Reflections on a Paradigm Shift for Extra-Contractual Liability

In the Restatement of the Law, Liability Insurance

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Introduction

In 2010, the American Law Institute ("ALI") initiated a project on Liability Insurance Law. Initially, it was a “Principles” project to identify Principles of the Law of Liability Insurance. Professor Tom Baker of the University of Pennsylvania was recruited to be the Reporter for the project, and Kyle Logue of the University of Michigan agreed to be the Associate Reporter. After several years of work on the project, in 2015 it was changed from a “principles” project to the Restatement of the Law, Liability Insurance. This moved from a more aspirational statement of principles to a restatement of current common law concerning liability insurance. The final draft of the Restatement is schedule for final vote at the ALI’s Annual Meeting in May 2017.

The restatements produced by the ALI often are significantly persuasive authority for the courts. The ALI process tends to produce restatements that are thoughtful and well-researched, and the ALI membership and processes add legitimacy. The ALI is an independent organization of prominent judges, lawyers and professors. The organization is governed by a Council of its members. The initiation of the Liability Insurance project and the appointment of the Reporter and Associate Reporter was approved by the Council. The Reporter and Associate Reporter are responsible for the drafting of the Restatement. They present drafts to a group of Advisers and to a Members Consultative Committee. Advisers are experts in the field invited by the Council to participate. Members of the Members Consultative Committee are members of the ALI who volunteer to participate in the project.
Drafts are revised by the reporters based on feedback from those presentations. In addition, drafts are presented to the Council for approval before being placed on the agenda for review by the general membership. Approval by the general membership includes procedures for discussion and amendment by motion.

With the considerable work that has gone into the production of the Restatement of the Law, Liability Insurance, and with the leadership of Tom Baker and Kyle Logue, it is likely that the Restatement will have considerable influence on the understanding and development of the law of liability insurance. This paper focuses on the Restatement’s treatment of an insurer’s duty to settle and of insurance bad faith. With the permission of the ALI, the current drafts of sections 24, 51 and 52 of the Restatement have been reprinted as part of the materials for our presentation, along with this written commentary.

The Reporters, after discussion with the Advisers and the Members Consultative Committee, and with approval of the Council and the general membership, have framed the duty to settle as an objective “duty to the insured to make reasonable settlement decisions.”¹ At the same time, however, the Reporters have retained a separate claim for an insurer’s “bad faith” breach of its duties (including the duty to settle). The Reporters adopted a subjective element for the bad faith standard. To be liable for “bad faith,” an insurer must act “without a reasonable basis for its conduct” and must also act with “knowledge of its obligation to perform or in reckless disregard of whether it had an obligation to perform.”² I suggest that this use of the objective and subjective standards creates a new paradigm, one that distinguishes between the duty to settle and other “bad faith” conduct and applies different standards for liability. These reflections on that paradigm begin with a general description of the

¹ RESTATEMENT OF THE LAW, LIABILITY INSURANCE § 24(1) (Council Draft No. 3, December 12, 2016) [hereinafter RESTATEMENT LIABILITY INSURANCE]. All citations to the Restatement will be to the Council Draft No. 3 dated December 12, 2016, unless otherwise indicated.
² RESTATEMENT LIABILITY INSURANCE § 51.
standards and the case law in support of them. The paper then turns to the implications of the new paradigm, both in terms of the damages available to insureds and the application of that standard to insurer conduct at the margins of reasonableness.

The Restatement Adopts an Objective Standard for the Duty to Settle

The Restatement’s adoption of an objective standard for the duty to settle endorses the current trend in the law and helps to clarify the standard that should be applied. The comments explain that the duty to accept reasonable settlements arises out of “a special application of the general contract-law duty of good faith and fair dealing.” The courts recognize that a liability insurer “may have an incentive to undervalue the possibility of a loss at trial” because of its policy limits, and therefore it may not accept an otherwise reasonable settlement offer. The objective duty to accept reasonable settlement offers addresses this problem by creating “an incentive for insurers to take into account” the insured’s interest in avoiding a judgment in excess of the policy limits.

The comments recognize, however, that “courts in some jurisdictions refer to the standard for breach of the duty in the settlement context as one of ‘bad faith,’” which “suggests the need to prove some bad intent on the part of the insurer that goes beyond the reasonableness standard stated in this Section.” The Restatement rejects this approach. It intentionally chooses not to use the term “bad faith” because “an insurer’s duty is grounded in commercial reasonableness.” It suggests that in most breach-of-the-duty-to-settle cases, “even those that invoke the language of bad faith, the ultimate test of

