

# BAD FAITH LAW REPORT

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## Common Law Insurance Bad Faith in Texas and The Duty to Defend

By Michael Sean Quinn\*

When the Texas Supreme Court recognized the tort of first-party bad faith in 1987, it acted first in the context of ordinary first-party coverage<sup>1</sup> and promptly extended the tort to workers' compensation cases.<sup>2</sup> Current wisdom holds that the supreme court was in an expansive mood when it recognized the tort but is now cutting back. Perhaps so. Nevertheless, bad faith litigation is getting more interesting, as plaintiffs' lawyers are bringing fewer frivolous bad faith cases.

Texas courts have not addressed the important question whether one may base a bad faith claim on an insurer's unreasonable failure to defend. This article answers in the affirmative and addresses the application of several established principles of bad faith law to the problem of refusals to defend. I argue first that if insurers recognize the social function of the duty to defend and treat claims for defense in the way they approach claims for other first-party benefits, they will have little to fear in terms of liability for bad faith. Second, insurers should obtain objective legal opinions in complex cases. As a matter of legal theory, such opinions should inoculate insurers against bad faith liability. Third, insurers should make intelligent use of experts in bad faith cases based on failures to defend.

### First Party Insurance and the Duty to Defend

In defining the tort of bad faith the Texas Supreme Court has identified four elements:

1. The defendant insurer breached a policy insuring the plaintiff.
2. The defendant insurer denied or delayed payment of the plaintiff's claim

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<sup>1</sup> Arnold v. National County Mut. Ins. Co., 725 S.W.2d 165 (Tex. 1987).

<sup>2</sup> Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210 (Tex. 1988).

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without having a reasonable basis for doing so.

3. The insurer knew or should have known of its lack of a reasonable basis.
4. The insurer thereby injured the insured.<sup>3</sup>

Despite its obviously close connection to the claims process, insurer bad faith applies beyond the adjustment context. The

<sup>3</sup> Republic Ins. Co. v. Stoker, No. 94-0110, 1995 WL 407383 (Tex. 1995); Union Bankers Ins. Co. v. Shelton, 889 S.W.2d 278, 283 (Tex. 1994) ("The threshold of bad faith is reached only when the breach of contract is accompanied by an independent tort."). See also Transportation Ins. Co. v. Moriel, 879 S.W.2d 10, 17 (Tex. 1994). The court is not completely consistent on the first element. According to *Stoker*, in rare circumstances an insurer might conceivably incur liability for bad faith even though the insurer did not breach the contract: "We do not exclude . . . the possibility that in denying [a] claim, [an] insurer may commit some act, so extreme, that it would cause injury independent of the policy claim." Republic Ins. Co. v. Stoker, No. 94-0110, 1995 WL 407383, \*9 (Tex. 1995).

supreme court has held that an insurer may cancel a policy in bad faith, and the court has hinted that the concept of insurer bad faith may generate yet other tort actions as the law evolves.<sup>4</sup> Disputes often arise when an insured seeks a defense under a liability policy. Can a liability insurer commit bad faith when deciding whether to defend? Whether the tort duty of good faith extends to refusals to defend hinges upon two issues: What is the difference between third-party and first-party insurance? How should the duty to defend be classified?

Writers commonly classify insurance as providing either "first-party" or "third-party" coverage.<sup>5</sup> In general, one may say that insurance indemnifying the insured against liability to a third-party is third-party coverage and that all other insurance is first-party coverage. Liability insurance policies commonly include a promise by the insurer to defend the insured and thus, in a sense, to insure against the risk of being sued. Is the duty to defend first- or third-party coverage? Obviously, it is first-party coverage. Though we customarily think of liability policies as providing third-party coverage, they in fact involve both third-party coverage (the duty to indemnify or the duty to pay judgments or settlements on behalf of the insured) and a first-party coverage (the duty to defend).

Perhaps the matter can better be expressed if we speak in terms of first-party *claims* and third-party *claims*. Some Texas courts have taken this approach.<sup>6</sup> Expressed that way, a claim under a health or property policy is a classic first-party claim. The claim of the injured person under a liability policy is a classic third-party claim. This pragmatic approach may be inelegant as a matter of theory, but it unquestionably captures what everyone in the insurance industry instinctively knows. According to this approach, an insured's claim for a defense under a liability policy is a first-party claim.<sup>7</sup>

<sup>4</sup> Union Bankers Ins. Co. v. Shelton, 889 S.W.2d 278 (Tex. 1994).

<sup>5</sup> See, e.g., Bowman v. Charter Gen. Agency, Inc., 799 S.W.2d 377 (Tex. App.—Corpus Christi 1990, writ denied); Warrilow v. Norrell, 791 S.W.2d 515 (Tex. App.—Corpus Christi 1989, writ denied).

<sup>6</sup> See, e.g., Charter Roofing Co. v. Tri-State Ins. Co., 841 S.W.2d 903 (Tex. App.—Houston 1992, writ denied); Unauthorized Practice of Law Comm. v. Jansen, 816 S.W.2d 813 (Tex. App.—Houston 1991, writ denied). See also Caserotti v. State Farm Ins. Co., 791 S.W.2d 561 (Tex. App.—Dallas 1990, writ denied).

<sup>7</sup> Texas Farmers Ins. Co. v. Soriano, 881 S.W.2d 312, 317 (Tex. 1994); see State Farm Lloyds Ins. Co. v. Maldonado, No. 04-93-00046-CV, 1994 WL 723670 (Tex. App.—San Antonio 1994, writ denied). *Maldonado* speaks in terms of "claims" rather than "coverage."

Not even using the language of claims dispels all errors, however. One Texas court blithely announced that all claims under liability policies are third-party claims since every such claim is made by persons (allegedly) injured in an actionable way by an insured. Charter Roofing Co. v. Tri-State Ins. Co., 841 S.W.2d 903, 905 (Tex. App.—Houston 1992, no writ). Of course, this suggestion simply is not true. It ignores requests of the insured for a defense.

The Texas Supreme Court has not said whether insurer bad faith applies to the denial of a defense under a liability policy. Nor has it resolved whether an insurer's defense of its insured under a reservation of rights might constitute delay in the provision of an insurance benefit. The supreme court has held that a third-party claimant has no standing to sue an insurer directly for bad faith<sup>8</sup> and that the tort of bad faith does not extend to the settlement of a third-party claim covered by a liability policy.<sup>9</sup> It is an open question, therefore, whether the tort duty of good faith extends to the conduct of an insurer when it decides whether to defend its insured.

It should. Coverage for the defense of a lawsuit is a form of first-party coverage. It fits the standard picture of insurer bad faith. Defense costs can be enormous. Much may be at stake. Defense costs have helped drive even very large companies into bankruptcy in mass tort situations. Unlike the duty to settle, there is no other common law tort doctrine touching upon the insurer's decision whether to defend. Nothing about the duty to defend makes it different from other first-party benefits, except that the insurer's duty to investigate may be somewhat circumscribed in the defense context.

In Texas, as in many other states, an insurer's duty to defend is determined from the face of the complaint (known in Texas as the "petition").<sup>10</sup> If the petition alleges facts, which, if true, would entitle the plaintiff to a recovery from the defendant for which the policy provides coverage, then the insurer must defend. It does not matter whether the allegations are true or false. According to the so-called "Eight Corners Rule,"<sup>11</sup> the insurer normally need not look beyond the face of the petition and the face of the policy to determine whether it has a duty to defend. This special rule arguably limits the type of investigation required by the third element of the tort of bad faith, that the insurer knew *or should have known* of the absence of a reasonable basis for its action. Occasionally, however, an insurer may have a duty to look further than the petition and the policy.

