PASICH LLP

The New

Restatement of the Law, Liability Insurance

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Table of Contents

Introduction

The American Law Institute was founded in 1923. The Institute's members include U.S. Supreme Court justices, judges of the highest courts of most states, law school deans, professors, and private practitioners. Putting it simply, when the Institute speaks, courts and others tend to listen.

Now, for the first time in its storied history, the American Law Institute has spoken on the subject of liability insurance. It has published the *Restatement of the Law, Liability Insurance* (Revised Proposed Final Draft No. 2, Sept. 7, 2018).

According to the Institute, "Restatements are primarily addressed to courts. They aim at clear formulations of common law and its statutory elements or variations and reflect the law as it presently stands or might appropriately be stated by a court." *Id*., Restatements (Excerpt of the Revised Style Manual approved by the ALI Council in January 2015).

The purpose of this *Restatement*, like any other Restatement, is described as follows by the Institute:

> [W]hat a Restatement can do that a busy common-law judge, however, distinguished, cannot is engage the best minds in the profession over an extended period of time, with access to extensive research, testing rules against disparate fact patterns in many jurisdictions.
> . . . .
> It will operate to produce agreement on the fundamental principles of the common law, give precision to use of legal terms, and make the law more uniform throughout the country. Such a restatement will also effect changes in the law, *which it is proper for an organization of lawyers to promote* and which make the law better adapted to the needs of life.

Id.

The *Restatement of the Law, Liability Insurance* has been a long time coming. It has been the subject of seven Institute annual meetings and a lengthy back-and-forth process involving more than 160 lawyers representing insurers, insureds, and others. As drafts were proposed and revised, there were heated debates among the various constituent groups. The drafting process produced 29 drafts presented formally in Institute meetings.

Restatements can be important and influential, particularly in jurisdictions

where the law on a given subject is neither deep nor broad, or where a particular issue has not been addressed. Therefore, we do not expect that the *Restatement* will be a significant vehicle for a change in existing law in jurisdictions like California, New York, and Illinois, where there already exists a deep body of insurance law. But, that is not to say that it will have no effect in those states. On issues of "first impression," or issues that have not been addressed for some time, the *Restatement* may prove influential. Also, when the law of a jurisdiction varies from that suggested in the *Restatement*, advocates will use the *Restatement* to support a change in the law. And, it is likely that citations to the *Restatement* will be used to provide additional support for a point. Indeed, courts already have begun citing the *Restatement*. *See*, *e.g.*, *Endurance Am. Specialty Ins. Co. v. Bennington Group, LLC*, No. BC 535853, 2017 WL 4225945, at *4 (Cal. Los Angeles Super. Ct. Aug. 22, 2017, quoting March 28, 2017 proposed final draft regarding "misrepresentation").

While there's a lot in the new *Restatement* that could be talked about, we focus on ten topics.

1. Insurance Policy Interpretation

As the *Restatement* recognizes,

> There are two main approaches to the interpretation of contracts that fid support in the common law of insurance: The contextual approach and the plain-meaning approach. Under the contextual approach, which was adopted in the Restatement Second of Contracts, courts interpret insurance policy terms in light of all the circumstances surrounding the drafting, negotiation, and performance of the insurance policy. Under the plain-meaning approach, which is typically followed in insurance law, courts interpret an insurance policy terms on the basis of its plain meaning, if it has one.

Restatement, § 3, Comment a.

The *Restatement* describes the plain-meaning approach as the one that is "typically followed in insurance law." The California Supreme Court has said, on multiple occasions, that the "'clear and explicit' meaning of [insurance policy and other contract] provisions, interpreted in their 'ordinary and popular sense,' unless 'used by the parties in a technical sense or a special meaning is given to them by usage,' controls judicial interpretation." *AIU Ins. Co. v. Superior Court*, 51 Cal. 3d 807, 822 (1990) (citation omitted). Notwithstanding such statements, it is generally recognized that California follows the contextual approach. *See id*., § 30, Reporter's Note a; *Bay Cities Paving & Grading, Inc.*

v. Lawyers' Mut. Ins. Co., 5 Cal. 4th 854, 867 (1993) ("'*Language in a contract* must be construed in the context of that instrument as a whole, and in the circumstance of that case.'").

