October 6, 2017

Richard Revesz, Esquire
Executive Director
American Law Institute
4025 Chestnut Street
Philadelphia, PA 19104

RE: *Restatement of the Law, Liability Insurance*

Dear Mr. Revesz:

Last May, we wrote to express our concerns with respect to the Proposed Final Draft of the *Restatement of the Law, Liability Insurance* and, in particular, concerning several provisions that were at odds with the common law of insurance or would impede the ability of our members to represent policyholders pursuant to the tripartite relationship. Additionally we believed that, contrary to the Reporters' stated goals and expectations, some of the novel ideas proposed in this Restatement would engender more insurance coverage controversies and litigation. We therefore urged that further consideration be given to this Restatement before it received final approval from your Institute.

We are gratified that the ALI acknowledged these concerns and deferred a final vote until May 2018 to give the project's Reporters further time to consider and respond to the concerns that DRI and others expressed at the time. On August 4, the Reporters issued Preliminary Draft No. 4, including changes primarily in the Comment and Notes portions of the Draft. It is also our understanding that the ALI Reporters met with the project Advisers and others on September 7 and that some further revisions may be forthcoming before this revised draft is submitted to the ALI Council in January, preliminary to a final vote on this *Restatement* at your Annual Meeting in May 2018.

For almost sixty years, DRI has been committed to enhancing the skills and professionalism of defense lawyers. As part of its mission, it seeks to anticipate and address issues that are germane to defense lawyers and the civil justice system, including the effective operation of the civil justice system—and to promote the public's understanding and confidence in the civil justice system. A large percentage of our membership is engaged in the defense of civil suits in which they are hired by liability insurance companies to represent policyholders in tort cases. As such, we believe DRI has a nuanced understanding of the issues that the *Restatement of the*

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Law of Liability Insurance is addressing and the consequences the draft provisions in this Restatement will have for the practice of law in this area.

While we appreciate that consideration of the issues DRI raised in its submissions last spring is ongoing, our members continue to have deep concerns with the *Restatement*, particularly the respect to the following sections:

Section 3: *Principles of Policy Interpretation*

We remain concerned that the proposed abandonment of the "plain meaning" rule will make coverage litigation more protracted and expensive. Additionally, the substitution of a new "presumption of plain meaning" approach in place of settled insurance law can only diminish the credibility of this Restatement in the eyes of common law judges.

Notwithstanding the rules for Restatements set forth in the ALI Style Manual, it is apparent from the Comments to this latest draft that the Reporters' "presumption" approach is entirely novel and an effort on the part of the Reporters to create a new rule that purportedly would fall somewhere between the well-established majority "plain meaning" rule in insurance law, and the view of a handful of courts that looks to context as a means of dividing a "latent ambiguity" in otherwise plain language.

We are also concerned that opening the door to extrinsic evidence would significantly increase the complexity, duration and cost of insurance coverage litigation. Certainly, Section 3's endorsement of the relevance of extrinsic evidence as a source of policy meaning would open the door to far more discovery than is presently the case.[1] Section 3(2) would make summary judgment less available and disputes more protracted, thus imposing substantial added costs on the parties and the courts, possibly without changing the outcome of the dispute. We do not share the hopeful suggestion in Comment b. that courts will serve as gatekeepers against abusive or frivolous discovery by requiring insureds to present some "offer of proof" of textual meaning before allowing wide-ranging discovery of extrinsic evidence in such cases. Those increased costs, together with the increased uncertainty in outcomes, particularly under a rule allowing the insured alone to defeat the plain meaning of the insurance contract, will negatively impact the affordability of insurance.

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1 We also note that the Comments to Section 3 do not provide guidance to common law courts with respect to the sort of extrinsic evidence that might be allowed to establish a "more reasonable" interpretation of meaning than that apparent from the text of the policy itself. While the Reporters have provided two Illustrations in their Comments to this Section, both result in a finding that the textual meaning is controlling.

