Section 24, Comment (d): An Insurer's Duty to Act Reasonably Does Not Require the Acceptance of Any and All "Reasonable Settlement Demands"

Proposed Amendment to Restatement of the Law of Liability Insurance, Tentative Draft No. 1

By Robert F. Cusumano

Amend § 24, comment (d) to delete the requirement imposed on insurers to accept a "reasonable" settlement offer on pain of voiding the policy limits, as reflected in the following text of draft comment (d):

> In determining whether a settlement decision was reasonable, the factfinder should view the settlement from the perspective of the parties at the time the settlement was made. A reasonable insurer is expected, at the time of settlement negotiations, to take account of the realistically possible outcomes of a trial, and, to the extent possible, to weigh those outcomes according to their likelihood…. The insurer will be liable for any excess judgment against the insured in the underlying litigation if the trier of fact finds that the insurer rejected a settlement demand, or failed to consent to a settlement that was reasonable….
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> The effect of this rule is that, once a claimant has made a settlement demand in the underlying litigation that is reasonable, an insurer that rejects that demand thereafter bears the risk of any excess judgment against the *insured defendant* at trial. One practical effect of this rule is to give claimants an incentive during the pretrial phase to make reasonable settlement demands within policy limits, since the insurer's rejection of such a demand creates the conditions for a subsequent breach-of-settlement-duty lawsuit in the event of a plaintiff's verdict that produces an excess judgment. Although courts have not on the whole emphasized this point, the fact that reasonableness is a range and not a point means that an insurer is liable even if the rejected settlement was at the high end of the reasonableness range.

This language has already been the subject of a prior motion that was resolved by removing and amending certain language that indicated that there might be a "range" of "reasonable settlement offers". That amendment, however, does not address the basic problems associated with imposing an obligation on insurers to accept any "reasonable settlement offer" on pain of voiding policy limits. A linguistic fix is not available for what ails this provision and the new mandate it entails.

Supporting Statement

The black letter text of section 24 of the draft of the Restatement of the Law of Liability Insurance imposes on insurers defending lawsuits an obligation to act in good faith, and then defines that obligation as a duty to act as if the insurer "bears sole financial responsibility for the full amount of the potential judgment." Although the black letter text does not say it, these obligations are backed by a powerful incentive: failure to abide by them results in the voiding of policy limits and the payment of the full judgment by the insurer (see comment (d)).

This framework for settlement obligations broadly reflects current law, and is formulated in a way that, although not crystal clear in day-to-day litigation activity, practitioners can understand and live with. This framework allows defending insurers to take cases to trial when it is reasonable to do so, while punishing unreasonable behavior in settlement negotiations. It forces insurers to act in good faith, while preserving opportunities for the give-and-take of negotiations that, in the aggregate, effectively set settlement values for claims. It is a workable framework, and has already been the stage on which millions of insured tort claims have been handled, settled or adjudicated.

The Comments, however, interpret this sensible and practical black letter provision in a very different way, and they place insurers who are trying to defend claims in an impossible position: *The Comments, particularly Comment (d,) indicate that insurers must accept any and all "reasonable" settlement demands.* If they fail to do so, the stated limits of their policies will be voided.

This approach constitutes a radical reformulation of litigants' duties to try to settle tort claims, with implications for justice and fairness as well as for the proper operation of the tort system as a whole. For the reasons that follow, I respectfully request that the comment language requiring acceptance of reasonable settlement offers be stricken, and that, to the extent that commentary about the black letter formulation is deemed necessary at all in this area, the Reporters be requested to craft language completely consistent with the black letter of section 24.

1. The Comments to Section 24 Contradict the Text of Section 24.

Section 24 requires one thing – acting reasonably as if a potential judgment were entirely an insurer's own money – but Comment (d) requires a completely different thing – acceptance of all reasonable settlement offers on pain of voiding policy limits. The difference between the two is massive and encompasses almost the entirety of settlement negotiation in the tort system.

First, no one who is actually taking "sole financial responsibility" for a claim would ever imagine settling the exposure just because a plaintiff had made a demand that fell within the "range of reason". Even if we imagine a rather narrow "range of reason" for settling, the high end of that range is, by definition, not the place where a self-interested litigant wants to land. Indeed, our justice system has created vast infrastructures for sorting out how to settle cases

somewhere within the range of reason, including litigation activity and mediation of all sorts. This new rule set forth in Comment (d) would, for cases with insurance, force-select the highest settlement value that can be justified within reason, and this directly contradicts the sensible text of Rule 24 itself. The recent amendment that removes references to a "range" of reason does not solve this problem, simply because "reasonableness" i a range whether we call it that or not.

