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ROY BAHARAD

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Summary

This dissertation consists of essays exploring the microeconomic implications of liability insurance in three distinct domains: signaling, bargaining, and externalities. Each essay is dedicated to a separate topic.

The first essay, *Reliability Insurance*, concentrates on signaling. Aside from deterring carelessness and guaranteeing compensation to victims, tort liability communicates willingness to bear any loss that results from imprudence. In so doing, tort liability counterintuitively serves the interest of injurers, allowing them to signal quality and substantiate credible commitment to careful behavior. In many market interactions, liability thus serves as a quintessential warranty, establishing injurers' reliability. Yet the purchasing of liability insurance, at least on the surface, directly contradicts the credibility signal communicated by tort liability: instead of committing to self-incur the cost of any loss generated by their risky activity, tortfeasors choose to transfer this cost to an insurer. Insurance, in simple terms, seems to erode the skin-in-the-game message that injurers often wish to convey. The essay delves into this conundrum, and in studying the insurance-credibility interface, it shows that the signal conveyed by the presence or absence of insurance is complex, multifaceted, and context-dependent, with some markets responding negatively to the involvement of liability insurance and others that favor it. Normative policy prescriptions that enhance the value of the signal communicated by insurance are likewise discussed.

The second essay, *Insurance Settlements and the Perpetuation of Legal Risks*, spotlights the unique bargaining strategies deployed by liability insurance carriers and identifies their profound legal implications. Conventional wisdom suggests that insurers—who normally decide whether to litigate or to settle—are better off with litigating instead of reaching socially desirable settlements with claimants. The reason is that the lion's share of the risk of litigation is borne by

the policyholder, rather than the insurer: since liability insurance policies invariably contain a coverage limit, any excess amount that the court is expected to award in damages is incurred by the injurer. Ordinarily, then, the insurer has little to lose from litigating—it pays nothing if winning; the insured pays any excess damages if losing. Courts and legislators have thus established a "duty to settle," effectively prohibiting such opportunistic behavior by mandating insurers to ignore coverage limits and accept any commercially reasonable settlement offer. Be that as it may, against the anti-settlement tendencies routinely attributed to insurers, the essay identifies a mirror-image phenomenon that scholars have thus far overlooked: under certain circumstances, it might be in insurers' best interest to settle and avoid socially desirable litigation. This emanates from the fact that insurers are better off with legal uncertainty: ambiguity preserves injurers' liability risks, thus enhancing their demand for insurance. The essay analyzes insurers' strategic use of settlement to maintain legal risks, discusses concrete realms in which this behavior is observable, offers a normative discussion on the social costs and benefits of insurance, and considers potential mechanisms that may eliminate the ascribed problem.

The third essay, *Risk Allocation in a General-Equilibrium Model of Liability Insurance*, offers a general-equilibrium analysis of externalities and risk allocation within the triangle of the insured, the insurer, and a third party. To date, both legal and economic literature on insurance has confined its focus to risk externalities that arise from the bilateral relationship between the insured and the insurer. Canonic accounts have introduced the problem of moral hazard, whereby the insured externalizes risk on the insurer. More modern contributions have highlighted insurer monitoring, which may induce the insured to reinternalize those risks. It was not until the last few years that commentators incorporated third parties into the equation, maintaining that they, too, tend to externalize risks on insurers. My proposed analysis completes the picture, demonstrating that the presence of third parties may actually generate multiple equilibria. When third parties are deterred by the involvement of insurance—which, as established in the first essay of this dissertation, may signal the insured's increased riskiness—their reluctance to interact in a transactional setting may likewise induce (partial or full) risk internalization by the insured, thus functioning as a substitute to insurer monitoring. When third parties' anticipated reaction does not feed back into the insured's behavior, which happens in non-transactional interactions, then the third party would ultimately be the one who bears the cost of excessive riskiness by increasing its investment in precautions. Under either scenario, the expected loss emanating from the insured's behavior is lower, meaning that the insurer is better off reducing monitoring effort. Indeed, this results in insurer moral hazard. The essay thus makes two main contributions to existing understanding of insurance dynamics. First, it shows that any actor within the triangle of insurer, insured, and a third party may act opportunistically and exhibit moral hazard that facilitates excessive risk. Second, any actor within this triangle may be the one who ultimately bears the cost of such excessive risk.

Reliability Insurance

Abstract

Liability for harm not only incentivizes individuals to exercise optimal care and guarantees compensation to victims; it also serves the interest of potential injurers. The prospect of liability equips subjects with a "right to be sued," which enables them to credibly signal their prudence in potentially harmful interactions, thus substantiating trust among counterparties. Liability for medical malpractice, for instance, bolsters the reliability of physicians exactly because they would be the ones suffering the cost of inadequate treatment.

Oddly, however, individuals and businesses regularly choose to waive their "right to be sued" by purchasing liability insurance. At its core, insurance is antithetical to the informational power of liability. Liability establishes reliability in the eyes of potential victims precisely because it forces injurers to internalize the cost of the risk created by their activity, but insurance does the opposite. In transferring the cost of the risk to an insurer, individuals seem to forego the credibility signal they could have communicated had they subjected themselves to liability. One may therefore wonder, for example, why contracting parties acquire insurance against misrepresentation, why employers insure themselves against liability for overlooking sexual misconduct in the workplace, why corporations extensively insure officials against liability for losses resulting from their imprudence, why media outlets choose to insure themselves against liability for defamation, or how come insurance against medical malpractice has become so prevalent among physicians and hospitals. In those and many other settings, insurance might undermine credibility and attenuate policyholders' reliability in the eyes of actors with whom they interact—business counterparties, employees, investors, audiences, regulators or patients.

So, does insurance serve as a bad signal? More simply stated, would the reasonable patient prefer to be treated by an insured or an uninsured doctor? And, as an upshot, is a doctor better off with insurance or should she relinquish it and subject herself to liability in order to regain credibility? The present Article develops a comprehensive account on insurance and reliability, drawing on theory and practice alike. It demonstrates that the insurance-reliability interface is complex, equivocal and multifaceted. In certain environments—the capital market, for instance—liability insurance may certainly undermine the insured's credibility. Since counterparties are concerned with insureds' moral hazard, actors need to eschew insurance if they wish to signal trustworthiness. In other areas, however, insurance is actually an instrument for bolstering reliability and increasing the attractiveness of policyholders, compared to uninsured individuals. This emanates from two, interrelated features of insurance discussed in this Article: its quasi-regulatory role, which guarantees that the insured's riskiness has been vetted and is being consistently monitored by an insurer; and its ability to secure solvency in case of harm, which eliminates the risk of confronting a judgment-proof injurer.

The Article first offers a theoretical framework for how insurance redesigns trust-based market interactions, uncovering the contradicting forces that it might carry on reliability. Upon establishing the analytical underpinnings, it proceeds to examine various types of liability insurance, some of which impair reliability whereas others enhance it. The reason for this disparity is that some market relationships are dominated primarily by the credibility-eroding, rather than the reliability-advancing characteristics of insurance, whereas others are governed more prominently by the latter ones. Finally, based on the conceptual blueprint it sets forth, the Article introduces a normative discussion concerning the appropriate policy responses to the insurance-reliability interface.

INTRODUCTION

When we are asked to think about the objectives of liability—for causing a physical injury, imposing an economic loss, making defamatory statements, breaching a contract, or for inflicting any other imaginable harm—deterrence and compensation are the immediate associations.[1] Liability is designed to deter any socially undesirable behavior ex ante and, concurrently, to assure victims with adequate compensation ex post.[2] As a legal construct, liability caters to the interests of victims and society at large by disciplining potential injurers—holding them accountable to harms caused by wrongful conduct.[3]

But this customary view fails to consider a third, highly important yet underexplored function of liability. The missing feature is that liability is not only advantageous to victims, but also to potential injurers. This might sound surprising at first blush but becomes intelligible and even trivial once the underlying logic is explicated. When potential victims and third parties know that an individual is subject to liability whenever her conduct is proven unlawful, harmful or excessively risky, their willingness to interact with her automatically increases. Liability, in short, allows individuals to substantiate *reliability* by making them more credible and trustworthy. Liability for medical malpractice, for instance, bolsters the trustworthiness that patients ascribe to a physician exactly because she would be the one suffering the cost of inadequate treatment.[4]

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[1] *See, e.g.*, Kalavity v. United States, 584 F.2d 809, 811 (6th Cir. 1978) (noting that the purpose of liability is "both to compensate and deter").

[2] *See, e.g.*, John C.P. Goldberg, *Twentieth-Century Tort Theory*, 91 GEO. L.J. 513 525 (2003) (arguing that the function of liability "to compensate and deter" is routinely resonated "by countless law review articles....").

[3] *See, e.g.*, Ralph. A. Winter, *The Liability Insurance Market*, 5 J. ECON. PERSP. 115, 115 (1991) ("In addition to providing incentives to avoid accidents, [liability] provid[es] compensation for accident victims.").

[4] *See generally* Jennifer Arlen, *Contracting Over Liability: Medical Malpractice and the Cost of Choice*, 158 U. PENN. L. REV. 957 (2010) (considering the signaling function of medical malpractice liability, as seen by patients). *See also infra* notes 120-144 and accompanying text.

Examples are of course myriad and go far beyond doctors, which implies that the reliability-enhancing role of liability is epicentral to day-to-day human interactions. Manufacturers' liability for deficient products increases consumers' willingness to purchase their products.[5] Directors' and officers' accountability for the corporation's performance is a *sine qua non* for investors' trust.[6] Holding an employer liable for her failure to take preventive measures against employees' sexual misconduct is what allows job candidates to assume that the workplace would not tolerate such behavior.[7] Liability for deception and misrepresentation—conveying false information or failing to communicate relevant facts in negotiations—bolsters the credibility of the information that a contracting party provides.[8] Liability for defamatory, slanderous and libelous speech makes individuals' statements against other people more credible.[9]

The reliability-enhancing function of liability is well-established, time-honored, and has been espoused in the academic literature even before the now-standard conception of liability as a

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[5] *See generally* George A. Akerlof, *The Market For "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (seminally establishing manufacturers' willingness to incur cost in case of deficiency as a market mechanism for signaling product quality) and an extensive discussion *infra*, notes 152-165 and accompanying text. *See also* Andrew F. Daughety & Jennifer F. Reinganum, *Product Safety: Liability, R&D, and Signaling*, 85 AM. ECON. REV. 1187, 1187 (1995) (discussing the signaling role of products liability).

[6] *See generally* Edward M. Iacobucci, *Toward a Signaling Explanation of the Private Choice of Corporate Law*, 6 AM. L. & ECON. REV. 319 (2004) (contending that firms choose their state of incorporation based on the stringency of its inner rules in order to signal their quality to potential investors); Robert M. Lawless, Stephen P. Ferris & Bryan Bacon, *The Influence of Legal Liability on Corporate Financial Signaling*, 23 J. CORP. L. 209 (1998) (advancing a general theory of corporate liability on managers' ability to signal quality). *See also infra* notes 61-76 and accompanying text.

[7] *See, e.g.*, Joshua C. Polster, *Workplace Grievance Procedures: Signaling Fairness but Escalating Commitment*, 86 N.Y.U. L. REV. 638, 643-44 (2011) (noting that the prospect of liability for discrimination enhances a workplaces' perceived fairness). *See also infra* notes 92-119 and accompanying text.

[8] *See, e.g.*, Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002) (arguing that mandatory disclosure, for example in the context of securities law, is valuable for allowing firms to credible commit that all relevant information is reported). *See also infra* notes 77-91 and accompanying text.

[9] *See, e.g.*, Daniel Hemel & Ariel Porat, *Free Speech and Cheap Talk*, 11 J. LEGAL ANALYSIS 46, 50 (2019) ("[W]ith a robust regime of defamation liability in the background, audiences ascribe greater credibility to allegations than they would if defamation laws were weak.").

legal instrument that incentivizes efficient care and guarantees adequate compensation to victims.[10] Its origins trace back to Nobel laureate Thomas Schelling, who famously framed liability as "the right to be sued." In his pioneering treatise, *An Essay on Bargaining*, Schelling highlighted:[11]

> "Among the legal privileges of corporations, two that are mentioned in textbooks are the right to sue and the "right" to be sued. Who wants to be sued! But the right to be sued is the power to make a promise: to borrow money, to enter a contract, to do business with someone who might be damaged. If suit does arise the "right" seems a liability in retrospect; beforehand it was a prerequisite to doing business. In brief, the right to be sued is the power to accept a commitment."

Equipped with this understanding—that liability is constitutive to reliability—the present Article sets out to introduce a simple but hitherto unstudied question. It inquires why individuals and businesses regularly choose to waive their "right to be sued" by purchasing *liability insurance*. Insurance, at least on the surface, seems to hinder the reliability-producing function of liability. Liability establishes reliability in the eyes of counterparties exactly because it forces injurers to internalize any cost caused by reckless, malevolent or excessively risky behavior. In transferring this cost to an insurer, then, individuals seem to forego the credibility signal they could have enjoyed had they subjected themselves to liability. One may therefore wonder, for example, why

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[10] For example, the cornerstone of the economic theory of tort liability have been established in the 1960s in Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960) and extended in the early 1970s in, e.g., GUIDO CALABRESI, THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC FRAMEWORK (1970).

