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Bad Faith: Limiting Insurers' Extra-Contractual Liability in Texas

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COMMENT

BAD FAITH: LIMITING INSURERS' EXTRA-CONTRACTUAL LIABILITY IN TEXAS

by Kelly H. Thompson

THE competing considerations of promptly paying legitimate claims and protecting policyholder premium dollars from fraudulent claims impose a tremendous tension upon insurance companies.[1] Texas courts currently are debating the duties owed and the extent of the insurers' liability under these and other situations. Two major concerns are at the heart of these debates. First, whether an insurance company should be liable to its insured for damages beyond those specified in the insurance contract. Second, whether such extra-contractual liability should extend to third parties who did not contract with the insurer.

This Comment analyzes the issue of insurers' extra-contractual liability in the first and third party context in four steps. First, the article presents a general introduction explaining the development of extra-contractual liability. With this general background as a basis, section two discusses the development and current state of law in Texas on insurers' extra-contractual liability. Third, since California pioneered the development of insurers' extra-contractual liability, this Comment briefly illustrates that state's contrasting view. Finally, section four reviews the public policy considerations both favoring and opposing the award of extra-contractual damages in Texas breach of insurance contract cases. Given these considerations, the Comment concludes that: (1) no cause of action for damages beyond policy limits should exist for an insurer's bad faith refusal to pay first party insurance claims; and (2) courts should not expand a direct cause of action for extra-contractual liability to claimants in the third party context.

I. GENERAL DEVELOPMENT OF INSURERS' EXTRA-CONTRACTUAL LIABILITY

Traditionally, the insurance policy itself has limited insureds' recoveries

1. Ryan, *The Bad Faith Blast*, FOR THE DEF., Mar. 1986, at 20, 20.

for claims brought under the contract provisions.[2] This concept of limited recovery emerged from the landmark damages case of *Hadley v. Baxendale*.[3] The concept follows the general rule that in breach of contract actions the court should not put the injured party in a better position than he would have been in had the parties performed the contract.[4] The theory developed from *Hadley* that a court may limit an action for breach of an insurance contract to the amount specified in the policy.[5] The limits specified in the policy represent the only foreseeable damages that the parties envisioned at the time they executed the contract.[6]

Not satisfied with the foreseeability guidelines of *Hadley*, American courts developed creative theories for the imposition of extra-contractual liability on insurance companies.[7] Extra-contractual damages include any recoveries in excess of the policy benefits provided by an insurance contract as a result of a loss.[8] The most creative theory for extra-contractual damages applies a new tort, commonly referred to as "bad faith," within the context of a contract action.[9] Courts refer to this new tort as a "duty of good faith and fair dealing."[10]

Bad faith implies something more than mere negligence, errors in judgment, bad manners, or breakdowns in communications.[11] The courts have defined bad faith as an intentional tort in which the insurer, knowingly or with reckless disregard, lacks a reasonable basis for denying policy proceeds.[12] The types of losses that are particularly vulnerable to bad faith allegations include: (1) questions of coverage; (2) questions of cause or origin of damage; (3) substantial differences of opinion as to amounts, scope, or cost; (4) adjustment problems, including the insured's unreasonableness and per-

2. Kornblum, *An Introduction to the Principles of Extra-Contractual Liability of Insurers*, in BAD FAITH 1986, at 1.1 (1986).

3. 156 Eng. Rep. 145 (Ex. Ch. 1854); *see* Miller, Overview and Historical Development of the Problem of Bad Faith and Punitive Damages 2 (Aug. 1979) (prepared for presentation to Property Ins. Comm. of ABA, Dallas, Tex.).

4. Hadley v. Baxendale, 156 Eng. Rep. 145, 151 (Ex. Ch. 1854); Comment, *Bad Faith Refusal of Insurance Companies to Pay First Party Benefits—Time for the Illinois Supreme Court to Recognize the Tort and Resulting Punitive Damages*, 1984 S. ILL. U.L. REV. 121, 121.

5. *See* Miller, *supra* note 3, at 3.

6. *Id.*

7. *See* Kornblum, *supra* note 2, at 1.1. For a discussion of the development in Texas courts, see *infra* notes 76-114 and accompanying text. For a discussion of the development in California courts, see *infra* notes 166-83 and accompanying text.

8. *See* Kornblum, *supra* note 2, at 1.3.

9. Although courts gloss over the name, commentators refer to the tort of "bad faith." *See* Kornblum, *supra* note 2, at 1.23; Miller, *supra* note 3, at 2; Ryan, *supra* note 1, at 20; Comment, *supra* note 4, at 124-26.

10. United States Auto Ass'n v. Werley, 526 P.2d 28, 33 (Alaska 1974); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 576, 510 P.2d 1032, 1038, 108 Cal. Rptr. 480, 486 (1973); Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

11. *See* Blue Cross & Blue Shield, Inc. v. Whitaker, 687 S.W.2d 557, 559 (Ky. Ct. App. 1985).

12. *See* Centennial Ins. Co. v. Liberty Mut. Ins. Co., 62 Ohio St. 2d 221, 404 N.E.2d 759, 762 (1980) (Bad faith "imports a dishonest purpose, moral obliguity [sic], conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partaking of the nature of fraud."); Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 271 N.W.2d 368, 377 (1978) (court applies objective test based on ordinary care to determine existence of bad faith).

sonality conflicts between the insured and the adjuster; (5) policy violations; and (6) long delays in adjustment.[13] California has pioneered the development of the bad faith tort and resulting extra-contractual liability in both first party and third party situations.[14]

The insurer's liability arises in first party cases out of coverages that the insurer contracts to pay directly to the insured.[15] The insurer and the insured constitute the sole parties to the dispute.[16] The cases typically arise out of claims for damages caused by fire, accident, disability, or loss of life.[17] Policy benefits represent the contractual damages payable to the insured.[18]

Extra-contractual liability arises in third party cases when a third party receives a verdict against an insured for an amount in excess of the available limits of liability insurance, or when the insurer otherwise mishandles a third party claim.[19] When the insured is unable to pay the judgment, the third party or the insured sues the insurance company for the judgment in excess of the insurance policy limits.[20] The basis of this action is the insurer's bad faith refusal to settle with the third party within the insured's policy limits.[21]

In addition to the case law development of extra-contractual damages, state legislatures have statutorily imposed extra-contractual penalties in the form of treble damages in both the first and third party context.[22] Given these various common law and statutory remedies, Texas courts are presently struggling with the issue of the extent of insurers' liability to first and third parties. An appropriate resolution of this issue requires a thorough understanding of the development and current state of the law in Texas, as well as a survey of the experience in a state such as California that has greatly expanded the scope of insurers' extra-contractual liability.

II. CURRENT STATE OF THE LAW IN TEXAS

The development of insurers' extra-contractual liability began in Texas in the third party context. In the first party context Texas courts have historically refused to recognize extra-contractual theories of recovery and recognize only contract remedies.[23] The Texas Supreme Court, however, has recently reevaluated this well-reasoned tradition.[24] In addition to the common law development, the Texas Legislature has maintained a steady devel-

13. Berg, *Good Faith/Bad Faith - First Party*, D-14-15 (Mar. 1984) (DRI Defense Practice Seminar).

14. *See infra* notes 152-92 and accompanying text.

15. *See* Kornblum, *supra* note 2, at 1.4; Comment, *supra* note 4, at 121 n.2 (citing 16 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 877 (1979)).

16. *See* Comment, *supra* note 4, at 121 n.2.

17. *Id.*

18. *See* Kornblum, *supra* note 2, at 1.1.

19. *See id.* at 1.4; Comment, *supra* note 4, at 121 n.1 (citing 7 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 4682 (1979)).

20. *See* Comment, *supra* note 4, at 121 n.1.

21. *Id.*

22. For a discussion of Texas legislative action exemplifying such penalties, see *infra* notes 75 and 130 and accompanying text.

23. *See infra* notes 88 and 104 and accompanying text.

24. Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

opment in regulating the insurance industry.[25] This section discusses the Texas case law and statutory development in both the third and first party context.

A. Extra-Contractual Liability in the Third Party Context

1. Case Law Development

Stowers Furniture Co. v. American Indemnity Co.,[26] although over fifty years old, remains the authoritative case in Texas explaining the duties of the insurer in the third party context.[27] The *Stowers* doctrine arises whenever a third party claimant offers to settle a disputed claim within the policy limits, and the insurer refuses the offer.[28] In refusing to settle with the claimant, the insurer realizes that the policy limits restrict its liability in the event of a judgment in excess of those limits. At the same time, however, the insured prefers that the parties settle so that it avoids the risk of personal liability resulting from a judgment in excess of the policy amount.[29] These opposing interests result in a conflict that the *Stowers* doctrine governs.[30]

According to the *Stowers* doctrine, the insured must prove that the insurer was negligent in declining to settle with the claimant for a sum within policy limits.[31] If successful, the insured may recover a judgment against the insurer in excess of such policy limits.[32] The *Stowers* court held that a court must consider three elements in order to determine the negligence of an insurer in handling settlement negotiations: (1) the severity of the third party's injuries as well as all the surrounding facts and circumstances; (2) the actual knowledge or constructive knowledge of the facts and circumstances surrounding the original injury that the insurer could have gained through the exercise of ordinary care; and (3) evidence of strict rules that the insurer followed that indicated a desire not to make settlement offers.[33] The doc-

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25. *See infra* notes 60-75, 112-51 and accompanying text.

26. 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved).

27. *See* Knox, *An Insurer's Duty to Defend: The* Stowers *Doctrine*, 2 TEX. INS. L. REP. 65, 67 (1985).

28. *Id.* at 545; *see* Comment, *An Insurer's Failure to Settle: Standing Under the* Stowers *Doctrine, Texas Deceptive Trade Practices Act, and Article 21.21 of the Insurance Code*, 34 BAYLOR L. REV. 441, 442 (1982).

29. Comment, *supra* note 28, at 442.

30. *Id.*

31. 15 S.W.2d at 547; *see* Knox, *supra* note 27, at 65.