Respectfully, whatever the creative merits of Reporters' novel "presumption" approach, we think that will either result in more courts finding ambiguity by reference to extrinsic evidence or courts questioning the merits of this Restatement as a whole as adopting an approach that is so alien from the rules that they have followed for decades.

--*Liability of Insurer for Conduct of Defense* (Section 12)

As revised, Section 12 introduces vicariously liability for insurers if defense counsel is an employee of the insurer, and direct liability if the insurer "has undertaken a duty to select defense counsel and the insurer breaches that duty, including by retaining counsel with inadequate professional liability insurance" or where "the insurer has undertaken a duty to supervise defense counsel and the insurer breaches that duty."

The Comments to Section 12 do not explain the basis for a new rule imposing vicarious liability for the legal malpractice of employees who defend policyholders, although one may assume that this part of the section is directed at so-called "staff counsel" operations and assumes a right of control by the insurance company. However, the Reporters' proposal is at odds with the reality of insurer staff counsel operations. While these lawyers are employed by insurers, these law firm operations are required to operate autonomously and insurers have no more right of direct control over the attorneys' strategic decisions in the defense of policyholders than they do over the independent professional judgment of outside counsel.

Unlike true agent-principal situations, an insurer has no more right of control over staff counsel than any other defense counsel employed by that insurer. For instance, the *Restatement, Third, Law Governing Lawyers* § 134(2), which concerns a third-party directing the actions of a lawyer, states that:

> (2) A lawyer's professional conduct on behalf of a client may be directed by someone other than the client if:
>
> (a) the direction does not interfere with the lawyer's independence of professional judgment;
>
> (b) the direction is reasonable in scope and character, such as by reflecting obligations borne by the person directing the lawyer; and

(c) the client consents to the direction....

The independence of the attorney's professional judgment is paramount; it cannot be overridden by insurer direction or control of defense counsel whether or not the attorney is an employee of the insurer. For this reason, imposing vicarious liability on an insurer for the actions of employee defense counsel has been rejected by the courts and should be rejected here as well. If the Restatement were to retain Section 12 as written, there is little doubt that the impact of such a rule would be to impede the attorney-client relationship of such defense counsel with the policyholder, and to tread on counsel's professional obligations.

We therefore disagree with and do not understand the basis for ever imposing direct liability on insurers over the judgments of defense counsel, whether they are employees of insurers or simply paid by them.

Section 12(2) is equally, if not more, troubling. It would impose a new legal duty on insurers that is not supported by existing authority and is at odds with professional liability rules and the law governing lawyers. Section 12 would introduce a new theory of liability for insurers for negligently "selecting" or "supervising" any defense counsel, with further liability in the event defense counsel has "inadequate" malpractice insurance. This appears to envision direct liability of insurers to policyholders for the conduct of defense counsel, in the event such counsel was negligently selected or supervised.

The proposed basis for insurer liability introduced in Section 12(2) is at odds with existing law, including regulation of the legal profession in many jurisdictions. Existing cases hold that an insurer is not liable for the litigation decisions of counsel. *See, e.g., Marlin v. State Farm Mut. Auto. Ins. Co.*, 761 So. 2d 380, 381 (Fla. Dist. Ct. App. 2000). Creating a new basis for direct liability of insurers to policyholders where the insurer negligently selected or supervised defense counsel, in the event of malpractice or other misfeasance by defense counsel, would encourage greater intrusion by insurers into their professional services.

Specifically, Section 12(2) appears to envision direct liability of insurers to policyholders for the independent professional conduct of defense counsel, in the event such counsel allegedly was negligently selected or supervised. This liability is not supported by agent-principal law for the same reasons that vicarious liability of the insurer for malpractice of defense counsel who is an employee of the insurer is not supported by the law: under applicable professional responsibility standards, the insurer cannot control the decisions of the attorney, who must exercise independent professional judgment. Any direction or "supervision" of defense

counsel's professional activity must yield to the attorney's independent judgment. Any attempted direction by a third-party insurer must not "interfere with the lawyer's independence of professional judgment." *Restatement of the Law (Third), The Law Governing Lawyers* § 134.

