1993

Judicial Limitations in the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique

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"Bad faith" litigation between insurers and insureds encompasses a range of issues: the insured may challenge the denial of benefits under a first-party policy,[1] the insured may challenge the quality of the insurer's defense effort under a third-party liability policy,[2] or the insured may challenge a decision by an insurer to settle a case in which the insured would bear much of the cost due to a sizeable deductible.[3] Another common type of dispute arises when insurers expose their insureds to substantial uncovered liability through the rejection of settlement offers, followed by litigation that results in a judgment in excess of both the settlement offer and the policy limits.[4] These cases are the subject of this Paper.[5]

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1. *See* STEPHEN S. ASHLEY, BAD FAITH ACTIONS: LIABILITY AND DAMAGES § 2:14 (1992) (detailing and criticizing the rationales used to extend the bad faith cause of action to first-party insurance claims); ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 7.9(a), at 907-08 (student's ed. 1988) (explaining that numerous jurisdictions have recognized a tort of insurer bad faith in first-party insurance claims).

2. *See* ASHLEY, *supra* note 1, § 4:10 (recognizing that some courts have allowed a cause of action for bad faith failure to defend); KEETON & WIDISS, *supra* note 1, § 7.9(c) (remarking that several courts have held that the insurer's duty to defend is subject to a good faith standard).

3. *See* Nationwide Mut. Ins. Co. v. Public Serv. Co., 435 S.E.2d 561 (N.C. Ct. App. 1993) (suggesting that an insured can maintain a bad faith cause of action against an insurer for settling for the amount of the deductible); Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1185-93 (1990) (identifying the confiicting interests of insureds and insurers in the settlement of a third-party claim when the policy contains a large deductible).

4. *See* ASHLEY, *supra* note 1, § 2:05 (noting that a bad faith cause of action can arise when an insurer, defending a claim that exceeds the policy limits, risks a judgment exceeding the policy limits rather than settling for the full amount of coverage); KEETON & WIDISS, *supra* note 1, § 7.8(a), at 877 (observing that courts in many states have concluded that insurers are required to act in good faith to pursue a settlement within the applicable policy limits).

5. Such cases are also the focus of a thorough survey by Kent Syverud in which he touches on many of the issues that I address here. *See generally* Syverud, *supra* note 3 (examining the way in which insurers and their insureds contract for the contingency of settlement and its effect on litigation); Charles M. Silver, *A Missed Misalignment of Interests: A Comment on Syverud,* The Duty to Settle, 77 VA. L. REV. 1585 (1991) (critiquing Syverud's views regarding insurers' incentives to reject settlement offers).

Disputes over the rejection of settlement offers by insurers would not arise absent provisions in insurance contracts setting policy limits because an insured with unlimited coverage would face no exposure in the event of a large judgment. Likewise, these settlement disputes would not arise absent provisions giving insurers control over the decision whether to settle or litigate. However, many, and perhaps most, liability insurance policies contain both types of provisions.[6] Consequently, a conflict of interest between the insurer and the insured can arise whenever the outcome of litigation is uncertain.

Suppose, for example, that an insured has bcen involved in an accident in which an injured party has suffered damages of $100,000. The insured's policy affords coverage up to $50,000. Assume further that the plaintiff cannot recover without proof of negligence and that an honest assessment of the case suggests a fifty-percent probability that the insured will be found negligent. The expected judgment against the insured is thus $50,000, an amount exactly equal to the policy limit. Suppose finally that the plaintiff offers to settle for that amount before trial. Putting aside any reputational damage that might accompany a decision to settle, the insured will prefer to accept the settlement offer because, ignoring any deductible, the insurer is contractually obligated to pay the entire amount. The insurer, however, will wish to accept the settlement offer only if the total expected cost of going to trial would be greater than $50,000, again putting aside any reputational concerns. Therefore, the insurer will prefer to reject the offer unless defense costs exceed $25,000 because the insurer's expected liability at the conclusion of trial, not including defense costs, is $25,000.[7] Such a refusal to settle exposes the insured to the possibility of $50,000 in uncovered liability should negligence be found.

This potential conflict of interest has been well understood for decades, and courts have long considered the question of what, if anything, to do about it.[8] Early courts often held the insured to the bargain that

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As suggested in the text, an insured may at times prefer to litigate when the insurer wishes to settle. This divergence of interests may occur for several reasons: the insured may bear a large deductible in the event of settlement, Syverud, *supra* note 3, at 1188-89, or the insurer may fail to consider the reputstional damage a settlement would cause the insured to suffer, *id.* at 1158. I do not address these problems here.

6. *See infra* notes 20-22 and accompanying text (discussing the terms giving settlement discretion to insurers). Policy limits are, of course, ubiquitous.

7. The insurer has a 50% chance of owing nothing and a 50% chance of owing $50,000 if the case goes to trial. The expected cost of trying the case is therefore $25,000, absent defense costs. The cost of settling, on the other hand, is a certain payment of $50,000. Thus, if litigation costs are less than $25,000, a risk-neutral insurer will prefer to reject a $50,000 settlement offer, assuming its only concern is its own financial exposure.

8. *See, e.g.*, Syverud, *supra* note 3, at 1116 ("For seventy-five years, courts have invoked a doctrine known as 'the duty to settle' to impose liability on insurance companies who fail to settle lawsuits against the people they insure.").

appeared on the face of the policy and allowed the insurer essentially unfettered discretion to litigate even when the insured would much prefer a settlement.[9] In contrast, other early courts imposed on the insurer an obligation to take into account the insured's interests during settlement negotiations.[10] Today, the view that courts must restrict the ability of insurers to reject settlement offers is virtually universal,[11] although the precise statement of the insurer's obligations varies. For example, courts may say that the insurer must exercise "due care" to protect the interests of the insured, that it must act in "good faith" with regard to the interests of the insured, or that it must avoid rejecting settlement offers in "bad faith."[12] Courts also differ in the implementation of these concepts[13] and in the remedies available when an insurer breaches its obligations.[14]

The most widespread approach is the "disregard-the-limits" rule, advocated years ago by Robert Keeton.[15] This principle requires the insurer to behave in settlement negotiations as if the policy contained no limits upon the insurer's obligations to pay.[16] The usual remedy against an

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9. *See, e.g.*, Georgia Casualty Co. v. Cotton Mills Prods. Co., 132 So. 73, 76-77 (Miss. 1931) (holding that the insurer had no obligation to settle a third-party claim within the policy limits); St. Joseph Transfer & Storage Co. v. Employers' Indem. Corp., 23 S.W.2d 215, 221 (Mo. Ct. App. 1930) (refusing to find a duty to settle because "[w]e could not hold . . . that refusal to settle was negligent, unless we assumed . . . that it is the duty of the insurance eompany to shut its eyes to its own interests and seek only the protection of the assured when an offer of settlement is made").

10. Among the earliest cases imposing limitations upon the insurer's discretion in the settlement context is Brassil v. Maryland Casualty Co., 104 N.E. 622, 624 (N.Y. 1914) (holding that the insurer, by refusing to settle, violated the obligations of good faith underlying all contracts).

11. *See* KEETON & WIDISS, *supra* note 1, § 7.8(a), at 877 (stating that, in general, courts hold that an insurer cannot exercise unrestricted discretion in accepting or rejecting settlements).

12. For citations to cases stating each expression of the doctrine, see *id.* § 7.8(b)(1). Actions against an insurer for failure to consider properly the interests of the insured may sound in contract for breach of an implied term or in tort for breach of a duty of care, *id.* § 7.8(a), at 877-78, a distinction that is of little practical importance in most cases. *But see id.* (acknowledging that the contract-tort distinction may sometimes prove significant if, for example, a contract suit has a longer statute of limitations or if a tort claim permits a broader measure of damages). In some states, the insured has a choice between the two theories. *Id.* § 7.8(a), at 878-79.

13. *See id.* § 7.8(b)(2) (observing that appellate courts differ as to the relative degree of consideration that they require an insurer to give to the insured's interests in comparison with its own).

14. *See id.* § 8.7(h)-(i) (indicating that some courts limit consequential damages to the amount by which the tort judgment exceeds the liability coverage whereas others allow emotional distress and punitive damages).

15. Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1183-84 (1954).

16. *Id.* A leading case embracing this test is Crisci v. Security Insurance Co., 426 P.2d 173 (Cal. 1967). According to *Crisci*, "[i]n determining whether an insurer has given [proper] consideration to the interests of the insured, the test is whether a prudent insurer without policy limits would have accepted the settlement offer." *Id.* at 176. The popularity of this approacb has been documented by Kenneth Abraham: "The *Crisci* rule is standard law now in most jurisdictions." KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 586 (1990) [hereinafter ABRAHAM, INSURANCE LAW]. For further discussion of this approach, see KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 192, 191-93 (1986) [hereinafter ABRAHAM, DISTRIBUTING RISK]

insurer who fails to observe this rule is to allow the insured to recover the amount by which the judgment at trial exceeds the policy limits.[17] It is misleading to label this a "bad faith" standard because the insured does not need to show any malice or recklessness on the part of the insurer.[18] Rather, it is enough that a reasonable insurer without a policy limit would have accepted the settlement offer.[19]

This Paper employs economic analysis to explore the wisdom of such judicial constraints on insurers' discretion to reject settlements. The issues are complex, and the discussion accordingly tentative, but on the whole I conclude that the economic case for a bad faith cause of action against the insurer is, at best, uneasy when the insurance contract clearly provides the insurer with discretion to settle or litigate. I base this claim on inferences to be drawn from actual insurance contracts, on the potential that pretrial bargaining between the insurer and the insured has to ameliorate conflicts of interest, on the difficulty of fashioning and administering an acceptable remedy for conflicts of interest in the settlement context, and on the uncertainties surrounding the *ex ante* consequences of bad faith doctrine.

