 that the same line items were submitted for both the contractual and tort damages questions, and the jury awarded lesser amounts for the tort items).

45 *Id.* (quoting *Castañeda*).

46 *See, e.g., Lyons v. Millers Cas. Ins. Co. of Texas*, 866 S.W.2d 597, 601 (Tex. 1993) (evidence of valid claim might in some circumstances support a finding that insurer lacked reasonable basis for denial but in case at hand, plaintiffs offered no such evidence).

47 *See AFS/IBEX Fin. Servs., Inc.*, 612 F.3d at 808.

48 *Id.* at 803.

49 *Id.*

50 *Id.* at 806.

51 *Id.* at 808 n.1.

52 *See AMJ Investments, LLC*, 447 S.W.3d at 11.

53 *See id.* at 6 n.2; *see also* Tex. Ins. Code § 541.152(b).

54 *State Farm Lloyds v. Fuentes* No. 14-14-00824-CV, 2016 WL 1389831 (Tex. App.—Houston [14th Dist.] April 7, 2016, pet. filed) (memorandum op.).

55 *See id.* at *5 n.4.

56 *Menchaca*, 2017 WL 1311752 at *4.

57 315 S.W.3d 525, 532 (Tex. 2010). *See USAA Texas Lloyd's Co. v. Menchaca,* No. 13–13–00046–CV, 2014 WL 3804602, at *5 (Tex. App.—Corpus Christi-Edinburg 2014), *judgment rev'd*, 2017 WL 1311752.

58 *Id.* at *5.

59 *Id.* at *6.

60 *Menchaca*, 2017 WL 1311752, at *6.

61 *Id.* at *6.

62 *Id.* at *7.

63 *Id.* at *8.

64 *Id.* at *8.

65 *Id.* at. *7, *8 n.18 (noting circumstances of *Vail* wherein the insured pleaded and proved the amount of the policy's coverage and insurer, on appeal, admitted that the claim was covered: "*Vail* should not be read, however, as suggesting that an insured can recover benefits for a statutory violation when the insured fails to establish and the insurer does not concede that the insured has a contractual right to the benefits.").

66 *Id.* at *14.

67 *Id.*

68 *Id.* at *4.

69 *Id.* at *7.

70 *See, e.g., Royal Globe Ins. Co. v. Bar Consultants, Inc.*, 577 S.W.2d 688, 693 (Tex. 1979) (distinguishing contractual liability with liability for statutory misrepresentation claim based on false promises of coverage); *see also In re Allstate County Mut. Ins. Co.*, 447 S.W.3d 497 (Tex. App.—Houston [1st Dist.] 2014, orig. proceeding) (severance required of bad faith-failure to settle- claim from contract claim for underinsured motorist benefits; no severance required for misrepresentation claims because such claims independent of contractual claims and will not be rendered moot if insurer prevails on breach of contract).

71 *See, e.g., Ulico Cas. Co. v. Allied Pilots Ass'n*, 262 S.W.3d 773, 787 (Tex. 2008) ("In sum, if an insurer defends its insured when no coverage for the risk exists, the insurer's policy is not expanded to cover the risk simply because the insurer assumes control of the lawsuit defense. But, if the insurer's actions prejudice the insured, the lack of coverage does not preclude the insured from asserting an estoppel theory to recover for any damages it sustains because of the insurer's actions.").

72 *See, e.g., JAW the Pointe, L.L.C. v. Lexington Ins. Co.*, 460 S.W.3d 597, 602 (Tex. 2015) (observing insured's contention that policy covered ordinance-compliance costs and insurer should have paid those costs before it made other payments that exhausted policy limits).

73 *Menchaca*, 2017 WL 1311752, at *9–10.

74 *Id.* at *11–12.

75 *See, e.g., Twin City Fire Ins. Co. v. Davis*, 904 S.W.2d 663, 666 n.3 (Tex. 1995) (some extra-contractual claims may not relate to duty to pay claims and may thus result in different damages).

76 *See id.* at 667 (where exclusivity of workers' compensation remedy required evidence of actual damages other than benefits to recover for breach of duty of good faith, absence of actual damages barred award of punitive damages).

77 *Menchaca*, 2017 WL 1311752 at *12.