ENCOURAGING CONSTRUCTIVE CONDUCT BY POLICYHOLDERS IN THE RESTATEMENT OF THE LAW OF LIABILITY INSURANCE

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It is no exaggeration to say that the American Law Institute ("ALI") is the most influential private organization in the development of American law.[1] The ALI's membership is comprised of many of the nation's most distinguished judges, law professors, and practitioners, and, for that reason, the organization's work products have a reputation for presenting carefully considered, balanced legal rules and policy.[2] Every state has, at some point, relied upon one of the ALI's signature

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1. *See* Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212, 1216 (1993); *see also About ALI*, A.L.I., https://www.ali.org/about-ali (last visited Oct. 21, 2015) ("The American Law Institute is the leading independent organization in the United States producing scholarly work to clarify, modernize, and improve the law.").

2. *See About ALI*, *supra* note 1 (noting that the ALI publishes three basic work products: (1) Restatements; (2) Model Codes; and (3) Principles, each of which has a specific purpose and audience for the development of the law). *See also* AM. L. INST., CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 3–4 (rev. ed. 2015), https://www.ali.org/media/filer_public/65/25/6525b3d0-0ac1-4dba-b2bb-5b0eb022fd55/stylemanual.pdf [hereinafter ALI STYLE MANUAL].

work products called a "Restatement of Law" when developing state common law.[3]

In 2014, the ALI made an unprecedented decision to convert an existing "Principles of Law" project on insurance law into a first-ever Restatement of the Law of Liability Insurance ("RLLI").[4] This conversion was significant because it meant that a project initially developed to set forth guiding principles of what the law "should be" with respect to particular insurance law topics would, moving forward, conform to the more rigorous standards of a Restatement of Law that endeavors to "restate" the most sound liability rules from existing case law.[5] Accordingly, the RLLI project has been re-evaluated by the ALI through the Restatement project lens. This is a necessary process that should help ensure the project's ultimate success, which may be informally measured by how the project is used, relied upon, and cited by courts over many years, even decades, into the future.

The potential impact of this new Restatement makes an understanding of the project's objectives and ideology, as well as its specific provisions, essential for courts deciding whether a particular Restatement rule represents the best public policy for their state to follow. This Article provides important context for that analysis by examining how the Restatement, which is still a work in progress, addresses several key issues that implicate a policyholder's incentives to "follow the rules" and behave in a constructive manner. Such incentives, or the lack thereof, are telling with respect to the RLLI project's core objectives and guiding philosophy: is the project designed to balance and protect the interests of both parties that enter an insurance transaction—policyholders and insurers—or does the project propose to tip the scales to enable greater recoveries for policyholders?

This Article examines three specific areas where the RLLI rules, as initially developed and refined, did not encourage optimal conduct on the part of policyholders. These areas include: (1) a policyholder's

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3. *See, e.g.*, Dominick Vetri, *The Integration of Tort Law Reforms and Liability Insurance Ratemaking in the New Age*, 66 OR. L. REV. 277, 284 n.34 (1987) ("After the American Law Institute adopted section 402A in the RESTATEMENT (SECOND) OF TORTS, virtually every state has adopted some version of strict products liability."). The proliferation of the doctrine of strict products liability provides just one example, albeit a major one, of the influence of ALI Restatements. Other examples include the ALI's Restatement multi-edition projects on contracts, property, agency, and trusts.

4. RESTATEMENT OF THE LAW OF LIAB. INS. intro. at ix (AM. LAW INST., Discussion Draft 2015).

5. *See* ALI STYLE MANUAL, *supra* note 2, at 4–6, 13–15; *see also Frequently Asked Questions*, A.L.I., http://www.ali.org/publications/frequently-asked-questions/ (last visited Oct. 21, 2015) (explaining the difference between Restatement and Principles projects).

misrepresentation in his or her policy agreement;[6] (2) a policyholder's potential manipulation of the insurer's duty to make "reasonable settlement decisions";[7] and (3) a policyholder's duty to cooperate with his or her insurer.[8] In each area, the RLLI project's rule formulation, if approved by the ALI and adopted by courts, could enable policyholders to engage in practices designed to manipulate or otherwise abuse the insurance claims handling process to enhance a potential individual recovery.

Fortunately, progress has been made in the RLLI project. The first of the areas, misrepresentation, was substantially revised due to a lack of case law support for the initial Restatement rule formulation. This change represents a positive development both with respect to encouraging constructive conduct by policyholders and adhering to the general requirement of Restatements to ground rules in existing common law.[9] The two other areas, however, continue to raise concerns in the project's development. They represent only a sample of numerous RLLI provisions that have generated concern, yet are illustrative of some of the project's broader public policy implications.

This Article analyzes the development of these rules and their public policy implications. Part I begins with an overview of the RLLI project's development leading up to the 2015 ALI Annual Meeting.[10] Part II discusses the topic of misrepresentation and the changes that have occurred in the RLLI project. Part III examines the RLLI's formulation of an insurer's duty to make "reasonable settlement decisions"[11] and its potential for abuse by policyholders. Finally, Part IV examines the RLLI's formulation of a policyholder's duty to cooperate and its potential for abuse by policyholders.

The Article concludes that the current RLLI project creates unsound avenues for policyholders to engage in gamesmanship and improper conduct that subverts the fair and efficient handling of liability insurance claims. As a result, the RLLI could unjustly increase the burdens and costs on insurers; costs which would, in turn, be passed on to all

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6. RESTATEMENT OF THE LAW OF LIAB. INS. §§ 7–9 (AM. LAW INST., Discussion Draft 2015); *see also infra* Part II.

7. *Id.* §§ 24, 27 (AM. LAW INST., Discussion Draft 2015); *see also infra* Part III.

8. *Id.* §§ 29–30 (AM. LAW INST., Discussion Draft 2015); *see also infra* Part IV.

9. *See* ALI STYLE MANUAL, *supra* note 2, at 7–8.

10. This Article was submitted for publication prior to the 2015 ALI Annual Meeting and is based on the latest project Discussion Draft issued on April 30, 2015. Therefore, the Article does not address subsequent changes to the RLLI project.

11. RESTATEMENT OF THE LAW OF LIAB. INS. §§ 24, 27 (AM. LAW INST., Discussion Draft 2015).

policyholders in the form of increased insurance premiums.[12] For that reason, the Article further concludes that the RLLI's rule formulations should be revised to ensure that only constructive conduct is encouraged from all parties involved in a liability insurance transaction.

