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OREGON SHOULD REJECT THIRD-PARTY BAD FAITH

By R.J. Lehmann

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EXECUTIVE SUMMARY

The Oregon State Legislature is expected to consider several bills this year that would create a direct cause of action for third parties who assert "bad faith" by a liability insurer in its claims-settlement processes. The experience of other states who have created "third-party bad-faith" actions against insurers has been an explosion of litigation, ultimately leading to higher cost of insurance coverage. While such costs might theoretically be justified in an environment in which regulators were unable to adequately protect consumers from bad faith, examination of consumer complaint statistics in Oregon demonstrate that its regulatory agency is well-staffed to handle the volume of complaints it experiences.

INTRODUCTION

All insurance contracts create duties of care for an insurer to act with the insured's best interests in mind. Contracts for liability insurance, under which an insurer may defend an insured's interests in court, extend this duty to situations wherein the insured must choose whether to settle claims brought against the insured by third parties.[1]

Failing to settle a claim when there is a reasonable opportunity to do so – particularly when there is an offer that falls within the policy's coverage limits – may be considered a "bad faith" breach of an insurer's fiduciary duty to exercise reasonable care. State courts and statutory liability systems diverge in the standards they apply to determine whether an insurer's decision not to settle a given third-party claim constitutes an act of "bad faith." Under precedent established by the Oregon Supreme Court in 1985, Oregon law requires that an insurer must use such care "as would have been used by an ordinarily prudent insurer with no policy limit applicable to the claim."[2]

However, in several recent sessions of the Oregon State Legislature, there have been efforts to expand the statutory scope of "bad faith" standards, such that actions alleging unfair claims settlement practices could be brought against insurers even by third parties. Some bills also have sought to reclassify insurance as falling under the state's Unlawful Trade Practices Act (UTPA), which grants consumers a statutory right to recover damages stemming from allegedly unfair business practices.[3]

Currently, insurance is excluded from the UTPA, as it is already subject to the separate Oregon Insurance Code, which includes a section on Unfair Claim Settlement

1. Steve Rawls, "Selected third-party bad faith liability standards governing failure to settle cases," *Mealey's Litigation Report: Insurance Bad Faith* 20:4 (June 2006). http://www.butler.legal/selected-third-party-bad-faith-liability-standards-governing-failure-to-settle-cases.

2. Oregon Supreme Court, *Maine Bonding & Cas. Co. v. Centennial Ins. Co.*, 693 P.2d 1296, 1299, Jan. 22, 1985. https://law.justia.com/cases/oregon/supreme-court/1985/298-or-514-0.html.

3. Oregon Legislature, "Background Brief on The Unlawful Trade Practices Act," Background Brief - *Legislative Committee Services*, September 2014, p. 1. https://www.oregonlegislature.gov/lpro/Publications/BB2014UnlawfulTradePracticesAct.pdf.

Practices.[4] Indeed, the Legislature has revisited the applicability of the UTPA to financial services as recently as 2010, when it passed HB 3706. That legislation added state-regulated mortgage bankers, mortgage brokers, loan originators and consumer loan businesses to the UTPA's definition of covered "real estate, goods or services."[5] The law explicitly did not extend the UTPA to insurance.

As this paper shows, the experience of states that have offered access to "third-party bad-faith claims"—particularly Oregon's neighbors to the north and south, Washington and California—has been an explosion of litigation that drives up the cost of common insurance coverages like private passenger auto. While such costs might be considered a worthwhile investment in consumer protection in jurisdictions where insurance regulators are ill-equipped to manage egregious business practices on the part of the insurance industry, the data show that the volume of insurance-related consumer complaints in Oregon is manageable and that the Department of Consumer and Business Services' (DCBS) Division of Financial Regulation is well-staffed to address such complaints.