[11] Thomas C. Schelling, *An Essay on Bargaining*, 46 AM. ECON. REV. 281, 299 (1956).

contracting parties acquire insurance against misrepresentation,[12] why employers insure themselves against liability for overlooking sexual misconduct in the workplace,[13] why firms extensively insure executives against liability for losses resulting from their imprudence,[14] why media outlets choose to insure themselves against liability for defamation,[15] or how come insurance against medical malpractice has become standard among physicians.[16] In those and many other environments, liability insurance might undermine credibility and attenuate policyholders' reliability in the eyes of actors with whom they interact—business counterparties, vulnerable employees, investors, audiences, or patients. If liability indeed embodies a "right to be sued" and insurance eliminates it, it seems that counterparties might respond by declining their willingness to engage or interact with insured parties.

So, does insurance in fact undermine reliability? Would a reasonable patient prefer to be treated by an insured or an uninsured doctor? Correspondingly, are physicians better off with insurance or should they relinquish it if they wish to enhance reliability? And what about investing in a firm whose executives are covered by insurance for imprudence compared to a firm with uninsured officials? Does a journalist's unflattering statement of fact against public figures become more or less credible when the former is insured against defamation liability? Are job candidates better off working for an employer who insures herself against negligence in overseeing employees' sexual harassment and other types of workplace discrimination, or for one that

[12] *See infra* notes 77-91 and accompanying text.
[13] *See infra* notes 92-119 and accompanying text.
[14] *See infra* notes 61-76 and accompanying text.
[15] *See infra* notes 194-214 and accompanying text.
[16] *See infra* notes 120-144 and accompanying text. Professor Jennifer Arlen, for example, alludes to this conundrum in a footnote, but does not develop it further. *See* Arlen, *supra* note 4 at 998 n. 104 (mentioning that the reliability-enhancing function of liability may not hold if physicians acquire malpractice liability insurance).

confronts liability in those cases? Should the Internal Revenue Service (IRS) dedicate increased focus to auditing holders of tax risk insurance policies or uninsured taxpayers?

The present Article is the first to develop a comprehensive account on insurance and reliability, drawing on economic theory and legal practice at once. It demonstrates that the insurance-reliability interface is complex, equivocal and multifaceted. In certain environments that I discuss and characterize, insurance certainly undermines the insured's credibility. Since counterparties are heavily concerned with insureds' moral hazard—excessive risk-taking—actors should and do avoid insurance, at least to a certain extent, when they wish to signal trustworthiness. In other instances, insurance actually bolsters individuals' reliability from counterparties' perspective, rather than impedes it. This emanates from two interrelated features of insurance: its quasi-regulatory role, which guarantees that the insured's riskiness has been vetted and is being consistently monitored by an insurer; and its ability to secure solvency in case of harm, which eliminates the risk of a judgment-proof injurer. Both features are detailed and extensively discussed throughout the Article.

Upon establishing the theoretical blueprint of the so-far overlooked relationship between insurance and reliability, the Article turns to portray the insurance-reliability landscape in practice, analyzing various types of liability insurance and evaluating the reliability effect—positive or negative—generated by each of them in real-world interactions. It offers a detailed discussion on each type of liability insurance based on the analytical framework developed here, showcasing some that manifest the positive weight that insurance carries on reliability, and juxtaposing them along others that illustrate the negative effect. The Article suggests that the reason for the disparate influence of insurance on reliability across different industries is that some market relationships are dominated primarily by the credibility-eroding, rather than the reliability-advancing characteristics of insurance, whereas others are governed more prominently by the latter ones. The Article likewise offers a normative framework for policy measures that could extract the informational value of insurance.

Structurally, the Article unfolds in three main parts. Part I grounds the two competing forces of insurance – risk-enhancing (traditional views) and risk-reducing (modern approaches). The stronger is the risk-enhancing force, the more likely insurance is to undermine reliability, and vice versa. Yet, Part I proceeds by introducing two additional features of insurance that go beyond the baseline characteristics—securing injurer solvency and signaling excessive prudence. Each of those features is likewise a key factor in the relationship between insurance and reliability. Even when insurance allows the insured to act less carefully, individuals might ultimately prefer to interact with an insured rather than uninsured actors because insurance guarantees compensation, namely, assures that in case of harm, victims would not face an insolvent, judgment-proof injurer. Likewise, even when the presence of insurance incentivizes the insured to act more cautiously by "disciplining" her—for reasons that would be explicated momentarily—individuals might prefer interactions with uninsured actors if disciplined insureds are excessively prudent.

Thereafter, Part II turns from the theoretical analysis to practice, studying various kinds of liability insurance and the effect that each of them has on reliability. Part III proceeds to a normative discussion and considers several policy measures that might aid at extracting the informational value of insurance. Concluding remarks shortly ensue.

I. INSURANCE AND RELIABILITY: A THEORETICAL PREFACE

Intuitively, it might seem that the effect of insurance on policyholders' reliability should simply boil down to the question of how insurance influences the insured party's riskiness.

Counterparties, after all, would probably prefer to interact with potential injurers whose activity creates a lower expected loss. If so, the answer to the question stated above—whether, for example, a patient would rather be treated by an insured or an uninsured physician—is just tantamount to asking whether insurance reduces or enhances this physician's riskiness.

But this framing does not fully capture the dynamics of insurance and reliability. True, whether insurance enhances or reduces riskiness is clearly a relevant—in some cases the pivotal—consideration in the broader question of whether insurance strengthens or weakens potential injurers' reliability, but viewing reliability through the myopic lens of riskiness would fail to encompass the entire picture. As I shall clarify, there are certain types of interactions in which insurance incentivizes excessive riskiness among insureds, but counterparties would still hold a strong preference toward interacting with a riskier policyholder, rather than with a less risky, uninsured actor. This might be the case when counterparties care about assuring solvency in case of harm, which in certain cases is only possible when injurers are insured. Counterparties might thus be willing to encounter a riskier injurer—with higher likelihood of inflicting harm upon them—for the sake of securing full compensation in case that harm does occur. Other instances embody the mirror-image scenario, where insurance reduces potential injurers' risk and counterparties would nonetheless be worse off when confronting an overly prudent actor.

The present Part consists of two main sections. Section I.A concentrates on the risk-enhancing versus risk-reducing effects of insurance, being the core contradictory forces that insurance might have on policyholders' reliability. It first introduces the traditional economic view of insurance as incentivizing policyholders to reduce care, thus enhancing risk. It then turns to describe modern outlooks that regard insurance as a quasi-regulatory apparatus, thereby assimilating prudence among insureds and, consequently, reducing riskiness. Section I.B integrates an additional set of traits that delineate the effects of insurance on reliability, completing the conceptual depiction of the insurance-reliability interface.

A. *Moral Hazard or Governance: What Does Insurance Tell Counterparties About Riskiness?*

According to the orthodox scholarly approach, the presence of insurance would increase the insured's riskiness, and the logic is rather straightforward: with insurance, potential injurers internalize the benefits but not the costs that originate from their risky activity, meaning that their motivation to exercise risk-reducing care diminishes.[17] To put more simply, if a potential injurer is insured against any loss created by her activity, she has a weaker incentive to prevent it. This phenomenon, colloquially termed "moral hazard,"[18] has been the focal point of voluminous legal and economic literature on insurance, residing at the epicenter of thousands of academic articles and hundreds of judicial opinions.[19] As some have recognized, "[r]ivers of ink have been spilled discussing the moral hazard problem of insurance and ways to mitigate it."[20]

The prospect of moral hazard portrays insurance as the antipode of the "right to be sued" that liability vests upon subjects. If liability signals reliability because potential injurers internalize both the costs and the benefits emanating from their risky conduct, then insurance, in affording morally hazardous behavior by policyholders, undermines reliability by the very same logic. In

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[17] For some of the foundational models of insurance that embed this line of reasoning see, e.g., Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963); Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979); Ariel Rubinstein & Menahem Yaari, *Repeated Insurance Contracts and Moral Hazard*, 30 J. ECON. THEORY 74 (1983); Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541 (1979).

[18] For a comprehensive review see generally Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

[19] *See* Gideon Parchomovsky & Peter Siegelman, *Third-Party Moral Hazard and the Problem of Insurance Externalities*, 51 J. LEGAL STUD. 93, 93-94 (2022) ("The problem of moral hazard […] has been the subject of almost 1,600 scholarly articles […] and the term has appeared in more than 850 judicial opinions.").

[20] *See* Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 199 (2012).

various of noninsurance contexts, the possibility of moral hazard among actors has been shown to be a grave concern among counterparties.[21] Moral hazard in the context of insurance is by no means different, and as will be shown below, is indeed a strong—albeit not always exclusive—consideration for prioritizing interactions with actors who indeed incur the costs of the risk they create, namely uninsured ones.

This insight is undergirded by an additional, closely related academic paradigm that associates insurance with enhanced riskiness: the one known as "adverse selection."[22] The gist of the idea is that the riskier is an injurer, the more valuable is insurance for her. Consequently, we may witness a greater turn to insurance among riskier actors, and if so, the fact that an individual is insured might signal to counterparties her a-priori proneness to riskiness.[23] As opposed to moral

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[21] Specifically, the law oftentimes designs regimes that are analytically akin to insurance, which gives rise to moral hazard. Intuitive examples are strict liability in tort law or expectation damages for a breach of contract. Both scenarios provide individuals with guaranteed compensation, which immediately raises concerns about victims' incentives to take precautions or promisees' willingness to reduce their investment and consequently minimize their own losses at the sight of the promisor's potential inability to perform. It has likewise been argued that the government's centralized enforcement of private property rights reduces owners' incentives to exert private efforts for doing so. And so does federal relief in case of disasters. Scholars have long analogized all these settings to insurance, which undermines incentive to exercise care and gives rise to moral hazard. *See, e.g.*, Abraham Bell & Gideon Parchomovsky, *The Case for Imperfect Enforcement of Property Rights*, 160 U. PENN. L. REV. 1927, 1929 (2012) ("[S]tate enforcement also has a downside: it may give rise to a moral hazard problem that distorts owners' investment incentives, causing them to take suboptimal precautions to protect their property and externalize those costs onto the state instead."); Saul Levmore & Kyle D. Logue, *Insuring Against Terrorism—and Crime*, 102 MICH. L. REV. 268, 281 (2003) ("[T]he expectation of federal relief has almost certainly increased the willingness of some individuals and businesses to locate or remain in disaster prone areas."); Susanne Ohlendorf, *Expectation Damages, Divisible Contracts, and Bilateral Investment*, 99 AM. ECON. REV. 1608, 1608 (2009) ("Remedies such as expectation damages act as insurance against breach. The victim of breach invests more than if he or she internalized the lost investment in case of breach."); Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 7 n. 11 (1980) ("It is of course clear that under strict liability without the defense [of contributory negligence] the outcome is inefficient, for victims would have no motive to take care.").

[22] *See, e.g.*, Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 373 (2003) ("Two reasons commonly given for the limits on the promise of insurance are the problems of moral hazard and adverse selection.").

[23] *See* Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629, 632 (1976) ("[T]hose with high

hazard that indicates weaker *incentives* to exercise care *ex post*—that is, once insurance has been acquired—adverse selection conveys information about the *nature* of the actor's risky activity or her inability to exert sufficient prudence, which is likely the reason for her decision to insure herself *ex ante*.[24] Moral hazard and adverse selection are the twofold cornerstone of the traditional approach to insurance, which perceives it as a risk-enhancing social institution.[25] Thus, if this approach is the one that prevails in certain marketplaces—which is indeed the case, as will be shortly noted—insurance clearly undermines the reliability signal that potential injurers could have communicated by subjecting themselves to liability. Injurers who nonetheless decide to acquire an insurance policy basically trade off reliability for coverage.[26]

Against the canonic economic approach that associates insurance with moral hazard, modern legal literature has developed a parallel, competing vantage point. The modern approach revisits the standard outlook by conceptualizing insurance as a risk-reducing mechanism. The intuitiveness of the underlying reasoning is almost as striking as its elegance. Rejecting the scholarly perception according to which insurance is invariably followed by policyholders' moral hazard, the novel paradigm sets emphasis on the regulatory role of insurance, and particularly of private insurance companies.[27]

What the classic line of literature has generally ignored is the fact that an insurer is an economic actor who, at the end of the day, simply wishes to minimize losses caused by insureds' risky activity. In many cases, insurers also occupy a position that allows them to control

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accident probabilities will demand more insurance than those who are less accident-prone."). For the classic description of an adverse selection problem see generally Akerlof, *supra* note 5.

[24] *See, e.g.*, Alma Cohen & Peter Siegelman, *Testing for Adverse Selection in Insurance Markets*, 77 J. RISK & INS. 39, 71 (2010) (explaining the distinction between moral hazard and adverse selection).

[25] *See generally supra* note 17.

[26] *See infra* Section III.A.

