Restatement of the Law of Liability Insurance: Restatement or Recreation?

Authored by ALFA International Attorney:

Angela M. Higgins
BAKER STERCHI COWDEN & RICE
Kansas City, MO
higgins@bscr-law.com
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Introduction

- Passed in May 2018 after a one-year delay in voting
- Policyholder-oriented
- Many entirely new principles and minority rather than majority rules
- Began as a Principles of Law project – aspirational rather than reflecting settled legal holdings
- Internally inconsistent in many respects
- Concerns expressed by several states that it usurped the highly state-specific legislative and regulatory schemes for insurance
  - Ohio – RLLI “does not constitute the public policy of Ohio” – Ohio Revised Code of Insurance, Title XXXIX, Chapter 3901.82
  - Several governors sent letters protesting drafts of the RLLI – Iowa, Maine, Nebraska, South Carolina, Texas and Utah – stating that the ALI was usurping the state legislatures and RLLI was at odds with the common law

Policy Interpretation – Exclusions

A. THE RLLI LANGUAGE

§ 32 Exclusions

(1) An “exclusion” is a term in an insurance policy that identifies a category of claims that are not covered by the policy.

(2) Whether a term in an insurance policy is an exclusion does not depend on where the term is in the policy or the label associated with the term in the policy.

(3) Exclusions are interpreted narrowly.

(4) Unless otherwise stated in the insurance policy, words in an exclusion regarding the expectation or intent of the insured refer to the subjective state of mind of the insured.

(5) An exception to an exclusion narrows the application of the exclusion; the exception does not grant coverage beyond that provided in the insuring clauses.
B. WHY IT IS PROBLEMATIC

The RLLI proposes that any exclusion related to the expectation or intent of the insured should be determined by the subjective state of mind of the insured. RLLI proposes that even the insured’s statement of his/her state of mind can be disregarded – “even an insured’s admission of intent to harm is subject to cross-examination and the jury’s assessment of credibility.” Comment d.

Furthermore, RLLI suggests that as to exclusions such as sexual abuse, physical and mental abuse, etc., “The default rule is that such exclusions are severable, meaning that they apply only to insureds whose conduct meets the requirements of the exclusion.” Comment c. That is not an accurate statement of the law, which depends upon the precise language of the exclusion, including whether the exclusion applies to “the insured” or to “any insured.” In policies with severability or “separation of insureds” language, claims against each insured are evaluated separately for coverage, but there is considerable case law distinguishing between “the insured” and “any insured” language, where “any insured” language will exclude coverage for all insureds if any of them has engaged in the excludable conduct. See, e.g., Am. Family Mut. Ins. Co. v. Copeland-Williams, 941 S.W.2d 625, 629-30 (Mo. App. E.D. 1997) (“The use of the phrase ‘any insured’ makes the exclusionary clause unambiguous even in light of the severability clause. . . . [it] unambiguously precludes coverage to all persons covered by the policy if any one of them engages in excludable conduct.”).

Moreover, many modern exclusions are written to exclude coverage for particular claims and losses, without regard to the insured’s intent, including the sexual, physical, and mental abuse exclusions. Courts interpreting this kind of policy language have

RLLI mentions, in passing, that some states have adopted an inferred-intent approach to the insured’s subjective intent with sexual molestation claims, but otherwise takes no position that intent may (and should) be inferred or determined on an objective basis in many circumstances. Not only does this raise significant questions of how the insurer could prove the insured’s subjective state of mind, it is inconsistent with well-established law in all jurisdictions that will infer intent as to certain conduct as a matter of public policy, including sex abuse and other criminal conduct.

As discussed below, it is clearly distasteful and inappropriate to allow insureds who have engaged in certain conduct to advance an argument regarding whether they subjectively believed that their victims would welcome, rather than be harmed by, offensive behavior. Moreover, the principle that the insured is deemed to intend the reasonable and probable consequences of his/her voluntary acts, an objective standard for intent, is a widely-accepted standard that serves public policy and preserves the resources of the courts and parties.
1. **Sexual abuse and expected/intended exclusions**

Many modern policies will have a specific sexual abuse/molestation exclusion. However, practitioners can face a lack of case law interpreting their specific exclusion(s) or a policy that lacks a sex abuse-specific exclusion, including in older policies. Historically, sex abuse has been addressed, in whole or in part, through expected/intended exclusions.

A person who sexually molests a minor is deemed as a matter of law to have expected and intended to cause harm or injury. *See, e.g., B.B. v. Cont'l Ins. Co.,* 8 F.3d 1288, 1296 (8th Cir. 1993) (applying Missouri law).

Forcing the insurer to indemnify the insured “subsidizes the episodes of sexual abuse of which its victims complain, at the ultimate expense of other insureds to whom the added costs of indemnifying child molesters will be passed.” . . . “The average person purchasing homeowner’s insurance would cringe at the very suggestion that he was paying for [coverage for liability arising out of his sexual abuse of a child]. And certainly he would not want to share that type of risk with other homeowner’s policy holders.” *B.B.*, 8 F.3d at 1295 (citations omitted).

“The inference or inferred-intent standard in cases of sexual molestation is now the unanimous rule among jurisdictions that have considered the issue.” *B.B.*, 8 F.3d at 1293.