LEGISLATION TO EXPAND THIRD-PARTY BAD-FAITH

Efforts to apply the UTPA to insurance and to create a right to third-party bad-faith have been unsuccessful in several recent state legislative sessions. In 2015, the Legislature considered SB 314[6] and HB 2248,[7] two pieces of legislation that would add insurance to the state's UTPA and thus create a private cause of action for parties alleging an insurer has violated the act. It also considered SB 313,[8] allowing third parties to bring action against an insurer alleging unlawful insurance practices, and SB 510,[9] which would allow third-party suits alleging unfair claim-settlement practices. The latter bill would set minimum statutory damages of $200 and allow courts to enter judgments for treble damages where they found willful violations of fair-settlement practices. None of the four bills advanced to passage.

In the 2016 short legislative session, former state Sen. Chip Shields (D-Portland) introduced SB 1590, which would require that an insurer not only has a fiduciary duty to place the insured's interests above its own, but that it must provide independent counsel for the insured whenever an insurer defends a claim against the insured under reservation of rights or where the insured's potential liability exceeds the policy limits.[10] The bill, which died in committee in March 2016, also spelled out damages for an insurer's breach of duty to defend and would bar insurers found to have breached that duty from participating in the defense or controlling the settlement.[11]

The issue has returned in the 2019 session, with a pair of bills already having been introduced, though neither yet has an official sponsor:

- **SB 728**,[12] which has been referred to the Senate Judiciary Committee, would include insurance under the UTPA's definition of "real estate, goods and services." This would allow third-party claimants to seek both "equitable relief" and monetary damages for violations of the UTPA. Requested by Sutherlin, Oregon, attorney Danny Lang, the bill also would allow UTPA violations by insurers to be prosecuted by the attorney general, but only where requested by the DCBS director.
- **HB 2421**,[13] which has been referred to the House Committee on Business and Labor, would allow complainants to petition the DCBS director to examine violations of the Oregon Insurance Code. Third parties could bring a direct cause of action for such violations and courts could, in addition to actual damages, award punitive damages, equitable or injunctive relief and attorneys' fees. If settlement negotiations fail, the DCBS director would be required to issue orders to remedy any violations of the code. The measure was introduced at the request of Paul Terdal, the Oregon chapter policy chair of Autism Speaks.

4. 2017 ORS Vol. 16 Chapter 746 Section 746.230 - *Unfair claim settlement practices*.

5. Oregon Legislature, "2010 Summary of Legislation," Legislative Administration Committee Services, April 2010, p. 13. https://www.oregonlegislature.gov/lpro/summleg/2010SummaryOfLegislation.pdf.

6. SB 314, 78th Oregon Legislative Assembly—2015 Regular Session. https://olis.leg.state.or.us/liz/2015R1/Downloads/MeasureDocument/SB314/Introduced.

7. HB 2248, 78th Oregon Legislative Assembly—2015 Regular Session. https://olis.leg.state.or.us/liz/2015R1/Downloads/MeasureDocument/HB2248/Introduced.

8. SB 313, 78th Oregon Legislative Assembly—2015 Regular Session. https://olis.leg.state.or.us/liz/2015R1/Downloads/MeasureDocument/SB313/Introduced.

9. SB 510, 78th Oregon Legislative Assembly—2015 Regular Session. https://olis.leg.state.or.us/liz/2015R1/Downloads/MeasureDocument/SB510/Introduced.

