CLM 2018 Annual Meeting
March 14-16, 2018, Houston, Texas

# Rethinking Claims and Litigation Management with the Proposed Restatement of Law on Liability Insurance

## A. Overview of American Law Institute and History of The *Restatement of Law, Liability Insurance.*

The ALI is arguably the most influential private organization in development of American law. It was founded in 1923 to produce scholarly work to “clarify, modernize or otherwise improve the law.” ALI membership consists of over 4,500 lawyers, judges and academics “of the highest qualifications.” ALI publications have been cited by courts 206,000 times.

The ALI develops and publishes Restatements, which aim at clear formulation of common law, Model Laws, such as the Model Penal Code, and Principles, which are aspirational recommendations for policy or guidelines.

The Liability Insurance project began as a “Principles of the Law” project in 2010. This was the first-of-its-kind project – aspirational principles of what the law “should be” on liability insurance topics. Industry was involved early on - the American Insurance Association was appointed as Liaison to the project. However, after repeated attempts to have insurer perspective heard, the AIA Liaison withdrew in protest in Jan. 2014.

In the fall of 2014, ALI leadership converted the Principles to a Restatement. This was an unprecedented decision in ALI’s 94-year history. The conversion was initially viewed as a positive step, as the standards and rules for a Restatement are based on the actual common law, not the aspirations of the Reporters.

In early 2015, the first Restatement was released. The rules for a Restatement should have required significant redrafting of the prior Principles. However, there were few changes to novel and unsupported provisions and it appeared the “Principles” was simply relabeled a “Restatement.”

Later in 2015, Laura Foggan was appointed as the new AIA Liaison. Over the next few years, hundreds of letters were sent to Reporters, several revised drafts were issued, and the project was before the membership at each Annual Meeting. Since the first draft in 2015, there have been some improvements, largely facilitated by an insurer led working group documenting project departures from prevailing common law.

In May of 2017, the project was scheduled for final vote of approval at the Annual Meeting. At the last minute, it was determined the project would benefit from another year's work. The Reporters promised to go on a "listening tour".

Three months later, in August, the Reporters issued the new draft, making "relatively few changes to the black letter" and the Reporters indicated future substantive changes were unlikely. In early December, the Council Draft was issued. While there was one notable improvement, some problematic provisions were actually worse.

As it stands, insurers continue to have grave concerns about the fairness and integrity of the project. Unless ALI leadership steps in to take corrective action, Council Draft is likely going to be the new Restatement. Let us now hear from our esteemed panel.

**B. Significant/Controversial Sections of the 2017 Proposed Final Draft Of the *Restatement of Law, Liability Insurance.***

**1. Section 3 (Rules for Policy Interpretation)**

(a) Proposes to replace "plain meaning" with "presumption of plain meaning"

(b) Presumption of plain meaning - Extrinsic evidence is admissible to show that an otherwise unambiguous policy term is reasonably susceptible to a different meaning in light of all the circumstances including those related to the negotiation of the policy.

Under traditional rules of policy interpretation accepted by the overwhelming majority of jurisdictions extrinsic evidence is not admissible to alter the terms of a policy that is clear and unambiguous when applied to the claim at issue. Under this admittedly "new" proposed rule, courts would be required to consider extrinsic evidence of policy negotiation, drafting history, and the like to determine if an unambiguous term is reasonably susceptible to a different meaning.

In addition to not following the well-established the majority rule, it is unclear how courts would apply this new rule in practice. In many ways, the rule appears geared to opening

the doors to extensive discovery with little guidance to courts on how to determine if a term is "reasonably susceptible" to a different meaning. The draft also justifies the new rule with citations to cases involving the concept of latent ambiguity which the commentary misstates is a distinct approach to contract interpretation that allows for the admissibility of extrinsic evidence to develop ambiguity. However, in the insurance context, latent ambiguity is part of the plain meaning approach and refers only to the concept that policy terms may be ambiguous when applied to the actual facts of the claim. The draft also justifies the rule by citing numerous contract cases outside the insurance context.

For courts, practitioners, and insurers, this new rule has the potential to significantly disrupt coverage litigation and undermine long-established principles governing how courts interpret insurance policies. The rule would also reduce certainty for insurers and the value of having clear policy language communicate a consistent meaning. In the courtroom, insurers will also be faced with a new rule that increases the burdens of discovery while undermining the benefits of clear contract language.