I. The Economic Argument for Constraints on Insurers' Discretion to Reject Settlement Offers

Insurance contracts vary in their language, but typical liability policies obligate the insurer to defend lawsuits alleging claims within the scope of the policy and vest settlement discretion in the insurer. For example, the Commercial General Liability Coverage Form drafted by the Insurance Services Office provides: "We will have the right and duty to defend any 'suit' seeking [covered] damages. But . . . [w]e may investigate and settle any claim or 'suit' at our discretion."[20] Similarly, a standard auto policy drafted by the Insurance Services Office provides: "We will settle or defend, as we consider appropriate, any claim or suit asking for these [covered] damages."[21] Older contracts often put the matter slightly less

(explaining that the disregard-the-limits rule "gives insurers the incentive to act in an economically efficient manner" because the insurer must internalize the risks of rejecting a reasonable settlement offer).

17. ABRAHAM, DISTRIBUTING RISK, *supra* note 16, at 192.

18. *See* KEETON & WIDISS, *supra* note 1, § 7.8(b)(1), at 883 ("[C]ourts have concluded that 'bad faith' may exist even though the representatives of the company have been scrupulously honest in their handling of the claim.").

19. *See id.* § 7.8(b)(2), at 884 (noting that several cases have required the insurer to "view the opportunity for a settlement as it would if there were no limit of liability applicable to the insured's coverage").

20. Insurance Services Office, Commercial General Liability Coverage Form (1984), *in* ABRAHAM, INSURANCE LAW, *supra* note 16, at 440, 442 [hereinafter Commercial Form].

21. Insurance Services Office, Personal Auto Policy (1985), *in* ABRAHAM, INSURANCE LAW, *supra* note 16, at 602, 604 [hereinafter Auto Policy].

precisely—the insurer "may make such investigation, negotiation, and settlement of any claim or suit as it deems expedient."[22]

Provisions giving the insurer settlement discretion are often buried somewhere in the middle of the policy, and many insureds may neglect to read and reflect upon them. Judicial decisions restricting insurer discretion in settlement typically do not proceed on a contract-of-adhesion or lack-of-conspicuousness theory, however, perhaps because such decisions would be hard to confine to settlement clauses and could then make it difficult for insurers to enforce a vast range of other contractual terms designed to control the risks that insurers undertake. Instead, courts sometimes suggest that the policy language is ambiguous about the existence of any constraints on the insurer's settlement discretion. Consequently, the parties should be presumed to have intended that the insurer would act in good faith or with due care toward the insured when exercising its discretion.[23] In the alternative, it is sometimes suggested that the insurer's obligation to provide the insured with a legal defense creates "a reasonable expectation" that the insurer will not disregard the insured's interests in settlement decisions, an expectation that the law should protect.[24] "The insured has paid for at least some consideration of his interests when settlement is contemplated. Settlement decisions that completely ignore the insured's interest attempt to reallocate this already allocated contractual advantage. They are abuses of contractual discretion."[25]

These legal argnments in favor of constraints on insurers' discretion in settlement can be bolstered with economic arguments. In the remainder of Part I, I develop the economic arguments as forcefully as I can, with the rejoinder to follow in Part II.

A. *The Simple (Simplistic?) Economics of the Conflict-of-Interest Problem*

The simplest economic argument for constraints on insurers' discretion in settlement negotiations runs as follows:[26] Assume that the plaintiff's

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22. KEETON & WIDISS, *supra* note 1, § 7.8(a). Virtually the same language is quoted in ABRAHAM, DISTRIBUTING RISK, *supra* note 16, at 188.

23. *See, e.g.*, Hilker v. Western Auto. Ins. Co., 231 N.W. 257, 258-59 (Wis. 1930) (suggesting that any ambiguity in the language of the contract should be construed to impose a duty to make discretionary decisions in good faith), *aff'd on reh'g*, 235 N.W. 413 (Wis. 1931).

24. One court expressed this theory in the following way:

> The insured surrenders to the insurer the right to investigate and compromise or contest claims knowing that, in the event of a claim, the insurer will have its own interests to consider. But an insured also has a right to assume that his interests will not be abandoned merely because the insurer faces the prospect of a full loss under the policy.

Southern Fire & Casualty Co. v. Norris, 250 S.W.2d 785, 790 (Tenn. Ct. App. 1952); *see also* ABRAHAM, DISTRIBUTING RISK, *supra* note 16, at 189 (discussing the insured's reasonable expectation that the insurer will consider the insured's interests in settling a claim).

25. ABRAHAM, DISTRIBUTING RISK, *supra* note 16, at 190.

26. The discussion that follows is an elaboration of the analysis first put forward in ABRAHAM,

settlement offer is "exogenous"—that is, it is fixed and unaffected by the rule governing the insurer's discretion. Let the insurer bear all litigation costs at trial, as many liability policies provide. Assume further that the insured has the assets to pay any judgment in excess of the policy limits. Finally, suppose the plaintiff makes an offer that is less than the sum of the expected judgment at trial and the litigation costs that the insurer would expend on the insured's behalf. Under these conditions, the joint expected wealth[27] of the parties to the insurance contract would be greater if the settlement offer were accepted than if it were rejected and the case litigated. Nevertheless, the insurer may be tempted to reject the offer when the insured bears part of the expected judgment because of a policy limit. In other words, the policy limit allows the insurer to "externalize" some of the risk of going to trial.[28]

To complete the argument, it is necessary to understand why parties to an insurance contract would ordinarily desire *ex ante* that each behave in a manner that increases joint expected wealth. To this end, it is useful to recall and extend the numerical example found in the introduction.[29] Again, the plaintiff's damages are $100,000, payable only if the insured is found negligent. The probability of a negligence finding is 50%, the policy limit is $50,000, and the settlement offer is $50,000. In addition, assume the insurer's defense costs at trial are $20,000. In this example, the parties' expected joint payment to the plaintiff at the conclusion of the trial is $50,000, and the trial will generate $20,000 in defense costs. Thus, the total, joint expected cost of a trial is $70,000, which plainly exceeds the $50,000 settlement offer, and the settlement is joint-wealth-increasing. The insurer, however, expects to pay only $25,000 at the conclusion of the trial—the other $25,000 of expected liability being borne by the insured.[30] When added to the costs of litigation, this amounts to only $45,000, a figure that is less than the $50,000 settlement offer. Suppose then that the insurer, acting selfishly, rejects the settlement offer despite the negative impact on the parties' joint wealth.

The parties in this illustration could make themselves jointly better off if they could write a contract that would induce the insurer to accept the settlement offer under these circumstances. This could be accomplished in one of two ways. First, the insured could compensate the insurer for accepting the offer by paying the insurer $5000 at the time of settlement.

DISTRIBUTING RISK, *supra* note 16, at 190-91, and in Syverud, *supra* note 3, at 1126-32, but it articulates more clearly the assumptions that are required to develop the argument.

27. Joint expected wealth is simply the sum of the insurer's and the insured's expected wealth.

28. For an illustration of this problem, see *supra* note 7 and accompanying text.

29. *See supra* note 7 and accompanying text.

30. Like the insurer, the insured has a 50% probability of paying $50,000 (the difference between the plaintiff's damages—$100,000—and the portion that the insurer would pay—$50,000).

The insurer would then be indifferent between going to trial, in which case it would expect to pay $45,000, and settling for $50,000, in which case it would still only pay $45,000 after receiving the $5000 payment from the insured. The insured, on the other hand, would surely be better off with this arrangement, because by paying $5000 to the insurer, the insured would avoid a 50% chance of sustaining $50,000 in uncovered liability—an expected cost of $25,000. Indeed, because the insured is risk averse—otherwise insurance is not valuable—he would in fact be willing to pay more than $25,000 to avoid an expected liability equal to that amount.[31] This example illustrates a general principle: Whenever the insured's expected cost from the rejection of a settlement offer exceeds the insurer's expected gain, a mutually advantageous arrangement can be devised whereby the insured compensates the insurer for settling.

