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INSURANCE LAW UPDATE

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THE SUPREME COURT OF TEXAS ARTICULATES CLEAR RULES FOR BREACH OF CONTRACT, BAD FAITH CLAIMS AGAINST INSURERS.

In *USAA Texas Lloyds Co. v. Menchaca,* -- S.W.3D --, No. 14-0721, 2017 WL 1311752 (Tex. April 7, 2017), to clear up confusion as a result of past decisions, the Supreme Court of Texas announced five rules that "address the relationship between contract claims under an insurance policy and tort claims under the Insurance Code." The biggest unresolved legal question in the Texas bad faith world was whether a breach of contract was necessary for an insured to recover common law or statutory bad faith damages.

The Supreme Court of Texas began by stating: ***"Today's case presents an opportunity to provide clarity regarding the relationship between claims for an insurance policy breach and Insurance Code violations."*** The court then set forth five "distinct but interrelated rules that govern the relationship between contractual and extra-contractual claims in the insurance context." Carriers who get sued in Texas for bad faith must now understand these parameters from the Texas Supreme Court

In *Menchaca*, the insured's home was damaged by Hurricane Ike. The insured made a claim on her homeowner's policy with USAA. USAA denied the claim twice. Menchaca sued for breach of contract and Insurance Code violations. The jury found that USAA did not breach Menchaca's policy. But it also found that USAA violated the Insurance Code by failing to conduct a reasonable investigation before denying the claim and awarded the same amount of damages that would have been owed had USAA covered the claim. The trial court entered judgment for Menchaca (disregarding the jury's finding of no breach) and the court of appeals affirmed.

The Texas Supreme Court accepted the case in order to address "whether the insured can recover policy benefits based on jury findings that the insurer violated the Texas Insurance Code and that the violation resulted in the insured's loss of benefits the insurer 'should have paid' under the policy, even though the jury also failed to find that the insurer failed to comply with its obligations under the policy." In its opinion, the court announced the following five rules governing "the relationship between contractual and extra-contractual claims" in first-party cases:

(1) The General Rule: An insured may not recover policy benefits for an insurer's statutory violation if it has no right to those benefits under the policy.

(2) The Entitled-To-Benefits Rule: If an insured establishes a right to receive policy benefits, it may recover those benefits as actual damages under the Insurance Code if the insurer's statutory violation caused the loss of the benefits.

(3) The Benefits-Lost Rule: Even if the insured has no present contractual right to policy benefits, it may recover benefits under the Insurance Code if the insurer's statutory violation caused the insured to lose that contractual right.

(4) The Independent Injury Rule: If the insurer's statutory violation causes an injury independent from the loss of policy benefits, the insured may recover damages for that injury even if it has no right to benefits under the policy.

(5) The No-Recovery Rule: An insured may not recover damages for a carrier's Insurance Code violation if the insured had no right to receive benefits and sustained no independent injury.

THE SUPREME COURT OF TEXAS HOLDS THAT A HOMEOWNER'S POLICY UNAMBIGUOUSLY PROVIDES COVERAGE FOR A DAMAGED FENCE UNDER THE DWELLING COVERAGE WHEN THE FENCE IS ATTACHED TO THE HOUSE.

In *Nassar v. Liberty Mutual Fire Insurance Company*, 508 S.W.3d 254 (Tex. 2017), the insured had 4000 linear feet of fencing that sustained $58,000 in damage as a result of Hurricane Ike. The insurer argued that the fence was not part of the dwelling and only qualified for coverage as an "other structure" which was limited to 10% of the dwelling limit or $24,720 as paid. The insured filed suit and the trial court agreed with the insurer's policy interpretation and granted summary judgment in their favor. The 14th Court of Appeals in Houston affirmed.