32. *See* Knox, *supra* note 27, at 65.

33. 15 S.W.2d at 548; *see* Knox, *supra* note 27, at 68. Since the *Stowers* decision, the judiciary as well as commentators have suggested several additional factors to consider in determining the insurer's negligence in failing to accept an offer to settle. *See* Globe Indem. Co. v. Gen-Aero, Inc., 459 S.W.2d 205, 208 (Tex. Civ. App.—San Antonio 1970, writ ref'd n.r.e.); Knox, *supra* note 27, at 68; Comment, *Insurer's Liability for Judgments Exceeding Policy Limits*, 38 TEX. L. REV. 233, 238-39 (1960). In *Globe Indem.* the court listed six factors to consider:

> (A) An opportunity to settle during the course of investigation or trial.
> (B) Failure to carry on negotiations to settle or make a counter offer after receipt of an offer to settle. . . .
> (C) Failure to investigate all the facts necessary to protect properly the insured against liability.
> (D) Question of liability—if liability is clear, greater duty to settle may exist.

trine establishes an objective standard that requires the insurer to exercise the same ordinary care and prudence in the management of the insured's business as he would in the management of his own business.[34] The basis of this rule is the premise that policy provisions that give the insurer complete control of the litigation, as a matter of law, carry with them a corresponding duty and obligation.[35]

Four cases have refined the *Stowers* doctrine. The first, *Highway Insurance Underwriters v. Lufkin-Beaumont Motor Coaches*,[36] distinguished between the negligence standard that Texas courts follow and the alternative good faith standard.[37] The negligence standard of *Stowers* constitutes a much stricter standard than that of good faith, since an insurer acting in good faith may violate the due care element of the negligence standard.[38] Although the negligence standard is much stricter than the good faith standard, the court in *Highway* held that even under the negligence standard the insurer will not be liable merely because subsequent events proved that a decision to reject the claimant's offer was wrong.[39] The second case, *Jones v. Highway Insurance Underwriters*,[40] confirmed that the claimant's offer to settle must be unconditional before the *Stowers* doctrine will classify an insurer's rejection as a breach of a duty.[41] The third refinement, found in *Chancey v. New Amsterdam Casualty Co.*,[42] held that the insurer's policy right to investigate, negotiate, and settle imposes a duty on the insurer actually to negotiate, as well as to settle under the *Stowers* doctrine.[43] Finally, in *Hernandez v. Great American Insurance Co.*,[44] the Texas Supreme Court abolished the prepayment rule[45] in favor of the judgment rule.[46] The insured now has a cause of action against the insurer on the day the excess judgment becomes final.[47] The insured's ability to pay the judgment is ir-

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(E) Element of good faith—whether insurer acts negligently, fraudulently, or in bad faith. . . .

(F) If there are conflicts in evidence which increase the uncertainty of the insured's defense to the injured party's claim, the possibility of the insurer being held negligent increases.

459 S.W.2d at 208.

34. *Stowers*, 15 S.W.2d at 548.

35. *Id.* at 547.

36. 215 S.W.2d 904 (Tex. Civ. App.—Beaumont 1948, writ ref'd n.r.e.).

37. *Id.* at 927.

38. *Id.* at 927-28.

39. *Id.*

40. 253 S.W.2d 1018 (Tex. Civ. App.—Galveston 1952, writ ref'd n.r.e.).

41. *Id.* at 1022. The Texas Supreme Court recently gave cause to doubt this requirement in Ranger County Mut. Ins. Co. v. Guin, 723 S.W.2d 656, 660 (Tex. 1987). *See infra* note 52 and accompanying text.

42. 336 S.W.2d 763 (Tex. Civ. App.—Amarillo 1960, writ ref'd n.r.e.).

43. *Id.* at 764-65. For a current debate on the extent of this agency relationship, see *infra* notes 53-54 and accompanying text.

44. 464 S.W.2d 91 (Tex. 1971).

45. *See* Universal Auto. Ins. Co. v. Culberson, 86 S.W.2d 727, 730 (Tex. Comm'n App. 1935, opinion adopted) (the insured must not only prove negligence, but also must pay the judgment that is in excess of the policy amount before it can successfully bring a *Stowers* action).

46. 464 S.W.2d at 93.

47. *Id.*

relevant.[48] Although *Hernandez* broadens the doctrine, a *Stowers* cause of action remains unavailable to the third party claimant.[49]

Recent decisions illustrate the fact that the *Stowers* doctrine remains a major element in Texas insurance litigation. In *Ranger County Mutual Insurance Co. v. Guin*[50] the Texas Supreme Court applied the *Stowers* doctrine to uphold a jury's finding that the insurer acted negligently even though the third party claimant's settlement offer was deficient.[51] In so holding, the court expanded the doctrine by relegating the requirement of an unconditional settlement offer to an evidentiary point.[52] In addition, the majority expanded the scope of the agency relationship between the insurer and the insured.[53] As the insured's agent, the insurer's duty includes investigation, defense, preparation, trial, and reasonable settlement attempts.[54] Applying this expanded agency relationship, the court found sufficient evidence to support an award of exemplary damages.[55]

A recent Fifth Circuit opinion interpreting Texas law extended an insurer's liability to include attorney's fees, as well as punitive damages, for the insurer's failure to handle a third party claim as would a reasonably prudent person by neglecting to settle the claim in a timely manner.[56] In support of the award for attorney's fees, the court reasoned that the insurer proximately caused the insured's expense by breaching its duty to resolve the third party's claim without the requirement of a lawsuit between the third party and the insured.[57] The court contrasted attorney's fees incurred by the insured in defense of the third party's suit to attorney's fees incurred as payment of costs of a lawsuit by the insured against the insurer.[58] The justification for the award of attorney's fees in the first situation is that they constituted some of the insured's foreseeable damages, and the insurer's breach of its duty to settle within policy limits proximately caused such

48. *Id.*

49. *Id.* at 94. The *Stowers* cause of action is a tort of negligence designed to help the insured, not a third party. The third party holder of the former judgment benefited from the tort to the extent of the judgment above the insured's policy limits. Cook v. Superior Ins. Co., 476 S.W.2d 363, 364 (Tex. Civ. App.—Beaumont 1972, writ ref'd n.r.e.); *see also* Samford v. Allstate Ins. Co., 529 S.W.2d 84, 86 (Tex. Civ. App.—Corpus Christi 1975, writ ref'd n.r.e.) (insured was the injured party under the *Stowers* doctrine in suffering an excess jury verdict—not the third party); Comment, *supra* note 28, at 445 (no Texas court has allowed a third party claimant a *Stowers* cause of action).

50. 723 S.W.2d 656 (Tex. 1987).

51. *Id.* at 660.

52. *Id.* The dissent, citing Jones v. Highway Ins. Underwriters, 253 S.W.2d 1018, 1022 (Tex. Civ. App.—Galveston 1952, writ ref'd n.r.e.), correctly interpreted the majority's statement as a misapplication of the *Stowers* doctrine. *Ranger*, 723 S.W.2d at 662 (Gonzales, J., dissenting) (unconditional offer to settle is a necessary prerequisite in a *Stowers* case).

53. 723 S.W.2d at 659.

54. *Id.* In contrast, the dissent stated that the *Stowers* doctrine holds the insurer liable for negligent failure to settle a claim within policy limits. *Id.* at 661-62 (Gonzales, J., dissenting) (investigation, preparation of the defense, and trial are merely factors to consider in determining if the insurer negligently failed to settle).

55. *Id.* at 660.

56. Texoma AG-Prods., Inc. v. Hartford Accident & Indem. Co., 755 F.2d 445, 448-50 (5th Cir. 1985).

57. *Id.* at 450.

58. *Id.*

damages.[59]

2. Statutory Remedies

The basis of a common law *Stowers* cause of action is the insurer's negotiations with a third party claimant. The *Stowers* cause of action belongs to the insured; the third party claimant may, however, possess an independent statutory cause of action against the insurer. A person aggrieved by an insurance company possesses three statutory sources of relief in Texas: (1) the Deceptive Trade Practices Act,[60] (2) article 21.21 of the State Insurance Code,[61] and (3) article 21.21-2, the Unfair Claim Settlement Practices Act.[62] Although each of these statutes awards some form of extra-contractual relief to prevailing plaintiffs in the first party context, only article 21.21 is available to third party claimants.

Article 21.21 specifies conduct that constitutes unfair competition and deceptive practices in the insurance industry.[63] Any person aggrieved by an insurance company's violation of the prohibited acts or practices possesses a private cause of action under the article.[64] The Texas Supreme Court has recognized expressly that article 21.21 confers a cause of action under section 17.46(a) of the DTPA.[65] The significance of this determination exists because unlike the DTPA, article 21.21 does not require "consumer" status.[66] Article 21.21's definition of "person" denotes the only requirement for standing to sue.[67] This distinction makes a suit under article 21.21 available to third party claimants for a DTPA complaint when no such opportunity exists directly under the DTPA.[68]

Article 21.21 allows three causes of action.[69] The first cause of action

59. *Id.* (citing Donnelly v. Young, 471 S.W.2d 888, 897 (Tex. Civ. App.—Fort Worth 1971, writ ref'd n.r.e.)) (if foreseeable, parties may recover attorney's fees).

60. TEX. BUS. & COM. CODE ANN. §§ 17.41-.63 (Vernon Supp. 1987) [hereinafter DTPA].

61. TEX. INS. CODE ANN. art. 21.21 (Vernon Supp. 1987) [hereinafter article 21.21].

62. *Id.* art. 21.21-2 (Vernon Supp. 1987) [hereinafter article 21.21-2].

63. Article 21.21, § 4. Statements misrepresenting the terms of an insurance policy are within the definition of unfair competition and deceptive practices. *Id.* § 4(1).

64. Article 21.21, § 16(a).

65. Hi-Line Elec. Co. v. Travelers Ins. Cos., 593 S.W.2d 953, 954 (Tex. 1980); Royal Globe Ins. Co. v. Bar Consultants, 577 S.W.2d 688, 691-92 (Tex. 1979).

