The American Law Institute Principles/ Restatement of the Law of Liability Insurance: Part III—Selected Comments From a Policyholder Perspective

by
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I. INTRODUCTION

The American Law Institute's ("ALI") Restatement of the Law, Liability Insurance project ("Restatement") presents a unique opportunity to clarify existing law and reinforce fundamental principles of insurance law. The project, under the leadership of Reporters Tom Baker and Kyle Logue,[1] began in 2010 as

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The views expressed in this article are the authors' own and should not be attributed to clients, the ALI, or others. The authors thank Advisors John G. Buchanan, David Brown, and David Mulliken, as well as Nancy Kornegay and Dustin Cho, for their contributions to this article.

[1] The Reporters for this Restatement are Professor Tom Baker of the University of Pennsylvania Law School and Professor Kyle D. Logue of the University of Michigan Law School.

a "Principles" project.[2] Under new ALI Director Ricardo Revesz, the ALI's Council voted in late 2014 to change the project to a Restatement. The project seeks to state "the efficient and fair rules that should govern the insurer/insured relationship."[3] Through its dialectical process, the Restatement reflects and molds diverse perspectives of policyholder lawyers and advocates, insurance company lawyers and advocates, judges, professors, brokers, and others.

As stated by the ALI, Restatements "provide clear formulations of common law and its statutory elements or variations and reflect the law as it presently stands or might appropriately be stated by a court."[4] The ALI also suggests that, while a Restatement aims to "recapitulate the law as it presently exists," it also reflects an "impulse to reformulate it, thereby rendering it clearer and more coherent while subtly transforming it in the process."[5] A Restatement is "work of highly competent group scholarship, thus reflecting the searching review and criticism of learned and experienced members of the bench and bar."[6]

Once finalized and published, the Restatement of the Law, Liability Insurance will significantly affect litigation outcomes, which in turn impact our economy and society. Liability insurance helps fuel the engine of our economy by protecting against risk and thus encouraging innovation and consumer confidence. It provides essential protection and a resiliency resource for businesses, people, and property. It assures compensation for accident victims and injured people, and prevents a wide range of economic devastation. We believe that, for all these reasons, the Restatement of the Law, Liability Insurance is among the ALI's most important projects.

Courts have long recognized that, as aleatory contracts—promises for future performance—insurance differs from other contracts. The Iowa Supreme Court noted the "increasing tendency of the public to look upon the insurance policy not as a contract but as a special form of chattel. The typical applicant[s buy]

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[2] *See* http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=135. As discussed further in this article, a Restatement restates and summarizes the common law. In contrast, a Principles project seeks to declare what the ALI thinks the law ought to be. American Law Institute, CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE, A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK, at 312 (2005, revised in part 2015) (available at www.ali.org/doc/stylemanual.pdf; accessed Jan. 14, 2015).

[3] *See* http://www.ali.org/00021333/Liability%20Insurance%20TD%20No%202%20-%20revised%20as%20of%20July%202014%20-%20catalog.pdf.

[4] ALI Revised Style Manual (approved by the ALI Council in Jan. 2015) (http://www.ali.org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015).

[5] ALI Revised Style Manual (approved by the ALI Council in Jan. 2015) (http://www.ali.org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015).

[6] ALI Revised Style Manual (approved by the ALI Council in Jan. 2015) (http://www.ali.org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015). The ALI website also states: "Many Institute publications have been accorded an authority greater than that imparted to any legal treatise, an authority more nearly comparable to that accorded to judicial decisions" (https://www.ali.org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015).

'protection' much as [they buy] groceries."[7] As noted during consideration of various drafts of the Principles and the current Restatement Drafts,[8] courts are frequently engaged in evaluating disputes and applying laws affecting personal lines insurance, including automobile, homeowners, and umbrella liability insurance purchased by consumers.

Policyholder advocates view the Restatement, and insurance and the topics the Restatement addresses, differently than insurer advocates in key respects.[9] We policyholder advocates view the Restatement project as an endeavor drawing on the best reasoning applied to date by courts, lawyers, and commentators that have interpreted liability insurance policies and ruled on the claim and coverage disputes. Our hope is that the project will help restore a healthy balance between the objectives of for-profit insurance companies and policyholders, insureds, claimants, and consumers. We advocate for rules that help level the playing field between the insureds, on the one hand, and the power of the insurance industry and insurers' role as repeat, "institutional" litigants.

Insurance industry advocates seek to influence the Restatement in their favor, arguing among other things, that portions of the current draft do not reflect the current state of the law because they adopt minority or plurality rules for controversial topics. They argue that the Restatement provisions are not equitable to insurers or "unjustly enrich" policyholders and insureds. They argue that many insurance consumers, especially big businesses, are "sophisticated" and do not deserve protection and the same rules on the standard-form policy provisions drafted by the insurance industry.[10] We believe that these contentions are unsupported, or ignore or downplay, insurers' breaches of their promises of protection. Regardless, however, it is crucial to keep in mind the central goal of the ALI in creating Restatements: to "make the law better adapted to the needs of life."[11] That overall objective is important in addressing insurance as it affects

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[7] C&J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 175 (Iowa 1975) (citing the reference by Professor Williston, Reporter of the RESTATEMENT (FIRST) OF CONTRACTS, to insurance as "merchandized 'protection.' ").

[8] Preliminary Draft No. 1, RESTATEMENT OF THE LAW, LIABILITY INSURANCE (Mar. 2, 2015) (available at http://extranet.ali.org/docs/Liability-Insurance-PD1%20-%20online.pdf). [hereinafter "Restatement Draft"]. Excerpts from Tentative Drafts of the Restatement of the Law of Liability Insurance copyright © 2014 and 2015 throughout this article by The American Law Institute are reproduced with permission. All rights reserved.

[9] *See, e.g.*, comments in William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW (Spring 2015).

[10] William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 25, 36 (Spring 2015). In the change from Principles to a Restatement, the Reporters have worked to adhere to ALI standards for a Restatement, seeking largely to restate the common law.

[11] ALI REVISED STYLE MANUAL (approved by the ALI Council in Jan. 2015) (http://www.ali.

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consumers, businesses, and our economy in so many ways. Insurance industry advocates consistently repeat the mantra that, if minority rules that place additional burdens on insurers are adopted in the Restatement, costs will rise. No evidence is cited in support of this contention.[12]

This article addresses the policyholder and consumer perspective on key concepts set forth in the Restatement and serves as a counterpoint to insurance industry viewpoints.[13] Section II of this article discusses the business of insurance, why it is unique among other types of contracts in the United States, and the public-policy rationale for heightened judicial scrutiny of insurance policies due to their status as adhesion contracts and their use of standard-form insurance policy provisions drafted by the insurance industry and approved by insurance regulators across the country. Even insurance policies that are "non-standard" use concepts and definitions of terms like "occurrence," "claim," and "accident," among others, that are standard-form provisions developed by the insurance industry, without negotiation by policyholders. Section III discusses fundamental principles of insurance that guide our thinking and comments. Section IV sets forth a brief background on the drafting first of the Principles and, since late 2014, the Restatement. Section V discusses selected portions of the Restatement providing policyholder commentary on Chapter 1 and analysis supporting, or in some cases suggesting revisions to the Restatement Draft's black-letter principles, Comments, and Reporters' Notes. Section VI concludes the article with a summary of important points.

In reviewing provisions proposed for, first, the Principles and now the Restatement, we have used the following concepts as touchstones for analysis:

- As courts have concluded and as discussed below (at § II): insurance is different. For example, the breach of this special kind of contract cannot be cured, as the breach of other contracts can, by providing a substitute performance.
- Almost no liability insurance policies are negotiated by policyholders. Certainly, insurance policies sold to ordinary individuals, nonprofits, and all but the very largest businesses are adhesion contracts, containing

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org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015).

[12] *See* William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 4, 25, 35, 36, 50, 62 (Spring 2015). Conversely, when the insurance industry has achieved objectives promoted as benefitting insurance consumers, insurers have often not reduced premiums. A study in 1999–2002 by the Center for Justice and Democracy authored by J. Robert Hunter and Joanne Joroshow, entitled *Premium Deceit: The Failure of "Tort Reform" to Cut Insurance Prices*, states at 2, 6, 17–18 that, after enactment of the toughest tort reform laws in the country, consumers saw no appreciable decrease in premiums.

[13] For example, those stated in William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW.

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substantive terms that are boilerplate provisions and that policyholders do not negotiate.[14] Insurance policies use standard-form language—and terms and concepts repeated from one type of insurance to the next. Even non-standard coverages (like directors and officers ("D&O"), and cyber insurance) use the same standard-form concepts. This benefits the insurance industry by allowing insurance to be mass-marketed, priced, and sold to millions of policyholders.

- There is an imbalance of power between the insurance industry and policyholders, even those that are big companies. Unlike policyholders and insureds, insurers participate in insurance industry groups, draft standard-form policy language, and routinely challenge and litigate the meaning of the standard-form contracts they draft. Policyholders simply do not do any of that, or have the knowledge that springs from it.
- Finally, policyholders and insureds[15] should not be worse off because they have insurance.

II. THE BUSINESS OF INSURANCE

Insurance is different—different from almost any other type of financial product or contract. Accordingly, as courts over the decades have concluded, insurance disputes warrant heightened judicial scrutiny and allow for unique remedies.[16] The Delaware Supreme Court, in *E.I. du Pont de Nemours & Co. v. Pressman*, stated it this way:

> Insurance is different. Once an insured files a claim, the insurer has a strong incentive to conserve its financial resources balanced against the effect on its reputation of a "hard-ball" approach. Insurance contracts are also unique in another respect. *Unlike other contracts, the insured has no ability to "cover" if the insurer refuses without justification to pay a claim*. Insurance contracts are like many other contracts in that one party (the insured) renders performance first (by paying premiums) and then awaits the counter-performance in the event of a

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[14] As noted by Samuel Williston, Reporter of the RESTATEMENT (FIRST) OF CONTRACTS in his treatise on contract law, "The insurance company tenders the insurance on a 'take it or leave it' basis." Therefore the rules "devised to govern the formation of ordinary contracts . . . cannot be mechanically applied" to insurance. SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 900 (3d ed. 1963).

[15] Both the Principles and the Restatement have included definitions of both terms. "Policyholder" is defined as:

> [T]he natural person or entity that acquires an insurance policy. In the liability insurance context, the policyholder typically is an insured under the policy, but there often are other persons or entities that also qualify as insureds.

Restatement Draft § 1(3). " 'Insured' is defined as a natural person or entity with a right to coverage under an insurance policy." *Id.* § 1(2). We adhere to those definitions throughout this article. On occasion, we use "insureds" to include both "policyholders" and "insureds" as defined in the Restatement.

[16] *See* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION (2d ed. 2000 & Supp. 2015).

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> claim. Insurance is different, however, if the insurer breaches by refusing to render the counter-performance.[17]

Insurance plays a distinctive role in our society: it spreads risk *and* provides financial security, making it possible for people and businesses to thrive and not fear bankruptcy from an adverse event. Individuals and businesses, large and small, know from experience that insurance protection from litigation, whether it is a lawsuit for damages from a slip-and-fall or a complex lawsuit, can make the difference between business as usual and ruin.[18] In discussing liability insurance specifically, an insurance executive once noted in a prominent publication covering the insurance industry that "the liability system is the engine of the insurance industry."[19] Indeed, insurance companies, unlike typical policyholders, insureds, and consumers, are in the litigation business.[20]

Insurance has proven so essential in our modern economy that Americans who want to drive cars, operate businesses, maintain their health, and borrow money to purchase a home are now legally required to buy insurance. Despite those key facts, industry advocates regard the purchase of insurance as "voluntary," that is, an ordinary contract whose breach can be cured by ordinary contractual remedies.[21] That is hardly the case.

Insurance is so crucial and so integral a part of our economy that U.S. regulators from the Financial Stability Oversight Council ("Oversight Council"), created by the Dodd-Frank law,[22] have designated numerous large insurance companies (and financial institutions) as "systemically important."[23] U.S. Treasury Secretary Jack Lew noted the "stabilizing" effect of these designations: "[T]he [Oversight] Council [has taken] another important step forward by exercising one of its principal authorities to protect taxpayers, reduce risk in the

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[17] E.I. du Pont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996) (emphasis added).

[18] As the Kentucky Supreme Court stated, "[f]rom cradle to grave, individuals are willingly paid premiums to insurance companies to obtain financial protection against property and personal loss." Curry v. Fireman's Fund Ins. Co., 784 S.W.2d 176, 179 (Ky. 1989).

[19] F. Nutter, *Search for Stability*, BUS. INS., at 21 (June 17, 1985) (cited in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 1.01[A], at 1–3 (2d ed. 2000 & Supp. 2015)).

[20] *See* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 1.01[B], at 1–10 (2d ed. 2000 & Supp. 2015).

[21] *E.g.*, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 4, 23 (Spring 2015).

[22] Pub. L. No. 111–203, 24 Stat. 1376 (2010) *codified at* 31 U.S.C. § 313 (establishing the Federal Insurance Office within the U.S. Department of the Treasury to monitor all aspects of the insurance industry).

[23] Emily Stephenson, *Council Proposes AIG, Prudential, GE Capital as Systemically Important, Due Extra Scrutiny*, REUTERS INS. J. (June 2013) (http://www.insurancejournal.com/news/national/2013/06/04/294264.htm).

financial system, and promote financial stability."[24] Commercial insurance alone accounted for $4,100,000,000 in net premiums in 2013.[25]

However, a perennial conflict exists. To insurers, the paramount purpose of selling their product may be to generate revenues to support a profitable, solvent business enterprise by reducing claim payments.[26] To policyholders and insureds, however, the economic safety-net function of insurance—the protection it promises—is paramount. For these reasons, a decades-old body of case law governs the integrity of the products that insurers sell and imposes duties upon their insurance products that are higher than those imposed on other commercial contracts.[27] As the California Supreme Court noted in a seminal insurance bad-faith case:

> Insurers' obligations are . . . rooted in their status as *purveyors of a vital service labeled quasi-public in nature. Suppliers of services affected with a public interest must take the public's interest seriously, where necessary placing it before their interest in maximizing gains and limiting disbursements* . . . . [A]s a supplier of a public service rather than a manufactured product, the obligations of insurers go beyond meeting reasonable expectations of coverage. The obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary.[28]

These duties, or rules, do—and, given the public interest and standard-form nature inherent in insurance, rightly should—apply to all insurers and all insurance products. The common-law doctrines of *contra proferentem* and *reasonable expectations* supplement black-letter contract law in almost all U.S. jurisdictions.[29] Not only have many state and federal courts of appeal recognized the special nature of the insurance relationship, but also the U.S. Supreme Court has recognized the public interest inherent in insurance.[30]

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[24] Emily Stephenson, *Council Proposes AIG, Prudential, GE Capital as Systemically Important, Due Extra Scrutiny*, REUTERS/INS. J. (June 2013) (http://www.insurancejournal.com/news/national/2013/06/04/294264.htm).

[25] *See* Insurance Information Institute, http://www.iii.org/fact-statistic/commercial-lines (accessed Mar. 11, 2015).

[26] *See, e.g.*, McKinsey slides 10, 13, 14, discussing Allstate's Claims Core Process Redesign ("Claim Objective: Improve execution and optimize balance of severities and expenses to minimize total . . . how can Allstate reduce overpayment?") (reproduced by DAVID J. BERARDINELLI, MICHAEL D. FREEMAN, AARON C. DESHAW, FROM "GOOD HANDS" TO BOXING GLOVES, HOW ALLSTATE CHANGED CASUALTY INSURANCE IN AMERICA (Trial Guides, LLC, 2d ed. 2008) (Forward by Eugene R. Anderson)).

[27] *See, e.g.*, Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141 (Cal. 1979) (emphasis added).

[28] *Egan*, 620 P.2d at 146.

[29] *See, e.g.*, 1 JEFFREY E. THOMAS, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 5.02 (*contra proferentem* has been cited and used in thousands of insurance cases). *See also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION §§ 2.02, 2.04 (2d ed. 2000 & Supp. 2015) (same).

[30] *See, e.g.*, Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 415–16 (1946) (explaining that the

Given this inherent "quasi public" interest, insurance has long been regulated.[31] However, regulators do not have the resources or authority to scrutinize every policy wording[32] submitted for approval or every insurance policy sold in their state;[33] nor does the homeowner who purchases a basic homeowners insurance policy, or even a risk manager at a Fortune 500 company who purchases a complex liability policy.[34] Most insurance purchasers do not understand—or even read—the complex documents that make up the typical insurance policy. Indeed, most (*e.g.*, auto and homeowners liability) policies are purchased, literally, sight unseen. Beyond that, however, insurers rely on standardized policy forms and concepts in order to sell and rate[35] their insurance to the millions of ordinary people and businesses who buy them. Insurance simply could not be marketed,

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"[insurance] business affected with a vast public interest"); *Robertson v. California*, 328 U.S. 440, 447 (1946); United States. v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 540 n.14 (1944) ("evils" in the sale of insurance "vitally affect the public interest"); Osborn v. Ozlin, 310 U.S. 53, 65 (1940) ("Government has always had a special relation to insurance."); O'Gorman & Young, Inc. v. Hartford Fire Ins. Co., 282 U.S. 251, 257 (1931) ("The business of insurance is so far affected with a public interest that the State may Regulate the Rates").

[31] *See generally* National Association of Insurance Commissioners, Center for Insurance Policy and Research, STATE INSURANCE REGULATION (2011) (http://www.naic.org/documents/topics_white_paper_hist_ins_reg.pdf).

[32] The Insurance Services Office, Inc., an insurance industry drafting and rating organization, drafts standard-form insurance policies and substantive policy terms used by most, if not all, insurers selling insurance in the United States.

[33] National Association of Insurance Commissioners, REGULATORY BRIEF: STATE INSURANCE REGULATION: HISTORY PURPOSE AND STRUCTURE (http://www.naic.org/documents/consumer_state_reg_brief.pdf) (only half the states require insurers to submit property-casualty forms for prior approval). Even in those states, it is questionable whether policy forms are reviewed from the standpoint of what the law is.

[34] The Reporters have omitted from Chapter 1 of the Restatement the "sophisticated policyholder" standard which appeared in drafts of the Principles. *See* PRINCIPLES OF THE LAW OF LIABILITY INSURANCE, Preliminary Draft No. 1 and 2 (revised); Restatement Draft §§ 1(5)–(6) (https://ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=23). We strongly believe that this distinction should not be made or endorsed by the Restatement because, as discussed below in our Fundamentals, it will lead to different standards applied to the very same standard-form language or terms, one for individuals, consumers, and certain companies; and a different one for other companies. Big companies often are the only ones with the resources to fight out these issues. In addition, over time, the rules for big companies will inevitably bleed over, improperly, into the consumer context, further disadvantaging those with the least power and knowledge to negotiate with the insurance industry.

[35] The insurance industry, through rates established by the insurance industry group, Insurance Services Office ("ISO"), uses rates to calculate insurance premiums. ISO calculates rates by accumulating statistics about claims and using actuarial analysis to calculate rates. Insurers apply the rates to individual policyholders or businesses to calculate premiums. Rates are set for different classes of business and could not be calculated if insurance were not standardized and sold on standardized terms, allowing "apples to apples" comparisons. *See* http://www.verisk.com/capabilities/underwriting-and-rating.html (accessed Apr. 3, 2015); *see also, e.g.*, Charles E. McClenehan, *Principles of Ratemaking*, Ch. 1 of the CASUALTY ACTUARIAL SOCIETY TEXTBOOK (Spring 1988).

priced, and sold on a mass basis were it not for the adhesion-contract, standardized nature of substantive insurance contract terms.[36]

It follows that the common-law rules governing standardized insurance terms should be the same, regardless of insurance product and type of consumer. Even "sophisticated" policyholders and insureds need courts' protection.[37] A "manuscript policy," though it may contain some substantive terms that are negotiated or supplied by the insurer, uses standard terms like "occurrence" and "accident." The primary purpose of insurance—which is sold on a mass basis using standard substantive terms developed by one side and rarely negotiated—is indemnity.[38]

The Restatement states as goals uniformity, predictability, and reduction of disputes and litigation.[39] The Restatement then should seek to promote consistency and predictability in the rules applicable to all policyholders and insureds.

III. FUNDAMENTAL PRINCIPLES

At the outset, we state our first principles. *First and foremost*, *the purpose of an insurance contract is to effectuate indemnity in case of loss*. It is not, as insurance industry advocates seem to contend, simply a device for sharing risk or earning profits.[40] Indeed, to state those goals as purposes to the exclusion of the protective purpose of insurance contradicts the public interest that insurance serves.

Second, as discussed above, insurance serves as important public purpose—hence, its status as a regulated industry. Businesses and individuals rely on insurance for crucial protection. Insurance, in turn, helps facilitate commerce and innovation.[41]

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[36] *See, e.g.*, LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION §§ 1.02, at 1-14–1-16 (2d ed. 2000 & Supp. 2015).

[37] Indeed, less than 5% of the risk managers employed by major companies have underwriting functions in their backgrounds or have even underwritten an insurance policy. They do not belong to ISO or other insurance industry organizations and do not have in-depth experience in insurance litigation or policy drafting, rating, or regulation.

[38] *See, e.g.*, Keene Corp. v. Ins. Co. of N. Am., 667 F.2d 1034, 1048 (D.C. Cir. 1981)*, cert. denied,* 455 U.S. 1007 (1982)*, rev'g,* 513 F. Supp. 47 (D.D.C. 1981) (*"Keene v. INA"*).

[39] ALI REVISED STYLE MANUAL (approved by the ALI Council in Jan. 2015) (http://www.ali.org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015).

[40] *See, e.g.*, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 2 (Spring 2015).

[41] *See, e.g.*, Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 415–16 (1946) (explaining that the "[insurance] business affected with a vast public interest"); Robertson v. California, 328 U.S. 440, 447 (1946); United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 540 n.14 (1944) ("evils" in the sale of insurance "vitally affect the public interest"); Osborn v. Ozlin, 310 U.S. 53, 65 (1940) ("Government has always had a special relation to insurance."); O'Gorman & Young, Inc. v. Hartford Fire Ins. Co., 282 U.S. 251, 257 (1931) ("The business of insurance is so far affected with a public interest that the State may Regulate the Rates"). *See also, e.g.*, National Association of Insurance Commissioners, REGULATORY BRIEF: STATE INSURANCE REGULATION: HISTORY PURPOSE AND STRUCTURE (http://www.naic.org/documents/consumer_state_reg_brief.pdf).

Third, insurance policies are not ordinary commercial contracts.[42] Insurance contracts are aleatory contracts, meaning they promise future performance.[43] In insurance, the policyholder pays a premium in exchange for a future promise of insurance coverage. Insurers understand that an individual insurance policy involves an unequal transfer. A single policyholder's premium up front likely will not pay for the cost of the defense of a lengthy lawsuit or a judgment or settlement against the insured; however, they knowingly and willingly take on this risk because it is spread among a large number of policyholders and insureds. Insurance is based on the law of large numbers—risk spread over a large number of insureds based on the calculated risk that only a small percentage of insureds will have a claim or loss in any given period.[44] Thus, insurance is both a risk-spreading device and a safety net.

