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Why Criticism Of ALI's Insurance Restatement Is Valid

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The saga of the proposed "Restatement of the Law — Liability Insurance" (the "Insurance Restatement" or "Restatement") of the American Law Institute continued to unfold recently with the publication by the Restatement's authors, professors Tom Baker and Kyle Logue, of their rebuttal[1] to an article by professor George Priest critical of the proposed Restatement.[2] In essence, Priest contends that the proposed Insurance Restatement, if followed by courts, would make a number of changes in the law governing liability insurance which would destabilize insurance markets and lead to increased premiums and less availability of insurance.

A. Hugh Scott

In response, Baker and Logue disagree — rather vehemently — stating that his arguments are "wildly overstated or flatly wrong."[3] In a bout of professorial internecine warfare, they do not spare the rod with Priest. For example, they spend more than 10 percent of their paper dissecting and endeavoring to rebut in excruciating detail Priest's comments on language that was removed from the proposed Insurance Restatement before Priest wrote his article and thus appears to be of no consequence to the present issue.[4] At bottom, they say that Priest's premise — that the Restatement would make significant changes in insurance law — is flawed, as is his economic analysis of what those changes would cause. Rather, Baker and Logue write that "[a]ll of the rules that the Restatement adopts are grounded in existing case law" and "none of the rules contained in the Restatement are either radical or new."[5]

So who's right: professor Priest or professors Baker and Logue? Obviously, a paper of this short length cannot address all 51 sections of the proposed Insurance Restatement, so we will look at several of the sections that may have a significant impact.

The Plain Meaning Rule

One of the fundamental, classic rules for the interpretation of contracts — including insurance contracts — is that a contract is to be interpreted according to the plain meaning of its language. Law students are taught this rule, and the cases stating it are legion. The Insurance Restatement in § 3 adopts the rule. But then, it tacks on a huge exception: it states that the rule will not apply if "extrinsic evidence shows that a reasonable person in the policyholder's position would give the term a different meaning." This does two things: (1) the policy term will not be given its plain meaning if the policyholder reasonably thinks it might mean something else; and (2) it invites the use of extrinsic evidence. Traditionally, it has been the judge who resolves any question about whether a policy term should be given its plain meaning. The Restatement proposes to give the policyholder a veto over whether the policy term should be given its plain meaning by using extrinsic evidence to do so.

Experienced insurance coverage litigators know that summary judgment has historically been an efficient and effective tool for disposing of weak or ill-founded coverage cases that turn on application of the policy's plain meaning. Introducing extrinsic evidence into the equation, as the Restatement does, will likely mean that early dispositive motions will be replaced by burdensome discovery efforts by policyholder counsel to find extrinsic evident that might support their invocation of the Restatement's new exception to the plain meaning rule. This will inevitably prolong coverage litigation and increase its cost.

Historically, the gold standard for an ALI Restatement provision has been that it reflects a rule followed by a majority of the states. The Insurance Restatement's proposed plain meaning rule "is at odds with the majority rule in most jurisdictions."[6] "Section 3 of the Draft [Restatement] ... contradicts the majority view: the language of an insurance policy will be given its plain meaning unless an ambiguity exists and extrinsic evidence is not permitted absent ambiguity."[7]

The Restatement's "novel approach to the traditional [plain meaning] rule ... would create uncertainty and invite unnecessary collateral litigation."[8] It "undermines a longstanding rule that insurance contract language must be given its plain meaning" and "'would inject great uncertainty and expense into insurance cases.'"[9] "It is anticipated that the approach to policy interpretation adopted by the Restatement will lead to greater uncertainty in the interpretation of standard coverage forms and higher costs in resolving insurance coverage disputes because courts will often be called upon to interpret coverage forms in light of extrinsic evidence rather than the plain language of the coverage form at issue."[10]

The Consequences Of A Breach Of The Duty To Defend

Section 19 of the Insurance Restatement provides that an insurer who declines to provide a defense "without a reasonable basis" forfeits all of its coverage defenses. Section 49 provides that an insurer who breaches the duty to defend is liable for defense and indemnity costs up to its policy limits, for the costs of establishing the breach, and for any other loss caused by the breach. In defense of the "reasonable basis" test, Baker and Logue do not contend that this test is the majority rule. Rather, they point out that it is simply less severe than the rule in a very few jurisdictions that any refusal to defend, reasonable or not, works a forfeiture of coverage defenses.[11]

