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Is Common Law Bad Faith Dead in Texas, or Simply Getting a Second Breath? The History of Bad Faith in Texas

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I. INTRODUCTION

In 1920, when Mamie Bichon's drive home was violently interrupted by a Stowers Furniture truck, who would have known what lay ahead in Texas over the next seven decades? Since that time, Texas courts have struggled with the tort of bad faith. Recently, the Texas Supreme Court in *Lyons,*[1] *Dominguez*[2] and *Moriel,*[3] went to great lengths to settle the widespread confusion generated by the misunderstanding of *Aranda*[4] and the tort of bad faith. Now, in *Stoker,*[5] the Texas Supreme Court has the opportunity to clarify what constitutes bad faith.

The threshold of bad faith is reached when a breach of contract is accompanied by an independent tort. Evidence that merely shows a bona fide dispute about an insurer's liability on a contract does not rise to the level of bad faith. Nor is bad faith established if the evidence shows the insurer was merely incorrect about the factual basis for its denial of a particular claim. A simple disagreement among experts about whether the loss is covered by the policy will not support a judgment for bad faith. An insured claiming bad faith must prove that the insurer had no reasonable basis for denying or delaying payment of the claim, and that it knew or should have known that fact. Under the *Aranda* standard, insurers who arbitrarily deny compensable claims are liable for breach of the duty of good faith and fair dealing. However, insurers who deny questionable claims will not be exposed to such liability, even if the denial is erroneous.

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1. Lyons v. Millers Cas. Ins. Co., 866 S.W.2d 597 (Tex. 1993).

2. National Union Fire Ins. Co. v. Dominguez, 873 S.W.2d 373 (Tex. 1994)(Affirming Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210 (Tex. 1988). In order to establish a case of bad faith, a claimant must prove (1) absence of a reasonable basis of denial of a claim, and (2) the carrier knew or should have known there was no reasonable basis of denial. The claimant must prove a negative proposition, the absence of a reasonable basis of denial of a claim, which the carrier knew or should have known).

3. Transportation Ins. Co. v. Moriel, 879 S.W.2d 10 (Tex. 1994).

4. Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210 (Tex. 1988).

5. Republic Ins. Co. v. Stoker, 867 S.W.2d 74 (Tex. App.—El Paso 1993, writ granted).

On the other hand, in *Stoker*, the insured submitted a claim for uninsured motorist benefits to her insurance company. A claims representative conducted a cursory investigation and denied the insured's claim because of her negligence. The appellate court held that even though the uninsured motorist claim was not covered by the policy, the insurer's substandard investigation and failure to state the correct reason for denying coverage, by themselves, constituted bad faith.

The result in *Stoker* serves to punish the insurance company for its cursory investigation and poor service in handling the insured's claim. The court's displeasure with the insurance company did not alter the fact that there was no coverage under the policy. The insured was not able to establish the threshold requirement of a breach of contract claim, therefore, the bad faith claim should have been denied as a matter of law. The insurer should not be required to compensate perils which are not covered under contracts made with the insured. If allowed to stand, the *Stoker* case will severely undermine, if not destroy, the very foundation of *Aranda*.

This comment will discuss the history and evolution of the tort of bad faith in Texas. It analyzes recent decisions and suggests precedential and policy reasons for the reversal of *Stoker*.

II. THE HISTORY OF BAD FAITH IN TEXAS

A. *G.A. Stowers Furniture Co. v. American Indemnity Co.*[6]

Over six decades have passed since *Stowers* was decided, but it remains the authoritative Texas case explaining the duties of the insurer when third party claimants are involved. The *Stowers* doctrine arises when a third party claimant offers to settle a disputed claim within the policy limits, and the insurer refuses the offer.

In *Stowers,* American Indemnity issued an auto insurance policy covering Stowers Furniture Company, with policy limits of $5,000. In 1920, a truck belonging to the insured was at fault in an accident in which Mamie Bichon, the third party claimant, received severe injuries. The claimant filed suit asking for $20,000 in damages, but later offered to settle for $4,000. The insurance company refused her offer and proceeded to trial. The jury rendered a verdict for the claimant and awarded damages, including interests and costs, totalling $14,107.15. The insurance company tendered the policy limits of $5,000, but refused to pay the excess. Stowers Furniture Company, the insured, subsequently paid the full amount of the judgment and sued the insurance company.[7]

The insurance company argued the terms of the policy limited its liability to $5,000. The insured argued the claim could have been set-

6. 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved).
7. *Id.* at 545.

tled within policy limits, and thus, the insurance company should be liable for the entire judgment regardless of the policy limits.[8] In *Stowers,* the insurance company thought it was only risking $1,000 dollars of its own money by refusing the settlement. In effect, it was shifting the risk of a larger judgment to the policyholder. It should be noted that the insured paid the full amount of the judgment before bringing suit. For many years in Texas, it was thought that an insured who had not paid a judgment could not sue under these circumstances because he had not suffered damages until he actually paid the judgment. Thus, the *Stowers* cause of action belonged to the insured, although he could assign his rights.[9]

The Texas Supreme Court held that because the terms of the policy gave the insurance company exclusive control of the case, including settlement, the insurer owed a duty of ordinary care to its insured in deciding whether to accept a settlement offer.

> The provisions of the policy giving the indemnity company absolute and complete control of the litigation, as a matter of law, carried with it a corresponding duty and obligation, on the part of the indemnity company, to exercise that degree of care that a person of ordinary care and prudence would exercise under the same or similar circumstances, and a failure to exercise such care and prudence would be negligence on the part of the indemnity company.[10]

Therefore, under *Stowers,* if a jury finds that a person of "ordinary care and prudence"[11] in the insurance company's position would have agreed to the settlement offer, the insurance company's refusal of such an offer is negligent, and the insurance company can be held liable for the amount of the judgment that exceeds the policy limits.

B. Hernandez v. Great American Insurance Co.[12]

In 1958, A. T. Baucum was injured in an automobile accident. He sued Jesus R. Hernandez, the employer of the driver of the other vehicle, and in 1961 obtained a judgment against him for $81,636. Hernandez was insured by Great American with policy limits of $25,000. Before trial, the insurer had allegedly received several reasonable settlement offers within the $25,000 policy limits. The insurer paid the policy limits leaving Hernandez liable for the remaining $56,636. For several years, Hernandez did not pay any part of the $56,000, and in 1967 Baucum attached and executed upon land owned by Hernandez in the amount of $10,500. Hernandez then sued his insurer to recover the $10,500 under the *Stowers* doctrine, and further sought a declaratory judgment asking that the insurance company immediately reim-

8. *Id.* at 544-45.
9. *Id.* at 547-48.
10. *Id.* at 547.
11. *Id.*
12. 464 S.W.2d 91 (Tex. 1971).

burse him for any further payments he might make to Baucum. The trial court dismissed Hernandez's suit on the grounds that the statute of limitations had expired. The court of appeals affirmed, ruling that the statute of limitations on Hernandez's *Stowers* claim started to run from the time of the original judgment in 1961.[13]

The *Hernandez* court further held that "[a]ssuming no concealment of the act of negligence and no tolling of the statute, limitations will bar the suit two years after the excess judgment becomes final."[14] Prior to *Hernandez*, the statute of limitations on a *Stowers* action did not begin to run until the insured made a payment, which might be many years after the accident. As a result of the holding in this case, the statute of limitations on a *Stowers* action begins to run when final judgment in excess of the policy limits is rendered.

In *Hernandez*, the Texas Supreme Court recognized, that prior to Hernandez, Texas law "required the insured to pay some portion of the judgment against him before bringing suit for reimbursement from the insurer."[15] This is based on the belief that the insured is not damaged until he actually pays some part of the excess judgment.

Nevertheless, the court held that the insured is harmed by the insurance company's negligent failure to settle immediately after a judgment is rendered against him because "[t]he judgment injures [the insured] while it remains unpaid. His credit is affected. A lien attaches to his land [and] [h]is non-exempt property is constantly subject to sudden execution and forced sale."[16] Therefore, the *Hernandez* court held that an insured, who is injured by his carrier's negligent failure to settle a claim, can bring an action without first paying any portion of the excess judgment.[17]

Prior to *Hernandez*, an insured who suffered a judgment in excess of policy limits as a result of an insurance company's unreasonable refusal to settle was placed in a very vulnerable position. Before his cause of action matured he had to pay at least some part of the judgment and then could sue to recover the amount he had actually paid. In the interim, the judgment against the insured would impact his ability to obtain credit, his employment opportunities, and perhaps most importantly, the stress related to the potential seizure of his property. There is a possibility insurance companies would refuse to settle claims against those insureds, who have limited assets, because there would be little risk that the policyholder could ever pay the excess judgment and succeed in an action against the insurer under the *Stowers* doctrine.

13. *Id.* at 92.
14. *Id.* at 95.
15. *Id.*
16. *Id.* at 94.
17. *Id.* at 94-95.

