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2017

### In Defense of the Restatement of Liability Insurance Law

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#### Repository Citation

Baker, Tom and Logue, Kyle D., "In Defense of the Restatement of Liability Insurance Law" (2017). *Faculty Scholarship at Penn Law*. 1748.

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## IN DEFENSE OF THE RESTATEMENT OF LIABILITY INSURANCE LAW

*Tom Baker & Kyle D. Logue\**

### INTRODUCTION

The importance of liability law to the American system of justice, and to the US economy in general, are well known. Somewhat less well known, at least among non-lawyers, is the corresponding centrality of liability insurance.<sup>1</sup> For most non-contractual legal claims for damages that are brought against individuals or firms, there is some form of liability insurance coverage. Such coverage, provided by state-regulated insurance companies, ranges from auto and homeowners' policies (sold to consumers throughout the country) to commercial general liability policies (sold to businesses of all sizes) to professional liability policies of various sorts (including Directors and Officers coverage as well as legal and medical malpractice coverage). The Restatement of the Law Liability Insurance is the American Law Institute's first effort to "restate" the common law governing all such liability insurance contracts, and we are the reporters.<sup>2</sup>

George Priest is a Professor at Yale Law School, where he has been teaching for over three decades. Within the legal academy, Priest is known best for his work on consumer product warranties,<sup>3</sup> products liability law,<sup>4</sup>

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<sup>1</sup> See generally KENNETH S. ABRAHAM, *THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11* (2008).

<sup>2</sup> Tom Baker is the Reporter. Kyle Logue is the Associate Reporter. Most of the Restatement was approved in 2016, and the remainder was approved by the ALI Council in January 2017 and is ready for final approval in May 2017. Except where noted to the contrary, all citations to the Restatement of the Law Liability Insurance ("RLLI") in this response are to Tentative Draft No. 1 (April 2016). RESTATEMENT OF THE LAW LIABILITY INSURANCE (Am. Law Inst., Tentative Draft No. 1, Apr. 2016) [hereinafter RLLI]. In the text we often refer to the RLLI as the "Restatement of Liability Insurance Law."

<sup>3</sup> E.g., George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297 (1981).

<sup>4</sup> E.g., George L. Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985)

antitrust law,<sup>5</sup> and the economic analysis of the litigation and settlement process.<sup>6</sup> Among practitioners of insurance law, he is best known for his decades-long service as a leading expert witness for insurance companies in coverage disputes against policyholders. In *A Principled Approach Toward Insurance Law: The Economics of Insurance and the Current Restatement Project*, published in the *George Mason Law Review*,<sup>7</sup> Priest offers an aggressive and somewhat meandering attack on the Restatement. What follows is our response.

Priest's written critique of the Restatement, which he candidly acknowledges was paid for by the American Insurance Association, contains bold (and, this essay will argue, groundless and unsubstantiated) assertions about the Restatement and about us. It goes on at length about basic principles of insurance economics that anyone who took microeconomics in college will remember, thereby not-so-subtly seeking to create the (erroneous) impression that the Restatement is somehow inconsistent with, and written in ignorance of, those economic principles. Further, it claims that the Restatement will undermine the stability of insurance markets. The basic structure of his argument can be summarized as follows:

(1) In drafting the Restatement, Baker and Logue have chosen many new rules that radically depart from existing case law.<sup>8</sup>

(2) These radical new rules have a clear "pro-policyholder" bias, a bias that is misguided because it is premised on mistaken assumptions about how insurance markets work and fails to take into account well-known principles of the "economics of insurance."<sup>9</sup>

(3) The radical pro-policyholder rules that Baker and Logue have proposed will harm policyholders by causing liability insurance premiums to skyrocket and the availability of coverage to evaporate, harming all policyholders but especially the poor.<sup>10</sup>

Our responses to these assertions are straightforward:

(1) All of the rules adopted by the Restatement are grounded in existing case law. In that sense, none of them are new, and certainly none are radical. Most of the rules in the Restatement have in fact been adopted by a majority of the U.S. jurisdictions that have considered them. The Restatement follows a minority rule in only a few instances and only when the minority rule is better reasoned and will likely lead to better consequences than the alternatives. This is a common practice among ALI Restatement projects.

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<sup>5</sup> E.g., George L. Priest, *Cartels and Patent License Arrangements*, 20 J.L. & ECON. 309 (1977).

<sup>6</sup> E.g., George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984).

<sup>7</sup> George L. Priest, *A Principled Approach Toward Insurance Law: The Economics of Insurance and the Current Restatement Project*, 24 GEO. MASON L. REV. 635 (2017).

<sup>8</sup> *Id.* at 636, 652–53.

<sup>9</sup> *Id.* at 636 (noting that, although the Restatement has "toned down" its earlier aspirations, "it remains a strikingly pro-policyholder statement").

<sup>10</sup> *Id.* at 636–37.

(2) Like the law on which it is based, the Restatement is not premised on mistaken assumptions about how insurance markets work; nor does it fail to take account of basic principles of insurance economics. Instead, it is Priest who either misunderstands or intentionally ignores basic facts about insurance markets. Specifically, Priest ignores the insights, accumulated over many decades now by psychologists and empirical economists, regarding how people actually behave, facts that are contrary to the largely discredited perfectly-rational-actor model on which Priest's arguments are premised.<sup>11</sup>

(3) Therefore, expanding the geographical application of the rules that the Restatement follows, thereby creates greater national uniformity in liability insurance law, and supports, not disrupts, insurance markets.

(4) Finally, Priest provides no evidence to the contrary. Because all these rules, or some variant of them (in some cases, a more pro-policyholder alternative rule), have been adopted in some jurisdiction in this country, if those rules were disruptive to the market, there should be evidence of that fact in those jurisdictions. So far as we know, there is no such evidence.

Liability insurance companies have access to the best data that could prove or disprove the claim that some of our proposed rules would cause premium spikes or availability "crises."<sup>12</sup> If the insurance industry truly believes that broader application of the rules adopted in the Restatement will harm liability insurance markets, it should provide disinterested empirical legal studies researchers with access to the data needed to test that belief, rather than simply attacking the Restatement. The researchers can then use the data to evaluate the comparative effects of the legal rules among which the Restatement is choosing. As an industry that prides itself on sophisticated use of data and analytics, insurers should embrace the use of data to assess which legal rules are economically efficient, rather than simply making claims when there is a paucity of empirical evidence. As economically and empirically minded legal scholars, we would welcome such evidence, and we expect that the American Law Institute would as well.

The remainder of this essay develops these points in greater detail. In addition, it addresses the few specific sections of the Restatement that Priest has singled out for criticism, including the rules on misrepresentations, duty to defend, and duty to settle. With respect to those rules, Priest's arguments are either wildly overstated or flatly wrong.<sup>13</sup>

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<sup>11</sup> See generally, RICHARD THALER, *MISBEHAVING: THE MAKING OF BEHAVIORAL ECONOMICS* (2016) (providing an entertaining memoir and introduction to behavioral economics by a founding father of the field).

<sup>12</sup> See Tom Baker, *Transparency Through Insurance: Mandates Dominate Discretion*, in *CONFIDENTIALITY, TRANSPARENCY, AND THE U.S. CIVIL JUSTICE SYSTEM* 184, 191 (Joseph Doherty et al. eds., 2012) (discussing consequences for public knowledge of the civil justice system of the proprietary nature of liability insurance claims data).

<sup>13</sup> For a more serious, scholarly analysis of an earlier draft of the Restatement, see the 2015 symposium issue of the Rutgers University Law Review. 68 RUTGERS U. L. REV. 1 (2015).

## I. THE RESTATEMENT IS BASED IN THE COMMON LAW

Most of the readers of this essay will be familiar with the genre of the Restatement. Recall how a Restatement works. The most important part is the “black letter,” which consists of a collection of legal rules written in quasi-statutory language that are derived from reported judicial decisions, sometimes as informed by state statutes. Accompanying each set of black letter rules are “comments” that explain the details of how those rules operate, sometimes including illustrations applying the rules to simplified hypothetical scenarios. The comments typically contain both the rationale for the rule and an explanation of how the rule fits into the broader common law. Following the comments are so-called “reporters’ notes,” which contain citations to the relevant court decisions on which the rules are grounded and secondary authority discussing those rules.

The process through which a Restatement gets drafted is layered and time-consuming. A Restatement is not, as Priest’s essay implies, invented by the reporters.<sup>14</sup> The reporters do write the initial drafts of the black letter, comments, and notes. But those drafts are then vetted multiple times by advisory groups within the American Law Institute. These groups consist of experts in the relevant fields of law, including highly respected lawyers who have been practicing in those areas for many years, well-known judges who have decided important cases applying the relevant doctrine, and law professors who have been teaching and writing in the field for most of their careers.

In our case, the advisory groups include experts both from the policyholder and the insurance industry side of the aisle. The members of these advisory groups make a range of suggestions, from advice about general topics to address in the Restatement, to ideas about how to organize various sections, to specific wording suggestions for the black letter and the comments, to recommendations of cases that should be cited in the reporters’ notes for a given proposition or for citations that should be removed because the relevant case had been superseded or called into question.

After considering all the input from all these experts, and after making the appropriate revisions, the reporters submit a draft to the council of the ALI for approval (at which stage the reporters often receive additional comments that give rise to further revisions). Once the council has approved the document, the draft is submitted for still more discussion to the full membership of the ALI, who then vote to approve (or not) the draft, sometimes offering amendments. Typically, this process takes place over many years, as the reporters take drafts of portions of the Restatement through this iterative process. The creation of a Restatement, in sum, is a group effort that incorporates the collective wisdom of many of the best and most experienced legal and industry experts in the country.

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<sup>14</sup> See Priest, *supra* note 7, at 635–36.

The Restatement of Liability Insurance Law is no exception. The project began in 2010, initially as the “Principles of the Law of Liability Insurance.” The ALI’s Principles projects are addressed more to legislatures and are not required to be based in the existing common law. When it became clear that the rules were largely taking the form of a restatement of existing common law, however, the ALI Council decided to make the project a Restatement. As part of that process, some rules in the draft changed to be more in line with the existing common law.<sup>15</sup>

The Restatement drafting process has produced 24 drafts presented formally in just as many ALI meetings. It has prompted scores of written comments filed formally with the ALI and even more comments provided directly to us. We have also discussed drafts at meetings of the American Bar Association’s Torts Trial and Insurance Practice Section and Litigation Section, the Defense Research Institute, and a committee of the American Insurance Association. In addition, the Rutgers Law School Center for Risk and Responsibility hosted a symposium on the project, attended by both law professors and practitioners, with papers published in the Rutgers Law Review.<sup>16</sup> It would be a shock, then, if, after all of this process, the resulting rules would be wildly out of line with existing common law.

And yet that is one of the primary claims in Priest’s essay. He says, for example, that the Restatement is “not generally reflective of the law in the various U.S. jurisdictions.”<sup>17</sup> This statement is obviously meant to be a criticism but is hard to pin down. At a minimum, it must mean that most, or at least many, of the rules adopted in the Restatement are contrary to the law in most states.

