

**AFFIRMATIVE AND DEFENSIVE
PLEADINGS IN INSURANCE COVERAGE
AND BAD FAITH LITIGATION**

THE 18TH ANNUAL INSURANCE SYMPOSIUM

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**AFFIRMATIVE AND DEFENSIVE
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I. INTRODUCTION

The purpose of this paper is to explore the nature of affirmative and defensive pleading in typical coverage and/or bad faith litigation in state and federal court in Texas. This paper will not attempt to deal with every type of scenario that may arise in a particular case, but will, instead, concentrate on the more common claims that may be asserted in such cases by an insured against an insurer and defenses that may, or must be, asserted by the insurer in order to be able to pursue such defenses at trial in the case. We will first address the general nature of pleadings in a declaratory judgment action in state and federal court. We will then address other common bases for suits in coverage litigation, whether they be included in a declaratory judgment action or pursued separately.

II. DECLARATORY JUDGMENT SUITS

In Texas, an insurer or an insured may bring an action for a declaratory judgment to resolve an issue in dispute under an insurance policy. *Western Casualty & Surety Co. v. Newell Manufacturing Co.*, 566 S.W.2d 74 (Tex.Civ.App.—San Antonio 1978, writ ref'd n.r.e.); *Insurance Company of North America v. Asarco, Inc.*, 562 S.W.2d 557 (Tex.Civ.App.—Corpus Christi 1978, writ ref'd n.r.e.). In state court, the Declaratory Judgments Act is found in Tex.Civ.Prac. & Rem.Code §37.001 et seq. In federal court, declaratory relief is available under 28 U.S.C. §§2201 and 2202.

A. State Court Declaratory Judgment Requirements

Under the Declaratory Judgments Act, Tex.Civ.Prac. & Rem.Code §37.001 et seq., a court has the power to declare rights, status and other legal relations between litigants, whether other affirmative relief is sought in the same suit. Such an action is neither legal nor equitable, but *sui generis* (its own peculiar action). *Cobb v. Harrington*, 190 S.W.2d 709, 144 Tex. 360 (1945). The Act does not confer any new substantive rights on a litigant, nor any

additional jurisdiction on a court. *White v. Robinson*, 260 S.W.3d 463, 468 (Tex.App.—Houston 14th Dist.] 2008, writ granted). The Act simply provides a procedural device that would not otherwise be available for the determination of controversies that are within the court's jurisdiction. *Marshall v. City of Lubbock*, 520 S.W.2d 553, 555 (Tex.Civ.App.—Amarillo 1975, writ ref'd n.r.e.).

In order to determine if an insurer has a duty to defend or indemnify an insured against a third policy liability claim involves the interpretation of a written contract, and so is an appropriate matter for declaratory relief. Tex.Civ.Prac. & Rem.Code §37.004. An insurer's duty to defend becomes a justiciable controversy once the insured has been sued. *Ranger Insurance Co. v. Mustang Aviation, Inc.*, 533 S.W.2d 903, 905 (Tex.Civ.App.—Eastland 1976, writ ref'd n.r.e.).

In a declaratory judgment action, all parties that have an interest that would be affected by the declaration must be made parties. Tex.Civ.Prac. & Rem.Code §37.006(a). Otherwise a declaratory judgment will not prejudice the rights of a person not a party to the proceeding. Tex.Civ.Prac. & Rem.Code §37.006(a). That means that a declaratory judgment is not binding on the claimant that is suing the insured in an underlying lawsuit unless that claimant is made a party to the declaratory action.

Under §37.009 of the declaratory act, a court “may award costs and reasonable and necessary attorney's fees as are equitable and just.” In other words, a trial judge can award attorney's fees to a prevailing party, but is not required to do so. *Bocquet v. Herring*, 972 S.W.2d 19, 20 (Tex. 1998). It has also been held that a court may award attorney's fees to a non-prevailing party. *Scottsdale Insurance Co. v. Travis*, 68 S.W.3d 72, 77 (Tex.App.—Dallas 2001, pet. denied).