C. *Allstate Insurance Co. v. Kelly*[18]

In April 1978, an auto accident occurred between Willie Alves and George Veevers. Deposition testimony showed Alves, the insured, was at fault. Sandra Kelly, a third party claimant in the Veevers auto, was seriously injured. The insured had an auto policy with Allstate with $50,000/100,000 limits.

By September 1978, Kelly's attorney had furnished medical bills in excess of $13,000 to the insurer. Medical reports showed, as a result of injuries sustained in the collision, the claimant had completely lost vision in one eye, and 50% of her field of vision in the other eye. The adjuster received authority to extend an offer of $50,000 to the claimant on November 9, 1978. On November 13, 1978, Kelly's attorney offered to settle the claim for $50,000 with a two week deadline. The adjuster told Kelly's attorney that he would pay the $50,000, but only if a release could be obtained from Kelly's husband. Kelly's attorney told the insurer that while the claimant was in the hospital, her husband had absconded with the family car and bank account. Thus, Kelly's attorney could not secure the release. The insurer then rejected the offer without consulting the insured.

On January 16, 1979, the insurance company dropped its demand that both the claimant and her husband execute releases, and unconditionally offered the $50,000. The claimant rejected the offer. On February 22, 1979, the insurer tendered $50,000 into the registry of the court.

The claimant's suit against the insured went to trial in April 1979, and the jury returned a verdict in her favor and awarded damages of $521,453. Afterwards, the insured sent a demand letter, and the insurance company and their adjuster responded by filing a declaratory judgment action against the insured and the claimant in November 1979. The insured counterclaimed for negligence in failure to settle the claim within policy limits (a *Stowers* action), seeking treble damages under both article 21.21 of the Insurance Code[19] and the Texas Deceptive Trade Practices Act ("DTPA")[20] and punitive damages for the insurer's gross negligence. The jury returned a verdict in favor of the insured and the claimant against the insurance company and its adjuster and awarded damages of $582,413.12 and punitive damages against the insurer for $800,000 and $1,164,826.24 as treble damages. The jury found that the insurance company's failure to settle the claim constituted both negligence and gross negligence.[21]

On appeal, the Tyler court held "as erroneous and meritless the argument of Allstate that if Alves recovers her actual damages, she has

18. 680 S.W.2d 595 (Tex. App.—Tyler 1984, writ ref'd n.r.e.).
19. *Id.* at 604-06.
20. *Id.* at 601-04.
21. *Id.* at 598-99.

not been damaged so as to authorize recovery of treble damages in this case."[22] The court found that the insurer's rejection of Kelly's offer to settle, without informing the insured of the offer, and the risks involved in accepting such offer, deprived the insured of her choice to settle Kelly's claims and taking a chance against any further claim that Kelly's husband might assert.[23] In rejecting the insurer's argument that Kelly's two-week deadline was too short, the court noted the insurer knew all the material facts to establish that the claim was worth more than $50,000 before the demand was ever made.[24] The court held, however, that because punitive damages and treble damages are both punishment damages and are based on the same actions, the insured could recover only one, not both.[25] Because the treble damages were greater, the court disallowed punitive damages.[26] The court also upheld an agreement between the insured and Kelly by which the insured assigned two-thirds of the recovery from the insurance company to Kelly, and further ruled that this assignment extended to the DTPA and article 21.21 claims as well as to the negligence and gross negligence claims.[27]

D. Ranger County Mutual Insurance Co. v. Guin[28]

Ranger County Mutual issued an auto policy on Billy Peden's truck with limits of $10,000/$20,000/$10,000. John Wesley Guin, an independent contractor, drove Peden's truck for various contractors. While driving Peden's truck, Guin collided with a truck owned by Eagle Trucking, driven by Robert Fitch. Fitch received serious injuries and Eagle suffered property damages of $37,000. Peden, the insured, and Guin sued Fitch and Eagle for property damages and Guin's injuries. Fitch and Eagle cross-claimed for their own injuries and damages. The insurer's attorney, Ritter, represented both Guin and the insured. The insurance company's claim file showed that Fitch and Eagle would probably prevail at trial, and that a jury verdict would probably exceed policy limits. The insurance company authorized their attorney to offer $10,000 for Fitch's personal injuries, but did not authorize an offer for Eagle's property damages. The attorney conditioned the $10,000 offer to Fitch on Eagle's agreement to pay something to Guin and the insured. No settlement was reached and the case proceeded to trial. During the trial, Fitch offered to settle his claim against the insured for $19,500 and agreed not to collect any judgment against Guin. Eagle agreed to accept $19,500. The insur-

22. *Id.* at 604 (emphasis in original).
23. *Id.* at 608.
24. *Id.*
25. *Id.* at 606.
26. *Id.*
27. *Id.* at 609-10.
28. 723 S.W.2d 656 (Tex. 1987).

ance company rejected Fitch's offer, but did not advise or provide any explanation for the rejection to Guin or the insured. At trial, the jury found Guin to be 100% negligent and awarded $216,000 to Fitch and $47,000 to Eagle.[29]

Claiming the insurer could have settled the claim within policy limits, the insured and Guin subsequently sued the insurance company under the *Stowers* doctrine. The jury found in favor of Guin and the insured and awarded each of them actual damages of $175,000 and punitive damages of $50,000, for a total of $450,000.[30]

The Texas Supreme Court affirmed the judgment.[31] The court noted that when an insurance company defends its insured, it becomes the insured's agent.[32] When the insurance company hires an attorney to defend an insured, the attorney becomes a sub-agent of the company.[33] Therefore, negligence by either the insurance company or their attorney will support a suit for damages by the insured.[34] The court found that the insurer's refusal to extend to their attorney any authority on Eagle's property damage claim was negligent, even though the insurer knew there was a high probability they would lose on liability, and Eagle's damages were far in excess of the policy limits.[35] The court further held that failure by the insured's attorney to disclose and explain to Guin and Peden the offer to settle, extended by Fitch and Eagle during trial, would further support a finding of negligence.[36] Moreover, the court held that the insurer's attorney's condition that Eagle pay something to Guin and Peden, before he offered the $10,000 to Fitch, was negligent.[37]

The insurance company argued that it merely breached its contract, thus punitive damages should not be allowed.[38] The court held "[a]n insurer's duty to its insured is not limited to the narrow boundaries contended by Ranger, rather it extends to the full range of the agency relationship. In this case, that includes investigation, preparation for defense of the lawsuit, trial of the case and reasonable attempts to settle."[39]

The court found that the insurer negligently breached its agency relationship with Guin and the insured constituting an independent tort for which punitive damages can be awarded. The court held that the

29. *Id.* at 657-60.
30. *Id.* at 658.
31. *Id.* at 660.
32. *Id.*
33. *Id.* at 659.
34. *Id.* at 659 (citing G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved)).
35. *Guin*, 723 S.W.2d at 659.
36. *Id.* at 660.
37. *Id.*
38. *Id.*
39. *Id.* at 659.

mental state of the insurer was evidence that there was a conscious disregard of the rights of the insured. The testimony of the insurer's claim personnel, together with the contents of the claim file, showed that the insurer had the requisite mental state to support an award of punitive damages.[40]

The insurance company unsuccessfully contended that "a '*Stowers* Doctrine' case can be based only upon an insurer's failure to settle a claim against the insured when the claimant offers to settle within the policy limits and fully release the insured from all liability."[41] The court disagreed and established an affirmative duty on the insurer to extend an offer of settlement within policy limits, if it appears probable that the insured will be found liable and that damages will probably exceed policy limits.

E. Arnold v. National County Mutual Fire Insurance Co.[42]

In June 1974, Glen Arnold was severely injured when the motorcycle he was operating was struck by a car driven by an uninsured motorist. Arnold was insured by National County Mutual with $10,000 policy limits on his uninsured motorist coverage. The insured made a timely demand for policy limits on his coverage and the independent adjusting firm investigating the accident recommended to the insurer that policy limits be paid.[43] However, the attorney for the insurer recommended that payment not be made under the uninsured motorist coverage because it was the attorney's "perception that a jury would be prejudiced against motorcyclists, that Arnold was driving too fast under the existing conditions and that Arnold was intoxicated."[44] Furthermore, "[the insurer] failed to investigate the facts supporting the attorney's contentions."[45]

In late June 1974, Arnold sued the uninsured motorist and the insurer obtaining a judgment against both for $17,975. The insurance company tendered the $10,000 policy limit. In December 1978, the insured filed a suit against the insurer alleging breach of the duty of good faith and fair dealing in the handling of his claim. The trial court granted summary judgment in favor of the insurer and the court of appeals affirmed. Arnold then appealed to the Texas Supreme Court.[46]

The Texas Supreme Court held that an insurance company owes a duty of good faith and fair dealing to its insureds as a result of the

40. *Id.* at 660.
41. *Id.* at 659.
42. 725 S.W.2d 165 (Tex. 1987).
43. *Id.* at 166.
44. *Id.*
45. *Id.* at 167.
46. *Id.* at 166.

special relationship between the parties.[47] This is based upon the unequal bargaining power of the parties and the nature of the insurance contract which can allow an unscrupulous insurer to take advantage of an insured's misfortunes in bargaining for settlement or resolution of claims.