Of course, it is not necessary that the insured pay the insurer to settle *after* a lawsuit has been filed. Instead, the parties could agree at the outset of their contractual relationship that the insurer would settle under the hypothesized circumstances. The insurance premium could then be increased to compensate the insurer *ex ante*. To make this claim concrete, suppose there is a 1% chance of an accident that will lead to the above-described circumstances. If the insurer anticipates that it will be able to act selfishly in settlement by rejecting the offer, its expected cost from the accident *ex ante* is $450 (1% of $45,000).[32] The insured's expected liability from the accident when the insurer acts selfishly is $250 (1% of $25,000).[33] By contrast, if the insured can extract from the insurer a promise to settle the case, the insured is protected from any liability to the plaintiff. Thus, the insured would be willing to pay more than $250 because of its risk aversion for an *ex ante* promise from the insurer to settle. Recall that the added eost to the insurer of settling is only $5000 after the accident occurs, or $50 *ex ante* (1% of $5000). Hence, there is room for a profitable deal—the insurer would be happy to promise to settle for an *ex ante* payment of $50 or more, and the insured would be willing

31. This claim follows from the definition of risk aversion—a risk averse individual confronted with an uncertain prospect of loss, with a given expected value, would be willing to pay more than that expected value to eliminate the risk of loss. The difference between the expected value of the loss and the amount the risk averse individual would be willing to pay to avoid it is termed the "risk premium." *See* Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economics Analysis*, 72 CAL. L. REV. 569, 627 (1984) (describing "risk premium" as "measur[ing] how much an individual would be willing to pay for the privilege of purcbasing actuarially fair insurance"). It is the existence of positive risk premiums that makes the insurance business profitable and creates the gains from trade under an insurance contract. *See* HERBERT S. DENENBERG, RISK AND INSURANCE 17-18 (1974) (discussing the concept of risk aversion in the insurance context).

32. Recall that the $45,000 includes both the insurer's expected cost of liability after trial and the expected litigation costs. *See supra* text accompanying note 30.

33. The $25,000 represents the insured's expected liability if the case goes to trial. *See supra* note 30 and accompanying text.

to pay considerably more *ex ante* to obtain such a promise. An ideal insurance contract[34] in our example would thus require the insurer to settle in return for a premium increase that both compensates the insurer for such a promise and is less than the insured is willing to pay. Again, the result here is quite general—when settlement would be joint-wealth-increasing and the insurer acting selfishly would be tempted to litigate, the parties could make themselves jointly better off if the insurer promised *ex ante* to settle in return for an increase in the insurance premium that compensates for the added cost.[35]

This analysis has two implications. First, if its assumptions usefully characterize the insurance arrangement, it suggests that parties to an insurance contract containing a policy limit would ideally like to restrict the insurer's discretion in settlement negotiations. The insured can benefit even though the insurer is fully compensated by a premium increase—a "Pareto improvement"[36] in economic parlance. A contractual provision that allows the insurer to behave entirely selfishly, by contrast, is not an ideal arrangement. This observation provides some basis for the claim that unfettered insurer discretion in settlement decisions may be inconsistent with the intent or reasonable expectations of the parties.

Second, the analysis suggests a possible standard to apply in restricting insurer discretion. My numerical example hints that the insurer should be induced to accept all settlement offers that are joint-wealth-increasing, even if the insurer's selfish interests at the time the offer is made would lead the insurer to litigate. Indeed, because of the insured's risk aversion, even some offers that are not joint-wealth-increasing should ideally be accepted—any such offer in which the joint loss in expected wealth is smaller than the "risk premium" that the insured would pay to avoid its share of the risk of liability.[37] The disregard-the-limits rule fares reasonably well from this perspective: If we assume that insurers are approximately risk neutral, an insurer without policy limits would accept any settlement offer that increased its expected wealth. When the insurer behaves *as if* there were no policy limits, its own expected wealth corresponds to the joint expected wealth of the parties to a contract with policy limits—assuming, as before, that the insured can pay any judgment in

34. By "ideal contract" I mean the contract that would prevail if the parties could costlessly write down the terms that best promote their joint interests—in economic parlance, the "first-best" contingent contract.

35. The division of the joint gains between the insurer and the insured would depend upon the structure of the insurance market. If the insurance market is competitive, for example, we would expect the premium to rise only by an amount necessary for the insurer to cover its costs, with the surplus going to the insured.

36. PAUL WONNACOTT, ECONOMICS 441 (1979) (defining "Pareto improvement" as a "change that will make one individual better off without hurting anyone else").

37. *See supra* note 31 (defining "risk premium").

excess of the limits. Hence, the disregard-the-limits rule seemingly asks the insurer to accept all joint-wealth-increasing settlement offers. The insurer can comply with the rule and still reject some settlement offers that would be accepted under an ideal contract due to the insured's risk aversion, but the disregard-the-limits rule may nonetheless be a reasonable first approximation of the ideal contract given the costs that would attend any effort to ascertain the insured's risk premium.[38] Thus, the argument runs, if insurance contracts omit a disregard-the-limits requirement—why they do so remains to be explored—the courts can promote the joint interests of the parties by inserting such a provision after the fact.

B. *Qualifications and Refinements to the Basic Argument: Reputation, Coasean Bargaining, and Asymmetric Information*

The illustration above supposes that, in the absence of contractual or judicial restrictions on insurers' discretion, insurers will reject joint-wealth-increasing settlement offers whenever litigation increases their own expected wealth. That supposition is no doubt too strong for the reasons described below.

First, insurers care about their reputations in the marketplace. When an insurer rejects a settlement offer that is within the policy limits and the policyholder ultimately bears substantial uncovered liability, insurers can anticipate that the policyholder will not keep quiet about the matter. The insurer will likely suffer some market penalty even in the absence of any legal penalty following a bad faith lawsuit.[39] The magnitude of such a market penalty is, however, unclear. Information about insurer behavior during settlement negotiations may disseminate poorly in the marketplace, and even when it is conveyed, potential customers may have little basis for judging whether an insurer's decision to reject a settlement offer was reasonable. Thus, although it would be a mistake to dismiss the importance of reputational concerns out of hand, it is unlikely that they will be sufficient to control the conflict-of-interest problem completely.

A second check on the conflict-of-interest problem comes from policyholders themselves. In the numerical example above, we noted the opportunity for the insured to contribute toward a settlement when the insurer would otherwise be tempted to litigate.[40] If settlement is joint-wealth-increasing, there exists a payment by the insured to the insurer that is less than the insured's expected uninsured liability at trial and that will suffice

38. This amount is wholly subjective and unobservable, and it cannot be ascertained with confidence by a court.

39. *See* Syverud, *supra* note 3, at 1161 (noting the reputational effects of insurers' rejection of settlement offers that their insureds would prefer to accept).

40. *See supra* note 31 and accompanying text.

to induce settlement by the insurer. Further, to the degree that insurers anticipate the receipt of such payments, premiums should fall in order to compensate insureds *ex ante* for what they must pay *ex post*. The reduction in premiums will likely induce some insureds to purchase more coverage, further ameliorating the problem because as the policy limit rises, the number of cases in which a conflict of interest emerges will decline.[41] The opportunity here for bargaining to avoid the inefficient rejection of a mutually advantageous settlement offer, despite the absence of a legal rule to protect the insured, is an illustration of the Coase Theorem.[42]

Like reputational concerns, however, payments by the insured to the insurer after a claim arises are only an imperfect solution to the problem. The possible need to make such payments represents a risk to the insured that, in an ideal world, would be borne by the superior risk bearer: the insurance company. The payments thus represent a departure from optimal risk sharing, the importance of which will depend upon the circumstances. In addition, some insureds will lack the information necessary to determine when to offer to contribute to a proposed settlement. Because liability insurance usually provides the insured with legal defense services,[43] insurers will often have better information both about the legal issues in the case and about the possibility of a judgment in excess of the policy limits. Thus, insureds may unknowingly fail to explore valuable opportunities for making a contribution toward a settlement.

One might argue in response to this last observation that even if the insured lacks knowledge at the outset, the better-informed insurer has an incentive to reveal information to the insured in an attempt to ascertain whether a profitable deal can be struck between them. However, asymmetric information creates another problem. If the insurer is better informed about the expected outeome of the case, what is to prevent the insurer from exaggerating the expected value of uncovered liability? Indeed, the insurer might employ such a strategy to extract a contribution from the insured that is larger than what is really necessary to induce the insurer to settle. Bargaining with the insured over a contribution to a settlement thus has a double-edged quality—it may represent a (concededly imperfect) solution

41. The higher the policy limit, other things being equal, the less expected liability is borne by the insured. The difference between the insurer's expected wealth and the joint expected wealth of the parties diminishes, and the range of settlement offers that the insurer would be tempted inefficiently to reject contracts. Likewise, as the policy limit rises, the number of accidents for which the insured bears uncovered liability decreases.

42. *See generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (demonstrating that, in the absence of transaction costs, parties will contract to reach the most efficient result, regardless of the law's assignment of rights).

43. *See supra* notes 20-22 and accompanying text.

to the conflict-of-interest problem created by the policy limit, or it may embody opportunism by the insurer. Again, premiums will tend to decline if insurers are opportunistic, and insureds can respond by purchasing more coverage. That outcome, however, is plainly less than ideal because the optimal allocation of risk to the insurer is thwarted by the insurer's opportunistic extraction of payments from the insured. The counterstrategy available to insureds—retaining separate counsel to advise on the credibility of the insurer's threat to litigate—is obviously costly as well.