**2. Section 12 (Liability of Insurers for Conduct of Defense)**

The drafters of the *Restatement of Law, Liability Insurance,* have not restated a majority or even minority view, nor clarified existing law on the liability of insurers for the action of defense counsel. Rather they have legislated public policy and foisted on insurers another avenue for recovery by an unsatisfied insured.

Despite numerous and vocal objections to the inclusion of Section 12 in the final version of the *Restatement of Law, Liability Insurance,* the drafters have bolstered the case for this Section in the introduction to the fourth version of the *Restatement* issued in August of 2017. The drafters clarified this section only applied to an insurer that undertakes the legal duty to select or supervise defense counsel, but the section does not require an insurer to either select or supervise defense counsel. In this version, the drafters revised its black letter and comments to clarify that fact without changing the substance of the provision nor heeding the objections regarding the issues with the section.

Section 12 in the latest version (Council draft of December 2017) provides:

**Liability of Insurer for Conduct of Defense**

**(1) An insurer exercising its right to defend a legal action brought against an insured is subject to vicarious liability to the insured for defense counsel's negligence or other breach of professional obligation in the following circumstances:**

**(a) Defense counsel provided by the insurer to defend a legal action, who is an employee of the insurer, causes harm to the insured while acting within the scope of that employment; or**

**(b) Defense counsel provided by the insurer to defend a legal action, who is not an employee of the insurer, causes harm to the insured while acting with the apparent authority of the insurer.**

**(2) An insurer exercising its right to defend a legal action brought against an insured is subject to liability to the insured in the following circumstances:**

**(a) The insurer undertakes to select defense counsel to defend a legal action against the insured and fails to take reasonable care in so doing, and such failure causes harm to the insured; or**

**(b) The insurer undertakes to supervise defense counsel in defending a legal action against the insured and fails to take reasonable care in so doing, and such failure causes harm to the insured.**

The drafters have supported their position that an insurer should be liable for the actions of the employee defense counsel based upon the provisions of the *Restatement, Third, Agency.* A principal is liable for the torts of its agent where the agent is a direct employee and not an independent contractor, so why, they reason should it be any different with an attorney who is a direct employee, ignoring the fact that an attorney must exercise independent professional judgment on behalf of their client, the insured, and not the insurer.

Similarly, the drafters' commentary to the August 2017 draft states the position that under subsections (2) and (3) of the section, the same agency principles support the direct liability of the insurer for the actions of its independent contractor defense counsel. The drafters reason under agency law a principal can be held liable for the torts of the agent if the principal breaches their duty in selecting or supervising the agent and that agent harms another. The drafters ignore the common law limitations on tort recovery for purely economic loss stating instead that this type of liability is more closely aligned with that of professional negligence, negligent misrepresentation or negligent performance of services.

Although the drafters concede that the issue is fact specific, they note an "insurer undertakes the duty to supervise defense counsel when the insurer retains the power to control any part of the work" of defense counsel. The section puts the onus on the insurance carrier to determine not only that defense counsel has adequate skill and experience, but that defense counsel has enough malpractice insurance which is assessed by looking at the policy under which the insured is being defended, the availability of

liability insurance coverage, the potential liability of the insured, and customary liability insurance purchasing patterns for defense lawyers handling similar legal matters. According to the drafters, this will not be burdensome to insurance carriers to vet their defense counsel on the issue of malpractice insurance. This is despite the controversy on attorneys having to disclose their malpractice limits to clients, let alone to non-client insurance carriers. In addition, what is customary for one firm may not be customary for another firm, depending on the breadth of practice, region of practice and number of attorneys. All of these factors play a part in obtaining the appropriate amount of insurance. How will an insurance carrier assess how much is enough? How will an insurance carrier determine what is customary? There is only one state in the country that requires a lawyer to carry insurance, however the *Restatement* will force the mandatory carrying of insurance coverage for all defense counsel. Because of this problem with the language the council has taken out the liability insurance provision of the last version of this section and has moved it to the Commentary as something that will go into the analysis of whether the selection of defense counsel is appropriate.

Not only does this Section of the *Restatement* as outlined in the August 2017 version leave a lot to the subjective assessment of circumstances and provide another avenue of recovery against an insurance carrier by a disgruntled insured it is also inconsistent within its own provisions. Sections 11, 14, 19, 24, 50-51 of this *Restatement* limit information that a defense counsel can share with the insurance carrier, yet Section 12 puts the onus for any negligence of defense counsel on the insurer that cannot fully supervise where all facts are not known to it.

