

**Models of Liability & Compensation
National Health Policy Forum**

**ERISA Health Plan Liability:
Examining Models for Reform**

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Introduction

Good morning. Let me first thank the National Health Policy Forum and Karl Polzer for inviting me to participate this morning.

My assignment is to present some information to you about different models and theories of liability that have been employed by courts and legislatures primarily in non-health care service plan contexts. My remarks are a reminder that the history of liability provisions has been quite diverse and that liability in the health care service plan field doesn't have to be as simplistic as "You can't or can sue your HMO." My remarks are based largely upon a paper that I wrote for the Henry J. Kaiser Family Foundation titled "Alternative Approaches to Liability: Models for Health Plan Liability," a copy of which has been made available to each of you this morning. I've had one or two additional ideas since then which will slip into my remarks.

In essence, I'm going to give you about a semester's worth of the law of remedies crammed into fifteen minutes. We're going to be moving pretty quickly, so buckle up your seatbelts and hang on. For those of you with law degrees, I brought some bluebooks with me, and there will be an essay examination at lunch.

I'm dividing my remarks into three parts: First, Fields and Bases of Liability--this will be the basics of contracts, torts and restitution. Second, the History of Liability in Selected Industries and Contexts--what have courts and legislatures done elsewhere. Third, Health Care Plan Liability--a very brief summary of some of the major models for health care plan liability and how they fit within the overall history and context.

Fields and Bases of Liability

All of the theories of liability that I will be talking about today fall into three big categories: Contracts, Torts and Restitution.

Contracts

Contract law is designed to facilitate and promote private ordering of people's relationships with each other. Private ordering is just a fancy way of saying that contract law is designed to encourage people to make promises to each other about their future behavior. Promises, so long as they are usually enforced, permit contracting parties to manage future risks in what the contracting parties believe is the most cost efficient way.

Contract law encourages and facilitates reciprocal promises by strictly following certain principles. The first principle is that courts will generally enforce the terms of agreements. Courts are very reluctant to remake the bargain struck by the parties. While there are certain doctrines that permit courts, in extraordinary cases, to reform the terms of a contract or to refuse to enforce certain terms -- doctrines such as mistake, fraud, and unconscionability -- the doctrines are very rarely invoked. Because courts generally enforce a contract the way it was agreed to by the parties, parties can generally be confident when they strike a bargain that the terms of that bargain will be binding and will be enforced. That encourages people to make contracts.

The second principle which encourages private agreements is that remedies for breach of contract are limited. If you and I had to worry about the risk of a potentially ruinous or unexpected liability every time we entered into a contract, we'd be reluctant to enter into contracts. Unexpected liabilities would make all contracts more risky which would undermine the central goal of contract law to facilitate and promote *private* risk management where the parties get to determine their liability exposure. Absent limits on remedies for breach of contract, every contracting party would need to increase the price for entering into a contract to provide insurance against the risk of an unforeseeably high judgment in the event of a breach. Without damage limitations, there would be fewer contracts, and contracts would be somewhat more expensive.

Contract law recognizes this problem and imposes several interrelated damage limitations. First, damages are generally measured by the benefit of the bargain. In other words, I can recover damages from the party who breached the contract only up to the point at which I receive what I expected to receive from the contract -- what I expected would be my benefit of the bargain. Courts generally do not permit the plaintiff in a contracts action to recover more than the plaintiff would have received if the contract had

been performed.

The second limitation, and it is closely related to the first, is that you can recover only those damages which were reasonably in the contemplation of the parties at the time of making the contract. In other words, if a breach of contract results in consequential damages that were not reasonably expected by the parties at the time of contracting, or which were actually excluded by the parties at the time of contracting, those consequential damages are *not* recoverable in an action for breach of contract. Because of this rule, the parties can fix the price of the contract at an amount that will cover anticipated damages in the event of a breach.

The third limitation, which is closely related to the second limitation, is that you generally cannot recover damages for emotional distress resulting from a breach of contract or punitive damages. We generally enter into contracts to bring order to our economic lives. The pain and suffering or emotional distress we may suffer as a consequence of a breach of contract is ordinarily beyond what we have bargained for.