B. Declaratory Actions in Federal Court

The federal Declaratory Judgment Act (28 U.S.C. §§2201-2202) is fairly similar in operation to the state act. It does not create a

separate cause of action, but simply provides a form of relief. *Aetna Life Insurance Co. v. Haworth*, 300 U.S. 227, 240 (1937); *In re Joint E.&S. District Asbestos Litigation*, 14 F.3d 726, 731 (2nd Cir. 1993). A federal court can hear a declaratory judgment act if the case is within its subject matter jurisdiction and it involves an actual controversy. *Starter Corp. v. Converse, Inc.*, 84 F.3d 592, 594 (2nd Cir. 1996). That means that the case must also involve diversity or federal question jurisdiction.

Although attorney's fees are available for a case based on a federal question, the Fifth Circuit has held that attorney's fees are not available to the prevailing party under the Act in a diversity based suit. *Self-Insurance Institute v. Koriotoh*, 53 F.3d 694, 697 (5th Cir. 1995). However, a prevailing party may be able to recover attorney's fees if it pleads and proves a cause of action that does permit such a recovery.

C. Defensive Pleadings

There are several defenses that should be considered in a suit for declaratory relief in both state and federal court. The most significant is that there must be a justiciable controversy between the parties. *Brooks v. Northglenn Association*, 141 S.W.3d 158, 163-164 (Tex. 2004). A suit must generally have been filed in the underlying suit for a claim to be considered justiciable; the existence of an asserted claim is not sufficient.

Another defense would be to assert that a declaratory action has not included a necessary party. If an insurer files a declaratory action but declines to include the third party claimant, then the declaratory action has left out a person who has a claim or interest that will be affected by the declaration.

The defendant in a declaratory suit can seek affirmative relief and sue on the basis of any cause of action that may be appropriate in a particular situation. Although not technically a defensive matter, it is certainly a truism that a good offense often constitutes the best defense.

III. STATUTORY CLAIMS UNDER THE INSURANCE CODE & DPTA

There are several claims that are commonly asserted by an insured against an insurer in a suit in which coverage is being litigated. If an insurer files for declaratory relief on coverage issues, the insured will frequently assert causes of action for unfair claims practices and failure to make prompt payments under the Texas Insurance Code and for deceptive and misleading acts that violate the Texas Deceptive Trade Practices Act. The paper will address the more common allegations that are or may be made and then discuss defenses that should be pleaded to counter such causes of action.

A. Chapter 541 of the Insurance Code

Chapter 541 of the Texas Insurance Code addresses unfair competition and unfair or deceptive acts or practices in the insurance industry. Tex. Ins. Code §541.001 *et seq.*; *Crown Life Insurance Co. v. Casteel*, 22 S.W.2d 378, 383 (Tex. 2000). The statute declares that certain conduct in the insurance business is unfair competition or an unfair or deceptive act. Ins. Code §§541.051-541.061. The statute affords a private cause of action for damages when an insurer commits an unfair act or practice defined as such by §541.051 through §541.061.

One part of the statute deals with unfair claims settlement practices as defined in §541.060. That section states that an insurer must not do certain acts and these normally form the basis of the causes of action in an insurance code violation suit or counterclaim. The statute declares that an insurer must not:

1. Misrepresent a material fact or policy provision relating to the coverage issues. (§541.060(a)(1)).
2. Fail within a reasonable time to either affirm or deny coverage of a claim or, under a liability policy, submit a timely reservation of rights letter. (§541.060(a)(4)).
3. Refuse to pay a claim without conducting a reasonable investigation. (§541.060(a)(7)).
4. Fail to promptly provide a reasonable explanation of the basis in the policy, with

regard to the facts or applicable law, for the insurer's denial of a claim. (§541.060(a)(3)).

In order to succeed under one of these causes of action, an insured must plead and prove that:

1. The policy covers the claim;
2. The insured's liability is reasonably clear;
3. The claimant has made a proper settlement demand within policy limits; and
4. The demand's terms are such that an ordinarily prudent insurer would accept it.

Rocor International v. National Union Fire Insurance, 77 S.W.3d 253, 261-262 (Tex. 2002).

In order to establish a misrepresentation claim, it must be proved that there has been a misrepresentation of a **material** fact or a **material** misstatement of law. (§541.061). These may either be based on affirmatively making an untrue statement or by failing to disclose a matter required by law to be disclosed. (§541.061).

For a "person" to sue under the statute, they must be a party insured or a beneficiary named under the policy. (§541.060(a)). A third party does not qualify. (§541.060(b)). The conduct must also be alleged to have been the "producing" cause of any damages, and not the "proximate" cause.