The Supreme Court of Texas analyzed the homeowner's policy "dwelling" provision covering "the dwelling on the residence premises…including structures attached to the dwelling" and; the "other structures" provision referencing structures on the residence premises "set apart from the dwelling by clear space". The court observed that "structures" was not defined in the policy so the word should be given its "ordinary and generally accepted meaning" under Texas law. "Structure" was defined in part as "any construction…composed of parts purposely joined together." The court also observed that the fencing in this case was either bolted to the dwelling in four places (Liberty Mutual's contention) or "fastened to the dwelling either by being cemented to the brick and slab of the house (as the Nassar's contend)." And either way, the fence was "attached to the dwelling" and as such, the policy unambiguously extended coverage to the fence as part of the dwelling.

The court also addressed Liberty Mutual's question of "when a fence attached to a dwelling by another fence would become an 'other structure' under the policy" by noting that this is "a fact issue best resolved by the trial court on remand." "On the undisputed facts in this record, a fact finder could reasonably determine that some of the 4,000 feet of fencing constructed of different materials and spanning six acres in a 'network' across the Nassars' property is not part of the 'structure attached to the dwelling.'" Accordingly, the court of appeals decision affirming summary judgment in favor of Liberty Mutual was reversed and the case was remanded to the trial court for further proceedings.

FIFTH CIRCUIT HOLDS THAT BILLING GUIDELINES DID NOT PROVIDE REASONABLE BASIS FOR INSURER TO DEDUCT CLAIMED LEGAL EXPENSES INCURRED BY ITS INSURED.

In *Aldous v. Darwin National Assurance Company*, 851 F.3d 476 (5th Cir. 2017), the Fifth Circuit Court of Appeals held an insurer arbitrarily relied on billing guidelines to deduct costs of defending its insured against professional liability claims and allowed the insured's breach of contract claims to proceed. In that case, Charla Aldous successfully handled litigation between two trusts, eventually winning a judgment worth over $100 million for her client Albert Hill. Mr. Hill decided that he preferred to keep the entire judgment to himself rather than pay Aldous a hefty contingency fee. Additional litigation then began when Aldous and two other attorneys who had assisted on Hill's case sued him to recover the fee. In response, Hill brought counterclaims for malpractice and breach of fiduciary duties against his attorneys. Hill's claims triggered coverage under Aldous's professional liability insurance policy with Darwin National. Aldous and her colleagues eventually prevailed against Hill, and a court awarded them $21,942,961 in attorney's fees as well as $2,586,560 worth of costs of defending against Hill's professional liability counterclaims. A dispute then arose between Aldous and her insurer over whether it had adequately paid the costs of her defense against Hill. Aldous then sued her insurer for breach of contract. Based on declarations filed by her defense attorney in the previous suit, Darwin argued that she was prevented from recovering more than one-third of $668,068.38 in defense costs. The District Court for the Northern District of Texas granted summary judgment in favor of the insurer, reasoning that Aldous was judicially estopped from recovering more than $222,689.46 (one-third of $668,068.38) and that Darwin had committed no breach of contract.

On appeal, the Fifth Circuit analyzed declarations filed by Aldous's defense attorney in the underlying suit and policy language to determine whether Darwin had properly paid attorney's fees. With respect to judicial estoppel, the Fifth Circuit noted the doctrine prevents parties from asserting a position contrary to one asserted in a prior suit in order to gain an unfair advantage. Here, in the prior suit, Aldous's attorney filed two declarations asserting the total amount of his fees was in fact over $2 million. Noting that Aldous had never taken the position that she was entitled to only a one-third share of $668,068.38 in that case, the Fifth Circuit held that she was not judicially estopped from recovering the full costs of her defense and reversed the district court's grant of summary judgment in favor of Darwin on that issue.

The court then switched gears to analyze whether summary judgment in favor of Darwin on Aldous's breach of contract claim had been proper. On appeal, Aldous argued that Darwin had arbitrarily deducted fees and otherwise failed to fully pay her costs of defense. Darwin argued that the district court's decision should stand because its policy obligated it to pay only reasonable expenses and noted that "[t]he determination by the insurer as to the reasonableness of Claim Expenses shall be conclusive on all Insureds." Darwin argued that its reliance on its internal Billing Guidelines to categorically exclude certain legal expenses was functionally equivalent to a binding determination on the reasonableness of those expenses. On the contrary, Aldous argued that Darwin never made a binding reasonableness determination and allowing Darwin to prevail without having done so would render the insurer's duty to defend illusory. The Fifth Circuit agreed with Aldous and held that Darwin had arbitrarily "slashed claimed costs" by relying on an extra-contractual document—its billing guidelines. As additional factual support for its ruling, the Fifth Circuit relied on correspondence between the insurance adjusters showing that Darwin's own adjuster thought the deductions from Aldous's legal bills were

excessive. Thus, the justices reversed the district court's grant of summary judgment in favor of Darwin and allowed Aldous's breach of contract claims to proceed in the district court.