I. OVERVIEW OF THE DEVELOPMENT OF THE RESTATEMENT OF THE LAW OF LIABILITY INSURANCE

The origins of the RLLI project trace back to 2010 when the ALI embarked on a "Principles of Law" project to assist judges, legislators, and other policymakers in their development of insurance law.[13] ALI Principles projects, unlike Restatement projects, do not necessarily have to be grounded in existing case law.[14] Rather, the project's authors, called "Reporters,"[15] have latitude to develop rules and principles in line with their personal policy preferences of what the law "should be" on a particular topic.[16] The ALI's project on insurance law proceeded as a Principles project for its first four years. During this time, the first two chapters of the project, which comprised thirty-four sections of insurance law "principles," were approved by the ALI Council and ALI membership.[17] Approval by both of these bodies meant that the first two chapters were essentially a completed work product that would be looked at again only when the entire project, which would likely have included two additional chapters, was voted on for final approval.[18]

However, near the end of 2014, the leadership of the ALI announced that the Principles project on liability insurance would be converted into a Restatement.[19] This decision to convert an existing project into a Restatement was unprecedented in the ALI's ninety-two-year history.[20]

12. *See infra* notes 90–97 and accompanying text.

13. RESTATEMENT OF THE LAW OF LIAB. INS. intro. at ix (AM. LAW INST., Discussion Draft 2015).

14. *See* ALI STYLE MANUAL, *supra* note 2, at 13–15.

15. The ALI leadership selected University of Pennsylvania Law School Professor Tom Baker as project Reporter, and University of Michigan Law School Professor Kyle D. Logue as Associate Reporter.

16. *See* ALI STYLE MANUAL, *supra* note 2, at 13–15.

17. PRINCIPLES OF THE LAW OF LIAB. INS. intro. at ix (AM. LAW INST., Tentative Draft No. 2, 2014).

18. *See* PRINCIPLES OF THE LAW OF LIAB. INS. intro. at ix (AM. LAW INST., Tentative Draft No. 2, 2014); *see also* ALI STYLE MANUAL, *supra* note 2, at 1 ("The Institute's Bylaws provide that 'Publication of any work as representing the Institute's position requires approval by both the membership and the Council.'").

19. RESTATEMENT OF THE LAW OF LIAB. INS. intro. at ix (AM. LAW INST., Discussion Draft 2015).

20. The ALI leadership also approved a project conversion in the opposite direction. The

The organization's leadership chose this path for several reasons. First, Restatement projects, being based on existing common law rules, tend to have far greater influence with courts than the more aspirational Principles projects.[21] Thus, conversion provided an opportunity to increase the project's potential impact, even if it narrowed the project's intended audience to focus on judges' development of the common law rather than on the activities of legislators or other policymakers.[22] Second, because many of the provisions of the Principles project were untested "innovations" that could potentially disrupt longstanding insurance law practices,[23] the project was subject to broad criticism by members of the insurance community. Converting the project into a Restatement offered the project Reporters a potential means to revisit some of the controversial, and potentially unworkable, provisions of the Principles project that had already been approved by the ALI Council and ALI membership.

The ALI entered uncharted territory as a result of the decision to convert the Principles project into a Restatement. Prior votes approving sections of the project, which had occurred incrementally over several years, were properly discarded so that the project could be evaluated anew under the heightened scrutiny traditionally applied to a Restatement.[24] In March 2015, the project Reporters issued the initial draft of the project's first two chapters recast as a Restatement.[25] Later that month, the ALI hosted meetings of the project's Advisory Committee and Members Consultative Group ("MCG") to discuss the converted Principles provisions in advance of a proposed vote by the ALI Membership to tentatively approve the draft RLLI at the 2016 ALI

ALI's Restatement of Data Privacy Principles project, which was unique in including both the "Restatement" and "Principles" labels, was converted into a Principles project at the end of 2014 and relabeled the Data Privacy Principles project. *See* RESTATEMENT OF DATA PRIVACY PRINCIPLES (AM. Law INST., Preliminary Draft No. 1, 2014).

21. The ALI Principles differ from a Restatement in that they "give greater weight to emerging legal concepts." *See* PRINCIPLES OF THE LAW OF FAMILY DISSOLUTION: ANALYSIS & RECOMMENDATIONS foreword at xiii (AM. LAW INST., Proposed Final Draft 1997); *see e.g.*, Vetri, *supra* note 3, at 284 n.34.

22. *See* ALI STYLE MANUAL, *supra* note 2, at 4.

23. *See* PRINCIPLES OF THE LAW OF LIAB. INS. reporters' memorandum at xvii (AM. LAW INST., Tentative Draft No. 1, 2013) (noting that "Chapter 2 does contain some innovations").

24. *See* ALI STYLE MANUAL, *supra* note 2, at 4, 8 (stating that guidelines for "Restatement aim to 'restate' legal propositions as precisely and coherently as possible" in comparison to Principles projects which may cover "an area [which] is so new that there is little established law").

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

Annual Meeting.[26] Subsequently, and in light of numerous changes to the project agreed upon during the project's Advisory Committee and MCG meetings, the ALI leadership wisely decided to postpone a vote on the RLLI's first two chapters to allow for more discussion by the membership.[27] In April 2015, the project Reporters issued a second draft of the first two chapters of the RLLI project in preparation for discussion at the 2016 ALI Annual Meeting.[28] This draft represents the latest version of the project at the time of this writing.[29]

Chapter 1 of the RLLI, titled, "Basic Liability Insurance Contract Rules," covers the following topics: (1) Interpretation; (2) Waiver and Estoppel; and (3) Misrepresentation.[30] Chapter 2, titled, "Management of Potentially Insured Liability Claims," covers the following topics: (1) Defense; (2) Settlement; and (3) Cooperation.[31] Each topic consists of related sections that each set forth a "black letter" rule to apply to an insurance law issue in addition to comments explaining the rule's intended application.[32] The three areas discussed in this Article, with respect to a policyholder's incentive to engage in certain behavior, are covered in specific sections of these first two chapters of the RLLI.

II. MISREPRESENTATION BY A POLICYHOLDER

Chapter 1 of the RLLI project addresses the topic of misrepresentation, which refers to the situation where a policyholder makes an incorrect statement of fact on his or her insurance policy application or renewal agreement.[33] Under common law, an insurer is generally allowed to void or rescind an insurance agreement *ab initio*, or "from the beginning," when a policyholder has supplied false information

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26. *See* RESTATEMENT OF THE LAW OF LIAB. INS. foreword at xiii (AM. LAW INST., Discussion Draft 2015).

27. *See id.*

28. *Id.*

29. As this Article was going to press, the Reporters issued a revised draft of Chapters 1 and 2 of the RLLI project, which may have partially addressed some of the concerns discussed in this Article. The authors welcome such changes. *See* RESTATEMENT OF THE LAW OF LIAB. INS. (AM. LAW INST., Council Draft No. 1, 2015).

30. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 2–9 (AM. LAW INST., Discussion Draft 2015).

31. *See id.* § 10–30.

32. *See* ALI STYLE MANUAL, *supra* note 2, at 3 ("Each [ALI project] consists of a series of concise 'black-letter' legal formulations, elucidated by extended commentary and illustration, and supported by scholarly annotation of the sources considered.").