Available damages for a suit alleging the statutory violations includes actual damages and attorney's fees. (§541.152). To recover damages for mental anguish, an insured must plead and prove that any violation was done knowingly as set out in §542.002(1). Such a pleading can also support an award of enhanced damages, not to exceed three times the amount of actual damages. (§541.152(b)).

B. Pleadings in a Claim under the Texas Deceptive Trade Practices Act

The Texas DTPA provides four bases for relief. First is any conduct specifically enumerated under the Act as false misleading or deceptive. Tex. Bus. & Comm. Code §17.46(b). A second basis is the breach of an express or implied warranty. Third is any "unconscionable conduct", which is somewhat broader a category than any under the Insurance Code. §17.50(a)(3). Finally, a fourth base is any act or practice in violation of the Insurance Code. §17.50(a)(4). Because of the additional requirements under the DTPA when compared to the Insurance Code, it is generally not any increased benefit in suing under the DTPA when an Insurance Code violation exists.

The DTPA is similar in effect as the Insurance Code in a coverage litigation case with a few additional requirements. In order to sue under the DTPA, one must plead and prove that you are a "consumer" as defined in §17.50 of the Act. Under the DTPA, a plaintiff may recover economic damages and attorney's fees, but recovery of mental anguish damages is dependent on pleading and proving that the wrongful conduct was committed knowingly or intentionally. §17.50(b)(1). Enhanced damages are also available on such pleading and proof. §17.50(b)(1).

C. Chapter 542 of the Insurance Code

Chapter 542 of the Texas Insurance Code sets forth deadlines for insurers to: (a) inform insureds regarding the acceptance or rejection of the claim tendered; and (b) make payment on valid claims. Moreover, Section 542.060 imposes penalties for insurers that fail to meet the statutory deadlines.

Under Texas law, an insurer has 15 days from its receipt of notice of a claim to: (a) acknowledge receipt of the claim in writing; (b) begin to investigate the claim; and (c) request all necessary documents from the policyholder. TEX. INS. CODE § 542.055(a). The acknowledgement of the claim must be in writing to satisfy Section 542.055. *Daugherty v. American Motorists Ins. Co.*, 974 S.W.2d 796,

799 (Tex.App.—Houston [1st Dist.] 1998, no writ).

Under Section 542.056(a) of the Texas Insurance Code, the carrier must notify the insured in writing of its acceptance or rejection of the claim tendered not later than the 15th business day after it receives all necessary documents requested from the insured to secure final proof of loss. *See* TEX. INS. CODE ANN. §542.056(a). Any rejection of the claim must be in writing and must state the reason the claim was rejected. *Id.* § 542.056(c).

Section 542.056(d) provides for an extension of forty-five days to the fifteen-day deadline if the carrier requires additional time to render a decision regarding the acceptance of the claim. *See* TEX. INS. CODE ANN. § 542.056(d). To take advantage of this extension, the insurer must notify the insured in writing prior to the expiration of the fifteen-day deadline and must specify the reasons the insurer requires additional time. *Id.*

After the insurer notifies an insured that it will pay a claim (in whole or in part), it must pay the claim within five business days after it gives the notice. TEX. INS. CODE ANN. § 542.057(a). If the insurer conditions payment upon some action by the insured (such as signing a release), the insurer must pay within five days of the insured's performance of the required action. *Id.*

However, the carrier can withdraw the notice if it receives new information upon which it can validly deny the claim. *Daugherty*, 974 S.W.2d at 799.

Section 542.058 overlays the deadline in Section 542.057. Section 542.058 provides that, if an insurer fails to pay a valid claim for more than sixty days after receiving all requested documentation from the insured, it will be liable for the statutory penalties in Section 542.060. TEX. INS. CODE ANN. § 542.058(a).

D. Available Defenses to Statutory Claims

There are a number of potentially applicable defenses that should be asserted by an insurer in a coverage suit alleging the statutory claims set

out above. Many of those defenses are applicable as to all of the claims, but we will note when a defense is more limited.

Under both the Insurance Code and the DTPA, the insured is required to give a sixty day notice of a claim. Failure to give such notice will not void the suit, but does entitle the defendant insurer to obtain an abatement of sixty days, if such an abatement is deemed helpful. Such verified plea in abatement must be filed within thirty days. (Ins. Code §541.155). That also will allow the insurer to make, and file with the court, an offer of settlement which must be made within sixty days of notice of the suit pursuant to Ins. Code §§541.156, 541.157. The offer, if rejected, will have the effect of limiting the recovery of the plaintiff with regard to the ultimate judgment.

