

DUTY TO SETTLE: WHY PROPOSED SECTIONS 24 AND 27 HAVE NO PLACE IN A RESTATEMENT OF THE LAW OF LIABILITY INSURANCE

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In May 2010, the American Law Institute (“ALI”) began a project to develop the Principles of the Law of Liability Insurance (“PLI” or “Principles”). As described by the ALI, Principles of the Law projects “may suggest best practices” for legislatures, administrative agencies, private actors, or courts.¹ After a series of drafts of proposed sections were circulated, discussed, and in some cases objected to by various constituencies, including insurers, the ALI decided in August 2014 to convert the project from a “Principles of the Law” into a “Restatement of the Law.”² The change is significant.

Unlike Principles, Restatements “aim at clear formulations of common law and its statutory elements or variations”; they “reflect the law as it presently stands or might appropriately be stated by a court.”³ In short, while Principles might be aspirational, Restatements historically have aimed to describe the law as it is.⁴ Even though recent revisions to the handbook governing Restatements have described new elements in the process,⁵ the standard remains that any changes to

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1. AM. LAW INST., CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 13 (rev. ed. 2015) [hereinafter REVISED HANDBOOK].

2. RESTATEMENT OF THE LAW OF LIAB. INS. intro. at ix (AM. LAW INST., Council Draft No. 1, 2015).

3. REVISED HANDBOOK, *supra* note 1, at 3, 4 (emphasis omitted).

4. AM. LAW INST., CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 4 (2005).

5. In January 2015, the ALI Council approved revisions to *A Handbook for ALI Reporters and Those Who Review Their Work*, including revisions to the discussion of the “Nature of a Restatement.” RESTATEMENT OF THE LAW OF LIAB. INS. at x–xi (AM. LAW INST.,

majority law must be “accretional,” and departures from majority law must be clearly identified.⁶ Inasmuch as many key sections of the PLI reflected the views of the Reporters as to how courts *should* apply policy provisions rather than how most courts *had* applied them, with acknowledged innovations and pronouncements not based on established authority, the new Restatement of the Law of Liability Insurance (“RLLI” or “Restatement”) cannot simply adopt the PLI formulations. Instead, it must revisit and revise the earlier pronouncements to fit within the constraints of a Restatement, and where it “declines to follow the majority rule, it should say so explicitly and explain why.”⁷

One key area in which the PLI, and now the Restatement, divert from accepted law is in sections 24 and 27.⁸ In describing the “duty to make reasonable settlement decisions” and the consequences of breach of that duty, the Reporters created legal responsibilities not found in the insurance policies that necessarily define the obligations of the insurer and the policyholder—nor in the law itself.⁹ Further, the sections as drafted and explained by the Reporters run, in some cases, against sound public policy and would create severe collateral consequences, which are unexplored. Sections 24 and 27 as drafted, extreme for Principles, are outside the proper bounds of a Restatement, even as described in the ALI’s *Handbook for ALI Reporters and Those Who Review Their Work* (“Revised Handbook”).

Section 24 provides that an insurer has a duty “to make reasonable settlement decisions” as to claims where the insured is exposed to liability in excess of the policy limits.¹⁰ A “reasonable settlement decision” is defined as “one that would be made by a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment.”¹¹ It includes the duty to accept reasonable settlement demands by claimants and to contribute policy limits to a reasonable settlement that exceeds those limits.¹² Section 27 establishes the measure of damages when an insurer is held liable for a breach under

Council Draft No. 1, 2015). See *infra* text accompanying notes 15–21, for revisions to the Revised Handbook as applied to the RLLI.

6. REVISED HANDBOOK, *supra* note 1, at 6; see also *infra* text accompanying notes 16–21.

7. REVISED HANDBOOK, *supra* note 1, at 6.

8. Numbering and content of sections 24 and 27 are as contained in RESTATEMENT OF THE LAW OF LIAB. INS. (AM. LAW INST., Council Draft No. 1, 2015).

9. *Id.* § 23(3).

10. *Id.* § 24(1). The full text of Council Draft No. 1, section 24 black letter law is included as Appendix A.

11. *Id.* § 24(2).

12. *Id.* § 24(3)–(4).

section 24 that results in an excess judgment.¹³ This section permits the insured to recover “the full amount of damages assessed against” it at trial “without regard to the policy limits, as well as any other foreseeable harm caused by the insurer’s breach,” including punitive damages awarded against the insured, loss of business reputation, and emotional distress.¹⁴

In understanding sections 24 and 27, it is important to recognize the assumptions that underlie these sections, as well as other parts of the RLLI. These drafts are driven by a narrative that large insurers advance their own interests at the expense of relatively powerless small policyholders. Under this construct, when a policyholder faces potential liability in excess of policy limits, the insurer has an incentive to reject settlement demands at or close to those limits, because the insurer has little to lose in taking a case to trial. The policyholder is thus put at risk of excess judgments. The RLLI also apparently assumes that insurers exacerbate this problem by selling policies that are inadequate to cover policyholders’ true liability exposure. Sections 24 and 27 are intended to protect these presumed vulnerable policyholders, even where the policy does not provide such recourse and even at the cost of raising the expense of insurance for the public at large.

One problem with this narrative of the power imbalance between insurers and insureds is the reality that major corporations with sophisticated insurance programs and enormous bargaining power would be the true beneficiaries of these proposed rules, which are significantly weighted in favor of policyholders. Further, the interests of small policyholders, the intended objects of the RLLI’s protection, will not be served in the long run by the changes proposed; small “Ma and Pa” businesses, most susceptible to the increased premium costs, may well find themselves priced out of the liability insurance market. Because increased claims payments and market uncertainty will need to be paid for by the pool of insureds, individual consumers, too, will share the burden of higher premiums, a further collateral consequence of the proposed RLLI. A Restatement, as distinct from a purely academic analysis, should consider the desirability of rules by taking into account the real world effects of the provisions it adopts, as indicated in the Revised Handbook.¹⁵

13. *Id.* § 27.

14. *Id.* § 27(1), § 27 cmt. b, illus. 1, 4, § 27 cmt. d.

15. See REVISED HANDBOOK, *supra* note 1, at 5 (“[T]he fourth step is to ascertain the relative desirability of competing rules. Here social-science evidence and empirical analysis can be helpful.”).

I. THE RESTATEMENT OF THE LAW OF LIABILITY INSURANCE SHOULD REFLECT “THE LAW AS IT PRESENTLY STANDS OR MIGHT APPROPRIATELY BE STATED BY A COURT,” NOT PRESENT UNSUPPORTED ASPIRATIONS.

In a recent revision to the Revised Handbook, approved in January 2015, the ALI Council reframed the “Restatement process.” This process now involves “four principal elements”: (1) “to ascertain the nature of the majority rule,” (2) “to ascertain trends in the law,” (3) “to determine what specific rule fits best with the broader body of law and therefore leads to more coherence in the law,” and (4) “to ascertain the relative desirability of competing rules.”¹⁶ Reporters are to include “an appropriate mix of these four elements” in each Restatement.¹⁷ Clarity and transparency in drafting is imperative: “[I]f a Restatement declines to follow the majority rule, it should say so explicitly and explain why.”¹⁸ As before, any proposed change in the common law reflected in a Restatement is solely “accretional,” and “[w]ild swings” in the law must be avoided.¹⁹ While Reporters may consider “which competing rules lead to more desirable outcomes . . . *the choices generally are constrained by the need to find support in sources of law.*”²⁰ This constraint applies because the ALI, as an unelected body, “has limited competence and no special authority to make major innovations in matters of public policy” and must instead “draft[] precise and internally consistent articulations of law.”²¹

As is discussed below in greater detail, the RLLI in sections 24 and 27, among others, is the latest example of “restating” the law according to the drafters’ “aspirations for what the law ought to be,” presenting an alarming shift away from the ALI’s mission.²² Last term, Justice Scalia observed that Restatement sections that operate in this way

should be given no weight whatever as to the current state of the law, and no more weight regarding what the law ought to be than the recommendations of any respected lawyer or scholar. And it cannot safely be assumed, without further inquiry, that a

16. *Id.*

17. *Id.* at 6.

18. *Id.*

19. *Id.*

20. *Id.* (emphasis added).

