The Changing Face of First-Party Bad Faith Claims in Texas

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TABLE OF CONTENTS

I. INTRODUCTION ........................................ 867
II. BACKGROUND ........................................ 869
   A. Tort Standard for First-Party Bad Faith ..... 869
   B. Texas Courts Adopt Tort Standard .......... 870
III. STATING A CLAIM OF BAD FAITH ................... 872
   A. The Arnold Test ................................ 872
   B. The Aranda Decision ............................ 873
   C. Choosing Between Arnold & Aranda .......... 875
   D. Summary of the Current Law ................. 877
   E. Judgment as a Matter of Law ................. 878
   F. A "Particularized" Approach to Appellate
      Review ............................................ 879
IV. BAD FAITH IN THE ABSENCE OF COVERAGE .......... 882
   A. The Viles Case .................................. 882
   B. Post-Viles Interpretation .................... 884
   C. The Stoker Decision ............................ 885
   D. Reconciling Viles and Stoker ............... 888
   E. Should Texas Allow Bad Faith in the Absence
      of Coverage? ............................. 888
V. REMEDIES FOR BAD FAITH ............................. 892
   A. Tort Damages vs. Contract Damages ........ 892
   B. A Shift Towards Statutory Law .............. 894
VI. CONCLUSION ........................................ 896

I. INTRODUCTION

The expression that "everything is bigger in Texas" certainly holds true when it comes to insurance litigation. During the mid- to late-1980s, the judicial pendulum in Texas appeared to favor insureds, resulting in both a large quantity of claims and large recoveries for plaintiffs. In fact, the perceived "pro-insured" tilt of the judicial pendulum nearly caused an insurance crisis in Texas as insurance companies contemplated their future existence in the Lone Star State. During this time,

* I would like to thank Professor Ellen S. Pryor for sparking my interest in insurance
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perhaps nothing struck more fear in the hearts of insurance companies than the threat of "bad faith" claims.¹

In 1987, the Texas Supreme Court first recognized the existence of the independent tort of "bad faith" in the first-party context.² Since then, the Texas courts have grappled with a host of issues that continue to plague the insurance law practitioner while providing plenty of legal and social issues for academic debate. While it is undisputed that under Texas law an insurer owes its policyholder a duty of good faith and fair dealing, the Texas courts have had difficulty articulating a clear standard for determining what actions or omissions by an insurer constitute bad faith conduct. Equally challenging has been the Texas courts' struggle to articulate and apply the proper scope of appellate review for bad faith cases.

A prominent issue within the debate over the proper scope of the first-party tort of bad faith has been whether or not to recognize a cause of action in the absence of coverage. In 1995, the Texas Supreme Court reversed an appellate decision permitting such a cause of action and held that, in general, there can be no bad faith claim in the absence of coverage.³ While purporting to announce a general rule, however, the court stated, "We do not exclude . . . the possibility that in denying the claim, the insurer may commit some act, so extreme, that would cause injury independent of the policy claim."⁴ The court did not, however, advise the practitioner as to what types of acts or omissions are extreme enough to overcome the general proscription against liability in the absence of coverage.

Not only has defining the elements of a bad faith cause of action created confusion, an issue has arisen among scholars and courts as to whether tort law, contract law, or statutory law provides the best foundation for remedying bad faith liability. As will be illustrated, this debate is being answered by plaintiffs who are increasingly avoiding the heightened

¹. In Texas, the term "bad faith" is synonymous with a breach of the duty of good faith and fair dealing. For the purposes of this Comment, "bad faith" and "breach of the duty of good faith and fair dealing" will be used interchangeably.
². Arnold v. National County Mut. Ins. Co., 725 S.W.2d 165 (Tex. 1987). The term first-party refers to insurance policies in which the insured contracts with the insurer to indemnify the insured against a loss suffered directly by the insured. Third-party insurance, on the other hand, is designed to protect the insured against claims made by a third-party against the insured. All forms of insurance other than liability insurance can be considered first-party insurance. ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 38-39 (2d ed. 1996). At the time Arnold was decided, Texas had already long recognized that an insurer has a duty to exercise ordinary care in the handling of settlement negotiations. G.A. Stowers Furniture Co. v. American Indemn. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved). This duty, known as the Stowers duty, is limited to the handling of third-party claims. Arnold, on the other hand, recognized the duty of good faith and fair dealing in the handling of first-party claims. As will be illustrated, the standard for proving breach of the duty of good faith and fair dealing is more onerous than proving breach of the Stowers duty. Because Texas law differs with respect to first-party and third-party insurance, this Comment will focus exclusively on first-party insurance.
⁴. Id. at 341.
burden of proving common law bad faith actions and are instead seeking statutory recoveries under the Texas Insurance Code.

This Comment focuses on the recent shift of the judicial pendulum away from the perceived "pro-insured" tilt of the mid- and late-1980s and the resulting emergence and predominance of the Texas Insurance Code in bad faith litigation. Part II of this Comment provides a brief historical overview of the evolution of first-party bad faith and its ultimate adoption by the Texas Supreme Court. Part III discusses the different formulations articulated by the Texas Supreme Court for determining when an insured has breached its duty of good faith and fair dealing. This section includes a discussion on the increasing willingness of Texas courts to use summary judgment and directed verdicts to resolve common-law bad faith claims as a matter of law. Furthermore, this section analyzes the Texas Supreme Court's "particularized" approach to appellate review in bad faith cases. Part IV explores the concept of allowing bad faith liability in the absence of coverage. Finally, Part V will examine whether tort law, contract law, or statutory law is the best source for providing a remedy to aggrieved insureds. This examination will center on the policy concerns surrounding the availability of extracontractual damages.

This Comment strives to provide an objective focus on all of the above-mentioned issues. Accordingly, it should be read as an exploration of the recent shift in Texas law as opposed to an endorsement or condemnation of either the plaintiff's bar or the insurance industry.

Additionally, although this Comment concentrates on Texas law, the issues and concerns raised are certainly not unique to Texas. It is hoped, therefore, that this Comment will benefit legal practitioners throughout the country.

II. BACKGROUND

A. TORT STANDARD FOR FIRST-PARTY BAD FAITH

To better understand the current status of first-party bad faith law in Texas, it is helpful to briefly examine the evolution of bad faith from its contract origins to its current existence, in most jurisdictions, as an independent tort.

In the early 1970s, the courts of California led the way in developing a tort standard for the breach of the duty of good faith and fair dealing. In *Fletcher v. Western National Life Insurance Co.*, a California appellate court held that an insurer was liable both for breach of contract and in tort for damages caused by its unreasonable refusal to indemnify its insured under a disability policy. In 1973, the California Supreme Court, in *Gruenberg v. Aetna Insurance Co.*, squarely addressed the issue of

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7. *Id.* at 93.
whether a tort remedy was available for a breach of the duty of good faith and fair dealing. The Gruenberg court agreed with the reasoning of Fletcher and affirmatively recognized bad faith as an independent tort:

It is manifest that a common legal principle underlies all of the foregoing decisions; namely, that in every insurance contract there is an implied covenant of good faith and fair dealing. The duty to so act is imminent in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself. Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.9

Although it is difficult to determine which states have formally adopted the independent tort of first-party bad faith,10 it is clear that a majority of states do recognize some form of independent tort recovery for bad faith conduct.11

A survey of the states also illustrates that a fair number of jurisdictions have explicitly refused to recognize a common-law action for bad faith. The most recognized and widely used rationale for refusing to do so is the existence of state legislation that provides exclusive remedies for legislatively defined bad faith conduct on the part of the insurer.12 Another common reason advanced by jurisdictions that reject a common-law cause of action for bad faith is that the important policy concerns for allowing bad faith recovery in third-party claims do not exist in the first-party context.13 Finally, it is clear that an underlying rationale for refusing to adopt the tort of first-party bad faith is fear of a tidal wave of tort litigation and its resulting negative consequences.

B. TEXAS COURTS ADOPT TORT STANDARD

The Texas courts were slow to recognize a duty of good faith and fair dealing in the first-party insurance context. In the 1983 case of English v.

9. Id. at 1038.
12. See, e.g., Spencer v. Aetna Life & Casualty Ins. Co., 611 P.2d 149, 158 (Kan. 1980) ("The legislature has provided several remedies for an aggrieved insured and has dealt with the question of good faith first party claims . . . . Where the legislature has provided such detailed and effective remedies, we find it undesirable for us to expand those remedies by judicial decree."); Lawton v. Great Southwest Fire Ins. Co., 392 A.2d 576, 581 (N.H. 1978) ("[W]e take cognizance of the fact that the legislature has established mechanisms designed to deal with insurer malfeasance in [the insurance] area, which, in our opinion, vitiates the need for recognition of a new cause of action in tort."); D'Ambrosio v. Pennsylvania Nat'l Mut. Casualty Ins. Co., 431 A.2d 966, 970 (Pa. 1981) ("[T]he Unfair Insurance Practices Act serves adequately to deter bad faith conduct . . . .").
13. Lawton, 392 A.2d at 580-81 (reasoning that an insurer in the first-party context "is not in a position to expose the insured to a judgment in excess of the policy limits through its unreasonable refusal to settle a case, nor is it in a position to otherwise injure the insured by virtue of its exclusive control over the defense of the case"); see also Spencer, 611 P.2d at 153.
Fischer, the Texas Supreme Court, like the Gruenberg court, recognized that an implied covenant of good faith and fair dealing may arise out of a "special relationship" between parties to a contract. The court declined, however, to extend the implied covenant of good faith and fair dealing to every contract, including insurance contracts. The English decision, therefore, restricted an insured to a suit for breach of contract. Accordingly, an insured was entitled only to contractual damages which were, by nature, limited to the benefits due under the policy.