Yet Priest fails to provide *any* evidence for this strikingly broad claim. In the footnotes that accompany the quote above, he says this: “This paper is meant to be conceptual and will not specifically address differences between the proposed rules and the law in the several jurisdictions though. As shall be occasionally indicated, there are many differences.”<sup>18</sup> How can the paper be “conceptual” when one of its central claims is the *empirical* assertion that the Restatement is not generally reflective of the law in the various jurisdictions? Further, why exactly will the paper “not address specific differences”? If one is going to make the not-generally-reflective-of-the-law claim about an entire Restatement project, is one not obligated to provide at least a few

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<sup>15</sup> See, e.g., RLLI, Reporters’ Memorandum xix–xx (Am. Law Inst., Discussion Draft, Apr. 2015) (listing changes made as a result of the new status of the project as a Restatement). There have been additional changes since then as a result of the layered, iterative drafting process. As of this writing the most recent version of most of the sections of the Restatement is Tentative Draft No. 1 (Am. Law Inst., Apr. 2016), with additional sections and some revisions reflected in Council Draft No. 3 (Am. Law Inst., Dec. 2016).

<sup>16</sup> See Jay M. Feinman, *The Restatement of the Law of Liability Insurance as a Restatement: An Introduction to the Issue*, 68 RUTGERS U. L. REV. 1 (2015).

<sup>17</sup> Priest, *supra* note 7, at 636.

<sup>18</sup> *Id.* at 636 n.8.

citations to court decisions in specific jurisdictions that run counter to the particular rules that have been proposed? Perhaps the most striking characteristic of Priest's essay, which again critiques a document that is primarily about the common law, is the complete lack of citations to any judicial decisions.

The Restatement of course has many citations. Hundreds of them. Indeed, for every rule that is articulated, in addition to comments explaining the rule's application, the reporters' notes provide citations to judicial decisions in jurisdictions that have adopted the rule.<sup>19</sup> In addition, where we address some of the specific Restatement sections that Priest singles out for criticism, we cite some of the relevant case law that bears on those issues, which we of course borrow from the Restatement itself.

A more precise, and less overblown, version of Priest's complaint might be that, while the Restatement's rules are generally grounded in the common law, they do not frequently enough reflect the "majority view," by which is usually meant the rule that a majority of states that have addressed the question have followed. We have two general responses to this more modest concern.

First, the concept of what constitutes a majority rule in the context of state-based common law is often disputed.<sup>20</sup> Is it defined by the ratio of jurisdictions that have adopted the rule to the total number of jurisdictions? Or should the ratio be adjusted so that the jurisdictions with larger populations receive greater weight, as in the federal electoral process? Presumably decisions of the highest court in a state count more than the decisions of lower courts within that state, but how much more? And what about decisions of federal courts interpreting the state law? Also, what if a question of insurance law has been addressed by only a handful of courts? If three out of the only four states that have addressed a question reached result A, does that mean result A is "the majority rule," even though 47 jurisdictions have not yet had an occasion to address the issue? What if the trend of recent decisions conflicts with older decisions? What if courts commonly recite a standard that has one meaning in common parlance but the courts routinely give that standard a different meaning, so much so that commentators generally remark upon it? That none of these questions have simple answers suggests that, in the process of drafting a Restatement of a given area of law, the drafters should not give the concept of the majority rule more weight than it is due.

Second, the American Law Institute does not, nor has it ever, required that Restatements adopt only rules that have been followed by a majority of

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<sup>19</sup> See generally RLLI (every section is followed by a reporters' note citing case law).

<sup>20</sup> We know this because we have received comments—from both insurance company and policyholder lawyers at different times—using different definitions of the "majority rule" to support their arguments concerning which rule the ALI ought to adopt.

states. Consider the following description of a Restatement from the ALI Council's Revised Style Manual:

A Restatement thus assumes the perspective of a common-law court, attentive to and respectful of precedent, but not bound by precedent that is inappropriate or inconsistent with the law as a whole. Faced with such precedent, an Institute Reporter is not compelled to adhere to what Herbert Wechsler called "a prepondering balance of authority" but is instead expected to propose the better rule and provide the rationale for choosing it. A significant contribution of the Restatements has also been anticipation of the direction in which the law is tending and expression of that development in a manner consistent with previously established principles.<sup>21</sup>

According to the ALI Council, while a Restatement should take into account what the majority rule is on a particular issue (insofar as that can be determined), it should also take into account the direction of or trends in the law as well as the desirability of alternative rules.<sup>22</sup> When diverging from a clear majority rule, Restatements should openly acknowledge that fact and explain why, which is what the Restatement of Liability Insurance Law does in those few instances in which it does not follow a majority rule (and in most of those instances there is in fact no majority rule in the strong definition of that term).<sup>23</sup>

## II. RESPONDING TO PRIEST'S ARGUMENT THAT THE RESTATEMENT HAS A PRO-POLICYHOLDER BIAS THAT WILL DISRUPT INSURANCE MARKETS

Priest's essay argues that there are two flaws in our understanding of how insurance works, which lead to a "pro-policyholder" bias in the Restatement that is socially undesirable.<sup>24</sup> First, he claims that we proceed from the false assumption that most insurance policyholders do not actually read their policies and so are unaware of all the terms to which they are agreeing.<sup>25</sup>

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<sup>21</sup> AM. L. INST., CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 5 (rev. ed. 2015), <https://www.ali.org/publications/style-manual/>.

<sup>22</sup> *Id.*

<sup>23</sup> *See, e.g.*, RLLI § 21, reporters' note to cmt. a (noting that some commentators have characterized the default rule in favor of recoupment of defense costs as the majority rule); RLLI § 25 cmt. e ("While perhaps not yet the majority rule, an increasingly large number of states permit the insured to settle without the consent of the insurer under the conditions stated in subsection (3)."); RLLI § 27, reporters' note to cmt. d (providing a detailed, exhaustive description of the case law related to the inclusion of an underlying punitive damages award as consequential damages for breach of the duty to make reasonable settlement decisions); RLLI § 37, cmt. g (noting that "[a]mong the few published opinions to address this situation, the majority strictly enforce the claim-reporting condition").

<sup>24</sup> Priest, *supra* note 7, at 636. We unpack what Priest means by "pro-policyholder" below.

<sup>25</sup> *See, e.g., id.* at 651 ("The drafters of the proposed Restatement make much of their assertion that consumers do not read the terms of their insurance contracts before entering into them . . .").



Second, he claims that we are under the erroneous belief that the central function of private insurance arrangements is to engage in redistribution from those who have not suffered losses to those who have, irrespective of what the insurance contract says.<sup>26</sup> These two flaws, he argues, have led us to propose a series of rules that will ultimately lead to a reduction in the availability of liability insurance, thereby harming policyholders.<sup>27</sup>

As to the claim that we are under the impression that most policyholders do not read their insurance policies, he is right. We are indeed under that impression. It is certainly true with respect to most consumers and small-business policyholders, and, in our experience, even many larger corporate policyholders. Moreover, those policyholders who do try to read their policies, especially but not only the consumer policyholders, do not understand much of what they are reading.<sup>28</sup> In the process of getting the policyholder to purchase an insurance policy, the agent of the insurer will usually disclose to the policyholder the policy limits, the amount of the deductible, and (certainly) the amount of the premium. The agent may even mention a few special features of the coverage that he believes will make the policy seem appealing to the potential policyholder. But that information is only a tiny portion of what a policyholder would need to know to fully understand the terms of the insurance policy, which are often more than twenty pages of single-spaced fine print. Those few known terms are almost never the subject of the insurance coverage litigation that is covered by the rules in the Restatement.<sup>29</sup>

Moreover, the vast majority of insurance companies—possibly all of them—provide the policyholder (consumers and even large businesses) with

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<sup>26</sup> *Id.* at 636 (“[T]he Reporters’ central understanding of insurance is that it serves simply to redistribute risks from person who have suffered a loss to persons who have not.”).

<sup>27</sup> *Id.* at 661 (stating that the Restatement, “if adopted, will reduce insurance availability generally and, especially, for the low income in the society.”).

<sup>28</sup> It is common knowledge that the vast majority of people do not read and do not understand the standard form contracts that they sign, including insurance contracts, and that, when they do read them, they do not understand the terms of those contracts. *See, e.g.*, John Aloysius Cogan, Jr., *Readability, Contracts of Recurring Use, and the Problem of Ex Post Judicial Governance of Health Insurance Policies*, 94 ROGER WILLIAMS U. L. REV. 93, 102-03 (2010) (“One of the defining characteristics of contracts of adhesion, and insurance contracts in particular, is that they are unreadable. There appears to be total consensus on this point. Law professors, treatises, commentators and the Restatement (Second) of Contracts all concede that people do not read their insurance contracts due in large part to the complexity of the contracts.” (citations omitted)). *See generally* Omri Ben-Shahar, *The Myth of the “Opportunity to Read” in Contract Law*, 5 EUR. REV. CONT. L. 1 (2009) (commenting on the widespread “unreadiness” of standard form contracts). For a recent summary of the academic literature on why people have difficulty understanding standard form contracts of all sorts and why they are therefore not inclined to read them, see OMRI BEN-SHAHAR & CARL E. SCHNEIDER, *MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 79–93* (2014) (documenting the problems of illiteracy, innumeracy, and “sector illiteracy”).

<sup>29</sup> Priest regards the fact that policyholders know their policy limits and deductibles as evidence that they read their policies and understand what is in them. Priest, *supra* note 7, at 651. We are unpersuaded.

an actual copy of their policy only *after* the policyholder has agreed to purchase the coverage and has paid at least the initial premium.<sup>30</sup> By that time, very few consumers will have the inclination or the energy even to look at their policies. Further, most of the ones who do read their policies will lack the concentration (as well as the literacy and numeracy) necessary to read and understand the whole thing.<sup>31</sup> Nor is it worth their while to do so. Many of the provisions in the policy will be incomprehensible without the assistance of lawyer, an insurance agent, or a broker. Moreover, even if the policyholder struggles through the many pages of fine print, obscure jargon, and seemingly simple words that have been given highly specialized meanings, and they are able to understand all aspects of their insurance policy, what would be the point? Insurance contracts are standard forms; it's not as if the terms are negotiable. For all of these reasons, it is unreasonable to expect a typical policyholder to read her policy.<sup>32</sup>

What is the significance of all this? What follows from the Reporters' belief and the Restatement's acknowledgment that policyholders tend not to read (and not to understand) their insurance policies? Not as much as Priest implies. As it turns out, our belief that insurance purchasers often do not (and reasonably do not) read their insurance policies does not serve as the justification for any rule in the Restatement, save one (estoppel, which we address in detail below). To the contrary, the Restatement, in the vast majority of cases, holds policyholders to the terms of the insurance agreement whether or not they read it. Thus, if the only reasonable interpretation of the policy provides that there is no coverage for a given loss, there is no coverage for that loss. Whether the policyholder has read the insurance policy in such a case does not matter. This is true even if the policyholder reasonably believes that the loss is covered.<sup>33</sup>

Priest's second claim is that we do not believe that liability insurance policies are part of a private market for contractually provided insurance coverage. Rather, he attributes to us the view that insurance serves "to redistribute risks from persons who have suffered a loss to persons who have not."<sup>34</sup> In his opinion, we see insurance as "basically a redistributive instrument"<sup>35</sup>

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<sup>30</sup> See Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1266 (2011) ("Despite massive marketing campaigns by insurers emphasizing the importance of coverage in addition to premiums, it is currently virtually impossible for ordinary consumers to compare the scope of coverage that different carriers provide. Insurers do not make their policy language available to consumers until after they purchase coverage. . . . And preliminary evidence suggests that many insurance agents are both unaware of potential differences in coverage among carriers and unfamiliar with many details of coverage they sell.").