If a petition is silent on a particular fact and that fact is crucial to the determination of coverage, then an insurer arguably does not have the right to assume the truth of the fact that would favor non-coverage but must investigate. An insurer's

failure to make such an investigation would constitute a failure to investigate for purposes of proving the tort of bad faith.<sup>12</sup>

A similar situation arises when a petition asserts a fact irrelevant to the tort action but relevant to coverage. The Eight Corners Rule should not govern this situation, particularly if the fact pertains to the determination whether the alleged tortfeasor was an insured. After all, the duty to defend runs to the insured, not to the third-party claimant; a stranger has no right to force an insured upon an insurer by fraudulent pleading. Offer, acceptance, and consideration create the relationship of insurer and insured, not clever pleadings.<sup>13</sup>

#### An Objective and Empirical but Unscientific Observation

It might serve the insurance industry well if courts would treat a carrier's duty to defend as a type of first-party coverage subject to the duty of good faith and fair dealing. When I began practicing first-party insurance law some fifteen years ago, I represented the Kemper Group of insurance companies. I was working on a coverage problem arising under a boiler and machinery policy. Kemper's representative was Al Mueller, a wise gentleman with years of insurance experience. I wrote him a nitpicking coverage opinion letter—my first—ransacking every nook and cranny of the policy in a devoted attempt to save the Kemper Group from paying its insured one thin dime. Mr. Mueller responded, "I see we have yet another lawyer to educate." He then taught me that the insurance company's responsibility, and that my responsibility as the insurance company's lawyer, was, "Look for coverage." I now know that many substantial and reputable property insurance companies share this view. The consequence of "Al's Axiom" is that an insurer should deny coverage under an insurance contract only if it is mandated by a straightforward reading of the contract language. Otherwise, it should pay the claim. This axiom has given me a standard for measuring deficient conduct by insurers and for preserving my self-respect when representing insurers. Roughly the same psychology applies to adjusters in first-party contexts.<sup>14</sup>

Earlier this year, while addressing a group of attorneys on the topic of insurance coverage opinions, I had occasion to refer to Al's Axiom and to apply it to duty-to-defend situations. I suggested that the axiom might exceed strict legal requirements

<sup>8</sup> Allstate Ins. Co. v. Watson, 876 S.W.2d 145 (Tex. 1994).

<sup>9</sup> American Physicians Ins. Exch. v. Garcia, 876 S.W.2d 842 (Tex. 1994). An insurer has a duty to settle in third-party cases, but the standard of liability is negligence, and the duty arises only after the carrier receives a demand to settle within policy limits. G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929) (holdings approved); see Ranger County Mut. Ins. Co. v. Guin, 723 S.W.2d 656 (Tex. 1987).

<sup>10</sup> The ins and outs of this rule are discussed in Michael S. Quinn & L. Kimberly Steele, *Insurance Coverage Opinions*, 36 S. TEX. L. REV. 479, 483, 510-13 (1995).

<sup>11</sup> *Id.* (collecting cases).

<sup>12</sup> Cases have held that insurers may make duty-to-defend decisions based upon facts beyond the pleadings, when those facts do not contradict assertions made in the pleading. See, e.g., State Farm Fire & Cas. Co. v. Wade, 827 S.W.2d 448 (Tex. App.—Corpus Christi 1992, writ denied).

<sup>13</sup> *But see* Montrose Chem. Corp. v. Superior Court, 6 Cal. 4th 287, 861 P.2d 1153, 24 Cal. Rptr. 2d 467 (1993); Amato v. Mercury Casualty Co., 18 Cal. App. 4th 1784, 23 Cal. Rptr. 2d 104 (1993). See also Stephen S. Ashley, *Extrinsic Facts and the Duty to Defend*, 9 BAD FAITH L. REP. 197 (1993) (criticizing Amato).

<sup>14</sup> H. LAWRENCE ROSS, *SETTLED OUT OF COURT* (2d. ed. 1980).

but that its application would ensure decisions that are correct as a matter of both contract and bad faith law. The audience responded with a storm of protest. One particularly truculent young lawyer said, with barely concealed contempt, that I misconceived the function of a coverage lawyer. Coverage lawyers, he argued, have insurance companies, not their insureds, as clients. The lawyer, therefore, must help the insurer avoid paying under the contract, if at all possible.

At this point, a former law clerk of mine joined the conversation. I was reminded that she had once expressed, in brazen terms, her delight in writing no-coverage letters. Taking delight in a denial is something I find suspect. Unless a claim is fraudulent, its denial should not bring on lightheartedness, much less ecstasy, for denial means that a person (or a business) who is your client's customer must bear an unanticipated loss. This fact should evoke at least a little sympathy. My former law clerk suggested that my view of what insurance adjusters want is entirely unrealistic. She went on to argue that, at least in some circumstances, adjusters seek help in escaping any duty to defend because plaintiffs' lawyers twist pleadings to create a duty to defend when none exists. "Look at all the distorted pleadings trying to get 'occurrence'-based coverage for sexual abuse," she said. "Our job is to represent insurance companies by giving adjusters what they want. Adjusters are experienced people. They frequently know more about insurance practice than lawyers do." There is some truth and a little wisdom in what she said.

There is a problem nestled here. It is what sociologists call "role-confusion." Liability adjusters, accustomed to opposing the complaints of third-party claimants, sometimes confuse their insureds with the third-party claimant. Sometimes they see both as adversaries. (Of course, sometimes this confusion is justified. Sometimes insureds try to bluster their way into receiving a defense to which they have no right. Sometimes insureds assist third-party claimants in framing their complaints so as to trigger defense coverage.<sup>15</sup>) Nevertheless, if insurers would treat the duty to defend like any other first-party coverage, they would be less inclined toward the error just diagnosed. Lawyers should remember that representing a client does not mean mindlessly following the client's instructions. Lawyers have a duty to put clients in touch with their better natures.

If, as I argue, the insurer's duty of good faith extends to the decision whether to defend an insured, we need to consider the application of principles of first-party bad faith in this context.

#### Reasonable Basis

What constitutes a reasonable basis for denying a claim? The answer has three components. First, the insurer must actu-

<sup>15</sup> Some lawyers even (impliedly) suggest that insureds assist plaintiffs in this way. See Daniel P. Callahan, *War on Two Fronts*, 58 TEX. BAR J. 676 (1995).

ally deny the claim for the reason asserted. Second, the insurer must believe that the basis is reasonable. Third, the basis must actually be reasonable. Any bona fide reason for denial constitutes a reasonable basis.<sup>16</sup> The reason may relate to the facts of the claim, to the construction of the insurance contract, to the requirements of the law, or to any combination of these factors.

But what is a bona fide reason? It is a reason that a reasonable insurer, after appropriate investigation, would regard as an arguably valid ground to deny a claim. Notice that the standard is not *a reason for which a reasonable insurer would actually deny a claim, after appropriate investigation*. Courts have stated the standard this way from time to time, but this formulation must be wrong. The Texas Supreme Court has indicated that insurer bad faith is not a negligence action.<sup>17</sup> If the italicized putative standard were correct, then insurer bad faith would simply be the tort of negligent claims denial. Of course, insurers may profitably think of insurer bad faith in negligence terms.<sup>18</sup> But to impose liability, one must prove something more.

Is a bona fide reason for denying a claim any reason that is fairly debatable?<sup>19</sup> No Texas court has addressed the issue in these terms, although some courts in other jurisdictions have used this standard. If an action is fairly debatable simply when it is not arbitrary, I view the "fairly debatable" standard as too lenient. Surely, there may be actionable conduct which is not completely irrational but which, at the same time, does not involve even minimally good reasons.

What is a bona fide reason for refusing a defense? A reason that an honest, reasonable, and objective insurer would regard as a good reason for denying a defense. It would be the sort of reason about which a careful, informed, and thoughtful adjuster would say something such as:

"The insurer raises an interesting point. I've never thought about this issue. I think I know how this would be re-

<sup>16</sup> *Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10, 17 (Tex. 1994).

