THE
NATIONAL LAW REVIEW

Restatement of Liability Insurance and the Expanded Duty to Settle: Windfall for Claimants'

Article By
Kim V. Marrkand
Martha J. Koster
Mintz
Insurance

- Civil Procedure
- Election Law / Legislative News
- Insurance Reinsurance & Surety
- Litigation / Trial Practice

- All Federal

Thursday, September 3, 2015

The ***American Law Institute*** has been rethinking the law of liability insurance for more than five years. Beginning in 2010, the ALI began a "***Principles of the Law***" project. After four years of work and numerous drafts, the ALI decided, in August 2014, to convert the project into a "Restatement" of the law of liability insurance. The change is significant.

While "Principles" may be aspirational, proposing "the law as it should be," Restatements traditionally have sought to describe the law as it is. Under rules as revised by the ALI, Restatements, which are addressed to courts, "reflect the law as it presently stands or might appropriately be stated by a court." The guiding rule is that proposed changes to majority law must be "accretional" and departures from majority law must be identified. While the Reporters who draft the Restatement may consider competing rules and their outcomes, the ALI guidelines instruct that they "are generally constrained by the need to find support in sources of law."

Despite this guidance, the Reporters have transferred their proposed rules, many of them aspirational concepts, from the Principles project into the draft Restatement. While some modifications in language and approach have been made, where proposed rules do not explain that they are a departure from the majority rule or do not reflect an emerging trend in the law, judges and litigants are left to assume — incorrectly — that the proposed rule is in line with the norm. In short, the Reporters describe the law as they would have it — a vision, in some cases, strikingly at odds with the law as it is. Since the current April 30, 2015 draft will be subject to further discussion and revision, it is important to focus on those sections that are dissonant with existing law so that needed changes may be made in advance of the ALI annual meeting in May, 2016. One of these areas is the Reporters' proposed expansion of an insurer's duty to settle and the damages for breach of that expanded duty.

Section 24 of the latest draft of the Restatement (Discussion Draft, April 30, 2015) imposes liability on an insurer for breach of a "duty to make reasonable settlement decisions." This duty attaches when the insurer has the authority (or its consent is required) to settle a claim that exposes the insured to liability in excess of the policy limits. Although, as the Reporters acknowledge, this duty arose out of the implied contractual duty of good faith and fair dealing, no bad faith on the insurer's part is required for liability to be established in Section 24. To the contrary, the insurer's liability is focused on the reasonableness of the rejected offer. As stated in the draft Restatement, "...once a claimant has made a settlement demand in the underlying litigation that is reasonable, an insurer that rejects that demand thereafter bears the risk of any excess judgment against the insured at trial." (Comment *a)* .

The approach taken by the draft Restatement puts a heavy emphasis on the calculation, long after the fact, of the claimant's likelihood of success and possible damages in the underlying lawsuit. Regardless of its good intentions or the legitimate reasoning behind its settlement offer, an insurer rejects any settlement offer within policy limits at its peril. Since rejection exposes the insurer to liability not only for an excess judgment but also for punitive damages assessed against the insured and other elements of damages, the stakes for the insurer are very high. This proposed new iteration of liability and damages, without a footing in accepted case law, will have broad impact, severely tipping the negotiating table in favor of the claimant and ultimately raising the cost of insurance. Although the draft is premised on the narrative of small policyholders who need protection from insurers with conflicted interests, large corporations with sophisticated insurance programs will benefit from these proposed new rules. The real winners here are the claimants, who would have a powerful tool to raise the settlement value of even marginal or nuisance cases; the real losers are the purchasers of insurance, the public who must bear in increased insurance premiums the cost of this windfall to claimants.