The rationale behind the inferred-intent standard is based on the inherently harmful nature of child molestation. . . . Courts have stated that “acts of sexual molestation against a minor are so certain to result in injury to that minor that the law will infer an intent to injure on behalf of the actor without regard to his . . . claimed intent.” . . . “in the exceptional case of an act of child molestation, cause and effect cannot be separated; that to do the act is necessarily to do the harm which is its consequence; and that since unquestionably the act is intended, so also is the harm.” . . . “the very essence
of child molestation is the gratification of sexual desire. The act is the harm. There cannot be one without the other. Thus the intent to molest is, by itself, the same thing as intent to harm.”

B.B., 8 F.3d at 1293.

When an adult subjects a minor to “unwanted and unconsented to sexual contact,” the perpetrator is deemed as a matter of law to have intended and expected the resulting physical and psychological damages, even if the perpetrator “believed in some perverse way” that his conduct would be welcomed by the minor. State Farm Fire & Cas. Co. v. Caley, 936 S.W.2d 250, 252 (Mo. App. W.D. 1997). “Missouri case law specifically holds that a person engaging in sexual misconduct against a minor intends to cause any resulting injuries.” California Cas. Gen. Ins. Co. v. Nelson, 2014 U.S. Dist. LEXIS 191438, *15-16 (W.D. Mo. Dec. 22, 2014).

With a “unanimous rule” for legally inferred intent as to acts of sexual abuse, is there a place for the RLLI’s subjective intent standard? In the modern climate of “me too” and a growing awareness and litigation of sex abuse, who has the appetite to argue for a subjective standard of intent as to such conduct? Although we might expect any jurisdictions tempted to adopt the subjective intent standard to try to carve out sex abuse against minors, for the same reasons that intent is inferred for this type of behavior, intent is properly inferred or judged on an objective basis for many types of conduct.

2. Criminal acts and expected/intended exclusions

Although many policies will include a criminal acts exclusion, the expected/intended exclusion is often used to address conduct that constitutes a crime,
particularly under commercial policies. Many jurisdictions apply an inferred-intent standard to this exclusion as a matter of public policy.

In *James v. Paul*, 49 S.W.3d 678 (Mo. 2001), the Missouri Supreme Court agreed with an insurer that it was entitled to summary judgment on the question of the applicability of its intended/expected acts exclusion based upon the insured’s plea of guilty in a criminal case arising out of the same underlying conduct that gave rise to the civil case. 49 S.W.3d at 682.

If issue preclusion is not permitted, Paul will, in effect, be insulated by an insurer from the full brunt of economic responsibility resulting from his admittedly intentional criminal act. This runs contrary to the public policy of Missouri. . . . Both James and Paul stood to profit from Paul’s duplicity in admitting intentional wrongdoing in the criminal proceeding while, in effect, denying it in the present case. Applying collateral estoppel in this situation serves to prevent the potential of collusive litigation as well as promoting the other policies of finality, consistency and judicial economy discussed above.

*James*, 49 S.W.3d at 687-88 (citation omitted).

“[W]here the insured made a judicial admission as part of a prior judicial determination in a criminal case that the insured's conduct was intentional,” a court considering the application of an intended/expected exclusion is also required to presume that the insured’s conduct was intentional. *James*, 49 S.W.3d at 689. “The criminal conviction foreclosed [the insured] and any party claiming through him from asserting that his conduct was not intentional.” *Id.* (emphasis added).

Again, there are significant public policy considerations underlying an inferred-intent approach to the expected/intended acts exclusions commonly found in liability policies. RLLI’s suggestion that a subjective intent standard is preferred, which would
place the burden on the insurer to establish the insured’s state of mind, is inconsistent with well-developed precedent in most jurisdictions.

Duty to defend

C. THE RLLI LANGUAGE

§ 13. Conditions Under Which the Insurer Must Defend

(1) An insurer that has issued an insurance policy that includes a duty to defend must defend any legal action brought against an insured that is based in whole or in part on any allegations that, if proved, would be covered by the policy, without regard to the merits of those allegations.

(2) For the purpose of determining whether an insurer must defend, the legal action is deemed to be based on:

   (a) Any allegation contained in the complaint or comparable document stating the legal action; and

   (b) Any additional allegation known to the insurer, not contained in the complaint or comparable document stating the legal action, that a reasonable insurer would regard as an actual or potential basis for all or part of the action.

(3) An insurer that has the duty to defend under subsections (1) and (2) must defend until its duty to defend is terminated under § 18 by declaratory judgment or otherwise, unless facts not at issue in the legal action for which coverage is sought and as to which there is no genuine dispute establish that:

   (a) The defendant in the action is not an insured under the insurance policy pursuant to which the duty to defend is asserted;

   (b) The vehicle or other property involved in the accident is not covered property under a liability insurance policy pursuant to which the duty to defend is asserted and the defendant is not otherwise entitled to a defense;

   (c) The claim was reported late under a claims-made- and-reported policy such that the insurer’s
performance is excused under the rule stated in § 35(2);

(d) The action is subject to a prior and pending litigation exclusion or a related claim exclusion in a claims-made policy;

(e) There is no duty to defend because the insurance policy has been properly cancelled; or

(f) There is no duty to defend under a similar, narrowly defined exception to the complaint-allegation rule recognized by the courts in the applicable jurisdiction.

