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ALI Draft Restatement Misstates Key Insurance Law Issues

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By now all interested parties know that, in May, the American Law Institute (ALI) deferred for a year the vote on approving the publication of its much anticipated Restatement of the Law, Liability Insurance to respond to the onslaught of criticism from the defense bar, insurers, trade organizations, commentators and even insurance regulators. Succinctly stated, the overriding concern is that the draft "restatement" actually constitutes a "misstatement" with respect to several key points of liability insurance law.

The Wake-Up Call

Although many of us have been following developments for some time, until this year the "restatement" project simply was not on the radar of many companies and lawyers. The industry finally awoke and bombarded ALI with letters and comments regarding its third preliminary draft "restatement" released in March. In response, the ALI "reporters" went back to work on the document. Due in part to the project starting out in 2010 as an aspirational "principles" project, rather than a more objective "restatement" of the law, the document, on several points, appears to be more a policyholder advocacy document than an accurate, objective recitation of the law or a balanced effort to shape the law.

The grounds for rebuke of the "restatement" are multifold, but first and foremost the critics seek a "restatement" that enunciates the law correctly. Experience in today's high stakes coverage wars teaches that the motivation and potential for misuse of such a document are strong. Indeed, the document already has been used as an advocacy piece — having been presented to and cited by numerous courts before it even has been finalized.

The Current Draft Remains Biased and Contrary to Law in Several Respects

On Aug. 4, ALI released preliminary draft no. 4 of this "restatement" project and it was debated earlier this month in Philadelphia by a group of ALI "reporters," "advisors," and "consultative" members. In fairness, the current draft — like the one before it — accurately summarizes several points of liability insurance law and contains citations that often serve as a useful starting point for researching topics.

Although some improvements were made in the latest draft (e.g., clarifying that "legal uncertainty" does

not give rise to a duty to defend), it still fails on many significant points of law — often evincing at least subtle pro-policyholder bias in various portions of its "black letter" law, comments and reporters' notes. Such instances run the gamut from policy interpretation principles (e.g., watering down the "plain meaning rule" to a "presumption" that can be overcome by a "plainer" meaning), insurer liability for conduct of defense counsel, duty to defend and duty to settle issues among others areas. Many of the revisions do not represent adequate improvements, while others are little more than weak attempts to justify the "reporters" unwarranted departure from recognized (and often cogent) law. For example, the "default rule" of no recoupment of defense costs runs contrary to Section 35 of the Restatement Third, Restitution and Unjust Enrichment and the reporters' note attempting to justify this departure is underwhelming. The no recoupment rule advocated by the "reporters" also is not the majority position.

ALI Set Out to Change the Law, Not to Accurately Capture Existing Law

It bears noting that the draft "restatement" does not purport or seek to accurately reflect liability insurance law. In the introduction, ALI states that a "restatement" is not a mere recapitulation of the law as it presently exists. but also represents an effort to "subtly" transform the law. With respect to many topics, it subtly (and sometimes not so subtly) deviates from the long-standing precedent of many states. ALI grants itself leave to ignore precedent, stating a "restatement" is "not bound by precedent" or to "a preponderating balance of authority." Instead, it is "expected to propose the better rule." ALI describes itself as "a law reform organization." Unfortunately, too often the "reporters" appear to equate a "better rule" or a "default rule" with a rule more favorable to policyholders.

Liability Insurance Law Does Not Lend Itself to the Uniformity ALI Seeks to Interject

ALI also states that it aspires to obtain "uniformity" in the law. Liability insurance law largely has developed on a state-by-state basis and there are meaningful differences among the states on several points of law. It also is an area of the law that the United States Congress has left to regulation by the several states under the McCarran-Ferguson Act of 1945. Changing a given principle in isolation for the sake of interposing uniformity among the states on that principle can produce unfair and unworkable results because of the interrelationship among principles, precedent and regulatory scheme within a given state.

The Draft "Restatement's" Treatment of Insurance Contract Interpretation is Particularly Problematic

In Section 3, the "reporters" seek to take the "plain meaning rule," — a principle that is as widely followed as any principle of insurance law — and reduce it to a presumption that may be overcome by a "plainer meaning." Under the guise of being a hybrid between the "plain meaning rule" and the "contextual approach," the "reporters" are advocating a nonsensible rule that invites the discovery and introduction of extrinsic evidence by policyholders to attempt to overcome the plain meaning of insurance contract terms.

Such an approach, if followed by courts, threatens to reduce the likelihood of insurers obtaining summary judgment on matters appropriate for summary disposition, encourages policyholders to conjure up disputes regarding the meaning of terms, promotes disparate and inferior decision-making by courts, and increases the volume of discovery in coverage litigation. The "reporters" correctly concede this approach may increase the cost of coverage litigation. If widely employed by courts, a likely result also would be an overall premium increase to subsidize the litigation tactics of a small universe of policyholders. The comments go so far as to suggest that policyholders should have greater latitude than insurers with respect to the type of extrinsic evidence that may be introduced. The language of the

proposed rule remained unchanged in response to comments and the changes made to the comments were unsatisfactory.