[27] *See generally* RICHARD V. ERICSON ET AL., INSURANCE AS GOVERNANCE (2003).

policyholders' level of riskiness.[28] Insurers could—and often do—utilize their status as a powerful, deep-pocket entity and function as a quintessential regulator of risky behavior; a regulator with strong pecuniary incentives to prevent losses.[29] This manifests ex ante in conditioning insurance upon due diligence,[30] the adoption of private precautions by the insured,[31] and disclosure requirements,[32] as well as in tailoring premiums in commensuration with the assessed risk;[33] ex interim in insurer-intensified monitoring and supervision,[34] and even trainings for the sake of entrenching risk-reducing practices;[35] and ex post—once the risk is realized into loss—in updating the rate of deductibles and risk premiums in the course of policy renegotiations.[36]

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[28] For reviews of the regulatory function of private insurers see, e.g., Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers Professional Liability*, 60 UCLA L. REV. 1412 (2013); Ben-Shahar & Logue, *supra* note 20. *See also* Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PENN. L. REV. 653, 683-97 (2013) (discussing the "governance conception" of insurance).

[29] Although with some reluctance to eliminate them altogether, in order to retain some risk, which is the insurer's primary source of income. *See generally* Ronen Avraham & Ariel Porat, *The Dark Side of Insurance*, 19 REV. L. & ECON. 13 (2023) (identifying insurers' desire to maintain long term risks in order to keep their businesses profitable).

[30] *See, e.g.*, Nathaniel Hendren, *Private Information and Insurance Rejections*, 81 ECONOMETRICA 1713, 1713-14 (2013) (noting that individuals who exhibit high-risk tendencies are often denied insurance).

[31] *See, e.g.*, Kenneth S. Abraham & Daniel Schwartz, *The Limits of Regulation by Insurance*, 98 IND. L.J. 215, 226 n. 46 (2022) ("Homeowners' insurance, for instance, exclude coverage for the freezing of plumbing, heating, and air conditioning systems unless the insured used reasonable care to maintain heat in the building or shut of the water supply.").

[32] *See, e.g.*, Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 26-27 (1978) ("[I]f an applicant has a history of heart trouble […] and he does not disclose the problem itself, the insurance company will usually be permitted to set the contract of insurance aside.").

[33] *See, e.g.*, Omri Ben-Shahar, *Privacy Protection, At What Cost? Exploring the Regulatory Resistance to Data Technology in Auto Insurance*, 15 J. LEGAL ANALYSIS 129 (2023) (advocating for the use of artificial intelligence technology to dynamically adjust auto insurance premiums based on drivers' fluctuated riskiness).

[34] *See, e.g.*, Ben-Shahar & Logue, *supra* note 20 at 236-37 ("The improved monitoring allows insurers to price policies to reflect individual risk more accurately.").

[35] *See, e.g.*, Baker & Swedloff, *supra* note 28 at 1421-22 ("[L]oss prevention [training] services may be the easiest aspect of the insurance business to understand as a form of regulation, because the insurers are advising clients on how to modify behavior to avoid losses.").

[36] *See, e.g.*, Rubinstein & Yaari, *supra* note 17 (noting that repeated periodical interactions between the insurer and the policyholder reduce moral hazard).

This "insurance as governance" phenomenon is well-documented.[37] As detailed below, commentators have attested that private insurance has been proven efficient in regulating the behavior of potential tortfeasors in various contexts.[38] One surprising example is the regulatory role of private insurance against police misconduct. Against a prominent work by Professor Joana Schwartz, who powerfully demonstrated that municipal indemnification erodes deterrence of police misconduct,[39] Professor John Rappaport's influential article has contrasted public regulation with the case of private insurance, suggesting that:[40]

> "When the insurer assumes the risk of liability, it also develops a financial incentive to reduce that risk through loss prevention. By reducing risk, the insurer lowers its payouts under the liability policy and thus increases profits. […] [A]n insurer writing police liability insurance may profit by reducing police misconduct. […] In fact, the insurer may be better positioned than the government to reform police behavior. Relative to government regulators, the insurer may possess superior information […]; deeper and more nimble resources […]; market incentives that favor good, but not overzealous, risk-management policies; and the flexibility to develop and prescribe individualized risk-reduction plans. If it uses

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[37] *Supra* note 27-28.

[38] *Infra* Part II.

[39] *See* Joanna C. Schwartz, *Police Indemnification*, 89 N.Y.U. L. REV. 885, 953 (2014) ("[O]fficers can have no reasonable expectation that their misconduct will lead to financial sanctions. [...] [Consequently,] available evidence suggests that the threat of being sued does not significantly influence officer behavior.").

[40] *See* John Rappaport, *How Private Insurers Regulate Public Police*, 130 HARV. L. REV. 1539, 1544 (2017)

> the loss-prevention tools at its disposal, the insurer can reintroduce, or possibly even enhance, constitutional tort law's deterrent effect."

Insurer monitoring and related risk-reducing practices, when adequately deployed, may eclipse the concern of moral hazard.[41] Similarly, against the ex-ante, adverse selection problem that the traditional viewpoint ascribes to insurance, commentators have highlighted the obverse phenomenon of "propitious selection."[42] In contrast with the adverse-selection argument per which insurance applicants are necessarily those who need one, namely riskier actors, studies focusing on propitious selection subscribe to a starkly opposite understanding: the acquisition of an insurance policy might be indicative of the risk-averse, and in many cases overcareful, character of the applicant.[43] In addressing the underpinnings of propitious selection, Professor Peter Siegelman once noted:[44]

> "[M]any insurance markets are actually characterized by "propitious," rather than adverse, selection. Propitious selection, as its name suggests, implies that insurance is most attractive to the lowest-risk individuals among those eligible to buy it, not to those with the highest risks…. [In those markets,] there is a negative correlation between risk aversion and riskiness. In other words, the

[41] Ben-Shahar & Logue, *supra* note 20 at 205 ("While much of the literature on insurance has focused on the moral hazard problem [...] it is also widely recognized that insurers have the means to limit and overcome moral hazard.").

[42] For the pioneering introduction of the concept see David Hemenway, *Propitious Selection*, 105 Q.J. ECON. 1063 (1990).

[43] *See id*., at 1068 ("The theory of propitious selection suggests that risk-averse individuals will tend to be more generalized risk avoiders—not only will they buy insurance, but they will also take physical precautions....").

[44] *See* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223, 1266 (2004).

> "belt-and-suspenders" types are not only more averse to financial risks—and hence more willing to pay to eliminate such risks through insurance—but they are also more likely to reduce risks on their own by, for example, taking precautions or refusing to engage in physically risky activities."

Owing to propitious selection, insurance may serve as a signal for reduced riskiness not only due to insurers' ability to discipline excessively risky actors, but also because of the inherent self-selection process of liability insurance, which is at the outset more likely to attract risk averse—and likely more prudent—actors.[45] According to this line of reasoning, Siegelman argues, "the riskier insureds are precisely those who do not want to buy insurance; the same attitudes that lead them to take risks in the first place give them little reason to insure against risks."[46]

The unorthodox, risk-reducing view of insurance offers a fundamentally different take on the purportedly negative signal that insurance delivers with respect to reliability. If an insurer is a powerful entity that captures an advantageous position to scrutinize individuals' riskiness—be it by assessing their a-priori harmfulness or by requiring the adoption of various risk-mitigating measures as a precondition for coverage—then counterparties might actually find it preferable to interact with a policyholder, rather than with an uninsured actor. Consider again the physician hypothetical, which will be discussed in a real-world setting in the ensuing Part. A patient might reasonably assume that a well-informed insurer—who, again, possesses the best means and methods for preventing loss—would not have insured an excessively risky doctor in the first place, nor would it have insured at all had it believed that coverage substantially distorts policyholders'

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[45] *See generally* Hemenway, *supra* note 42. *See also* David Hemenway, *Propitious Selection in Insurance*, 5 J. RISK & UNCERTAINTY 247 (1992).

[46] Siegelman, *supra* note 44 at 1266.

incentives to exercise care. The involvement of an insurer may therefore serve as an expression of faith—indeed, a signal of nonharmful conduct—and, in turn, enhance the reliability that counterparties ascribe. Substitute the moral-hazard approach with the incentives of insurers to constantly monitor and eliminate risky behavior, couple this insight together with the theory of propitious selection that counters the standard premise of adverse selection, and conclude that liability insurance may well contribute to—rather than undermine—the insured's reliability. All is encapsulated tabularly below.

Table 1.1. The Competing Effects of Insurance on Riskiness

	Ex Ante	*Ex Post*
Risk-Enhancement	Adverse selection	Moral hazard
Risk-Reduction	Propitious selection	Insurer monitoring

The preceding Section has set forth two competing forces of insurance—risk-enhancing and risk-reducing—noting that the one that would dominate in a given context would likewise carry a more powerful signal on reliability. Except this conclusion is incomplete. As detailed in the next Section, counterparties might be better off interacting with an insured party even when insurance gives rise to reckless, morally hazardous behavior. Similarly, the regulatory function of insurance may reveal itself as a double-edged sword and in specific instances might erode, rather than enhance, policyholders' reliability in the eyes of counterparties.

B. *Beyond Moral Hazard and Governance: The Prospects of Solvency and Excessive Prudence*

1. Reliability *Despite* Moral Hazard

Even when insurance gives rise to policyholders' moral hazard, it does not immediately eradicate reliability. The reason is that counterparties first account for the counterfactual scenario: what are the possible consequences of interacting with an uninsured actor? On the surface, and compatible with the "right-to-be-sued" argument, liability for losses would cause the uninsured to internalize both the benefits and costs that originate from her activity and induce optimal level of riskiness. Counterparties may therefore rest assured. But this assertion must be caveated by one important contingency: a judgment-proof injurer. Specifically, when the relevant interaction involves potentially substantial losses, an individual who does not enjoy the coverage of a deep-pocket entity might turn out insolvent, i.e., unable to compensate for the entire loss generated by her activity.[47] In that case, the counterparty would not be able to fully recover the losses it suffers, which induces strong inclination toward interactions with an insured actor—even a morally hazardous one—as a deep-pocket coverage rules out the possibility that the injurer at hand would ever become judgment proof.[48]

In those cases, the reason for preferring an insured—beyond the trivial one of guaranteeing compensation—is twofold. First and foremost, as the legal and economic literature has long established, the judgment proof problem not only carries detrimental distributional effects by leaving victims bereft of the ability to receive adequate compensation for their losses, but also creates perverse incentives to potentially insolvent injurers. Judgment-proof actors are discouraged

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[47] *See generally* Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986).

[48] *See* Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375, 1375 (1994) ("Liability insurance can ameliorate […] judgment-proof problems….").

from exerting optimal prudence since they, too, enjoy the full benefits of their risky activity but would not suffer the full cost of harm, if ever realized. Best illustrated by Professor Steven Shavell:[49]

> "[When individuals are judgment-proof,] [l]iability does not furnish adequate incentives to alleviate risk…. [An insolvent] injurer will treat liability that exceeds his assets as imposing an effective financial penalty only equal to his assets; an injurer with assets of $30,000, for example, will treat an accident resulting in liability of $100,000 identically with an accident resulting in liability of only $30,000. Hence, injurers' expected penalty may be less than the expected losses for which they are liable."

In terms of incentives to exercise optimal care, then, judgment-proof individuals act just like policyholders under the standard moral hazard paradigm. In that case, counterparties confront the easy choice of interacting with a morally hazardous actor who is insured against harm she causes, or with a morally hazardous actor who is judgment proof. Under either alternative she confronts an excessively risky individual, but only under the former one she may recover the losses this individual might inflict on her. Thus, in interactions that realistically feature a judgment-proof contingency, the reliability effect of liability is no longer valid, meaning that insurance does not undermine it, but simply ensures compensation in case of harm.[50]

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[49] Shavell, *supra* note 47 at 45.

[50] *See* Stephen G. Gilles, *The Judgment-Proof Society*, 63 WASH. & LEE L. REV. 603, 605-606 (2006) (arguing that tort liability is a "myth" considering the ubiquity of judgment-proof tortfeasors in society).

But there is more to it, which brings us to the second reason for preferring to interact with insured actors. Even when the prospect of insolvency does not affect the potential injurer's incentive to decline her loss-reducing effort—that is, even when a judgment-proof actor takes optimal care—the risk of an unrecoverable harm would still render a morally hazardous insured more attractive. Recall the insured and uninsured doctor comparison, and suppose that with the proper precautionary measures taken by the physician, a treatment involves an expected harm of $100,000. Further assume that a morally hazardous physician who does not exercise optimal care might increase the expected harm to $150,000. Even when insured physicians are more likely to act as the latter one, the potential insolvency of the careful doctor might still make interaction with insured actors more desirable from patients' perspective.

In many real-world interactions discussed in detail in the next Part, the securance of recovery in case of harm and the elimination of insolvency would play a key factor in the reliability that counterparties ascribe to insurance and, in turn, to actors' decision to acquire liability insurance.[51] What lends further support to this insight is that the judgment-proof problem oftentimes serves as the primary rationale mandating insurance, which removes the distrust-prompting trait of insolvency.[52]

2. Unreliability *Due to* Insurer Monitoring

The argument that increased prudence enhances reliability hinges on the intuitive premise that elevated care is correlated with lower expected harm. As stated below, however, the impetuses

[51] *Infra* Part II.