The *Restatement* also comments on evidence to be considered in determining a policy's "plain meaning" that could be influential:

> Some courts that follow a plain-meaning rule also consider custom, practice, and usage when determining the plain meaning of insurance policies entered into between parties who can reasonably be expected to have transacted with knowledge of that custom, practice, or usage. When such sources of meaning can be discerned from public sources and with only limited discovery (such as through an affidavit of an expert in the trade or business, who is subject to deposition, but without the need for extensive document requests), this is the better approach. Informed insurance-market participants conduct their business in light of custom, practice, and usage in the insurance market and in the trade or business being insured. . . . [C]ustom, practice, and usage inform the court's determination of the objective meaning of insurance policy terms in the relevant market, as distinguished from the specific or subjective intent of a particular party. . . .
>
> Consideration of custom, practice, and usage at the plain-meaning stage does not open the door to extrinsic evidence such as drafting history, course of dealing, or precontractual negotiations. . . .
>
> . . . There should be no need to take discovery to discern prima facie, the existence of a custom, practice, or usage. Each party should be knowledgeable of custom, practice, and usage in its own trade or business; insurers should have access to information outside of discovery regarding custom, practice, and usages in the trades or businesses that they insure; and insureds should have access outside of discovery to insurance brokers and others with knowledge of the insurance industry.

Id., § 3, Comments b-c, at 18-19.

The *Restatement* also addresses how to resolve an ambiguity:

> An ambiguous policy term is a term that lacks a plain

> meaning in the context of the claim at issue, *i.e.*, a term that has at least two interpretations to which the language of the term is reasonably susceptible when applied to the facts of the claim in question . . . . This definition follows the traditional insurance-law approach pursuant to which the competing interpretations need not be equally reasonable for a term to be ambiguous. All that is required is that the language of the policy be reasonably susceptible to the coverage-promoting interpretation urged by the insured.

Id., § 3, Comment f, at 21. *See id.*, § 4, Comment a, at 33 ("All that is required is that the language of the policy be reasonably susceptible to the coverage-promoting interpretation urged by the insured.").

In this regard, the *Restatement*'s approach is quite similar to California's. *See MacKinnon v. Truck Ins. Exch.*, 31 Cal. 4th 635, 655 (2003) ("even if [an insurer's] interpretation is considered reasonable, it would still not prevail, for in order to do so it would have to establish that its interpretation is the *only* reasonable one"); *Ticketmaster, LLC v. Illinois Union Ins. Co.*, 524 F. App'x 329, 331-32 (9th Cir. 2013) (fee exclusion does not apply to class action lawsuit regarding false representations regarding delivery fees and order-processing charges because insurer "failed to satisfy its burden of showing that . . . its interpretation of [the exclusion] is the *only* reasonable one").

In assessing ambiguity, the *Restatement* allows consideration of the ease with which alternative language could have been drafted:

> In determining the meaning of an ambiguous term, it is appropriate to consider the difficulty of redrafting the insurance policy to more plainly express the meaning urged by the drafting party, ordinarily the insurer, taking into account that some residual risk of ambiguity is to be expected. The easier it would be for the drafter to state that meaning more plainly, the more likely it is that the other party's proposed meaning is the meaning that a reasonable policyholder would give to the term. This approach creates an incentive for insurers to draft insurance policy terms that provide clear guidance regarding the scope of the risks insured under their policies.

Id., § 4, Comment k, at 40.

The *Restatement* also recognizes that ambiguity may be construed against an insurer even if the language was suggested by the insured:

> [T]he fact that a policyholder requested that one insurer use a standard-form term taken from an insurance policy drafted by another insurer should not as a matter of course result in the application of the *contra proferentem* rule against the policyholder in the event of a dispute regarding the meaning of that term. . . . If a policyholder requests an insurer to use a standard-form term that the insurer does not ordinarily use, the parties can choose to apply the ordinary contract-law *contra proferentem* rule to that term, pursuant to which the term would be interpreted against the policyholder. To avoid dispute, the parties' intention to adopt such a different interpretive rule for a standard-form term selected by the policyholder should be incorporated in the endorsement to the insurance policy or in another writing clearly assented to by the parties. In no event should the *contra proferentem* rule by applied against an insured unless the policyholder in fact drafted or supplied the term.

Id., § 4, Illustration 3.l, at 41-42. This, too, is consistent with California law. *See AIU Ins. Co. v. Superior Court*, 51 Cal. 3d 807, 823 n.4 (1990) ("The insurers have submitted evidence . . . that [the insured] individually negotiated the policies in question. This evidence does not, however, shed light on the meaning to be ascribed to the coverage provisions at issue here. These provisions . . . are adopted verbatim from standard form policies used throughout the country. For this reason, even if the policies were 'negotiated' in a broad sense, this fact has little bearing on construction of the specific policy language in question here.").