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3 RESTATEMENT LIABILITY INSURANCE § 24, comment a.
4 Id.
5 Id.
6 Id., comment c. A classic example of this is found in the Missouri Supreme Court case of Zumwalt v. Utilities Ins. Co., 228 S.W.2d 750 (Mo. 1950), where the court quoted with approval the statement that “bad faith, of course, is a state of mind indicated by acts and circumstances.” 228 S.W2d at 753 (quoting Johnson v. Hardware Mut. Casualty Co. 1 A.3d 817, 822 (Vt. 1938). For a detailed doctrinal and normative analysis of this bad faith standard, see Jeffrey E. Thomas, A Case Study of Bad Faith Refusal to Settle: A Doctrinal, Normative and Practical Analysis of Missouri Law, 64 UMKC L. REV. 695 (1996)
7 RESTATEMENT LIABILITY INSURANCE § 24, comment c.
liability is whether the insurer’s conduct was reasonable under the circumstances.” It submits that the objective reasonableness standard “is more closely tailored to the conflict of interest that underlies the legal duty.” The restatement’s approach is consistent with the general trend in the case law. As William Barker and Ronald Kent note, “[s]tates requiring subjective culpability are now a small and dwindling minority.”

An example of this evolution can be seen in the way the standard has developed in California. The early (1957) articulation of the standard in Brown v. Guarantee Ins. Co. provided that liability was based on “bad faith” that was a “substantial culpability” beyond “mere negligence.” The California Supreme Court moved away from this notion of subjective bad faith in Crisci v. Security Ins. Co. in 1967. Although the court noted that “[s]everal cases, in considering the liability of the insurer, contain language to the effect that bad faith is the equivalent of dishonesty, fraud, and concealment,” such language was not to be understood “as meaning that in the absence of [such] evidence . . . no recovery may be had for a judgment in excess of the policy limits.” The court held that prior case law made it “clear . . . that liability may exist when the insurer unwarrantedly refuses an offered settlement where the most reasonable manner of disposing of the claim is by accepting the settlement.”

8 Id.
9 RESTATEMENT LIABILITY INSURANCE § 24, comment a. For a criticism of the subjective state-of-mind standard, see Thomas, supra note 6, at 711-717.
10 WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEGATE INSURANCE BAD FAITH LITIGATION § 2.03[2][a][iii] (2nd ed. 2017). The two most notable exceptions explored by Barker and Kent are Missouri and New York. See id. § 2.03[2][a][i]-[ii]. Others also conclude that the objective test is the predominant test. See, e.g., Ellen S. Pryor & Charles Silver, Defense Lawyers’ Professional Responsibilities: Part I – Excess Exposure Cases, 78 TEX. L. REV. 599, 656-657 (2000) (finding that “all jurisdictions require carriers to make reasonable settlement decisions”).
11 319 P.2d 69 (Cal. 1957).
12 319 P.2d at 74. The California Supreme Court recognized that some cases had “indicated a coalescence of the bad faith and negligence tests,” yet while recognizing some overlap between the two, the court concluded that “bad faith should be the basis of the insured’s cause of action.” Id. at 75.
14 426 P.2d at 176.
15 Id.
16 Id. at 176-177. A Federal District Court opinion makes this point even more bluntly: “When there is a great risk of recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement, a
The California Supreme Court’s most recent articulation of the test, while still giving some lip service to “bad faith,” uses language of the objective test similar to that in the Restatement. In 2000, the California Supreme Court articulated the standard this way in the case of *Kransco v. American Empire Surplus Lines Ins. Co.*:

[T]he insurer must settle within policy limits when there is substantial likelihood of recovery in excess of those limits. The duty to settle is implied in law to protect the insured form exposure to liability in excess of coverage . . . . An insurer breaches its implied duty . . . by unreasonably refusing to accept a settlement offer within policy limits.

**The Restatement Adopts a Subjective Test for Other Bad Faith**

Notwithstanding the clear movement away from a subjective standard for the duty to settle, which is consistent with the general trend in the case law, the Restatement adopts a subjective test for other acts of bad faith outside of the duty to settle. This distinction is noted in the comments to section 24: “an insurer is subject to liability for insurance bad faith only when it fails to perform its duties under a liability insurance policy without a reasonable basis for its conduct and with knowledge or in reckless disregard of its obligation to perform.” Thus, a liability insurer can be liable for an excess of limits judgment by failing to make reasonable settlement decisions, “but is not thereby subject to liability for insurance bad faith” unless the insured can prove subjective intent (knowledge or reckless disregard).

The standard identified in the comments of section 24 is the black-letter for section 51:

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17 2 P.3d 1 (Cal. 2000).
18 2 P.3d at 9 (citations omitted).
19 RESTATEMENT LIABILITY INSURANCE § 24, comment c (emphasis supplied).
20 *Id.* The comments include a cross-reference to § 51, discussed *infra.*
§ 51. Liability for Insurance Bad Faith

An insurer is subject 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.

This is a novel approach; reasonableness for the breach of the duty to settle, but subjective knowledge or reckless disregard for “other” bad faith conduct. While the reporters’ notes suggest that this distinction is drawn by the case law, I am not convinced. In the course of my review of a large body of bad faith cases to study the use and application of the equal consideration test and the disregard the limits test for breach of the duty to settle,21 I found that in the context of liability insurance bad faith conduct such as the failure to investigate or the failure to communicate is often considered along with the failure to accept a reasonable settlement offer. These cases generally do not impose different requirements for the duty to settle from the duty to otherwise act in good faith in connection with liability insurance. Let us consider the authority relied upon in support of the Restatement’s adoption of the subjective standard for bad faith.

