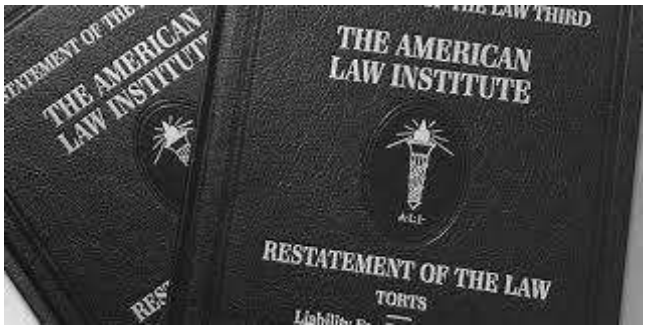
The American Law Institute Embraces First Party Bad Faith



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Michael F. Aylward is a senior partner in the Boston office of Morrison Mahoney LLP where he chairs the firm's complex insurance claims resolution group. For the past four decades, Mr. Aylward has represented insurers and reinsurers in coverage disputes around the country concerning the application of liability insurance policies to commercial claims involving intellectual property disputes, environmental and mass tort claims and construction defect litigation. He has also advised various medical malpractice insurers concerning professional liability claims and consults frequently on bad faith and ethics disputes. He has also served as an arbitrator in numerous insurance coverage matters and has testified as an expert in matters involving coverage and reinsurance issues arising out of such claims.

Mr. Aylward is a leading member of the defense bar, including roles as:

American Bar Association Section of Insurance Litigation
--CLE Co-chair (2004-2006).

American College of Coverage Counsel
--Board of Regents (2012-19)
--President (2019-20)

Defense Research Institute
--Board of Directors (2000-2003)
--Insurance Law Committee Chair (2000-2002)
--Law Institute (2004-2015, Chair—2012-2014)

Federation of Defense and Corporate Counsel
--Reinsurance Excess Surplus Lines Committee Chair (2016-2017)
--Amicus Committee (2010 to present)

International Association of Defense Counsel
--Reinsurance, Excess and Surplus Lines Committee Chair (2005-2007)
--Board of Editors, *Defense Counsel Journal* (2005-2015).

National Foundation for Judicial Excellence
--Board of Directors (2020-2023)

Mr. Aylward has lectured and written frequently on insurance issues and has contributed chapters to the *New Appleman* insurance treatise (2007 and 2010); the Law and Practice of Insurance Litigation (West 2005) and Emerging Issues in the CGL (National Underwriter 2020); the ABA's *Environmental Liability and Insurance* treatise (2012) and Thompson Reuters' 2021 *Reinsurance Desk Handbook*. In 2023, he was designated by Massachusetts Lawyer's Weekly as a 2023 Lawyer of the Year for his achievements in insurance law.

Mr. Aylward is a member of the American Law Institute and served as one of the 43 ALI-appointed advisors to the Reporters during the creation of the *Restatement of Law, Liability Insurance*. He presently is on the Members Consultative Group for the Torts Restatement (3d).

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By
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I. Introduction

On May 22, 2018, the American Law Institute gave final approval to the *Restatement of Law, Liability Insurance.* Ten years in the making, the RLLI was the first Restatement devoted solely to a single industry and was fiercely opposed by the insurance industry. The controversy that dogged the RLLI has continued since 2018 with numerous state legislatures approving measures that forbid their courts from relying on the Restatement to resolve cases.

It may come as a surprise to many that the ALI, after its harrowing experience with liability insurance, would be willing to wade back into these troubled waters in attempt to codify first party insurance. Yet, this is indeed the case. On May 20, 2023, the ALI will meet in Washington to debate and vote on portions of the emerging Restatement (Third), Torts that will include a lengthy section addressing first party bad faith.

II. The Origins of The Third Torts Restatement

Founded in 1923 by eminent judges and scholars such as Benjamin Cardozo and Learned Hand, the American Law Institute takes as its mission the goal of promoting "the clarification and simplification of the law and its better adaptation to social needs, to secure the better administrative of justice and to encourage and carrying out scholarly insights of legal work." Its membership includes hundreds of prominent state and federal appellate judges, as well as leading legal scholars and practicing attorneys.

