

**THE DUTY OF GOOD FAITH AND FAIR DEALING
IN WORKERS' COMPENSATION CLAIMS**

DAVID BRENNER

Burns Anderson Jury & Brenner, LLP
P. O. Box 26300
Austin, Texas 78755-6300

and

JEFF RAIZNER

ANDREW SLANIA

Doyle Raizner, LP
1221 McKinney Suite 4100
Houston, Texas USA 77010

State Bar of Texas
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DAVID BRENNER
BURNS ANDERSON JURY & BRENNER, LLP
P. O. Box 26300
Austin, TX 78755-6300
512-338-5322
Fax: 512-338-5363

DAVID BRENNER
BIOGRAPHICAL INFORMATION

EDUCATION

B.B.A. University of Texas
Doctor of Jurisprudence, Baylor University

PROFESSIONAL ACTIVITIES

- **Managing Partner, Burns Anderson Jury & Brenner, LLP, Austin Texas**
- **Focus in trial and appellate practice**
- **Board Certified Personal Injury Trial Law, Texas Board of Legal Specialization**
- **Certified, Civil Trial Law, National Board of Legal Specialty Certification**
- **Fellow, Texas Bar Foundation**
- **Member, American Board of Trial Advocates**

LAW RELATED PUBLICATIONS, ACADEMIC APPOINTMENTS AND HONORS

American Jurisprudence Award – Contracts
American Jurisprudence Award –Property II
Author/Speaker, Bad Faith Update, TADC 2002 Winter Seminar
Author/Speaker, *Extra-contractual Exposure Beyond the Labor Code*, Texas Workers' Compensation Commission Education Conference, 2003, 2004 and 2008.
Author/Speaker, Bad Faith, State Bar of Texas, Advanced Workers' Compensation Course, 2004, 2005 and 2006.
Author/Speaker, *Cross-Examination of Expert Witnesses*, State Bar of Texas, Advanced Workers' Compensation Course, 2007
Author/Speaker – Avoiding Exposure in Wrongful Discharge Claims – Texas Self Insurance Association Annual Educational Conference, 2006, 2007 and 2008.
Texas Super Lawyers – Civil Trial 2007 and 2008.

Jeffrey L. Raizner
DOYLE RAIZNER LLP
1221 McKinney Suite 4100
Houston, Texas, USA 77010
www.DoyleRaizner.com

Contact Information:

In Houston: 713.571.1146
Fax: 713.571.1148
U.S. Toll Free: 888.571.1001
UK/Europe: 0871 218 1001
email: jraizner@DoyleRaizner.com
Web address: www.DoyleRaizner.com

Areas of Practice: Representing Plaintiffs in -

Admiralty and Maritime Law
Transnational Personal Injury and Insurance Bad Faith
Insurance Bad Faith
Aviation Disaster Law

Bar Admissions:

Texas, 1992
U.S. District Court for the Southern District of Texas
U.S. District Court for the Northern District of Texas
U.S. District Court for the Eastern District of Texas
U.S. District Court for the Western District of Texas

Education:

University of Houston Law Center, 1992
Houston Law Review: Note and Comment Editor, Board 29, 1990-92
Graduated Cum Laude
American Jurisprudence Awards in Civil Trial Advocacy and Property
Order of the Coif
Phi Delta Phi

Tulane University, 1989
B.A., History

Firms:

Doyle Raizner LLP – Houston, Texas – Since April 2003
The Doyle Law Firm – Houston, Texas – April 2002-April 2003
Vinson & Elkins, LLP – Houston, Texas – 1992 to April 2002

Publications, Presentations and Honors:

Jeffrey L. Raizner, *The Differences Between Personal Injury Litigation in the UK and the USA*, Legal and Medical Conference 2007, London, United Kingdom, February 21, 2007

Prof. Robert Force, Mark D. Latham, and Jeffrey Raizner, *Recent Developments in Maritime Law*, Tulane University Law School 22nd New Orleans Fall Maritime Law Seminar New Orleans, Louisiana, September 29, 2006

David Brenner and Jeffrey L. Raizner, *Bad Faith*, State Bar of Texas Third Annual Advanced Workers' Compensation Course 2006, Austin, Texas, August 24-25, 2006

Jeffrey L. Raizner, "KRE Policies: Your Money or Your Life," *Legal + medical Magazine (UK)*, Issue 19, July 2006

Deposing the Insurance Adjuster, Workers' Compensation Publications, Avoiding and Defending Allegations of Bad Faith Seminar, Dallas, Texas, August 4, 2006

Jeffrey L. Raizner and Amanda Gerke, "KRE Policies: Your Money or Your Life," *Legal + medical Magazine (UK)*, Issue 19, July 2006

Texas Workers' Compensation Claims Handling Pitfalls and Bad Faith, Workers' Compensation Publications Seminar, Dallas, Texas, March 31, 2006.

Jeffrey L. Raizner, "The American Dream? Litigation abroad," *Legal + medical Magazine (UK)*, Issue 16, January 2006

Handling the Insurance Bad Faith Lawsuit, 2005 Barnes Law Seminar, Houston, Texas, November 9, 2005

The Jones Act: Navigating the Warm Waters of Maritime Employer's Liability, 2005 Barnes Law Seminar, Houston Texas, November 9, 2005

Procedural Points and Case Handling: The Plaintiff's Perspective, Lorman Education Services Maritime Personal Injury in Texas Seminar, Houston, Texas

October 14, 2005

Jeffrey L. Raizner and Amanda Gerke, Litigating the Auto/Trucking Case - The Plaintiff's Perspective, Lorman Education Services Automobile and Trucking Liability in Texas Seminar, Houston, Texas

September 16, 2005

Jeffrey L. Raizner and Amanda Gerke, Insurance Issues from the Plaintiff's Perspective, Lorman Education Services Automobile and Trucking Liability in Texas Seminar, Houston, Texas

September 16, 2005

Jeffrey L. Raizner and Jeffrey E. Kalina, M.D., F.A.C.E.P., Anatomy and Injuries: Common Medical Issues in Personal Injury and Workers' Compensation Litigation, Workers' Comp 201 Seminar, Houston, Texas

August 26, 2005.

Multiparty Litigation: The American Practice, Association of Personal Injury Lawyers Annual Conference 2005.

Newport, South Wales, United Kingdom

April 28, 2005

Voir Dire and Jury Selection - The Injured Workers' Strategy, Workers' Compensation Litigation and Ethics Seminar.

April 8, 2005

Insurance Bad Faith and Skullduggery - How Not to Handle Claims, Houston Claims Association Seminar.

February 9, 2005

Completing the Unfinished Picture - Soriano and the Problem of Having So Many Claims and So Little Coverage, University of Texas, Ninth Annual Insurance Law Institute.

November 11-12, 2004

The Potential Costs When "Case Management" Crosses the Line: The Law on the Penalties and Pitfalls for Improper Handling of a Claim for Benefits by an Injured Worker, The Barnes Law Firm Workers' Compensation Seminar.