The evaluation of reasonableness is at the heart of the liability discussion in Section 24. Noting that the insurer is required to give equal consideration to the interests of the insured, the Restatement's Comment defines a reasonable settlement offer as 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." As the Reporters note, this definition is derived from the "disregard the limits" test first articulated by Professor Robert E. Keeton, who concluded that a reasonable settlement decision should be made without regard to policy limits. The test adopted in Section 24, however, differs significantly from Professor Keeton's well-recognized standard. Whereas Section 24 weighs reasonableness by a hypothetical "reasonable person," Professor Keeton's test asks whether the insurer used such care as would have been used by "an ordinarily prudent insurer with no policy limit applicable" (while the Restatement Comment speaks in places of a "reasonable insurer," the test, as articulated above, looks to a "reasonable person."). The language matters. Considering the point of view of an "ordinarily prudent insurer" allows the trier of fact to weigh the insights, experience and related considerations of insurers in settling claims, factors that are critical in assessing the justification of a real life insurer's settlement decision. Professor Keeton's test opens the inquiry to the actual issues analyzed by insurers, such as the value of the claim, the jurisdiction, strengths and weaknesses of the claim, the jury pool, the possibility of creating a precedent that will encourage future litigation and the likelihood of a plaintiff or defense verdict.

Another significant difference in the draft Restatement from the test of reasonableness as formulated by Professor Keeton — and adopted by most courts — is the consideration of probability. As stated by Professor Keeton:

> The insurer is negligent in failing to settle if, but only if, such ordinarily prudent insurer would consider that choosing to try the case (rather than to settle on the terms by which the claim could be settled) would be taking an unreasonable risk — that is, trial would involve chances of unfavorable results out of reasonable proportion to the chances of favorable results. Robert E. Keeton, *Liability Insurance and Responsibility for Settlement,* 67 HARV. L. REV. 1136, 1146 (1954, emphasis added.)

Thus, Professor Keeton's test weighs the likelihood of a plaintiffs verdict at trial: liability for an insurer arises when the risk of that result is out of proportion to the chances of a result favorable to the insured. In stark contrast, Section 24 would impose liability on the insurer even when the likelihood of a plaintiff's verdict is low. In Illustration 1 of Section 24, liability is imposed on an insurer for a rejected offer when the plaintiff had only a 30% chance of success. Case law, consistent with Professor Keeton's rule, sets a much higher bar, weighing, for example, the "substantial likelihood" of a verdict unfavorable to the policyholder. (E.g. *Jackson v. Am Equity Ins. Co.,* 90 P.3d 136, 142 (Alaska 2004). By no measure is a 30% probability a substantial likelihood. The draft Restatement repeatedly stresses that reasonableness encompasses a range of settlement values, not a single number. However, the examples given in Section 24 belie that. In Illustration 4, a claim is valued between $ 30,000 and $45,000. The claimant demands $45,000 and the insurer answers with a $35,000 offer. Negotiations break down and the case goes to trial, resulting in an excess verdict. Even though the insurer made an offer well within the range of reasonableness and its offer was rejected and not answered, "the insurer is subject to liability for the full amount of the judgment, because the insurer rejected a reasonable settlement demand in the underlying litigation." Thus, the "range" is meaningless; in effect, only the highest value matters for the insurer's newly created liability.

The draft Restatement further treats the "reasonable settlement range" as self-evident, whereas in reality it is anything but. The plaintiffs likelihood of success turns on a number of factors and opinions may differ widely. Yet, for the insurer, rejection of any demand that might later appear to have been "reasonable" is done at its peril, a risk that is heightened because the likelihood of an event will be determined after it has already taken place. The fact that an excess judgment has entered will necessarily color a conclusion as to the reasonableness of a settlement decision made much earlier. A result properly assessed as low probability when the decision was made will appear — or can be made to appear — much greater years later, if that small likelihood were realized.

The draft Restatement thus would create a significant shift in the treatment of duty to settle cases. Instead of a "substantial likelihood" of a plaintiff's verdict, or Professor Keeton's chances of an unfavorable result out of reasonable proportion to a favorable result, here, an even slight possibility of a plaintiff's verdict (30%) creates a potential basis for liability years later. The calculations used in the Illustrations are simplistic; they do not take into account the range of potential damages, instead applying simple probability to a single figure. While the draft Restatement backs away from using the "automatic" liability description employed in the previous versions of the Restatement and notes other factors that may be considered, the Illustrations consider nothing beyond numbers. In these examples, refusing an offer in an amount later deemed to be within the range of reasonableness leads to an insurer's liability after an excess judgment. Other factors are used only in one direction — to establish the insurer's liability when the numbers do not. No example is given as to how such factors might mitigate a purely numeric result against an insurer.