The punitive damage limitation is an expression of the fundamental policy that remedies for breach of contract are designed to compensate the injured party by protecting his or her economic expectations. Remedies for breach are not intended to punish or deter parties from breaching when that is the economically sensible thing to do. From a contract law perspective, there is no such thing as a malicious or bad faith breach giving rise to punitive damages.

Torts

Now let's turn to the law of torts. Tort law has very different purposes. Tort law reflects public policies about how people should behave with respect to each other. Contract law is about private ordering; tort law is about public responsibility and accountability. There are three main goals: First, deterrence--we want people to behave in a certain way, and so we impose liability if they misbehave. Second, compensation for injuries--someone is going to have to pay for the injury, and the only question is who. Third, we want to minimize society's overall costs associated with accidents--where accident-related costs include the costs of injuries which result from accidents, the cost of safety measures to avoid accidents, and the costs of administering an accident liability system.

These multiple goals are reflected in a few basic principles of tort law. First, because deterrence is such an important part of torts, we spend a lot of time worrying about the standards of care for breach and impose liability only when the standard is not

met. In contract law, the standards are set by the parties themselves in their contract. In torts, standards are determined by the legislature or the courts and reflect public values. The most common standard is “the reasonable person in the circumstances,” but courts and legislatures have developed somewhat more specific standards that govern behavior in particular contexts, although generally the decision about whether a standard has been breached is a decision made by a jury, and we don’t really know how well specific standards are applied by juries.

The second area where torts goals are most clearly seen is in the area of remedies. The goal in torts is to compensate the plaintiff for all of the injuries which proximately resulted from the defendant’s wrongful conduct. That approach to compensatory damages ensures the plaintiff is fully compensated for all injuries, encourages defendants to conform their conduct to society’s standards, and, because recoveries are usually limited to compensatory damages, avoids the vice of over-compensation and over-deterrence. We want defendants to behave reasonably; we don’t want defendants to be overly-defensive since that would drive up their costs without achieving a significant gain in real safety and would drive up the overall costs of accidents, contrary to the third goal.

There are times, however, when compensatory damages are insufficient to achieve a proper level of deterrence. When a defendant has acted maliciously or has deliberately injured another, society has a legitimate concern that the defendant may repeat the same conduct again even though the defendant knows he or she may have to pay compensatory damages. For example, the defendant may simply consider the cost of compensatory damages as the cost of doing business. In these type of cases, we permit juries to award punitive damages. In order for punitive damages to do their job -- which is to deter people who are essentially not deterrable by compensatory damages -- the amount of punitive damages has to be left somewhat uncertain. The uncertainty makes it difficult for potential defendants to calculate in advance the liability cost of injuring someone, and that should make defendants reluctant to get close to the line of malicious, oppressive or fraudulent conduct.

Restitution

Finally, I want to mention briefly the doctrine of restitution, a traditionally under-utilized theory of liability. The basic principle of restitution is simple: A person who has been unjustly enriched at the expense of another is required to make restitution to the other. Restitution is a cause of action and remedy for unjust enrichment.

Restitution has traditionally been an equitable doctrine, which means it has

traditionally been a doctrine invoked by judges instead of juries to remedy injustice. Because it is an equitable doctrine, courts have generally had discretion to choose among a wide range of remedies. The usual remedy is to restore to the plaintiff the benefit which has been unjustly taken or retained by the defendant. Sometimes, particularly where the defendant has been a conscious wrongdoer, courts will permit the plaintiff to recover *more* than what the plaintiff has lost by depriving the defendant of any profit made by the defendant as a result of the defendant's wrongful conduct.

Restitution sometimes appears in breach of contract cases and sometimes in tort cases as an alternative theory of recovery. It also features prominently in certain federal statutes, such as the remedial provision in the Lanham Act for unfair competition (Section 35(a)).

That's it for my summary of basic principles of contracts, torts and restitution. I've probably given everyone in the room just enough law to be dangerous in the upcoming discussions.

History of Liability in Selected Industries and Contexts

I am now ready to turn to a consideration of liability in a few selected industries and contexts. I've picked six big areas: professional malpractice, workers compensation, product liability, insurance bad faith, wrongful termination, and public utilities.

Professional Malpractice

Let's start with professional malpractice. One of the first things to note about malpractice is that it almost always arises out of a contractual relationship. You go to a doctor, lawyer or accountant and enter into a contract for services. Although there is a contract that governs certain aspects of your relationship (most typically, the financial side of the relationship), the law imposes independent duties upon the professional regarding his or her performance in the relationship. So these are cases where a breach of contract is also treated by the law as a tort.

