

Economic Perspectives on the Restatement of the Law on Liability Insurance Project

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Abstract

This paper provides perspectives on the Restatement of the Law, Liability Insurance (RLLI) project in view of theory and evidence on the economics of liability insurance and the operation and regulation of liability insurance markets. The RLLI project reflects prodigious effort by the Reporters over six years, and many revisions in response to feedback in the drafting process and the project's evolution from Principles to Restatement. My focus is on the proposed black letter rules regarding insurers' defense obligations and other issues that would expand policyholder rights compared with existing law in a significant number or even majority of jurisdictions. These proposed rules reflect an emphasis on the potential advantages to insureds facing legal actions of expanding their post-claim rights and protections, with relatively little attention paid to the potential impacts on insurance prices, coverage terms, and demand for coverage ex ante. Such proposals risk significant disruption of current law with uncertain, unintended, and adverse consequences on liability insurance markets in the form of higher prices, less availability of coverage, reductions in policy limits purchased, aggravation of the judgment proof problem, and increased adverse selection and moral hazard.

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I. Introduction

The American Law Institute (ALI) Restatement of the Law, Liability Insurance (RLLI) project began as a “Principles” project in 2010. Reporter Professor Tom Baker and Associate Reporter Professor Kyle Logue submitted the first chapter as a discussion draft in 2012. “Tentative Drafts” of two chapters were submitted and approved by the ALI membership in 2013 and 2014. In 2014 it was decided to convert the Principles project to a Restatement. The ALI membership approved substantial portions of the first three chapters of Tentative Draft No. 1 at its May 2016 Annual Meeting: (1) Basic Liability Insurance Contract Rules, dealing with interpretation, waiver and estoppel, and misrepresentation; (2) Management of Potentially Insured Liability Claims, dealing with defense and settlement; and (3) General Principles Regarding the Risks Insured, dealing with coverage provisions, policy limits, coverage triggers and allocation, and related issues.¹ Portions of Chapters 2 and 3 were revised in Preliminary Draft No. 3 in September 2016 and Council Draft No. 3 in December 2016.

According to the ALI, the Restatement process has four principal elements: ascertaining the majority legal rule, ascertaining trends in the law, determining “what specific rule fits best with the broader body of law,” and ascertaining “the relative desirability of competing rules.”² The Reporters are not compelled to adhere to majority rules. If, however, “a Restatement declines to follow the majority rule, it should say so explicitly and explain why.”³

The RLLI project is fundamentally important in view of its potential impact on court decisions, substantive law, and the costs, terms, availability, and scope of liability insurance. The

¹ Chapter 4, which addresses enforceability and remedies, including bad faith actions, is not considered in this paper.

² The American Law Institute, *Capturing the Voice of the American Law Institute—A Handbook for ALI Reporters and Those Who Review Their Work*, revised 2015, p. 5.

³ *Ibid*, p. 6.

draft reflects prodigious effort by the Reporters, and many revisions in response to feedback in the drafting process, including changes made as the project evolved from Principles to Restatement. There has been a long and ongoing debate on the appropriate role and form of Restatements in general and whether they can be viewed as authoritative as opposed to expressions of specific views.⁴ This debate notwithstanding, the development of the RLLI confronts formidable challenges posed by a large number of complex issues with many nuances and subtleties, by wide variation in court decisions across jurisdictions, by limited theoretical and empirical evidence on the effects, benefits, and costs of particular rules, and by different perspectives concerning the criteria that should be used to assess the relative merits of different rules. It is often challenging to summarize what the law is in various jurisdictions, to make firm statements about a rule's prevalence, and to assess whether a trend exists towards adoption of a particular rule, let alone develop compelling arguments for why one rule may be preferable to another.

This paper offers perspectives on the first three chapters of the RLLI project in view of theory and evidence on the economics of liability insurance and the operation and regulation of liability insurance markets.⁵ The RLLI project has been subject to considerable debate, including

⁴ See Jay M. Feinman, *The Restatement of the Law of Liability Insurance as a Restatement: An Introduction to the Issue*, 68 Rutgers University Law Review 1(2015).

⁵ Specific quotations are from Tentative Draft No. 1, dated April 11, 2016 and Council Draft No. 3, dated December 14, 2016. George L. Priest, *A Principled Approach to Insurance Law: The Economics of Insurance and the Current Restatement Project*, June 17, 2015 provides a related analysis of an earlier RLLI draft, emphasizing the potential adverse effects of “pro-insured” proposals on the availability of liability insurance. My article with Georges Dionne, *Insurance and Insurance Markets*, in Mark Machina and W. Kip Viscusi, eds., *Economics of Risk and Uncertainty*, Vol. I (Elsevier, 2013) provides an overview of the extensive literature on the economics of insurance and insurance markets. My earlier articles with Patricia Danzon, *The Demand for and Supply of Liability Insurance*, in *Contributions to Insurance Economics*, Georges Dionne, ed. (Kluwer, 1992), and *The Economics of Liability Insurance*, in *The Handbook of Insurance*, Georges Dionne, ed. (Kluwer Academic, 2000) do likewise for liability insurance specifically. (The latter article has been updated with the same title by Jan M. Ambrose, Anne M. Carroll, and Laureen Regan, in Georges Dionne, ed., *Handbook of Insurance* (Springer, 2013).)

to a great extent whether the specific proposed rules are either excessively “pro-insured” or “pro-insurer.”

My focus is on proposed black letter rules that would expand policyholder rights with respect to insurers’ defense obligations and a number of other dimensions compared with existing law in a significant number or even majority of jurisdictions.⁶ I conclude that the stated rationales for such expansion generally are not sufficiently grounded in theory or evidence on the scope of the problems they are designed to address. They reflect an emphasis on the potential advantages to insureds facing legal actions of expanding their post-claim rights and protections, with relatively little attention paid to the potential impacts on insurance prices, terms, and demand for coverage *ex ante*. Such proposals risk significant disruption of current law with uncertain, unintended, and adverse consequences on liability insurance markets, including from the inherent uncertainty associated with their possible adoption and interpretation by the courts. The potential effects include higher prices, less availability of coverage, reductions in policy limits purchased, aggravation of the judgment proof problem, and increased adverse selection and moral hazard.⁷ The proposals therefore warrant additional consideration and revision.

Section II examines the RLLI draft’s treatment of insurers’ defense obligations, including (in the order followed in the draft) liability for conduct of the defense, the duty to defend,

⁶ My focus is on aspects of the first three chapters that could be problematic, rather than the solid treatments of a number of complex issues.