September 28, 2004

Hon. Sarah Vance, Kathleen Charvet, and Jeffrey Raizner, Recent Developments in Maritime law, 21st New Orleans Fall Maritime Law Seminar, Tulane University.
October 2-3, 2003

The Potential Costs When “Case Management” Crosses the Line: The Law on the Penalties and Pitfalls for Improper Handling of a Claim for Benefits by an Injured Worker, Workers’ Comp Update 2003.
July 24-25, 2003

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Professional Associations:

Association of Trial Lawyers of America
Texas Trial Lawyers Association
Houston Trial Lawyers Association
Association of Personal Injury Lawyers (UK)
Houston Bar Association

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THE DUTY OF GOOD FAITH AND FAIR DEALING IN WORKERS' COMPENSATION CLAIMS

I. INTRODUCTION

Workers' compensation insurers have a duty to insureds and, in the area of workers' compensation insurance, to injured workers to deal fairly and in good faith when investigating, adjusting, and settling claims. The duty arises from both common and statutory law. Insurer "bad faith" is, in its most general of definitions, a breach of this duty that can result in exposure to the insurer, and sometimes the claims handler, for the insured's independent damages. Whether or not the insurer acted reasonably in investigating, adjusting, and timely paying claims is the key component of a bad faith cause of action. We offer the following discussion regarding insurer good faith and bad faith generally and, more specifically, about exposure beyond the Labor Code.

II. THE EVOLUTION OF CAUSES OF ACTION FOR INSURER BAD FAITH

A. The Common Law Duty of Good Faith and Fair Dealing

The common law duty of good faith and fair dealing emerged because of inherently unequal bargaining power between an insurer and its policyholders. The existence of this unequal bargaining power was the foundation for the Texas Supreme Court's creation of the duty, owed by an insurer to the insured, to deal fairly and in good faith when investigating, adjusting and settling claims. A breach of this duty by an insurer can result in the insured having an extra-contractual cause of action against the carrier for damages beyond those otherwise recoverable under the workers' compensation policy.

The common law cause of action for breach of the duty of good faith and fair dealing was adopted by the Texas Supreme Court in its decision in *Arnold vs. National County Mutual Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987). The *Arnold* court stated that a duty of good faith and fair dealing may arise out of the "special relationship" between the insured and the carrier that is the foundation of the insurance contract.

B. The Common Law Duty of Good Faith and Fair Dealing in Workers' Compensation Claims

In *Aranda vs. Ins. Co. of North America*, 748 S.W.2d 210 (Tex. 1988), the Texas Supreme Court extended the duty of good faith and fair dealing to worker's compensation carriers adjusting claims of injured employees. *Aranda* surfaced before the legislative restructuring of the Texas workers' compensation system from 1989-1991. In its current

structure, the Texas Department of Insurance, Division of Workers' Compensation ("DWC") administers the handling and payment of workers' compensation claims in Texas. Under authority granted to it throughout the Texas Labor Code, DWC has adopted extensive rules that regulate and resolve these claims. TEX. LAB. CODE ANN. §§ 401-418 (2003) or DWC Rules. 28 TEX. ADMIN. CODE Chapters 102-180 (2004).

C. Defining the Duty

The Supreme Court struggled to define the duty of good faith and fair dealing within the insurance context. The definition of an insurance good faith and fair dealing claim was given its latest incarnation in *Universe Life Ins. Co. v. Giles*, 950 S.W.2d 48 (Tex. 1997) and tracks the language of former Article 21.21 of the Texas Insurance Code:

Failing to attempt in good faith to effectuate a prompt, fair and equitable settlement of a claim when the insurer's liability has become reasonably clear. State Bar of Texas, *Texas Pattern Jury Charges – Business, Consumer & Employment* 101 (2000).

In an opinion issued on the same day as *Giles*, the Texas Supreme Court also applied the good faith and fair dealing standard stated therein to workers' compensation claims. *United States Fire Ins. Co., et al v. Bessie D. Williams*, 955 S.W.2d 267 (Tex. 1997).

Attorneys and claims professionals dealing with workers' compensation claims may look at the *Giles* standard and question how it can apply to the handling of a worker's compensation claim because of the language regarding "settlement," as any settlement of a workers' compensation claim in its entirety is prohibited by the Texas Labor Code. TEX. LAB. CODE ANN. § 408.005 (1993). In fact, settlement agreements made in violation of the Act will result in sanctions ... and referral to the Commissioner of Insurance of the Texas Department of Insurance with a request to revoke the carrier's authority to write workers' compensation insurance in the state. In addition, carriers that enter into improper settlements or agreed judgments will remain liable for all benefits under the Act. See DWC Advisory 94-10.

The State Bar of Texas Pattern Jury Charge-- Volume IV Committee recognized the difficulty in reconciling this fact with the common law duty in its 2000 version of the applicable *Texas Pattern Jury Charges*. The committee suggests a modification of the *Giles*-type instruction as follows:

Failing to [pay][initiate] benefits when the insurer's liability has become reasonably clear. State Bar of Texas, *Texas Pattern Jury*

Charges – Business, Consumer & Employment. 103.f (2000).

In order to prevent the argument that a carrier did not know liability was reasonably clear, when it obviously should know, given the facts of the case, the Supreme Court left open a second basis for pursuing the breach of the good faith and fair dealing claim when a carrier refuses to pay a claim without conducting a reasonable investigation. *Republic Ins. Co. v. Stoker*, 903 S. W. 2d 338 (Tex. 1995).

In this regard, the Pattern Jury Charge Committee suggested submission in a workers' compensation bad faith case should be:

“Refusing to [pay] [initiate] benefits without conducting a reasonable investigation.” See State Bar of Texas, *Texas Pattern Jury Charges – Business, Consumer & Employment*. 103.f (2000).

These Texas Pattern Jury Charge instructions were favorably endorsed by the Dallas Court of Appeals in *Bennett v. Security Insurance of Hartford*, 160 S.W.3d, 213 (Tex. App.—Dallas 2005, pet. denied).

The overlay of the administrative system on the common law duty of good faith and fair dealing has been respected by the Texas Supreme Court. In *U. S. Fire*, the first “new law” workers' compensation bad faith case, the court found that a carrier cannot be liable for simply misinterpreting or misapplying an administrative rule. See generally, *U. S. Fire Ins. Co. v. Williams*, 955 S.W. 2d 267 (Tex. 1997).

The deference the court gives the DWC process was underscored at the end of 2001, when the Supreme Court handed down *American Motorists Ins. Co. v. Fodge*, 63 S.W.3d 801 (Tex. 2001), in which the court held that the question of the injured worker's entitlement to workers' compensation benefits is a matter committed exclusively to the DWC and, therefore, no cause of action can be asserted against a workers' compensation carrier in the absence of a determination that such benefits are due. *Id.* at 803. *Fodge* illustrates the Supreme Court's willingness to look to statutes to confine an insurance carrier's duties. *Id.* See also *Henry v. Dillard Dep't Stores*, 70 S.W.3d 808 (Tex. 2002).

