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The American Law Institute Restates the Law of First-Party Bad Faith

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> Section 20 A is a useful summary of first-party bad faith and is unlikely to generate the same opposition that the RLLI faced.
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On May 22, 2018, the American Law Institute (ALI) gave final approval to the *Restatement of the Law of Liability Insurance* (RLLI). 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. (1)

It may come as a surprise to many that after its harrowing experience with liability insurance, the ALI is willing to wade back into these troubled waters in an attempt to restate the law of bad faith for first-party insurance. Yet, this is indeed the case. On May 21, 2024, the ALI membership met in San Francisco and voted to approve volume 3 of the new *Restatement (Third) of Torts* (Third Restatement), including section 20 A, a lengthy section addressing first-party bad faith.

Origins of the Third Restatement

Founded in 1923 by eminent judges and scholars such as Benjamin Cardozo and Learned Hand, the mission of the ALI is "to promote the clarification and simplification of the law and its better adaptation to social needs, to secure the better administration of justice, and to encourage and carry on scholarly and scientific legal work." (2) 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 not only its model statutes, such as the Uniform Commercial and Penal Codes, but also its various restatements of the law. Of these restatements, 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 (Second) of Torts* (Second Restatement). (3)

ALI restatements proceed through a slow iterative process. First, reporters circulate memoranda and preliminary drafts. These initial drafts are reviewed by the advisers—a small group of specialized ALI members selected by the ALI executive director to advise the reporters—and the Members Consultative Group (MCG)—a self-appointed group of ALI members who serve a similar but less consequential advisory role compared to that of the advisers. Based on input from the advisers and the MCG, 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

restatements before they go to the full membership for final approval at the ALI's annual May meeting in Washington, D.C.

As important as the Second Restatement proved to be, it is now nearly 50 years old. Not only have some of its provisions been eclipsed by developments in tort law, but significant areas of modern tort law (e.g.,medical malpractice and medical monitoring) are not addressed at all in the Second Restatement.

With these concerns in mind, the ALI Council voted in 2019 to authorize the creation of the Third Restatement. The reporters for this project were instructed not only to update the earlier restatement but also 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 D. Green of the Washington University School of Law, who was appointed as the reporter for "Concluding Provisions" (recently renamed "Miscellaneous Provisions"), determined early on that his volume should include a discussion of first-party bad faith. Although not a specialist in insurance law, Green, based on his study of torts, concluded that first-party bad faith is an important area of tort law that has emerged since the Second Restatement, tracing the roots of first-party bad faith to the California Supreme Court's 1973 holding in *Gruenberg v. Aetna Insurance Co.* (4) That case held 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. (5)

ALI's 2018 Treatment of Third-Party Bad Faith

The common law of liability insurance was exhaustively analyzed in the 2018 RLLI. (6) The reporters for that project—Professor Tom Baker of the University of Pennsylvania and Kyle D. Logue of the University of Michigan—explicitly avoided addressing 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 with which Baker and Logue had experimented 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.

Once the proposed bad faith rules were disclosed, the discussion of bad faith in chapter 4 was something of an anticlimax, consisting of only section 49 (what bad faith is) and section 50 (what damages 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 extracontractual lability claims are not susceptible to a restatement. For instance, the RLLI 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 areas that practitioners and many courts may consider as involving bad faith as something other than bad faith. 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 2 and is characterized as the duty to make reasonable settlement decisions rather than a duty of good faith. Similarly, the problem of how insurers should act when there are more claimants than limits is dealt with in section 26 as part of the duty to make reasonable settlement decisions rather than as a matter of bad faith.

Section 49. Section 49 defines when insurers may be liable for bad faith:

> An insurer is subject to liability to the insured for insurance bad faith when it fails to perform 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. [7]

Comment b observes that the proposed rule contains both an objective and a subjective element. The objective element is the requirement that insurers lack a "fairly debatable" basis for their coverage position. Instead of merely relying on this element, however, the reporters also required a subjective element that the insurer act "with knowledge or in reckless disregard of" a lack of a good faith basis for its position. [8]

Policyholder advocates had criticized the reporters for setting the bar too high and requiring them to prove both subjective and objective elements of liability in order to recover. In response, the reporters defended their position in comment b, 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 24 and 27. Second, they took the viewpoint that the insured's right to attorney fees under the law of many states means 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 noted 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.