Without such a duty, an insurance company can arbitrarily deny claims with no more penalty than the interest on the amount actually owed. Furthermore, the insurance company has exclusive control over the evaluation, processing and denial of claims.[48]

> A cause of action for breach of the duty of good faith and fair dealing is stated when it is alleged that there is no reasonable basis for denial of a claim or delay in payment or a failure on the part of the insurer to determine whether there is any reasonable basis for the denial or delay.[49]

Because breach of the duty of good faith and fair dealing is a tort, "exemplary damages and mental anguish damages are recoverable . . . under the same principles allowing recovery of those damages in other tort actions."[50]

F. Aranda v. Insurance Co. of North America[51]

In March 1982, Miguel Aranda was working two jobs when he became disabled by carpal tunnel syndrome. Aranda was covered by worker's compensation on both jobs. One employer had coverage with Insurance Company of North America and the other employer had coverage with Lumberman's. Both insurance companies investigated the claim, and both determined that his injuries were work-related and were covered. However, the insurers were unable to agree which carrier bore primary responsibility, and therefore, each refused to pay until the dispute could be resolved by the Industrial Accident Board. Thereafter, Aranda sued both insurers for breach of the duty of good faith and fair dealing.[52]

Aranda establishes the bona fide dispute defense which allows an insurer to assert reasonable policy defenses and provides a test to determine such reasonableness.[53]

> A workers' compensation claimant who asserts that a carrier has breached the duty of good faith and fair dealing by refusing to pay or delaying payment of a claim must establish (1) the absence of a reasonable basis for denying or delaying payment of the benefits of

47. *Id.* at 167 (citing Manges v. Guerra, 673 S.W.2d 180, 183 (Tex. 1984)), *See* English v. Fischer, 660 S.W.2d 521, 524 (Tex. 1983)(Spears, J., concurring).
48. *Arnold,* 725 S.W.2d at 167 (citing *Stowers*, 15 S.W.2d at 548).
49. *Arnold,* 725 S.W.2d at 167.
50. *Id.* at 168 (citations omitted).
51. 748 S.W.2d 210 (Tex. 1988).
52. *Id.*
53. *Id.* at 213.

> the policy and (2) that the carrier knew or should have known that there was not a reasonable basis for denying the claim or delaying payment of the claim. The first element of this test requires an objective determination of whether a reasonable insurer under similar circumstances would have delayed or denied the claimant's benefits. The second element balances the right of an insurer to reject an invalid claim and the duty of the carrier to investigate and pay compensable claims. This element will be met by establishing that the carrier actually knew there was no reasonable basis to deny the claim or delay payment, or by establishing that the carrier, based on its duty to investigate, should have known that there was no reasonable basis for denial or delay. Under the test, carriers will maintain the right to deny invalid or questionable claims and will not be subject to liability for an erroneous denial of a claim. Carriers that breach the duty of good faith and fair dealing, however, will be subject to liability for their tortious conduct.[54]

In addition, to sustain a cause of action for breach of the duty of good faith and fair dealing, an employee must also show that the carrier's lack of good faith, separate and independent from the original job-related injury, proximately caused the damages, and that the employee sustained damages as result of the carrier's action.[55]

G. Vail v. Texas Farm Bureau Mutual Insurance Co.[56]

Melvin and Maryanne Vail insured their home under a policy issued by Texas Farm Bureau Mutual with coverage of $25,000 on the structure and $10,000 on the contents. The home was completely destroyed by fire. The insurer notified the Vails that it was denying their claim because the list of destroyed contents prepared by the Vails was inadequate. The insurance company hired an engineering firm to conduct an arson investigation, and the firm concluded that no fire-setting materials were present. The insurance company then asked the State Fire Marshal's office to conduct a second investigation. The State Fire Marshal reported that it found fire-setting materials in three out of four samples taken from the fire. The insurer then changed its basis for denial of the claim to arson. The insured sued the insurance company under the DTPA and the Texas Insurance Code alleging bad faith failure to pay the claim.

At trial, evidence showed that the tests done by the State Fire Marshal were questionable. The insureds proved that the fire loss coverage was $25,000 on the home and $10,000 on the contents. Their home policy was a valued policy, one in which the measure of the value of the property insured was set by the contract. Thus, it was not necessary for the insured to prove actual damages.[57] The jury found

54. *Aranda*, 748 S.W.2d at 213 (citations omitted).
55. *Id.* at 215.
56. 754 S.W.2d 129 (Tex. 1988).
57. *Id.* at 137.

in favor of the insured and awarded actual damages of $35,000, which were trebled.[58] The insurance company appealed.

The Texas Supreme Court held that the insureds could recover under the DTPA, and were therefore entitled to treble damages because, the DTPA incorporates unfair claims practices as defined by the Texas Insurance Code or by the rules and regulations of the State Board of Insurance.[59]

"Thus, because section 17.50(a)(4) of either version of the DTPA incorporates section 16 of article 21.21 and the Vails pleaded and presented evidence on damages, the trial court was warranted in awarding trebled damages to the Vails."[60] 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."[61] *Vail* confirms the holding in *Kelly* that an insured can recover under the DTPA. Prior to *Vail*, *Kelly* was simply persuasive authority to Texas courts because it was an appellate court opinion. Lastly, *Vail* confirms that "prejudgment interest may not be awarded on punitive damages."[62]

III. INTERPRETATION AND APPLICATION OF *ARANDA*

A. Aranda *clarifies the necessary elements for a cause of action for breach of the duty of good faith and fair dealing.*

The *Aranda* court established a conjunctive test that requires a plaintiff to establish (1) the absence of any reasonable basis for denying or delaying payment of policy benefits and (2) that the insurer knew or should have known that there was not a reasonable basis for denying or delaying payment of the claim.[63]

The *Aranda* court also recognized the insurer's right to dispute questionable claims. In *Aranda*, the court said, "[u]nder the test, car-

58. *Id.* at 131.

59. *Id.* at 132-33 (citing TEX. INS. CODE ANN. art. 21.21, § 16(a) (Vernon Supp. 1988)); Section 17.50(a)(4) of the DTPA incorporates section 16 of article 21.21 of the Insurance Code. Section 16 permits recovery by any person who has been injured by another's engaging in [1] any of the practices declared to be unfair or deceptive by Section 4 of article 21.21; [2] conduct defined in rules or regulations lawfully adopted by the Board under article 21.21 as unfair methods of competition and unfair or deceptive acts or practices in the business of insurance; or [3] any practice defined by Section 17.46 of the Business & Commerce Code, as amended, as an unlawful deceptive trade practice.

60. *Vail*, 754 S.W.2d at 137.

61. *Id.* at 136 (citing Aetna Cas. & Sur. Co. v. Marshall, 724 S.W.2d 770, 771-72 (Tex. 1987); Royal Ins. Globe Co. v. Bar Consultants, Inc., 577 S.W.2d 688, 694 (Tex. 1979); Allstate Ins. Co. v. Kelly, 680 S.W.2d 595, 605 (Tex. App.—Tyler 1984, writ ref'd n.r.e.)).

62. *Vail*, 754 S.W.2d at 136 (citing Cavnar v. Quality Control Parking, Inc., 696 S.W.2d 549, 555 (Tex. 1985)).

63. *Aranda*, 748 S.W.2d at 213.

riers will maintain the right to deny invalid or questionable claims and will not be subject to liability for an erroneous denial of a claim."[64] Under the first prong of the *Aranda* test, there can be no bad faith, as a matter of law, if a reasonable basis exists for denial or delay of payment.[65] In other words, if an insurer in good faith concludes that a claim is questionable, the insurer maintains the right to contest that claim, even though a jury may reject the insurer's position.[66]

B. When a claim is questionable Aranda *precludes a finding of bad faith as a matter of law.*

Proper application of *Aranda* requires more than the superficial reading given by most courts. Careful review shows that the *Aranda* court avoided creation of a negligence test. Rather, the *Aranda* court set forth the substantive requirements for the relatively new Texas tort of breach of the duty of good faith and fair dealing. The court specifically excluded denial of questionable claims as a basis for bad faith.[67] The court relied on *Anderson v. Continental Insurance Co.*,[68] discussed herein, to reinforce the exclusion of denial of questionable claims as a basis for bad faith, as a matter of law.[69]

Moreover, *Aranda* reflects a balanced approach to the rights of the insured and the insurer. *Aranda* mandates that insurers who arbitrarily deny claims must fully account to the injured insured, but simultaneously recognizes the insurer's right to investigate, analyze, and under certain circumstances deny questionable claims without exposure to punitive and extra-contractual damages.

Stated differently, *Aranda* distinguishes legitimate claims that should have been paid immediately from those which are questionable. Common sense dictates the necessity for this distinction. Otherwise, an insurer's investigation is meaningless and the insurer is automatically liable for all claims, even in the face of objective evidence which leads to a result contrary to that advocated by the insured.