§ 14. Duty to Defend: Basic Obligations

When an insurance policy obligates an insurer to defend a legal action:

(1) Subject to the insurer’s right to terminate the defense under § 18, the insurer has a duty to provide a defense of the action that:

   (a) Makes reasonable efforts to defend the insured from all of the causes of action and remedies sought in the action, including those not covered by the liability insurance policy; and

   (b) Requires defense counsel to protect from disclosure to the insurer any information of the insured that is protected by attorney–client privilege, work-product immunity, or a defense lawyer’s duty of confidentiality under rules of professional conduct, if that information could be used to benefit the insurer at the expense of the insured;

(2) The insurer may fulfill the duty to defend using its own employees, except when an independent defense is required; and

(3) Unless otherwise stated in the policy, the costs of the defense of the action are borne by the insurer in addition to the policy limits.
§ 18. Terminating the Duty to Defend a Legal Action

An insurer’s duty to defend a legal action terminates only upon the occurrence of one or more of the following events:

(1) An explicit waiver by the insured of its right to a defense of the action;

(2) Final adjudication of the action;

(3) Final adjudication or dismissal of parts of the action that eliminates any basis for coverage of any remaining parts of the action;

(4) Settlement of the action that fully and finally resolves the entire action;

(5) Partial settlement of the action, entered into with the consent of the insured, that eliminates any basis for coverage of any remaining parts of the action;

(6) If so stated in the insurance policy, exhaustion of the applicable policy limits;

(7) A correct determination by the insurer that it does not have a duty to defend the legal action under the rules stated in § 13; or

(8) Final adjudication that the insurer does not have a duty to defend the action.

§ 21. Insurer Recoupment of the Costs of Defense

Unless otherwise stated in the insurance policy or otherwise agreed to by the insured, an insurer may not seek recoupment of defense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs.

§ 33. Timing of Events That Trigger Coverage

(1) When a liability insurance policy provides coverage based on the timing of a harm, event, wrong, loss, activity, occurrence, claim, or other happening, the determination of the timing is a question of fact.

(2) A liability insurance policy may define a harm, event, wrong, loss, activity, occurrence, claim, or other happening
that triggers coverage under a liability insurance policy to have taken place at a specially defined time, the timing of which is also a question of fact, even if it would be determined for other purposes to have taken place at a different time.

§ 45. Insurance of Liabilities Involving Aggravated Fault

(1) Except as barred by legislation or judicially declared public policy, a term in a liability insurance policy providing coverage for defense costs incurred in connection with any legal action is enforceable, including but not limited to defense costs incurred in connection with: a criminal prosecution; an action seeking fines, penalties, or punitive damages; and an action alleging criminal acts, expected or intentionally caused harm, fraud, or other conduct involving aggravated fault.

(2) Except as barred by legislation or judicially declared public policy, a term in a liability insurance policy providing coverage for civil liability arising out of aggravated fault is enforceable, including civil liability for: criminal acts, expected or intentionally caused harm, fraud, or other conduct involving aggravated fault.

(3) Whether a term in a liability insurance policy provides coverage for the defense costs and civil liability addressed in subsections (1) and (2) is a question of interpretation governed by the ordinary rules of insurance policy interpretation.

D. WHY IT IS PROBLEMATIC

1. Duty to defend continues until the insurer has made a “correct determination” that it has no duty to defend under § 13, or “final” adjudication that it has no duty to defend.

Initially, the insurer cannot make its own “correct determination” that it has no duty to defend where there is no “occurrence,” offense, “wrongful act,” etc., even though it is the insured’s burden to prove that the claim is within the scope of the insuring agreement under the default rule of the common law. Similarly, § 13 does not identify the insured’s failure to satisfy the policy’s conditions for coverage, including,
significantly, the duty to give notice and to cooperate, as bases upon which the insurer may deny or terminate a defense. Many jurisdictions hold that it is the insured’s burden to prove compliance with the policy’s conditions, including the duty to cooperate. See, e.g., Steadfast Ins. Co. v. Purdue Frederick Co., No. X08CV020191697S, 2005 Conn. Super. LEXIS 3286, at *8 (Super. Ct. Nov. 29, 2005). There is ample case law supporting the proposition that not only does pre-suit conduct by the insured in breach of its obligations under the policy obviate a duty to defend, the duty to defend may be terminated by the insured’s breach during the course of the claim. See, e.g., Arton v. Liberty Mutual Ins. Co., 163 Conn. 127, 302 A.2d 284 (1972). RLLI simply abrogates the insurer’s contractual rights under the policy, with no firm support in well-established case law.

The RLLI proposes that the insurer must also litigate the applicability of any exclusions other than the prior/pending litigation exclusion. This would include exclusions such as the sexual molestation, criminal acts, “your work,” professional liability, and many similar commonly-applicable exclusions. One of the most common coverage questions presented is the contractor seeking coverage under a CGL policy for faulty work, and under the RLLI the insurer would apparently have a duty to defend these claims to the bitter end despite clear case law in most jurisdictions that CGL policies do not afford coverage for professional errors and omissions by contractors in the performance of their contracts. See, e.g., Owings v. Gifford, 237 Kan. 89, 94, 697 P.2d 865 (1985) (“the [CGL] insurance policy is not a performance bond or a guarantee of contract performance. A house built or being constructed by an insured builder is the
work product of the builder and under the exclusion clause of the policy no coverage is provided the insured for damages due to faulty construction.”).

“Final adjudication” means the exhaustion of all appeals. Because the appellate process can reasonably be expected to take longer than the course of litigation of the underlying civil claim, this proposition effectively negates the insurer’s contractual right to deny a defense for uncovered claims. RLLI also proposes that the insurer has no right to recoupment of defense costs. Moreover, the RLLI’s position is inconsistent with the position of a significant number of jurisdictions (including what are regarded as policyholder-friendly jurisdictions) that an insurer may terminate its defense upon its discovery of facts placing the claim outside of coverage. See, e.g., Scottsdale Ins. Co. v. MV Transportation, 36 Cal. 4th 643, 661, 31 Cal. Rptr. 3d 147, 115 P.3d 460 (2005); Certain Underwriters at Lloyd’s London v. Mestmaker, No. F066016, 2014 Cal. App. Unpub. LEXIS 3021, at *27 (Apr. 29, 2014).