[52] *See* Gilles, *supra* note 50 at 700 (considering mandatory insurance as a way to remediate the judgment proof problem). *See also* Mattias K. Polborn, *Mandatory Insurance and the Judgment Proof Problem*, 18 INT'L REV. L. & ECON. 141 (1998) (comparing the effects of voluntary and compulsory insurance in mitigating problems of insolvency).

that prompt enhanced care—insurer monitoring and propitious selection—might ultimately result in injurers exercising *excessive* care to avert losses. In some cases, insurer-induced overprudence might undermine reliability just as much as underprudence does. Counterparties might wish to avoid engaging with an excessively careful actor for two related reasons. First, excessive prudence might deprive counterparties of the full benefit they could elicit from potentially harmful market interactions. An overly prudent physician, for example, might fail to prescribe patients even with desirably risky treatments to avoid the harm they may inflict.[53] Second, and by the same token, she is more likely to engage in the omnipresent practice of "defensive medicine," whereby doctors recommend patients to undertake cost-unjustified treatments or diagnoses just to avoid the occurrence of a harm that might pave the way for a future suit.[54] In other words, an overcareful doctor's objective is "to address every possible risk for the patient, no matter how small it is."[55]

The problem of excessive prudence is not limited to defensive medicine. An overcareful contracting party who worries too much about failure to disclose relevant information might overburden her correlative with unnecessary information—"spam"—just to be on the safe side of the disclosure requirement.[56] Overcareful employers who are worried about liability for employees' workplace behavior might set exceedingly stringent standards that reduce their

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[53] *Infra* notes 129-133 and accompanying text.

[54] *Id. See also* Gideon Parchomovsky & Alex Stein, *The Distortionary Effect of Evidence on Primary Behavior*, 124 HARV. L. REV. 518, 545 (2010) (arguing that defensive medicine practices include "unnecessary diagnostic procedures, hospitalizations and referrals to specialty doctors, needless gathering of laboratory information, and even prescription for unneeded medications."); Ariel Porat, *Misalignments in Tort Law*, 121 YALE L.J. 82, 119 (2011) ("[A]long with excessive precautions, [defensive medicine] is detrimental to both patients and society at large.").

[55] Parchomovsky & Stein, *supra* note 54 at 545.

[56] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 699 (1984) (identifying and discussing the prospect of "excessive disclosure" as a measure taken against the risk of liability for not disclosing relevant information).

attractiveness in the eyes of job candidates.[57] An overcareful corporate executive would avoid taking risks that may well be beneficial from investors' perspective.[58] A media outlet might avoid even the socially desirable risk of a potentially defamatory publication.[59]

In terms of reliability, then, the scenario in which insurers channel injurers toward carefulness—or attract more careful ones at the outset—does not in itself contribute to credibility. If insurers tend to intensely monitor policyholders and induce them to exert inordinate loss-prevention effort or, say, condition policies upon excessive precautionary measures—a requirement to which sufficiently risk-averse actors would accede—then the presence of insurance would beget excessive care. In that case, the very regulatory role of insurance—which might intuitively be thought of as enhancing the insured's credibility for reinstating her incentive to

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[57] Some have argued, for instance, that companies are establishing exceedingly stricter policies against workplace relationships, taking measures to avert even small risks for future lawsuits. *See, e.g.*, Yoree Koh & Rachel Feintzeig, *Can You Still Date a Co-Worker? Well, It's Complicated*, WALL ST. J. (Feb. 6, 2018), https://www.wsj.com/articles/can-you-still-date-a-co-worker-well-its-complicated-1517913001. This might be at odds with workplace romance statistics, which reveal people's favorable view of finding love at work, compared to other environments. *See, e.g.*, Kelly Main & Lauren Holznikemper, *Workplace Romance Statistics: Survey Shows Employees Regularly Engage in Office Relationships*, FORBES (July 21, 2023), https://www.forbes.com/advisor/business/workplace-romance-statistics/. To complete the picture, it should be noted that many insurance companies advance policy guidelines for office romance for the purposes of avoiding future liabilities. *See, e.g.*, *Office Romance: When Your Employees Date...*, CEDAR RISK MGM'T. & INS., https://www.cedarrisk.com/office-romance-employees-date/ ("When they're together, you have claims of favoritism. When they break up, then starts the possibility of retaliation or harassment."); *Is It Time to Rekindle Your Office Romance Policy?*, BENDER INS. SOLUTIONS, https://mybendersolutions.com/is-it-time-to-rekindle-your-office-romance-policy/ ("[H]aving a policy can help you mitigate some of the potential risks of office relationships.").

[58] *See, e.g.*, Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1688 (1996) (explaining that excessive risk aversion "is likely to make an agent of the corporation much more cautious than a principal-shareholder in determining the way that the business of the corporation is conducted.").

[59] *See, e.g.*, Oren Bar-Gill & Assaf Hamdani, *Optimal Liability for Libel*, 2 CONT. ECON. ANALYSIS & POL'Y 1 (2003) (studying the socially desirable liability regime for defamation in light of the chilling effect that liability might carry on publications).

prevent harm—actually undermines reliability, causing counterparties to favor interactions with uninsured actors.[60]

The ensuing Part grounds the theoretical account in commercial practice and day-to-day conduct, studying how the multifaceted forces of insurance shape the reliability that counterparties ascribe to the insured. It notes that in some cases, the reliability-undermining forces of either insufficient or excessive prudence would dominate the prospect of insurer-monitoring and solvency assurance, whereas in other market settings the opposite is true. The following Part portrays the insurance-reliability landscape by mapping multiple markets that inhabit liability insurance.

II. FROM THEORY TO PRACTICE

A. *Directors' and Officers' Liability Insurance*

In most cases, there is contradictory evidence on whether insurance carries perverse or favorable effects on reliability. Hence, it might be useful to start with a market setting in which this effect is unequivocally distortive—directors' and officers' (D&O) liability insurance. In finance literature, D&O insurance against claims made by shareholders or other third parties is consistently regarded as a facilitator of distrust. Considering the excessive risk-taking associated with D&Os coverage[61]—mainly in the context of investment decisions,[62] loan spreads,[63] or higher

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[60] *Infra* Part II.

[61] *See, e.g.*, M. Martin Boyer & Sharon Tennyson, *Directors' and Officers' Liability Insurance, Corporate Risk and Risk Taking: New Panel Data Evidence on the Role of Directors' and Officers' Liability Insurance*, 82 J. RISK & INS. 753, 781 (2015) (contending that the data "strongly favor the hypothesis that D&O insurance leads to more aggressive earnings management, suggesting moral hazard effects of insurance.").

[62] *See generally* Chen Lin et al., *Directors' and Officers' Liability Insurance and Acquisition Outcomes*, 102 J. FIN. ECON. 507 (2011).

[63] *See generally* Chen Lin et al., *Directors' and Officers' Liability Insurance and Loan Spreads*, 110 J. FIN. ECON. 37 (2013).

likelihood of suits[64]—firms whose officials are extensively insured from liability are routinely treated with increased suspicion by market participants.[65] Voluminous empirical literature attests, for example, that analysts exhibit repeated pessimism with respect to the performance of firms with high-level D&O insurance.[66] Additional effects include generally negative market reactions,[67] as well as poorer stock performance.[68] Similarly, corporations whose directors and officers enjoy enhanced coverage are reportedly offered lower bid premiums in mergers and acquisitions (M&A) negotiations,[69] and substantially higher audit fees.[70] The striking empirical evidence corresponds to the previous theory of the insurance-reliability interface. According to studies, the negative market response to extensive D&O insurance emanates from concerns over the excessive risk-taking notoriously associated with executives who are insured from liability.[71]

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[64] *See generally* Stuart L. Gillan & Christine A. Panasian, *On Lawsuits, Corporate Governance, and Directors' and Officers' Liability Insurance*, 82 J. RISK & INS. 793 (2015).

[65] For a literature review see Ning Jia & Xuesong Tang, *Directors' and Officers' Liability Insurance, Independent Director Behavior, and Governance Effect*, 85 J. RISK & INS. 1013, 1013-18 (2018).

[66] *See generally* Narjess Boubakri & Lobna Bouslimi, *Directors' and Officers' Liability Insurance and Analyst Forecast Properties*, 19 FIN. RES. LETTERS 22 (2016).

[67] *See, e.g.*, Michael Bradley & Cindy A. Schpani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989) (reporting empirical evidence on negative market reaction as a result of limitations on directors' personal legal liabilities); Zhihong Chen et al., *Directors' and Officers' Liability Insurance and the Cost of Equity*, 61 J. ACC. & ECON. 100 (2016) (associating higher level of D&O insurance with increased cost of equity).

[68] *See, e.g.*, John M. R. Chalmers et al., *Managerial Opportunism? Evidence from Directors' and Officers' Insurance Purchases*, 57 J. FIN. 609, 633 (2002) (concluding that "[c]onsistent with the managerial opportunism hypothesis, there is a negative association between the amount of D&O insurance coverage at the IPO and the three-year stock price performance of the firm.").

[69] *See generally* Ines Aguir et al., *Liability Protection, Director Compensation, and Incentives*¸ 23 J. FIN. INTERMEDIATION 570 (2014); Lin et al., *supra* note 62.

[70] *See generally* Noel O'Sullivan, *The Impact of Directors' and Officers' Insurance on Audit Pricing: Evidence from UK Companies*, 33 ACC. FOR. 146 (2009); Hyeesoo H. Chung et al., *Directors' and Officers' Legal Liability Insurance and Audit Pricing*, 34 J. ACC. & PUB. POL'Y 551 (2015).

[71] *See, e.g.*, Chalmers et al., *supra* note 68 at 633 (arguing that the empirical evidence are consistent with the theoretical prediction of opportunistic risk-taking among insured corporate officials). *See also* Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT'L REV. L. & ECON. 115, 116 (1990) (noting that objectors maintain that "liability insurance largely nullifies the disciplining potential of litigation, causing directors and officers to be less attentive to their duties to shareholders."); Parchomovsky & Siegelman, *supra* note 19 at 98 ("Directors and managers who have insurance tend to be less diligent in the performance of their obligations.").

But what about the opposing, regulatory forces of insurance? In a thorough study that asks whether D&O insurance manages to regulate executives' riskiness, Professors Tom Baker and Sean Griffith's joint book has delved into the market.[72] Baker and Griffith first contrast the risk-enhancing and risk-reducing effects of insurance in the context of D&Os, explaining that:[73]

> "This insurance disrupts the deterrence mechanism by transferring the obligations of prospective bad actor (the officer, directors, or the corporation itself) to [the insurer]. An actor that is no longer forced to internalize the costs of its actions is no longer deterred from engaging in harmful conduct – managers who are no longer personally at risk for investor losses are less likely to take care in avoiding them, and corporations that are no longer at risk from shareholder litigation are less likely to monitor the conduct of their manager – and the regulatory effect of shareholder litigation is diminished, distorted or destroyed. […] [However, because insurers] are the ones ultimately paying for the harms caused by their corporate insureds, insurers have ample incentive to exert […] constraining influence, and they have the means to do so."

With this in mind, Baker and Griffith inquire to what extent D&O insurance indeed serves as a regulatory apparatus. After conducting a thorough research which included interviews with relevant professionals, they submit the gloom conclusion that "D&O insurers do almost nothing

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[72] *See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION (2010).
[73] *Id*., at 2.

to monitor the public corporations they insure, and D&O insurers do not condition the sale of insurance on compliance with loss-prevention requirements in any systematic way."[74]

In the context of D&O insurance, then, it seems clear that the reliability-increasing potential of insurance largely fails to deliver. Moreover, even the assurance of solvency—a strong consideration for preferring interactions with insured parties—becomes somewhat less compelling in the context of D&O liability, considering the prospect of corporations' vicarious liability for officials' faulty conduct.[75] The involvement of the insurer thus does not seem to contribute to reliability, as it simply substitutes one deep-pocket entity with another. The following table concludes.[76]

Table 1.2. The Effect of D&O Insurance on Reliability

Positive Effects		Negative Effects		Overall
Governance	Solvency	Moral Hazard	Excessive Care	
✗	✗	✓	✗	✗

[74] *Id*., at 109. *See also* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance*, 95 GEO. L.J. 1795, 1808 (2007).

[75] *See, e.g.*, Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 688 (1997) ("[A] firm is directly and vicariously liable for wrongs committed by its agents (managers and other employees) within the scope of their employment. A firm's liability under this principle is far-reaching.").

[76] Notational clarifications: ✓ denotes existence, ✗ stands for nonexistence, whereas "?" signifies inconclusive evidence.

B. *Misrepresentation Liability Insurance*

Another type of insurance of relevance to our discussion is representation and warranty (R&W) insurance, which is used by corporations in the course of M&A contracting. As detailed in Professor Griffith's comprehensive empirical contribution, parties purchasing R&W insurance choose to avoid bearing the risk of liability for disclosing false information or failing to disclose relevant facts, and instead transfer the risk to a third-party insurer.[77] In the first and, thus far, only study to explicitly wonder how come R&W insurance—and insurance at large—could be compatible with the insured's party aspiration to retain credible commitment to the information she transmits, Griffith emphasizes:[78]

> "The introduction of [R&W insurance] … suggests greater potential for misinformation in M&A, leading to increased mispricing risk, which might induce buyers to discount or abandon otherwise wealth-enhancing transactions. [R&W insurance,] in other words, threatens to recreate the very problem that [representations and warranties] were designed to solve."

