

ALI's Restatement of the Law Liability Insurance: Synopsis of Regulatory Considerations¹

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I. Overview

The American Law Institute (“ALI”) is preparing to issue a Restatement of the Law, Liability Insurance that has the potential to disrupt the liability insurance system to the detriment of policyholders and insurers alike. The proposed Restatement sets forth a revision of insurance law that dramatically departs from the law with respect to the topics described below. If adopted by courts, the draft Restatement (“Draft”) could create market disruption in the form of an uncertain and unpredictable pricing and reserving environment, increased claim handling costs and litigation, inflated settlements, increased premiums, and the potential for market exits by insurers and reinsurers, as well as carrier insolvencies.

The Draft changes longstanding and fundamental precepts in key areas that form the foundation for policy coverages, rates, reserving, claim handling and reinsurance, while insurers are recast as quasi-governmental financial guarantors under the Draft’s proposed rules which are designed to force insurers to defend and pay for all claims. Absent corrections, adoption of the Draft rules by the Court may result in the cost of insurance becoming more unaffordable to many, leaving people and companies uninsured or underinsured.³

Liability Insurance Principles & Restatement Projects

The ALI publishes Restatements of the Law, model statutes, and Principles of the Law that are enormously influential in the courts, having been cited in published cases over 201,000 times. Restatements are designed to contain clear formulations of common law and reflect the law as it currently stands or might appropriately be stated by a court. Principles, on the other hand, are aspirational, promoting changes that academics identify. The Liability Insurance project began in 2010 as a *Principles project*, an aspirational project on what academics thought insurance law should be. As such, it was not confined, like a Restatement, to stating what the law is or what the emerging trend in the law is as supported by a majority of jurisdictions. Between 2011 and 2014, there were multiple drafts and revisions and significant segments of the Principles project that were approved by and supported by the ALI membership, under the standards applicable to a Principles project.

In August of 2014, the ALI transmogrified the Principles to a Restatement project, the first time in ALI’s history that a project was changed from a Principles to a Restatement. Most importantly, the project thus should have abandoned the aspirational standard and instead moved to the Restatement standard requiring clear formulations of common law as it currently stands or could be appropriately stated by a court. Instead of *adapting* the Principles to a different set of standards, the Restatement essentially *adopted*

¹ This Synopsis is a condensed version of the January 17, 2017 thirty-nine page paper prepared by the authors.

² Financial support for this analysis was provided by the National Association of Mutual Insurance Companies. The views expressed herein are those of the authors. Prior to joining Debevoise, Mr. Dinallo served as the New York State Superintendent of Insurance from 2007-2009. In 2008, he received the “Espirit de Corps Award” from the National Association of Insurance Consumers for accomplishments as an “ambassador for state-based insurance regulation.” Prior to joining Debevoise, Mr. Slattery held various senior positions at AIG from 1998-2007.

³ The views expressed herein are not a recommendation of what decisions any individual insurer or reinsurer should take in response to the Draft or any subsequent iteration of the Draft.

the Principles as if they were the majority law rather than merely aspirational. Thus, this white paper discusses what we understand the law is, rather than what it could or should be.

In an attempt to transform the insurer to financial guarantor, the Draft diminishes fundamental contractual protections, and if adopted by the courts, could result in increased losses and expenses and underwriting uncertainty and unpredictability. Notwithstanding the Draft's presumed goal of providing additional protection for the tort claimant and insurance consumer, the highlighted Draft rules could have the opposite effect by creating significant market disruption, while usurping the role of the regulator. While each insurer will make its own independent underwriting decisions, the Draft rules could lead to a decrease in the overall availability and quality of insurance, significant premium increases, more restrictive coverage terms and conditions and greater leverage for the remaining insurers in a less competitive market.

II. Market Effect

If adopted by the courts, the Draft could disrupt the insurance market by eliminating fundamental rights of the insurer, including the protection of negotiated policy limits, the right to refuse unreasonable settlement demands, the right to exclude coverage for punitive damages and the right to rely upon unambiguous negotiated policy language. As a result of the ALI's Restatement initiative, insurer losses may increase dramatically, by requiring settlement of weak claims and payment of excessive demands to avoid extra contractual liability, while incurring increased claim handling expenses through the likely proliferation of collateral coverage litigation. A troubling theme throughout the Draft is the notion of insurer as financial guarantor, notwithstanding the terms, conditions and limitations of the operative insurance contract. For example, as discussed more fully below, the collective effect of Sections 24 and 27 is to marginalize the negotiated limits protection.

Reserves

Because the Draft is re-writing insurance law (including diminishing the historical protection of the negotiated policy limits, creating settlement premiums, requiring coverage for otherwise excluded liabilities (for example, punitive damages), presuming coverage for intentionally harmful conduct and allowing unambiguous policy terms to be challenged via extrinsic evidence), it will be very difficult to determine adequate reserve levels because there will be no historical basis to assess the anticipated loss experience.⁴ Reserves may be found inadequate due to the new Draft exposures and the lack of historical data,⁵ which may lead to increased risk of insolvencies or other claim paying impairment.