66. *See* Hi-Line Elec. Co. v. Travelers Ins. Cos., 593 S.W.2d 953, 954 (Tex. 1980).

67. Article 21.21, § 2(a). The Act's definition of person includes "any individual, corporation, association, partnership, reciprocal exchange, inter-insurer, Lloyds insurer, fraternal benefit society, and any other legal entity engaged in the business of insurance, including agents, brokers, adjusters and life insurance counselors." *Id.*

68. *See* Stagg, McCall & Witt, *Bad Faith & Deceptive Trade Practices Act Claims*, in SUING, DEFENDING AND NEGOTIATING WITH INSURANCE COMPANIES—STATE BAR OF TEXAS G-18 (1984).

69. Article 21.21, § 16. *Id.* § 16(a) provides:

> Any person who has sustained actual damages as a result of another's engaging in an act or practice declared in Section 4 of this Article or in rules or regulations lawfully adopted by the Board under this Article to be unfair methods of competition or unfair or deceptive acts or practices in the business of insurance or in any practice defined by Section 17.46 of the Business & Commerce Code, as amended, as an unlawful deceptive trade practice may maintain an action against the person or persons engaging in such acts or practices.

arises from any violation of the enumerated unfair and deceptive acts or practices.[70] For example, the Texas Supreme Court has held that a misrepresentation of an agent subjects the insurance company to liability under article 21.21.[71] The second cause of action under article 21.21 originates in any violation of DTPA section 17.46, which declares unlawful false, misleading, or deceptive acts or practices in the insurance industry.[72] The third cause of action under article 21.21 comes from any violation of the regulations that the State Board of Insurance has issued to expand and explain article 21.21.[73] The most important of these Board regulations defines and sets the standards for determining misrepresentation as a violation of article 21.21, section 4.[74] Extra-contractual relief available to the third party includes treble damages, attorney's fees, and costs.[75]

B. Extra-Contractual Liability in the First Party Context

1. Case Law Development

The 1929 *Stowers* decision firmly established insurers' extra-contractual liability in the third party context. Unlike the third party situation, however, case law on first party extra-contractual liability has been unpredictable. Historically, the most frequent common law causes of action that insureds raised in the first party context included: (1) breach of contract,[76] (2) fraud,[77] (3) negligence,[78] and (4) breach of a duty of good faith and fair dealing.[79]

Since the insurance policy constitutes a contract between the insurance company and the insured, the traditional contract action, not surprisingly, is

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See Longley & Maxwell, *Suits Against Insurance Companies: Analysis, Strategy & Pitfalls*, in SUING & DEFENDING UNDER THE DECEPTIVE TRADE PRACTICES ACT—STATE BAR OF TEXAS D-1 (1985).

70. Article 21.21, § 4 lists the following as unfair methods of competition and unfair and deceptive acts or practices: "(1) misrepresentations and false advertising of policy contracts; (2) false information and advertising generally; (3) defamation; (4) boycott, coercion and intimidation; (5) false financial statements; (6) stock operations and advisory board contracts; (7) unfair discrimination; and (8) rebates."

71. Royal Globe Ins. Co. v. Bar Consultants, 577 S.W.2d 688, 693 (Tex. 1979). *Contra* American Ins. Cos. v. Reed, 626 S.W.2d 898, 903 (Tex. App.—Eastland 1981, no writ) (plaintiff cannot recover damages under article 21.21 for failure of insurance company to advise him of all policy provisions). Following the *American Ins.* decision, however, the legislature added DTPA § 17.46(b)(23), which provides that failure to disclose information is deceptive conduct. Thus, since article 21.21 incorporates § 17.46, whether failure to furnish the policy or information about the policy to the insured violates article 21.21 remains an open issue. *See* article 21.21, § 16; Stagg, McCall & Witt, *supra* note 68, at G-20.

72. DTPA § 17.46(a). For a discussion of the limitation of this cause of action to pre-sale conduct of the insurer, see *infra* note 123 and accompanying text.

73. Article 21.21, § 16(a).

74. State Bd. of Ins., Board Order 186663 (Dec. 3, 1971), repromulgated as Board Order 41060 (June 4, 1982); *see* Longley & Maxwell, *supra* note 69, at D-12.

75. Article 21.21, § 16(b).

76. *See* Longley & Maxwell, *supra* note 69, at D-24.

77. *Id.*

78. *Id.*

79. *Id.* at D-19.

a common law cause of action in the first party context.[80] In applying contract law, the insured may recover only the amount specified by the contract itself.[81] Rules of contract construction, however, run against the insurance company, and a court will construe ambiguous clauses in favor of the insured.[82] If the insurer breaches the insurance contract, the plaintiff-insured may recover compensatory damages and attorney's fees.[83] In the absence of an independent tort, however, courts will not allow exemplary damages for breach of contract.[84] This rule applies even if the breach is malicious, intentional, or unreasonable.[85]

Fraud, the second common law cause of action, may clearly form a basis for recovery by an insured against an insurance company.[86] Unlike the tort of fraud, the availability of the third cause of action, negligence, is presently unclear. Although no Texas court has previously applied the third party *Stowers* negligence standard[87] to property insurers in the first party context,[88] a recent Texas Supreme Court decision appears to adopt such a standard in conjunction with the fourth common law cause of action, breach of the duty of good faith and fair dealing.[89]

In *Arnold v. National County Mutual Insurance Co.*[90] the Texas Supreme Court applied the fourth cause of action: a tort action for breach of a duty of good faith and fair dealing.[91] Analysis of the law distinguishes this tort action from a contract action. The basis of such a distinction is the differ-

80. *See* American Standard Life Ins. Co. v. Redford, 337 S.W.2d 230, 231 (Tex. Civ. App.—Austin 1960, writ ref'd n.r.e.).

81. Gross v. Connecticut Gen. Life Ins. Co., 390 S.W.2d 388, 390 (Tex. Civ. App.—El Paso 1965, no writ).

82. Jones v. American Economy Ins. Co., 672 S.W.2d 879, 881 (Tex. App.—Dallas 1984, no writ) (possibly meaning no limitation will apply in the policy).

83. TEX. CIV. PRAC. & REM. CODE ANN. § 38.001(8) (Vernon 1986).

84. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 571 (Tex. 1981) (lessee's failure to comply with implied covenant of prudent operation, no matter how oppressive, does not subject the lessee to punitive damages); Mobile County Mut. Ins. Co. v. Jewell, 555 S.W.2d 903, 911-12 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (suit upon insurance contract furnishes no basis for punitive damages); McDonough v. Zamora, 338 S.W.2d 507, 513 (Tex. Civ. App.—San Antonio 1960, writ ref'd n.r.e.) (punitive damages not allowed in action to enforce "hot checks").

85. *See* Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 571 (Tex. 1981); A.L. Carter Lumber Co. v. Saide, 140 Tex. 523, 526, 168 S.W.2d 629, 631 (1943); K.W.S. Mfg. Co. v. McMahon, 565 S.W.2d 368, 372 (Tex. Civ. App.—Waco 1978, writ ref'd n.r.e.).

86. *See* Stone v. Lawyers Title Ins. Corp., 554 S.W.2d 183, 188 (Tex. 1977); Boenker v. American Title Co., 590 S.W.2d 777, 780 (Tex. Civ. App.—Houston [14th Dist.] 1979, no writ).

87. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544, 547 (Tex. Comm'n App. 1929, holding approved) (a liability insurer is held to an objective standard of ordinary care and prudence, and a failure to meet such standard constitutes negligence on the part of the indemnity company).

88. *See* Texas Farm Bureau Mut. Ins. Co. v. Vail, 695 S.W.2d 692, 694 (Tex. App.—Dallas 1985, no writ) (*Stowers* doctrine is inapplicable to cases involving only property insurance). The Texas Supreme Court has applied the tort of negligence to first party contractual relationships outside the insurance context. *See* Montgomery Ward & Co. v. Scharrenbeck, 146 Tex. 153, 157, 204 S.W.2d 508, 510 (1947) (tort of negligence applicable for failure to perform a service contract with care, skill, reasonable expedience, and faithfulness).

89. Arnold v. National County Mut. Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

90. *Id.*

91. *Id.* at 178.

ence between a contract covenant and a tort duty.[92] The supreme court has refused explicitly to imply a covenant of good faith and fair dealing in all contracts.[93] In a noninsurance context the court held that no implied covenant exists for issues specifically dealt with by the terms of the contract.[94]

Massey v. Armco Steel Co.[95] first expressly raised the tort duty of good faith and fair dealing in the context of insurance contracts. The dissent expressed the opinion that a tort action for a breach of a duty of good faith and fair dealing exists in addition to a contract cause of action arising under the policy of insurance.[96] Significantly, however, the majority neither rejected nor accepted the tort duty of good faith and fair dealing.[97] The concurring opinion in *English v. Fischer*[98] also raised the tort duty of good faith and fair dealing.[99] Justice Spears noted that the common thread in the cases adopting such a duty was a special relationship between the contracting parties.[100] Although the list of cases adopting such a duty included *Stowers*,[101] the justice failed to acknowledge or distinguish the fact that *Stowers* involved the duty in a third party context, rather than a first party context.[102] One federal district court case, *Thompson v. M & B Construction Corp.*,[103] refused to accept the idea that an implied duty of good faith and fair dealing exists in all contracts in Texas.[104] In reviewing Texas law, the *Thompson* court based its conclusion on the fact that it did not anticipate that Texas courts would adopt a good faith and fair dealing cause of action in the first party context.[105] Less than three years later, however, the Texas Supreme Court did adopt that exact duty.[106]

With the decision of *Arnold v. National County Mutual Fire Insurance Co.*[107] the Texas Supreme Court adopted both the negligence standard of the *Stowers* doctrine and the tort duty of good faith and fair dealing in the first

92. For an additional discussion on this distinction, see Comment, *A New Tort for Texas: Breach of the Duty of Good Faith and Fair Dealing*, 18 ST. MARY'S L.J. 1295, 1309-11 (1987) (tort of bad faith blurs distinction between contract theory and tort law).