33. RESTATEMENT OF THE LAW OF LIAB. INS. § 7 (AM. LAW INST., Discussion Draft 2015); RESTATEMENT (SECOND) OF CONTRACTS § 159 (AM. LAW INST. 1981).

and that information is material to the insurance agreement.[34] For example, if a policy application for health insurance asked whether the applicant was a smoker and the applicant, an occasional smoker, either negligently or intentionally answered that he was not, the insurer would have a basis to rescind the policy for that misrepresentation.[35]

With respect to the RLLI project, the topic of misrepresentation was initially developed when the project was a Principles project.[36] The Reporters adopted an approach that limited an insurer's remedy of rescission only to situations where the policyholder's misrepresentation was committed intentionally or recklessly.[37] Thus, if a policyholder were negligent in providing information to apply for or renew a policy, the insurer would not be able to rescind the agreement.[38] Rather, the Principles project stated that the insurer "must pay the claim" of the negligent policyholder.[39]

The project further defined an intentional misrepresentation as a statement which the policyholder knew or believed to be false at the time

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34. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 7 cmt. d (AM. LAW INST., Discussion Draft 2015) ("[I]f a policy is rescinded, it is as if the policy had never been written; the policy does not provide coverage for any claims. . . . If the insurer rescinds the policy, it must return all premiums collected from the policyholder for that policy."); *see also* Bullock v. Life Ins. Co. of Miss., 872 So. 2d 658, 661 (Miss. 2004) ("To rescind an application for insurance, an insurer must show that the application contains answers which are false, incomplete, or misleading and that such answers are material to the acceptance of the risk or to the hazard to be assumed." (citing Prudential Ins. Co. of Am. v. Estate of Russell, 274 So. 2d 113, 116 (Miss. 1973))); Rutgers Cas. Ins. Co. v. LaCroix, 946 A.2d 1027, 1030 (N.J. 2008) ("We hold that the . . . material misrepresentation entitled the insurer to rescission of the insurance contract . . . ."). Numerous state statutes also permit rescission based on any material misrepresentation by a policyholder. *See, e.g.*, ALA. CODE § 27-14-7 (2014); *see also* Alfa Life Ins. Corp. v. Lewis, 910 So. 2d 757, 762 (Ala. 2005) ("Under § 27-14-7, it is not necessary that the insured have made the misrepresentation with an intent to deceive; even if innocently made, an incorrect statement that is material to the risk assumed by the insurer or that would have caused the insurer in good faith not to issue the policy in the manner that it did provides a basis for the insurer to avoid the policy.").

35. The same rationale applies to other types of insurance. *See, e.g.*, Foster v. Auto-Owners Ins. Co., 703 N.E.2d 657, 658 (Ind. 1998) ("We hold, as we have before, that an insurance company may void coverage based on a material misrepresentation in the [property insurance] application."); Webb v. Am. Family Mut. Ins. Co., 493 N.W.2d 808, 813 (Iowa 1992) (allowing insurer to rescind policy based on material misrepresentation in homeowners' policy application); Van Horn v. Atl. Mut. Ins. Co., 641 A.2d 195, 200 (Md. 1994) (recognizing insurer's common law right to void *ab initio* an insurance policy, but holding that this right was abrogated in the context of auto insurance by the state's compulsory motor vehicle insurance law).

36. PRINCIPLES OF THE LAW OF LIAB. INS. § 7 (AM. LAW INST., Tentative Draft No. 1, 2013).

37. *Id.* § 7(2)(a).

38. *See id.*

39. *Id.* § 11.

it was made.[40] An insurer seeking to rescind a policy on this basis would thus face the difficult practical burden of proving a policyholder's subjective intent when making the misrepresentation. The project also defined a reckless misrepresentation as one in which the policyholder was "willfully indifferent to whether the statement is true or false";[41] a burden that similarly required a showing of the intentional nature of the misrepresentation, along with the policyholder's subjective mindset at the time. In addition, the Reporters required an insurer seeking to rescind a policy for an intentional or reckless misrepresentation to satisfy two other criteria: (1) the material nature of the misrepresentation and (2) reasonable detrimental reliance by the insurer.[42] Here, the Reporters also adopted definitions that set a potentially high bar for insurers to meet. A misrepresentation was only deemed "material" if the insurer would have either not issued the policy at all "or would have issued the policy only under substantially different terms."[43] Similarly, an insurer was only deemed to have detrimentally relied on the misrepresentation if it "would not have issued the policy" at all "or would have issued the policy only with substantially different terms," and if such actions were "reasonable under the circumstances."[44]

A showing of a combination of these requirements, required for an insurer to establish a basis to rescind any policy, created a much narrower rule than existed under common law. This rule would have effectively shielded policyholders who misrepresented material information to their insurer by (1) precluding rescission for a negligent misrepresentation and (2) increasing the practical burdens on insurers to prove an intentional or reckless misrepresentation.

The project Reporters acknowledged that their approach was "an innovation."[45] Where a policyholder negligently provided information to obtain an insurance policy, the Principles project established a novel "quasi-reformation remedy."[46] Under this approach, the insurer was required to pay the claim of the negligent policyholder in full, but could recoup some higher premium for the increased risk the insurer would have undertaken had the policyholder supplied the correct information

40. *Id.* § 8(1).
41. *Id.* § 8(2).
42. *See id.* § 7(2)(b)–(c).
43. *Id.* § 10.
44. *Id.* § 9(1)–(2).
45. *Id.* § 7 cmt. b ("The rule limiting rescission and claim denial to intentional and reckless misrepresentations is an innovation.").
46. *Id.* § 11 cmt. a.

when asked.[47] Also, if the insurer would not have issued any policy had the policyholder provided the correct information, the insurer would be entitled to some "reasonable additional premium for the increased risk" after paying the negligent policyholder's claim.[48] Neither of these remedy provisions exists under the law of any state.

Therefore, the project's approach to the topic of misrepresentation was designed to permit policyholders to negligently misrepresent information in an insurance policy or renewal application subject to some payment of additional premium instead of having the policy rescinded. Such a rule, if adopted by courts, would have encouraged policyholders to exercise less care in providing and verifying information when applying or renewing an insurance policy. It could also have emboldened policyholders to lie when providing information to an insurer given the greater obstacles an insurer would have in proving the policyholder acted intentionally or with willful indifference when making a misrepresentation.[49] The end result could have meant higher premiums for most policyholders to offset the higher likelihood of a misrepresentation.