<sup>31</sup> BEN-SHAHAR & SCHNEIDER, *supra* note 28, at 79–93.

<sup>32</sup> Again, many others have said this before us. See *generally* sources cited at note 28, *supra*.

<sup>33</sup> This last statement reflects the fact that the Restatement does not adopt the strongest form of the doctrine of reasonable expectations. See RLLI § 4, cmt. b.

<sup>34</sup> Priest, *supra* note 7, at 636.

<sup>35</sup> *Id.* at 639.

and simply do not understand that “not all risks can be insured.”<sup>36</sup> The “fact” that we hold this view is another reason why the Restatement is supposedly stacked with pro-policyholder rules: the reporters of the Restatement want to redistribute from the haves to the have-nots.<sup>37</sup>

To support the case that the Restatement includes a bunch of redistributive rules, Priest spends several pages, in a long section of his paper entitled “How Liability Insurance Operates,” explaining the basics of insurance economics.<sup>38</sup> He notes, for example, that a private insurance market aggregates risks (i.e., it groups together similar but uncorrelated risks, thereby using the law of large numbers to reduce variance), segregates risks (i.e., classifying insureds into risk pools according to their expected losses to combat adverse selection), and seeks to combat moral hazard (through deductibles and co-payments).<sup>39</sup> By contrast, Priest seems to be arguing, a system of pure redistribution does not do any of those things. The impression Priest is going for in this part is that the Restatement’s rules are less characteristic of what one would expect to find in a private insurance market and more characteristic of what one would expect to find in a social insurance program along the lines of Medicare or the Affordable Care Act.<sup>40</sup>

Taken on its face, the argument is silly. There is obviously nothing in the Restatement that suggests all risks can or must be insured. As already discussed, under the rules in the Restatement, if a liability insurance contract excludes a particular loss, that loss is not covered by that policy.<sup>41</sup> Also under the rules in the Restatement, if the policyholder fails to satisfy one of the policy’s conditions, there is no coverage, subject in some cases to a requirement that the insurer demonstrate prejudice.<sup>42</sup> As the Restatement repeatedly makes clear, the common law of insurance has its source in contract law; and, accordingly, it is the insurance policy that determines the outcome.<sup>43</sup>

There is also nothing in Priest’s description of the economics of private insurance markets that is inconsistent with the rules in the Restatement. Indeed, the rules of insurance law articulated in the Restatement *are* fundamental to the economics of insurance, as described by Priest. More specifically, there can be no risk aggregation through private insurance without rules of

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<sup>36</sup> *Id.* at 637.

<sup>37</sup> It is not clear whether he thinks we are trying to redistribute to the liability insurance policyholders who suffer losses or to the tort victims who have suffered losses and are suing those policyholders as defendants. Either way, he regards such redistribution as counterproductive, for the reasons described below.

<sup>38</sup> Priest, *supra* note 7, at 637–51.

<sup>39</sup> *Id.* at 640–50.

<sup>40</sup> *See id.*

<sup>41</sup> *See* RLLI §§ 2–4 (addressing insurance policy interpretation).

<sup>42</sup> RLLI § 35, cmt. *b, c* (addressing conditions in insurance policies).

<sup>43</sup> Examples include the sections addressing interpretation, RLLI, §§ 2–4, and sections stating default rules that can be altered by contrary language in the insurance policy. *See, e.g.*, RLLI §§ 10, 20, 21, 23, 33, 42.

insurance policy interpretation.<sup>44</sup> There can be no risk segregation, and no combatting of adverse selection, without the doctrine of misrepresentation.<sup>45</sup> As Priest notes, insurers attempt to reduce the possibility of moral hazard through exclusions, coinsurance, and deductibles.<sup>46</sup> As Priest fails to note, however, all those categories of insurance policy terms are addressed in specific sections of the Restatement.<sup>47</sup> Moreover, just to be clear, there is almost no resemblance between the vision of insurance embodied in the contract-based Restatement of the Law Liability Insurance and the social welfare vision of insurance embodied in the clearly and intentionally redistributive programs of Medicare or the Affordable Care Act.<sup>48</sup>

A more precise and more modest version of Priest's redistribution critique might be this: When justifying one insurance law rule over another, the Restatement sometimes takes into consideration which rule is more likely to result in compensation for the injured victims who are bringing a claim against the policyholder. That statement would be true, though the number of times the Restatement does so is far fewer than Priest's essay suggests, and that consideration is not dispositive in any of those instances.<sup>49</sup> In our view, and as the Restatement reflects, liability insurance serves multiple functions. It primarily provides insurance coverage for liability policyholders against the risk of a lawsuit.<sup>50</sup> But it also works with liability law itself to create incentives for policyholders to take reasonable care to minimize risks.<sup>51</sup> And it helps to ensure that victims of legitimate tort claims have the

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<sup>44</sup> See e.g., RLLI § 2, cmt. *d* (explaining how consistent interpretation of insurance policy terms “facilitates the orderly operation of the insurance market”).

<sup>45</sup> See, e.g., RLLI § 7, cmt. *a*.

<sup>46</sup> Priest, *supra* note 7, at 640.

<sup>47</sup> See, e.g., RLLI Ch. 3, Topic 3, *Application of Limits, Retentions, and Deductibles*. It's also mystifying why Priest would try to create the impression that the Reporters—or anyone working in this area—would not be aware of such basic concepts as risk segregation, risk aggregation, and moral hazard. Again, this is the stuff of high school or perhaps college microeconomics.

<sup>48</sup> For just one example, the Patient Protection and Affordable Care Act expressly forbids the sort of risk segregation that the Restatement's misrepresentation rules assume. See 42 U.S.C. § 300gg(a)(1)(A) (2012). See generally Tom Baker, *Health Insurance Risk and Responsibility after the Affordable Care Act*, 159 U. PA. L. REV. 1577, 1577 (2011) (“The Affordable Care Act embodies a new social contract of health care solidarity through . . . markets, choice and individual responsibility, with government as the insurer for the elderly and poor.”). On competing conceptions of insurance, see generally Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653 (2013).

<sup>49</sup> The complete list: RLLI § 2 cmt. *e*, § 9 cmt. *f*, § 26 cmt. *a* and § 37 cmt. *b* (Tent. Draft No. 1, April 2016) and § 47 cmts. *f-h* (Council Draft No. 3 December 2016) Note that the § 37 in TD No. 1 became § 36 in the December 2016 draft.

<sup>50</sup> RLLI § 1 (defining “liability insurance”).

<sup>51</sup> See generally Tom Baker & Peter Siegelman, *The Law and Economics of Liability Insurance: A Theoretical and Empirical Review*, in HANDBOOK ON THE ECONOMICS OF TORTS 169–98 (Jennifer Arlen, ed. 2013); Omri Ben-Shahar & Kyle Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 U. MICH. L. REV. 197 (2012).

opportunity to bring their claims and receive compensation that they are owed.<sup>52</sup>

### III. THE RESTATEMENT'S SO-CALLED "PRO-POLICYHOLDER" RULES

Priest repeatedly implies that the Restatement is chockfull of what he calls "pro-policyholder" rules, a fact that he contends will ultimately lead to bad consequences for policyholders because of the effects on the price and availability of coverage.<sup>53</sup> Priest does not define the term "pro-policyholder," but he seems to mean this: As between two possible rules of insurance law that a court could choose to apply to a given issue before it, the rule that is more likely to result in a judgment for the policyholder is the pro-policyholder rule. The other rule, the one more likely to result in a judgment for the insurer, might be called the pro-insurer rule, though Priest does not use that term. Focusing on remedies, a relatively pro-policyholder rule regarding, say, damages would be one that, on average, tended to produce larger damage awards for policyholders in coverage disputes than some alternative pro-insurer damage rule.

Before we get into the question of which particular rules in the Restatement are pro-policyholder, relatively speaking, we should acknowledge the obvious: whether a rule is pro-policyholder or pro-insurer in the narrow *ex post* sense described above reveals nothing about whether the rule is socially desirable or not.<sup>54</sup> To know whether a pro-policyholder or pro-insurer rule is socially desirable, we need to know—or have an educated guess about—the consequences of the rule.<sup>55</sup> For example, a pro-policyholder rule of insurance law would be socially desirable, all else equal, if it allocated to the insurer a risk that the insurer was in the best position to reduce or eliminate. In that situation, the pro-policyholder rule would reduce social costs (i.e., the total costs of insurance plus private precaution), and perhaps even reduce the price of insurance. In that case, calling the rule simply "pro-policyholder" would be myopic. Yes, the rule is "pro-policyholder" in that it would be more likely to lead to a policyholder victory in litigation over coverage, but it would also be "pro-insurer" by improving the functioning of liability insurance markets.

Perhaps the most obvious example of such a pro-policyholder rule is the doctrine of *contra proferentem* (CP): the rule that ambiguities in contracts

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<sup>52</sup> See generally ABRAHAM, *supra* note 1. See also David A. Fischer & Robert H. Jerry, II, *Teaching Torts Without Insurance: A Second-Best Solution*, 45 ST. LOUIS U. L.J. 857 (2001).

<sup>53</sup> Priest, *supra* note 7, at 636, 658 (discussing pro-policyholder bias of Restatement generally and negative consequences if adopted, including reduction in availability of coverage).

<sup>54</sup> From now on, when we use the term pro-policyholder and pro-insurer, we mean them in the narrow *ex post* sense.

<sup>55</sup> We might also be concerned with non-consequentialist questions, such as which rule is more consistent with some conception of justice.

are construed against the party who drafted the ambiguous language.<sup>56</sup> Because insurance policies are typically standard form contracts that are drafted by insurance companies, the CP rule generally works to the advantage of policyholders in coverage litigation against insurers. Specifically, when an insurer seeks to deny coverage (or to decline to provide a defense) on the basis of its interpretation of a particular term in the contract, if there is a reasonable interpretation of that term that favors coverage, the policyholder will generally prevail.<sup>57</sup> In a sense, the CP rule in the insurance context places the risk of an ambiguous policy term on the insurer rather than the policyholder.<sup>58</sup> Because the insurer—being the drafter of the policy term—is in the better position to reduce the risk of contract-term ambiguity, the allocation of that risk to the insurer-drafter via the CP rule is typically thought to be socially desirable. After all, CP is and has long been the prevailing rule in every U.S. jurisdiction.<sup>59</sup>

Not only does CP have the effect of minimizing the risk of ambiguity. It also allocates efficiently and fairly the risk of ambiguity that cannot be eliminated. It is not possible to write an insurance policy that contains *no* risk of ambiguity. While a well-drafted contract term may seem clear when applied to one context, that same term, when applied to a new setting not fully anticipated by the drafter, may take on additional meanings. Under the CP rule, that risk of irreducible ambiguity is allocated to the insurer-drafter of the policy.<sup>60</sup> Does this allocation of such risk make sense? It does. Although such an allocation might result in somewhat higher premiums being charged to policyholders than would be charged under some alternative rule (though this would have to be proven, and not simply assumed),<sup>61</sup> the additional premium is more than offset by the additional “ambiguity insurance” that is implicitly provided with every policy.<sup>62</sup>

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<sup>56</sup> RLLI § 4 (addressing the interpretation of ambiguous policy terms).