2. Requires the insured’s consent to settlement of covered claims

Where the insurer is defending without a reservation of rights, it has the contractual right to control the investigation, defense, and settlement of claims under the policy. The RLLI cites no legal authority for the proposition that a majority of courts have held, as the ALI suggests in § 18(5), that the insured’s consent is required to settle covered claims under the policy, leaving uncovered claims unresolved. Why would the presence of uninsured claims in the action give the insured veto power over the insurer’s contractual right to control settlement of covered claims?
3. Whether there was an occurrence within the policy period becomes a fact question that precludes summary disposition.

One of the most remarkable positions taken by the RLLI is in § 33, which suggests that it is a fact question whether there is a trigger of coverage. In describing this language, Comment a expressly discusses this “trigger” in terms of whether there is an occurrence within the policy period. In Comment b, “Because all liability insurance policies are issued for a defined policy period, all liability insurance policies have some trigger of coverage.” Comment d expressly suggests that, “Determining whether the required event took place during the required period involves the application of the policy, as interpreted by the court, to the facts,” and suggests that unless the facts are undisputed the matter cannot be resolved with a trial.

The tripartite relationship

The reimagining of the tripartite relationship is perhaps the part of the RLLI that ventures farthest afield from any “restatement” of existing legal principles.

E. THE RLLI LANGUAGE

§ 11. Confidentiality

(1) An insurer or insured does not waive rights of confidentiality with respect to third parties by providing to the insured or the insurer, within the context of the investigation and defense of a legal action, information protected by attorney–client privilege, work-product immunity, or other confidentiality protections.

(2) An insurer does not have the right to receive any information of the insured that is protected by attorney–client privilege, work-product immunity, or a defense lawyer’s duty of confidentiality under rules of professional conduct, if that information could be used to benefit the insurer at the expense of the insured.
§ 12. Liability of Insurer for Conduct of Defense

(1) If an insurer undertakes to select counsel to defend a legal action against the insured and fails to take reasonable care in so doing, the insurer is subject to liability for the harm caused by any subsequent negligent act or omission of the selected counsel that is within the scope of the risk that made the selection of counsel unreasonable.

(2) An insurer is subject to liability for the harm caused by the negligent act or omission of counsel provided by the insurer to defend a legal action when the insurer directs the conduct of the counsel with respect to the negligent act or omission in a manner that overrides the duty of the counsel to exercise independent professional judgment.

F. WHY IT IS PROBLEMATIC

1. It is not a “restatement”

A restatement should express the majority view of the law, except in rare instances where that majority view has become outdated and there is a clear trend away from it. These changes are not a “restatement” of existing law, but rather a wholesale creation of new law. As noted by DRI in its opposition to the 2017 draft, Section 12 “would create new direct liability on the part of the insurer to the insured for the acts of defense counsel” with no support from the case law.

This is not an entirely insurer-oriented problem. Policyholders, too, should be concerned about greater intrusion into the attorney-client relationship between insured and defense counsel. Facing potential liability for negligent selection or “supervision” of counsel, we would expect insurers to exert greater influence over defense counsel. Moreover, this is in tension with provisions that defense counsel is not permitted to share certain information or communications with the insurer. If these provisions of RLLI are adopted, there would be a new and real conflict of interest between the insurer
and the insured, placing defense counsel in an untenable and practically unworkable position.

2. **The insurer faces potential liability but is foreclosed from managing the defense in such a way as to limit its exposure.**

   These sections of the RLLI propose to render insurers liable to insureds for mistakes by defense counsel, while at the same time preventing the insurer from receiving a full account from defense counsel of any information that defense counsel deems he/she should not share with the insurer. Indeed, as discussed in the above section, if the insurer is defending under a reservation of rights, the insurer is required to pay for independent counsel, and the insured is free to act without the insurer’s consent. It appears that the actions of independent counsel, who are not controlled by the insurer but who might be “selected” by the carrier, could subject the insurer to liability even though the insurer has no meaningful opportunity to supervise or control defense counsel.

   Some jurisdictions have case law addressing insurer liability for the professional negligence of insurer-retained defense counsel. However, there is by no means a consensus on this issue such that the RLLI’s approach could be said represent a “restatement” of the law. “The question of whether an attorney appointed to represent an insured to defend a claim is an agent for the insurer is one that has divided courts, and often turns on specific facts.” Remodeling Dimensions, Inc. v. Integrity Mut. Ins. Co., 819 N.W.2d 602, 615 (Minn. 2012). Some jurisdictions hold that the insurer does not have the necessary opportunity to control defense counsel’s conduct that would justify rendering the insurer vicariously liable for acts or omissions of the attorney. See, e.g., Ingersoll-Rand Equip. Corp. v. Transp. Ins. Co., 963 F. Supp. 452, 454 (M.D. Pa.
1997) (stating that an attorney's ethical obligations to the insured "prevent the insurer from exercising the degree of control necessary to justify the imposition of vicarious liability"); *Lifestar Response of Ala., Inc. v. Admiral Ins. Co.*, 17 So. 3d 200, 214-18 (Ala. 2009) (imposing no vicarious liability for defense attorney's alleged negligence because insurer could not control attorney's professional judgment).