Nevertheless, this "innovation" was approved by both the ALI Council and ALI Membership when the project was a Principles project.[50] When the project was converted into the initial draft of the Restatement, the Reporters decided to retain the rule limiting rescission to only a policyholder's intentional or reckless misrepresentation.[51] The Reporters struck the "quasi-reformation remedy" for negligent or unintentional misrepresentations because there was simply no legal support for the rule that had been adopted.[52] Including such a provision would have violated a basic purpose of a Restatement to "restate" common law rules that actually exist.[53]

In the second draft of the RLLI, however, the project Reporters reversed their longstanding approach limiting rescission to only

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47. *Id.* § 11(1).
48. *Id.* § 11(2).
49. *See supra* text accompanying notes 40–44.
50. *See* PRINCIPLES OF THE LAW OF LIAB. INS. § 7 cmt. b (AM. LAW INST., Tentative Draft No. 1, 2013).
51. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 7(2)(a) (AM. LAW INST., Preliminary Draft No. 1, 2015).
52. *See id.* § 7 cmt. c ("[T]his Section exempts innocent, including negligent, misrepresentations from the misrepresentation defense.").
53. *See* ALI STYLE MANUAL, *supra* note 2, at 6 (stating that Restatements "generally are constrained by the need to find support in sources of law" and cautioning against "[w]ild swings" which would be "inconsistent with the work of both a common-law judge and a Restatement").

intentional or reckless misrepresentations.[54] They did so after conducting a more exacting survey of existing case law. Just as there was no legal support for a "quasi-reformation remedy" providing policyholders with a full recovery based on their negligent misrepresentations minus some additional premium, there was a dearth of common law generally limiting rescission to only intentional or reckless misrepresentations.[55] Some states have, by statute, limited rescission in this way,[56] but statutory law has traditionally been viewed as outside the subject matter of a Restatement project analyzing the development of common law.[57]

States have continued to follow the common law approach allowing an insurer to rescind a policy agreement that contains a material misrepresentation, regardless of the policyholder's intent in making the statements, for sound public policy reasons.[58] First, policyholders should be incentivized to provide accurate information when expressly asked by an insurer in a policy or renewal application. This includes not lying or intentionally misleading the insurer, as well as performing a careful review of the information given. The penalty of potential rescission of the policy provides a strong incentive for a policyholder to meet this basic condition on which the entire insurance transaction is based. Second, public policy supports placing the responsibility on policyholders to carefully review and verify information *they* supply because they are in the most knowledgeable and efficient position to provide the information. Insurers may perform their own verification processes in an effort to prevent fraud by policyholders, but the onus is, and should be, on the policyholder. Third, as courts have recognized, a material misrepresentation can have the effect of changing an insurer's total risk

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54. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 7 (AM. LAW INST., Discussion Draft 2015).

55. *Id.* reporters' memorandum.

56. *See, e.g.*, OKLA. STAT. tit. 36, § 3609 (2011); Scottsdale Ins. Co. v. Tolliver, 127 P.3d 611, 614 (Okla. 2005) (stating that court interpretations of the Oklahoma's misrepresentation statute require a finding of the policyholder's intent to deceive before an insurer may void the policy). *But see* FLA. STAT. § 627.409 (2015); Fed. Deposit Ins. Corp. v. Verex Assurance, Inc., 645 So. 2d 427, 429 (Fla. 1994) ("[FLA. STAT. § 627.409] protects an insurer from material misrepresentations in an application for insurance, even those innocently made by the insured.").

57. *See* ALI STYLE MANUAL, *supra* note 2, at 8–11 (discussing the use of statutes in Restatement projects and stating that "statute[s] ordinarily should be described and discussed or compared in the Reporter's Notes").

58. *See, e.g.*, Jones-Smith v. Safeway Ins. Co., No. 2014-CA-00180-SCT, 2015 WL 5157597, at *1 (Miss. Sept. 3, 2015) ("For more than one hundred and thirty years, this Court has held that an insurance company may void a policy when the insured made material misrepresentations during the application process.").

assessment with respect to a policyholder.[59] Such a distortion could impact the types and lines of policies offered or combined with other policies, and may not be capable of reduction to some "reasonable" dollar amount of increased premium as envisioned by a "quasi-reformation remedy."[60] A policyholder's material misrepresentation can also have the effect of changing the very essence of what was bargained for in the insurance transaction regardless of any malicious motive.

For all of these reasons, courts have adhered to the traditional common law approach to the topic of misrepresentation. The RLLI project now follows suit. The Reporters' decision to make this change, however, appears to have more to do with begrudging deference to existing common law than endorsing the rule's public policy. In the comments to the RLLI's misrepresentation rule, the Reporters express their view of the "harshness" and "unfairness" of the traditional rule and state that "there is not yet sufficient common-law authority" to adopt a different approach, such as the one they had long advocated and initially sought to include in the RLLI.[61] Thus, although the RLLI adopts the traditional misrepresentation approach, which promotes constructive conduct by policyholders, this change does not appear to be the product of a desire to necessarily instill greater balance in the project as to the responsibilities of policyholders and insurers.

III. INSURER DUTY TO MAKE "REASONABLE SETTLEMENT DECISIONS"

Another topic in the RLLI project that implicates a policyholder's incentives to engage in constructive conduct is the "insurer's duty to make reasonable settlement decisions."[62] This duty, which is rooted in the general contract duty of good faith and fair dealing, is often referred to in the common law as the insurer's "duty to settle."[63] The RLLI adopts a broader formulation to emphasize that an "insurer's duty is not to settle every claim," but rather to act "reasonable" with respect to the policyholder's claim.[64] Chapter 2 of the RLLI, which addresses the topic of "Settlement," sets forth this duty focusing on the actions of insurers.

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59. *See, e.g.*, Klopp v. Keystone Ins. Cos., 595 A.2d 1, 4 (Pa. 1991) ("Under basic contract principles, the omission was a material misrepresentation which would certainly justify the rescission of the [insurance] contract.").

60. PRINCIPLES OF THE LAW OF LIAB. INS. § 11(2) (AM. LAW INST., Tentative Draft No. 1, 2013).

61. RESTATEMENT OF THE LAW OF LIAB. INS. § 7 cmt. j (AM. LAW INST., Discussion Draft 2015).

62. *Id.* § 24(3).

63. *Id.* § 24 cmt. a.

64. *Id.*

The actions of a policyholder, however, can have a profound impact on the insurer's ability to satisfy this duty. For that reason, concerns have been raised with respect to the RLLI's rule formulation and its potential to allow some errant policyholders to engage in tactics designed to frustrate or manipulate their insurer's claims handling process and trigger a breach of the insurer's duty to make reasonable settlement decisions.