The standard of care in malpractice actions is profession-related. The professional has a duty to possess and exercise the ordinary skill and care of a competent member of his or her profession. If the professional breaches the standard of care, he or she is liable for damages in tort, including consequential economic damages, emotional distress, and possibly punitive damages.

Medical malpractice is a special subset of professional malpractice in part because

of the widespread enactment by state legislatures of tort reform bills that, among other things, limit the amount which a plaintiff can recover. The most common limitations are to cap emotional distress damages and to restrict the recovery of punitive damages.

Because of these limitations, it is fair to describe medical malpractice now in many states as a contract-tort hybrid. There is greater predictability to damages than in a pure tort system, but damages are clearly larger than would be true in a pure contract system.

There is a fair amount of research now which I think suggests that the medical malpractice system doesn't work all that well in achieving the goals of the tort system. Studies suggest that only a small fraction of medical malpractice events ever makes it to the point of a complaint against a doctor, malpractice cases that go to trial are notoriously difficult to win with a success rate of between 20-25% (which is much lower than other types of cases and much lower than common sense and economic theory would suggest), and a big chunk of ultimate recoveries (perhaps as much as 40-60%) goes for attorneys fees and other administrative costs. Medical malpractice may be in need of some serious reevaluation.

Workers Compensation

The next model is workers compensation. Until the adoption of workers compensation statutes, employees usually did not recover damages from the employer for workplace injuries. This was because of what some scholars referred to as the "unholy trinity" of defenses: contributory negligence, assumption of risk, and the fellow servant doctrine. The combined effect of these defenses was to make an action against an employer almost impossible to win. This is somewhat analogous to ERISA preemption's effect on suits against HMOs.

As our society became increasingly industrialized and the workplace became increasingly dangerous, workers were being injured with alarming frequency. The legislative response was to create a workers compensation system. Under this system, all workplace injuries would be compensated pursuant to a statutory schedule. Liability would be strict--the system applied to all injuries, not just to injuries resulting from employer negligence, and the unholy trinity of defenses was rejected. But the damages were going to be statutorily set and limited, and the worker was going to be denied the opportunity to sue in tort.

The workers compensation model is one of quick and certain recoveries for all injuries but with well-defined limits on damages.

Product Liability

Next we have the manufacturing industry and product liability. Two hundred years ago, when you wanted to buy a product, you were pretty likely to buy it directly from the person who made it. Complex corporate structures and vertical marketing through wholesalers and retailers did not exist as it does today. The result was that if you were injured by a product, your remedy was to go back to the person who sold you the product. You had a contract with that person, and, at a minimum, you could sue for breach of contract.

As we industrialized, corporate structures and product distribution became more complex, and products became more dangerous. An increasing number of consumers were being injured by dangerous products. Before the development of products liability, the consumer often had no effective recourse. The retailer may have done nothing but sell the product, so a negligence claim against the retailer wasn't possible. Moreover, even a contract or breach of warranty claim against the retailer wasn't likely to be very useful, because retailers often were effectively judgment-proof and damages would be limited to the value of the product. A tort suit against the manufacturer was blocked by a requirement that there be privity of contract between plaintiff and defendant for product-related suits. The slogan "You can't sue your manufacturer" would have been appropriate at this time.

One by one, these bars to a consumer action fell away, until today a consumer generally has a tort claim against a manufacturer, wholesaler or retailer for injuries resulting from the use of a defectively manufactured or designed product. The conceptual breakthrough came when the courts realized that although the manufacturer, wholesaler and retailer were legally distinct entities, they each were part of a single enterprise engaged in selling products to consumers. All parts of that enterprise had to bear the burden of potential liability.

And products liability is entirely a tort cause of action giving rise to tort damages. Interestingly, drugs and medical device manufacturers have been treated somewhat differently than other product manufacturers. As a general matter, other product manufacturers are held strictly liable for product defects; drug and medical device manufacturers are usually held liable only for *negligently* manufacturing or producing a drug or medical device. The difference in practice is slight, but it does indicate that even in the field of products liability, courts have treated health care related issues as deserving special treatment.