<sup>17</sup> *Lyons v. Millers Casualty Ins. Co.*, 866 S.W.2d 597, 599-601 (Tex. 1993).

<sup>18</sup> The negligence analogy is a valuable heuristic device, since if an insurer avoids negligence, it will necessarily avoid insurer bad faith. Negligence is also a valuable analogy for the insurer to use because it focuses the mind on defective processes. Theoretically, an insurer could, by serendipity, obtain a bona fide reason for denying a claim. In the real world, however, one usually has an acceptable reason for conduct only if one has thought about the problem correctly. If an insurer tries to base its conduct on good reasons and pursues a rational process in denying the claim, then the process arguably imbues the result with reasonableness.

<sup>19</sup> *Arnold* hints at this standard. Justice Ray wrote that without a cause of action for common law bad faith, insurers could "arbitrarily deny coverage and delay payment of a claim with no more penalty than interest on the amount owed." *Arnold v. National County Mut. Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987); see Michael S. Quinn, *The Advice of Counsel Defense*, 72 TEX. L. REV. 1487, 1503-04 (1994).

solved, but the courts should be asked to think about it."

- "Good point! I've wondered about this, but have never gotten any manager to see that we should litigate it."
- "I'm embarrassed. I've never thought of this issue before. We have all assumed we've known the answer to this question, but now I'm not so sure that the received orthodoxy is correct. If the policy is understood literally, the insurer is correct. I am not sure that literalism should triumph over tradition here. Then, again, a consensus misreading of the contract language is not really authority, is it?"

### Special Relationship

The key to understanding the tort of insurer bad faith lies in its rationale. The Texas Supreme Court describes insurance contracts as creating special relationships, and the duties fundamental to insurer bad faith flow from these relationships.<sup>20</sup> The insurance special relationship has at least two features. First, it involves unequal bargaining power. Second, the realities of the claims situation require the insured to place trust in the insurer. An insured making a claim is in a vulnerable position. Such a person needs protection, for the more dominant entity in the insurance relationship has a temptation to exploit the weaker member. Consequently, the law imposes on the insurer a duty to be trustworthy.<sup>21</sup> In some contexts, courts have said that insurers must treat the interests of their insureds as at least equal to their own. Perhaps this is also the standard for judging insurer bad faith. In the claims process, an insured is at the insurer's mercy. As a result, the latter has a duty to act reasonably (*i.e.*, to take actions only for arguably good reasons). An insurer may not breach the insurance contract with impunity and simply pay contract damages. Fundamentally, the tort of insurer bad faith exists to deter opportunistic breaches.

What connection does the special relationship have with the duty to defend? Let us begin with by far the greatest number of insureds: individuals and small businesses. Litigation costs are enormous. One of the purposes of liability insurance is to provide coverage for attorneys' fees in litigation. That coverage hinges upon what the plaintiff's petition alleges. The Eight Corners Rule, however, is quite broad, with any doubts to be resolved in favor of the insured. Moreover, one does not have to accept the ultimate subjectivity of linguistic interpretation to acknowledge that language is a supple instrument, that many terms have fuzzy edges, and that interpretation is flexible. Given these facts, it behooves insurers to take a broad view of their duties to defend. Any refusal to defend predicated upon a

<sup>20</sup> Arnold v. National County Mut. Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

<sup>21</sup> The duty does not, however, rise to the level of a fiduciary duty. Caserotti v. State Farm Ins. Co., 791 S.W.2d 561, 565 (Tex. App.—Dallas 1990, writ denied).

narrow outlook is quite possibly in bad faith, at least in a good number of Texas trial courts.

### Burden of Proof

The insured bears the burden of proving by a preponderance of the evidence that the insurer breached the policy and had no reasonable basis for doing so.<sup>22</sup> Texas courts have not explored the confusing relationship between these two burdens. Confusion arises because the insurer's reliance upon a given basis plays no role in a contract action whereas it plays a central role in bad faith actions.

Suppose an insurer denies a claim (say, a request for a defense) on the basis of reason  $R_1$ , which is a legally invalid reason, but there exists another reason  $R_2$ , which is a valid reason to deny the claim. Further suppose that the insurer does not rely on  $R_2$ . In theory, the insured's bad faith claim must fail even though the insurer relies on  $R_1$  because the existence of  $R_2$  means that there has been no breach of contract.

Now let us change the hypothetical. Let us assume that  $R_1$  is both invalid and not bona fide; let us further assume the  $R_2$  is also invalid but is bona fide. In other words,  $R_2$  provides the insurer a reasonable basis to deny the claim, but  $R_1$  does not. Finally, assume that the insurer relied on  $R_1$  but not on  $R_2$ . The insured should win his bad faith case given these new assumptions. The insurer breached the policy, as neither  $R_1$  nor  $R_2$  is a legally valid reason for denying the claim. Moreover, because the insurer relied on  $R_1$  and not on  $R_2$ , there was no *reasonable basis* for denying the claim.

Texas courts try to avoid the confusion inherent in this situation in three ways. First, they bifurcate the breach of contract case from the bad faith case. The same jury might try both, but it tries the cases one after the other. Bifurcation, however, is discretionary with the trial judge. Second, the courts condition the jury's answering questions on the bad faith issue upon the jury's affirmative findings as to the insurer's breach of the policy. Unless the jury finds a breach of contract, it never reaches the bad faith issues. Third, in the duty-to-defend context, some confusion is dispelled and the insured's burden of proof is eased by the conventions, practices and legal rules surrounding claims denials. As a supposed matter of black-letter insurance law, a carrier is deemed to have waived every ground for refusing a defense not mentioned in its denial letter.<sup>23</sup> Thus, viewing matters simplistically, one may argue that an insured may re-

<sup>22</sup> Lyons v. Millers Casualty Ins. Co., 866 S.W.2d 597 (Tex. 1993); see David L. Plaut, *Lyons v. Millers Casualty: The Last Word on the Standard for Assessing Bad Faith in Texas?*, 57 TEX. BAR J. 823 (1994). See also National Union Fire Ins. Co. v. Dominguez, 873 S.W.2d 373 (Tex. 1994). *Lyons* was a property insurance case, while *Dominguez* was a worker's compensation case. Thus, the parallelism between *Arnold* and *Aranda* is preserved, although *Lyons* and *Dominguez* say roughly the same thing.

<sup>23</sup> Hirsch v. Texas Lawyers' Ins. Exch., 808 S.W.2d 561, 564 (Tex. App.—El Paso 1991, writ denied).

strict his proof of the nonexistence of a reasonable basis to the points set forth in the insurer's denial letter. This simplifies the insured's proof.

Matters become complicated again, however, when one considers, in light of the doctrines of waiver and estoppel as they apply to denial letters, the requirement that the insured prove that the insurer breached the policy. If the insurer, through omission from the denial letter of a valid ground for refusing to defend, waived that ground, one might argue that the omission perfected the tort of bad faith. This conclusion makes no sense, however, because it ignores the requirement of causation.

An insurer's failure to cite or rely upon a particular reason for the denial of a claim cannot give rise to a bad faith claim unless the omission harmed the insured. Yet precisely this result obtains if unmentioned reasons for denying a claim automatically disappear from the case. Why should an insurer's failure to recite a reason for the denial of a claim always eliminate that reason from the case? The theory of waiver—the intentional relinquishment of a known right—does not mandate that result. Nor does the theory of estoppel, which does not apply unless the insured relied to his detriment on the omission. At least one thoughtful Texas decision has recognized that the “use it or lose it” rule is probably not really the law,<sup>24</sup> and the author of that opinion now sits on the Texas Supreme Court.

