How "Bad Faith" Becomes Bad Law

Legislators should continue to reject efforts to unreasonably expand liability for insurance claims handling

BY VICTOR E. SCHWARTZ & CHRISTOPHER E. APPEL

State legislatures around the country have become increasingly bombarded with proposals to overhaul state insurance laws in order to root out so-called "bad faith" in the handling of insurance claims. Generally speaking, this legislation purports to compel insurers to act in good faith in their dealings by expanding the scope of liability and heightening existing penalties for "bad" insurer acts, such as the unjust delay or denial of a claim.

While on the surface this expansion of law may seem to many state legislators like a helpful and attractive consumer protection measure, the reality is that bad-faith initiatives often miss their basic purpose and are anything but a step in the right direction. Knowledgeable legislators have appreciated that in many instances this legislation is designed to generate mass litigation and punish insurers even where they try to act responsibly. For these reasons, most legislators have appropriately repudiated such proposals.

ALEC recently passed a resolution to address the growing area of concern regarding unfair and unbalanced bad-faith legislation. The resolution identifies and opposes types of acts which create new and expansive private causes of action, lower existing bad-faith standards, and impose unreasonable penalties beyond the limits of what is recoverable under an insurance contract. This article builds on the ALEC resolution to provide a guide for legislators and other interested parties to navigate the landscape of bad-faith law, learn how these laws are commonly abused and manipulated, and understand how expansive bad-faith legislation can become a recipe for disaster that harms both insurers and ordinary insurance consumers.

What's really at stake in bad-faith legislation

An important first step in becoming educated about insurance bad faith is to identify from where efforts to transform this

Victor E. Schwartz is Co-Chair of ALEC's Civil Justice Task Force and Chairman of the Public Policy Group in the Washington, D.C. office of the law firm of Shook, Hardy, & Bacon L.L.P. Christopher E. Appel is an associate in the firm's Public Policy Group.

area of law are coming. Unlike other legislation heralded as "consumer protection" and championed by bonafide consumer groups, the driving force behind state lobbying efforts for bad-faith laws are often plaintiffs' lawyers who view expansive bad-faith legislation as a major boon to their litigation business. More than that, the organized plaintiffs' bar understands that an expansive bad-faith law can have the effect of creating a market for litigation, and one that can secure the financial future of many of their members. In this regard, the plaintiffs' bar appears less concerned about the needs of most insureds and the public policy impacts of overly expansive bad-faith laws than in dramatically increasing litigation opportunities for their members.

Increasing the amount of litigation, however, is only one part of this trial lawyer agenda; a concurrent objective is to increase the value of each new case substantially. To accomplish this goal, bad-faith proposals often heighten the range of available penalties while lowering the standards for those penalties to be imposed. The effect provides plaintiffs' attorneys with the best of both worlds—less work for a higher payoff—and is nothing short of a complete transformation in the law. That insurers are perceived in a negative light by many in the public and are often viewed as having "deep pockets" make them an attractive target for this type of proposal, which would likely be scoffed at by legislators if attempted against other industries or in other contexts. Moreover, given the incredible potential to expand both the quantity and dollar value of litigation, it is easy to see why bad-faith bills are honey in the mouth for their underwriting members in the plaintiffs' bar.

Where the law currently stands

Recognition of bad faith as the basis for an independent right of action is only a product of the last 35 years of American jurisprudence.[1] Over this comparatively short period, the law of bad faith has witnessed unprecedented growth and development. Throughout the 1970s and 1980s, a majority of states adopted a bad-faith action as an addition to their common law.[2] With few exceptions, states recognize that to succeed in a bad-faith lawsuit, there must be "an absence of a reasonable basis for denial of policy benefits and the knowledge or reckless disregard of a reasonable basis for a denial."[3] In other words, courts have made it clear that bad faith means an intentional wrong perpetrated by the insurer.

During this same period of development, every state also adopted statutes to supplement the common law and establish a state regulatory layer of protection. These laws were based on model legislation that was produced by the National Association of Insurance Commissioners (NAIC) for enforcement by state insurance regulators, not private personal injury lawyers.[4] The statutes generally require insurers to communicate promptly with respect to claims, implement reasonable standards for claims investigation, negotiate in good faith, and pay insureds promptly when liability has become reasonably clear. They also prohibit intentional insurer acts such as altering claims forms, making payments without stating the policyholder's coverage, requiring submission of preliminary claims reports with duplicative information to cause delay, and intimidating claimants by making them aware of an insurer's policy of appealing any arbitration award favorable to the insured.