Typically, an insurer encounters two types of claims, those which are clearly legitimate and should be paid, and those which are questionable.[70] Insurers who fail to pay claims which are clearly legitimate will be liable, under *Aranda*, for breach of the duty of good faith and fair dealing.[71] Insurers who deny questionable claims, however, will

64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. 271 N.W.2d 368 (Wis. 1978).
69. *See id.*
70. The ordinary meaning of questionable is defined as "inviting inquiry" or "liable to judicial inquiry or action." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 958 (10th ed. 1993).
71. *Aranda*, 748 S.W.2d at 212-13.

not be held liable for breach of the duty of good faith and fair dealing.[72]

Insurance companies are required to, and should, investigate claims presented to them because the insurer's investigation may reveal objective and credible evidence which leads to conclusions different from those advocated by the insured. Pursuant to *Aranda*, in these circumstances, an insurer maintains the right to rely on its investigation and handle the claim accordingly. To deny the insurer the right to rely on its investigation renders its investigation and its duty to investigate meaningless. Neither *Aranda*, its policy, or any other authority requires the insurer to accept the insured's contentions when its own investigation discloses other objective evidence leading to different conclusions. Likewise, no authority supports punitive or extra-contractual damages under those circumstances.

C. The tort of bad faith requires an objective determination that there was no reasonable basis for the denial or delay in payment

In *Anderson*, the Wisconsin Supreme Court was the first to adopt a two-pronged test for bad faith in first-party cases, requiring the insured to show (1) that the insurer had no reasonable basis for denying the claim and (2) that the insurer either knew there was no reasonable basis or recklessly disregarded that fact.[73] In so doing, the court defined the tort of bad faith as a "separate, intentional wrong, which results from a breach of duty imposed as a consequence of the relationship established by contract."[74] Bad faith, as defined by the Wisconsin court, includes deceit, duplicity, and insincerity, and cannot be unintentional.[75]

However, under *Anderson*, an improper investigation alone is not sufficient for recovery if the insurer has an objectively reasonable basis for denying the claim.[76] Something more than negligence is required.[77] Negligence alone in the claims handling process cannot constitute bad faith because the absence of an objectively reasonable basis for denying or delaying payment of a claim is an essential element of the tort of bad faith.[78]

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72. 748 S.W.2d at 213.

73. 271 N.W.2d at 374-76.

74. *Id* at 374.

75. *Id.* at 376, (citing AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 471 (1969)).

76. Braesch v. Union Ins. Co. 464 N.W.2d 769, 777 (Neb. 1991); Pace v. Insurance Co. of N. Am., 838 F.2d 572, 584 (1st Cir. 1988).

77. *See Braesch*, 464 N.W.2d at 777; Travelers Ins. Co v. Savio, 706 P.2d 1258, 1274 (Colo. 1985) (rejecting negligence as basis for a claim); *Anderson*, 271 N.W.2d at 375-76.

78. Reuter v. State Farm Mut. Auto. Ins. Co., 469 N.W.2d 250, 254 (Iowa 1991); Mills v. Regent Ins. Co., 449 N.W.2d 294, 298 (Wis. Ct. App. 1989); Gulf Atl. Life Ins.

The court in *Anderson* concluded, "[w]here a claim is 'fairly debatable,' the insurer is entitled to debate it."[79] The requirement that there be no reasonable basis for the denial of the claim focuses on whether the insured's claim was fairly debatable.[80]

Courts in other jurisdictions, following *Anderson*, have agreed that it is this "objective element of the two-pronged test for bad faith which enables insurers to retain the right to challenge questionable claims."[81] While recognizing that insurers should not be permitted to arbitrarily deny or delay payment of claims, courts have concurred that a party who entertains bona fide questions about his legal obligations *must* be allowed to seek adjudication of those questions in the courts. For example, the *Anderson* court recognizes the necessity for allowing insurance companies the right to adjudicate claims in court when they determine that there is a question of law or fact which must be decided.[82] It is this objective requirement of no reasonable basis for the denial or delay which provides protection to insurers and other policy holders referred to in *Anderson*.[83] The insurer is entitled to question fairly debatable claims which protects the insurer's right to seek adjudication of such claims with the courts.[84] Based on this policy, the *Aranda* court concluded that insurers maintain the right to deny questionable claims.[85]

Under this two-pronged objective standard, the burden of proof is on the plaintiff to establish the absence of a reasonable basis for denying or delaying payment of the claim.[86] Stated differently, the insured must establish that the insurer had "no legal or factual defense to the insurance claim."[87] *National Savings Life Insurance Co. v. Dutton* defined a reasonable basis, as an "arguable reason, one that is open to

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Co. v. Barnes, 405 So. 2d 916, 924 (Ala. 1981); State Farm Fire & Cas. Co. v. Balmer, 891 F.2d 874, 877 (11th Cir. 1990); Pace v. Insurance Co. of N. Am., 838 F.2d 572, 584 (1st Cir. 1988).

79. *See also Reuter*, 469 N.W.2d at 254 (if a claim is "fairly debatable," there is an objectively reasonable basis for not paying the claim); State Farm Fire & Cas. Ins. Co. v. Balmer, 672 F. Supp. 1395, 1399 (M.D. Ala. 1987), *aff'd*, 891 F.2d 874 (11th Cir. 1990) ("no reasonable basis" means that the claim was not "fairly debatable"); T.D.S., Inc. v. Shelby Mut. Ins. Co., 760 F.2d 1520, 1528 (11th Cir. 1985) (the logical premise of the "fairly debatable" standard is that if a realistic question of liability does exist, the insurer is entitled to "reasonably pursue that debate").

80. *See* McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 860 (Wyo. 1990) (stating that the "focus" of the test is whether the basis for the denial was "fairly debatable").

81. *Anderson*, 271 N.W.2d at 376 (recognizing the undesirability of forcing insurers to pay "questionable" claims by threats of bad faith suits).

82. *Id.* at 376.

83. Mills v. Regent Ins. Co., 449 N.W.2d 294, 298 (Wis. Ct. App. 1989).

84. Callioux v. Progressive Ins. Co., 745 P.2d 838, 842 (Utah Ct. App. 1987).

85. *Aranda*, 748 S.W.2d at 213.

86. *Id.; See also Anderson*, 271 N.W.2d at 376.

87. National Sav. Life Ins. Co. v. Dutton, 419 So. 2d 1357, 1361 (Ala. 1982)(citing National Sec. Fire & Cas. Co. v. Bowen, 417 So. 2d 179 (Ala. 1982)).

dispute or reason."[88] In *Dutton*, the Supreme Court of Alabama described the plaintiff as having a heavy burden. In order for the plaintiff to make out a prima facie case of bad faith refusal to pay, the proof offered must show that the plaintiff would be entitled to a directed verdict on its contract claim.[89] "[I]f the evidence produced by either side creates a fact issue with regard to the validity of the claim, and thus, the legitimacy of the denial thereof, the tort claim must fail and should not be submitted to the jury."[90] Therefore, the insurer should be entitled to judgment as a matter of law on a bad faith claim under these circumstances.[91]

The *Dutton* rule has been adopted by a number of other jurisdictions.[92] However, it should be noted that other courts have independently reached the same logical conclusion.[93]

D. The bona fide dispute defense is compatible with Texas procedure.

The bona fide dispute defense is not a true defense, but rather describes the particular type of evidence necessary to defeat an essential element of the plaintiff's case. The plaintiff has the burden of proof on each essential element of his claim.[94]

While the burden of proof never shifts, the burden of going forward may shift back and forth throughout trial.[95] If a plaintiff makes out a prima facie case by going forward with evidence to establish each essential element of his claim, then the burden of going forward shifts to the defendant.[96] To meet the burden of establishing a prima facie case under the objective element of the *Aranda* standard, a plaintiff

88. *Dutton*, 419 So. 2d at 1361.
89. *Dutton*, 419 So. 2d at 1362.
90. *Id.* at 1362.
91. *Id.*
92. *See, e.g.,* Rumford Property & Liab. Ins. Co. v. Corbone, 590 A.2d 398, 400 (R.I. 1991); Curry v. Fireman's Fund Ins. Co., 784 S.W.2d 176, 177 (Ky. 1989); Mills v. Regent Ins. Co., 449 N.W.2d 294, 297 (Wis. Ct. App. 1989); Callioux v. Progressive Ins. Co., 745 P.2d 838, 842 (Utah Ct. App. 1987); Dunn v. State Farm Fire & Cas. Co., 927 F.2d 869, 873 (5th Cir. 1991)(applying Mississippi law).
93. *See, e.g.,* Reuter v. State Farm Mut. Auto. Ins. Co., 469 N.W.2d 250, 253 (Iowa 1991) (whether "reasonable basis" exists is for the court, not the jury); Manis v. Hartford Fire Ins. Co., 681 P.2d 760, 762 (Okla. 1984) ("issue of fact" on arson claim entitles insurer to judgment as a matter of law on bad faith claim); Santilli v. State Farm Life Ins. Co., 562 P.2d 965, 967 (Or. 1977)(*en banc*)("valid question" entitles insurer to prevail); Carter v. Allstate Ins. Co., 399 S.E.2d 500, 503 (Ga. Ct. App. 1990)("bona fide controversy" entitles insurer to judgment as a matter of law). *See also* Westers v. Auto-Owners Ins. Co., 711 F. Supp. 946, 949 (S.D. Ind. 1989)(under "right to disagree" rule of Indiana, insurer conclusively established "reasonable basis" to question arson claim based on evidence of incendiary origin and motive).
94. Vance v. My Apartment Steak House of San Antonio, Inc., 677 S.W.2d 480, 482 (Tex. 1984).
95. *See* ROY R. RAY, TEXAS LAW OF EVIDENCE, § 47 (3d ed. 1980).
96. *Id.*

must introduce some evidence that there is no reasonable basis for the denial or delay of payment of the claim on the policy by the insurer.[97] If the insurer introduces competent and probative evidence from which reasonable persons could conclude the claim is not valid, then the logical conclusion is that a reasonable basis existed to deny the claim. Such evidence of a bona fide dispute establishes a reasonable basis for denial of the claim and defeats the first element of the plaintiff's claim for bad faith as a matter of law.