2. Broker/Agent Representations Regarding Coverage

Section 6 of the *Restatement* states:

> A party to an insurance policy who makes a promise or representation that can reasonably be expected to induce detrimental reliance by another party to the policy is estopped from denying the promise or representation if the other party does in fact reasonably and detrimentally rely on that promise or representation.

Id., § 6, at 62. The *Restatement* explains:

> In general, it is reasonable for a policyholder or applicant for insurance to rely on the representations of the insurer's agent with respect to the meaning and significance of questions in the

> insurance application or renewal process, as well as to what will and will not be covered by the policy. Thus, even if the promise or representation of an insurer's agent contradicts the clear language of the policy, it will generally be reasonable for the policyholder to rely on that promise or representation.

Id., § 6, Comment c, at 63.

California law is in accord. *See Desai v. Farmers Ins. Exch*., 47 Cal. App. 4th 1110, 1119 (1996) (insurance agent represented to insured that he was receiving the level of coverage requested, only for the insured to later discover that he did not receive such coverage; "[a]n insurance agent has an 'obligation to use reasonable care, diligence, and judgment in procuring insurance requested by an insured'"); *Papersavers, Inc. v. Nacsa*, 51 Cal. App. 4th 1090 (1996) (summary judgment against insured on duty issue reversed when there was evidence the agent suggested a "replacement cost coverage" endorsement and negligently explained the endorsement was sufficient to replace all lost or damaged property regardless of policy limits).

3. An Insurer's Receipt of Confidential Information

There has been considerable debate about what information is to be shared with an insurer that has reserved its rights to deny. California has addressed this issue, at least in part, in Civil Code section 2860. Section 2860 provides that when an insurer has a duty to defend and reserves rights that create a conflict of interest between it and its insured, then the insured has the right to be represented by independent counsel paid for by the insurer. Cal. Civ. Code § 2860(a). In that circumstance, the insured and its independent counsel have a duty "to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes . . . . Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party." *Id*., § 2860(d).

However, section 2860 applies, by its terms, only when an insurer has a duty to defend and only when an insurer is honoring that duty. Therefore, if an insured or its counsel discloses privileged information or attorney work product to a non-defending insurer (including an excess insurer or an insurer whose policy obligates it to pay defense costs, but has not actually undertaken the defense of an insured), there is a risk of privilege waiver. *See*, *e.g.*, *Continental Cas. Co. v. St. Paul Surplus Lines Ins. Co*., 265 F.R.D. 510, 525 (E.D. Cal. 2010) ("[T]he attorney-client privilege has never been extended to cover communications among an insured, defense counsel, and an insurer that is not defending its insured without reservation, let alone an insurer that is not defending its insured at all."); *Durkin v. Shields (In re Imperial Corp. of Am.)*, 167 F.R.D. 447, 452-

53 (S.D. Cal. 1995) (underlying plaintiffs entitled to discover litigation assessments provided by insured's counsel to its directors and officers liability insurer when letters were written for purposes of apprising insurer of case status, insurer did not have a duty to defend and did not defend the insured, and the insured did not share a common legal representation with the insurer).

The *Restatement* takes a somewhat different view. It recognizes that

> [a]n 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.

Restatement, § 11, at 109. It states that this protection also applies "when the insured or the insurer provides the information to an intermediary such as a broker or claims administrator." *Id*., § 11, Comment a, at 109.

However, the *Restatement* goes on to state:

> An insurer that is not providing a defense should also be regarded as an agent of the insured for purposes of receiving confidential information related to the legal action, because the insurer may subsequently be called upon to pay a settlement or a judgment on behalf of the insured or, in some cases, even to take over the defense on behalf of the insured. A non-defending insurer should also come within the scope of the common-interest rule, pursuant to which disclosure of privileged information by parties within a common interest is protected as against third persons, with the caveat that some authorities require that both parties be represented by counsel with respect to the matter.

Id., § 11, Comment b. It also provides "A note of caution," warning: The rule stated in this Section is not universally followed. *Id*., § 11, Illustrations 2.b, at 110.