In contrast to the objective "fairly debatable" element, the subjective element is whether the insurer failed to perform when it knew that it was obligated to perform or without regard to whether it had a reasonable basis for not performing. Comment b observes that a "reckless disregard" may be found because of (1) lack of investigation of the relevant facts, (2) 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. [9]

Section 50. Section 50 sets forth the damages that are recoverable in such cases, including (1) the attorney 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) punitive damages if the insurer's conduct meets the applicable state-law standard. 10

Differences between RLLI's and Third Restatement's Treatment of First-Party Bad Faith

In contrast to the RLLI, which devoted most of its analysis to substantive issues of insurance law, the Third Restatement only addresses first-party bad faith. Further, Green has largely adopted the third-party bad faith framework that Baker and Logue had earlier set forth in their restatement.

Another important difference between the treatment of bad faith issues in these two restatements is that the RLLI was developed over 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, including the Defense Research Institute (DRI). By contrast, these stakeholders have been almost entirely absent from the creation of the Third 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, none of the ALI members who were appointed to serve as the 51 advisers on this project has 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 MCG that provides that second layer of input to the reporters.

Finally, whereas the RLLI took nearly a decade to be completed, this section of the Third Restatement has proceeded with comparative 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, which was circulated to

the project advisers and the MCG and was one of numerous major topics that were discussed at a group meeting in Philadelphia on September 15, 2022, which 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, 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 the ALI's annual meeting in the spring.

Unsurprisingly, given the dearth of insurance practitioners who are advisers or serve on the MCG for this project, section 20 A drew little attention at the September 2022 meeting or in the months since. Indeed, apart from letters that the author and William Barker of Chicago (now retired from Dentons) wrote to 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 for consideration at the ALI's annual meeting in Washington, D.C., on May 22, 2023. However, the two hours that the ALI had devoted to the "Miscellaneous Provisions" topics were almost entirely taken up by a debate about whether the ALI should acknowledge a cause of action for medical monitoring, and further action on the "Miscellaneous Provisions" was postponed until the ALI 2024 annual meeting.

This yearlong pause was a fortunate thing. It gave Green time to consider objections and concerns that had been presented shortly before the May 2023 meeting. It also galvanized various insurance specialists to reach out to Green to provide insight and constructive advice. The result was Preliminary Draft No. 4, which Green circulated in August, which was then submitted and approved by the ALI Council in October 2023, and which, as approved by the council, was circulated to ALI members in April 2024 as Tentative Draft No. 3.

As will be detailed below, this latest draft of section 20 A has eliminated or ameliorated most of the provisions from earlier drafts about which insurers and bad faith counsel had expressed concern. Additionally, Tentative Draft No. 3 uses language that is more familiar to first-party lawyers, whereas earlier drafts of section 20 A used terms that derived from third-party claims.

Third Restatement's Treatment of First-Party Bad Faith

The Third Restatement's treatment of first-party bad faith is entirely contained in section 20 A. Section 20 A is unusual for its length and scope. Rather than setting forth separate sections to address the universe of first-party bad faith issues, the ALI has elected to combine all of these together in section 20 A.

Like all restatements, section 20 A is composed of a blackletter statement of the law, comments, and the reporter's notes setting forth case law that purports to support these comments.

The blackletter statement of section 20 A states:

> An insurer is subject to tort liability to its insured when:
>
> (a) the insurer's claims processing of a first-party insurance policy lacks a reasonable basis;
>
> (b) the insurer acted with knowledge of the lack of a reasonable basis or acted in reckless disregard of the lack of a reasonable basis; and
>
> (c) the insurer's deficient performance is a factual cause of harm to the insured and the harm is within the insurer's scope of liability.
>
> 11

This general statement of the law is explained in 16 separate comments that address diverse aspects of first-party bad faith.

Comment a: History, terminology, and scope. This initial comment is a prologue to the balance of section 20 A, setting the stage by noting that first-party bad faith had only just been recognized at the time that the Second Restatement was created and, accordingly, had not previously been considered by the ALI.

