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5 Controversial Rules In The ALI's Insurance Law Project

By **Jeff Sistrunk**

Law360 (May 18, 2018, 5:02 PM EDT) -- The American Law Institute is poised to vote Tuesday on a final draft of guidelines designed to help courts navigate liability insurance cases, including hotly contested provisions establishing when insurers can be held liable for malpractice by attorneys they pick to represent policyholders and when carriers can recoup defense costs paid on policyholders' behalf.

Here, Law360 looks at five of the most controversial sections in the final version of the ALI's Restatement of the Law on Liability Insurance.

Basic Policy Interpretation Rules

One of the most contentious provisions of the restatement, Section 3, addresses foundational principles of insurance law: how policy language should be interpreted and when courts may refer to outside "extrinsic" evidence — such as documents relating to the drafting and negotiation of a policy — in order to ascertain whether a term is subject to multiple reasonable interpretations and is therefore ambiguous.

The previous version of the section approved by the ALI membership adopted a "strong presumption" in favor of courts applying the plain meaning of policy terms where possible, and against courts referring to extrinsic evidence to determine whether terms are ambiguous.

According to Covington & Burling LLP senior counsel John G. Buchanan III, a policyholder lawyer who serves as an adviser on the liability insurance restatement, a strong presumption rule would already have been more favorable to insurers than the "Corbin rule" adopted by the ALI in its influential second restatement on contract law. Under the Corbin rule, also known as the contextual approach, courts may interpret policy terms in light of "all the circumstances surrounding the drafting, negotiation and performance of the insurance policy."

However, insurance industry representatives objected to the strong presumption rule and successfully lobbied to have Section 3 changed to reflect an even stricter "plain meaning" rule to policy interpretation. Under that rule, courts must construe an insurance policy term on the basis of its plain meaning, if it has one.

Courts applying the plain meaning rule may only refer to a limited number of sources, including dictionaries, past court decisions, statutes and insurance industry customs and practices, to determine

whether a policy term is ambiguous. Extrinsic evidence regarding an insurer's negotiations and course of dealing with a policyholder "may be considered only if the court first makes the threshold determination that the insurance policy term is ambiguous when applied to the facts of the claim at issue," the restatement says.

Covington partner David Goodwin characterized the current version of Section 3 as a "mishmash" of ideas that "threatens to end up a mess."

"The basic rule of insurance policy interpretation in all 50 states is that a court will start with the plain meaning of policy language, and if it is ambiguous, it will then construe the ambiguous language in favor of coverage," Goodwin said. "What the reporters ended up doing in the comments is giving a lot of weight to custom and practice."

In essence, the reporters "turned what has been a question of law in every jurisdiction in the United States into an inquiry that requires the consideration of evidence, if judges take it literally," Goodwin said.

"This opens the door to an argument by insurers that they ought to be entitled to discovery," he said. "If courts were to agree, that could make insurance disputes much more expensive."

Insurer Liability for Defense Counsel's Conduct

Section 12 of the restatement allows an insurer to be held liable for the conduct of the defense counsel it hires to represent a policyholder, in two limited sets of circumstances.

In the first scenario, outlined in Section 12(1), an insurer may be subject to liability for "negligent selection" if it failed to exercise "reasonable care" in picking a defense attorney for its policyholder. A court's analysis of a negligent selection claim will be "fact-specific" and focus on, among other things, the insurer's efforts to ensure the lawyer had "adequate skill and experience" to handle the claim against the policyholder, according to the restatement.

Under Section 12(2), an insurance company may also wind up facing liability for any harm caused to its policyholder by a defense attorney's negligence if the insurer took steps to "override" the lawyer's "independent professional judgment."

While the current version of Section 12 eliminated a third potential source of liability for insurers, for "negligent supervision" of selected defense counsel, the portion of the section creating a cause of action for negligent selection remains troubling to the insurance industry, said Crowell & Moring LLP partner Laura Foggan, the American Insurance Association's liaison on the restatement. The law generally doesn't provide for a negligent selection claim against an insurer, she said.

"Section 12(2) already provides for liability if an insurer overrides counsel's duty to exercise independent professional judgment," Foggan said. "If that occurs, that is a very different circumstance. Section 12(1) is unnecessary and creates a tangle of new issues and concerns."