Judicial Authority Does not Support the Subjective Requirement

The Reporters notes assert that “The majority approach to determine whether an insurer acted in bad faith requires courts to evaluate the insurer’s conduct with both an objective and subjective test.”22 Three cases are cited in support of this proposition, Nardelli v. Metro. Group Property & Casualty

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21 This work was done in connection with a Symposium sponsored by Rutgers and resulted in the publication of an article about the standard to be applied for the duty to settle. See Jeffrey E. Thomas, The Standard for Breach of a Liability Insurer’s Duty to Make Reasonable Settlement Decisions: Exploring the Alternatives, 68 Rutgers U. L. Rev. 229 (2015).

22 Restatement Liability Insurance § 51, Reporters Note b.
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_Ins. Co._, 23 decided by the Arizona Court of Appeals; _Adamski v. Allstate Ins. Co._, 24 decided by a Pennsylvania Superior Court; and _Republic Ins. Co. v. Stoker_, 25 decided by the Texas Supreme Court. The notes also indicate that other courts have adopted “a purely objective standard,” citing to the Supreme Courts of California, Ohio and Washington. We now turn to consideration of the cases purportedly supporting the majority rule.

_Nardelli v. Metro. Group Property & Casualty Ins. Co._, 26 applied both the objective reasonableness test and the subjective knowledge or reckless disregard test, but it was in the context of a first-party insurance claim, not a third-party liability claim. The case involved a dispute over whether a car damaged by thieves was a total loss or could be repaired. 27 Under Arizona law, the subjective knowledge or reckless disregard requirement does not apply to third-party bad faith claims. In _Clearwater v. State Farm Mutual Automobile Ins. Co._ 28 the Arizona Supreme Court rejected the use of a first-party bad faith standard in third party cases. After stating the same test as in _Nardelli_ for first-party bad faith claims, 29 the court held that “because the risk to the insured and the responsibilities of the insurer are distinguishable in first- and third-party claims, the applicable standard of conduct is necessarily different.” 30 For third-party bad faith claims, the court held that the standard was “equal consideration of the comparative hazards,” 31 a “standard of reasonableness [that] requires that the insurer consider various factors.” 32

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25 903 S.W.2d 338 (Tex. 1995).
27 277 P.3d at 793-794.
29 “In a first-party situation the insurer breaches the implied duty of good faith and fair dealing if it (1) acts unreasonably towards its insured, and (2) acts knowingly or with reckless disregard as to the reasonableness of its actions.” 792 P.2d at 723.
30 792 P.2d at 723
31 _Id._ (quoting General Acc. Fire & Life Assur. Corp. v. Little, 443 P.2d 690, 698 (Ariz. 1968)).
32 792 P.2d at 723. The factors to be considered are: “(1) the strength of the injured claimant’s case on the issues of liability and damages; (2) attempts by the insurer to induce the insured to contribute to a settlement; (3) failure of the insurer to induce the insured to contribute to a settlement; (4) the insurer’s rejection of advice of its own
Adamski v. Allstate Ins. Co.,\textsuperscript{33} concerned a third-party claim against a driver of a motor vehicle, but the standard applied was a \textit{statutory} standard, not the common law standard for breach of the duty to make reasonable settlement decisions. The statute, section 8371 of the Pennsylvania Code, “was passed by the legislature in 1990 to rectify the lack of a common law remedy for bad faith conduct in denying an insured’s claim.”\textsuperscript{34} The statute provides that “if the court finds that the insurer acted in bad faith toward the insured,” the court may award interest, award punitive damages and assess court costs and attorney fees.\textsuperscript{35} While the statute does not define “bad faith,” the court cited to Black’s Law Dictionary\textsuperscript{36} and to \textit{Terletsky v. Prudential Property & Casualty Ins. Co.},\textsuperscript{37} which used a two-part test very similar to the black-letter of § 51 with the subjective requirement that “the insurer knew or recklessly disregarded its lack of a reasonable basis.”\textsuperscript{38} The two-part test from the \textit{Terletsky} case, which involved a statutory claim alleging first-party bad faith for uninsured motorist benefits,\textsuperscript{39} originated in \textit{Anderson v....}
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Continental Ins. Co., a Wisconsin Supreme Court case addressing a first-party bad faith claim arising out of a coverage dispute for a furnace fire or explosion under a homeowners policy. Thus, the requirement for subjective knowledge or reckless disregard in Pennsylvania originally came from a Wisconsin first-party bad faith, and was applied to a third-party claim through a Pennsylvania statute.