In 1987, fourteen years after the Gruenberg decision, the Texas Supreme Court, in Arnold v. National County Mutual Fire Insurance Co., squarely addressed the issue of whether a first-party claimant can bring a tort action for breach of the duty of good faith and fair dealing.

Arnold involved a motorcyclist who was severely injured when he was struck by an uninsured motorist. After the accident, Arnold made a timely request to recover policy proceeds from his uninsured motorist carrier. The insurer, National County Mutual (NCM), refused to pay the claim and in doing so, ignored the recommendations of an independent adjusting firm that NCM pay the entire policy limit to Arnold. After successfully suing both the uninsured motorist and NCM for breach of contract, Arnold initiated another suit against NCM alleging various statutory causes of action and a common-law cause of action for NCM's breach of the duty of good faith and fair dealing.

The trial court granted summary judgment to NCM on all of the statutory and common-law causes of action and the court of appeals affirmed. The Texas Supreme Court granted writ in the case to determine whether a common-law cause of action for breach of the duty of good faith and fair dealing exists in the insurance context.

The Texas Supreme Court affirmatively recognized that the insurance context is marked by a special relationship arising out of unequal bargaining power between the insurers and their insureds. Additionally, the court noted that the insurance company has complete and exclusive control over the evaluation, processing, and denial of claims. It is precisely this unfair bargaining power, the court stated, that could "allow unscrupulous insurers to take advantage of their insureds' misfortunes in bar-

14. 660 S.W.2d 521 (Tex. 1983). The case involved a homeowner who sued his mortgagee for breach of the duty of good faith and fair dealing for failing to turn over fire insurance proceeds following a fire.
15. Id. at 524 (Spears, J., concurring).
16. Id. at 522.
18. 725 S.W.2d 165 (Tex. 1987).
19. The evidence demonstrated that NCM followed the advice of their attorney/agent in denying the claim. During deposition testimony, the attorney/agent acknowledged his inexperience in handling automobile accidents and further testified that his decision was based on his belief that a jury would be prejudiced against a motorcyclist, especially since Arnold was driving too fast under the existing conditions. Id. at 166.
20. Id. at 167.
21. Id.
gain for settlement or resolution of claims."

In recognizing that a special relationship exists in the first-party insurance context, the court was no longer constrained by the English precedent. Thus, the tort of first-party bad faith was expressly adopted in Texas. Notwithstanding this recognition, defining the parameters of the tort proved to be a difficult task for Texas courts.

III. STATING A CLAIM OF BAD FAITH

Although the Arnold decision established the uncontroverted fact that insurers owe their insureds a duty of good faith and fair dealing, the decision, apart from setting out a two-pronged test, did little to define the parameters of the newly adopted tort. Furthermore, because claims of bad faith exist in nearly every modern insurance coverage dispute, this lack of clarity led to some confusion on the part of both the plaintiff's bar and the insurance industry.

A. THE ARNOLD TEST

In Arnold, the Texas Supreme Court set forth a two-pronged test for determining when a cause of action for breach of the duty of good faith and fair dealing has been stated:

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.

The use of a two-pronged test for stating a claim of bad faith is fairly common among jurisdictions recognizing the duty of good faith and fair dealing in the first-party context. Although the test varies slightly from jurisdiction to jurisdiction, the majority of jurisdictions has a test that requires that an insured must prove "(1) that the [insurer's] conduct was unreasonable and (2) that the insurer intentionally denied a claim or delayed payment of a claim that the [insurer] knew to be valid or showed a reckless disregard of the fact that a valid claim had been submitted."
As one can see, the second prong of the Arnold test differs from that of the traditional test. Specifically, the Arnold test does not require intent or reckless disregard. Furthermore, because Arnold speaks only in terms of reasonableness, one could infer that the court intended negligence to suffice as the standard for stating a claim of bad faith. Certainly, if the court meant to exclude mere negligence as the standard for recovery, they could have easily added a subjective requirement. An additional difference between the Arnold test and the traditional test is that under the second prong of the Arnold formulation, failure to investigate, in and of itself, can serve as an independent basis for bad faith recovery.

B. THE ARANDA DECISION

One year after the decision in Arnold, the Texas Supreme Court, in Aranda v. Insurance Co. of North America, was given an opportunity to extend the Arnold holding into the worker's compensation arena. Aranda involved an injured worker who, at the time he became unable to work, was employed by two different companies. Aranda filed a claim against both companies and alleged that his injuries were the result of his work at either or both of the companies. Both carriers subsequently refused to pay weekly disability payments until the Industrial Accident Board ruled on the matter. Aranda claimed intentional misconduct and breach of the duty of good faith and fair dealing on the part of both carriers.

The Texas Supreme Court held that "[t]he contract between a compensation carrier and an employee creates the same type of special relationship that arises under other insurance contracts." In extending bad faith liability into the worker's compensation arena, the court also, arguably, changed the Arnold test:

A worker's 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 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.

28. See, e.g., Anderson v. Continental Ins. Co., 271 N.W.2d 368, 378 (Wis. 1978) (recognizing that bad faith is an intentional tort in which knowledge or reckless disregard must be demonstrated). The Arnold court, on the other hand, cited to the negligence standard as set forth in G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved), for the proposition that an insurer should be held to the degree of care that an ordinary and reasonable insurer would exercise in the management of a claim. Arnold, 725 S.W.2d at 167.
29. Stephen S. Ashley, The Scope of Appellate Review in Texas Bad Faith Cases, 10 BAD FAITH L. REP. 1, 4 (1994). This conclusion follows from the court's use of "or" to separate the two prongs of the Arnold test.
30. 748 S.W.2d 210 (Tex. 1988).
31. Id. at 212.
32. Id. at 213 (emphasis added).
The first prong of the Aranda test is "an objective determination of whether a reasonable insurer under similar circumstances would have delayed or denied the claimant's benefits." As in Arnold, the court's use of "reasonableness" leads to the inference that the court intended for negligence to be the standard basis for recovery.

The second prong of the Aranda formulation differs significantly from Arnold in that it adds a subjective element, which was missing from Arnold. To satisfy the second prong of the Aranda test, an insured must either demonstrate that "the carrier actually knew there was no reasonable basis to deny the claim or delay payment or [establish] that the carrier, based on its duty to investigate, should have known that there was no reasonable basis for denial or delay." This addition, according to the Aranda court, "balances the right of an insurer to reject an invalid claim and the duty of the carrier to investigate and pay compensable claims." Ultimately, the effect of this addition is that insurers are shielded from liability for making erroneous denials as long as some reasonable basis existed at the time. Additionally, a literal reading of Aranda illustrates that, unlike in Arnold, a failure to investigate, in and of itself, is not sufficient to state a claim of bad faith.

A further difference between Arnold and Aranda is that only Aranda is truly a two-pronged test. Specifically, the second prong of the Aranda test is connected to the first by the conjunctive "and" instead of the disjunctive "or" as in Arnold. This is not merely a grammatical difference without consequence. In Arnold, an insured can state a claim of bad faith by alleging that the insurer failed to meet either the first prong of the test or the second. Under Aranda, it is clear that the insured must prove both prongs of the test in order to prevail.

Implicitly, both the Arnold and Aranda formulations contain a third element—causation. In order to recover damages for breach of the duty of good faith and fair dealing, the insured must prove that the insurer's lack of good faith proximately caused damages to the insured. This is significant when it comes to recovery for mental anguish or emotional distress. Accordingly, the plaintiff must prove, by a preponderance of the evidence, that it was the insurer's conduct and not the underlying incident that proximately caused the extracontractual damages.

33. Id.
34. It is clear, however, that application of the Aranda test requires the plaintiff to make a showing above mere negligence. See Aetna Casualty & Sur. Co. v. Garza, 906 S.W.2d 543, 549-50 (Tex. App.—San Antonio 1995, no writ).
35. Aranda, 748 S.W.2d at 213.
36. Id.
37. Id.
38. As one appellate court has recently noted, "This simple change in phraseology from 'or' to 'and' set the stage for an effective dismantling of the bad faith cause of action." Columbia Universal Life Ins. Co. v. Miles, 923 S.W.2d 803, 807 (Tex. App.—El Paso 1996, writ requested).
39. See Aranda, 748 S.W.2d at 215.
What makes the *Aranda* decision confusing for Texas practitioners is the fact that the Texas Supreme Court never explained how the *Aranda* holding was supposed to effect the *Arnold* precedent. Specifically, the *Aranda* court never stated whether the new test for stating a claim of bad faith was supposed to replace, modify, or co-exist with *Arnold*. As illustrated above, the two formulations are clearly different and, thus, can produce varying results depending upon which test a court chooses to apply.