The Fort Worth Court of Appeals applied *Fodge* to affirm a plea to the jurisdiction by a carrier relating to bad faith claims based on preauthorization that had not been ruled upon by the DWC, but denied the plea as to treatment that had eventually been ordered by the Medical Review Division of the DWC. *Malish v. Pacific Employers Ins. Co.*, 106 S.W.3d 744 (Tex. App.—Fort Worth 2003; no pet.); see also *Cunningham Lindsay Claims Management and Glenda Higgins v. Snyder*, NO. 14-07-00449-CV (Tex. App.—

Houston [14th Dist.] June 25, 2009, pet. anticipated) (dismissing for lack of jurisdiction when administrative process not exhausted). There are two lessons here. First, some courts require that a plaintiff in a bad faith lawsuit exhaust all pertinent administrative processes prior to bringing a bad faith lawsuit even if all disputes are eventually resolved within the system. Second, if the DWC has addressed entitlement to the benefit, the case may proceed at the courthouse.

Again, the Fort Worth Court of Appeals affirmed a summary judgment in a case where the injured worker and his pain management provider sought to avoid *Fodge* and *Malish* by suing not for the wrongful denial of policy benefits, but for misrepresentation as independent tort and extra-contractual causes of action. The Fort Worth Court, citing *Fodge*, held to the requirement of litigating the entitlement of benefits through the DWC before any tort or extra-contractual causes of action may be asserted. *Bone v. Utica Nat'l Ins. Co. of Texas*, No. 2-02-209-CV (Tex. App.—Fort Worth, August 7, 2003).

What is clear is that a party must exhaust its administrative remedies and obtain a final adjudication that the benefits that formulate the basis of the extra-contractual claim are owed before filing suit. However, not only must a party exhaust its administrative remedies. A party must also plead and prove it has exhausted its administrative remedies and obtained an award that the benefits were due. The failure to plead and prove the exhaustion of administrative remedies can justify the dismissal of the extra-contractual claim for want of jurisdiction. *Roskey v. Continental Casualty Co.*, 190 S.W.3d 875 (Tex. App.—Dallas; 2006, pet. filed July 6, 2006).

Nevertheless, the application of *Fodge* is not without its limits. Administrative resolution does not necessarily mean a final decision by a DWC hearing officer. The First Court of Appeals has held that a binding benefit dispute agreement resolving the disputed issue in favor of the injured worker constituted a final determination that benefits were due, thus allowing the claimant to proceed with the extra-contractual claim. *Tex. Mut. Ins. Co. v. Ruttiger*, 2008 Tex. App. LEXIS 440 (Tex. App. Houston [1st Dist.] Jan. 17, 2008).

The Fifth Circuit Court of Appeals held that when a carrier subverts the claimant's ability to exercise administrative review, then an administrative ruling is not a prerequisite to bringing an extra-contractual claim. *Gregson v. Zurich*, 322 F.3d 883 (5th Cir. 2002).

D. Who Faces Potential Liability?

Who can be sued for breach of the common law duty of good faith and fair dealing or for that matter, violations of Chapter 541 of the Texas Insurance Code, is still not totally resolved by the courts. It is still not

unusual to see a plaintiff sue the individual claims handler for breach of the common law duty of good faith and fair dealing. However, in 1994, the Texas Supreme Court held that there is no cause of action against an individual claims handler for breach of the duty of good faith and fair dealing, because the individual claims handler does not meet the criteria to establish the “special relationship” between insurer and policyholder that gives rise to this non-delegable duty. *Natividad v. Alexis*, 875 S.W.2d 695 (Tex. 1994).

Natividad dealt with the common law bad faith cause of action. The question remains, can the claims adjuster be held liable for breach of the same “non-delegable” duties under Chapter 541 of the Texas Insurance Code, when not under common law? In addressing a claims adjuster’s liability for statutory violations, the 5th Circuit Court of Appeals held that there must be evidence sufficient to sustain a finding that that claims adjuster *himself or herself* committed a violation of the insurance Code before liability could be imposed. *Hornbuckle v. State Farm Lloyds*, 385 F.3d 538 (5th Cir. 2004).

Insurance company vendors, such as experts retained to render opinions to support claim evaluation, do not owe a duty of good faith and fair dealing to the policyholder in the absence of contractual privity. *Dagley v. Haag Engineering*, 18 S.W.3d 787 (Tex. App.—Houston [14th Dist.] 2000). Some cases have worked their way through the appellate process dealing with the question of whether a DWC-designated doctor or a peer review doctor can be sued under a theory of conspiracy. For now, there is at least one decision from an appellate court holding that a designated doctor does not become a state actor for purposes of establishing the defense of governmental immunity. *Charles Xeller & Medical Evaluation Specialists, Inc. v. Richard Locke*, 37 S.W.3d 95 (Tex. App.—Houston [14th Dist.] 2002, pet. den.).

E. Standing to Pursue the Bad Faith Claim

As noted above, the duty of good faith and fair dealing, whether at common law or under the Insurance Code, only exists because of the disparity of bargaining power inherent in the insured-insurer relationship. *Mid-Century Ins. Co. v. Boyte*, 80 S.W.3d 546 (Tex. 2002). With exception to employees injured in the course and scope of employment, Texas courts have steadfastly refused to extend the duties beyond the insured-insurer relationship. The Texas Supreme Court has held that the duties arising at common law or by statute do not apply to claimants who are third-parties to the contract. *Allstate v. Watson*, 876 S.W.2d 145 (Tex. 1994). The Texas Supreme Court has also refused to extend the duties to an insured seeking recovery of policy benefits from his/her insurer after a trial court has entered a judgment for those benefits because the unique relationship of insurer-insured

ceases to exist and one of judgment creditor-debtor is formed. *Mid-Century Ins. Co. v. Boyte*, 80 S.W.3d at 549.

Consistent with these lines of cases, the Fort Worth Court of Appeals has held that the spouse of an injured worker lacks standing to assert an independent claim for violations of Texas Insurance Code or breach of the duty of good faith and fair dealing. *Transportation Ins. Co., v. Archer*, 832 S.W.2d 403 (Tex. App.—Ft. Worth 1992, writ denied). In refusing to extend the standing to the spouse of an injured worker, the court held that the carrier’s duty arises out of the special relationship created by the contract between the employee, employer and carrier. Because the spouse is not a party to the contract, the spouse does not have a “special relationship” with the carrier. Consequently, the spouse had no cause of action against the carrier for the failure to act in good faith in connection with the carrier’s handling of a claim.