Moreover, most denial letters contain language designed to avoid the effect of any rule of automatic waiver:

Nothing about this letter is intended to suggest that there are no other reasons or bases upon which coverage might be denied. Indeed, the insurer specifically reserves its right to deny coverage at a later time for any reason based upon the contract of insurance, law, or fact, whether that consideration is presently available or subsequently to be discovered.

Does the inclusion of such a boilerplate paragraph permit the insurer to assert new grounds for denial at a latter date? The doctrines of waiver and estoppel suggest a “yes” answer. Most insurance lawyers have little confidence in this conclusion. I incline to the view that the court should give effect to such a paragraph if the denial letter is otherwise reasonable.

### Sophisticated Insureds

Should the law of insurance bad faith treat large, sophisticated insureds the same way it treats small, unsophisticated ones? Is the standard measuring the reasonableness of an insurer's refusal to defend the same when dealing with a sophisticated insured as when dealing with an unsophisticated one? The Texas Supreme Court has not ruled on whether a large, sophisticated insured can assert a bad faith claim. All insurer bad faith cases in the supreme court have involved individual in-

sureds, and nearly half have involved workers' compensation claimants.

Insurers argue that it makes no sense to provide tort remedies to large, sophisticated insureds invulnerable to insurer mishandling of their claims. A Fortune 500 company in good financial shape is not at the mercy of its insurer. What counts as a business-ending disaster to Mom-&-Pop Corp. is an everyday occurrence to TransUniversal Consolidated, Inc., a Fortune 500 company. A loss does not put a huge corporation down, much less out. TransUniversal can fight back. It can dip into its cash reserves. It can borrow money. Besides, the market punishes an insurer who irrationally denies a claim from a good customer who can easily make other good customers aware of the insurer's conduct.

Texas trial and intermediate appellate courts have uniformly assumed that the tort of bad faith extends to every first-party insurer-insured relationship; no reported case rejects an insured's right to seek tort damages on account of its size. This implicit assumption makes sense. Unequal bargaining power is part of the justification for insurer bad faith, not one of its elements. If the general pattern of unequal bargaining power between insurers and insureds justifies a cause of action for insurer bad faith, then inequality in bargaining power need not be proved in every case.

Recently, however, insurance law has developed a new doctrine, sometimes called the “Doctrine of the Sophisticated Insured,” holding that the law should treat sophisticated insureds differently. The doctrine developed in the context of policy interpretation. The rule of *contra proferentum* holds that ambiguities in a policy should be construed against the drafter in favor of coverage. The justification for this doctrine is that insureds need protection from larger, more sophisticated insurers. It is often pointed out that insurers insist on the use of preprinted contracts. These justifications are less compelling when the insured is an economically sophisticated entity with a risk management department thoroughly knowledgeable about insurance contracts and procedures. Thus, some courts have held that insurance contracts should not be automatically construed in favor of coverage when the insured is a sophisticated entity.<sup>25</sup> No Texas cases have considered whether the sophisticated insurance purchaser exception is part of Texas law or whether a policyholder's status as a sophisticated insurance purchaser should diminish the tort duty of good faith and fair dealing that the insurer would otherwise owe.

Theory is one thing, however, and application another. Drawing the line between financially sophisticated insureds and others would be difficult for both courts and adjusters. Try-

<sup>24</sup> *State Farm Lloyds Ins. v. Williams*, 791 S.W.2d 542 (Tex. App.—Dallas 1990, writ denied) (insured must show harm before it can invoke waiver or estoppel).

<sup>25</sup> JEFFREY W. STEMPER, *INTERPRETATION OF INSURANCE CONTRACTS* ch. 23 (1994); see Michael S. Quinn & H. Michelle Caldwell, *Insurance, Ambiguity and the Sophisticated Insured*, 4 ENV. CLAIMS J. 89 (1991).

ing to do so might exert a corrupting influence on adjusters. Such a distinction might not sit well with the observing public either, as the idea violates intuitive notions of equal justice under law. Moreover, there are aspects of unequal bargaining power other than comparative economic power. Insurers usually know more about insurance and the claims process than even large insureds. Insurers mostly insist upon their own pre-printed contract forms, even with quite large insureds, and this makes the policies contracts of adhesion. Even when insurers negotiate some parts of the contract, they insist upon the use of standardized key terms, such as "occurrence," "bodily injury," and others. This inflexibility is an underwriting necessity, but it distinguishes insurance negotiations from other arm's-length deals. A sophisticated insured should have no lesser right to its insurer's good faith than anyone else. A sophisticated insured may, of course, have its own risk management department. This fact should enhance its responsibilities in the claims process, but it should not diminish the level of the insurer's obligations. Thus, insurers should probably conceptualize their duty to defend in uniform terms, whether or not they are dealing with sophisticated insureds. Undoubtedly, the fact that an insured is a large and sophisticated business will silently affect judicial rulings as to whether there have been breaches of the duty to defend. Similarly, finders of fact will also take account of the insured's sophistication when they consider whether an insurer's refusal to defend was in bad faith. Nevertheless, these considerations should probably not be written expressly into the rules.

### Damages

If an insurer wrongfully fails to defend, then the insured may make whatever deal it can with the third-party claimant. The normal scenario goes like this: The third-party claimant and the insured settle. The court enters an agreed (or stipulated) judgment against the insured, and the third-party claimant signs a covenant not to execute upon the insured's personal assets. The insured assigns to the third-party claimant all of his rights against his insurer, including his cause of action for bad faith. The third-party claimant then seeks to enforce the judgment against the insurer and to obtain the insured's bad faith damages. As the insured's assignee, the third-party claimant contends that the insurer's breach of the policy bars the insurer from relitigating issues resolved by the stipulated judgment. Under these circumstances, what damages does a liability insurer face for failing in bad faith to defend its insured?

The insurer would owe contract damages. These would include attorneys' fees the insured incurred in the suit the carrier should have defended. Contract damages would also include sums for which there was indemnity coverage, up to the policy limits, if and only if (1) the insured's wrongful act caused the third-party claimant's loss, (2) the policy covers the third-party's claim against the insured, and (3) it was reasonable to value the third-party claimant's injury at or in excess of the policy limits at the time the case was settled. In addition, the third-

party claimant, as the insured's assignee, would be entitled to attorneys' fees expended in the breach of contract action against the insurer.<sup>26</sup>

But what about bad faith damages? If the insured's settlement with the third-party claimant exceeds the policy limits, the claimant, as the insured's assignee, will attempt to recover compensation for the excess portion of the judgment. But upon what theory?

One must distinguish between the common law tort of insurer bad faith and insurer negligence in the settlement of third-party claims. According to the so-called *Stowers* doctrine, the negligence standard governs only if the insured suffered an excess judgment after the third-party claimant made an unconditional liquidated demand to settle within policy limits and the insurer negligently failed to accept the offer.<sup>27</sup> The negligence standard is not relevant to bad faith refusals to defend. An insurer should be liable for the extracontractual damages caused by its bad faith refusal to defend only if the elements of bad faith are proved.

Is recovery of the excess portion of the judgment warranted by applying bad faith law to a failure to defend? Although the Texas Supreme Court has not reached this issue, it would appear that the third-party claimant should have the right to recover the excess portion of the judgment only if (1) the insured's wrongful act caused the third-party claimant's loss, (2) the policy covers the third-party's claim against the insured, and (3) it was reasonable to value the third-party claimant's injury at or in excess of *the judgment* (that is, the insured agreed to an amount of damages that one could reasonably have foreseen would be recoverable by the claimant had there been a trial). What is foreseeable should be judged from the point of view of the insured at the time the settlement agreement was formed. Thus, the insurer might be liable for only a fraction of the excess portion of the agreed judgment.