We are also troubled by Section 12(2)'s provision that insurers may be liable if they select defense counsel with insufficient professional liability insurance and we question the utility or practicality of this provision. To begin with, we do not see the need for such a rule. Nearly all of our members maintain malpractice coverage and DRI maintains relationships with qualified brokers to arrange quality coverage for our members. Moreover, liability insurers insist annually upon proof of this coverage as a basis for naming law firms to their panels of defense counsel.

Section 12 not only seeks to address a problem which does not exist, it creates an impracticable rule that lacks any safeguards against unfairness. There is certainly no objective basis for assessing how much coverage is enough, nor does Comment d. even seek to supply guidance to courts or counsel. Inevitably, therefore, some sort of *post hoc* standard would be applied that would unreasonably generate malpractice suits against counsel and law suits against insurers more out of sympathy for victims than any rational evaluation of what risks should have been insured against.

We are also deeply concerned by Section 12(3)'s vagueness with respect to the "supervision" that would warrant direct liability. It is our understanding the Reporters explained at the Advisors' meeting on September 7 that they are only intending to impose liability in cases where the insurer somehow controls the conduct of defense counsel and that a mere engagement letter or the issuance of Billing Guidelines would not give rise to liability. In reality, however, insurers choose to manage litigation through a strategic partnership with outside counsel that involves consultation and frequent inter-actions. While the ultimate decision with respect to legal matters necessarily rests with counsel, consistent with the Rules of Professional Conduct, insurers are not mere passive participants in the process, as the Comments to Section 12 suggest. There is a difference, however, between having input into the conduct of an insured's defense, and overtly directing or condoning improper conduct by defense counsel.

The proposals in Section 12 reflect a lack of familiarity with the current litigation management practices of liability insurers. The proposed rules do not reflect an understanding that, when an insurance company hires a lawyer to defend its policyholder, there may be discussions between the insurer and defense counsel with respect to the insured's possible exposure, whether the case should be settled

and a proposed course of strategy for resolving the claim favorably. At the same time, the fact that such discussions occur falls far short of the approach that common law courts have nearly universally adopted, wherein insurers are only held liable for misconduct on the part of defense counsel if they directly caused or contributed to these acts or omissions. We strongly urge the Reporters to reconsider this Section.

If adopted, Section 12 would alter the law regarding defense counsel's independence, as well as insurer liability for negligence or other professional breach by attorneys. The effect of the proposed innovations in this Section would be to impede the relationship between defense counsel and policyholders, and tread on the professional independence and ethical obligations of defense counsel. For these reasons, DRI submits that Section 12 of the draft Restatement of the Law, Liability Insurance should be deleted in its entirety. Insofar as the Reporters feel that some version of Section 12 be retained, we would recommend that it be as follows:

> An insurer may only be liable for the negligence of defense counsel if the insurer overtly directed defense counsel's negligent acts or omissions.

--*Remedies-Mitigation and Fee-shifting* (Sections 48, 49(3) and 51(1))

DRI also continues to have concerns regarding the remedies provisions in the draft *Restatement*. First and most fundamentally, these sections omit any recognition of a duty to mitigate damages. It is well established that a party seeking recovery under a contract has a duty to mitigate its damages and cannot recover for loss that the injured party could have avoided without undue risk, burden or humiliation. See Restatement (Second) of Contracts § 350 (1981). The Restatement should therefore include the duty to mitigate damages in its discussion of remedies. Currently, there is no acknowledgment whatsoever of the important principle of mitigation. DRI therefore urges that the introductory sentence to Section 48 be amended to read:

> The damages recoverable by an insured for breach of a liability insurance policy include those listed below, except that damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation.

