



## WITH INSURANCE LIABILITY RESTATEMENT, AMERICAN LAW INSTITUTE DEVIATES FROM ITS MISSION AND THE COMMON LAW

by Kim V. Marrkand

As the very first Restatement of the Law, Liability Insurance<sup>1</sup> (RLLI) nears a possible final vote by the members of the American Law Institute (ALI) at its Annual Meeting on May 23, 2017, courts, consumers, policyholders, insurers, regulators, and ALI members alike should ask one question: Is this a good thing? The answer: in its current form, no, it is not.

In 2010, ALI initially decided to embark upon the first “Principles of the Law, Liability Insurance” (Principles). However, in October, 2014, in an unprecedented move, ALI switched the project to a Restatement. The Reporters,<sup>2</sup> who had already submitted two chapters of a largely aspirational treatment of what they believed liability insurance law “should be”—which had been approved by the ALI membership—did not change, nor did the timeline for completion of the project. Nor did much else, except for the addition of a perfunctory nod to the higher standards that exist for a Restatement. This LEGAL BACKGROUNDER describes ALI’s role, relates the growing concerns about ALI’s expanding mandate, and provides three concrete examples of why, in its current form, ALI members should not approve the RLLI.

**ALI’s Role.** ALI is a 4,300-member private organization comprised predominantly of academics and lawyers. Included within its membership are also approximately 245 *ex officio* members who include the US Supreme Court justices, federal courts of appeal chief judges, the chief justices of each state’s highest court, and the deans of every accredited law school, among others. Thus, when ALI “speaks,” it does so with a voice of legitimacy this august body of *ex officio* members provides. ALI’s Restatements have become influential because of their reputation for neutrality; the projects are not supposed to reflect a bias for or against any constituency, nor may they promote sweeping public policy changes that are the purview of elected officials.

**Alarm over ALI’s Expanding Mission.** Given that tradition, Restatements are routinely cited by courts across the country. In an effort to ensure that drafts of proposed Restatements do not overreach ALI’s limited mandate, Reporters must carefully guard against using a Restatement as a platform to promote their own public policy viewpoints in the face of well-settled law. As recently as 2015, Justice Scalia was alarmed enough by what he saw as a severe dilution of the legitimacy of modern Restatements to warn that they “are of questionable value, and must be used with caution. ... Over time, the Restatements’ authors have abandoned the mission of describing the law, and have chosen instead to set forth their aspirations for what the law ought to be.” *Kansas v. Nebraska*, 135 S. Ct. 1042, 1062 (2015). Therefore, according to Justice Scalia,

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<sup>1</sup> Restatement of the Law, Liability Insurance, Proposed Final Draft (Mar. 28, 2017).

<sup>2</sup> The two Reporters for the RLLI are Professors Tom Baker (University of Pennsylvania Law School) and Kyle D. Logue (University of Michigan Law School).

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“Restatements should be given no weight whatsoever as to the current state of the law, and no more weight regarding what the law ought to be than the recommendations of any respected lawyer or scholar.” *Ibid.*

To date, ALI’s public response to Justice Scalia’s powerful warning has been silence and an exasperated shrug of its institutional shoulders. Restatement Reporters still control the drafting pen, essentially leaving them with the sole discretion to accept or ignore the comments they receive that a particular proposed rule has no or minimal common-law support and does not reflect an emerging trend in the law. Granted, an overarching ALI “Council” watches over each project, and the ALI membership does vote at an annual meeting on each new chapter of a Restatement. The reality, however, is that neither the Council nor the membership can read, let alone deconstruct and then challenge, all the material the Reporters have provided them, particularly for Restatements on subjects with which most members have little familiarity. The Council and the ALI members are left to rely on the Reporters to do their job, understandably defaulting to their expertise and arguments given the sheer scope of each project.

***Three RLLI Sections that Depart from the Mission of a Restatement.*** The RLLI contains numerous provisions that reflect what the common law should be, rather than the law as it presently exists or might appropriately be stated by a court. The three described below are among the most inappropriate provisions for a Restatement.

1. *Consequences of the Breach of the Duty to Defend in the Absence of Bad Faith.* RLLI § 19 has had a troubled history. When the RLLI was originally a Principles project, ALI approved a radically aspirational concept whereby an insurer who breached the duty to defend—for whatever reason—automatically forfeited all of its coverage defenses. Regardless of the insurer’s good faith, the fact that the insured retained defense counsel, the immateriality of the breach, and the availability of contract damages for such a breach, the insurer lost its right to show that the loss was not covered. In other words, even though the insurer had *not* breached the duty to indemnify, it was to be treated as if it had by being estopped from showing it had no duty to indemnify through coverage defenses. Principles, Council Draft No. 4, § 21 (Sept. 20, 2013).