This conclusion is susceptible to an enticing but ultimately erroneous objection. Suppose that the insurer *reasonably but mistakenly* refuses to defend (that is, there is no bad faith). The insured's damages are attorneys' fees he incurred in defending himself. Pursuant to the policy's covenant to indemnify, the insured may also recover the amount of the judgment or settlement, but only up to the policy limits. Why stop at the policy limits? Because the insured is only entitled to compensation for harm proximately caused by the refusal to defend. Presumably, if the insurer had fulfilled its duty to defend, it would not have achieved a result more favorable than that which the insured achieved in his own defense. The excess judgment is not harm

<sup>26</sup> TEX. CIV. PRAC. & REM. CODE § 38.001(8) (1995). (If the third-party claimant includes tort claims in the same suit, he may not recover compensation for fees incurred for the tort claims.)

<sup>27</sup> G.A. *Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929).

proximately caused by the refusal to defend but rather a result of the insured being underinsured.

Now let us assume that the insurer refused to defend *in bad faith*. Some argue that the fact that the refusal was not only wrong but also unreasonable has no bearing whatsoever on what harm the refusal to defend proximately caused. Damages for tortious refusals to defend, therefore, should be the same as damages for nontortious refusals to defend, except to the extent that tort damages rules allow broader recoveries than contract damages rules. The broader tort damages rules might open the door to compensation for emotional distress and punitive damages, but there is no reason why the availability of tort damages should open the door to recovery of the excess judgment.<sup>28</sup>

I contend that this argument contains the seeds of its own destruction. The breach of contract action is governed, in effect, by a contractual clause limiting damages, the policy limits. There is no such limit on the damages flowing from the tort of bad faith. Hence, a bad faith refusal to defend may well result in insurer liability for all or some of the excess judgment, depending upon how much of it is reasonable, but only if the third-party claimant would have been willing to settle within the policy limits. If the plaintiff had never been willing to settle within policy limits, then the absolute threshold for actionable failure to settle would not be reached. So, the *Stowers* doctrine reemerges as an element of causation, and in a highly problematic way.

It is difficult to prove that the third-party claimant would have been willing to settle within policy limits had the insurer provided a defense. How can a jury be sure what would have happened in a complex and unpredictable process that never occurred? This problem must be addressed in court, and it is no worse than the case-within-a-case feature of legal malpractice litigation. The fact that the third-party claimant would have been willing to settle within policy limits tends to contradict the claim that the third-party claimant's injuries were worth at least the face value of the agreed excess judgment. The third-

party claimant will, therefore, need very clear expert testimony to prove this point.

If the third-party claimant has played the assignment game correctly, he will actually have offered to settle within the policy limits, and the insured will have forwarded that offer to the non-defending insurer. After the insurer refuses to defend, the insured will refuse the settlement and blame the failure to settle on the insurer. Some discovery will be had, or, at least, disclosures will be made. The plaintiff will make another offer to settle, this time not within policy limits, and the insured will accept, subject to receiving a covenant not to execute in exchange for an agreed judgment. Perhaps this settlement will come in the context of court ordered mediation, which gives the deal an aura of legitimacy, even if the mediation is theatre, implicitly bargained for and staged without explicit directions. The danger arises that a court will find illegitimate collusion between the third-party claimant and the insured in such a scenario. Rational courts are skeptical of agreed judgments. Even if achieved in mediation, unreasonable agreed judgments will not withstand judicial scrutiny.

I doubt that the Texas Supreme Court will hold that an insurer automatically, or even presumptively, violates its duty to settle when it wrongfully refuses to defend in bad faith. I suspect it will demand proof. This conclusion is especially compelling in light of the fact that only covered claims trigger the insurer's duty to settle. Nevertheless, if the third-party claimant has sustained serious injuries, the insurer faces the risk of extracontractual damages resulting from a reasonable agreed judgment when an insurer fails to defend in bad faith, and so long as the insurer is not "at the table." The *Stowers* doctrine is susceptible to substantial manipulation.

What about other tort damages? An individual insured may suffer mental anguish due to the insurer's wrongful refusal to defend. Theoretically, the insured may suffer some loss of business, though one should expect the insured to move with some dispatch in settling the underlying case, as it will be paying its own defense costs. The settlement of the underlying case is likely to reduce lost profits.

Attorneys' fees are not recoverable in Texas tort actions, so they will not be at issue. Punitive damages are recoverable, of course, if the insurer committed bad faith willfully and with malice (ill-will, spite, or the like) or in a grossly negligent manner. The standard for gross negligence in Texas is now quite high, however. The insurer must display an "I-don't-give-a-damn" attitude toward the rights of the insured.<sup>29</sup> In addition, an insured must experience injuries that are extraordinary and beyond those normally flowing from a mere breach of contract:

In general . . . an insurance carrier's refusal to pay a claim cannot justify punishment unless the insurer was actually aware

<sup>28</sup> See ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 111[g][2], at 576-77 (1987):

Subject to some important qualifications, the insurer is not liable for an excess judgment against the insured after the insurer has breached the duty to defend. Presumably the attorney hired by the insured will provide the same quality of representation as the attorney that the insurer would have provided. If this is so, the amount of the judgment in the underlying action against the insured should be the same, regardless of who provides the insured's defense. Therefore, it cannot be said that the insurer's refusal to defend the insured is the cause of any excess judgment; that is, any excess judgment that results does not 'naturally arise' from the breach. The same is true if the insured settles the case for an amount exceeding the policy limits after the insurer breaches the duty to defend. The settlement is presumably a fair reflection of the value of the plaintiff's claim, and in theory this settlement value should not increase if the insurer breaches the duty to defend.

<sup>29</sup> *Transportation Ins. Co. v. Moriel*, 879 S.W.2d 10, 21-23 (Tex. 1994).

that its action would probably result in extraordinary harm not ordinarily associated with breach of contract or bad faith denial of a claim—such as death, grievous physical injury, or financial ruin.<sup>30</sup>

The Texas Supreme Court is deliberately unclear about the types of injuries that may justify punitive damages in bad faith cases. The court is quite clear, however, that punitive damages are never justified in an insurer bad faith case when the insured has suffered only contract damages, that is, economic losses resulting from an erroneous denial of coverage.<sup>31</sup>

For insurer bad faith lawsuits filed before September 1, 1995, there is no bright-line statutory limit on punitive damages.<sup>32</sup> Before the adoption of new statutory limits, caps on punitive damages covered only gross negligence actions. One court of appeals recently held that the monetary limits on punitive damages specified in the Civil Practices and Remedies Code apply to insurer bad faith cases.<sup>33</sup> That holding is almost certainly wrong, since insurer bad faith cases are not negligence cases. The supreme court will review this case. (Of course, the duty to investigate implicit in the third element of the tort of bad faith contains a negligence component, but the duty to investigate only comes into play in proving a bad faith claim when the plaintiff seeks to use the insurer's deficient investigation as a substitute for knowledge.)

There are always unique circumstances that may justify punitive damages. Nevertheless, in future run-of-the-mill duty-to-defend cases, insurers probably do not face substantially greater damages for bad faith than they presently face for good faith breaches of the duty to defend. Given the availability of assignment, this conclusion should apply even to individuals.

### Affirmative Defenses

Affirmative defenses available to insurers complicate the already overgrown thicket of issues surrounding the bad faith breach of the duty to defend. Of course, all the usual affirmative defenses apply. The Texas Supreme Court has not yet announced whether insurer bad faith is subject to the affirmative defense of comparative bad faith by an insured. Several Texas trial courts have submitted appropriate jury questions, however. Obviously, insurers have to place considerable trust in insureds during the claims process. If an insurer had to check every detail, the cost of adjustment, and hence the price of insurance, would rise appreciably. (This consideration is insignificant in duty-to-defend decision-making, unless a reservation of rights

is to be utilized.) The affirmative defense of comparative bad faith will probably be adopted on the basis that fairness requires it. It is unfair to deny an insurer protection if its insured acts in bad faith. The logic of this argument is supported by the fact that the supreme court has described the special relationship as one of "shared trust."<sup>34</sup> The idea of shared trust presupposes some symmetry of duty.