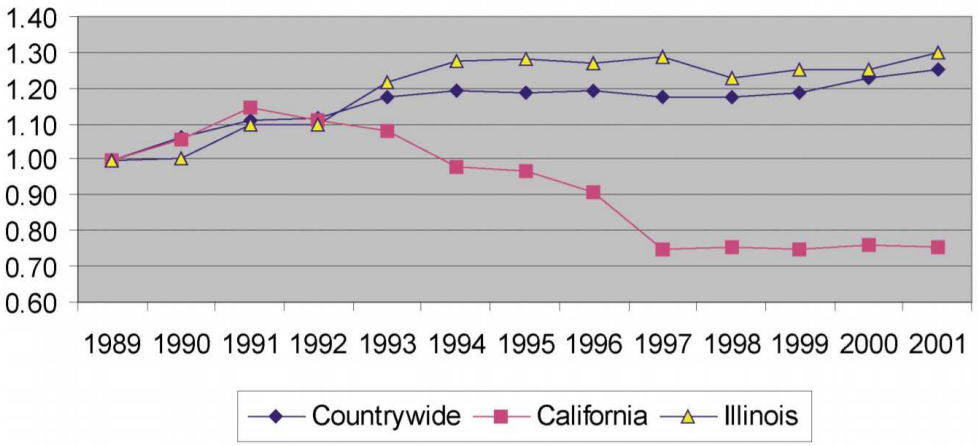
10. SB 1590, 78th Oregon Legislative Assembly—2016 Regular Session. https://olis.leg.state.or.us/liz/2016R1/Downloads/MeasureDocument/SB1590/Introduced.

11. Lloyd Bernstein, "Oregon Bad Faith Bill Dies on the Vine," Bullivant, Houser, Bailey PC, March 2016. http://www.bullivant.com/Oregon-Bad-Faith-Bill-SB-1590.

12. SB 728, 80th Oregon Legislative Assembly—2019 Regular Session. https://olis.leg.state.or.us/liz/2019R1/Downloads/MeasureDocument/SB728/Introduced.

13. HB 2421, 80th Oregon Legislative Assembly—2019 Regular Session. https://olis.leg.state.or.us/liz/2019R1/Downloads/MeasureDocument/HB2421/Introduced.

FIGURE I: LOSS COST INDEX – US, CA AND IL



SOURCE: Milliman, Inc.

THE CALIFORNIA EXPERIENCE

For Oregon legislators who are preparing to consider measures like SB 728 and HB 2421, a major cautionary tale can be found in the neighboring state immediately to the south. In 1979, the California Supreme Court ruled in the landmark *Royal Globe Insurance Company v. Superior Court* that third-party claimants could bring direct actions alleging bad-faith by insurers in settling contracts to which the claimant was not a party.[14] The effect was to create through common law the same sort of right to third-party bad-faith claims that Oregon now may create under statute.

The effects of the *Royal Globe* decision were predictable and felt almost immediately. Offered the promise of attorneys' fees and the potential to win punitive damages, many more claims disputes became attractive for the California's plaintiffs' bar to take on. And, presented with the threat of bad-faith judgments, insurers moved to settle many more of these cases quickly for the maximum policy limits. Between 1980 and 1987, the number of auto liability claim filings in California's Superior Courts increased by 82 percent and their severity grew by a factor of four.[15]

In 1978, the year before *Royal Globe*, 30 percent of auto physical damage claims in California also included a claim for bodily injury, compared with 21 percent in other states. By the time of the *Moradi Shalal v. Fireman's Fund*[16] decision in 1988, 46 percent of California physical damage claims included a bodily injury claim, compared to 27 percent in other states. Researchers from the Rand Institute for Civil Justice posit this jump from a 43 percent higher ratio to a 70 percent higher ratio was a result of the introduction of third-party bad-faith.[17] However, while total bodily injury payments increased, the average claim payment fell, suggesting many of the new claims were either dubious or of very limited value.[18]

The ruling stood for nearly a decade, until *Moradi Shalal* overturned the *Royal Globe* decision. By that point, there was no doubt of the chaos that the earlier decision had wrought, both in the courts and in the state's insurance markets, as the *Moradi Shalal* court held:

> Most authors have noted another unfortunate consequence of our holding in Royal Globe that insurers owe a direct duty to third party claimants: It tends to create a serious conflict of interest for the insurer, who must not only protect the interests of its insured, but also must safeguard its own interests from the adverse claims of the third party claimant. This conflict disrupts the settlement process and may disadvantage the insured.[19]

Just as quickly as *Royal Globe* caused lawsuits to spike, *Moradi Shalal* contributed to their precipitous fall. While personal injury lawsuits associated with auto claims doubled between 1982 and 1987, reaching a peak of 91,450 cases, there was a

14. California Supreme Court, *Royal Globe Ins. Co. v. Superior Court*, 23 Cal.3d 880, 1979. http://scocal.stanford.edu/opinion/royal-globe-ins-co-v-superior-court-30520.