⁷ The detrimental effects of uncertainty and the potential for such effects are highlighted by the liability insurance crisis in the mid 1980s. This experience generated voluminous analysis and commentary on the underlying causes, including from greater insurer uncertainty in predicting costs and expansive court interpretations of contract language. Kenneth S. Abraham, *The Once and Future Crisis*, *Journal of Risk and Uncertainty* 4(1991), Ralph A. Winter, *The Liability Insurance Market*, *Journal of Economic Perspectives* 5 (1991), and Harrington and Danzon, *The Economics of Liability Insurance*, *supra* note 5, pp. 291-301, provide overviews. Also see Scott E. Harrington, *Liability Insurance: Volatility in Prices and in the Availability of Coverage*, in Peter H. Schuck, ed., *Tort Law and the Public Interest* (Norton, 1991). Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 *Columbia Law Review* 942(1988) discusses the adverse effects of expansive legal doctrines and judicial interpretation of policy language on insurers’ ability to write coverage in the specific context of environmental liability.

consequences of breach, recoupment of defense costs, and the duty to settle. Section III considers the treatment of contract interpretation, misrepresentation, and liability for aggravated fault. Section IV addresses arguments for expansive interpretations of liability insurance contract terms and associated legal duties within the context of the underlying economics of liability insurance. It elaborates the shortcomings of those arguments and the uncertainty and potential adverse consequences to liability insurance markets and consumers of seemingly pro-insured rules that fail to reflect adequately the underlying economics, regulation, and performance of liability insurance markets.

II. Insurers' Defense Obligations

Most liability insurance policies, such as auto liability, liability coverage included in homeowners' insurance, and small business and commercial general liability insurance, specify that the insurer has the right and duty to defend the policyholder for potentially covered claims, with the insurer bearing the cost of and controlling the defense.⁸ Bundling defense with the obligation to pay damages reduces risk to the insured of incurring potentially large defense costs, and it helps achieve efficiencies from specialization and economies of scale in the provision of defense.

Bundling defense and indemnity and allowing the insurer to control the defense generally provide the insurer with incentives—subject to contractual terms, buyer demand, and legal rules—to minimize the sum of expected indemnity and defense costs. Such cost minimization is

⁸ Charles E. Silver, Basic Economics of the Defense of Covered Claims, in Daniel Schwarcz and Peter Siegelman, eds., *Research Handbook on the Economics of Insurance Law* (Elgar, 2015) provides an overview of the treatment of defense in different types of liability policies. When an insured has both primary and excess coverage, the primary insurer generally provides for a defense of the policyholder. Excess insurers typically have the option to participate in the defense of the policyholder by the primary insurer, and sometimes do so if it appears that the claim could exceed the primary limits. (Some excess insurance policies do not provide for payment of defense costs.) If primary limits are exhausted, the primary insurer's obligation for providing a defense usually ceases.

typically consistent with the preferences of insureds, because contractual arrangements that help minimize the expected total cost of indemnity and defense allow insurers to charge lower premiums. Subject to contractual terms, buyer demand, and relevant legal rules, when an insurer is responsible for paying damages and defense costs, it generally has an incentive to incur additional defense costs only if the additional expenditure is less than the expected savings in damage payments. In contrast, if the buyer were responsible for defense and did not have to bear the cost of any damage payments, the buyer generally would have much less incentive to resist claims or negotiate a lower settlement—a form of moral hazard.⁹ Higher settlements and judgments would result, which would require higher premiums over time and reduce the amounts of coverage purchased.

Policies with the right and duty for the insurer to defend generally include several provisions that facilitate the insurer's defense obligations and rights and thereby help to reduce overall costs and premiums. The policyholder is required to provide timely notice of occurrence and timely notice of claim as a condition of coverage. The insured is required to cooperate with the insurer in its defense of a claim. The insured is often prohibited, except at its own cost, from voluntarily (i.e., without the insurer's permission) making any payment, assuming any obligation, or incurring any expense associated with an occurrence, claim, or suit.

These provisions facilitate the insurer's provision of a cost-effective defense. Late notice, lack of cooperation, or voluntary payments by an insured can prejudice the insurer by reducing its ability to negotiate settlements that help minimize the total cost of damages and defense or to resist non-meritorious claims. Notice, cooperation, and voluntary payment provisions also help prevent coordination between claimants and policyholders that could benefit the parties at the

⁹ Section IV elaborates the concept of moral hazard—policyholders' reduced incentives to prevent and control losses—and adverse selection—the greater proclivity at a given premium rate for higher risk policyholders to buy coverage than lower risk buyers.

insurer's expense, which would increase the cost and uncertainty of providing coverage and thus the premiums that insurers would need to charge. Contracts that require timely notice, cooperation with the insurer's defense, and prohibit making voluntary payments therefore allow policyholders to obtain needed protection at lower premiums than would be available without such provisions. Sophisticated policyholders with special needs (and their brokers) can seek to negotiate modifications in such provisions for higher premiums or other changes in the terms of coverage. While data are not available concerning the amount premiums would increase (or the magnitude of higher premiums for any negotiated modifications), it is patently obvious that premiums would increase due to higher defense and indemnity costs without such provisions. Moreover, changes in legal rules and contract interpretation that would diminish the force of the provisions would increase insurers' costs and uncertainty for contracts written in the past—without the ability to reprice coverage—thus adversely affecting their financial performance, financial strength, and the supply of liability coverage going forward.

While the bundling of indemnity and defense obligations provides fundamental benefits to buyers, the right and duty to defend and control the defense in liability insurance contracts is associated with a number of possible conflicts between the insurer and insured confronting a legal action.¹⁰ A variety of factors help reduce the frequency and severity of conflicts, including: (1) insurers' desires to establish and maintain favorable reputations with current and prospective buyers and with agents and brokers who assist buyers in obtaining coverage, (2) allowing an

¹⁰ See, for example, Kent D. Syverud, *The Duty to Settle*, 76 *Virginia Law Review* 1113 (1990), Alan O. Sykes, *Bad Faith Refusal to Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem*, *Journal of Legal Studies* 23 (1994), and Kenneth S. Abraham, *The Liability Insurer's Duty to Settle Uncertain and Mixed Claims*, 68 *Rutgers University Law Review* 337 (2015), which illustrate the complexities and subtleties of the issues involved. Settlement decisions are considered in a substantial and often highly technical law and economics literature, typically focusing on bilateral negotiation between plaintiffs and defendants. Kowsar Yousefi and Bernard Black, *Three-Party Settlement Bargaining with an Insurer Duty to Settle: Structural Model and Evidence from Malpractice Claims*, *Journal of Law, Economics, and Organization* 32 (2016) briefly summarizes this literature and develops a model of insurer-defendant-plaintiff interaction.

insurer to defend a claim that may not be covered under the policy while reserving its rights to deny coverage, (3) legal rules governing circumstances in which a policyholder is entitled to independent counsel, and (4) standards of professional conduct for defense counsel. Moreover, sophisticated policyholders with special needs that favor active participation by the buyer in defense and/or claim settlement generally have the ability to deal with insurers that will accommodate these interests informally or by purchasing policies with specialized contract provisions.

