

May 18, 2017

Director Richard L. Revesz  
Deputy Director Stephanie A. Middleton  
The Executive Office  
The American Law Institute  
Philadelphia, PA  
Via e-mail: director@ALI.org

Re: A Response to Debevoise & Plimpton's "Regulatory Considerations" letter  
*Restatement of the Law: Liability Insurance*

Dear Director Revesz and Deputy Director Middleton:

We write to address the "Regulatory Considerations" issues first raised in the January 17, 2017 letter written by Eric J. Dinallo and Keith J. Slattery at Debevoise & Plimpton (D&S letter), and later summarized and repeated by the authors and industry supporters.<sup>1</sup> The D&S letter addresses the ALI's *Restatement of the Law, Liability Insurance* (Restatement) and fundamentally mischaracterizes both the wording and effect of multiple sections in the Restatement and important aspects of insurance regulation. These assertions also appear to provide the foundation for the National Conference of Insurance Legislators' May 5, 2017 letter demanding that the ALI postpone voting on the Restatement at the upcoming annual meeting, which we will also discuss in this letter. We respectfully submit that both letters lack a firm factual foundation and are untimely, given how long this project has been pending and the numerous opportunities the Reporters and the ALI have afforded for industry advocates to provide input.

The undersigned are active in the Restatement and are either Advisors to or part of the Members Consultative Group (MCG), and individually have decades of experience teaching and working in the insurance regulatory area. Three of us have also served as funded Consumer Representatives to the National Association of Insurance Commissioners (NAIC), which affords an in-depth perspective into the strengths and limitations of our state-based insurance regulatory system.<sup>2</sup> Professor Thomas has been serving on the ABA Tort Trial and Insurance Practice Section Task Force on Federal Involvement in Insurance Regulation Reform since 2004. Amy Bach's organization, United Policyholders, brings the additional perspective of having filed more than 430 friend of the court briefs in coverage and claim legal proceedings throughout the country that have touched on every one of the issues the Restatement draft addresses.

Professors Baker and Logue have already thoroughly addressed the many inaccuracies in the D&S letter pertaining to Restatement itself<sup>3</sup> and we will not reiterate those corrections in this letter. Nor is our

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<sup>1</sup> We understand that the National Association of Mutual Insurance Companies funded the work for the letter. We do not know whether the opinions expressed in it represent those of its drafters or NAMIC.

<sup>2</sup> Amy Bach, Executive Director of United Policyholders, has been a NAIC Consumer Representative since 2008, Professor Daniel Schwarcz from 2008-2014, and Associate Professor Peter Kochenburger since 2010.

<sup>3</sup> "Defending the Restatement of the Law, Liability Insurance: 'Regulatory Considerations.'"

purpose here to defend the choices the Restatement makes in addressing certain issues,<sup>4</sup> but rather to dispel the misconceptions of state insurance regulation asserted in the D&S letter, and which underlie their critique.

D&S' understanding of the regulatory system is demonstrated in its conclusion:

Contrary to the Draft's presumption regarding the vulnerability of the insurance consumer, comprehensive regulatory oversight, extensive insurance laws and regulations, well-developed case law and competitive market forces are already in place to protect the consumer. Therefore, the highlighted Draft rules are unnecessary and overreaching. Those rules also depart from case law and attempt to displace the role of the regulator.<sup>5</sup>

Their premise is that the current system of "comprehensive regulatory oversight" already fully protects insurance consumers, making the Restatement sections they disagree with both unnecessary and posing a threat to state regulatory functions and prerogatives. The D&S analysis in this area centers on three areas of formal state insurance regulation: (1) regulation of rates and forms, (2) financial regulation and threats to insurer solvency that D&S claims is posed by the Restatement, (3) regulation and enforcement of claim handling standards. We review each of these areas below.

