

A Look At The ALI's Restatement Of Liability Insurance

Law360, New York (May 3, 2016, 11:27 AM ET) --

For decades, Yale Law School Professor George L. Priest has researched and written about important issues in insurance law and policy. This scholarship has made him an internationally recognized expert on the operation of private and public insurance and the role of the legal system in promoting economic growth and sound public policy. He has also instructed some of the nation's brightest legal scholars on the subject of insurance law and policy. Thus, when Professor Priest "takes on" a topic of insurance law, the legal and academic community typically pays attention.

Recently, Professor Priest has focused his attention on the American Law Institute (ALI) Restatement of the Law of Liability Insurance (RLI) project. The ALI is the nation's most influential private organization in the development of American law, and this first-of-its-kind ALI project was commissioned to "restate" the most sound legal rules on a wide range of insurance law topics. Professor Priest has followed the development of this project and found that a number of the project's proposed legal rules would adversely impact insurance operations, causing harm to insurers, policyholders and society as a whole.

Professor Priest prepared a law review article analyzing the ongoing RLI project and its public policy implications on the cost and availability of insurance. The article, titled "A Principled Approach to Insurance Law: The Economics of Insurance and the Current Restatement Project," will be published in the upcoming edition of the *George Mason Law Review*. Because Professor Priest's critique of the RLI project may be of great interest to both insurance law practitioners and ALI members, this article highlights his key observations.



Victor E. Schwartz



Christopher E. Appel

The Importance of Maximizing the Availability of Insurance

Professor Priest's fundamental criticism of the RLI project is its failure to recognize just how vital, from an economic and public policy perspective, it is to develop insurance law rules with an eye towards promoting greater availability of insurance. According to Professor Priest, "the most important objective of the law governing liability insurance is to maximize the availability of insurance." He states that this objective "helps all of society," and, in particular, low-income individuals whose entry into the insurance market allows more people to obtain the benefits of coverage and reduces costs for existing policyholders.

As Professor Priest explains, the RLI project gives short shrift to this objective, and, instead, puts forth

unsound rules that would reduce a person's ability to acquire insurance. He states that the RLI project's two authors (called "Reporters") have developed rules that, by and large, would require insurers to pay more claims and pay greater amounts per claim.

Professor Priest explains that the fallacy in the Reporters' basic approach to the RLI project is that these unwarranted "pro-policyholder" rules would benefit only a small number of policyholders in the short-term. In the long-term, *all* policyholders would be disadvantaged because such rules would effectively require insurers to increase their premiums to cover the costs of paying more claims. These needless cost increases would price some policyholders (e.g. low-income policyholders) out of the insurance market; a result that would further increase insurance costs on the remaining smaller pool of policyholders.

In Professor Priest's view, the failure of the RLI project Reporters to develop rules that account for these economic realities stems, in part, from an incorrect view of insurance as purely a means to redistribute risks from one party (a policyholder) to another (an insurer). Professor Priest shows that the operation of insurance really achieves much more than so-called "risk-spreading"; it can be *risk-reducing*.

Professor Priest identifies three specific ways in which maximizing the availability of liability insurance – the goal he believes should be the guiding principle of the RLI project's development – effectively reduces risk levels and benefits society. They include:

1. Aggregation of Risks — An increase in the number of policyholders enables insurers to better predict the likelihood that a loss will occur. As this predictive ability improves, it can reduce the level of risk associated with an injury (and allow for more accurate pricing of insurance policies).

2. Segregation of Risks — An increase in the number of policyholders allows insurers to better distinguish high-risk from low-risk policyholders. By grouping together individuals of similar risks, insurers can reduce the overall level of risk (and better tailor policies).

3. Controlling Moral Hazard — A moral hazard occurs where a policyholder takes more risk knowing he or she has insurance coverage. An increase in the number of policyholders enables insurers to better identify and curb moral hazard through deductibles, coinsurance, or coverage exclusions. Insurers can reduce risk levels by reducing policyholder incentives to engage in risky behavior.

Professor Priest's main critique of the RLI project, therefore, is that it overlooks these important functions of insurance to reduce risk levels, and instead favors rules that would reduce insurance availability without any demonstrated need to do so. Such a path, he asserts, is unsound public policy.

Specific Problem Areas in the New Restatement

Rather than examine every provision in the RLI project, Professor Priest highlights a few to illustrate his concerns. He submits that while the Reporters designed these provisions to put policyholders in a "better position" than they are today, the rules would ultimately make all policyholders worse off by unfairly increasing insurance costs and reducing the availability of insurance.

Two major areas of concern cited by Professor Priest are the RLI project's treatment of an insurer's "duty to defend" a claim and the insurer's "duty to settle" a claim. With respect to an insurer's duty to defend its insured under a policy, Professor Priest describes the RLI project's rules as "punitive." In particular, he argues that the project adopts a minority approach for an insurer's breach of the duty to

defend a claim that strips an insurer of its right to assert any control over the defense or settlement of a claim, and potentially requires the insurer to pay claims not covered under a policy.

With respect to the insurer's duty to settle or otherwise make reasonable settlement decisions, Professor Priest believes the RLI project adopts an improper, overly "formalistic" approach to whether an insurer has acted reasonably. He states that the RLI project's standard subjects insurers to automatic liability whenever an insurer rejects a settlement offer determined by a court in hindsight to be within a hypothetical "range of reasonableness." Professor Priest points out that such a standard would impair settlement negotiations and distort settlement values because claimants will demand amounts at the upper-most limit of what could conceivably be "reasonable," and treat any insurer attempt to negotiate a more reasonable settlement on behalf of a policyholder as a rejection of the offer and then sue for a breach of the duty to make reasonable settlement decisions.

Professor Priest also cautions that the RLI project's rigid rules, in addition to trapping insurers, could subject them to liability for a broad array of unfair penalties, including punitive damages that have been awarded against a policyholder in an underlying action. He explains that this unwarranted, enhanced liability exposure would increase insurance costs and reduce the availability of insurance.

The core "takeaway" of Professor Priest's forthcoming study is that the RLI project has its priorities misplaced. The project's chief priority appears to be to craft rules benefiting policyholders, but the project sets out to achieve this goal by unfairly making insurers pay more money, more often. Professor Priest demonstrates that this approach may benefit some policyholders in the short-term, but would hurt all policyholders in the long-term. He further states that to correct this problem, the primary objective of the RLI project should be to develop provisions that maximize the availability of insurance. This approach, he argues, will truly benefit all policyholders.

—By Victor E. Schwartz and Christopher E. Appel, Shook Hardy & Bacon LLP

Victor Schwartz is co-chairman of Shook Hardy's Washington, D.C.-based public policy group. He is co-author of PROSSER WADE & SCHWARTZ'S TORTS (13th ed. 2015), and is also an ALI Life Member. Christopher Appel is an associate in the firm's public policy group.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2016, Portfolio Media, Inc.