These last remarks provide another possible economic justification for judicial restrictions on insurers' discretion to reject settlement offers. Not only may such restrictions discourage insurers from rejecting joint-wealth-increasing settlements when the conflict of interest over settlement is bona fide, but they may also discourage opportunistic behavior under conditions of asymmetric information. Under the disregard-the-limits rule, for example, an insured would know that even if the insurer threatened to litigate unless the insured contributed to the settlement, the insurer would be subject to liability for any judgment in excess of the policy limits if settlement would have been joint-wealth-increasing. Hence, if the disregard-the-limits rule is applied accurately, threats to litigate will not be carried out so long as the settlement offer is, in fact, joint-wealth-increasing. The imperfectly informed insured, protected by a disregard-the-limits rule, might thus adopt a strategy of refusing to contribute to the settlement if the settlement offer is within the policy limits, reasoning that the insurer will carry out a threat to litigate only when the plaintiff's offer exceeds the joint expected losses of the insurer and the insured. This strategy is not ideal to be sure, due to the insured's risk aversion,[44] but it may be the best that the insured can do in the face of imperfect information, and it may leave the insured better off than it would be in the absence of a legal duty to settle on the part of the insurer.

In summary, absent a legally enforceable duty to settle, two potential problems arise: insurers may be tempted to reject some settlements that an ideal contract would require them to accept, and insurers may attempt to extract settlement contributions from insureds opportunistically. Concern for reputation is likely an imperfect check on both problems, and although pretrial Coasean bargaining can ameliorate the first problem if the insured is well informed about the expected judgment, bargaining comes at the expense of optimal risk sharing. Finally, the imperfectly informed insured will not know when to offer to contribute toward a settlement and cannot be sure that the insurer will be truthful in disclosing information about the possible outcome of the case. Consequently, insureds are vulnerable to opportunistic efforts by insurers to extract settlement contributions. For all

44. *See supra* note 31 and accompanying text.

of these reasons, an ideal insurance contract arguably would contain some restrictions on the settlement discretion of insurers, perhaps similar to the obligation imposed by the disregard-the-limits rule. The remainder of this Paper will explore difficulties with this economic argument for a duty to settle, at least when that duty is imposed by the courts rather than expressly by the insurance contract.

II. Objections to the Economic Case for Constraints on Settlement Discretion

The argument outlined above requires a number of assumptions that may not prove to be true in practice. Once these are relaxed, the economic case for judicially imposed restrictions on settlement discretion weakens considerably. Further, any benefits that might be derived from such restrictions must be weighed against the associated administrative costs, which are likely to be considerable.

A. If Restrictions on Settlement Discretion Are Such a Good Idea, Why Do Insurance Policies Omit Them?

The economic argument for restrictions on settlement discretion implies that parties to insurance contracts would benefit by including such restrictions. Yet, despite decades of attention to the problem of confiicts of interest in the settlement context, policies systematically omit such provisions today and typically have in the past.[45] This fact poses a puzzle that requires careful attention.

Insurance law students may be tempted to respond that this "puzzle" is really nothing more than a straw man. Insurance companies have all the bargaining power, they may suggest, and no opportunity exists for most insureds to negotiate over the details of their policies. Thus, it is no wonder that provisions on settlement discretion, like other policy provisions, are unfairly desigued to promote the interests of the insurer over those of the insured.[46]

To an economist, however, arguments along this line are fallacious. Even granting the assumption that insurance companies have considerable bargaining power, which is at best a dubious one given the intensity of competition in many insurance markets,[47] it would nevertheless be folly for insurance companies to insist on policy provisions that are understood

45. *See, e.g.*, Commercial Form, *supra* note 20; Auto Policy, *supra* note 21.

46. *See* Christina M.L. Lass, *The Injured Third Party*, 26 VAL. U. L. REV. 843, 843 (1992) (stating that because the insurer's bargaining power is superior to that of the insured, the insurer controls the policy provisions).

47. Banks McDowell, *Competition as a Regulatory Mechanism in Insurance*, 19 CONN. L. REV. 287, 309 (1987).

by insureds to be joint-wealth-decreasing. To return to our numerical example, recall that the policyholder would be willing to pay over $250 *ex ante* for a promise by the insurance company to settle the hypothetical case and that the cost to the insurer of such a promise was only $50 *ex ante*.[48] A profit-maximizing insurance company with all the bargaining power would agree to settle at a cost of $50 and would raise the premium by an amount approaching $250 in order to extract all the surplus from its policyholder, thereby increasing its expected profit by $200. Equivalently, omitting the promise to settle lowers the insured's willingness to pay by more than it lowers the insurer's costs, thus reducing the insurer's potential profit. Therefore, a sound explanation for the omission of joint-wealth-increasing terms from the insurance contract cannot rest on the insurer's advantage in bargaining power.

Another standard explanation for the omission of valuable contractual terms involves the transaction costs of drafting and including them in insurance contracts. If the costs of putting terms in writing are significant, and if the probability or importance of the contingencies under which these terms might prove useful is low, rational contracting parties may prefer to omit the terms because the costs of including them exceed the expected benefits. Such reasoning provides a conventional justification for contract law "default rules" that approximate what the parties would have drafted for themselves absent the costs.[49] Appropriate default rules allow the parties to avoid the transaction costs of writing custom agreements while still enjoying many of the gains in joint wealth that customized agreements would facilitate.[50]

This argument similarly fails to provide a convincing explanation for the omission of constraints on insurer discretion in settlement, or at least it fails to justify any particular judicially imposed default such as the disregard-the-limits rule. Most insurance policies are derived from standard forms developed by industry associations such as the Insurance Services Office.[51] Standard forms greatly economize on the costs of writing detailed agreements, and a glance at almost any liability policy will reveal terms covering all manner of low-probability contingencies. If a simple constraint on insurer discretion such as the disregard-the-limits rule were broadly valuable in insurance contracts, it could easily be included in standard forms among existing policy terms. Thus, for the transaction

48. *See supra* note 33 and accompanying text.

49. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989) (discussing the default rules for incomplete contracts as gap-fillers, the basic purpose of which is to enforce "what the parties would have contracted for").

50. *See* E. ALLEN FARNSWORTH, CONTRACTS § 7.15 (1982) ("If all terms were expressly agreed to, even the simplest contracts would become intolerably long.").

51. *E.g.*, Commercial Form, *supra* note 20; Auto Policy, *supra* note 21.

costs of drafting to explain the omission of constraints on insurer discretion in settlement, the appropriate constraints must vary across policyholders to such an extent that attempts to standardize them would be unproductive. Any universally applicable judicial default, such as the disregard-the-limits rule, then becomes highly suspect.

There is a third possible explanation for the omission of valuable constraints on insurers' settlement discretion that may provide some basis for the use of a judicially imposed default; however, it is hardly conclusive in my view. This argument also relates to transaction costs—in particular, information costs. Policyholders, the argument runs, are typically unsophisticated in legal matters and do not appreciate *ex ante* the consequences of provisions that give the insurer complete discretion to settle.[52] Indeed, many policyholders cannot bring themselves to wade through their policies at all, much less to reflect on the implications of particular terms down the road. Thus, even if a sophisticated policyholder would value appropriate constraints on insurer settlement discretion and would, in fact, be willing to pay for such constraints, most policyholders are *un*sophisticated and do not value them. Consequently, an insurer who includes such constraints in a policy will incur costs that cannot be recouped through higher premiums. Under competitive conditions, therefore, policies containing constraints on insurer settlement discretion will be driven from the market—a "lemons" problem to use the terminology of Akerlof.[53] Likewise, there will be no incentive for industry associations to include such constraints in their standard forms because they will recognize that, ultimately, insurers will not use them.

While plausible, this argument also has its difficulties. Plainly, not all insureds are unsophisticated in legal matters. Indeed, recall that the Commercial General Liability Coverage Form, used as the basis for policies sold to large companies with considerable legal resources, says nothing about any constraints on the insurer's discretion to settle or litigate.[54] It would be interesting to investigate whether any significant number of large, commercial insureds have negotiated departures from the language of this Form or its predecessors, particularly during the period prior to the widespread acceptance of the bad faith cause of action or in the modern jurisdictions in which the cause of action is fairly restrictive. I am aware of no evidence to this effect, nor am I familiar with any modern cases in which

52. *See* KEETON & WIDISS, *supra* note 1, § 2.8(a) (stating that the average buyer of insurance "lacks information that would be essential to a reasoned choice about details of the transaction").

53. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 89 Q.J. ECON. 488, 489-90 (1970) (noting that when consumers cannot distinguish good products from bad, "bad [products] drive out the good because they sell at the same price as good" products).

54. Commercial Form, *supra* note 20.

such negotiated constraints on the insurer's discretion have come to light through litigation.

If commercial insureds have never to any significant extent pressed for contractual restrictions upon their insurer's discretion to reject settlement offers, the inference that such restrictions are desirable is certainly weakened. This point is reinforced by the fact that commercial insureds *have* obtained other types of restrictions on settlement discretion—for example, consent-to-settle clauses. Some insureds, like doctors sued for malpractice, fear that settlements will damage their reputations. As a result, insurers have responded for many years by offering policies under which they cannot settle without the insured's consent.[55] If the market is responsive to the demand for constraints on the insurer's ability to *accept* settlement offers, it seems that the market would also be responsive to a demand for constraints on the insurer's ability to *reject* settlement offers. As noted, that response does not seem to have been forthcoming either now or previously, thus leading to the inference that insureds do not want such constraints, that the constraints would require a degree of customization that would be prohibitively costly, or that the administrative costs associated with them would swamp any gains.