The Houston Fourteenth Court of Appeals attempted to distinguish the *Archer* holding and held that a workers’ compensation death beneficiary has standing to assert extra-contractual claims. *Nationwide Ins. Co. v. Crowe*, 857 S.W.2d 644 (Tex. App. Houston [14th Dist.] 1993; writ granted, decision set aside based on settlement, 863 S.W.2d 462 (Tex. 1993)). Whether *Archer*, *Crowe* or both are correct is not yet known. However, a word of caution with respect to the standing issue in cases where the plaintiff is not the injured worker. First, the *Crowe* court summarily disposed of the standing issue on motion for rehearing after raising doubts of whether the issue was properly preserved for appeal. Second, unlike *Archer*, the *Crowe* opinion does not address whether the “special relationship” or disparity in bargaining positions exists that gives rise to the creation of the applicable duties. Finally, the *Crowe* decision was set aside, following the granting of writ, albeit based on the settlement of the parties.

F. Limitations on the Common Law Duty of Good Faith and Fair Dealing

In *Republic Ins. Co. vs. Stoker*, 903 S.W.2d 338 (Tex. 1995), the Supreme Court held that the duty of good faith and fair dealing is not breached by an insurer that denies a claim erroneously if, at the time of the denial, a reasonable basis for the denial existed. *Stoker* is discussed in greater detail below.

One post-*Stoker* Court of Appeals decision holds that if there is no evidence to suggest the insurer obtained the evidence on which it relies to deny or delay the claim in an unobjective or unfair manner, and the evidence, viewed in isolation, suggests that the claim is invalid or questionable, the carrier’s basis is *reasonable as a matter of law*. *Columbia Universal Life Ins. v. Miles*, 923 S.W.2d 803, 810 (Tex. App.—El Paso 1996, writ denied).

G. Statute of Limitations

A suit for breach of the duty of good faith and fair dealing accrues on the date an insurer denies a claim for coverage. *Murray v. San Jacinto*, 800 S.W.2d 826 (Tex. 1990). Likewise, a cause of action for statutory violations arising out of the insurance code similarly arises two years from the date of the denial of the insurance benefit. *Campbell v. TEIA*, 920 S.W.2d 323 (Tex. App.—Houston [1st Dist] 1995, no writ). In a recent case evaluating the statute of limitations, the Amarillo Court interpreted *Murray* to hold that a cause of action accrues when facts come into existence that authorize a claimant to seek a judicial remedy, not when the insurance company admitted to wrongly denying the claim. *Cooper v. St. Paul Fire ins. Co.*, 2006 Tex. App. LEXIS 6799, (Tex. App.—Amarillo August 1, 2006, pet. denied). In *Cooper*, the court held that limitations accrued when the insurance company notified the claimant, in writing, that it was disputing the claim. Based on that denial, the claimant was able to seek a judicial remedy by requesting a BRC and, therefore, limitations began to accrue at the point of denial. *Id*

Consistent with *Cooper*, the Fort Worth Court of Appeals held the accrual of the cause of action does not await the outcome of the administrative process but, instead, accrues on the date the insurer wrongfully denies coverage. *Childers v. Gallagher Bassett Services, Inc.*, 2008 Tex. App. LEXIS 2474, (Tex. App.—Fort Worth April 3, 2008, no pet. hist). Interestingly, the court in *Childers* also held that additional or later denials of coverage, after the initial denial has been fully and finally resolved, starts the running of the statute of limitations on the new denial. *Id.* (citing, *Pena v. State Farm Lloyds*, 980 S.W.2d 949 (Tex. App.—Corpus Christi 1998, no pet.).

H. Statutory Provisions

While we are all familiar with, and often refer to, Article 21.21 section 16 of the non-codified insurance code, be aware that the provisions were repealed and codified, effective April 1, 2005, as Chapter 541 of the Texas Insurance Code.

1. Texas Insurance Code - Chapter 541

Section 541.003 of the Insurance Code prohibits persons from engaging in unfair methods of competition or unfair or deceptive acts or practices in the business of insurance. Section 541.151 creates a cause of action for a person who has sustained actual damages as a result of an act or practice declared to be an unfair method of competition, *or* an unfair or deceptive act or practice in the business of insurance *or* any practice enumerated in a subdivision of section 17.46(b) of the Deceptive Trade Practices Act (“DTPA”), discussed below, as an unlawful deceptive trade practice.

The duties under Chapter 541 are owed by persons “engaged in the business of insurance, including agents, brokers, adjusters and life insurance counselors.” TEX. INS. CODE § 541.002. Unlike a common law “bad faith” claim, a Chapter 541 claim may, therefore, be asserted against individual marketing and claims professionals.

The specific prohibited conduct of Chapter 541 most applicable to workers’ compensation claims can be found in sections 541.060 and 541.061. While most sections have little, if any, relevance to workers’ compensation claims, there are a few that appear particularly relevant. Those provisions create a cause of action for:

1. misrepresenting to a claimant a material fact or policy provision relating to coverage at issue;
2. failing to attempt, in good faith, to effectuate a prompt, fair, and equitable settlement under one portion of a policy of a claim with respect to which the insurer’s liability has become reasonably clear in order to influence the claimant to settle an additional claim under another portion of the coverage
3. failing to provide promptly to a policyholder a reasonable explanation of the basis in the policy, in relation to the facts or applicable law, for the insurer’s denial of a claim or for the offer of a compromise settlement of a claim;
4. refusing to pay a claim without conducting a reasonable investigation with respect to the claim.

TEX. INS. CODE §§ 541.060 and 541.061.

2. Texas Deceptive Trade Practices Act (“DTPA”)

The DTPA is intended to protect consumers against false, misleading and deceptive business practices. TEX. BUS. & COM. CODE ANN. §§ 17.01, et seq. (Vernon 2004). An action under the DTPA must be brought by a “consumer.” The DTPA defines “consumer” in section 17.45(4) as an individual, partnership, or corporation, who seeks or acquires by purchase or lease any goods or services. The term does not include a business consumer that has assets of \$25 million or more, or that is owned or controlled by a corporation or entity with assets of \$25 million or more.

The issuance of an insurance policy has been held to be a service. *McNeill vs. McDavid Insurance Agency*, 594 S.W.2d 198 (Tex. Civ. App.—Fort Worth 1980, no writ). Thus, the DTPA applies to the purchase of an insurance policy, and probably applies to first-party claims handling. Application to third parties to the contract is a different question. With

respect to consumer standing to third parties, the Austin Court of Appeals held that the contracting parties must *intend* for the third party to have the use and benefit of the goods and services furnished under the contract before consumer status is extended to the third party. *Keightley v. Republic Ins. Co.*, 946 S.W.2d 124, 128 (Tex. App.—Austin 1997). While many plaintiffs argue that a workers' compensation claimant should have consumer status as an intended beneficiary of a policy, at least one court has rejected consumer status for workers' compensation claimants. *Rodriguez v. TEIA*, 598 S.W.2d., 677 (Tex. App.—Fort Worth 1980, writ ref'd n.r.e.)