Before examining how certain manipulative tactics may be employed by errant policyholders, it is important to understand what is at stake. Pursuant to the RLLI, "[a]n insurer that breaches the duty to make reasonable settlement decisions is subject to liability for the full amount of damages assessed against the [policyholder] in the underlying [insurance coverage] suit, without regard to the policy limits."[65] Further, if the policyholder is permitted to recover an amount in excess of the policy limits, an insurer may additionally be subject to liability for any "other foreseeable loss" arising out of the breach.[66]

An example illustrates the effect of these provisions. Consider a policyholder who purchases auto insurance with a $50,000 coverage limit and is later involved in a serious car accident, for which the policyholder is substantially at fault. The policyholder is sued for one million dollars in damages, and turns the defense of the claim over to his insurer.[67] In this situation, the policyholder will likely be responsible for damages that far exceed his policy's coverage limit. But, if the policyholder is able to show that the insurer somehow breached its duty to make reasonable settlement decisions, he would be able to shift the entire one million dollars potential damages amount to his insurer and pay nothing out of pocket. The policyholder could even recover damages greater than one million dollars provided such damages were "foreseeable."[68] Thus, by establishing a breach of the insurer's duty to make reasonable settlement decisions, the policyholder could transform a potentially devastating financial loss into a gain.

In addition, a policyholder who has engaged in especially egregious conduct warranting an award of punitive damages could shift those damages, which were intended to punish and deter the policyholder's individual behavior, to the insurer.[69] The RLLI expressly provides that an insurer should be subject to liability for any punitive damages awarded against a policyholder related to the underlying insurance claim

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65. *Id.* § 27(1).
66. *Id.* § 27(2).
67. *See generally id.* § 13 (addressing conditions under which an insurer owes a duty to defend a claim).
68. *Id.* § 27(2).
69. *See id.* § 27 cmt. d.

where the duty to make reasonable settlement decisions has been breached.[70] Such rules unfortunately provide a strong incentive for errant policyholders to find ways to "game the system" and trigger a breach of the insurer's duty to make reasonable settlement decisions.

The RLLI's formation of the duty could facilitate attempts by policyholders to engineer such a breach. The project's "black letter" rule states that all insurers have a duty to make reasonable settlement decisions, which will be evaluated under the standard of "a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment."[71] The rule requires an insurer to accept *any* "reasonable settlement demand[]," as well as to make a reasonable settlement offer in the event no demand is made.[72]

The determination of what qualifies as a "reasonable" settlement offer, by either a claimant or an insurer, is a starting point for problems with the rule formulation. The Comments to the rule adopt the notion that every claim has a "range of reasonable settlement values," and that if an insurer rejects a settlement demand, or fails to make a settlement offer, within that hypothetical range, the insurer is essentially strictly liable for the full damage amounts described above.[73] In attempting to provide courts with greater precision as to the calculation of a reasonable settlement value, the formulaic rule appears to move further away from the traditional common law approach to an insurer's duty to settle, which focuses on whether the insurer took an unreasonable risk in not settling the claim.[74] The RLLI approach, in comparison, presumes an insurer took an unreasonable risk whenever an excess judgment has been awarded against the policyholder and there is any departure (even one dollar)

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70. *See id.* (stating that allowing policyholders to recover punitive damages awarded against them as a measure of damages for an insurers' breach of the duty to make reasonable settlement decision presents a "difficult question," but one in which the RLLI project recommends recovery).

71. *Id.* § 24(2).

72. *Id.* § 24(3) & cmt. e.

73. *Id.* § 24 cmt. d.

74. *See, e.g.*, Cotton States Mut. Ins. Co. v. Brightman, 580 S.E.2d 519, 521 (Ga. 2003) ("Judged by the standard of the ordinarily prudent insurer, the insurer is negligent in failing to settle if the ordinarily prudent insurer would consider choosing to try the case created an unreasonable risk."); *see also* Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1147 (1954); Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1163 (1990) ("Attitudes of insureds and insurance companies toward settlement and trial are affected by many factors, including the allocation of potential liability and defense costs, risk aversion, bargaining strategy, and a variety of additional stakes in the outcome. The insurance company's decision to reject a particular settlement demand may take into account any combination of these factors.").

from the insurer's settlement offer and the range of reasonableness determined by a court in hindsight.[75]

Policyholders could exploit this duty rule in a number of ways. First, a policyholder could leverage the threat of broad damages for breach of the duty to make reasonable settlement decisions to effectively force an insurer to agree to an unreasonable settlement within a policy's limits. The combination of ambiguity with respect to a claim's range of reasonable settlement offers and the potential of being subject to, in essence, strict liability for any excess judgment and foreseeable damages would likely compel a risk-averse insurer to accept an offer within a policy's limits that the insurer believes is unreasonable, but a court could conceivably rule otherwise.

Second, a policyholder could collude with an injured claimant (or their counsel) to either increase a settlement value or trigger a breach of the insurer's duty to make reasonable settlement decisions. A policyholder might engage in such collusive behavior for the same reasons discussed previously, namely to avoid paying out-of-pocket costs where the policyholder chose a policy with relatively modest policy limits and subsequently caused serious injury to another. In addition, a policyholder might desire to trigger a breach of the insurer's duty to make reasonable settlement decisions to establish a basis to later sue the insurer for "bad faith" in the handling of the claim.[76] This result could permit the policyholder to recover additional extra-compensatory damages, or punitive damages, and convert a modest policy into a multi-million dollar tort recovery that the policyholder does not need to share with an injured claimant.[77] Alternatively, a policyholder of limited means who caused serious injury to another might view a potential bad faith claim against the insurer as his most valuable asset, and, accordingly, collude with a claimant to trigger a breach of the insurer's duty to make reasonable settlement decisions as a way to generate that asset.[78] The errant policyholder could then assign the bad faith claim to the claimant

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75. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. d (AM. LAW INST., Discussion Draft 2015).

76. *See generally* Victor E. Schwartz & Christopher E. Appel, *Common-Sense Construction of Unfair Claims Settlement Statutes: Restoring the Good Faith in Bad Faith*, 58 AM. U. L. REV. 1477, 1495–99 (2009) (discussing differences in the level of conduct that may give rise to a "bad faith" claim against an insurer).

77. *See id.* at 1499–500.

78. *See, e.g.*, Victor E. Schwartz, *Restoring the Good Faith in Florida's "Bad Faith" Insurance Litigation*, FLA. JUST. REFORM INST. 19–25 (Mar. 2014), http://www.fljustice.org/docfjri/VS%20BF%202014.pdf (discussing abusive tactics employed by claimants to generate bad faith claims against an insurer).

he injured in exchange for that person agreeing not to pursue any monetary recovery against the policyholder individually.[79]

There are various tactics policyholders and claimants could employ to trigger a breach.[80] A policyholder, for example, could purposefully fail to communicate material information to his or her insurer in an effort to delay the claims handling process with the claimant or augment the insurer's calculation of a reasonable settlement value.[81] In addition, a claimant could facilitate a policyholder's breach claim by making an initial settlement demand around the upper limit of the likely range of reasonableness, and then simply refuse to negotiate further.[82] If the insurer tried to negotiate a lower settlement amount on behalf of its policyholder, the claimant could treat the insurer's counteroffer as a rejection of the initial reasonable settlement demand.