15. David Appel, "Revisiting the Lingering Myths About Proposition 103: A Follow-Up Report," Milliman Inc., September 2004. https://www.heartland.org/_template-assets/documents/publications/appelfinalrpt.pdf.

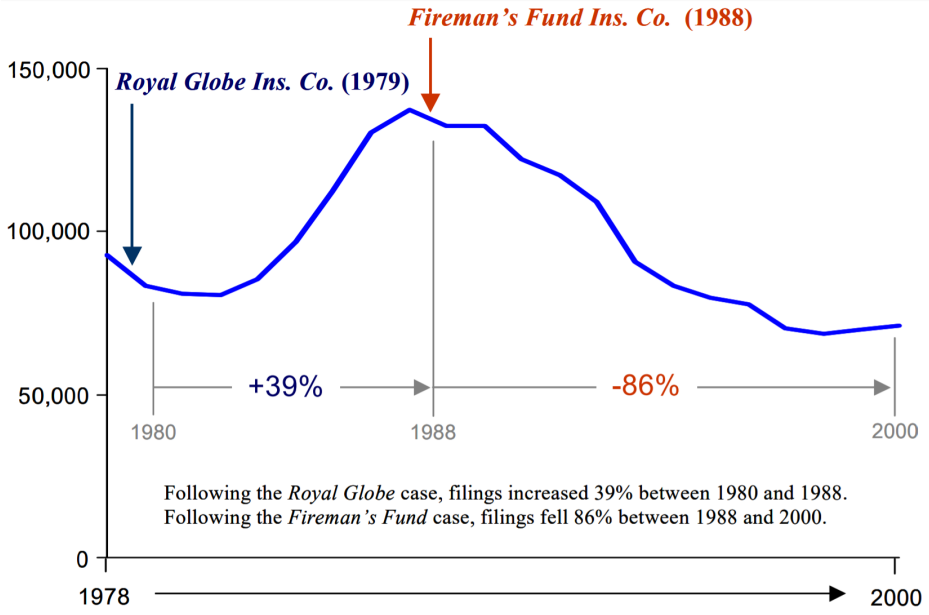
16. California Supreme Court, *Moradi-Shalal v. Fireman's Fund Ins. Companies*, 46 Cal. 3d 287 (1988). http://scocal.stanford.edu/opinion/moradi-shalal-v-firemans-fund-ins-companies-28538.

17. Angela Hawken et al., "The Effects of Third-Party, Bad Faith Doctrine on Automobile Insurance Costs and Compensation," Rand Institute for Civil Justice, 2003, p. 26. http://www.rand.org/pubs/monograph_reports/MR1199.html.

18. Ibid.

19. Ibid., pp. 301-02.

FIGURE 2: BAD-FAITH CLAIMS IN THE ROYAL GLOBE ERA



SOURCE: California Administrative Office of the Courts

drop-off of 33,100 cases between 1989 and 1998.[20] Overall, in the decade following *Royal Globe*'s repeal, the number of lawsuits related to auto insurance claims fell from 91,000 to 42,000.[21] Within five years of the *Moradi Shalal* decision, payments to claimants were 29 percent lower than they would have been under the Royal Globe rules and within a decade they were 35 percent lower.[22]

OTHER STATES

While California offers the most notable cautionary tale for the effect of permitting third-party bad-faith claims against insurers, the experience has been similar in other states that have opened up the courts to these kinds of "second lawsuits."