Given this context, the remainder of this section deals with ways in which the RLLI draft's treatments of insurers' defense obligations often deviate from majority legal views and, in my opinion, have insufficient theoretical, empirical, and/or judicial support and risk unintended and adverse consequences for liability insurance policyholders and markets, including from significant uncertainty concerning their possible adoption and interpretation by the courts.

Insurer Liability for Conduct of Defense

Section 12 on insurer liability for conduct of defense would hold an insurer liable for negligent selection or supervision of defense counsel (TD1, Sect. 12, p. 107).¹¹ In an attempt to provide an intermediate position between full vicarious liability for insurers and no vicarious liability, Section 12(2) proposes direct liability for an insurer which negligently retains "counsel with inadequate liability insurance". The goal apparently is to achieve some of the potential risk spreading and loss prevention benefits of vicarious liability. The determination of whether the amount of liability insurance was adequate would be a question of fact depending on a variety of factors set forth in Comment b (TD1, Sect. 12, p. 108).

¹¹ The page numbers are from Tentative Draft No. 1 ("TD1") dated April 11, 2016 or Council Draft No. 3 ("CD3") dated December 14, 2016.

Note a (TD1, Sect. 12, p. 109) indicates that a majority of courts reject vicarious liability for insurers and the clear trend is in that direction.¹² The Reporters do not indicate that any court has adopted their proposed rule. Little or no evidence exists of any significant problem that the proposal is designed to address.¹³ The rule would likely increase claims against insurers in many jurisdictions, increase transactions costs associated with retaining defense counsel, and involve courts in a thorny fact finding exercise. It also might expose insurers to additional claims in cases where a plaintiff's demand for damages exceeded defense counsel's own liability coverage limits, further increasing insurers' costs and needed premiums.

Duty to Defend

Section 13(3) would require an insurer to defend a legal action brought against the insured unless facts as to which there is no genuine dispute establish as a matter of law that one of four limited circumstances exists (CD3, Sect. 13, p. 1). No other information outside of the complaint and policy—even undisputed facts—could be used to relieve the insurer of its defense obligation, unless the insurer obtained a declaratory judgment.

A previous draft of Section 13(3) allowed for an “all of the facts and circumstances” approach of determining duty to defend in cases where either a vehicle for which a claim is covered under an automobile liability policy or whether a person is insured under a policy is in question. Under the facts-and-circumstances approach, “the insurer would be able to consider any and all circumstances that bear on whether the action is covered.” (CD3, Sect. 13, Comment d, p. 5). Facts would not need to be undisputed, and a declaratory judgment would not be required.

¹² Citing George M. Cohen, *Liability Insurance for Defense Counsel Malpractice*, 68 Rutgers University Law Review 119 (2015).

¹³ The Reporters cite Cohen, *ibid*, who simply argues that even a relatively small number of claims for vicarious liability suggests that some problem exists.

The Reporters justify their strict proposal based on risk spreading—stating that it would substantially reduce “uncertainty borne by insureds regarding when they can expect to receive a defense from their insurer” (CD3, Sect. 13, Comment d, p. 6). They do not discuss the potential adverse effects of the proposal on the cost of coverage nor explain whether it is likely that any reduction in uncertainty outweighs the potential costs.¹⁴

Consequences of Breach of Duty to Defend

Under Section 19(2), an insurer that breaches the duty to defend without a “reasonable basis” would lose its right to contest coverage of a claim (TD1, Sect. 19, p. 158). The Reporters view this proposed rule as “a middle ground between the rule in some jurisdictions that an insurer that breaches the duty to defend loses the right to contest coverage even if it had a reasonable basis for its conduct and the rule in other jurisdictions that the insurer that breaches the duty to defend retains the ability to contest coverage”, noting that courts in “respectable minority of states” have adopted the former approach (Sect. 19, Comment c, p. 160). This proposal represents a major change that in effect would impose extra contractual damages (sanctions)—with no nexus to any specific harm caused—under an uncertain standard that somehow differs from either negligence or bad faith. It risks all of the adverse consequences for liability insurance discussed in Section IV below.¹⁵

The Reporters’ detailed but unconvincing discussion provides little indication that a significant problem exists that would favor moving away from the law adopted by a large

¹⁴ I discuss reduction in uncertainty / risk spreading arguments generally in Section IV. Charles Silver and William T. Barker, *The Treatment of Insurers’ Defense-Related Responsibilities in the Principles of the Law of Liability Insurance: A Critique*, 68 Rutgers University Law Review 83 (2015), p. 104, argue that the reduction in uncertainty rationale has no logical stopping point without considering potential costs.

¹⁵ Also see Laura A Foggan and Karen L. Toto, *The Draft ALI Restatement of the Law of Liability Insurance: Consequences of Breach of the Duty to Defend are Not and Should Not Become the Automatic Forfeiture of Coverage Defenses*, 68 Rutgers University Law Review 65 (2015), which addresses an earlier proposal by the reporters.

majority of courts. They assert that their proposal “corrects the misalignment of incentives that might otherwise lead a rational insurer to abandon its insured in some cases” (TD1, Section 19, Comment b, p. 159), and they express concern that the majority rule allowing insurers to retain the ability to contest coverage risks turning a duty-to-defend policy into a duty-to-reimburse policy (TD1, Sect. 19, Comment d, p. 161). But there is no demonstrated need for such a significant change, the effect of which would be amplified given other proposed rules in the draft concerning the duty to defend and breach of that duty.

The Reporters acknowledge that the proposed rule could lead to increased costs and premiums (although “there is insufficient evidence to draw a sound conclusion”). They speculate that any “increase could be justified by the increased value to insureds” (TD1, Sect. 19, Comment f, p. 162), while ignoring the potential adverse effects of adoption of the proposed rule on insurers’ defense decisions and costs for policies written before the change.