21. *Id.*

22. See *Kansas v. Nebraska*, 135 S. Ct. 1042, 1064 (2015) (Scalia, J., concurring in part and dissenting in part) (citing W. Noel Keyes, *The Restatement (Second): Misleading Quality and a Proposal for Its Amelioration*, 13 PEPP. L. REV. 23, 24–25 (1985)).

Restatement provision *describes* rather than *revises* current law.²³

While scholars debate whether a Restatement should be normative instead of descriptive in its approach,²⁴ critics and ALI policy *both* support identifying for the Restatement reader any departures from majority law, or a split among jurisdictions, and the reasons for the Restatement's chosen approach.²⁵

The RLLI fails to follow the guidance of the Revised Handbook. In many sections, the majority rule is not identified, and departures from majority law are not highlighted, potentially misleading judges and litigants.²⁶ Trends are not clearly defined. Further, consideration of how proposed innovations would lead to coherence in the body of law is not apparent, and statements concerning the desirability of proposed rules are not based on any empirical evidence. As one scholar has noted:

The ALI does not accomplish its functions, even as amended over time, when it advocates instead of teaches. It cannot teach by hiding or sliding by the facts. When the ALI fails to be forthright, even if only in small respects or isolated instances, its entire project cannot help but lose respect.²⁷

23. *Id.* (emphasis added).

24. Kristen David Adams, *The Folly of Uniformity? Lessons from the Restatement Movement*, 33 HOFSTRA L. REV. 423, 437–38, 438 n.61 (2004) (describing the debate).

25. REVISED HANDBOOK, *supra* note 1, at 6; Keyes, *supra* note 22, at 24–25, 50–52, 54–55; Joseph W. Morris, *The Worthier Title Doctrine: Does Draft Restatement III of Property Write a Premature Obituary?*, 45 WASHBURN L.J. 387, 392–93 (2006); Fred C. Zacharias, *The Restatement and Confidentiality*, 46 OKLA. L. REV. 73, 82–83 (1993).

26. See Keyes, *supra* note 22, at 24–25, 50–51, 54–55 (“[I]f there is no majority, the ALI can easily state so in Blackletter . . . [and] may then set down a rule preferred by a majority of the ALI, which might be printed in redletter or some other color.”). A number of scholars have called for the ALI to be explicit in disclosing when “its position . . . constitutes a view that is not the law in many jurisdictions and represents what the writers of the *Restatement* . . . believe the law ought to be.” Morris, *supra* note 25, at 393; accord Keyes, *supra* note 22, at 50 (observing that where a Reporter adopts a position with little or no judicial support, the Reporter can become an “advocate” for that position “regarding changes in existing law and the choice of alternatives, often without disclosing that his [or her] writing is, in effect, a ‘brief for [that] approach’”); Zacharias, *supra* note 25, at 83 (“[A Restatement should] demonstrate why the ALI’s respected membership of judges, lawyers, and scholars all agree that it is correct to quit the majority approach [because] if the members simply seem to be voting personal preferences or adopting reporters’ preferences, why should any jurisdiction that has recently debated the issue defer?”).

27. Zacharias, *supra* note 25, at 86; accord REVISED HANDBOOK, *supra* note 1, at 6.

II. “DUTY TO MAKE REASONABLE SETTLEMENT DECISIONS” IS AT ODDS WITH SETTLED LAW.

An assessment of the newly-envisioned “duty to make reasonable settlement decisions,”²⁸ must start from the fundamental source of all insurance law: the policy itself. A contract between two parties, an insurance policy articulates the rights and duties of the insurer and the policyholder. While case law over many years and jurisdictions has construed policies and found implied duties, such as the implied covenant of good faith and fair dealing, a court (or a lawmaker or ALI Reporter) may not create explicit new duties outside of the four corners of the policy.²⁹ This limitation derives from the basic rules of contract law barring courts from creating a contract for the parties.³⁰ The Restatement (Second) of Contracts could not be clearer that, except for a handful of immaterial exceptions, “the formation of a contract requires a bargain in

28. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 (AM. LAW INST., Council Draft No. 1, 2015).

29. See, e.g., *Am. Prot. Ins. Co. v. Airborne, Inc.*, 476 F. Supp. 2d 985, 989, 992 (N.D. Ill. 2007). In *Airborne*, applying Illinois law, the court recognized that “[i]nsurance policies are subject to the same rules of construction applicable to other types of contracts,” and held that, “looking only at the ‘four corners’ of the contract . . . the [p]olicy gave [the insurer] an unambiguous power to settle a third-party lawsuit against its insured . . . even when that settlement committed [the insured]’s [d]eductible [a]mount over its objection.” *Id.* at 989, 992 (first quoting *Nicor, Inc. v. Associated Elec. & Gas Ins. Servs. Ltd.*, 860 N.E.2d 280, 285–86 (Ill. 2006); and then quoting *Camico Mut. Ins. Co. v. Citizens Bank*, 474 F.3d 989, 992–93 (7th Cir. 2007)). The court also emphasized that the insurer was subject “only to the duty of good faith that is the *normal expectation under any contract—not some higher standard.*” *Id.* at 994–95 (emphasis added) (holding that the insurer performed its duties to act in good faith under the contract when it negotiated a settlement on the insured’s behalf, even without the insured’s consent).

30. See, e.g., *Nationwide Mut. Ins. Co. v. Overlook, LLC*, 785 F. Supp. 2d 502, 514, 526 (E.D. Va. 2011) (declining to apply a “substantive reasonableness” test to exclusions in an insurance policy, because it is not the court’s function to “make a new contract for the parties different from that plainly intended and thus create a liability not assumed by the insurer” (quoting *Blue Cross & Blue Shield of Va. v. Keller*, 450 S.E.2d 136, 140 (Va. 1994)); see also *Dollar Phone Corp. v. St. Paul Fire & Marine Ins. Co.*, No. CV-09-1640 (DLI) (VVP), 2012 WL 1077448, at *12, *17 (E.D.N.Y. Mar. 9, 2012) (relying on the principle that courts “may not by construction add or excise terms, nor distort the meaning of those used and thereby make a new contract for the parties under the guise of interpreting the writing” of an insurance contract, and recommending granting the insurer’s motion for summary judgment on the insured’s claims for breach of contract and breach of the duty to defend (quoting *Reiss v. Fin. Performance Corp.*, 764 N.E.2d 958, 961 (N.Y. 2001))) (applying New York law); *Hill v. State Farm Mut. Auto. Ins. Co.*, 83 Cal. Rptr. 3d 651, 673 (Ct. App. 2008) (“[P]arties . . . to [an insurance] contract h[ave] the right to insert such lawful provisions in the agreement as they [see] fit. It is the duty of the courts to construe and enforce them as made, and not to make a new contract for the parties.” (quoting *Coons v. Home Life Ins. Co. of N.Y.*, 13 N.E.2d 482, 485 (Ill. 1938))).

which there is a manifestation of mutual assent to the exchange and a consideration.”³¹ In seeking to impose—unilaterally—an explicit “duty to make reasonable settlement decisions,” outside of the implied duty of good faith and fair dealing, sections 24 and 27 depart from the principles set forth in the Restatement (Second) of Contracts.

The implied covenant of good faith and fair dealing prohibits either party from doing anything to harm the other party’s right to the benefits of the contract.³² According to the Restatement (Second) of Contracts, good faith is the absence of bad faith, which is understood as behavior that “violate[s] community standards of decency, fairness, or reasonableness.”³³ The insurer’s obligation to act in good faith when undertaking settlements for the insured derives from the insurance contract and the relationship between the insurer and the insured established by that policy, which gives the insurer the right to control settlement and to defend litigation against the insured. This “right to control settlement carries with it a corresponding duty of good faith and fair dealing to the insured,” which imposes on the insurer a duty “to settle where appropriate even if the duty is not expressly imposed in the terms of the policy.”³⁴ Some cases consider claims relating to an insurer’s actions in settlement primarily on the basis of the duty of good faith and fair dealing that is implied in every insurance contract.³⁵ Others speak to a “duty to settle” and apply a tort-based standard; however, these cases still rely on the relationship between the insurer and the insured for the source of the duty and view the question of whether the insurer breached that duty largely from the perspective of “bad faith.”³⁶

31. RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (AM. LAW INST. 1981).

32. *DeWitt v. Monterey Ins. Co.*, 138 Cal. Rptr. 3d 705, 711 (Ct. App. 2012); *De La Concha of Hartford, Inc. v. Aetna Life Ins. Co.*, 849 A.2d 382, 387–88 (Conn. 2004) (quoting *Gaudio v. Griffin Health Servs. Corp.*, 733 A.2d 197, 221 (Conn. 1999)); RONALD D. KENT & WILLIAM T. BARKER, *NEW APPLEMAN INSURANCE BAD FAITH LITIGATION* § 7.02[1] (2d ed. 2014).

33. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (AM. LAW INST. 1981).

34. Steven Plitt et al., *Duty to Settle or Compromise Claims*, COUCH ON INSURANCE §§ 203:14 (Lee R. Russ & Thomas Fe. Segalla eds., 3d ed. 2005).

35. *E.g.*, *Murphy v. Allstate Ins. Co.*, 553 P.2d 584, 589 (Cal. 1976) (noting that a “duty to settle” is based on implied covenant of good faith and fair dealing); *see also* *Iowa Physicians’ Clinic Med. Found. v. Physicians Ins. Co. of Wis.*, 547 F.3d 810, 812–13 (7th Cir. 2008) (applying Illinois law that “[a]n insurer’s duty to settle in good faith on behalf of its insured . . . arises from the covenant of good faith and fair dealing implied in an insurance contract” (citing *Haddick v. Valor Ins.*, 763 N.E.2d 299, 303 (Ill. 2001); *Cramer v. Ins. Exch. Agency*, 675 N.E.2d 897, 903 (Ill. 1996))).

36. *E.g.*, *Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 656, 659 (Md. 1994) (cause of action sounds in tort for “bad faith” refusal to settle a claim within policy limits); *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171, 180 (Wis. 1986) (finding that an insurer has “breached its duty to settle requires a finding that it committed the tort of bad faith,” and

As the RLLI Reporters' Note observes, "some courts have expressed a breach of the duty to settle as a bad-faith failure to settle and have hinged their rulings on whether actual bad faith could be ascribed to the insurer."³⁷ Indeed, a number of cases expressly require a showing that the insurer acted in bad faith in order to find a breach of the duty to settle.³⁸ The focus in section 24, however, is "*only* on whether the insurer declined a reasonable settlement offer."³⁹ The settlement decision itself, stripped of consideration of reasons or factors, viewed without any context beyond numbers, is the primary concern of section 24.⁴⁰ Unlike courts across jurisdictions that weigh settlement decisions, section 24 does not look at the insurer's actions or motivation, its good or bad faith in deciding whether to settle; only the decision not to settle matters. In essence, section 24 applies a formulaic approach to find liability against an insurer for having declined an offer of settlement within policy limits when an excess judgment occurs.⁴¹ This approach, viewing the insurer's decision in a vacuum, is divorced from the origins of the duty in the

determining whether the insurer's choice "to litigate rather than settle" constitutes a breach "involves more than a mere finding of negligence on the part of the insurer" (citing *Warren v. Am. Family Mut. Ins. Co.*, 361 N.W.2d 724, 727 (Wis. Ct. App. 1984)).

37. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 reporters' note b (AM. LAW INST., Council Draft No. 1, 2015).

38. *E.g.*, *Sentry Select Ins. Co. v. Hosmer*, No. 08-4254-CV-C-NKL, 2009 WL 2151557, at *6 (W.D. Mo. July 17, 2009) (applying Missouri law, which requires four elements to state a claim for "bad faith failure to settle": "(1) the insurer 'has assumed control over negotiation, settlement, and legal proceedings against the insured; (2) the insured has demanded that the insurer settle the claim brought against the insured; (3) the insurer refuse[d] to settle the claim within the liability limits of the policy; and (4) in so refusing, *the insurer act[ed] in bad faith.*" (alterations in original) (emphasis added) (quoting *Freeman v. Leader Nat'l Ins. Co.*, 58 S.W.3d 590, 598 (Mo. Ct. App. 2001)); *see also Campbell*, 639 A.2d at 659 (finding that a cause of action against insurer for "failure, in bad faith, to settle a claim" requires "entry of a judgment against the insured in excess of policy limits"); *Nelson v. McLaughlin*, 565 N.W.2d 123, 132 (Wis. 1997) (observing that an insurer may be held liable for damages "flow[ing] from its breach of the duty to settle in good faith" where the "insured show[s] by clear and convincing evidence that its insurer rejected a pretrial settlement offer without a reasonable basis for doing so, *and it knew or recklessly disregarded this lack of a reasonable basis*" (emphasis added) (citing *Mowry*, 385 N.W.2d at 180)).

39. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 reporters' note b (AM. LAW INST., Council Draft No. 1, 2015) (emphasis added).

40. The RLLI Reporters' Note to section 24 asserts that section 27's standard "is analogous to the negligence standard in tort law" and purports to reject a "strict-liability" standard. *Id.* § 24 reporters' note c. Section IV, *infra*, explains why, far from imposing a negligence standard on the insurer, the result of section 24's formulation is in fact subjecting the insurer to automatic liability.

41. *Contra Mowry*, 385 N.W.2d at 181 (rejecting an approach "which would make an insurer strictly liable for an offer of settlement within policy limits"). Section 24's imposition of formulaic liability is discussed in greater depth in Section IV, *infra*.

implied covenant of good faith and fair dealing and by doing so is at odds with settled law.⁴²

In general, factors that courts weigh in determining whether the insurer's decision not to settle was made in good faith include the plaintiff's likelihood of success in proving liability, the potential damages award, the information available to the insurer when the settlement demand was made, whether a proper investigation was done, whether the advice of the defense lawyers retained by the insurer was considered, and whether the insurer failed to inform the policyholder of the offer, among other like considerations tending to establish or negate the insurer's good faith in declining to settle.⁴³ Because courts do not apply a formulaic approach to determine whether an insurer acted in good faith, existing law is flexible, providing for consideration of various factors and allowing for a range of outcomes if bad faith is found. Given the well-developed existing case law to adjudicate the insurer's conduct with

42. The conscious decision to create a new name for this newly-created duty—the “duty to make reasonable settlement decisions,” as opposed to the “duty to settle”—underscores that the standard proposed in section 24 singles out the insurer's decision (whether or not to accept a given settlement offer), and puts up blinders as to the insurer's course of conduct. See RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. a (AM. LAW INST., Council Draft No. 1, 2015).

43. See, e.g., *St. Paul Mercury Ins. Co. v. JBA Int'l, Inc.*, No. Civ. 01-297 JNE/JGL, Civ. 01-2161 JNE/JGL, 2003 WL 22272120, at *10 (D. Minn. Sept. 30, 2003) (“All factors bearing on the advisability of settlement must be considered. These factors include the view of the insurer as to liability, the anticipated range of an adverse verdict, the strength and weakness of the evidence so far as known, the history of similar cases in the area where the action is to be tried, and the relative appearance, persuasiveness, and appeal of the claimant, the insured, and witnesses at trial.” (citations omitted) (citing *Rova Farms Resort, Inc. v. Inv'rs Ins. Co. of Am.*, 323 A.2d 495, 503–04 (N.J. 1974)); see also *Plitt, et al. supra* note 34, §§ 203:23 (noting that a court may weigh a number of factors to determine whether the insurer “committed bad faith for failure to give equal consideration” to the insured's interests, including (1) “whether the insurer has failed to communicate with the insured, including particularly informing the insured of any compromise offers;” (2) the financial risk that the parties will be exposed to if the insurer refuses a settlement offer; (3) “the strength of the injured claimant's case on the issues of liability and damages;” (4) “whether the insurer has thoroughly investigated the claim;” (5) “whether the insurer has refused to negotiate;” (6) “the failure of the insurer to follow the legal advice of its own attorney or agent;” (7) “any attempts by the insurer to induce the insured to contribute to a settlement; and” (8) “any misrepresentations by the insured which have misled the insurer in its settlement negotiations and induced the insurer's rejection”). The RLLI disregards substantive factors in determining whether a settlement decision is reasonable. While it suggests in section 24, comment d that certain facts such as the time allowed to evaluate a demand and the jurisdiction of the trial “may” be taken into account, the illustration given of the application of the standard reveals that such evidence plays no role in determining liability. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. d & § 24 cmt. d, illus. 1 (AM. LAW INST., Council Draft No. 1, 2015). Further, as discussed *infra* in note 67, procedural factors go only to the issue of whether an insurer who has refused an *unreasonable* settlement offer may nonetheless be liable.

respect to settlements, there is little rationale for the creation of a newly conceived and expansive duty—and one with a low threshold of liability—as in section 24.