Comment b: Bad faith performance of third-party insurance contracts. Comment b briefly summarizes how the ALI addressed third-party bad faith in RLLI sections 49 and 50. (12) In particular, the reporter observed that most liability insurance bad faith claims are based upon an insurer's failure to make "reasonable settlement decisions," which has no counterpart in the context of first-party insurance, or failure to perform claims handling "without a reasonable basis for its conduct and with knowledge of its duty to perform or in reckless disregard of its obligation to perform." (13)

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

> Courts explain this differential treatment 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 (and some other) policies; (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 their coverage obligations promptly when losses occur and when financial compensation is urgently needed; (5) some insureds are economically fragile and vulnerable, particularly after suffering a significant loss; (6) without liability for

> insurance bad faith, there exist inadequate alternative mechanisms to ensure that insurers will promptly and reasonably process claims and pay covered losses; and (7) the insurer is in the dual role of party and, at least initially, the judge, imposing special obligations to judge neutrally. (14)

Comment d: Dual subjective and objective nature of the bad faith tort. As with section 49 of the RLLI, section 20 A states that the prima facie case for first-party bad faith must contain a subjective and an objective element. (15) To establish a prima facie case of bad faith, the claimant must prove both that there was no reasonable basis for the defendant insurer's claims processing and that, in its claims-processing conduct, the defendant insurer knew or acted in reckless disregard of the lack of reasonable basis. Thus, the first element requires a showing that a reasonable insurer would have performed differently from the defendant insurer. The second element, a subjective one, requires proof that the insurer knew its conduct was unreasonable or acted in reckless disregard of facts or legal authority that reveal the unreasonableness. (16)

Comment e: Various bases for bad faith claims processing. Comment e identifies various means by which a first-party insurer may commit bad faith. Of the eight cited examples, three were added in the final draft along with a definition of "claims processing":

> (1) denials of claims for which no reasonable basis exists for the denial; (2) offers of settlement in amounts below the minimum that would be reasonable based on the facts of the claim and the scope of coverage; (3) investigations that take an unreasonably long time, that are unreasonably onerous or demanding, or that are otherwise unreasonable; (4) imposing conditions on insureds during claims processing that are unreasonable or impossible to fulfill; (5) conditioning payment for an uncontested aspect of a claim on the insured agreeing to a global settlement of the claim; (6) misrepresentations about coverage; (7) improper destruction of evidence; or (8) overpaying to accelerate the exhaustion of policy limits when the policy otherwise would fund ongoing obligations.

> "Claims processing" as used in this Section covers the insurer's conduct from the time when an insurer first has notice of a claim through to final resolution of the claim. [17]

Comment f: Intentional or negligent tort. Comment f struggles with the problems inherent in characterizing first-party bad faith as an intentional tort. The reporter noted that "[t]he conduct aspect of the bad-faith tort is similar to negligence insofar as it adopts an objective standard based on reasonableness," whereas "[t]he objective unreasonableness aspect . . . is not consistent with intentional torts." [18] Comment f concludes that "[c]ourts and commentators should accept this tort for the hybrid that it is rather than laboring to place it into the traditional tort taxonomy." [19]

Comment g: Timing of insurer's knowledge of facts supporting good faith. Comment g is one of the few sections that reflect changes between Preliminary Draft No. 3 in August 2022 and Tentative Draft No. 3. Whereas the draft originally only allowed insurers to defend against bad faith claims by showing that their position was based on facts that not only were known to them at the time but also had been communicated to the insured in the coverage denial, this latter requirement has now been deleted. [20] This rule is stated to apply only to instances in which claims are denied rather than cases of late payment and the like. [21]

Comment h: Factual cause and scope of liability. Comment h states that an insurer can act unreasonably but not be subject to bad faith liability if the loss in question was, in fact, not covered by the policy:

> Thus, an insurer who fails reasonably to investigate a claim 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 insurer cynically denies a claim for which there is, in fact, a justifiable basis for denial so long as the facts that support the justifiable basis were known at the time of the denial. See Comment *g*. However, an insurer that engages in dilatory claims investigation or 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. [22]

The reporter cautioned, however, that an insurer may still be liable for infliction of emotional distress if its conduct is sufficiently outrageous or unreasonable. [23]

Comment i: Obligation reasonably to investigate. Comment i declares that first-party insurers not only must act reasonably in their claims decision but also must

> act reasonably in investigating a claim when there are factual or legal matters that must be resolved. An insurer acting reasonably will: engage in a prompt investigation that does not unreasonably delay resolution of the claim; hire independent and unbiased experts when expertise is required to determine relevant facts; and even-handedly seek and give due regard to all of the facts bearing on the coverage issue, claim, and the amount of the loss (although, in so doing, an insurer is entitled to consider the fact that insureds do not have a concomitant obligation of even-handedness in filing and supporting their claims). [24]

Comment j: Other tortious conduct by an insurer. Comment j observes that bad faith conduct by a first-party insurer may also support recovery on other tortious theories of liability, including infliction of emotional distress and defamation. [25]