There are certain defenses that must be made in a verified denial in order to be preserved. Under Rule 93 of the Texas Rules of Civil Procedure, these will include:

1. Insured's failure to give notice of the claim;
2. Insured's failure to file a proof of loss; and
3. Lack of consideration to support a contract of insurance.

The insurer must determine if the plaintiff has proper standing to file the statutory claims in the first place. Generally speaking, that would include an insured under the policy that has been damaged by some act or omission of the insurer. (§541.060(a)). The DTPA also primarily requires that the plaintiff be a "consumer" as that term is defined by §17.50. That means that for an insured to be able to sue under the DTPA it must plead and prove that it was a purchaser of goods and services and it cannot have assets of over \$25 million (or be controlled by an entity that has such assets). Tex. Bus. & Comm. Code §17.45.

Another significant defense to consider is the statute of limitations, which, under §541.162 of the Insurance Code, is two years from the date of actionable conduct or the date the

plaintiff discovered, or should have discovered such conduct. The DTPA has the same requirement. Tex. Bus. & Comm. Code §17.565. An insurer should also plead the *res adjudicata* effect of any prior coverage determination between the parties involving the same issues.

An insurer must plead and prove that the insured's loss was due to a risk or cause within a particular exception or exclusion of the policy. Ins. Code §554.002. The insurer must also affirmatively plead that the insured has breached its obligations under the policy. *State Farm Lloyds Insurance Co. v. Maldonado*, 963 S.W.2d 38, 40 (Tex. 1998). The insurer must also plead regarding its belief that the insured and a third party fraudulently colluded in allowing the third party to obtain a judgment against the insured. *State Farm Fire and Casualty Insurance v. Gandy*, 925 S.W.2d 696 (Tex. 1996).

If the insurer discovers that the insured made a material misrepresentation of a matter material to the risk, that it was made to deceive the insurer and that the representation was relied on by the insurer, then the insurer can plead that the policy was void from the outset. Ins. Code §705.004. (Note - that statute has specific timing requirements if an insurer wishes to rely on its provisions).

IV. DUTY OF GOOD FAITH AND FAIR DEALING

A. Insured's Claim

An insurance company has a common-law duty to deal fairly and in good faith with its insured. *Arnold v. National County Mutual Fire Insurance Co.*, 725 S.W.2d 165, 167 (Tex. 1987). An insurer must treat its insured under its policy of insurance on a reasonable basis and investigate the insured's claim thoroughly and in good faith, denying coverage only after that investigation reveals that there is a reasonable basis for doing so. *Viles v. Security National Insurance Co.*, 788 S.W.2d 566, 568 (Tex. 1990). The duty has generally been applied when litigating over the insurer's conduct with regard to the handling of a claim. The duty of good faith, and the resulting tort cause of action,

is based on a special relationship between the insurer and insured and its breach allows for relief beyond that available in a breach of contract case. *Arnold v. National County* at 167. It should be noted that the duty is not applicable to insurers providing third party coverage. *Maryland Insurance v. Head Industries*, 938 S.W.2d 27, 28-29 (Tex. 1996).

The Texas supreme court, in *Universal Life Insurance Co. v. Giles*, 950 S.W.2d 48, 55 (Tex. 1997), stated a two element test for application of the duty:

1. The insurer's liability to perform its contractual obligation must have been reasonably clear at the time of the insurer's conduct alleged as a breach of the duty of good faith.
2. The insurer, at the time of its conduct claimed to be a breach of duty, knew or by the exercise of reasonable diligence should have known that its liability was reasonably clear.

Damage in a "bad faith" claim does not include the policy benefits because those arise out of the breach of contract. *Izaguirre v. Texas Employers' Insurance Association*, 749 S.W.2d 550, 553 (Tex.App.—Corpus Christi 1988, writ denied). Damages for mental anguish are recoverable even without a showing of physical injury. *Arnold v. National County Mutual Fire Insurance Co.*, 725 S.W.2d 165, 167 (Tex. 1987); *St. Elizabeth Hospital v. Garrard*, 730 S.W.2d 649, 650 (Tex. 1987). The prevailing insured can also recover appropriate consequential damages that come out of the tort claim. *Chitsey v. National Lloyds Insurance Co.*, 738 S.W.2d 641, 643 (Tex. 1987). Exemplary damages are recoverable, but only if the insured pleads and proves the existence of actual damages beyond the policy benefits. *Twin City Fire Insurance Co. v. Davis*, 904 S.W.2d 663, 665-667 (Tex. 1995).