Reinsurance

Adoption of the Draft may force the ceding insurer to pay unreasonable settlement demands, damages that might be otherwise excluded (punitive damages) and to pay extra contractual damages *absent* bad faith. These new liabilities could have a material impact on the availability of reinsurance. Specifically, reinsurers can challenge their obligation to fund the unreasonable settlements created under Sections 24 and 27. The reinsurer will also refuse coverage for damages under Section 27 for punitive awards assessed against the policyholder that are otherwise excluded, or for extra-contractual damages pursuant to Section 24 and 27 (unless otherwise endorsed as part of the Reinsurance Agreement.) Reinsurers may be disinclined to offer extra-contractual damages coverage under the quasi-strict liability imposed upon the ceding insurer under Sections 24 and 27.⁶ Therefore, ceding insurers may be less likely to access this essential source of

⁴ See *Delta Holdings, Inc. v. National Distillers and Chem. Corp.*, 945 F.2d 1226, 1230 (2d Cir. 1991) ("Many of the judgment calls needed to implement the loss development or loss ratio methods rely upon historical data as to loss reporting patterns.").

⁵ Steven Plitt et al., *1 Couch on Insurance* (3d ed. 1995) § 2:29 at 125-127.

⁶ Restatement of the Law Liab. Ins. §§ 24, 27

capital, which allows the insurer to increase its writing capacity and diversify its risk if there is an overconcentration in any particular market.

Rates

Even if the underwriting is competent, assigning proper variables to insurance applicants, if the rate is based on variables that do not reliably predict future losses, the insurance company may suffer significant losses. Current rate structures may be found inadequate in response to the new liabilities created by the Draft rules. Inadequate rates may result in significant market disruption due to the increased risk of insolvencies, claim paying impairment and market exits. As the projected new losses are recognized, the insurers who do not exit the market could be forced to dramatically increase rates/premiums.

Forms

The underlying assumption for the Draft rules is wrong: that all insurance policies are contracts of adhesion and that due to unequal bargaining power and a complete lack of protection for the insured, the field needs to be tilted further in favor of insureds. Disregarding the level of regulatory oversight regarding policy forms that are admitted for use in a particular state (including mandatory state endorsements that protect against potential gaps in coverage), that flawed assumption presumably led to Draft rules allowing the insured to challenge unambiguous policy language via extrinsic evidence in an effort to reconcile the insured's expectations.

Claim Handling Procedures

Insurers may be forced to pay inflated settlements and unjustified claims and abandon prudent claims handling and valuation processes under threat of Sections 24 and 27. Additionally, the insurer's claim handling expenses may dramatically increase, as insureds are encouraged to challenge the meaning of otherwise unambiguous terms with extrinsic evidence under Section 3.

III. Specific Draft Topics That Will Create Market Disruptions

A. Failure to Settle

The proposed Draft creates an affirmative duty for the insurer to "make reasonable settlement decisions" or risk excess damages beyond policy limits. The standards applied by the Draft transform a traditional "bad faith" analysis into a quasi-strict liability standard, obviating the most fundamental protection for the insurer: the negotiated policy limits. Consequently, the insurer may be forced to accept unreasonable settlement demands to avoid the extra-contractual damages risk created by the Draft rules. The Draft creates a new legal obligation regarding the insurer's duty to settle when substantial protections against unfair claim practices are already in place, including well-developed case law regarding the insurer's implied duty of good faith and fair dealing inherent in every insurance contract. Although the Draft conflates negligence and bad faith in the settlement context, the majority rule for failure to settle claims and reported cases involve bad faith allegations.⁷ Notwithstanding, Sections 24 and 27 allow the policyholder to disregard whatever bad faith statutory or common law requirements must be proven to exist in a particular jurisdiction.

The Draft rules significantly depart from existing case law regarding the insurer's duty to settle and the availability of extra-contractual damages by applying a quasi-strict liability standard to the insurer's

⁷ See 3-23 APPELMAN ON INSURANCE LAW § 23.02[2][a]-[c] (commenting that majority view adopts bad faith standard while minority view adopts negligence standard).

decision whether to accept a settlement offer, disregarding the *likelihood* of an excess judgment at the time the offer was refused. Specifically, Section 24 mandates that the insurer has a duty to the insured if there is a mere “*potential* for a judgment in excess of the applicable policy limit.” Illustration (1) highlights the Draft’s problematic approach.⁸ Notably, the insurer can be found liable by a “*trier of fact*” for the judgment beyond limits because it failed to settle when the plaintiff had a mere thirty (30%) percent chance of success at trial because the Draft reduces the insurer’s duty to settle to a simple formula: probability of liability times potential damages.⁹ This simplistic approach can lead to absurd results. For example, if the potential damages are sufficiently high, insurers would be forced to settle a claim with a five (5%) percent chance of success, or be liable for a potential excess judgment. Another inherent flaw in the Draft’s approach is that the analysis is applied retroactively from the excess judgment award. Therefore, even though the determination as to whether to settle is conceptually made “at the time of settlement,” the excess judgment will undoubtedly taint the determination as to whether the decision was reasonable at the time. Specifically, good faith defenses at the time will likely be discounted in hindsight following the excess award and the risk will appear to be higher than it was when the decision not to settle was made.¹⁰