This conclusion is particularly true where the insured is a large commercial entity with bargaining power to negotiate terms, such as those giving it total or some control over settlement decisions. But, regardless of the nature of the insured, insureds who may have been injured by improper settlement actions by their insurers already have a full panoply of remedies under existing law.

III. SECTION 24: DEFINITION OF A “REASONABLE SETTLEMENT DECISION.”

The black-letter law of section 24 provides that an insurer has a duty to make “reasonable settlement decisions” with respect to claims that expose the insured to liability beyond policy limits.⁴⁴ A “reasonable settlement decision” is defined as “one that would be made by a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment.”⁴⁵ It includes the duty to accept reasonable settlement demands by claimants and to contribute policy limits to a reasonable settlement that exceeds those limits.⁴⁶

The concern addressed by this section, as described in the Comment, is that insurers, faced with a claim against the insured that may exceed policy limits, may reject a demand for policy limits and take the case to trial, on the theory that they have little to lose by doing so, defense costs borne by the insurer notwithstanding.⁴⁷ In order to deter insurers from rejecting reasonable offers, section 24 allows a policyholder to recover from its insurer when there is an excess judgment resulting from an unreasonable settlement decision.⁴⁸

The definition of a “reasonable settlement decision,” is, according to the Comment and Reporters’ Note, derived from the “disregard-the-limits” standard first articulated by Professor Robert E. Keeton.⁴⁹ However, the test adopted in section 24 differs significantly from Professor Keeton’s standard. Whereas section 24 defines reasonableness as the decision of a hypothetical reasonable person bearing “the sole

44. RESTATEMENT OF THE LAW OF LIAB. INS. § 24(1) (AM. LAW INST., Council Draft No. 1, 2015).

45. *Id.* § 24(2).

46. *Id.* § 24(3)–(4).

47. *Id.* § 24 cmt. a.

48. *Id.*

49. *Id.* § 24 cmt. c & § 24 reporters’ note c.

financial responsibility for the full amount of the potential judgment,”⁵⁰ 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 to the claim.”⁵¹ While these formulations sound similar, there are important differences. Judging from the point of view of “an ordinarily prudent insurer” allows the trier of fact to weigh the insights, experience and procedures of insurers in settling claims, factors that are critical in assessing the justification of a real life insurer’s settlement decision.⁵² Second, Professor Keeton’s test of an insurer with no policy limit opens the inquiry to the actual concerns of insurers, such as the value of the claim, the law in the jurisdiction, the claimant’s attorney’s track record, the possibility of creating a precedent that will encourage future litigation, and the costs of going to trial.

In the Reporters’ Note to section 24, the Reporters discuss the disregard-the-limits rule, which they profess to be applying, and its iterations in some detail.⁵³ However, generally, the cases and articles as cited in the Reporters’ Note do not apply the “reasonable person” test as adopted in section 24, but rather apply either the standard of a “prudent insurer” or use the equal consideration test (requiring the insurer to give at least “equal consideration” to its own interests and to the interests of the insured).⁵⁴ In fact, many courts apply Keeton’s formulation and use a “prudent insurer standard.”⁵⁵ Contrary to the directives of the Revised

50. *Id.* § 24(2).

51. Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1147 (1954).

52. *See id.* at 1146 n.27 (“If there is a difference between these hypothetical beings in terms of *experience with claims*, the hypothetical insurer probably is closer to the standard to be inferred from a study of the decisions than the hypothetical ‘ordinary’ person.”).

53. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. c & § 24 reporters’ note c (AM. LAW INST., Council Draft No. 1, 2015).

54. *Id.* § 24 reporters’ note c.

55. *E.g.*, *State Farm Mut. Auto. Ins. Co. v. Mendoza*, No. CIV-02-1141-PHX-ROX, CIV-03-164-PHX-ROS, 2006 WL 44376, at *18 (D. Ariz. Jan. 5, 2006) (applying Arizona law) (“prudent insurer without policy limits” standard); *Camacho v. Nationwide Mut. Ins. Co.*, 13 F. Supp. 3d 1343, 1354 (N.D. Ga. 2014) (applying Georgia law) (“The insurer’s failure to settle is in bad faith ‘if the ordinarily prudent insurer would consider choosing to try the case created an unreasonable risk.’” (quoting *Cotton States Mut. Ins. Co. v. Brightman*, 580 S.E.2d 519, 521 (Ga. 2003))); *Me. Bonding & Cas. Co. v. Centennial Ins. Co.*, 693 P.2d 1296, 1299 (Or. 1985) (en banc) (“In conducting the defense of a claim against an insured, including the investigation, negotiation, and litigation of the claim, the insurer must use such care as would have been used by an ordinarily prudent insurer with no policy limit applicable to the claim.”); *Rocor Int’l, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh*, 77 S.W.3d 253, 262 (Tex. 2002) (“[A]n insurer’s settlement duty is not activated until a settlement demand within policy limits is made, and the terms of the demand are such that an ordinarily prudent insurer would accept it.” (citing *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994))).

Handbook, the Reporters give no explanation for the rejection of that standard, cite no trends, indeed, no cases, in support of the new formulation and fail even to acknowledge that the Council Draft is at variance with settled law in numerous jurisdictions.

Another important area where section 24's test of reasonableness departs from Keeton's standard is in the consideration of probability. According to 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*.⁵⁶

Thus, as articulated by Keeton, the test must take into account the likelihood of a plaintiff's verdict at trial; liability for an insurer results when the risk of that unfavorable result is unreasonable, that is, out of proportion to the chance of a favorable result. In stark contrast, section 24 imposes liability on the insurer when the likelihood of a plaintiff's verdict is as low as thirty percent.⁵⁷ Unlike section 24, Professor Keeton's test is consistent with case law, which considers the "substantial likelihood" of a verdict unfavorable to the policyholder.⁵⁸ Standards like Professor Keeton's are more balanced, fixed in the context of real-life decisions, and not stacked toward an anti-insurer result, in contrast to the section 24 test. Here, too, the RLLI departs from accepted law without explanation or justification. Further, the collateral consequences of adopting a test that tilts toward insurer exposure to liability are set forth in Part V.

IV. AUTOMATIC LIABILITY—DRACONIAN AND UNDEFINED.

A major distinction between the rules articulated in section 24 and those of Professor Keeton, and indeed those found in case law, is the necessary imposition of liability when the rejected demand, viewed retroactively, is deemed reasonable. The innovation proposed by this section was extreme for a Principles approach and is without any ground

56. Keeton, *supra* note 51, at 1147 (emphasis added).

57. See RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. d, illus. 1 (AM. LAW INST., Council Draft No. 1, 2015).

58. *E.g.*, Jackson v. Am. Equity Ins. Co., 90 P.3d 136, 142 (Alaska 2004); Reid v. Mercury Ins. Co., 162 Cal. Rptr. 3d 894, 902 (Ct. App. 2013).

in a Restatement. Liability in section 24 is premised on the breach of the duty to make “reasonable settlement decisions.”⁵⁹ In construing “reasonableness,” the Comment to section 24 states that, on account of the many contingencies that can affect trial outcomes, there is not one reasonable settlement value, but rather “a range of reasonable settlement values.”⁶⁰ This range, however, will be *conclusively determinative* of an insurer’s liability for an excess judgment. As set forth in the Comment to section 24:

The effect of this rule is that, 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 claimant at trial.⁶¹

Otherwise stated, an insurer that rejects a settlement demand later found to be anywhere within the range of reasonableness will be held liable if there is an excess judgment. As emphasized in comment d, rejection of a reasonable settlement “demand creates the conditions for a subsequent breach-of-settlement-duty lawsuit in the event of a plaintiff’s verdict that produces an excess judgment.”⁶² The range of reasonableness consists only of dollars; that is, how much money was it reasonable for the plaintiffs in the underlying case to demand from the defendants—and, therefore, for the insurer to accept? Section 24 does not define the range of reasonable demands. Instead, non-binding “illustrations are provided to suggest how a court might use” computations in determining the range, “recognizing that any such computation will be imperfect.”⁶³

The illustrations are the only guidelines provided in section 24 for determining what might be construed as reasonable. They focus on numbers, multiplying the likely damages by the percentage likelihood of a plaintiff’s verdict. For example, in illustration 1, there is an assumption of a thirty percent likelihood of a plaintiff’s verdict with likely damages of \$150,000.⁶⁴ These numbers are applied to produce a settlement range of up to \$45,000.⁶⁵ When the insurer rejects a demand of \$45,000, it “is

59. RESTATEMENT OF THE LAW OF LIAB. INS. § 24(1) (AM. LAW INST., Council Draft No. 1, 2015).

60. *Id.* § 24 cmt. d.