By putting insurers at risk virtually every time a settlement demand is rejected, Section 24 evinces a philosophy that favors claimants by pressuring insurers into accepting demands that they would otherwise — and more reasonably — reject. The proposed rule creating this exposure provides a roadmap to claimants as to how to position themselves for a policy limits settlement. Aware of policy limits, claimants are empowered to make larger demands, just at or within those limits, knowing that they have significant leverage over insurers from the possibility of an excess judgment. Indeed, given the provisions of Section 27, discussed below, claimants also have an incentive to assert claims against the insured for punitive damages, whether or not justified, to drive up the insurer's risk and hence, the settlement value of the case.

The distortion of the bargaining process is not limited to the final outcome of negotiations; the insurer is not free to respond to a "reasonable" offer with a counter-offer, even a counter-offer within the range of reasonableness. As shown by Illustration 4, noted above, if the negotiations break down and an excess judgment results, the claimant's rejected offer may be seen to have been within the reasonableness range, making the insurer liable, even though its counter-offer was also in that range. Further, under Section 24, as explained in the Comment, an insurer may be liable for failing to make any offer at all. If the claimant makes no demand — or if its only demand is unreasonable — the insurer's failure to make an offer, or counter-offer, is "evidence of the insurer's unreasonableness. Despite rejection by courts of such a duty to initiate settlement offers, an insurer, given Section 24, would be constrained to make an offer in the absence of a reasonable demand and, in doing so, would undercut its negotiating position.

The provisions of proposed Section 24 taken together distort the ordinary give and take of settlement negotiations. Although Section 24 imposes upon the insurer a duty to accept a demand that will later be deemed reasonable, the claimant has no concomitant duty to *make* a reasonable demand. Hence, there is disequilibrium, giving the claimant a broad advantage. The consequence of this imbalance must necessarily result in too much money being spent to settle cases with small merit, a cost that will be passed onto the public in the form of increased premiums. The Comment to Section 24 acknowledges this but asserts, without citing any support, that protection of insureds trumps the need to contain the cost of premium for the public at large. This conclusion, however, is both misguided and naive. Many of the insureds that would be protected at the public's expense are large corporations, with more than sufficient resources to look out for themselves — and to purchase adequate insurance in the first instance. And others affected are small policyholders with excellent claim histories, who will nonetheless be faced with premium increases. When Section 27 is considered as well, it becomes apparent that the public is not only being asked to bear the cost of policyholders that chose to underinsure but also of those that are responsible for egregious actions, with punitive damages being awarded against them for their misconduct.

Section 27 of the draft Restatement sets out the measure of damages when an insurer is held liable to the policyholder for a breach under Section 24 resulting in an excess judgment. First, the policyholder may recover the full amount of damages assessed against it in the underlying suit, without regard to policy limits. Second, the insured may also recover for "any other foreseeable loss." Such losses include loss of business reputation, emotional distress and punitive damages awarded against the insured.

The most extreme deviation from accepted case law in the draft Restatement is in the provision that, in the case of a Section 24 breach, payment for the insured's punitive damages may be passed on to the insurer. According to the draft Restatement Comment, such damages are a reasonably foreseeable consequence of a breach of the duty to settle and should be recoverable even in jurisdictions that forbid insurance coverage of punitive damages as a violation of public policy.

Punitive damages are not meant to reimburse an injured plaintiff for harm suffered. They are imposed to punish the defendant for his wrongful acts and to deter similar acts in the future. Allowing the recovery of punitive damages from the insurer would permit the insured to "shift to its insurance company, and ultimately to the public, the payment of punitive damages awarded in the third party lawsuit against the insured as a result of the insured's intentional, morally blameworthy behavior against the third party." *PPG Indus., Inc.,* 975 P.2d at 658. As the California Supreme Court explained in the *PPG Industries* case, "To allow such recovery would (1) violate the public policy against permitting liability for intentional wrongdoing to be offset or reduced by the negligence of another; (2) defeat the purposes of punitive damages, which are to punish and deter the wrongdoer; and (3) violate the public policy against indemnification for punitive damages."

Although Section 27 characterizes punitive damages as a reasonably foreseeable harm caused by the insurer's breach, in reality the imposition of such damages was caused by the policyholder, not the insurer. "Regardless of how egregious the insurer's conduct has been, the fact remains that any award of punitive damages that might ensue is still directly attributable to the insured's immoral and blameworthy behavior," not the insurer's actions. *Lira v. Shelter Ins. Co.* 913 P.2d 514, 516 (Colo. 1996).