Because the insurer in this scenario would have rejected an arguably reasonable settlement offer, the insurer would be subject to liability for breaching its duty to make reasonable settlement decisions, even though the insurer acted perfectly reasonably in trying to negotiate and make a reasonable counter-offer on behalf of its policyholder.[83] Indeed, the insurer would more likely be viewed as acting unreasonably if it did not try to negotiate a more reasonable settlement on behalf of its policyholder, especially if that policyholder might be potentially responsible for an out-of-pocket expense. The RLLI approach, however, effectively penalizes the insurer in this situation. The rule formulation places significant pressure on the insurer to accept any settlement demand that might conceivably be viewed as within a hypothetical range of reasonableness determined by a court in hindsight, even if doing so would ultimately not be in the policyholder's best interests because that policyholder's premiums could increase when claims are settled without any meaningful negotiation process.[84]

The Comments to the RLLI's duty to make reasonable settlement decisions concede that insurers may be "reluctant" to make reasonable

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79. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. l (AM. LAW INST., Discussion Draft 2015) ("A claimant is permitted to accept an assignment of the insured's cause of action for breach of the duty to make reasonable settlement decisions and thereafter to bring that action against the insurer.").

80. *See* Schwartz, *supra* note 78, at 19–25.

81. *See id.* at 24–25. The RLLI's approach to a policyholder's duty to cooperate would also provide significant leeway for a policyholder to engage in certain abusive tactics without penalty. *See infra* Part IV.

82. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. g (AM. LAW INST., Discussion Draft 2015).

83. *See id.*

84. *See id.*

counteroffers for the purpose of negotiating lower settlements.[85] The Comments also acknowledge that "bargaining practices may tend to produce lower settlements on average" and that this "can lead to lower overall liability insurance premiums."[86] Nevertheless, the project Reporters rejected an alternative duty rule that would promote reasonable claims negotiations for three reasons. First, the Reporters did not view lowering insurance costs as a "primary objective of the duty to make reasonable settlement decisions."[87] Second, the Reporters believed that "even if there are particular situations in which rejecting reasonable settlement demands is what a reasonable" insurer would do, "identifying such cases would be difficult for the trier of fact in the breach-of-settlement-duty suit."[88] Third, the Reporters submitted that the RLLI's rule formulation would not prevent insurers from making reasonable settlement counteroffers; "[r]ather, the rule simply imposes on insurers, and thus the insurance pool, the risks associated with making the wrong decision in individual cases."[89]

Such explanations are unconvincing. They do not address or dispute the potential that the RLLI duty rule formulation, if adopted by the ALI and courts, would encourage policyholders and claimants to engage in improper behaviors. Policyholders would have greater incentives not to cooperate with their insurer, and claimants would have the tools to take unfair advantage of settlement negotiations.[90] As a result, insurers would likely pay out higher amounts both in terms of settlements and excess judgments.[91] Although this result could financially benefit some errant policyholders and claimants, the cumulative impact would be to increase costs that would be incorporated into future premium amounts and passed on to all policyholders.[92] Policyholders who have not engaged in any abusive conduct or attempt to manipulate the insurance claims handling system would thus be the ones penalized the most.[93]

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85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. *See infra* Part IV.
91. *See, e.g.*, Time Ins. Co. v. Burger, 712 So. 2d 389, 393 (Fla. 1998) ("[An insurer's] [p]ayment of illegitimate claims raises the cost of insurance for all policyholders.").
92. *See* Schwartz & Appel, *supra* note 76, at 1528; Syverud, *supra* note 74, at 1168 ("As a result [of ambiguous duty to settle standards], insurers will accept some unreasonable, inefficient settlements, and they will sometimes avoid bargaining strategies that are in the interests of insureds. The resulting overpayment on such claims is a cost to all insureds.").
93. *See* Robert W. Emerson, *Insurance Claims Fraud Problems and Remedies*, 46 U. MIAMI L. REV. 907, 913 (1992) ("Because premium increases partly incorporate fraud costs, insurance fraud hurts all policyholders, not just insurers.").

A rule that results in increased insurance costs could also have other deleterious impacts on the insurance system. Potential insureds at the margins of being able to reasonably afford insurance could be priced out of the market,[94] which would undermine a "central" public policy goal of maximizing the availability of insurance coverage.[95] With fewer individuals able or willing to procure insurance, insurers would face greater difficulty in accurately predicting, segregating, and pooling risks to value policies, which could further increase costs on the remaining policyholders.[96] These effects could cause an "unraveling" of the insurance system.[97] This is precisely why an insurer's duty to make reasonable settlement decisions must be crafted in a manner that does not give policyholders the ability to abuse the claims handling system.

IV. POLICYHOLDER DUTY TO COOPERATE WITH INSURER

A third area where the RLLI project would establish a rule that could lead to mischief on the part of a policyholder is, ironically, the policyholder's duty to cooperate. Chapter 2's topic of "Cooperation" recommends that courts follow a fairly modest common law rule that a policyholder has an "obligation to provide reasonable assistance" to his or her insurer in the investigation, defense, and settlement of a claim.[98]

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94. *See* Schwartz, *supra* note 78, at 34–35.

95. *See* George L. Priest, *The Antitrust Suits and the Public Understanding of Insurance*, 63 TUL. L. REV. 999, 1000 (1989) ("[A] central ambition of a civilized society is to maximize the availability of insurance against all forms of prospective loss.").

96. *See* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1541 (1987) ("Adverse selection is a problem central to every insurance context, and it dominates the insurance function. An insurer must collect into a risk pool individuals with a sufficiently narrow range of exposure to risk for the insurance to remain financially attractive to each member of the pool."); *see also* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 946 (1988) (suggesting that adverse selection and moral hazard create asymmetrical uncertainty, where the policyholder has more information than the insurer, and that this impedes insurance from working efficiently). *See generally* Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976).

97. Priest, *supra* note 96, at 1571. As Professor George Priest has explained:

> The unraveling process would consist of the lowest-risk members of the pool dropping out, which, in turn, would necessitate premium increases. The premium increases would be followed by a new set of lowest-risk members dropping out; then, further increases in premiums; and so on, in successive episodes of withdrawals and premium rises. Of course, as low-risk members withdraw, the constituency of the pool becomes further concentrated among high-risk members.

Id. at 1576.

98. RESTATEMENT OF THE LAW OF LIAB. INS. § 29 (AM. LAW INST., Discussion Draft 2015).

Concern here arises not with respect to endorsing such a basic policyholder duty, but rather with how a potential breach of the duty is intended to be enforced. Specifically, under-enforcement and a failure to adequately sanction policyholder failures to cooperate with his or her insurer could incentivize policyholders to engage in purposeful acts designed to frustrate their insurers' handling of a claim.