<sup>57</sup> The rule as applied is slightly more nuanced. If there are two reasonable meanings of a term, courts will typically consider extrinsic evidence to determine if a single meaning can be isolated. RLLI, § 4(2) (“When an insurance policy term is ambiguous, the term is interpreted in favor of the part that did not supply the term, unless the other party persuades the court that this interpretation is unreasonable in light of extrinsic evidence.”). Put differently, the extrinsic evidence is used to determine if one of the otherwise plausible readings of the language of the term is, considering all the evidence, not in fact reasonable. If after this analysis, there remain two reasonable meanings, then the ambiguity is construed against the insurer. *Id.*

<sup>58</sup> RLLI § 4, cmt. *i* (regarding the “residual risk of unavoidable ambiguity”).

<sup>59</sup> RLLI § 4, reporters’ note to cmt. *h*.

<sup>60</sup> This is true because the CP rule is generally understood as a rule of strict liability against the drafter. An alternative version of the CP rule would be one that construed ambiguous terms against the drafter only if the ambiguity could not reasonably be eliminated. That is not the rule in most jurisdictions, and it is not the rule adopted in the Restatement. If such a negligence-based rule of CP were adopted, it would mean that the risk of irreducible ambiguity would typically be borne by the policyholder.

<sup>61</sup> Say, under a negligence-based CP rule or under a rule that did not apply at all.

<sup>62</sup> While definitive empirical proof of this last point requires evidence that only the insurance industry has, it is certainly a reasonable presumption in this context, given that policyholders have a clearly

In sum, there is every reason to believe that the doctrine of *contra proferentem*, a clearly pro-policyholder rule of insurance law, is socially desirable. A similar analysis can be applied to any Restatement rule that is thought to be pro-policyholder in the narrow, *ex post* sense. Consider, for example, the Restatement's rule on estoppel, which can be understood as allocating the risk of a misleading statement or action by an agent of the insurance company. Under the rule of estoppel in insurance law, if an insurer through its agent makes a representation that a particular type of claim is covered, and the policyholder reasonably relies on this representation to her detriment (by neglecting to look elsewhere for coverage or by engaging in some activity under the belief that she is covered), the insurer is estopped from later denying that representation.<sup>63</sup> This is so even if there happens to be language in the policy that directly contradicts the agent's misleading representation, again assuming the policyholder's reliance was reasonable.

If we assume that it is unreasonable to expect most policyholders to read and understand their policies, then clearly the party in the best position to reduce the risk of a misleading statement by an agent of the insurer is the insurer. The insurer can devote resources to hiring competent people to be agents, training them how to do their jobs, monitoring their performance, and disciplining them when they say or do things to mislead policyholders. Even though the insurer cannot eliminate the risk of the agents engaging in misleading behavior (even with a first-rate hiring and training regimen), the best allocation of that residual risk is on the insurer. Here again, there is the residual or irreducible risk of unpreventable insurance agent misbehavior. As to that risk, surely a reasonable policyholder would be willing to pay a miniscule additional premium to cover her against the risk that, notwithstanding the insurer's best efforts, an insurance company agent might, intentionally or unintentionally, mislead a policyholder into detrimental reliance.

This is the reasoning on which the Restatement's estoppel rule is based. That is also the reasoning that can be used to justify almost all the pro-policyholder rules (in Priest's *ex post*, myopic sense) in modern insurance law and, thus, in the Restatement, including the set of rules that together fall under the duty of good faith and fair dealing, which are the focus of Priest's critique, to which we turn next.

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demonstrated aversion to risk (hint: they are purchasing insurance) and given the beneficial deterrence effect of the CP rule discussed above, and given that the rule CP has been applied for decades in every jurisdiction in the country without disrupting insurance markets or undermining insurance availability. See generally Tom Baker, *The Shifting Terrain of Risk and Uncertainty on the Liability Insurance Field*, 1 J. FIN. PERSP. 29 (2013) (using financial data filed with the National Association of Insurance Commissioners to show that the U.S. liability insurance market has grown since the early 20<sup>th</sup> Century at roughly the same rate as the U.S. GDP).

<sup>63</sup> RLLI § 6 (addressing the doctrine of estoppel).

#### IV. THE RESTATEMENT WILL NOT DESTABILIZE INSURANCE MARKETS: A CLOSER LOOK AT MISREPRESENTATION, DUTY TO DEFEND, AND DUTY TO SETTLE

Priest's primary argument is that, if courts were to adopt the (according to him) radical new pro-policyholder rules proposed in the Restatement, the result would be destabilization of liability insurance markets. In our view, none of the rules contained in the Restatement are either radical or new. Certainly the rules discussed above regarding contract interpretation and estoppel are neither radical nor new. So which Restatement rules in particular does Priest believe are radical and new? Again, he is somewhat mysterious on this point.<sup>64</sup> The few specific rules he does mention involve the insurer's ability to deny a claim and rescind a policy based on a misrepresentation by the policyholder, the insurer's duty to defend, and the insurer's duty to make reasonable settlement decisions. Yet, these rules—presumably the best examples he could find to prove his point—support neither the proposition that the Restatement rules are new nor that they would destabilize insurance markets. We address his specific arguments with respect to these doctrines next.

##### A. *Misrepresentation*

The first specific rule adopted in the Restatement that Priest chooses to critique is the rule regarding misrepresentation.<sup>65</sup> What is most interesting about Priest's critique is that, while he focuses on certain details that he regards as being excessively pro-policyholder (discussed below), he downplays the fact that the core of the rule is exceptionally pro-insurer. In fact, most of his misrepresentation critique is directed at a more pro-policyholder version of that core rule that was in a much earlier draft, when the project was a Principles project, rather than the pro-insurer rule that is in the Restatement.<sup>66</sup>

In the insurance context, the doctrine of misrepresentation deals primarily with false statements made by policyholders to insurers in the application and renewal process.<sup>67</sup> According to the Restatement, if a policyholder makes a misrepresentation in filling out her application for coverage (or in the renewal proposes) that is material and reasonably relied upon by the insurer in providing coverage, the insurer can deny a claim filed under the policy and

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<sup>64</sup> Priest, *supra* note 7, at 636 n.8 (“This paper is meant to be conceptual and will not specifically address differences between the proposed rules and the law in the several jurisdictions.”).

<sup>65</sup> *Id.* at 653–55.

<sup>66</sup> We address this earlier rule and Priest's critique of it, below.

<sup>67</sup> Estoppel and waiver tend to be the doctrines used to deal with misrepresentations made by insurers, or agents of insurers, to policyholders.



can rescind the policy.<sup>68</sup> This is true even if the policyholder's mistake is unintentional, indeed even if the mistake is not even negligent.<sup>69</sup> In such a case, although the policyholder gets a refund of her premiums (since she in effect never had coverage), she is left without coverage for the loss in question. This pro-insurer rule is the common-law rule in well over half of the U.S. states (though it is modified by statute in some states), and, for that reason, it is the rule adopted by the Restatement.<sup>70</sup>

The specific aspects of the Restatement's misrepresentation rules that Priest takes issue with involve the definitions of materiality and reliance. The entire critique of these rules, which is representative of Priest's more general critique of the Restatement generally, consists of the following three sentences:

They propose very strong standards for an insurer proof of materiality and detrimental reliance. These provisions simply add to the shift in responsibility from the insurance applicant to the insurer in determining the risk attributes of the applicant. Even as amended, these rules, if adopted, will have the economic effect of reducing insurance availability to the society by increasing the costs and reducing the predictability of the underwriting process.<sup>71</sup>

What this argument suggests is that (a) the materiality and detrimental reliance standards that we adopt are new, (b) they are pro-policyholder, and (c) if adopted would disrupt insurance markets, which causes a reduction in insurance availability.

As to the first point, Priest does not explain how the materiality standard adopted by the Restatement diverges from existing law. That is not terribly surprising, because in fact some version of this definition of materiality is used in every jurisdiction in the country.<sup>72</sup> As to the second point, Priest does not explain why the materiality definition chosen by the Restatement is relatively pro-policyholder. That too is not surprising, because in fact the definition of materiality adopted by the Restatement is distinctly pro-insurer relative to a leading alternative rule.

This point could use additional explanation. The Restatement's definition of materiality is straightforward: "A misrepresentation . . . is material only if, in the absence of the misrepresentation, a reasonable insurer in this insurer's position would not have issued the policy or would have issued the policy only under substantially different terms."<sup>73</sup> In adopting this "material to the risk" definition of materiality, the Restatement rejects the "contribute-

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<sup>68</sup> RLLI § 7.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at cmt. *j.*

<sup>71</sup> Priest, *supra* note 7, at 655.

<sup>72</sup> See RLLI § 8, Reporter's Notes to cmts. *a-c.*

<sup>73</sup> RLLI § 8.

to-the-loss” approach favored by a leading law and economic analysis of misrepresentation law.<sup>74</sup> Under the “contribute-to-the-loss” materiality rule, the insurer can raise the misrepresentation defense only in “situations in which the misrepresentation by the policyholder actually materialized in (‘contributed to’) the loss that occurred and for which the insured filed a claim.”<sup>75</sup> There are a number of reasons that the material-to-the-risk approach was chosen.<sup>76</sup> The simple point to be made here, however, is that the contribute-to-the-loss approach would afford insurers with a misrepresentation defense in far fewer cases than does the material-to-the-risk approach. Thus, the rule adopted by the Restatement is, by comparison, clearly the pro-insurer rule (again, in the narrow *ex post* sense).

Finally, as to the third point above, regarding the effects of the Restatement’s rules on insurance markets, the answer is clear: Inasmuch as every jurisdiction in the country seems to be using some version of the definition of materiality that the Restatement adopts—which is a relatively pro-insurer conception of materiality—it is very difficult to take seriously the argument that the adoption of this rule will lead to disruption in liability insurance markets.<sup>77</sup>

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<sup>74</sup> See generally Henrik Lando, *Optimal Rules of Negligent Misrepresentation in Insurance Contract Law*, 46 INT’L REV. L. & ECON. 70 (2016). For a discussion of the contribute to the loss rule in relation to materiality, see generally Kathryn H. Vratil & Stacy M. Andreas, *The Misrepresentation Defense in Causal Relation States: A Primer*, 26 TORT & INS. L.J. 832 (1991).