Recoupment of Defense Costs

Section 21 proposes that an insurer not be allowed to recoup defense costs even if it is subsequently determined that the insurer had no defense duty or indemnity obligation, unless the right of recoupment is stated in the policy or agreed to by the insured (TD1, Sect. 21, p. 178). The Reporters support this proposal as an “emerging” default rule (TD1, Sect. 21, Comment a, p. 178). While noting that permitting recoupment is the majority rule, they assert that more recent cases “tend to allow” recoupment only if reflected in a policy term or subsequent agreement (TD1, Sect. 21, Note a, p. 179). This assertion has been strongly disputed.¹⁶

¹⁶ The Reporters cite Randy Maniloff and Jeffrey Stempel, *General Liability Insurance Coverage—Key Issues in Every State*, 3rd ed. (Mathew Bender & Company, undated) for support (TD1, Note a, p. 182). Laura A. Foggan, *Insurer Restatement of Defense Costs: Why the Restatement Adopts the Wrong Approach*, 68 Rutgers University Law Review 193 (2015) stresses that the majority view is to allow recoupment and disputes any trend towards the minority view of prohibiting recoupment absent an explicit contractual agreement, noting that (p. 195) “dozens of decisions illustrate the strong and continued vitality of the majority rule.”

An important issue is the extent to which a no recoupment rule could discourage insurers from offering a defense when there is legal uncertainty regarding the insurer's obligation. The Reporters recognize this possibility (TD1, Sect. 21, Comment c, p. 181). They argue that a no recoupment default rule permits parties to address this issue by including a policy provision permitting recoupment, or by a subsequent agreement between the parties whereby the insurer would condition defense on the right to recoup. The policy provision solution would require development of contract language, subject to regulatory approval in multiple jurisdictions and uncertain interpretation, in order to establish a specific right that would be irrelevant in a large majority of claims. In addition, many recoupment disputes could arise for claims under policies issued before any change from the majority view.¹⁷ The post-claim contracting solution would be unlikely to substantially lessen the negative effect of the proposed default rule on insurers' willingness to defend.

Duty to Settle

Section 24 of the draft sets forth a duty for insurers to make reasonable settlement decisions when the insurer has authority to settle, or when the insured has authority to settle with the insurer's prior consent, if there is potential for a judgment in excess of the policy limit (CD3, Sect. 24, p. 11). Section 24(2) defines a reasonable settlement as "one that would be made by a reasonable insurer who bears the sole financial responsibility for the full amount of the potential judgment." Comment b (CD3, Sect. 24, p. 13) essentially equates this reasonable insurer standard to a "disregard the limits" criterion: reasonable settlement decisions are those that would be made if there were no policy limit.¹⁸

¹⁷ Foggan, *ibid.*

¹⁸ Jeffrey E. Thomas, *The Standard for Breach of a Liability Insurer's Duty to Make Reasonable Settlement Decisions: Exploring the Alternatives*, 68 Rutgers University Law Review 229 (2015) notes that disregarding

Section 24 deals with one of the most complex and nuanced issues in liability insurance defense and settlement.¹⁹ The change in terminology from the “duty to settle” used by “commentators and some courts” (CD3, Sect. 24, Comment a, p. 11) to the “duty to make reasonable settlement decisions” would not be primarily semantic. The Reporters indicate that while the proposed reasonableness standard is consistent with a variety of court decisions, other courts have adopted a bad faith standard, albeit one that they argue need not vary substantially from a reasonableness standard. But movement from a bad faith standard to a negligence standard under Section 24 would represent a significant change. It would increase the leverage of claimants to achieve higher settlements, with adverse effects on the cost of coverage and amount of coverage purchased.²⁰ In addition, uncertainty concerning courts’ potential adoption and interpretation of Section 24 by itself would undermine the affordability and availability of coverage.

Moreover, at the time of purchase, a hypothetical buyer who is well informed about the likelihood that claims could exceed the policy limit might prefer a lower premium with greater risk of an excess judgment than the additional protection provided by a “disregard the limits” or related standard. Virtually all liability insurance purchase decisions tradeoff lower premiums

the limits is a minority approach and less prevalent than requiring “equal consideration” of the interests of the insured and insurer.

¹⁹ See note 10 *supra*.

²⁰ Kim V. Marrkand, *Duty to Settle: Why Proposed Restatement Sections 24 and 27 Have No Place in a Restatement of the Law of Liability Insurance*, 68 *Rutgers University Law Review* 201 (2015) argues that the RLLI’s reasonable person standard based on a retrospective analysis of purportedly reasonable settlement ranges following an excess judgment is an “innovation” that would represent a significant departure from the law in many states, create strong pressure for insurers to accept settlement demands they would otherwise reject, and increase premiums. She concludes that (p. 218) “the result would be an increase in litigation and the creation of a new legal industry based on claims arising out of section 24.” Victor E. Schwartz and Christopher E. Appel, *Encouraging Constructive Conduct by Policyholders in the Restatement of the Law of Liability Insurance*, 68 *Rutgers University Law Review* 455 (2015) argue that policyholders could exploit the RLLI’s proposed duty of reasonable settlement in ways that would increase premiums, noting that (p. 469): “The rule formulation places significant pressure on the insurer to accept any settlement demand that might be conceivably viewed as within a hypothetical range of reasonableness standard determined by a court in hindsight”

versus a greater risk of an excess judgment. Disregarding the limits likely provides more protection to insureds with limited assets than they would prefer.²¹ The nature of potential economic efficiencies from a standard that ignores policy limits under certain situations is less than transparent.

The duty to settle issue highlights the complexity that makes specifying and providing compelling support for black letter rules particularly challenging. The notion, for example, that an insurer should disregard the limits when making settlement decisions that could involve an excess judgment would seem to be based heavily on pragmatism.²² The prevalence and magnitude of the potential conflict between insurers and insureds are uncertain. An insurer that eschews settlement within or at the policy limit faces higher costs of defense and trial. Contrary to Comment a (CD3, Sect. 24, p. 12), “an insurer that rejects a reasonable settlement demand in favor of going to trial” is unequivocally not just “gambling with the insured’s money.”

Section 27 would amplify the potentially disruptive effects of Sections 24 and 19. Its proposed black letter rule (TD1, Sect. 27, p. 234) would make an insurer that fails to make reasonable settlement decisions as set forth in Section 24 liable for the full amount of damages against the insured and for any other foreseeable harm from the breach of duty. The Comments indicate that foreseeable harm could include emotional distress, damage to business reputation, and punitive damages. The inclusion of punitive damages would represent a significant change in many jurisdictions (discussed further below). The extent to which potential liability for emotional distress and damage to business reputation could unsettle existing law is uncertain.²³ The cases in

²¹ Abraham, *supra* note 10. Another issue is that plaintiffs’ lawyers apparently seldom seek to recover judgments from personal assets. Silver and Barker, *supra* note 14.