The Draft "Restatement" Properly Endorses Pro Rata Allocation

As my mother often says, "give credit where credit is due." The latest draft continues to employ the "pro rata by years" allocation method for allocation of indemnity costs (judgments and settlements) with respect to long tail insurance coverage claims (e.g., asbestos or environment losses that involve injuries or damages spanning multiple years or periods). See Section 42.

The reporters are correct to endorse a pro rata allocation methodology and to reject the quest of policyholder advocates for an "all sums" or "pick and choose" allocation method. Pro rata allocation remains the majority rule. See S.M. Seaman & J.R. Schulze, Allocation of Losses In Complex Insurance Claims (5th Ed. West Thomson Reuters 2016–2017). Further, pro rata allocation (whether by time-on-the-risk, limits or some combination) is the approach supported by policy language as well as by principles of fairness and other considerations. See S.M. Seaman, "Why Pro Rata Allocation Is the Majority Rule," Law360, New York (October 16, 2014). The "reporters'" draft adoption of a pro rata allocation is sound, but the reporters' comments to Section 42 do evince some pro-policyholder bias.

No Endorsement of an "Insurance Unavailability Exception"

Mirroring the approach taken by policyholders in coverage litigation, after losing the front line allocation methodology argument and ending up with a pro rata allocation, policyholder advocates presented their "Plan B" to ALI. They argue that, even under a pro rata allocation, no sums should be allocated to policyholders at such point in time that insurance coverage became unavailable due to policy exclusions (i.e., absolute pollution or asbestos exclusions). Although some courts have applied a limited "insurance unavailability" exception, that is a distinct minority position and an exception that is at odds with the logical consequences of a pro rata allocation requiring that the policyholder bear responsibility for uninsured, self-insured or underinsured periods. See S.M. Seaman, "Door Closing on 'Unavailability of Insurance' Exception: Part 1," Law360, New York (January 9, 2017); S.M. Seaman "Door Closing on 'Unavailability of Insurance' Exception: Part 2," Law 360, New York (January 10, 2017).

The latest draft "restatement" does not adopt an "unavailability of insurance" exception to allocating to the policyholder. It does, however, discuss the subject in a lengthy reporters' note on what it calls "the unavailability rule." The note contains citations to numerous cases, but does not adequately address the demerits of the "insurance unavailability" exception.

Liability Insurance Law Simply Does Not Lend Itself to a "Restatement" as Envisioned by ALI at This Time

Many of the topics addressed in the "restatement" involve high stake issues that remain subject to extensive litigation, competing views, and conflicting authority. By putting a heavy hand on the policyholders' side of the scale on some issues, the draft "restatement" would not advance the law in an appropriate manner. This is the first time a "restatement" has targeted a single industry and, in the current form, the draft "restatement" is decidedly inferior to other restatements.

Traveling Down the Road Toward ALI Approval

Notwithstanding the' numerous deficiencies, ALI appears poised to push out a "restatement" on the law

of liability insurance next year. The road to adoption of the "restatement" has two remaining scheduled stops: ALI Council approval (scheduled for January 2018); and a vote by the ALI membership at its next annual meeting in May 2018.

Commentators Must Continue to be Vocal and Point Out the Flaws and the "Reporters" Must Be Urged to Produce a Better, More Balanced "Restatement"

Significant inaccuracies and bias remain in the latest draft "restatement". Insurers, industry organizations, regulators, lawyers and other interested persons should continue to be vocal in pointing out the problems with the draft and pushing for appropriate revisions. The "reporters" still have the ability to make changes. Hopefully, additional feedback and dialogue will lead the "reporters" to produce a product that more accurately restates the law of liability insurance with respect to all of its sections and eliminates the areas of pro-policyholder bias.

Education About the Limitations of a "Restatement" on Liability Insurance Law Remains Important

Realistically, in view of the "reporters" advocacy inclinations, the end product is likely to remain flawed by leaning in favor of policyholder positions. Parties and counsel involved in coverage litigation should be prepared to educate courts that the version of the Restatement of the Law, Liability Insurance likely to emerge is neither an ultimate authority on liability insurance law nor is it an entirely objective, balanced or accurate work. In addition to pointing out the shortcomings of the document, it is important to educate courts and the public about the realities and dynamics of liability insurance law that limit the utility of a "restatement" in this area of the law and about the dangers of selectively changing points of law based upon a "restatement."

No "restatement" can serve as an adequate substitute for a thorough and independent examination of the law with respect to a particular point of liability insurance law in the relevant jurisdiction and in the context of the claim-specific facts presented.

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