Despite ostensibly operating under a "no-fault" system that requires insureds to purchase personal injury protection, the State of Florida authorizes third-party bad-faith lawsuits against insurers. In a September 2018 report, the Insurance Research Council estimated that, between 2006 and 2017, Florida's system resulted in $7.6 billion more in bodily injury claims than would have been anticipated in similar no-fault systems, such as those in New York, New Jersey and Pennsylvania, that do not permit third-party bad-faith lawsuits.[23]

But perhaps of more immediate relevance is the experience of Oregon's neighbor to the north, the State of Washington. In 2007, the Washington State Legislature passed SB 5726, the Insurance Fair Conduct Act, which created a statutory right for claimants to bring direct lawsuits for actual damages and attorneys' fees and for courts to award treble damages where an insurer is found to have acted in bad faith.[24] The measure was also approved by Washington voters with the November 2007 passage of the R-67 referendum.

As in California during the *Royal Globe* era, there is evidence that enabling third-party bad-faith lawsuits against insurers has increased claims costs in Washington. According to research from the Insurance Research Council, the clearest impact has been in homeowners insurance claims. The IRC estimates that, in the two years after enactment of SB 5726, loss costs increased by $190 million.[25] The council also estimates the legislation was responsible for $17.4 million in excess loss costs for uninsured motorists coverage, where claims frequency held steady in Washington, despite falling significantly in comparable states.

20. The Center for Court Research, Innovation, and Planning, "Exploring the Work of the California Trial Courts: a 20-Year Retrospective," California Administrative Office of the Courts, 2003, p. 43. https://www.courts.ca.gov/documents/retrointro.pdf.

21. Chris Kissell, "Why are Car Insurance Rates Falling?", *Forbes*, Aug. 11, 2011. https://www.forbes.com/sites/moneybuilder/2011/08/11/why-are-car-insurance-rates-falling/#6d2a8f2f3a43.

22. The Center for Court Research, Innovation, and Planning, "Executive Summary," California Administrative Office of the Courts, 2003, p. vii. https://www.courts.ca.gov/documents/retroexecsum.pdf.

23. Victoria Prussen Spears, "IRC estimates Florida 3rd-party bad faith costs at $7.6B over 12 years," *PropertyCasualty360.com*, Sept. 25, 2018. https://www.propertycasualty360.com/2018/09/25/irc-estimates-florida-3rd-party-bad-faith-costs-at-7-6b-over-12-years/?slreturn=20190116152817.

24. Engrossed Substitute Senate Bill 5726, Washington State 60th Legislature—2007 Regular Session. http://lawfilesext.leg.wa.gov/biennium/2007-08/Pdf/Bills/Senate%20Passed%20Legislature/5726-S.PL.pdf#page=1.

25. "The Impact of First-Party Bad-Faith Legislation on Key Insurance Claim Trends in Washington State," Insurance Research Council, February 2011, pp 1-2. https://www.insurance-research.org/research-publications/impact-first-party-bad-faith-legislation-key-insurance-claim-trends-washington.

