

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

By:

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

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

Liability Insurance Principles & Restatement Projects

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

In August of 2014, the ALI transmogrified the Principles to a Restatement project, the first time in ALI’s history that a project was changed from a Principles to a Restatement. Most importantly, the project thus should have abandoned the aspirational standard and instead moved to the Restatement standard requiring clear formulations of common law as it currently stands or could be appropriately stated by a court. Instead of *adapting* the Principles to a different set of standards, the Restatement essentially *adopted* the Principles as if they were the majority law rather than merely aspirational. Thus, this white paper discusses what we understand the law is, rather than what it could or should be.

¹ This Executive Summary summarizes the January 17, 2017 thirty-nine page paper prepared by the authors.

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

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

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

Regulatory Considerations

Effect on the Markets: If adopted by the courts, the Draft can disrupt the insurance market by eliminating fundamental rights of the insurer, including the protection of negotiated policy limits, the right to refuse unreasonable settlement demands, the right to exclude coverage for punitive damages and the right to rely upon unambiguous negotiated policy language. Insurer losses may increase dramatically, by requiring settlement of weak claims and payment of excessive demands to avoid extra contractual liability, while incurring increased claim handling expenses through the likely proliferation of collateral coverage litigation. The anticipated Draft induced losses, expenses and underwriting uncertainty may cause widespread disruption in the insurance market.

Market Competition: The anticipated Draft induced losses, expenses and underwriting uncertainty may have a significant anti-competitive effect on the insurance markets by forcing insurers to tighten terms and conditions or exit the market, to the detriment of all potential insureds.

Reserves: Current reserves may be found inadequate in response to the new liabilities created by the Draft. The combination of potentially inadequate premiums and claim reserves increases the risk of insurer insolvencies or other potential claim paying impairment.

Reinsurance: The Draft may force the ceding insurer to pay unreasonable settlement demands or damages that are excluded (punitive damages assessed against the insured). Reinsurers can challenge their obligation to fund unreasonable settlements or excluded damages, threatening the accessibility of this essential source of capital.

Rates: Current rate structures may be found inadequate in response to the new liabilities created by the Draft. Inadequate rates may result in increased risk of insolvencies, claim paying impairment and market exits.

Forms: The Draft's underlying premise for modifying policy rules of construction is wrong. Specifically, that policy forms are contracts of adhesion with inadequate protections in place for the insurance consumer.

Claim Handling Procedures: The Draft imposes overreaching and unnecessary quasi-strict liability on the insurer for any judgment in excess of policy limits, despite well-established regulatory, statutory and common law protections against unfair claim handling practices.

Specific ALI Restatement Topics That May Create Market Disruptions

Failure to Settle: Section 24 of the Draft subjects the insurer to excess damages beyond policy limits for failure to "make reasonable settlement decisions." By requiring the insurer to settle weak claims to avoid the risk of extra-contractual damages, Section 24 transforms a traditional "bad faith" analysis into a quasi-strict liability standard, obviating the most fundamental protection for the insurer: the negotiated

policy limits. Specifically, Section 24 diverges from established case law by: (i) potentially requiring settlement of claims with a minimal chance of success, while disregarding traditional factors that are considered when assessing the insurer's decision to refuse a settlement offer; (ii) overruling the majority rule that bad faith on the part of the insurer is required for damages in excess of the policy limits and (iii) holding the insurer liable for extra contractual damages even when the insurer acted reasonably and in good faith. Moreover, Section 27 of the Draft (in conjunction with Section 24) holds the insurer responsible for punitive damages (assessed against the insured) that are part of a judgment in excess of the policy limits following a refusal to settle, even where the insurer excludes punitive damages under the policy, if such damages were "foreseeable." Consequently, the insurer may be forced to accept unreasonable settlement demands, including paying for excluded matters, to avoid the extra-contractual damages risk created by the Draft.

Duty to Defend: Section 13 of the Draft expands the insurer's duty to defend beyond case law precedent that either limits the insurer's duty to defend to the actual pleadings or information beyond the pleadings that the insurer has actual knowledge of, by requiring the insurer to defend any claim if the insurer *should know* of information that would require the insurer to defend.

Draft Rules of Construction-Plain Meaning: Section 3 of the Draft allows the insured to disregard unambiguous policy terms, by permitting the insured to offer extrinsic evidence in the absence of any ambiguity to reconcile the insured's expectations for coverage. This rule 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.

Intentional Acts Coverage: Section 47 highlights the Draft's efforts to make the insurer a financial guarantor by presuming coverage for intentionally harmful conduct, unless barred by legislation or judicially declared public policy. The Draft is focused upon the availability of funds for victims, inappropriately interjecting a third party's perspective into a two-party contract.

Insurer's Ability to Rescind: Section 8 of the Draft does not allow the insurer to rescind coverage, following insured misconduct, unless the insurer can demonstrate that it would have issued the policy on "substantially different terms." However, case law only requires that the insurer demonstrate that it would not have issued the policy with the *same* terms and conditions.

Duty to Cooperate: Section 30 of the Draft allows the insured to refuse to cooperate with the insurer, including collusion with the plaintiff under certain circumstances, unless the insurer can demonstrate that failure to cooperate prejudiced the insurer. However, prejudice is described as being outcome determinative. This standard contradicts case law holding that the insurer is prejudiced if the insured's failure to cooperate impairs the insurer's contractual rights.

Implied-in-Law Terms and Restrictions: Section 46 of the Draft allows the parties to rewrite the insurance contract through implied-in-law terms and restrictions, which can be based upon common law. This approach diverges from the more narrow traditional view, allowing for implied-in-law terms if based upon legislation or regulations.

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