<sup>75</sup> RLLI § 9, cmt. *b*.

<sup>76</sup> RLLI § 9, cmt. *b* explains these reasons as follows:

This Section does not follow the contribute-to-the-loss approach for four reasons. First, the contribute-to-the-loss rule does not address the primary concern to which the doctrine of misrepresentation is a response: the problem of high-risk policyholders intentionally and dishonestly understating their risks in order to obtain coverage at a price that is subsidized by honest members of the same risk pool. Such adverse selection is unfair and inefficient (as discussed in Comment a to § 7) and should be discouraged even if the policyholder’s misrepresentation did not give rise to the loss under the policy. The contribute-to-the-loss approach would penalize only those misrepresentations that happen to contribute to the particular loss for which the insured files a claim. By contrast, the standard followed in this Section appropriately penalizes all misrepresentations that meet the requirements of § 7. Second, the contribute-to-the-loss rule can be unreasonably difficult for an insurer to satisfy, because of the absence of proof of the precise connection between the misrepresentation in question and the cause of the loss for which a claim is being filed. The rule therefore results in unfair cross-subsidies, as relatively high-risk policyholders who have misrepresented their risks under circumstances in which the causal connection is present but impossible to prove are subsidized by relatively low-risk policyholders who have made no such misrepresentations. Third, no court has adopted the contribute-to-the-loss rule as part of the common law of liability insurance. Finally, if a court were willing to adopt a common-law innovation to address the unfairness of the strict-liability misrepresentation rule, the arbitrary outcomes that the contribute-to-the-loss approach is intended to avoid are better addressed by limiting the insurer’s misrepresentation defense to situations in which the policyholder acted intentionally or recklessly.

<sup>77</sup> All of the same points could be made about the Restatement’s “reasonable reliance” requirement. Priest fails to explain precisely what it is about this rule: how precisely it diverges from existing law and how that divergence will lead to insurance market disruptions and lack of insurance availability. The reasonable reliance rule adopted by the Restatement also is a common formulation of the doctrine, used in many states. *Knights of Pythias v. Kalinski*, 163 U.S. 289, 298 (1896) (“If the company ought to have known of the facts, or with proper attention to its business, would have been apprised of them, it has no

Strangely, most of Priest's criticisms of the misrepresentation rules—most of the words he writes on the subject—are addressed not to explaining his critique of the Restatement's materiality and reliance standards, but rather to developing a critique of a version of the misrepresentation rules that were in a prior draft, when the project was still a Principles project, but that were not carried over into the Restatement. We address this criticism at some length to make the following important point: in this and other instances, the Restatement adopts a rule that is much more pro-insurer (in the narrow sense) than an alternative for which there are good economic justifications.

The Principles version of the misrepresentation rule worked as follows: If, in response to an insurer's invocation of the misrepresentation defense, a policyholder could demonstrate that her misrepresentation was neither reckless nor intentional, then the insurer's remedy would be limited.<sup>78</sup> Thus, under that rule (which was not adopted in the Restatement because of a lack of sufficient common law authority), the insurer could deny the claim only if the policyholder's misrepresentation was reckless or intentional. The innocent, or merely negligent, policyholder would still receive coverage, though at the expense of having to pay the higher premiums she should have been paying all along.<sup>79</sup>

Notwithstanding Priest's arguments to the contrary, discussed further below, there is a lot to be said for such a rule from an economics-of-insurance perspective, as is explained in the Principles draft.<sup>80</sup> It is important that intentional misrepresentation be punished, to prevent relatively high risk policyholders from attempting, in effect, to commit a species of fraud by understating their risk and tricking the insurer into including them in an insurance pool whose average risks is significantly lower than that of the dishonest policyholder. The harm of this extreme form of adverse selection is inefficiency and unfairness, as the other members of the pool are forced to cross-subsidize the dishonest policyholder. If the policyholder's misrepresentation, however, is an honest mistake, there is less concern with grouping them into the pool with the people who do not make the mistake. This happens with liability insurance pools all the time. This sort of negligence is just the type of mistake that people purchase liability insurance for.<sup>81</sup>

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right to set up its ignorance as an excuse [in order to secure forfeiture]."); 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 16.08[1][c] (Jeffrey E. Thomas ed., 2012).

<sup>78</sup> PRINCIPLES OF THE LAW OF LIABILITY INSURANCE § 7 (Tent. Draft No. 1, 2013).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at § 7 cmt. b; § 11 & cmts.

<sup>81</sup> Of course, under a misrepresentation rule that protected innocent misrepresentation, insurers would be given an incentive to do a more thorough up-front investigation of the truth or falsity in the underwriting process. They might also start sorting people into risk pools according to who is more likely to make innocent mistakes on their insurance applications.

Priest's has an answer to this very argument. Characterizing the argument as "sophistical, not persuasion," he responds as follows:

It is a different matter entirely when an insured drifts into a different lane or mistakes the brake for the gas pedal in parking or neglects to trim trees (leading to a branch fall that causes loss) than where an insurance applicant "mistakes" the son's driving record or the number of claims filed against previous insurers on an application sitting right before. [*sic*]<sup>82</sup>

True enough, there is a difference between the negligence that gives rise to liability risk and the negligence that produces mistakes in the insurance underwriting process. But the next question is why the difference is important. The difference would be important, for example, if innocent mistakes that policyholders tend to make on their insurance applications are easier for them to avoid than mistakes they make driving their cars or trimming their trees. Such a difference would help explain why policyholders might prefer not to purchase coverage for their negligent misrepresentations, whereas they would want to purchase coverage for their negligent driving and tree-trimming. In that scenario, it might make sense to leave policyholders responsible for their own negligence, while not doing so with respect to their negligent driving and tree-trimming habits. But there is no evidence to support this potential difference in people's ability to avoid different kinds of mistakes, and no theoretical reason to expect such a difference.

Priest does not even mention this argument, however. Instead, he analogizes filling out an insurance form with filing an individual's tax returns: "Ask the IRS whether insurance is available for negligence in our tax returns?"<sup>83</sup> This analogy is useful. However, not for the reasons Priest thinks. The IRS does indeed rely heavily on taxpayer-provided information to do its job of determining how much each taxpayer owes in federal income taxes. Individuals and corporations file returns on which they are expected to provide truthful information. Indeed, in the tax context, it is the taxpayer who decides initially how much they owe in taxes. And a taxpayer's failure to provide accurate information, if it results in an underpayment of taxes, has consequences for the taxpayer. She must pay the additional corrected amount of tax plus interest. Moreover, if the understatement is "substantial"<sup>84</sup> or if it is "negligent,"<sup>85</sup> the taxpayer will also owe a penalty. Presumably it is this penalty that Priest is referring to when he implies that the IRS will not be offering "insurance . . . for negligence."<sup>86</sup>

The problem with the argument is that the amount of the penalty is merely 20 percent of the amount of the understated tax.<sup>87</sup> That is, if you owed

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<sup>82</sup> Priest, *supra* note 7, at 655.

<sup>83</sup> *Id.*

<sup>84</sup> 26 U.S.C. § 6662(a) (2012).

<sup>85</sup> *Id.* at § 6662(b)(1).

<sup>86</sup> Priest, *supra* note 7, at 655.

<sup>87</sup> 26 U.S.C. § 6662(b)(1) (2012).

\$20,000 in tax, but you paid only \$15,000, so you underpaid by \$5,000, the penalty would be an additional \$1,000 in penalty. This is not trivial. But it is not comparable to the consequence of an innocently negligent misstatement on one's insurance application. Say your annual liability insurance premium, if properly calculated to reflect your risk, would be \$2,000; however, because you made an innocent mistake on your application, you ended up wrongly paying a premium of only \$1,500. Now assume that, once the policy is issued, you then suffer \$500,000 in liability losses from a tort judgement and accompanying defense costs. Then the insurer determines that it does not owe coverage for any of these losses because of the \$500 innocent misrepresentation. That's a penalty of one thousand percent (!), and it is easy to see why policyholders might be willing to pay a bit extra for an insurance policy that includes insurance for the enormous consequences of such innocent mistakes. By contrast, even though it may be true that the IRS does not provide insurance against innocent taxpayer mistakes, it also punishes them so mildly that insurance is hardly necessary. The same cannot be said of the risk of an innocent misrepresentation by a policyholder on an insurance application.

In sum, there is a decent argument to be made for adopting a rule of misrepresentation that protects innocent mistakes, although such a rule has some obvious costs. The more important point, from the perspective of evaluating Priest's critique of the Restatement, however, is that the Restatement did not adopt such a version of the misrepresentation doctrine! It does not appear in the black letter of the Restatement, in Sections 7, 8, or 9, and it is not adopted in any of the Comments to those sections. Priest is aware that the black letter changed when the project became a Restatement. But he claims that, despite the change in the black letter, "[t]he Discussion Draft . . . continues to contain many passages suggesting that the insurer defense should only extend to misrepresentations that are intentional or reckless."<sup>88</sup>

We are not sure which passages in the April 2015 Discussion Draft Priest has in mind. But since Professor Priest had access to the language of the misrepresentation sections of the Restatement as they were approved by the Council and the ALI membership in May 2016, we will refer to that language. It is true that Comment b to Section 9, as approved, mentions the possibility that a court might adopt the reckless/intentional limitation to the traditional misrepresentation rule.<sup>89</sup> However, it mentions that possibility only as a possible alternative to adopting the pro-policyholder contribute-to-the-loss definition of materiality. That is, the Restatement argues that, if a court is worried that the pro-insurer increase-the-risk definition of materiality adopted by the Restatement is too harsh towards policyholders, the better reform would be the one directed explicitly to protecting innocent policyholders, as discussed above, rather than the contribute-to-the-loss rule. However, neither that Comment nor any other provision in the Restatement states

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<sup>88</sup> Priest, *supra* note 7, at 654.

<sup>89</sup> RLLI § 9, cmt. b.

or even suggests that the rule adopted by the Restatement limits the misrepresentation defense to situations in which the policyholder recklessly or intentionally misled the insurer. Therefore, why Priest devoted so many words to this abandoned proposal—given the hundreds of pages of the Restatement that were in fact adopted—is mysterious.

### B. *The Duty to Defend*

Priest also applies his formulaic critique—radical new pro-policyholder proposals that will disrupt insurance markets—to the Restatement’s approach to the duty to defend. Most liability insurance policies include a term that obligates the insurer to provide a defense if the policyholder is sued for something that is covered under the policy.<sup>90</sup> Thus, the insurer has a contractual duty to provide the policyholder with a defense. As the common law interpreting this duty has developed, most courts have held that the insurer’s “duty to defend” is somewhat broader than its “duty to indemnify.”<sup>91</sup> What this means in practice is that the insurer’s duty to defend is based in the first instance on the claimant’s allegations, not the true facts, and if a claimant files suit against the policyholder and alleges both covered and uncovered claims, the liability insurer must provide a defense for the whole claim.<sup>92</sup> Priest does not appear to take issue with these basic ground rules, which the Restatement adopts.<sup>93</sup>

In a situation involving potentially covered and potentially uncovered claims, the Restatement provides a process by which an insurer can assume the defense of a policyholder while reserving its rights to contest coverage later. The insurer simply issues a “reservation of rights” letter to the policyholder, stating the grounds on which it might later contest coverage.<sup>94</sup> If, however, the insurer undertakes to provide a defense without issuing such a reservation of rights, the insurer in effect waives its rights to contest coverage.<sup>95</sup> On the other hand, if the insurer breaches its duty to defend by declining to provide a defense when a defense is owed, then there are consequences.