²² Abraham, *supra* note 10, notes: “The most sensible and understandable formulation of the duty [to settle] is that the insurer must disregard the limits ... of liability of its policy in deciding whether to settle.”

²³ Marrkand, *supra* note 20.

which courts have allowed damages for foreseeable losses described in Note b (TD1, Sect. 27, pp. 241-243) generally deal with bad faith breach of duty, not the negligence-type standard proposed in Section 24.

III. Other Issues

The draft's treatment of contract interpretation, misrepresentation, and damages for aggravated fault also have insufficient theoretical, empirical, and/or judicial support and risk unintended and adverse consequences on liability insurance policyholders and markets.

Contract Interpretation

Contract interpretation plays a critical role in the design and provision of liability insurance contracts to meet needs for protection at prices that maximize the value of coverage to policyholders. As illustrated by the mid-1980s' disruptions in liability insurance markets, changes in established law regarding contract interpretation and uncertainty concerning possible changes have significant potential for adverse effects on coverage terms and practices, insurers' risks, costs, prices, and the availability of coverage.²⁴

The proposed black letter rule on contract interpretation in Section 3 (TD1, Sect. 3, pp. 13-14) attempts to reach an intermediate position between courts that have adopted a "plain meaning" rule, which precludes the use of extrinsic evidence to show the meaning of a contract term if the term is unambiguous on its face, and a "contextual approach", in which extrinsic evidence is permitted to show that such a term is ambiguous. The section essentially states that a policy should be interpreted according to its "plain meaning"—unless extrinsic evidence indicates that a reasonable policyholder would give the term a different meaning that is more reasonable than the "plain meaning" (which then apparently isn't plain after all).

²⁴ See note 7 supra and Section IV below.

The Notes in Section 3 describe a variety of court decisions adopting variants of the plain meaning rule and contextual approaches. It is not clear which if either approach has been adopted in a majority of states, or the extent to which the Reporters' proposal is closely aligned with a significant number of states. The Reporters indicate that the trend has been towards the plain meaning rule rather than more contextual approaches (TD1, Sect. 3, Note a, p. 22). As a result, Section 3's proposed intermediate approach apparently is neither the majority rule, a prevalent rule, nor representative of a trend.

If adopted by courts in states that currently favor the plain meaning approach, Section 3's proposed rule would risk the adverse consequences noted above and elaborated in Section IV, including more contract disputes and higher litigation costs. The rule would increase costs of claims handling and settlement associated with challenges to unambiguous contract language. Uncertainty concerning the possible adoption and interpretation of this proposal by the courts would again by itself tend to undermine the affordability and availability of coverage.

Misrepresentation

Legal rules regarding information disclosure by applicants for insurance are fundamentally important to insurance pricing and underwriting, and to mitigating potential adverse selection in ways that mutually benefit insureds and insurers.²⁵ Section 8 on the materiality requirement for policy rescission based on misrepresentation could unsettle established doctrine in many jurisdictions, in ways that would increase insurers' risks, costs, and the premiums needed to provide coverage.

²⁵ Hugh S. Gravelle, Insurance Law and Adverse Selection, *International Review of Law and Economics* 11(1991), for example, provides an early economic analysis of how sanctions for misrepresentation can promote truthful disclosure of information and lower premiums.

Section 8 proposes that a misrepresentation is only material if absent the misrepresentation a reasonable insurer “would not have issued the policy or would have issued the policy only under substantially different terms.” (TD1, Sect. 8, p. 78). This language raises the conundrum of what constitutes “substantially”. Illustration 2 (TD1, Sect. 8, p. 80) asserts that a \$50 increase above a \$1,000 premium would not be material. The specific context notwithstanding, it is not at all clear why a 5 percent premium increase should be regarded as immaterial, especially given that liability insurers’ profit margins, including investment income, generally are only a small percentage of premiums.

Perhaps much more important, Illustration 4 (TD1, Sect. 8, p. 81) indicates that the Reporters’ proposal would place the court in the position of assessing whether even a large premium increase would be considered material unless the insurer could provide actuarial justification for the increase. This radical and ill-considered approach would involve the court in evaluating insurers’ pricing and underwriting decisions. It would impose a significant burden of proof on insurers, undermining the affordability and availability of coverage. It could also conflict with the “filed rate doctrine” in states in which premium rates are approved by state regulators. To the extent that it would reduce incentives for the accurate information disclosure by insureds, the approach would increase adverse selection and insurers’ underwriting expenses.

Damages for Aggravated Fault

A variety of insurance contract provisions help mitigate adverse selection and moral hazard and tailor coverage to what consumers are willing to pay for given the underlying cost of providing coverage (see Section IV). A common provision in liability insurance contracts excluding coverage for intentional harm plays an obvious role on these dimensions. Public policy has also commonly restricted coverage for intentional harm, and many jurisdictions prohibit liability coverage for punitive damages on public policy grounds.

Section 47 on insurance of liabilities for “aggravated fault” would expand insurers’ potential obligations—and contravene established law in many jurisdictions—by permitting any term in a policy providing coverage for defense costs for legal actions to include defense costs for criminal prosecution, actions seeking fines and penalties or punitive damages and an action alleging criminal acts, intentional harm or other aggravated fault, and any term providing coverage for civil liability arising out of aggravated fault is enforceable, including civil liability for criminal acts, intentional harm or other aggravated fault, unless barred by legislation or judicially declared public policy (CD3, Sect. 47, p. 72). The supporting Comments (CD3, Comments b, c, d, f, g, h, and i, p. 73-75) and Notes (CD3, Notes b, c, d, f, g, h, and i, pp. 76-81) rely heavily on the compensation function of tort liability—suggesting that the goal of compensating victims outweighs any deterrent and justice functions of existing prohibitions on paying such damages and questioning the magnitude of deterrence. In the case of punitive damages, the Reporters also argue that large corporations can often circumvent restrictions on insuring punitive damages by purchasing policy forms with special provisions (CD3, Sect. 47, Comment i, p. 76).

The issues are complex. Some buyers may well be willing to pay the amount of premium needed to induce insurers to supply insurance protection against the risk of damages from certain types of aggravated fault, and the potential economic viability of such coverage should inform public policy on the merits of any prohibition. But whether a Restatement should encourage courts in jurisdictions which currently prohibit such payments to change their laws is another matter entirely.