### **1. Rate and Form Regulation**

The D&S argument regarding insurance rates has nothing to do with rate regulation. The basic argument is that insurance rates may go up "in response to *new liabilities* created by the Draft rules."<sup>6</sup> These purported "new liabilities" are not demonstrated by the D&S letter, and the substantive criticisms have been addressed by the response from Professors Baker and Logue. Moreover, the D&S letter fails to consider the benefits of the greater certainty in common law rules promoted by the Restatement. By articulating black letter rules from the common law, the Restatement improves clarity and reduces transaction costs associated with resolving insurance coverage disputes.<sup>7</sup> Savings from reduced transaction costs may offset costs associated with rules substantively helpful to insureds (if there are such costs), and could result in a net savings for the insurance industry.

Furthermore, the appropriate balance to be struck between greater protection on one hand, and the costs associated with such protection on the other, is left to the courts, regulators, and legislators. The Restatement is a resource (one that reflects enormous individual and collective effort on part of the Reporters and the ALI), not a mandate. Ultimately the courts, exercising their common law powers, will

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<sup>4</sup> While we support the overall purposes of the Restatement, we have our own individual concerns and criticisms with some of the positions taken, including the Notice requirements applicable to claims-made and reported policies in Section 36(2), Excess Attachment in Section 40, and Allocation in Long-Tail Harm Claims in Section 42. However, we recognize that the ALI's purpose in drafting restatements is not to satisfy the wish-lists or agendas of interested parties on any one side of an issue.

<sup>5</sup> D&S letter p. 38. The reference to "well-developed case law" implies that no further common law developments will be necessary. This is contrary to the essence of the common law, and fails to recognize that an ALI Restatement is a tool for courts to improve the clarity, consistency and protections offered by the common law.

<sup>6</sup> D&S Letter at 9 (emphasis supplied).

<sup>7</sup> See generally G. Edward White, *The American Law Institute and the Triumph of Modernist Jurisprudence*, 15 Law & Hist. Rev. 1 (1997).

decide whether to adopt any of the rules set forth in the Restatement.<sup>8</sup> Should this increase the cost of insurance, insurance regulators will respond as necessary, including asking for legislative intervention to preempt the common law if needed.

As to form regulation, it is difficult to identify exactly what the D&S letter is arguing. The letter notes that the Restatement accurately summarizes insurance form regulation in comment e, but then suggests, without explanation, that “the Draft seemingly disregards the level of regulatory oversight.”<sup>9</sup> It then contends that the Restatement is “wrong” because it assumes “that all insurance policies are contracts of adhesion and that due to unequal bargaining power and complete lack of protection for the insured, the field needs to be tilted further in favor of insureds.”<sup>10</sup> Thus, it appears that the argument is that the Restatement gives undue protection to insureds, the implication being that regulatory protection is more than enough.

This is the classic regulatory attack on the common law, and is answered empirically by the thousands of cases using the rules of insurance policy interpretation.<sup>11</sup> If regulatory protection was sufficient, there would be no need for the common law rules.<sup>12</sup> Surely the D&S letter is not contending that this entire

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<sup>8</sup> See, e.g., Gregory E. Maggs, *Ipse Dixit: The Restatement (Second) of Contracts and the Modern Development of Contract Law*, 66 Geo. Wash. L. Rev. 508 (1998) (analyzing the adoption by the courts of six provisions in the Restatement (Second) of Contracts).

<sup>9</sup> D&S Letter at 10.