What are the consequences of breaching the duty to defend? First, under section 19(1), the insurer loses the right to assert any control over the defense.<sup>96</sup> Second, under section 19(2), if the insurer did not have a “reasonable

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<sup>90</sup> See RLLI, § 10, cmt. *a*.

<sup>91</sup> RLLI § 13, cmt. *b*.

<sup>92</sup> RLLI §§ 13(1), 14(1). Insurance law permits the insurer to avoid paying a judgment or settlement on the basis of the true facts (as opposed to those alleged by the underlying tort plaintiff) and to litigate on the basis of the true facts in a declaratory judgment action seeking to avoid continuing to provide a defense. RLLI § 18(7).

<sup>93</sup> See Priest, *supra* note 7, at 658.

<sup>94</sup> RLLI § 15(4).

<sup>95</sup> RLLI § 15(1).

<sup>96</sup> RLLI § 19(1).

basis” for its refusal to provide a defense, the insurer loses its ability to invoke its coverage defenses to avoid payment of a judgment entered in the suit.<sup>97</sup> It is the latter rule that Priest regards as excessively punitive. In fact, he says it is so punitive and such a departure from liability insurance law as it presently exists that it will—you guessed it—lead to massive premium increases and ultimately to disruption in the availability of insurance coverage.<sup>98</sup>

Once again, that argument does not hold water. The rule is not a radical departure from existing law. And there is no evidence that the liability insurance markets have failed in the jurisdictions that follow it or the even more pro-policyholder (in the narrow sense) alternative.

With regard to the claim that the rule is new, we note, first, that the section 19(2) rule applies only if the insurer both failed to provide the defense that was owed and lacked a reasonable basis for its failure.<sup>99</sup> A classic example would be a homeowners insurer that refused to defend a bodily injury negligence suit on the grounds that the policyholder intentionally caused the harm. The insurer would lack a reasonable basis for that refusal because it is settled law in every U.S. jurisdiction of which we are aware that the insurer must defend such a suit. This rule is well within the norm of what courts do when an insurer refuses to defend without a reasonable basis. Many courts regard such a refusal to defend as a “bad faith” breach of the liability insurance contract, and one of the consequences of a bad faith breach is loss of coverage defenses.<sup>100</sup> Section 19(2) simply adopts that rule in the duty to defend context, without the emotive overtones of the “bad faith” label. That approach permits the Restatement to reserve the “bad faith” label for circumstances in which the insurer’s culpability extends beyond negligence.<sup>101</sup>

<sup>97</sup> RLLI § 19(2)

<sup>98</sup> Priest, *supra* note 7, at 656–57.

<sup>99</sup> To be fair, when Priest first drafted his critique of the Restatement (back when it was a Principles project), the rule that we proposed did not have the lack-of-reasonable-basis requirement. It is possible (but very disturbing given the tenor of his attack on the Restatement) that Priest simply did not notice our addition of this element when the project changed to a Restatement.

<sup>100</sup> The noted California jurist, Walter Croskey explained this point in the context of California law, which refers to the lack of a reasonable basis test as the “genuine dispute doctrine,” as follows:

[W]hile there are no cases applying the genuine dispute doctrine in duty to defend cases, the application of general principles does permit some reasonable conclusions. First, if a potential for coverage exists (i.e., there is a factual dispute over coverage) then the insurer has a duty to defend and its failure to do so, whatever its reason, will result in bad faith liability. Or, to put it another way, the failure or refusal to provide a defense when a potential for coverage exists constitutes bad faith as a matter of law. . . .

Walter Croskey, *Genuine Dispute Doctrine in Third Party Bad Faith Cases*, 23 CAL. LITIG. 10 (2010). For cases supporting the loss of coverage defenses as a consequence of a bad-faith refusal to defend, see, e.g., *Truck Ins. Exch. v. Vanport Homes*, 58 P.3d 276, 284 (Wash. 2002) (insurer forfeits coverage defense because of bad-faith breach of the duty to defend); *Sentinel Ins. Co., Ltd. v. First Ins. Co. of Haw., Ltd.*, 875 P.2d 894, 912 (Haw. 1994) (loss of coverage defenses would be appropriate in the case of a bad-faith breach of the duty to defend).

<sup>101</sup> RLLI § 51 (adopting a more demanding, two prong test for liability insurance bad faith) (Council Draft No. 3, December 2016).

Second, a significant number of jurisdictions provide a remedy for an insurer's breach of the duty to defend that is even stronger (and thus, in Priest's sense, more pro-policyholder) than the Restatement rule.<sup>102</sup> In those jurisdictions, an insurer's breach of the duty to defend always leads to the forfeiture of coverage defenses.<sup>103</sup> The forfeiture is automatic; the policyholder does not have to show a lack of reasonable basis on the part of the insurer. Relative to those jurisdictions, the rule adopted in the Restatement is, again, relatively pro-insurer.

With regard to the claim that the Restatement rule will destabilize insurance markets, our response is: Where is the evidence? In those jurisdictions just mentioned, where the automatic forfeiture rule applies, there is no evidence of disruption in coverage or premium instability.

This may be because the automatic forfeiture rule functions as a commitment device that encourages insurers to make the right choice in circumstances in which they might be tempted to refuse to defend a case that they should defend. Indeed, if we think that insurers cannot credibly promise to always doing the right thing from the perspective of the policyholder once they are actually faced with a claim and their incentives to breach are substantial, then this rule could function as a commitment device that would increase the credibility of that promise and, hence, the value of insurance to the policyholder and therefore increase the purchase of insurance.<sup>104</sup> Testing this is, of course, an empirical question. But, assuming some myopia on the part of insurance claims departments, the automatic forfeiture could well be efficient. Thus, as with misrepresentation, there is a good economic argument in favor of a rule that is more pro-policyholder, or less pro-insurer, than the rule the Restatement adopts.<sup>105</sup>

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<sup>102</sup> Indeed, this more punitive, more pro-policyholder rule, which is in fact the rule in a substantial number of jurisdictions, was included in the Principles version of this project but was rejected for the more pro-insurer rule currently found in RLLI § 19(2).

<sup>103</sup> See *Twin City Fire Ins. Co. v. City of Madison*, 309 F.3d 901, 906 (5th Cir. 2002) (applying Mississippi law); *Valley Improvement Ass'n v. U.S. Fid. & Guar. Corp.*, 129 F.3d 1108, 1125–26 (10th Cir. 1997) (applying New Mexico law); *Missionaries of Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 230 A.2d 21, 26 (Conn. 1967), *abrogated in part*, *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d 961 (Conn. 2013); *Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134–35 (Ill. 1999); *Farmers Union Mut. Ins. v. Staples*, 90 P.3d 381, 387 (Mont. 2004); *Ames v. Cont'l Cas. Co.*, 340 S.E.2d 479, 485 (N.C. App. Ct. 1986); *Conanicut Marine Servs., Inc. v. Ins. Co. of N. Am.*, 511 A.2d 967, 971 (R.I. 1986); *Prof'l Office Bldgs., Inc. v. Royal Indem. Co.*, 427 N.W.2d 427, 431 (Wis. Ct. App. 1988).

<sup>104</sup> Thank you to Paul Heaton for bringing the commitment justification to our attention. See generally Gharad Bryan, et al., *Commitment Devices*, 2 ANN. REV. ECON. 671 (2010).

<sup>105</sup> Indeed, some policyholder representatives have complained that the lack-of-reasonable-basis requirement will make it difficult for policyholders ever to get the forfeiture remedy. On this view, well advised insurers will always be able to come up with a reasonable basis after the fact. We disagree. Courts are regularly asked to make *ex post* reasonableness determinations in many contexts. This context should be no more difficult for them than others.



Priest also objects to two other rules relating to the duty to defend, asserting that they are “equally punitive” as the rule in 19(2): the rule relating to the insurer’s recoupment of defense costs paid in circumstances when it is later determined that the insurer did not have a duty to defend; and the rule regarding insurers’ duty to defend in circumstances in which a policyholder is covered by multiple liability insurance policies.<sup>106</sup> Regarding recoupment, the Restatement rule is that the insurer’s right to recoupment is governed by contract law rules.<sup>107</sup> If the insurance policy contains a provision permitting recoupment, or if the parties otherwise agree that the insurer may seek recoupment, the insurer may do so; otherwise the insurer may not.<sup>108</sup> Regarding defense obligations when there are multiple insurance policies in play, the Restatement rule is that the policyholder may request a defense from any of the insurers that issued the policies in play, and the insurers may then work out among themselves how to manage the payment of the costs of the defense.<sup>109</sup>

What is most interesting about Priest’s objections to these two rules is their internal inconsistency. Regarding the recoupment rule, Priest would like to use a general principle of the law of restitution and unjust enrichment rather than the insurance policy language.<sup>110</sup> But in the multiple insurer situation, Priest appears to prefer strict construction of the insurance policy language whenever possible, obligating the policyholder to figure out how the multiple policies fit together.<sup>111</sup>

One of Priest’s criticisms of the Restatement’s non-recoupment default rule is almost as interesting as this analytical inconsistency. He accuses us of offering a “sophistical explanation” for the rule, namely that “the current practice is not to seek recoupment, so non-recoupment must be efficient.”<sup>112</sup> Although that is not the primary explanation for the rule in the Restatement, it is one of the explanations.<sup>113</sup> And we stand by it, because there is good

<sup>106</sup> Priest, *supra* note 7, at 657.

<sup>107</sup> RLLI § 21, cmt. a.

<sup>108</sup> *Id.*

<sup>109</sup> RLLI § 20.

<sup>110</sup> Priest, *supra* note 7, at 659–60. Priest fails to mention that there is an even more general rule of restitution and unjust enrichment that disfavors the use of unjust enrichment when the parties are in a position to address the issue by contract. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT, § 2, cmt. e (AM. LAW INST. 2011).

<sup>111</sup> See Priest, *supra* note 7, at 657–58. Priest inaccurately describes the multiple insurer rule approved in May 2016. As described in RLLI §20, cmt. a:

The rules stated in this Section provide a practical approach to the “other insurance” problem that (a) gives effect to the order of priority of defense obligations when it is possible to do so, (b) provides a clear rule that governs when it is not possible to determine all or part of the order of priority, (c) protects insureds from having to hire an insurance-coverage expert to determine which insurer to ask for a defense, and (d) provides a mechanism for an insurer that provides the defense to obtain contribution or indemnification from others.

<sup>112</sup> Priest, *supra* note 7, at 660.