No reported case has been found in state or federal jurisdictions that allows a policyholder in a duty to settle case to recover punitive damages assessed against it. The Reporters concede that no state cases exist in support of their theory (they rely on dissents). Of the four federal cases they cite, two explicitly prohibit shifting punitive damages from the insured to the insurer, one is silent and one, while not allowing it in that case, finds that such damages might be assessed in another case. In the most recent case on the subject, decided in June, 2015, the Third Circuit held that punitive damages awarded against an insured in the underlying case may not be considered compensable damages in a bad faith/failure to settle claim against the insurer. "To hold otherwise would shift the burden of the punitive damages to the insurer, in clear contradiction of Pennsylvania public policy." *Wolfe v. Allstate Prop. & Cas. Ins. Co.,* 2015 U.S. App. LEXIS 9876, at *12 (3d Cir. June 12, 2015). On this empty foundation, the draft Restatement would rest a radical departure from accepted law.

Section 27 also departs from established law in the elements of recoverable damages permitted. Subsection 2 allows an insured, in addition to an excess judgment, to recover for "other foreseeable loss," which is explained to include loss of business reputation and emotional distress. While the draft Restatement does not attempt to define "foreseeable," the inclusion of these elements of damages runs counter to the Restatement of the Law of Contracts, Second § 351, which provides that "[d]amages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made." Under that definition, a loss may be foreseeable as a probable result if it follows from the breach in the ordinary course of events or as a result of special circumstances that the party in breach had reason to know.

In the context of liability insurance, damages such as loss of business reputation or emotional distress are not, at the time the policy is entered into, foreseeable as a probable result of a breach. Indeed, as one court pointed out, an insurer, when weighing a settlement offer, is not obliged by the policy to consider possible harm to the insured's business reputation from an adverse judgment. *Parking Concepts, Inc. v. Tenney,* 83 P.3d 19, 26 (Ariz. 2004). It would be inconsistent to include this loss as an element of damages. Further, as with punitive damages, the insurer's decision not to accept a settlement offer is not the cause of any harm to business reputation that the insured may incur. Rather, that loss resulted from the conduct of the policyholder that gave rise to the lawsuit as well as to the adverse judgment.

Damages for emotional harm would not be a foreseeable loss under the Restatement of Contracts, Second definition since it is highly unlikely that such a loss would be seen as a probable result of the breach, either occurring in the ordinary course of events or as a result of special circumstances that the insurer would have reason to know. Further, only a few jurisdictions have explicitly allowed the inclusion of mental distress damages in this context; those that permit recovery have generally done so when there has been bad faith or exceptional misconduct by the insurer. Under Sections 24 and 27, however, liability may be premised upon a good faith misjudgment, thereby providing no justification for the imposition of these damages.

Sections 24 and 27 of the draft Restatement of the Law of Liability Insurance, taken together, would rewrite existing law and transform the negotiation of settlements, to the major advantage of claimants. The public that purchases insurance would ultimately pay the bill for this windfall to plaintiffs. That is neither sound public policy nor the accretional change in the law envisioned by the ALI, particularly where it is not supported by majority law and does not reflect an emerging trend.

Thus, in the ongoing discussions and evaluation of the draft Restatement, critical revisions should be undertaken to make the draft Sections 24 and 27 congruent with present majority law. First, the determination of when a settlement decision is unreasonable should be made by applying the standard of the "ordinarily prudent insurer," including consideration of the non-numeric factors that weigh into such a decision. Second, the probability of a plaintiff's verdict at trial should be a "substantial likelihood" for liability to attach, not a chance as low as 30%. Third, the reasonableness of an insurer's offer should be the focus of the inquiry, regardless of whether a counter-offer is also reasonable. Fourth, the onus should not be put upon the insurer to come forward with an offer when the claimant makes no demand or only an unreasonable demand. Fifth, with regard to damages in Section 27, punitive damages assessed against the insured should not be recoverable from the insurer as an element of damages. Finally, emotional harm and loss of business reputation should not be recoverable elements of damages. These basic changes will make the next draft of the Restatement a truer reflection of the law of liability insurance as it is today in the majority of jurisdictions and will comply with the very purpose of a Restatement under the revised rules of the ALI.