Insurance is not the only form of aleatory contract. However, insurance differs from other aleatory contracts, and other contracts generally, in important respects. As the Delaware Supreme Court explained:

> In a typical contract, the non-breaching party can replace the performance of the breaching party by paying the then-prevailing market price for the counter performance. With insurance this is simply not possible. This feature of insurance contracts distinguishes them from other contracts.[45]

As one text on insurance claims-handling explains: "When an insurance company fails to pay claims it owes or engages in other wrongful practices, contractual damages are inadequate."[46]

Insurance also is unique because the product there—that is, the promise—often

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[42] *See generally* Eric M. Holmes, *A Contextual Study of Commercial Good Faith Disclosure in Contract Formation*, 39 U. PITT L. REV. 381, 393 (1978) (arguing that insurance law has never been fully integrated into ordinary contract law; "insurance is an amalgam of statutory and common law" and "whether insurance is simply a specialized body of contract law or is outside the realm of contract is somewhere in between those two statements"); *see also.*, LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 11.01, at 11-5 (2d ed. 2000 & Supp. 2015).

[43] The International Risk Management Institute ("IRMI") defines an aleatory contract as:

> [A]n agreement concerned with an uncertain event that provides for unequal transfer of value between the parties. Insurance policies are aleatory contracts because an insured can pay premiums for many years without sustaining a covered loss. Conversely, insureds sometimes pay relatively small premiums for a short period and then receive coverage for a substantial loss.

http://www.irmi.com/online/insurance-glossary/terms/a/aleatory-contract.aspx (accessed Apr. 3, 2015).

[44] *See, e.g.*, American Insurance Association, PROPERTY-CASUALTY INSURANCE BASICS: A LOOK INSIDE THE FUNDAMENTALS AND FINANCE OF PROPERTY & CASUALTY INSURANCE (http://www.aiadc.org/AIAdotNET/docHandler.aspx?DocID=319988; accessed Apr. 9, 2015).

[45] E.I. du Pont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996). The Delaware Supreme Court noted that these differences justified "the availability of punitive damages for breach in limited circumstances." *Id.*, 679 A.2d at 447.

[46] JAMES J. MARKHAM, ET AL., THE CLAIMS ENVIRONMENT 274 (1993).

is sold long before (sometimes, decades before) its benefits are either needed or delivered.[47] This promise to provide benefits in the future is the most essential component of the insurance policy, and the transaction is virtually worthless in its absence.[48] The *Restatement (Second) of Contracts* recognizes the incentives implicit in traditional contract law for insurance companies to breach:

> The traditional goal of the law of contract remedies has not been compulsion of the promisor [that is, the insurance company] to perform but compensation of the promisee [the policyholder] for the loss resulting from the breach.[49]

A policyholder wrongfully denied insurance coverage cannot be made whole by ordinary contract remedies:

> Insurance is far from the market ideals of complete information and no transaction costs. Opportunistic breaches are especially likely, and traditional damage rules do not sufficiently deter them. Additionally, it is the very nature of the insurance contract that payment is to be made automatically without the need for a lawsuit.[50]

Once they are sued, insureds cannot obtain defense and payment of claims from another source.

Moreover, delay can benefit insurers—but does not benefit policyholders. Insurance companies may use insurance accounting—which includes the creation of reserves for payment of claims and the investment monies made from them—to their benefit. By contrast, policyholders must advance monies from their own products that would otherwise benefit the business. In extreme cases, insureds face ruin.[51]

Fourth, insurance policies use standard-form terms, and their substantive terms (contrasted with terms addressing locations covered, premium, policy period, etc.) are typically not subject to negotiation as is the case with other contracts. As such they are contracts of adhesion;[52] and insurance consumers, large and small,

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[47] *See generally* Richard E. Stewart & Barbara D. Stewart, *The Loss of the Certainty Effect*, 4 RISK MGMT. & INS. REV. 29, 29–30 (2001).

[48] Richard E. Stewart & Barbara D. Stewart, *The Loss of the Certainty Effect*, 4 RISK MGMT. & INS. REV. 29, 29–30 (2001).

[49] American Law Institute, RESTATEMENT (SECOND) OF CONTRACTS, Intro. Note. ch. 16 at 100 (1979). *Accord* G. Richard Bell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 222 (1991) (footnote omitted). *See also* E.I. du Pont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996).

[50] Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Last Ten Years*, 42 ARK. L. REV. 31, 54 (1989).

[51] *See, e.g.*, Amerigraphics v. Mercury Cas. Co., 182 Cal. App. 4th 1538 (2010) (when considering a punitive damages award, the court's reprehensibility analysis focused on the fact that the insurer's failure to pay caused the insured company to go out of business).

[52] In discussing the rationale for additional tort remedies available to policyholders when an insurer breaches the covenant of good faith and fair dealing, the Connecticut Supreme Court in *Grand Sheet Metal Products Co. v. Protection Mutual Insurance Co.*, concluded: "[The] unequal

generally have no power to alter their terms.[53] Courts carefully scrutinize adhesion contracts and sometimes void certain provisions because of the possibility of unequal bargaining power, unfairness, and unconscionability. Factors in such decisions include the nature of the assent, the possibility of unfair surprise, lack of notice, unequal bargaining power, and substantive unfairness.[54] In 1966, a group called Professional Risk Managers recognized one of the important advantages of standardization:

> One reason for standardization is an attempt by the insurers to agree upon phraseology designed to best express the coverage intended . . . . Use of the same language in the policies of most companies has enabled court interpretations which clarify the meaning of policy language in any given area to be extended, in most cases, as an acceptable interpretation in similarly worded contracts and has thus avoided repeat litigation.[55]

An Insurance Services Office ("ISO") memorandum written in 1984 explained other advantages of standardization: "Reasons for this effort include savings on printing costs, simplified assembly, ease in locating policy information, and one

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bargaining power of the parties, the special nature of the insurance business, and the disastrous economic effects that a bad faith refusal to pay may cause the insured are paramount concerns." 375 A.2d 428, 430 (Conn. 1977) (citing the landmark California Supreme Court decision in Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566 (1973)). Most jurisdictions recognize standard-form insurance policies as contracts of adhesion. *See, e.g.*, Lambert v. Liberty Mut. Ins. Co., 331 So. 2d 260, 263 (Ala. 1976); Hahn v. Alaska Title Guar. Co., 557 P.2d 143, 145 (Alaska 1976); Gordinier v. Aetna Cas. & Sur. Co., 742 P.2d 277, 282 (Ariz. 1977); Hallowell v. State Farm Mut. Auto Ins. Co., 443 A.2d 925, 926 (Del. 1982); Hawaiian Ins. Guar. Co. v. Chief Clerk of First Cir. Ct., 713 P.2d 427 (Haw. 1986); Powers v. Detroit Auto. Inter-Ins. Exch., 398 N.W.2d 411, 413 (Mich. 1986). In *Prudential Insurance Co. v. Lamme*, for example, the Nevada Supreme Court emphasized that "an insurance policy is not an ordinary contract" because it is almost always drafted by the insurance company unilaterally:

> [A]n insurance policy is not an ordinary contract. It is a complex instrument, unilaterally prepared, and seldom understood by the assured . . . The parties are not similarly situated. The company and its representatives are experts in the field; the applicant is not. A court should not be unaware of this reality and subordinate its significance to strict legal doctrine.

425 P.2d 346, 347 (Nev. 1967). *Cf.* St. Paul Fire & Marine Ins. Co. v. Pryseki, 438 A.2d 282, 286–87 (Md. 1981) (Maryland courts obligation to construe insurance policies like "ordinary contracts"). *See also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 1.02, 1.03, at 1-14–1-28; § 2.01, at 2-3–2-24 (2d ed. 2000 & Supp. 2015).

[53] Friedrich Kessler, *Contracts of Adhesion-Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

[54] Legal Information Institute at Cornell Law School, *Adhesion Contract: Definition* (https://www.law.cornell.edu/wex/adhesion_contract_contract_of_adhesio; accessed Apr. 6, 2015).

[55] American Soc'y of Ins. Mgmt., CUSTOMER ANALYSIS OF THE COMPREHENSIVE GENERAL LIABILITY POLICY at iii (Professional Risk Managers ed., adopted Oct. 1966) (quoted in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 1.02[B], at 1-26 (2d ed. 2000 & Supp. 2015)).

set of forms and rules standardized for all lines of coverage."[56]

Fifth, there is an inherent imbalance of power between insurers, and policyholders and insureds—even when they are large companies.[57] To state the obvious, but necessary, point: Insurers are in the insurance business; policyholders and insureds are not. There is not simply an imbalance of power in terms of bargaining power but in terms of knowledge. Insurers go to the National Association of Insurance Commissioners ("NAIC") and ISO, for example, and get information on rates and market conditions from the American Insurance Association ("AIA"). Policyholders (even commercial ones) rarely have any of that knowledge and information. Consumers and small businesses have no access whatsoever to such information.

Sixth, insurance, by definition, serves as protection. Absent fraud, a policyholder, or an insured, should be better off for having insurance, not worse. To address these fundamentals and help ensure a level playing field, courts have developed doctrines applicable to issues and policy interpretation. For example, Professor Williston, Reporter for the *Restatement (First) of Contracts*, explained: "Courts often use the doctrine of *reasonable expectations* to enforce an insured's reasonable expectations of coverage under the adhesion contract language in an insurance policy."[58] The weaker party (the policyholder) will not be held to adhere to contract terms that are beyond what the weaker party would have reasonably expected from the contract, even if what he or she reasonably expected was outside the strict letter of agreement. Because the purpose of insurance is to effectuate indemnity in case of a loss, the understanding of the purchase—the policyholder—of the coverage offered is the most important consideration.

Similarly, a majority of courts favor *contra proferentem*, a doctrine that requires ambiguous terms to be construed in favor of the policyholder and in favor of coverage.[59] As explained in *Williston on Contracts*:

> The fundamental reason which explains [*contra proferentem*] and other forms of judicial predisposition toward the insured is the deep-seated often unconscious but justified feeling or belief that the powerful underwriter, having drafted its

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[56] Interoffice memo to File from Bob Patton regarding ISO seminar, Hartford, Connecticut, at 1 (Aug. 16–17, 1984) (quoted in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 1.01[B], at 1-26 (2d ed. 2000 & Supp. 2015).

[57] *See, e.g.*, 16 RICHARD A. LORD, WILLISTON ON CONTRACTS § 49.15 (4th ed. 2014) (referring to "the powerful underwriter"). *See also, e.g.*, Prudential v. Lamme, 425 P.2d 346, 347 (Nev. 1967) ("the parties are not similarly situated. The insurance company and its representatives are experts in the field; the applicant is not.").

[58] SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 900 (3d ed. 1963). Most jurisdictions acknowledge that the standard-form insurance policy is a contract of adhesion. *See, e.g.*, Arrow Exterminators, Inc. v. Zurich Am. Ins. Co., 136 F. Supp. 2d 1340 (N.D. Ga. 2001); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 2.01, at 2–5 (2d ed. 2000 & Supp. 2015).

[59] See discussion of the doctrine in 1 JEFFREY E. THOMAS, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 5.02.

> several types of insurance contracts with the aid of skillful and highly paid legal talent, from which no deviation desired by an applicant will be permitted, is almost certain to overreach the other party to the contract. The established underwriter is magnificently qualified to understand and protect its own selfish interests. In contrast, the applicant is a shorn lamb driven to accept whatever contract may be offered on a 'take-it-or-leave-it' basis if he or she wishes insurance protection . . . insurance policies, while contractual in nature, are certainly not ordinary contracts, and should not be interpreted or construed as individually bargained for, fully negotiated agreements, but should be treated as contracts of adhesion between unequal parties. *This is because . . . insurance contracts are generally not the result of the typical bargaining and negotiating processes between roughly equal parties that is the hallmark of freedom of contract*.[60]

The rules of interpretations applied to insurance policies do, and should, differ from those that apply to ordinary contracts.

These fundamental principles underscore the insurance law and theory that developed over the course of the 20th century. These fundamentals have not changed, and, we submit, should inform the Restatement as they have informed the development of the common law on insurance. They form the backbone of our counterpoint to Mr. Barker's "overview" and discussion of insurance.[61] We submit that the Restatement should account for these fundamentals and formulate the clearest statement of the law that is both fair and equitable while allowing for "[f]lexibility and capacity for development and growth of the common law."[62]

IV. BACKGROUND ON THE DRAFTING OF CHAPTERS 1 AND 2 OF THE RESTATEMENT

The Restatement will ultimately contain four chapters. Chapters 1 and 2 have been written but are undergoing revision at this writing given the change from a Principles project to a Restatement. Like other Restatements, the drafts of this project include statements of "black-letter" rules, followed by Comments, Illustrations, and Reporters' Notes. Chapter 1, entitled "Basic Liability Insurance Contract Principles," addresses principles of insurance policy interpretation, the doctrines of waiver and estoppel, and the effect of misrepresentations made by policyholders during the application process. Chapter 2, entitled "Management of Potentially Insured Liability Claims," focuses on the duty to defend (and pay defense costs), the duty to settle, and cooperation issues. Chapter 3 is partially written, and addresses the scope of insured risks and topics such as trigger, allocation, and issues related to high profile exclusions and conditions. Chapter 4,

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[60] 16 RICHARD A. LORD, WILLISTON ON CONTRACTS § 49.15 (4th ed. 2014) (emphasis added).

[61] *See* William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 2–4 (Spring 2015).

[62] ALI REVISED STYLE MANUAL (approved by the ALI Council in Jan. 2015) (http://www.ali.org/index.cfm?fuseaction=about.instituteworks; accessed Jan. 14, 2015).

not yet written, will focus on advanced insurance issues like choice of law, remedies, bad faith, and enforceability.

Chapters 1 and 2 were first written for the Principles and, in that form, were approved by both the ALI Council and at ALI's Annual Meetings in May 2012, 2013, and 2014. The Reporters have now revised Chapters 1 and 2 in light of the change from Principles to Restatement. The Advisors and Members Consultative Group have reviewed those revised chapters at meetings in late March 2015, and the plan at this writing is to submit those chapters to the ALI Annual Meeting in May 2015 and to the Council for approval.

V. POLICYHOLDER COMMENTARY ON CHAPTERS 1 AND 2 OF THE RESTATEMENT

A. Chapter 1: Basic Liability Insurance Contract Principles

1. Mandatory Versus Default Rules—"Negotiated" Liability Policies

Most of the rules in the Restatement are mandatory rules, *i.e.*, rules that cannot be changed by contract.[63] Having such rules helps ensure fairness and consistency in interpretation and application of the substantive standard-form policy terms used in modern liability insurance policies. This is a logical approach because insuring agreements and provisions for all types of liability insurance are almost always standardized and use standard concepts and terms. They thus use boilerplate language and constitute contracts of adhesion.[64] As Professor Rakoff explains, a contract of adhesion "purports to be a contract"; and is "drafted by, or on behalf of, one party to the transaction." Furthermore, the "drafting party will enter into the transaction only on the terms contained in the document."[65] It follows that the rules of interpretation should be guided by the equities unique to insurance contracts—our "fundamentals" discussed in Section III above. In addition, while the focus of the Restatement is liability insurance, the rules of policy interpretation adopted are universal rules, and it is important to recognize that they likely will spill over to other types of insurance.

As the Restatement states in Comments, the rules apply to all forms of liability insurance, including homeowners, automobile, and commercial liability insurance.[66] The Comments to § 1 state that "default," or non-mandatory, rules may apply to "negotiated" insurance policies—that is, "manuscript" policies issued to "sophisticated" policyholders that describe risks specific to the policyholder's trade, business, or profession. The Preliminary Draft dated March 2, 2015, defines a "negotiated liability insurance policy" as "a liability insurance policy issued to

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[63] Restatement Draft § 1(9), at 2.

[64] LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 1.01[A], at 1–7 (2d ed. 2000 & Supp. 2015).

[65] *See* T.D. Rakoff, *Contracts of Adhesion; An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1185 (1983).

[66] Restatement Draft § 1, Comment *a. Liability insurance*.

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a sophisticated commercial policyholder in which at least one term is a policy negotiated term."[67] It does not define "sophisticated commercial policyholder" in the black-letter, as did the Principles. The Comments refer to a "commercial policyholder" as "a policyholder that purchases a liability insurance policy that is wholly or primarily related to the policyholder's trade, business, or profession, including a policy purchased by a non-profit organization or a government entity."[68] The Comments further define a "sophisticated commercial policyholder" as a "commercial policyholder who is or should be reasonably well informed about how liability insurance functions, the meaning of standard terms in liability insurance policies, and the consequences of choosing alternative wording in insurance policies."[69] The black-letter also defines "negotiated term" as a "term in an insurance policy that is provided by the policyholder or with respect of which the policyholder has a meaningful role in negotiating or drafting."[70]

The distinctions between sophisticated commercial and other policyholders and negotiated policy terms are included in the Restatement[71] to allow a commercial policyholder to bargain for specific changes to substantive standardized terms in its insurance. As the Comments say:

> [W]hen the policyholder has access to expertise and the bargaining power to negotiate for a specific language in the policy, the arguments for making some of the policyholder protections of insurance law mandatory weaken. In such situations, policyholders may prefer to contract for different rules in exchange for lower premiums, for example.[72]

We strongly object to inclusion in the Restatement of provisions that might justify application of different rules for different types of policyholders and insureds. The Restatement also should be clear that "negotiated policies" are those insurance policies in which the policyholder has substantial input into the wording of the substantive contract provisions. The re-wording at the policyholder's behest of a single substantive phrase should not be used as a basis for arguing that a different rule should apply to that policyholder. Certainly, the usual and necessary negotiation over premiums, covered locations, limits, and the like should never be the basis for arguing an adhesion contract like insurance is "negotiated."[73] The

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[67] Restatement Draft § 1(4). We understand the provision may be deleted but it is in the Restatement Draft available at the time of this writing.

[68] Restatement Draft § 1, Comment *c. Negotiated insurance policies, negotiated terms, and sophisticated commercial policyholders.*

[69] Restatement Draft § 1, Comment *c. Negotiated insurance policies, negotiated terms, and sophisticated commercial policyholders*.

[70] Restatement Draft § 1(5), at 2.

[71] The Principles used the term more broadly.

[72] Restatement Draft § 1(9), Comment *c. Negotiated insurance policies, negotiated terms, and sophisticated commercial policyholders.*

[73] *See, e.g.*, Hoechst Celanese Corp. v. Certain Underwriters at Lloyd's, 656 A.2d 1094, 1100

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decision about whether a contract is negotiated should be strictly limited to those situations in which a policyholder engaged in extensive negotiations over substantive provisions throughout the contract. This distinction should not be used as a sword, but as a shield for policyholders who wish to have input into substantive insurance policy terms.

Finally, the Restatement should allow application of default rules only if the insurance policy term or terms at issue in a dispute has been negotiated by the policyholder. This rule is important to ensure uniform rules on policy terms and reduce litigation, stated goals of the Restatement.[74]

2. Commentary on Topic 1—Interpretation: Sections 2–4

a. Purpose and Theory of Insurance

To ensure that courts accord appropriate attention to the special function and standard-form nature of insurance, the Restatement should discuss in Comments the special nature of insurance at the outset of the Restatement, and when the black-letter or Comments refer to rules applicable to interpretation of ordinary contracts. The Reporters Note to § 1 recognized this issue:

> Although the legal status of insurance policies as contracts is well established, it has long been recognized that insurance policies do not in fact fit easily within an ordinary contract model. See, e.g., Edwin S. Patterson, *The Delivery of a Life Insurance Policy*, 33 Harv. L. Rev. 198 (1919); see also Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629 (1943). As a result insurance policies are not subject to all of the rules of ordinary contract doctrine. See generally Kenneth S. Abraham, *Four Conceptions of Insurance*, 163 U. Penn. L. Rev. 653 (2013). The principles stated in Chapter 1 reflect what Professor Abraham refers to as the "contract conception" of insurance, but some of the principles in other chapters are strongly influenced by the other conceptions of insurance.[75]

However, courts, parties, and others typically look to specific, relevant provisions of a Restatement and easily may overlook or not understand these differences. In addition, the Restatement Draft does not collect these distinctions in any one place, an omission that should be corrected. It is likely most important to collect these principles (theory of insurance plus fundamentals or differences between insurance and ordinary contracts) in Sections 2–4 of the Restatement which address interpretation.

Most disputes arising under insurance policies involve a dispute over what the terms mean in the context of the alleged liability or claim at issue. Given the public-interest function of insurance and its status as an adhesion contract, courts

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(Del. 1995) (insurer must show as a matter of fact that policy provisions in question were drafted in some part by the policyholder).

[74] *E.g.*, Restatement Draft § 2, Comment *c. The importance of consistent meanings of standard form policy terms.*

[75] Restatement Draft § 1 Reporters Note *a. A question of law.*

over the decades have developed rules of insurance policy interpretation. As discussed above, a number of these rules have special resonance and unique applicability in the insurance context. For these reasons, and those discussed further in Section III above on Fundamental Principles, the Restatement Draft's repeated references to rules of interpretation applicable to ordinary contracts deserve scrutiny and clarification. *First*, the Restatement Draft does not define "insurance."[76] Because most people, and courts, do not understand the theory of insurance, the distinguishing characteristics of insurance merit a definition or comment in Section 1. Definitions.

Second, the Restatement Draft provides:

> (3) Except as this Restatement otherwise provides, the ordinary rules of contract interpretation apply to the interpretation of liability insurance policies.[77]

The Restatement is seeking to reach a middle ground between a strict approach to interpretation[78] and a highly contextual approach.[79] The Restatement first defines "insurance policy interpretation"[80] and provides that insurance policy interpretation is a question of law.[81] Section 3 states the Restatement's presumption in favor of plain meaning, defining it as the

> "single meaning," if any, to which the language of the term is reasonably susceptible when applied to the claim at issue, in the context of the insurance

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[76] *See generally* Restatement Draft § 1 and Comments thereto.

[77] Restatement Draft § 2(3).

[78] As evidenced by, for example, THE RESTATEMENT (FIRST) OF CONTRACTS.

[79] As evidenced by, for example, THE RESTATEMENT (SECOND) OF CONTRACTS.

[80] In defining "insurance policy interpretation," § 2 distinguishes between interpretation and enforceability:

> (1) Insurance policy interpretation is the process of determining the meaning of the terms of an insurance policy. Whether those terms are so interpreted are enforceable is determined by reference to other legal rules.

Restatement Draft § 2(1). The Comments identify the objectives of interpretation also as follows:

> These objectives include: effecting the dominant protective purpose of insurance; facilitating the resolution of insurance-coverage disputes and the payment of covered claims; encouraging the accurate marketing of insurance policies; and providing clear guidance on the meaning of insurance policy terms in order to promote, among other benefits, fair and efficient insurance pricing, underwriting, and claims management.