Others take a compromise approach:

In the typical situation in which an insurer hires an attorney to defend an insured, the relationship of the insurer and its attorney is precisely that of principal to independent contractor. For example, the attorney is engaged in the distinct occupation of practicing law, and this occupation is one in which the attorney possesses special skill and expertise. . . . Finally, and obviously, the practice of law is not, nor could it be, part of the regular business of an insurer.

*Givens v. Mullikin*, 75 S.W.3d 383, 393-94 (Tenn. 2002). However, “an insurer can be held vicariously liable for the acts or omissions of an attorney hired to represent an insured when those acts or omissions were directed, commanded, or knowingly authorized by the insurer.” *Id.* at 395.

Even under this approach, however, the insurer can face liability only if it expressly directed the conduct of defense counsel at issue. The RLLI approach would render the insurer liable for “negligent selection of defense counsel,” not for specific actions or omissions that the insurer directed the defense attorney to undertake.

3. **Defense counsel is required to “hide the ball” from the insurer**

Defense counsel hired by the insurer is required to keep from the insurer any privileged information if the information could be used to benefit the insurer at the expense of the insured. While there is existing case law in many jurisdictions that prevents an insurer from directing defense counsel to develop a coverage case against the insured, what is new is this notion that defense counsel, who typically does
represent the insurer in the tripartite relationship, is obligated to hide from the insurer information that is pertinent to the insurer’s interests.

Unfettered communication with both clients on the subject of the joint representation is therefore a practical necessity. Both are directly interested in the case, its progress and any material developments, counsel's litigation and trial strategy, his assessments of the merits and likelihood of success, his views on whether the case ought to be tried or settled, and myriad other issues, many of which require expression of counsel's strategic judgments and mental impressions. In communicating with the insurer on these matters, the attorney is rendering advice and counsel to a client as a necessary aspect of his representation, both of the insurer and of the insured.


Some jurisdictions expressly hold that both defense counsel and the insured have a duty to disclose to the insurer relevant information regarding the claim and defense. *See, e.g., Cont'l Cas. Co. v. St. Paul Surplus Lines Ins. Co.*, 265 F.R.D. 510, 518 (E.D. Cal. 2010). This is a contractual duty on the part of the insured, and an ethical obligation by the defense counsel. Furthermore, some courts have held that the insured does not have a reasonable expectation that information it communicates to defense counsel will be privileged and withheld from the insurer that has hired defense counsel for the action. *Northwood Nursing & Convalescent Home, Inc. v. Continental Ins. Co.*, 161 F.R.D. 293, 297 (E.D. Pa. 1995).

Notably, there is a significant absence of established case law regarding what information an attorney may ethically withhold from its insurer client in a tripartite relationship, so the RLLI’s position is in no respect a “restatement” of the existing law on this question. A number of courts to have considered the issue have held that the insurer is entitled to be completely informed of information related to the defense of the
claim. Obviously, information that is relevant to a coverage issue (such as intent) is likely to be highly relevant to the defense as well. RLLI proposes no practical approach to defending claims here, and fails to recognize that in the ordinary course of the defense facts discovered will bear on both the defense to liability and the insurer's coverage position.

Moreover, RLLI seeks to intrude upon the individualized ethical obligations imposed upon attorneys by weighing in upon what defense counsel may or may be required to withhold from insurers in a tripartite relationship in which defense counsel is also deemed to represent the insurer. This is not the place of RLLI, and is not a "restatement" of insurance law, but a statement on professional ethics. It would also seem to open the door for plaintiffs’ counsel to seek to discover information communicated to the insurer by defense counsel on the argument that, where the insurer is not permitted to receive the information under § 11, there is no attorney-client relationship between the insurer and defense counsel.

Independent counsel

G. THE RLLI LANGUAGE

§ 16. The Obligation to Provide an Independent Defense

When an insurer with the duty to defend provides the insured notice of a ground for contesting coverage under § 15 and there are facts at issue that are common to the legal action for which the defense is due and to the coverage dispute, such that the action could be defended in a manner that would benefit the insurer at the expense of the insured, the insurer must provide an independent defense of the action.

§ 17. The Conduct of an Independent Defense

When an independent defense is required under § 16:
(1) The insurer does not have the right to defend the legal action;

(2) The insured may select defense counsel and related service providers;

(3) The insurer is obligated to pay the reasonable fees of the defense counsel and related service providers on an ongoing basis in a timely manner;

(4) The insurer has the right to associate in the defense of the legal action under the rules stated in § 23; and

(5) The rules stated in § 11 govern the insured’s provision of information to the insurer.

H. WHY IT IS PROBLEMATIC

1. Right to independent counsel upon issuance of reservation of rights

The majority rule is that an insurer has a duty to defend a liability claim if there is even an arguable basis for coverage. The accepted approach, where the insurer must defend but reasonably questions coverage, is to issue a reservation of rights letter. The insurer is at a clear disadvantage, as compared to the parties embroiled in the dispute, regarding the underlying facts of the claim. RLLI suggests that there is something nefarious about an insurer’s reservation of rights, but insurers are routinely obligated to undertake a defense on short notice with minimal knowledge of the facts.

conflict of interest does not arise every time the insurer proposes to provide a defense under a reservation of rights”). If the insurer must provide independent counsel, and surrender control of the defense as suggested by RLLI, the insurer is precluded from exercising its contractual right to control the defense if it asserts its contractual rights to disclaim coverage. This is an outlier position, not a “restatement.”