The existence of a factual dispute regarding the validity of a claim does not entitle the insured to submit the issue of reasonableness of the basis for denial to the jury in a bad faith case. Such a submission simply invites the jury to determine whether the insurer's decision was correct, thereby subjecting insurers to bad faith liability for mistakes in judgment. In effect, the jury is asked to consider the validity of a contract claim for a second time. Additionally, a jury question on reasonableness is nothing more than a question of negligence based on whether the insurer deviated from a standard of ordinary care in its conduct in handling the claim. Negligence is, or should be, an entirely different cause of action from bad faith.

Additionally, the question of whether a reasonable basis exists for a denial or delay without any objective standard of care enables the jury to determine whether the claim should have been denied based upon some undefined notions of fairness. More significantly, allowing a jury to decide that there is no reasonable basis, when there is evidence otherwise, effectively makes claims indisputable and will ultimately deprive insurers of the right to disagree as to the validity of a claim.

E. The Hudson *and* Luker *courts properly applied* Aranda.

The *Aranda* holding was properly applied in *National Union Fire Insurance Co. v. Hudson Energy Co.*[98] and *St. Paul Guardian Insurance Co. v. Luker.*[99] These cases are well reasoned and comport with the reasoning and holding of *Aranda*. They further reflect balanced and fair results.

Hudson involved a claim for damage to a private airplane. The nature of the crash left several determinative facts relative to coverage unresolved, including who was piloting the plane when the damage occurred and whether the insured had a certified pilot's license. Additionally, a legal question existed as to whether the insurer or the insured properly interpreted the policy.

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97. *Aranda*, 748 S.W.2d at 213.

98. 780 S.W.2d 417 (Tex. App.—Texarkana 1989), *aff'd*, 811 S.W.2d 552 (Tex. 1991).

99. 801 S.W.2d 614 (Tex. App.—Texarkana 1990, no writ).

The *Hudson* court set forth the *Aranda* elements of a bad faith claim and discussed the significance of a bona fide factual and legal dispute between the parties. The court stated,

> In order to determine what inferences can be drawn from the delay and refusal to pay, we must look at the circumstances. A failure to pay after sufficient time for an investigation can be evidence of malice or gross negligence if the failure to pay is arbitrary and capricious. If, however, there is a bona fide controversy, this will suffice as a reason for the failure of the insurer to make prompt payment. . . . Furthermore, delays or refusal to pay are not unreasonable where there is a legitimate question of policy construction.[100]

While the court affirmed the judgment for breach of the insurance policy, the court found no evidence that the insurer breached the duty of good faith and fair dealing and reformed the judgment of the trial court by deleting the award of exemplary damages.[101] *Hudson* reflects proper application of *Aranda.*

Luker involved a fire claim under a homeowner's policy. Several objective factors supported the insurer's arson defense. The trial court entered judgment against the insurer for breach of the insurance policy and for breach of the duty of good faith and fair dealing. The appellate court affirmed the breach of policy findings, but found the evidence insufficient to support a finding of breach of the duty of good faith and fair dealing. The court noted that the insureds presented evidence that they did not cause the fire, in other words, some evidence of no reasonable basis for denial. The court then reviewed the evidence presented by the insurer, which supported its belief that the cause of the fire was arson, including the fact that the insured had a motive as well as access to the house at the time of the fire.[102] Relying on *Aranda* and *Hudson,* the court stated,

> The determination to deny the claim is not to be based on the insurer's success or failure in court on liability for the claim. The denial may be erroneous and still be in good faith if it is based upon the information which was available to the insurer at the time of the denial and which supported the denial of the claim. When there is a bona fide controversy, the insurer has a right to have its day in court and let the jury determine each witness's truthfulness.[103]

100. *Hudson*, 780 S.W.2d at 426-27.
101. *Id.*
102. *Luker*, 801 S.W.2d at 621.
103. *Id.* at 621-22.

F. Other Texas authority holds that denial of questionable claims does not subject an insurer to liability for breach of the duty of good faith and faith dealing.

Other Texas decisions have denied recovery for breach of the duty of good faith and fair dealing when a bona fide factual dispute exists. Such examples include *Lyons v. Millers Casualty Insurance Co.*[104] and *St. Paul Lloyd's Insurance Co. v. Fong Chun Huang.*[105]

Huang is notable as a fire claim and a defense of arson case. Characteristic of arson cases, the insurer could not prove that the insured started the fire, except by circumstantial evidence. Based upon the results of its investigation, the insurer denied the claim. Thereafter, Huang filed suit for breach of the duty of good faith and fair dealing. The trial court awarded damages to Huang for breach of the duty of good faith and fair dealing. The insured's principal contention was that the insurer had not diligently investigated the claim.[106] The appellate court reversed and rendered judgment in favor of the insurer finding that the insurance company conclusively established a reasonable basis for the denial by presenting a reasonable fact question as to whether the fire was due to arson by the insured.[107] The court correctly stated,

> Insurance carriers maintain the right to deny questionable claims without being subject to liability for an erroneous denial of a claim.[108] A bona fide controversy is a sufficient reason for failure of an insurer to make a prompt payment of a loss claim. Also, the insurer need only show that it had a reasonable basis for believing the insured was at fault in order to defend a bad faith allegation.[109]

Lyons is another example recognizing that *Aranda* allows insurance carriers to deny questionable claims without exposure to extra-contractual damages. *Lyons* involved an insurer's refusal to pay a claim under a homeowner's policy for damage to the insured's home. The insured contended that the damage was caused by a windstorm. The insurance company contended that the damage was caused by settlement, an excluded condition under the terms of the policy.[110]

Both parties presented objective evidence in support of their particular theory. The trial court entered judgment in favor of the insured and allowed recovery for breach of the duty of good faith and fair dealing. The appellate court, however, concluded that there was no evidence of breach of the duty of good faith and fair dealing, and the supreme court affirmed. Citing *Aranda*, the court stated,

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104. 866 S.W.2d 597 (Tex. 1993).
105. 808 S.W.2d 524 (Tex. App.—Houston [14th Dist.] 1991, writ denied).
106. *Id.* at 526.
107. *Id.*
108. *Id.*; (citing Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210 (Tex. 1988)).
109. *Huang,* 808 S.W.2d at 526 (citations omitted).
110. 866 S.W.2d at 599.

> [C]arriers . . . will maintain the right to deny invalid or questionable claims and will not be subject to [bad faith] liability for an erroneous denial of a claim. In other words, if the insurer has denied what is later determined to be a valid claim under the contract of insurance, the insurer must respond in actual damages up to the policy limits. But as long as the insurer has a reasonable basis to deny or delay payment of the claim, even if that basis is eventually determined by the fact finder to be erroneous, the insurer is not liable for the tort of bad faith.[111]

In summary, under the *Aranda* standard, insurers who arbitrarily deny compensable claims are liable for breach of the duty of good faith and fair dealing, however, insurers who deny questionable claims will not be exposed to such liability, even if the denial is erroneous.