TABLE I: INSURANCE CONSUMER COMPLAINTS IN THE 50 STATES

STATE	2019 POPULATION (MILLIONS)	CONSUMER AFFAIRS STAFF	INSURANCE CONSUMER COMPLAINTS					COMPLAINTS PER 100K	COMPLAINTS PER CA STAFF
			2017	2016	2015	2014	AVG		
AK	0.74	3	197	271	245	245	239.5	32.4	79.8
AL	0.49	12	2,154	2,608	2,378	2,378	2,379.5	48.7	198.3
AR	3.02	19	2,193	2,473	2,432	2,432	2,382.5	78.9	125.4
AZ	7.12	10	2,472	2,431	2,173	2,173	2,312.3	32.5	231.2
CA	39.78	129	42,878	42,878	37,807	37,807	40,342.5	101.4	312.7
CO	5.68	21.5	4,836	4,098	3,272	3,272	3,869.5	68.1	180.0
CT	3.59	14	4,627	5,846	4,724	4,724	4,980.3	138.8	355.7
DE	0.97	17	778	927	933	933	892.8	91.9	52.5
FL	21.31	118	19,060	16,253	17,056	17,056	17,356.3	81.4	147.1
GA	10.55	29	12,218	12,027	9,718	9,718	10,920.3	103.6	376.6
HI	1.43	8	576	597	567	567	576.8	40.4	72.1
IA	3.16	18	1,584	1,814	1,575	1,575	1,637.0	51.8	
ID	1.75	19	885	992	808	808	873.3	49.8	46.0
IL	12.77	28	8,994	11,068	9,941	9,941	9,986.0	78.2	356.6
IN	6.70	10	3,834	4,171	3,769	3,769	3,885.8	58.0	388.6
KS	2.92	16	2,955	3,139	3,074	3,074	3,060.5	104.9	191.3
KY	4.47	13	4,919	5,306	4,090	4,090	4,601.3	102.9	353.9
LA	4.68	29	3,479	4,369	2,999	2,999	3,461.5	73.9	119.4
MA	6.90	6	1,684	1,855	892	892	1,330.8	19.3	221.8
MD	6.08	56	12,178	14,151	13,619	13,619	13,391.8	220.3	239.1
ME	1.34	15	776	790	882	882	832.5	62.1	55.5
MI	9.99	31.7	4,507	4,394	4,793	4,793	4,621.8	46.3	145.8
MN	5.63	8	3,244	3,306	5,451	5,451	4,363.0	77.5	545.4
MO	6.14	31	3,574	3,904	4,191	4,191	3,965.0	64.6	127.9
MS	2.98	14	1,342	1,316	1,057	1,057	1,193.0	40.0	85.2
MT	1.06	9	1,148	1,278	1,332	1,332	1,272.5	119.8	141.4
NC	10.39	58.5	10,681	14,283	8,393	8,393	10,437.5	100.5	178.4
ND	0.76	6	148	130	173	173	156.0	20.7	26.0
NE	1.93	14	1,436	1,576	1,520	1,520	1,513.0	78.3	108.1
NH	1.35	7	972	987	1,175	1,175	1,077.3	79.8	153.9
NJ	9.03	38	6,729	7,095	7,340	7,340	7,126.0	78.9	187.5
NM	2.09	3	1,504	1,346	1,143	1,143	1,284.0	61.4	428.0
NV	3.06	8	3,256	3,976	2,882	2,882	3,249.0	106.3	406.1
NY	19.86	73	39,641	40,951	36,708	36,708	38,502.0	193.8	527.4
OH	11.69	47	5,875	6,805	6,450	6,450	6,395.0	54.7	136.1
OK	3.94	17	4,558	3,208	4,636	4,636	4,259.5	108.1	250.6
OR	4.20	16.5	3,843	3,963	3,522	3,522	3,712.5	88.4	225.0
PA	12.82	19	10,821	12,654	12,438	12,438	12,087.8	94.3	636.2
RI	1.06	4.5	346	411	345	345	361.8	34.1	80.4
SC	5.09	10	3,496	3,518	3,305	3,305	3,406.0	66.9	340.6
SD	0.88	4.5	530	641	720	720	652.8	74.4	145.1
TN	6.78	15	4,420	3,985	3,187	3,187	3,694.8	54.5	246.3
TX	28.70	228.75	24,566	26,122	27,022	27,022	26,183.0	91.2	114.5

UT	3.16	5	1,246	883	688	688	876.3	27.7	175.3
VA	8.53	26	4,002	4,174	4,033	4,033	4,060.5	47.6	156.2
VT	0.62	4	489	444	460	460	463.3	74.2	115.8
WA	7.53	40	7,705	7,915	6,135	6,135	6,972.5	92.6	174.3
WI	5.82	10.75	3,568	4,129	3,809	3,809	3,828.8	65.8	356.2
WV	1.80	22	2,006	2,021	2,014	2,014	2,013.8	111.7	91.5
WY	0.57	3	406	414	380	380	395.0	68.8	131.7