Over the past century, the ALI has had a profound impact on American law through model statutes such as the Uniform Commercial and Penal Codes as well as its various Restatements of the law. Of these, few have been as influential as the Restatement of Torts ,particularly the groundbreaking analysis of strict liability for defective products in Section 402A of the Restatement of Torts (Second).

ALI Restatements proceed through a slow iterative process. First, Reporters circulate Memoranda and Preliminary Drafts. These initial drafts are reviewed by the Advisors and the Members Consultative Group, who provide feedback to the Reporters. With this input, the Reporters produce so-called Tentative Drafts. When these drafts are approved, a so-called Council Draft is submitted to the ALI Council, a small group of senior members that vets all proposed Restatement before they go to the full membership for final approval at the ALI's annual May meetings in Washington, D.C.

As important as the Second Restatement of Torts proved to be, it is now nearly fifty years old. Not only have some of its provisions been eclipsed by developments in tort law but there are significant areas of modern tort law (*e.g.* medical malpractice and medical monitoring) there were not addressed at all in the Second Restatement.

It was with these concerns in mind that the ALI Council voted in 2019 to authorize the creation of a Third Restatement of Torts. The Reporters for this project were instructed to not only update the earlier Restatement but to expand its scope to encompass new and emerging common law tort issues. As part of this goal, the project was split up into separate volumes, including Defamation and Privacy; Intentional Torts to Persons; Medical Malpractice and Concluding Provisions.

Professor Michael Green, who was appointed as the Reporter for Concluding Provisions (recently renamed "Miscellaneous Provisions"), concluded early on that his volume should include a discussion of first party bad faith. Although not a specialist in insurance law, Green's study of the field led him to conclude that first party bad faith is an important area of tort law that has emerged since the Second Torts Restatement, tracing its roots to the California Supreme Court's holding in *Gruenberg v. Aetna Insurance Co.*, 9 Cal. 3d 566 (1973) that if an insurer fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, it may be held liable in tort for breach of an implied covenant of good faith and fair dealing.

III. The ALI's 2018 Treatment of Third Party Bad Faith

The common law of liability insurance was exhaustively analyzed in the *Restatement of Law, Liability Insurance* that the ALI completed in 2018. The Reporters for that project (Professor Tom Baker of the University of Pennsylvania and Kyle Logue of the University of Michigan) explicitly avoided addressed first party insurance.

In the months leading up to the release of Chapter 4, there was great uncertainty and anticipation with respect to the approach that the Reporters would follow in addressing bad faith law. Given the ambitious innovations that Professors Baker and Logue had experimented with during the project, insurers feared that Chapter 4 would set forth broad and controversial rules seeking to transform the terrain upon which bad faith claims are litigated.

In the event, the discussion of bad faith in Chapter 4 was something of an anti-climax, consisting of only Section 50 (what is bad faith) and Section 51 (what damages that may be recovered in such cases). The brevity of this analysis may reflect *Restatement* fatigue on the part of the Reporters after seven years of labor on this project. It may also have resulted from the Reporters' sense that some of the more complex issues presented by extra-contractual lability claims are not susceptible to a *Restatement*. For instance, this *Restatement* does not address the nature of the duty that liability insurers owe to their policyholders and whether there is some sort of actual or quasi-fiduciary obligation that insurers take on.

Also, the Reporters elected to treat some issue areas that practitioners and many courts may consider as involving "bad faith" as only reflecting contractual issues. In particular, the issue of whether and when insurers may be liable for failing to settle within policy limits is separately dealt with in Section 24 of Chapter 3. Similarly, the problem of how insurers should act when there are more claimants than limits is dealt with as a contract issue in Section 26.

Section 50 defines when insurers may be liable for "bad faith," whereas Section 51 enumerates the damages that bad faith claimants may recover against liability insurers.

An insurer is subject to liability to the insured for insurance bad faith when it fails to perform its duties under a liability insurance policy:

(a) Without a reasonable basis for its conduct; and

(b) With knowledge of its obligation to perform or in reckless disregard of whether it had an obligation to perform.

The Reporters observe in Comment a. that the rule that they are proposing contains both an objective and a subjective element. The objective element is the requirement that insurers have a "fairly debatable" basis for their coverage position. Instead of merely relying on this element, however, the reporters have also required that the insurer act "with knowledge or reckless disregard" of a lack of a good faith basis for its position.