The RLLI rule formulation states that a policyholder's "breach of the duty to cooperate relieves [the] insurer of its obligations under [the] insurance policy only if the insurer demonstrates that the failure caused substantial prejudice to the insurer in the outcome of the claim."[99] The provision relieving an insurer of its obligations where a policyholder has breached the duty to cooperate is widely supported by case law;[100] however, the precise formulation providing relief to an insurer *only* where the policyholder's failure to cooperate "caused substantial prejudice . . . in the outcome of the claim"[101] does not appear to have express case law support.[102] In particular, the "substantial prejudice"

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99. *Id.* § 30.

100. *See, e.g.*, S. Tippecanoe Sch. Bldg. Corp. v. Shambaugh & Son, Inc., 395 N.E.2d 320, 329 (Ind. Ct. App. 1979) ("[Insured] was under an implied duty to cooperate fully with its insurer in its inspection of any loss covered under the policy."); Darcy v. Hartford Ins. Co., 554 N.E.2d 28, 32 (Mass. 1990) ("Under current law, breach of the duty to cooperate on the part of an insured must be 'substantial and material' before it permits an insurer to disclaim liability." (quoting Morrison v. Lewis, 221 N.E.2d 401, 404 (Mass. 1966), *abrogated by Darcy*, 554 N.E.2d 28)); Pa. Gen. Ins. Co. v. Park-Ohio Indus., 930 N.E.2d 800, 803 (Ohio 2010) ("[T]he insured has a duty to cooperate."); *see also* OR. REV. STAT. § 656.262(14) (2013) ("Injured workers have the duty to cooperate and assist the insurer or self-insured employer in the investigation of claims for compensation."); Staples v. Allstate Ins. Co., 295 P.3d 201, 205 (Wash. 2013) (en banc) ("Most insurance policies contain cooperation clauses requiring the insured to cooperate with the insurer's handling of claims.").

101. RESTATEMENT OF THE LAW OF LIAB. INS. § 30 (AM. LAW INST., Discussion Draft 2015).

102. *See, e.g.*, Boesel v. State Farm Fire & Cas. Ins. Co., 565 F. App'x 611, 613 (9th Cir. 2014) (stating that insured's actions "breached the duty to cooperate, and substantially prejudiced [insurer's] ability to approximate the value of the claimed loss"); Kannaday v. Ball, No. 12-2742-JTM, 2014 WL 4259152, at *17 (D. Kan. Aug. 29, 2014) ("The insurer is relieved of responsibility where the insured violates the duty to cooperate, and this results in substantial prejudice to the insurer." (citing Boone v. Lowry, 657 P.2d 64, 70 (Kan. Ct. App. 1983))); Soyoola v. Oceanus Ins. Co., No. 2:13-cv-08907, 2014 WL 4215515, at *6 (S.D. W. Va. Aug. 25, 2014) ("[T]o void a policy based on the insured's breach of the duty to cooperate, the insurer must establish: (1) substantial prejudice as a result of the breach, (2) the breach was willful and intentional, and (3) the insurer diligently sought the insured's cooperation." (citing Bowyer *ex rel.* Bowyer v. Thomas, 423 S.E.2d 906, 907 (W. Va. 1992))); Aetna Cas. & Sur. Co. v. State Farm Mut. Auto. Ins. Co., 771 F. Supp. 704, 707 (W.D. Pa. 1991) ("Pennsylvania law provides that for a disclaimer of coverage to be valid the insurer must prove (1) that the putative insured breached its duty to cooperate in the insurer's investigation and defense of a claim, and (2) that the insurer suffered substantial prejudice as a result." (citing Paxton Nat'l Ins. Co. v. Brickajlik, 522 A.2d 531 (Pa. 1987))), *aff'd*, 961

standard is supported by some case law, but the addition of "in the outcome of the claim" is not.[103]

This difference between the "black letter" rule formulation and the general common law approach is significant. It could permit a policyholder to engage in willful misconduct to sabotage an insurer's claims handling process in several scenarios without any penalty or consequence. Pursuant to the RLLI's duty rule, a policyholder could try every way imaginable to impair his insurer's handling of a claim, but if that intentional misconduct was ultimately unsuccessful (despite the policyholder's best efforts) in substantially prejudicing the claim's "outcome," the insurer would have no recourse against these improper tactics.[104] Similarly, a policyholder who acted intentionally to frustrate his insurer's handling of a claim and was ultimately successful in prejudicing the claim's "outcome" would avoid any adverse consequences so long as he did not "substantial[ly] prejudice" the claim's outcome.[105] In either case, the duty rule, if adopted by a court, would operate to protect rather than deter a policyholder's intentional misconduct.

As discussed previously with respect to an insurer's duty to make reasonable settlement decisions, policyholders might engage in intentional acts to impede their insurers' handling of a claim for a variety of reasons.[106] For instance, policyholders might wish to hide material facts related to an accident or claim from their insurer, which, if known, might preclude coverage. Policyholders might also seek to impair their insurers' handling of a claim as a means to avoid paying any out-of-pocket costs where the policyholder chose a policy with relatively modest policy limits, or to potentially convert an insurance claim into a broad tort recovery.[107] By purposefully frustrating the claims handling process, policyholders could facilitate a breach of the insurer's duty to make reasonable settlement decisions or possibly trigger actions that the policyholder could later allege constituted "bad faith" and achieve such results.

Establishing a rule that allows any of these scenarios by excusing both attempted fraud by policyholders and successful fraud by policyholders that does not rise to the level of substantially prejudicing a claim's outcome would be unsound public policy. The rule, if adopted by

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F.2d 207 (3d Cir. 1992).

103. *See supra* note 102.

104. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 30 (AM. LAW INST., Discussion Draft 2015).

105. *See id.*

106. *See supra* notes 77–80 and accompanying text.

107. *See supra* notes 77–80 and accompanying text.

courts, would open the door to intentional acts designed to unjustly enhance the recovery of relatively few errant policyholders at the expense of the many honest policyholders; these increases in insurance costs would, as explained, ultimately be passed on to all policyholders through higher premiums and undermine the functioning of insurance markets.[108]

Further, under the RLLI's duty rule, an insurer that took positive steps to mitigate the impacts of attempted fraud or misconduct by a policyholder would actually be made worse off for having done so. By instructing courts to examine how a policyholder's misconduct affected the claim's final "outcome," the duty rule would force insurers to wait until after a claim has been settled or litigated before seeking relief.[109] Hence, an insurer dealing with a policyholder who purposefully failed to cooperate would be better off allowing the misconduct to worsen to the level of substantially prejudicing the claim's outcome than taking positive steps to lessen the misconduct while it is occurring.[110]

The rule formulation, therefore, could have the effect of giving policyholders an incentive to fail to cooperate with their insurers, and insurers an incentive to do nothing about it. This could result in wasteful and unnecessarily protracted claims handling and litigation, which would also increase insurance costs for all policyholders (including those policyholders who cooperate fully with their insurer).