Professor Logue, in his comment on this Paper, argues that sophisticated insureds do not seek duty-to-settle clauses because modern courts provide this protection automatically and such clauses would be, in effect, superfluous.[56] I am unpersuaded. The law did not always provide the bad faith cause of action, and, more importantly, its workings in modern courts can be quite uneven and unpredictable.[57] For example, juries are often instructed that insurers must give "equal consideration" to the interests of their insureds in deciding whether to settle, an instruction that hardly ensures careful implementation of the disregard-the-limits rule, or any other discernible principle for that matter. Other juries may be told simply to decide whether the settlement offer was "reasonable," whether there was "great risk of recovery beyond the policy limits," or something else yet.[58] Therefore, if a specific principle like the disregard-the-limits rule were generally desired by parties to insurance contracts, they would do well to include it in their contracts to ensure its application later. But as noted, I am aware of no evidence that sophisticated insureds have done so with any regularity.

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55. *See* Syverud, *supra* note 3, at 1172-85 (describing the advantages of consent-to-settle clauses in professional liability insurance contracts).

56. Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375, 1382-83 (1994).

57. *See* Walbrook Ins. Co. v. Liberty Mut. Ins. Co., 7 Cal. Rptr. 2d 513, 518 (Ct. App. 1992) (observing that the concept of bad faith is amorphous and necessarily changes depending on the context).

58. *See* ASHLEY, *supra* note 1, § 3:20 (collecting various formulations of the jury instructions in bad faith actions).

The argument that policies will omit joint-wealth-increasing terms due to the insureds' inattention to detail or lack of sophistication also seems to prove too much. Various terms in insurance policies sold to "unsophisticated" consumers—terms equally buried away in the fine print—confer significant benefits upon insureds. For example, the standard auto policy includes, in its first-party medical coverage, payments to insureds who, as pedestrians, are injured by a motorist.[59] This is coverage that most purchasers of an auto liability policy seemingly would not expect. The same policy also provides coverage for bail bonds[60]—again something that the typical purchaser seemingly would neither expect nor demand. The presence of these and various other benefits[61] can only be explained, in my view, by the existence of careful comparison shopping by *some* sophisticated consumers whose preferences are eventually reflected in industry standard forms. If such discriminating consumers indeed exist, it is by no means obvious why their preferences regarding the conduct of settlement negotiations would not also be reflected.

For these reasons, the omission from insurance policies of explicit constraints upon insurer discretion in settlement is not self-evidently the result of market failure. Quite the opposite, the omission may support an inference that such constraints are undesirable after all or that the terms would need to vary so much from policyholder to policyholder that the transaction costs of customization would make them impracticable. Either way, the notion that courts can benefit the parties to insurance contracts by enforcing a simple and universally applicable default rule for insurers' settlement decisions is problematic.

We also cannot necessarily infer that judicial constraints on settlement discretion are valuable simply because industry-standard forms have not made serious attempts to contract around either the modern law of bad faith or the disregard-the-limits rule. The decisions in this area often rest on a duty of good faith said to be implicit in every contract or on a tort duty that is external to the contract.[62] It is not easy to contract around such obligations. Many courts would likely strike down contractual waivers of the obligation of good faith (or due care) on public policy grounds or as being unconscionable.[63] Further, the inclusion of such waivers in a

59. Auto Policy, *supra* note 21, at 606.

60. *Id.* at 604.

61. *See, e.g.*, Insurance Services Office, Business Auto Coverage Form (1990), *in* 1 SUSAN J. MILLER & PHILIP LEFEBVRE, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 259, 263.1 (1991) (covering damages caused by war, whether declared or undeclared; insurrection; or rebellion).

62. *See supra* text accompanying note 12 (describing the various expressions of the insurer's obligation toward the insured).

63. *See* ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW § 6.3(a), at 351 (1971) (explaining the judicial regulation of contracts of adhesion to enforce the objectively reasonable expectations of the parties); *see also* Ayres & Gertner, *supra* note 49, at 87 (explaining that the duty of good faith is "an immutable part of every contract")

contract might mislead or frighten insureds and thereby do more harm than good—who wants to contract with an insurer that disclaims its "good faith"? Therefore, the fact that insurers seemingly acquiesce in the persistence of judicial restrictions on their settlement discretion does not necessarily support an inference that such restrictions are economically desirable.

I do not wish to overstate the case. In the end, I believe that inferences about the optimal bargain drawn from the terms of insurance contracts are weak inferences and that none of the arguments presented here rules out the possibility of a market failure in the insurance-contracting process that might be correctable through judicial intervention. I simply wish to suggest the possibility that insurance contracts may omit constraints on insurers' discretion in settlement because such constraints are not in the parties' economic best interests. The following sections present economic arguments supporting this possibility.

B. *The Inability of Insureds to Pay Judgments in Excess of Policy Limits*

The conflict of interest at issue here—that occurring when the insured wishes to settle but the insurer does not—would not arise absent a policy limit.[64] Insureds could thus avoid this conflict altogether by purchasing liability insurance with sufficiently high coverage limits. Yet, often they do not do so, suggesting that policy limits serve a valuable economic function notwithstanding any conflicts of interest that they generate. In fact, although there are several reasons why insurance policies contain limits on coverage,[65] among the most important is the fact that most insureds have assets considerably less than the largest possible liability judgment they might incur.[66] Individuals who are entirely judgment proof, for example, have no reason to purchase insurance at all—it is irrational to insure against loss if you have nothing to lose. Similarly, an individual with assets of $10,000 is unlikely to want a policy with a $10,000,000 liability limit if the premiums on such a policy would be $9000. In general, if the likelihood of liability greatly in excess of an insured's assets is sufficiently high and the premium for coverage to protect those assets fully is high enough, the insured may prefer to take a chance on bankruptcy rather than part with a sizable portion of its assets to preclude that chance altogether. The result is often a policy limit that affords protection against smaller levels of liability, but does not cover fully the larger claims that may arise.[67]

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64. *See supra* text accompanying note 6.

65. *See* Alan O. Sykes, *"Bad Faith" Refusal to Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem*, 23 J. LEGAL STUD. 77, 86 & n.25 (1994) (listing several possible explanations for the existence of policy limits including the fact that insureds have finite assets and the fact that the price of insurance exceeds the actuarially fair price).

66. *Id.* at 81.

67. The formal economics of insurance purchases by individuals with finite assets is developed in

When a policyholder is underinsured because of its limited assets, the consequences of restrictions upon the insurer's settlement discretion are more complex. Consider first the earlier numerical example in which the insured has a 50% chance of facing a $100,000 judgment and has a $50,000 policy limit.[68] Previously, we assumed that the insured could pay the difference between the maximum judgment and the policy limit. Let us now assume that the insured has only $10,000 in assets that the plaintiff could reach under the applicable personal bankruptcy laws. Then, the expected *payment* to the plaintiff is $30,000,[69] even though the expected *judgment* is $50,000. Therefore, if defense costs are less than $20,000, a $50,000 settlement is joint-wealth-*decreasing*. The insured's risk premium[70] may still make settlement worthwhile, but we know that this premium will be less than $5000.[71] If defense costs are sufficiently low, therefore, an ideal insurance contract would require the insurer to reject a $50,000 settlement offer.

Now consider the application of the disregard-the-limits rule in this situation. Given an expected judgment of $50,000 plus defense costs, an insurer with no policy limit would certainly accept the $50,000 offer—assuming as before that the offer is "exogenous" and cannot be bargained down. Thus, the earlier proposition—that the disregard-the-limits rule is underinclusive of the offers that an ideal contract would require to be accepted because it does not account for the insured's risk aversion—no longer holds when we assume that the insured's assets are less than the largest possible judgment.

To be sure, if the disregard-the-limits rule would place liability on the insurer for rejecting settlement offers that the parties' joint interests require to be rejected, Coasean bargaining[72] between the insurer and the insured might ameliorate the problem. In particular, the insurer might offer the insured a "bribe" in return for a waiver of a bad faith cause of action down the road. However, because this bargain might be upset on public policy

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Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986) (concluding that the motive to purchase liability insurance is diminished when an individual's assets are less than the harm he might cause), and in Sykes, *supra* note 65, at 86, 86-95 (developing "a model of the optimal contract between an insurer and an insured with limited assets").

68. *See supra* text accompanying note 7.

69. The expected payment is calculated by adding the expected contributions from the insurer and the insured. In this case, the insurer's expected contribution is $25,000—50% probability of paying the $50,000 policy limit—and the insured's is $5000 (50% probability of paying the $10,000 available to its creditors).

70. *See supra* note 31 (defining "risk premium").

71. The insured's expected loss at trial is $5000, and the risk premium is the amount in excess of $5000 that the insured would pay to avoid going to trial. Because the insured only has $10,000, the risk premium must be less than $5000.