Pennsylvania common law recognizes a claim for an insurer’s breach of the duty to settle, and that claim does not require knowledge or reckless disregard. The Pennsylvania Supreme Court recognized the bad faith claim for breach of the duty to settle in Cowden v. Aetna Casualty & Surety Co. That case concerned a third-party claim under an automobile liability policy. The court recognized the right of the insured to recover for the excess verdict beyond a limits of a liability policy “if the insurer’s handling of the claim, including a failure to accept a proffered settlement, was done in such a manner as to evidence bad faith on the part of the insurer.” The court then adopted a standard very close to the Restatement’s objective test. The insurer, consistent with the “predominant majority rule,” must “accord the interest of its insured the same faithful consideration it gives its own interest, [and] the fairest method of balancing the interests is for the insurer to treat the claim as if it were alone liable for the entire amount.”

41 271 N.W.2d at 371-372.
42 134 A.2d 223 (Penn. 1955).
43 The claimant was injured when the automobile in which he was a passenger was driven into a truck stopped on the highway because of an apparent fire. The truck driver, who was the insured involved in the bad faith claim, was under the truck with a fire extinguisher trying to put out the fire at the time of the accident. Id. at 225. The insurer did not settle the claim because it believed the truck driver was not liable. Id. at 231.
44 Id. at 227.
45 Id. at 228 (citations omitted).
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While this articulation of the standard does not include the subjective element of knowledge or reckless disregard, the court’s analysis and application of the rule may support a subjective consideration of the insurer’s state of mind, though more in the form of an affirmative defense than a prima facie requirement. The court held that the insured’s refusal to accept the settlement within policy limits was not bad faith because it “was the result of the honest, considered judgment its trial lawyer, claims manager and associate counsel.” 46 On one hand, this is evidence that the insurer acted reasonably, especially because “[t]heir judgment coincided with the opinion of the trial court written after the second trial.” 47 On the other hand, this could suggest that even if another reasonable insurer would have settled, an insurer that makes an “honest mistake,” that is, has an honest state of mind, should not be liable. This same evidence, of course, would show that the insurer did not have knowledge that it was acting unreasonably in refusing the settlement and that it did not act with reckless disregard for its duty to settle. Nevertheless, the court did not require a showing the knowledge or reckless disregard as part of the test for bad faith, though perhaps one could imply such a requirement from the court’s holding.

The Texas case relied upon for the subjective standard in the Notes, Republic Ins. Co. v. Stoker, 48 is another case involving first-party bad faith. In addition, the standard cited in that case does not require the subjective element of knowledge or recklessness. Stoker concerned uninsured motorist benefits sought by the insured after a collision caused by furniture that fell off an unidentified pickup truck. The insurer originally denied the claim on the ground that the accident was the insured’s fault, but

46 Id. 231.
47 Id. The case was tried three times. The first trial resulted in a mistrial. The second trial resulted in a verdict for the plaintiff for $100,000, but the trial court granted a motion for a new trial because it found the judgment against the weight of the evidence showing that the insured truck driver was not negligent. The new trial order was affirmed on appeal. Id. at 225-226. The third trial resulted in a verdict of $90,000. Id. at 227. The liability policy had limits of $25,000. Id. at 225.
48 903 S.W.2d 338 (Tex. 1995).
later denied because the hit-and-run vehicle (the pickup) did not come into physical contact with the insured’s vehicle. In the course of deciding the issue of first impression whether a bad faith claim could be based on the insurer’s denial of coverage for an incorrect reason, the court cited the standard for bad faith. “A breach of the duty of good faith and fair dealing is established when: (1) there is an absence of a reasonable basis for denying or delaying payment of benefits under the policy and (2) the carrier knew or should have known that there was not a reasonable basis for denying the claim or delaying payment of the claim.” As with Adamski, this statement of the standard can be traced back to the Wisconsin first-party bad faith case of Anderson v. Continental Ins. Co. However, unlike Anderson and Adamski, the second element of the standard under Texas law is that the insurer “knew or should have known that there was not a reasonable basis for the denial.” The requirement that an insurer “should have known” that its conduct was unreasonable is an objective standard that can satisfy the second element. Therefore, if the insurer did not know the conduct was unreasonable, but a reasonable insurer would have known, the insurer is liable.

The Majority of States do not Require Subjective Intent

Although I believe there is some room for debate whether the majority of states follow the standard that requires insurers to give equal consideration to the interests of the insured, the standard