After the Principles project became a Restatement, the Reporters modified that provision (renumbered § 19 in the RLLI). But the new § 19 still does not reflect the common-law rule of any state and penalizes an insurer for breaching the duty to defend by forfeiting its coverage defenses absent bad faith. The only difference is that § 19(2) now says that an insurer who breaches the duty to defend “without a reasonable basis for its conduct” forfeits its coverage defenses. But, as Judge Sarah Vance of the US District Court for the Eastern District of Louisiana explained in her October 26, 2015 letter to the RLLI Reporters and the Director and Deputy Director of ALI (available from ALI), the Reporters’ Note “does not adequately support the proffered rationale for adopting the draft’s ‘limited forfeiture rule’ [and] the Note identifies no trends in support of the proposed rule; nor does it provide any social science evidence or empirical analysis to support its proposal to change the status quo.” Ultimately, Judge Vance concluded that “the draft’s policy analysis is too thin to justify an apparent departure from existing law.” Instead of addressing these and other commentators’ concerns, the Reporters elected to renew their policy-based justification to simply overlook the law in nearly 30<sup>3</sup> states that do not penalize insurers for breaching the duty to defend—absent bad faith—by saying

<sup>3</sup> *Afcan v. Mut. Fire, Marine & Inland Ins. Co.*, 595 P.2d 638, 647 (Alaska 1979); *Alabama Hosp. Ass’n Trust v. Mut. Assur. Soc. of Alabama*, 538 So. 2d 1209, 1216 (Ala. 1989); *Quihuis v. State Farm Mut. Auto. Ins. Co.*, 334 P.3d 719, 728–29 (Ariz. 2014); *Hogan v. Midland Nat’l Ins. Co.*, 476 P.2d 825, 832 (Cal. 1970); *Colonial Oil Indus., Inc. v. Underwriters*, 491 S.E.2d 337, 339 (Ga. 1997); *Sentinel Ins. Co. v. First Ins. Co. of Hawai’i*, 875 P.2d 894, 912–14 (Haw. 1994); *Deluna v. State Farm Fire & Cas. Co.*, 233 P.3d 12, 16 (Idaho 2008); *State Farm Fire & Cas. Co. v. T.B. ex rel. Bruce*, 762 N.E.2d 1227, 1232 (Ind. 2002); *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 535 (Iowa 1995); *Cincinnati Ins. Co. v. Vance*, 730 S.W.2d 521, 524 (Ky. 1987); *Arceneaux v. Amstar Corp.*, 66 So. 3d 438, 452 (La. 2011); *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 922 (Mass. 1993); *Elliott v. Hanover Ins. Co.*, 711 A.2d 1310, 1313 (Me. 1998); *Brown v. State Auto. & Cas. Underwriters*, 293 N.W.2d 822, 825–26 (Minn. 1980); *Butters v. City of Independence*, 513 S.W.2d 418, 425 (Mo. 1974); *A.B.C. Builders, Inc. v. Am. Mut. Ins. Co.*, 661 A.2d 1187, 1191 (N.H. 1995); *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 6 N.E.3d 1117, 1120 (N.Y. 2014); *Timberline Equip. Co. v. St. Paul Fire & Marine Ins. Co.*, 576 P.2d 1244,

§ 19(2)'s draconian results will provide "an incentive to insurers to fulfill their duty to defend." RLLI, Reporters' Note *b*. But, as Judge Vance asked, "how big of a refusal-to-defend problem are we confronting? Is it on the increase? Is the risk of unreasonable denials of a defense sufficient to overcome the risks identified by insurers of encouraging frivolous claims to cover and reducing the availability of insurance because of the attendant increases in costs?"

Instead of answering those questions or dealing with the dearth of common-law support for this novel "quasi-forfeiture" rule, the Reporters freely cite to cases that stand for the proposition that a "bad faith" denial of the duty to defend may result in a forfeiture of coverage defenses, § 19, Reporters' Note *c*, while simultaneously rejecting "bad faith" as the standard for imposing this penalty upon an insurer who breaches the duty to defend. It is difficult to reconcile citing bad-faith case law to justify a rule that omits bad faith as the standard. But, as the Reporters have explained in a remarkably candid admission, why bother to have the RLLI and the prestige of ALI clutter § 19(2) with the "emotive overtones of the 'bad faith' label."<sup>4</sup> Section 19(2), however, does not reflect the law of any state, does not reflect a trend in the law, and is not supported by any empirical evidence.