G. The bona fide dispute defense is consistent with public policy.

Insurers who arbitrarily deny claims should be punished. On the other hand, insurers owe a duty to their other policy holders, as well as to the insurance-buying public as a whole, not to pay fraudulent or invalid claims. The possibility of scaring insurers into paying questionable claims because of the threat of a bad faith suit and its excessive damages is undesirable.[112] This will cause payment of claims which should not be paid and result in higher costs which will then be borne by all policy holders.[113]

The *Hudson* court recognized that insurers "should have the right to litigate a claim when [they] feel that there is a question of law or fact which needs to be decided."[114] From a purely economic standpoint, "the insurer is permitted to dispute its liability in good faith because of the prohibitive social cost of a rule which would make claims nondisputable."[115] Allowing recovery to an insured for bad faith in the face of a legitimate legal or factual dispute, will deny insurers the right to litigate questionable claims in court.[116]

The legitimate exercise of the right to disagree should not subject insurers to penalty of bad faith awards.[117] An insurer is entitled to have a court resolve its liability without being punished for going to court.[118] The right to litigate honest disputes of law or fact through resolution in the court system is a fundamental right.[119] Even insur-

111. *Id.* at 600 (citations omitted).
112. Anderson v. Continental Ins. Co., 271 N.W.2d 368, 377 (Wis. 1978) (citing Thornton & Blaut, *Insurers: Compensatory and Punitive Damages*, 12 FORUM 699, 719 (1977)).
113. *Anderson*, 271 N.W.2d at 377.
114. *Id.*
115. Hoosier Ins. Co. v. Mangino, 419 N.E.2d 978, 982-83 (Ind. Ct. App. 1981).
116. St. Paul Guardian Ins. Co. v. Luker, 801 S.W.2d 614, 621-22 (Tex. App.—Texarkana 1990, no writ).
117. *See Hoosier*, 419 N.E.2d at 987.
118. Dunn v. State Farm Fire & Cas. Co., 927 F.2d 869, 874 (5th Cir. 1991).
119. U.S.CONST. amend. XIV, § 1; TEX. CONST. art. I, § 15.

ance companies are entitled to due process and the right of access to the courts.[120] It is repugnant to basic principles of law and justice to impose a rule which penalizes insurers for the honest and good faith exercise of that right.[121] Where there is a legitimate factual or legal issue, as a matter of law, there can be no bad faith.

Aranda did not establish a negligence test for determining breach of the duty of good faith and fair dealing. *Aranda* did not establish a test for negligent breach of contract. *Aranda*, did however, set forth limited circumstances under which a cause of action for breach of the duty of good faith and fair dealing can exist. Breach of the duty of good faith and fair dealing occurs when carriers arbitrarily deny valid claims. The court was careful to make it clear that insurance carriers maintain the right to deny questionable claims without being subject to extra-contractual liability.[122] To hold otherwise, renders the insurance contract virtually meaningless.

IV. *MORIEL* AND ITS EFFECT ON PUNITIVE DAMAGES

A. Transportation Inc. v. Moriel[123] *establishes when punitive damages are avaliable for bad faith.*

Two basic questions consistently arise after *Aranda*. First, what are the elements of a bad faith claim? And second, does an insurer retain the right to dispute questionable claims? Prior to *Moriel*, "confusion reign[ed] in Texas as to the parameters of the first-party bad faith cause of action."[124] Many courts failed to inquire whether a claim was questionable, thereby removing it from bad faith altogether. The abhorrent result, which *Moriel* eliminated, is that an insurer could be held liable for extra-contractual and punitive damages when it denies a questionable claim. A result which is completely contrary to the spirit of *Aranda*.

Moriel has provided a new understanding of the applicability of punitive damages for bad faith.

Our law recognizes a three-tier framework for measuring damages in an insurance coverage dispute, and each level is associated with distinctly different policies, substantive definitions, and measures of

120. Connecticut Gen. Life Ins. Co. v. Johnson, 303 U.S. 77 (1938); State Mut. Life Assurance Co. v. State, 345 S.W.2d 325, 335 (Tex. Civ. App.—Austin 1961), *rev'd on other grounds*, 353 S.W.2d 412 (Tex. 1961).

121. *Callioux*, 745 P.2d at 841.

122. *Aranda*, 748 S.W.2d at 213.

123. 879 S.W.2d 10 (Tex. 1994).

124. Edward J. Ozog & Jean-Pierre Ruiz, *Property Insurance Law: 1990-1991 Developments*, 27 TORT & INS. L.J. 404, 407 (1991), *citing* Stephen S. Ashley, *Confusion, Texas Style*, 7 BAD FAITH LAW REP. 103 (1991). *See also* Jeff E. Tankersley, *The Texas Supreme Court Characterizes Duty of Good Faith and Fair Dealing and Insurer's Standard for Meeting It... or Does It?*, 22 TEX. TECH. L. REV. 257, 276-77 (1990)(in which the author commented on the confusion created by differing standards for determining bad faith announced by the Texas Supreme Court).

proof. A bad faith case can potentially result in three types of damages: (1) benefit of the bargain damages for an accompanying breach of contract claim, (2) compensatory damages for the tort of bad faith, and (3) punitive damages for intentional, malicious, fraudulent, or grossly negligent conduct. It is important to preserve distinct legal boundaries between the three bases of recovery to prevent arbitrariness and confusion at the critical thresholds.[125]

> The threshold of bad faith is reached when a breach of contract is accompanied by an independent tort. Evidence that merely shows a bona fide dispute about the insurer's liability on the contract does not rise to the level of bad faith. Nor is bad faith established if the evidence shows the insurer was merely incorrect about the factual basis for its denial of the claim, or about the proper construction of the policy. A simple disagreement among experts about whether the cause of the loss is one covered by the policy will not support a judgment for bad faith. To the contrary, an insured claiming bad faith must prove that the insurer had no reasonable basis for denying or delaying payment of the claim, and that it knew or should have known that fact.[126]
>
> The final critical threshold is that separating the tort of bad faith from conduct subject to punishment. Even if the insurer has "no reasonable basis" to deny or delay payment of the claim, the plaintiff may not recover punitive damages on that basis alone. The bad faith of the insurer justifies an award of compensatory damages and nothing more. Only when accompanied by malicious, intentional, fraudulent, or grossly negligent conduct does bad faith justify punitive damages.[127]

B. The conflict between Polasek *and* Simmons

The problem encountered post *Moriel* is the subjective determination of reasonableness by the courts. There is currently a conflict among various Texas courts of appeals as to what constitutes a reasonable basis for denial of claim. In *State Farm Lloyd's Inc. v. Polasek*,[128] the court held that a "bad faith cause of action require[s] proof of a negative: that *no reasonable basis existed* for denying, or delaying payment of an insurance claim."[129] Thus, the *Polasek* court held a bad faith cause of action requires more demanding proof than a suit on the insurance policy.

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125. *Moriel*, 879 S.W.2d at 17. *See, e.g.*, Lyons v. Millers Cas. Ins. Co., 866 S.W.2d 597, 600 (Tex. 1993)("This focus on evidence and its relation to the elements of bad faith is necessary to maintain the distinction between a contract claim on the policy, and a claim of bad faith delay or denial. . .").

126. *Moriel*, 879 S.W.2d at 17-18 (citations omitted).

127. *Id.* at 18 (citations omitted).

128. 847 S.W.2d 279, 283 (Tex. App.—San Antonio 1992, writ denied).

129. *Id.* (emphasis in original).

> [I]t is not enough for the insured to show that the insurer should have known to pay the claim or that there were other facts suggesting the claim was valid. The insured must show that no reasonable basis existed for denying the claim.
>
> . . . .
>
> This means that the insured must prove that there were no facts before the insurer which, if believed, would justify denial of the claim.[130]

In assessing whether an insurance company has a reasonable basis for denying a claim, the jury must consider what evidence the company had at the time it handled the claim.[131] Under the standard provided by the *Polasek* court, a plaintiff must demonstrate that there is no reasonable basis for denying the claim, whether known or unknown to the insurer at the time of denial, rather than simply showing some evidence of unreasonableness.[132]

On the other hand, in *State Farm Fire & Casualty Co. v. Simmons*,[133] the Beaumont Court of Appeals set forth a two-pronged test by which a cause of action arises for breach of the duty of good faith and fair dealing similar to the *Aranda* test.[134] The court voiced its dissatisfaction with the San Antonio Court of Appeals holding in *Polasek*. Nevertheless, the *Simmons* court agreed with the *Polasek* court's statement, "if a reasonable basis exists for questioning the insurance claim, the insurer may deny it and litigate the matter without also facing a bad faith claim."[135] However, the *Simmons* court disagreed with the ultimate application of this statement in *Polasek*. Primarily, the *Simmons* court was concerned with the *Polasek* court's statement that "[i]n a bad faith action, the issue is whether there was evidence . . . before [the insurer] . . . not whether [the insurer] correctly evaluated the evidence."[136]

An insurer should not be able to deny a claim on one basis and then later change its position when additional evidence comes to its attention. The *Simmons* standard is based on whether "the insurer fulfill[s] its dut[ies] to its insured by pursuing a thorough, systematic, objective, fair, and honest investigation of the claim prior to denying such claim."[137] The *Simmons* court stated that the standard set forth in

130. *Id.* at 284 (citing *Aranda*, 748 S.W.2d at 213; *Arnold*, 725 S.W.2d at 167).
131. *Id.* at 287 (citing Viles v. Security Nat'l Ins. Co., 788 S.W.2d 566, 567 (Tex. 1990)).
132. 847 S.W.2d at 283.
133. 857 S.W.2d 126 (Tex. App.—Beaumont 1993, writ denied).
134. [The Plaintiff] "must establish 'the absence of a reasonable basis for denying or delaying payment of the benefits of the policy' and that the carrier knew or should have known that there was no reasonable basis for denying or delaying payment." *Id.* at 134 (quoting *Aranda*, 748 S.W.2d at 213).
135. 857 S.W.2d at 136.
136. *Id.* (quoting State Farm Lloyd's Inc. v. Polasek, 847 S.W.2d 279, 285 (Tex. App.—San Antonio 1992, writ denied)).
137. *Simmons*, 857 S.W.2d at 136.