Jeffrey Stempel, a professor at the University of Nevada, Las Vegas, William S. Boyd School of Law who teaches insurance law and also serves as an adviser on the restatement, said the proposed version of Section 12 has been "watered down a bit" from previous iterations but is still a useful tool for deterring insurers from cutting corners or prioritizing its own interests over the policyholder's.

"The rule in Section 12 is a nice way of keeping the insurance company honest about who it hires and how it handles claims, so it doesn't go down the street and hire the cheapest, most pliable lawyer or unduly interfere with effective representation," Stempel said.

Insurer's Right to Recoup Defense Costs

Courts around the country have split on whether an insurance company has the right to recover defense costs it has paid on a policyholder's behalf if it is ultimately determined that the claim against the insured is not covered.

Section 21 of the restatement, however, establishes a "default rule" that an insurer has no right to recoupment in such circumstances unless that right is specified in the policy or has been "otherwise agreed to" by the policyholder.

The restatement's authors suggested that the default rule would curtail expensive litigation between insurers and policyholders over recoupment.

"For example, in cases involving covered and noncovered causes of action, under a recoupment rule there would often have to be subsequent litigation over the question whether, or to what extent, the defense costs were incurred by the insurer in connection with noncovered causes of action," Section 21 says. "The rule followed in this section entails no such secondary litigation."

But Foggan said the default rule could have unfair consequences for insurance companies if it is applied retroactively to coverage disputes involving policies issued years ago. In such cases, if the insurer did not secure the right to recoupment through explicit policy language or an agreement with the policyholder, it would be out of luck under the new rule — even if courts in that jurisdiction previously allowed recoupment without those prerequisites.

“It is not as though we are just talking about the prospective application to insurance policies, where we can go forward and make new agreements to address how the restatement will affect the legal landscape," Foggan said. "Insurers are litigating long-tail claims involving decades of policies under the law that exists, which allows for recoupment. Changing that would create substantial unfairness and a major monetary impact."

Defense Costs for Known Claims

Section 46 of the restatement provides that a policy will generally only cover a liability known to the policyholder before the policy's inception if the policyholder discloses that liability to its insurer during the application or renewal process.

According to the section, a "known liability" exists if, prior to the policy period, the policyholder is "substantially certain" that a claim against it will result in either defense costs or an adverse judgment exceeding any applicable deductibles in the policy.

Buchanan said Section 46's expansion of the known liability rule to defense costs that would otherwise be covered by a policy could have dire consequences for policyholders. He pointed out that the restatement's authors conceded that no case law supports that notion.

"I think it would be an inappropriate legal innovation," Buchanan said. "It would increase the number of cases where insurers would decline to defend their policyholders, which in turn would encourage default judgments against individual and small-business policyholders that cannot afford to defend themselves, even in frivolous lawsuits."

According to Goodwin, even if Section 46 is approved in its current form, it is unlikely that any court will opt to apply the known liability rule to defense costs.

"No state has adopted this rule in the past, and I have to believe no state would adopt this going forward either," he said.

Settling Without the Insurer's Consent

Part of Section 25 of the restatement sets out a rule that, when an insurance company has agreed to fund its policyholder's defense while reserving its right to later challenge coverage, the policyholder may still enter a settlement without the insurer's consent under certain circumstances.

The provision, Section 25(3), states that a policyholder may unilaterally settle an action without violating its "duty to cooperate" or other policy restrictions if it gives the insurer a "reasonable opportunity" to participate in the settlement process or makes a "reasonable effort" to obtain the insurer's consent, among other steps.

According to Foggan, the provision would eviscerate policy clauses requiring insurers' consent to settlement agreements. Furthermore, she said, the section lacks protections to discourage policyholders from entering into collusive settlements with claimants.

"What this does is take existing law one step further and state that, even when an insurer has not breached the duty to defend but has in fact offered a defense and is actively defending, the policyholder can still make a decision to enter a settlement without the insurer's consent," Foggan said.

"That takes away from the insurer the right to control the litigation strategy, which is part of what is bargained for," she said.

--Editing by Brian Baresch and Alanna Weissman.