93. English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983) (California policy contrary to long-established adversary system of Texas).

94. *See* Exxon Corp. v. Atlantic Richfield Co., 678 S.W.2d 944, 947 (Tex. 1984) (a court may not vary the terms of a contract with an implied covenant of good faith and fair dealing). While the Texas Supreme Court is reluctant to impose a covenant in contract causes, it is willing to recognize an implied duty of good faith and fair dealing. *See* Montgomery Ward & Co. v. Scharrenbeck, 146 Tex. 153, 157, 204 S.W.2d 508, 510 (1947).

95. 635 S.W.2d 596 (Tex. App.—Houston [14th Dist.] 1982, *rev'd on other grounds*, 652 S.W.2d 932 (Tex. 1983) (case decided on another issue).

96. 635 S.W.2d at 599 (James, J., dissenting).

97. *Id.* at 598. The majority contended that plaintiffs failed to allege a cause of action based on this tort duty. *Id.*; *see* Longley, *supra* note 69, at D-21.

98. 660 S.W.2d 521 (Tex. 1983).

99. *Id.* at 524 (Spears, J., concurring).

100. *Id.*

101. *Id.*

102. *Id.* For a discussion of this distinction, see *infra* notes 239-46 and accompanying text.

103. 585 F. Supp. 561 (N.D. Tex. 1984).

104. *Id.* at 563.

105. *Id.*

106. Arnold v. National County Mut. Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

107. *Id.*

party context.[108] Breach of this duty may result in the plaintiff's extra-contractual recovery of both exemplary and mental anguish damages.[109] Due to the court's failure to explain the rationale supporting its decision, the previous uncertainty has merely multiplied. The court based its adoption of this tort action on the special relationship that exists between the insurer and insured.[110] Similar to Justice Spears's concurrence in *English v. Fischer*,[111] the court's opinion failed to recognize that courts have previously only applied this special relationship rationale in the third party context in the area of insurance.[112] Upon analyzing the development of a similar first party cause of action in California,[113] the undeniable ramifications of such a move by the judiciary, and the abundance of alternative remedies available,[114] the author respectfully submits that the Texas Supreme Court should reevaluate this drastic decision.

2. *Statutory Remedies*

In contrast to the disparity among the courts on the available common law causes of action, the statutory actions available to insureds to recover extra-contractual remedies from their insurers are relatively clear. As previously mentioned, the three statutory sources of relief in Texas for a person aggrieved by an insurance company are the DTPA, article 21.21, and the Unfair Claim Settlement Practices Act.[115] The DTPA and article 21.21 clearly provide a private cause of action to an aggrieved insured.[116] The courts of appeals addressing the issue of a private cause of action under the Unfair Claim Settlement Practices Act, however, has held that no such action exists.[117]

The DTPA provides a statutory source of relief in the first party context.

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108. *Id.* The proposed elements of the cause of action for breach of the duty of good faith and fair dealing are:

> (1) a contract between the insurer and the insured; (2) the insurer denied the insured's claim or delayed in payment; and (3) (a) the insurer knew that it had no reasonable basis for denying the claim or delaying in payments or (b) the insurer failed to determine whether there was any reasonable basis for the denial or delay.

Id. at 168 (Gonzales, J., concurring).

109. *Id.*

110. *Id.* at 167. The court reasoned that this special relationship resulted from: (1) the parties' unequal bargaining power; (2) the insurer's lack of incentive to settle claims if the only penalty for such conduct is payment of interest on the amount owed; and (3) the insurer's exclusive control of the claims process. *Id.*

111. 660 S.W.2d at 521. The court in *Arnold* cited Justice Spears's concurrence in *Fischer*. *Arnold*, 725 S.W.2d at 167.

112. *See* Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved) (insurance company must make a good faith effort to settle with third party claimant within insured's policy limits). For a discussion of the distinction between the first and third party context, see *infra* notes 239-46 and accompanying text.

113. *See infra* notes 166-83 and accompanying text.

114. *See infra* notes 222-53 and accompanying text.

115. *See supra* notes 60-62 and accompanying text.

116. DTPA § 17.50(a); Article 21.21, § 16.

117. McKnight v. Ideal Mut. Ins. Co., 534 F. Supp. 362, 364-65 (N.D. Tex. 1982); Texas Farm Bureau Mut. Ins. Co. v. Vail, 695 S.W.2d 692, 694-95 (Tex. App.—Dallas 1985, no writ); Lone Star Life Ins. Co. v. Griffin, 574 S.W.2d 576, 580-81 (Tex. Civ. App.—Beaumont

In contrast to article 21.21, which provides relief to "any person," only a consumer may maintain an action under the DTPA.[118] The DTPA includes in the definition of consumer an individual who acquires any services.[119] This definition of consumer includes insureds.[120] Although an insured clearly possesses a cause of action for the insurer's pre-sale conduct,[121] a dispute exists as to whether an insured has a cause of action for the post-sale conduct of an insurer.[122] The weight of authority suggests no such cause of action exists.[123]

In the context of an insurer's pre-sale conduct, four basic causes of action exist under the DTPA.[124] The first, and most common, cause of action arises from a violation of any of the unlawful deceptive trade practices enumerated in the "laundry list" of section 17.46.[125] The second is a breach of an express or implied warranty.[126] The third cause of action results from any unconscionable action.[127] If the insurer knowingly commits the unconscionable acts, a successful plaintiff may recover an extra-contractual award

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1978, writ ref'd n.r.e.); Russell v. Hartford Casualty Ins. Co., 548 S.W.2d 737, 742 (Tex. Civ. App.—Austin 1977, writ ref'd n.r.e.).

118. DTPA § 17.50.

119. *Id.* § 17.45(4). Texas courts have established that an insurer provides a "service" as defined by DTPA § 17.45(2) when the insurer issues an insurance policy. *See* McNeill v. McDavid Ins. Agency, 594 S.W.2d 198, 202 (Tex. Civ. App.—Fort Worth 1980, no writ); Dairyland County Mut. Ins. Co. v. Harrison, 578 S.W.2d 186, 190 (Tex. Civ. App.—Houston [14 Dist.] 1979, no writ).

120. Allstate Ins. Co. v. Kelly, 680 S.W.2d 595, 603 (Tex. App.—Tyler 1984, no writ) (an insured is a consumer under the DTPA when he purchases a liability insurance policy).

121. *See infra* notes 124-35 and accompanying text.

122. *See* Jay Freeman Co. v. Glens Falls Ins. Co., 486 F. Supp. 140, 142 (N.D. Tex. 1980) (post-sale conduct of an insurer is not conduct occurring in connection with the purchase of goods or services); Texas Farm Bureau Mut. Ins. Co. v. Vail, 695 S.W.2d 692, 694 (Tex. App.—Dallas 1985, no writ) (no private cause of action exists under DTPA for post-sale conduct of insurer investigating an alleged arson under a fire insurance policy); Rosell v. Farmers Tex. County Mut. Ins. Co., 642 S.W.2d 278, 279 (Tex. App.—Texarkana 1982, no writ) (conduct of an insurer occurring after the purchase and delivery of an insurance policy cannot form the basis of a cause of action under DTPA). *But see* Allstate Ins. Co. v. Kelly, 680 S.W.2d 595, 603 (Tex. App.—Tyler 1984, no writ) (specifically rejected *Rosell* as clearly erroneous in allowing insured to assert a cause of action under DTPA for post-sale conduct of insurer).

123. Of the four above cited courts addressing the issue, three hold that an insurer's post-sale conduct cannot give rise to a DTPA cause of action. *Jay Freeman Co.*, 486 F. Supp. at 142; *Vail*, 695 S.W.2d at 694; *Rosell*, 642 S.W.2d at 279.

124. DTPA § 17.50 (relief for consumers).

125. *Id.* § 17.50(a)(1). The most pertinent laundry list violations of § 17.46 to this article are: "(12) representing that an agreement confers or involves rights, remedies, or obligations which it does not have or involve, or which are prohibited by law; . . . (23) the failure to disclose information . . . ." *Id.* § 17.46; *see* McNeill v. McDavid Ins. Agency, 594 S.W.2d 198, 203 (Tex. Civ. App.—Fort Worth 1980, no writ). The plaintiff brought an action under DTPA § 17.46(b)(2), which imposes liability for failure to disclose information about services with the intent to induce a consumer into a transaction. The court held that the agent's mere failure to explain was not a deceptive act since the soliciting agent acted as an agent of the insurer and not the insured. *McNeill*, 594 S.W.2d at 203.

126. DTPA § 17.50(a)(2).

127. *Id.* § 17.50(a)(3). *Id.* § 17.45(5) defines "unconscionable" as an act or practice that either "takes advantage of the lack of knowledge, ability, experience or capacity of a person to a grossly unfair degree" or "results in a gross disparity between the value received and consideration paid, in a transaction involving transfer of consideration."

in the form of punitive damages.[128] Finally, a cause of action arises under the DTPA for any violation of article 21.21.[129]

In the event an insured is successful in presenting any of the above causes, the DTPA provides extra-contractual remedies. Such remedies may include treble damages,[130] injunctive relief,[131] court orders restoring property,[132] actual damages,[133] and attorney's fees.[134] Although treble damages are appropriate for a violation of the DTPA, a plaintiff may not recover both exemplary and treble damages based on the same conduct of the insurer since such an award would improperly award double recovery of punitive damages.[135]

In addition to the DTPA cause of action, the insured possesses a private cause of action under article 21.21. An insured clearly meets the definition of "person" to qualify for standing under article 21.21.[136] As in the third party context, insureds prefer article 21.21 provisions over the DTPA in the first party context.[137] Under article 21.21, section 16(b)(1), treble damages mandatorily arise if the insurer "knowingly" committed such actions.[138] In contrast, treble damages are discretionary under the DTPA.[139] The only

128. *See* Luna v. North Star Dodge Sales, Inc., 667 S.W.2d 115, 117 (Tex. 1984). The plaintiff sued under DTPA, alleging damages for mental anguish and loss of use of an automobile. The Texas Supreme Court held that since gross negligence is sufficient to support mental anguish damages at common law and since "knowing" standard exceeds gross negligence standard, plaintiff may recover damages for mental anguish. *Id.* at 117-18. *But see* United Travelers Ins. Co. v. Perkins, 611 S.W.2d 152, 156-57 (Tex. Civ. App.—Waco 1981, writ ref'd n.r.e.) (the plaintiff could not recover under § 17.50 on an unconscionability theory, even though the trial court found the insurer guilty of unconscionable conduct, since the insurer never actually issued the policy).