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* § 24 cmt. d, illus. 1.

65. *Id.*

subject to liability for the full amount of the verdict” for failing to accept a reasonable settlement offer.⁶⁶

The imposed liability approach adopted by section 24 skews the outcome because it is applied where there is no “substantial likelihood” of an excess verdict, or even of *any* plaintiff’s verdict. Further, it rules out consideration of the factors that a reasonable insurer would in fact weigh in deciding upon a reasonable settlement range.⁶⁷

In addition to these concerns, the section 24 test incorporates the serious problem of hindsight. Many types of cases require the trier of fact to make a judgment based upon events that took place in the past. Here too, the determination of reasonableness is to be viewed from the time the decision is made. However, in this situation, the focal question is the likelihood of an event (excess judgment) that 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. Calculations of reasonableness by fact-finders must be influenced by the outcome; a result that was assessed as low probability when the decision was made may look more likely several years later, after that small likelihood was realized. Viewed in retrospect, any time a plaintiff receives an excess judgment, the risk will appear—or can be made to appear—greater than it was. The consequence of this is that the rule of section 24 could apply to turn any decision, no matter how seemingly justifiable when made, into a basis for liability.⁶⁸ Section 24 should not be used to force insurers to agree to a settlement of a weak case because of the risk, even as a fluke, of a plaintiff’s excess verdict. The illustration to section 24 concerning the application of the standard of reasonableness is thus problematic because of its use to demonstrate liability in circumstances

66. *Id.* The distortion inherent in this approach is evident. The test considers only the likelihood of a plaintiff’s verdict of the amount demanded. A reasonable calculation would take into account the range of possible verdicts, from the highest demanded to lesser amounts within that range, as well as beyond the policy limits, including a defendant’s verdict.

67. Comment i to section 24 provides for the consideration of “procedural factors,” all of which go only to determining whether an insurer acted unreasonably in rejecting an *unreasonable* settlement demand. *Id.* § 24 cmt. i. If, for example, an insurer failed to conduct a proper investigation, its settlement decision may be found unreasonable even if the rejected demand was outside of the range of reasonableness. Thus, “other factors” are not included in the consideration of reasonableness but apply only to increase the insurer’s potential for liability.

68. The Reporters acknowledge that “hindsight bias” might lead triers of fact to overestimate the likelihood of an adverse judgment and hence to overestimate the reasonableness of a settlement demand. *Id.* § 24 reporters’ note c. Indeed, they conclude that this factor makes the reasonableness rule of this section not substantially different from a strict liability test in its effects on liability. *Id.*

with very attenuated risks of recovery (far beyond Professor Keeton's "unreasonable risk" standard).⁶⁹ However, equally problematic is the failure of the proposed rule itself to establish any standard. Noting the contingencies affecting the trial outcome and the difficulty in arriving at objective valuations, the Comment to section 24 states that "a definitive guide to what constitutes a reasonable settlement value, or even a reasonable settlement range," cannot be provided and that the illustrations are given "to suggest how a court might" evaluate reasonableness.⁷⁰ The effect of this approach is that there is no clear standard on which liability would be imposed on insurers. This "suggestion only" approach leaves insurers faced with a settlement demand at or near policy limits without a clear measure to determine how to respond in order to avoid formulaically imposed liability. The critical factors of the probability of a plaintiff's verdict and the likely range of such a verdict are subjective and, as noted above, cannot help but be distorted by hindsight. Section 24 leaves no solid ground for an insurer trying to determine, *at the time of a demand*, whether an offer is within or outside what a court may later find to be the range of reasonableness.

While "reasonableness" is a standard often determined by juries in civil cases, it is applied through consideration of many factors, not in the context of liability assumed from retroactive calculations. The vagueness of the standard, combined with the assumed liability that is imposed here, also raises significant due process concerns. Further, the Reporters do not acknowledge that their proposed rule is an innovation. Although a few cases discussing the "range of reasonableness" are cited (in the Reporters' Note to section 24), none suggests that liability is effectively made without consideration of a range of other pertinent factors.⁷¹ This approach fails to meet the guidance set out in the Revised Handbook.

69. One scholar's criticism of another Restatement is suggestive here: "In the political world we have created, the proposed restatement seems to be sneaking positions by. The draft tries to convince readers that its position is the majority position. It uses illustrations that change the law, but characterizes the illustrations as reflecting traditional rules." Zacharias, *supra* note 25, at 82.

70. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. d (AM. LAW INST., Council Draft No. 1, 2015).

71. In fact, one of the cases cited in the Reporters' Note to comment d states that "[a]s long as an insurer acts reasonably and in good faith, it may reject a policy-limits demand that it determines is too high without exposing itself to liability if the judgment eventually exceeds the policy limits." *Christian Builders, Inc. v. Cincinnati Ins. Co.*, 501 F. Supp. 2d 1224, 1230–31 (D. Minn. 2007). Underestimating the size of a jury verdict "does not, standing alone, constitute bad faith. No mortal has the gift of prophecy." *Id.* at 1232 (quoting *Peterson v. Am. Family Mut. Ins. Co.*, 160 N.W.2d 541, 544 (Minn. 1968)). The other two cases relied upon in the notes to support the proposed "range of reasonableness"

V. THE REAL WORLD COLLATERAL CONSEQUENCES OF THE AUTOMATIC
LIABILITY RULE.

A. *Settlement Negotiations.*

One of the most severe real world problems that would be created by incorporating section 24 and its imposed liability rule into the Restatement is the effect upon settlement negotiations and the consequent public cost. By putting insurers at risk virtually every time a settlement demand is rejected, even where there is a remote possibility of a verdict exceeding policy limits, the rule strongly pressures insurers to accept demands that they would otherwise—and more reasonably—reject. In creating this exposure, section 24 heavily tilts the bargaining table, giving claimants a very strong negotiating advantage. Aware of policy limits, claimants would be empowered to make larger demands, just within those limits, knowing that they have leverage over insurers from the possibility of an excess judgment.⁷² Indeed, given the provisions of section 27, claimants would also have an incentive to add claims for punitive damages, whether or not justified, to drive up the insurer's potential exposure 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 counteroffer, even if the counteroffer is within the range of reasonableness. If the negotiations break down and a trial and excess judgment result, the rejected offer may be seen to have been within the reasonableness range and the insurer is then liable, regardless of the fact that its counter-offer was also in the range of reasonableness. Further, section 24, as explained in the Comment, also provides that an insurer may be liable for failing to make any offer at all.⁷³ If the claimant makes no demand—or if its only demand is unreasonable—the insurer's failure to make an offer, or counteroffer, may be held to be “an unreasonable settlement decision,” giving rise to liability.⁷⁴ The insurer, given this provision, would feel obliged to make

are unreported.

72. The Reporters concede that the rule gives claimants an incentive to demand “the high end of the reasonableness range, but within the policy limits.” RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. d (AM. LAW INST., Council Draft No. 1, 2015).

73. *Id.* § 24 cmt. f.

74. *Id.* The argument that insurers have a duty to initiate settlement offers has been rejected by courts as follows:

A few courts have held insurers liable for a breach of the duty to settle in the absence of a within-limits demand. However, these cases generally involve affirmative misconduct by the insurer to subvert or terminate settlement

an offer in the absence of a reasonable demand and, in doing so, would severely undercut its negotiating position.