C. Choosing Between *Arnold* & *Aranda*

The confusion over the *Arnold*/*Aranda* dichotomy was illustrated in the case of *Automobile Insurance Co. v. Davila*, a case involving a wrongful denial of insurance benefits following a fire loss. In *Davila*, the plaintiffs alleged that the defendant insurer wrongfully denied insurance benefits following a fire loss. Specifically, the alleged bad faith conduct was the insurer’s failure to investigate beyond Mrs. Davila’s initial accusation that her husband set the fire. The defendant insurer "seized on the substance of the accusations and failed to look beyond them into the circumstances of the situation and recognize that the accusations could have been retaliatory or made in anger." The defendant insurer, Aetna, tendered a requested instruction that tracked the test as set forth in *Aranda*. The trial court, however, submitted an instruction that tracked the language in *Arnold*. As noted by the court, an essential difference between an instruction tracking *Aranda* as opposed to one tracking *Arnold* is the addi-

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40. The *Aranda* court ignored the one-year-old *Arnold* holding when announcing the new standard for first-party bad faith claims. Instead, the court relied on two cases from other states: Travelers Ins. Co. v. Savio, 706 P.2d 1258, 1272 (Colo. 1985); Anderson v. Continental Ins. Co., 271 N.W.2d 368, 376 (Wis. 1978). *Aranda*, 748 S.W.2d at 213.
41. Ashley, supra note 29, at 5.
42. See discussion infra part III.C.
43. 805 S.W.2d 897 (Tex. App.—Corpus Christi 1991, writ denied) (disapproved on other grounds).
44. Id. at 906 (emphasis added).
45. Aetna tendered the following instruction:
   You are instructed that there is a duty on the part of an insurance company to deal fairly and in good faith with those persons whom it insures. You are further instructed that, in order for the conduct of an insurance company in denying or delaying payment of a claim to constitute a failure to exercise good faith, it must be shown that the insurer denied or delayed payment of the claim at a time when it knew it had no reasonable basis for denying the claim or delaying the payment of the claim or the insurer failed to determine whether there was any reasonable basis for delay.
   *Id.* at 903-04.
46. The trial court submitted the following instruction:
   There is a duty on the part of an insurance company to deal fairly and in good faith with those persons whom it insures. You are further instructed that, in order for the conduct of an insurance company in denying or delaying payment of a claim to constitute a failure to exercise good faith, it must be shown that the insurer had no reasonable basis for denying the claim or delaying payment or the insurer failed to determine whether there was any reasonable basis for the delay.
   *Id.* at 903.
tional subjective element contained in the *Aranda* test. Aetna claimed that by not including the subjective element, it was deprived of a fair trial.

Although the appellate court expressly recognized that *Arnold* and *Aranda* set forth different standards for stating a claim of bad faith, it noted that both tests constitute correct statements of Texas law. The court did state, however, that the *Aranda* test "more specifically defines the elements of the cause of action for breach of good faith and fair dealing." Nevertheless, the court held that issuing an instruction that tracks *Arnold* does not constitute reversible error.

The *Davila* decision illustrates that a bad faith case can be won or lost by the instruction given to the jury. Clearly, the *Arnold* instruction was more beneficial to the Davilas in that failure to investigate, by itself, would have been actionable bad faith conduct. On the other hand, the *Aranda* formulation would have favored the defendant insurer because the failure to investigate, by itself, would not have been sufficient to state a claim for bad faith. Furthermore, application of the *Aranda* test increases the burden on the plaintiff by requiring a showing, by a preponderance of evidence, that the insurer had subjective knowledge that it was acting unreasonably.

Another case which demonstrates the confusion over which test to apply is *In re Texas Eastern Transmission Corp. PCB Contamination Insurance Coverage Litigation*. This case is interesting because it involved a federal district court judge sitting in Pennsylvania trying to predict how the Texas Supreme Court would resolve the differences between *Arnold* and *Aranda*. The plaintiff contended that *Arnold* set forth the exclusive test for stating a claim of bad faith in Texas. The court disagreed by noting that Texas courts have consistently applied both the *Arnold* and *Aranda* formulations. The court did, however, cite *Davila* to support the proposition that *Aranda* more specifically sets out the elements of the bad faith cause of action. Accordingly, the court dismissed the bad faith case.

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47. Id. at 904.
48. Id.
49. Id. But see Southland Lloyd's Ins. Co. v. Tomberlain, 919 S.W.2d 822, 829-30 (Tex. App.—Texarkana 1996, writ denied) (holding that use of "or" rather than "and" in jury instruction constituted reversible error). The current version of the *Texas Pattern Jury Charges* contains alternative instructions, one that tracks *Arnold* and one that tracks *Aranda*. 4 STATE BAR OF TEXAS, PATTERN JURY CHARGES PJC 103.02A, 103.02B (1993). The committee designated to draft the *Texas Pattern Jury Charges* is currently revising PJC 103.02. Based on decisions such as *Tomberlain*, it is doubtful that future revisions of PJC 103.02 will allow for alternative submissions.
50. This is a difficult burden to meet. Accordingly, a large number of bad faith cases tried under the *Aranda* test never reach a jury. See discussion infra part III.E.
51. No. MDL 764, 1992 WL 167984 (E.D. Pa. July 10, 1992). Texas Eastern sued 21 insurance companies under a CGL policy to try to recover future expenses for a governmentally mandated environmental cleanup. The case was originally brought in Texas, but was transferred by the Judicial Panel on Multidistrict Litigation to Pennsylvania for consolidation for pretrial purposes. Despite the transfer of venue, Texas law applied to all of the relevant issues.
52. Id. at *3.
53. Id.
claim, noting that an insurer's alleged failure to investigate, by itself, cannot support a bad faith judgment and that the plaintiff never alleged that the insurer lacked a reasonable basis for denying or delaying payment of the claim. Of significance under Aranda, according to the court, is the insurer's right to deny debatable or questionable claims without fear of being subjected to bad faith liability. The court further noted that "[a]llowing an insured to state a cause of action without alleging that no reasonable basis for denial or delay existed would effectively deny the insurer this important right."

D. Summary of the Current Law

Although the Davila holding appears to be a bright light for insureds, an examination of recent cases illustrates that Davila is nothing more than a flickering candle in the wake of hurricane force winds. Assuming that the Aranda test is the test used for stating a claim of bad faith in Texas, a plaintiff has the difficult burden of proving a negative proposition—that the carrier knew or should have known it had no reasonable basis for denying a claim.

Furthermore, as stated earlier, although the Aranda test sounds in negligence, the application of the test requires the plaintiff to prove conduct that goes beyond traditional notions of negligence. For example, under the Aranda test, an insurance adjuster can, without being subjected to bad faith liability, deny a claim where ten percent of the evidence points to noncoverage and the other ninety percent points to coverage. As one can see, a plaintiff has a difficult obstacle to overcome in proving that the insurer acted in bad faith. Accordingly, Texas courts have become

54. Id.
55. Id. at *4.
56. Id.
57. Although the Texas Supreme Court relied on the duty to investigate in Viles v. Security Nat'l Ins. Co., 788 S.W.2d 566 (Tex. 1990), it certainly appears clear that the "Arnold standard has since been subsumed by Aranda" and is of dubious validity standing alone. Columbia Universal, 923 S.W.2d at 807 n.3. In fact, none of the major reported cases over the last two years have applied the Arnold test by itself for stating a claim of bad faith. See, e.g., Republic Ins. Co. v. Stoker, 903 S.W.2d 338 (Tex. 1995); Transportation Ins. Co. v. Moriel, 879 S.W.2d 10, 18 (Tex. 1994); National Union Fire Ins. Co. v. Dominguez, 873 S.W.2d 373 (Tex. 1994); Lyons v. Millers Casualty Ins. Co., 866 S.W.2d 597 (Tex. 1993). However, in footnote two of the Lyons opinion, Justice Cornyn stated: "This case was tried under the Aranda formulation of the bad faith test, and we therefore restrict our analysis accordingly." Lyons, 866 S.W.2d at 600 n.2. A liberal reading of this statement could lead to the conclusion that the Texas Supreme Court was granting trial courts the leeway to tender instructions that track either the Arnold or Aranda test. See Ashley, supra note 29, at 5.
58. Dominguez, 873 S.W.2d at 376.
60. Although it is certainly true that an insurer's reason for denial cannot be merely pretext, Michael S. Quinn & L. Kimberly Steele, Insurance Coverage Opinions, 36 S. Tex. L. Rev. 479, 493 (1995), the fact that the Texas Supreme Court has broadly construed what constitutes "reasonable" conduct leads to the conclusion that this example would hold true even if the ratio was 99% to 1% as long as the insurer reasonably relied on that 1% of evidence in denying the claim.
increasingly more willing to dispose of bad faith claims as a matter of law by summary judgment and directed verdict.61

E. JUDGMENT AS A MATTER OF LAW

In Transportation Insurance Co. v. Moriel,62 the court noted that "[e]vidence that merely shows a bona fide dispute about the insurer's liability on the contract does not rise to the level of bad faith."63 Similarly, the court noted that "bad faith [is not] established if the evidence shows the insurer was merely incorrect about the factual basis for its denial of the claim . . . ."64 These findings demonstrate why plaintiffs are increasingly falling victim to judgments as a matter of law.65

When determining whether a material fact issue exists in a bad faith case, all evidence favorable to the nonmovant (i.e., the insured) is considered true, and all reasonable inferences are decided in the nonmovant's favor.66 While this standard sounds favorable for insureds, the reality is that an insurer, in order to prevail, must only prove the existence of a bona fide dispute:

Since the proponent of a bad faith claim has the burden of proving that there existed no reasonable basis for the insurer's action, the insurer may satisfy its summary judgment burden by establishing the existence of a reasonable basis for denial or delay, thus negating an essential element of plaintiff's claim.67

Furthermore, as stated earlier, the courts have taken a broad view of what constitutes a "bona fide" dispute. For example, in Packer v. Travelers Indemnity Co.,68 the court held that even the fact that the claims adjuster subjectively desired to deny the claim was not sufficient to overcome a motion for summary judgment as long as some reasonable reason for the denial existed.69 Accordingly, the court affirmed the summary judgment even though the plaintiff presented uncontroverted written proof that the adjuster purposefully tried to take advantage of the fact that the claimant was not yet represented by counsel.70

The court in Packer cited Lyons v. Millers Casualty Insurance Co.71 for

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61. Schubert, supra note 23, at N-1.
62. 879 S.W.2d 10 (Tex. 1994).
63. Id. at 17 (citing Dominguez, 873 S.W.2d at 376-77).
64. Id. at 18 (citing Lyons, 866 S.W.2d at 601).
68. 881 S.W.2d 172 (Tex. App.—Houston [1st Dist.] 1994, no writ).
69. Id. at 177.
70. Id.
71. 866 S.W.2d 597 (Tex. 1993).
the proposition that the focus of a bad faith claim is not on the contract issue of coverage, but rather on the reasonableness of the insurer’s conduct. Although Lyons is the seminal case discussing the proper scope of appellate review in bad faith cases, the Packer court noted that “its analysis is properly applied in a summary judgment case because the quantum of evidence necessary to raise a fact issue is the same in both contexts.”

As one can see, the plaintiff has a significant burden to overcome before passing the summary judgment stage of a bad faith cause of action. Even if the plaintiff survives a summary judgment or directed verdict and obtains a favorable jury verdict, the plaintiff must still face the daunting forces of appellate review.

F. A “PARTICULARIZED” APPROACH TO APPELLATE REVIEW

The scope of appellate review for bad faith cases has been a constant source of confusion for Texas courts. The confusion has centered around how to apply the traditional “no evidence” or “legal sufficiency” test to a negative proposition—that the insurer had no reasonable basis to deny or delay payment of a claim. The traditional application of a legal sufficiency review of a “no evidence” point of error permits the appellate court to “consider only the evidence and inferences tending to support the finding and disregard all evidence and inferences to the contrary.” This approach was followed by the Beaumont Court of Appeals in State Farm Fire & Casualty Co. v. Simmons, a first-party bad faith case involving a fire loss under a homeowner’s policy. In affirming judgment for the plaintiff, the appellate court noted that it cannot second guess the factfinder and, therefore, must affirm the decision of the trial court if there is some evidence of unreasonableness.

A very different view was taken by the San Antonio Court of Appeals in State Farm Lloyds v. Polasek, yet another fire loss claim. In reversing the bad faith portion of the case, the court noted that those courts who affirm trial court judgments on the basis that “some” evidence supports the jury verdict “have not correctly interpreted the nature of the bad faith cause of action set forth in Arnold and Aranda, in which the insured must negate the existence of a reasonable basis for denying or delaying payment.” The correct standard, according to the Polasek court, requires that a plaintiff “prove that there were no facts before the insurer which, if

72. Packer, 881 S.W.2d at 174 (citing Lyons, 866 S.W.2d at 601).
73. Id.
74. Lyons, 866 S.W.2d at 600.
75. Alm v. Aluminum Co. of Am., 717 S.W.2d 588, 593 (Tex. 1986) (citing Garza v. Alviar, 395 S.W.2d 821, 823 (Tex. 1965)).
76. 857 S.W.2d 126 (Tex. App.—Beaumont 1993, writ denied).
77. Id. at 132.
78. 847 S.W.2d 279 (Tex. App.—San Antonio 1992, writ denied).
79. Id. at 286.
believed, would justify denial of the claim."80 Furthermore, the court reaffirmed the proposition that the seminal issue in a bad faith action "is whether there was evidence in existence before [the insurer] . . . not whether [the insurer] correctly evaluated the evidence before it."81 Essentially, the court's holding stands for the proposition that a bad faith judgment cannot be affirmed upon a showing that "some" evidence supports the jury's verdict since the total absence of any reasonable basis implicitly requires that there be no evidence before the insurer that, if believed, would support denial of recovery.82

In an attempt to clarify the standard, the Texas Supreme Court granted writ in Lyons,83 and the court's subsequent decision has been called "the most significant decision penned by the Texas Supreme Court concerning the duty of good faith and fair dealing since Arnold and Aranda."84 The case involved a bad faith suit arising out of an insurer's refusal to pay a homeowner's claim made after a windstorm damaged her home. Following the denial of the claim, the insured initiated a lawsuit alleging breach of contract, violation of the Texas Deceptive Trade Practices Act (DTPA), violation of the Texas Insurance Code, and breach of the duty of good faith and fair dealing.

In addition to finding that the insurer violated the DTPA, the jury also found that the insurer had breached its duty of good faith and fair dealing. The trial judge rendered judgment on the verdict in the amount of $89,950. The court of appeals, however, reversed and held that there was no evidence of a breach of the duty of good faith and fair dealing or a violation of the DTPA. The case presented the Texas Supreme Court with the opportunity to articulate the proper scope of appellate review in bad faith cases.

The Texas Supreme Court held that "when a court is reviewing the legal sufficiency of the evidence supporting a bad faith finding, its focus should be on the relationship of the evidence arguably supporting the bad faith finding to the elements of bad faith."85 Essentially, the court rejected the reasoning of the Simmons court that it should only look to the evidence supporting the judgment.86 Instead, the court held that an ap-

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80. Id. at 284 (emphasis added).
81. Id. at 285.
82. Id. The court further noted that "[w]here there is undisputed evidence that a reasonable basis existed for denying an insurance claim, the bad faith cause of action is defeated as a matter of law." Id. at 284 (emphasis in original). In Simmons, the court harshly referred to the Polasek opinion as being "the beginning of the end of a common law cause of action against insurers for bad faith" and that the holding effectively "whittle[s] away yet another avenue of recourse for the people." Simmons, 857 S.W.2d at 142.
83. 866 S.W.2d 597 (Tex. 1993).
85. Lyons, 866 S.W.2d at 600.
86. Interestingly, the Beaumont Court of Appeals, which wrote the Simmons opinion, recently narrowed the holding: "We view Simmons as narrowly restrictive to those cases where an insurer wholly disregards its obligation to its insured in pursuit of the insurer's self-serving interest." Connolly, 910 S.W.2d at 562.
pellate court must focus its attention on the reasonableness of the insurers conduct in denying or delaying payment of the claim.87

Although the decision appears to adopt a standard close to the one articulated in Polasek, the Lyons approach is not as extreme.88 Whereas the court in Polasek focused on the mere existence of evidence negating coverage,89 the Lyons court recognized that evidence of coverage "might in some circumstances support a finding that an insurer lacked any reason-able basis for denying a claim . . . when the insurer unreasonably dis-regards the evidence of coverage."90 This is significant in that the court affirmatively recognized that the mere existence of evidence calling coverage into question will not automatically defeat bad faith liability.91 Despite this, some courts apparently still rely on the stricter test set forth in Polasek.92 Furthermore, the Texas Supreme Court’s current tendency to closely scrutinize first-party bad faith claims suggests that it would affirm a lower court’s reliance on the stricter Polasek standard.

The Lyons majority labeled their approach to appellate review a “particularized application” of the traditional no evidence rule.93 In a strong dissent, three justices accused the majority of “unprecedented disregard of [the Texas] [C]onstitution and over a century of jurisprudence.”94 Specifically, the dissent argued that the majority’s “particularized” approach to no evidence review is nothing more than a “device by which this Court can circumvent the Constitution to consider the credibility and weight of the evidence, something known until now only by its true name—a factual sufficiency review.”95 According to the dissent, as long as more than a mere scintilla of evidence supports a jury’s verdict, the claim is sufficient as a matter of law.96

Under the majority’s approach, however, an appellate court is permitted to weigh the evidence in order to determine whether the insurer’s conduct was reasonable. Determining reasonableness, as the dissenters point out, has always been an issue for a jury to decide.97 Despite these

87. Lyons, 866 S.W.2d at 601.
88. Maxwell & Labadie, supra note 84, at 1358.
89. Polasek, 847 S.W.2d at 284.
90. Lyons, 866 S.W.2d at 601 (emphasis added).
91. In other words, the Lyons court recognized that “reasonableness goes to the sub-stance of the evidence supporting the insurer’s basis, not to the transaction when viewed as a whole.” Columbia Universal, 923 S.W.2d at 809.
93. Lyons, 866 S.W.2d at 600.
94. Id. at 603 (Doggett, J., dissenting). The dissenting justices commented on the Texas Supreme Court’s apparent pro-insurer posture: “When an unequivocal constitutional command and concern for the insurance industry collide in this Court, the outcome is no longer in doubt.” Id. at 602.
95. Id.
96. Id. Not surprisingly, the dissenters cited the Simmons case with approval. Id. at 603 n.2.
97. Id. at 603.
constitutional attacks, the Lyons approach has taken a firm hold. Furthermore, although there is a motion for rehearing pending on the denial of writ in Simmons, there is nothing to suggest that the court will give further credence to the constitutional challenges.