129. DTPA § 17.50(a)(4).

130. *Id.* § 17.50(b)(1).

131. *Id.* § 17.50(b)(2).

132. *Id.* § 17.50(b)(3).

133. *Id.* § 17.50(b)(1). *Compare* Connecticut Gen. Life Ins. Co. v. Stice, 640 S.W.2d 955, 959-60 (Tex. App.—Dallas 1982, writ ref'd n.r.e.) (since insured received the policy proceeds in a suit against her insurer, the insurer's denial of liability resulted in no actual damages) *with* Allstate Ins. Co. v. Kelly, 680 S.W.2d 595, 604 (Tex. App.—Tyler 1984, writ ref'd n.r.e.) (court rejected as meritless the insurer's argument that if the insured recovers actual damages in the form of the excess judgment, then the insured may not recover treble damages).

134. DTPA § 17.50(d).

135. Allstate Ins. Co. v. Kelly, 680 S.W.2d 595, 606 (Tex. App.—Tyler 1984, writ ref'd n.r.e.); Butler v. Joseph's Wine Shop, Inc., 633 S.W.2d 926, 933 (Tex. App.—Houston [14th Dist.] 1982, writ ref'd n.r.e.); Charlie Thomas Courtesy Ford v. Avalos, 619 S.W.2d 9, 11 (Tex. Civ. App.—Houston [1st Dist.] 1981, no writ); DTPA § 17.43.

136. *See supra* note 67 and accompanying text. A suit under article 21.21 appears more advantageous than under the DTPA since the former imposes a less restrictive standing requirement. *See supra* note 68 and accompanying text.

137. *See* Longley & Maxwell, *supra* note 69, at D-17. Although significant differences arise between the DTPA and article 21.21, similarities also exist. For example, both DTPA and article 21.21 require a thirty-day presuit notice. DTPA § 17.50A; article 21.21, § 16(c)-(i). They both provide a two-year statute of limitations. DTPA § 17.50A; article 21.21, § 16(d). The insurer's cause of action for a groundless claim is the same under both statutes. DTPA § 17.50B; article 21.21, § 16(c). Also, similar to the DTPA, a denial of coverage does not give rise to liability under any of the article 21.21 causes of action. *See* General Accident, Fire & Life Assurance Corp. v. Legate, 578 S.W.2d 505, 506-07 (Tex. Civ. App.—Texarkana 1979, writ ref'd n.r.e.).

138. Article 21.21, § 16(b)(1); *see* Longley & Maxwell, *supra* note 69, at D-2.

139. DTPA § 17.50(b); *see* Longley & Maxwell, *supra* note 69, at D-17.

action provided for under the DTPA that is unavailable under article 21.21, section 16 is one for unconscionable conduct by the insurer.[140]

The third statutory source of relief arises from article 21.21-2, commonly referred to as the Unfair Claim Settlement Practices Act.[141] The State Board of Insurance enforces this statute.[142] Unlike the previously discussed statutory provisions, Texas courts have debated the issue of whether article 21.21-2 confers a private cause of action to individuals.[143]

Article 21.21-2 provides that no insurer shall engage in unfair claim settlement practices.[144] At least two Texas appellate courts were of the opinion that this article does not grant a private cause of action to an individual injured by those unfair claim practices.[145] In both of these cases the complainants attempted to bring private actions under the provisions of article 21.21-2. Although the courts in these cases held that no private cause existed, the courts did not address whether the absence of a private cause of action under article 21.21-2 foreclosed any action for these unfair claim practices under either the DTPA or article 21.21.[146]

Dictum in *Humphreys v. Fort Worth Lloyds*[147] addressed the question of the availability of an article 21.21-2 cause of action under either the DTPA or article 21.21. The Amarillo court of appeals, in interpreting article 21.21-2, stated that the legislature did not intend the statute to foreclose a private cause of action for bad faith settlement practices for acts that a court may hold as unfair or deceptive outside the provision of the act.[148] In other words, this court would appear to allow the Unfair Claim Settlement Practices Act and its prohibited provisions to constitute the basis of a private cause of action should the insured properly allege damages under article 21.21 or the DTPA. The federal district court for the Northern District of Texas, however, reached a contrary result.[149] That court held that only the State Board of Insurance may enforce the Unfair Claim Settlement Practices Act.[150] The court further held that an insured cannot sue an insurer under

140. DTPA § 17.50(a)(3); *see* Longley & Maxwell, *supra* note 69, at D-17.
141. Article 21.21-2.
142. *Id.* §§ 2, 6(a).
143. *See* McKnight v. Ideal Mut. Ins. Co., 534 F. Supp. 362, 364-65 (N.D. Tex. 1982) (no private cause of action exists under article 21.21-2); Texas Farm Bureau Mut. Ins. Co. v. Vail, 695 S.W.2d 692, 694-95 (Tex. App.—Dallas 1985, no writ) (no private cause of action under either article 21.21-2 or DTPA for unfair claim settlement practices); Humphreys v. Fort Worth Lloyds, 617 S.W.2d 788, 790 (Tex. Civ. App.—Amarillo 1981, no writ) (legislature did not intend article 21.21-2 to foreclose a private cause of action if pleaded through article 21.21 or the DTPA); Lone Star Life Ins. Co. v. Griffin, 574 S.W.2d 576, 580-81 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.) (no private cause of action under article 21.21-2); Russell v. Hartford Casualty Ins. Co., 548 S.W.2d 737, 742 (Tex. Civ. App.—Austin 1977, writ ref'd n.r.e.) (no private cause of action exists under article 21.21-2).
144. Article 21.21-2, § 2.
145. *See* Lone Star Life Ins. Co. v. Griffin, 574 S.W.2d 576, 580 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.); Russell v. Hartford Casualty Ins. Co., 548 S.W.2d 737, 742 (Tex. Civ. App.—Austin 1977, writ ref'd n.r.e.).
146. *See supra* notes 116-23 and accompanying text.
147. 617 S.W.2d 788 (Tex. Civ. App.—Amarillo 1981, no writ).
148. *Id.* at 790.
149. McKnight v. Ideal Mut. Ins. Co., 534 F. Supp. 362, 364-65 (N.D. Tex. 1982).
150. *Id.* at 364.

section 17.50 of the DTPA for violations of article 21.21-2.[151] This latter position is the more persuasive in interpreting the legislative intent behind article 21.21-2.

III. EXTRA-CONTRACTUAL LIABILITY IN CALIFORNIA: A CONTRASTING VIEW

Unlike the reluctance appearing in the Texas courts, the California courts have aggressively extended extra-contractual liability in both the third and first party contexts. Since California led the way to the imposition of extra-contractual liability, that state's policies and results can assist Texas courts in their analysis of whether to extend further the insurer's liability. Upon evaluation of the California system, however, this Comment concludes that Texas should not adopt California's liberal standard.

A. Third Party Context

1. Common Law Remedies

As in Texas, the development of extra-contractual remedies began in California in third party cases. In *Comunale v. Traders & General Insurance Co.*[152] the California Supreme Court recognized the duty of good faith and fair dealing in third party insurance contract cases.[153] The court read into the contract an implied covenant that neither party would engage in conduct that would injure the right of the other to receive the policy benefits.[154] The court held that within the context of the contractual relationship of the parties to an insurance contract, a court can compel the insurer to ignore its own best interest in favor of the insured's best interest.[155]

The California Supreme Court expanded *Comunale* in *Crisci v. Security Insurance Co.*[156] The court in *Crisci* held that an insurer stands liable for the full amount of any subsequent judgment whenever the insurer refuses to accept an offer within policy limits.[157] The basis for the adoption of this duty of good faith dealings in third party situations is that a fiduciary relationship exists between the insurer and the insured arising out of the insurer's exclusive control over the settlement negotiations.[158]

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151. *Id.* at 364-65.

152. 50 Cal. 2d 654, 328 P.2d 198 (1958).

153. 328 P.2d at 200-01. The court ignored the insurer's defense of no coverage and held that whenever a claimant makes a settlement demand within policy limits, the courts will impose a duty to settle or defend the insured. *Id.*

154. *Id.* at 200.

155. *Id.* at 201.

156. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

157. 426 P.2d at 178, 58 Cal. Rptr. at 18; *see* Johansen v. California State Auto. Ass'n Inter-Ins. Bureau, 15 Cal. 3d 9, 538 P.2d 744, 746-48, 123 Cal. Rptr. 288, 290-92 (1975) (trend toward strict liability on part of insurer that rejects an offer to settle within policy limits in a case of major damages).

158. *See* Yeomans v. Allstate Ins. Co., 130 N.J. Super. 48, 324 A.2d 906, 908 (1974); *see also* Rova Farms Resort, Inc. v. Investors Ins. Co., 65 N.J. 474, 323 A.2d 495, 505 (1974) (a fiduciary relationship exists with respect to third party liability insurers at least with respect to that part of the relationship requiring it to defend claims on behalf of its insured).