72. *See supra* note 42.

or other grounds,[73] and because it could be costly to negotiate, the parties may be unlikely to reach such an agreement very often.[74] As a result, the disregard-the-limits rule may have the effect of putting more assets at risk than an ideal insurance arrangement would allow, thereby increasing insurance premiums and making insureds worse off *ex ante*.[75]

More generally, when insureds have assets insufficient to pay large excess judgments, the possibility arises that no simple rule can come close to replicating the disposition of settlement offers that most insureds and insurers would desire under an ideal contract. Under such a contract, the decision whether to litigate or settle would be dependent upon the insured's assets at risk at the time of litigation, the policy limit, the exact probability distribution of possible outcomes after litigation, and the insured's associated risk premium (or, upon the insured's degree of risk aversion or "utility function"[76]).[77] Although we cannot rule out the possibility that the disregard-the-limits rule would remain a serviceable default for many insurance contracts despite all these complications, we can bardly be certain that this would be so. It is quite plausible that no single, simple rule can adequately serve the needs of a large proportion of insureds. In fact, this possibility may explain the absence of settlement constraints upon insurers in actual insurance policies.

The analysis to this point is perhaps too simplistic, however, because it treats the policy limits as fixed irrespective of the legal rule governing the insurer's discretion in settlement. Things become even more complicated if we suppose that the insured chooses the policy limit with an eye toward the settlement game that will be played in the event of a lawsuit. Then, the effects of the disregard-the-limits rule—or of any other restriction upon insurers' settlement discretion—will depend upon how the rule influences settlement demands and outcomes and upon how insureds respond to these prospects by adjusting their level of coverage.

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73. *See supra* note 63 and accompanying text.

74. For reasons that we need not dwell upon, this bargain would also represent a departure from optimal risk sharing. *See generally* Shavell, *supra* note 67; Sykes, *supra* note 65.

75. Two interesting issues here are whether the insured's bad faith cause of action can be assigned to the plaintiff, and whether the insured must first pay the excess judgment to the plaintiff in order to recover it from the insurer in a bad faith suit. Plainly, when bad faith doctrine allows the insured or the plaintiff to recover more from the insurer than the plaintiff could recover from the insured, the effect noted in the text is magnified. *See generally* ASHLEY, *supra* note 1, § 3:36 (highlighting the various approaches courts have adopted to resolve this issue and noting that most courts hold that an insured need not first pay the excess judgment, but instead acquires a bad faith cause of action as soon as the excess judgment becomes final).

76. *See* 4 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 202 (John Eatwell et al. eds., 1987) ("The representation of individual's preferences over distributions by the shape of their von Neumann-Morgenstern utility functions provides the first step in the modern economic characterization of risk.").

77. *See generally* Sykes, *supra* note 65.

Such issues are the focus of another recent paper of mine in which I analyze the effects of bad faith doctrine in a model in which the insured's assets are limited.[78] Without going into great detail, the analysis begins with the observation that as coverage declines, so does the plaintiff's reservation price for settlement because the plaintiff's expected return from litigation falls.[79] The plaintiff's best settlement offer is accordingly a function of the policy limit, and a clever insured can select a limit with that in mind. In my model, for a typical accident and an appropriately chosen policy limit, the disregard-the-limits rule induces the insurer to settle, and the insured bears no risk *ex ante* because litigation is unlikely to occur.[80] By contrast, with no duty to settle imposed on the insurer, the insured must choose between increasing the level of coverage to protect its assets against a large judgment or bearing a risk of bankruptcy.[81] Working under the assumptions of this model, I demonstrate formally that for this reason the insured prefers the disregard-the-limits rule to unfettered insurer discretion.[82]

Yet, this result does not rehabilitate the case for the disregard-the-limits rule when insureds cannot pay large judgments. The model employs some strong simplifying assumptions.[83] Further, if insureds cannot pay excess judgments against them in their entirety, there is an obvious divergence between social welfare and the welfare of the parties to the insurance contract. In particular, when insureds "externalize" part of the risks that they pose to others, they may take too few precautions from a societal perspective against injuring others, and they may expand their risky activities excessively.[84] In my model, this problem can grow more acute under the disregard-the-limits rule because insureds may respond by reducing their level of coverage. The reason for this reduction is that they no longer need as much coverage to protect them from the risk of excess judgments. Consequently, the possibility arises in my model that the disregard-the-limits rule may benefit the parties to the insurance contract, yet be socially unproductive because it leads to lower levels of coverage, to greater externalization of liability, and thus to inadequate safety measures and excessive risk taking.

78. *See generally id.*

79. The plaintiff's expected return diminishes because the plaintiff realizes that more of the potential judgment will be above the policy limit and, thus, uncollectible.

80. *See id.* at 90-94 (noting that at a certain level of coverage, the disregard-the-limits rule will lead the insurer to settle, thus bearing the whole cost of the settlement).

81. *See id.* at 88-90, 96-98 (discussing the no-duty standard and how it would affect the insured's behavior).

82. *Id.* at 92-94, 98-99.

83. For a discussion of these assumptions, see *id.* at 100-07.

84. *Id.* at 107-08.

In short, when insureds cannot pay large judgments, the problem of crafting an acceptable solution to the settlement conflict-of-interest problem becomes immensely more complicated. Although the conflict surely remains, the case for the disregard-the-limits rule—or any other simple rule that one might imagine—weakens greatly. We can no longer be confident that such a rule tends to induce settlement in the circumstances in which an ideal contract would require it. It is also possible that, because the disregard-the-limits rule encourages insurers to settle more often, insureds will find that they need less coverage, thus worsening the problems associated with liability externalization.

In his comment, Professor Logue suggests that these problems might be resolved by widespread adoption of the "Michigan Rule," which modifies the disregard-the-limits rule to ask whether the settlement offer was less than the expected *collectible* judgment, taking into account the insured's limited assets.[85] It is not self-evident that such a rule is an appealing solution, however, for at least two reasons. First, its *ex ante* consequences for coverage choices and attendant liability externalization have not, to my knowledge, been worked out, and thus its social-welfare consequences remain unclear.[86] Second, and perhaps more important, the Michigan Rule apparently requires insurers, as a part of their analysis of lawsuits in which settlement is a close call, to make an exhaustive survey of their insured's assets. They must assess what would be protected by the personal bankruptcy laws and what would not, value it, and then be held accountable if their analysis was inaccurate or "unreasonable." Insureds would have an incentive to lie about their assets to induce insurers to settle during this process. In the end, bad faith litigation would become even more complex than it is now. Therefore, even if the Michigan Rule might be shown to be superior in a world of costless litigation and zero error, it is hardly clear that it is worth the additional transaction costs within the insurance relationship and the additional litigation costs in bad faith lawsuits. I am even less sanguine about Professor Logue's suggestion that the problems noted in this section might be addressed by legislation requiring mandatory, universal liability insurance with no policy limits,[87] but will leave discussion of the difficulties with such a proposal to another time.

C. *Bargaining with Plaintiffs*

The illustrations thus far have uniformly assumed that the plaintiff's settlement offer is "exogenous" and, consequently, that the insurer cannot

85. Logue, *supra* note 56, at 1386-90.

86. Professor Logue acknowledges the problem in Part V of his comment. *See id.* at 1393-94.

87. *Id.* at 1394.

hope to bargain down the settlement amount by rejecting certain offers that are otherwise joint-wealth-increasing. In reality, of course, bargaining over the settlement amount is routine, and one must inquire how imposing liability on an insurer for the rejection of certain settlement offers may affect the insurer's bargaining position, and thus indirectly the welfare of the insured.

At first blush, the possibility that an insurer may incur liability for the rejection of "reasonable" settlement offers might seem to improve the plaintiff's bargaining position and harm the insurer's. This is indeed a possible, though not a necessary, consequence of the rule. In particular, if the disregard-the-limits rule or any other restriction upon settlement discretion is to enable the plaintiff to bargain for a larger settlement, it seems that such a restriction must either increase the plaintiff's expected returns from litigation or increase the defendant's expected losses. Otherwise, the plaintiff's threat to litigate carries no more weight in bargaining than it did before. But how might a doctrine such as the disregard-the-limits rule have that effect?

I begin with a case in which the rule arguably has little or no effect on the settlement amount. Return to the numerical example in the introduction: the probability of a $100,000 judgment is 50%, the policy limit is $50,000, and the insured can pay any excess judgment.[88] Let the plaintiff's litigation costs equal $10,000, and, for simplicity, suppose that the plaintiff is risk neutral. Let defense costs also equal $10,000. Under these assumptions, the insurer's total expected costs at trial are $35,000.[89]

Suppose first that the insurer can reject any settlement offer with impunity. In this case, the insurer will not agree to settle for an amount in excess of $35,000 unless the insured contributes. The insured faces an expected excess judgment of $25,000 and would be willing to contribute more than that amount to avoid litigation.[90] Thus, the most the plaintiff can hope for is a settlement that exceeds $60,000[91] by the size of the insured's risk premium. The plaintiff, by going to trial, expects to net $40,000,[92] and a risk-neutral plaintiff would not settle for less. Hence, there exists a bargaining range between $40,000 and somewhat more than $60,000 within which a settlement can occur.

88. *See supra* text accompanying note 7.

89. Expected costs to the insurer equal the $25,000 probable contribution to the judgment—50% of the $50,000 policy limit—plus the $10,000 defense costs.