49 903 S.W.2d at 339-340.
50 Id. at 340 (citing Aranda v. Insurance Co. of N. Am., 748 S.W.2fd 210, 213 (Tex. 1988)).
51 271 N.W.2d 368 (Wis. 1978). The Stoker case relied upon Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 213 (Tex. 1988). 903 S.W.2d at 340. The Aranda case cited to Anderson and a Colorado case, Travelers Ins. Co. v. Savio, 706 P.2d 1258, 1272 (Colo. 1985). It should be noted, however, that the second element in Anderson was “knowledge or reckless disregard of a reasonable basis for the denial,” 271 N.W.2d at 693, while the standard here is the more objective standard that the insurer “knew or should have known that there was not a reasonable basis,” 903 S.W.2d at 340 (emphasis supplied). For additional analysis of Anderson, see supra n. 40.
52 903 S.W.2d at 340 (emphasis supplied).
53 See, e.g., Stephen S. Ashley, Bad Faith Actions: Liability and Damages § 3:18 (2d ed. 1997) (noting that the equal consideration standard “has garnered by far the largest share of support among the states); Barker & Kent, supra n. 10, § 2.03[2][b] (“one of the most common formulation of the duty is as one to give equal consideration to the insured’s interest with the insurer’s own interests”); Kent D. Syverud, The Duty to Settle, 76 Va. L. Rev. 1113, 1122 (The majority of states today require the insurance company to give ‘equal consideration’ to the interest of the insured”).
that requires insurers to act as a reasonable insurer that disregards the policy limits,\textsuperscript{54} or some combination of the two, there should be no dispute that the majority of states follow one or both of these standards.\textsuperscript{55} Neither the equal consideration standard nor the disregard the limits standard require knowledge of the unreasonableness or reckless disregard.\textsuperscript{56} This is consistent with section 24 of the Restatement, which adopts the disregard the policy limits standard\textsuperscript{57} as “implementation” of the equal consideration standard.\textsuperscript{58} There is no dispute that this standard is an objective one.\textsuperscript{59}

So why does the Restatement adopt the subjective requirement? For two related reasons. First, the Restatement needed a different standard than the one adopted for the duty to settle. The Restatement’s standard for the duty to settle requires insurers to act as a reasonable insurer without policy limits. While this standard is elegant,\textsuperscript{60} it cannot be applied to non-settlement bad faith actions. For example, a third-part bad faith claim may allege that the insurer failed to adequately investigate the claim,\textsuperscript{61} or that the insurer failed to properly communicate the settlement offer to the insurer.\textsuperscript{62} These behaviors are not “settlement decision” and cannot be evaluated in a meaningful way by a standard that asks whether a reasonable insurer without limits would have accepted the settlement offer; the

\textsuperscript{54} See, \textit{e.g.}, \textsc{Kenneth S. Abraham}, \textsc{Insurance Law and Regulation} 664-665 (5th ed. 2010) (The Crisci rule is standard law in most jurisdictions); 3 \textsc{Paul E.B. Glad, William T. Barker, Michael Barnes, New Appleman on Insurance Library Edition § 16.06[4][a] (2012)(“The most widely used test is typically formulated as ‘whether a prudent insurer without policy limits would have accepted the settlement offer’”).

\textsuperscript{55} See Thomas, \textit{supra} note 21, at 260-273 (classifying thirty states as following equal consideration standard, disregard the limits standard, or a combination of both).

\textsuperscript{56} See Barker & Kent, \textit{supra} n. 10 § 2.03[2][b]-[d]. Barker and Kent also point out that “[s]tates requiring subjective culpability are now a small and dwindling minority.” \textit{Id.} § 2.03[2][a][iii].

\textsuperscript{57} \textsc{Restatement Liability Insurance} § 24 (2).

\textsuperscript{58} \textit{Id.} § 24, comment b.

\textsuperscript{59} See id. § 52, comment d (the standard for bad faith under § 51 “is more demanding than the purely objective standard stated for breach of the duty to make reasonable settlement decisions stated in § 24”) (emphasis supplied).

\textsuperscript{60} What I mean by an “elegant” standard is that it provides a simple, easy to understand and apply, algorithm to determine whether an insurer has made an unreasonable settlement decision. The primary competing standard, that an insurer should give equal consideration to the interests of the insured, has been justly criticized as “providing no guidance at all.” Barker & Kent, \textit{supra} n. 10, § 2.03[2][b].

\textsuperscript{61} This is one of the examples I use to illustrate the difference between the disregard-the-limits standard and the equal consideration standard. See Thomas, \textit{supra} n. 21, at 249-252.

\textsuperscript{62} See Thomas, \textit{supra} n. 21, at 243-249.
standard simply asks the wrong question.63 (I believe that the equal consideration standard is flexible enough to include such behavior in its bad faith assessment.)64

Second, the Restatement, in large part because it has primarily considered the duty to settle from the standpoint of the disregard-the-limits standard, presumed that duty to settle cases were a discrete set of bad faith cases that were being (or could be) treated differently than other third-party bad faith cases. This assumption fails to account for the historical evolution of third-party bad faith and for the case law that often combines a failure to settle with other bad faith conduct.