The *Restatement* also notes that even when formalities such as the express appointment of the insurer as the insured's communication agent for purposes of managing the dispute or as the insured's co-client under a common interest arrangement are observed, "there may be some risk that disclosure will waive a privilege or immunity, and that risk is greater when an insurer has not unequivocally accepted coverage for the claim." *Id.*

Like California Civil Code section 2860, the *Restatement* notes that "the insurer's right to defend does not include the right to receive confidential

information from the defense lawyer that could harm the insured with regard to a matter that is in dispute, or potentially in dispute, between the insurer and insured." *Id.*, § 11, Comment d. *See also id.*, § 14, Comment e ("Because of the potential for uninsured risks, there are circumstances in which confidential information of the insured could be used to benefit the insurer at the expense of the insured—for example, confidential information that would assist the insurer to avoid coverage for a legal action. In such circumstances, . . . the insurer does not have the right to receive that confidential information from defense counsel, notwithstanding that such information may be relevant to the defense or settlement of the claim.").

4. Reserving Rights

The *Restatement* recognizes that an insurer may reserve its right to dispute coverage. *See id*., § 15. However, like California and many jurisdictions, it requires specificity in the reservation:

> Notice to the insured of a ground for contesting coverage must include a written explanation of the ground, including the specific insurance policy terms and facts upon which the potential ground for contesting coverage is based, in language that is understandable by a reasonable person in the position of the insured.

Id., § 15(3), at 142. *See* 10 Cal. Code Regs. § 2695.7(b)(1) ("Where an insurer denies or rejects a first party claim, in whole or in part, it shall do so in writing and shall provide to the claimant a statement listing all bases for such rejection or denial and the factual and legal bases for each reason given for such rejection or denial which is then within the insurer's knowledge.").

The *Restatement* also conforms to the law in most jurisdictions, including California, that "An insurer that undertakes to provide a defense without providing timely notice to the insured of any ground of any kind for contesting coverage of which it knows or should know loses the opportunity to contest coverage on that basis." *Restatement*, § 15, Comment b, at 144.

The *Restatement* is in accord with California law in recognizing that an insurer must undertake its insured's defense in a timely manner, even if it has not finished its coverage investigation:

> If circumstances require an insurer to begin defending a legal action before it has a reasonable time to conclude its investigation, the insurer may preserve the right to contest coverage by providing the insured with a general notice that the insurer is not yet able to make a determination about whether the action is covered. Thereafter, the insurer must timely provide the specific notice

> required by this Section in order to avoid losing a potential ground for contesting coverage.

Id., § 15, Comment d, at 144-45. *See*, *e.g.*, *Truck Ins. Exch. v. Superior Court*, 51 Cal. App. 4th 985, 993-94 (1996) (recognizing that an insurer must acknowledge coverage, unqualifiedly assuming its duty to defend; acknowledge coverage while assuming its duty to defend under a reservation of rights; or deny coverage, while refusing to defend).

The *Restatement* also contemplates that if an insurer needs more time to determine what rights it wishes to reserve, it should undertake the defense of its insured subject to a temporary, and generic, reservation of rights:

> When an insurer reasonably cannot complete its investigation before undertaking the defense of a legal action, the insurer may temporarily reserve its right to contest coverage for the action by providing to the insured an initial, general notice of reservation of rights, in language that is understandable by a reasonable person in the position of the insured, but to preserve that reservation of rights the insurer must pursue that investigation with reasonable diligence and must provide the detailed notice stated in subsection (3) within a reasonable time.

Id., § 15(4), at 143.

5. When Multiple Insurers Have a Duty to Defend and Indemnify

California long has recognized that if at least some part of injury or damage may have occurred in a policy period, an insurer must pay "all sums" that the insured is legally obligated to pay. As a Court of Appeal wrote, "Although each policy is triggered only by the occurrence of injury during the policy period, once a policy is triggered, the policy obligates the insurer to pay 'all sums' for which the policyholder becomes liable. There is nothing in the policies limiting the scope of coverage to that portion of a continuous injury that developed during the policy period." *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co*., 45 Cal. App. 4th 1, 54-55 (1996).

Indeed, according to the California Supreme Court:

> [The duty to indemnify] is triggered if specified harm is caused by an included occurrence, so long as at least some such harm results within the policy period. . . . It extends to all specified harm caused by an included occurrence, even if some such harm results beyond the policy period. In other words, if specified harm is caused by an included occurrence and results, at least in part,

> within the policy period, it perdures to all points of time at which some such harm results thereafter.

Aerojet-Gen. Corp. v. Transport Indem. Co., 17 Cal. 4th 38, 56-57 (1997).