III. SPECIFIC EXAMPLES OF THE APPLICATION OF THE COMMON LAW DUTY OF GOOD FAITH AND FAIR DEALING

A. Claims Investigation

In *Republic Ins. Co. vs. Stoker*, 903 S.W.2d 338 (Tex. 1995), an unidentified vehicle dropped some furniture on the highway causing a chain reaction collision. None of the vehicles involved in the accident made contact with the driver of the unidentified vehicle. The Stokers filed an uninsured motorist ("UM") claim with Republic, who denied their claim on the basis that Mrs. Stoker was more than 50 percent responsible for the collision, although it should have been clear to Republic that there was no coverage because the "actual physical contact" requirement under the insured motorist provision of the policy had not been met.

The Stokers sued Republic and prevailed on their assertion that Republic breached the duty of good faith and fair dealing in not denying their claim for a valid reason. The Court of Appeals affirmed the judgment favoring the Stokers, essentially relying on the fact that Republic did not cite the coverage issue in denying their claim. Simply put, Republic reached the correct result – denial – for the wrong reason.

However, the Texas Supreme Court disagreed with the court of appeals, holding that the most important element to determine if the carrier made a good faith denial of a claim is the set of facts in existence when the carrier made its decision. The court stated: "what is dispositive is whether, based upon the facts existing at the time of the denial, a reasonable insurer would have denied the claim." *Id.* at 341.

The Supreme Court nevertheless left the door open to a narrow set of circumstances that might support a bad faith cause of action, even when insurance coverage is absent. They are (1) conduct by an insurance company so extreme that it causes injury independent of the insurance claim; and (2) failure to timely investigate an insured's claim. *Id.* at 341. Note however, the *Fodge* court held that the extra-

contractual exposure for the denial of a non-covered claim *is not* a possibility because of detailed regulatory process. *American Motorist v. Fodge*, 63 S.W.3d. 801 (Tex. 2001).

B. Reliance on Experts

In *Lyons vs. Millers Casualty Ins. Co.*, 866 S.W.2d 597 (Tex. 1993) the policyholder filed a property damage claim for damage to a portion of the exterior of her home allegedly due to a windstorm. Millers hired a reconstruction expert who reported that the damage was due to settling of the foundation and rotted wood. Mrs. Lyons did not agree with the conclusion, and Millers then hired a professional engineer who agreed with the first expert. Mrs. Lyons hired an expert who reported that the damage had been caused by the windstorm. She then sued Millers on theories that included breach of the duty of good faith and fair dealing.

At the trial, Mrs. Lyons and two neighbors testified there was no prior damage and the storm had knocked over a tree away from the house. The jury found that the windstorm had caused 25 percent of the problems and Millers had breached the duty of good faith and fair dealing.

In reviewing the case, the Supreme Court noted, in some instances, evidence of coverage would support a finding that there was no reasonable basis for denying a claim. Nevertheless, the Supreme Court stated the existence of bad faith is not determined solely by whether the claim was valid, but on the *reasonableness of the insurer's conduct* in rejecting the claim.

Stated another way, the Court felt that review of the carrier's conduct should focus on *how* it reached its denial decision, and not simply that the carrier was incorrect in its denial. The Court went on to note there was no evidence that Millers' experts did not act objectively, or that Millers unreasonably relied on their reports. This appears to be the rationale followed by the El Paso Court in the *Millers* case discussed above.

Regarding claims professionals' reliance on peer reviewers, *State Farm Lloyds v. Nicolau*, 951 S.W.2d 444 (Tex. 1997), the Texas Supreme Court identified the type of evidence that could allow a jury to infer that a peer reviewer's report was not objectively prepared:

- (1) the expert's firm performed a substantial amount of work for insurance carriers;
- (2) a high percentage of the expert's individual work is performed for insurance carriers;
- (3) he expert was aware that the carrier would be required to pay the claim if he made findings in favor of the policyholder; and
- (4) the expert was selected because the carrier knew the expert's general view of this type of claim would be favorable to its position. *Id.*

at 448-450.

Although the Supreme Court expressed the view that this type of evidence would not always be evidence of bad faith, it nevertheless concluded this evidence *taken as a whole* was legally sufficient to support the jury's conclusion that it was unreasonable for the carrier to rely on the expert's opinion. Thus, choosing a peer review doctor because of a conservative tendency or a track record favoring the carrier's position may be a perilous undertaking.

Expert shopping has also been found to give rise to bad faith exposure. In *Liberty Mutual v. Crane*, 898 S.W.2d, 944 (Tex. App.—Beaumont 1995, no writ), the Beaumont Court addressed the adjuster's refusal to pay for surgery related to a carpal tunnel claim. The treating doctor, selected by agreement of the parties, recommended surgery. The carrier rejected the treating doctor's opinion, its own peer review doctor's opinion, and then sought a third opinion. The court held there was ample evidence that the carrier pressed on in a "dogged pursuit of a predetermined course of action to deny the claim" as opposed to a reasonable investigation. *Id.* at 950.

C. Reliance on Controlling Law

Carriers are generally secure in situations where a claim is denied based upon the application of controlling law. Two case examples illustrate this point.

In *North American Shipbuilding, Inc. v. Southern Marine & Aviation Underwriting*, 930 S.W. 2d 829 (Tex. App.—Houston [1st Dist.] 1996, no writ), a claim based upon numerous defects in a ship hull that required eight to ten months to repair was denied based, in part, upon the holding of a Fifth Circuit case that the policy language at issue did not cover the cost to repair "faulty initial construction."

The trial court granted a summary judgment in favor of Southern Marine & Aviation, which was affirmed by the court of appeals on the basis that the case law taking the claim out of coverage provided a reasonable basis upon which to deny the claim. The court further commented that even if the controlling case did not take the claim out of coverage, "its close similarity to this case constitutes a reasonable basis for the underwriters to have denied coverage." *Id.* at 835.

The San Antonio Court of Appeals was faced with a question regarding the effect of controlling case law in *Saunders v. Commonwealth Lloyd's Insurance Company*, 928 S.W. 2d 322 (Tex. App.—San Antonio 1996, no writ). The Saunders' home, which was community property, was destroyed by fire. There was evidence that Mr. Saunders deliberately started the fire, which resulted in one criminal conviction that was subsequently overturned and led to a jury finding in the breach of contract claim that Mr. Saunders was

responsible for the arson fire.

Commonwealth denied the claim on the basis of Texas decisions, holding that as a matter of law, an innocent spouse cannot recover for the destruction of community property by the arson of a culpable spouse. The summary judgment granted against Mr. Saunders was upheld on appeal because the controlling case law provided a reasonable basis upon which to deny the claim. *Id.* at 325.

D. Untimely Payment of Benefits

Transportation Ins. Co. vs. Moriel, 879 S.W.2d 10 (Tex. 1994) involved a worker's compensation claim where the carrier was alleged to have delayed paying for medical bills associated with the claimant's impotence, which was asserted to be related to the compensable injury. The jury awarded actual and punitive damages after finding that the carrier breached the duty of good faith and fair dealing by delaying the processing and paying of the medical bills in question.