Second, we must recognize that the range of reason for tort claims is rather broader than it would be for the purchase or sale of tangible property or merchandise. The tort system, and just about every lawsuit within the tort system, liquidates (or tries to judgment) an array of legal and factual controversies that are often highly uncertain. It does so through processes that themselves have uncertainty around them, and through decision-makers (judges and juries) who see controversies through lenses as varied as human nature itself. All of these factors play into settlement negotiations, right alongside the individual needs and wants of the parties, the quality of their counsel, and the subjective justice of their cause. In tort actions, one can say that ranges of reasonable are often several hundred percent of each other or more. Indeed, in many cases where liability itself is questionable, or where the law is disputed, that ratio may rise to infinity as a perfectly reasonable defendant concludes that a given action has no merit at all. Once again, to force an outcome at the highest point in such a wide range is incompatible with a mandate to negotiate as if one "bears sole financial responsibility" for a potential judgment. And, once again, "reasonableness" is very much in the eye of the beholder, and there are many beholders (plaintiff, defendant, mediator, judge, jury in the main tort case, appellate bench, jury in the second case against the insurer for failure to settle) and they all have very different cognitive apparatus, wants, needs and exigencies. To suggest that there is such a thing as a central "probable verdict value" is to kid ourselves. In the tort system, "reaosnable settlement value is a very wide range indeed, and this mandate requires payment at the upper point of it.

Third, the black letter text clearly permits a defendant (insured or not) to litigate a case to conclusion simply because the defendant or insurer believes in the justice of their cause or, more broadly, allows a defendant to litigate aggressively in court in order to suppress an ultimate payout. Defendants do this every day, whether they are insured or not. Under Comment (d), however, insurers would be compelled to pay a very significant pre-trial penalty – voiding of limits – in order to continue with the litigation/mediation process. Thus, again, the approach in the Comments fundamentally contradicts the terms of section 24 itself.

2. The Legal and Practical Rationale for Comment (d) is Dubious

There have been hundreds of reported decisions that deal with the admittedly vexing questions that surround settlement dynamics where a defending insurer has a policy limit. We must acknowledge, as the law does, that such circumstances involve externalities that can create bad incentives. As a result of this recognition, the courts have crafted standards that look very much like the black letter text of section 24 in order to minimize the operation and effects of those externalities.

The reporters' note to section 24 cites just two reported decisions, however, that can be read to sponsor the kind of solution that Comment (d) grafts on to the sensible approach reflected in the black letter of section 24. Our research suggests that a truly overwhelming majority of reported decisions support the basic rule set forth in the black letter, and explicitly or implicitly reject the notion that all reasonable settlement offers must be accepted formulated in Comment (d). I believe it is fair to call the system set forth in Comment (d) an untried innovation in an area of law that has been combed over by the courts for at least decades.

The accepted solution to the potential externality problem has been to put the insurer under a "good faith microscope", so to speak, and to hold the enforceability of policy limits hostage to demonstrably good behavior. This, in turn, has compelled insurers to develop claims-handling procedures and protocols, often in the form of long manuals, and to take great care in "limits at risk" situations to attempt to settle cases fairly. But until now, it has not been considered reasonable or even feasible to require insurers to accede to *any* settlement offer "within the range of reason" on pain of voided limits. This is because of the radical shift such a rule would inflict on good faith, self-interested settlement negotiations (see section 3 below) and, in general, insurers' ability to contest claims and to move them into the lower regions of the "range of reason".

But there is a more elemental problem with the approach of Comment (d). In purporting to solve for a minor externality, it imposes a vastly larger, more dangerous one. Yes, the new settlement negotiation regime will certainly make it impossible for an insured defendant to suffer from the absence of insurer "downside" in taking cases to trial. But that new regime does so by making it basically impossible to resist settlement demands at all. If Comment (d) is adopted, we will have solved for an annoying but relatively minor paradox by creating a gigantic and debilitating paradox. In this new regime, the making of a "reasonable settlement demand" (whatever that is) leads immediately to one of two things: either (a) an acceptance and payment, or (b) the voiding of policy limits. Without question, this will constitute an existential change in the nature of settlement talks, and entail a dramatic, perhaps virtually total, shift in bargaining power among litigants.