The traditional common law approach, in comparison, provides a more flexible standard such that an insurer may be relieved of its policy obligations whenever the policyholder causes substantial prejudice to the insurer at any point in the handling of the claim. An insurer is not required to await the "outcome" of the claim (however that term might be defined) and then have the policyholder's conduct evaluated in hindsight,

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108. *See supra* notes 90–97 and accompanying text.

109. As comment b of section 30 of the RLLI explains:

> [T]his Section sets a high standard for meeting the substantial-prejudice requirement that focuses on the impact of the failure to cooperate on the outcome of the claim. It is not enough that the insured's failure to cooperate increased the cost or difficulty of the defense. Rather that failure must have affected the outcome of the claim for the insurer, for example by depriving the insurer of a full or partial defense to liability, substantially increasing the amount of the judgment, or depriving the insurer of an opportunity to settle the case for a substantially lower amount than the insured damages ultimately awarded.

RESTATEMENT OF THE LAW OF LIAB. INS. § 30 cmt. b (AM. LAW INST., Discussion Draft 2015). *But see id.* § 30 cmt. d (stating that if an insurer discovers collision by a policyholder with a claimant before substantial harm has occurred, the prejudice requirement may "be satisfied as long as the collusion would have affected the outcome of the claim if the collusion had not been discovered").

110. *See id.* § 30 cmts. b & d.

perhaps months or years later.[111] Courts have, instead, appreciated that purposeful misconduct by a policyholder in the investigation and evaluation of a claim can cause significant harm to an insurer that is deserving of relief regardless of whether that harm is directly reflected in the claim's final "outcome."[112]

Most courts allow an insurer to be relieved of its policy obligations whenever the insurer is able to show "actual prejudice" as a result of the policyholder's breach of the duty to cooperate.[113] This standard provides broader relief than the RLLI duty rule for insurers where a policyholder engages in misconduct, even if the novel phrase "in the outcome of the claim" were deleted. Thus, the "substantial prejudice" standard in the RLLI's duty rule already sets the highest bar for insurers to be relieved from their policy obligations under prevailing case law.[114] There is not a sound rationale for increasing the bar even higher through a novel rule formulation that offends the Restatement's guideline to develop legal rules "constrained by the need to find support in sources of law"[115] and escalates existing concerns about policyholders engaging in insurance fraud.[116]

Moreover, the RLLI project imposes only one basic duty on policyholders: to act reasonably in cooperating with their insurer. This

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111. *See id.* § 30 cmt. b (recognizing the "drawback" of the RLLI formation of the duty to cooperate that "because of the occasional difficulty of proving substantial prejudice, the rule will sometimes require an insurer to cover a claim or provide a defense even though the insurer in fact was prejudiced by the insured's failure to cooperate").

112. *See* W. E. Shipley, Annotation, *Duty of Liability Insurer to Settle or Compromise*, 40 A.L.R.2d 168 § 18 (1955) ("Evidence reasonably justifying the insurer in believing that the injured claimant and the insured were in collusion in urging acceptance of a settlement offer has been held to justify its rejection.").

113. *See* Darcy v. Hartford Ins. Co., 554 N.E.2d 28, 33 (Mass. 1990) ("The vast majority of jurisdictions which have considered the issue have decided that actual prejudice to an insurer's interests due to lack of an insured's cooperation must be demonstrated before a denial of coverage will be permitted, and we conclude that that should be the rule here as well."); *see also* RESTATEMENT OF THE LAW OF LIAB. INS. § 30 cmt. b (AM. LAW INST., Discussion Draft 2015) ("The approach that is least protective of insureds employs a presumption that a breach of the duty to cooperate causes prejudice to the insurer, with the insured bearing the proof of rebutting the presumption, and an undemanding standard for prejudice to the insurer (for example, increased costs or difficulty in investigating or defending the claim, even if cooperation would not have affected the outcome of the claim).").

114. *See* RESTATEMENT OF THE LAW OF LIAB. INS § 30 cmt. b (AM. LAW INST., Discussion Draft 2015) ("[T]his Section sets a high standard for meeting the substantial-prejudice requirement . . . .").

115. ALI STYLE MANUEL, *supra* note 2, at 6.

116. Insurance fraud has been estimated to cost the industry approximately eighty billion dollars per year. *How Big is $80 Billion*?, COALITION AGAINST INS. FRAUD, http://www.insurancefraud.org/80-billion.htm#.VhrCe3jkxHw (last visited Oct. 22, 2015).

duty and its enforcement should, therefore, be robust enough to effectively deter misconduct and fraud by policyholders in all forms, and promote the fair and efficient handling of an insurance claim. In its present formulation, the RLLI's duty rule appears to belie the very purpose of having a duty to cooperate. If adopted, the rule could have the opposite effect of encouraging intentional misconduct by policyholders by excusing such misconduct in all except the most egregious circumstances.[117] The ALI would, in effect, be adopting a rule that condones fraud, provided the harm inflicted does not cause "substantial prejudice . . . in the outcome of the claim."[118]

V. CONCLUSION

The initial draft of the converted RLLI project included a number of areas, three of which have been discussed here, where the insurance rules developed had the potential to incentivize or otherwise allow conduct on the part of a policyholder that would have been antithetical to the fair and efficient handling of a liability insurance claim. With respect to one of these areas, misrepresentation, the Reporters of the RLLI have revised what was a novel rule formulation to conform to the traditional common law approach. With respect to the other two areas, the insurer's duty to make reasonable settlement decisions and the policyholder's duty to cooperate with the insurer, the RLLI approach continues to raise serious public policy concerns. These concerns may also be heightened by how the ALI addresses other current provisions in the RLLI, which are outside the scope of this Article, as well as future insurance law topics the project is expected to cover such as "bad faith."[119] Any RLLI provision that could create avenues for gamesmanship would unfairly increase the burdens and costs on insurers, which would be passed onto all policyholders in the form of increased premiums and could lead to a lack of insurance availability and other system failures. For these basic reasons, it is important for both the ALI and judges debating whether to follow provisions of the RLLI to carefully consider how proposed rules may be abused by some policyholders, and adopt only rules that

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117. Illustrations set forth in the Comments to section 30 show that insurers cannot meet the rule's substantial prejudice requirement where a policyholder's misconduct results in harms such as increased defense costs. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 30 cmt. b, illus.1 (AM. LAW INST., Discussion Draft 2015).

118. *See id.* § 30.

119. The topic of insurance "bad faith" is slated to be covered in Chapter 4 of the RLLI project. *See id.* § 19 cmt. g n.5 (AM. LAW INST., Discussion Draft 2015).

encourage positive behaviors by all parties involved in a liability insurance transaction.