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PERSPECTIVE

The new Restatement of the Law, Liability Insurance: a primer

By Kirk Pasich

Restatements of the Law have been a feature of the legal landscape nearly 100 years. Issued by the American Law Institute, they influence and shape the law. 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, the institute has spoken on the subject of liability insurance. It has published the Restatement of the Law, Liability Insurance. This Restatement has proven to be controversial, both in its drafting process and since its final approval. Yet, it was not adopted lightly. It was the subject of seven institute annual meetings and a lengthy back-and-forth process involving more than 160 lawyers representing insurers, insureds, and others. This process produced 29 drafts presented formally in institute meetings. Therefore, this Restatement may have a significant impact on the law — exactly what it is intended to do.

According to the institute, the Restatement “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.” Courts in California already have begun citing the new Restatement. *See, e.g., Webcor Constr., LP v. Zurich Am. Ins. Co.*, 2019 WL 1129554, at *4 (N.D. Cal. Mar. 12, 2019); *Endurance Am. Specialty Ins. Co. v. Bennington Group, LLC*, 2017 WL 4225945, at *4 (L.A. 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, here are three key highlights.

Insurance Policy Interpretation (Section 3)

The Restatement's approach is similar to California's. However, its guidance may clarify and influence California's approach in important ways. For example, the Restatement provides substantive and practical guidance regarding evidence of

custom, practice and usage to assist in policy interpretation, even when policy language appears to be clear. According to the Restatement, when custom, practice, and usage “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. ... 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.”

An Insurer's Receipt of Confidential Information (Section 11)

There has been considerable debate about what information can be shared with an insurer that has reserved its rights to deny coverage without potentially jeopardizing the attorney-client privilege. California Civil Code section addresses this issue, at least in part. Section 2860(a) 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. Section 2860(d) states that 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.”

However, Section 2860 applies only when an insurer has, and is honoring, a duty to defend. If an insured discloses privileged information to a non-defending insurer (e.g., a denying insurer, an excess insurer, or an insurer whose policy obligates it to pay defense costs, but not to actually defend the 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.”).

The Restatement takes a more protective approach to privilege. It states: “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.”

This approach should facilitate settlements because it will allow for a more fulsome exchange of information. However, 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.”

Recoupment of Defense Costs (Section 21)

California, like most states, takes a very pro-insured approach to an insurer's duty to defend its insured, holding that such a duty exists whenever there is a potential for coverage. However, unbeknownst to many, California law allows an insurer to seek reimbursement of a settlement or defense costs that may be allocated solely to uninsured claims, even if it funded a settlement over the insured's objection. *See Buss v. Superior Court*, 16 Cal. 4th 35, 57-58 (1997) (insurer may seek reimbursement of “claims that are not even potentially covered,” but not of claims that are “potentially covered,” although it bears “extremely difficult” burden of allocating costs “solely to claims that are not even potentially covered”).

The Restatement rejects this reimbursement rule, instructing: “Unless otherwise stated in the insurance policy or otherwise agreed to by the insured, an insurer may not seek recoupment of de-

fense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs.” It explains: “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 ... have rejected the insurer's claim to recoupment in the absence of a provision in the policy or other agreement permitting reimbursement.”

The Restatement's explanation may lead to a reconsideration of the rule in California: “[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.” As it further explains, “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.”

Kirk Pasich is the managing partner of Pasich LLP and a mediator with Signature Resolution. He represents insureds in complex insurance coverage matters. He may be reached KPasich@PasichLLP.com and KPasich@SignatureResolution.com.

