By Laura J. Grabouski

MENCHACA, THE SEQUEL: WHAT'S NEW IN THE TEXAS SUPREME COURT'S OPINION ON REHEARING?

In its original opinion in *USAA Texas Lloyds Company v. Menchaca*, the Texas Supreme Court clarified that "[w]e did not reject the *Vail*[1] rule in *Stoker*[2] or in *Castañeda*,[3] reasoning that "if an insurer's 'wrongful' denial of a 'valid' claim for benefits results from or constitutes a statutory violation, the resulting damages will necessarily include 'at least the amount of the policy benefits wrongfully withheld.'"[4] This pronouncement ended a line of authorities in the Fifth Circuit, which viewed *Castaneda* as a retreat from *Vail* and required a "separate and independent damage" element in order to prevail on a bad faith claim in federal court.[5] The central holding—that policy benefits constitute actual damages for a statutory violation irrespective of the existence of "independent damages"—was left intact on rehearing, as were the five rules governing the relationship between coverage and bad faith remedies.[6]

The rehearing opinion also addressed procedural issues raised by USAA with regard to how disputed coverage and bad faith cases should be tried.[7] A large portion of the opinion discusses preservation of error on appeal, conflicting jury findings, and the evolution of "fundamental error."[8]

The Five Rules

For coverage practitioners, the most significant lessons from *Menchaca*, post-rehearing, continue to be the five rules governing the relationship between coverage and bad faith remedies and how to apply them to advocate for your position. The five rules are summarized below:

> **1. The General Rule.** Similar to the no-recovery rule, the *"general rule"* is that an insured cannot recover policy benefits as actual damages if there is no right to the benefits.[9]
>
> **2. The Entitled-to-Benefits Rule.** 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.[10]
>
> **3. The Benefits Lost Rule.** Policy benefits may also be recoverable as actual damages under the *"benefits-lost rule"* if an insurer, through a misrepresentation of coverage, waiver and/or estoppel, or statutory violation, causes the loss of benefits.[11]
>
> **4. The Independent Injury Rule.** The *"independent-injury rule"* announced in *Stoker* remains viable, although extremely limited in application. This is because the insured's statutory claim must be independent of the duty to pay contractual benefits, and it must cause injury that is independent of the loss of such benefits. It is worth repeating that the Court has yet to find an independent injury in the twenty-three years since it issued the *Stoker* decision.[12]
>
> **5. The No-Recovery Rule.** Finally, 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.[13]

The Jury Charge

Menchaca was greatly complicated by conflicting jury findings regarding whether Menchaca (the policyholder) was entitled to benefits under the policy USAA issued. On one hand, the jury answered "no" to the question of whether USAA "failed to comply with the terms of the insurance policy" (Question 1).[14] On the other hand, the jury found that USAA "should have paid" Menchaca $11,350 "for her Hurricane Ike damages" (Question 3).[15]

While the dissent and the majority did not disagree on the "five rules," the same was not true regarding the application of the rules to the facts of the case. Key to that application, was whether Jury Question 3 three merely went to damages or addressed the questions of *both* damages and causation.

In his dissenting opinion, Justice Green claimed that once the issue of breach (Question 1) had been decided in USAA's favor, the answer to Question 3 could not serve to rehabilitate that finding:

> The jury's answer to Question 1 represents the jury's conclusion that Menchaca failed to satisfy her burden of proof on her claim that USAA breached the policy. *See id.* at 509 (agreeing that the answer to Question 1 "confirms [the jury's] conclusion that Menchaca 'failed to carry [her] burden of proof' to establish that USAA failed to comply with the policy's terms" (citing *Sterner v. Marathon Oil Co.*, 767 S.W.2d 686 (Tex. 1989))). In other words, the

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> jury rejected Menchaca's claim that the policy required USAA to do something that it failed to do. . . . Menchaca cannot use a statutory violation theory of recovery to recover the very same contract damages that the jury specifically rejected. *Cf. City of Brownsville v. Alvarado*, 897 S.W.2d 750, 752–53 (Tex. 1995) (holding that jury's "no" answer to liability question rendered submission of question involving plaintiff's negligence immaterial).
>
> This result is consistent with the Court's no-recovery rule, 545 S.W.3d at ___, and with our holding in *Provident American Insurance Co. v. Castañeda*, 988 S.W.2d 189 (Tex. 1998), which I believe govern this case. Under the no-recovery rule, an insured cannot recover *any* damages for an insurer's statutory violation without establishing either the right to receive policy benefits or an independent injury. 545 S.W.3d at ___.[16]

The majority disagreed with the dissent's characterization, reasoning that the two jury findings inherently conflicted:

> The no-recovery rule requires an insured to establish a right to receive benefits under the policy or an injury independent of a right to benefits. *Castaneda*, 988 S.W.2d at 198. Here, Menchaca obtained two conflicting findings: one, in Question 1, that she did not have the right to receive policy benefits, and two, in Question 3, that she *did* have the right to policy benefits. If Question 3 did not contain that finding, there [sic] no conflict would exist. The Dissent also tacitly acknowledges this by noting that the trial court 'eliminated any conflict when it decided to disregard Question 1.' *Post* at __ (Green, J., dissenting).[17]

The Court also reasoned that a cause of action for bad faith or a statutory violation is not predicated on a "breach of contract" but rather the insured's entitlement to benefits:

> Although our prior decisions refer interchangeably to both "breach" and "coverage," our focus in those cases was on whether the insured was entitled to benefits under the policy, because an insurer's statutory violation cannot "cause" the insured to suffer the loss of benefits unless the insured was entitled to those benefits. Thus, although we have referred to both "breach" and "coverage," what matters for purposes of causation under the statute is whether the insured was entitled to receive benefits under the policy.[18]

Did the Court announce new rules for submitting these issues to the jury?

In the new opinion, the Court included Section II, F., "Submitting Claims for Policy Benefits" in response to concern over how to submit dual claims for policy benefits and statutory violations to the jury.[19] The Court noted that any guidance it could provide would be necessarily limited because "the proper submission depends on the disputed facts and issues in each case. There is, for example, no one single proper way to submit a breach-of-contract claim to a jury."[20]

As one example, an insurer may fail to comply with the policy by paying the proper amount of benefits but failing to meet the deadlines specified by Subchapter B of Section 542 of the Code.[21] Conversely, "an insurer may comply even if it fails to pay the proper amount of benefits if, for example, its noncompliance is excused, the insured committed a prior material breach, a condition precedent was unmet, or waiver, estoppel, or duress applies."[22]

To that end, the Court directed litigants to the Texas Pattern Jury Charges, and specific questions therein, as appropriate based on the facts of the particular case for breach of contract.[23] The Court also generally endorsed the PJC where the insured seeks policy benefits as damages for a statutory violation with the caveat that a proper jury submission must include an appropriate question or instruction to establish entitlement to benefits. "[O]ur holdings today clarify that, to establish 'causation of policy benefits as damages' on a statutory-violation claim, the jury must find that the violation caused the insured to lose benefits she was otherwise entitled to receive under the policy."[24] The Court noted the risk of conflicting answers and advised trial courts to avoid the risk by ensuring that the jury answer the entitlement-to-benefits question only once.[25]

Why is *Menchaca* important?

Jurisprudentially, *Menchaca* demonstrates the Court's effort to consistently apply its precedent in the context of coverage disputes where bad faith is alleged. Further, by addressing the post-*Castaneda* confusion head-on, the Court provided both sides with clarity on the elements of a bad faith claim.

For insureds, *Menchaca* affirms the *Vail* principle that bad faith denial of a claim can expose the insurer to both contractual and extra-contractual liability, regardless of whether the insured proves "independent" damages. The loss of benefits to which the insured was contractually entitled, when caused by a violation of Section 541.060, is itself "actual damage" for purposes of the statute.

However, for insurers, the Court also adhered to precedent which held that Section 541.060 cannot circumvent the contractual agreement made by the parties. For example, if a policy excludes damage caused by flood, an insured

cannot sue for bad faith denial or unreasonable investigation and receive policy benefits as damages.[26] Under *Menchaca*, carriers can continue to seek summary judgment on bad faith claims based on non-coverage. Moreover, *Menchaca* imposes no limitation on a carrier's ability to seek summary judgment on a bad faith claim, irrespective of potential contractual liability, where it establishes a "bona fide dispute" over coverage.[27]

Emerging Issues

Although the Court's lengthy opinion in *Menchaca* addressed a wide variety of coverage disputes, insureds and insurers continue to disagree over its application in the following contexts:

Appraisal:

Although *Menchaca* does not directly address appraisal, some insureds have argued that the "entitled to benefits" rule is a good fit for appraisal cases. If a breach of contract is not a required element of an extra-contractual cause of action, so long as the insured is "entitled to recover benefits," does payment of an appraisal award supply this element and pave the way for post-appraisal litigation?