<sup>10</sup> D&S Letter at 10. The D&S letter exaggerates the position of the Restatement (“all” policies are contracts of adhesion and a “complete” lack of protection for the insured) to make it seem unreasonable, but does not attempt to disprove the basic assumptions, which are found throughout the insurance common law, that insurance policies are contracts of adhesion and that insurers generally have more power than insureds. See Gerald P. Dwyer, Jr., 1-4 New Appleman on Insurance Law Library Edition § 4.02[3][b] & n.14 (“Insurance policies have been used as the leading examples of adhesion contracts for many years” and noting that the term comes from a 1919 Harvard Law Review Article by the esteemed Professor Edwin W. Patterson entitled *The Delivery of a Life Insurance Policy*); Jeffrey E. Thomas, 1-5 New Appleman on Insurance Law Library Edition § 5.02[2][b] (explaining that courts often use the adhesive nature of insurance policies and unequal bargaining power as a basis for the contra proferentem rule). For examples of cases, see *Egan v. Mutual of Omaha Ins. Co.*, 620 P.2d 141, 146 (Cal. 1979) (“The relationship of insurer and insured is inherently unbalanced; the adhesive nature of insurance contracts places the insurer in a superior bargaining position.”); *Buzzard v. Farmers Ins. Co.*, 824 P.2d 1105, 1109 (Okla. 1991) (noting that after a loss, “the insured will be disabled and in strait financial circumstances and, therefore, particularly vulnerable to oppressive tactics on the part of an economically powerful entity”); *Hayseeds, Inc. v. State Farm Fire & Cas.*, 352 S.E.2d 73, 77 (W. Va. 1986) (“the bargaining power of an insurance carrier vis-à-vis the bargaining power of the policyholder is disparate in the extreme”).

<sup>11</sup> See Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 Mich. L. Rev. 531, 532 & n. 4 (noting that contra proferentem, waiver, estoppel and reasonable expectations are frequently invoked by the courts and estimating that contra proferentem was used in more than 4,000 cases between 1980 and 1995).

<sup>12</sup> Regarding coverage disputes and claims practices in particular, the current regulatory system cannot hope to adequately protect policyholders. State insurance departments are spread too thin to adequately police contract language, contracting practices, and treatment of policyholders. Further, because insurance departments approve policy forms, insurers sometimes argue that this means (as a matter of law) that policy language is unambiguous and does not violate policyholder reasonable expectations or public policy. We find such “safe harbor” arguments by insurers utterly unconvincing in light of regulator inability to closely monitor policy language and the impossibility of foreseeing difficulties in applying a particular policy to a specific claim context. Consequently, common law courts will always have a pivotal role to play in protecting the legitimate interests of both policyholders and insurers. The current Draft of the Restatement simply continues this time-honored tradition of ALI efforts to improve the law and its functioning. It does not undermine the regulatory function.

body of common law serves no purpose. The Restatement is a study of that body of law, and while reasonable minds may disagree on the particulars of the black letter rules as articulated by the Restatement (the appropriateness of which Professors Baker and Logue have already explained), no reasonable person would contend that the common law rules of insurance policy interpretation are unnecessary. To put it simply, the regulatory approval of insurance policy forms, while useful and beneficial, cannot anticipate all the possible circumstances in which the language in the policy forms will be applied. This is the role (and strength) of the common law: developing rules to address a wide variety of cases in practice.

## **2. Threats to Insurance Solvency**

The D & S letter asserts that the proposed Restatement “increases the risk of carrier insolvency or other potential claim paying impairment” by creating the prospect of new loss trends that were not appropriately accounted for in insurers’ pricing determinations. Loss trending is the process by which insurers adjust historical loss data to predict future loss expenses in light of anticipated changes, such as inflation or shifts in claim frequency or severity. In long-tail lines of coverage – where there is a long gap between policy issuance and claim payment – loss trending requires that insurers project the costs of claims years into the future.

The argument that the Restatement project could undermine insurer solvency borders on the absurd. First, even assuming that the Restatement project would dramatically alter the law – a premise that is incorrect for the reasons that Professors Baker and Logue have developed elsewhere, and with which we concur – the magnitude of those alterations would be nowhere near sufficient to jeopardize insurers’ solvency. The vast majority of insurers operate with regulatory capital far in excess of what state insurance regulators require, in order to convey financial strength to the market. Indeed, out of the approximately 2500 licensed p/c insurers in the U.S., all but 39 maintained minimum risk-based capital levels more than 250% above the minimum amount regulators require.<sup>13</sup> Moreover, these capital levels are themselves based on future loss predictions that are inherently conservative, and thus are specifically designed to account for errant estimates of future losses.