In addition, this Section of the *Restatement* conflicts with the *Restatement, Third, Law Governing Lawyers,* especially Section 134 that provides that a third party can direct a lawyer only if the directions "does not interfere with the lawyer's independence of professional judgment." The conflict arises in that the new Section 12 in the Liability Restatement puts liability directly on the insurer even though the insurer cannot affect the independence of the lawyer's judgment. Further the comment to that *Restatement* states although an insurer can select defense counsel to represent its insured, but the attorney client relationship is between the attorney and the insured. The insured has a remedy if the attorney is negligent and that is malpractice. To correct this issue the council has rewritten this section and noted in the Commentary that an insurer can relieve itself from liability by sending a clear statement to the insured that the defense counsel is an independent contractor BUT what about the litigation guidelines, they may in many cases be interpreted as supervising the defense counsel and get you to the same place regarding liability.

This section will impact the practice of law by giving rise to conflicts with the independence and ethical duties of counsel. There are several possible scenarios of how the practice may change. The insurer may change its policy to allow selection of defense counsel of the insured's choosing with certain limitations, like the per hour billing,

however that is unlikely as the insurer would lose control of expenses and resolving the litigation at an earlier junction to save costs. Another possible result would be that insurance companies will pare their panel counsel lists down to the least number of firms or attorneys they can to handle their litigation across the country to assure them with a known quantity of lawyering. They may limit the ability of firms to use inexperienced associates on a case or have greater oversight on all actions of counsel. Insurers may limit the role of the attorney in a case, taking away any ability to negotiate or set out the plan of action. There may no longer be employee attorneys for insurance carriers and they will go back to using outside defense counsel across the country.

Clearly there will be an impact on the relationship between counsel and the insurer, but at this point it is only conjecture as to what avenue insurers will take to protect themselves from possible liability for any negligent actions of defense counsel.

**3. Sections 13 and 18 (Conditions Under Which Insurers Must Defend)**

Section 13(2) lays out the circumstances in which an insurer must defend. It requires an insurer to defend based on allegations in the complaint and known allegations outside the complaint that a reasonable insurer would regard as an actual or potential basis for all or part of the action. There are several elements of this test that are controversial.

First, Section 13 actually refers to a duty to defend the complaint "or comparable document stating the legal action." This might be read to imply that the insurer's duty to defend s broader than a suit, but it also could simply reference a cross-complaint or interpleader and thus be consistent the widely-used policy general liability language. Presumably the Reporters are also attempting to address defense to the extent it is applicable under professional liability policies where a claim or demand may trigger coverage.

Second, Section 13(2) requires the insurer to defend based on known allegations outside the complaint. The law is divided on whether an insurer must defend based on allegations outside the complaint with several jurisdictions adhering to the rule that a duty to defend cannot be created by facts outside the complaint.

Third, Section 13(2) requires a defense based on "allegations" (not "facts") outside the complaint, and allegations that a "reasonable insurer" would regard as an actual "or potential" basis for all or part of the action. This creates a duty to defend under a test that is broader than the case law in most jurisdictions and presents a vague standard that is likely to prompt litigation on what a reasonable insurer would regard as a potential basis for a part of the action.

Section 13(3) provides that an insurer must defend even if facts not at issue in the complaint and as to which there is no genuine dispute establish no coverage, except for

5 exceptions. This is a narrow exception to a rule that the insurer cannot rely on facts outside the complaint. The case law, however, supports a broader exception allowing reliance on facts that are not at issue in the underlying action, or as to which there is no genuine dispute, whether they relate to the 5 specified questions or not. The Restatement has reversed itself on this issue in various drafts. Overall, the Restatement will impose a duty to defend in circumstances where it would not exist under existing law in many states. However, note that, while "factual uncertainty" gives rise to a duty to defend, "legal uncertainty" (when a jurisdiction does not have settled coverage law) does not.

The concerns about the breadth of the duty to defend are reinforced by the requirement that the insurer must defend until its duty to defend is terminated under Section 18 by declaratory judgment, with limited exceptions. This requires judicial supervision of the insurer, disallowing it from exercising its contractual right to withdraw from the defense when facts establish the absence of coverage – without first getting permission from the court to withdraw, by filing a declaratory judgment action and obtaining a judgment. This is a waste of judicial and private resources and will add costs to insurance.