Furthermore, while Griffith identifies methods taken by R&W insurers to avert the problem of subject-matter adverse selection—i.e., excluding certain issues from coverage—it appears that like D&O insurers, they too do little to prevent or mitigate loss, which seemingly makes moral hazard more likely.[79] So, given that the environment is largely constitutive to moral hazard—which might lead contracting parties to draw an adverse inference regarding the insured's

[77] *See* Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839 (2020).
[78] *Id*., at 1843-44.
[79] *Id*., at 1892.

reliability—why do some companies nonetheless choose to acquire insurance against misrepresentation?

According to Griffith, the ascribed credible commitment problem is addressed by applying R&W insurance to diminution-in-value damages caused by misrepresentation.[80] This is by-and-large the solvency-guaranteeing function of insurance, ascertaining that counterparties would always be compensated for any harm and enhancing their willingness to interact with insureds. Although Griffith contends that liability for losses caused by R&W practices are unlikely to render the defendant insolvent,[81] the idea is that since restitution is ascertained, buyers are essentially indifferent as to whether the insured is trustworthy or not.[82]

In the context of R&W insurance, broader coverage might, on the one hand, substantially undermine trustworthiness, but on the other hand, could simply nullify the central role of trust in negotiations, thus obviating parties' need for substantiating credible commitment. It is unclear which phenomenon is more likely to prevail in the future, as Griffith himself concludes:[83]

> "Insurers may be willing to undertake these commitments in an expanding market but less so as insurance markets contract. The tightening of coverage terms in a hardening market may cause transacting parties to rediscover the credible commitment problem at the heart of [R&W insurance], which in turn may lead them to abandon the product."

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[80] *Id*., at 1886.
[81] *Id*., at 1899.
[82] *Id*., at 1884.
[83] *Id*., at 1920.

R&W insurance generates an irregular result, where the credibility of the information communicated by the insured is just immaterial to counterparties: the presence of insurance ensures that any transmission of misleading information or failure to convey pertinent data would be fully compensated, meaning that counterparties could contract with the insured with peace of mind. The case of R&W insurance thus manifests the widely adopted but generally unrealistic economic principle of "perfect compensation." According to the perfect compensation assumption, economic actors are indifferent between not suffering harm at the outset and suffering harm with full restitution.[84] Under this postulation, we are supposed to witness a widespread indifference to injurers' insurance in various contexts, including in D&O insurance and basically any other setting. So, why don't we?

Though observable in the context of R&W insurance, the perfect compensation equivalence is hardly plausible in real-world settings for many practicability constraints that economic theory oftentimes fails to embed.[85] In practice, given the choice, individuals normally prefer avoiding harm ex ante to being compensated for such harm ex post, for a variety of reasons. To name just a few, individuals' basic intuitions tend to prioritize the preservation of bodily integrity or personal autonomy, rather than compromising it and receiving an equivalent economic value.[86] The argument is even sounder when accounting for physical or mental injuries, whose

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[84] *See* Robert Cooter, *Punitive Damages, Social Norms, and Economic Analysis*, 60 L. & CONTEMP. PROBS. 73, 76 (1997) ("In economic models, "perfect compensation" leaves the victim indifferent between no harm and harm with compensation.").

[85] *See, e.g.*, ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 203 (6th ed. 2016) (acknowledging that the perfect compensation assumption is unrealistic and is adopted mainly for being analytically useful).

[86] *See, e.g.*, Gideon Parchomovsky & Alex Stein, *Autonomy*, 71 U. TOR. L.J. 61 (2021) (arguing that any harm involves a separate violation of victims' autonomy, but that this distinct wrong is not recognized by courts).

avoidance ex ante is perhaps instinctively preferred by individuals.[87] Besides, as has long been recognized, individuals tend to exhibit loss aversion,[88] namely, the value they ascribe to losses exceeds the one they associate with profits, which implies that by being harmed and then compensated (namely, loss followed by profit), they are worse off compared to avoiding harm in the first place.[89]

But the main reason for the implausibility of the perfect compensation assumption in real-world legal disputes is, *ipso facto,* that plaintiffs are never really *perfectly* compensated. Restorative compensation is never a standalone: litigation normally requires plaintiffs to invest costly resources and oftentimes involves reputational losses.[90] All such costs could be averted by avoiding the harm in the first place. Individuals' prioritization of averting harm over receiving compensation for their suffering is most natural, commonsensical, and intuitive. It furthermore becomes economically acceptable once accounting for the ascribed costs that restitution involves, namely the difficulties of asserting and consummating rights in our legal system.[91]

The role of R&W in designing insured's reliability is encapsulated by the following table, in accordance with the relevant parameters set forth in Part I.

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[87] For example, some have identified the inherent problem of the perfect compensation principle for risks of death. *See generally* Ariel Porat & Avraham Tabbach, *Willingness to Pay, Death, Wealth and Damages*, 13 AM. L. & ECON. REV. 45 (2011).

[88] *See generally* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) (introducing the concept of loss aversion).

[89] Indeed, the law tends to punish acts that caused losses more severely than ones that prevented profits. *See generally* Eyal Zamir, *Loss Aversion and the Law*, 65 VAND. L. REV. 839 (2012).

[90] *See, e.g.*, Yotam Kaplan & Ittai Paldor, *Social Justice and the Structure of the Litigation System*, 101 N.C. L. REV. 469, 477-89 (2023) (addressing the often-insurmountable costs of litigating a lawsuit).

[91] *See id*.

Table 1.3. The Effect of R&W Insurance on Reliability

Positive Effects		Negative Effects		Overall
Governance	Solvency	Moral Hazard	Excessive Care	
✗	✓	✓	✗	?

C. *Workplace Liability Insurance*

Against the risks posed by employment law provisions, businesses can resort to Employment Practices Liability (EPL) insurance, which ordinarily covers claims for workplace discrimination such as wrongful termination, sexual harassment and more.[92] For the most part, EPL insurance protects a business from being held liable for the actions of employees either vicariously or by negligently failing to address them.

For understandable reasons, perhaps, EPL insurance has been viewed by commentators as antithetic to integrity and social justice, undermining the objectives of employment law, and moreover, as distorting incentives for optimal conduct for igniting the problem of moral hazard among employers.[93] Professors Erin Meyers and Joni Hersch, however, identify that EPL

[92] *See, e.g.*, NATIONWIDE MUTUAL INSURANCE COMPANY, *Employment Practices Liability Insurance*, https://www.nationwide.com/business/insurance/employment-practices-liability/.

[93] *See, e.g.*, Joan T.A. Gabel et al., *The Peculiar Moral Hazard of Employment Practices Liability Insurance: Realigning the Incentive to Transfer Risk with the Incentive to Prevent Discrimination*, 20 NOTRE DAME J. L. ETHICS & PUB. POL'Y 639. 641 (2006) (stressing that employers' moral hazard "is particularly troubling given the way in which the law has come to specifically protect employees by emphasizing that employers actively engage in prevention."). *But see* Francis J. Mootz III, *Insurance Coverage of Employment Discrimination Claims*, 52 U. MIAMI L. REV. 1, 78 (1997) (arguing that despite the "dubious motivation" behind acquiring EPL insurance, insurer involvement might actually reduce the risk of discrimination).

insurance by-and-large reinforces accountability.[94] In correspondence to the "insurance as governance" paradigm, Meyers and Hersch note that insurers employ various means and methods designed to reduce employers' moral hazard,[95] including deductible and coverage limits which guarantee that insureds have sufficient "skin in the game" of loss prevention.[96] EPL insurers likewise offer a host of loss-prevention measures, *inter alia*, training programs and HR consultancy.[97]

But regulation by insurance is not the whole story in EPL. Meyers and Hersch caveat their general finding by noting that EPL insurance policies do not normally exclude coverage for employers' intentional actions and deliberate oversight.[98] It is for this reason, they attest, that insurance companies have paid the damages in the class action against the Weinstein Company concerning Harvey Weinstein's repeated sexual assault.[99] In particular, Meyers and Hersch point out that EPL insurance provides indemnification even for what they call "employer-facilitated wrongs," namely, misconducts that the upper management has actively participated in or deliberately avoided preventing.[100] Consequently, ex-post moral hazard—the management's underreaction to complaints of wrongful acts—is inevitable.[101] As Meyers and Hersch maintain:[102]

> "While an individual employee's actions may have been intentional and reprehensible, upper management might reasonably have been

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[94] *See* Erin E. Meyers & Joni Hersch, *Employment Practices Liability Insurance and Ex-Post Moral Hazard*, 106 CORNELL L. REV. 947, 950 (2021).
[95] *Id*., at 972-74.
[96] *Id*., at 962.
[97] *Id*., at 965.
[98] *Id*., at 949.
[99] *Id*.
[100] *Id*., at 950.
[101] *Id*., at 974-77.
[102] *Id*., at 950-51.

> unaware of its employee's behavior. […] [On the other hand,] [c]onsider a situation wherein a company's upper management fails to address an employee's continuous racist comments because the employee's performance at work is especially valuable. Or consider the instance of Weinstein himself, wherein his harassing behavior was "widely known" within The Weinstein Company, yet it went unaddressed for years. Providing full insurance coverage for these employer-facilitated wrongs introduces […] an unjustifiable level of ex post moral hazard. The fact that [EPL insurance] further covers punitive damages only aggravates the situation."

The immediate question that follows is what singles out deliberate from unintentional practices. Specifically, why do insurers vigorously operate to eliminate moral hazard in cases of unwilful employer actions, yet completely fail to induce adequate business' reaction to wrongs in which executives took active part? If EPL insurers work so well in motivating employers to properly handle EPL-related claims, how come Harvey Weinstein's deeds remained covered up for decades? Meyers and Hersch point to a surprising explanation, which pertains to uncertainty regarding the legal enforceability of the insurance contract.[103] Since insurance law regularly limits actors' ability to secure coverage against intentional wrongs—and in many cases prohibits such practice altogether[104]—the expected loss confronted by insurers in case of EPL harms that originate from employer-facilitated wrongs becomes paradoxically lower.[105] The reason is that plaintiffs who sue for damages against an employer-facilitated wrong, confront the threat that

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[103] *Id.,* at 974-77.
[104] *Id*., at 949.
[105] *Id.,* at 974-77.

courts would invalidate insurance coverage.[106] This plausible contingency attenuates their bargaining power and allows insurers to extract settlements for lower-than-deserved payments.[107] Because courts lack coherent jurisprudence on the validity of such insurance contracts, the practice of insuring against employer-facilitated wrongs becomes lucrative: insurers receive premiums from businesses, but when harm is caused by the employer, the insurer only covers it partially.[108] In short, due to the uncertainty that surrounds the validity of such agreements, less is at stake for insurer—in terms of both revenues and losses. This reduces its incentives to engage in loss-preventing activities at a desirable level.[109] The vague validity laws thus result in the insurer externalizing part of the loss onto victims. In a separate project, I offered an economic model explaining those dynamics—whereby insurers underinvest in monitoring for knowing that third parties would bear part of the loss—and termed it "insurer moral hazard:"[110] basically, an inverse phenomenon is created, so that the insurer is partially insured by potential victims, and therefore, fails to exert optimal risk-reducing effort.[111]

This brings us to the related question of solvency. Even though EPL cases typically involve large-scale entities and major corporate actors,[112] they might occasionally introduce plaintiffs with a judgment-proof employer. Meyers and Hersch's review briefly addresses this point when highlighting that insurers have acquired a stronger bargaining position by dint of "[t]he combination of Weinstein's apparent bankruptcy and the insurers' threat of disputing coverage."[113]

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[106] *See generally id*.
[107] *See generally id*.
[108] *See generally id*. For an early review of courts' validity decisions see Sean W. Gallagher, *The Public Policy Exclusion and Insurance for Intentional Employment Discrimination*, 92 MICH. L. REV. 1256 (1994).
[109] Meyers & Hersch, *supra* note 94 at 974-77.
[110] *See* Roy Baharad, *Deterrence by Insurance*, 54 J. LEGAL STUD. 239 (2025).
[111] *Id*.
[112] *See* Meyers & Hersch, *supra* note 94 at 960-61.
[113] *Id*., at 977.

So, it is unclear whether the securance of injurer solvency enhances reliability in the context of EPL. On the one hand, in cases where insolvency is a viable concern, insurance does provide some assurance of compensation. On the other hand, since there is a nonnegligible likelihood that courts would invalidate coverage on account of the act in question being intentional, the insurer could exploit uncertainty and force plaintiffs into settlement for reduced damages.

In terms of reliability, the effect is ambiguous. It seems that insurance does reduce the frequency and intensity of wrongs to which the employer is oblivious, as EPL insurers manage to effectively regulate them and successfully implement loss-preventing techniques. Contrariwise, when it comes to employer-facilitated wrongs, insurance gives rise to failures in adequately treating complaints, which exacerbates harm. Moreover, while the solvency-guaranteeing effect of insurance cannot be denied, its contribution to the employer's reliability is expected to be limited for several reasons.

First, as stated above, the insurer might take advantage in those instances and make victims accede to rather unfavorable settlements, lest insurance coverage would be invalidated altogether by the court. Second, and also noted previously, considering the fact that EPL insurance is mostly acquired by large-scale businesses and corporations,[114] insolvency should not normally be a major concern compared to, say, cases of automobile or mortgage insurance.[115] Third, relating to the abovementioned point on the economic tenet of "perfect compensation," it seems that individuals' tendency to avoid harms ex ante instead of suffering them and recovering damages ex post is particularly apt in EPL cases. This tendency is most natural considering the disadvantages that

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[114] *Id*., at 960-61.