Insurance Bad Faith

The next area I want to cover involves so-called first-party claims for insurance bad faith. These are claims by an insured against his or her own insurance company for their failure to pay in accordance with the contract of insurance.

One of the early leading cases came in California in a 1967 decision, *Crisci v. Security Insurance Co.*, where the California Supreme Court created a cause of action for bad faith breach of an insurance contract, and the plaintiff was permitted to recover not only damages for economic loss (that is, what the plaintiff was entitled to receive under the contract of insurance), but also damages for emotional distress and (we learned in later cases) punitive damages. The cause of action plainly sounded in *tort* rather than *contract* notwithstanding the existence of a contract between the plaintiff and defendant and the fact that the dispute between the plaintiff and the defendant had entirely to do with the proper interpretation and performance of an essentially economic contract.

Although the courts have struggled with the doctrinal confusion of tort liability arising out of a breach of contract, the basic result in *Crisci* and subsequent insurance bad faith cases made sense. Think about it. If the insured in such a case were limited to an action for breach of contract, the insurance company would apparently have a built in incentive to breach whenever possible (even if there were no reasonable grounds for a dispute) and then to delay settlement of any dispute with insureds as long as possible. This is because the contract measure of damages would limit the plaintiff to recovery under the policy. Contract damages would only force the insurance company to pay what it was contractually obligated to pay in any event, but by delaying the payment, might give the insurance company time to make some more profits with the insured's money and coerce a lower settlement from the insured. Insurance companies dispute the factual premise that they profit from delay in payment, but it makes common sense to me.

I have often thought that a better basis for recovery in these cases was restitution instead of tort, because the whole point is to deprive the insurance company of the benefit of keeping money which rightfully belongs to the insured, and that is what restitution is all about. But so far, courts have not adopted this approach, and have given insureds a tort claim for bad faith breach of an insurance contract.

For our purposes, the insurance bad faith cases are interesting because they clearly impose tort liability for bad faith in the handling of a claim under an insurance policy. Bad faith claims against HMOs would seem to be possible in appropriate circumstances, but for ERISA preemption.

Wrongful Termination

My next field of liability arises in the employment market and is known as wrongful termination. We begin with the same type of problems that plaintiffs originally had in workers compensation and products liability cases. It is difficult successfully to sue an employer who fired you in bad faith and with no legitimate reasons because most employees work on an “at will” basis. In an at will employment contract, the employee is free to leave at any time for any reason, and the employer is free to fire the employee at any time for any reason (except, obviously, for reasons that would violate federal or state employment and civil rights statutes).

When courts decided to do something about this perceived problem in the 1970s and 1980s, they found a useful analogy in the insurance bad faith cases. In the insurance cases, the courts found that breach of the covenant of good faith and fair dealing could give rise to an action in tort. And when an employer discharges you for no reason at all after telling you what a good employee you have been for years, that sounds like unfair dealing and bad faith.

The California Supreme Court suggested in the early 1980's that breach of the covenant of good faith and fair dealing by an employer might constitute a tort giving rise to an action for “wrongful discharge.” The court in effect suggested that the employer-employee relationship had the same special characteristics as an insurer-insured relationship. The lower courts in California and in a few other jurisdictions quickly adopted the suggestion as law, and it appeared the covenant of good faith and fair dealing would become the instrument for remaking employer-employee relationships.

The heady days of “wrongful discharge” came to an end in 1988 with the California Supreme Court’s decision in *Foley v. Interactive Data Corp.* In *Foley*, the court emphasized the contractual nature of the relationship and the statutory status of the “at will” employment doctrine (Labor Code § 2922). Concerned that tort liability would upset contractual expectations, the court largely rejected tort liability in the employment context for breach of the covenant of good faith and fair dealing, with only narrow exceptions.

The wrongful termination cases demonstrate the difficulty in balancing the risks and benefits of private ordering through contract law against the risks and benefits of public regulation through the tort system. They stand as something of a warning to those who would immediately expose HMO’s to the full force of tort liability.

Public Utilities

I would like to close my review of selected industries with a few words about

liability rules that apply to public utilities, which includes the telecommunication industry, electricity providers, water providers, and other regulated industries. I only recently began to see the possible relevance of public utility liability rules to the HMO debate.