Among other issues, changes in established prohibitions could cause insurers to pay additional damages for policies that were issued and priced prior to the changes. Proposed Section 47 also could undermine insurers’ ability to enforce economically justified policy

exclusions and other coverage limitations for intentional harm, leading to higher costs for policies previously issued and higher premiums for new and renewal coverage, including from potential increases in adverse selection and moral hazard.

IV. The Limitations of Seemingly “Pro-Insured” Perspectives

From an economic perspective, appropriate legal rules help encourage the provision of liability insurance contracts that provide indemnity and defense consistent with buyers’ willingness to pay for protection at the time policies are purchased—with consideration as appropriate to complexities that arise from the judgment proof problem (see below) and the goal of reinforcing the injury deterrent function of tort liability. While the issues are highly complex and not amenable to quantification, this perspective helps focus attention on buyers’ willingness to pay for coverage, the costs to insurers of providing coverage, the potential impact of rules on the demand for coverage, and potential effects on risky behavior. It naturally leads to the question of the ways in which liability insurance markets might be imperfect, the scope of imperfections, and whether and how legal rules, in conjunction with regulation, might cost effectively mitigate those imperfections.

As noted in the introduction, the debates over the RLLI drafts have often centered on whether a particular proposed rule might be construed as either “pro-insured” or “pro-insurer”, generally in the context of whether the rule provides more or fewer rights or protection to the insured facing a legal action vis-à-vis the insurer. There generally are two major arguments for “pro-insured” proposals. The first—that risk spreading favors rules that provide greater protection to policyholders—often fails to appreciate limits on insurers’ comparative advantage in risk bearing and the potential aggravation of the liability insurance judgment proof problem (discussed further below). The second—that pro-insured rules help protect insureds from abuses that are purported to arise from an imbalance of power between insureds and insurers who draft

contract language—pays short shrift to the roles of competition and regulation in liability insurance markets, and to potential litigation under existing law. A basic understanding of insurance economics is important in assessing both arguments, as well as to understanding factors that likely drive insurers' and policyholders' expectations concerning coverage.²⁶

Limits on Insurers' Comparative Advantage in Risk Bearing

Limits on insurers' comparative advantage in bearing risk influence the optimal design of insurance contracts and should be considered when assessing existing and proposed liability rules and legal doctrines. The purchase of an insurance contract transfers specified risks of loss from the buyer to the insurer. When an insurer can reduce statistical variability in its average costs of settling and paying claims by writing many policies for different types of risk in different geographic areas—i.e., by diversifying and spreading risk—the insurer is generally better able to bear risk than the policyholder. Under suitable conditions the insurer can therefore charge a premium low enough to attract policyholders who seek protection against loss, but high enough to cover the insurer's expected costs from selling policies and produce a reasonable level of expected profit. Well-functioning insurance markets therefore work towards meeting policyholders' needs for protection at minimum cost, and competitive insurance markets entail strong incentives for the supply of coverage as long as the value of protection to policyholders—and thus their willingness to pay for coverage—exceeds the insurer's expected costs, including the cost of capital held to back the promise to pay claims.

But a number of factors limit and in some cases eliminate insurers' advantages in bearing risk. These include insurers' administrative expenses and capital costs that are required to sell and

²⁶ The economics literature on the demand for and supply of insurance and optimal contracting is vast. My article with Georges Dionne, *Insurance and Insurance Markets*, supra note 5, for example, cites over 450 references. Mark A. Geistfeld, *Interpreting the Rules of Insurance Contract Interpretation*, 68 *Rutgers University Law Review* 371, explains how economic limits on the insurability of risk can help explain limitations on liability coverage. Also see Priest and the other references in note 5 supra.

distribute policies, factors that may increase the frequency and severity of losses for many policyholders at once (“correlated losses”) or for which the magnitude of expected claim costs is highly uncertain, and potential moral hazard and adverse selection. Well-designed insurance contract provisions and legal doctrines help mitigate these problems.

Insurers’ administrative expenses associated with selling, underwriting, and distributing policies and settling claims obviously increase the premium that the insurer needs to charge above the amount needed to pay expected claims (and defense costs). Very importantly, most insurers also seek to hold enough capital and surplus—assets in excess of projected liabilities—to make it highly likely that they will have sufficient funds to meet obligations to policyholders—even if claim costs substantially exceed the amounts predicted when policies are sold. As a result, the premium must also provide a margin for the insurer to obtain a reasonable, after-tax expected return on these funds. The additional premium needed to compensate the insurer for necessary administrative expenses and provide a reasonable expected return on investment provides one rationale for contract limitations on the amount of coverage, such as deductibles or self-insured retentions, which require the policyholder to retain part of the cost of any losses that occur.²⁷

When losses can be positively correlated across policyholders from factors that increase the frequency or severity of losses for many policyholders during a given period, insurers are less able to reduce variability in their average claim costs by selling large numbers of policies. Correlated losses can arise from natural catastrophes or from unexpected inflation in the cost of medical services or of repairing or replacing damaged property, which affect claim costs for many

²⁷ While deductibles and related provisions that require policyholders to bear part of the cost of losses increase risk to the buyer, the buyer saves on some of the non-claim costs that would have to be included in the premium if more complete coverage were provided. Harris Schlesinger, The Optimal Level of Deductibility in Insurance Contracts, *Journal of Risk and Insurance* 48 (1981) provides an early technical treatment of this issue. Also see Harris Schlesinger, The Theory of Insurance Demand, in Georges Dionne, ed., *Handbook of Insurance* (Springer, 2013).

policyholders during a given period. They also can arise from unexpected increases in claim and defense costs from changes in legal rules or theories of liability of policyholders and insurers and from changes in judicial interpretation of coverage terms.²⁸

The risk of correlated losses requires insurers to hold more capital and surplus to achieve a high probability of honoring their commitments, increasing the premiums needed to sell a given amount of coverage. The higher premiums in turn reduce the attractiveness of insurance to buyers, which might lead to less coverage being purchased or modifications in the terms of coverage. The increased risk also might make some risks uninsurable.

In addition and closely related, insurers often face considerable uncertainty concerning the magnitude of expected costs of paying and settling claims at the time policies are priced (i.e., uncertainty concerning the parameters of the statistical distribution of insured losses). Insurance premiums charged at the time policies are sold or renewed reflect the insurer's estimate of the average claim cost per unit of exposure that will arise from the coverage. Statistical evaluation of historical data often leads to reasonably reliable predictions. In other cases there is considerable uncertainty about the expected average frequency and severity of claims due, for example, to limited information about prior losses, or to changes in economic, environmental, and legal factors that influence trends in losses—including possible changes in liability insurance legal doctrines and interpretation of contract provisions. This uncertainty again increases the amount of capital and surplus that insurers need to hold and thus the premiums needed to supply coverage.