[115] *See, e.g.*, Gilles, *supra* note 50 at 615, 664 (naming both auto and mortgage insurance as an instrument for assuring solvency).

plaintiffs appear to face in lawsuits against employers in discrimination cases—the focal point of EPL. As Professors Sandra Sperino and Suja Thomas report:[116]

> "Judges have constructed a complex system of legal frameworks, doctrines, and evidentiary rules that allow them to dismiss [discrimination] claims before trial. Even when a case makes it to trial, and a jury finds that discrimination has occurred, trial court and appellate judges use these same legal frameworks to overturn the jury's verdict. In fact, discrimination cases are some of the most disfavored cases on the federal docket. Judges dismiss these claims at rates far higher than most other kinds of claims."

Another point that should be made regarding reliability concerns the relationship between insurance and convention. Although in certain industries—wherein buying insurance is extremely common—acquiring insurance could signal solidity via conformation to customary practice or conventional standards (see the next Section for an extensive discussion), this is not the case with EPL. Since there is no well-established, across-the-board employer propensity to buy an EPL insurance policy—about 40 percent of large-scale businesses and 7 percent among small ones do so[117]—the presence of insurance would not in itself indicate that the employer follows the behavior that is considered industrially reasonable.

The main conclusion as to employer-facilitated harm is that even the single contributor to reliability—the avoidance of a judgment-proof employer—is eclipsed by the perverse incentives

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[116] SANDRA F. SPERINO & SUJA A. THOMAS, UNEQUAL: HOW AMERICA'S COURTS UNDERMINE DISCRIMINATION LAW 4 (2017).

[117] Meyers & Hersch, *supra* note 94 at 961.

insured businesses as well as insurers themselves seem to have. In this respect, EPL insurance appears to impair reliability, meaning that potential job candidates are better off working for an uninsured employer. But things might change in the foreseeable future. Referring to the Betterley Report, a project providing annual overviews of the EPL insurance market, Meyers and Hersch assert that EPL insurers increasingly exit the entertainment market on account of the risk they introduce in discrimination suits induced by the #MeToo movement.[118] The market may thus converge into a new equilibrium in which the presence of insurance is a stamp of reliability, signaling job candidates that an insured workplace is safer, whereas uninsured ones pose increased risk of discrimination, which therefore prompted insurers' reluctance to provide coverage. Table 1.4, below, summarizes existing evidence.

Table 1.4. The Effect of Workplace Liability Insurance on Reliability

	Positive Effects		Negative Effects		Overall
	Governance	Solvency[119]	Moral Hazard	Excessive Care	
Employer-oblivious wrongs	✓	✓	✗	✗	✓
Employer-facilitated wrongs	✗	✗	✓	✗	✗

[118] *Id.*

[119] In case of employer-facilitated wrongs, however, solvency is not fully secured, because of the abovementioned threat of coverage-invalidation. *See supra* notes 103-111 and accompanying text.

D. *Professional Liability Insurance*

Begin with medical malpractice insurance. Scholars have been resonating with the argument that liability for medical malpractice enhances the quality of care provided by physicians,[120] but more important for the purposes of our discussion, retains the credibility that patients ascribe to doctors and enhances trust in modern medicine in general.[121] Some commentators do not seem to find insurance as antithetic to doctors' "right to be sued" for medical malpractice. According to Professors William Sage and Kristen Underhill, contemporary malpractice insurance is institutionalized—rather than individually-purchased—and serves as an effective regulator of riskiness.[122] As an anecdote that could perhaps qualify as a compelling testimony, the authors note that the Physician Insurers Association of America has recently rebranded itself, presently going by The Medical Professional Liability Association and "broadening its reach to include new types of risk bearing such as captive insurers, risk retention groups, and institutional self-funding."[123] Sage and Underhill likewise contend that the threat of premium increase in case of negligence serves as deterrent device, implying that insurance retains the objective of malpractice liability rather than undermines it.[124] This outlook highlights the governance role of insurance, and especially when coupled with the favorable trait of insurance as

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[120] *See, e.g.*, Alex Stein, *Toward a Theory of Medical Malpractice*, 97 IOWA L. REV. 1201, 1248-49 (2012) (noting that liability for medical malpractice is designed to optimize physicians' care). *But see* Michelle M. Mello et al., *Malpractice Liability and Health Care Quality: A Review*, 323 JAMA 352 (2020) (finding no causal connection between malpractice liability and the quality of care).

[121] *See* William M. Sage & Kristen Underhill, *Malpractice Liability and Quality of Care: Clear Answer, Remaining Questions*, 323 JAMA 315, 316 (2020)

[122] *Id.*, at 315 ("Individual physicians working as small businesspeople who purchase their own malpractice insurance is a fading model for good reason. That model fails the basic tests of financial sustainability, responsible governance, and health system science.").

[123] *Id.*

[124] *Id.*, at 316.

ensuring physician solvency in case of actual malpractice, it points to its reliability-enhancing role.[125]

Be that as it may, other strands of literature have identified moral hazard as a major concern in the context of medical malpractice liability insurance, because "doctors rarely have to pay of their pockets to settle malpractice claims."[126] Insurance coverage has thus been argued to prompt moral hazard—reduced prudence—among physicians.[127] Additional studies have highlighted the opposite problem of insurance-induced overcarefulness. Just as its brethren of excessive riskiness, overprudence might reveal itself as damaging to patients. In the physician population, excessive prudence manifests in a phenomenon famously termed "defensive medicine."[128] Defensive medicine comes in two forms: positive and negative.[129] Positive defensive medicine involves the supply of unproductive—and sometimes counterproductive—cost-unjustified and even harmful treatment.[130] Negative defensive medicine, by contrast, means avoiding the supply of potentially beneficial care that might result in tangible—and thus actionable—harm.[131] Both deprive patients of optimal treatment, which makes overcareful doctor an unfavorable option. Some who traced the

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[125] *See, e.g.*, Kathryn Zeiler et al., *Physicians' Insurance Limits and Malpractice Payments: Evidence from Texas Closed Claims, 1990-2003*, 36 J. LEGAL STUD. 9, 39 (2007) (attesting that "[m]any doctors have limited wealth, [...] or use asset protection strategies to insulate their wealth[.] One cannot squeeze blood from a stone....").

[126] *See* Baker & Swedloff, *supra* note 28 at 1434.

[127] *See, e.g.*, Michelle M. Mello & Troyen A. Brennan, *Deterrence of Medical Errors: Theory and Evidence for Malpractice Reform*, 80 TEX. L. REV. 1595, 1616 (2002) (noting that the existence of malpractice liability insurance "dampens incentives for taking safety precautions," and that due to insurance "the deterrent effect of malpractice litigation is greatly blunted."). *See also* Ronen Avraham & Max M. Schanzenbach, *The Impact of Tort Reform on Intensity of Treatment: Evidence from Heart Patients*, 39 J. HEALTH ECON. 273 (2015) (noting that imposing limitations on doctors' personal liability by capping damages has led them to choose riskier treatments).

[128] *Supra* note 54.

[129] *See* Daniel P. Kessler, *Evaluating the Medical Malpractice System and Options for Reform*, 25 J. ECON. PERSPS. 93, 95 (2011).

[130] *Id*.

[131] *Id*. *See also* Parchomovsky & Stein, *supra* note 54 at 545 (describing doctors' evidentiary considerations when choosing to engage in defensive medicine).

origins of physicians' overcarefulness and engagement in defensive medicine, have named the burden of increased insurance premiums if a harm ever occurs as a central reason.[132] This lends real-world support to the hypothesis that the regulatory role of insurance, while eliminating moral hazard, might equivalently undermine reliability by encouraging excessive carefulness among the insured.[133]

The analysis is not confined to physicians as individuals. In the last decade, some hospitals across the country have decided to deliberately avoid malpractice coverage.[134] The subsequent suspicion is that this is a strategic decision to self-impose insolvency, and there are good reasons to believe this narrative. First, insurance executives submit that in general, "the uninsured hospitals are in areas where juries award big judgments."[135] This obviously raises the expected loss that may be caused by malpractice, which in turns raises insurance premiums and enhances policy burdens, making it more lucrative for hospitals to deflate their solvency rates. Second, and relatedly, it has been reported that the choice of going uncovered—"naked" or "bare," in the common jargon[136]—is not completely voluntary. In New York City, for example, the decision to forego coverage might emanate from multiple malpractice insurers' exiting the market exactly on account of a rise in the number of claims.[137] This indicates insurers' perception of increased riskiness of medical

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[132] *See* David M. Studdert et al., *Defensive Medicine Among High-Risk Specialist Physicians in a Volatile Malpractice Environment*, 293 JAMA 2609, 2613 (2005).

[133] Of course, uninsured doctors might also engage in defensive medicine, but insurance clearly has the potential of exacerbating the problem by conditioning coverage upon carefulness or adjusting premiums to prudence. *See, e.g.*, James Gibson, *Doctrinal Feedback and (Un)Reasonable Care*, 94 VA. L. REV. 1641, 1668 (2008).

[134] Anemona Hartocollis, *Troubled New York Hospitals Forgo Coverage for Malpractice*, N.Y. TIMES (July 15, 2012), https://www.nytimes.com/2012/07/16/nyregion/some-hospitals-in-new-york-lack-a-malpractice-safety-net.html#:~:text=Hospitals%20in%20New%20York%20do,where%20hospitals%20go%20without%20coverage.

[135] *Id.*

[136] *Id.*

[137] *Id.*

malpractice and, simultaneously, reduces competition in the liability insurance market, raising the prices of policies and again rendering insurance less attractive to hospitals. Finally, it seems that as in the case of D&O insurance, uninsured hospitals—if indeed perceived as less reliable—might lose consumers to insured ones, but such market reaction is less likely considering the fact that, at least in New York City, disclosure of the absence of insurance is not required.[138] Commentators have come to conclude that hospitals devoid of coverage is "a sign of […] trouble."[139]

Others have nonetheless adopted the opposing vantage point. It has been argued that when hospitals are required to pay overwhelmingly high premiums—which are not affected merely by insurers' adjustments to the industry's riskiness, but also by exogenous constraints such as the competitiveness of the liability insurance market[140]—this would inevitably come at the expense of consumers, maintaining that the ultimate choice might be between "pay[ing] for nurses versus fund[ing] for malpractice."[141] This implies that the lack of insurance might benefit some patients after all. It is perhaps for this reason that the trend of avoiding coverage is also observable among hospitals that are capable of covering their liabilities—hospitals for which the strategy of designed insolvency does not apply.[142]

Thus, in the world of medical malpractice liability insurance, the evidence points to the entire panoply of reliability-enhancing and reliability-weakening factors, which ultimately obfuscates the overall effect on credibility. We might still have an intuitively strong preference

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[138] *Id*.
[139] *Id*.
[140] For uncompetitive insurance markets see, e.g., Ronen Avraham & David Gilo, *Insurance Collusion, Imperfect Competition and Regulation when Insurers Increase Risks* (Mar. 22, 2023) University of Texas Law School Research Paper. Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4042854
[141] Hartocollis, *supra* note 134.
[142] *Id*.

toward being treated by an insured, rather than an uninsured, physician or hospital. This sense presumably emanates from compliance with customary practice. As opposed to EPL insurance that is not widely prevalent,[143] medical malpractice liability insurance is omnipresent, regarded as "a standard safeguard across the country."[144] In this reality, any deviation from standard practice might signify idiosyncrasy at best and shadiness at worst, which would presumably deter risk averse parties—mainly patients—who are reluctant to roll the dice when it comes to their health.

Next, consider legal malpractice. Although evidence is less abundant than in the area of physicians,[145] lawyer insurance seems to portray the very same landscape, unfolding the entire array of reliability-increasing and reducing factors. To begin, at least in certain cases, insurance is definitely useful in ascertaining solvency. In this vein, some have noted that solo and small-firm lawyers are hardly ever sued after alleged malpractice.[146] Specifically, experienced lawyers who specialize in malpractice suits are often reluctant to take the case exactly because those practitioners are typically uninsured,[147] thus lacking the financial wherewithal required for paying damages. Insurance is likewise perceived as advantageous in terms of regulating attorneys' riskiness. Professors Tom Baker and Rick Swedloff's comprehensive overview of the industry indicates that legal malpractice insurers exhibit impressive competence in adjusting prices to risks, and employ various regulatory techniques to avert moral hazard among insured lawyers.[148] These

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[143] *See* Meyers & Hersch, *supra* note 94 at 961.

[144] Hartocollis, *supra* note 134.

[145] *See* Baker & Swedloff, *supra* note 28 at 1438 ("[T]here has been much less research on legal malpractice than on medical malpractice….").

[146] *See, e.g.*, Leslie C. Levine, *When Lawyers Screw Up*, 32 GEO. J. LEGAL ETHICS 109, 113 (2019) (reviewing HERBERT M. KRITZER & NEIL VIDMAR, WHEN LAWYERS SCREW UP: IMPROVING ACCESS TO JUSTICE FOR LEGAL MALPRACTICE VICTIMS (2018)) (noting that in such cases, malpractice lawyers would not take the case as they "know that even if a case is meritorious, they will not receive their contingent fee because there will be no money to pay the judgment.").

[147] *Id*. *See also* Baker & Swedloff, *supra* note 28 at 1439 ("Some insurers will not write insurance for small firms and solo practitioners.").