It seems clear that a synthesis of Lyons, Dominguez, and Moriel stands for the proposition that Texas has firmly adopted a bona fide dispute standard whereby a court must undertake a two-part analysis. First, the court must determine the basis or potential basis relied upon by the insurer in denying the claim. Second, the court must conduct a “qualitative evaluation of that basis to determine whether an insurer could reasonably rely on it.” Although it is uncontroversial that the existence of a bona fide dispute will result in a finding of no liability on the part of the insurer, the courts have not elaborated on what type or amount of evidence is sufficient to constitute a bona fide dispute. Nevertheless, even without clearly-defined parameters, application of the bona fide dispute standard in conjunction with the Aranda test will result, more often than not, in a judgment of no bad faith liability.

IV. BAD FAITH IN THE ABSENCE OF COVERAGE

In the past few years, the Texas Supreme Court has had the opportunity to address the issue of whether an insurer can breach its duty of good faith and fair dealing toward its insured when the insured’s claims are not covered under the insurance policy. Resolution of this issue turns on whether one believes the duty of good faith and fair dealing extends to cover all interactions between an insurer and its insured, or alternatively, whether the duty stems only from those interactions involving covered claims.

A. THE VILES CASE

The issue of bad faith in the absence of coverage was first addressed by the Texas Supreme Court in Viles v. Security National Insurance Co. William and Mary Viles filed a claim under their homeowner’s insurance policies for moisture damage to their home. The damage had been discovered during a routine inspection of the home in connection with a planned sale of the house. The Viles family promptly notified their insurance agent of the damage, but failed to submit a sworn proof of loss state-

98. The Texas Supreme Court reaffirmed the Lyons approach in National Union Fire Ins. Co. v. Dominguez, 873 S.W.2d 373, 376 (Tex. 1994). In Dominguez, Justices Doggett and Gammage renewed their dissent, noting that “[t]he majority’s similar contemporaneous writing in Lyons . . . offers no more support for today’s opinion than the converse.” Id. at 377 n.1. Justice Hightower, however, abandoned his dissent in Lyons and joined the majority.

99. Columbia Universal, 923 S.W.2d at 810.

100. Id.

101. For example, the court in Columbia Universal noted that the Lyons opinion “[t]hough seemingly logical on its face . . . does little to clarify what evidence is relevant to the question of reasonableness.” Id. at 809.

102. 788 S.W.2d 566 (Tex. 1990).
ment within the applicable time limit stated in the insurance contract. Nevertheless, an agent of the insurance company had already inspected the home and determined that moisture damage was attributable to a shower leak that predated coverage. The insurer denied the claim before the applicable time limit for filing the sworn proof of loss expired. The result of the denial was that the house sold for nearly half of the original contract price.

The Viles family filed a claim against the insurer for breach of contract and breach of the duty of good faith and fair dealing. After a jury trial, the judge entered judgment for William and Mary Viles, including an award for punitive damages. The court of appeals reversed and held that a failure to comply with a contract condition was controlling as to the question of breach of the duty of good faith and fair dealing. The Texas Supreme Court granted writ to determine whether an insurer can breach the duty of good faith and fair dealing when, ultimately, no coverage is due under the policy because of a procedural default.

The majority, quoting Arnold, noted that the duty of good faith and fair dealing "emanates not from the terms of the insurance contract, but from an obligation imposed in law 'as a result of a special relationship between the parties governed or created by a contract.'" The court concluded that while a failure to comply with a contract condition may be of evidentiary value in that it may constitute a reasonable basis for denial of a claim, "a breach of the duty of good faith and fair dealing will give rise to a cause of action in tort that is separate from any cause of action for breach of the underlying insurance contract.'" Essentially, the Viles court affirmatively recognized that the viability of a bad faith claim does not depend upon coverage in the underlying policy. As for the evidentiary value of the procedural default of coverage, the court held that because the insurer had denied its insureds' claim prior to the expiration of the applicable time limits, they could not rely on it as a basis for denial.

Evidently, the timing of the denial was important to the majority in Viles. Specifically, the majority stated that "[w]hether there is a reasonable basis for denial . . . must be judged by the facts before the insurer at the time the claim was denied." Although not explicitly stated in the Viles opinion, one can infer that the holding may have been different had the insurer waited to deny the claim until after the applicable time limit had expired.

The concurring opinion expressed concern that the holding would be misconstrued as adopting a broad policy of permitting bad faith actions in the absence of coverage. Indeed, the broad language used in the majority opinion certainly adds credence to that concern. The concurring justices,

103. Id. at 567 (quoting Arnold, 725 S.W.2d at 167).
104. Id.
105. Id. at 568.
106. Id. at 567 (emphasis added).
however, joined the majority because they agreed that the insurer had waived the proof of loss defense. Therefore, and for only that reason, a cause of action for breach of the duty of good faith and fair dealing could exist. The concurrence accused the majority, however, of contriving the facts to comport with its own agenda:

It is . . . unnecessary, unwise and improper for the Court to hold, as it does, "that a breach of the duty of good faith and fair dealing will give rise to a cause of action in tort that is separate from any cause of action for breach of the underlying insurance contract." Arguably, the concurring justices believed that the viability of a bad faith cause of action depends on the existence of coverage at the time of the bad faith conduct.

B. Post-Viles Interpretation

Apparently, the concern of the concurring justices in Viles that the decision would be misinterpreted was well founded. The Fifth Circuit, in First Texas Savings Ass'n v. Reliance Insurance Co., was faced with the issue of whether Texas law permits bad faith liability in the absence of coverage. The case involved a savings association which brought suit against its insurer for refusing to cover losses suffered in a check-kiting scheme. On appeal, the Fifth Circuit held that the plaintiff's loss fit within the loan exclusion clause of the insurance contract. Having negated coverage, the court was then faced with the issue of whether the plaintiff could still recover damages based on the district court's findings that the insurer breached its duty of good faith and fair dealing. The Fifth Circuit interpreted Viles as allowing an insured to recover damages in the absence of policy coverage "because the obligations made enforceable by . . . the common law duty of good faith and fair dealing are imposed independent of the duties under the policy itself . . . ."

Two years later in Meridian Oil Production, Inc., v. Hartford Accident & Indemnity Co., the Fifth Circuit again faced the issue of whether a plaintiff can bring a bad faith cause of action against an insurer where there is no coverage under the policy. This time, however, the court refused to rely on its previous interpretation of Viles. Instead, the court declined to address the issue because the Texas Supreme Court had recently granted a writ of error to hear Stoker, which, according to the Fifth Circuit, "squarely addresses the question of whether an extra-contractual bad faith claim can exist when coverage is lacking."

Even prior to granting writ in Stoker, however, the Texas Supreme Court hinted that the Viles holding was narrowly limited to its facts. Spe-

107. See id. at 568-69 (Hecht, J., concurring).
108. Id. at 568.
109. 950 F.2d 1171 (5th Cir. 1992).
110. Id. at 1179.
111. 27 F.3d 150 (5th Cir. 1994).
112. See id. at 152.
113. Id. at 153 n.4.
specifically, one can infer from the court's denial of a writ of error in *Koral Industries v. Security-Connecticut Life Insurance Co.*\(^{114}\) that the broad post-*Viles* interpretations of bad faith liability in the absence of coverage were incorrect. In *Koral*, the plaintiff claimed that Security-Connecticut Life Insurance had breached its duty of good faith and fair dealing in its handling of a life insurance policy. The defendant insurer raised a fraudulent misrepresentation defense to coverage.\(^{115}\) The jury found that plaintiff had indeed made false representations. Despite this jury finding, the trial court rendered judgment for plaintiff. The court of appeals, however, reversed the judgment and held that a defense of fraudulent misrepresentation negated any breach of the duty of good faith and fair dealing.

**C. THE STOKER DECISION**

The *Stoker* case arose out of a multi-car accident in which the Stokers' automobile hit another vehicle as it was trying to avoid a piece of furniture that had fallen onto the highway from an unidentified pickup truck. The Stokers filed a claim with their uninsured motorist carrier, but it was denied due to the insurer's conclusion that Mrs. Stoker was more than fifty percent at fault. Following this denial, the Stokers filed suit alleging breach of the duty of good faith and fair dealing and various statutory violations. Specifically, the suit alleged that the insurer gave an invalid and unreasonable reason for denying their claim.\(^{116}\) Republic, the uninsured motorist carrier, responded with a motion for summary judgment that asserted, for the first time, that the reason for denial was predicated on the fact that there was no physical contact between the unidentified vehicle and the Stoker vehicle. Physical contact was a requirement for coverage under the Stokers' policy. In response to this, the trial court granted summary judgment on the contract issue, but allowed the Stokers to continue their bad faith action against the carrier. The jury returned a verdict in favor of the Stokers.\(^{117}\) Republic appealed the decision on the grounds that there can be no bad faith liability in the absence of coverage.

The El Paso Court of Appeals held that *Viles* was directly on point and that Republic's failure to conduct a reasonable investigation was actionable bad faith conduct regardless of coverage:

Where that investigation does not include inquiries generally considered essential, or where it applies erroneous standards of fault and liability, the insurer's denial of a claim can be an independent breach

\(^{114}\) 802 S.W.2d 650 (Tex. 1990).

\(^{115}\) The insurer alleged that the plaintiff fraudulently misrepresented his health in order to obtain insurance. *Koral*, 802 S.W.2d at 650-51.