All of these provisions taken together distort the ordinary give-and-take of settlement negotiations. Although the insurer has 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 assert, without citing any support, that protection of insureds trumps the need to contain the cost of premiums for the public at large.⁷⁵ This conclusion, however, is misguided. Many of the insureds being protected at the public's expense are large corporations, with more than sufficient resources to protect 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 resulting from policyholders that chose to underinsure but also those that are responsible for egregious actions that have led to punitive damages being awarded against them for their own misconduct.

B. Underinsuring.

The Comment to section 24 also holds insurers responsible when the policy turns out to be insufficient to cover the liability exposure. The Reporters' Note to section 24, comment c notes that a desirable effect of a strict liability standard would be to "encourage insurers to provide coverage that includes adequate policy limits."⁷⁶ This statement ignores

negotiations. . . . [W]e disagree with any reading of the no-demand cases that would require insurers rather than claimants to make settlement offers. . . . The reasoning in many of [these] cases . . . is actually consistent with our holding that an insurer cannot *breach a duty* by not tendering a settlement offer.

Am. Physicians Ins. Exch. v. Garcia, 876 S.W.2d 842, 850 n.17 (Tex. 1994) (citations omitted).

75. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. g (AM. LAW INST., Council Draft No. 1, 2015). ("[M]inimization of liability insurance premiums is not the primary objective of the duty to make reasonable settlement decisions. Rather, the primary objective is to protect insureds from the conflict of interest inherent in a less-than-full-coverage case in which the insurer has sole settlement discretion.")

76. *Id.* § 24 reporters' note c.

the fact that it is up to the insured who pays the premium to decide what level of coverage to purchase. Indeed, economic incentives would arguably lead an insurer to seek to sell higher, not lower, coverage limits in order to realize higher premiums.

Instead of encouraging insureds to increase coverage, the proposed rule insulates them from the consequences of their decisions to purchase and pay for too little coverage. Even if the insured knew or should have known that potential claims would exceed the policy limits it purchased, under section 24, the insurer is obligated to assume the cost of an excess judgment or will be under strong pressure to settle at an unwarranted amount to avoid exposure to an excess judgment. In this way, directly contrary to sound public policy, the policyholder's choice to underinsure is rewarded.

C. Increasing Litigation.

Another collateral consequence of incorporating section 24 into the Restatement would be an increase in litigation. Every time an insurer rejects a settlement demand, regardless of how unreasonable that demand was, and an excess judgment results, the policyholder has a strong incentive to bring suit against the insurer, or to assign its claim to the claimant to bring suit. Faced with a judgment assessing a real out-of-pocket loss in a legal landscape that creates a very favorable likelihood of recovery against the insurer, policyholders will naturally respond by either bringing a lawsuit against the insurer or assigning their claim against the insurer to the plaintiff who holds the judgment. In either case, the result would be an increase in litigation and the creation of a new legal industry based on claims arising out of section 24.

The real world consequences of section 24 of the RLLI thus include distorting the negotiating process, driving up insurance premium rates, encouraging policyholders to underinsure, and increasing litigation. The Reporters' indifference to these effects ignores the instruction of the Revised Handbook to ascertain the relative desirability of competing rules, using when helpful "social-science evidence and empirical analysis."⁷⁷

77. REVISED HANDBOOK, *supra* note 1, at 5.

VI. SECTION 27: DAMAGES FOR BREACH OF THE DUTY TO MAKE
REASONABLE SETTLEMENT DECISIONS.

Section 27 sets out the measure of damages when an insurer is held liable for a breach under section 24 resulting in an excess judgment.⁷⁸ As set forth in the RLLI, the policyholder is allowed to recover the difference between the damages awarded the claimant at trial and the policy limits, “as well as any other foreseeable harm caused by the insurer’s breach,” including punitive damages awarded against the insured, loss of business reputation, and emotional distress.⁷⁹

A. Indemnifying an Insured for Punitive Damages Assessed Against It.

One of the most alarming parts of this section, from the perspective of public policy, is the clear intention, expressed in the Comment, that punitive damages assessed at trial against the insured be included in the amounts recoverable from the insurer if there is a breach of the section 24 duty resulting in an excess judgment. As set forth in section 27, 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.⁸⁰

This proposed new rule is wholly inconsistent with established law in a number of jurisdictions, which holds that there is no insurance coverage for punitive damages awarded to a third-party claimant for the insured’s misconduct.⁸¹ Where state law prohibits insurance coverage of punitive damages, such damages, which “are not meant to reimburse an injured plaintiff for harm suffered by that individual, but rather are intended to punish the defendant for his wrongful acts and to deter similar conduct in the future,” by definition cannot be compensatory damages recoverable from an insurer for a “bad faith refusal to settle.”⁸² Allowing the recovery of punitive damages would permit the insured to

78. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 (AM. LAW INST., Council Draft No. 1, 2015).

79. *Id.* § 27(1), § 27 cmt. b, illus. 1 & illus. 4 & § 27 cmt. d. The full text of Council Draft No. 1, section 27 black letter law is set forth in Appendix B.

80. *Id.* § 27 cmt. d.

81. *E.g.*, PPG Indus., Inc. v. Transamerica Ins. Co., 975 P.2d 652, 658 (Cal. 1999); Lira v. Shelter Ins. Co., 913 P.2d 514, 518 (Colo. 1996) (en banc); Soto v. State Farm Ins. Co., 635 N.E.2d 1222, 1224–25 (N.Y. 1994); *see also* Magnum Foods, Inc. v. Cont’l Cas. Co., 36 F.3d 1491, 1506 (10th Cir. 1994) (noting that a policyholder may not shift liability for punitive damages to insurer; the duty of good faith does not include duty to settle or contribute to settlement of a punitive damages claim, which is “uninsurable”).

82. *Lira*, 913 P.2d at 517 (citing Seaward Constr. Co. v. Bradley, 817 P.2d 971, 974 (Colo. 1991) (en banc)).

“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.”⁸³ As the California Supreme Court has explained:

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.⁸⁴

No reported case has been found in state or federal jurisdictions that shifts punitive damages from the insured to the insurer in the absence of the insurer’s bad faith.⁸⁵ In fact, of the three federal cases cited in the Reporters’ Note in support of this proposed rule, only one supports the proposed rule, while two explicitly prohibits imposing punitive damages levied against the insured onto the insurer.⁸⁶ In the most recent case, decided in June 2015, the Third Circuit held that punitive damages awarded against an insured in the underlying case could not be considered compensable damages in an action against the insurer for bad faith/failure to settle.⁸⁷ “To hold otherwise would shift the burden of the punitive damages to the insurer, in clear contradiction of Pennsylvania public policy.”⁸⁸ Additionally, absent any legal authority, the proposed section 27 rule would, in effect, override state laws prohibiting insurance coverage of punitive damages by awarding coverage to a person or entity

83. *PPG Indus., Inc.*, 975 P.2d at 658.

84. *Id.*

85. For this reason, even under the most expansive view of a Restatement’s purpose, section 27’s proposed rule shifting punitive damages to the insurer in the absence of the insurer’s bad faith reflects the aspirations of the Reporters; comment e and the accompanying Reporters’ Note, which relies heavily on the *dissenting* opinions in *Lira* and *PPG*, RESTATEMENT OF THE LAW OF LIAB. INS. § 27 reporters’ note d (AM. LAW INST., Council Draft No. 1, 2015), reads as the advocacy of a “brief” in favor of this approach. *See* Keyes, *supra* note 22, at 50 (criticizing such advocacy in a Restatement). Including this rule in the RLLI, far from describing settled law, or even a trend, would radically revise the law. *See* *Kansas v. Nebraska*, 135 S. Ct. 1042, 1064 (2015) (Scalia, J., concurring in part and dissenting in part).

86. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 reporters’ note d (AM. LAW INST., Council Draft No. 1, 2015).

87. *Wolfe v. Allstate Prop. & Cas. Ins. Co.*, 790 F.3d 487 (3d Cir. 2015).