California courts also recognize that insured has the right to choose which insurer it would like to assume responsibility for its defense or indemnity. In fact, under California law, the insured is not obligated to prorate its coverage over multiple years or to deal with multiple insurers in obtaining a defense or indemnity. Instead, "a policyholder may obtain full indemnification and defense from one insurer, leaving the targeted insurer to seek contribution from other insurers covering the same loss." *Armstrong*, 45 Cal. App. 4th at 52. Thus, an insured has great flexibility in determining which policy or policies to select for defense and indemnity.

The *Restatement* likewise states that the insured may pick an insurer to respond:

> 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 . . . or until another insurer assumes the defense . . . .

Restatement, § 20, at 174-75. It recognizes that "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." *Id*., § 20(4)(b), at 175. It also recognizes that "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." *Id*., § 20(5)(b), at 174. In so stating, the *Restatement* notes that this "precise articulation of these rules may be an innovation, but the rules are consistent with the spirit of all of the well-reasoned cases and with the holdings of most cases." *Id.*, § 20, Comment a, at 176.

However, the *Restatement* differs from California law with respect to an insurer's duty to indemnify. It rejects the notion that an insurer must pay "all sums" up to its policy limits if any portion of damage or injury takes place in

the policy. Instead, it instructs:

> For purposes of determining the share allocated to an occurrence-based liability insurance policy that is triggered by harm during the policy period, the amount of the judgment or settlement is allocated equally across years, beginning with the first year in which the harm occurred and ending with the last year in which the harm would trigger an occurrence-based liability insurance policy; and . . . .
>
> For liability claims involving divisible harm, courts generally will attempt to allocate among the policy periods according to the actual injury or harm that occurred during the policy period even if the total harm occurred over a long period of time.

Id., § 41(a) & Comment b, at 354-55. The *Restatement* offers this explanation:

> Although the all-sums approach has been adopted by a significant number of courts and many courts have not yet taken a position, a clear majority of the jurisdictions that have addressed the question have adopted the pro rata approach. Among the courts that have adopted a pro rata rule, there is a split of authority regarding whether to allocate losses to years in which the policyholder could not have purchased insurance. Some courts that have adopted the pro rata approach allocate all uninsured years to the insured without regard to the reason for the lack of insurance in a given year, while other courts follow the "unavailability rule" and allocate losses to uninsured years only if liability insurance covering the risks in question was available during those years. . . .
>
> This Restatement follows the pro rata by years default rule for allocation in the case of long-tail harms, because that approach is the most consistent, simplest, and fairest solution to this problem. It is consistent because it provides the same result for every triggered year. It is simple because it requires very little information to determine the pro rata percentage to be applied, and it presents the fewest complications regarding exhaustion, deductibles, and settlement. It is fair because all triggered years, including the years in which the insured did not purchase insurance, share equally in the indivisible losses.

Id., § 41, Comments c & d, at 357.

6. Duty to Defend Versus Duty to Indemnity Policies

Insurers long have argued that while a duty to defend is triggered by a mere potential for coverage, when a policy obligates an insurer only to pay defense costs, it need not pay unless the underlying claim or suit actually is covered.

There is a split in authorities on this subject. However, at least some courts applying California and New York law have found that the duty to pay is judged by the same standards applicable to the duty to defend. *See*, *e.g.*, *Gon v. First State Ins. Co*., 871 F.2d 863, 868 (9th Cir. 1989) (the insurer "must pay legal expenses as they are incurred, because an insured becomes legally obligated to pay legal expenses as soon as the services are rendered"); *Commercial Capital Bancorp., Inc. v. St. Paul Mercury Ins. Co*., 419 F. Supp. 2d 1173, 1180-81 (S.D. Cal. 2006) (default rule requires insurer to make contemporaneous payment of defense costs incurred by insured) (California law); *Federal Ins. Co. v. Sammons Fin. Grp., Inc*., 595 F. Supp. 2d 962, 976 (S.D. Iowa 2009) ("state courts generally have viewed an insurer's duty to advance defense costs as an obligation congruent to the insurer's duty to defend") (citing *Acacia Research Corp. v. Nat'l Union Fire Ins. Co.*, 2008 WL 4179206, at *11 (C.D. Cal. Feb. 8, 2008)); *Federal Ins. Co. v. Kozlowski*, 18 A.D. 3d 33, 40 (N.Y. App. Div. 2005) ("The duty to defend arises whenever the underlying complaint alleges facts that fall within the scope of coverage. 'The same allegations that trigger a duty to defend trigger an obligation to pay defense costs.' . . . The ultimate validity of the underlying complaint's allegations is irrelevant.")