In its discussion of the case, the Supreme Court listed conduct which would *not* be considered a breach of the duty of good faith and fair dealing. The list included:

- (1) evidence that merely shows a bona fide dispute as to liability;
- (2) evidence the carrier was incorrect about the factual basis for its determination about proper construction of the insurance policy; and
- (3) a simple disagreement among experts about whether the cause of the loss is one covered by the policy. *Id.* at 17-19.

The Supreme Court reiterated the standard it had set forth in *Aranda* requiring an insured to prove "that the insurer had no reasonable basis for denying or delaying payment of the claim, and that it knew or should have known of that fact." *Aranda v. Insurance Co. of North America*, 748 S.W.2d, 210 (Tex. 1988).

The *Moriel* Court further defined the conduct necessary to impose liability for punitive damages on the carrier:

"In general ... an insurance carrier's refusal to pay a claim cannot justify punishment unless the insurer was actually aware that its action would probably result in extraordinary harm not ordinarily associated with breach of contract or bad faith denial of a claim, such as death, grievous physical injury or financial ruin." *Id.* at 19.

E. Waiver [Lawton] and Bad Faith?

Recently, there has been an upsurge of bad faith suits claiming a carrier that untimely disputes an extent

issue, is doing so without a reasonable basis. Thus far, the courts have not addressed this factual scenario and, considering the complexity of the *Lawton* holding, it is questionable whether an untimely but otherwise legitimate dispute can give rise to bad faith.

Looking at the appellate jurisprudence in the area, there is no clear statute or rule that provides that a carrier waives the right to dispute "extent of injury," by failing to raise the dispute within sixty days. The rule and statute expressly apply to compensability. Rule 124.3(c) explains that section 409.021 and subsection (a) of the rule (concerning carrier's duty to investigate and dispute a claim) do not apply to disputes of extent of injury. In the preamble to TWCC Rule 124.3, the TWCC explained:

Texas Labor Code, § 409.021, is intended to apply to the compensability of the injury itself or the carrier's liability for the claim as a whole, not individual aspects of the claim. When a carrier disputes the extent of an injury, it is not denying the compensability of the claim as a whole, it is disputing an aspect of the claim. This is similar to when a carrier accepts a claim but disputes the existence of disability. A dispute of disability is a dispute of the amount of benefits that a person is entitled to. In much the same way, a dispute involving extent of injury is a dispute over the amount or type of benefits, specifically, medical benefits, to which the employee is entitled (i.e. what body areas/systems, injuries, conditions, or symptoms for which the employee is entitled to treatment); it is not a denial of the employee's entitlement to benefits in general.

Though the rule gives a carrier a time frame to file the dispute of extent of injury, failure to do so timely is a compliance issue. It does not create liability. Because a carrier has 45 days to either pay or deny a medical bill and because in a situation where the carrier does not accept a new body part/system as part of the compensable injury, the carrier is likely to deny the medical bill for treatment for that body part, the time frame for filing the dispute of extent of injury is tied to the carrier's deadline for paying or denying the medical bill.

25 Tex. Reg. 2096, 2102 (March 10, 2000).

A 2003 Waco Court of Appeals decision held that a carrier's failure to promptly raise an extent of injury dispute does not create liability, but may raise a compliance issue. In *TIG Premiere Ins. Co. v. Pemberton*, 127 S.W.3d 270 (Tex. App.—Waco 2003,

pet. denied), a claimant contended that under section 409.021(c), the carrier waived the right to dispute the extent of the claimant's injury because the extent of injury dispute was not raised within sixty days. The court held that section 409.021 pertains only to a carrier's initial response to a notice of injury and does not preclude a carrier from later contesting a specific part of the injury or the extent of the injury.

Despite the *Pemberton* decision, the DWC Appeals Panel continued to require a carrier to dispute "extent of injuries" within sixty days if the disputed condition was discoverable within sixty days. Then in a recent appellate decision, *SORM v. Lawton*, 256 S.W.3d 436 (Tex. App.—Waco 2008, pet. granted), the same court that issued *Pemberton*, distinguished its own holding. In *Lawton*, SORM again argued that Rule 124.3 expressly states that the waiver provision of Labor Code section 409.021 does not apply to extent of injury disputes. The *Lawton* Court held that Rule 124.3 applies when a new injury, symptom or condition arises outside the sixty-day period. In *Lawton*, the court concluded that SORM could have reasonably discovered the additionally diagnosed conditions within the sixty-day investigation period and, therefore, waived its right to contest the extent of the injury. So, it appears that the current *Lawton* decision and appeals panel decisions do support the potential for waiver, if the carrier could have reasonably discovered the additionally diagnosed [disputed] conditions within the sixty-day investigation period, but failed to dispute them within that period. *Lawton* is now pending before the Texas Supreme Court and the Supreme Court has granted petition for review on the *Lawton* case. We are hopeful for a prompt decision before the Texas Supreme Court.

Despite the ruling in *Lawton*, whether failure to timely dispute an otherwise legitimate dispute resulting in waiver can constitute bad faith remains an unresolved question. A proponent would argue that the waiver results from the failure to conduct a reasonable investigation. However, in contrast, if the failure to conduct a reasonable investigation would only disclose facts foreclosing liability and a carrier cannot be held to be liable for a claim it otherwise does not owe, it may appear illogical to a reviewing court to hold a carrier liable for bad faith in such circumstance.

IV. DISCOVERY IN BAD FAITH CASES

There is little case law addressing discovery in workers' compensation "bad faith" litigation. Many plaintiffs argue that the scope of discovery in a lawsuit alleging a breach of the duty of good faith and fair dealing can be summarized in two words: *almost unlimited*. A comment from a plaintiff's lawyer regarding how to seek discovery from an insurance carrier sums up what you can expect from the plaintiff in a bad faith lawsuit:

“The big insurance companies are bureaucratic engines fueled by masses of paper. It is claimant’s counsel’s responsibility to obtain copies of that paper, determine which documents help or hurt the case, and identify what’s missing. Items absent from an insurer’s claims file may prove to be as revealing as those which are present.”

A. Ball, “Using the Texas DTPA and Insurance Code in Litigation with Insurance Companies,” *Texas Insurance Bad Faith Litigation I-36 (1995)*.

Mr. Ball, who writes frequently on the use of computers and the internet in law practice, might update the aforementioned passage to “fueled by masses of electronic data entries.”

However, like all litigation, discovery in bad faith cases is limited to those matters that are relevant and reasonably calculated to lead to the discovery of admissible evidence. While plaintiff’s counsel will generally seek to parade every denial, dispute or adjustment of payment before the jury, the Supreme Court tells us that only those matters that have been adjudicated by the DWC and found owing are within the court’s jurisdiction to litigate. *Fodge*, 63 S.W. 3d, 801. As such, it may be wise to seek to limit discovery to the extent it is relevant to the specific denial that forms the basis of the complaint.