Perhaps the most interesting affirmative defense might be failure to mitigate. Every tort victim has a duty to use reasonable efforts to mitigate his damages.<sup>35</sup> The requirement that the insured mitigate his damages does not mean that all insureds must hire an attorney and pay for a full defense.<sup>36</sup> Mitigation does not require expenditures exceeding what the insured can fairly easily afford. If the insured settles, receives a covenant not to execute, and assigns to the third-party claimant his rights against the insurer, then the insured has capped his damages and acted rationally. This is true without respect to the amount of the settlement and agreed judgment. Moreover, the insured has also cut off his own exposure to attorneys' fees and to a runaway verdict. If all this is true, then in whatever sense there is a duty to mitigate<sup>37</sup> the insured also has an obligation to settle and assign, and if he does not do so, his insurer would have something to argue about.

<sup>34</sup> Federal Deposit Ins. Corp. v. Coleman, 795 S.W.2d 706, 708 (Tex. 1990).

<sup>35</sup> Sorbus, Inc. v. VHW Corp., 855 S.W.2d 771 (Tex. App.—El Paso 1993, writ denied) (ordinary care is the governing standard); see Hanna v. Lott, 888 S.W.2d 132 (Tex. App.—Tyler 1994, no writ) (injured plaintiff need not take all possible action to mitigate). See also Trinity Universal Ins. Co. v. Fuller, 524 S.W.2d 335 (Tex. Civ. App.—Dallas 1975, writ ref'd n.r.e.) (mitigation requires reasonable effort but only slight expense).

<sup>36</sup> ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.34, at 169 (1982):

A third possible exception to the rule that an insurer should not be held liable in excess of the policy limits because of a breach of its duty to defend is when the insured is financially unable to hire defense counsel and, as a result, a default judgment in excess of the policy limits is entered. The insurer may then be liable for the entire judgment. *This should not, however, be the case if the insured was financially able to hire defense counsel, but elected not to do so.*

ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 9.5(b)(3)(ii), at 1051–52 (1988):

If an insured has been heedless in failing to protect his or her own interests—as, for example, when the insured has done nothing to prevent a default judgment—the insured should be precluded from recovering reimbursement of any amount that is in excess of what the losses would have been if the insured had acted responsibly. Although some judicial decisions appear to have taken a contrary view, it is submitted that they do not take due account of the doctrine of avoidable consequences, which by the weight of authority applies even to cases of intentional wrongdoing.

<sup>37</sup> Federal Depositors Ins. Corp. v. Niblo, 821 F. Supp. 441 (S.D. Tex. 1993) (duty to mitigate is a duty a plaintiff owes himself if full satisfaction is desired).

<sup>30</sup> *Id.* at 24.

<sup>31</sup> Twin Cities Fire Ins. Co. v. Davis, No. D-4600, 1995 WL 407379, \*9 (Tex. 1995); see Federal Express Corp. v. Dutschmann, 846 S.W.2d 282 (Tex. 1983).

<sup>32</sup> Tex. S. 25, § 41.011 (1995).

<sup>33</sup> Universe Life Ins. Co. v. Giles, 881 S.W.2d 44 (Tex. App.—Texarkana 1994, writ granted).

My conclusion seems paradoxical. To be sure, the insured is mitigating his damages, but he does so by transferring them elsewhere, not by reducing them. Reduction, not conveyance, is what the common law has always had in mind with respect to mitigating damages. Still, the logic of a "mitigation" defense of this sort of settlement seems safe from purely legalistic attack. There is no Texas law on this issue. The literal logic of mitigation points in one direction; common sense points in the other. Hopefully, the latter will rule.

#### Discovery by the Insured

The structure of the common law tort of insurer bad faith suggests how the insured should conduct discovery when the carrier has breached its duty to defend. First, and most significantly, the insured should concentrate on the denial letter.<sup>38</sup> Insurers include every reason they think might possibly be relevant to deny a claim because they fear that if a ground is not included, then it is waived. As a result, insurers often include in their denial letters grounds for denial that are contradicted by the factual allegations in the complaint. (One wonders how this kind of conduct fits with the insurer's duty to investigate.) Consequently, the insured should follow a deposition strategy of "divide and conquer." The insured should isolate each reason mentioned in the denial letter and examine the adjuster carefully about why he thinks it is, by itself, a good reason for refusing a defense. If the reason is not sufficient, by itself, to refuse a defense, then the insured should take the position that it has no place in a denial letter, and hence, that the denial lacks a reasonable justification, at least as to that reason. Perhaps the items in the letter should be reviewed in ascending order of plausibility, rather than sequentially. (One wonders how reasonable an insurer can look when it denies a defense on grounds that the law specifically prohibits.)

Second, the insured should review with the adjuster the portions of the company's claims manual governing the duty to defend and the preparation of denial letters in this context. If there is no claims manual, then expert testimony should be procured that this procedure is unreasonable on its face. The insured's theme should be that because the insurer breached the contract it probably did not act for a good reason. A written standard governing duty-to-defend decisions is a key feature of any minimally acceptable claims manual, as is a written principle governing when to retain coverage counsel. In the absence of such a writing, the insured may argue, the adjuster was not properly educated and controlled. Hence, it is no wonder the adjuster went wrong and relied upon reasoning that was not even faintly plausible.

The insured will get the claims manual in discovery, if there is one. If there isn't one, the plaintiff should find out whether

there ever was one. If so, he should find out what happened to it. In any case, if the up-to-date, technologically advanced insurer does not have written rule books guiding claims representatives, the insurer looks sloppy and is susceptible to the following rhetorical gambit at trial: "This insurer is so slipshod in its claims operation that it does not even have a manual for its hundreds of adjusters to follow. Each of you has a manual for your desktop computer. Is it any wonder that this insurer went so badly wrong?"

The insurer may respond that the question is whether the insurer had a reasonable basis to refuse to defend, not whether it has a claims manual. It is not a tort not to have a claims manual. In the give-and-take of a trial, however, this argument is not a winner.

If there is a manual, it is unlikely the company has completely conformed to it. Further, large insurance companies train their claims people, who tend to keep their training materials. These should be obtained in document discovery and explored in depositions. If an insurer claims not to have training materials, an insured may wish to consider deposing whoever is in charge of training the insurer's personnel. If the insurer claims it cannot figure out who that person is, then the insured should seek to take the deposition of the person at the company most knowledgeable about the structure, organization, and personnel involved in the claims-support function. Often, the vice president of claims will know this. Almost always, the administrative assistant to the vice president of claims will know this. In any bad faith case, the insured should seek to obtain organizational charts from the claims department of the insurer.

Third, the insured should try to obtain the coverage opinion letter of counsel, if there is one. The insured has the right to know if there is one, and who provided it, even if the letter itself is privileged. Frequently, insurers will wish to produce the coverage letter as the basis for an advice of counsel defense. If the insurer's reliance on the lawyer's opinion is reasonable, this defense should succeed.<sup>39</sup> After all, under Texas law if an insurer has a bona fide reason for denying a defense, it cannot be guilty of bad faith. If an insurer goes to court with an opinion letter signed by a lawyer known to be experienced, fair-minded, objective, and rational, the court will be inclined to want to help. If the matter goes to a jury, even the opposing expert will have to acknowledge the sterling qualities of the opinion's author, and that acknowledgment may substantiate the bona fides of the opinion.