I believe that it is fair to say that very nearly all of the negotiations of meaning in the tort system take place within the "range of reason". Certainly, all of the meaningful ones do. Thus, this new paradox being created by Comment (d) represents, in effect, the replacement of a system that requires "reasonable settlement negotiations" with a system that requires payment of any reasonable amount requested.

3. The Comments to Section 24 Announce a New Rule with Daunting and Widespread Implications

Where else in our law or our society is there a rule that establishes a price for *anything* that is explicitly and solely based on the highest number within a highly subjective "range of reason"? Broadly speaking, the constructively ambiguous term "reasonable" is widely used in the law to afford review and reversal of "unreasonable" determinations, but not to force one actor to

succumb to the demands of another actor, if only the latter's actions are later held to be reasonable. This has justice implications, as well as severe economic implications. Here are just a few of the immediate consequences to expect if the approach of Comment (d) were actually to be adopted into the common law.

First, there is a basic injustice in forcing an insurer who is defending a claim in good faith to stop defending it and pay it instead. On a universal basis, settlement values are now determined through the push and pull of litigation and the battle between parties' subjective/objective views of what is advantageous and what is reasonable, all playing through the lenses of procedure and emotion, case law and economic need. It is admittedly a messy, very human system, but it has worked. In the new Comment (d) regime, on the other hand, a plaintiff's selection of a settlement demand within some range of reason *will become determinative per se*. Plaintiff's reasonable demands must be met *before any judgment is rendered* (i.e., before there is any adjudication that the claim has merit), on pain of a punitive contractual reformation in the form of the deletion of the most essential economic term in every insurance policy, its limit of liability. Similarly, an insurer's totally reasonable behavior must be ignored in this new system, since it *is not relevant at all* under the new rule set forth in Comment (d). Our justice system, however, is based on the availability of an actual adjudication if a party acts in good faith. This new rule impinges directly on that precept by inflicting a significant penalty on insurers – and *only on insurers* – if they decide in good faith to continue to litigate in court even if a plaintiff has made a reasonable (but very high) demand. And we must take note of the fact that the new rule will at least call into question insured defendants' rights to argue in good faith for extensions of the law (which are not sanctionable, but now will be punished through the voiding of policy limits), while it simultaneously gives *immediate economic value* to a plaintiff arguing for an extension of the law, who may issue a (somewhat discounted) "reasonable" settlement demand based on any new legal theory they espouse.

Second, and similarly, the new Comment (d) settlement regime will, in effect, give mere allegations *actual value*. Although it has always been true that allegations can serve as a prompt to settlement, it has always *also* been true that a litigant can never be required to pay settlement moneys solely on the basis that a demand for such moneys might be considered to be "reasonable". Settlement demands, for example, can be deemed "reasonable" simply because they are a rational reaction to uncertainties, i.e., unproven allegations. This new settlement regime would empower a plaintiff to liquidate the uncertainty around its own unproven allegations by the simple expedient of putting a somewhat lower "reasonable" number on the table. The insurer would have to accept the offer or lose its policy limits, unless it could prove that the guesswork entailed in discounting the offer to reflect uncertainty was fully outside the range of reason. This new system, then, gives plaintiffs a tremendous amount of power to extract immediate value out of uncertain litigable claims, in the form of either an accepted settlement at the highest end of a range of reason, or a blown limit caused by a rejection of a demand for same.

Third, Comment (d) seems to anticipate the existence of some follow-up decision-making mechanism, presumably an ensuing litigation, about the question whether a rejected settlement demand was or was not within the range of reason. One never wants litigation about litigation,

but this particular variant of the species promises to be particularly gruesome in terms of defining proper standards for adjudication. We must imagine cases in their thousands in which insurers take entirely reasonable approaches in a sincere effort to settle cases, in which plaintiff's own settlement number is far-distant and not agreed, and in which a second jury is convened to assess *not* the good faith of the settlement dialogue, but *only* the "reasonableness" of plaintiff's pre-trial demand. Who will volunteer to write the jury instructions for that trial? And how will claims-handlers and defense counsel predict in advance – as they must do -- what that follow-on decision-maker will deem to be "reasonable".