Comment k: Fiduciary duty. Comment k takes the position that first-party insurers are not fiduciaries but also cautions that an insurer cannot place its own concerns over those of its insured:

> The insurer must, in other words, act in its role as investigator in a way that gives equal weight to its and its insured's often divergent interests. The insurer must act in a way that recognizes the insured's interest in recovering for legitimately covered losses and the insurer's coequal interest in not paying uncovered claims. (26)

Comment *l*: Judge and jury. Earlier drafts of section 20 A had strongly suggested that issues of first-party bad faith must be determined by juries and were inappropriate for resolution by a judge on a motion for summary judgment. Tentative Draft No. 3 takes a softer approach by adding two exceptions to this general rule:

> First, when the question that must be assessed is whether the insurer's denial of coverage was reasonable based on the policy or statutory language—and that inquiry turns on the interpretation of specific policy or statutory language—courts must assess whether the insurer acted reasonably as a matter of law. Addressing that limited matter as a legal one is consistent with the rule that interpretation of insurance policy or statutory language is a matter for the court because a legally trained official is better able to make that determination than a lay adjudicator. . . . Second, in instances in which the plaintiff claims bad faith based only on the insurer's denial of coverage and the facts bearing on whether coverage exists are not in dispute, the question of whether the insurer had a reasonable basis for denying coverage is a legal one for the court. (27)

Comment m: State unfair insurance claims practices provisions. Earlier drafts of comment m declared that an insurer's violation of state unfair claims practices statutes might constitute a per se basis for finding first-party bad faith:

> 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. [28]

Various insurer-side lawyers, including the author, protested that there was little or no legal support for applying negligence per se to bad faith claims. As revised in Tentative Draft No. 3, this comment now merely states that such violations "may be considered in an insurance bad-faith claim in determining whether there was a lack of a reasonable basis in the insurer's claims processing." [29]

Comment n: Negligent and honest mistakes. Comment n declares that "ordinary negligence or insurers' good-faith mistakes are not an adequate basis for bad-faith tort liability." [30]

Comment o: Independent contractors hired to perform claims processing. Council Draft No. 5 added a new subsection dealing with the liability of first-party insurers for the actions of independent contractors, which carried over into Tentative Draft No. 3. It states that while insurers are free to delegate claims-handling duties to employees or independent contractors, insurers remain vicariously liable for their acts or omissions under ordinary vicarious liability principles. [31]

Comment p: Damages. Finally, comment p identifies the damages that an insured may recover for first-party bad faith. Consistent with section 50 of the RLLI, it states that consequential damages may be recovered, together with emotional harm and loss of consortium damages where appropriate. It also declares that an insured may generally recover attorney fees for establishing coverage but not for bad faith. [32]

Will Section 20 A Shape the Future Course of First-Party Bad Faith Law?

After several twists and turns in its evolution over the past few years, the final draft of section 20 A succeeds in restating generally agreed principles of first-party bad faith law without advancing any particularly novel or controversial

proposals. In this respect, it differs markedly from the RLLI, which was harshly criticized by the insurance coverage industry and several state legislatures for going far beyond accepted law in most states.

Regardless of whether it was necessary or appropriate to have a restatement of first-party bad faith law—especially when, unlike the RLLI, these principles were not accompanied by sections addressing first-party insurance law generally—Green may well be correct that so many states have treated first-party bad faith as a tort that it would be anomalous to omit first-party bad faith from a comprehensive review of tort law. At the same time, it remains to be seen whether section 20 A will have a significant influence on the future course of the law in this area or will simply be a useful recitation of basic legal principles to be used by counsel and judges.

In general, it seems unlikely that section 20 A will have much of an impact. Judges are most likely to look to restatements as a source of authority on novel issues or in states where there are no common law precedents, statutes, or regulations to guide their decisions. That is rarely the case for insurance, especially as heavily regulated an industry as first-party insurance is. For instance, in the six years since the RLLI was approved, it has only been cited a few dozen times, typically as supplemental supporting authority for otherwise accepted legal principles. Only in a handful of cases has the RLLI had a decisive impact.

Nevertheless, section 20 A may yet prove important and useful. As a result, lawyers practicing in this area would be foolish to ignore it and should, at a minimum, be conversant with its contents, regardless of whether they choose to cite this restatement.

Endnotes

ENTITY:

TORT TRIAL AND INSURANCE PRACTICE SECTION

TOPIC:

TORTS

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