[148] Baker & Swedloff, *supra* note 28 at 1440-45.

efforts notwithstanding, others keep expressing concerns of lawyer moral hazard which would, of course, come at the expense of clients.[149] The problem of "defensive lawyering" has likewise been acknowledged, and contributors have particularly pointed to lawyers' need of frequently reporting to their insurer as a central cause of such practice.[150]

The results on reliability may ultimately pull in each direction. In legal malpractice insurance, too, abidance by custom in acquiring insurance might thus be the most effective tool in ultimately telling harmful from benign actors. Table 1.5 concludes this Section.

Table 1.5. The Effect of Professional Liability Insurance on Reliability

	Positive Effects		Negative Effects[151]		Overall
	Governance	Solvency	Moral Hazard	Excessive Care	
Medical malpractice	✓	✓	✓	✓	?
Legal malpractice	✓	✓	✓	✓	?

[149] *See, e.g.*, George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 321-22 (describing lawyers' moral hazard due to legal malpractice insurance).

[150] *See, e.g.*, Gary A. Grasso, *Defensive Lawyering: How to Keep Your Clients from Suing You*, 75 ABA J. 98, 98 (1989) (explaining how insurance carriers contribute to lawyers' decision to engage in "defensive lawyering").

[151] Although the negative effects are mutually contradictory, evidence indicates both of them in different contexts.

E. *Products Liability Insurance*

The "right to be sued" is foundational to products liability. In his seminal *The Market for Lemons* treatise, economist George Akerlof depicted a market interaction between manufacturers and sellers.[152] Under his model, manufacturers produce either high-quality products ("peaches") or deficient ones ("lemons"), whereas consumers are unable to distinguish one from another when making the purchase.[153] Akerlof importantly noted that the absence of liability for product deficiency would disadvantage not only consumers, but also high-quality producers.[154] With no ability to tell the actual quality of products in the marketplace, consumers would be willing to pay for any given product a price representing the average quality—the expected value of the product at hand.[155] This implies underpricing of high-quality products and overpricing of low-quality ones. Consequently, high-quality producers are induced to exit the market and deficient-good manufacturers are motivated to enter (a manifestation of adverse selection), resulting in consumers facing exclusively low-quality products.[156] According to Akerlof, the problem is solved due to liability for product deficiency, which countervails the adverse selection problem: holding manufacturers accountable to the product's quality would generate the obverse outcome where deficient goods are slowly pushed off the market, high-quality products are adequately priced and consumers may readily tell the difference between the two.[157] More generally stated, Akerlof's framework captures the essence of liability as the "right to be sued:" liability is tantamount to the actor's commitment to suffer costs if she is ever proven to be a harmful.

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[152] *See generally* Akerlof, *supra* note 5. 489-92.

[153] *Id*., at 489.

[154] *Id*., at 489-92. For the sake of accuracy, Akerlof's main focus is warranty, framed as "guarantee." *Id*., at 499. Warranty is tantamount to liability in our discussion.

[155] *Id*., at 489-92.

[156] *Id*.

[157] *Id*., at 499.

Literature on the economics of products liability has identified that insurance might distort the market structure generated by the "right to be sued" that products liability bestows upon manufacturers.[158] The ability to signal quality—which is conferred upon manufacturers by virtue of liability that indicates commitment to self-incurrence of deficiency costs—is eradicated: under coverage, it is the insurer—rather than the manufacturer—who ultimately bears those costs. The resulting moral hazard of manufacturers, which has been extensively documented in the theoretical literature,[159] thus seems to diminish reliability.

Against this backdrop, however, subsequent works point to the contrary, demonstrating that the monitoring ability of insurance trumps the moral hazard problem. Chief among them is Professors Omri Ben-Shahar's and Kyle Logue's comprehensive account, which stresses that insurance not only retains the role of tort liability in assuring optimal deterrence, but may also outperform the ex-ante safety regulation provided by government agencies.[160] Specifically, they submit:[161]

> "Products liability insurance is underwritten on a company-specific basis rather than a group basis. Products liability insurers have much at stake in the actuarial experience of each of their insured manufacturers, and so they collect detailed information about how the product is designed, inspected, and manufactured, what types of quality controls and manufacturing standards the insureds have in place, whether parts used in the production process contain

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[158] *See generally* Mark Geistfeld, *Manufacturer Moral Hazard and the Tort-Contract Issue in Products Liability*, 15 INT'L REV. L. & ECON. 241 (1995)

[159] *See generally id*.

[160] *See generally* Ben-Shahar & Logue, *supra* note 20.

[161] *Id*., at 218-19.

> dangerous inputs, whether those parts are warranted by suppliers, and much more. [...] These information inputs are then used by the insurers not only in pricing products liability policies, but also in training manufacturers on how to reduce their liability exposure. Insurers inquire as to whether the manufacturer is in compliance with international and domestic standards of design and production, and advise them regarding how to protect against malicious tampering, how best to label products to minimize the risk of accidents, and even when and how to issue recalls."

Ben-Shahar and Logue identify that the involvement of products liability insurance eliminates moral hazard.[162] Based on this analysis, the concern that it compromises reliability is not only exaggerated; it is utterly false. This, before even integrating solvency considerations. According to Ben-Shahar and Logue, the tort liability system as a standalone is just ill-equipped to handle the entire population of actors involved in the product chain.[163] Because many of the potential injurers are oftentimes judgment-proof—small manufacturers, retailers and importers—the tort system would fail to optimally deter them from harmful conduct.[164] Likewise, some of them—e.g., foreign firms—may not be identified with ease, and many of them are just too small to care about the reputational damage that an injured consumer may cause them.[165] Liability insurance is the answer. Table 1.6 summarizes.

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[162] *See id*.
[163] *Id*., at 244.
[164] *Id*.
[165] *Id*.

Table 1.6. The Effect of Products Liability Insurance on Reliability

Positive Effects		Negative Effects		Overall
Governance	Solvency	Moral Hazard[166]	Excessive Care	
✓	✓	✗	✗	✓

F. *"Externality" Liability Insurance*

Thus far, the analysis has concentrated on cases that involve business counterparties who engage in a (direct or indirect) contractual relationship with the insured. But in many instances, liability insurance is not purchased against harms that injurers may inflict on counterparties as part of a business relationship—such as investment, negotiations, employment or the consumption of goods and services—but rather, for a loss they may cause to society at large. Two cases in point are failure to pay taxes and the emission of pollutants. The reason that tax liabilities and environmental harms are normally subject to public, regulatory scrutiny rather than private enforcement via the tort system is that typically, there are no victims who suffer sufficient individual harm that would justify their initiation of a suit.[167] Tax avoidance, for example, causes meager harm to each citizen individually, but constitutes potentially major collective loss to society as a whole.[168] Similarly, pollution of the public domain surely upsets each subject

[166] Concerns exists in theory but has been largely invalidated when studied in practice.

[167] *See, e.g.*, A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LIT. 45, 45-46 (2000) (introducing this argument as a justification for public law enforcement).

[168] *See* A. Mitchel Polinsky & Steven Shavell, *The Theory of Public Enforcement of Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 403, 405 (A. Mitchel Polinsky & Steven Shavell, eds., 2007) (naming

personally, but presumably not enough for her to be willing to pursue costly litigation against the polluter.[169] In those externality cases, the counterparty that injurers ordinarily confront is the regulator, which raises the question of whether government agencies should scrutinize insured injurers more or less intensely, depending again on the overall effect that insurance has on reliability.

Begin with tax liability insurance. The concept might sound perplexing but is surprisingly common among taxpayers.[170] Uncertainty is a widely recognized hallmark of the tax system.[171] The fact that tax reality is rife with ambiguity generally hinders economic efficiency, as nebulousness poses major barriers against business transactions and commercial initiatives, even to the extent of thwarting them altogether.[172] Alas, in terms of policy measures, there is not much to do about tax law obscurity: formulating a comprehensive code that preempts all contingency in advance is an impossible mission, and the Internal Revenue Service (IRS) is generally reluctant to issue case-specific advance rulings that would shed clarity on the tax position taken in the transaction at hand.[173]

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tax enforcement as a conventional form of public enforcement, and then justifying such enforcement using this argument).

[169] *Id.* (same for environmental enforcement).

[170] *See, e.g.*, Heather M. Field, *Tax Lawyers as Tax Insurance*, 60 WM. & MARY L. REV. 2111, 2129 (2019) (noting that even though tax liability insurance has been historically uncommon, the industry has substantially developed in recent years and is expected to keep growing).

[171] *See, e.g.*, Scott Baker & Alex Raskolnikov, *Harmful, Harmless, and Beneficial Uncertainty in Law*, 46 J. LEGAL STUD. 281 (2017) ("[B]y refusing to clarify the law, the IRS imposes a cost even on risk-neutral taxpayers...."); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PENN. L. REV. 1017, 1021 (2009) (underscoring tax law's "uniquely problematic types and degrees of uncertainty."); Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX. REV. 339, 343 (2005) ("[S]ophisticated taxpayers who are considering engaging in some sort of business transaction [often] face substantial uncertainty as to how the tax laws will be applied to their particular transaction.").

[172] Logue, *supra* note 171. *See also* Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 139 (2009) ("Uncertain tax consequences deter some taxpayers from carrying out contemplated transactions, while others, who do carry out the transactions, bear the risk of potential loss.").

[173] *See, e.g.*, Ben-Shahar & Logue, *supra* note 20 at 227.

Against this backdrop, the institution of tax insurance has emerged.[174] Tax insurance covers taxpayers against uncertain tax consequences, essentially protecting them from additional tax liabilities that may emerge as a result of a given transaction.[175] Overall, the modestly volumed literature on tax insurance offers a hesitantly favorable perspective on such coverage. Regular concerns of moral hazard among taxpayers are relaxed by tax insurers' substantial regulatory effort to ameliorate it, consistently inspecting and monitoring insured taxpayers.[176] Specifically, insurers negotiate the amount of coverage for each transaction individually,[177] consult with top tax experts regarding the risk involved in the relevant transaction,[178] and typically include considerable deductibles to deter taxpayer undercompliance.[179] "Effectively," Ben-Shahar and Logue conclude, "the insurers become private tax law enforcers."[180] Thus, and even though the judgment-proof problem hardly plays a major role here—taxpayers, by definition, have sufficient resources to pay their tax duties—tax insurance is socially advantageous for serving as a seemingly more effective private substitute to centralized regulation.

But even if private insurers manage to avert moral hazard—i.e., combat undercompliance with tax law—this does not imply that they necessarily incentivize taxpayers' *optimal* compliance. Not unlike the case of defensive medicine, there are good reasons to suspect that if private insurers indeed wish to minimize the loss associated with tax liability, they may channel certain taxpayers—especially those already predisposed to risk aversion—toward excessive prudence that

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[174] *See* Logue, *supra* note 171 at 395.
[175] *Id*.
[176] *Id*., at 412 ("Insurance companies are especially adept at combating adverse selection and moral hazard.").
[177] *Id*., at 387.
[178] *Id*., at 390.
[179] *Id*., at 388.
[180] Ben-Shahar & Logue, *supra* note 20 at 227.

manifests in overcompliance with tax law.[181] Overcompliance is a well-established problem in the law and economics of tax.[182] Individuals and businesses who are substantially deterred by the prospect of excess tax liability would in the best case take insufficiently aggressive tax positions; in the worst case, they would simply refrain from privately- and socially-beneficial economic activities.[183] Although the issue has yet to be examined with satisfactory empirical rigor, existing anecdotal evidence lends support to the conceptual problem of insurance-induced overcompliance. Professor Joshua Blank, for example, reports that insured taxpayers tend to engage in superfluous disclosure to the IRS, even in transactions that do not involve controversial or even somehow risky tax plannings.[184]

Things are different with environmental liability insurance. Another type of "externality" coverage, environmental liability insurance pertains to legal ramifications of various environmental harms caused by industry participants.[185] Chief among them is the cost of cleanup and restoration, which commentators have framed as sometimes insurmountable.[186] This brings us to the first and foremost value of insurance in the context of environmental liability, which is the assurance of solvency.[187] Absent any ability to bear the costs of harm-elimination, regulators

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[181] *See* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966 (1984) (establishing the problem of overcompliance with uncertain legal standards).

[182] *See, e.g.*, Jean-Louis Arcand & Grégoire Rota Graziosi, *Tax Compliance and Rank Dependent Expected Utility*, 30 GENEVA RISK & INS. REV. 57, 57-59 (2005) (describing the problem of tax overcompliance); Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX REV. 241, 295 (2007) (arguing that risk averse taxpayers "would have a tendency to over-comply....").

[183] *See, e.g.*, Givati, *supra* note 172.

[184] Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1649-50 (2009).

[185] Ben-Shahar & Logue, *supra* note 20 at 225.

[186] *Id*.