Discovery requests often also seek information relating to other workers’ compensation claim files. A carrier’s ability to disclose that information is questionable. Generally, a party should not be required to disclose information of non-parties that constitutes an invasion of those non-parties’ personal and constitutional privacy right. TEX. R. CIV. P. 192.6(b); *Hoffman v. Fifth Ct. of App.*, 756 S.W.2d 723 (Tex. 1988). The medical records contained in the claim files are generally confidential and not subject to disclosure to third parties. *In Re Charles Xeller, M.D.*, 6 S.W.3d, 618, 626 (Tex. App.—Houston [14th Dist.] 1999, no pet.).

Finally, The Texas Labor Code explicitly states that the DWC is not to disclose confidential claim information. TEX. LAB. CODE ANN. § 402.086. The Labor Code furthers this confidentiality in section 402.091 where it specifically forbids any person, not just the DWC, from knowingly, intentionally, or recklessly publishing, disclosing, or distributing information that is confidential under the subchapter to persons not authorized to receive the information directly from the DWC. Construing these two sections together, one must question the ability of a carrier to produce third-party claim information in response to discovery requests.

V. USE OF ATTORNEYS AS EXPERTS IN EXTRA-CONTRACTUAL CLAIMS

It seems somewhat surprising that attorneys are designated by the plaintiff as liability experts in extra-contractual claims. Texas courts have not come down clearly on the admissibility of attorney liability testimony in an extra-contractual context. By analogy to parallel situations, attorneys have not been permitted to testify as liability experts. The analogies below are offered as guidance on how to address this issue as it moves forward through the court system.

Admissibility of expert testimony is governed by Texas Rule of Evidence 702. Rule 702 states: “If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise.” TEX. R. EVID. 702. (emphasis added). The Texas Supreme Court has outlined the analysis that a trial court should reason through when making a threshold determination of admissibility. *Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713 (Tex. 1998). The court must consider whether the expert’s testimony is relevant, reliable, and whether the opinions are beyond average common knowledge, so as to be of assistance to the trier of fact. *Id.* at 718.

While an attorney may adjust a workers’ compensation claim by virtue of his license to practice law, generally to adjust or make claims decisions on behalf of an insurance carrier, one must possess a worker’s compensation adjuster’s license. It is rare that an attorney possesses such a license or has actual experience in the adjusting of claims. Generally, the attorney becomes involved after the adjusting decision has been made. Nevertheless, attorneys are often used as experts to prove whether a carrier complied with the statutory or common law duty of good faith and fair dealing. Such opinions are often, at best, legal opinions and, at worst, no more than a restatement of a party’s argument under the guise of expert testimony. If so, the expert-attorney’s opinion might be excluded.

Generally, opinion evidence from an expert witness on a pure question of law is inadmissible because it invades the province of the Court. *Pegasus Energy Group, Inc. v. Cheyenne Petroleum Co.*, 3 S.W.3d 112, 134 (Tex. App.—Corpus Christi 1999, pet. denied); *Upjohn Co. v. Rylander*, 38 S.W.3d 600, 611 (Tex. App.—Austin 2000, pet. denied) (An expert may not testify regarding a pure matter of law.).

In *Pegasus*, the appellant argued that attorney-expert’s testimony was necessary to explain certain provisions of a contract that contained specialized usage and meaning within the oil and gas accounting field, and the testimony was required to explain the accounting interpretations of the provision. *Pegasus*, 3 S.W.3d at 611. The opposing party argued that the

testimony was inadmissible because it incorporated legal conclusions concerning the interpretation of the contract.” *Id.* at 133. The trial court agreed the testimony was merely legal conclusions. In excluding the testimony, the trial court held, “The whole gist of this case is the meaning of the [approval clause]...And that’s going to be my ruling – a legal decision, and he cannot tell me what my legal ruling should be.” *Id.* The court held that the expert “was making his own legal interpretation of the provision and explaining that interpretation to the court,” which “encroached upon the province of the court to determine the correct legal interpretation of the clause.” *Id.* The appellate court in *Pegasus*, agreed that the expert testimony was not admissible and upheld the trial court’s decision. *Id.*

The Fifth Circuit Court of Appeals has upheld the exclusion of the testimony of an attorney-expert regarding whether or not directors of a corporation committed misconduct with regard to their fiduciary duties. *Askanase v. Fatjo*, 130 F.3d 657 (5th Cir. 1997). Relying on a Tenth Circuit case, *Specht v. Jensen*, the Fifth Circuit acknowledged that it constitutes reversible error to admit testimony from an attorney-expert regarding “their view of what law governs a case, what the applicable law means, or whether a party’s conduct violated the law.” *Id.* at 673, citing, *Specht v. Jensen*, 853 F.2d 805, 808-809 (10th Cir. 1988), cert. denied, 488 U.S. 1008 (1989).

The *Specht* court noted that admission of attorney-expert testimony caused two kinds of harm. *Specht*, 853 F.2d at 808-809. First, it would mislead the jury into thinking that the titled ‘expert’ is more knowledgeable than the presiding judge in that area of law. *Id.* Second, attorney-expert testimony would damage the whole trial process because both parties would want their attorney-expert to testify, which compounded with a separate jury instruction given by the court, would certainly raise questions as to what standard of law truly applies. *Id.*

Under Texas precedent, an expert may offer his opinion to a mixed question of law and fact if the expert possesses greater knowledge, skill, experience, and education than the trial court. See *Helena Chem. Co. v. Wilkins*, 47 S.W.3d 486, 500 (Tex. 2001); *Holden v. Weidenfeller*, 929 S.W.2d 124, 134 (Tex. App.—San Antonio, 1996, no writ); Cf., *Royal Maccabees Life Ins. Co. v. James*, 146 S.W.3d 340, 353-354 (Tex. App.—Dallas 2004, review denied, reh’g for pet. for review denied)(where no abuse of discretion was found when a trial court allowed an experienced insurance adjuster, as opposed to an attorney, testify as to his interpretation of the insurance policy).

In *Holden v. Weidenfeller*, the appellate court recognized the height of the hurdle an attorney has in overcoming this burden as an expert witness:

“This is an extremely difficult burden to meet given that the expertise at issue in this case is legal expertise and the trial judge is presumed to have specialized competency in all aspects of the law. The result might have been different had the expertise involved been scientific or technical in nature. Under the circumstances, however, the trial court, a legal expert itself, was perfectly capable of applying the law to the facts and reaching a conclusion without the benefit of expert testimony from another attorney.” *Id.*

The appellate court found the only purpose of admitting an attorney’s testimony was to “lend credibility and strength to the position” of the proffering party. *Id.* The appellate court found no abuse of discretion in excluding the attorney-expert testimony that sought to assist the court in applying facts to law. *Id.*

VI. DAMAGES IN A “BAD FAITH” LAWSUIT

Under the common law, a party may recover his actual damages arising out of the breach of the duty of good faith and fair dealing. Chapter 541 of the Insurance Code provides that a person who prevails in a suit filed under this section may obtain the amount of actual damages plus court costs and reasonable and necessary attorneys’ fees. If the fact finder determines that the defendant *knowingly* committed the acts complained of, it may also award up to three times the amount of actual damages or enjoin the defendant from committing such acts or failing to act, or any other relief which the court deems appropriate..