THE AUSTIN COURT OF APPEALS CONCLUDED THAT THE EFFECT OF THE FAMILY MEMBER EXCLUSION IS DETERMINED AT THE TIME OF THE ACCIDENT AND NOT WHEN THE LIABILITY CLAIM IS MADE.

In *Johsnon v. State Farm Mutual Automobile Insurance Company*, -- S.W.3d --, No. 03-16-00086-CV, 2017 WL 1315379, (Tex. App.—Austin April 6, 2017, no pet. h.) Jerry C. Johnson sought declarations construing the terms of two insurance policies following an automobile accident in which Jerry's son, Jacob, a minor at the time, was injured while Jerry was driving. Jacob admitted Jerry's claims and asserted a cross-claim for declaratory relief against State Farm. State Farm asserted counterclaims for declaratory relief against Jerry and Jacob.

In 2008, Jerry, Jacob, and another individual were traveling on Interstate 70 in Colorado in a rented car driven by Jerry. Jerry became confused about which exit to take and turned into the path of a semi-truck, resulting in a collision. Jacob, who was eleven years old at the time and asleep in the back seat, suffered serious bodily injuries, including severe traumatic brain injury. Jacob lived with his parents at the time of the accident and remained in the home until May 29, 2015, when he permanently moved out of the residence. At the time of the accident, Jerry was insured by a Texas Personal Auto Policy (the auto policy) and a Personal Liability Umbrella Policy (the umbrella policy), both issued by State Farm. The auto policy contained a provision, the "family member exclusion," that excluded from liability coverage bodily injury to "any *family member*, except to the extent of the minimum limits of Liability Coverage required by Texas [Revised] Civil Statutes, Article 6701h, entitled 'Texas Motor Vehicle Safety–Responsibility Act,' " which at the time was $25,000. Family member" was defined as "a person who is a resident of your household and related to you by blood, marriage, or adoption." The umbrella policy contained a similar provision, also referred to as a "family member exclusion," that excluded coverage for "bodily injury ... to any insured," defined as "you and your relatives whose primary residence is your household." "Relative" was defined as "any person related to you by blood, adoption, or marriage." Jerry sought coverage for Jacob's injuries under both policies. State Farm contended that the family member exclusions in the policies excluded coverage except to the extent of the minimum limits of liability coverage required under the auto policy by the Texas Motor Vehicle Safety Responsibility Act and offered to pay $25,000

Jerry filed suit seeking declarations that the family member exclusions in the policies are unconstitutional and/or contrary to public policy and invalid. In the alternative, he sought a declaration that to the extent the family exclusions are valid, they apply only so long a Jacob is a member of Jerry's household. State Farm filed a counterclaim seeking declarations that the family member exclusions are valid and enforceable to exclude coverage under the auto and umbrella policies for any amount over the statutory minimum of $25,000 and that the application of the family member exclusions occurs at the time of the accident.

Citing to *National County Mutual Fire Insurance Company v. Johnson*, 879 S.W.2d 1, (Tex. 1993), the court upheld the constitutionality of family member exclusions and, therefore, concluded the family member exclusion before it was valid and enforceable. As to determining when the effect of the exclusion is determined, the Austin court of appeals agreed with State

Farm that Texas courts have uniformly determined "residency" of a family member at the time of the accident. Moreover, the court pointed out that the insured's interpretation (to determine "residency" based on when the claim was made) was unreasonable because a policyholder could defeat application of the exclusion and create coverage simply by moving the family member out of the home after an accident but prior to filing a claim, rendering the family exclusion meaningless.