Id. § 1(9).

See also id., § 2, Comment *b. Objectives of legal insurance interpretation*. These objectives in many ways, parallel the fundamental principles of insurance set forth in the article, above.

[81] Restatement Draft § 2(1), at 2. Comment *a. A question of law*, acknowledges that, in some cases, a factual question will arise that may bear on the intent of the parties in the contracting phase of in the course of performance, but "ordinarily the application of extrinsic evidence to determine the meaning of an ambiguous term is a question for the court to determine." (available at http://extranet.ali.org/docs/Liability-Insurance-PD1%20-%20online.pdf). *See* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996).

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policy as a whole, without reference to extrinsic evidence regarding the meaning of the term.[82]

Extrinsic evidence may be used to give a term a different meaning from the plain meaning as long as that different meaning is "one to which the language of the term is reasonably susceptible after consideration of the extrinsic evidence."[83] Section 3, entitled "The Presumption in Favor of the Plain Meaning of Standard Form Insurance Policy Terms," then, creates a rebuttable presumption that the plain meaning applies unless "the court determines that a reasonable person would clearly give the term a different meaning in light of the extrinsic evidence."[84] The presumption can be displaced if a court concludes that extrinsic evidence reveals an alternative meaning that "reasonable persons in the policyholder's position would give to the term under the circumstances and that the plain meaning is, in this sense, a less reasonable meaning."[85] The black-letter, importantly, also recognizes that insurance policies should be read as a whole and defines "plain meaning" as "the single meaning to which language of the term is reasonably susceptible when applied to the claim at issue."[86] This principle—that, at the outset, a court should interpret an insurance policy according to its plain meaning—is recognized in many jurisdictions.[87]

These rules are intended to bring the Restatement rules into line with "the actual practice of interpretation" especially when a court addresses the questions of law raised by interpretation on summary judgment motions. The Comments explain that this is so because the "efficient practice" in summary judgment proceedings is to consider the extrinsic evidence that parties submit in the affidavits supporting many such summary judgment motions.[88] However, this process should always proceed with reference to "the meaning that reasonable persons in the policyholder's position" would give. For a court to reject plain meaning, it must conclude that plain meaning is less reasonable; if after considering extrinsic evidence, the court cannot decide which meaning is more reasonable, "the plain meaning of the term prevails."[89]

As almost all insurance policies and certainly those sold to consumers, qualify

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[82] Restatement Draft § 3(1).

[83] Restatement Draft § 3(2).

[84] Restatement Draft § 3(1).

[85] Restatement Draft § 3, Comment *c. Rebuttable presumption.*

[86] Restatement Draft § 3(2).

[87] *See, e.g.*, BARRY R. OSTRAGER & THOMAS N. NEWMAN, HANDBOOK OF INSURANCE COVERAGE DISPUTES, § 1.01 (15th ed.); Jeffrey W. Stempel, LAW OF INSURANCE COVERAGE DISPUTES, § 4.04 (2d ed.); *accord* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 2.03 (2d ed. 2000 & Supp. 2015).

[88] Restatement Draft § 3, Comment *b. The practical operation of the presumption as opposed to a strict plain meaning rule*.

[89] Restatement Draft § 3, Comment *c. Rebuttable presumption*.

as the "archetypical adhesion contract,"[90] Section 3 allows consideration of extrinsic evidence. The Comments state this does not "refer to burden of proof, which pertains only to factual issues," but rather to the burden of persuasion.[91] This section should be read to accord with the case law that provides that an insurance company, as drafter of the policy's standard-form language, must show that its interpretation is the only reasonable interpretation under the circumstances.[92] However, the current Restatement can be read to depart too far from the more contextual approach of the *Restatement (Second) of Contracts*, and, given the Fundamentals above, the "presumption" in favor of "plain meaning" set forth in Section 3 is puzzling. The insurance industry largely controls the standard-form contract language, and insurers already routinely withhold any document discovery beyond insured-specific underwriting and claims files, thereby making it burdensome and costly (often extremely so) for insureds to gain access to the extrinsic evidence that insurers control (*e.g.*, drafting history, contemporaneous alternative wordings, etc.). We policyholder advocates do not view this proposal as an improvement in the law, or as an accurate restatement of the current majority rule. A better restatement of existing law would be a more neutral blackletter along the following lines:

> (2) A court may consider extrinsic evidence to determine whether an insurance policy term that initially appears on its face to have only one plain meaning is in fact reasonably susceptible to a different meaning in light of the extrinsic evidence.

This provision hews more closely to the *Restatement (Second) of Contracts*.[93]

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[90] S. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1464 (1989).

[91] Restatement Draft § 3, Comment *a. The plain meaning presumption*. *See also, e.g.*, Vargas v. Insurance Co. of N. Am., 651 F.2d 838, 840 (2d Cir. 1981).

[92] *See, e.g.*, LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION ch. 2 (2d ed. 2000 & Supp. 2015).

[93] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 202 (5) ("Wherever reasonable, the manifestations of intention of the parties to a promise or agreement are interpreted as consistent with each other and with any relevant course of performance, course of dealing, or usage of trade."); § 202, *Comment a.* (rules in aid of interpretation do not depend on any determination of ambiguity); § 220, *Comment d.* ("no requirement that an ambiguity be shown before usage can be shown, and no prohibition against showing that language or conduct have a different meaning in the light of usage from the meaning they might have apart from the usage."). The Comments also should provide examples not just where extrinsic evidence is used to reject coverage, but also where extrinsic evidence has been used to support coverage. This is especially important with regard to standard-form insurance where courts frequently have relied on insurance "lore" (drafting and regulatory history, course of dealing, and other background) to uphold coverage. For just a few important landmark cases as examples; *see* Keene Corp. v. Insurance Co. of N. Am., 667 F.2d 1034 (D.C. Cir. 1981) (trigger of coverage); Morton, Int'l, Inc. v. General Accident Ins. Co., 629 A.2d 831 (1993)*, motion granted, cert. denied,* 114 S. Ct. 2764 (1994), *reconsideration denied* (Jan. 13, 1994) (sudden and accidental pollution exclusion); Belt Painting Corp. v. TIG Insurance Co., 795 N.E.2d 15 (N.Y. 2003) ("absolute pollution exclusion"); *see also* Hoechst Celanese Corp. v. Certain Underwriters at Lloyd's, London, 673 A.2d 164 (Del. 1996) (definition of "property damage"). To

This rule allowing introduction of extrinsic evidence to show another reasonable meaning is the avenue in the Restatement that allows policyholders and insureds the benefit of the traditional interpretive rules applicable to ambiguous terms.[94] Those doctrines, including *contra proferentem* and other doctrines that allow for the introduction of such extrinsic material to supplement ambiguous terms, are captured in the rules on ambiguity in Section 4. We believe the Restatement should more closely follow the common law which uses such doctrines to balance the scales which, on boilerplate policy language, is already weighted toward insurers.

Section 4 defines ambiguity as a term for which "there is more than one meaning to which the language of the term is reasonably susceptible when applied to the claim in question."[95] When a term is ambiguous, it "is interpreted in favor of the party that did not supply the term, unless the other party persuades the court that this interpretation is unreasonable in light of the extrinsic evidence."[96] This section also makes clear that a standard-form term should be interpreted as if the insurer supplied it unless "the policyholder agreed in writing to the contrary."[97] While the Restatement does not explicitly incorporate the doctrines in the black-letter of *contra proferentem*, reasonable expectations and the like, the Comments do attempt to reconcile them. For example, Comments to Section 4 state that the principles in this section are "broadly consistent with the principle that insurance policy terms are to be interpreted according to the *reasonable expectations* of the insured."[98]

However, the Restatement rejects the "strongest formulation of the *reasonable*

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do otherwise puts too heavy a thumb on the scale of "plain meaning," which in our experience, tends to benefit insurers.

[94] Professor Geistfeld points out that extrinsic evidence should be allowed, at least to some extent, because purchasers of insurance, unlike parties to most ordinary contracts, rely on solicitations, ads, and oral representations at the point of sale and do not fully understand the contract or the significance of its terms. Mark Geistfeld, *Interpreting the Rules of Contract Interpretation* (forthcoming in the RUTGERS UNIVERSITY LAW SCHOOL JOURNAL, presented at the Rutgers Symposium on the Restatement (Feb. 27, 2015)). As the Restatement correctly notes "a meaning that appears plain to a judge examining an insurance policy may differ from the meaning that is plain in the circumstances in which such policies are sold." Preliminary Draft No. 1, RESTATEMENT OF THE LAW, LIABILITY INSURANCE § 3, Comment *a. The plain meaning presumption* (Mar. 2, 2015) (available at http://extranet.ali.org/docs/Liability-Insurance-PD1%20-%20online.pdf).

[95] Restatement Draft § 4(1).

[96] Restatement Draft § 4(2).

[97] Restatement Draft § 4(3).

[98] Restatement Draft § 4, Comment *b. Relationship to reasonable expectations; see, e.g.*, Travelers Ins. Co. v. Jones, 529 So. 2d 234 (Ala. 1988); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 2.05[A], at 2-46–48 (2d ed. 2000 & Supp. 2015) (many courts have adopted Professor Keeton's reasonable expectations doctrine).

expectations doctrine,"[99] referencing "wide variation in the way that courts have employed that term."[100] The Comments state that the strongest formulation of the doctrine enforces the policyholder's expectations no matter how clear the policy language is. They thus conclude that that formulation, of the doctrine is not a rule of interpretation, but of "enforceability."[101] In our view, this perspective ventures into semantics and ignores the fundamentals of insurance (and our Fundamental Principles)—that, as an aleatory contract, and a special one at that, insurance is different and perhaps unique; and, as an adhesion contract, it is subject to true negotiation of substantive terms by none but the very largest multinational companies.

The Restatement also eschews the doctrine of *contra proferentem* on the ground that it cannot be expected to eliminate all ambiguity.[102] Yet the rationale for *contra proferentem*, as discussed by Professor Williston and others, is to construe ambiguous terms in favor of coverage when the supplier of the term, the insurer, has superior bargaining power, and the insured, does not have the power or expertise to negotiate terms.[103]

Certainly, the two doctrines are complementary. In any event, rules of interpretation proposed in the Restatement should recognize that insurance policies are contracts of adhesion and are imbued with important public interest functions.[104]

The references to large or "sophisticated" commercial policyholders has led to confusion about whether the Restatement supports a different set of rules on

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[99] *See, e.g.*, Robert Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part One*, 83 HARV. L. REV. 961 (1970) (reconciling insurance law jurisprudence with the doctrine of reasonable expectations).

[100] Restatement Draft § 4, Comment *b. Relationship to reasonable expectations*.

[101] Restatement Draft § 4, Comment *k. No sophisticated policyholder exception*. That is, policy terms are unenforceable if they violate the policyholder's or the insured's *reasonable expectations*.

[102] Restatement Draft Comment *h. Interpretation against the supplier of the term*.

[103] *E.g.*, Mark Geistfeld, *Interpreting the Rules of Contract Interpretation* (forthcoming in the RUTGERS UNIVERSITY LAW SCHOOL JOURNAL, presented at the Rutgers Symposium on the Restatement 10 (Feb. 27, 2015) (citing Mark Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 329 (1986) ("As numerous commentators beginning with Patterson, Kessler and Llewellyn have noted, there is no mutual assent to most terms of an insurance policy. Policy language is standardized and mass produced. It, or language very similar to it, appears in nearly every policy of like kind offered by underwriters. The purchaser of the policy probably has no opportunity to read the policy language before purchase. And even when read, the import of much of the technical language used would, in most circumstances, escape notice. Beyond that, in the unlikely event that the potential insured could both read and understand the policy before purchase, he or she would be powerless to negotiate any change. In other words, in most cases the insurance policy is the classic example of the 'adhesion' contract."). *See also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 2.01, at 2–3 (2d ed. 2000 & Supp. 2015).

[104] SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 900 (3d ed. 1963).

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VER: [SC_00389-Local:07 Aug 13 11:14]**[MX-SECNDARY:** 08 May 15 08:57]**[TT-:** 23 Sep 11 07:01 loc=usa unit=60098-aliprinciplesrestatement] 0

interpretation of the same standard-form policies sold to big companies. However, this section specifically "rejects the idea of a sophisticated policyholder exception to the *contra proferentem* doctrine."[105] The rationale for such an exception is that both parties "have control" of the language, with no one party considered the "drafter" against which it would be construed. As stated in our section on Fundamentals, this is largely a fiction because the insurance company, in reality, always drafted all of the substantive terms, regardless of the size of the insured. According to the Comments, "[t]his rule ensures that the party most in control of the language of the policy will have the incentive to draft terms clearly and will ultimately bear the responsibility of residual ambiguity."[106] This rule is mandatory and promotes uniformity in the rule on the standard-form provisions in liability insurance contracts.[107]

In opposing these rules, insurer advocates argue that the Restatement rules will increase costs that will be passed onto other policyholders in the form of higher premiums. Regardless we have seen no empirical evidence to support such assertion.[108] We have seen little evidence of this alleged correlation between liberal interpretation rules and premium costs; perhaps more importantly, one would assume that insurers, by this point in time, have factored those rules—which have been around for decades—into premiums.

3. Commentary on Chapter 1, Topic 2—Waiver and Estoppel: Sections 5–6

a. Overview

Insurance law provides two related common-law defenses to coverage, waiver and estoppel. Either may operate to preclude an insurance company from advancing a defense to an insured's claim, and thus implicate the public policy abhorring forfeitures of coverage. As the New York Court of Appeals has said with regard to waiver, the doctrine evolved because of courts'

> disfavor of forfeitures of the insured's coverage which would otherwise result where an insured breached a policy condition, as for instance, failure to give timely notice of a loss or failure to co-operate with the insured.[109]

Courts traditionally have defined waiver as a voluntary and intentional relinquishment of a known right and found waiver where direct or circumstantial evidence shows that the insurer intended to abandon the defense to coverage. In contrast, estoppel, an equitable doctrine, arises when an insurer has pursued an

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[105] Restatement Draft § 4, Comment *k. No sophisticated policyholder exception.*

[106] Restatement Draft § 4, Comment *l. A mandatory rule.*

[107] Restatement Draft § 4, Comment *l. A mandatory rule; see also id.* at § 3, Comment *i. Non-standard form terms present a contrasting case*.

[108] *See* William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 4 (Spring 2015).

[109] Albert J. Schiff Associates, Inc. v. Flack, 435 N.Y.S.2d 972, 975 (N.Y. 1980).

action upon which the policyholder has relied to its detriment.[110] In addition to common-law principles, some states have enacted statutes that bear on this issue.[111] Unlike waiver, estoppel requires words or conduct by the insurer upon which the policyholder specifically relies to its detriment. Thus, estoppel requires a showing of prejudice while waiver typically does not. Unlike waiver, however, estoppel does not depend upon the actual or constructive knowledge by the policyholder or insured in order to give rise to prejudicial reliance.

Section 5 of the Restatement generally follows these principles. Under the Restatement, waiver is defined as follows:

> Section 5. Waiver
>
> (1) A party to insurance policy waives a right under the policy if that party, with actual or constructive knowledge of the facts giving rise to that right, expressly relinquishes the right, or engages in conduct that would reasonably be regarded by the counter party as an intentional relinquishment of that right, and the waiver is communicated to the counter party.[112]

Thus, the Restatement requires proof of these elements:

1. Actual or constructive knowledge of facts giving rise to the right subject to waiver;
2. Relinquishment of the right or conduct that reasonably can be regarded as intentional relinquishment of that right; and
3. Communication of the waiver to the counter party.

b. Insurer Objections on Waiver

Insurers have objected to this provision on the ground that it recasts the traditional standard of waiver. However, this section specifically requires an express relinquishment of a right; and actual or constructive knowledge of the facts that give rise to that right, or conduct that the policyholder would reasonably regard as an intentional relinquishment of the right; coupled with communication to the policyholder. With the "communication" element, this could be conceived as a more stringent standard than the traditional standard and should not be objectionable to insurers on that ground.

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[110] *Schiff*, 435 N.Y.S.2d at 975. For example, an insurer may undertake the defense of a policyholder or insured without reserving rights, and the policyholder rely to its detriment on the insurer's defense of the policyholder. Unlike English law, for example, waiver under U.S. law typically does not require actual knowledge of the facts relevant to waiver; constructive knowledge suffices. *See, e.g.*, Luria Bros. & Co. v. Alliance Assurance Co., 780 F.2d 1082 (2d Cir. 1986); *see also* RICHARD JACOBS, LORELIE S. MASTERS, & PAUL STANLEY, LIABILITY INSURANCE IN INTERNATIONAL ARBITRATIONS: THE BERMUDA FORM ch. 13 (2d ed. 2011) (contrasting English and New York law on waiver and estoppel).

[111] For example, New York has required by statute that insurers disclaim coverage within a reasonable time in cases involving potential liability for death or bodily injury arising out of a motor vehicle accident or any other accident happening in New York. N.Y. Ins. Law § 3420(d).

[112] Restatement Draft § 5(1).

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VER: [SC_00389-Local:07 Aug 13 11:14]**[MX-SECNDARY:** 08 May 15 08:57]**[TT-:** 23 Sep 11 07:01 loc=usa unit=60098-aliprinciplesrestatement] 0

In addition, Subsection 2 of Section 5 states: "(2) Except as otherwise provided by this Restatement or other applicable law, statements or other actions of the insurer made or taken after receiving notice of a claim do not waive the insurer's right to deny coverage for the claim."[113] From a policyholder's perspective, this could be construed as limiting also. Indeed, this proposition ignores reality. We know from experience that insurers may engage in conduct post-loss or claim that constitutes a waiver of policy defenses. English law, which is not considered as overly pro-insured, recognizes waiver, or "ratification," of a pro-insured position based on insurer conduct after a loss.[114] It may be that the Restatement is assuming that any post-loss conduct, *ipso facto*, includes reliance. The Draft does not make that point. The Restatement should not foreclose use of waiver in those situations where post-loss conduct provides a basis for waiver, particularly given the public-policy function of insurance.

The Comments to this section justify this principle on the ground that both waiver and estoppel reduce an insurer's ability to control risks that they assume, by allowing their agents to obligate insurers to assume risks that the insurers do not wish to assume. This loss of insurer control in the long run increases the price of insurance for all policyholders.[115]

First, neither the Restatement nor insurers produce evidence to support the statement that the "loss of insurer control in the long run increases the price of insurance for all policyholders." An argument like this, cited frequently by insurers, calls for evidence to support it.[116]

Second, this principle seems to rely heavily on what agents of insurers may do. It is unclear whether these references refer to insurance brokers, insurance agents, or employees acting as the agents of the insurance company as their principal. An insured relies heavily on agents of the insured, and *inter alia*, as discussed above, advertising promises when purchasing insurance. Insureds' expectations of coverage often are based on what their agents told them. The Restatement seems to adopt an insurer-friendly and unsupported position by positing, again without citation to empirical evidence, that waiver and estoppel will increase costs to insureds in the long run and, painting with too broad a brush, that policyholders

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[113] Restatement Draft § 5(2).

[114] For example, an insurer's continuing renewal of coverage may "waive" a defense of alleged misrepresentation, thus "ratifying" coverage. See the discussion, for example, in RICHARD JACOBS, LORELIE S. MASTERS, & PAUL STANLEY, LIABILITY INSURANCE IN INTERNATIONAL ARBITRATIONS: THE BERMUDA FORM ch. 13 (2d ed. 2011) (discussing cases finding waiver when insurers retained premiums and renewed coverage after learning facts that supported rescission).

[115] Restatement Draft § 5, Comment *c. The general rule of no post-loss waiver*.

[116] *See, e.g.*, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 10–18 (Spring 2015). *See also* WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION § 3.02 (2d ed.).

will be dishonest in order to obtain coverage.[117]

In commenting on these sections, insurers have cited to statements in some cases that "waiver cannot expand coverage." As the Comments to Section 5 explain, at most, that idea applies to prevent a finding that the policy should provide coverage that, absent waiver, would not apply. However, it clearly is the case that insurer conduct can waive policy conditions, such as notice or, as the Comments of the Restatement say, "a payment deadline for a premium."[118] It thus does not "expand coverage" certainly with regard to breach of policy conditions. More generally, this rule, like other rules meant to decrease incentives for insurers to breach (for example with regard to duty to defend), actually does not "expand coverage" when analyzed conceptually but, rather, provides a remedy for those situations where an insurer has refused, improperly, to perform; those results are conceptually proper as a remedy and prophylactic rule to encourage good conduct by insurers. As stated in our Fundamental Principles (Section III of this article), policyholders and insureds cannot cure a breach at the point of claim, and the "special nature" of insurance requires "special rules" to ensure proper alignment of incentives in insurance.

c. Estoppel and Reasonable Reliance

In Section 6, the Restatement codifies a long-standing black-letter rule of contract law—that a contract may be reformed or enforced without new consideration usually required for a new contract when one party detrimentally relies.[119] This rule of fairness and equity set forth in general contract law[120] properly applies in the insurance context.

The Comments explain that the Restatement's formulation of estoppel encompasses both equitable and promissory estoppel "in one rule."[121] The party seeking

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[117] *See* Restatement Draft § 5, Comment *b*. *Agency law as applied to waiver*. *See also* Comment *c*. *The general rule of no post-loss waiver*.

[118] Restatement Draft § 5, Comment *i. The rule that waiver cannot expand coverage*.

[119] Restatement Draft § 6, entitled "Estoppel" defines estoppel as follows:

> When a party to a liability insurance policy makes a promise or representation, including by engaging in conduct that the party knows or should know can reasonably be interpreted to be a promise or representation; the promise, representation, or conduct can reasonably be expected to induce detrimental reliance by another party to the policy; and that other party does in fact reasonably and detrimentally rely; the first party is estopped from denying that promise or representation.

[120] The RESTATEMENT (SECOND) OF CONTRACTS § 90 sets forth the general contract rule as follows:

> PROMISE REASONABLY INDUCING ACTION OR FORBEARANCE
>
> (1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.

[121] Restatement Draft § 6, Comment *e. Equitable and promissory estoppel*.