The proposed Draft standard contradicts well-settled case law that requires the insurer to accept a demand within policy limits when there is a *great* risk of recovery beyond the policy limits.¹¹ In contrast, Sections 24 and 27 create extra-contractual liability for the insurer for failing to settle even when the plaintiff’s probability for success is negligible. Moreover, the new Draft rule would overrule long established case law in the majority of jurisdictions that apply a traditional “*bad faith*” analysis,¹² with the insurer bearing the risk of an excess judgment even if the insurer acted reasonably in rejecting the settlement offer.

Despite the passing reference in Section 24(d) to the consideration of other “*evidence*,”¹³ as described above, the insurer’s duty to settle is reduced to a rigid equation. Section (d) provides that the insurer should “take into account the realistically possible outcomes of a trial and to the extent possible, to weigh those outcomes according to their likelihood,”¹⁴ but Illustration (1) under section (d) highlights the practical application of the Draft’s approach.¹⁵ Despite hollow references to “*evidence supporting the conclusion*,” the “*reasonable settlement offer*” (\$45,000), is reduced to multiplying the liability probability (30%) times the damages calculation (\$150,000).¹⁶ Unlike the Draft’s simple equation, the question of an insurer’s good or bad faith “is to be tested against the background of the totality of the circumstances in which the insurer’s disputed actions occurred”¹⁷ and “the reasonableness of a settlement offer cannot be

⁸ Restatement of the Law Liab. Ins. § 24 cmt. (d) illus. 1.

⁹ *Id.*

¹⁰ See *Covill v. Phillips*, 452 F. Supp. 224, 237-38 (D. Kan. 1978).

¹¹ See *Hamilton v. Maryland Cas. Co.*, 41 P. 3d 128, 132-33 (Cal. 2002) (finding an insurer must take into account the insured’s interest if a great risk of recovery beyond the policy limits exists).

¹² See *Benkert v. Med. Protective Co.*, 842 F.2d 144, 149 (6th Cir. 1988) (“Good-faith denials, offers of compromise, or other honest errors of judgment are not sufficient to establish bad faith”); *Bar Plan Mut. Ins. Co. v. Chesterfield Mgmt. Assocs.*, 407 S.W.3d 621 (Mo. Ct. App. 2013) (“[N]o action will lie against the insurer for the amount of the judgment recovered against the insured in excess of the policy limits, unless the insurer is guilty of fraud or bad faith in refusing to settle a claim within the limits of the policy”) (quoting *Zumwalt v. Utils. Ins. Co.*, 228 S.W.2d 750, 753 (Mo. 1950); *Eskind v. Marcel*, 951 So. 2d 289, 293 (La. 2006) (“in the absence of bad faith, [an insurer] is generally free to settle or to litigate at its own discretion, without liability to its insured for a judgment in excess of the policy limits”) *Mowry v. Badger State Mut. Cas. Co.* 385 N.W.2d 171, 180 (Wis. 1986) (determining whether the insurer’s choice to litigate rather than settle constitutes a breach “involves more than a mere finding of negligence on the part of the insurer”).

¹³ Restatement of the Law Liab. Ins. § 24

¹⁴ *Id.* § 24 cmt. d.

¹⁵ *Id.* § 24 cmt. d illus. 1.

¹⁶ *Id.*

¹⁷ *Walbrook Ins. Co. Ltd. V. Liberty Mut. Ins. Co.*, 5 Cal. App. 4th 1455, 1456 (Cal. Ct. App. 1992).

evaluated in a vacuum...,”¹⁸ as courts consider an extensive list of factors regarding an insurer’s decision to settle.¹⁹ The Draft also suggests that procedural factors are only used against the insurer “in a close case by allowing the jury to draw a negative inference.”²⁰

The Draft can incentivize plaintiffs to make excessive demands as a result of the new excess limits risk to the insurer and prompt insureds to underinsure because it is unlikely that the insured will be capped at the policy limit in the event of an excess judgment following a refusal to settle. The anticipated result is inflated, unreasonable settlements that will significantly increase market losses and premiums across the board, negatively impacting the insurance purchaser. Additionally, due to the lack of limits protection, smaller premium/lower limit policies may exit the market because the newly created extra contractual risk outweighs the premium benefit.