²⁸ Chapter 4, Pooling Arrangements and Diversification of Risk, in my textbook with Greg Niehaus, *Risk Management and Insurance*, 2nd ed. (McGraw-Hill Irwin, 2003), provides a basic treatment of how pooling through insurance reduces the variability of average claim costs for an insurer and how positive correlation in losses increases variability. Theoretical work has analyzed how such correlation and uncertainty in predicting claim costs more generally reduces insurers' comparative advantage in bearing risk, thus increasing premiums and narrowing coverage. My article with Greg Niehaus and Tong Yu, Insurance Price Volatility and Underwriting Cycles, in Georges Dionne, ed., *Handbook of Insurance* (Springer, 2013) reviews the literature in the context of the mid-1980s liability insurance crisis. Also see note 7 *supra*.

Moral hazard also limits the insurability of risk. Insurance often reduces policyholders' incentives to take precautions to reduce the likelihood of loss or to limit the size of losses that occur. Some policyholders might engage in activities where harm is expected or intended, or deliberately cause loss, in ways that cannot be detected or proved. The expected cost of losses and thus the premium needed to provide a given amount of coverage therefore will increase. Potential moral hazard provides another reason that it often is mutually beneficial to policyholders and insurers for insurance contracts to include deductibles and other limits on coverage.²⁹ A variety of other contract provisions, insurer practices, and legal doctrines help mitigate moral hazard, including basing premiums on a policyholder's own loss experience, investigation of claims, policy exclusions and other coverage limitations, and contractual conditions regarding notice of loss or occurrence, mitigation of damage, and cooperation with the insurer.

Potential adverse selection also limits the scope of insurance and influences contract design, as well as influencing legal doctrines, such as those dealing with information disclosure by applicants for coverage. At the time a policy is purchased the buyer may have information related to the risk of loss that is unobservable to the insurer or too costly to obtain. Within a group of buyers with similar observable characteristics, buyers with higher than average expected losses are likely to buy more insurance protection at a given price per unit of coverage than buyers with lower than average expected losses. The resulting adverse selection against the insurer increases the average cost of claims overall and the premium needed per unit of coverage. The higher premium that buyers with lower than average risk of loss in a group with similar observable characteristics must pay in order for the insurer to cover the average expected claim cost for the

²⁹ Steven Shavell, On Moral Hazard and Insurance, *Quarterly Journal of Economics* 93 (1979) provides a seminal analysis of this issue. Ralph A. Winter, Optimal Insurance under Moral Hazard, in Georges Dionne, ed., *Handbook of Insurance* (Springer, 2013) reviews the academic literature.

group encourages low-risk buyers to purchase less coverage (e.g., to buy a policy with a higher deductible or lower policy limit).³⁰

Insurer underwriting and basing premium rates on the estimated risk of policyholders to the extent that is feasible and cost effective—i.e., risk-based underwriting and rating—are fundamental to increasing the homogeneity of insurance rating classes and thus reducing adverse selection (as well as providing incentives for insureds to reduce the risk of loss).³¹ Contractual limits on the total amount that an insurer will pay for certain types of losses or in aggregate help mitigate adverse selection by requiring policyholders with higher risk of loss to purchase and pay for extra protection. A variety of other policy provisions, insurer practices, and legal doctrines help mitigate adverse selection, such as excluding coverage for some types of losses, offering policies with a higher deductible or lower limits (which might help attract buyers with lower risk), and, as discussed earlier, legal doctrines that require accurate disclosure by policyholders of information concerning the risk of loss.

Willingness to Pay for Liability Insurance and the Judgment Proof Problem

Liability insurance encompasses diverse types of coverage for entities with varying exposures to different types of liability claims. There is substantial heterogeneity in buyers' characteristics and demands for coverage, ranging from purchasers of personal automobile, homeowners', and small business policies—with widely varying amounts of assets at risk from lawsuits—to large, multi-national corporations. Larger corporate buyers often have sophisticated staff with considerable knowledge of risk management and insurance, and generally are assisted

³⁰ Michael Rothschild and Joseph Stiglitz, Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information, *Quarterly Journal of Economics* 90(1976) provides the seminal theoretical treatment deriving stylized conditions where lower-risk buyers may sort into policies with lower limits. Georges Dionne, Natalie Fombaron, and Neil Doherty, Adverse Selection in Insurance Contracting, in Georges Dionne, ed., *Handbook of Insurance* (Springer, 2013) reviews the literature.

³¹ Keith Crocker and Arthur Snow, The Efficiency Effects of Categorical Discrimination in the Insurance Industry, *Journal of Political Economy* 94(1986) provides an early theoretical treatment.

by knowledgeable brokers, consultants, and/or counsel in the negotiation of complex insurance programs. Those programs frequently involve primary liability coverage and multiple layers of excess liability or umbrella coverage.

The willingness to pay for liability insurance depends fundamentally on the amount of wealth that prospective buyers would have at risk from lawsuits without insurance.³² On average, individuals, professionals, and businesses with greater assets at risk will be willing to purchase greater liability insurance limits to protect those assets. Persons or businesses with little to lose from lawsuits will purchase little or no coverage, or the minimum amounts of coverage required either by law or business necessity.

The dependence of the amount and types of liability insurance that will be willingly purchased on the insured's wealth at risk gives rise to the well-known judgment proof problem. Actual or potential tortfeasors with little wealth at risk and thus little incentive to buy liability insurance will have insufficient resources to compensate injured parties, and they may accordingly have too little incentive to take precautions to reduce the likelihood of injury to others from their activities.³³

The judgment proof problem has important implications for liability insurance contracts and legal rules governing liability insurance. Expansive coverage or legal rules that increase the cost of coverage can aggravate the judgment proof problem because the willingness to pay higher premiums for greater coverage generosity or post-claim rights will be low for entities with relatively little wealth at risk from lawsuits. Some if not many policyholders with more wealth

³² See Han-Werner Sinn, Kinked Utility and the Demand for Human Wealth and Liability Insurance, *European Economic Review* 17(1982) for an early economic analysis. Steven Shavell, The Judgment Proof Problem, *International Review of Law and Economics* 6(1986) provides the seminal treatment of the attendant judgment proof problem. Also see my articles with Patricia Danzon, *supra* note 5.