Policyholder advocates had criticized the Reporters for setting the bar too high and requiring them to prove both subjective and an objective elements of liability in order to recover. In response, the Reporters defended their position in Comment a., setting forth three reasons why they chose not to adopt a purely objective standard. First, they felt that the objective approach was already embodied in other insurance law rules requiring that the insurer act reasonably as set forth in Sections 19, 24 and 27. Second, they take the viewpoint that the insured's right to attorney's fees as set forth in Sections 49 and 50 mean that the insured will already be receiving fees when their rights to a defense are denied or threatened without regard to whether the insurer's failure to do so is bad faith. Finally, they note that many of the cases in which courts have adopted a purely objective standard involve types of conduct that this Restatement treats as not involving bad faith such as the insurer's failure to settle or defend.

Comment a. to Section 50 identifies the "objective" element as the familiar requirement that the insurer's coverage position be "fairly debatable." Comment a. explains that the Reporters mean to use the same standard for Section 50 as they adopted in 2016, when in compromising the issue of whether insurers are estopped to contest indemnity when they fail to defend, they revised Section 19 of Chapter 2 to limit estoppel to cases in which insurers lack of "reasonable basis" for failing to defend. As Comment f. to Section 19 explains:

> The expressions of this objective standard include the "absence of a reasonable basis" formulation that appears in subsection (2), as well as the "not fairly debatable," "no genuine dispute," and "no bona fide dispute" formulations. What all these expressions of the objective standard have in common is the principle that insurers may refuse to defend, without facing a risk of liability beyond ordinary contract damages, when there is a sufficient basis in the law for taking that legal position. Whether that sufficient basis is expressed as "reasonable," "debatable," "genuine," or "bona fide," it does not require that the insurer be certain to prevail in its legal position. Rather, it is enough that the legal position be one that a reasonable insurer would take in the circumstances.

> Easy cases showing an absence of a reasonable basis include those in which an insurer refuses to defend because it contends that the factual allegations favoring coverage are not true. Those cases are easy because they directly conflict with the complaint-allegation rule that is central to the duty to defend. See § 13, Comment *a*. An insurer that wishes to avoid the duty to defend an action in that circumstance must begin by defending under a reservation of rights and then file a declaratory-judgment action seeking to terminate the duty to defend. See §§ 15 and 18. Easy cases in which there is a reasonable basis include those in which the insurer is pressing a legal position that has been followed by courts in other jurisdictions but has not yet been decided in the jurisdiction in question.

In contract to this objective "fairly debatable" element, the subjective element is whether the insurer failed to perform when it knew it was obligated to perform or without regard to whether it had a reasonable basis for not performing. Comment a. observes that a "reckless disregard" may be found (1) because of lack of investigation of the relevant facts; (2) a failure to conduct the necessary state-specific legal research to evaluate the coverage position or (3) some other circumstance that placed the insurer on notice that it had not done what it needed to do in order to evaluate whether it had a reasonable basis for its position.

Section 51 sets forth the damages that are recoverable in such cases including (1) the attorney's fees and other costs incurred by the insured in the legal action establishing the insurer's breach; (2) any other loss to the insured proximately caused by the insurer's bad-faith conduct; and (3) if the insurer's conduct meets the applicable state-law standard, punitive damages.

In contrast to the RLLI, which devoted most of its analysis to issues of substantive issues of insurance law, the Third Torts Restatement only addresses first party bad faith. Further, Professor Green has for the most part adopted the bad faith framework that Professors Baker and Logue had earlier set forth in the Liability Restatement.

There is one other important difference between the treatment of bad faith issues in these two Restatements. The *Restatement of Law, Liability Insurance* was developed over a period of eight years through a process of intense debate between the project Reporters and hundreds of lawyers and judges who were experts in insurance law. The RLLI project also benefited from the input of a liaison from the insurance industry and, in its final three years, voluminous input from major U.S. insurers as well as stakeholders in the insurance defense community.

By contrast, these stakeholders have been almost entirely absent from the creation of the Torts Restatement's analysis of first party bad faith. This was due in large part to the fact that it was not apparent to many people that a Torts Restatement would include a discussion of insurance law. As a result, few of the ALI members who were appointed to serve as Advisors on this project have any serious expertise in insurance or bad faith litigation. Nor, despite the large number of insurance lawyers who are members of the ALI, did many of these individuals sign up for the Members Consultative Group that provides a second layer of input to the Reporters.