Failure to Settle Damages

Section 27 provides for the damages for a breach of Section 24 (duty to make reasonable settlement decisions) which include “the full amount of damages assessed against the insured in the underlying legal action, without regard to those policy limits, as well as any other *foreseeable* harm caused by the insurer’s breach of the duty,” “including punitive damages awarded at the underlying trial (against the policyholder),” even when punitive damages are *excluded* under the policy. Moreover, the Section 27 effect of transferring the insured’s underlying punitive damages risk to the insurer (for failing to settle) also violates the public policy of not allowing liability for intentional wrongdoing to be offset or reduced by the negligence of another.²¹

Courts have applied a much different standard for punitive damages award for failure to settle than is provided under Section 27, which simply compliments the quasi-strict liability standard under Section 24.²² Although standards vary, in order to justify an award of punitive damages the insurer’s breach of the

¹⁸ *Camelot by the Bay Condo. Owners’ Assn. v. Scottsdale Ins. Co.*, 27 Cal. App. 4th 33, 51 (Cal. Ct. App. 1994).

¹⁹ *Carrier Express, Inc. v. Home Indem. Co.*, 860 F. Supp. 1465, 1479-80 (N.D. Ala. 1994).

²⁰ Restatement of the Law Liab.Ins. § 24 cmt. e.

²¹ See *PPG Indus., Inc. v. Transamerica Ins. Co.*, 975 P.2d 652 (Cal. 1999) (“Here, the Colorado jury’s award of punitive damages in the third party action against the insured was based on the insured’s own intentional, morally blameworthy behavior.... By contrast, the action that the insured [] then brought against its insurance company, was based on [insurer’s] alleged negligent failure to settle the third party lawsuit against the insured Such a cause of action is based not on a bad faith breach of the insurance contract but on the failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.”) (internal quotations omitted); *Johansen v. California State Auto. Inter-Ins. Bureau*, 538 P.2d 744, 748 n. 5 (Cal. 1975); Restatement (Second) of Torts § 481 (1965); W. Page Keeton et al., *Prosser & Keeton on Torts*, § 65, p. 462; and § 67, pp. 477-78 (5th ed. 1984).

²² See *Amadeo v. Principal Mut. Life Ins. Co.*, 290 F.3d 1152, 1164 (9th Cir. 2002) (Under California law, punitive damages are available on an insured’s bad faith claim against an insurer “if in addition to proving a breach of the implied covenant of good faith and fair dealing proximately causing actual damages, the insured proves by clear and convincing evidence that the insurance company itself engaged in conduct that is oppressive, fraudulent, or malicious”) (quoting *PPG Indus.*, 975 P.2d at 658); *Mitchell v. State Farm Fire and Cas. Co.*, 799 F. Supp. 2d 680, 695 (N.D. Miss. 2011) (punitive damages requires insured to prove that there was no arguable or legitimate reason to deny coverage and the insurer acted willfully, maliciously, or with gross and reckless disregard for the insured’s rights) (applying Mississippi law); *Medical Protective Co. v. Pang*, 606 F. Supp. 2d 1049, 1064 (D. Ariz. 2008) (“the insured may recover punitive damages when, ‘and only when, the facts establish that [the insurer’s] conduct was aggravated, outrageous, malicious, or fraudulent’”) (quoting *Lange v. Penn Mut. Life Ins. Co.*, 843 F.2d 1175, 1183 (9th Cir. 1988)); *Eccobay Sportswear, Inc. v. Providence Washington Ins. Co.*, 585 F. Supp. 1343, 1344 (S.D.N.Y. 1984) (“New York courts routinely dismiss claims for punitive damages against insurers when there has been no allegation or showing that the carrier... had engaged in a fraudulent scheme evincing such a ‘high degree of moral turpitude and ... such wanton dishonesty as to imply a criminal indifference to civil

duty of good faith and fair dealing must be shown to have been particularly outrageous.^{23 24} Ultimately, the insurer is pressured to pay unreasonable settlement demands to avoid potentially funding a “foreseeable” punitive damages award, even where affirmatively excluded.

Failure to Settle Effect on Reinsurance

As described above, Sections 24 and 27 significantly depart from case law precedent, imposing extra-contractual damages for failure to settle even if: (i) the probability of success for the claim is extremely low; (ii) the insurer acted reasonably and in good faith (iii) other relevant factors support a decision not to settle and (iv) punitive damages are affirmatively excluded, but the excess judgment includes a punitives component, if “foreseeable.” Because Sections 24 and 27 may create unreasonable settlement values, including payment for excluded liabilities,²⁵ the ceding insurer’s ability to procure the applicable reinsurance for those settlements is jeopardized.