Next, while much of Section 48 mirrors the common law remedies available to prevailing policyholders, Section 48(4) is misleading in its punishment of insurers that bring declaratory judgment actions but are ultimately held to owe coverage. In some states, notably Illinois, insurers may face drastic estoppel consequences if they

fail to bring declaratory judgment actions. In all states, declaratory relief is the favored remedy for an insurer to obtain court guidance clarifying the scope of its coverage obligations. It makes no sense at all, therefore, to punish insurers for doing what courts have recommended that they do to obtain certainty on the scope of their obligations. Ironically, under Section 48(4), an insurer might actually be in a stronger position strategically if it simply refused to defend and did not file a declaratory judgment action, than would be the case if it did seek court guidance. Moreover, in many cases the *Restatement* actually forces insurers to seek a court determination of when a duty to defend is terminated under Section 18(8). It should not do so and then also endorse the potential for fee-shifting in the event the insurer does not prevail in such a required court action.

The better approach on fee-shifting is reflected in Section 48(3), which provides that available remedies include court costs or attorneys' fees to a prevailing party "when provided by legislation." Rather than reinforcing the legislative prerogative and otherwise following the longstanding common law American rule, the other Sections endorse, in varying degrees (and with confusing differences and possible distinctions), what is essentially one-way attorney fee shifting. But only a handful of jurisdictions allow attorney fee shifting as a matter of common law in insurance disputes.

The overwhelming majority of states either do not permit attorney fee shifting or do so as a matter of specific statutory law. *See, e.g., ACMAT Corp. v. Greater New York Mut. Ins. Co.*, 923 A.2d 697, 699 (Conn. 2007) (rejecting fee-shifting for prevailing insured in declaratory judgment action where the "sole issue in this appeal is whether we should adopt a common-law exception to the American rule" in absence of bad faith by the insurer). The *Restatement* lacks adequate common law support for its fee-shifting proposals, and fails to give appropriate deference to the existence of specific statutes addressing potential one-way attorney fee shifting. To resolve the myriad problems created by these Sections, the *Restatement* should simply defer to states' existing law with respect to potential fee-shifting. *See* 1 Allan D. Windt, Insurance Claims & Disputes: Representation of Insurance Companies and Insureds § 8:14 (5th ed. 2007) (analyzing the multiple theories put forth in support of allowing insureds to recover attorneys' fees incurred in a declaratory judgment action and concluding that courts "have failed, in the few cases in which they have tried, to provide any persuasive justification for those rules").

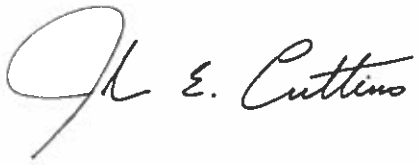
We also note that the case law cited in the Note for Section 48(4) is misleading in the extreme. Apart from New York, only a tiny number of states permit recovery of fees where the insurer is the plaintiff. Most of the cases cited in the Note either rely on state statutes or other bases for awarding fees to

policyholders. With respect to Sections 49(3) and 51(1), the *Restatement* also enters into an area carefully considered and resolved by state legislatures and fails to defer to the legislatures' determinations of whether and when it may be appropriate to divert from the American Rule and permit fee-shifting in insurance law disputes.

As the leading voice of the defense bar, DRI has decades of experience anticipating and addressing issues relating to defense lawyers and the civil justice system. In addressing this *Restatement* project, DRI has carefully considered the effective operation of the civil justice system and the ability of its membership to carry out their roles in the defense of civil suits in which they are hired by liability insurance companies to represent policyholders in tort cases. At this point, we are greatly concerned that the problems with the *Restatement* draft that DRI raised in its submissions last spring still have not been corrected, and that this project continues on a trajectory that is deeply flawed in several important respects, including in its rejection of settled insurance common law such as the plain meaning rule, its failure to recognize the fundamental problems that would result from its proposal for insurer liability for the actions of defense counsel, and its refusal to defer to legislative determinations such as those regarding whether and when special fee-shifting rules should be applied to insurance law.

DRI respectfully and urgently calls on the ALI leadership and the ALI Council to review this Restatement project and especially the issues highlighted in this letter. Thank you for your attention to our concerns.

Very truly yours,



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