

The Supreme Court of Texas's decision of *USAA Texas Lloyds Company v. Menchaca*, and whether there can be common law and/or statutory bad faith without breach of contract.

In many states, a finding that that an insurer is entitled to summary judgment on an insured's breach of contract claim quickly disposes of any claims for insurance code violations, common law bad faith, and/or statutory bad faith, as these claims are considered ancillary to a finding that the insurer breached the insurance contract. While some states have found that a breach of an insurance contract can be tortious in some instances, or to be a violation of the state's insurance code entitling an insured to additional damages, many state courts have found that—without a breach of contract—damages can only be recovered in rare situations. Indeed, the Third Circuit Court of Appeals decision in *Gallatin Fuels, Inc. v. Westchester Fire Insurance Co.*, 244 F. App'x 424, 435 (3d Cir. 2007) is one such example, where the court identified “one of the exceedingly rare cases in which an insurer can be liable for bad faith even after the insured cancels the policy.” *Id.*

In *Gallatin*, both the insurer and the insured mistakenly believed that the insurance contract remained in full force when, in fact, the contract had been cancelled and did not provide coverage. *Id.* at 428. Before realizing that the contract was cancelled, the insurer denied the claim without a reasonable basis, misrepresented the terms of the contract, dragged its feet in the investigation of the claim, hid information from the insured, and continued to shift its basis for the denial. *Id.* at 428, 435. Because of the malpresentations and dishonesty of the insurer in denying the claim without a reasonable basis—the legitimate reason being unknown to the insurer at the time of denial—the jury could have found, and did find, that the insurer acted in bad faith given its working assumption that the contract was in force. See *id.*

Similarly, other courts have recognized the viability of bad faith claims without a finding that the insurer breached the insurance contract. For example, the Supreme Court of Hawaii in *Enoka v. AIG Hawaii Insurance Co.*, 128 P.3d 850, 865 (Haw. 2006) addressed whether there can be a breach of the covenant of good faith without coverage under the policy. The *Enoka* court held that an insured is not precluded from bringing a bad faith claim even where there is no coverage liability on the underlying contract, reasoning that the tort of bad faith does not turn on whether the claim was payable, but rather the conduct of the insurance company in handling the

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claim. *Id.* at 864. Nevertheless, the *Enoka* court held that AIG did not act in bad faith when it denied Enoka's claim inasmuch as AIG's denial was reasonable as it was based on an open question of law. *Id.* at 866.

Importantly, the Supreme Court of Texas also recently attempted to clarify the law in this area. In *USAA Texas Lloyds Co. v. Menchaca*, No. 14-0721, 2017 WL 1311752, at *1 (Tex. Apr. 7, 2017), the Supreme Court of Texas set out the following rules that are applicable under Texas law:

First, the general rule is that an insured cannot recover contract benefits for an insurer's statutory violation if the insured does not have a right to those benefits under the contract. *Id.* at *4.

Second, the entitled-to-benefits rule provides that an insured who establishes a right to receive benefits under an insurance contract can recover those benefits as actual damages under the insurance code if the insurer's statutory violation causes the loss of benefits. *Id.* at *7.

Third, the benefits-lost rule provides that an insured can recover benefits as actual damages under the insurance code even if the insured has no right to those benefits under the contract if the insurer's conduct caused the insured to lose that contractual right. *Id.* at *9.

Fourth, the independent-injury rule recognizes the possibility that in denying a claim, the insurer may commit some act, so extreme, that it would cause injury independent of the contract claim, for which damages are recoverable. *Id.* at *11

Finally, the non-recovery rule provides that an insured cannot recover any damages based on an insurer's statutory insurance code violations unless the insured establishes a right to recover benefits under the contract or an injury independent of a right to benefits. *Id.* at *12

While specific to Texas, the analysis in *Menchaca* is a good summary of many of the arguments made for the expansion of this area of the law that are applicable in many jurisdictions, which will no doubt continue to be made in the future. 