2. *Fee Shifting in Violation of the American Rule*. RLLI §§ 48(4), 49(3), and 51(1), contrary to the majority rule and with no emerging trend otherwise, would require insurers to pay the insured's attorneys' fees.

Fee shifting is not unique to liability insurance. It is, as attorneys Victor E. Schwartz and Christopher E. Appel wrote in a letter to the RLLI Reporters, a "major public policy issue that has been debated for decades, perhaps most notably by Congress and state legislators."<sup>5</sup> The "American Rule," as the loser-pays principle is known, is deeply entrenched in the common law. Absent a recent contrary trend in the law (and there currently is none), ALI should not cast aside the American Rule based on the Reporters' unproven theory that doing so will "incentivize" insurers to alter their behavior.

In particular, § 48(4) would require insurers to pay an insured's attorneys' fees whenever an insured substantially prevails in a declaratory judgment action brought by an insurer seeking to terminate its duty to defend.<sup>6</sup> The Reporters' Note relies upon three outdated cases for this radical change: two from the New York Court of Appeals (one from 1979, the other in 2004) and a 1978 South Carolina Supreme Court decision.<sup>7</sup> The Note makes no mention, however, of the multiple state supreme courts that have considered and rejected the rule more recently.<sup>8</sup>

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1248 (Or. 1978); *Utica Nat'l Ins. Co. of Texas v. Am. Indem. Co.*, 141 S.W.3d 198, 203 (Tex. 2004); *Lafarge N. Am., Inc. v. K.E.C.I. Colorado, Inc.*, 250 P.3d 682, 687 (Colo. App. 2010); *Keller Indus., Inc. v. Emp'rs Mut. Liab. Ins. Co. of Wisconsin*, 429 So. 2d 779, 780-81 (Fla. Dist. Ct. App. 1983); *Aselco, Inc. v. Hartford Ins. Grp.*, 21 P.3d 1011, 1020 (Kan. Ct. App. 2001); *Fireman's Fund Ins. Co. v. Rairigh*, 475 A.2d 509, 514 (Md. Ct. Spec. App. 1984); *St. Paul Ins. Co. v. Bischoff*, 389 N.W.2d 443, 445 (Mich. Ct. App. 1986); *Seven Hills Master Community Ass'n v. Granite Silver Dev. Partners*, 2012 WL 12033586, at \*3 (Nev. Dist. Ct. Sep. 28, 2012); *Am. State Ins. Co. v. State Auto Ins. Co.*, 721 A.2d 56, 64 (Pa. Super. Ct. 1998); *Signature Dev. Cos., Inc. v. Royal Ins. Co. of Am.*, 230 F.3d 1215, 1222 (10th Cir. 2000); *Spencer v. Assurance Co. of Am.*, 39 F.3d 1146, 1149 (11th Cir. 1994); *Korn, Womack, Stern & Assocs., Inc. v. Fireman's Fund Ins. Co.*, 1994 WL 264263, at \*7-9, 27 F.3d 566 (6th Cir. 1994) (table); *Andrew v. Century Sur. Co.*, 134 F. Supp. 3d 1249, 1263 (D. Nev. 2015); *Capital Envtl. Servs., Inc. v. N. River Ins. Co.*, 536 F. Supp. 2d 633, 645 (E.D. Va. 2008).

<sup>4</sup> Tom Baker and Kyle D. Logue, *In Defense of the Restatement of Liability Insurance Law*, Law and Examiners Research Paper Series, Paper No. 17-001 Apr. 2017. <http://ssrn.com/abstract=2952804> at 22.

<sup>5</sup> November 7, 2016 letter from Victor E. Schwartz and Christopher E. Appel to the Reporters addressing fee shifting (available from the ALI).

<sup>6</sup> Sections 49(3) and 51(1) are equally improper fee-shifting provisions as they too reject the American rule and blur the lines between common law versus statutory support for this public policy shift. Section 49(3) would award an insured its attorneys' fees in establishing that an insurer breached its duty to defend. Section 51(1) would award an insured its attorneys' fees in establishing any breach.

<sup>7</sup> RLLI, § 48(4) Reporters' Note *d*.

<sup>8</sup> See, e.g., *Wetovick v. County of Nance*, 782 N.W. 2d 298, 318 (Neb. 2010); *ACMAT Corp. v. Greater New York Mut. Ins. Co.*, 923 A. 2d 697, 699 (Conn. 2007); *Aetna Cas. & Sur. Co. v. Commonwealth*, 179 S.W. 3d 830, 842 (Ky. 2005).