2. Statutory Remedies

In addition to the case law expansion of extra-contractual liability in the third party situations developed above, California statutes provide penalties in the event of violations. Like Texas's article 21.21-2, California has a statutory provision that regulates unfair claim practices of insurers.[159] Also similar to Texas law, the California statute provides for the state's Insurance Commission to enforce its provisions.[160] Unlike the Texas courts, however, the California Supreme Court has further held that a court may imply a third party private cause of action from the provisions of the unfair claim practices statute.[161]

In *Royal Globe Insurance Co. v. Superior Court*[162] the plaintiff incurred personal injuries when she slipped and fell in a food market. The plaintiff sued the liability insurer of the market for violating the unfair claims settlement provisions of the Insurance Code[163] by failing to settle promptly and by advising the plaintiff not to retain an attorney. The California Supreme Court expressly held that a violation of the unfair claims settlement practices provisions of the California Insurance Code gave rise to a private cause of action for money damages and that such a cause of action extends to third party claimants.[164] The third party may not bring suit against the insurer, however, until the third party and the insured conclude any suit between them.[165]

B. First Party Context

1. Common Law Remedies

In addition to the expansion of extra-contractual liability in third party situations, the California courts have laid the foundation for its extension to first party situations. These courts first extended extra-contractual liability under the tort theories of fraud,[166] intentional infliction of emotional distress,[167] breach of an implied covenant of good faith and fair dealing,[168] and interference with a property interest.[169] Eventually, however, the California Supreme Court adopted a tort theory of bad faith to allow insureds to re-

159. CAL. INS. CODE §§ 790-790.10 (West 1972).
160. *Id.* at § 790.05.
161. Royal Globe Ins. Co. v. Superior Ct., 23 Cal. 3d 880, 885, 592 P.2d 329, 332, 153 Cal. Rptr. 842, 845 (1979).
162. *Id.*
163. CAL. INS. CODE § 790.03(h)(5), (14) (West Supp. 1987).
164. 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845.
165. *Id.*
166. *See* Wetherbee v. United Ins. Co., 265 Cal. App. 2d 921, 71 Cal. Rptr. 764, 769 (1968) (insurer's conduct after entering the contract and failure to settle the claim sustained an inference of fraudulent intent).
167. *See* Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 401-02, 89 Cal. Rptr. 78, 93-94 (1970) (insured's recovery for emotional distress justified based on insurer's attempt to economically coerce insured to settle for less than fair amount).
168. *See id.* at 401, 89 Cal. Rtpr. at 93 (breach results from insurer's threatened or actual withholding of payments without probable cause).
169. *See id.* at 401-02, 89 Cal. Rptr. at 93-94 (insured's right to policy proceeds constitutes a protected property interest).

cover extra-contractual damages.[170]

The California Supreme Court established the concept of the bad faith tort in first party insurance situations in *Gruenberg v. Aetna Insurance Co.*[171] In adopting the tort of bad faith in the first party context, the court reasoned that an implied covenant of good faith and fair dealing exists in every insurance contract.[172] Such a duty exists whether third persons bring the claim against the insured or the insured itself makes the claim.[173] The court concluded that an insurer is liable in tort if the insurer unreasonably and in bad faith withholds payment of its insured's claim.[174] The court added that the existence of a contractual relationship does not insulate the insurers from liability.[175] Although the *Gruenberg* court made an impact on extra-contractual damages in the context of property insurance policies, it left unanswered the issue of when insurers' conduct would support an award for punitive damages.

Silberg v. California Life Insurance Co.[176] dealt with the question of the type of conduct necessary to support an award of punitive damages.[177] *Silberg* held that in order to have a punitive damage claim, the insured must prove more than just bad faith.[178] The insured must additionally prove the insurer guilty of oppression, fraud, or malice.[179] In addition to setting the standard for punitive damages, the *Silberg* decision appears significant in four aspects. First, the court established that an insurer may face liability based upon action or inaction.[180] Second, the court held the insurer to a higher standard of conduct than the ordinary negligence standard.[181] Third, evidence of customs of the insurance industry is not conclusive on the scope of the insurer's duty.[182] Finally, the bad faith tort does not require the insurer's intentional conduct.[183]

Several jurisdictions have adopted the California tort of bad faith in first party actions.[184] The following policy considerations support this duty of

170. Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 575, 510 P.2d 1032, 1038, 108 Cal. Rptr. 480, 486 (1973).

171. *Id.*

172. *Id.* at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486.

173. *Id.*

174. *Id.*

175. *Id.* at 578, 510 P.2d at 1040, 108 Cal. Rptr. at 488.

176. 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

177. *Id.* at 462-63, 521 P.2d at 1110, 113 Cal. Rptr. at 718.

178. *Id.*

179. *Id.*; Fanning, *Bad Faith & Other Extra-Contractual Actions Against Insurers*, FOR THE DEF., Nov. 1985, at 11, 14.

180. 11 Cal. 3d at 461, 521 P.2d at 1109, 113 Cal. Rptr. at 717; *see also* Fanning, *supra* note 179, at 14 (mere refusal to pay without adequate grounds is sufficient to constitute liability).

181. 11 Cal. 2d at 460, 521 P.2d at 1108-09, 113 Cal. Rptr. at 717. The insurer's good faith duty includes paying at least as much attention to the insured's interest as it pays to its own interest. *Id.*

182. *Id.* at 462, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

183. Fanning, *supra* note 179, at 14.

184. *See* United Servs. Auto Ass'n v. Werley, 526 P.2d 28, 33 (Alaska 1974); Findley v. Time Ins. Co., 264 Ark. 647, 573 S.W.2d 908, 909 (1978); Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co., 34 Conn. Supp. 46, 375 A.2d 428, 430 (Super. Ct. 1977); Colonial Life & Accident Ins. Co. v. McClain, 243 Ga. 263, 253 S.E.2d 745, 756 (1979); Vernon Fire &

good faith and fair dealing: (1) unequal bargaining power;[185] (2) intent of insurance is not private economic gain of insurer, but economic security in case of loss to insured;[186] (3) bad faith refusal to pay policy benefits often has disastrous effects on the insured;[187] (4) insurance policies may be contracts of adhesion;[188] (5) such a duty will punish insurers for breach and deter others from future violations;[189] and (6) a fiduciary duty exists between insurer and insured in a first party insurance claim based on an implied covenant of fair dealing that exists in every contract.[190] Although the courts accepting the tort of bad faith in first party actions justify their actions based on a national trend, further research reveals that this trend does not exist.[191]

2. *Statutory Remedies*

Although an implied covenant of good faith and fair dealing clearly protects the insured in California,[192] a first party statutory cause of action is available as a supplement to existing common law remedies.[193] The California Supreme Court has extended its holding in *Royal Globe* to apply in the first party context so that insureds have a private cause of action under the unfair claim settlement practice provisions of the California Insurance Code.[194] Thus, while the Texas courts currently debate the first party private cause of action,[195] the California courts allow such a cause of action.

IV. RECOMMENDATIONS TO THE TEXAS SUPREME COURT

Those jurisdictions that choose to follow California argue that the national trend urges the adoption of bad faith and its accompanying extracontractual liability in first party cases.[196] In actuality, however, the more recent and growing trend arises among those jurisdictions specifically re-

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Casualty Ins. Co. v. Sharp, 264 Ind. 599, 349 N.E.2d 173, 180 (1976); First Sec. Bank v. Goddard, 181 Mont. 407, 593 P.2d 1040, 1047 (1979); United States Fidelity & Guar. Co. v. Peterson, 91 Nev. 617, 540 P.2d 1070, 1071 (1975); Frizzy Hairstylists, Inc. v. Eagle Star Ins. Co., 89 Misc. 2d 822, 392 N.Y.S.2d 554, 556 (Civ. Ct. 1977); Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co., 279 N.W.2d 638, 645 (N.D. 1979); Kirk v. Safeco Ins. Co., 57 Ohio St. 2d 49, 273 N.E.2d 919, 921 (1970); Christian v. American Home Assurance Co., 577 P.2d 899, 904 (Okla. 1978).

185. Christian v. American Home Assurance Co., 577 P.2d 899, 902 (Okla. 1978).

186. *See* Comment, *supra* note 4, at 141.

187. Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co., 34 Conn. Supp. 46, 375 A.2d 428, 430 (Super. Ct. 1977).

188. Christian v. American Home Assurance Co., 577 P.2d 899, 902 (Okla. 1978).

189. *See* Comment, *supra* note 4, at 141.

190. Polito v. Continental Casualty Co., 689 F.2d 457, 462 (3d Cir. 1982).

191. *See infra* notes 197 and 222 and accompanying text.

192. *See* Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78, 93 (1970).

193. W. SHERNOFF, S. GAGE & H. LEVINE, INSURANCE BAD FAITH LITIGATION § 6.04(2)(a) (1984).

194. Colonial Life & Accident Ins. Co. v. Superior Ct., 31 Cal. 3d 785, 647 P.2d 86, 70, 183 Cal. Rptr. 810, 813-14 (1982).

195. *See supra* notes 144-51 and accompanying text.

196. *See supra* note 184 and accompanying text (eleven jurisdictions have adopted the first party cause of action; all in the 1970s).

jecting the tort of bad faith in the first party context.[197] What the current law is and where it is going in the area of insurers' extra-contractual liability in both the first and third party context concerns Texas. Although the *Stowers* doctrine established extra-contractual liability of the insurer to its insured in the third party context, uncertainties exist in all other areas. As the following discussion illustrates, it is essential that the Texas Supreme Court not extend this liability to third party claimants and that the court reexamine its extension to insureds in the first party context.

A. Limit Extra-Contractual Liability to Third Party Stowers *Context and Specific Statutory Situations*

To date, the Texas Supreme Court has refused to extend insurer's extra-contractual liability to the liberal extremes of the California courts. Texas courts adhere to the *Stowers* doctrine wherein the insured must prove the insurer negligent in refusing to settle a tort claim within the policy limits in order to recover a judgment in excess of such limits.[198] Although the Texas Supreme Court has not addressed the issue of an insurer's liability to the third party claimant, the court has refused writ for cases involving the question as containing no reversible error.[199] The courts should maintain the position that the *Stowers* doctrine does not apply to the third party claimant.[200] This third party direct action appears unnecessary since the claimant benefits from the insurer's neglect to the extent of the harm caused to the insured.[201] The insured suffers the excess judgment, not the third party claimant.[202] The insured, therefore, possesses any cause of action that may exist against the insurer.