Regrettably, judicial interpretation of these existing, often identical, bad-faith statutes has varied significantly. Some state courts have interpreted these laws to allow private enforcement, while others retain exclusive oversight and enforcement through the state insurance commissioner. Adding greater complexity to the landscape of bad- (*Faith*, continued on p. 19)

1 See generally Victor E. Schwartz & Christopher E. Appel, Common-Sense Construction of Unfair Claims Settlement Laws: Restoring the Good Faith in Bad Faith, 58 Am. U. L. Rev. 1477 (2009).

2 See id. at 1482-86.

3 Anderson v. Continental Insurance Co., 271 N.W.2d 368, 377 (Wis. 1978).

4 See Schwartz & Appel, supra, at 1512, n.169.

(*Faith*, *continued from p. 14*) faith law is that a number of states have adopted private enforcement provisions and additional prohibited acts that are not part of the model NAIC laws. These enforcement provisions can enable private actions to be brought under statute or common law, and can result in inconsistent standards for what constitutes "bad faith." The presence of additional prohibited insurer acts can also compound this adverse effect. For instance, additional provisions often include rigid criteria, such as specific time limits within which an insurer must process a claim, and provide a basis for much of the bad-faith litigation raising concern to ALEC members. States such as Missouri, Illinois, and Rhode Island, for example, have statutes prescribing a strict 10- or 15-day window in which an insurer must provide claims forms or violate the state's unfair claims settlement act.[5] Some states also set strict and arbitrary deadlines for other practices, such as when an insurer must respond to a claim[6] or even when a claim must be settled.[7]

Sanctions also vary significantly across states. Oklahoma, for instance, imposes a fine, enforced by the state Insurance Commissioner, between $100 and $5,000 for each violation of its bad-faith statute,[8] while Maryland imposes a penalty up to $125,000 for any violation.[9] A number of states also allow private claimants to recover punitive damages.[10] Still others, such as Louisiana, provide additional private recovery beyond the insurance contract by permitting as damages a multiple of any compensatory award.[11]

The differences among states regarding identification of bad-faith conduct, enforcement mechanisms, and remedies create a wide range of treatment for bad faith in the handling of insurance claims. Although most states' statutes appear similar, and sometimes nearly identical in form, their interpretation by courts and the presence of additional provisions or remedies creates close to 50 unique state landscapes. It is against this backdrop that much of the recent legislation has sought to take advantage of the muddled state of the law and unreasonably expand and distort the core principles of bad-faith law.

How plaintiffs' lawyers want to change the law

Plaintiffs' lawyers have sought to legislatively modify bad-faith laws in four key ways: (1) create a statutory private right of action; (2) remove any intentional conduct standard; (3) enumerate strict criteria that purports to show bad faith; and (4) increase and expand bad-faith penalties. As the ALEC Resolution Opposing Unfair and Unbalanced Bad Faith Legislation illustrates, each of these modifications standing alone has the potential to alter a state's litigation environment dramatically and unfairly. When they are combined, as they routinely are in bad-faith bills, a broad new "super-tort" is created which allows virtually any claimant who has been denied payment on an insurance claim to maintain a bad-faith lawsuit.

The overreaching and unbalanced effect of such proposals can be appreciated by even the harshest critic of insurers. Consider what would happen if a bill adopting these proposals were enacted and plaintiffs could bring a statutory bad-faith action against an insurer for technical errors—regardless of any malicious or intentional insurer conduct—and recover broad damages. It would give rise to unreasonable litigation with unjust outcomes: for example, if an insurer reasonably disputed a claim, but because of a clerical error in data-entry failed to meet a statute's window of time for providing the proper claims forms, that insurer could be punished by being forced to pay the reasonably disputed claim in full, subjected to extra-contractual damages such as a compensatory damages multiplier, made to pay attorney's fees and court

5 See 215 ILL. REV. STAT. ANN. § 5/154.6(o); MO. REV. STAT. § 375.1007(13); R.I. GEN. LAWS § 27-9.1-4(13).

6 See, e.g., FLA. STAT. ANN. § 626.9541(1)(i)(3)(e); OKLA. STAT. tit. 36, § 1250.4(C); R.I. GEN. LAWS § 27-9.1-4(16); S.D. CODIFIED LAWS § 58-33-67(1).

7 See, e.g., CONN. GEN. STAT. § 38a-816(15)(B) (requiring an insurer to settle claims within forty-five days); N.M. STAT. ANN. § 59A-16-20(F) (characterizing the failure to settle "catastrophic claims" within ninety days as a prohibited unfair claims practice); W. VA. CODE § 33-11-4(9)(o) (requiring claims to be settled within a ninety-day period).

8 See OKLA. STAT. ANN. tit. 36, § 1250.14.

9 See MD. CODE ANN. INS. § 27-1001.

10 See MASS. GEN. LAWS ch. 176D, § 7; MASS. GEN. LAWS ch. 93A, § 9.

11 See LA. REV. STAT. ANN. § 22:1973(C).

costs, fined thousands of dollars by the state, and forced to reengineer its claims processing system.