The *Restatement* echoes the view of these courts that the duty to pay defense costs is subject to the same standards governing the duty to defend:

> (2) When a defense-cost-indemnification policy obligates an insurer to pay the costs of defense on an ongoing basis:
>
> > (a) The scope of the insurer's defense-cost obligation is determined using the rules governing the duty to defend . . . ;
> >
> > (b) To preserve the right to contest coverage for a legal action, the insurer must follow the reservation-of-rights procedure . . . ;
> >
> > (c) An insurer that breaches this defense-cost obligation loses the right to associate in the defense of the action . . . and the right to exercise any control in the settlement of the action.

Restatement, § 22, at 192. The *Restatement*'s reasoning is straightforward:

> Most courts that have considered the issues addressed in this Section treat defense-cost-indemnification policies the same as duty-to-defend policies, as long as the defense-cost-indemnification policies obligate the insurer to pay the defense costs on an ongoing basis. By contracting to pay defense costs on an ongoing basis, an insurer promises to provide the policyholder access to a timely, insurer-funded defense. This promise implicates the same access-to-justice justifications that undergird the duty-to-defend rules incorporated by reference in this Section. Accordingly, the insurer has an obligation to pay all of the costs of the defense, including costs that are incurred solely to defend components of the legal action that are not covered . . . .

Id., § 22, Comment a, at 193.

7. An Insurer's Right to Associate in the Defense of an Insured

When an insurer is not actually defending its insured, whether that is because there is a conflict of interest entitling the insured to control its own defense, its policy is not a duty-to-defend policy, or the policy is an excess policy, the question arises as to what role an insurer can play in its defense. Most insurance policies do authorize an insurer to "associate" in its insured's defense. Case law and certain statutes also give the insurer to associate in its insured's defense. *See*, *e.g*., Cal. Civ. Code § 2860(f) ("where the insured selects independent counsel . . . , both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation." As the *Restatement* explains, "The right to associate is not the right to direct the defense of the action. It is the right to be heard in the course of the defense and to obtain information reasonably necessary to be heard." *Id.*, § 23, Comment a, at 198.

The *Restatement* states the proposed rule as follows:

> (1) When an insurer has the right to associate in the defense of a legal action, that right includes, unless otherwise stated in the insurance policy:
>
> > (a) The right to receive from defense counsel and the insured, upon request, information that is reasonably necessary to assess the insured's potential liability and to determine whether the defense is being conducted in a manner that is commensurate with that potential liability, with the exception of information protected by attorney-client privilege, work-product immunity, or a defense

> lawyer's duty to confidentiality under rules of professional conduct, if that information could be used to benefit the insurer at the expense of the insured.

Id., § 23(1), at 198.

The *Restatement* also recognizes that the level of "association that an insurer may have depends upon its level of engagement." *Id.*, § 23, Comment c, at 199. "It would not be efficient to require insureds to consult to the same degree with all insurers in all cases. A one-size-fits-all rule would lead to excessive consultations in some situations and insufficient consultations in others." *Id.*

Perhaps even more importantly, the *Restatement* cautions that "an insurer with the right to associate does not have the right to certain confidential information." *Id.*, § 23, Comment d, at 199. This is consistent with the restrictions on insurer access to confidential information discussed above. Furthermore, the *Restatement* notes, "there is a risk in sharing information in a jurisdiction in which courts have not previously agreed" with the position that "information shared with an insurer pursuant to a right to associate should be subject to the same level of protection from third parties as information shared with an insurer exercising the right to defend." *Id*., § 23, Comment e, at 199.

There is, however, one question that frequently arises: what happens if an insurer unreasonably refuses to settle a lawsuit against its insured and, thereafter, there is a judgment against an insured that includes a punitive damages award? Courts that have addressed this issue have tended to hold that the insurer is not obligated to pay a punitive damage award. *See Restatement*, § 27, Comment e ("Although most courts have not addressed this issue, the very few state courts that have addressed it have resolved the tension in favor of the public policy against insurance for punitive damages, typically in divided judgments with strong dissents indicating that there is considerable uncertainty regarding the direction insurance law should take."); *PPG Indus., Inc. v. Transamerica Ins. Co*., 20 Cal. 4th 310, 319 (1999) ("an insured may not shift to its insurance company, and ultimately to the public, the payment of punitive damages awarded in the third party lawsuit against the insured as a result of the insured's intentional, morally blameworthy behavior against the third party"); *but see id*. at 322-23 (dissent, Mosk) ("[T]he 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 . . . . [O]therwise, for the wrong the insured suffered at its insurer's hands, there would not be a remedy, or at least not a complete remedy.").