Polasek makes an insured's burden of proof virtually impossible and eliminates the should have known requirement in *Aranda*.[138]

V. THE TEXAS SUPREME COURT'S PENDING DECISION IN *STOKER*[139]

In both *Simmons* and *Polasek*, the Texas Supreme Court denied writ of error. The supreme court could have reviewed either case, but apparently the court chose to wait and decide the issue in its pending case *Republic Insurance Co. v. Stoker*.[140]

A. Factual background of Stoker

John and Linda Stoker purchased an insurance policy from Republic Insurance Company. In December 1989, traffic halted on a highway due to a dropped load of furniture by an unknown driver. Consequently, Mrs. Stoker, the insured, rear-ended a stopped vehicle. The insured submitted a claim for uninsured motorist benefits to her insurance company. A claims representative, hired by the insurer, conducted a cursory investigation and denied the insured's claim because of the insured's negligence in rear-ending the vehicle. The denial was based solely on the information the representative received from the insured.[141]

The insured filed suit against the insurer alleging breach of contract, breach of the duty of good faith and fair dealing, breach of the Texas DTPA and for violations of the Texas Insurance Code. The insurance company filed a motion for summary judgment based on a different reason than its original denial, claiming since there was no physical contact between the insured's automobile and the vehicle responsible for dropping the furniture, the claim was not covered under the policy. The trial court granted summary judgment for the insurer on the contract, but submitted the bad faith claim to the jury who found in favor of the insured.

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138. *Id.* at 134.

139. Republic Ins. Co. v. Stoker, 867 S.W.2d 74 (Tex. App.—El Paso 1993, writ granted).

Editor's Note: While this volume was in publication, the Texas Supreme Court decided Republic Ins. Co. v. Stoker. The court held that the plaintiffs' claim for bad faith failed.

> [A]s a matter of law, they cannot meet the first prong of the *Aranda* test [the absence of any reasonable basis for denying or delaying payment of policy benefits]. . . . Accordingly, the judgement of the court of appeals in favor of the Stokers is reversed, and judgement is rendered that the Stokers take nothing.

Republic Ins. Co. v. Stoker, 38 TEX. SUP. CT. J. 1011, ___ (July 7, 1995). *See supra* notes 63-97 and accompanying text for a discussion of the test established in *Aranda*.

140. *Id.* at 79.

141. *Id.* at 76.

On appeal, the El Paso court upheld the summary judgment on the breach of contract claim and the judgment in favor of the insured on her bad faith claims. Therefore, even though the uninsured motorist claim submitted by the insured was never covered under the policy, the appellate court concluded the insurance company acted in bad faith due to their substandard investigation and failure to articulate the correct reason for denying the claim prior to the suit being filed.[142]

B. *Justice Hecht's premonition in* Viles

In his concurrence, in *Viles v. Security National Insurance Co.*,[143] Justice Hecht noted that the majority holding "suggests, at least, that a breach of the duty of good faith and fair dealing may occur even when there has been no breach of contract."[144]

In dicta, the *Viles* majority stated that "[w]hether there is a reasonable basis for denial, however, must be judged by the facts before the insurer at the time the claim was denied."[145] Justice Hecht argued that the majority's statement was in direct conflict with *Aranda*[146] and completely ignored *Aranda's* requirement "that one element of a cause of action for breach of the duty of good faith and fair dealing is 'the absence of a reasonable basis for denying or delaying payment of the benefits of the policy.' "[147] Recognizing that mistakes will be made in the handling of claims, Justice Hecht stated, "there may be a reasonable basis for denying a claim even if the adjuster who actually makes the decision is not aware of it and denies the claim for some other reason, even an invalid one."[148]

In *Stoker*, the El Paso Court of Appeals, relying on *Viles*, held that an insurer can breach the duty of good faith and fair dealing even when there is no coverage under the contract.[149] Therefore, in his concurring opinion, Justice Hecht framed perfectly the issue before the *Stoker* court. The *Stoker* court's reliance on *Viles* was inappropriate, and the court extended the duty of good faith and fair dealing well beyond the limits of the existing law.

C. *The* Stoker *court's reliance on* Viles *is inappropriate.*

The *Stoker* court relied almost exclusively on dicta from *Viles*, by focusing on the reasonableness of the insurer's investigation of the

142. *Id.* at 79.
143. 788 S.W.2d 566 (Tex. 1990).
144. *Id.* at 568 (Hecht, J., concurring).
145. *Id.* at 567.
146. *Id.* at 569 (Hecht, J., concurring)(citing Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 213 (Tex. 1988)).
147. *Viles*, 788 S.W.2d at 569 (Hecht, J., concurring)(quoting Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 213 (Tex. 1988)).
148. *Viles*, 788 S.W.2d at 569.
149. Republic Ins. Co. v. Stoker, 867 S.W.2d 74, 79-80 (Tex. App.—El Paso 1993, writ granted).

claim to determine whether it had acted in bad faith.[150] However, *Viles* is easily distinguishable from *Stoker*. Unlike *Stoker,* the claim submitted in *Viles* was covered under the policy. The insureds' claim was valid when it was initially denied by the adjuster.[151] However, the insurance company denied the claim for a second time because the insured failed to file a proof of loss within the 91 day period required under the policy, and failed to comply with a condition of the contract. Had the insured filed a proof of loss within the 91 day period, there would have been no reasonable basis for denial of its claim. But since the insurer had already denied their claim prior to the expiration of the 91 day period, the court held the insurer acted in bad faith in later denying the insured's claim based on a technical breach of contract.[152]

In contrast, *Stoker's*, claim was never covered under the policy. In *Stoker,* if the insurance company would have conducted a more thorough investigation in the beginning, the lack of coverage would have been discovered. Nonetheless, the substandard investigation did not change the fact that there was an objective reasonable basis for denial of the claim. Since the claim was not covered under the policy, the court should never have reached the question of whether the investigation was conducted in good faith.

Notwithstanding that fact, the court of appeals in *Stoker* focused almost exclusively on the investigative prong of the *Aranda* test. However, the purpose of the *Aranda* investigative prong is to show that if an insurer conducts a reasonable investigation, it will discover, or should discover, it does not have a reasonable basis for denial of a claim. Ironically, in *Stoker*, if the insurance company had conducted a more thorough investigation at the outset, it would have discovered there was an undisputed basis for denial. The court of appeals completely ignored the fact that there was a reasonable basis for denying the insured's claim.

D. Bad faith cannot exist without an accompanying breach of contract.

The Texas Supreme Court has consistently held that a claim for the breach of the duty of good faith and fair dealing is separate from any cause of action for breach of the insurance contract.[153] With the exception of *Viles*, the court has never held that an insurer can breach its duty of good faith and fair dealing when there has been no breach of the underlying contract. In fact, in *Koral Industries v. Security-Connecticut Life Insurance Co.,* the court held that a jury finding of no breach of contract negated any breach of good faith and fair dealing,

150. *Id.* at 78-79.
151. *Viles*, 788 S.W.2d at 567.
152. *Id.* at 567-68.
153. *Moriel*, 879 S.W.2d at 17 (quoting Viles v. Security Nat'l Ins. Co. 788 S.W.2d 566, 567 (Tex. 1990)).

violation of the Insurance Code, and any action for unconscionability under the DTPA.[154]

The Texas Supreme Court has gone to great lengths to establish the elements of the duty of good faith and fair dealing. Other than the dicta in *Viles*, no other decision suggests that there may be bad faith when there is no coverage under the contract. In fact, *Moriel* specifically declared, "[t]he threshold of bad faith is reached when a breach of contract is accompanied by an independent tort."[155] As a result, the first inquiry in bad faith litigation is whether the insurer breached the underlying insurance contract. If there is a breach of contract, then this threshold is reached, and a court must determine whether the breach is accompanied by an independent tort. However, when there is no breach of contract, a court never reaches the threshold of bad faith, and there should be no discussion of an independent tort. If the claim is not covered under the policy, there is obviously a reasonable basis for denying the claim. Therefore, there can be no bad faith as a matter of law.

In *Koral,* the court announced that a finding in favor of the insurance company on the contract claim negated any bad faith claims against the company.[156] The insurer refused to pay benefits under a life insurance policy due to an alleged misrepresentation of medical history in the application. The beneficiary sued the insurer for breach of contract, breach of the duty of good faith and fair dealing, and violations of the DTPA and Texas Insurance Code.