B. Defenses Available to Insurer

There are certain defenses that have already been discussed that are also applicable to a "bad faith" claim. These include the two-year statute

of limitations, applicable exclusions and provisions of the policy that preclude coverage in the first place and any effect of *res adjudicata* in a prior lawsuit.

The strongest defense to a “bad faith” claim is by showing that a “bona fide dispute” existed concerning liability on the policy. *Koral Industries v. Security-Connecticut Life Insurance Co.*, 802 S.W.2d 650, 651 (Tex. 1990). This is established by demonstrating that either (1) there was a reasonable basis for the denial or delay of the claim, or (2) if its position on the claim was unreasonable, that the insurer had no reason to know, after a reasonable investigation of the claim, that its position was unreasonable. *Aranda v. Insurance Company of North America*, 748 S.W.2d 210, 213 (Tex. 1988).

The insurer can avoid liability for extra-contractual damages by establishing that the insurance policy is void because of misrepresentations made by the insured. *Koral Industries v. Security-Connecticut Life Insurance Co.* at 651. The insurer must plead and prove five factors:

1. The insured’s representation to the insured.
2. The falsity of the representation.
3. The insurer’s reliance on the representation.
4. The insured’s intent to deceive.
5. The materiality of the representation.

Mayes v. Massachusetts Mutual Life Insurance Co., 608 S.W.2d 612, 616 (Tex. 1980).

Collusion with a third party or the insured’s contributory negligence in the presentation of the claim may also be bases for a defense to a “bad faith” action. Reliance on the advice of counsel or other expert can also be an appropriate defense, as long as such reliance is reasonable. See e.g., *St. Paul Guardian Insurance Co. v. Luker*, 801 S.W.2d 614, 622 (Tex.App.—Texarkana 1990, no writ); *Millers Casualty Insurance Co. v. Lyons*, 798 S.W.2d 339, 343 (Tex.App.—Eastland 1990, no writ).

A settlement agreement for the policy benefits may be broad enough to preclude a subsequent suit for breach of the duty of good faith and fair dealing. *Price v. Texas Employers’ Insurance Association*, 782 S.W.2d 938, 942 (Tex.App.—Tyler 1989, no writ); *Torchia v. Aetna Casualty and Surety Co.*, 804 S.W.2d 219, 222 (Tex.App.—El Paso 1991, pet. den.).

Finally, in a tort claim such as this, it would appear that only an insured is entitled to sue for “bad faith.” *Chaffin v. Transamerica Insurance Co.*, 731 S.W.2d 728, 732 (Tex.App.—Houston [14th Dist.] 1987, writ ref’d n.r.e.).

V. Breach of Contract

A. Insured’s Allegations

A breach of contract action involves allegations of the existence of a valid insurance policy and the facts and policy terms under which recovery is sought. The insured should assert that it has given notice of the claim, demand was made and that the insured has complied with all terms and conditions precedent in the policy. Damages are generally the policy benefits, consequential damages and attorneys’ fees.

B. Insurer’s Defenses

The defenses available to a breach of the insurance policy correspond to many of the defenses to the actions detailed above. Several defenses also generally relate to the allegations that must be proved by the insured. Therefore, an insured should plead, when applicable, that an insured has failed to provide notice or gave late notice; that the insured has failed to provide any proof of loss required by the policy; that the insured failed to comply with any condition precedent contained in the policy; the applicability of any policy exclusions that preclude coverage; that the plaintiff(s) has proper standing to sue; and the insurer can also allege that any breach of contract did not cause all or part of the damages alleged.

VI. CONCLUSION

The foregoing is not intended to be an exhaustive list of claims and defenses that may be asserted in an insurance coverage or “bad

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faith” lawsuit. We have simply attempted to set out the more typical allegations and defenses in such cases. The exact nature of the actual claim and the facts that exist therein will affect what the insured may be able to affirmatively assert against the insurer and what defenses may be mandatory or available to the insurer.