<sup>113</sup> Other explanations include the following:

- The non-recoupment default rule is the emerging majority rule.

reason to believe that, on the whole, insurers (who, again, generally tend to opt not to seek recoupment) are both well informed and rational, and we cannot think of any reason why insurers would be making myopic decisions in this context. Thus, per standard economic reasoning, the insurers are making efficient choices. Priest's criticism is so interesting because, elsewhere in the essay, he applies this same economic reasoning to consumers, despite the strong evidence that they are not well informed and often make irrational insurance choices.<sup>114</sup> Thus, Priest apparently wants us to assume that the people making efficient liability insurance decisions are not the people who work full time for insurance companies but rather the people who spend a handful of afternoons over the course of their lives buying insurance policies.

For a complete explanation of the reasoning behind these two Restatement rules we refer readers to the Restatement. It suffices to say here that both rules are mainstream. The Restatement's recoupment rule is the emerging majority rule, meaning that it has been adopted by most of the courts that have considered the question in recent years.<sup>115</sup> The Restatement's multiple insurer rule has long been the prevailing rule, based on the principle that a policyholder who is covered by multiple policies should not be worse off than she would be if she were covered by only one of them.<sup>116</sup>

For all these reasons, the rules adopted by the Restatement regarding the liability insurer's duty to defend are neither radical nor likely to undermine the availability of liability insurance. Some of the rules are, in Priest's narrow

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- Because insurers could contract for recoupment at very low cost (simply by inserting a recoupment term in their policies), the usual justifications for applying unjust enrichment do not apply.
  - Because the insurer receives substantial benefits from defending under a reservation of rights, there is no unjust enrichment.
  - A recoupment rule reduces insurers' incentive to manage defense costs and potentially expands the scope of insurance coverage litigation.
  - A default non-recoupment rule requires an insurer that wants to seek recoupment to inform the policyholder (and insurance regulators approving the form) by inserting a recoupment term in the policy, thereby facilitating informed choice by both.

See RLLI § 21, cmts. *a* & *b*.

<sup>114</sup> See, e.g., Priest, *supra* note 7, at 651.

<sup>115</sup> See RANDY MANILOFF & JEFFREY STEMPER, GENERAL LIABILITY INSURANCE COVERAGE: KEY ISSUES IN EVERY STATE 195 (2015) (“[L]itigation surrounding an insurer’s right to reimbursement of defense costs has been active for the past fifteen years, with a significant spike in the last five. In general, insurers have won a few more of these cases than they’ve lost. But the score is close. And the minority view is gaining ground.”); Angela R. Elbert & Stanley C. Nardoni, *Buss Stop: A Policy Language Based Analysis*, 13 CONN. INS. L.J. 61, 92–93 (2006). See also *Nat’l Sur. Corp. v. Immunex Corp.*, 297 P.3d 688, 693 (Wash. 2013) (“More recently . . . courts deciding in the first instance whether insurers can recover defense costs have generally concluded that they cannot.”).

<sup>116</sup> See, e.g., Douglas R. Richmond, *Issues and Problems in “Other Insurance,” Multiple Insurance, and Self-Insurance*, 22 PEPP. L. REV. 1373, 1380–81 (1995) (“‘Other insurance’ clauses only affect insurers’ rights among themselves; they do not affect the insured’s right to recovery under each concurrent policy. Inter-insurer loss allocation by way of ‘other insurance’ clauses never permits allocation of a loss to the insured. Payment of the insured’s claim always takes priority over the allocation of the loss between concurrent insurers.” (internal citations omitted)).

sense, pro-policyholder—as compared with some alternative rules. But they are less pro-policyholder (and more pro-insurer) in that same sense than other alternative rules that the Restatement rejected. All of the rules adopted by the Restatement with respect to the duty to defend are consistent with the common law and likely to have socially desirable consequences and, thus, to be beneficial for the liability insurance market.

### C. *Duty to Make Reasonable Settlement Decisions*

Most liability insurance policies that give the insurer the obligation to provide a defense also give the insurer the discretion to settle the case, which means the power to decide which settlement offers (often tendentiously called “settlement demands” by lawyers for insurance companies) from plaintiffs to reject and which to accept. Invoking the duty of good faith and fair dealing, which is said to be an implied term in every contract, courts have long held that liability insurers have a duty to make reasonable settlement decisions.<sup>117</sup> The concern is that, in cases in which the potential liability in the underlying case exceeds the limits of coverage in the liability policy, the insurer has an incentive to gamble with the policyholder’s money: to reject reasonable settlement offers—which a party facing the entire liability would not have rejected—take the case to trial, and impose on the policyholder the risk of a judgment in excess of the policy limits.<sup>118</sup> Under the Restatement’s rule, if an insurer does this—rejects a reasonable settlement offer and takes the case to trial—the risk of an excess judgment shifts from the policyholder to the insurer.<sup>119</sup> This rule is consistent with the rule in many jurisdictions and is essentially the same as the rule adopted in those jurisdictions that follow Judge Keeton’s “disregard the limits” rule.<sup>120</sup> This rule also creates efficient

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<sup>117</sup> This duty is commonly referred to in the secondary literature and by some courts as the “duty to settle.” Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1116 (1990) (“For [a century], courts have invoked a doctrine known as ‘the duty to settle’ to impose liability on insurance companies who fail to settle lawsuits against the people they insure.” (footnote omitted)). The Restatement “uses the term ‘duty to make reasonable settlement decisions’ to emphasize that the insurer’s duty is not to settle every legal action, but rather to make reasonable decisions with respect to settlement.” RLLI § 24 cmt. a.

<sup>118</sup> RLLI § 24 cmt. a. It is worth noting that Priest’s analysis of the economics of insurance ignores such agency/opportunism costs.

<sup>119</sup> *Id.* As explained in the comments to § 24, the rule is somewhat more nuanced in application, requiring the policyholder to prove that a reasonable insurer would have accepted the offer. At least in theory it may be reasonable to refuse to accept a reasonable offer. See RLLI § 24 cmt. d & e (Council Draft No. 3, December 2016).

<sup>120</sup> See Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1160–61 (1954). See also, e.g., *Crisci v. Security Ins. Co.*, 426 P.2d 173, 176 (Cal. 1967) (“In determining whether an insurer has given consideration to the interests of the insured, the test is whether a prudent insurer without policy limits would have accepted the settlement offer.”).

settlement incentives—incentives to make decisions that maximize the joint well-being of policyholder and insurers.<sup>121</sup>

Priest seems not to object to the Restatement's settlement duty rule generally, beyond his complaint that the rule is excessively "mathematical" and would require the use of expert witnesses.<sup>122</sup> But he does object to the rules adopted by the Restatement for calculating damages for breach of the duty to make reasonable settlement decisions.<sup>123</sup> Under the rule adopted in the Restatement, if the policyholder proves that the insurer's unreasonable settlement decision resulted in the judgment against the policyholder in the underlying case (e.g., a tort case), the policyholder is entitled to the total amount of the underlying judgment, including any punitive damages assessed against the policyholder, as well as damages for any consequential harm caused to the policyholder—such as emotional distress or loss of business reputation.<sup>124</sup>

Priest objects to the inclusion of punitive damages on the grounds that many policies exclude such coverage and many jurisdictions regard such coverage as being against public policy.<sup>125</sup> He argues that the rule is essentially forcing insurers to provide, and preventing the states from forbidding, liability insurance coverage for the worst sort of behavior, the sort of behavior that qualifies for punitive damages.<sup>126</sup> Priest also objects to the inclusion of emotional distress damages as potential remedies. He says, in effect, that emotional distress damages are never awarded in contract cases. Thus, he argues, the Restatement is unjustifiably treating settlement duty cases as tort

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<sup>121</sup> See, e.g., Syverud, *supra* note 117 at 1164 (observing that the doctrine requires that insurers internalize "all of the costs of going to trial before rejecting a settlement").

<sup>122</sup> Priest, *supra* note 7, at 659. The rule is mathematical in the sense that the rule regards as important the expected value of the underlying suit, as calculated at the time the insurer's allegedly unreasonable settlement decision was made. The judge is asked to compare the expected value of likely trial count, or of the range of such values, with the settlement offer received. This sort of *ex post* evaluation of an *ex ante* determination is not different in kind from reasonableness analyses that courts are asked to do every day in many types of cases, including tort cases. And in many of those case, expert witnesses are asked to provide written or oral testimony.

<sup>123</sup> *Id.* at 661.

<sup>124</sup> RLLI § 27 cmt. *b.*

<sup>125</sup> Priest, *supra* note 7, at 660–61.

<sup>126</sup> *Id.* at 660 ("There are two serious problems with these proposals. First, most (though not all) insurance policies exclude coverage of punitive damages judgements . . . Second, and even more tellingly, many jurisdictions prohibit the insurance of punitive damages on grounds of public policy[.]") (internal footnotes omitted). It may not be surprising to learn that Priest provides no support for the empirical claim that most insurance policies exclude coverage of punitive damages. Our impression is to the contrary, but we acknowledge that we have not conducted the empirical research needed to answer that question (though we would be delighted to do so if the American Insurance Association would be willing to provide us access to the necessary data). Priest simply cites his 1989 Alabama Law Review article about the insurability of punitive damages, but that article does not provide any empirical support. Indeed, it suggests that our contrary impression is more likely to be correct. See *id.* at 660 n.101 (citing George L. Priest, *Insurability and Punitive Damages*, 40 ALA. L. REV. 1009, 1033 (1989) ("The puzzle remains . . . why insurers have not modified policies to exclude coverage of punitive liability despite invitations to do so by the courts." (footnote omitted))).

rather than contract cases.<sup>127</sup> With respect to both emotional distress damages and punitive damages, Priest notes: “I do not need to emphasize the radicalism of these views.”<sup>128</sup> He then goes on to point out that the rules permitting such damages, because of their radical pro-policyholder nature, will result in more costs being shifted to the insurance pool, premiums rising, and, ultimately, “will diminish insurance availability.”<sup>129</sup>

These arguments have several responses. First, the mistake in Priest’s reasoning with respect to whether settlement duty damages should include punitive damages awarded in the underlying suit against the policyholder is apparent. The Restatement expressly does not provide that liability insurers must cover such punitive damages or that a state’s expressed public policy to the contrary will be contravened.<sup>130</sup> Rather, the Restatement merely provides that, if the liability insurer’s unreasonable failure to settle the case against the policyholder *results in* punitive damages award against the policyholder in that case, the insurer must be held responsible.<sup>131</sup> For example, if a reasonable insurer would have accepted a settlement offer in a product liability suit that was within the limit of the policy, an insurer that rejected that settlement offer would be liable for the full amount of a subsequent verdict in excess of the policy limits, including any punitive damages component of that excess verdict. Thus, so long as the insurer makes reasonable settlement decisions, it will not have to pay for any punitive damages awards, unless of course the state jurisdiction permits coverage for punitive damages and the policy provides for that coverage (as many liability insurance policies do).