In addition to the common law context, a third party should not possess a statutory cause of action against an insurer. No Texas case has extended a statutory cause of action to a third party claimant. When presented with the opportunity, the Texas Supreme Court should not adopt the California position of *Royal Globe Insurance Co. v. Superior Court*.[203]

The position of the California Supreme Court in *Royal Globe* appears both irrational and destructive of the public policy that forms the basis of the Model Unfair Claim Settlement Practices Act,[204] which both California and Texas follow. The Texas Unfair Claim Settlement Practices Act sets out, as

197. *See infra* note 222 and accompanying text (ten jurisdictions addressing the issue have specifically rejected the first party cause of action; this move made by all but one since 1980).

198. *See* Knox, *supra* note 27, at 67.

199. *See* Samford v. Allstate Ins. Co., 529 S.W.2d 84, 86 (Tex. Civ. App.—Corpus Christi 1975, writ ref'd n.r.e.); Cook v. Superior Ins. Co., 476 S.W.2d 363, 364 (Tex. Civ. App.—Beaumont 1972, writ ref'd n.r.e.).

200. Samford v. Allstate Ins. Co., 529 S.W.2d at 86; Cook v. Superior Ins. Co., 476 S.W.2d at 364.

201. Cook v. Superior Ins. Co., 476 S.W.2d at 364.

202. Samford v. Allstate Ins. Co., 529 S.W.2d at 86.

203. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979); *see supra* notes 162-65 and accompanying text.

204. AN ACT RELATING TO UNFAIR METHODS OF COMPETITION AND UNFAIR AND DECEPTIVE ACTS AND PRACTICES IN THE BUSINESS OF INSURANCE (Nat'l Ass'n of Ins. Comm'rs 1972); *see* Ryan, *supra* note 1, at 24.

do both the California[205] and Model Acts, unfair claim practices that are violative when performed so frequently as to indicate a requisite general business practice.[206] The third party claimant's claimed right to direct action against the insurer evolves from the insurer's failure to attempt "in good faith to effectuate prompt, fair, and equitable settlements of claims submitted in which liability has become reasonably clear."[207] In extending this provision to third party claimants, California effectively has destroyed the public policy of regulating only those acts that the insurer performs with frequency.[208] A single alleged violation by an insurer does not constitute a general business practice.

In allowing a third party cause of action under the Unfair Claim Settlement Practices Act, California has adopted the attitude that the insurer must make settlements with claimants without regard to the social costs of such a position.[209] The social cost of this statutory interpretation equals the elimination of the trial court process to resolve such issues. By compelling the insurer into compromise settlements, the insurer's fair access to a jury trial becomes unprotected.[210]

The Texas courts should enforce this same general business practice rationale in statutory actions brought by insureds against their insurers. As in the third party context, insurer conduct solely with respect to the particular insured's claim should not give rise to a cause of action under the Unfair Claim Settlement Practices Act.[211] The Texas courts do not dispute the issue that an insured cannot sue its insurer under the Unfair Claim Settlement Practices Act.[212] A dispute does exist, however, on the issue of whether an insured can sue under the DTPA for violations of the Unfair Claim Settlement Practices Act.[213] The DTPA expressly provides a cause of action to an insured for any violation of article 21.21.[214] Had the legislature intended a

205. CAL. INS. CODE § 790.03(h) (West Supp. 1987); *see* Ryan, *supra* note 1, at 24.

206. Article 21.21-2, § 2.

207. *Id.* § 2(d).

208. *See* Ryan, *supra* note 1, at 25.

209. *Id.*

210. *Id.* at 25-26.

211. *See* Dano v. Royal Globe Ins. Co., 59 N.Y.2d 827, 829, 451 N.E.2d 488, 489, 464 N.Y.S.2d 741, 742 (1983).

212. *See, e.g.*, Humphreys v. Fort Worth Lloyds, 617 S.W.2d 788, 790 (Tex. Civ. App.—Amarillo 1981, no writ) (legislature prohibiting private cause of action under article 21.21-2 not intended to foreclose private action if plead through article 21.21 or DTPA); Lone Star Life Ins. Co. v. Griffin, 574 S.W.2d 576, 580 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.) (no private cause of action under article 21.21-2); Russell v. Hartford Casualty Ins. Co., 548 S.W.2d 737, 742 (Tex. Civ. App.—Austin 1977, writ ref'd n.r.e.) (no private cause of action under article 21.21-2).

213. *Compare* McKnight v. Ideal Mut. Ins. Co., 534 F. Supp. 362, 364-65 (N.D. Tex. 1982) (no private cause of action under article 21.21-2) *and* Lone Star Life Ins. Co. v. Griffin, 574 S.W.2d 576, 580-81 (Tex. Civ. App.—Beaumont 1978, writ ref'd n.r.e.) (article 21.21-2 does not confer a private cause of action) *with* Humphreys v. Fort Worth Lloyds, 617 S.W.2d 788, 790 (Tex. Civ. App.—Amarillo 1981, no writ) (legislature did not intend article 21.21-2 to foreclose a private cause of action if pleaded through article 21.21 or the DTPA).

214. DTPA § 17.50(a)(4). A consumer may maintain a private action when the insurer's violation of article 21.21, or its rules or regulations issued by the State Board of Insurance, constitutes a producing cause of actual damages. *Id.*

private cause of action for violations of article 21.21-2, the Unfair Claim Settlement Practices Act, the legislature would have included this provision among the DTPA causes of action. Instead, only the State Insurance Department may enforce the Unfair Claim Settlement Practices Act.[215] Since the early 1970s the Texas Legislature has demonstrated a marked interest in statutorily governing the relationship between the insurer and insured.[216] The judiciary should not read into these statutes additional, unnecessary regulations.

B. Retreat from the Unwarranted Extension of Extra-Contractual Liability in the First Party Context

Clearly, the insurer's obligation to accept a good faith settlement within the policy limits represents the law in Texas in the third party context.[217] The obligation of good faith settlements in first party actions, however, has been quite controversial.[218] California has extended the duty of good faith and fair dealing that existed in third party claims to the first party context.[219] The Texas Supreme Court recently addressed the important question of whether to reject a first party bad faith tort since no case existed that approved such a cause of action in Texas or, in view of the lack of clear prohibition against such claims in Texas, whether the court should adopt such a tort action.[220] Unfortunately, in electing to adopt a first party cause of action for breach of a duty of good faith and fair dealing, the court offered little justification for its conclusion.[221] At its first opportunity, the court should give serious consideration to overruling this decision.

The recent and growing trend is among those jurisdictions specifically rejecting the tort of bad faith and the accompanying extra-contractual liability in the first party context.[222] These jurisdictions base their decisions on more persuasive policy grounds and traditional concepts of contract, tort, and statutory liability. Examples of policy justifications for refusing to adopt ex-

215. *See* McKnight v. Ideal Mut. Ins. Co., 534 F. Supp. 362, 364 (N.D. Tex. 1982); Article 21.21-2, § 6.

216. The Texas Legislature enacted both the DTPA and article 21.21, § 16 in 1973. *See* Comment, *supra* note 28, at 456.

217. *See supra* notes 26-59 and accompanying text.

218. *See supra* notes 91-114 and accompanying text.

219. Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 575, 510 P.2d 1032, 1038, 108 Cal. Rptr. 480, 486 (1973); *see supra* notes 172-73 and accompanying text.

220. Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987).

221. *Id.*

222. *See* Casson v. Nationwide Ins. Co., 455 So. 2d 361, 368-69 (Del. Super. Ct. 1982); Guarantee Abstract & Title Co. v. Interstate Fire & Casualty Co., 232 Kan. 76, 652 P.2d 665, 668 (1982); Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149, 158 (1980); Kewin v. Massachusetts Mut. Life Ins. Co., 409 Mich. 401, 295 N.W.2d 50, 56 (1980); Haagenson v. National Farmers Union Property & Casualty Co., 277 N.W.2d 648, 652-53 (Minn. 1979); Duncan v. Andrew County Mut. Ins. Co., 665 S.W.2d 13, 19 (Mo. Ct. App. 1983); Craig v. Iowa Kemper Mut. Ins. Co., 565 S.W.2d 716, 723-24 (Mo. Ct. App. 1978); Jarvis v. Prudential Ins. Co. of America, 122 N.H. 648, 448 A.2d 407, 409 (1982); Milcarek v. Nationwide Ins. Co., 190 N.J. Super. 358, 463 A.2d 950, 957 (Super. Ct. App. Div. 1983); Farris v. United States Fidelity & Guar. Co., 284 Or. 453, 587 P.2d 1015, 1018-21 (1978); D'Ambrosio v. Pennsylvania Nat'l Mut. Casualty Ins. Co., 494 Pa. 501, 431 A.2d 966, 969-70 (1981); Beck v. Farmers Ins. Exch., 701 P.2d 795, 799 (Utah 1985).

tra-contractual liability in the first party context include: (1) general rules of contract law disallow punitive damages;[223] (2) other means of recovery are unnecessary based on the favorable rules of construction already granted insureds by case law;[224] (3) judicial intervention is unnecessary since statutes provide insureds with necessary protection;[225] (4) the rationale supporting extra-contractual liability in third party situations does not apply in the first party context;[226] and (5) public policy does not support compelling settlements and discouraging insurers from challenging claims that appear fairly debatable.[227]

The most obvious of these justifications for rejecting the imposition of liability upon an insurer in excess of policy limits in an action brought by one of its insureds is found in traditional contract law. Prior to the *Gruenberg* wave, *Hadley v. Baxendale*[228] and the historic concept of limited recovery under a contract governed insurers' liability.[229] From *Hadley* American courts logically reasoned that an action for breach of an insurance contract was limited to the policy amount.[230] Such a limitation encompassed the foreseeable damages within the contemplation of the parties at the time the parties executed the contract.[231] These contractual damages for breach of an insurance contract do not include mental anguish or punitive damages.[232] The arguments that the insured and insurer have unequal bargaining power,[233] or that the insurance policy is a contract of adhesion,[234] possess no merit. First, the courts have firmly established that they will interpret any contract ambiguities in favor of the insured.[235] Second, the State Insurance Board strictly regulates and controls the insurance industry in Texas.[236] The truth of the matter is that neither the insured nor the insurer controls the terms of the contract.