Second, once again assuming that the D&S letter were correct that the Restatement would fundamentally alter insurance law, the timing of these changes means that they would not pose a plausible risk of jeopardizing insurers’ solvency. The insurance industry has been on notice of the ALI’s project since its inception in 2011. Although it is true that the project was officially converted from a Principles project to a Restatement project in 2014, this conversion resulted in the jettisoning of the individual provisions within early drafts that were most at odds within existing law. For all these reasons, to the extent the industry really believed the ALI project could dramatically impact loss trends, they have had between six and three years to reflect that fact in their loss trending projections.

Perhaps even more importantly, at the very least it will take years for the ALI’s Restatement project to concretely influence insurance law. The process will likely take even longer to the extent that the D&S letter is correct that the Restatement would dramatically alter insurance law. As a result, even insurers providing long-tail lines of coverage will have ample time to adjust their loss trending appropriately if they genuinely believe that adoption of the Restatement rules would impact loss trends.

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<sup>13</sup> [http://www.naic.org/documents/research\\_stats\\_rbc\\_results\\_pc.pdf](http://www.naic.org/documents/research_stats_rbc_results_pc.pdf)

### 3. Claim Handling Regulation and the Common Law

The D&S letter continues its pattern of inaccurate statements and exaggerations in its discussion of claim handling regulations: “The Draft imposes quasi-strict liability on the insurer regarding any judgment in excess of policy limits under [Restatement] sections 24 and 27 despite well-established regulatory, statutory and common law protections against unfair claim handling practices.<sup>14</sup> Claim handling regulations, including the Unfair Claim Settlement Practices Act (UCSPA),<sup>15</sup> market conduct exams, and review and mediation of consumer complaints have always existed side by side with common law standards and protections such as the duty to defend, the “duty to settle,” and the duty of good faith and fair dealing insurers owe to their policyholders. What does vary is how these common law standards are interpreted, and the damages available when an insurer breaches its contract. Systematically compiling and analyzing these classifications and differences among 56 state, district and territorial jurisdictions, evaluating “majority” and “minority” views, and then setting forth the preferred position after years of study, comment and deliberation, are precisely what ALI Restatements are supposed to do.

State regulatory actions such as market conduct exams and complaint investigation are important tools but cannot adequately investigate and regulate the millions of claims adjusted each year, nor do state insurance departments have the resources to do so. Further, even the most thorough market conduct exams are unlikely to discover or evaluate many of the issues covered in the Restatement, such as the duty to defend and the duty to make reasonable settlement decisions in individual cases, nor are they pertinent to traditional common law considerations such as rules of contract interpretation, allocation rules between multiple primary and excess policies in long-tail claims, the effectiveness of a reservation of rights letter, and similar issues.<sup>16</sup>

The D&S letter references the UCSPA several times, but ignores the fact that the large majority of jurisdictions do not allow a private cause of action under the UCSPA,<sup>17</sup> and that formal UCSPA enforcement actions in the courts are rare, making common law standards even more important.<sup>18</sup>

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<sup>14</sup> As discussed, Sections 24 and 27 do not impose a “quasi-strict liability” standard in this area, but rather a requirement that insurers adjust claims to reasonable commercial standard. This is clear from both the black letter text and the comments and notes to these sections; continually stating an incorrect proposition will not make it correct, no matter how many times the authors repeat it.

<sup>15</sup> NAIC Model Law: Unfair Claim Settlement Practices Act, Vol. VI-900-1.

<sup>16</sup> Restatement Sections 10 – 23 (duty to defend), 24-28 (settlement), 2-6 (contract interpretation), 38 – 44 (allocation rules), 15 (reservation of rights letters).

<sup>17</sup> William T. Barker & Ronald D. Kent, *New Appleman Insurance Bad Faith Litigation* § 10.4[1][a] (2d ed. 2017) (“the overwhelmingly majority of states have declined to recognize any cause of action for violation of [Unfair Claims Practices statutes] following the NAIC model”).