88. *Id.* at 493.

whose wrongful acts caused such damages to be assessed against it.⁸⁹ This is not “accretional” change in the law.

It is also important to consider what part punitive damages played in the offer that was rejected, giving rise to the section 24 claim and to the resulting damages. In jurisdictions in which insurance against punitive damages is prohibited (and hence where policies do not cover them),⁹⁰ insurers should not be held liable for rejecting offers premised on such damages. In such a case, under sections 24 and 27, the demand may force the insurer to pay settlement dollars for something that is excluded from the policy. For example, if an insured has a policy with a \$1,000,000 limit and a claimant brings suit seeking \$1,000,000 in compensatory damages and \$2,000,000 in punitive damages, even if the insurer believes the reasonable settlement value of the case (based only on compensatory damages) is \$250,000, section 24 and section 27 all but force the insurer to pay the policy limits of \$1,000,000 for a claim worth \$250,000 in order to avoid exposure to liability for failing to make a reasonable settlement decision. By agreeing to pay a \$750,000 windfall in order to avoid liability, the insurer is in effect paying for the punitive damages that are not covered in the policy.⁹¹ In this way, section 24 operates to mandate coverage of punitive damages, notwithstanding contrary state law.

This problem is exacerbated by the fact that the Comment to section 24, in illustrating a reasonable settlement demand, does not exempt punitive damages from the assessment. Illustration 6 posits a situation where punitive damages are covered by the policy.⁹² By not addressing

89. See *PPG Indus., Inc.*, 975 P.2d at 656 (“[T]he purposes of punitive damages . . . are to punish the defendant and to deter future misconduct by making an example of the defendant.”); *Lira v. Shelter Ins. Co.*, 913 P.2d 514, 517 (Colo. 1996) (en banc) (“Punitive damages are not meant to reimburse an injured plaintiff for harm suffered by that individual, but rather are intended to punish the defendant for his wrongful acts and to deter similar conduct in the future.” (citing *Seaward Constr. Co. v. Bradley*, 817 P.2d 971, 974 (Colo. 1991) (en banc))).

90. See, e.g., *PPG Indus., Inc.*, 975 P.2d at 658; *Lira*, 913 P.2d at 518; *Soto v. State Farm Ins. Co.*, 635 N.E.2d 1222, 1224–25 (N.Y. 1994); see also *Fox v. Am. Alt. Ins. Corp.*, 757 F.3d 680, 684, 686 (7th Cir. 2014) (noting that “states that, like Illinois, have public policies prohibiting insurance against punitive damages have held that an insured . . . may not shift to an insurance company through a suit against the insurer for breach of its duty to defend, the wrongdoer’s duty to pay punitive damages” and questioning whether Illinois courts would permit a suit that so “shifts the burden of punitive damages from the tortfeasor to the insurer,” but concluding on other grounds that insured had no claim for relief against insurer).

91. See *Lira*, 913 P.2d at 516 (“An insurer who has not contracted to insure against its insured’s liability for punitive damages has no duty to settle the compensatory part of an action in order to minimize the insured’s exposure to punitive damages.”).

92. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. j, illus. 6 (AM. LAW INST., Council Draft No. 1, 2015).

the frequent case in which punitive damages are *not* covered by the policy, the Comment provides no measure for determining a reasonable offer beyond the general numeric approach that it is weighted toward construing demands as reasonable. As a consequence, when punitive damages are sought by the plaintiff, insurers have little choice but to pay an inflated settlement amount in order to avoid a subsequent lawsuit for breach of the duty to settle.

Although section 27 characterizes punitive damages as a foreseeable harm “caused by the insurer’s breach,”⁹³ in reality, the imposition of such damages is 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.⁹⁴ Thus, the Restatement should not countenance—let alone adopt—a rule that punishes the insurer for the insured’s wrongful acts.⁹⁵

B. “Foreseeability.”

Under section 27, an insured entitled to recover an excess judgment from an insurer for breach of the duty to make reasonable settlement decisions may also recover for “any other foreseeable harm caused by the insurer’s breach of the duty.”⁹⁶ The language of this rule and the Comment confuse the standard of contract damages with the unrelated test of tort liability in order to expand the types of damages available to an insured.

Section 27 now provides that the insurer is liable for the full amount of damages assessed against the insured in the underlying suit “as well as any other foreseeable harm caused by the insurer’s breach of the duty.”⁹⁷ The standard of “foreseeability” in contract law governs the recoverability of damages. Contract damages are available only when, at the time of contracting, the loss was foreseeable to the breaching party as a probable result of a breach. Thus, the crucial issue is not simply foreseeability but also *probability*, and the contractual legal

93. *Id.* § 27(1).

94. *Lira*, 913 P.2d at 518 (quoting *Soto*, 635 N.E.2d at 1225).

95. See *PPG Indus., Inc.*, 975 P.2d at 658; *Lira*, 913 P.2d at 518; *Soto*, 635 N.E.2d at 1224–25; William T. Barker & Ronald D. Kent, *Bad Faith in Insurance Liability*, in 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 23.09[3] (Jeffrey E. Thomas & Francis J. Mootz III eds., 2014).

96. RESTATEMENT OF THE LAW OF LIAB. INS. § 27(1) (AM. LAW INST., Council Draft No. 1, 2015).

97. *Id.*

understanding of foreseeability necessarily incorporates that concept. As explicated in the Restatement (Second) of Contracts, section 351:

(1) Damages 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.

(2) Loss may be foreseeable as a probable result of a breach because it follows from the breach

(a) in the ordinary course of events, or

(b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know.⁹⁸

When the Restatement of Contracts rule is applied to a breach of the duty to settle, it is plain that for damages to be assessed for breach of that duty, the insurer must have had reason at the time it issued the policy to foresee that the imposition of such damages on the insured in a lawsuit was a *probable* result of the insurer's breach of the duty.⁹⁹ But an insurer at the time of contracting would have no reason to expect that punitive damages would *probably* result in the event of a future lawsuit against the policyholder, particularly where such damages are excluded by the policy. Currently, section 27 neither reflects nor addresses this critical meaning of foreseeability, and expands the scope of recoverable damages beyond that allowed by law.¹⁰⁰

Section 27 further conflates the contract law standard of foreseeability of damages with the tort concept of foreseeability as an element of liability. Comment b notes that in contract law, foreseeability is considered as of the time of contracting but “[b]y contrast, under the

98. RESTATEMENT (SECOND) OF CONTRACTS § 351(1)–(2) (AM. LAW INST. 1981) (emphasis added).

99. *Id.* § 351 cmt. a (noting that “the requirement of foreseeability is a more severe limitation of liability than is the requirement of substantial or ‘proximate’ cause in the case of an action in tort or for breach of warranty”).

100. See *Altronics of Bethlehem, Inc. v. Repco, Inc.*, No. 89-4918, 1991 WL 133518, at *12 (E.D. Pa. July 15, 1991) (“It is necessary in order to charge the defendant with a particular loss that the loss be one that ordinarily follows the breach of such a contract in the usual course of events or is one that reasonable men in the position of the parties would have foreseen as a probable result of the breach.” (citing *R. I. Lampus Co. v. Neville Cement Prods. Corp.*, 378 A.2d 288, 291 (Pa. 1977))), *aff’d*, 957 F.2d 1102 (3d Cir. 1992); RESTATEMENT (SECOND) OF CONTRACTS § 351(1)–(2) (AM. LAW INST. 1981).

rules of tort law, foreseeability generally is assessed as of the time of the breach.”¹⁰¹ However, in tort law, foreseeability goes only to negligence, that is, the foreseeability of the risk at the time of the act, not to the measure of damages. As set out in the Restatement (Third) of Torts, section 3 (Negligence):

Primary factors to consider in ascertaining whether the person’s conduct lacks reasonable care are the foreseeable likelihood that the person’s conduct will result in harm, the foreseeable severity of any harm that may ensue, and the burden of precautions to eliminate or reduce the risk of harm.¹⁰²

Foreseeability is not a measure of tort damages. Nor is “harm,” the term used by section 27. According to the Restatement (Second) of Torts, “[d]amages flow from an injury,” which “denotes the invasion of a legally protected interest.”¹⁰³ “Injury” is thus distinguished from ‘harm,’ which is a nonlegal word implying merely a detriment in fact.”¹⁰⁴ In short, the phrase in section 27 “as well as any other foreseeable harm,” is entirely inapposite.