90. The insured would be willing to pay more because it is risk averse. *See supra* note 31 and accompanying text (explaining the concept of risk aversion).

91. The $60,000 figure is reached by adding the expected settlement contributions of the insurer ($35,000) and the insured ($25,000)

92. Net recovery is the expected value of the judgment ($50,000) less associated litigation costs ($10,000).

Now let the disregard-the-limits rule apply. An insurer without a policy limit would benefit from any settlement below $60,000,[93] so assume that the insurer will be liable for the entire judgment if it litigates after rejecting a settlement offer of $60,000 or less.[94] The insurer will not settle for more than $60,000, however, without a contribution from the insured. Nevertheless, the plaintiff might still be able to obtain more than $60,000. In particular, suppose that the plaintiff absolutely refuses to accept a settlement of $60,000 or less. The rational insurer at this point will contribute no more than $35,000 because a refusal to pay over $60,000 is not bad faith. The insured will be in the same position as before, confronting expected liability of $25,000 if the case goes to trial. We can thus imagine the insurer paying $35,000 and the insured something over $25,000, just as described above. The range of settlement outcomes is the same, from $40,000 to something over $60,000, and if the settlement range is unaffected, it is plausible that the actual settlement outcome will be unaffected as well.

Of course, if the plaintiff in this example is willing to settle for less than $60,000, the disregard-the-limits rule will assuredly affect the division of the settlement payments between the insurer and the insured by eliminating the need for the insured to contribute to the settlement. This effect is economically desirable because it shifts the risk to the better risk bearer.[95] Hence, under the assumptions implicit in the discussion up to this point, the disregard-the-limits rule seemingly does not harm the joint bargaining position of the insurer and the insured, and it may benefit the insured by protecting it from the risk of having to make a settlement contribution.

There are three reasons why this analysis may mislead, however, and why the disregard-the-limits rule may indeed improve the plaintiff's bargaining position. First, as noted in the preceding section, the insured may have limited assets. The disregard-the-limits rule can then increase the plaintiff's expected returns from litigation by reducing the extent to which the insured's inability to pay large judgments lowers the plaintiff's expected receipts.[96] And, if the rule increases the plaintiff's expected

93. The $60,000 figure here is the sum of the expected judgment ($50,000) and the defense costs ($10,000).

94. Actually, the analysis is a bit more complex because it is unclear to what extent the disregard-the-limits rule requires the settlement offer to be weighed against the expected judgment plus defense costs, as distinguished from the expected judgment alone. "[I]f defense costs are added in, more settlement demands will appear to be reasonable, and insurance companies are more likely to be held liable for an excess judgment." Syverud, *supra* note 3, at 1141.

95. *See supra* text accompanying note 43.

96. This assumes either that the bad faith cause of action can be assigned to the plaintiff or that the insured can recover from the insurer and use the proceeds to pay the plaintiff. It also assumes that, contrary to the model in my prior paper, Sykes, *supra* note 65, the policy limit is not reduced in response to the disregard-the-limits rule.

returns, it likely also increases the minimum amount for which the plaintiff will settle. Here, the simple intuition that bad faith doctrine enhances the plaintiff's bargaining power may be correct.

A second way in which bad faith doctrine may enhance the plaintiff's bargaining power arises when the damages for a finding of bad faith can include more than just the excess judgment, and when there is also uncertainty over how a jury may assess the insurer's reasonableness. If the insurer is subject to liability both for the excess judgment and for additional punitive damages, attorneys' fees, emotional distress damages, and the like, the insurer's exposure in the event of a bad faith lawsuit is potentially greater than that envisioned by our numerical illustration. Suppose, for example, that the plaintiff in our hypothetical offers to settle for $65,000. The insurer may well believe that the sum of the expected judgment and defense costs is only $60,000, but may also worry that a jury will disagree and find bad faith if the $65,000 offer is rejected. If a finding of bad faith would require the insurer to pay not only the full $100,000 judgment, but also considerable additional damages, the insurer may indeed be willing to settle for $65,000 or more. Such an increase in the insurer's maximum willingness to contribute toward settlement might be expected to increase the settlement amount on average. Although the usual remedy for bad faith is simply to require the insurer to pay the whole judgment, some jurisdictions do allow additional damages.[97] In these jurisdictions, plaintiffs may indeed gain a bargaining advantage from the disregard-the-limits rule or any other "bad faith" doctrine.

A third way in which the disregard-the-limits rule may enhance the plaintiff's bargaining power arises if it is difficult for the plaintiff to draw the insured into settlement negotiations due to transaction costs or some other impediment. This hypothesis is the focus of a recent paper by Michael Meurer.[98] Simple numerical examples suffice to convey the essence of his argument. Suppose that the court will set damages at either $10,000 or $50,000, with a 50% probability that each judgment will occur. Expected liability is thus $30,000.[99] Assume now that litigation costs in the absence of settlement are $10,000 for each party and that the insured is able to pay any judgment against it. For simplicity, ignore the parties' risk aversion and assume that each is risk neutral.

97. *See* ASHLEY, *supra* note 1, § 8:02-:15 (outlining the possible remedies available for a bad faith claim, including compensation for other economic harms caused by the insurer's bad faith, damages for emotional distress, punitive damages, and attorneys' fees).

98. Michael J. Meurer, *The Gains from Faith in an Unfaithful Agent: Settlement Conflicts Between Defendants and Liability Insurers*, 8 J.L. ECON. & ORGANIZATION 502 (1992).

99. The $30,000 figure is reached by adding the 50% probability of a $10,000 judgment ($5000) to the 50% probability of a $50,000 judgment ($25,000).

Consider first a defendant without insurance. The plaintiff's expected gain from litigation is $20,000,[100] and the defendant's expected loss is $40,000.[101] The $20,000 difference, equal to the parties' combined litigation expenses, represents the joint gains from settlement. Meurer assumes that the parties always "split the difference" in bargaining;[102] thus, settlement occurs here at a payment of $30,000, exactly the amount of the expected liability.[103]

Now, suppose that the same defendant purchases an insurance policy with a $25,000 policy limit. Assume that the insurer bears the $10,000 defense costs and that the policy gives the insurer sole discretion over settlement. Once again, the plaintiff's expected gains from litigation are $20,000 because any judgment over the policy limit will be collected from the insured. What is the maximum amount that the insurer will offer in settlement? The expected payment under the policy at the conclusion of litigation is $17,500.[104] If the insurer elects to litigate, it will also bear defense costs of $10,000. Hence, it seems that the insurer would pay up to only $27,500 to avoid litigation. If the insured cannot be induced to contribute to the settlement, then the range of possible settlements is between $20,000 and $27,500. Any amount within this settlement range is plainly below the $30,000 that the uninsured defendant would have paid to settle under the split-the-difference assumption. The plaintiff nevertheless settles because the expected outcome of litigation is even less favorable.[105] Thus, Meurer argues that even without any risk aversion on the part of the defendant, insurance can be beneficial to the defendant in this context because it delegates the authority to bargain to the insurer, who will refuse to pay as much as the insured might have to pay in the absence of insurance.[106] The insured can benefit *ex ante* because the competitively determined insurance premium is accordingly less than the expected judgment in the absence of insurance.

To be sure, delegation of authority to the insurer is a two-edged sword, as the following modified hypothetical suggests. Suppose now that the liability judgment will equal either $20,000 or $100,000, again with a 50% probability for each outcome. The policy limit is assumed to be $50,000, and litigation costs are $10,000. The plaintiff's expected gain

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100. Net expected gain equals the expected judgment ($30,000) less litigation costs ($10,000).

101. Total expected loss equals the expected judgment ($30,000) plus litigation costs ($10,000).

102. Meurer, *supra* note 98, at 505.

103. That is, the plaintiff receives a settlement equal to its "threat point" of $20,000 plus half the joint gains.

104. The $17,500 figure is reached by adding the 50% probability of paying a $10,000 judgment ($5000) and the 50% probability of paying the $25,000 policy limit toward the $50,000 judgment ($12,500).

105. *See supra* note 100 and accompanying text.

106. Meurer, *supra* note 98, at 506-10.

from litigation is $50,000,[107] yet the insurer's expected loss is only $45,000.[108] Supposing again that the insured cannot be induced to contribute to a settlement, the parties will now go to trial. If this situation were sure to materialize after an accident, the purchase of insurance with insurer discretion over settlement would be disadvantageous to the insured *ex ante*. The insured would not only bear the full expected judgment through a combination of insurance premiums and liability in excess of the policy limits, but would also have to pay a premium to cover the insurer's expected litigation costs.