The insured may attack the opinion in several ways. First, it may attack the identity of the lawyer or the firm that produced the opinion. Perhaps the lawyer who wrote the opinion was not experienced or was in a hurry. Perhaps portions of the opinion sound canned. This is why insurers do not use in-house counsel

<sup>38</sup> Alternatively, the focus might be on a reservation of rights letter. That is an analogous subject, so much of what is said here applies, *mutatis mutandis*.

<sup>39</sup> Michael S. Quinn, *The Advice-of-Counsel Defense*, 72 TEX. L. REV. 1447 (1994); see Quinn & Steele, *supra* note 10.

to provide formal coverage opinions. It also suggests what is wrong with the view of the young woman in my second story. Second, the insured may attack the substance of the opinion letter through an expert witness. Third, it may attack the way the adjuster relied upon the letter. Did the adjuster read the letter? Make notes? Read pertinent authorities? Ask questions of the lawyer?

Some commentators are skeptical about the advice of counsel defense. Stephen Ashley, for example, suggests:

[B]y pleading reliance on the advice of counsel, the insurer tacitly admits that the advice was wrong and that the insurer's handling of the claim was incorrect—otherwise, there would be no point in pleading the defense. If the lawyer was correct in advising the insurer that the policy did not cover the plaintiff's claim, then there is no point invoking the defense, for if the advice was correct, then the claim was meritless.<sup>40</sup>

This argument is debatable. First, insurers should claim both that they correctly denied coverage but that even if they did not (*i.e.*, their denial of coverage was wrong), they still had a good faith reason for the denial. This proposition is always true when the coverage and bad faith cases are tried together.<sup>41</sup> If coverage is tried first, Texas courts will not reach the bad faith case unless the coverage issue has been decided against the insurer.

Second, Mr. Ashley says that relying on the fact that the insurer received advice from counsel suggests that the basis for denying the claim was weak. (Otherwise, why not simply rely on the merits of the denial?) Mr. Ashley's error is fundamental. If the insurer got the right sort of lawyer, she did her job, and the insurer relied reasonably, then the insurer had a good faith reason for denying the claim as the result of the process from which the denial issued. The concept of a "reasonable basis" need not rest solely upon the substantive quality of the reason. The thought processes of the insurer are important, too. Besides, a formal opinion from respected counsel places a halo of reasonableness upon what is said in the letter and upon what is done on the basis of the opinion. This is true even though despising lawyers is a national sport.<sup>42</sup>

Fourth, the insured should explore the insurer's adjustment practices to show (1) that the insurer knows it has to be trust-

worthy and (2) that the insurer treats everyone alike and knows that it should. (This last point should undermine a sophisticated insured defense.<sup>43</sup>) In the same context, the insured should try to pin the adjuster down on how inflexible the company is about deviating from policy forms in the context of writing (*i.e.*, selling insurance). Of particular interest are the use of the term "occurrence," the meaning of the term "accident" in the definition of "occurrence," trigger of coverage provisions of policies (which are usually found in the insuring agreements), the use of the term "bodily injury," its definition, the use of the term "property damage," its definition, and the use and definition of a number of other standard terms. This kind of inflexibility is absolutely required for sound underwriting, and this point should be developed insofar as possible. Underwriting inflexibility justifies the asymmetry of the special relationship.

Lastly, the insured should try to secure the insurer's agreement that the insured has done nothing wrong in the claims process. This inquiry would include issues of notice, the provision of information, compliance with requests, and so forth. These kinds of questions can be used to defeat both the affirmative defense of comparative bad faith, and the (improbable, but possible) counterclaim for reverse bad faith. If the insurer thinks that the insured has done something wrong, then the insured should insist upon an exhaustive, itemized list of the insured's alleged misdeeds. These can be explored and perhaps challenged in depositions.

### Insurer Discovery

Unless it asserts a late notice defense, the insurer has little discovery to do in defending a bad faith case arising out of its refusal to defend its insured. The duties of insurers in this context are fixed by the face of the policy and the face of the pleadings. It is far more important that insurers prepare their adjusters and their coverage counsel for deposition than it is for the insurer to take depositions. If enough money is at stake, a persistent insured may wish to depose the line adjuster, his supervisor, all members of the committee that made the decision not to defend, the home office adjuster who supervised the process, and the head of claims. Insurance adjusters often make poor witnesses, and claims executives resent having to appear for deposition and hold the process in contempt. A persistent insured can make headway in his case if he manipulates these weaknesses. Counsel for the insurer must therefore prepare his witnesses accordingly. Unfortunately, there is no known way of

<sup>40</sup> Stephen S. Ashley, *The Advice of Counsel Defense: Lessons from Malicious Prosecution*, 6 BAD FAITH L. REP. 21, 25 (1990).

<sup>41</sup> Mr. Ashley comments:

The insurer can take the position, "The denial of the claim was correct, but even if it wasn't, we aren't liable because we relied on the advice of counsel." While pleading in the alternative in this manner is a viable approach from a procedural point of view, this approach presents the practical drawback that it mutes the persuasive force of each of the alternatives: the jury is likely to give less credence to the insurer's assertions of no coverage if the insurer hedges its bet by saying, "But even if there is coverage, its [sic] not our fault."

*Id.* at 25-26.

<sup>42</sup> Mr. Ashley continues to think I am dead wrong about the advice of counsel defense. In fact, he has said to me, "You are the only insurance lawyer I know who thinks the advice of counsel defense is worth ainker's damn. Insurers rarely rely upon it in California." I plead guilty to thinking highly of it. Under Texas law it is a winner because it tends to show that the insurer thought about the claim before denying it. Of course, if the insurer's claims personnel never read the letter, then reliance on the advice of counsel defense would backfire.

<sup>43</sup> See *supra* note 25 and accompanying text.

mollifying executive resentment about the deposition process. Some sort of drug might help, but—alas—that is probably an abuse of the medical process. Here are some next best alternatives:

- Educate the witnesses as to the deposition process and the peculiarities of the approach of insured's counsel. This must be done even with witnesses who think they already know everything.
- There are now popular books available on the deposition process.<sup>44</sup> Lawyers should buy these books by the case and liberally distribute them to clients. (Alas, the giving of pop-quizzes is probably unrealistic.)
- Potential witnesses should watch any of the excellent video tapes of the deposition process that are commercially available.<sup>45</sup> They might also watch cuttings from videotapes of previous depositions taken by plaintiff's counsel in the present case (or others).
- In important cases, the entire deposition should be rehearsed. The rehearsal should be designedly pointed, even unpleasant, in spots, so that the witness will know how to deal with his own anger. This might be called "desensitizing" the witness.
- In particularly important cases, consider employing a psychologist who specializes in alleviating deposition anxiety.

The insurer should obtain the insurance agent's file, and if the insured is a business entity, its risk management file. Risk managers have allegiance to the institutional contours of insurance markets. As a result, much of their testimony, if well-solicited, will tend to support the insurer's side of the case. If the insured is trying to press its claim for a defense beyond normal limits, risk managers will sometimes balk. The depositions of risk managers can be extremely helpful.

Discovery on comparative bad faith and on the contractual duty to cooperate is important. The insured sometimes cooperates with the third-party claimant in framing the petition to trigger a duty to defend. The insured and the third-party claimant often share an interest in establishing coverage. An insured working with a third-party claimant in framing the petition to trigger coverage may not technically violate the policy's cooperation clause, as helping the plaintiff frame his pleadings does not constitute a failure to help in defending against the claim. Nevertheless, collusion with the third-party claimant violates the spirit of the duty to cooperate and may support a comparative bad faith defense. Therefore, the insurer should explore

any contacts between the insured and the third-party claimant. Contacts between lawyers for the insured and the third-party claimant are not subject to the attorney-client privilege. The best way to get at them is by means of interrogatories and requests for production of documents, followed by depositions. Requests for admissions may be useful to nail down the facts of the collusion. Often, they should be used last.