Historically, the Restatement correctly notes that the basis for the duty to settle was the conflict of interest between the insurer and the insured when dealing with the tripartite relationship that exists with liability insurance and a third-party claimant.65 But what the Restatement fails to point out is that the duty to settle cases historically are the basis for all third-party bad faith liability. One unfamiliar with insurance bad faith law, in reading the Restatement, might think that there were separate bodies of law that developed around the duty to settle and the duty to otherwise act in good faith. Indeed, the comments to section 51 indicated that “[m]uch of the law governing insurance bad faith has developed in the first-party insurance context because successful, true liability insurance bad-faith actions are uncommon.”66 This statement is only true if duty to settle cases are excluded, or if “true” bad faith actions are those that apply the subjective element. In fact, the earliest cases to rely

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63 I propose that the equal consideration standard can be used, and is being used, to evaluate this kind of insurer behavior. See id. at 243-252.
64 See generally, Thomas, supra n. 21.
65 See RESTATEMENT LIABILITY INSURANCE § 24, comment a.
66 Id. § 51, comment b. The comment goes on to note that “An action for breach of the duty to make reasonable settlement decisions that is framed as a “bad faith” action is not a true liability insurance bad faith action under the rules followed in this Restatement, unless the more demanding standard followed in this section is met. See Comment d and § 24, Comment c.” This appears to be a tautology; the breach of the duty to settle is not bad faith because the standard adopted by the Restatement says it is not bad faith. While the term “bad faith” may be considered a misnomer, it is the term commonly associated with the breach of the duty to settle in the case law. See Barker & Kent, supra n.10, § 2.03[2][b] (“In the majority of American jurisdictions liability [for breach of the duty to make reasonable settlement decisions] is predicated on bad faith.”).
upon the implied covenant of good faith and fair dealing in the insurance context were failure to settle cases starting in the 1930s.\textsuperscript{67} It was not until some forty years later, in 1970s, that bad faith liability was extended to first-part cases.\textsuperscript{68}

Because third-party bad faith evolved from the duty to settle, cases addressing non-settlement bad faith commonly include failure to settle claims.\textsuperscript{69} Not only is this true historically, but it makes sense from a practical standpoint. The failure to settle claim has more easily measurable damages (the excess of limits verdict) than non-settlement bad faith claims. Therefore, claimants (which often end up in control of the claim through an assignment by the insured) have an incentive to include the failure-to-settle claim with other bad faith claims. At the same time, claimants who seek recovery beyond the policy limits have an incentive to include non-settlement bad faith claims as a means to bolster the unreasonableness and bad faith conduct of the insurer in handling of the settlement. In addition, to the extent that there are additional damages for bad faith besides the excess of limits judgment (such as emotional distress damages), the availability of such damages to the insured can create an incentive for cooperation with the claimant.

\textsuperscript{67} See, e.g., Auto. Mutual Indem. Co. v. Shaw, 184 So. 852 (Fla. 1938); Tiger River Pine Co. v. Maryland Cas. Co., 161 S.E.491 (S.C. 1931); Hilker v. Western Auto. Co, 231 N.W. 413 (Wis. 1930), aff’d on reh’g, 235 N.S. 413 (1931).


\textsuperscript{69} In Arizona and California, the jury instructions for third party bad faith include consideration of the reasonableness of the settlement decision along with other behaviors of the insured. See Clearwater v. State Farm Mut. Auto. Ins. Co., 792 P.2d 719, 722 (Ariz. 1990) (including attempts to induce insured to contribute to the settlement, failure to properly investigate, and failure to inform insured of the settlement offer as factors to be considered along with the strength of the claimant’s case, the advice of counsel to settle, and the amount of financial risk); Brown v. Guarantee ins. Co., 319 P.2d 69, 75 (same). For examples of cases addressing failure to settle along with non-settlement behavior, see Allstate Ins. Co. v. Miller, 212 P.3d 318, 324 (Nev. 2009) (failure to communicate the settlement offer along with failure to settle); Betts v. Allstate Ins. Co., 201 Cal. Rptr. 528, 533-534 (Cal. App. 1984) (insurance investigation unreasonably sought to support the theory that insured was not at fault, along with failure to settle). These cases are discussed in Thomas, supra n. 21, at 247-249 (\textit{Miller}) and at 250-252 (\textit{Betts}).
Implications of the Paradigm Shift

Implications for Damages

What are the implications of this paradigm shift? Because the Restatement adopts the reasonableness standard for the duty to settle, as a general proposition it makes it easier for insureds (and claimants who stand in the shoes of the insureds via assignment or through garnishment) to recover excess verdicts. While I disagree with the suggestion that adopting the reasonableness standard covers substantially all of the third party bad faith claims, I agree that most of the third party bad faith claims involve the breach of the duty to settle (along with other bad faith allegations). Consequently, by adopting a reasonableness standard, the Restatement addresses the biggest part of the great majority of third-party bad faith cases.

What is left of third-party bad faith after the adoption of the reasonableness standard for the duty to settle? It is hard to tell. Section 51 does not provide any examples of non-settlement bad faith. Presumably, such conduct would give rise to potential bad faith liability, though it is unclear what the

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70 While this is true as a general proposition, I contend that the use of the disregard-the-limits standard for the reasonableness standard provides less protection to the insured than the equal consideration standard. See Thomas, supra n. 21, at 235-257.