\(^{116}\) It was undisputed that at the time of the denial, the adjuster had not reviewed the police records or talked with any of the witnesses to the accident. Republic Ins. Co. v. Stoker, 867 S.W.2d 74, 76 (Tex. App.—El Paso 1993), rev'd, 903 S.W.2d 338 (Tex. 1995).

\(^{117}\) The jury found that Republic had breached its duty of good faith and fair dealing, had engaged in unfair or deceptive acts, had not attempted to effectuate an equitable settlement, and had generally behaved unconscionably. *Id.* Furthermore, the jury found that Republic did all of the above acts knowingly. *Id.*
of good faith and fair dealing, even where another reason for denying the claim is later discovered to justify the denial.\(^{118}\)

The appellate court justified this conclusion on several grounds. First, the court reasoned that Republic's actions of quickly denying the claim without conducting an adequate investigation was exactly the sort of claim denial that extracontractual causes of action are designed to discourage.\(^{119}\) Second, the court noted that an insured should be able to rely on the insurer's stated grounds for denial of their claim so that they can make reasoned decisions about pursuing a claim in court.\(^{120}\)

The lone dissent filed by Justice Koehler mimicked the concern of the concurring justices in *Viles*. Justice Koehler noted that "under *Viles* and the majority reasoning herein, you will hope that when suffering a non-covered loss, the company claims representative, when denying your claim, is rude and gives you some cockamamie or wrong reason for not honoring your claim."\(^{121}\) Additionally, Justice Koehler stated that the very fact that the Stokers' claim was not covered under the applicable policy gives the insurance company a reasonable basis to deny the claim.\(^{122}\)

The Texas Supreme Court granted writ presumably to decide, once and for all, whether a bad faith cause of action exists in the absence of coverage. Upon review, the Texas Supreme Court reversed the lower court and held that "[a]s a general rule there can be no claim for bad faith when an insurer has promptly denied a claim that is in fact not covered."\(^{123}\) In reaching this holding, the court did not overrule *Viles*, but rather distinguished it on the basis that the Stokers' accident, unlike the claim made by the Vileses, was never covered by their insurance policy.\(^{124}\) The *Stoker* court, like the *Viles* court, held that the time of denial is the crucial focal point.\(^{125}\) Accordingly, the court concluded that although the insurer used an erroneous excuse to deny the claim, a reasonable insurer would have denied the claim based on the valid exclusion.\(^{126}\)

To bolster their holding that there can be no bad faith in the absence of coverage, the court pointed to the *Aranda* test for stating a claim of bad faith. Recall that the first part of the *Aranda* test deals with the reasona-

\(^{118}\) *Id.* at 79.

\(^{119}\) *Id.*

\(^{120}\) *Id.* at 80. The dissent filed by Justice Koehler dismissed the reliance justification in the majority's opinion by reminding the court that the insured's attorney also has an affirmative duty to read the policy and investigate the facts to determine the validity of the claim. *Id.* at 81 (Koehler, J., dissenting).

\(^{121}\) *Id.* at 80 (Koehler, J., dissenting).

\(^{122}\) *Id.* at 81.

\(^{123}\) Republic Ins. Co. v. Stoker, 903 S.W.2d 338, 341 (Tex. 1995). See also Liberty Nat'l Fire Ins. Co. v. Akin, 927 S.W.2d 627, 629 (Tex. 1996) ("But, in most circumstances, an insured may not prevail on a bad faith claim without first showing that the insurer breached the contract.").

\(^{124}\) *Stoker*, 903 S.W.2d at 340.

\(^{125}\) *Id.*

\(^{126}\) *Id.*
bleness of denying or delaying payments due under a policy. The Stoker court interpreted this part as shielding the insurer from liability for erroneously denying a claim so long as a reasonable basis exists at the time of the denial. Because the court concluded that a reasonable insurer would have denied the Stokers' claim for the right reason, the court held that the Stokers failed to satisfy the Aranda test.

As in Viles, there was a concurrence which expressed concern over the majority's broad language. The justices concurred on the basis that the Stokers had not suffered any damages as a result of the insurer's conduct, but they strongly disagreed with the majority's proposition that bad faith liability is tied to the existence of coverage. The concurring justices feared that the Stoker decision will encourage insurers to deny claims for erroneous reasons in the hopes that a valid reason will later surface.

The major thrust of the concurrence is that the Stoker majority ignores the fact that bad faith is an independent tort and instead focuses entirely on the contractual issue of coverage:

The majority today alters [the] basic principle [that a bad faith claim is not a claim for breach of contract] by making the Stokers' bad faith recovery dependent on their claim for breach of contract. In thus recasting the bad faith claim, the majority adopts a view that completely disregards the relationship between an insurance company and its insureds.

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127. Aranda, 748 S.W.2d at 213.
128. Stoker, 903 S.W.2d at 340; see also Lyons, 866 S.W.2d at 600.
129. Stoker, 903 S.W.2d at 341. ("The Stokers' claim fails because, as a matter of law, they cannot meet the first prong of the Aranda test."). In addition to Aranda, the court cited various other authorities to support their conclusion that there can be no bad faith liability in the absence of coverage. Id. (citing Wittmer v. Jones, 864 S.W.2d 885, 890 (Ky. 1993)) (noting that in order to establish a tort action for bad faith the insured must first prove that the insurer was obligated to pay under the policy); Bartlett v. John Hancock Mut. Life Ins. Co., 538 A.2d 997, 1000 (R.I. 1988) ("there can be no cause of action for an insurer's bad faith refusal to pay a claim until the insured first establishes that the insurer breached its duty under the contract of insurance"); OSTRAGER & NEWMAN, INSURANCE COVERAGE DISPUTES § 12.01, at 503 (7th ed. 1994) ("The determination of whether an insurer acted in bad faith generally requires as a predicate a determination that coverage exists for the loss in question."); 15A GEORGE J. COUCH, COUCH CYCLOPEDIA OF INSURANCE LAW § 58:1, at 249 (Ronald A. Anderson & Mark S. Rhodes eds., rev. 2d ed. 1983) ("As a general rule, there may be no extra-contractual recovery where the insured is not entitled to benefits under the contract of insurance which establishes the duties sought to be sued upon.").
130. William T. Barker, an insurance litigation specialist who believes that bad faith liability should not exist absent coverage states that "bad faith conduct, standing alone, does not give rise to bad faith liability: at a minimum, liability requires some form of damage to the insured resulting from the conduct." William T. Barker, Bad Faith Liability Without Coverage: A Reply to Rossi (Oct. 26, 1995) (emphasis in original) (unpublished manuscript, on file with the SMU Law Review).
131. Stoker, 903 S.W.2d at 342 (Spector, J., concurring).
132. Id. at 345 (Spector, J., concurring). Furthermore, the justices felt that "[f]ine print in an insurance policy should not excuse an insurer from liability for damages caused by its slipshod handling of a claim." Id. at 342.
133. Id. at 343.
The concurrence further added, "Because the duty of good faith and fair dealing arises from the [special] relationship between the parties, rather than the terms of the contract, a breach of the duty does not depend on a breach of the contract's terms." Interestingly, the majority in Stoker agreed with the principle that a bad faith claim is independent of a policy claim; however, they noted that permitting liability in the absence of coverage does not necessarily follow. In other words, on the one hand the Stoker majority recognized that bad faith issues and contract issues are independent, but on the other hand, they held that a bad faith claim is dependent on contract coverage.

D. Reconciling Viles and Stoker

Both the Viles court and the Stoker court agree that the focal point of bad faith analysis is at the time of denial. Where the two holdings appear to split ideologically centers on whether the "reasonableness" of the denial should be judged on a subjective or objective basis. Under a broad reading of Viles, an insurer who denies a claim based on erroneous reasons still may be subject to liability even if a valid reason for denial exists. Under Stoker, however, the mere existence of a valid reason for denial purportedly shields the insurer from liability despite the fact that the insurer is unaware of the valid reason.

Despite this difference, the Stoker decision did not overrule Viles, but rather limited it to its facts. Accordingly, Viles remains good law in that an insurer is still subject to bad faith liability if the bad faith conduct occurred prior to a procedural default of coverage.

E. Should Texas Allow Bad Faith in the Absence of Coverage?

Having recognized that a "special relationship" exists between an insurer and its insured, should the duties flowing from this special relationship apply only when the insured files a covered claim? It is certainly not surprising that the answer to this question differs depending on whether one looks through the eyes of the insurer or through the eyes of the insured.

The insurer's perspective is that the duty of good faith and fair dealing is designed to protect the insured's interest in receiving the benefits bargained for in the insurance contract. The rationale behind denying bad faith liability in the absence of policy coverage is that there can be no economic harm for the mishandling of a claim if the proper handling of

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134. Id.
135. Id. at 340-41. This principle was recognized both in Viles and in Moriel. "[C]laims for insurance contract coverage are distinct from those in tort for bad faith; resolution of one does not determine the other." Moriel, 879 S.W.2d at 18 n.8 (emphasis added).
136. Viles, 788 S.W.2d at 567; Stoker, 903 S.W.2d at 340.
137. Arnold, 725 S.W.2d at 167.
the claim would have resulted in the same outcome. This view does not discount the existence of a special relationship, but rather asserts that the absence of economic harm negates the need for a cause of action.