The *Hurst v. National Security Fire & Casualty Company* appeal may present the Court with an opportunity to resolve issues arising as courts attempt to apply *Menchaca* in the appraisal context. In that case, the appellate court held that the insurer was entitled to a directed verdict on Hurst's claims asserted under the Texas Insurance Code and Deceptive Trade Practices Act where it had timely paid an appraisal award.[28] The court, referencing the original *Menchaca* decision, applied an independent injury analysis, holding that absent such damages, the insured was estopped from pursuing extra-contractual claims. The lower court also held that payment of an award conditioned on a release did not alter the estoppel defense in the absence of a genuine issue of fact to set aside the appraisal award.[29] Briefing is underway at the Texas Supreme Court.[30]

Insured's Breach of Policy:

In *State Farm Lloyds v. Fuentes,* the insureds obtained favorable jury findings on their extra-contractual claims, but the jury also found that both parties had breached the policy.[31] The appellate court held (pre-*Menchaca*) that the extra-contractual findings independently supported the judgment for policy benefits, mental anguish, additional damages, prejudgment interest, penalty interest, and attorney's fees.[32] Multiple issues were raised on petition for review to the Texas Supreme Court including whether, under *Menchaca*, an insurer is obligated to pay under another theory of liability if an insured is precluded from recovering policy benefits on a breach of contract theory. Another issued raised was whether an insured's breach of the policy precludes proof of *Menchaca*'s "entitlement to benefits" requirement.

The Texas Supreme Court addressed State Farm's separate issue on excessive demand but vacated in part and remanded "for further proceedings in light of *Menchaca*."[33]

Prime Natural Resources?

Another case that may involve application of *Menchaca* is *Certain Underwriters at Lloyd's, London v. Prime Natural Resources, Inc.* In that case, Certain Underwriters appeals an approximately $20 million judgment which included actual damages for property damage, additional damages for knowing Insurance Code violations, penalty interest, attorneys' fees, costs, and interest. The appeal is currently pending before the First Court of Appeals.[34] Among many issues, Certain Underwriters argues that the insured failed to prove that statutory violations caused the loss of additional policy benefits as required by *Menchaca*.[35]

Conclusion

Menchaca illustrates that the breadth of Texas coverage law does not lend itself to a "one size fits all" approach. Even with agreement on the outlines of the five rules, the specific facts of each case may generate varying outcomes. Nonetheless, *Menchaca* provided tools for both sides in coverage disputes.

1. *Vail v. Texas Farm Bureau Mut. Ins. Co.*, 754 S.W.2d 129, 136–37 (Tex. 1988).

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

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

4. *USAA Texas Lloyds Co. v. Menchaca*, No. 14-0721, 2017 WL 1311752 (Tex. Apr. 7, 2017), reh'g granted (Dec. 15, 2017), opinion withdrawn and superseded, 545 S.W.3d 479 (Tex. 2018).

5. *See Lyda Swinerton Builders, Inc. v. Oklahoma Surety Co.*, 877 F.3d 600, 618 (5th Cir. 2017) (holding, based on *Menchaca*, that district court erred in requiring evidence of an injury separate and apart from denial of benefits to support insured's Texas Insurance Code claims).

6. *See USAA Texas Lloyds Company v. Menchaca*, 545 S.W.3d 479, 484 (Tex. 2018).

7. *See id.* at 506–09.

8. *See id.* at 510–20.

9. *Id.* at 490.

10. *Id.* at 495.

11. *Id.* at 497–99.

12. *Id.* at 499–500.

13. *Id.* at 501.

14. *See Castaneda*, 988 S.W.2d at 201.

15. *Menchaca*, 545 S.W.3d at 486.

16. *Id.* at 525 (J. Green, dissenting) (emphasis in original).

17. *Id.* at 41-42507.

18. *Id.* at 494.

19. *See id.*

20. *Id.*

21. *Id.* at 502.

22. *Id.*

23. *Id.* at 502.

24. *Id.* at 503.

25. *Id.*

26. *See State Farm Lloyds v. Page*, 315 S.W.3d 525, 532 (Tex. 2010) (where contractual claim failed, so too did bad faith claim as matter of law).

27. *See, e.g, United States Fire Ins. Co. v. Williams*, 955 S.W.2d 267, 269–70 (Tex. 1997).

28. *National Security Fire & Cas. Co. v. Hurst*, 523 S.W.3d. 840, 846 (Tex. App.—Houston [14th Dist.] May 23, 2017, pet. filed).

29. *Id.*

30. The appeal is docketed as No. 17-0719.

31. 549 S.W.3d 585, 585 (Tex. 2018).

32. No. 14-14-00824-CV, 2016 WL 1389831 at *7 (Tex. App.—Houston [14th Dist.] Apr. 7, 2016), review granted (June 8, 2018), aff'd in part, vacated in part, 549 S.W.3d 585 (Tex. 2018).

33. 549 S.W.3d at 585.

34. The appeal is docketed as No. 01-17-00881-CV.

35. *See* Brief of Appellants, Appeal No. 01-17-00881-CV, in the First Dist. Ct. of App., Houston, Tex.