A. Actual Damages

The term “actual damages” is not defined in the statute. Therefore, courts have construed this term to mean damages that are recoverable at common law. Such damages include:

1. Value of the policy benefits wrongly withheld.

In cases that are not workers’ compensation claims, the value of the policy benefits wrongly withheld are recoverable; however, in a workers’ compensation bad faith context, the claimant can only recover those damages that are separate and produce independent injury from the caused workers’ compensation claim. *Aranda v. Insurance Co. of North America*, 748 S.W.2d 210 (Tex. 1988). Therefore, whatever elements of damages are pled, they must be separate and distinct to the injuries arising out of the work-related injury. However, an employee may recover additional physical pain and suffering, impairment, or mental anguish damages that were aggravated by a workers’ compensation carrier’s

misconduct in handling his claim. *Tex. Mut. Ins. Co. v. Ruttiger*, 2008 Tex. App. LEXIS 440 (Tex. App. Houston [1st Dist.] Jan. 17, 2008).

2. Mental Anguish

Mental Anguish generally constitutes the largest element of damage recovery in an extra-contractual claim. Unlike the common law claim, damages for mental anguish are not recoverable under Chapter 541 unless the fact finder determines that the defendant committed wrongful acts knowingly. Worry, anxiety, vexation, embarrassment, or anger does not constitute mental anguish, as an element of damages. *Latham v. Castillo*, 972 S.W.2d 66 (Tex. 1998). Instead, a party must prove a high degree of mental pain that substantially disrupts the plaintiff's daily routine *Id.* Mental anguish includes the mental sensation of pain resulting from severe and painful emotions such as grief, shame or despair. *Parkway v. Woodruff*, 901 S.W.2d 434, 444 (Tex. 1995). Additionally, if a plaintiff fails to present direct evidence of the nature, duration and severity of the mental pain, sufficient to prove a disruption in the plaintiff's daily routine, the award cannot survive a legal sufficiency challenge. *Id.*

3. Medical Expenses or Loss of Earning Capacity

At the time of the writing of this paper, no found workers' compensation bad-faith cases have been found that address the award of medical expenses or the loss of earning capacity as an element of extra-contractual damages. However, to recover for any element of damages, the plaintiff must establish more than aggravation of the compensable injury. He must demonstrate that the wrongful conduct created physical injury separate and distinct from compensable injury. *Hulhouser v. TWCIF*, 139 S.W.3d 789 (Tex. App.—Dallas 2004, no pet.). Therefore, if the plaintiff can somehow establish that the extra-contractual behavior of the carrier caused physical injuries that created a separate, distinct and non-compensable injury, then he should be able to recover mental anguish or loss of earning capacity.

4. Loss of Credit and/or Credit Reputation

To recover for the loss of credit reputation, the plaintiff must demonstrate inability to obtain a loan, or that higher interest rates were charged as a result of the inability to pay bills because of denial of benefits. *St. Paul Ins. Co. v. Dal-Worth Tank Co.*, 974 S.W.2d 51 (Tex. 1998).

5. Interest

Whether pre-judgment interest is considered part of "actual damages" is somewhat unclear. If such interest can be included as "actual damages," it may be trebled. However, if it is not considered part of "actual damages," it is not subject to trebling by the fact

finder. The courts are split on this issue.

B. Reasonable and Necessary Attorneys' Fees

The amount and reasonableness of attorneys' fees are decided by the fact finder. An award of such fees will not be disturbed unless the defendant can establish the amount awarded was an abuse of discretion.

Attorneys' fees are not recoverable when the plaintiff has not sustained actual damages. Further, such fees are not recoverable in an action sought for the breach of the duty of good faith and fair dealing when asserted as a common law cause of action only.

There is also a split of authority on whether attorneys' fees are deemed "actual damages." As with pre-judgment interest, if attorneys' fees are deemed "actual damages," then they are subject to trebling.

C. Treble Damages

As stated previously, if the fact finder determines that a defendant knowingly committed acts prohibited under Chapter 541, it may award up to three times the amount of the actual damages. "Knowingly" is defined in the statute as the "actual awareness of the falsity, unfairness, or deception of the act or practice made the basis for a claim for damages." Although not characterized as such, these types of damages are often deemed punitive in nature. Treble damages cannot be awarded unless the plaintiff has sustained actual damages.

Two recent appellate opinions affirm that a jury's finding of 'knowing' will be upheld when evidence supports such a finding. In *Texas Mut. Ins. Co. v. Ruttiger*, 265 S.W.3d 651 (Tex. App. — Houston [1st Dist.] (July 31, 2008) (slip op.)(pet. filed September 25, 2007), The Court held that, "[A] reasonable juror could believe that, under the circumstances presented in this case, [the adjuster] should have been highly suspect of the veracity of the unsubstantiated allegations he was hearing from [Mr. Ruttiger's employer]." *Id.* at *10. Following the *Giles* definition of bad faith, the Court affirmed the jury's decision that Texas Mutual had acted in bad faith and had done so knowingly. Similarly, in *Morris v. Texas Mut. Ins. Co.*, 2008 WL 4092921, Tex. App.—Houston [14th Dist.] August 26, 2008 (NO. 14-06-00651-CV)(pet. filed), the Houston Fourteenth Court of Appeals upheld a trial court judgment against Texas Mutual, including the award of extra-contractual damages and upheld a jury finding of bad faith and that such conduct was 'knowing.' In both cases, because the jury determined that Texas Mutual had acted knowingly, the award of damages for mental anguish was affirmed.

Additionally, a plaintiff cannot simultaneously recover treble damages under Chapter 541 and common law punitive damages. The plaintiff must elect a remedy in cases where the plaintiff alleges common law causes of action and statutory causes of

action for the same conduct. The Texas Civil Practices and Remedies Code, section 41.004(b) provides that exemplary or punitive damages may not be awarded to a plaintiff who is seeking to multiply damages under another statute.

D. Punitive Damages

Under the Texas Supreme Court decision in *Transportation Ins. Co. v. Moriel*, 879 S.W. 2d 10 (Tex. 1994), punitive damages in a bad faith claim requires a showing, as referenced above, of:

- (1) Evidence that the carrier had actual awareness of an extreme risk created by in carrier's conduct; and
- (2) Risk of an extraordinary harm such as death, grievous personal injury or genuine likelihood of financial catastrophe. *Id.* at 19.

VII. CONCLUSION

There are common law and statutory duties that the insurer and insurance claims professionals must respect when dealing with workers' compensation claims. The breach of these duties results in insurer exposure to the independent causes of action of insureds and claimants and multiple levels of recoverable damages. The key to assisting insurer clients in preventing extra-contractual exposure is to encourage insurer clients to instill reasonable, consistent, and sound claims handling procedures to fulfill their legal duties.