Taken together, the insurer may be dealt a devastating blow, on multiple levels, for a single unintended act. Furthermore, even with a well-trained staff, such human errors are practically unavoidable where insurers are tasked with handling hundreds of thousands of claims per year, or thousands of claims per day. By creating a private right to sue that removes the essential bad-faith requirement of intentional or willful conduct, and reduces the standard to mere negligence, plaintiffs' attorneys are able to turn an insurer's minor technical error (the criteria for which is often created by the same legislation) into a highly profitable settlement.

In the past few years, plaintiffs' attorneys have managed to successfully sell such legislation in a few states. For example, since 2007, Colorado and Washington have each significantly amended their bad-faith laws to permit a private right of action incorporating a negligence standard.[12] In 2009, there were also similar bad-faith bills introduced in more than a dozen other jurisdictions.[13]

Why expanding bad-faith represents unsound public policy

The consequences of unreasonably expanding—perhaps more aptly described as re-defining—the law of bad faith would be adverse to both sides of the insurance transaction. When the law allows an insurer to effectively be punished where there is no intent to harm a policyholder, and especially when the insurer is willing to correct a mistake, the dynamics of the system change dramatically. The pressure to settle a case when there is any doubt—no matter how remote—that the insurer *could be* incorrect or mistaken and therefore liable for substantial extra-contractual damages, can become enormous. Plaintiffs' lawyers, attune to this changed dynamic and seeing blood in the water, would have a clear incentive to simply "add on" a bad-faith claim to every insurance coverage dispute and expand the scope of recovery. As a result, the number and amount of insurance settlements would significantly increase, unnecessarily driving up insurance costs.

Ultimately, these costs would be borne not by a "wealthy insurer," but rather by individuals, small businesses and other insurance consumers onto whom higher premiums are passed. The increase in costs would also likely price many consumers out of the market for insurance altogether, increasing the number of uninsured and underinsured, and further increasing costs for those able to maintain insurance. Some insurers might discontinue or substantially curtail their insurance services because it would be too risky to do business in a jurisdiction with an overly-expansive bad-faith law. This would additionally penalize consumers through less insurer competition and fewer coverage choices.

Both insurers and insurance consumers would also likely be harmed by a greater incidence of insurance fraud by insureds. As a practical matter, the increased settlement pressure from an expansive bad-faith law would make it more risky for insurers to try to "get to the bottom" of any claim, even those the insurer believes lack merit.

Finally, it is important to note that despite all of these adverse public-policy effects, there has been no clear showing of a need for broader remedies for an insured who believes his or her claim should be paid. State insurance regulators function to safeguard insureds, and are empowered to impose penalties against insurers or otherwise take corrective action. Contract remedies are also available to insureds, in addition to other intentional torts outside the perimeters of the contract. If legislators determine that more legal power is needed to assist insureds, that additional enforcement responsibility should be held by state regulators charged with safeguarding insureds and not by private actions in an already expansive tort system.

ALEC members should be cognizant of the harmful impacts of expansive bad-faith legislation and the often self-serving motives of those who underwrite efforts to water down and redefine bad-faith law. Legislators must continue to maintain rational limits, or soon, even good faith will become consumed by bad faith. ■

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12 See H.B. 1407, 2008 Leg., 66th Sess. (Colo. 2008) (codified at COLO. REV. STAT. § 10-3-1115); S.B. 5726, 2007 Leg., 60th Sess. (Wash. 2007) (codified at WASH. REV. CODE § 48.30.015).

13 In 2009, bad-faith bills were introduced in the following jurisdictions: S.B. 103, 2009 Leg., 67th Sess. (Colo. 2009); S.B. 763, 2009 Leg., Reg. Sess. (Conn. 2009); S. 962, 2009 Leg., Reg. Sess. (Fl. 2009); H.B. 450, 2009 Leg., Reg. Sess. (Ga. 2009); S.B. 1137, 2009 Leg., Reg. Sess. (Iowa 2009); L.D. 1305, 2009 Leg., 124th Sess. (Me. 2009); H.B. 345, 2009 Leg., 61st Sess. (Mont. 2009); S.B. 157, 2009 Leg., Reg. Sess. (N.M. 2009); A.B. 224, 2009 Leg., Reg. Sess. (Nev. 2009); S. 132, 2008-09 Leg., 213th Sess. (N.J. 2008); A. 3698, 2009 Leg., Reg. Sess. (N.Y. 2009); H.B. 2791, 2009 Leg., Reg. Sess., 75th Sess. (Or. 2009); S.B. 746, 2009 Leg., Reg. Sess. (Pa. 2009); H. 5196, 2009 Leg., Reg. Sess. (R.I. 2009); B. 18-103, 2009 Leg., Reg. Sess. (D.C. 2009).