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VER: [SC_00389-Local:07 Aug 13 11:14]**[MX-SECNDARY:** 08 May 15 08:57]**[TT-:** 23 Sep 11 07:01 loc=usa unit=60098-aliprinciplesrestatement] 0

to invoke estoppel bears the burden of proof, and extrinsic evidence may be considered to prove the elements of estoppel.[122]

The Comments to this section make clear that, contrary to rulings by some courts (and the Restatement's current proposal on waiver), post-loss statements and conduct can provide for the basis for estoppel. Especially given the special nature of insurance and the inability of insureds to obtain performance, or cure breach, at the point of claim, this rule is necessary to ensure fairness and protection for policyholders and insureds. As the Comments state, "[t]here is no reason to suppose that pre-loss misrepresentations by an insurer are systematically more likely to be misleading or to induce reliance by insureds than post-loss misrepresentations by the insurer."[123]

Finally, the Comments state that the determination of whether the reliance was reasonable should take into account "the sophistication of the insured and the practical reality that *ordinary people do not read, and cannot reasonably be expected to read*, their insurance policies."[124] The Comment does not, and should not be read to, adopt a "sophisticated insured" rule; rather, it refers to "sophistication" as one factor to be considered in this fact-based inquiry. The Comments to this section, like those in Section 5, also recognize the role that insurance agents, who are acting under the law of agency for insurance companies, can play in creating reliance. The Comments counsel that the facts relevant to this issue govern, again a sensible stance especially given that even an insurance broker hired by the policyholder "may be an agent of the insurer for certain purposes."[125] Even where the representation of an insurer's agent "contradicts the clear language of the policy, it will generally be reasonable for the policyholder to rely on that promise or representation," subject to an exception for proof of collusion between the policyholder and the agent.[126]

As we state in Section III of this article, Fundamental Principles, an insured should not be worse off because he or she has purchased insurance; if a policyholder or an insured has reasonably relied on statements or conduct by the insurer that created prejudice, estoppel should apply.[127]

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[122] Restatement Draft § 6, Comment *h. Burden of proof* and Comment *d. Use of extrinsic evidence*.

[123] Restatement Draft § 6, Comment *g. Post-loss statements and conduct can give rise to estoppel*.

[124] Restatement Draft § 6, Comment *c. Reasonable and detrimental reliance estoppel* (emphasis added).

[125] Restatement Draft § 6, Comment *f. Agency law as applied to estoppel*; *see also* Restatement Draft § 5, Comment *b. Agency law applied to waiver*.

[126] Restatement Draft § 6, Comment *c. Reasonable and detrimental reliance*.

[127] Restatement Draft § 6, entitled "Estoppel".

4. Commentary on Chapter 1, Topic 3—Misrepresentation: Sections 7–10[128]

a. Overview

Assertion of misrepresentation defenses puts an insured, even one with means, at a distinct disadvantage. It can be dire for an insured with few assets and little time to wait for resolution of an insurance claim. Especially in a jurisdiction that precludes recovery for insurance bad faith or attorneys' fees by insureds who prevail in their fights with their insurers, it can be ruinous. This inherently fact-based inquiry typically is decided as a jury question, delaying a policyholder's recovery until the often discovery-intensive litigation over such an issue has concluded and the issue has been tried to the finder of fact. In addition, in our experience, insurers typically have failed, or refused outright, to repay policy premiums even while litigation of their misrepresentation defense proceeds. This situation violates one of our Fundamental Principles stated above: that the policyholder should not be in a worse position for having purchased insurance. This is not equitable, and the eventual vindication of the policyholder's position may come at great cost. For these reasons, policyholders and insureds sometimes make a rational decision not to fight the insurer further even in situations where the facts clearly support the policyholder's position.

Rescission should not be available as a remedy where the insurance company knew, or should have known, about an alleged misrepresentation or where the misrepresentation is not relevant to the claim.[129] While policyholders must refrain from misrepresenting facts related to the risks insured at the time the policy is purchased, insurance companies should not engage in "post-claims" or "post-loss" underwriting.[130] Material misrepresentation in this context has become a heavily

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[128] In revising the Principles to create the March 2, 2015 Restatement Draft, the Reporters renumbered sections and deleted some provisions included in the Principles. As a result, the Draft includes no Section 11.

[129] *See, e.g.*, Lewis v. Equity Nat'l Life Ins. Co., 637 So. 2d 183 (Miss. 1994) ("*Lewis*").

[130] "Post-claim underwriting" or "post-loss underwriting" (or "retroactive underwriting" in the property insurance context) occurs when an insurer denies coverage for claims based on information it could have sought or ascertained at the time of application but chose not to or knew yet accepted the application for coverage. *See generally* Thomas C. Cady & Georgia Lee Gates, *Post Claim Underwriting*, 102 W. VA. L. REV. 809, 813 (2000) ("Cady & Gates"). In our experience, it also arises when the value of the claim involves not just two or three zeros, but six or more zeros; or when the claim is one, like asbestos or claims arising out of other disasters, that potentially may arise with great frequency. *See, e.g.*, First Colony Life Ins. Co. v. Sanford, 480 F. Supp. 2d 870, 875 (S.D. Miss. 2007) (discussing the assertion by plaintiff's attorneys that insurers engage in "post-claims underwriting" by issuing coverage based on the application responses and only investigate the accuracy of such responses with the intent of voiding the policy and claim time); *see also* Cady & Gates, at 827 (citing RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 5 4.1. (5th ed. 1998) ("An insurer engaged in post claim underwriting tries to take advantage of the postponement in fulfilling its promise, made possible by sequential performance, by waiting until after a claim has been filed to determine [policyholder's] eligibility. It takes advantage of [the policyholder] because it continues to accept premiums from the [policyholder], knowing that it will challenge the

litigated issue primarily because insurers often claim not to have learned of the misrepresentation until the time of the claim despite having ample resources to investigate applications and underwrite risks.[131]

Section 7 defines the Restatement's general rules on misrepresentation, defining "misrepresentation" as "[a]ny statement of a past or present fact made by a policyholder applying for renewing a liability insurance policy."[132] It identifies the elements of misrepresentation as:

(a) The misrepresentation was either intentional or reckless as defined in § 8;

(b) The insurer reasonably relied on the misrepresentation in issuing or renewing the policy as specified in § 9; and

(c) The misrepresentation was material as defined in § 10.[133]

Section 8 defines when representations are "intentional" or "reckless."[134] Section 9 defines the detrimental reliance requirement, which must be reasonable and can be satisfied only if such actions "would have been reasonable under the circumstances."[135]

As the Comments note, these requirements, as with the misrepresentation doctrine generally, include "both subjective and objective aspects."[136] Subsection a. of Section 9 requires proof that the insurer in question would not have issued the policy or would have issued it with substantially different terms absent the misrepresentation. Section 10, similarly, includes both objective and subjective elements. It refers to a "reasonable insurer" but states that such an insurer must be "in this insurer's position."[137] As discussed below, an objective insurer standard

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policyholder's eligibility for coverage to avoid contract performance. As a consequence, the law of contracts should protect the [policyholder] from an insurer's efforts to implement post claim underwriting as a means of taking advantage of the vulnerabilities created by sequential performance.")).

[131] *Lewis*, 637 So. 2d at 188–89.

[132] Restatement Draft § 7(1).

[133] Restatement Draft §§ 7(2)(a)–(c).

[134] Restatement Draft §§ 8(1) and (2) states:

> Section 8. Intentional or Reckless Misrepresentation by Policyholder
>
> (1) A misrepresentation by a policyholder is intentional only if at the time it is made the policyholder knows or believes that the statement is false.
>
> (2) A misrepresentation by a policyholder is reckless only if at the time it is made the policyholder is willfully indifferent to whether the statement was true or false.

[135] Restatement Draft §§ 9(1) and (2).

[136] Restatement Draft § 9, Comment *a. The function of the detrimental reliance requirement*.

[137] Restatement Draft § 10, is entitled "Materiality Requirement." The Restatement defines "materiality" in Section 10 as follows:

> Misrepresentation by [a policyholder] during the application or renewal of an insurance policy is material only if, in the absence of the misrepresentation, a reasonable insurer in this insurer's

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VER: [SC_00389-Local:07 Aug 13 11:14]**[MX-SECNDARY:** 08 May 15 08:57]**[TT-:** 23 Sep 11 07:01 loc=usa unit=60098-aliprinciplesrestatement] 0

skews the standard significantly toward insurers, particularly if, as in the current Restatement Draft, ameliorating rules on proof are not included.

Finally, in a sensible and equitable rule—but one in experience honored not even in the breach—under Section 7(4), an insurer must return the policyholder's premium if it asserts a misrepresentation defense.

b. Standard for Insurer Reliance and Materiality

An insurer will be deemed to have been prejudiced by a misrepresentation if it would not have issued the policy, or would have issued the policy with substantially different terms, had it known the truth.[138] The Comments state that the standard articulated includes both subjective and objective elements:

> Misrepresentation doctrine includes both subjective and objective aspects. The reliance element, especially in § 9(1), primarily addresses the subjective aspect: the impact of the misrepresentation on the particular insurer. This element requires an insurer to demonstrate that the misrepresentation caused it significant harm. *If the insurer would have issued the policy on substantially the same terms even if it had received the correct information, then the insurer did not rely to its detriment on the misrepresentation.* Thus, a misrepresentation by an insured will not render a policy voidable when the insurer has actual knowledge of the true facts or of the falsity of the insured's representation. While the materiality requirement focuses on what a reasonable insurer in this insurer's position would have done absent the misrepresentation in question, the reliance requirement focuses on what the particular insurer seeking to invoke the misrepresentation doctrine would have done absent the misrepresentation.[139]

The "substantiality" aspect of the reliance requirement is intended to discourage rescissions for trivial reasons.[140]

A misrepresentation is material if it affects "(1) the acceptance of the risk or (2)

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position would not have issued the policy or would have issued the policy only under substantially different terms.

The Restatement Draft dated March 2, 2015, used "an insured" in place of "a policyholder" in the black-letter; however, the Reporters acknowledged that this provision should be revised to refer to "policyholder" rather than "insured" given the definitions in Section 1 of those two terms.

[138] Restatement Draft §§ 9(1) and (2). Section 9, entitled "Reasonable Detrimental Reliance Requirement," provides:

> The reliance requirement of § 7(2)(b) is met only if (1) Absent the misrepresentation, the insurer would not have issued the policy or would have issued the policy only with substantially different terms; and (2) Such actions would have been reasonable under the circumstances.

See also RESTATEMENT (SECOND) OF CONTRACTS § 162.

[139] Restatement Draft § 9, Comment *a. The function of the detrimental reliance requirement* (emphasis added).

[140] Restatement Draft Comment *b. The function of the substantiality aspect of the reliance requirement*.

the hazard assumed by the company."[141] Consistent with our Fundamental Principles stated above, the Restatement rules here should make clear that an insurer cannot void coverage unless it can show that it, subjectively, would not have issued this policy or would have required substantially different terms had it known the facts.

A purely objective standard is a harsh, or certainly harsher, one, than a subjective one; it also is one that is not, in our view, the majority rule in the United States. It does not adequately protect policyholders or insureds who, as stated above, are at a disadvantage vis-a-vis their insurers and ignores the proof requirements that ameliorate the effect of the rules, confirming the subjective approach that protects policyholders from the harsh effects of what the Restatement Draft seems to see as a "strict liability" standard.[142] Section 3105 of New York Insurance Law specifically requires proof that the insurer would not have written the insurance policy in question on the same terms had the policyholder presented the facts accurately, an important distinction from English law, which applies a "reasonable" underwriting standard.[143] Therefore, the question of a "reasonable" or a "prudent" underwriter is not dispositive under New York law. The New York statute also requires the insurer to show that the misrepresentation was material,[144] and case law interpreting that provision specifically concludes that unsupported, conclusory statements from the underwriter will not sustain the insurer's burden of proof on this issue.[145] It is reasonable to require, as New York courts do, documented evidence of the insurer's underwriting policies and its

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[141] Restatement Draft § 10, entitled "Materiality Requirement," provides:

> A misrepresentation by an insured during the application or renewal of an insurance policy is material only if, in the absence of the misrepresentation, a reasonable insurer in this insurer's position would not have issued the policy or would have issued the policy only under substantially different terms.

[142] *See, e.g.*, discussion of differences between New York law on the one hand and English law on the other on misrepresentation at RICHARD JACOBS, LORELIE S. MASTERS, & PAUL STANLEY, LIABILITY INSURANCE IN INTERNATIONAL ARBITRATIONS: THE BERMUDA FORM ¶¶ 12.01–12.11 (2d ed. 2011).

[143] See discussion of New York Insurance Law standards on misrepresentation in RICHARD JACOBS, LORELIE S. MASTERS, & PAUL STANLEY, LIABILITY INSURANCE IN INTERNATIONAL ARBITRATIONS: THE BERMUDA FORM ch. 12 (2d ed. 2011).

[144] N.Y. Ins. Law § 3105(b). See also discussion of misrepresentation in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION ch. 19 (2d ed. 2000 & Supp. 2015).

[145] *See, e.g.*, Wittner v. IDS Ins. Co. of N.Y., 466 N.Y.S.2d 480 (App. Div. 1983); Berger v. Manhattan Life, 805 F. Supp. 1097, 1102 (S.D.N.Y 1992); Feldman v. Friedman, 661 N.Y.S.2d 9 (App. Div. 1997); McDaniels v. American Bankers Ins. Co., 643 N.Y.S.2d 846, 847 (App. Div. 1996); Nationwide Mut. Fire Ins. Co. v. Pascarella, 993 F. Supp. 134 (S.D.N.Y. 1998); First Financial v. Allstate, 193 F.3d 109, 119 (2d Cir. 1999); Campese v. National Grange Mutual, 689 N.Y.S.2d 313, 314 (App. Div. 1999); Carpinone v. Mutual of Omaha, 697 N.Y.S.2d 381, 383 (App. Div. 1999); Curanovic v. N.Y. Central Mut. Fire Ins. Co., 762 N.Y.S.2d 148 (App. Div. 2003); Parmar v. Hermitage Ins. Co., 800 N.Y.S.2d 726 (App. Div. 2005); Lenhard v. Genesee Patrons Ins. Co., 818 N.Y.S.2d 644 (App. Div. 2006); Schirmer v. Penkert, 840 N.Y.S.2d 796 (App. Div. 2007).

practice in relation to similarly situated policyholders.[146] Such evidence provides corroboration for what may be considered self-serving assertions by underwriters that they would have acted differently had they been given different information. The Restatement should also recognize that application questions, which typically are drafted by insurers, can be unclear, and that insurers have a duty of reasonable inquiry.[147]

The insurer bears the burden of proof on the issues of misrepresentation, and materiality is ordinarily a question of fact for a jury to decide. The Restatement recognizes the important public-policy reasons for requiring full disclosure about the risks to be insured, while acknowledging that insurers should not be allowed to void a contract and walk away from their promises of protection and future performance to the policyholder, when they know or have the ability to gather a policyholder's risk characteristics.[148] They should ensure that the Restatement addresses the ameliorating rules on proof and ambiguity of application questions and process addressed in New York and other law on misrepresentation.

c. "Intentional or Reckless" Standard

A misrepresentation under the current Restatement rule is intentional or reckless if it was known to be false at the time that it was made or if the applicant was "willfully indifferent" to its truth or falsity.[149]

This standard is harsher and more protective of insurers in cases involving intentional or reckless misrepresentation than is the rule on common-law fraud. The Restatement in Section 8 does not require a showing of reliance and also sets up a reasonable insurer standard, without adequately addressing burden and proof issues.

As discussed below, this standard should not be adopted unless it requires

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[146] On this point, the New York statute provides:

> In determining the question of materiality, evidence of the practice of the insurer which made such contract with respect to the acceptance or rejection of similar risks shall be admissible.

N.Y. Ins. Law § 3105(c).

[147] *E.g.*, Vella v. Equitable Life Assurance Soc'y, 887 F.2d 388, 391–92 (2d Cir. 1989) (applying New York law) ("*Vella*"); Bifulco v. Great N. Ins. Co., 2001 U.S. Dist. LEXIS 11382 (W.D.N.Y. July 3, 2001) ("*Bifulco*"); Home Ins. Co. of Ill. v. Spectrum Info., Techs., Inc., 930 F. Supp. 825, 837–38 (E.D.N.Y. 1996) ("*Home Insurance v. Spectrum*"); *see* Cherkes v. Postal Life Ins. Co., 138 N.Y.S.2d 788, 790 (App. Div. 1955), *aff'd*, 309 N.Y. 964 (1956) (insurer duty to inquire) ("*Cherkes*").

[148] Restatement Draft § 7, Comment *b. Encouraging insurers' best practices in information gathering*.

[149] Restatement Draft § 8, entitled "Intentional or Reckless Misrepresentation by Policyholder," provides:

> (1) A misrepresentation by a policyholder is intentional only if at the time it is made the policyholder knows or believes that the statement is false.
>
> (2) A misrepresentation by a policyholder is reckless only if at the time it is made the policyholder is willfully indifferent to whether the statement is true or false.

insurers to prove that the alleged misrepresentation would have mattered to *that insurer*. That requirement would prevent application of misrepresentation as a kind of "strict liability" standard and accord with the special nature of insurance. The Restatement's current formulation ignores important law to the contrary, adopted, it seems clear, to avoid the harsh and unfair aspects of a supposedly "strict liability" standard on misrepresentation. New York Insurance Law, which governs many policies including Bermuda Form and other insurance policies with New York choice-of-law provisions, for example, requires that the insurer introduce evidence corroborating that it would have rejected the application if the true facts had been disclosed.[150] The issue of what a "reasonable insurer" would have done is not dispositive. That rule then rights the balance on what otherwise would seem a pro-insurer position and one that (improperly under U.S. law) parallels English law on misrepresentation. Reliance on a reasonable or prudent insurer standard fails to capture the essence of the calibrations of this doctrine under New York and other law.[151]

d. Contribute-to-the-Loss Rule

The Restatement Draft—wrongly in our view—rejects the "contribute-to-the-loss rule" or "cause relation approach" which limits an insurer's ability to assert a misrepresentation defense to situations in which the policyholder's misrepresentation actually "materialized in ('contributed to') the loss that occurred."[152] It puts no duty on the insurer to engage in reasonable inquiry. It also totally ignores the law placing the onus on insurers when the applications *they draft* are ambiguous or do not elicit information that they say, often with the benefit of hindsight at the time of claim, they needed.[153] Consider, for example, a situation in which a policyholder has answered a question falsely and on a question that turns out to be trivial or does not lead to reasonable detrimental reliance on the part of the insurer. The insurer should not be allowed without reasonable inquiry

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[150] N.Y. Ins. Law § 3105(c). As stated above, New York Insurance Law also allows for discovery of other policyholder evidence, again to prevent the insurer from voiding coverage on a conclusory allegation, without corroboration.

[151] Compare discussion of New York law and the "more pro-insurer" English law and its "prudent underwriter" standard in RICHARD JACOBS, LORELIE S. MASTERS, & PAUL STANLEY, LIABILITY INSURANCE IN INTERNATIONAL ARBITRATIONS: THE BERMUDA FORM ch. 12 (2d ed. 2011). See also the discussion of the Bermuda Form generally and its selection of New York as the governing law in RICHARD JACOBS, LORELIE S. MASTERS, & PAUL STANLEY, LIABILITY INSURANCE IN INTERNATIONAL ARBITRATIONS: THE BERMUDA FORM chs. 1, 3, and 4 (2d ed. 2011). It is particularly important to discuss and acknowledge New York standards on this issue given the New York choice-of-law provisions in commercial standard-form liability insurance policies in Bermuda Forms and other commercial policies.

[152] Restatement Draft § 9, Comment *c. The contribute-to-the-loss approach rejected*, at 70, lines 8–14, 17–28.

[153] *See, e.g., Vella*, 887 F.2d at 391–92; *Home Insurance v. Spectrum*, 930 F. Supp. at 837–38; *see also Cherkes*, 138 N.Y.S.2d at 90.

at time of underwriting and, after a loss, to deny coverage for the claim and retroactively rescind the policy.

As a result, the Restatement—far from eliminating litigation between insureds and insurers—would encourage it because any misrepresentation could lead to a fight over voidability of the policyholder's contract even if the misrepresentation had nothing to do with the loss in question. The Restatement rejects this reasonable approach for three reasons, none of which we believe is well-taken or considers how insurance differs from ordinary contracts.

First, the Comments refer to "the problem of high-risk policyholders intentionally and dishonestly understating their risks in order to get coverage at a price that is subsidized by honest" policyholders.[154] How extensive is that problem? No evidence is cited. How does that compare to what we see as the far-too-common assertion by insurers of misrepresentation defenses that are baseless or do not succeed? How is this point balanced against the public policy favoring enforcement of contract, especially these special contracts written by insurers and imbued with important public purposes?

Second, the Comments state, without explanation or support, that "the contribute-to-the-loss rule can be unreasonably difficult for an insurer to satisfy, because of the absence of proof of the precise connection between the misrepresentation in question and the cause of the loss for which a claim is being filed."[155] However, removing this contribute-to-the-loss requirement makes it "unreasonably difficult" for insureds to enforce their coverage, requiring what is often an expensive and protracted battle where the insured's own insurer (thought at the time of purchase to be a "protector") is accusing it of fraud. The Restatement gives not even a nod to this serious issue. It also gives no weight to the very real problem faced by our clients who confront these assertions of fraud: (i) that proving a negative—and one that, in our experience, often is asserted (purely?) with the benefit of 20-20 hindsight—can be impossible; and (ii) that assertion of "fraud" can make an insured worse off than if he or she had no insurance at all.

Third, the Comments state that this problem is better addressed, as the Restatement Draft seeks to do, by requiring that this is better addressed by making misrepresentations actionable only if made intentionally or recklessly as stated in Sections 7(2)(a) and 8.[156] However, this approach puts too strong a thumb on the scale for insurers given that the Restatement fails to include the protective approaches on proof insurers need to adduce. This approach certainly ignores our Fundamental Principles—and makes it too easy for insurers to cry "misrepresentation" and too hard for policyholders and insureds to rebut these fact-based,

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[154] Restatement Draft § 9, Comment *c. The contribute-to-the-loss approach rejected*, at 70, lines 10–11.

[155] Restatement Draft § 9, Comment c. *The contribute-to-the-loss approach rejected*, at 70, lines 17–20.

[156] Restatement Draft § 9, Comment *c. The Contribute-to-the-loss approach rejected.*

"nuclear option" defenses to coverage. They certainly do not serve well the vast majority of policyholders who are ordinary consumers.

e. Requirement of Tendering Back Premiums

In our experience, insurers typically assert misrepresentation claims without tendering back the premiums paid by the policyholder, and courts and decision-makers in arbitrations, improperly (or at the least, unfairly) consider misrepresentation as a valid defense notwithstanding that fact. The failure to require a return of premiums in our view encourages bad conduct by insurers, allowing them to treat misrepresentation as any ordinary policy defense, while at the same time accusing their insureds of fraud. Clearly, the insured in such a situation is worse off than if no premium dollars had been paid. If, as insurers argue in asserting misrepresentation, the policy is "void *ab initio*," then the insurer should disgorge the premiums paid.