Finally, in Section 21, the Restatement takes another minority position in providing that there should be no ability of an insurer to recoup defenses costs advanced even when a court later finds there was no coverage, unless a right to reimbursement is explicitly set out in the insurance policy or an agreement with the policyholder. By overturning unjust enrichment rights, this compounds the injury of forcing the insurer to defend despite facts outside the complaint showing no coverage, and to continue defending even after facts show there is no coverage until a court judgment allows the insurer to withdraw from the defense.

Overall the impact of the Restatement project sections addressing the conditions under which insurers must defend will be to force a defense of uncovered claims in many cases, and to require that defense to continue until a court rules the insurer may withdraw. This will add to the costs of insurance, especially since the added expense is not subject to recoupment under normal unjust enrichment principles.

**4. Section 24 (Duty to Make Reasonable Settlement Decisions)**

Section 24 addresses settlement when a liability insurer has the authority to settle a legal action against the insured, or the policy requires the insurer's consent for a settlement negotiated by the insured.

Section 24(1) provides that, when there is a potential for a judgment in excess of the policy limit, the insurer has a duty to the insured to make reasonable settlement decisions. Section 24(2) defines a reasonable settlement decision a "one that would be made by a reasonable insurer that bears the sole financial responsibility for the full

amount of the potential judgment." Finally, Section 24(3) provides that the insurer's duty includes the duty to make the policy limits available for settlement of a covered legal action that exceeds those limits if a reasonable insurer would do so.

Preliminary Draft No. 4 removes controversial black letter language from the prior draft that the insurer has a duty to the insured "to protect the insured from a judgment in excess of the applicable policy limit." However, Comment b continues to state that, "…the insurer's duty is… to protect the insured from *unreasonable exposure* to a judgment in excess of the limits of the liability insurance policy" (emphasis added).

Comment d now includes additional language to propose that a "reasonable insurer" includes both the concept of an average or ordinary liability insurer "as well as a more aspirational concept that protects against circumstances in which average conduct is objectively unreasonable." It concludes, "the insurer will be liable for any excess judgment against the insured in the underlying litigation if the trier of fact finds that the insurer rejected a settlement offer that a reasonable insurer would have accepted (or failed to consent to a settlement to which a reasonable insurer would have consented."

Section 24 continues to equivocate with respect to the very controversial topic of whether an insurer is required to make a settlement offer in absence of a demand from the plaintiff. Comment f states the Section "adopts a reasonableness standard, not a hard-and-fast rule"; but proposes that, "[i]n the absence of a reasonable settlement offer by the plaintiff, there can be circumstances in which it would be unreasonable for an insurer not to make a settlement offer before trial" (such as when the policy limits are significantly less than the reasonable settlement value of the case). It acknowledges there may be good reasons for an insurer not to make an offer early on.

Finally, with respect to settlement offers in excess of policy limits, the Section confirms that an insurer has no obligation to accept or make a settlement offer that exceeds the policy limits. However, the insurer must inform the insured that the insurer is prepared to offer the policy limits toward a reasonable settlement and make the insured aware of the option to pay the amount of the settlement in excess of the limits.

**5. Sections 48 and 49 (Fee Shifting)**

Sections 48 and 49 authorize fees to be awarded to insureds after substantially prevailing in coverage disputes with insurers.

Section 48 applies where the insurer loses a coverage suit that it filed while it is defending the underlying action. Section 48(4) would require insurers to pay an insured's attorneys' fees whenever an insured substantially prevails in a declaratory judgment action brought by an insurer seeking to terminate its duty to defend. This provision is a minority position

and is also contrary to the majority rule that makes litigants responsible for their own legal fees.

Section 49 addresses the insured's right to attorney's fees when the insured obtains a ruling finding a duty to defend after the insurer declines to defend. Section 49(4) states that an insured that "substantially prevails in a declaratory-judgment action brought by an insurer seeking to terminate the insurer's duty to defend under the policy" may be entitled to its reasonable attorneys' fees. there is no explanation of what it means to "substantially prevail." If adopted, this rule would penalize insurers for filing declaratory judgment suits to seek clarification of their coverage obligations.

These one-way fee shifting provisions in the Restatement deviate from the "American Rule" that generally requires litigants to pay for their own attorneys' fees and costs, regardless of the outcome of a case. Attorney fee shifting is not limited to insurance cases but is a broader public policy issue more appropriately determined by state