On appeal, the Dallas court held that the insurer was entitled to rescind the policy based on the defense of misrepresentation.[157] By denying the application for writ of error, the Texas Supreme Court left standing the Dallas court's holding that the insurer's misrepresentation defense "negated any breach of good faith and fair dealings violations under the Insurance Code and any actions for unconscionability under the DTPA."[158]

In *Commonwealth Lloyds Insurance Co. v. Downs*,[159] the insured brought suit against the insurance company alleging breach of contract, breach of the duty of good faith and fair dealing, and violations of the DTPA and Texas Insurance Code. The Fort Worth Court of Appeals held that a finding of no coverage negated bad faith. In *Downs*, ice accumulated on the roof of the insured's horse arena after

154. Koral Indus. v. Security-Connecticut Life Ins. Co., 802 S.W.2d 650, 651 (Tex. 1990). *See also* Commonwealth Lloyd's Ins. Co. v. Downs, 853 S.W.2d 104, 118 (Tex. App.—Fort Worth 1993, writ denied); Bartlett v. American Republic Ins. Co., 845 S.W.2d 342, 348 (Tex. App.—Dallas 1992, no writ).

155. *Moriel*, 879 S.W.2d at 17.

156. 802 S.W.2d at 651.

157. *See* Koral Indus. Inc. v. Security-Connecticut Life Ins. Co., 788 S.W.2d 136, 146 (Tex. App.—Dallas), *writ denied per curiam*, 802 S.W.2d 650 (Tex. 1990).

158. *Koral*, 802 S.W.2d at 651.

159. 853 S.W.2d 104 (Tex. App.—Fort Worth 1993, writ denied).

a winter storm and caused the roof to collapse. The insured submitted a claim for benefits under his casualty insurance policy. The claim was denied because the policy excluded damage caused by the weight of ice or snow. The trial court rendered judgment in favor of the insured on his bad faith and Insurance Code claims, but judgment was denied on the breach of contract claim and violations of the DTPA.[160] The court found the loss was not covered under the insurance policy[161] and the jury's answer regarding the charge of bad faith could not be upheld.[162]

In *Bartlett v. American Republic Insurance Co.*,[163] the insured purchased a health insurance policy from American Republic. The insurance company rescinded the policy after the insured made a claim for cancer treatment, allegedly because she misrepresented in her application that she would cancel her existing coverage with another carrier. The insurance company later changed its reason for rescinding the policy to cancellation due to a pre-existing condition. The insured sued the insurance company for breach of contract, breach of the duty of good faith and fair dealing, and violations of the DTPA and Texas Insurance Code. The trial court granted the insurer's motion for summary judgment and rendered a take nothing judgment against the insured.[164] The Dallas Court of Appeals affirmed the summary judgment and held the insurer had established, as a matter of law, that the insured had a pre-existing condition which excluded coverage under the policy. Further, the court held that this exclusion constituted a reasonable basis for denying the claim. Thus, the court held that the insurer had negated the first element of a claim for breach of the duty of good faith and fair dealing, and cited *Koral* as its authority.[165]

Texas courts have consistently held in bad faith litigation, in order for the plaintiff to prove that the insurer acted in bad faith, the burden is on the plaintiff to first prove that there was no reasonable basis for denying the claim. If the insurer is able to negate this element by proving there was no coverage under the policy, there can be no bad faith as a matter of law.

160. *Id.* at 106-07.
161. *Id.* at 114.
162. *Id.* at 118.
163. 845 S.W.2d 342, 345 (Tex. App.—Dallas 1992 no writ).
164. *Id.* at 344-45.
165. *Id.* at 348 (citing Koral Indus. v. Security-Connecticut Life Ins. Co., 802 S.W.2d 650, 651 (Tex. 1990)).

E. The Stoker *court's decision alters the legal relationship between the insurer and the insured, and imposes an impractical and inequitable burden on the insurer.*

1. The insurer/insured relationship is not fiduciary.

While an insurer owes its insured a common law duty of good faith and fair dealing, no Texas court has declared that duty to be fiduciary.[166] This fact notwithstanding, the El Paso Court of Appeals' decision in *Stoker* places a burden on the insurer analogous to that of a fiduciary. The court of appeals requires an insurer to not only be certain it has articulated to the insured every conceivable reason for denial of a claim, but also to subordinate its own interests to those of the insured and forego assertion of additional legitimate reasons for denial when those reasons are later discovered.

Unquestionably, an insurer should not breach its contract, and should have a reasonable basis for denying a claim. However, an insurer is not the insured's legal advisor, and the insurer should not be required to subordinate its own interests to those of the insured. The *Stoker* holding precludes the insurer from raising a newly discovered defense to coverage, while the insured may raise as many new legal theories as desired. This result is patently unfair. The *Stoker* holding erroneously impresses upon the insurer the same duties it would have if the insurer/insured relationship were a fiduciary relationship.

2. Practical realities of claims handling

Regardless of how professionally, or diligently the claims adjuster may act in the performance of his job duties, mistakes will be made. Given the average claim adjusters work load, it can be expected that some incorrect decisions will be made. In addition to incoming claims, adjusters are required by statute to make decisions to pay or deny claims within fifteen business days after receipt of the insured's claims processing forms and other information requested by the insurer.[167] Although a decision must be made within this fifteen day time frame, the handling of a claim is not a static process and additional information is received daily which may alter or reinforce a previous decision. The adjuster, therefore, must act on the information he has before him during this fifteen day period.

In *Stoker,* it was reasonable for the claims adjuster to believe that the insured's comparative negligence would be great enough to bar recovery. Although the decision by the adjuster might prove to be incorrect, it is unfair to hold the insurance company liable for a bad

166. Tectonic Realty v. CNA Lloyd's of Texas, 812 S.W.2d 647, 651 (Tex. App.—Dallas 1991, writ denied)(citing Caserotti v. State Farm Ins. Co., 791 S.W.2d 561, 565 (Tex. App.—Dallas 1990, writ denied)).

167. TEX. INS. CODE ANN. art. 21.55 § 2 (Vernon Supp. 1995).

faith claim simply because the adjuster made a mistake when he initially denied the claim.

VI. CONCLUSION

In *Viles*, Justice Hecht correctly pointed out the problem of focusing exclusively on the investigation process in determining whether an insurer has acted in bad faith. He noted there may be situations where there is a reasonable basis for denial of a claim, even if the adjuster makes a mistake and denies the claim for an invalid reason. That is precisely what happened in *Stoker*. There was no contact between the alleged uninsured motorist and the Stoker vehicle, therefore, there was a reasonable basis for denial of the Stokers' claim. Unfortunately, the adjuster did a cursory investigation and denied the claim. However, the adjuster's mistake did not negate the fact that the Stokers could not establish the first and critical element required under *Aranda*, that there was no reasonable basis for denying their claim. Since the insurance company was able to negate that element, the court should have concluded that there was no bad faith as a matter of law.

The result in *Stoker* serves to punish the insurance company for its cursory investigation and poor service in handling the insured's claim. The court's dissatisfaction with the insurance company did not alter the fact that there was no coverage under the policy. The insured was not able to establish the threshold requirement of a breach of contract claim, therefore, the bad faith claim should have been denied as a matter of law.

Stoker stands for the proposition that a thorough and good faith investigation should include inquiries generally considered essential. But as reiterated in *Simmons* and *Polasek*, there is disagreement as to what is essential. In *Simmons*, the Beaumont Court of Appeals stated, "[w]e believe the far better rule in bad faith actions to be, [d]id the insurer fulfill its duty to its insured by pursuing a thorough, systematic, objective, fair, and honest investigation of the claim prior to denying such claim?"[168]

In *Polasek*, on the other hand, the plaintiff argued that the insurer had a duty to leave no stone unturned.[169] This contention was rejected by the court stating, "[e]ven the most thorough investigation must stop somewhere; there is always something else the investigators could have done. The cases have not upheld bad faith judgments for failure to investigate, when the insurer simply failed to pursue every lead."[170]

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168. *Simmons*, 857 S.W.2d at 136.

169. *Polasek*, 847 S.W.2d at 288.

170. *Id. See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Zubiate, 808 S.W.2d 590, 598 (Tex. App.—El Paso 1991, writ denied)(insurer denied claim without investigating accident scene); Beacon Nat'l Ins. Co. v. Reynolds, 799 S.W.2d 390, 398 (Tex. App.—

In *Lyons, Dominguez*, and *Moriel*, the Texas Supreme Court went to great lengths to put to rest the substantial confusion generated by the widespread misunderstanding of *Aranda* and the tort of bad faith. If allowed to stand, the *Stoker* case will severely undermine, if not destroy, the very foundation of *Aranda*. The court must find the common ground between *Simmons* and *Polasek*.

Ultimately an insured's main goal in purchasing an insurance policy is to obtain peace of mind. The insurer, on the other hand, should not be required to compensate perils which are not covered under contracts made with the insured. In cases where reasonable disputes between the parties exist, *Simmon's* systematic investigations should lead to *Stoker's* essential inquiries, but as stated in *Polasek*, those inquires must stop somewhere. In other words, these cases stand for the proposition that an insurance company may not arbitrarily deny a claim, but should investigate and have valid reasons for denying coverage, and when a valid reason exists, the insurer should not be held liable for bad faith.

David Lloyd (Trey) Harlin III

Fort Worth 1990, writ denied)(insurer denied claim without investigation; file contained no records of investigation by adjuster).