B. Duty to Defend

Section 13 Comment (b) of the Draft provides: “if the insurer knows or *reasonably should know* of information that, under existing pleading rules, could reasonably be expected to be added as an obligation, and that, if so added, would require the insurer to defend, then the insurer has a duty to defend the action.”²⁶ The rule that the insurer’s duty to defend is determined by the allegations contained within the “four corners of the complaint” is followed in many jurisdictions.²⁷ Courts following the “four corners of the complaint” rule typically refuse to look beyond the pleadings to determine whether an insurer has a duty to defend (lower court erroneously considered evidence outside four corners of the complaint to determine defense obligations).²⁸

obligations.”) (quoting *Leidesdorf v. Fireman’s Fund Ins. Co.*, 470 F. Supp. 82, 85 (S.D.N.Y. 1979) (internal quotations omitted)); *Stewart v Truck Ins. Exch.*, 17 Cal. App. 4th 468, 483 21 Cal. Rptr. 2d 338 (Cal. Ct. App. 1993) (“Evidence that an insurer has violated its duty of good faith and fair dealing does not thereby establish that it has acted with the requisite malice to justify an award of punitive damages. In order to establish that an insurer’s conduct has gone sufficiently beyond mere bad faith to warrant a punitive damage award, it must be shown by clear and convincing evidence that the insurer has acted maliciously.”) (quoting *Mock v. Michigan Millers Mut. Ins. Co.*, 4 Cal. App. 4th 306, 328 (Cal. Ct. App. 1992) (italics omitted).

²³ See *Bush v. Allstate Ins. Co.*, 425 F.2d 393, 396 (5th Cir. 1970); *Bailey v. Hardware Mut. Cas. Co.*, 322 F. Supp. 387, 393 (W.D. La. 1969), *affirmed*, 439 F.2d 763 (5th Cir. 1971); *Ins. Corp. of America v. Webster*, 906 S.W.2d 77, 79 (Tex. Ct. App. 1995).

²⁴ Cf. *American Mut. Ins. Co.*, 338 A.2d 306, 309 (Md. Ct. Spec. App. 1975) (holding that insurer could not be liable for third-party bad faith when insured never demanded the insurer to settle the claim against him); *Miller v. Kronk*, 519 N.E.2d 856, 858 (Ohio Ct. App. 1987) (holding that insurer does not have duty to initiate settlement negotiations when plaintiff had not previously instituted negotiations).

²⁵ Restatement of the Law Liab. Ins. §§ 24 & 27

²⁶ *Id.* § 13 cmt. b (emphasis added).

²⁷ *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 908 A.2d 888, 896-97 (Pa. 2006). See also *Admiral Ins. Co. v. Ford*, 607 F.3d 420, 424-25 (5th Cir. 2010) (applying Texas law); *Emhart Indus., Inc. v. Century Indem. Co.*, 559 F.3d 57, 65-69 (1st Cir. 2009); *Indian Harbor Ins. Co. v. Valley Forge Ins. Grp.*, 535 F.3d 359, 363 (5th Cir. 2008); *Fireman’s Fund Ins. Co. v. Univ. of Georgia Athletic Ass’n, Inc.*, 288 Ga. App. 355, 356 (Ga. Ct. App. 2007); *H.L. Libby Corp. v. Fireman’s Fund Ins. Co.*, No. 03-601 (W.D. Pa. July 24, 2006).

²⁸ *Kvaerner Metals*, 589 Pa. at 317; see also *Sony Computer Entm’t Am., Inc. v. Am. Home Assur. Co.*, 532 F.3d 1007, 1020 (9th Cir. 2008) (insured “may not speculate about unpled third party claims to manufacture coverage”) (quoting *Hurley Constr. Co. v. State Farm Fire & Cas. Co.*, 10 Cal. App. 4th 533, 538-39 (Cal. Ct. App. 1992)); *Employers Mut. Cas. Co. v. Indus. Rubber Prods., Inc.*, Civ. No. 04-3839, at *7 (D. Minn. Feb. 23, 2006) (duty to defend is based on claims in underlying complaint; extrinsic evidence is not considered); *General Star Indem. Co. v. Schools Excess Liab. Fund*, 888 F. Supp. 1022, 1029 (N.D. Cal. 1995) (under California law “although insurance contracts often have special features, ordinary rules of contract interpretation still apply”). In turn, insurers are not

The Draft also departs from jurisdictions that do consider facts beyond the pleadings when considering the insurer's duty to defend because the Draft requires the insurer to defend if it "should reasonably know" of information that would trigger a duty to defend.²⁹ Reporter's note (b) highlights the distinction: "the insurer must defend ... if the insurer *possesses* extrinsic information..."³⁰ Courts applying the expanded extrinsic information test require that the insurer has "actual knowledge" of information that would trigger a duty to defend, but there is no obligation based upon what an insurer should have known.³¹

The Draft duty to defend imposes an elusive framework that will be difficult to apply or to predict. The insurer would be at risk for bad faith claims if it fails to defend unpled, hypothetical claims that it "should have reasonably known." Like other Draft provisions, this proposed burden may invite significant coverage litigation causing the underwriters to adjust their pricing and terms and conditions accordingly.