<sup>18</sup> In 1988 California Supreme Court Justice Stanley Most famously remarked:

Since 1959 ... 62 volumes of California Reports and 297 volumes of California Appellate Reports have been published. In those 359 volumes there are more than 300,000 pages. On not one page of one volume is a single case reported in which the Insurance Commissioner has taken disciplinary action against a carrier for ‘unfair and deceptive acts or practices in the business of insurance involving a claimant. *Not one case in 29 years.* (*Moradi-Shalal v. Fireman’s Fund Ins. Companies*, 758 P.2d 58, 77 (Cal. 1988) (Most, J, dissenting) (emphasis in the original). We believe this observation regarding regulatory litigation involving UCSPA obligations owed to policyholders or claimants remains accurate in 2017.

Courts have also recognized state versions of the Unfair Claim Settlement Practices Act as establishing appropriate claim handling standards in common law bad faith actions, demonstrating again that regulatory and common law requirements are mutually reinforcing, rather than competing.<sup>19</sup>

D&S heavily relies on a single lower-level appellate decision, *Roldan v. Allstate Ins. Co.*,<sup>20</sup> to support its proposition that enforcement of claim handling standards should properly be left to the regulators.<sup>21</sup> However, D&S fails to provide the relevant context for the decision, which, as made clear by the Reporters, is whether punitive damages should be assessed in private civil actions, and not whether courts should properly exercise jurisdiction over allegations of a pattern and practice of improper claims handling.<sup>22</sup> In addition, several minutes of research on *Roldan*'s precedential value demonstrates it has been rejected by other appellate districts in New York and essentially overruled by the New York Court of Appeals.<sup>23</sup>

### **National Conference of Insurance Legislators**

NCOIL wrote to ALI Director Richard Revesz on May 5, 2017, requesting ALI postpone voting on the Restatement at the upcoming Annual Meeting and to meet with NCOIL representatives to discuss the draft Restatement at an unspecified NCOIL meeting later this year before taking further action on the draft. NCOIL stated: "While NCOIL just recently learned of this issue and our review of the proposed Restatement is, accordingly, ongoing, several of its provisions that go beyond established law are of immediate concern because they appear to address matters which are properly within the legislative prerogative."<sup>24</sup>

We urge the ALI to reject this request. We recognize NCOIL's commitment to state insurance regulation, but their demand is untimely and based on the same misinformation concerning sections of the Restatement that plague the D&S letter, and which have already been thoroughly addressed.

This project was initiated as a Principles Project in 2010 and approved as a Restatement in 2014. Since 2011, it has gone through eleven drafts, discussed at five ALI Annual Meetings, four meetings with the ALI Council, and twenty meetings with the project Advisers and the MCG. Insurers were provided a

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<sup>19</sup> The Idaho Supreme Court noted "[t]he Act is not simply 'potential evidence of the industry standard.' It is a legislative enactment establishing insurance industry standards." *Weinstein v. Prudential Property and Cas. Ins. Co.*, 233 P.3d 1221, 1235 (Idaho 2010) (citation omitted); *American Family v. Allen*, 102 P.3 333, 344 (Colo. 2004) ("This statute sets out requirements for insurers in adjusting claims and is considered valid evidence of industry standards").

<sup>20</sup> 49 A.D.2d 20 (N.Y. App. Div. 1989).

<sup>21</sup> D&S letter pp. 11-15.

<sup>22</sup> "Defending the Restatement," p. 16.

<sup>23</sup> *Belco Petroleum Corp. v. AIG*, 164 A.D.2d 583, 588, 591 (N.Y. App. Div. 1991); *Rocanova v. Equitable Life Assur. Co.*, 83 N.Y.2d 603, 615 (N.Y. 1994) ("The First Department in *Belco* correctly disagreed with the Second Department's decision in *Roldan v. Allstate Ins. Co.*, 149 A.D.2d 20, 544 N.Y.S.2d 359 and held that an insured's common-law right to sue an insurer for punitive damages for morally culpable conduct directed at the general public was not preempted by the enactment of section 2601").