2. **Communications with the insurer are not shielded by attorney-client privilege**

   Where counsel is independent, he/she does not have an attorney-client relationship with the insurer. Accordingly, communications with the insurer are not protected by the attorney-client privilege. Instead, the RLLI assures us that these communications would be protected by a “common interest” doctrine. However, many jurisdictions do not have a well-developed body of law on the common interest doctrine. Where such law exists, often the interests must be **identical** for the common interest to apply. See, e.g., *Ayers Oil Co. v. Am. Bus. Brokers, Inc.*, 2009 U.S. Dist. LEXIS 111928, *5 (E.D. Mo. Dec. 2, 2009). The RLLI establishes, by virtue of the provisions on reservations of rights and the supposed resulting need for independent counsel, as well as by the tripartite provisions discussed above, that the interests of the insured and insurer are not identical.

3. **The insurer must provide independent counsel, but the insured “may” select that counsel.**

   Under § 16, if the insurer issues a reservation of rights, it “must” provide independent counsel. However, under § 17, the insured “may” select that counsel. The gap here anticipates that there will be circumstances in which the insurer is obligated to supply independent counsel, but the insured leaves that selection up to the insurer. Under other provisions of the RLLI discussed above, the insurer would, presumably,
then face potential liability for the conduct of the defense by the counsel that it selected, all the while being precluded from controlling the defense and existing in a tenuous environment with respect to attorney-client privilege for its communications. Liable for failing to supervise defense counsel, but unable to do so.

**Insured’s duty to cooperate**

I. THE RLLI LANGUAGE

§ 29. The Insured’s Duty to Cooperate

When an insured seeks liability insurance coverage from an insurer, the insured has a duty to cooperate with the insurer. The duty to cooperate includes the obligation to provide reasonable assistance to the insurer:

(1) In the investigation and settlement of the legal action for which the insured seeks coverage;

(2) If the insurer is providing a defense, in the insurer’s defense of the action; and

(3) If the insurer has the right to associate in the defense of the action, in the insurer’s exercise of the right to associate.

§ 30. Consequences of the Breach of the Duty to Cooperate

(1) An insured’s breach of the duty to cooperate relieves an insurer of its obligations under an insurance policy only if the insurer demonstrates that the failure caused or will cause prejudice to the insurer.

(2) If an insured’s collusion with a claimant is discovered before prejudice has occurred, the prejudice requirement is satisfied if the insurer demonstrates that the collusion would have caused prejudice to the insurer had it not been discovered.

§ 25. The Effect of a Reservation of Rights on Settlement Rights and Duties

(1) A reservation of the right to contest coverage does not relieve an insurer of the duty to make reasonable settlement
decisions stated in § 24, but the insurer is not required to cover a judgment on a non-covered claim.

(2) Unless otherwise stated in an insurance policy or agreed to by the insured, an insurer may not settle a legal action and thereafter demand recoupment of the settlement amount from the insured on the ground that the action was not covered.

(3) When an insurer has reserved the right to contest coverage for a legal action, the insured may settle the action without the insurer’s consent and without violating the duty to cooperate or other restrictions on the insured’s settlement rights contained in the policy if:

(a) The insurer is given a reasonable opportunity to participate and is kept reasonably informed of developments in the settlement process;

(b) The insured makes a reasonable effort to obtain the insurer’s consent or approval of the settlement;

(c) The insurer declines to withdraw its reservation of rights after receiving prior notice of the proposed settlement; and

(d) The settlement agreed to by the insured is one that a reasonable person who bears the sole financial responsibility for the full amount of the potential covered judgment would make.

J. WHY IT IS PROBLEMATIC

Initially, the recognition that collusion with a claimant would constitute a breach of the duty to cooperate is useful, though why the insurer must still demonstrate that such “collusion” would be prejudicial (rather than such prejudice being implied) is questionable. Notable is how the duty to cooperate is conceived of as very much bare-minimum conduct by the insured – even collusion is not a breach unless it is or, if completed would have been, prejudicial to the insurer. The RLLI thus conceives of the
obligations under an insurance policy as almost entirely running in one direction, from the insurer to the insured.

Allowing the insured to settle a claim without the insurer’s consent merely because it has issued a reservation of rights letter is not a “restatement” of the law. This is the bad faith set up, in many ways worse than the Missouri problem. Missouri allows this because it treats a reservation of rights as an inherent, unwaivable conflict of interest between the insurer and insured. But Missouri does not provide for independent counsel. RLLI requires provision of independent counsel, not controlled by the insurer, if there is a reservation of rights, to address the perceived conflict, then still allows the insured to settle/submit to judgment. The insurer has no meaningful right to control the defense/settlement if it issues a reservation of rights. RLLI proposes that an insurer can only exercise its contractual right to control the defense and settlement of claims if it waives its contractual rights to limit or deny coverage based on its policy language.

Bad faith

K. THE RLLI LANGUAGE

§ 19. Consequences of Breach of the Duty to Defend

An insurer that breaches the duty to defend a legal action forfeits the right to assert any control over the defense or settlement of the action.

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

(1) When an insurer has the authority to settle a legal action brought against the insured, or the insurer’s prior consent is required for any settlement by the insured to be payable by the insurer, and there is a potential for a judgment in excess
of the applicable policy limit, the insurer has a duty to the insured to make reasonable settlement decisions.

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

(3) An insurer’s duty to make reasonable settlement decisions includes the duty to make its policy limits available to the insured for the settlement of a covered legal action that exceeds those policy limits if a reasonable insurer would do so in the circumstances.

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

An insurer that breaches the duty to make reasonable settlement decisions is subject to liability for any foreseeable harm caused by the breach, including the full amount of damages assessed against the insured in the underlying legal action, without regard to the policy limits.