3. *Insurer's Duty to Make a Reasonable Settlement Offer in the Absence of a Demand.* RLLI § 24, Comment *f* provides that, when a claimant has not made a settlement demand, the insurer may be obligated to do so. This rule, too, has not been adopted by the majority of jurisdictions and, as with § 19(2), is another innovation that does not comply with ALI's guidelines for a Restatement.

The Texas Supreme Court effectively dismantled the Reporters' suggested affirmative settlement-offer rule in *American Physicians Insurance Exchange v. Garcia*:

A few courts have held insurers liable for a breach of the duty to settle in the absence of a within-limits demand. However, these cases generally involve affirmative misconduct by the insurer to subvert or terminate settlement negotiations ... [W]e disagree with any reading of the no-demand cases that would require insurers rather than claimants to make settlement offers ... The reasoning in many of [these] cases...is actually consistent with our holding that an insurer cannot *breach a duty* by not tendering a settlement offer.<sup>9</sup>

Reporters' Note *f* to § 24 acknowledges that "[t]here is a split of authority on the question whether the duty to settle includes a requirement that the insurer affirmatively explore settlement negotiations should the claimant or claimants not come forward with a settlement offer." It notes that at least one leading treatise has suggested that the position taken in § 24 concerning affirmative offers is a minority rule.<sup>10</sup> Nonetheless, the Reporters assert that, because a number of scholars have argued that an affirmative obligation *should* be imposed, they have done so in § 24.

The support for this radical change is thin. Eight jurisdictions have rejected an affirmative duty to make an offer or have acknowledged no precedent to do so within their jurisdiction.<sup>11</sup> Other jurisdictions that have considered the issue have, at most, concluded only that a formal settlement offer from a plaintiff is not a necessary prerequisite to a bad-faith claim where particular conditions are present (clear liability and serious injuries likely leading to an excess verdict).<sup>12</sup> Still other courts have looked at the absence of an affirmative offer as one factor, and then considered the totality of the circumstances to determine whether an insurer has acted in bad faith in discharging its duties to its insured.<sup>13</sup>

**Conclusion.** Courts, consumers, regulators, policyholders, insurers, and ALI members alike need to know they can rely upon the RLLI because, when it states a particular rule, it reflects the majority rule or an emerging trend in the law supported by compelling legal authority. They also know that sweeping public policy innovations are not included in the RLLI because public policy changes are rightly within the purview of legislators and regulators, not a private organization of academics and lawyers. In its current form, however, the RLLI does not satisfy those fundamental legal criteria and has wrongly blurred the line between its role and those of both legislators and regulators. Therefore, the RLLI is simply not reliable, nor good for anyone.

<sup>9</sup> 876 S.W.2d 842, 850, n.17 (1994) (emphasis added).

<sup>10</sup> Jerry & Richmond, *Understanding Insurance Law* 840 (5th ed. 2012) ("In most jurisdictions, the insurer cannot be liable for breaching the duty to settle unless a settlement offer within policy limits is made by the plaintiff. Without a settlement offer, it is not possible for the insurer to have breached its duty.")

<sup>11</sup> See, e.g., *Ranger Ins. Co. v. Home Indem. Co.*, 741 F. Supp. 716, 718 (N.D. Ill. 1990) ("A primary insurer ... is not obligated under Illinois law to initiate settlement negotiations."); *Wittmer v. Jones*, 864 S.W.2d 885, 891-92 (Ky. 1993); *Hemphill v. State Farm Mut. Auto. Ins. Co.*, 805 F.3d 535, 540 (5th Cir. 2015).

<sup>12</sup> See, e.g., *City of Hobbs v. Hartford Fire Ins. Co.*, 162 F.3d 576, 584 (10th Cir. 1998) (applying New Mexico law); *Hartford Ins. Co. v. Methodist Hosp.*, 785 F. Supp. 38, 41 (E.D.N.Y. 1992); *Boicourt v. Amex Assur. Co.*, 78 Cal. App. 4th 1390, 1392 (Cal. 2000).

<sup>13</sup> See, e.g., *Texoma Ag-Prods., Inc. v. Hartford Acc. & Indem. Ins. Co.*, 755 F.2d 445, 447 (5th Cir. 1985) (applying Texas law); *Safeway Ins. Co. v. Botma*, 2003 U.S. Dist. LEXIS 28663, at \*54-55 (D. Ariz. Mar. 7, 2003).