The *Restatement* endorses a different approach:

> If a liability insurer's unreasonable failure to settle a legal action against the policyholder results in a compensatory-damages award in excess of the policy limits and a punitive-damages award against the policyholder in that action, the amount of that punitive-damages award is included in the consequential damages owed for breach of the insurer's duty. This rule is unproblematic in most jurisdictions, because a punitive-damages award is a foreseeable consequence of the insurer's breach and the majority rule permits insurance for punitive damages.

Id., § 27, Comment e, at 255.

8. An Insurer's Duty to Settle

The *Restatement* also addresses an insurer's duty to settle and the consequences of a failure to effect a reasonable settlement. Most jurisdictions long have held that an insurer is obligated to effect a settlement of a suit against its insured when such a settlement is reasonable, is within policy limits, and avoids the potential liability the insured otherwise might face. "[T]he implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case although the express terms of the policy do not impose such a duty." *Communale v. Traders & Gen. Ins. Co*., 50 Cal. 2d 654, 659 (1958). "The duty to settle is implied in law to protect the insured from exposure to liability in excess of coverage as a result of the insurer's gamble—on which only the insured might lose." *Murphy v. Allstate Ins. Co*., 17 Cal. 3d 937, 941 (1976).

Most courts also hold that if an insurer does not accept a reasonable settlement offer within its policy limits, and the judgment exceeds those limits, then "the insurer risks liability for the entire judgment and any other damages incurred by the insured. Moreover, the insurer may not consider the issue of coverage in determining whether the settlement is reasonable." *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 502 (2001).

The *Restatement* adopts these notions:

> If an insurer breaches the duty to make a reasonable settlement decision under § 24 by unreasonably refusing to contribute its limit to an above-limits settlement of a covered legal action, the insured (or another insurer acting on the insured's behalf) may make a reasonable, non-collusive settlement with the claimant, notwithstanding any term in the insurance policy requiring the insurer's consent to, or approval of, the settlement of a covered claim and without regarding to whether the insurer is defending under a reservation of rights.

Restatement, § 27, Comment 6, at 249.

9. Insurance for Liabilities Involving Intentional Conduct and Aggravated Fault

Insurers typically dispute whether they must pay for claims and lawsuits against their insureds alleging that the insured acted intentionally or in a circumstance of aggravated fault. The *Restatement* adopts a pro-coverage view:

> (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.

Id., § 45, at 392.

This view is largely consistent with the law of any jurisdictions, including California. *See*, *e.g*., *Downey Venture v LMI Ins. Co*., 66 Cal. App. 4th 478 (1998) (even if insurer cannot indemnify insured for intentional wrongs, it is not excused from its duty to defend); *Dart Indus., Inc. v. Liberty Mut. Ins. Co*., 484 F.2d 1295 (9th Cir. 1973) (insurer obligated to indemnify corporation for libel judgment based on act of its president within the course of his employment even when other corporate officials were consulted or aware of the preparation of the libelous letter because there was no evidence that the policy-making management of the corporation approved, ratified, or had knowledge of the letter or its libel).

The *Restatement* specifically holds that "there are no public-policy-based restrictions on . . . defense coverage under prevailing insurance law" for the cost of defending criminal proceedings or "uninsurable civil actions." *Restatement*, § 45, Comments b & c. The *Restatement* also states: "There is no blanket, public-policy-based objection in insurance law to insuring a civil liability that arises out of a criminal act, even in jurisdictions with public-policy-based restrictions on the insurability of certain kinds of liability." *Id*., § 45, Comment d. And, consistent with California and Ninth Circuit law, the *Restatement*

holds: "Courts generally permit insurance coverage of liabilities that are assessed vicariously, even in situations in which the liability of the primary actor would be uninsurable in the jurisdiction, for example liability for punitive damages." *Id*., § 45, Comment e.

Finally, the *Restatement* comments with respect to the insurability of liability for punitive damages:

> There is a split in the authority regarding the insurable of liability for punitive damages. The courts in the majority of states that have considered the issue have held that liability for punitive damages is insurable, leaving the question of whether a liability insurance policy provides coverage for punitive damages to the interpretation of the insurance policy. Courts in nearly as many states have held that liability insurance for directly assessed punitive damages contravenes the public policy of the state, in some cases as expressed in legislation and in other cases as a matter of judicially declared public policy.