C. Draft Rules of Construction-Plain Meaning

Section 3 of the Draft departs from the majority rule by allowing the insured to introduce extrinsic evidence to disregard unambiguous terms, to prove that the insured's understanding of the term is "more reasonable than the plain meaning."³² Notwithstanding the Draft's strained reasoning (there can be a "more reasonable" meaning than the accepted "plain meaning" of the term),³³ to avoid a proliferation of litigation and to enforce the intent of the contracting parties, as evidenced in the written contract, courts "may not disregard clear provisions which the insurers inserted in [an insurance policy] and the insured accepted."³⁴ Moreover, "[i]n interpreting insurance contracts, courts are not at liberty to raise doubts where there are none or to make a new contract between the insured and insurer."³⁵ Counter to the precedent summarized above, the new rules can create ambiguity where none exists, through the use of extrinsic evidence. By allowing the insured to offer extrinsic evidence in the absence of any ambiguity, the Draft's rule regarding the use of extrinsic evidence contradicts the majority view: Generally, the language of an insurance policy will be given its plain meaning unless an ambiguity exists³⁶ and the Parol Evidence rule generally precludes extrinsic evidence of the meaning of an insurance contract unless the policy language is found to be ambiguous.³⁷

forced to "speculate beyond the written words of the complaint in order to imagine a claim that a plaintiff might be making." *State Farm Fire & Cas. Co. v. Easy PC Sols., LLC*, No. 2014AP2657, 2015 WL 8215533, ¶ 8 (Wis. Ct. App. Dec. 9, 2015).

²⁹ Restatement of the Law Liab. Ins. § 13 cmt. b.

³⁰ *Id.* § 13 Reporter's Note b.

³¹ *Fitzpatrick v American Honda Motor Co., Inc.*, 575 N.E. 2d 90 (N.Y. 1991); *Scottsdale Ins. Co. v. MV Transp.*, 115 P. 3d 460 (Cal 2005).

³² Restatement of the Law Liab. Ins. § 3(2).

³³ *id.* § 3.

³⁴ *Caporino v. Travelers Ins. Co.* 62 N.Y.2d 234, 239 (2d Cir. 1984) (citations omitted); *see also foreman v. Cont'l Cas. Co.*, 770 F. 2d 487 (5th Cir. 1985).

³⁵ *Sher v. Lafayette Ins. Co.*, 988 So. 2d 186, 196 (La. 2008) (citations omitted); *see also Liberty Mut. Ins. Co. v. Lone Star Indus., Inc.*, 967 A. 2d 1, 21-22 (Conn. 2009) (the parties' differing interpretations of a policy term does not give rise to an ambiguity); *Polarome Int'l, Inc. v. Greenwich Ins. Co.*, 961 A. 2d 29 (Super. Ct. 2008), cert. denied, 970 A. 2d 1050 (N.J. 2009).

³⁶ *Plastics Eng'r Co. v. Liberty Mut. Ins. Co.*, 759 N.W.2d 613, 620 (Wis. 2009); *Leonard v. Exec. Risk Indem.*, 545 F.3d 661, 668 (8th Cir. 2008).

³⁷ *Chicago Ins. Co. v City of Council Bluffs*, 713 F.3d 963 (8th Cir. 2013); *AstenJohnson v. Columbia Cas. Co.*, 562 F3d 213, 220 (3d Cir. 2009); *Merrimack Mut. Fire Ins. Co. v. Dufault*, 958 A.2d 620, 624-25 (R.I. 2008)

Reasonable Expectations Doctrine

The Draft seeks to impose an unqualified “reasonable expectations” standard that is not supported by case law precedent. Cases assessing the “reasonable expectations” doctrine have rejected the concept outright or applied the doctrine to resolve ambiguous language or to protect the insured against terms that are “buried in fine print,”³⁸ unlike the Draft’s unqualified application. The application of the reasonable expectations doctrine is typically limited to cases in which the policy is ambiguous and the mutual intent of the parties cannot be determined.³⁹

The Draft’s approach will likely result in a spike in coverage litigation, wherein insureds can dispute the “true meaning” of unambiguous terms and essentially re-write the negotiated insurance contract. The insurer’s claim handling expenses could increase dramatically, causing premiums to increase significantly. The negotiated policy language may not be enforceable, creating widespread underwriting uncertainty, consistent with the Draft’s apparent goal of moving away from the fundamental contractual relationship between insurer and insured towards the insurer as financial guarantor. The Draft would permit the rewriting of the contract by a court, limited solely by the insured’s expectations. Section 3 interferes with the parties’ fundamental freedom to contract and imposes duties on the insurer in addition to those stipulated in the insurance contract.