§ 36. Assignment of Rights Under a Liability Insurance Policy

(1) Except as otherwise stated in this Section, rights under a liability insurance policy are subject to the ordinary rules regarding the assignment of contract rights.

(2) Rights of an insured under an insurance policy relating to a specific claim that has been made against the insured may be assigned without regard to an anti-assignment condition or other term in the policy restricting such assignments.

(3) Rights of an insured under an insurance policy relating to a class of claims or potential claims may be assigned without regard to an anti-assignment condition or other term in the policy restricting such assignments, if the following requirements are met:

(a) The assignment accompanies the transfer of financial responsibility for the underlying liabilities insured under the policy as part of a sale of corporate assets or similar transaction;

(b) The assignment takes place after the end of the policy period; and
(c) The assignment of the rights does not materially increase the risk borne by the insurer.

§ 49. Liability for Insurance Bad Faith

An insurer is subject to liability to the insured for insurance bad faith when it fails to perform under a liability insurance policy:

(a) Without a reasonable basis for its conduct; and

(b) With knowledge of its obligation to perform or in reckless disregard of whether it had an obligation to perform.

§ 50. Remedies for Liability Insurance Bad Faith

The remedies for liability insurance bad faith include:

(1) Compensatory damages, including the reasonable attorneys’ fees and other costs incurred by the insured in the legal action establishing the insurer’s breach of the liability insurance policy and any other loss to the insured proximately caused by the insurer’s bad-faith conduct;

(2) Other remedies as justice requires; and

(3) Punitive damages when the insurer’s conduct meets the applicable state-law standard.

L. WHY IT IS PROBLEMATIC

1. **Bad faith is a highly state-specific cause of action**

   Bad faith, as a cause of action, is one of the most distinct and individualized expressions of each jurisdiction’s public policy. There is no uniform agreement as to whether “bad faith” is a contractual or tort cause of action, and state-specific expressions of what conduct rises to the level of “bad faith.” It is, therefore, a difficult subject for a “restatement” of the law.
2. Failure to settle

Initially, RLLI reformulates an existing cause of action commonly known as “bad faith failure to settle” or “bad faith refusal to settle” as simply a “breach of the duty to make reasonable settlement decisions.” Comment a to § 24 makes it clear that liability is imposed for less than a bad faith state of mind on the part of the insurer, but for simple negligence. RLLI construes the standard of care in terms of “commercial reasonableness.” As is clear from Comment c, it is a “disregard the limits” remedy, which blows up the limits even in the absence of wrongful intent by the insurer. Amazingly, the RLLI argues that this is a more lenient approach than “strict liability,” with the Comment b the only nod in the entire RLLI to any interest in preventing the bad faith setup, while citing no authority for the proposition that any jurisdictions presently impose a strict liability standard for failure to settle.

This is not a “restatement.” The Reporter’s Note to § 24 cites treatises rather than case law in support of the contention that this is a “majority rule,” and admits, without clearly addressing the issue, that liability for failure to settle is determined by different standards of “bad faith” or negligence by the various jurisdictions. Remarkably, the Reporter’s Note to § 27, in claiming that the majority of jurisdictions have adopted the principle, cite to cases establishing the measure of damages for “bad faith failure to settle,” without noting that this section is the measure of damages for a breach of duty to settle that is not predicated in “bad faith.”

The RLLI approach would eliminate the minimal protections afforded to insurers in some notorious “set up” states like Missouri. Every reported Missouri case involving insurer bad faith, beginning with Zumwalt v. Utilities Ins. Co., 228 S.W.2d 750 (Mo. 1950), limits liability to a bad faith refusal of an offer to settle within or for the liability
policy’s limits. See id. at 754 (bad faith for insurer to refuse reasonable settlement offer within liability limits and instead gamble on escaping liability by favorable verdict); Landie v. Century Indem. Co., 390 S.W.2d 558, 564-66 (Mo. App. K.C. 1965) (the insurer’s duty is to give good faith consideration to settlement offers within the liability limits; insurer’s refusal to accept such offer, if in bad faith, entitles insured to recover); Levin v. State Farm Mut. Ins., 510 S.W.2d 455, 458 (Mo. banc 1974) (offer to settle within liability limits is a “necessary predicate” to bad faith claim); Bonner v. Auto. Club Inter-Ins. Exch., 899 S.W.2d 925, 928 (Mo. App. E.D. 1995) (not only must there be an offer to settle within the liability limits, but also the offer must be definite in amount); Ganaway v. Shelter Mut. Inc. Co., 795 S.W.2d 554, 556 (Mo. App. S.D. 1990) (insurer liability results from failure to exercise good faith in considering offers to compromise within liability limits). An offer to “settle” within policy limits is a “necessary prerequisite” for a claim for bad faith in Missouri. Levin, 510 S.W.2d at 458. The “good faith” contemplated by the law is a duty to give consideration to settlement offers within the liability limits. Landie, 390 S.W.2d at 564-66. The RLLI would eliminate the need for the policy-limits demand to trigger potential bad faith liability in Missouri, and other similar jurisdictions.

Moreover, the RLLI would propose to blow up the policy limits without addressing circumstances in which the insurer’s position on settlement was based upon its coverage analysis. Again, even in insurer-hostile jurisdictions, this kind of liability generally requires more than an erroneous denial of coverage. See, e.g., Shobe v. Kelly, 279 S.W.3d 203, 211-12 (Mo. App. W.D. 2009).
3. **Bad faith**

Punitive damages are the only additional remedy brought to the table by the bad faith cause of action, with RLLI’s proposed standard for failure to settle already accomplishing the elimination of the policy’s liability limits and recovery of the insured’s attorneys’ fees and consequential damages. Again, the RLLI is lacking in case law support for this approach.