Finally, whereas the RLLI took nearly a decade to be completed, this section of the Third Torts Restatement is moving with lightning speed. "Bad Faith Performance of First-Party Insurance Contracts" appeared in draft form for the first time on August 18, 2022 in Preliminary Draft No. 3 that was circulated to the project Advisers (a small group of specialized ALI members selected by the ALI Executive Director to advise the Reporters) and the Members Consultative Group, a self-appointed group of ALI members who serve a similar but less consequential advisory role and was one of numerous major topics that were discussed at a group meeting in Philadelphia on September 15, 2022 that also included Children and Family Torts; Interference with Human Remains; Vicarious Liability; Wrongful Death and Survival Actions; Fetal Injury; Estoppel and Spoliation of Evidence.

Following the September meeting, Professor Green revised Preliminary Draft No. 3 and submitted it to the ALI Council in December for consideration at its January meeting. The Council, which is composed of the ALI's most senior members, must review all project drafts before they can be submitted to the full membership for debate and approval at our annual meetings in the Spring.

Unsurprisingly, given the dearth of insurance practitioners who are Advisors or serve on the MCG for this project, Section 20 A drew little attention at the September 15, 2022 meeting or in the months since. Indeed, apart from letters that William Barker of Chicago (now retired from Dentons) and I wrote to Professor Green at the time, there does not appear to have been any outside input with respect to Section 20 A.

Council Draft No. 4, including the Miscellaneous Provisions discussion of first party bad faith in Section 20 A was reviewed by the ALI Council at its January 19-20, 2023 meeting and was approved. It is now ready for review and a final vote at the ALI's Annual Meeting in Washington D.C. on Monday, May 22, 2023.

It remains to be seen whether Section 20 A will actually be approved. Only two hours have been set aside for debate. In addition to what is now a separate "Medical Malpractice" volume, ALI members will be asked to consider the following remaining topics in the Miscellaneous Provisions volume:

- Right of Sepulcher
- Medical Monitoring
- Vicarious Liability
- The Firefighter's Rule
- First-Party Bad-Faith Insurance Claims
- Wrongful-Death and Survival Actions
- Negligent Misrepresentation
- Marital and Family Torts
- Aiding and Abetting Liability

The Reporters have also stated in a March 20, 2023 memo to project participants that they want to concentrate on the Medical Monitoring and Right of Sepulcher sections, followed by the Medical Malpractice volume. If Section 20 A is reached at all, the discussion is likely to be perfunctory.

III. The ALI's 2018 Treatment of Third Party Bad Faith

The Third Torts Restatement's treatment of first party bad faith is entirely contained in Section 20 A. Like all Restatements, Section 20 A is composed of a black letter statement of the law, followed by fifteen separate comments that address diverse aspect of first party bad faith and concluding with the Reporter's Notes setting forth case law that purport to support these Comments.

> An insurer is subject to tort liability to its insured when:
>
> (1) the insurer's claims processing of a first-party insurance policy lacks a reasonable basis;
>
> (2) the insurer knew of the lack of reasonable basis or acted in reckless disregard of the lack of a reasonable basis; and
>
> (3) the insurer's deficient performance is a factual cause of harm to the insured and within the insurer's scope of liability.

Section 20 A is unusual for its length and scope. Of the fifteen Comments, most are unremarkable, either setting forth bland statements of the law or declarations copied from Sections 50 and 51 of the RLLI. The following sections may prove controversial, however:

Comment c. asserts that courts have been willing to create a tort remedy for contractual breaches due to certain "realities" that distinguish insurance from other types of contracts:

> Courts explain this by pointing to exceptional aspects of an insuring agreement, which include the following realities: (1) there is a significant disparity in market power between insurers and insureds, and, among other things, this disparity results in contracts of adhesion for all standard-form policies of insurance; (2) the insurance industry is suffused with public interest concerns—its extensive regulation reflects the public aspects of insurance; (3) concomitantly with (2), insurance contracts play a critical role in the American economy by transferring and distributing risk—and, in so doing, these contracts facilitate productive economic activity; (4) insureds rely on insurance—and Insureds reasonably expect that insurers will perform at the time when losses have been incurred and when financial compensation is urgently needed; (5) some insureds are economically fragile and vulnerable, particularly after suffering a significant loss; and (6) without bad-faith liability, there exist inadequate alternative mechanisms to ensure that insurers will promptly and reasonably pay covered losses.