<sup>24</sup> NCOIL concludes: "Should the ALI refuse our invitation for a dialogue and proceed towards seeking approval of the proposed Restatement from ALI membership at its annual meeting, NCOIL be forced to consider pass

project liaison through the American Insurance Association, a trade group representing many of the largest liability insurers in the United States,<sup>25</sup> and there have been dozens of articles on the Restatement in insurance trade magazines, legal publications, law firm articles and blogs, as well as the ALI Adviser. The Reporters have participated in Restatement discussions around the country, including meetings with the ABA TIPS and Litigation Sections, the Defense Research Institute, and the American Insurance Association.<sup>26</sup> In 2015 Rutgers Law School's Center for Risk and Responsibility held a symposium on the draft Restatement, which was later featured in the Rutgers University Law Review.<sup>27</sup> Industry-side attorneys spoke at the conference and wrote several of the articles published in the Law Review. There has been both wide publicity and many opportunities to comment on this Restatement over its six-year history

Second, NCOIL's examples of where the Restatement is "going beyond established law"<sup>28</sup> do not accurately describe the sections referenced. The Restatement's proposed use of extrinsic evidence in determining the duty to defend, and the loss of coverage defenses when an insurer breaches the duty to defend without a reasonable basis, are both amply supported in case law.<sup>29</sup> The fear that Sections 24 and 27 would dramatically expand insurers' existing obligations in responding to settlement demands has been thoroughly examined and debunked by the Reporters.<sup>30</sup> The statement that Sections 47 and 48 only allow policyholders to recoup their attorneys' fees in specific circumstances is correct, but NCOIL's statement that the "overwhelming majority of states either do not permit attorney fee shifting or do so as a matter of specific statutory law" is inaccurate. The large majority of jurisdictions have abandoned strict application of the American Rule, with significant variations as to the level of conduct required to shift fees, and the interplay between common and statutory law.<sup>31</sup>

This Restatement does not and in fact cannot intrude on legislative prerogatives for the simple reason that state legislatures are free to approve, modify or reject these common law doctrines largely as they see fit, whether in insurance or other areas of commercial regulation.<sup>32</sup> States occasionally do legislate in this area, but common law still governs most of the subjects covered in this Restatement. As such, and despite our disagreement with some of the positions taken in it, we believe the Restatement provides invaluable guidance and will be of considerable use to courts, lawyers, regulators and

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<sup>25</sup> Attorney Laura A. Foggan is one of the leading insurance coverage lawyers in the country and has ably represented insurers and their trade associations in hundreds of cases.

<sup>26</sup> On March 24, 2014 the Reporters received correspondence and a voluminous set of documents from the general counsels or corporate officers of ACE, AIG, Allstate, Chubb, Hartford, Liberty Mutual, State Farm, Travelers, USAA, and Zurich. This is yet another example that the industry has been provided and taken advantage of (as they should) many opportunities to comment on the Restatement over a multi-year period. The Reporters considered industry input and made the changes to the Restatement they thought appropriate, just as they have with policyholder-side participants.

<sup>27</sup> 68 Rutgers Univ. L. Rev. 1, Fall 2015: Restatement of the Law of Liability Insurance.

<sup>28</sup> NCOIL May 8, 2017 press release.

<sup>29</sup> The Reporters note in Comment C to Section 19 that the "without reasonable basis" standard is a middle ground between courts that have held a mere breach of contract results in the loss of coverage defense, and those holding that an insurer would still maintain its coverage defenses.

<sup>30</sup> "Defending the Restatement," pp. 3-10.

<sup>31</sup> See Comments and Reporters' Notes to Sections 47 and 48.

<sup>32</sup> Nor can legislation and the Restatement truly conflict, as a court could not apply principles from the Restatement that are contrary to state law.

legislative officials for decades – including those who disagree with a particular position it takes. For these reasons it fulfills the ALI’s exacting standards for a Restatement.

## **Conclusion**

We are in an era where technological innovations are altering traditional insurance underwriting, sales and claims handling techniques at a rapid pace. Yet the purpose and value of liability insurance, the adhesive nature of insurance contracts, and preserving insureds’ reasonable expectations of coverage remain as important as ever. The Restatement of the Law of Liability Insurance is a balanced treatise that will uphold that purpose and preserve that value for decades to come. It is ready for adoption.

Sincerely,

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