SOURCE: NAIC, U.S. Census Bureau

The experience of Oregon's neighbors in Washington and California make clear that creating a direct cause of action for third-party bad-faith lawsuits has amounted to a flood of litigation. Given the consequences such changes can have for the availability and affordability of consumer insurance products, lawmakers considering such a shift in Oregon must take into account whether those harms would outweigh any potential benefits.

A WELL-REGULATED INDUSTRY

If there were reason to believe consumers were insufficiently protected by Oregon's existing regulatory regime for insurance, the increased cost of a third-party bad-faith tort regime might be worthwhile. However, Oregon receives high marks for its regulation of the business of insurance, earning grades of B and B+, respectively, in the 2018 and 2017 editions of the R Street Institute's annual "Insurance Regulation Report Card."[26]

Drilling down more specifically to the subject of complaints raised by insurance consumers, data from the National Association of Insurance Commissioners demonstrate that Oregon is unexceptional in the volume of complaints it receives and that its regulators are reasonably well-staffed to handle that volume.

As demonstrated in Table 1, from 2014 to 2017, Oregon averaged 3,712.5 insurance consumer complaints annually. Weighted by population, there were an average of 88.4 complaints per 100,000 residents. Nationally, that ranked 17th among the 50 states, behind both California (101.4 complaints per 100,000 residents) and Washington (92.6 complaints per 100,000 residents).

The average rate among the 50 states was 77.4 complaints per 100,000 residents. Thus, Oregon was slightly above average, but by less than three-tenths of a standard deviation.

Fielding those complaints for the Oregon Division of Financial Regulation are 16.5 consumer affairs staff personnel: a supervisor, 9.5 complaint investigators, four assistance personnel and two support staff.[27] That averages to 225 complaints each year per consumer affairs staff member, placing Oregon 18th among the 50 states on that metric.

The average rate among the 50 states was 212.6 complaints per consumer affairs staff member. Thus, Oregon was, again, just slightly above average, this time by less than one-tenth of a standard deviation.

CONCLUSION

Oregon's existing system of insurance regulation serves consumers well and the regulatory office is well-staffed to manage the volume of consumer complaints it receives. Accordingly, there is no obvious need to redefine insurance regulation to fall under Oregon's Unlawful Trade Practices Act, nor is there a need to create a direct cause of action that would allow third-party claimants to sue for alleged "bad faith" in claims settlements

The experience of Oregon's neighbors California and Washington both demonstrate that permitting third-party bad-faith lawsuits invites litigation costs that inevitably threaten the availability and affordability of coverage. There is no question that this would be an attractive proposition for the state's trial bar, but the prospects for the state's consumers are far less sanguine. Oregon lawmakers, who have rejected these ideas when they have been proposed in the past, would therefore be wise to do so again.

ABOUT THE AUTHOR

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R.J. was a co-founder of R Street in June 2012, having previously served as deputy director of the Heartland Institute's Center on Finance, Insurance and Real Estate. Before joining Heartland, he spent nearly a decade covering the insurance and financial services industries, first as manager of A.M. Best Co.'s Washington bureau and later as a senior industry editor with SNL Financial (now S&P Global Market Intelligence).

26. R.J. Lehmann, "2018 Insurance Regulation Report Card," R Street Policy Study No. 163, December 2018, p. 24. https://2o9ub0417chl2lg6m43em6psi2i-wpengine.netdna-ssl.com/wp-content/uploads/2018/12/RSTREET163.pdf.

27. "2017 Insurance Department Resources Report," National Association of Insurance Commissioners, July 2018, p. 11. https://www.naic.org/Releases/2018_docs/naic_2017_insurance_department_resources_report_volume_1.htm.