The Restatement Draft specifically requires disgorgement of premiums paid by liability insurers.[157] The Restatement should retain this requirement as it should help discourage assertion of frivolous misrepresentation defenses and encourage insurers to marshal the facts needed to support such a defense in the first instance.

f. Rejection of "Innocent Misrepresentation"

The Restatement rightly rejects a defense of concealment or "innocent misrepresentation."[158] This is appropriate given that the Restatement seeks to adopt a standard in which only intentional or reckless misrepresentations may lead to a forfeiture of coverage and protects consumers, and to encourage best practices in underwriting. As the Comments note,

> The requirements of the concealment defense are particularly difficult for insurers to satisfy in the consumer insurance context because consumer policyholders ordinarily do not know what information not specifically asked about by the insurer is material to the underwriting process. The rejection of the concealment doctrine here simplifies liability insurance law and encourages insurers to ask questions about matters that they regard as material.[159]

Policyholders should not be expected to guess at what insurers need or want on their insurance applications, particularly those in the consumer context. Indeed, courts typically and properly put the burden of unclear or missing questions on a policy application on the insurer.[160]

Rescission for non-disclosure depends on the insurer pleading and proving (by

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[157] Restatement Draft § 7(4) provides: "When a claim is denied and the policy rescinded under subsection (2), the insurer must return all of the premiums paid for the policy."

[158] Restatement Draft § 7, Comment *g. Concealment doctrine rejected.*

[159] Restatement Draft § 7, Comment *g. Concealment doctrine rejected.*

[160] *See, e.g.*, *Vella*, 887 F.2d at 391–92; *Bifulco*, 2001 U.S. Dist. LEXIS 11382 (W.D.N.Y. July 3, 2001); *Home Insurance v. Spectrum*, 930 F. Supp. at 837–38; and *Cherkes*, 138 N.Y.S.2d at 790 (insurer duty to inquire).

clear and convincing evidence) "fraudulent concealment," a standard that is tantamount to misrepresentation as defined in the Restatement.[161] New York law, which does recognize concealment or "nondisclosure" as a defense to coverage, provides an instructive example, given the element of duty by the policyholder it includes. There, the elements of actionable non-disclosure include (i) an insurance applicant's failure to reveal facts (ii) that are material to the risk presented to the insurer (iii) when the applicant has a duty to reveal the facts. The duty to disclose facts exists only when (i) disclosure is plainly and directly requested in application questions or (ii) non-disclosure would be tantamount to fraudulent concealment.[162] Thus, under New York law, non-disclosure arises in practice only in the absence of specific questions on the insurer's application. If the insurer asked a specific question and received an incorrect answer, then the insurer's defense is misrepresentation, not non-disclosure.

As stated above, the Restatement should continue to adopt the common reasoning in cases that reject these forfeitures of coverage when no questions are asked, the application questions are unclear, or the insurer did not ask for clarification on which it had questions regarding the policyholder's responses. In the cases cited above, the issue is whether the application questions are "so plain and intelligible" that any applicant can readily comprehend them.

If questions on the application form are interpreted in the manner most favorable to the policyholder, then a similar approach should be taken to the policyholder's answers; certainly, the Restatement should require the insurer to pursue reasonable inquiry regarding an ambiguous, partial, or seemingly non-responsive answer. When an insurer receives information that was "sufficiently indicative of something more to be tantamount to notice" of the information subsequently alleged to have been misrepresented, the insurer should not be allowed to rescind.[163]

g. Rejection of "Warranty" Defenses

The Restatement rejects, rightly, insurers' additional defense of breach of warranty. As noted in the Comments, marine insurance underwriters began to use warranties, or promises relating to disclosures, in the 17th century with regard to marine insurance which, to this day, continues to require "utmost good faith." Unlike misrepresentations, warranties can make the policy voidable without regard to whether the insurer detrimentally relied.[164] The Restatement rejects insurers' use of warranties for all kinds of liability insurance, including marine

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[161] *E.g.*, *Home Insurance v. Spectrum*, 930 F. Supp. at 840.

[162] *E.g.*, *Vella*, 887 F.2d at 391–92; *Home Insurance v. Spectrum*, 930 F. Supp. at 835–37. *See also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 19.02 (2d ed. 2000 & Supp. 2015).

[163] *E.g.*, *Cherkes*, 138 N.Y.S.2d at 790; *see also* Glatt v. Union Cent. Life Ins. Co., No. 92 Civ. 1227, 1994 U.S. Dist. LEXIS 9375 (S.D.N.Y. July 11, 1994).

[164] Restatement Draft § 7, Comment *f. Warranty law rejected.*

insurance; instead, the Restatement refuses to allow insurers the use of "warranty" as an additional defense, should misrepresentation fail, treating all statements of past or present fact made in connection with the process of applying for or renewing a liability insurance policy as representations.[165] Therefore, alleged warranties are subject to the same rules as other forms of misrepresentation, and rightly so as these defenses again make the voiding of coverage for alleged misrepresentation an ordinary policy defense.

h. Inapplicability of Misrepresentation Defenses to the Duty to Defend

The Restatement indicates that a claim of misrepresentation does not block the insurers' duty to defend.[166] The Restatement should make that point clear: Misrepresentation and other fact-based defenses to coverage do not obviate the duty to defend.[167]

B. Chapter 2: Management of Potentially Covered Claims

1. Commentary on Chapter 2, Topic 1—Defense: Sections 12–26

a. Overview

Typical liability insurance includes two key promises/duties:

- The duty to defend, and
- The duty to indemnify.

The duty to defend is the most fundamental duty of the insurance company and the primary reason consumers purchase liability insurance. As a result, many courts have described liability insurance as "litigation insurance."[168] The Comments to Section 16 explain:

> Liability insurance not only provides financial protection against judgments; it also protects insureds against the liability action itself. Some liability insurance policies highlight this protection by stating that the insurer will defend a claim even if it is "groundless, false or fraudulent." The insurer's promise to defend a claim is at least as important as the insurer's promise to pay a claim. Liability insurance law enforces this promise through a set of rules that in some cases give the insured remedies that go beyond ordinary contract damages.[169]

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[165] Restatement Draft § 7, Comment *f. Warranty law rejected.*

[166] Restatement Draft § 7(2) ("Subject to the rules governing defense obligations . . . ."). The Comments do not give elucidation of this point. Given the importance of the duty to defend, it would be helpful if the Restatement confirmed that assertion of a misrepresentation defense does not obviate the duty to defend.

[167] See also the discussion below of case law rejecting arguments that fact-based defenses preclude the duty to defend.

[168] *See, e.g.*, Avondale Indus. Inc. v. Travelers Indem. Co., 887 F.2d 1200, 1204 (2d Cir. 1989); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.01 (2d ed. 2000 & Supp. 2015).

[169] Restatement Draft § 16, Comment *n. Importance of the duty to defend* at 104, lines 18–24.

Under the duty to defend, the insurer agrees to protect the insured as soon as he or she is sued. In an uncontested case, the insurer hires counsel, and the insured gets the advantage of the "good hands" promise at the outset of a claim. Courts have protected that promise by uniformly holding that the duty applies as long as there is any potential for coverage.[170] Liability insurance, thus, differs significantly from "indemnity-only" defense coverage which does not promise that the insurer will hire a lawyer and defend an insured from the outset of a claim and does not advance a defense, but, rather, agrees to repay defense costs paid first by the insured. For these reasons, among others, courts routinely repeat that the duty to defend is broader than the duty to indemnify.[171]

The Restatement discusses not simply the duty to defend but also the insurer's "right to defend," defining it as:

> (1) The authority to direct all the activities of the defense of any claim that the insurer has a duty to defend, including the selection and oversight of defense counsel; and
>
> (2) The right to receive from defense counsel all information relevant to the defense or settlement of the claim.[172]

The right to defend vests control of the claim against the insured in the insurer and creates a "tripartite" relationship[173] among the insured, insurer, and defense counsel that is "unproblematic and routine in the case of an ordinary, paradigmatic liability claim in which there is adequate insurance for the claim."[174] The law developed the duty to cooperate to encourage insureds to assist in the defense of the claim.[175]

b. Standard

The standard used by the vast majority of courts and endorsed by the Restatement is that the insurance company is obligated to defend if the allegations

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[170] *E.g.*, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 17.01 *et seq.*; LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.01 at 3-3 (2d ed. 2000 & Supp. 2015).

[171] *See, e.g.*, Bridge Metal Indus., L.L.C. v. Travelers Indem. Co., 812 F. Supp. 2d 527 (S.D.N.Y. 2011).

[172] Restatement Draft §§ 12(1) and (2). Standard-form CGL insurance policies, for example, provide that the "insurer" will have the right and duty to defend the insured against any "suit" seeking damages because of bodily injury, property damage, or personal and advertising injury. *E.g.*, ISO CGL policy form 00 01 12 07. Insuring Agreements A and B.

[173] For a discussion of the tripartite relationship, see LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 11.03 at 11-9 (2d ed. 2000 & Supp. 2015).

[174] Restatement Draft § 12, Comment *b. The right to defend in the full-coverage case* at 85, lines 19–20.

[175] Restatement Draft § 12, Comment *b. The right to defend in the full-coverage case*. The Restatement discusses the duty to cooperate in Chapter 2, Topic 3, entitled "Cooperation."

against the policyholder raise a potential for coverage under the policy.[176] While the Restatement does not use those words, it supports that standard in the provisions in Sections 15–17.[177] To determine whether the duty to defend arises, a court looks at the allegations against the insured and any extrinsic evidence that supports coverage. Thus, under the Restatement, both alleged facts and facts extrinsic to the complaint against the insured are relevant to a determination of whether the duty applies as long as the extrinsic evidence gives rise to a potential for coverage. The Restatement, however, follows the common-law principle that rejects use of "extrinsic facts" to negate the insurer's duty to defend.[178]

Using extrinsic evidence to reject an insurer's duty to defend, of course, would be contrary to the protective purpose of this important duty and to representations about the protection promised that insurers make at the time of purchase. As set forth in Comments under Section 15, allowing insurers to use a "facts and circumstances" approach to reject the duty to defend creates uncertainty for the insured, requiring insureds to sue to enforce this crucial promise of protection.[179] The Restatement therefore sides with common law which has upheld the promise

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[176] *See, e.g.*, Home Ins. Co. v. St. Paul Fire & Marine Ins. Co., 229 F.3d 56, 65 (1st Cir. 2000) (applying Maine law). *See, e.g.*, Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co., 439 Mass. 387, 394 (2003) ("[I]f the allegations of the complaint are 'reasonably susceptible' of an interpretation that they state or adumbrate a claim covered by the policy terms, the insurer must undertake the defense"); *see also* NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE § 30.14[4][a]; LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION, INSURANCE COVERAGE LITIGATION § 3.06 at 3–58 (2d ed. 2000 & Supp. 2015).

[177] Section 15, entitled "Conditions Under Which the Insurer Must Defend," sets forth these principles:

> (1) Subject to any requirement in a liability insurance policy that the insurer's duty to defend is limited to a "suit" or other defined legal action, an insurer that has issued a liability insurance policy that includes a duty to defend must defend any claim that is based in whole or in part on any set of alleged facts and an associated legal theory that, if proven, would be covered by the policy, without regard to the merits of those allegations or that theory.

Restatement Draft § 15(1). Under the Restatement, "the 'claim' " is "deemed to be based on":

> (a) Any allegation contained in the complaint or comparable document stating the claim; and
>
> (b) Any additional allegation identified in the course of the investigation or defense of the claim or inferable from the complaint or comparable document that a reasonable insurer would regard as an actual or potential basis for all or part of the claim.

Restatement Draft § 15(2). Duty to defend policies, which are standard-form, typically do not define "claim"; other defense reimbursement (or "duty to pay defense costs") policies include definitions of "claim."

[178] *See, e.g.*, Atlantic Mut. Ins. Co. v. J. Lamb, Inc., 100 Cal. App. 4th 1017, 1034 (2002) ("The scope of the duty . . . rests on whether the alleged facts or known extrinsic facts reveal a possibility that the claim may be covered by the policy.").

[179] Restatement Draft § 15, Comment *g. Distinguishing this Section from the all-the-facts-and-circumstances approach*. Specifically, Comment g. at 99, lines 1–8, notes:

> The possibility of bringing a subsequent case against the insurer for breach of the duty to defend will be of little comfort to insureds, who will find such litigation expensive and daunting. By contrast, under the more rules-based approach adopted in subsection [§ 15](2),

of a defense for the insured as long as the allegations or evidence outside the complaint support the duty. The majority of courts follow this rule,[180] and the Restatement should continue to require that insurers defend if any "reasonably ascertainable" facts give rise to a potential for coverage.[181] The majority of the courts also uphold the duty to defend even if facts outside the complaint conflict with the plaintiff's allegations but support coverage. As several commentators have noted, the complaint-only, or "four corners," rule was designed as a rule of inclusion, not exclusion.[182] What if an insurance company relies on extrinsic facts that conflict with those alleged in the complaint? The majority rule is that an insurance company may not refuse to defend on this basis. As Judge Learned Hand concluded, relying on the "groundless, false, or fraudulent" language found in many standard-form liability insurance policies:

> This language means that the insurer will defend the suit, if the injured party states a claim, which *qua* claim, is for an injury "covered" by the policy; it is the claim which determines the insurer's duty to defend; and it is irrelevant that the insurer may get information from the insured, or from any one else, which indicates, or even demonstrates, that the injury is not in fact "covered."[183]

Insurer objections to what they call "the one-way rule"[184] ignore the policies' clear promise to defend. It ignores decades of common law enforcing the broad

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there is substantially less uncertainty borne by insureds regarding when they can expect to receive a defense from their liability insurer. So long as the complaint contains allegations that if proven true would be covered, or the insured can offer evidence outside of the complaint that supports coverage, the insured can be confident of receiving a defense.

[180] *See, e.g.*, 14 LEE R. RUSS WITH THOMAS F. SEGALLA, COUCH ON INSURANCE § 200:17 (3d ed. 2011) ("[A] liability insurer's duty to defend is not necessarily limited to what is set forth in the complaint. A modern trend is for insurers to conduct reasonable investigation of the claims prior to making a determination on the duty to defend a particular lawsuit. Consequently, some jurisdictions look to actual knowledge of facts or extrinsic facts, in addition to the allegations of the complaint, when determining an insurer's duty."); LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.03 (2d ed. 2000 & Supp. 2015).

[181] *See, e.g.*, Green Constr. Co. v. National Union Fire Ins. Co. of Pittsburgh, Pa., 771 F. Supp. 1000 (W.D. Mo. 1991); LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.03 and cases cited therein (2d ed. 2000 & Supp. 2015).

[182] *E.g.,* JEFFREY STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS § 31.10.1 (1994); ROBERT JERRY II, UNDERSTANDING INSURANCE LAW § 81[a] (1987); ROBERT J. KEETON, INSURANCE LAW: BASIC TEXT 464 (1971). This rule is also called the "eight corners" rule, referring to the "four corners" of both the complaint and the policy.

[183] Lee v. Aetna Cas. & Sur. Co., 178 F.2d 750, 751 (2d Cir. 1949). *See also* D'Amelio v. Federal Ins. Co, 2004 U.S. Dist. LEXIS 7488 (D. Mass. Apr. 28, 2004); Hartford Accident & Indem. Co. v. Strugnell, 2004 U.S. Dist. LEXIS 20758 (M.D. Fla. Sept. 30, 2004); All-Star Ins. Corp. v. Steel Bar, Inc., 324 F. Supp. 160, 162 (N.D. Ind. 1971).

[184] William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 5–19 (Spring 2015). *See also* William T. Barker, *When Can Extrinsic Evidence Defeat the Duty To Defend*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 1 (Apr. 2007).

duty to defend promised in the insurance industry's standard-form contracts, and promoted in advertisements and marketing materials.[185] Indeed, contrary to the insurer critique, this law specifically derives from contract, the protective nature of insurance, and the "piece of the rock" representations made at the time of purchase.

To avoid this uniform common-law rule, the policy language, and promises made in insurer solicitations, insurer advocates have proposed a "sliding scale" of coverage—those who want "broader cover and a duty to defend that is 'broader and harder to beat,' " would pay more; while those who "prefer not to incur extra costs" would pay less.[186] This race to the bottom approach might benefit insurers (though that seems debatable, particularly in the long run), but it certainly would take a sledge hammer to the public-policy function served by insurance. For example, automobile insurance is required not simply for insureds' protection but for that of claimants and the public treasury; homeowners' liability insurance helps protect not only the policyholder's investment but also the security interests of the bank/mortgagee. It also seems obvious that the "sliding scale" would undercut the rationale for insurance regulation: If insurance is an ordinary product, subject to ordinary market forces ("what the market will bear") and divorced from its public-policy purposes, regulation would seem irrelevant. Finally, this approach would leave both insureds and injured third parties unprotected in cases where a policyholder chose the cheaper coverage and was unable to pay. In this sense, insurance is not simply a risk-spreading device but also a liability-spreading mechanism.

The Comments correctly state: "[I]n determining whether to undertake the defense of an insured, an insurer is required to resolve factual uncertainty in favor of the duty to defend."[187] This standard preserves the benefit of "litigation insurance" for which "the insured has paid premiums." Section 15 defines the standard and uses the term "'suit' or other defined legal action" in Section 15(2). "Suit" is used in standard-form insurance policies, where it is not defined, and has been the subject of untold numbers of litigations over coverage around the country.[188] "Claim" often is defined in non-standard liability policies but it is not defined in standard-form commercial general liability, automobile, and homeown-

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[185] Some of the more memorable insurance company slogans include: "Like a good neighbor, State Farm is there"; "Peace of mind" (Chubb); "Amica. We keep our promises to you. We make our customers' problems our problems."; "Responsibility. What's your policy?" (Liberty Mutual); "What matters to you?" (Safeco); "Nationwide is on your side"; "It's better under the umbrella" (Travelers).

[186] *See, e.g.*, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 12–15 (Spring 2015). This suggestion is based in large part on one professor's analysis and begins with a discussion of indemnity coverage which is subject to different standards than the duty to defend.

[187] Restatement Draft § 15, Comment *e. Factual uncertainly*, at 97; lines 3–4.

[188] *See, e.g.*, discussion in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R.

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ers policies. The Restatement should state that, unless defined in the policy, the duty to defend applies to protect insureds from "claims" and any coercive legal proceeding, whether in court or some other forum.

The Restatement makes clear that, to fulfill the duty to defend, a liability insurer must provide a defense that:

> (a) Meets professional standards;
>
> (b) Makes reasonable efforts to protect the insured from all of the risks posed by the claim, including risks not covered by the liability insurance policy; and
>
> (c) Protects from disclosure to the insurer any information of the insured that is subject to attorney-client privilege or work product immunity and that could be used to advantage the insurer at the expense of the insured.[189]

This rule acknowledges the professional responsibilities of the lawyers insurers hire to defend insureds. It also gives the nod to the need to protect the insured's confidential information and attorney advice.[190]

Finally, the Restatement Draft is unhelpful on how to address the common situation in which an insurer challenges the reasonableness of defense fees charged by a lawyer chosen by the insured. Comment *b*. does not make clear how that situation is resolved.[191] The Comments say that a party should be able to pay fees under reservation and to resolve that dispute at the conclusion of the underlying case.[192] The Comments should eliminate the current ambiguity that arises in these common situations, by stating: "If the insurer pays only what the insured considers to be a partial share of the defense costs, and the insurer is later determined to have paid less than the reasonable fees that it was required to pay, the insurer thereby breached the duty to defend."

c. Trigger Facts

As originally proposed, and in the Restatement at this writing, the proposed black-letter provision in Sections 15(3)(b) and 20(7) would permit the insurer to litigate (or re-litigate) in connection with coverage, two issues: (i) whether the person claiming coverage is insured, and (ii) whether coverage is triggered. The first issue presents no problem as it is an issue that does not implicate facts that

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ANDERSON, INSURANCE COVERAGE LITIGATION § 15.05 and cases cited therein (2d ed. 2000 & Supp. 2015).

[189] Restatement Draft §§ 16(1)(a)–(c).

[190] A statement that such information should be "confidential" is helpful but it does not change well-established rules governing privileges. It should not be used to disadvantage insureds by requiring disclosure of privileged information where the interests of insureds and insurer do not align.

[191] Restatement Draft, § 19, Comment *b. Reasonable fees*, at 122, line 29–123, line 2, currently says: "An insurer that requests reasonable security from independent defense counsel for the fees in dispute or that conditions payment on proof of an adequate professional liability insurance does not thereby breach the duty to defend."

[192] Restatement Draft § 19, Comment *b. Reasonable fees*.

relate to an insured's potential liability. However, the second threatens to put the insured in an untenable "catch-22" and should be deleted.[193] It would force insureds who seek to preserve their rights to coverage to prove the very core of the claims made against them in the underlying action. It also risks seriously prejudicing the insured's defense and offends well-established collateral estoppel principles. An insured should not have to choose between fighting the case for the liability alleged and foregoing his or her insurance coverage. The insured also should not have to fight this kind of "two-front war"—fighting the plaintiff's claims, and fighting to preserve insurance coverage.[194]

Insureds in these situations face the following risks:

- The risk of inconsistent factual determinations that could prejudice the insured. To eliminate this risk, courts may stay a declaratory relief action on coverage pending resolution of the underlying liability suit when the coverage question turns on facts to be litigated in the underlying action.[195]
- Prejudice from concurrent litigation of the declaratory relief and third-party actions. When courts discuss this, they say, in effect, that the insurer should not be permitted to join forces with a plaintiff in the underlying action as a means of defeating coverage, either actually or because the insurer is making the same factual arguments as the plaintiff.
- Compelling the insured to fight a two-front war, battling with the plaintiffs

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[193] *See also* the discussion in the "duty to settle" section of this article discussing the law rejecting insurer arguments that a policyholder must prove the "actual facts" of the plaintiff's case against the policyholder in order to obtain the benefit of its insurance, even its "litigation insurance." This argument negates the value of a settlement; if an insured must litigate those facts even after settlement, then why settle? *Accord* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.12, 3.14, 4.04[D][2] (2d ed. 2000 & Supp. 2015).

[194] *See, e.g.*, RMD Produce Corp. v. Hartford Cas. Ins. Co., 37 A.D.3d 328 (N.Y. App. Div. 2007) (threat of prejudice presents valid grounds for staying a declaratory action); Harleysville Lake States Ins. Co. v. Granite Ridge Builders, Inc., No. 1:06-cv-397, 2007 U.S. Dist. LEXIS 41725 (N.D. Ind. June 7, 2007) ("prejudice to [policyholder] of fighting a 'two-front war' and of being collaterally estopped in the underlying litigation is not outweighed by [insurer's] interest in moving forward with discovery"); Wells Dairy, Inc. v. Travelers Indem. Co. of Ill., 241 F. Supp. 2d 945, 977 (N.D. Iowa 2003), *enforcement granted in part, denied in part sub nom.*, Wells' Dairy, Inc. v. Travelers Indem. Co., 266 F. Supp. 2d 964 (N.D. Iowa 2003) (stay is warranted to protect policyholder from "being prejudiced by inconsistent factual determinations" and from risk that discovery poses of "undermining possible defenses"); Great Am. Ins. Co. v. Superior Ct., 100 Cal. Rptr. 3d 258 (Ct. App. 2009); Home Indem. Co. v. Stimson Lumber Co., 229 F. Supp. 2d 1075, 1092 (D. Or. 2001) ("protecting an insured from possible prejudice may require a stay of a concurrent coverage action, or the abandonment of the application of issue preclusion so that no estoppel effect is accorded to the factual determinations made in the third-party action," but allowing coverage case to proceed as long as no estoppel effect is accorded to any factual determinations made first in the coverage case).