In the Comment to section 27 as well as in the Reporters’ Note, the Reporters discuss distinctions between the tort and contract approaches. Although they conclude that “[t]he cleaner conceptual understanding is that the duty to settle sounds in contract,”¹⁰⁵ they also state that section 27 “is agnostic as to the doctrinal label,” and that “the broader approach to whether a loss is foreseeable, which is most commonly associated with the tort-law label, is the proper approach.”¹⁰⁶ That is, the objective of the drafters is to allow for the broadest recovery of damages by the insured, regardless of the lack of any support in tort law and a much narrower standard in contract law.

C. *Damages for Non-Economic Harm.*

The provision in section 27 for recovery of damages for non-economic harm is similarly flawed. As with punitive damages, section 27 applies

101. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 cmt. b (AM. LAW INST., Council Draft No. 1, 2015).

102. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 (AM. LAW INST. 2010).

103. RESTATEMENT (SECOND) OF TORTS, § 902 cmt. a (AM. LAW INST. 1979).

104. *Id.*

105. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 reporters’ note b (AM. LAW INST., Council Draft No. 1, 2015).

106. *Id.* § 27 cmt. b.

the label of foreseeability to justify additional damages, including emotional distress and loss of business reputation.¹⁰⁷ However, such damages are not in fact generally foreseeable in a liability insurance context. As one court points out, “the insurer has no contractual obligation . . . to consider potential non-financial consequences on the insured from an adverse judgment.”¹⁰⁸

This reasoning would apply to loss of business reputation, one of the types of damages permitted to be recovered in section 27. As noted in *Parking Concepts, Inc. v. Tenney*, the insurer is not obliged by the policy to consider possible harm to the insured’s business reputation in weighing a settlement offer.¹⁰⁹ Indeed, under section 24, such a factor is not relevant to the determination of whether the settlement duty was breached. It is intellectually inconsistent, therefore, to include loss of business reputation 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 that may incur to the insured’s business reputation. Rather, that loss resulted from the conduct of the policyholder that gave rise to the lawsuit, as well as to the adverse judgment.¹¹⁰

The damages provided for in section 27 are also meant to include a policyholder’s emotional distress.¹¹¹ Presumably section 27 is not meant to allow recovery of such damages by corporate entities, since, by definition, corporations and commercial entities cannot incur emotional harm.¹¹² As for individual policyholders, it is highly unlikely that such a loss would be seen “as a probable result of a breach” following from the breach “in the ordinary course of events,” or “as a result of special circumstances” that the insurer would have had reason to know.¹¹³ Such damages would not, therefore, meet the Restatement of Contracts test of foreseeability.¹¹⁴ Further, only a few jurisdictions have explicitly allowed

107. *Id.* § 27(1), § 27 cmt. b, illus. 1 & § 27 cmt. b, illus. 4.

108. *Parking Concepts, Inc. v. Tenney*, 83 P.3d 19, 25–26 (Ariz. 2004) (en banc).

109. *Id.*

110. This provision is particularly favorable to large commercial insureds as it is they—not the small individual or “Ma and Pa” policyholders—who have a business reputation to protect.

111. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 cmt. b, illus. 1 & reporters’ note b (AM. LAW INST., Council Draft No. 1, 2015).

112. *TekDoc Servs., LLC v. 3i-Infotech Inc.*, No. 09-6573 (MLC), 2012 WL 3560794, at *21 & n.14 (D.N.J. Aug. 16, 2012) (collecting cases holding that “[b]usiness organizations cannot experience emotions and, as such, cannot experience emotional distress,” and concluding that the same reasoning applies to limited liability companies as to corporations, barring these entities, too, from incurring emotional harm).

113. RESTATEMENT (SECOND) OF CONTRACTS § 351(2) (AM. LAW INST. 1981).

114. *See id.* § 353 (“Recovery for emotional disturbance will be excluded unless the breach also caused bodily harm or the contract or the breach is of such a kind that serious

the inclusion of mental distress damages; those that permit recovery have generally done so in the context of a bad faith insurer case, for reasons like those discussed above with reference to consequential damages.¹¹⁵ Other courts have found that such damages should not be awarded even in bad faith cases, seeing mental distress damages as proper only when there is exceptional misconduct by the insurer.¹¹⁶ Under sections 24 and 27, however, liability may be premised upon a good faith misjudgment, providing no justification for the imposition of these damages.

CONCLUSION

Sections 24 and 27 evidence an approach that underlies much of the RLLI. They propose, in some cases, startling innovations in the law and, in others, rules that depart from the accepted, majority of case law. The proposals were problematic in the context of a Principles project; they are well outside the parameters of a Restatement and fail to comport with the mandate of the Revised Handbook. With the conversion of the effort into a Restatement, these sections must be subjected to close scrutiny and ultimately rejected from the Restatement.

emotional disturbance was a particularly likely result.”); *see also* *Tenney*, 83 P.3d at 25–26; *Jarvis v. Prudential Ins. Co. of Am.*, 448 A.2d 407, 410–11 (N.H. 1982) (“Recovery of damages for mental suffering and emotional distress that may accompany . . . economic damage is not . . . permitted in contract actions such as the [coverage dispute at bar.]”); RESTATEMENT (SECOND) OF CONTRACTS § 351(2) (AM. LAW INST. 1981); *Barker & Kent*, *supra* note 95, § 23.09[4] (“In jurisdictions where the suit against the insurer is held to sound in contract rather than tort, damages for mental distress may, in theory, be recoverable, but usually only if such damages could have been anticipated when the contract was entered into.”).

115. *See, e.g.*, *Lira v. Shelter Ins. Co.*, 913 P.2d 514, 517 (Colo. 1996) (en banc) (affirming appeals court’s reversal of jury verdict against insurer and observing that emotional distress damages are available in cases where the insurer acts in bad faith); *Gibson v. W. Fire Ins. Co.*, 682 P.2d 725, 738–39 (Mont. 1984) (finding no error in jury instruction including mental distress damages in compensatory damages for bad faith and no reason to disturb jury decision on its award of compensatory damages).

116. *See, e.g.*, *Benkert v. Med. Protective Co.*, 842 F.2d 144, 147–48 (6th Cir. 1988) (holding that an insured may not recover exemplary damages or damages for mental distress in a failure to settle action against his insurer, even where the insurer acted in bad faith); *Kunkel v. United Sec. Ins. Co. of N.J.*, 168 N.W.2d 723, 734 (S.D. 1969) (refusing to award damages for mental suffering in a “bad faith” duty to settle case and reasoning that recovery for mental suffering is only proper where there is exceptional misconduct by the insurer or an invasion of property rights).

APPENDIX A¹¹⁷

§ 24. The Insurer's Duty to Make Reasonable Settlement Decisions

(1) When an insurer has the authority to settle a claim brought against the insured, or when the authority to settle a claim rests with the insured but the insurer's prior consent is required for any settlement to be payable by the insurer, the insurer has a duty to the insured to make reasonable settlement decisions. The duty is owed only with respect to claims that expose the insured to liability in excess of the policy limits.

(2) A reasonable settlement decision is one that would be made by a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment.

(3) An insurer's duty to make reasonable settlement decisions includes a duty to accept reasonable settlement demands made by claimants, subject to the following limitation: the amount, if any, that an insurer is obligated by this duty to contribute to a settlement is never greater than its policy limits.

(4) An insurer's duty to make reasonable settlement decisions includes the duty to contribute its policy limits to a reasonable settlement of a covered claim if that settlement exceeds those policy limits.

117. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 (AM. LAW INST., Council Draft No. 1, 2015).

APPENDIX B¹¹⁸

§ 27. Damages for Breach of the Duty to Make Reasonable Settlement Decisions

(1) An insurer that breaches the duty to make reasonable settlement decisions is subject to liability for the full amount of damages assessed against the insured in the underlying suit, without regard to the policy limits, as well as any other foreseeable harm caused by the insurer's breach of the duty.

(2) The insured may assign to a claimant all or part of any cause of action for breach of the duty to make reasonable settlement decisions.

118. *Id.* § 27.