71 In the comments to § 51, the Reporters suggest that “true liability insurance bad-faith actions are uncommon” because “other liability insurance rules provide an incentive for insurers to behave reasonably.” RESTATEMENT LIABILITY INSURANCE § 51, comment b. This assumes, as noted above, that duty to settle cases are not “true liability bad-faith actions.” In addition, while the other rules create incentives, those incentives are not always enough. More important than incentives, I think, is the availability of easily proven damages. Judgments in excess of liability limits are easy to calculate, and claimants whose counsel are aware of bad faith potential, have learned how to capitalize on the prospect of a bad faith judgment to recover the excess verdict. Other bad faith damages are much harder to prove and to quantify. The most common is emotional distress, which, while real, is difficult to evaluate especially in light of the likelihood of some emotional distress from the tort claim regardless of how the insurer handles it.

72 The treatment of non-settlement misconduct by insurers is uncertain in part because it may be included in the duty-to-settle as a “procedural factor that affected the quality of the insured’s decisionmaking or that deprived the insured of evidence that would have been available if the insurer had behaved reasonably.” RESTATEMENT LIABILITY INSURANCE § 24, comment e. The Restatement does not explain how these factors are to be included in the evaluation, except to say that “they can make the difference in a close case by allowing the jury to draw a negative inference.” Id. Thus, a settlement offer that is not clearly a reasonable one, may become reasonable in a close case because the insurer’s non-settlement behavior (such as investigation or communication). But this same conduct
damages would be independent of the failure to settle. The only example of bad faith included with § 51 is a failure-to-settle scenario with limits of $25,000, an offer to settle for that amount, and judgment of $135,000. The bad faith aspect of the example is that the insurer’s investigator “reported to her supervisor that the Driver was at fault,” that the supervisor “directed investigator to change her report,” that jury verdicts in the jurisdiction “had all been greatly in excess of $25,000,” and that the “supervisor was under pressure to meet claim-payment-reduction goals.”73 This is clearly bad faith and the failure to make a reasonable settlement decision. The insurer would be liable for $110,000 excess of policy limits without bad faith liability. So what does bad faith add to the recovery?

Under § 52, upon proof of bad faith, the insurer would be liable for “attorneys’ fees and other costs incurred by the insured in the legal action establishing the insurer’s breach,” any “other loss to the insured proximately caused by the bad faith conduct” and, if the state standards are met, “punitive damages.”74 The Restatement does not provide any guidance on these “other losses” except to say that they include any consequential losses under the rule of proximate cause (for tort claims) rather than under the foreseeable loss rule under contract law.75 The Reporters’ notes, however, suggest that “emotional-distress damages” would be included as consequential damages.76

While emotional distress damages are available as bad faith damages, they are also available as foreseeable damages for the failure to make a reasonable settlement decision. Section 27, the section addressing damages for breach of the provides that, in addition to the portion of the judgment in excess of policy limits, the insurer also is liable for “any other foreseeable harm caused by the insurer’s

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73 RESTATEMENT LIABILITY INSURANCE § 51, comment d, illustration 4.
74 Id. § 52.
75 Id. § 52, comment a.
76 Id. § 52, Reporters Note a.
breech of duty.” While the comments simply focus on the notion of “foreseeable” losses, illustration 1 includes emotional distress damages in the award because “the obviously fragile emotional state of the insured” made it “foreseeable that the insured [would] suffer significant emotional distress as a result of an excess verdict.” So the only difference that a bad faith finding makes for emotional distress damages is that applicability of a somewhat looser standard of proximate cause instead of contractual foreseeability. It is hard to gauge how much difference, if any, this will make in the adjudication of claims. In addition, it seems odd, to say the least, to use the contract standard of foreseeability for what is widely recognized as a tort claim, and therefore would normally be subject to the more liberal tort standard.

Making attorneys’ fees damages available as damages could be more meaningful, but the case law does not support drawing a distinction between awarding attorneys’ fees for bad faith and not awarding them in failure to settle cases. The case law is highly variable for the awarding of attorneys’ fees. While the courts sometimes allow attorneys’ fees as consequential damages in bad faith cases, this case law does not predicate recovery on a subjective state of mind. In addition, attorneys’ fees could be warranted as foreseeable damages even under the more stringent contract rule. Some states even award attorneys’ fees without any unreasonableness on the part of the insurer by making them available in declaratory relief actions. The variable case law is further complicated by statutes in a number of states that provide for awarding attorneys’ fees in insurance cases.

77 RESTATEMENT OF THE LAW, LIABILITY INSURANCE § 27 (Tentative Draft No. 1, April 11, 2016). Section 27 was not included in the Council Draft No. 3, so citation is to the Tentative Draft No. 1 as the next most recent available version.
78 Id., comment b, illustration 1.
79 See, e.g., Douglas R. Richmond, An Overview of Insurance Bad Faith Litigation, 25 SETON Hall L. Rev. 74, 80 & n. 33 (citing cases from 45 states).
80 See id. at 79-80.
81 See Barker & Kent, supra n. 10, at § 9.05[2].
82 Id. at § 9.05[1].
83 See id.
The third type of damages mentioned in section 51 is punitive damages. However, the availability of punitive damages under the Restatement is not meaningful because it is predicated on satisfying state law punitive damages standards. While the mention of punitive damages in section 51 might create the impression that a bad faith claim is more likely to give rise to punitive damages, in reality the award of punitive damages will turn on the application of the state law standard for punitive damages, not bad faith law.