### The Use of Expert Witnesses

Expert witnesses are routinely used in bad faith cases. In Texas, experts may testify about ultimate issues. Hence, the right expert could testify as to whether an insurer breached its duty of good faith and fair dealing when it failed to defend. The fact that an expert may testify about ultimate issues does not mean that a lawyer, in the guise of an expert witness, can usurp the judge's role and instruct the jury on what the law is and what a policy means.

The testifying expert need not actually be an adjuster. Any lawyer who is familiar with insurance company standards and behavior will do very nicely. Lawyers often have better verbal skills than adjusters. Lawyers, however, have special problems as experts. Lawyers tend to confuse the roles of expert and advocate. As a result, the testifying lawyer-expert may diminish his own credibility. Strident, never-give-a-point testimony may be ineffective. Jurors expect lawyers to advocate and consequently suspect the testimony of a lawyer-witness.

The lawyer's role as expert is delicate, if not out-and-out tricky. To do his job, the lawyer-expert has to be able to testify as to the reasonableness of the insurer's grounds for denying the claim (this requires a knowledge of the logical structure of insurance law, and it requires knowledge of what prudent insurers do) and the habits and practices of prudent insurers with respect to the duty to defend. This last area of testimony is extremely important, as it is the most fact-based.

Many bad faith cases are not so complex that expertise is really needed. This is especially true in duty to defend bad faith cases, although it is not true of negligent failure to settle cases. Still, experts are widely used in bad faith cases; if one side gets an expert, the other side is almost forced to do the same.

The case of *Nicolau v. State Farm Lloyds*,<sup>46</sup> now pending before the Texas Supreme Court, raises several issues concerning the use of experts. The insured presented engineering reports showing that plumbing leaks had caused foundation damage.<sup>47</sup> The insurer obtained a second opinion from Haag Engineering. The appellate court repeatedly characterized Haag Engineering as "predisposed" to believe the proposition that plumbing leaks

<sup>44</sup> Consider, for example, STUART B. SHAPIRO, *HOW TO SURVIVE A DEPOSITION* (1994). I have had several witnesses read this 170 page paperback from John Wiley & Sons.

<sup>45</sup> See, e.g., JAMES JEANS, *DEPOSITIONS IN BUSINESS CASES* (1986). Matthew Bender & Co., which produced this video tape, has done several others for various dispute areas (e.g., personal injury).

<sup>46</sup> 869 S.W.2d 543 (Tex. App.—Corpus Christi 1993, writ granted).

<sup>47</sup> Although the opinion in the court of appeals does not say so, the homeowners' engineers are widely known to be strong advocates of the proposition that plumbing leaks cause foundation damage. The credentials, the qualifications, and the objectivity of these experts are open to some question. Some lawyers regard these experts as "true believers."

do not cause foundation damage. (A careful reading of the opinion reveals, however, that Haag has what it believes is empirical and theoretical support for this proposition. Hence, it seems misleading to brand its view as a "predisposition.") In any case, the insurer denied coverage for foundation damage on the basis of the Haag report. The jury awarded the Nicolaus contract and extracontractual damages for bad faith. The jury also awarded punitive damages. The trial court entered judgment for breach of contract, but denied extracontractual recoveries. The court of appeals reinstated the jury's verdict.

The court of appeals held that the insurer's reliance on the Haag report was not reasonable as a matter of law. The court criticized the insurer on two grounds. First, it relied upon the Haag report in spite of Haag's alleged predisposition to refuse to believe that leaks cause foundation damage. Second, the court faulted Haag, and the insurer's reliance on Haag's report, because Haag failed to link its theories to the empirical evidence of conditions underneath the Nicolau house. In other words, Haag theorized but did not look and see. The court of appeals concluded that "more than enough evidence existed for the jury to have found that a reasonable insurer under similar circumstances would not have denied the Nicolaus' claim."<sup>48</sup>

This is not the standard of bad faith. Insurer bad faith is not negligence. The question is whether the Haag report provided the insurer a reasonable basis for denying the claim. Of course, an adjuster may not blindly rely upon an expert's report, particularly if the expert is known to be a "whore." The court of appeals is correct about this. The insurer's reliance should be reasonable, under the circumstances. But, if a reasonable report from a reputable engineering company raises a substantial question about the facts of the loss, then an insurer has the right to have a coverage dispute adjudicated.

Similar considerations apply to coverage analyses by lawyers. An insurer may not blindly rely upon the fact that it has a coverage opinion stating that a denial is legally permitted. Reliance must be reasonable. The coverage opinion must be well reasoned; it must state the facts correctly, insofar as they are known; the interpretation of the cases cited must be sensible; and so forth. In addition, the lawyer who writes the coverage opinion must not have a known predisposition to deny a claim, and the lawyer must not be known to tell the adjuster whatever the adjuster wants to hear. To the contrary, the insurer must think the lawyer independent and objective.

The *Nicolau* case raises issues about an insurer's reliance on an expert *when denying a claim*. It also has implications for how experts should testify and how opponents should cross-examine them. Experts should not rely too heavily on theory, unless it has the currency of high school science. Experts should be dedicated empiricists, as well as sound theoreticians.

<sup>48</sup> *Nicolau v. State Farm Lloyds*, 869 S.W.2d 543, 551 (Tex. App.—Corpus Christi 1993, writ granted).

They should go and look. In the duty-to-defend arena, the expert should consider interviewing the claims representatives who made the decision not to defend. Lawyers should not retain experts who are so aligned with the insurance industry that they have (or may be portrayed as having) ideological blinders. Experts who are economically dependent on the insurance industry also cause problems. Industry bias is an especially easy topic for cross-examination. (Yet where else do you find lawyers with enough experience to testify knowledgeably?)<sup>49</sup>

The other lesson of *Nicolau* about experts is more subtle. The insurer should do two things in a bad faith case where experts played some role in the underlying case. First, it should try to vindicate the truth and reasonableness of the expert's view. Second, the insurer should argue that, irrespective of the truth of the expert's view, the insurer's reliance on the expert was reasonable. In a case like *Nicolau*, the expert upon whom the insurer relied to deny the claim cannot perform the role of validating expert at trial. In a bad faith case based on an insurer's failure to defend, however, if the author of the opinion letter is sufficiently distinguished, the author's testimony may establish the reasonableness of the insurer's reliance, depending on the author's skill as a witness and the nature of the case.

### Conclusion

The requirements for proving insurer bad faith are silently rising. Most insurance lawyers agree that the days of "junk" insurer bad faith claims are almost over. Defense lawyers report that filings are down. An undeveloped area of Texas bad faith law concerns the duty to defend. The Texas law of first-party bad faith implicates this contractual duty, but courts should proceed carefully when extending established principles of bad faith to this realm.

<sup>49</sup> The use of lawyers as experts in insurance bad faith cases has been quite common in Texas for several years. Sometimes the lawyer-witnesses have not been the most knowledgeable. That situation is likely to change. The Texas Supreme Court has ruled "junk science" inadmissible. No scientific testimony is to be admitted unless it is *relevant* (i.e., focused upon the facts of the case) and *reliable* (i.e., based upon sound scientific methodology). Scientific evidence is "helpful" under Rule 702 of the Texas Rules of Evidence only if it meets these two conditions. *E.I. duPont Nemours v. Robinson*, No. 94-0843, 1995 WL 359024 (Tex. 1995). Testimony about adjustment practices, what counts as the reasonable processing of a claim for a defense, and what counts as a reasonable basis for denying a claim is not, by any stretch of the English language, scientific. It involves, however, "specialized knowledge," to use the wording of Rule 702. *Robinson* signals that "junk" claims to specialized knowledge are a thing of the past and that specialized knowledge, like science, must be both relevant and reliable. It must be offered by someone who has in-depth knowledge (i.e., someone who is actually a qualified expert).