[195] *See, e.g.*, California Ins. Guar. Ass'n v. Superior Ct., 231 Cal. App. 3d 1617, 1627–28 (1991); General Ins. Co. of Am. v. Lilly, 258 Cal. App. 2d 465, 471 (1968).

in the underlying litigation while at the same time having to devote its money and its human resources to litigating coverage issues with its insurers.

- Finally, collateral estoppel. If the declaratory relief action for coverage is tried before the underlying litigation is concluded, factual findings there may be used as the basis for collateral estoppel, thus preventing the insured from arguing to defeat liability in the underlying action.[196]

Cases permitting an insurer to terminate its duty to defend to litigate such factual questions are in a distinct minority. More importantly, they do not address the concerns raised in the following six-part test set forth in one of the seminal coverage cases addressing these issues:

> Accordingly, the question before us is whether the coverage questions are logically unrelated (that is, irrelevant) to the issues of consequence in the contamination cases so that they could be determined in the declaratory relief action without prejudice to Montrose in the underlying actions . . . . To decide whether it is now appropriate to set the indemnity issues for trial, the trial court must determine:—(1) Which of the underlying contamination actions are still pending?—(2) Of those that are still pending, what issues remain to be decided and when will that happen?—(3) Which defenses to coverage (whether pleaded as affirmative defenses or raised by general denials) do each of the carriers intend to pursue as to each of the underlying actions?—(4) What facts have to be determined to reach the merits of the carriers' defenses?—(5) What other facts, if any, are relevant to the determination of prejudice?—(6) Who has the burden of proof? Since the carriers are pushing for a prompt trial date, is it their burden to prove that Montrose will not be prejudiced? Or does Montrose's request for an indefinite stay impose upon it the burden of proving prejudice?[197]

A black-letter rule that permits an insurer seeking to terminate its duty to defend to litigate coverage prior to the conclusion of the underlying action would not raise such prejudice—as long as the coverage action turns on facts wholly unrelated to the facts at issue in the underlying third-party action. Given the extreme prejudice this "trigger facts" proposal poses to insureds, however, Sections 15(3)(b) and 20(7) should be deleted in their entirety.[198] These changes

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[196] *See, e.g.*, Allstate Ins. Co. v. Harris, 445 F. Supp. 847, 851 (N.D. Cal. 1978); Village Mgt., Inc. v. Hartford Acc. & Indem. Co., 662 F. Supp. 1366, 1373 (N.D. Ill. 1987); R.E. Spriggs Co. v. Adolph Coors Co., 94 Cal. App. 3d 419, 429–31 (1979); Clemmer v. Hartford Ins. Co., 22 Cal. 3d 865, 873–74 (1978).

[197] Montrose Chem. Corp. v. Superior Court (Canadian Universal Ins. Co.), 31 Cal. Rptr. 2d 38, 42 (1994), *as modified* (Ct. App. June 30, 1994) (*Montrose II*); *see also* Montrose Chem. Corp. v. Superior Ct., 861 P.2d 1153, 1162 (Cal. 1993) (*Montrose I*).

[198] Section 20(7) provides that a liability insurer may terminate the duty to defend when there is "(7) a correct determination by the insurer, based on all of the facts and circumstances as permitted under § 15(3) that the defendant is not an insured under the policy or that the necessary events did not take place during the policy period." Restatement Draft § 15, Comment h. and Reporters Note h., both entitled *Determining whether the defendant is an insured or whether the events took place within the policy period*; and § 20, Comment j. and Reporters Note j., both entitled

will bring the Restatement into line with the black-letter law stating the majority rule,[199] while simultaneously promulgating rules that are analytically defensible, persuasive, and consistent with the body of jurisprudence addressing proof in liability insurance disputes and protection of insureds' interests.

d. Reservation of Rights

When coverage applies to all of the allegations against the insured, the insurance company should accept its duty to defend immediately upon receiving notice. When part of the allegations are covered, or potentially covered (meaning it is unclear whether the allegations are covered), the insurer should accept the defense under a reservation of rights, preserving its right to deny coverage later for liability that falls outside of the policy's coverage.

The Comments state that the appropriate approach is for an insurer to defend under a reservation of rights.[200] The Comments suggest that this rule is based in a form of estoppel that does not require a showing of detrimental reliance.[201]

Section 17 of the Restatement sets forth the parameters for an effective reservation of rights:

- The insurer must give "timely notice" before undertaking the defense on any ground "for contesting coverage of which it knows or should know."[202]
- The reservation must be in writing and include written explanation of each defense to coverage, "including the specific insurance policy terms and facts upon which the potential coverage defense is based."[203]
- The language used in the reservation must be "understandable by a reasonable person in the position of the insured and the policyholder."[204]

Adjudication that there is no duty to defend, all should also be modified accordingly.

[199] The Restatement Draft cites few cases to support the proposal in §§ 15(3) and 20(7) and ignores the well-reasoned cases and public-policy concerns to the contrary. *See, e.g.*, discussion and cases cited below; LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.12, 3.14, 4.04[D][2] (2d ed. 2000 & Supp. 2015).

[200] Restatement Draft § 17, Comment *f. Legal uncertainty*.

[201] Restatement Draft § 17, Comment *a. The basis for the reservation of rights requirement*, at 110, lines 24–30; 111, lines 1–21. The notice requirement is best satisfied through a well-written reservation of rights letter, which is timely and thorough. *See, e.g.*, Standard Mut. Ins. Co. v. Lay, 989 N.E.2d 591, 596 (Ill. 2013) ("[w]hen an insurer defends a claim against its insured under a sufficient reservation of rights [it benefits both the policyholder and the insurance company]"); *see also* Timothy P. Law & Lisa A. Syzymanski, Reed Smith LLP, *Reserving the Right to Contest Coverage Under the Proposed Restatement of the Law of Liability Insurance*, forthcoming in the Rutgers L. S. J. presented at Rutgers Center for Risk and Responsibility Conference on the Restatement (Feb. 27, 2015). This is a rule of practicality and fairness that serves the interests of insurers and insureds equally.

[202] Restatement Draft §§ 17(1)–(2).

[203] Restatement Draft § 17(3).

[204] Restatement Draft § 17(3).

- If the insurer cannot complete its investigation in order to give a timely reservation or rights, it may "temporarily reserve its right to contest coverage" by providing a reservation of rights in writing "in language that is understandable by a reasonable person in the position of the insured."

Under these guidelines, notice must be written; oral reservations of rights will not suffice. The grounds for reservation must be spelled out with specificity, citing policy language and relevant facts. The reservations must be understandable to a reasonable insured and asserted timely, even if the investigation cannot be completed before a timely reservation needs to be made. An insurer under Restatement Section 17 may give "an initial, general notice of reservation of rights, but to preserve that reservation of rights the insurer must pursue that investigation with reasonable diligence and must provide the detailed notice" required in Section 17(3) "within a reasonable time period."[205]

These requirements are for the protection of both the insured and the insurer. Furthermore, they help enforce other doctrines that protect policyholders and insureds, including waiver, estoppel, and related doctrines like mend-the-hold and various forms of estoppel including judicial estoppel, equitable estoppel, regulatory estoppel, and quasi-estoppel.[206] They also are implicit in the implied duty of good faith and fair dealing and may be required under state insurance statutes and regulations.[207]

Other provisions in the Restatement make clear that a reservation of rights does not relieve an insurer of its duty to make reasonable settlement decisions.[208]

e. Applicability of Duty to Defend Notwithstanding Assertion of Misrepresentation (and Other Fact-Based Defenses)

Courts hold that the duty to defend can be decided as a matter of law, based on the terms of the insurance policy and the allegations in the underlying complaints and related extrinsic evidence.[209] Insurers sometimes argue that fact-based

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[205] Restatement Draft § 17(4).

[206] For discussion of these doctrines, see LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION ch. 12 (2d ed. 2000 & Supp. 2015).

[207] For example, state fair claims-handling statutes require timely investigation of claim and notification of the insurer's position on coverage. *See, e.g.*, Cal. Code of Regs, Tit. 10, Ch. 5, Sub. 7.5 § 2697.7(b) ("Upon receiving proof of claim, every insurer, except as specified in subsection 2695.7(b)(4) below, shall immediately, but in no event more than forty calendar days later, accept or deny the claim, in whole or in part. The amounts accepted or denied shall be clearly documented in the claim file unless the claim has been denied in its entirety."). A majority of states have adopted the NAIC "Unfair Property/Casualty Claims Settlement Practices Model Regulation" which sets forth specific guidelines regarding the insurer's duty to promptly investigate a claim and timely respond to an insured's inquiries (http://www.naic.org/store/free/MDL-902.pdf, last visited April 21, 2015).

[208] Restatement Draft § 27. See the discussion of the duty to settle below.

[209] Restatement Draft § 15; *see also, e.g.*, National Union Fire Ins. Co. of Pittsburgh, Pa. v. Rhone-Poulenc Basic Chems., Inc., C.A. No. 87C-SE-11, 1992 Del. Super. LEXIS 45, at *17 (Jan.

coverage defenses like misrepresentation, expected/intended, etc., nullify their duty to defend. In effect, then, insurance companies argue that the policyholder cannot obtain judgment on the duty to defend as a matter of law. This argument clearly is wrong, and negates the duty to defend. Courts have rejected such efforts, concluding that "[a]n insurer then can be excused from its duty to defend only if it can be determined as a matter of law that there is no possible factual or legal basis upon which the insurer might eventually be obligated to indemnify the insured."[210] Thus, an insurance company's duty to defend "is a continuing one, arising on tender of defense and lasting until the underlying lawsuit is concluded . . . or it has been shown that there is *no* potential for coverage . . . ."[211]

In *Hoechst Celanese Corp. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*,[212] for example, the court noted that "[a] mere allegation of fraud is not sufficient to preclude summary judgment in favor of the insured" on the duty to defend.[213] Thus, the court obligated the insurer to defend until it was "able to obtain a factual decision that fraudulent procurement occurred."[214] Courts recognize that the fact that other fact-intensive coverage defenses such as trigger of coverage, prejudice due to timing of notice, etc., remain unresolved does not affect the policyholder's right to an immediate defense.[215] Similarly, because there is virtually no conflict in state law regarding an insurance company's duty to defend and pay defense costs, the Restatement should recognize, and confirm in Comments to these sections, that a policyholder's motion for summary judgment on the duty to defend should not be delayed or denied because of an argument that the motion raises choice-of-law issues.[216]

16, 1982) ("*Rhone-Poulenc*"); Villa Charlotte Bronte, Inc. v. Commercial Union Ins. Co., 487 N.Y.S.2d 314, 315 (N.Y. 1985); Spoor-Lasher Co. v. Aetna Cas. & Sur. Co., 352 N.E.2d 139, 140 (N.Y. 1976); *contra* International Envtl. Corp. v. National Union Fire Ins. Co., 860 F. Supp. 511 (N.D. Ill. 1994).

[210] *Rhone-Poulenc*, 1992 Del. Super. LEXIS 45, at *30. *See also* Armstrong World Indus. v. Aetna Cas. & Sur. Co., 45 Cal. App. 4th 1, 109–10, 52 Cal. Rptr. 2d 690 (1996).

[211] Montrose Chem. Corp. v. Superior Ct., 6 Cal. 4th 287, 295 (1993).

[212] No. 89C-SE-35, 1994 Del. Super LEXIS 566 (Apr. 8, 1994).

[213] 1994 Del. Super LEXIS 566, at *10.

[214] 1994 Del. Super LEXIS 566, at *12. *See also* United States Fidelity & Guar. Co. v. Thomas Solvent Co., 683 F. Supp. 1139 (W.D. Mich. 1988)*, vacated on other grounds*, No. K85-415, 1988 U.S. Dist. LEXIS 3560 (W.D. Mich. Mar. 16, 1988); LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.12[A] (2d ed. 2000 & Supp. 2015).

[215] *See, e.g.*, Montrose Chem. Co. v. Admiral Ins. Co., 10 Cal. 4th 645, *modified*, 11 Cal. 4th 219A, 913 P.2d 878 (1995).

[216] As the court in Independent Petrochemical Corp. v. Aetna Casualty & Surety Co. noted, "[T]here is little conflict in state law on [the] defense issue and general principles of insurance law are highly persuasive." 654 F. Supp. 1334, 1345 (D.D.C. 1986), *aff'd in part, rev'd in part on other grounds*, 944 F.2d 940 (D.C. Cir. 1991); *see also* Travelers Indem. Co. v. Dingwell, 414 A.2d 220, 226 (Me. 1980).

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f. Insurer Objections: Scope of the Duty to Defend and Remedies for Its Breach

Insurers have resisted the "broader duty to defend coverage" promised under the rules of the Restatement.[217] Following the clear weight of authority on this issue,[218] the Restatement requires a liability to defend "mixed claims," meaning those claims in which some allegations are clearly covered but others may not be. As the Comments explain:

> The insurer has a duty to defend the whole claim, even though the contractually limited nature of liability insurance coverage may preclude the insured from shifting to the insurer all the risks posed by every potentially covered claim . . . the duty to defend the whole claim includes an obligation to make reasonable efforts to protect the insured from all of the consequences of the claim, including uninsured risks . . . reasonableness means compliance with the insurer's duty of good faith and fair dealing.[219]

Insurers do not expressly dispute the general principle that they have a broad duty to defend "mixed claims" (both covered and uncovered claims). Rather, they take issue with the Restatement's remedy for breach and waiver of not only of the right to defend and the right to control settlement, but also the "right to contest coverage for the claim."[220]

An insurer's liability for a breach of the duty includes damages for:

> the amount of any judgment entered into against the insured or the reasonable portion of a settlement entered into by or on behalf of the insured after breach, subject to the policy limits, and the reasonable defense costs incurred by or on behalf of the insured, in addition to any other damages recoverable for breach of a liability insurance contract.[221]

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[217] *See* William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 12 (Spring 2015) (citing Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1754 (1997); Ellen S. Pryor, *The Tort Liability Regime and the Duty To Defend*, 58 MD. L. REV. 1 (1999); and Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty To Defend in Texas*, 31 TEX. TECH. L. REV. 869, 890–97 (2000)).

[218] *See, e.g.*, 14 Lee R. Russ with Thomas F. Segalla, COUCH ON INSURANCE § 200:25 (3d ed. 2011). *See also* 3 Seth D. Lamden, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 3.17[3][a] ("Virtually all courts agree that if an action contains both potentially covered and noncovered claims—a so-called 'mixed' action—the insurer must defend the entire action.") (Restatement Draft, Reporters Note *b. The duty to defend the whole claim,* at 108).

[219] Restatement Draft § 16, Comment *b. The duty to defend the whole claim*. According to a footnote in the Restatement Draft (at 105), the duty of good faith and fair dealing, and the consequences of the breach of that duty, will be addressed in Restatement Chapter 4. The footnote explains that a cross-reference and, if appropriate, a brief discussion will be inserted here when Chapter 4 is complete.

[220] Restatement Draft § 21(1).

[221] Restatement Draft § 21(2).

Thus, relying on well-reasoned cases, the Restatement imposes a rule of "forfeiture" of coverage on insurers that breach the duty to defend.[222] As the Restatement correctly notes, the rule more closely aligns the interests of the insurer and the policyholder. As the Comments explain:

> [T]he forfeiture-of-coverage-defense rule is one of the insurance law rules that firmly underscore[s] the principle that the *promise to defend is a promise to perform, not simply a promise to decide whether to perform or to pay ordinary contract damages*. By encouraging insurers to defend claims that they would not otherwise, the forfeiture-of-coverage-defense rule may increase the cost of liability insurance, but it provides a benefit to all insureds by increasing the certainty that insurers will defend them from liability claims.[223]

Insurer advocates contend that this section establishes an "extracompensatory penal rule whose only stated or apparent justification is to deter the insurer from denying a defense" and that "ordinary contractual rules do not provide adequate compensation and deterrence" to insurers.[224] As discussed at length above, insurance contracts differ from ordinary contracts, and ordinary contractual remedies do not cure the consequences of a breach of the duty to defend.[225] Indeed, contrary to insurer complaints,[226] these are reasonable rules consistent with common law, which seek to protect policyholders and insureds who cannot

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[222] See Restatement Draft, Reporters Note *a. Breach of the duty to defend*, at 138, lines 15–23, citing: "In re Abrams & Abrams, P.A., 605 F.3d 238, 241 (4th Cir. 2010) ("[I]f an insurer improperly refuses to defend a claim, it is estopped from denying coverage and must pay any reasonable settlement . . . ."); Gray v. Zurich Ins. Co., 419 P.2d 168, 179 (Cal. 1966) ("[A]n insurer that wrongfully refuses to defend is liable on the judgment against the insured."). *See also* Francis C. Amendola, et al., *Insurer's Liability for Wrongful Failure or Refusal to Defend*, 46 C.J.S. Insurance § 1641 (2012) ("When an insurance company wrongfully refuses to defend on the ground that the claim is not within policy coverage, the company is guilty of breach of contract, rendering it liable to the insured for all damages resulting to him or her because of such breach."); 14 Lee R. Russ & Thomas F. Segalla, Couch on Insurance § 202:6 (3d ed. 2011) (same)."

[223] Restatement Draft § 21, Comment *c. Loss of defenses to a claim for coverage*, at 136, lines 2–10 (emphasis added).

[224] William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 21 (Spring 2015). Mr. Barker suggests that insureds can find adequate protection notwithstanding a breach, by pursuing a covenant not to execute with the claimant. This "solution" ignores the breach of contract, and the fact that the policyholder bought insurance so as not to worry about such complicated legal maneuvering. Most insureds could simply not accomplish such a deal.

[225] *Grand Sheet Metal*, 375 A.2d at 430; *see also, e.g., du Pont v. Pressman*, 679 A.2d 436. The rule, rightly, is intended to enforce the duty to defend. An insurer determined to avoid the duty has two choices: to deny the defense and hope they are correct, or become liable for a breach of the duty to defend and face appropriate remedies. Restatement Draft Comment *f. Legal uncertainty*, at 97; lines 16–28.

[226] *E.g.*, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 21 (Spring 2015).

cure such a breach, and to protect the integrity of both contract and insurance.[227]

In response to disputes over when the duty to defend arises and what this "litigation insurance" entails, insurers propose a tiered approach to the sale and purchase of liability policies.[228] However, this would frustrate one of the purposes of insurance—peace of mind—and would most certainly violate a policyholder's *reasonable expectations* of coverage. Public policy should not allow the purchase and sale of "cheap" defense coverage that would contravene the public purposes of insurance and the modern tort system.[229] Regardless, any limitations on indemnity coverage should not affect the scope of the duty to defend.

Insurers contend also that the duty to defend should be analyzed based on the "actual facts" surrounding the claim.[230] This argument contradicts the clear majority rule set forth in common law and Restatement Section 15 which require a defense if allegations give rise to coverage.[231] The "scope of the pleading" rule is so widely accepted that it is now considered "hornbook law."[232] As the Comments state:

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[227] *See, e.g.*, Zipperer v. State Farm Mut. Auto. Ins. Co., 254 F.2d 853 (5th Cir. 1958) (applying Florida law); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.09 at 3-94.2 (2d ed. 2000 & Supp. 2015). An unjustified refusal to defend constitutes a breach of contract and, thereby, exposes the insurance company to damages resulting from that breach. *See, e.g.*, St. Louis Dressed Beef and Provision Co. v. Maryland Cas. Co., 201 U.S. 173 (1906); Blakely v. American Employers' Ins. Co., 424 F.2d 728 (5th Cir. 1970) (applying Texas law); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.08 at 3–95 (2d ed. 2000 & Supp. 2015).

[228] William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 34–36 (Spring 2015).

[229] *See, e.g.*, Doe v. Shaffer, 738 N.E.2d 1243, 1248 (Ohio 2000); Harasyn v. Normandy Metals, Inc., 551 N.E.2d 962, 965 (Ohio 1990).

[230] *See* William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 6, 10–12, 15 (Spring 2015), discussing "liability facts," "non-liability facts," and equating "liability facts" to "actual facts." One can be excused for wondering about references to "actual facts" as it seems that all facts are "actual." The references then are inconsistent with the potential for coverage standard applicable to the duty to defend.

[231] *See, e.g.*, Stevens v. United Gen. 35 Title Ins. Co., 801 A.2d 61, 66 n.4 (D.C. 2002).

[232] *See* Restatement Draft § 15, Reporters Note *b. The complaint-allegation rule*, at 101, lines 6–10: " 'The rule that the insurer must defend any suit whose allegations would fall within coverage if the allegations were proved to be true' has become 'hornbook law.' Kenneth S. Abraham, Insurance Law and Regulation 631 (5th ed. 2010) (noting that the rule 'is often called the "scope of the pleadings," or "four corners of the complaint" rule,' as well as the "eight corners" rule, referring to the comparison between the four corners of the complaint and what is contained in the four corners of the policy." *See also, e.g.*, cases cited in the Reporters Note *b. The complaint-allegation rule*: Capitol Indem. Corp. v. Elston Self Serv. Wholesale Groceries, Inc., 559 F.3d 616, 619 (7th Cir. 2009) ("In order to determine whether an insurer has a duty to defend its insured, we must compare the allegations in the underlying complaint to the language in the insurance policy."); Hartford Cas. Ins. Co. v. Litchfield Mut. Fire Ins. Co., 876 A.2d 1139, 1144 (Conn. 2005) ("[T]he

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> Whether the liability insurer must defend a claim often can be determined based solely on a comparison of the complaint or comparable document with the liability insurance policy. An allegation in a complaint that would subject the insured to a covered liability conclusively establishes that the insurer has a duty to defend. In such case, the insurer must defend the claim until the duty to defend terminates in one of the ways enumerated in § 20. This widely accepted "complaint allegation" rule generally means that the insurer must defend the claim all the way through final adjudication of the claim, unless the claim is settled or the insurer prevails in a declaratory judgment action establishing that the claim is not covered by the liability insurance policy.[233]

They also threaten to create uncertainty around the duty to defend, give insurers grounds to dispute coverage, and contravene case law rejecting this argument. Such arguments should be recognized as negating the duty to defend and the long-standing majority rules applicable to the duty to defend and other legal doctrines.

g. Insurer Arguments for Recoupment and "Unjust Enrichment"

Section 24 follows the majority rule—that "a liability insurer may not seek recoupment" for the defense of uncovered claims unless the insurance policy itself or a prior written agreement specifically allows such reimbursement.[234] As stated in the Comments, the Restatement rejects the reasoning of some courts that have allowed recoupment under an "unjust enrichment analysis." Instead, the Restatement follows the "[m]ore recent cases"[235]—and the clear majority rule—upholding an "exclusively contract-based approach" to what, after all, is a question of contract.[236] Insurers know how to draft recoupment clauses if they

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insurer's duty to defend is measured by the allegations of the complaint . . . . Hence, if the complaint sets forth a cause of action within the coverage of the policy, the insurer must defend.") (quoting Board of Educ. v. St. Paul Fire & Marine Ins. Co., 801 A.2d 752, 755 (Conn. 2002)).