The public utilities I am most interested in are ones which are required by federal or state law to provide universal service or coverage and which have their rates and other contract terms approved by a federal or state regulatory body such as a public utility commission. Throughout this century, public utilities have pretty successfully argued that liability for a mere negligent failure to provide service or for a negligent interruption in service had to be limited in order to ensure a reasonable rate of return without significantly raising rates to the consuming public. For example, in many states, a water company is not financially responsible for the destruction of a building by fire when the water company failed to provide water at a sufficient pressure to extinguish the fire. A gas company is not liable to a homeowner whose house explodes as a result of the utility's failure to turn off the gas to the neighborhood in the face of a rapidly approaching fire. Interruption in phone service that results in consequential harm to consumers is non-compensable. The most you can get is a contract-based recovery limited to the price of the lost service.

Tort liability against these public utilities is generally limited to cases of intentional harm, wilfull or wanton conduct, or gross negligence (and even gross negligence is limited in some jurisdictions).

So far, even though telecommunications has been opened up to competition, and electricity is increasingly being opened to competition, these no-liability or limited-liability rules are being maintained to ensure that rates for critical public services are kept as low as possible. This is a contract model of liability.

In order to ensure appropriate levels of service and to encourage quality and safety improvements, public utilities are heavily regulated. So in a very general sense, the law replaced the deterrent effect of tort liability with the direct control of government regulation, and part of the price for direct government regulation was imposing limits on liability which ultimately hurts a few individual consumers but to the benefit of most consumers.

I started thinking about public utilities recently when it occurred to me that the changes in the health care industry make the provision of health care services look a lot more like a public utility where universal service is required than the 19th century model of a solo medical practitioner entering into a contract with a single patient.

Health Care Plan Liability

This concludes my brief review of theories of liability in other industries and contexts. I now want to turn even more briefly to how some of those examples might be implemented in the context of health care service plan liability.

I think it is fair to say that the current scheme under ERISA essentially follows a contract model of liability. Health care service plans are structured to impose cost restraints on medical care. The plans can most readily contain costs through a contractual liability system which gives the plan the ability to control its liability exposure through its contracts. Arguably, the preemption provision in ERISA is designed with similar goals in mind--to facilitate and encourage employment-related insurance systems at lowest cost. Under the contract model, if the HMO breaches, the patient is limited to recovering the value of the benefit that was promised (either in the form of damages or an order of specific performance compelling coverage). Emotional distress and punitive damages are not recoverable.

Another model for HMO liability might draw upon a combination of professional liability for medical malpractice and product liability. As you know, some managed care organizations do not employ physicians directly and treat them as independent contractors, relying upon the corporate practice of medicine defense. We could apply the enterprise liability scheme from product liability to managed care, making the managed care organization responsible for the medical malpractice of physicians who have contracts with the plan. On the other side of the HMO-physician relationship, perhaps we could define some or all coverage decisions by the plans as medical decisions thereby transforming the contractual coverage decision into a medical decision.

Of course if we follow the state's lead in terms of medical malpractice, we would probably see some limitations on damage recoveries, such as putting limits on emotional distress recoveries and limiting punitive damages.

The next model would impose upon managed care organizations tort liability for bad faith coverage decisions, drawing upon our experience from the insurance industry. This seems like a very small step to take from a torts perspective, and there is already some California authority indicating that such liability may exist (*Sarchett v. Blue Shield of California* (1987)). The big problem here is, of course, ERISA preemption. A further step would be to make HMOs liable for not just bad faith coverage decisions, but unreasonable coverage decisions--decisions that fall short of the standard of ordinary care.

We could adopt a Medical Injury Compensation Fund along the lines of the workers compensation system which would provide quick but limited compensation without regard to fault for treatment-related injuries. So far, this idea has been suggested only in general terms, and I haven't seen a well-developed proposal along these lines.

Finally, we could follow the lead set with respect to public utilities, making a deliberate decision to compel universal coverage with government oversight and regulation as to quality and levels of service, with the trade-off being very limited liability for failure to provide or interruption in services, with the ultimate goal being reasonably affordable health care for all. For those of you who are wondering, this does not mean national health care. The public utility model is consistent with robust private market competition – just look at the telecommunications and electricity industries over the last decade.

Some of the models I have just mentioned can be found in various bills already pending before Congress and before state legislatures. Perhaps today's discussion will result in other models being explored and proposed. I hope that as you think about the possibilities, some of what I have said today will prove useful.