Many courts will define “bad faith” as a “state of mind” consisting of the insurer’s “‘intentional disregard of the financial interest of [the] insured in the hope of escaping the responsibility imposed upon [the insurer] by its policy.’” *Scottsdale Ins. Co. v. Addison Ins. Co.*, 448 S.W.3d 818, 828 (Mo. banc 2014). Often, evidence must establish that the insurer “intentionally disregarded” the insured’s financial interests in the hope of escaping its responsibility under the policy. *Rinehart v. Shelter Gen. Ins. Co.*, 261 S.W.3d 583, 595 (Mo. App. W.D. 2008). The principle is that the insure

4. **The measure of damages**

The RLLI fails to address a critical topic – how to measure the insured’s damages for bad faith failure to settle. There is a significant question as to whether courts should presume that the amount of the underlying judgment equals the amount of the judgment or settlement entered into by the insured.

This includes circumstances in which the insured has protected itself from the impact of a judgment in excess of its policy limits by virtue of a covenant not to execute against the insured’s assets, a/k/a a “Mary Carter” agreement, an agreement pursuant to Mo. Rev. Stat. § 537.065, etc. The essence of a bad faith cause of action is that the insured suffered tangible economic loss as a result of its insurer’s tortious refusal to settle claims against it. However, where the insured has not suffered these tangible
economic losses, including by virtue of a covenant not to execute, there is case law in many jurisdictions holding that the insured has sustained no actual damages. Allowing a party in such circumstances to collect all or part of the judgment amount:

perpetrates a fraud on the court, because it bases the recovery on an untruth, i.e., that the judgment debtor may have to pay the judgment. Such a result should be against public policy, because it allows, as here, parties to take a sham judgment by agreement, without any trial or evidence concerning the merits, and then collect all or a part of that judgment from a third party. Allowing recovery in such a case encourages fraud and collusion and corrupts the judicial process by basing the recovery on a fiction.... [T]he courts are being used to perpetrate and fund an untruth.

*H.S.M. Acquisitions, Inc. v. West*, 917 S.W.2d 872, 882 (Tex. App. Corpus Christi 1996) (citations omitted). The Texas court found that the consent judgment entered by the parties pursuant to the covenant not to execute could not be enforced against the insurer in a bad faith action. *Id.*

Moreover, Courts have found that a judgment entered into by the insured with the injured party need not even have been collusive for a court to refuse to give it any weight in determining the amount of insured’s damages in a bad faith action against his insurer. *See Hamilton v. Maryland Casualty Co.*, 117 Cal. Rptr. 2d 318, 327 (Cal. 2002). “A defending insurer cannot be bound by a settlement made without its participation and without any actual commitment on its insured’s part to pay the judgment.” *Id.* RLLI is astonishingly silent on these issues.
Additional Insureds and Other Insurance

M. THE RLLI LANGUAGE

§ 20. When Multiple Insurers Have a Duty to Defend

When more than one insurer has the duty to defend a legal action brought against an insured:

(1) The insured may select any of these insurers to provide a defense of the action;

(2) If that insurer refuses to defend or otherwise breaches the duty to defend, the insured may select any of the other insurers that has a duty to defend the action; and

(3) The selected insurer must provide a full defense until the duty to defend is terminated pursuant to § 18 or until another insurer assumes the defense pursuant to subsection (4)(a).

(4) If the policies establish an order of priority of defense obligations among them, or if there is a regular practice in the relevant insurance market that establishes such a priority, that priority will be given effect as follows:

   (a) An insurer selected pursuant to subsection (1) or (2) may ask any insurer whose duty to defend is earlier in the order of priority to assume the defense; and

   (b) An insurer that incurs defense costs has a right of contribution or indemnity for those costs against any other insurer whose duty to defend is in the same position or earlier in the order of priority.

(5) If neither the policies nor the insurance-market practice establish an order of priority:

   (a) The duty to defend is independently and concurrently owed to the insured by each of the insurers;

   (b) Any nonselected insurer has the obligation to pay its pro rata share of the reasonable costs of defense of the action and the noncollectible shares of other insurers; and
(c) A selected insurer may seek contribution from any of the other insurers for the costs of defense.

N. WHY IT IS PROBLEMATIC

It is admittedly not a restatement of the law – Comment a acknowledges that courts have developed a body of case law regarding “other insurance” clauses and priority of coverage. This is presented as a reimagining of the approach under the common law. The RLLI also suggests that it is necessary to “protect[] insureds from having to hire an insurance-coverage expert to determine which insurer to ask for a defense.” Comment a. This is frankly absurd – insureds with multiple potentially-applicable policies routinely tender to carriers for all potentially-triggered policies and leave them to ascertain how the defense is provided. The notion that the insured has, or should be entitled to enforce, any preference as to which policy defends is not well-founded, and certainly not a “restatement” of the state of existing law.

Furthermore, in the additional insured context, the AI is given the option to choose which policy defends. This disregards that the loss risk for general contractors is priced into their policies based upon the expectation that they will, in the ordinary course of business, have additional insured status under subcontractors’ policies that would ordinarily defend. The RLLI approach proposes to usurp the terms of the subcontract agreements, which typically address whether AI coverage is available on a primary, co-primary, or secondary basis, and whether contribution is permitted. These contracts are separate and distinct from the insurance policies at issue, and the RLLI cites no well-established body of case law that would override the enforceable provisions of underlying indemnity agreements.