Combining these illustrations, two possibilities arise when the insured does not contribute toward a settlement. The first is that the delegation of settlement discretion to the insurer will result in lower settlements. The other is that the insurer litigates even though settlement would be required under an ideal contract. It is an empirical question whether the costs of the latter possibility outweigh the benefits of the former. But the insured's ability to adjust the coverage level makes it more likely that gains will result from the delegation of settlement authority to the insurer and, in Meurer's formal model, a coverage level surely exists at which the benefits exceed the costs. Thus, Meurer argues, the delegation of settlement authority to the insurer is desirable from the perspective of the parties to an insurance contract, and lawsuits after the fact by disappointed insureds represent an effort to renege upon an implicit bargain.[109] Likewise, Meurer's model implies that the disregard-the-limits rule is *harmful* to insureds because they can no longer exploit the bargaining advantage associated with policy limits.[110]

As the numerical illustrations suggest, this analysis rests on the critical assumption that insureds cannot be drawn into settlement negotiations. If they can, any reduction in the insurer's willingness to pay toward a settlement, when the insurer can refuse settlement with impunity, will be offset by an increase in the insured's willingness to contribute. The problem of insureds with limited assets poses a further complication. Nonetheless,

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107. The plaintiff's expected gain equals the sum of a 50% probability of receiving a $20,000 judgment ($10,000) and a 50% probability of receiving a $100,000 judgment ($50,000) less $10,000 in litigation costs.

108. The insurer's expected loss equals the sum of a 50% probability of paying a $20,000 judgment ($10,000), a 50% probability of paying the $50,000 policy limit toward the $100,000 judgment ($25,000), and litigation costs ($10,000).

109. Meurer, *supra* note 98, at 506-10.

110. *Id.* at 519. Interestingly, Meurer nevertheless argues that the disregard-the-limits rule is socially desirable for three reasons: (1) it eliminates the danger of socially inefficient litigation, as illustrated by the second possibility above; (2) it eliminates the incentive for the insured to take on excessive amounts of risk through policy limits that increase bargaining power in settlement; and (3) it induces *ex ante* optimal caretaking by prospective injurers, assuming that expected judgments equal the expected social costs of accidents. *Id.* at 520-21.

Meurer's work provides a plausible account of how, at least in some cases, the disregard-the-limits rule will harm the insured rather than help it.

In sum, it is certainly plausible that the disregard-the-limits rule will weaken the bargaining position of the insurer and the insured in important classes of cases. They may for that reason prefer not to incorporate it into their contract *ex ante*. This provides another explanation for the absence of this rule in standard forms and raises further doubts that judicial constraints on insurers' settlement discretion will benefit insureds.

D. *Administrative and Error Costs*

Insureds, as a group, will benefit from judicial restrictions on insurers' settlement discretion only if those restrictions prod insurers toward behavior that an ideal contract would require, and then only if they do so at a reasonable administrative cost. The analysis to this point has focused on the first of these issues, concluding that the ability of prevailing doctrine to move behavior toward that required by an ideal contract is, at best, inconclusive. Once administrative and error costs are taken into consideration, the economic case for a judicially imposed duty to settle is weakened further.

The disregard-the-limits rule, like other approaches to bad faith refusal to settle, is a source of extensive litigation.[111] To my knowledge, data on the total costs of third-party bad faith litigation do not exist, but there seems to be little doubt that these costs have become quite significant in recent years.[112] The existence of this Symposium and of practitioner guides on the subject[113] is testimony to the growing importance of bad faith actions. The resulting costs to insurers of such bad faith litigation must ultimately be recovered through insurance premiums.[114]

These litigation costs are compounded by the uncertainties that attend bad faith litigation, particularly with a standard such as the disregard-the-limits rule under which juries are asked to determine if a "reasonable insurer" without policy limits would have accepted an offer that the defendant-insurer rejected.[115] I have assumed all along that juries will interpret this rule as requiring them to determine whether an insurer with no policy limits would have expected to lose more by litigating than by

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111. *See* ASHLEY, *supra* note 1, § 3:19, at 46 n.8 (collecting disregard-the-limits rule cases from 18 states).

112. *See* Peter C. Haley & Brandt L. Wolkin, *Bad Faith and the Financial Institution Bond*, 25 TORT & INS. L.J. 715, 715 (1990) ("The dramatic increase in bad faith verdicts may be the most important development in insurance litigation since . . . the 1960's.").

113. *E.g.*, ASHLEY, *supra* note 1.

114. Douglas O. Houser, *Good Faith as a Matter of Law: The Insurance Company's Right to Be Wrong*, 27 TORT & INS. L.J. 665, 665 (1992).

115. ASHLEY, *supra* note 1, § 3:19.

settling. Yet, juries may not systematically interpret the instruction in this fashion—does "reasonable insurer" necessarily mean "expected profit-maximizing insurer" to the average jury?[116] Further, in many jurisdictions, juries are not expressly instructed to focus on a "reasonable" insurer without policy limits. The instruction may simply inquire about "reasonableness" in general, or whether the insurer gave "equal consideration" to the interests of the insured, and so on.[117]

Even when juries do think in terms of the costs and benefits of settlement, it is hardly easy for them to measure these costs and benefits accurately. The expected outcome of litigation at the time of the settlement offer is difficult even for the insurer to determine. Thus, juries can do no more than make a best guess about what the probable distribution of expected judgments, defense costs, and other factors was at the time the settlement offer was made.

As a result of all these factors, it becomes difficult to predict how a jury will resolve an allegation of bad faith made against an insurer.[118] In turn, the parties to bad faith lawsuits may easily develop disparate expectations about the likely outcome of the bad faith suit, thereby impeding settlement and increasing expenditures on bad faith litigation.[119]

Related to uncertainty over the outcome of litigation is the possibility of error. Suppose, *arguendo*, that the disregard-the-limits rule roughly resembles what an ideal insurance contract would require. If so, unbiased errors of judgment in the jury's application of the standard may not be terribly harmful as long as damages are limited to the excess judgment, because a risk neutral insurer will expect the standard to be applied correctly on average and behave accordingly.[120] But juries' errors may not be unbiased.

In litigation between an individual insured faced with extensive personal liability and a deep-pocket insurer, jury sympathies may tend quite

116. *See* William W. Schwartzer, *Reforming Jury Trials*, 132 F.R.D. 575, 575 (1991) (discussing juries' inability to understand complex issues).

117. *See* ASHLEY, *supra* note 1, § 3:20-:21 (surveying the standards used by various jurisdictions in applying the disregard-the-limits rule).

118. *See* Hon. Joan B. Lefkowitz, *New York Third Party Bad Faith: Is It a Plaintiff's Dream or a Defendant's Nightmare?*, 12 PACE L. REV. 543, 548 (1992) (noting that many lawyers have been astonished by jury verdicts against insurance companies in cases in which they thought they had made a solid presentation).

119. A basic conclusion in the economic literature on suit and settlement is that parties will litigate rather than settle only if the plaintiff is more optimistic about the plaintiff's chances for success than the defendant. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 555-56 (4th ed. 1992). Although disparate expectations about the plaintiff's chances of success can run in either direction, a lack of predictability in the outcome of cases, from which disparate expectations generally result, is likely to result in a lower settlement rate.

120. *See supra* note 97 and accompanying text (discussing the possibility of awarding damages in addition to the amount of the excess judgment).

systematically toward the insured.[121] Further, juries may regularly overestimate the expected judgment at the time of the settlement offer and thus erroneously find the insurer to have been "unreasonable." This tendency may arise because bad faith suits will be brought only in cases in which the eventual judgment exceeded the policy limits, and juries may assign great weight to the actual amount of the judgment in deciding what the *expected* value of the judgment was when the settlement offer was made. Indeed, in some jurisdictions, an actual judgment in excess of the settlement offer is said to support an inference that the offer was reasonable.[122] Taken to the limit, this approach could result in liability anytime a judgment exceeds the policy limits and an earlier settlement offer within the limits was rejected. Juries would then be imposing liability not only when the insurer was unreasonable in refusing to settle, but also when the decision to litigate *was* reasonable in light of the available information, but an unfortunate outcome resulted.

Thus, despite its "negligence-like" formulation in theory, the disregard-the-limits rule may drift toward a strict liability standard in practice.[123] It is not self-evident that strict liability would be worse than the negligence formulation,[124] but its consequences are certainly not fully understood in this context.

III. Conclusion

Judicial restrictions on the discretion of liability insurers to settle or litigate are imposed as a response to two potentially important problems—the incentive for insurers to litigate inappropriately at times because some of the risk is borne by the insured, and the possible incentive for insurers to extract settlement contributions from their insureds opportunistically. A hard question is whether the cure is worse than the disease. In this regard, it is at best doubtful whether the disregard-the-limits rule—or any other single conception of "bad faith"—can come close to replicating what an ideal contract would require in most instances. Likewise, it is not possible to justify existing doctrine on the basis of theory alone. Although it is conceivable that bad faith doctrine serves the joint interests of insurers and insureds or in some other fashion promotes social welfare, a showing to that effect would require a wealth of empirical information

121. *Cf.* Robert K. Harris, *The Impeachment Exception to Rule 407: Limitations on the Introduction of Evidence of Subsequent Measures*, 42 U. MIAMI L. REV. 901, 943 (1988) ("[M]ost defendants will not raise the issue of insurance fearing that it will adversely affect the jury.").

122. ASHLEY, *supra* note 1, § 3:37.

123. That is, it may drift toward strict liability for any excess judgment whenever a settlement offer within the policy limits has been previously rejected.

124. *See* Sykes, *supra* note 65, at 94-95 (detailing a formal model in which the disregard-the-limits rule and the strict liability rule produce the same outcomes).

not heretofore developed. Absent that showing, I see no convincing basis for the widespread judicial interference with insurers' contractual discretion in settlement negotiations.