[233] Restatement Draft § 15, Comment *b. The complaint-allegation rule*.

[234] Restatement Draft § 24 states:

> § 24. Insurer Recoupment of the Costs of Defense
>
> Unless stated in the liability insurance policy or otherwise agreed to by the insured, a liability insurer may not seek recoupment of defense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs.

This rule is wide. *See, e.g.*, Excess Underwriters at Lloyd's, London v. Frank's Casing, 246 S.W.3d 42 (Tex. 2008).

[235] Restatement Draft § 24, Comment *a. The default rule is no recoupment of defense costs*.

[236] This rule also gives effect to the breadth of the duty to defend promised at the time of purchase. *See generally* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION ch. 3 (2d ed. 2000 & Supp. 2015); *see also generally* Angela R. Elbert and Stanley C. Nardoni, Buss Stop: A Policy Language Based Analysis, 13 CONN. INS. L.J. 61, 95–97 (2006–2007) ("Allowing the insurer to shift defense costs back to the insured through reimbursement would contravene the [expenses] clause's express promise that the insurer will pay them . . . . Quasi contractual remedies . . . are not designed to overcome such express contractual

want to do so, and are allowed to use them (after obtaining necessary regulatory approval of them; and with full disclosure, can sell them).[237]

Insurers often ask courts to write recoupment provisions into their policies at the point of claim, and some courts, in effect, have done just that.[238] However, this task of allocating defense costs to claims that are not even potentially covered "if ever feasible . . . [is] extremely difficult."[239] The Restatement should not support "recoupment" on the duty to defend in any respect. To do so:

- ignores insurer promises made at the time of purchase;
- rewrites the standard-form policy language and thus ignores decades of regulatory processes that have approved such provisions; and
- upends decades of law saying that, in the absence of policy provisions to the contrary, the duty to defend applies if even one claim or allegation is covered.[240]

Insurers are free to draft recoupment clauses and seek regulatory approval of them; but, in the absence of such clauses, neither the courts nor the Restatement should read them into standard-form policy language and allow insurers to obtain through the Restatement process provisions that they are unwilling to present to insurance regulators or for which they are unable to obtain regulatory approval.

The argument that enforcement of the duty to defend somehow amounts to

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terms . . . . The promise to bear all expenses in the cases the insurer defends weighs heavily against the right of recoupment") (cited in General Star Indemnity Co. v. Driven Sports, Inc., 2015 U.S. Dist. LEXIS 7966 (E.D.N.Y. Jan. 23, 2015)).

[237] Because primary CGL and personal lines insurance policy forms must be approved by state insurance commissions before they can be sold to the public, the understanding of the insurance industry in drafting standard-form policy provisions is relevant and should be considered in drafting and approving Restatement provisions. Some states require hearings on proposed standardized policy language before approval is granted. Other states employ a "file and use" system that allows the insurers to use provisions upon filing assuming no objection is made or hearing required. Carrie Cope, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION ch. 10, *Regulation of Policy Forms. See also, e.g.*, http://thismatter.com/money/insurance/insurance-regulation.htm. The ALI should not be a party to a process that ignores insurance drafting documents and the insurance regulatory process which was adopted in this country to protect both consumers and the public. Doing so would not advance the ALI's mission and intent of promoting "the clarification and simplification of the law and its better adaptation to social needs, secur[ing] the better administration of justice, and encourag[ing] and carry[ing] on scholarly and scientific legal work." ALI Charter, as quoted on ALI available on ALI website, Governance (Certification of Incorporation) tab, ALI Overview (Creation) tab (http://www.ali.org/index.cfm?fuseaction=about.chartercite; accessed Jan. 16, 2015).

[238] *See, e.g.*, Buss v. Superior Ct., 16 Cal. 4th 35 (1997).

[239] Hogan v. Midland Nat'l Ins. Co., 3 Cal. 3d 553, 564 (1970).

[240] *E.g.*, Sherilyn Pastor and William T. Barker, *Recoupment of Defense Costs for Noncovered Claims (With Multi-State Survey of Law on Insurer Recoupment of Defense or Settlement Costs*) NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW § V (Fall 2012); LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 3.02[B] at 3-25–3-34 (2d ed. 2000 & Supp. 2015).

"unjust enrichment" also deserves to be soundly rejected on the basis of insurance fundamentals.[241]

First, the "dominant purpose" of an insurance contract is indemnity.[242] It is not, as insurance industry advocates seem to contend, simply a device for sharing risk or earning profits. Indeed, to state those goals as purposes to the exclusion of the protective purpose of insurance contradicts the public interest and purposes that insurance serves.

Second, as stated in our Fundamental Principles in Section III above, insurance policies are not ordinary commercial contracts,[243] and they differ from other aleatory contracts because insurers get the benefit of the contract right up front—and a policyholder cannot be made whole by ordinary contract remedies.[244] Indeed, the *Restatement (Second) of Contracts* recognizes the incentives implicit in traditional contract law for insurance companies to breach:

> The traditional goal of the law of contract remedies has not been compulsion of the promisor [that is, the insurance company] to perform but compensation of the promisee [the policyholder] for the loss resulting from the breach.[245]

Third, insurance, by definition, serves as protection. Absent fraud, an insured should be better off for having insurance, not worse. If insurers can continue to envelop insureds in disputes over recoupment and "liability" or "actual" facts even when the defense is done, or the case settled, the insured is worse off for having bought insurance. That is not right.

Insurers also insist that "voluntary payments" clauses and "no action" clauses in their standard-form contracts require revision of this Restatement rule and justify allowing insurers to recoup both defense and liability payments related to uncovered claims,[246] even if (as is usually the case) there is no provision allowing

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[241] *See, e.g.*, Nat'l Sur. Corp. v. Immunex Corp., 176 Wash. 2d 872 (2013).

[242] *E.g.*, Keene Corp. v. Ins. Co. of N. Am., 667 F.2d 1034, 1041 (D.C. Cir. 1981) (citations omitted).

[243] *See generally* Eric M. Holmes, *A Contextual Study of Commercial Good Faith Disclosure in Contract Formation*, 39 U. PITT L. REV. 381, 393 (1978) (arguing that insurance law has never been fully integrated into ordinary contract law; "insurance is an amalgam of statutory and common law" and "whether insurance is simply a specialized body of contract law or is outside the realm of contract is somewhere in between those two statements"); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 11.01 at 11-5 (2d ed. 2000 & Supp. 2015).

[244] *See, e.g.*, Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Last Ten Years*, 42 ARK. L. REV. 31, 54 (1989).

[245] RESTATEMENT (SECOND) OF CONTRACTS, Intro. Note. Ch. 16 at 100 (1979). *Accord* G. Richard Bell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 222 (1991) (footnote omitted). *See also du Pont v. Pressman*, 679 A.2d 436, 447 (Del. 1996), for judicial recognition of this point.

[246] William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 27–31 (Spring 2015). A typical voluntary payment

such recovery (and thus no notice to the policyholder of such a "right"). This position contradicts promises made about policy coverage at the time of purchase, as well as the long-standing common-law rule that the duty to defend covers all claims as long as any allegation against the policyholder raises a potential for coverage.[247]

Insurers further use an unjust enrichment theory to contend that, if an insurer either defends or pays part of a claim it determines is not covered, the insured has gained all the benefits of the insurance relationship—and the insurer has gained none.[248] Thus, the argument goes, an insurer is entitled to recoup that "unjust enrichment."

We unequivocally reject this argument.[249] It ignores the special nature of insurance and the critical importance of that function to our economy and the innovative impulses that fuel it. Insurers—and their marketing for the standard-form automobile, homeowners, commercial general liability, and other insurance policies they draft—promise protection and defense coverage from the moment a claim is brought. At the point of claim, a policyholder has already relied on that promise by, at the very least, paying premiums and foregoing contractual relationships with other insurers. The uncertainty that accompanies an insurer's reservation of rights—or worse, denial—exacts a toll, even on so-called sophisticated insureds. As the New York Court of Appeals has said, insurance policies are not simply "pure agreements to pay" but bargains struck by policyholders to obtain the insurer's expertise and good-faith in handling claims.[250]

The Restatement Draft rightly rejects this clever, but wrong-headed, argument.

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clause reads as follows: "No insured will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent." *E.g.*, ISO CGL Form CG 00 01 12 07, Section IV—Commercial General Liability Conditions (page 10 of 16). A typical "no action" clause reads as follows: "No person or organization has a right under this Coverage Part . . . . To sue us on this Coverage Part unless all of its terms have been fully complied with." *E.g.*, ISO CGL Form CG 00 01 12 07, Section IV—Commercial General Liability Conditions (page 11 of 16).

[247] *See, e.g.*, cases cited in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION §§ 3.01–3.03 (2d ed. 2000 & Supp. 2015).

[248] *See*, for example, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 25–27 (Spring 2015). Such arguments cite the RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 35, which states: "[w]here a valid contract defines the scope of the parties' respective performance obligations, a performance in excess of contractual requirements—neither gratuitous, nor pursuant to compromise—results in the unjustified enrichment of the recipient and a prima facie claim in restitution."

[249] *See* discussion of this argument in the Restatement Draft § 24, Comment *b. Relationship to the Restatement Third, Restitution and Unjust Enrichment*, at 153.55. Comment *b.* states: "[T]here are substantial reasons to conclude that recognition of such a claim by a liability insurer is inappropriate because of special considerations of insurance law."

[250] Bi-Economy Market, Inc. v. Harleysville Ins. Co. of N.Y., 886 N.E.2d 127, 134 (N.Y. 2008).

The Draft rightly recognizes the "special considerations of insurance law," and enumerates the "substantial benefits" that an insurer, defending under a reservation of rights, receives:

> [A]n insurer that chooses to defend under a reservation of rights receives substantial benefits from exercising that choice, beyond avoiding the risk of enhanced liability. *These benefits include maintaining control over the cost, quality, and direction of the defense, obtaining access to privileged defense-related materials, and participating in settlement discussions*. All of these benefit the insurer in the event that the claim is later determined to be within the scope of coverage and, thus, cast doubt on the assertion that the inability to obtain recoupment is unjust in the liability insurance context. Indeed, encouraging insurers to provide a defense is one of the objectives of the legal rules that create the liability risks at issue.[251]

The Restatement should continue to reject the insurers' argument on recoupment and "unjust enrichment."

h. The Obligation to Provide an Independent Defense

Section 8 is consistent with the well-reasoned view of courts in certain jurisdictions that the insured's and insurance company's interests may not be aligned.[252] This approach "provides better [liability insurance] protection to insureds" and also "increases the legitimacy of liability insurance and defense lawyers within the civil justice system."[253] The former is a principle of fairness and equity while the latter has broader implications with respect to a lawyer's ethical obligations.[254] As Section 18 states:

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[251] Restatement Draft § 24, Comment *b. Relationship of the Restatement, Third, Restitution and Unjust Enrichment*, at 154, lines 13–20 (emphasis added).

[252] *See, e.g.*, San Diego Fed. Credit Union v. Cumis Ins. Soc'y, 162 Cal. App. 3d 358 (1984) (whenever an insurer issues a reservation of rights letter, a conflict necessarily exists requiring independent counsel). *See also* Paul E.B. Glad, William T. Barker, Michael Barnes, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 16.04[4][b][iii][D] ("If a reservation has been asserted, defense counsel should assume that there is a significant risk that some evidence might support that reservation. If that would create a conflict, it may be necessary for the insured to have independent counsel, unless the insurer will withdraw the reservation.").

[253] Restatement Draft § 18, Comment *a. Common facts at issue in the claim and the coverage defense*, at 116, lines 28–29.

[254] Model Rule of Professional Conduct, Preamble [2]: ". . . As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system."; Client-Lawyer Relationship Rule 1.8 Conflict of Interest: Current Clients: Specific Rules—Comment, Person Paying for a Lawyer's Services [11]: "Lawyers are frequently asked to represent a client under circumstances in which a third person will compensate the lawyer, in whole or in part. The third person might be a relative or friend, an indemnitor (such as a liability insurance company) or a co-client (such as a corporation sued along with one or more of its employees). Because third-party payers frequently have interests that differ from those of the client, including interests in minimizing the amount spent on the representation and in learning how the representation is progressing, lawyers are prohibited from accepting or continuing such representations unless the lawyer determines that there will be no interference with the lawyer's independent professional judgment and there is informed consent

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> When an insurer with the duty to defend provides the insured notice of a ground for contesting coverage under § 17 and when there are common facts at issue in the claim and the coverage defense such that the claim could be defended in a manner that would advantage the insurer at the expense of the insured, the insurer must provide an independent defense of the claim.[255]

2. Commentary on Chapter 2, Topic 2—Settlement: Sections 27–32

a. Overview

The duty to settle fairly and reasonably and engage in settlement negotiations is also fundamental. Liability insurance policies include both the duty to defend and the duty to pay judgments and settlements. In addition, given that insurers have, as stated in Section 12, not just the duty but the right, to defend, and thus often are handling or controlling the insured's defense, the issue of how insurers handle settlement is key.

Section 27 defines an insurer's duty to settle as the duty to make reasonable settlement decisions as follows:

> (1) When a liability insurer has the authority to settle a claim brought against the insured, or when the authority to settle a claim rests with the insured but the insurer's prior consent is required for any settlement to be payable by the insurer, the insurer has a duty to the insured to make reasonable settlement decisions. The duty to make reasonable settlement decisions is owed only with respect to claims that expose the insured to liability in excess of the policy limits.[256]

As the Comments explain:

> The rule set forth in this Section is a longstanding rule of insurance law. Although the rule is sometimes referred to by courts and commentators as the "duty to settle," this Section uses the term "duty to make reasonable settlement decisions" to emphasize that the insurer's duty is not to settle every claim, but rather to make reasonable settlement decisions. Under this duty the insurer is obligated both to accept reasonable settlement demands and, as addressed in Comment *g*, to make reasonable settlement offers when appropriate. The insurer, however, may reject unreasonable settlement demands.[257]

The Comments further explain: "A reasonable settlement demand or offer is one that would be accepted or made by a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment."[258]

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from the client." *See also* Rule 5.4(c) (prohibiting interference with a lawyer's professional judgment by one who recommends, employs, or pays the lawyer to render legal services for another).

[255] Restatement Draft § 18(1).

[256] Restatement Draft § 27(1).

[257] Restatement Draft § 27, Comment *b. Reasonable settlement decisions and the disregard the limits rule*, at 170, line 29–171, line 5.

[258] Restatement Draft § 27(2), Comment *b. Reasonable settlement decisions and the disregard*

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The Restatement requires an insurer not just to respond to settlement offers but also to make settlement demands, which is something, of course, that parties without insurance would do. The duty arises

> as a special application of the duty of good faith and fair dealing in the context of insurance policies that granted the insurer some discretion over the settlement of an insured liability claim, either as a result of the insurer's control over settlement or through a requirement in the policy that the insured must obtain the insurer's consent to a settlement. As courts early recognized, when the insured faces a potential judgment in excess of the policy limit (an "excess judgment"), the insurer may have an incentive to undervalue the possibility of a loss at trial, ...[259]

It defines a "reasonable settlement decision" as "one that would be made by a reasonable person that bears the sole financial responsibility for the full amount of the potential judgment."[260] The duty includes "the duty to contribute its policy limits to a reasonable settlement of a covered claim if the settlement exceeds those policy limits."[261] Paralleling the Restatement provision precluding recoupment of defense costs, an insurer defending under a reservation of rights "may not settle a claim and thereafter demand recoupment of the settlement amount from the insured on the grounds that the claim was not covered" unless the policy includes an explicit clause allowing recoupment.[262] This rule follows existing case law and accords with the rule prohibiting an insurer from subrogating against its insured to recover settlement proceeds.[263]

A reservation of rights does not relieve an insurer of this duty. The Restatement provides that, if the insurer has reserved rights, the insured may settle without the insurer's consent if:

> (a) The insurer is given the opportunity to participate in the settlement process;
>
> (b) The insurer declines to withdraw its reservation of rights after receiving prior notice of the proposed settlement;

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the limits rule. Section 27 Comments *c.-h.* discuss what constitutes "reasonableness."

[259] Restatement Draft § 27, Comment *a. The function of the duty to make reasonable settlement decisions*, at 169, lines 21–27.

[260] Restatement Draft § 27(2). Under § 27(3), the duty includes "a duty to accept reasonable settlement demands made by claimants" up to the insurers' policy limit. Restatement Draft § 27(3).

[261] Restatement Draft § 27(4).

[262] Restatement Draft § 28(2); *compare* Restatement Draft § 24. The rules precluding recoupment in the absence of explicit contract provisions allowing it are default ones. Restatement Draft § 28, Comment *c. The default rule is no right to recoupment*.

[263] An equitable doctrine, subrogation allows an insurance company to pursue a third party to recover sums that it has paid on a claim. The anti-subrogation rule prevents an insurance company from passing its payment of loss back to its own insured. *E.g.*, Pennsylvania Gen. Ins. Co. v. Austin Powder Co., 510 N.Y.S.2d 67, 69–70 (N.Y. 1986); Home Ins. Co. v. Pinski Bros., Inc., 500 P.2d 945, 948–49 (Mont. 1972). The concept that an insurer can subrogate against its own policyholder is antithetical to the very idea of insurance. In addition, the anti-subrogation rule helps prevent conflicts of interest between insurance companies and their insureds. *See, e.g.*, Stafford Mediaworks, Inc. v. Cook Paint & Varnish Co., 418 F. Supp. 56, 63 (N.D. Tex. 1976).

> (c) A reasonable person that bore the sole financial responsibility for the full amount of the potential covered judgment would have accepted the settlement; and
>
> (d) If the settlement includes payments for damages that are not covered by the liability insurance policy, the portion of the settlement allocated to the insured component of the claim is reasonable.[264]

A point of contention is whether the duty to settle should be predicated on a "disregard the limits" or "equal consideration" standard. The Restatement sides with the "disregard the limits" standard; *i.e.,* what would a reasonable person, bearing sole financial responsibility for the judgment do? The Restatement explains that this standard applies to both duty to defend and defense indemnification insurance policies:[265]

> This application of the reasonableness standard to settlement decisions is sometimes referred to by courts and commentators as the "disregard the limits" rule, since a reasonable person is defined as one who makes settlement decisions in disregard of the policy limits. With respect to defense cost indemnification policies, the same rule can be applied to the insurer's decision whether to grant its consent to a settlement entered into by the insured.[266]

b. Insurer Objections

The insurance industry takes issue with the Restatement's proposed rule that insurers should be required to make settlement offers, as opposed to simply responding to settlement demands. Insurers contend that requiring them to make affirmative settlement offers puts them "at the mercy of jury interpretations of the settlement strategies."[267] This assertion is largely unsupported and ignores the reality and standard practices of litigation and threats to livelihoods and assets faced by insureds who are sued.

Under the Restatement, a breach of this duty properly subjects an insurer to excess liability, a rule that the insurance industry, of course, has always strongly opposed.[268] However, again, it is instructive to return to our Fundamental Principles (in Section III of this article) above. Policyholders buy insurance to obtain protection from just such threats. Insurers promise protection and, in handling litigation, represent the insured. They—and the lawyers they pay to represent their insureds—have an obligation to the policyholder, and it is reasonable to require an insurer, and the lawyer charged with representing the

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[264] Restatement Draft §§ 28(3)(a)–(d).

[265] See Restatement Draft § 25 for discussion of "Defense Cost Indemnification Policies" which are insurance policies "in which the insurer agrees to pay the costs of a covered claim and does not undertake a duty to defend." Restatement Draft § 25(1).

[266] Restatement Draft § 27, Comment *b. Reasonable settlement decisions and the disregard the limits rule*, at 171, lines 7–11.

[267] *See* Kent D. Syverud, *The Duty To Settle*, 76 VA. L. REV. 1113, 1166–67 (1990).

[268] *See, e.g.*, Comunale v. Traders & General Ins. Co., 50 Cal. 2d 654 (1958).

insured as his or her client, to give the insured appropriate consideration and legal representation and counsel. No policyholder, or insured, should be worse off for having insurance. The duties of insurance companies clearly include ensuring that counsel appointed to defend insureds act reasonably, avoid conflicts, and follow the rules of professional conduct, giving "zealous" representation to insureds.[269] With regard to the duty to defend and the affirmative duty to make reasonable settlement decisions more specifically, insurers have made relevant admissions when their own coverage is at stake:

> [The Policyholder] is likely not as familiar with litigation and claims evaluation and disposition as the insurance company . . . [T]he insurer is a professional defender of lawsuits . . . . *Unlike the insured, an [insurance company] is not a novice as to matters involving litigation*.[270]

It is rational then, as many courts have held, and consistent with the Restatement's affirmative duty to make reasonable settlement decisions, to place the burden of negotiating and entering into settlements on the insurer, subject to the interests of the policyholder.[271] This approach is consistent with both the reality of the litigation process and the insurance company's expertise and resources and a lawyer's ethical obligations under the rules of professional conduct to consult the client about the client's "objectives" while directing the manner in which they are achieved.[272] This is also consistent with insurers' duty

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[269] *See* Preamble to Model Rules of Professional Conduct.

[270] *See, e.g.*, Liberty Mutual Insurance Company's Memorandum in Support of Motion for Partial Summary Judgment, at 7, filed July 5, 1988, National Union Ins. Co. v. Liberty Mut'l Ins. Co., 696 F. Supp. 1099 (E.D. La. 1988) (No. 86-2000) (emphasis added).

[271] *See, e.g.*, Coleman v. Holecek, 542 F.2d 532, 537 (10th Cir. 1976) (applying Kansas law and noting that "[t]he duty to consider the interests of the insured arises not because there has been a settlement offer from the plaintiff but because there has been a claim for damages in excess of the policy limits. This claim creates a conflict of interest between the insured and the carrier which requires the carrier to give equal consideration to the interests of the insured." (citations omitted)); City of Hobbs v. Hartford Fire Ins. Co., 162 F.3d 576, 586 (10th Cir. 1998) (applying New Mexico law and finding that an insurer can be liable for a bad-faith failure to settle even though a claimant has not submitted a firm reasonable offer); Maine Bonding & Cas. Co. v. Centennial Ins. Co., 693 P.2d 1296, 1299 (Or. 1985) (insurer's duty "may require that an insurer make inquiries to determine if settlement is possible within the policy limitations."); Alt v. American Family Mut. Ins. Co., 237 N.W.2d 706, 713 (Wis. 1976) ("in some circumstances at least [the insurer] has an affirmative duty to seize whatever reasonable opportunity may present itself to protect its insured from excess liability."); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 506–07 (N.J. 1974) ("an insurer . . . has a positive fiduciary duty to take the initiative and attempt to negotiate a settlement within the policy coverage. Any doubt as to the existence of an opportunity to settle within the face amount of the coverage . . . must be resolved in favor of the insured unless the insurer, by some affirmative evidence, demonstrates there was not only no realistic possibility of settlement within policy limits, but also that the insured would not have contributed to whatever settlement figure above that sum might have been available.").