³³ See Shavell, *ibid.*

and higher coverage limits also might respond to the higher premiums necessitated by more generous coverage or broader rights by reducing the amount of coverage purchased—even if the amount of coverage *that is* purchased provides greater protection on some dimensions. In particular, legal rules or doctrines that putatively provide greater protection to policyholders following a claim may reduce the number of entities that buy liability coverage and/or the policy limits of coverage that is purchased. This issue significantly complicates the assessment of whether particular rules are plausibly optimal from a societal perspective, and it highlights the potential for adverse consequences from ostensibly “pro-insured” changes in established legal rules.³⁴

Competition, Regulation, and Imbalance of Power

When generally assessing the benefits and costs of changes in legal rules and the specific argument that an imbalance of power favors “pro-policyholder” changes, it is important to consider the underlying economic bases for insurance policy provisions and practices discussed above. It is likewise important to consider the extent to which—in addition to potential litigation under existing law and rules—market competition and insurance regulation provide substantial safeguards against potential opportunistic behavior by insurers and the scope of potential abuse. The RLLI draft pays little attention to either market competition or regulation.

Liability insurance markets are generally highly competitive, with strong market incentives to provide consumers with coverage and services they are willing to pay for.³⁵ In

³⁴ Ralph A. Winter, Liability Insurance, Joint Torfeasors and Limited Wealth, *International Review of Law and Economics* 26(2014) develops a model in which reductions in coverage purchased due to expanded liability risk can reduce compensation for injuries and incentives to avoid injury and contribute to market instability.

³⁵ As stated by Silver and Barker, *supra* note 14, p. 117: “Competition should pressure insurers to package insurance coverage in ways that policyholders want, that is, in ways that maximize the joint wealth of policyholders and insurers as contracting parties. . . .” While the markets for specialized liability coverages tend to have fewer competitors than markets for personal, small business, and commercial general liability insurance, they also have relatively more buyers with substantial knowledge of insurance or expert assistance in making insurance decisions.

addition to general reputation concerns, insurance agents and brokers play important roles in helping to protect the interests of policyholders, including the choice of appropriate coverages and insurers and advocacy in the claims process. Insurance brokers commonly monitor insurers' claims practices as part of their services to attract and retain clients. In addition, the fact that most insureds do not read the details of their insurance policies has little relevance in determining appropriate public policy if competition, insurance intermediaries, and other influences work towards providing most buyers with coverage they are willing to pay for most of the time.³⁶

In addition, liability insurance markets are subject to substantial regulation designed to protect consumers. While administrative approval of policy forms and language does not imply that there will be no ambiguities in contract language (as noted in TD1, Sect. 2, Comment I, p. 10), it does significantly supplement competition as a means to protect uninformed consumers. Policy forms for personal lines and small business coverage must be approved by state regulators in all states. Policy forms for coverage sold to larger business are subject to regulatory approval in many states. In addition, many states require numerous state-specific endorsements to liability coverage with stipulated language, belying any notion that regulatory oversight of contractual terms is passive or without force. All states also have regulatory market conduct standards and examinations that consider claims settlement practices and systems for receiving and evaluating policyholder complaints.

Insurance market competition and regulation obviously do not eliminate the possibility of opportunistic behavior by some insurers some of the time. But they significantly undermine assertions that an imbalance of power between insurers and insureds provides a major rationale

³⁶ Even apart from reputational and liability concerns, much of the law and economics literature on standard-form contracts has emphasized that sellers can be deterred from offering contracts with unfavorable terms even if only a minority of buyers pay attention to terms. Alan Schwartz and Louis Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 *University of Pennsylvania Law Review* 630(1979) provides an early analysis with this implication.

for changes in liability insurance rules that would significantly expand policyholder rights or protections beyond existing law.

Unintended and Adverse Consequences

As emphasized throughout this paper, the adoption or potential adoption of ostensibly “pro-insured” rules that change existing law risks a variety of unintended and adverse consequences. Changes in rules that increase liability insurers’ expected costs of defense and indemnity will directly and inevitably increase premiums. Increased uncertainty about legal rules to be applied and the interpretation of contract terms increases liability insurers’ risk. Other things being equal, this increase in risk requires insurers to hold more capital at higher cost to maintain the same level of solvency, further increasing costs and premiums needed to offer coverage.

Increased prices for coverage will cause some if not many buyers to reduce policy limits, increase deductibles or self-insured retentions, or otherwise reduce the scope of coverage. Fewer entities will be willing to buy any liability coverage. A number of indirect effects could occur, such as the purchase by some buyers of policies with lower quality on other dimensions (such as insolvency risk), or tightening of underwriting standards by some insurers to help control costs. Depending on the specifics, “pro-insured” doctrines also risk increased adverse selection, as they may provide relatively greater benefits to higher risk buyers (i.e., to buyers with a higher probability and greater potential severity of claims). They also might increase moral hazard.

In addition to effects on ex ante contracting, the adoption of rules that expand policyholder rights and protections would impact many claims for coverage sold and priced by insurers prior to the change. The affected insurers generally will not be able to recover fully the resulting cost increases through pricing of new and renewal business. The unexpected increase in

costs for prior policies will therefore reduce their profitability and undermine their financial strength and ability to honor commitments to policyholders.

The mid-1980s' experience and other periods of significant price increases and reduced coverage availability in liability insurance markets highlight the risks from potentially disruptive changes in existing legal rules that would increase insurers' risks, costs, and premiums needed to supply coverage. The causes of these episodes are not completely understood despite extensive research. But the evidence suggests that increases in liability insurance claim and indemnity costs and uncertainty concerning ultimate costs for claims that have occurred and future claims in an environment of changing tort doctrines and expansive coverage interpretations by the courts have played meaningful roles.³⁷

V. Conclusion

The RLLI project is fundamentally important given its potential impact on substantive law and the costs, terms, availability, and scope of liability insurance. A number of the proposed black letter rules in the draft's first three chapters would expand policyholder rights compared with existing law in a significant number or even majority of jurisdictions. The stated rationales for such expansion reflect an emphasis on the potential advantages to insureds facing legal actions of expanding their post-claim rights and protections, with insufficient consideration of the potential impacts on liability insurance prices, terms, and demand for coverage *ex ante*. As a result, a number of the RLLI proposals risk disruption of current law with uncertain, unintended, and adverse consequences on liability insurance markets in the form of higher prices, less availability of coverage, reductions in policy limits purchased, aggravation of the judgment proof

³⁷ See note 7 *supra* and Harrington, Niehaus, and Yu, *supra* note 28.

problem, and potential increases in adverse selection and moral hazard. These proposals merit further consideration and revision.