Comment d. mirrors the "dual objective–subjective standard" that is set forth for third party bad faith in Section 50 of the RLLI. The Reporters declare that this approach

charts a middle court between conservative courts that would only impose bad faith in cases of malicious conduct by insurers and more liberal jurists that require only that an insurer's actions or decisions be "objectively unreasonable."

Comment e. struggles to answer whether first party bad faith is an intentional or negligent tort and observes that:

> The conduct aspect of the bad-faith tort is similar to negligence insofar as it adopts an objective standard based on reasonableness. But the subjective knowledge element cannot be squared with negligence, as an actor can act negligently without any knowledge of, indeed while remaining oblivious to, the risk and without appreciating that his or her conduct is unreasonable.

Comment g. is one of the few sections that were changed between Tentative Draft No. 3 in August 2022 and Council Draft No. 4. Whereas the draft originally only allowed insurers to defend against bad faith claims by showing that their position was based on facts that were not only known to them at the time but had been communicated to the insured in the coverage denial, this latter requirement has now been deleted.

Comment h. states that an insurer can act unreasonably but not be subject to bad faith liability if its misconduct did not actually harm the insured:

> Thus, an insurer who fails reasonably to investigate a claim and does so because of a cynical policy to reduce administrative costs, is not liable under this Section if the claim is for an uncovered loss; nor is the insurer liable if the claim is one for which a justifiable basis exists for denial. However, an insurer who engages in dilatory claims investigation and processing may be liable for any harm caused by the delay in payment or for other harm that the deficient claims processing caused. Simply, if the insurer harms the insured, the insurer may be subject to liability under this Section; if the insurer causes no harm to the insured, the insurer is not liable under this Section, no matter how egregious its conduct.

Comment i. expands upon Comment f.'s declaration that an insurer may be liable if it fails to investigate a first party loss, explaining that "[a]n insurer must act reasonably in investigating a claim when there are factual or legal matters that must be resolved.

Comment k. avers that insurers are not fiduciaries but affirms that they may not put their own interests ahead of their insured's:

> An insurer does not have a fiduciary duty to its insured in its processing of first-party insurance claims; the insurer is not required to take the insured's interests as primary over the insurer's. But, nor is the insurer in the opposite position; it cannot prioritize its own interests over the interests of the insured. The insurer must, in other words, act in a way that gives equal weight to its and its insured's often divergent interests.

Comment l. explores the respective roles of judge and jury in resolving first party bad faith and concludes that "[b]oth the objective and subjective elements of the bad-faith tort are mixed questions of law and fact that the factfinder must resolve." It appears that this section overstates the general rule and ignores instances in which an insurer may use summary judgment motions to dispose of bad faith claims.

Comment m. addresses the impact of state claims handling statutes on common law bad faith actions. It declares that:

> Virtually all states have enacted statutory provisions prohibiting specified unfair insurer claims practices, although, in most states, the statutes are not enforceable through private rights of action. However, in common-law bad-faith claims, courts may use the insurer's violation of such provisions as the basis for finding a lack of reasonable basis in the insurer's claims processing in a manner analogous to the doctrine of negligence per se.

In short, the Reporters call for courts to use a new "negligence per se" standard for private causes of action for policyholder suits based upon insurer violation of unfair claims practice statutes. The Reporter's Note only cites two decisions for this novel proposition, one of

which (*Moody v. Oregon Cmty. Credit Union*, 505 P.3d 1047 (2002), *leave to appeal granted* (Or. 2022) is still under review by the Oregon Supreme Court. The other is the West Virginia Supreme Court's 2003 decision in *Barefield v. DPIC* which says nothing about negligence per se. This is awfully thin legal authority for adding a new legal proposition to a Restatement.

Comment n. declares that "ordinary negligence or insurers' good-faith mistakes are not an adequate basis for bad faith tort liability."

Finally, **Comment o** sets forth the damages that an insured may recover for first party bad faith. Consistent with Section 51 of the RLLI, it states that consequential damages may be recovered, together with emotional harm, including loss of consortium damages. It also declares that an insured may generally recover attorneys fees for establishing coverage but not for bad faith.