The involvement of the State Insurance Board coupled with intense legislative regulation of insurers make judicial intervention unnecessary and inappropriate in protecting insureds. Texas has enacted statutory penalties against insurance companies that fail, without good cause, to settle claims

223. Comment, *supra* note 4, at 142.

224. *Id.*

225. *Id.*

226. Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149, 155 (1980).

227. Harvey & Wiseman, *First Party Bad Faith: Common-Law Remedies and a Proposed Legislative Solution*, 72 KY. L.J. 141, 190 (1983-84).

228. 156 Eng. Rep. 145 (Ex. Ch. 1854).

229. *See supra* notes 3-4 and accompanying text.

230. *See* Miller, *supra* note 3, at 3.

231. *See id.*

232. *See* Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149, 158 (1980).

233. Christian v. American Home Assurance Co., 577 P.2d 899, 902 (Okla. 1978).

234. *Id.*

235. *See* Ramsey v. Maryland Am. Gen. Ins. Co., 533 S.W.2d 344, 349 (Tex. 1976); Royal Indem. Co. v. Marshall, 388 S.W.2d 176, 180 (Tex. 1965); Republic Nat'l Life Ins. Co. v. Spillars, 368 S.W.2d 92, 94 (Tex. 1963).

236. Mutual Life Ins. Co. v. Daddy$ Money, Inc., 646 S.W.2d 255, 257 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

with their insureds.[237] These legislative remedies should be exclusive, thereby eliminating the need for other remedies.[238]

Traditional rules applicable to contract and statutory law provide the most obvious justifications for reevaluating the extension of extra-contractual liability in the first party context. A less obvious, but more widely debated, justification is that the rationale behind the widely accepted excess liability in a third party situation does not apply to a first party situation.[239] Courts can easily distinguish the rationale for the duty and imposition of liability in the third party case from an insurer's duty in the first party situation. In the third party context, the insurer possesses absolute control of settlement negotiations and the trial.[240] This control of the insurer over the liability of the insured creates a fiduciary relationship between the insurer and the insured.[241] In the first party context, the duties and obligations of the parties arise from a contract rather than a fiduciary relationship.[242] As in all contracts, an adversarial relationship exists between the insurer and the insured.[243] In this context, the insurer could not expose its insured to a judgment that is greater than the limits specified in the policy.[244] The supreme court invites great danger in allowing first party extra-contractual liability. The insured has the opportunity to transform a simple first party claim into a broad-ranging and costly inquiry into the general business practices of the insurer. The high risk and tremendous cost of defending may discourage the insurer from asserting a legitimate defense.[245] This possibility runs counter to Texas's long-established adversarial system.[246]

The adversary system evokes the final criticism of extra-contractual damages in the first party context. The threat of excess liability, in the form of punitive damages, may inhibit insurers from asserting appropriate defenses[247] and ultimately lead to payments under normally uninsurable situations.[248] The fear of such judgments should not be so great that it discourages insurers from challenging at least "fairly debatable" claims.[249]

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237. *See supra* notes 75 and 130-34 and accompanying text.

238. *See* Debolt v. Mutual of Omaha, 56 Ill. App. 3d 111, 371 N.E.2d 373, 378 (1978) (courts harbor serious doubts as to the desirability and wisdom of implementing or expanding a legislative remedy by judicial decree); Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149, 158 (1980) (when a legislature has provided effective remedies, the courts should not expand them by judicial decree); D'Ambrosio v. Pennsylvania Nat'l Mut. Casualty Ins. Co., 494 Pa. 501, 431 A.2d 966, 969-70 (1981) (state insurance departments and state legislatures are able to prohibit unfair claim practices).

239. Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149, 155 (1980).

240. *Id.*

241. *Id.*

242. Beck v. Farmers Ins. Exch., 701 P.2d 795, 800 (Utah 1985).

243. Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149, 155 (1980).

244. *Id.*; Lawton v. Great Southwestern Fire Ins. Co., 118 N.H. 607, 392 A.2d 576, 581 (1978).

245. Murray & Maillet, *Extra-Contractual Remedies & Punitive Damages in First-Party Insurance Claims*, 53 INS. COUNS. J., Apr. 1986, at 251, 252.

246. *See* English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983).

247. For a discussion on available defenses, see *infra* notes 254-56 and accompanying text.

248. *See* Miller, *supra* note 3, at 2.

249. Harvey & Wiseman, *supra* note 212, at 190. Examples of cases with fairly debatable claims include: Lynch v. Mid-America Fire & Marine Ins. Co., 94 Ill. App. 3d 21, 418 N.E.2d

The insurer does not, and should not, have to pay every claim submitted.[250] The insurer's obligation demands that it pay valid claims within a reasonable time.[251] When a claim is fairly debatable, the adversary system should encourage the insurer to debate it, regardless of whether the issue is one of fact or law.[252] Such debate encourages respect for the principle of the adversary system that injury, regardless of severity, is "never enough" and "victory is never certain."[253]

C. *Recognize Defenses and Precautions*

While the present judicial climate remains unpredictable, the justifications for reevaluating the recent expansion and rejecting any further expansion of extra-contractual liability in Texas appear abundant. In the event the insurer is faced with a bad faith allegation while the Texas courts remain in this unsettled state, the insurer may avail himself of several defenses.[254] Among those defenses is an insurer's "comparative bad faith" defense. This defense arises when the insured fails to provide the insurer promptly with full and complete information pertinent to the claim.[255] An insurer who has scrutinized its claims handling procedures and fulfilled all its policy obligations should assert an available defense and not withdraw from the civil challenge.[256]

421, 427 (1981) (when fire department officials told insurer a fire was deliberately set, the insurer did not act in bad faith in contesting the claim); Pruitt v. Alaska Pac. Assurance Co., 28 Wash. App. 802, 626 P.2d 528, 530 (1981) (bona fide dispute over the existence and extent of old versus new damage).

250. LePley, *Bad Faith Updated: Definitions & Defenses*, TRIAL, Apr. 1985, at 44, 48.

251. *Id.* An insurer does not breach the duty of good faith and fair dealing when it denies a claim that is fairly debatable. *Id.*; *see* Gulf Atl. Life Ins. Co. v. Barnes, 405 So. 2d 916, 924 (Ala. 1981).

252. Gulf Atl. Life Ins. Co. v. Barnes, 405 So. 2d 916, 924 (Ala. 1981).

253. *See* Ryan, *supra* note 1, at 26.

254. The insurer's available defenses include:

(1) The insurer believes that it has a fighting chance to defeat the claim or of holding the amount of the judgment within the policy limits.
(2) The insurer makes a mere mistake of judgment.
(3) The insured refuses to give the insurer the true facts.
(4) The insurer suspects collusion on the part of the insured.
(5) The insured is guilty of misconduct.
(6) The insured joins the insurer in rejecting any compromise offer.
(7) The insurer possesses a contractual right to appeal.
(8) The insured's claimant's mental condition prohibits the insured from consenting to a settlement.
(9) There is a breach of the cooperation clause.
(10) There is no settlement opportunity within policy limits.

Berg, *supra* note 13, at D-12. If the insurer tenders damages and attorney's fees within thirty days from the date of notice of the DTPA complaint, the insurer possesses a defense under the DTPA. *See* DTPA § 17.50B(d). Moreover, an insurer may recover attorney's fees for a groundless suit under the DTPA. *See* Genico Distribs., Inc. v. First Nat'l Bank, 616 S.W.2d 418, 420 (Tex. Civ. App.—Texarkana 1981, writ ref'd n.r.e.). *But see* Smith v. Baldwin, 611 S.W.2d 611, 616 (Tex. 1981) (no common law defenses are available to a DTPA claim; only those defenses provided by statute).

255. California Casualty General Ins. Co. v. Superior Court, 173 Cal. App. 3d 274, 283, 218 Cal. Rptr. 817, 822-23 (1985).

256. *See* Miller, *supra* note 3, at 2.

Although the insurer has many available defenses, the insurer obviously prefers to avoid any bad faith allegation. Insurers and their defense counsel should be aware of the threat of extra-contractual liability and take every precaution to avoid potential excess liability situations. In both the first and third party context, these precautions include: (1) the prompt and thorough investigation of losses;[257] (2) a fair evaluation of the claim's value;[258] (3) informing the insured about the investigation;[259] (4) providing complete, accurate, and timely responses to inquiries;[260] and (5) refraining from saying or doing things that courts may classify as tortious or unfair.[261] Additionally, in the third party context, the insurer should take care in deciding whether to defend the insured.[262]

V. CONCLUSION

The climate in Texas remains unstable in the area of insurers' extra-contractual liability. Questions exist as to the availability of a third party direct cause of action against the insurer for common law and statutory extra-contractual remedies. An equally turbulent debate exists on when an insured may recover extra-contractual remedies from its insurer in the first party context. The Texas Supreme Court should encourage the continued success of the adversarial system that has proven effective for the past 150 years.[263] The court's upholding of the contractual foundation that supports the relationship between the insurer and the insured will continue the success of the adversarial system. In the first party context, courts should limit damages to those that the parties reasonably anticipated when they entered into the agreement. In the third party context, the court should uphold traditional contract theory and forbid third party claimants, who are outside the contractual relationship, from pursuing an action against the insurer. The Texas Legislature extensively regulates the insurance industry. Since such regulations provide the public with the necessary protection, the judiciary should not interfere. The Texas Supreme Court should refuse to expand extra-contractual liability in the third party context. The court should also reevaluate its decision in *Arnold* and follow the growing trend that limits insurers' liability to the policy terms in the first party context.

257. *See* Berg, *supra* note 13, at D-11.
258. *Id.*
259. *Id.* at D-12.
260. *See* Ashley, *Guidelines for the Insurer in Avoiding Bad Faith Exposure*, 36 FED'N OF INS. & CORP. COUN. Q 103, 106 (1986).
261. *Id.* at 107.
262. *Id.* at 103.
263. English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983).