"The majority of jurisdictions that have addressed the issue have held that an insurer does not automatically forfeit its coverage defenses if it is found to have wrongfully breached its duty to defend."[12] By adding the reasonable/unreasonableness test for forfeiture of coverage defenses, the Restatement has moved away from setting forth "clear formulations of common law ... as it presently stands or might appropriately be stated by a court," as required for a Restatement.[13]

The consequence of (i) imposing a draconian penalty for a breach of the duty to defend (i.e. the insurer's loss of any coverage defenses) and (ii) creating a "reasonableness" test for determining the existence of a breach, is obviously to raise greatly the stakes of the insurer's decision whether or not to defend a claim. One person's "reasonableness" may be another person's "unreasonableness." Since the reasonableness of an insurer's decision not to defend would most likely rest with a decision-maker traditionally viewed as not insurer-friendly — namely, the jury — the scales would tip in favor of defending, even when the insurer believes that potential for coverage (and, thus, the duty to defend) does not exist. The new rule that the Insurance Restatement adopts would likely lead to insurers' defending more claims.

Such a system-wide increase in insurers' defense of claims would obviously lead to a systemic increase in the cost to insurers of liability insurance claims.

The Consequences Of A Breach Of The Duty To Settle

Section 24 of the Insurance Restatement provides that an insurer has a duty "to make reasonable settlement decisions." For a violation of this duty, Section 27 makes the insurer "subject to liability for the full amount of damages assessed against the insured in the underlying legal action, *without regard to policy limits*, as well as any other foreseeable harm caused by the insurer's breach of the duty." (Emphasis added.) Baker and Logue do not contend that Section 27 reflects the rule in a majority of jurisdictions.[14]

The policy limits are one of the fundamental elements of the insurance bargain. A policyholder pays a set premium for the insurer to assume a specified amount of risk — defined as the policy limits. Section 27 would strip the insurer of its policy limits if a jury, after the fact, were to decide that the insurer had unreasonably rejected a settlement offer. "Such a rule, if adopted by courts, would significantly impair insurer settlement negotiations."[15] In every settlement negotiation, the underlying plaintiff's counsel could make an initial demand for "policy limits" (indeed, this is frequently the norm), and the insurer would reply with a lesser counter-offer only at its peril, namely the threat that a jury might find the insurer's conduct to have been unreasonable, thus exposing the insurer to liability in excess of its policy limits. The settlement scales would be tipped against an insurer's bargaining hard, if at all.

The pressure that Section 27 would put on insurers is increased by the broad scope of liability for not only damages above policy limits, but also for "any other foreseeable harm" resulting from a breach of the duty to settle. Baker and Logue make clear in the article that "other foreseeable harm" is intended to include liability for punitive damages and for emotional distress or loss of business reputation.[16] Recovery of punitive damages in a duty to settle case appears to be unprecedented.[17]

"Regardless of its good intentions or the legitimate reasoning behind its settlement offer, an insurer rejects any settlement offer within policy limits at its peril."[18] If Sections 24 and 27 have their expected effect, systemic costs will increase as insurers either pay inflated settlement demands or settle cases where they perceive any risk that a jury might second-guess them about the reasonableness of the settlement demand.

What Will These Changes Mean in Practical Terms?

Based on the review of the three areas of the proposed Insurance Restatement discussed above, and laying aside the numerous other changes that commentators have identified,[19] it appears that Priest wins the debate with Baker and Logue as to whether the Restatement would introduce significant changes into the law governing liability insurance. That conclusion is bolstered by Baker's description at a recent Defense Research Institute program of the Insurance Restatement as being written in a way that was intended to incentivize insurers to defend and settle more cases than they do now.[20] By definition, the defense and settlement of more cases would mean a change, and the new rules of the Restatement would be the cause of that change.

In addition to arguing that Priest is wrong in saying that the Insurance Restatement would make changes, Baker and Logue also challenge his analysis of the economic consequences of those changes. Although they talk a good deal about economics in their article, neither Baker or Logue is an economist by trade. Nor am I. But that does not mean that we cannot have a practical discussion about what common sense suggests will be the effect of fundamental changes in insurance law like those discussed above.