D. Intentional Acts Coverage

Section 47(2) highlights the Draft’s efforts to make the insurer a financial guarantor. The relevant provision provides “*Except as barred by legislation or judicially declared public policy, a term in a liability insurance policy providing coverage for civil liability arising out of aggravated fault is enforceable, including civil liability for: criminal acts, expected or intentionally caused harm, fraud, or other conduct involving aggravated fault.*”⁴⁰ The Draft’s presumption of coverage for intended harm would have significant consequences for liability policies, which are not underwritten to cover intentional misconduct. The Draft’s reasoning that disallowing coverage for intentionally harmful acts is problematic from a victim’s perspective fundamentally alters the contractual nature of the insurance contract. It is a contract between the insurer and the insured. Insureds may not perceive a need to insure against behaviors that they see zero risk that they will engage in and not wish to pay premium to insure those who do engage in such reprehensible conduct. Introducing a victim’s perspective interjects a third party into a two-party contract.

³⁸ See *Derrickson v. Am. Nat’l Fire Ins. Co.*, 538 A.2d 1113, 1114 (Del. 1988) (“there is no “authority[] for a court to apply rules of construction which require an insurance contract to be construed in favor of the insured, or attempt to discern the reasonable expectations of the purchaser.”); *W.W.W. Assoc., Inc. v. Ginancontieri*, 77 N.Y. 2d 157, 162 (N.Y. 1990) (“Evidence outside the four corners of the document as to what was really intended but unstated or misstated is generally inadmissible to add to or vary the writing”) (citations omitted).

³⁹ See *W3i Mobile v. Westchester*, 632 F.3d 432, 438 (8th Cir. 2011) (under Minnesota law reasonable expectations doctrine is limited to resolving ambiguities and is not a license for rewriting policy terms); *Noble Energy v. Bituminous Cas. Co.*, 529 F.3d 642, 648 (5th Cir. 2008) (“under Texas law, the reasonable expectations on the insured are not to be considered when the policy language is unambiguous”) (*Qualcomm Inc. v. Certain Underwriters at Lloyd’s, London*, 161 Cal. App. 4th 184, 193, Cal. Ct. App. 2008) ([a]n expectation of coverage cannot create an ambiguity; it is merely an interpretive tool used to resolve an ambiguity once it is found); *150 Broadway N.Y. Assoc., L.P. v. Bodner*, 14 A.D.3d 1, 4 (N.Y. App. Div. 2004) (“[i]t is a court’s task to enforce a clear and complete written agreement according to the plain meaning of its terms without looking to extrinsic evidence to create ambiguities not present on the face of the document.”) (citations omitted); *Farmers Ins. Exch. v. Young*, 832 P. 2d 376, 379 (Nev. 1992) (expectations analysis only applicable when contested policy language is ambiguous or otherwise problematic).

⁴⁰ Restatement of the Law Liab. Ins. § 47(2).

E. Insurer's Ability to Rescind

Section 8 provides that a misrepresentation by or on behalf of an insured during the application or renewal of an insurance policy is material only if, in the absence of the misrepresentation, a reasonable insurer in the insurer's position would not have issued the policy or would have issued the policy under *substantially different terms*.⁴¹ Section 8 reflects another Draft rule that would impose a new legal standard for insurers, requiring the insurer to prove that it would have issued a policy on "substantially different terms" in the event that the insured makes misrepresentations during the insurance application or renewal process.⁴² What qualifies as "substantially different terms" remains unanswered. The Draft diverges from case law precedent regarding the insurer's burden following a misrepresentation by the insured in the underwriting process. Specifically, the test is whether the insurer at issue would have issued *the same coverage on the same terms and at the same price* if the requested information was accurately provided by the insured.⁴³

Duty to Cooperate

Section 30, "Consequences of the Breach of the Duty to Cooperate, acknowledges in Comment b: *The standard for prejudice* that most courts do "not require that the insurer demonstrate that the insured's lack of cooperation would have allowed it to defeat the legal action," but, nevertheless, concludes: "... it is appropriate to conclude that the prejudice determination focuses primarily on the impact of the failure to cooperate on the outcome of the action. It is not ordinarily enough that the insured's failure to cooperate increased the cost or difficulty of the defense. Rather, *that failure must be one that has affected or will affect the outcome of the action for the insurer...*"⁴⁴ However, states requiring prejudice do not require the insurer to demonstrate that the failure to cooperate prejudiced the insurer in the "outcome of the claim." Rather, courts focus on whether the failure to cooperate impaired the insurer's rights under the insurance contract.⁴⁵ Equally troubling is Section 30's allowance for collusive behavior between the insured and the

⁴¹ *Id.* § 8.

⁴² *Id.*

⁴³ *Geer v. Union Mut. Life Ins. Co.*, 273 N.Y. 261, 266-67 (N.Y. 1937); *Old Line Life Ins. Co. v. Superior Court*, 229 Cal. App. 3d 1600, 1604-06 (Cal. Ct. App. 1991); *Imperial Cas. & Indem. Co. v. Sogomonian*, 198 Cal. App. 3d 169, 177-82 (Cal. Ct. App. 1988); *Williamson & Vollmer Eng'g, Inc. v. Sequoia Ins. Co.*, 64 Cal. App. 3d 261, 272 (Cal. Ct. App. 1976) (material if the undisclosed or misrepresented information would have led the insurer not to issue the policy, or to issue the policy on different terms or for a different premium).