Fourth, claim costs will inevitably rise in this new environment. As a matter of logic, it is impossible for this not to happen, because the new rule in Comment (d) centers the valuation on solely on a plaintiff's unilateral (and always higher) "reasonable demand", and renders the insurer's own evaluation totally irrelevant. We must recognize that it is far more likely that the rule announced in Comment (d) will be so punitive and intimidating that insurers will "pay up" in accordance with its terms, rather than run any meaningful risk that their limits might be eradicated in a follow-on litigation about the reasonableness of a plaintiff's settlement demand. Under the current settlement duties set forth in the main text of section 24, insurers are already quite cautious about the possibility of voiding a limit. In this new regime, they will be equally cautious about it, but far more at risk for the outcome. This is simply because under the new system, the insurer's own behavior no longer matters; all that matters is whether the plaintiff's demand will be held to be "reasonable". Formerly, insurers could protect themselves by behaving well while negotiating; under this new system, they can only protect themselves by paying any reasonable amount within the limit. And in most cases, that is exactly what they will do.

Fifth, the opportunities for gaming the system will be vast. The current approach, well reflected in the black letter text of section 24, certainly encourages a dialogue structured around policy limits and duties of good faith, as it centers on *the insurer's* duty to act carefully and reasonably. This new regime will center not on good faith, and will not even center on the insurer's course of conduct. Rather it will center on predictions about how a later adjudicator will assess the reasonableness of a plaintiff's unilaterally selected settlement demand. It will do so based on an inventory of valuation factors that is hardly knowable and probably not even roughly predictable. Game theorists will have a field day, issuing demands that lay somewhere near the outer boundaries of "reasonableness", confident that such tactics will achieve either a large settlement or the voiding of the policy limit. And the people responsible for handling claims for insurers will not be able to take comfort in their own good faith behavior and sensible settlement offers. Rather they will be at the mercy of a future decision-maker's opinion of whether the plaintiff's demand was reasonable, and thus at the mercy of the uncertainties and insecurities associated with the very definition of "reasonable settlement offer".

Sixth, in that regard, and with due respect for the frequency and necessity of our society's usage of variants of the word "reasonable" in the law, Comment (d) represents a remarkably difficult new application of that word. By its very nature, "reasonable" is a loose concept-- intentionally so -- and one that becomes less useful and more dangerous the more weight we put upon it.

Here, the word must bear a heavy burden indeed. In this new regime, the word "reasonable" will not be directed at conduct or a course of dealing. It will, rather, be the basis for a post-facto inquiry into the legal enforceability of a demand for payment specific number (a plaintiff's settlement demand). The number under consideration, in turn, will have to be evaluated in connection with the vast array of factors that our tort system must consider as it determines "settlement values". Some of those factors are objective; some are highly subjective; others are actively disputed, often on the basis of evidence that is itself in dispute; and still others are relevant but embarrassing to admit to (e.g., demeanor or predisposition of judge, composition of jury, political disposition of appellate bench). And different people will, rightly, have different opinions about these factors, because these factors are all matters of opinion.

Individually, the various factors going into settlement evaluations are difficult to assess; collectively, they pose nearly infinite complexity. Challenging the "reasonableness" of a settlement demand will, I predict, be so impossibly challenging that few will undertake the effort at the risk of losing their limits of liability.

Lastly, it is terribly difficult to make confident predictions about how our complex tort and insurance systems will, in the end, adapt to this newly-tilted settlement field. But if it is adopted here, and then by the courts, this will be a very big deal indeed. Clearly, as noted, settlement values will rise significantly throughout the system as insurers are unable to resist any demand within the wide range of reason. The use of contractually stated limits of liability in insurance policies as a central factor in pricing will be have to be reconsidered. Clearly, insurers will be hard-pressed to challenge novel theories of liability or questionable evidence of injury, through trial and on to appeal and :limits settlements" will proliferate. Beyond the clear tendencies in the everyday cases, however, the mind is hard-pressed to envision how this kind of scheme will play out in the ever-changing world of mass torts and class actions, with 10- or 11-figure "demands" issued against merely 9- or 10-figure coverage charts.

A major overhaul of the usual rules of engagement in settlement negotiations should, I would think -- and recommend -- be the subject of much deep and practical consideration, and not be adopted in the comments to an otherwise non-controversial black letter section of an insurance restatement. The new system being innovated in Comment (d) has significant implications for the law of torts, for procedure, for the functioning of the courts, and for the underwriting and risk management practices of a worldwide industry. Such a proposal should, at the very least, be examined with care by all of the ALI constituencies with an interest in the proper functioning of our dispute resolution systems.