Id., § 45, Comment i, at 395.

10. Recoupment of Defense Costs

California law recognizes that an insurer may seek reimbursement of defense costs that may be allocated solely to uninsured claims. It states:

> An insurer may obtain reimbursement *only* for defense costs that can be allocated *solely* to the claims that are not even potentially covered. To do that, it must carry the burden of proof as to these costs by a preponderance of the evidence. And to do *that*, . . . it must accomplish a task that, 'if ever feasible,' may be 'extremely difficult.' Hence, the insurer will probably pursue the matter only in apparently exceptional cases—for example, where the defense costs the insurer may obtain in reimbursement are clear and substantial *and* where the assets the insured has available for reimbursement are themselves of the same sort.

Buss v. Superior Court, 16 Cal. 4th 35, 57-58 (1997).

The *Restatement* rejects this rule, instructing:

> 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.

Restatement, § 21, at 182. It explains its reasoning as follows:

> This Section follows the emerging state-court majority rule that the insurer does not have a right of recoupment of defense costs unless this right is stated in the insurance policy or otherwise agreed to by the parties. . . . . State courts that have decided this issue for the first time in more recent years, however, have rejected the insurer's claim to recoupment in the absence of a provision in the policy or other agreement permitting reimbursement. This Section follows this emerging state-court majority rule as the more appropriate one in the context of coverage disputes arising under liability insurance policies.

Id., § 21, Comment a, at 183.

While various D&O policies, and some other policies have express reimbursement/recoupment provisions, most general liability and other forms of liability policies do not. This fact, according to the *Restatement*, should preclude insurers from seeking reimbursement:

> [A]n insurer's choice not to insert a recoupment provision in the policy acquires contractual significance. At a minimum, it suggests that the hardship created by the lack of a right of recoupment is not as substantial as might appear in retrospect, when an insurer has defended a specific legal action that it was not obligated to defend. Moreover, recognizing that the insurer is making the choice not to insert a recoupment provision in the policy brings the default rule followed in this Section within the principle disfavoring the use of unjust enrichment when the parties are in a position to address the issues by contract. . . . The issue of the right to recoup the costs of defending a noncovered legal action is a known uncertainty that the insurer can address in the liability insurance contract, as is frequently the case in Directors' and Officers' Liability Insurance policies. In addition, a default no-recoupment rule better informs insurance regulators of the coverage that the insurer intends to provide under the policy form, facilitating informed administrative review of insurers' intent to seek recoupment, and, once the form permitting recoupment is approved, better informs insurance purchasers of the more limited defense coverage provided by the policy.

Id., § 21, Comment a, at 184.

Conclusion

The new *Restatement* likely will be the subject of significant discussion and debate, at least in insurance coverage circles and with courts addressing insurance coverage issues. In considering insurance issues, it should not be overlooked, nor its importance underestimated. It likely will be a resource oft consulted, and likely will gain the same respect as other *Restatements* have over the decades.

About the Author

Kirk Pasich is the Managing Partner of Pasich LLP and a mediator at Signature Resolution. He has been named by *Chambers USA: America's Leading Lawyers for Business* as one of the nation's top policyholder lawyers, by *Lawdragon* as one of the nation's 500 leading lawyers, by *Law360* as one of the nation's five insurance MVPs, by *Los Angeles Business Journal* as one of the Top 10 litigators in Los Angeles, by *Super Lawyers* as one of Southern California's Top 10 lawyers, and by *Variety* as one of the nation's Top 50 entertainment lawyers because of his insurance coverage work in the entertainment industry. *Chambers* says that "All-star lawyer" Mr. Pasich "is an unmistakable feature of California's insurance landscape," noting that he "is the leading name at this national practice." *Lawdragon* says, "When it comes to representing policyholders, there's no bigger name on the West Coast." Mr. Pasich conducts an active trial and appellate practice. He has helped clients obtain insurance recoveries of more than $7 billion and has three times obtained jury verdicts that have been ranked among the ten largest of the year in California. Mr. Pasich also is the author of more than 400 articles regarding insurance issues and the author, co-author, or editor of several books on insurance topics. He may be reached at (424) 313-7850, KPasich@PasichLLP.com, or KPasich@SignatureResolution.com.

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