The punitive damages awarded against the policyholder in the underlying suit are a clearly foreseeable consequence of the insurer’s negligence; it makes complete sense that the insurer whose bad behavior caused this loss should be held responsible. The majority rule (in the strong sense, meaning more than half of the states) permits insurance for punitive damages.<sup>132</sup> Therefore, in most states the inclusion of a punitive damages judgment in the

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<sup>127</sup> *Id.* at 661.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> Indeed, RLLI § 47 expressly recognizes that some states prohibit such insurance on public policy grounds. *See* RLLI § 47, cmt. *i*. This point was also made clear in the April 2016 Tentative Draft, which addressed this topic in § 34, cmt. *j*.

<sup>131</sup> RLLI § 27, cmt. *d*.

<sup>132</sup> *See generally* Catherine M. Sharkey, *Revisiting the Noninsurable Costs of Accidents*, 64 MD. L. REV. 409 (2005) (discussing jurisdictions’ differing approaches to the insurability of punitive damages, including an appendix with a 50-state survey, and noting how underwriters and insurance brokers have begun to circumvent public-policy objections to insuring punitive damages by including “most favorable venue” language, “a kind of ‘choice-of-law’ provision that specifies, for example, that if an issue arises regarding punitive damages, the carrier will apply the law and public policy of an applicable state with the ‘most favorable’ view of insurance coverage for punitive damages.”). *Id.* at 438–39 n.149. Priest does not disclose that more than half of the states permit insurance of punitive damages and that the issue is undecided in many others.

damages for breach of the duty to make reasonable settlement decisions would be non-controversial. Thus, the RLLI rule is not radical, nor is likely to reduce insurance availability.<sup>133</sup>

Second, while it is true that the vast majority of judgments in contract cases do not include emotional distress or “pain and suffering” damages, it is not true that none do. One important exception, of course, is found in insurance cases.<sup>134</sup> The most famous example of such a case involved, of all things, a breach of the duty to settle.<sup>135</sup> Whether those cases are characterized as tort cases or contract cases ultimately does not matter. The result can be justified using either doctrinal lens: in the right circumstances, emotional distress harm can be the foreseeable consequence of a contract breach, just as it can be the reasonably foreseeable proximate result of a tort.<sup>136</sup> What’s more, there is no evidence that the liability insurance markets in California, for example, have been in any way negatively affected by allowing policyholders to recover damages for emotional distress when insurers breach the duty to make reasonable settlement decisions. If insurers come forward with evidence suggesting otherwise, which they will allow disinterested empirical legal studies

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<sup>133</sup> In the states with a public policy against insurance for punitive damages, only three high courts have had occasion to consider the question of whether such damages can be included as damages for breach of the duty to make reasonable settlement decisions. While all three have ruled to the contrary of the Restatement rule, two of those decisions were 4-3 decisions, with strong dissents. *See* PPG Indus., Inc. v. Transamerica Ins. Co., 975 P.2d 652, 661 (Cal. 1999) (Mosk, J., dissenting) (“Inasmuch as the insurer is liable to its insured for damages to compensate for *all* the detriment that it proximately caused by its tortious breach of its duty to settle the claim of the insured’s victim, and inasmuch as such detriment includes *any* sums that its insured became legally obligated to pay *its* victim as damages for its claim, it follows that the insurer is liable to the insured for damages to compensate for detriment in the form of the sum that its insured became legally obligated to pay *its* victim as *punitive damages* as well as *compensatory damages*.”). As to the possible moral hazard effect of the Restatement’s rule on this point, the idea that the policyholder will, when deciding whether to engage in the conduct that gave rise to the underlying claim, be influenced by the possibility that, in the event they are sued for harm caused by this behavior, their insurer might engage in unreasonable settlement behavior that will then make the insurer potentially liable for any punitive damages that might be assessed against the policyholder, seems farfetched, to say the least.

<sup>134</sup> *See, e.g.,* Campbell v. State Farm Mut. Auto. Ins., 65 P.3d 1134, 1166 (Utah 2001) (allowing recovery for emotional distress damages in a liability insurance action alleging breach of the insurer’s settlement duties).

<sup>135</sup> *See* Crisci v. Sec. Ins., 426 P.2d 173, 176 (Cal. 1967).

<sup>136</sup> RLLI § 27 cmt. *b* explains this point as follows:

Jurisdictions differ with regard to whether the duty to make reasonable settlement decisions is a contract duty, a tort duty, or both. Under the rules of contract law, a promisee is entitled to recover for loss that was foreseeable at the time of contracting as a probable result of a breach. By contrast, under the rules of tort law, foreseeability generally is assessed as of the time of the breach. Because of the expertise of insurers in assessing risks at the time of underwriting and in handling legal actions, they are likely in many, if not most, cases to be aware at the time of contracting of the kinds of consequences that follow from a lost opportunity to settle a legal action. Thus, it is hardly surprising that most courts have not explicitly considered the question of the timing of foreseeability, as the result would be the same either way in many cases, provided that the meaning of “foreseeable” is the same for both tort and contract law.

scholars to examine, we are confident that the ALI would be willing to consider it.

#### V. CONCLUDING WORDS ON THE RLLI AND 21ST CENTURY LIABILITY INSURANCE ECONOMICS

It should be clear by now that we have many disagreements with Professor Priest's article. Some of its critiques are addressed to proposals that are not part of the current draft of the Restatement. The arguments that do address the current draft of the Restatement grossly misrepresent the relationship between the Restatement and prevailing insurance law. And the article wrongly accuses the Restatement's Reporters of ignoring basic insurance economics in the drafting of the Restatement.

Strangely, it is actually Priest's article that ignores basic economics, at least as understood in the 21<sup>st</sup> Century. Specifically, his critique proceeds from the assumption that pro-policyholder rules (in his narrow *ex post* sense of that term) are socially undesirable because they will raise insurance prices and reduce the availability of coverage. That assumption could only always be true if two other assumptions were also true: namely, the assumption that liability insurance purchasers are perfectly informed and fully rational. If those assumptions sound familiar, it is because they are. They are the "Chicago School" assumptions that held sway when Priest helped to establish law and economics as a serious discipline back in the 1970s and 1980s.<sup>137</sup>

A lot has happened in the field of law and economics since then. Neither empirical law and economics, nor behavioral law and economics, nor the fuller development of the economics of asymmetric information have been kind to those assumptions, especially when it comes to insurance. The evidence against fully informed and perfectly rational insurance purchasers—especially but not only for consumers buying insurance—is overwhelming.<sup>138</sup> So much so that the few remaining defenders of the faith are left with argu-

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<sup>137</sup> See, e.g., Priest, *supra* notes 3–6. Cf. Mark Geistfeld, Note, *Imperfect Information, the Pricing Mechanism, and Products Liability*, 88 COLUM. L. REV. 1057, 1061 n.18 (1988) ("One commentator has concluded that judicial expansion of manufacturer products liability in tort leads to a less optimal provision of product safety. George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1349 (1981). But Professor Priest assumes perfect information about product risks, *id.* at 1307, and thus implicitly assumes that manufacturers supply optimal product safety independent of liability rules."). For a more recent criticism of Professor Priest's work, see Alvin E. Roth, *Marketplace Institutions Related to the Timing of Transactions: Reply to Priest* (2010), 30 J. LABOR ECON. 479 (2012) ("In this reply I will argue that Priest's theoretical model lends no support to his position, and that the empirical claims he makes are simply false.").

<sup>138</sup> See generally e.g., HOWARD C. KUNREUTHER, ET AL., *INSURANCE AND BEHAVIORAL ECONOMICS: IMPROVING DECISIONS IN THE MOST MISUNDERSTOOD INDUSTRY* (2013).

ments about the ability of *some* well informed and reasonably rational consumers to make the market work for *everyone*.<sup>139</sup> But recent theoretical and empirical work—specifically in the field of insurance—has demonstrated the falsity of even that more modest claim.<sup>140</sup> Indeed, as taught in graduate level economics courses today, insurance economics proceeds from a baseline understanding that there are significant market failures, especially in consumer insurance markets.<sup>141</sup>

Today, no serious economic analysis of liability insurance rules would ever proceed from the assumption that, when comparing two possible rules, the one that is more friendly to policyholders in the litigation context will necessarily be more socially costly and therefore reduce the availability of liability insurance. That is something to be investigated, not assumed. If there are market failures—for example, consumers who are less than fully informed about the terms of the policy, consumers who misestimate the likelihood or extent of their potential liabilities, insurers with market power, unfaithful insurance intermediaries—it could easily be the case that adopting the policyholder friendly rule could increase the availability of insurance. To know whether this would in fact be the case for any choice of rules takes *work*: good evidence or a compelling theory built on realistic assumptions.

The difficulty of that work is one reason why the Restatement of Liability Insurance Law does not rest primarily on liability insurance economics. Instead, as any Restatement must, it rests primarily on careful, exhaustive analysis of legal authority and on the high quality analytical skills that the American Law Institute brings to bear on any topic worthy of its attention. Yes, Reporters pay close attention to what can be gleaned from liability insurance law and economics, and sometimes use the language of law and economics to explain a legal rule, but those gleanings and that language play a supporting role.

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<sup>139</sup> See, e.g., Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979) (concluding that “the presence of at least some consumer search in a market creates the possibility of a ‘pecuniary externality’: persons who search sometimes protect non-searchers from overreaching firms.” (footnote omitted)).

<sup>140</sup> See e.g., Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505 (2006); Justin Sydnor, *(Over)insuring Modest Risks*, 2 AM. ECON. J.: APPLIED ECON. 177 (2010). See generally, Tom Baker & Peter Siegelman, *Behavioral Economics and Insurance Law: The Importance of Equilibrium Analysis*, in HANDBOOK OF BEHAVIORAL ECONOMICS AND LAW 491 (Doron Teichman & Eyal Zamir eds., 2014).

<sup>141</sup> When the project was a Principles project, the draft made a distinction in some rules between large commercial policyholders and other policyholders. That distinction reflected our understanding that the market failures are more pervasive in consumer liability insurance markets than commercial liability insurance markets. See PRINCIPLES OF THE LAW OF LIABILITY INSURANCE § 1 (T.D. Draft No. 1 2014) (defining large commercial policyholder). That distinction was dropped when the project became a Restatement because of a lack of support in the common law. It remains a sensible distinction for a legislature or an administrative agency to make, consistent with the concept that ALI Principles projects are directed at legislatures and administrative agencies rather than courts.



That supporting role is, however, an important one; and we heartily encourage our law and economics colleagues and the liability insurance industry to contribute to the debate. All we ask is that those contributions rest on a solid empirical foundation.<sup>142</sup> Indeed, were the liability insurance industry to make claims data publicly available, there would be many empirical legal studies scholars eager to use the data in their research. That would contribute not only to our understanding of the comparative effects of different liability insurance law rules but also to our understanding of the civil justice system of which liability insurance is such an integral part.

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<sup>142</sup> See Richard Thaler, *Behavioral Economics: Past, Present and Future*, 106 AM. ECON. REV. 1577, 1597 (2016) (“[I]t is time to fully embrace what I would call *evidence-based economics*. . . . In that sense, I think it is time to stop thinking about behavioral economics as some kind of revolution. Rather, behavioral economics should be considered simply a return to the kind of open-minded, intuitively motivated discipline that was invented by Adam Smith and augmented by increasingly powerful statistical tools and datasets.”).