Insureds, on the other hand, view the duty of good faith and fair dealing in a broader sense. They believe that an insurer must act fairly and in good faith regardless of the merits of the underlying insurance claim. One proponent of bad faith in the absence of coverage has stated that “[t]he insurance industry must appreciate the special role it plays in American society, and its quasi-public nature, and understand that its breach of the covenant of good faith and fair dealing, even in the absence of coverage, can have serious consequences upon a person . . . .”

While it is uncontroverted that insurers hold a special role in American society, whether or not their mishandling of a noncovered claim should result in tort liability is legitimately debatable. One proposed reason for permitting liability in the absence of coverage is detrimental reliance. In Stoker, the plaintiff argued that she should have been entitled to rely on Republic's original and incorrect reason for denying the claim in deciding whether to file suit. The Texas Supreme Court, however, rejected this argument by stating that “[t]he Stokers cannot preclude Republic from relying on a reason for denying their claim that existed at the time, even if it was not the reason Republic gave.”

Although this result, on its face, is arguably unfair, one must remember that the insured and his or her attorney also have a duty to read the policy language and investigate the merits of a claim prior to initiating a lawsuit. It follows, therefore, that if the insureds knew or should have known that the claim was not covered under the policy, they should be denied recovery.

While permitting liability in the absence of coverage has been highly criticized, one narrow exception to the general rule has been recognized. This exception is best illustrated by the Arizona Supreme Court case of Rawlings v. Apodaca. In Rawlings, a fire damaged property on a farm owned by David and Elizabeth Rawlings. The Rawlings family suspected that the fire was caused by the negligence of their neighbors—the Apodaca. The Rawlings family had a $10,000 homeowner's policy covering the

139. Id. at 3. In support of this proposition, the authors state that “a determination of no coverage means that the insurer did not commit bad faith.” Id.


141. Recall that the majority opinion in the appellate court felt that an insured should be able to rely on the insurer's stated grounds for denying a claim. Stoker, 867 S.W.2d at 80. The court noted that “to hold otherwise vitiates the tort by allowing the insurer to escape liability under any theory that allows it to avoid payment, . . . no matter how weak the earlier theory that is abandoned.” Id. (citing Viles, 788 S.W.2d 566 (Tex. 1990)).

142. Stoker, 903 S.W.2d at 341.

143. Stoker, 867 S.W.2d at 81 (Koehler, J., dissenting).

144. 726 P.2d 565 (Ariz. 1986).
barn with Farmers Insurance Co. Shortly after the fire, the Rawlingses filed a claim with Farmers, which hired an investigation firm to determine the exact cause of the fire. The Rawlings family notified Farmers that their loss exceeded the $10,000 coverage and that they would be pursuing a personal claim against the Apodacas for the uninsured portion of the loss. The Rawlings family specifically asked Farmers if they needed to hire their own investigators. Farmers responded by telling the Rawlings family that they would be provided with copies of all the investigation reports prepared by Farmers' investigators.

Ultimately, the investigation revealed that the Apodacas were in fact at fault in the fire. However, during the pendency of the investigation, Farmers discovered that the Apodocas were also insured by Farmers and that their policy had $100,000 liability limits. Fearing that the Rawlings family would make a claim covered under the Apodocas' policy, Farmers refused to turn over the investigation reports to the Rawlings family as promised. In response to this refusal, the Rawlings family sued Farmers for bad faith, arguing that Farmers' conduct made the Rawlings family's situation worse with respect to their uncovered claim against the Apodacas.

The trial court awarded the Rawlings family $1000 in compensatory damages and $50,000 in punitive damages. The court of appeals, however, reversed the bad faith claim on the grounds that a first-party bad faith action could not be maintained when there is no allegation that the insurer denied or delayed payment of the Rawlings family's insurance claim. The Arizona Supreme Court granted review to address the issue of whether an insurer commits bad faith by impeding its insured's recovery of the uninsured portion of the loss.

The Arizona Supreme Court recognized that an insured is not entitled to either payment of claims that are not covered or to receive any services or protections beyond the scope of the insurance contract; however, the court affirmatively recognized that the implied duty of good faith and fair dealing "entitle[s] the insured to insist that . . . the insurer not provide the promised protection with one hand while destroying the very objects of the relationship with the other."145 The Arizona Supreme Court, therefore, affirmed the bad faith judgment.

In recognizing bad faith liability in the absence of coverage, the court stated that "the insurance contract and the relationship it creates contain more than the company's bare promise to pay certain claims when forced to do so; implicit in the contract and the relationship is the insurer's obligation to play fairly with its insured."146

The question after Rawlings was how broadly to apply the exception. Specifically, did the Rawlings exception open the door to any bad faith claim in the absence of coverage, or is the exception limited to cases

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145. Id. at 571.
146. Id. at 570.
where the insurer's conduct causes some injury that is separate and independent from the nonpayment of the claim?

The Arizona Supreme Court answered this question in *Deese v. State Farm Mutual Automobile Insurance Co.* by stating:

We reaffirm our holding in *Rawlings* . . . that a plaintiff may simultaneously bring an action both for breach of contract and for bad faith, and need not prevail on the contract claim in order to prevail on the bad faith claim, provided plaintiff proves a breach of the implied covenant of good faith and fair dealing.

The plaintiffs in *Stoker* relied on *Deese* to urge the Texas Supreme Court to recognize bad faith liability in the absence of coverage. The Texas Supreme Court, however, distinguished *Deese* by noting that it did not involve an insurer denying a claim not covered by the policy, as in *Stoker*, but rather involved a covered claim with an argument over the reasonableness of medical bills. Although the Texas Supreme Court rejected the application of *Deese*, it implicitly recognized a narrower version of the *Rawlings* exception: "We do not exclude . . . the possibility that in denying the claim, the insurer may commit some act, so extreme, that would cause injury independent of the policy claim." In other words, the *Stoker* court seemingly recognized that if an insurer's actions rise to the level of an independent tort, such as intentional infliction of emotional distress, slander, defamation, or the like, the viability of the independent claim would not depend on the existence of coverage.

At least one court has held that the dicta in *Stoker* is not limited to *Rawlings*-type cases. In *SnyderGeneral Corp. v. Century Indemnity Co.*, the court held that "*Stoker* does not deprive SnyderGeneral of its right to pursue an Insurance Code violation" and that "*Stoker* also appears to preserve a failure to investigate claim in at least some situations where the insurer ultimately denies coverage on a proper ground." The court relied on those rationales to hold that Century was not entitled to summary judgment on the bad faith claim even though there was no policy coverage. The significance of this decision, however, is limited by the fact that it was decided in a federal district court rather than a Texas state court. Furthermore, there has been no reported state court opinion in which a court has allowed an insured to maintain a claim for an insurer's breach of the duty of good faith and fair dealing despite a

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148. *Id.* at 1270.
149. *Stoker*, 903 S.W.2d at 341 n.1.
150. *Id.; see also Howard v. INA County Mut. Ins. Co.*, 933 S.W.2d 212, 217 (Tex. App.—Dallas 1996, no writ).
151. Because the plaintiff's claim would be for some independent injury not related to the insurance contract, the *Rawlings*-type case is not a true exception to the rule against bad faith liability in the absence of coverage. Rather, it provides a plaintiff with an avenue to side-step the proscription of bad faith liability in the absence of coverage.
153. *Id.* at 1006.
154. *Id.*
finding that there was no viable coverage claim.\textsuperscript{155}

Ultimately, absent actions that rise to the level of an independent tort, rejecting bad faith recovery in the absence of coverage rests on sound principles. First, as stated earlier, a valid coverage defense is a \textit{per se} reasonable basis to deny a claim. Second, an insured who is not entitled to coverage is not economically harmed by an insurer’s reliance on an erroneous reason to deny the claim. Third, although permitting bad faith liability in the absence of coverage might serve to deter certain conduct on the part of the insurer, the policyholders will be forced to pay higher premiums to compensate for the increased litigation that is certain to accompany such a rule.

V. REMEDIES FOR BAD FAITH

The issues discussed above primarily address the legalities and parameters of the bad faith cause of action. Determining the proper basis for providing a remedy to a bad faith plaintiff, on the other hand, is more of an academic debate. As such, the debate among scholars has centered primarily on whether tort damages or contract damages should be used to compensate successful plaintiffs.

A. \textit{Tort Damages vs. Contract Damages}

Prior to the recognition of an independent tort for breach of the duty of good faith and fair dealing, an aggrieved insured was limited to a cause of action for breach of contract.\textsuperscript{156} Accordingly, the insured could recover only up to the amount owed under the policy plus any provable consequential damages.\textsuperscript{157} Consequential damages are damages that naturally arise from the breach and are foreseeable at the time of contracting.\textsuperscript{158} In other words, in addition to being foreseeable, an insured had the burden of causally linking the damages to a breach of the duty of good faith and fair dealing.