[272] *See* Restatement Draft § 27, Comment *g. The effect on strategic negotiation. See also* Model Rules of Professional Responsibility:

- *Client-Lawyer Relationship*—Rule 1.2 Scope of Representation and Allocation of Authority

of good faith and fair dealing.[273]

Insurers take issue with the idea that a reasonable settlement would in some cases, require a settlement at the "high end" of the range of reasonableness.[274] Again, the refrain is that costs and premiums will necessarily increase. This seems an odd objection as settling in such a range is always part of the settlement calculus. Regardless, in Comments the Reporters clarify that the rule is flexible.[275] For example, while acknowledging difficulties inherent in complex cases, the Restatement adopts the following criteria for applying the "reasonableness" standard:

> In determining whether a settlement decision was reasonable, the factfinder should view the settlement decision from the perspective of the insurer and the insured defendant at the time the settlement decision was made. A reasonable

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Between Client and Lawyer: A "lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter."

- *Client-Lawyer Relationship*—Rule 1.4 Communication: "(a) A lawyer shall: (1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules; (2) reasonably consult with the client about the means by which the client's objectives are to be accomplished; (3) keep the client reasonably informed about the status of the matter; (4) promptly comply with reasonable requests for information; and (5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law. (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

[273] *See, e.g.*, Comunale v. Traders & General Ins. Co., 50 Cal. 2d 654, 654–55 (1958) (the implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case although the express terms of the policy do not impose such a duty).

[274] William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 48 (Spring 2015).

[275] Restatement Draft § 27, Comment *d. Reasonable is a range, not a point*, at 171, lines 27–31: "The reasonableness standard set forth in this Section is a flexible one that permits the fact finder to take into account the whole range of reasonable settlement values. In the real world of civil litigation, too many contingencies can affect trial outcomes for there to be only one reasonable settlement value. To the contrary, there generally is a range of reasonable settlement values." *See also* § 27 Reporters Note, Comment *c*. at 185, lines 24–49, citing Rhodes v. AIG Domestic Claims, Inc., 24 Mass. L. Rptr. 142 at n.13 (Mass. Super. Ct. June 3, 2008) (not reported in N.E.2d) (with a parenthetical explaining that "although the ultimate $3.5 million dollar settlement was at the low end of the reasonable range of settlement offers, an earlier offer of $6.5 million was 'also within the range of reasonable offers.'"). The Reporters Note continues: "An insurer has not breached its duty to settle by rejecting a settlement offer well above the range of reasonable settlement amounts. *See, e.g.*, Christian Builders, Inc. v. Cincinnati Ins. Co., 501 F. Supp. 2d 1224, 1237 (D. Minn. 2007) (holding that the insurer had not unreasonably refused to settle when the plaintiff refused to lower its $2 million offer and the insurer had accurately assessed the reasonable settlement value between $400,000 and $600,000)."

> liability insurer is expected, at the time of the settlement negotiations, to take into account the realistically possible outcomes of a trial and, to the extent possible, to weigh those outcomes according to their likelihood.[276]

Insurers also take issue with the wisdom in Comment *i*., which states that the reasonableness "standard requires the trier of fact in the breach of settlement duty suit to evaluate the expected value of underlying litigation at the time of the failed settlement negotiations."[277] Specifically, insurers disagree that factfinders should "consider procedural factors that affected the quality of the insurer's decision-making or that deprived the insured of evidence that would have been available if the insured had behaved reasonably."[278] However, the failure to investigate and properly communicate with an insured or a claimant are proper grounds for breach of the duty to settle. Most states' claims-handling and settlement regulations require insurers to follow best practices.[279] In many states, a failure to follow procedural guidelines set forth in the state's claim-handling statutes can give rise to, or is evidence of, bad-faith conduct.[280]

With regard to bad faith, insurers take the position that increased liability for bad faith increases costs and generates unnecessary litigation. Yet, there is no (or no other) mechanism for deterring insurer misconduct and compensating policyholders and insureds for a breach. This standard also properly aligns incentives for insurers and insureds and provides relief for insureds harmed by conduct that, contrary to the purpose of insurance, opens them to exposures that they might not have faced in the absence of insurance. Public-policy concerns outweigh rare examples of collusion.[281] When insureds entrust the settlement of a claim to an insurer, they are placing the utmost trust and confidence in the insurer to follow the accepted rules of procedure and ultimately to make reasonable settlement

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[276] Restatement Draft § 27, Comment *c. Applying the reasonable standard*, at 170, line 5.

[277] Restatement Draft § 27, Comment *i. Other factors to be considered*.

[278] Restatement Draft § 27, Comment *i. Other factors to be considered*, at 178, lines 23–25.

[279] *See* National Association of Insurance Commissioners, Model Regulation Service, Unfair Claims Settlement Practices Act (adopted by a majority of states) (http://www.naic.org/store/free/MDL-900.pdf).

[280] In California, for example, violations of Cal. Ins. Code. § 790.03 can be evidence of bad faith. *See, e.g.*, Wilson v. 21st Century Ins. Co., 38 Cal. Rptr. 3d 514 (Cal. Ct. App. 2006) (duty to investigate, delay is settling claim as enumerated in § 790.03 extend to the covenant of good faith and fair dealing, breach of which amounts to bad faith).

[281] *See* discussion in William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 57–67 (Spring 2015). *See, e.g.*, Gutierrez v. Yochim, 23 So. 3d 1221 (Fla. Dist. Ct. App. 2009) (discussed at length in William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 57–60 (Spring 2015) as an example of where the policyholder apparently hoped for a breach of the settlement duty as a means of collecting more than the policy would pay if exhausted).

decisions on their behalf.[282] It is necessary to include consideration of these procedural safeguards to protect insureds and the public-policy function of insurance.

c. Rebutting Insurers' "Actual Facts" Arguments

Insurer advocates argue that coverage should not apply if the "actual" or "non-liability" facts could, after litigation, disprove coverage.[283] Courts have rejected such arguments, and the Restatement should as well.

Liability insurance covers a policyholder's liability for negligence and other actions as defined in the insurance policy. Settlement agreements typically do not concede liability, or specify the precise basis for the insured's liability. Insureds who settle a case "need not prove" actual liability on the underlying claim[284] in order to recover under their insurance policies. In the absence of fraud between the plaintiff and the insured, an insurer should not be able to avoid covering a settlement on the grounds that no court rendered findings of fact on key liability issues. As long as there is evidence of the reasonableness of the insured's decision to settle the claim, the insurance applies to cover the settlement.[285] As courts have recognized, requiring policyholders to prove their own liability in order to recover insurance would defeat the purpose of liability insurance, increase the policyholder's (and, thus, the insurance company's) total liability, and provide other grounds to the insurer to argue against coverage. Significantly, doing so also would contravene the strong public policy favoring settlement.

Courts have recognized that, under these circumstances, it is unreasonable and unfair to require a policyholder who has settled the underlying case against it to prove the case (or, as the insurance companies typically argue, the "actual facts"

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[282] *See, e.g.*, Birth Center v. St. Paul Cos., 787 A.2d 376, 389 n.17 (Pa. 2001) ("Where the insurance company takes control of the decision to settle or litigate actions brought by third parties, the insurance company owes its policyholder a fiduciary duty, among other things, to engage in good faith settlement negotiations." (citing Gedeon v. State Farm Mut. Auto. Ins. Co., 188 A.2d 320 (Pa. 1963)); Gray v. Nationwide Mut. Ins. Co., 223 A.2d 8, 11 (Pa. 1966) ("by asserting in the policy the right to handle all claims against the insured . . . the insurer assumes a fiduciary position towards the insured and becomes obligated to act in good faith and with due care in representing the interests of the insured").

[283] *E.g.*, William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 36–40 (Spring 2015). In our experience, insurers frequently assert this argument in coverage litigation. See discussion of this issue in LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 4.04[D][2] (2d ed. 2000 & Supp. 2015).

[284] *See* Isaacson v. California Ins. Guarantee Assn., 44 Cal. 3d 775, 793 (1988).

[285] *E.g.*, Luria Bros. & Co. v. Alliance Assurance Co., 780 F.2d 1082 (2d Cir. 1986) (*Luria*); *accord* Uniroyal Inc. v. Home Ins. Co., 707 F. Supp. 1368 (E.D.N.Y. 1988) (*Uniroyal*); Dayton Indep. Sch. Dist. v. Nat'l Gypsum Co., 682 F. Supp. 1403, 1406–07 (E.D. Tex. 1988) (*Dayton*), *rev'd on other grounds sub nom*. W.R. Grace & Co. v. Continental Cas. Co., 896 F.2d 865 (5th Cir. 1990) (applying New York law).

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and now "liability facts") against itself, or to prove the precise basis of its liability which usually has been disputed anyway.[286] Rather, a policyholder need demonstrate only that the claims settled are of a "type" that are included within the policy's coverage. Thus, when a case against the insured is settled, the allegations of the complaint—as contrasted with the actual basis of liability, or "actual" or "liability" facts—determine whether the insured's coverage applies to the settlement.[287] An insured is not required to litigate the facts of a settled claim (and possibly prove the basis for its own liability) to obtain insurance coverage.[288]

Judge Weinstein's decision in *Uniroyal, Inc. v. Home Insurance Co.*[289] explains the point. *Uniroyal* arose out of the "Agent Orange" products liability litigation, in which approximately 2,500,000 Vietnam veterans and their family members organized as a class and sued the United States and manufacturers of chemicals used during the Vietnam war. The plaintiffs in that action alleged that exposure to these chemicals caused various forms of cancer and other severe medical conditions. The policyholder and other manufacturers of Agent Orange ultimately settled with the plaintiffs agreeing to pay $180 million in damages.

In the resulting coverage action, Uniroyal's insurance company argued that the policyholder was required to prove the "actual injury" to the Agent Orange claimants in order to obtain coverage. The court disagreed. *First*, the court noted, the plain text of the general liability insurance policies at issue did not support the insurance company's position. The insurance policies promise to cover "all sums which the insured shall be obligated to pay by reason of the liability (a) imposed upon the Insured by law or (b) assumed under contract or agreement by the Named Insured . . . for damages . . . on account of—(i) Personal Injuries . . . arising out of each occurrence."[290] In this language, the insurer explicitly agreed to cover "agreements" for damages "on account of . . . Personal Injuries"—that is, settlements.

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[286] *See* William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II—Selected Comments from an Insurer Perspective*, NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW 36–40 (Spring 2015).

[287] *Luria* and *Uniroyal* are key cases confirming this principle. *See also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION §§ 3.14[B], 4.04[D][2] (2d ed. 2000 & Supp. 2015).

[288] *Accord Dayton*, 682 F. Supp. at 1406–07 ("A [settling] policyholder, . . . does not have to prove its actual liability as a prerequisite to obtaining coverage"); Howard v. American Nat'l Fire Ins. Co., 187 Cal. App. 4th 498, 515 (2010) ("Plaintiffs were not required to prove molestation within the policy period in the underlying action. It is sufficient that plaintiffs proved to the jury that [a plaintiff] was molested by a priest negligently retained by the Bishop (establishing a basis for liability encompasses by the policy) and later proved, in this coverage action, that the molestation occurred within the policy period."); *see also* LORELIE S. MASTERS, JORDAN S. STANZLER, & EUGENE R. ANDERSON, INSURANCE COVERAGE LITIGATION § 4.12 (2d ed. 2000 & Supp. 2015).

[289] Uniroyal, Inc. v. Home Ins. Co., 707 F. Supp. 1368 (E.D.N.Y. 1988).

[290] *Uniroyal*, 707 F. Supp. at 1374.

Second, the court held that the insurance company's argument would place "settling defendants":

> in *the hopelessly untenable position of having to refute liability in the underlying action until the moment of settlement, and then of turning about face to prove liability in the insurance action*. Often the evidence needed to prove actual injury—such as the tort plaintiffs' medical histories—would be unavailable to the insured.[291]

Such a task, the court concluded, would "markedly reduce the advantages to the insured in settling: faced with the choice of defending the tort action vigorously or settling it without hope of insurance reimbursement, insureds would tend to choose the former."[292] The court rejected that outcome and its repudiation of the public policy encouraging settlement.

Similarly, in *United States Gypsum Co. v. Admiral Insurance Co.*,[293] an Illinois appellate court held that a policyholder "does not have to prove *de novo* the existence of damage in the underlying action; i.e., its own liability."[294] The court recognized that requiring the insured to prove its own liability would, in effect, "transform" the coverage action into another trial of underlying liability, with the attendant risks of inconsistent verdicts and estoppel:

> Regardless of the particular legal doctrine invoked to reject the attempt to transform a coverage action into a second liability action, the policy considerations which favor prohibiting such actions are the same. If the defendants' position was adopted, two different triers of fact, the one in the underlying action and the one in the coverage action would hear the same arguments . . . . The contrary positions which the insured would be forced to take would make it impossible for the insured to participate in both actions without charges of perjury or the invocation of the doctrine of judicial estoppel which could preclude a party from taking inconsistent positions in separate judicial proceedings.[295]

In trying to recover amounts of settlement, the policyholder is not required to prove, in a coverage action, the case that it has tried to disprove in the underlying

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[291] *Uniroyal*, 707 F. Supp. at 1374 (emphasis added).

[292] *Uniroyal*, 707 F. Supp. at 1374.

[293] United States Gypsum Co. v. Admiral Ins. Co., 643 N.E.2d 1226 (Ill. App. Ct. 1994).

[294] *United States Gypsum*, 643 N.E.2d at 1242.

[295] *United States Gypsum*, 643 N.E.2d at 1242. The court relied in part upon a leading treatise on insurance that states:

> One who has taken to indemnify another against loss arising out of a claim and has notice and opportunity to defend an action brought upon such a claim is bound by the judgment entered in such action, and is not entitled, in an action against him for breach of his agreement to indemnify, to secure a retrial of the material facts which have been established by judgment against the person indemnified. This concept of binding the liability insurer by the judgment against the insured is not an application of the principle of res judicata but is better termed estoppel by judgment.

18 GEORGE COUCH, COUCH ON INSURANCE 2D § 74:816, at 1087 (rev. ed. 1983).

actions. To recover from its insurance company the amounts paid in settlement, a policyholder need only show the basis for liability and that the settlement amount was reasonable. The Restatement should follow these principles, confirming coverage for settlements under liability insurance policies and supporting the public policy favoring settlements.

d. Damages for Breach of the Duty to Make Reasonable Settlement Decisions

Section 30 states that an insurer that breaches this duty is subject to liability "for the difference between the amount of damages assessed against the insured and the limits of coverage in the policy."[296] In such circumstances, the insured also is entitled "to recover for actually foreseen and highly foreseeable harms caused to the insured by the insurer's breach" of the duty.[297] Insureds are entitled to these damages for breach consistent with case law imposing such damages in order to enforce the covenant of good faith and fair dealing.[298] This rule protects the insured from exposure resulting from the insurance company's breach of this important duty and helps assure that insurers have the proper incentive to honor this obligation and protect their insureds' interests.

VI. CONCLUSION

The Restatement of the Law, Liability Insurance addresses a key area of the law, and one that touches both companies and individuals in significant ways. Because of the importance of insurance to the economy, it has been highly regulated, and the substantive terms of the standard-form policies that millions of businesses and ordinary consumers buy are drafted by the insurance industry and subject to extensive regulation. Insurance serves important public purposes, facilitating commerce and spreading both risk and liability. For these reasons, courts and legislatures have recognized that insurance is different and that a breach of this special kind of contract cannot be cured with a substitute for performance as ordinary contracts can. It is important, therefore, to ensure that

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[296] Restatement Draft § 30(1).

[297] Restatement Draft § 30(2).

[298] That covenant encompasses the duty to make reasonable settlement decisions. *E.g.*, Egan v. Mut. of Omaha Ins. Co., 24 Cal. 3d 809, 818 (1979); *see also, e.g.*, Hamilton v. Maryland Cas. Co., 27 Cal. 4th 718, 724 (2002); Comunale v. Traders & General Ins. Co., 50 Cal. 2d 654 (1958) (the decisive factor in fixing the extent of liability is not the refusal to defend; it is the refusal to accept an offer of settlement within the policy limits; the implied covenant of good faith and fair dealing imposes a duty on the insurer to settle a clam against its insured within policy limits whenever there is a substantial likelihood of a recovery in excess of those limits); Miller v. Elite Ins. Co., 100 Cal. App. 3d 739 (1980) ("the covenant of good faith and fair dealing is always a prominent issue in the settlement phase of insurance cases because of the possibility of a conflict of interest between the interests of the insurer and the insured." (citing Merritt v. Reserve Ins. Co., 34 Cal. App. 3d 858 (1973)); Amato v. Mercury Cas. Co., 53 Cal. App. 4th 825 (1997) ("rejection of a settlement offer, subject[s] the insurer to liability for the judgment against the insured even when it is in excess of the policy limit" (citing State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 9 Cal. App. 3d 508, 528–31 (1970)).

incentives between policyholders and insureds, on the one hand, and insurers, on the other, are properly aligned, and that remedies for breaches of insurance contracts adequately compensate policyholders and insureds.

This article discusses principles that we believe are important to help ensure that policyholders and insureds are adequately protected, as summarized below.

Rules of Interpretation:

- The Restatement should support universal rules that apply uniformly to policyholders of all sizes who have liability insurance policies using standard-form terms. Because substantive liability insurance terms and concepts are the same for all policyholders except for the very largest multi-national policyholders with significant market power, the Restatement should reject arguments that different rules should apply to "sophisticated commercial policyholders."
- We believe that the Restatement's proposed rules of policy interpretation are inordinately weighted toward "plain meaning" and should, instead, be more sensitive to the contextual approach and pro-policyholder doctrines that seek to protect the interests of policyholders and insureds.
- Given that liability insurance policies constitute the "archetypical adhesion contract," the Restatement properly allows for introduction of extrinsic evidence to establish ambiguity. Indeed, because liability insurance policies use substantive terms drafted by the insurance industry without input from policyholders, the Restatement should allow for introduction of extrinsic evidence to ensure that courts interpret such terms in accordance with the insurance industry's drafting intent. Failure to do so equates insurance policies with ordinary contracts, ignoring their "special nature" and public-policy purposes.
- The Restatement should recognize the rule, commonly applied, that requires the insurance company to show that its proffered interpretation is the only reasonable interpretation of the standard-form language at issue.

Waiver and Estoppel:

- The definition of waiver adopted in the Restatement accords with the traditional definition of waiver in most common-law cases, providing no basis for significant objection by insurers.
- We do not believe that the Restatement's adoption of a no post-loss waiver rule is appropriate. At a minimum, the Restatement should explain why such a rule is appropriate in situations where insurer conduct after the loss can disadvantage insureds.
- We do not agree with the idea that applying waiver somehow allows an insured to "waive into coverage." The majority rule clearly is that insurers can waive conditions to coverage. With regard to other issues, application of waiver is appropriate as a remedy and as a prophylactic rule to address

negligent or exploitative behavior by insurers particularly in light of the special and protective nature of the insurance relationship.

- The Restatement's rules on estoppel, combining elements of promissory and equitable estoppel in one rule, provide necessary protection for policyholders and insureds. The Restatement appropriately recognizes that estoppel can apply to post-loss conduct by an insurer.

Misrepresentation:

- The Restatement should not adopt objective standards with regard to what a "reasonable" insurer might have done with regard to misrepresentation. As under New York law, a subjective standard of what the insurer involved in the specific policy in question would have done is more appropriate, and recognizes the special and protective nature of liability insurance.
- The Restatement proposals appear too heavily slanted toward insurers, considering misrepresentation almost a "strict liability" issue. The Restatement's current proposals ignore the common-sense requirements, included in the law of states like New York, that require insurers to show that they would not have issued the specific policy in question had they known the facts, and that they provide proof corroborating their arguments that they would have issued different policy terms had they known the facts.
- At a minimum, the Restatement should adopt those rules of proof as a means of ameliorating the potential harsh effects of the proposed rules, paralleling the provisions of state law that require such proof.
- The Restatement should adopt the contribute-to-the-loss standard.
- The Restatement properly rejects "concealment" and "innocent misrepresentation" defenses, requiring insurers to show that any misrepresentation was intentional or reckless. It also properly refers to a clear and convincing standard on burden of proof.
- The Restatement should make clear that assertion of a misrepresentation defense will not relieve a liability insurer of its duty to defend. At present, that point is not clearly made in the Restatement Draft.

The Insurer's Duty To Defend:

- The Restatement properly adopts a potential for coverage standard (without stating it explicitly in such terms). Given the importance of the duty to defend, the Restatement also properly adopts "one-way rule" on use of extrinsic evidence in support of the duty to defend. This coincides with and supports the breadth of the duty to defend, as recognized in all jurisdictions in the United States.
- An insurer's breach of its duty to defend deserves the remedy adopted by courts and followed by the Restatement: waiver of the insurer's right to contest coverage. The Restatement rightly comes down on the side of

enforcing the contract and creating certainty for insureds on this important contractual promise.

- The Restatement should delete the provisions in Sections 15(3) and 20(7) that would allow insurers potentially to litigate, or relitigate, facts relevant to trigger of coverage with regard to the duty to defend. As recognized by key court decisions, such a rule requires insureds to prove the case against themselves in the underlying case and also requires them to fight a "two-front war," one on coverage and one against the plaintiffs in the underlying cases.

The Insured's Duty to Make Reasonable Settlement Decisions:

- The Restatement properly puts the burden on insurers defending policyholders and insureds to not simply respond to settlement demands, but make affirmative settlement offers. Clearly that is what a lawyer representing a party without regard to insurance would do.
- The Restatement also properly subjects insurers who have breached this duty to liability for damages that an insured suffers as a result.

Issues Relevant to Both the Duty to Defend and the Duty to Make Reasonable Settlement Decisions:

- The Restatement should clearly reject the insurer arguments that they should be able to rely upon "actual" or "non-liability" facts in order to negate either the duty to defend or the duty to settle. The law is to the contrary. In addition, allowing insurers to relitigate such issues will negate both the duty to defend and the public policy favoring settlements.
- The Restatement properly rejects efforts by insurers to recoup either defense costs or costs of settlement in the absence of an explicit contract provision allowing recoupment. Courts should not read such provisions into standard-form liability policies where none exists.
- The Restatement should reject insurer arguments about "unjust enrichment." Such arguments ignore the special nature of insurance and effectively, and improperly, convert insurance contracts into ordinary contracts.