⁴⁴ Restatement of the Law of Liab. Ins. § 30 cmt. b.

⁴⁵ *See Allstate Ins. Co. v. Occidental Int'l, Inc.*, 140 F.3d 1, 5 (1st Cir. 1998); *Northwest Prosthetic & Orthotic Clinic, Inc. v. Centennial Ins. Co.*, 997 P.2d 972, 976 (Wash. Ct. App. 2000) ("The loss of a meaningful opportunity to investigate a debatable claim before it is settled is, by itself, a sufficiently concrete detriment to establish actual prejudice."); *Am. Access Cas. Co. v. Alassouli*, 31 N.E.3d 803, 814 (Ill. App. Ct. 2015) ("An insurer must demonstrate that 'it was actually hampered' in its investigation or defense by the insured's violation of the cooperation clause.") (citing *M.F.A. Mut. Ins. Co. v. Cheek*, 363 N.E. 2d 809, 813 (Ill. 1977); *Tran v. State Farm Fire and Cas. Co.*, 961 P.2d 358, 366-67 (Wash. 1998) (summary judgment appropriate where the insured's breach of a notice cooperation clause prevented the insurer from conducting a meaningful investigation of a claim or presenting a viable defense to a claim); *Unigard Ins. Co. v. Leven*, 983 P.2d 1155 (Wash. Ct. App. 1999); *Prince George's County v. Local Gov't Ins.Trust*, 879 A. 2d 81, 98 (Md. 2005) ("The court rejected the proposition that [insurer] was required to prove prejudice other than the denial of its contractual rights [to investigate, evaluate coverage, choose defense counsel and attempt to settle] ... 'We do not perceive that Article 48A, § 482 of the Maryland Code requires the insurance carrier to assume the burden of proving a negative. It is impossible for the carrier to demonstrate to the court what witnesses it might have discovered, what defense it might have made, and what disposition it might have reached in settlement if it had received notice before the verdict was rendered in this case.") (citing *Washington v. Federal Kemper Ins.*, 482 A.2d 503, 507 (Md. Ct. Spec. App. 1984)); *Ward v. Custom Glass & Frame, Inc.*, 663 N.E.2d 734, 736 (Ohio Ct. App. 1995) ("the totality of the circumstances" will be considered when evaluating whether an insured's breach of the insurance contract by failing to comply with the

plaintiff under certain circumstances and the total disregard for an insured's breach of cooperation regarding its basic obligation to protect the insurer's rights under the subrogation clause.

Implied-in-Law Terms and Restrictions

Section 46 (1) is another provision under the Draft that allows the parties to rewrite the negotiated policy under various circumstances. Comment *a.* provides that "authoritative source[s] of positive law" can also provide implied-in-law terms or restrictions.⁴⁶ "*Authoritative sources of positive law*" include statutes, regulations, and the common law." The "common law" addition creates unnecessary uncertainty for the contracting parties. Either of those parties to the contract can simply argue that a particular case supports their position for the inclusion of an implied in law term or the voiding of an existing term, including precedent that was unforeseeable or unknowable to the parties at the time of contracting. Therefore, consistent with other Draft rules, Section 46 allows policy language to be re-written after the fact, beyond the traditional legislative or regulatory considerations.

IV. Conclusion

If the Draft rules are adopted by the courts, there could be a material and lasting impact in the insurance market because fundamental insurer protections such as negotiated limits, the right to rely upon unambiguous policy language and the ability to enforce exclusions (punitive damages) are diminished, with the insurer as guarantor. In sum, the insurer loses the ability to enforce the negotiated contract. The Draft rules, if adopted, could significantly increase insurer losses and expenses and historical rates and claim reserving practices may be found inadequate. That combination could threaten the solvency and claim paying ability of participating insurers and the anticipated losses, underwriting uncertainty and loss of fundamental contractual protections could lead to insurers exiting the market.

The potential cumulative effect of the Draft could materially detriment the insurance consumer because the less competitive and more cautious market will likely tighten underwriting terms and conditions and decrease available limits in response to the increased losses, elimination of contractual protections, the inability to enforce the contract and underwriting uncertainty. Premiums will likely increase significantly. The end result could be more uninsured and underinsured consumers.

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obligations of the cooperation clause is material); Richard L. Suter, *Insurer Prejudice: Analysis of an Expanding Doctrine of Insurance Coverage Law*, 46 Me. L. Rev. 221, 222-225 (1994) ("Generally speaking, courts have found prejudice from the insured's breach of a cooperation clause where the purposes of the cooperation requirement have been defeated. For instance, if the insurer is unable to properly investigate a claim, to prepare an adequate defense or to pursue a subrogation action, the insurer may be deemed prejudiced by the insured's acts and/or omissions in violation of the applicable cooperation clause.")

⁴⁶ Restatement of the Law of Liab. Ins. § 46 cmt. a.