Implications for Insurer Settlement Conduct

While the distinction between a reasonableness standard for the duty to settle and a subjective requirement of knowledge or recklessness may not make a significant difference for insureds asserting such claims, the shift away from “bad faith” terminology (as opposed to the subjective requirement which has not really been applied in third-party cases) could require more affirmative conduct from insurers in marginal cases. Two such cases are briefly considered here: 1) the duty to accept any reasonable settlement, and 2) the duty to offer policy limits even though the claimant has not asked for them.

If we embrace the reasonableness standard from the Restatement—that an insurer should behave as reasonable insurer with full responsibility for the entire judgment—an insurer’s liability is an open question in the case where a reasonable settlement offer is rejected but countered with a lesser but still reasonable offer. On one hand, the failure to accept the first reasonable offer could be unreasonable. On the other hand, if the insurer honestly believes that a lower counter offer, which is objectively reasonable, has a good chance of being accepted, the decision to make such a counter offer could be reasonable as well. The question is one for the jury. 85

84 Restatement Liability Insurance § 52(3). This is the Council Draft No. 3.
85 See id. § 24, comment d, illustration 2.
The use of the terminology of “bad faith” could make a difference in such a case. The terminology connotes some kind affirmative misconduct, not a mere failure to act. While one could characterize the insurer’s failure to accept the initial reasonable settlement offer as unreasonable, it is slightly more difficult to characterize that conduct as “bad faith.” After all, the insurer did in fact make an objectively reasonable settlement offer (albeit a lower one) and it honestly believed that such an offer was likely to be accepted. If, instead of using the standard of an insurer without limits we were to use the equal consideration standard, we could argue that by giving an objectively reasonable counteroffer, the insurer was sufficiently protecting the insured’s interest to satisfy the test. Moreover, achieving a lower settlement could be beneficial for the insured by reducing the incentive for others to file similar suits and by reducing the insured’s loss history.

This same distinction between an unreasonable failure to act and a bad faith response could be used for the affirmative duty to propose a settlement within limits. While a reasonable insurer facing the entire exposure might initiate a settlement, it is more difficult to say that the failure to initiate the settlement was bad faith. It is customary for insurers to request that the claimant make the first settlement offer; after all, the claimant is the one asserting the claim and so could be expected to put a value on that claim. This example also shows a possible difference between the disregard the limits standard and equal consideration. While one might expect a reasonable insurer to initiate settlement discussions, an insurer that waits for the claimant to initiate settlement discussions may be giving equal consideration to the interests of the insured because a settlement offer from the insurer could create expectations on the part of the claimant that the policy limits were the floor of the negotiations and that the insured would contribute more to obtain a settlement.
Conclusion

The Restatement of the Law, Liability Insurance, represents a paradigm shift to an objective standard of reasonableness for insurers’ settlement decisions. This shift was consistent with a general trend towards an objective evaluation of settlement decisions, and the Restatement makes the test clearer and easier to apply. As a general matter, this probably favors insureds somewhat more than insurers, but by making the standard that of a reasonable insurer, the Reporters have given a small concession to the insurers.

The Restatement’s treatment of third-party bad faith, however, is a much more radical paradigm shift. By adopting a subjective requirement of knowledge or recklessness, the Restatement has followed the approach used by some courts for first-party bad faith. This imposes a subjective requirement that is not reflected in third-party bad faith case law.

Whether this will make any difference (assuming the courts decide to follow this novel approach) remains to be seen. The damages that seem most likely to be associated with bad faith claims independent of an excess of policy limits judgment are for emotional distress. Those damages, however, are also available for failure to settle, though under the more limited standard for contractual foreseeability rather than tort proximate cause. Whether this distinction is meaningful, and whether courts will adopt it, is debatable. Availability of attorneys’ fees may be a more meaningful addition to damages, though the current rules for attorneys’ fees are quite variable and include a number of statutory provisions that may apply. The reference to punitive damages in connection with bad faith is not meaningful because the availability of punitive damages turns on meeting state law standards, which are independent of bad faith or duty to settle standards.

For insurer settlement behavior, the move to the objective reasonableness standard, and one operationalized by reference to a reasonable insurer without policy limits, could at the margins increase
insurer liability. The terminology of “bad faith,” even when it does not require a subjective bad state of mind, connotes some affirmative misconduct by an insurer rather than a failure to act. The equal consideration standard to some extent captures this connotation as it recognizes the insurer’s right to act in its own interest so long as it gives equal consideration to the interests of the insured. As a consequence of the standard requiring an insurer to act as a reasonable insurer without policy limits, insurers are at risk of being held liable for the failure to accept the first reasonable offer or for the failure to initiate settlement discussions.