The modified plain meaning rule contained in Insurance Restatement Section 3, which focuses on the policyholder's understanding of a provision as shown by extrinsic evidence, will prevent the early and inexpensive disposition of coverage cases that turn on the application of unambiguous policy provisions according to their plain meaning. On a systemic basis, coverage litigation will become more protracted and expensive. The provision in Section 19 that an insurer will lose its coverage defenses unless its decision not to defend is deemed "reasonable" by a jury after the fact, will likely result in insurers defending more cases "just to be safe." The provision in Section 27 that an insurer will be liable for damages in excess of its policy limits (including punitive and emotional damages) if it fails to make a "reasonable" settlement, will likely result in insurers settling more cases "just to be safe." Common sense suggests that the result will be increased costs for liability insurers system wide.

If actuaries who set premiums are doing their jobs, this will mean increased premiums for policyholders. Also, for some carriers, it may mean a preference for withdrawal from the market, especially when the market is unfavorable, thus meaning less underwriting capacity for the more expensive policies.

Knowing the future requires a crystal ball. Neither Baker, Logue, Priest or I have a crystal ball. But, based on a careful assessment of the information we have about the changes to liability insurance law proposed by the Insurance Restatement, professor Priest's view — that the changes wrought by the Restatement will likely result in higher future premiums and potential decreased availability of coverage for consumers — appears to win the day.

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[1] Tom Baker and Kyle D. Logue, "In Defense of the Restatement of Liability Insurance Law," Research Paper No. 17-15, University of Pennsylvania Law School Institute for Law and Economics (April 2017) (available at http://ssrn.com/abstract=2952804) (the "Article").

[2] George L. Priest, "A Principled Approach Toward Insurance Law: The Economics of Insurance and the Current Restatement Project," 24 Geo. Mason L. Rev. ___ (2017) (online draft available at https:/ssrn.com/abstract=2631123).

[3] Article at 3.

[4] Article at 17 – 20.

[5] Article at 2, 14.

[6] David G. Harris II and David L. Brown, “The ALI Adopts Significant Portions of the ‘Restatement of the Law of Liability Insurance,” Claims Journal (http://www.claimsjournal.com/news/national/2016/06/16/271591.htm?print) (June 16, 2016), at 2.

[7] Eric J. Dinallo and Keith J. Slattery, “ALI’s Restatement of the Law Liability Insurance: Regulatory Considerations” White Paper (January 17, 2017), at 4.

[8] “Business Community Concerns with the American Law Institute (ALI) Restatement of the Law of Liability Insurance,” A Message From The President, U.S. Chamber Institute For Legal Reform (April 27, 2017 e-mail bulletin) (“U.S. Chamber”), at 1.

[9] Nicholas Malfitano, “Insurers Concerned As New Legal Guidelines Are Drafted By Prominent Group,” Forbes (http://www.forbes.com/sites/legalnewsline/2016/10/25/insurers-concerned-as-new-legal-guidelines-are-drafted-by-prominent-group) (October 25, 2016) (citing and quoting attorney Laura Foggan), at 2.

[10] Harris and Brown, supra at 2.

[11] Article at 21-23.

[12] Harris and Brown, supra at 2.

[13] Id. at 2-3.

[14] See Article at 26-29.

[15] U.S. Chamber, supra.

[16] Article at 27.

[17] See Kim V. Marrkand and Martha J. Koster, “Restatement of Liability Insurance and the Expanded Duty to Settle: Windfall for Claimants,” The National Law Review (November 2016) (available at http://www.natlawreview.com/article/restatement-liability-insurance-and-expanded-duty-to-settle-windfall-claimants), at 4 (“No reported case has been found in state or federal jurisdictions that allows a policyholder in a duty to settle case to recover punitive damages assessed against it.”).

[18] Marrkand and Koster, supra at 1.

[19] See, e.g., Dinallo and Slattery, supra at 3-5 (identifying § 8 (rescission by insurer), § 13 (trigger of duty to defend), § 30 (breach of insured’s duty to cooperate), § 45 (implied-in-law terms and restrictions), and § 46 (intentional acts coverage)); U.S. Chamber, supra at 2 (identifying §§ 48, 49, and 51 (attorney fee shifting) and §§ 50 and 51 (bad faith)).

[20] A. Hugh Scott, “ALI’s Proposed Insurance Law Restatement: A Trojan Horse?,” Law360 (February 9, 2017) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2631123, at 1.