Some proponents of contract damages argue that a conflict in a first-party setting is nothing more than a disagreement about the terms of an insurance contract, and, therefore, tort analysis is unnecessary.\textsuperscript{159} Other proponents of contract damages argue that “[c]ontract remedies are not inherently incapable of redressing the kinds of losses and injuries frequently suffered by insureds when insurers fail to perform their obligations.”\textsuperscript{160} Notwithstanding the proposition that contractual remedies are

\begin{thebibliography}{99}
\item \textsuperscript{156} Ails, supra note 17, at 1320.
\item \textsuperscript{157} See, e.g., Spencer v. Aetna Life & Casualty Ins. Co., 611 P.2d 149, 151 (Kan. 1980).
\item \textsuperscript{158} Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854).
\item \textsuperscript{159} William Powers, Jr., \textit{Border Wars}, 72 Tex. L. Rev. 1209, 1230 (1994).
\end{thebibliography}
sufficient to deter bad faith conduct on the part of insurers, one problem with limiting bad faith recovery to contractual remedies is that contract theory promotes efficient breach. Under the efficient breach doctrine, if it is economically advantageous for one party to breach the contract, the law should not deter the breach. The efficient breach doctrine, therefore, would allow, if not encourage, an insurer to deny the claim and then play a wait-and-see game with the insured. Furthermore, during this wait-and-see period, the insured would often be left financially unable to remedy his or her loss while the insurer, on the other hand, would be able to retain the insurance premiums and invest them as it sees fit. Additionally, the first-party insurance framework involves certain human factors that are missing in ordinary business transactions. For example, while the efficient breach doctrine may be properly applied in a commercial setting, its application to an insured who has just suffered a personal loss is troubling. Opponents of restricting bad faith recovery to contractual remedies argue that contract law, by its very nature, is simply not designed to effectively regulate the actions of insurers. These opponents argue that tort damages are inherently more broad than contract damages and, therefore, provide a better source for both compensating the victim and deterring the wrongdoer. Specifically, the availability of recovery for mental anguish and emotional distress coupled with the possibility of punitive damages overrides the theoretical application of the

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161. See E. Allan Farnsworth, Contracts 847 (2d ed. 1990).
162. This discussion highlights a theoretical problem with applying contract theory to the tort of first-party bad faith. This application should not be misconstrued, however, as standing for the proposition that insurance companies purposefully deny valid claims because they know that there is a substantial chance that the insured, whether it be from unsophistication or financial strain, will not pursue litigation against them.
163. Admittedly, the insurer will have to pay a victorious insured prejudgment interest, however, if commercial interest rates exceed legal rates during the wait-and-see period, the insurer will profit from its breach. See Kerry L. Macintosh, Gilmore Spoke Too Soon: Contract Rises from the Ashes of the Bad Faith Tort, 27 Loy. L.A. L. Rev. 483, 531 (1994) (noting that if the only damages available to the insured are the amount due under the policy plus interest, the insurer “has every interest in retaining the money, earning the higher rates of interest on the outside market, and hoping eventually to force the insured into a settlement for less than the policy amount”).
164. See Gregory S. Crespi, Good Faith and Bad Faith in Contract Law: Reflections on a Cautionary Tale and Border Wars, 72 Tex. L. Rev. 1277, 1283 (1994) (noting that many contract law scholars criticize the efficient breach doctrine “because often there are substantial hidden social costs of contract breach that make so-called ‘efficient breaches’ highly inefficient”); see also Daniel Friedmann, The Efficient Break Fallacy, 18 J. Legal Stud. 1 (1989).
165. Rawlings, 726 P.2d at 575 (“[C]ontract damages not only fail to provide adequate compensation [in bad faith cases] but also fail to provide a substantial deterrence against breach by the party who derives a commercial benefit from the relationship.”); see also Robert H. Jerry, II, The Wrong Side of the Mountain: A Comment on Bad Faith’s Unnatural History, 72 Tex. L. Rev. 1317, 1338 n.110 (1994). Although Professor Jerry is a proponent of contractual remedies, he notes that the common theme for supporting tort recovery “is that insurance policies are different from ordinary commercial contracts, and contractual remedies are inadequate in this setting to balance the interests of insurer and insured fairly.” Jerry, supra, at 1338.
efficient breach doctrine by providing insurers with incentive not to breach. The Texas Supreme Court, for example, recognized that "without such a [tort] cause of action insurers can arbitrarily deny coverage and delay payment of a claim with no more penalty than interest on the amount owed." Inherent in this statement was the court's recognition of the narrow scope of contract damages.

In contrast, opponents of extracontractual tort remedies, such as Mark Gergen, counter the purported deterrent effect by arguing that allowing tort damages results in increased costs and limited benefits. Gergen argues that the tort of bad faith "has troubling distributional consequences: It enriches a few at the expense of many with significant transaction costs." Essentially, Gergen's argument is that the costs associated with increased litigation and high jury verdicts are passed on by the insurers to insureds through increased premiums.

While the debate over tort law or contract law is likely to continue among scholars, the resolution of the issue is of little significance to the modern-day plaintiff. Specifically, as the Texas Supreme Court has taken steps to reign in the common-law tort of first-party bad faith, more and more plaintiffs are turning to the Texas Insurance Code for a statutory basis of relief.

B. A Shift Towards Statutory Law

The availability of statutory remedies for breach of the duty of good faith and fair dealing was affirmatively recognized by the Texas Supreme Court in *Vail v. Texas Farm Bureau Mutual Insurance Co.* The case involved a bad faith failure to pay policy proceeds under a homeowner's policy after a fire destroyed the Vails' home. The Vails sued their insurer, Texas Farm Bureau Mutual Insurance Company, for the full amount of the policy and for damages under the Deceptive Trade Practices Act (DTPA) and the Texas Insurance Code. The jury found that Texas Farm Bureau had intentionally failed to exercise good faith in settling the claim. Based on these findings, the trial court awarded the Vails three times the amount of the full policy limit plus attorney's fees and prejudgment interest on the trebled figure.

The court of appeals reversed the trial court, holding that no private cause of action for unfair claims settlement practices existed under the DTPA or the Insurance Code. The Texas Supreme Court granted writ

168. Arnold, 725 S.W.2d at 167.
169. Mark Gergen is the Joseph C. Hutcheson Professor at the University of Texas School of Law.
171. Id. at 1250.
172. Id. at 1250-51 n.101.
173. 754 S.W.2d 129 (Tex. 1988).
174. The court of appeals affirmed the recovery of policy limits, prejudgment interest, and attorney's fees. The court, however, reversed the treble damages. Id. at 130.
in order to squarely address the issue. In a very important decision for Texas insureds, the Texas Supreme Court held that both the DTPA and the Insurance Code provide an insured with a remedy for the unfair or deceptive acts of insurers. This decision was accompanied by a strong dissent from Justice Gonzalez who stated that “[t]he legislature has not provided for a private cause of action for unfair claim settlement practices under either the DTPA or the Insurance Code. In finding such a cause of action, the majority has had to resort to a tortured reading of the DTPA [and] the Insurance Code ...”

As illustrated by the dissent, the original impact of the Vail decision was hampered by confusion over its scope and effect. For example, practitioners and judges alike were confused as to the interplay between the common law and the statutory law. The confusion intensified in 1994 with the Texas Supreme Court decision of Allstate Insurance Co. v. Watson. In Watson, the court reaffirmed the Vail decision as it applied to first-party cases, but refused to recognize that a private cause of action existed for unfair settlement practices under section 17.46(a) of the DTPA. This refusal, although dicta, was squarely at odds with the Vail opinion. As a result of this ambiguity, a split in the lower courts inevitably developed.

Fortunately, much of the early confusion surrounding the Insurance Code was cleared up by the 1995 Amendments to Article 21.21. Although all of the ambiguities have not yet been settled, the result of the amendments is a statute that will provide more predictability and certainty than the common law for both plaintiffs and insurance companies.

Ultimately, the success of Article 21.21 will depend on how the legislation is interpreted by the courts and what position the Texas legislature decides to take with respect to protecting the interests of both insureds and insurers. As one commentator noted, the current version of Article 21.21 allows “insurers ... to adjust claims on the true merits of the claim

175. Id. at 132 (citing The Texas Deceptive Trade Practices-Consumer Protection Act: Hearings on Tex. H.B. 417 Before the House Comm. on Bus. & Indus., 63d Leg., R.S. 17 (Feb. 27, 1973) (the DTPA was intended to apply to the insurance industry)).
176. Id. at 137 (Gonzalez, J., dissenting).
179. Watson, 876 S.W.2d at 149.
180. Compare Hart v. Berko, 881 S.W.2d 502, 509 n.3 (Tex. App.—El Paso 1994, writ denied) (holding that Watson extinguished the private cause of action under § 17.46(a)) with Crum & Forster, Inc. v. Monsanto Co., 887 S.W.2d 103, 116 (Tex. App.—Texarkana 1994, no writ) (relying on § 17.46(a) to support a private cause of action).
181. The substance of the statutory developments are beyond the scope of this Comment. For a detailed analysis of the statutory developments, see Christopher W. Martin, A LAWYER'S GUIDE TO TEXAS INSURANCE CODE ARTICLE 21.21 (1995).
without the foreboding shadow of bad faith hanging over their head."\textsuperscript{182} While this statement echoes the defense perspective of bad faith law, its message of adjusting claims on their true merits serves the interests of both insureds and insurers.

VI. CONCLUSION

As the common-law tort of first-party bad faith takes its last few breaths, the emergence of Article 21.21 will preside over Texas bad faith litigation. Although some may lament the imminent passing of common-law bad faith, the net effect for Texans is a system that is better equipped to balance the interests of both insureds and insurers. This balance, if maintained by both the courts and the legislature, will ensure the future existence of insurance companies in Texas and will provide a clearer set of guidelines and procedures for insurers to follow in adjusting claims.