[187] *See generally id* (describing the judgment-proof problem in the context of environmental liability, pointing out that "firms are often insufficiently capitalized to pay for [...] environmental costs....").

would confront the familiar judgment-proof firm problem discussed above. Insurance provides an easy way out of this scenario. Moreover, there seems to be a broad consensus regarding the ability of insurers to minimize moral hazard by insured firms.[188] Environmental liability insurers are argued to occupy a regulatory role against environmental risks, outperforming tort or criminal liability which might fail to do so efficiently. For instance, because some environmental harms remain latent for a long time before uncovered, ex-post liability might fail to achieve optimal deterrence: the procedural factfinding process is encumbered, and penalties are at best procrastinated and at worst never even imposed.[189] Wrongdoers would oftentimes prefer to trade off the present benefit from polluting for an obscure, uncertain sanction they may suffer in the future.[190] The moral hazard arguments that theorists have unfolded against the institution of environmental liability insurance at its inception,[191] at present pales against the overwhelming evidence on its ability to eliminate excessive riskiness. Finally, and as opposed to tax insurance, there is neither explicit nor implicit evidence of inducing excessive compliance.

In the environmental liability realm, then, the reliability-enhancing effects of insurance apparently dominate, and the effect is unclear in the context of tax. The question of pertinence in terms of reliability in "externality" insurance concerns the proper regulatory response to the existence of insurance. For example, should insurance be banned? Mandated? Allowed subject to compulsory disclosure? Those policy considerations are discussed at length in the next Part, but

[188] *Id*. (arguing that environmental liability insurance is a "striking example[] of how insurance minimizes rather than exacerbates moral hazard problems…."). *But see* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 955-56 (1988) (warning against legal fluctuations toward uncertain environmental law that may undermine the regulatory function of insurance).

[189] Ben-Shahar & Logue, *supra* note 20 at 225.

[190] *See, e.g.*, Tomoya Tajika, *Concealment as Responsibility Shifting in Overlapping Generations Organizations*, 38 J. L. ECON. & ORG. 511, 512-14 (2021) (describing organizational incentives to procrastinate any corrective action against potentially tortious failures).

[191] *See, e.g.*, Abraham, *supra* note 188 at 945-49.

may be succinctly mentioned here as well. It will be argued that any policy measure taken with respect to insurance might in itself modify the reliability effects of insurance. For instance, if taxpayers were to be required to disclose their insurance coverage to the IRS, then the IRS might react by changing its auditing effort accordingly. If tax insurance facilitates moral hazard, the IRS might increase the rate of audits directed against insured taxpayers, but in such a case, insurers would respond by increasing their loss-preventing regulatory measures, possibly inducing overcompliance. If, on the other hand, the IRS finds private insurers as adequate regulators of tax risks, it might prefer to concentrate enforcement effort against uninsured taxpayers. But this reduces the risk of enforcement against insured taxpayers, which might decline insurers' extant incentive to effectively regulate policyholders, reintroducing the problem of moral hazard among them.

In summary, crafting the right policy response to insurance depends on various factors, including how risk aversion is spread among market participants and their desire for insurance coverage. However, the primary consideration is whether insurance strengthens or weakens the reliability of insured parties in the view of regulatory entities, namely, whether it leads to excessive or insufficient compliance. This distinction aids at predicting the outcome of requiring insurance or forcing disclosure. Table 1.7 concludes with respect to tax and environmental liability insurance.[192]

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[192] It bears emphasis that there are other types of liability insurance involving "externalities," for example automobile and police misconduct insurance. Those cases are unique in that insured parties may fail to account for the reaction of counterparties, as the nature of the interaction is compulsory and not mutually consensual. In M&A negotiations, for example, contracting parties' decision to insure largely depends on the prospective reaction of their counterparties, that is, on how they perceive reliability in the presence of insurance. Similarly, in the case of tax avoidance or environmental harm, individual victims normally lack sufficient incentives to react, but the regulator takes in instead. In the context of automobile or police misconduct, however, victims' response to insurance—the enhanced or reduced reliability they associate with policyholders—is just irrelevant in the eyes of potential injurers. Since counterparties do not

Table 1.7. The Effect of "Externality" Liability Insurance on Reliability

	Positive Effects		Negative Effects[193]		Overall
	Governance	Solvency	Moral Hazard	Excessive Care	
Tax Liability	✓	✗	✗	✓	?
Environmental Liability	✓	✓	✗	✗	✓

G. *Defamation Liability Insurance*

The final insurance industry discussed here is the one of defamation coverage. Defamation liability insurance is rather understudied in academic literature, but has recently garnered the attention of popular press due to its involvement in high-profile legal disputes. For example, after the Virginia court awarded actor Johnny Depp with $8.3 million in damages following a defamation suit against his ex-wife, actress Amber Heard, the latter one filed a suit against her insurance company, contending that her liability insurance policy covers defamation.[194] This sure

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directly interact with the insured, nor are they being replaced by a relevant regulatory authority that caters to the interests of the entire victim population, the role of reliability signaling is nullified. For the distinction see generally Baharad, *supra* note 110.

[193] Although the negative effects are mutually contradictory, evidence indicates both of them in different contexts.

[194] Erin Mindoro Ezra, Jamie L. Rice & Tyler J. Angelini, *How Insurance Plays into the Johnny Depp v. Amber Heard Defamation Trial*, REUTERS (Feb. 10, 2023), https://www.reuters.com/legal/legalindustry/how-insurance-plays-into-johnny-depp-v-amber-heard-defamation-trial-2023-02-10/.

sounds like a rare exception, but the phenomenon is not as uncommon as one might surmise. Bill Cosby, for example, has enjoyed AIG's coverage of his gargantuan legal expanses when sued for defaming women who accused him of sexual assault.[195] Bill Clinton was similarly covered when sued for defamation by Paula Corbin Jones, who accused him of sexual harassment and then suffered a slanderous denial by Clinton who framed her as a liar.[196] Former baseball pitcher Roger Clemens likewise aided defamation insurance when confronted a defamation lawsuit by a former trainer.[197]

Defamation insurance is puzzling when considering the general rule that excludes coverage for deliberate actions, but courts routinely recognized the validity of such policies for negligent defamatory statements, i.e., ones made without complete knowledge of falsity.[198] Moreover, individuals are not sophisticated enough to actively seek coverage for defamation—not even Bill Clinton, who was reportedly surprised to find out that his policy covers defamation liability.[199] In those and many other cases, defamation liability insurance is part of an umbrella insurance policy for homeowners, designated to protect wealthy individuals—who can afford to pay enhanced premiums—from lawsuits in general.[200] So, for the most part, defamation liability insurance is acquired incidentally, oftentimes unbeknownst to the policyholder, and is invoked under limited circumstances.

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[195] *See* Graham Bowley & Sydney Ember, *To Defray Legal Costs in Defamation Suits, Bill Cosby Turns to His Insurance*, N.Y. TIMES (Mar. 13, 2016), https://www.nytimes.com/2016/03/14/arts/television/to-defray-his-legal-costs-in-defamation-suits-cosby-turns-to-his-insurance.html.

[196] *Id.*

[197] *Id.*

[198] *See, e.g.*, Baumann v. Elliot, 286 Wis.2d 667 (2005); Grange Ins. V. Lintott, 77 F. Supp. 3d 926 (2015); Hearst Corp. v. Hughes, 297 Md. 112 (1983); Moss v. Stockard, 580 A.2d 1011 (1990); Rozanski v. Fitch, 113 A.D.2d 1010 (1985).

[199] *See* Bowley & Ember, *supra* note 195.

[200] *Id.*

But things get more intriguing when accounting for the fact that media outlets—whose entire business operation is predicated on the credibility of the information they communicate to the public—are covered as well, in part of their professional error and omission insurance policy.[201] In her coverage of the Clinton saga, then-Fox host Greta Van Susteren was wondering "[h]ow is it that someone has insurance to cover a defamation claim? […] I mean, where do you buy that, or how do you get that?"[202] Fair questions. Van Susteren, then, would surely be surprised to hear that defamation insurance is no stranger to Fox News itself. Most recently, Fox has settled a defamation lawsuit brought against it by Dominion Voting Systems, upon accusations of rigging the 2020 presidential election.[203] Per sources, at least a substantial part of the unprecedented amount—$787.5 million—had been paid by insurers.[204] And to be sure, Fox by no means deviates from industry standards here. In a famous defamation case brought by Disney against ABC network following publications that casted doubt on food safety, AIG paid part of the settlement on behalf of ABC.[205] Likewise, despite the competition between the two, CNN's report of Fox's

[201] *See* Mae Anderson, *Fox Probably Won't Pay Anything Near $787.5 Million for its Settlement with Dominion Voting Systems*, FORTUNE (Apr. 24, 2023), https://fortune.com/2023/04/24/fox-7875-million-settlement-dominion-voting-systems-insurance-tax-deductions/ (noting that defamation liability insurance is part of media liability insurance); Medial Liability Coverage, IRMI https://www.irmi.com/term/insurance-definitions/media-liability-coverage (explaining that media liability insurance is part of error and omission insurance).

[202] Bowley & Ember, *supra* note 195.

[203] *See, e.g.*, Erin Mulvaney, Joe Flint & Isabella Simonetti, *Fox to Pay $787.5 Million to Settle Dominion's Defamation Lawsuit*, WALL ST. J. (Apr. 19, 2023), https://www.wsj.com/articles/fox-news-dominion-defamation-trial-set-to-begin-d5c7293a.

[204] *See* Anderson, *supra* note 201; Erin Snodgrass, Claire Atkinson & Jacob Shamsian, *Fox News Is Unlikely to Feel the Pinch from its Record $787.5 Million Payout to Dominon*, BUS. INSIDER (Apr. 18, 2023), https://www.businessinsider.com/fox-news-payout-big-for-company-but-insurance-may-help-2023-4.

[205] Anderson, *supra* note 201,

settlement was honest enough to admit that "media companies typically have insurance that would cover defamation payouts."[206]

Many commentators have criticized Fox in the aftermath of the paramount Dominion settlement.[207] A noteworthy reaction is the one made by comedian and late show host Stephen Colbert, who joked that "[o]f course Fox has to have liability insurance, to ensure their ability to lie."[208] Set aside Colbert's witty, humoristic tone and note that his response does point to an important conundrum: why would Fox and other media outlets seek coverage? Shouldn't a given news network be perceived by audiences as more reliable, at least in principle, when it commits to self-incur the cost of false publication?

From a theoretical standpoint, contributors would presumably agree that the answer is affirmative. For example, in a recent study, Professors Daniel Hemel and Ariel Porat conceptualize defamation liability as a legal mechanism that advantages truthful speakers.[209] To plainly illustrate this point, Hemel and Porat depict the counterfactual: in a world without defamation liability, actors are devoid of any feasible way of reliability stating accusations against others—they are bereft of the ability to substantiate credible commitment.[210] In game-theoretic parlance, their statement is nothing but "cheap talk."[211] Indeed, without defamation liability, it costs nothing for

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[206] Allison Morrow, *Fox Faces an 'Existential Threat' from its Multibillion-Dollar Defamation Cases*, CNN (Feb. 28, 2023), https://www.cnn.com/2023/02/28/media/fox-news-dominion-damages/index.html

[207] *See, e.g.*, Steven Lee Myers, Tiffany Hsu & Stuart A. Thompson, *Fox Settlement Is a Victory for Dominion. But the Misinformation War Continues.*, N.Y. TIMES (Apr. 20, 2023), https://www.nytimes.com/2023/04/20/business/media/fox-dominion-misinformation.html

[208] The Late Show with Stephen Colbert, *An Apology from Fox News*, https://www.youtube.com/watch?v=duKkHLm2QO0 at 0:39-0:45.

[209] *See generally* Porat & Hemel, *supra* note 9. For formal economic analysis see generally Yonathan Arbel & Murat C. Mungan, *Defamation with Bayesian Audiences*, 52 J. LEGAL STUD. 445 (2023).

[210] *Id.*, at 69.

[211] *Id.*

Alice to assert that Bob is corrupt. But when individuals are categorically liable for false statements, this cheap talk turns into a "signal," that is, a message accompanied with cost to the speaker if proven false, which is therefore more credible.[212] With insurance, however, such a cost is not incurred by the speaker, implying that the credible commitment problem should resurface on account of prospective moral hazard—in the Dominion case, by Fox.

But then again, it could be argued that insurance provides an additional layer of regulatory oversight, ensuring that factual statements have been well-verified by media outlets before publication. So much so, that the scant evidence that exists with respect to defamation insurance actually points to the mirror-image problem: insurers subject journalists to an excessive level of verification effort, and following major libel cases, publications have reportedly "had to scramble for [publishers to receive insurance] coverage."[213] While we might intuitively think of the acquisition of defamation insurance as trading off reliability for the reduction of economic losses, reality confronts us with an inverse concept: with insurance as a supplementary regulator, media outlets essentially impose more substantial constraints upon publication in order to guarantee coverage. This excessive kind of "insurance as governance" might well be socially undesirable: while bolstering the reliability of statements that *are* published, it also eliminates statements that are highly likely to be true, implying excessive prudence and underprovision of relevant

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[212] *Id.*, at 68. *See also* Yonathan A. Arbel & Michael D. Gilbert, *Truth Bounties: A Market Solution to Fake News*, 102 N.C. L. REV. 509, 545 (2024) ("Knowing that lies get punished increases trust in information.").

[213] Michael Massing, *Libel Insurance: Scrambling for Coverage*, 24 COL. JOURNALISM REV. 35, 35 (1986).

information to the public. In so doing, insurance might reinforce and even exacerbate the chilling effect that scholars have historically associated with defamation liability.[214]

Defamation insurance is a fascinating topic that has yet to receive its well-deserved academic attention. Sporadic treatments have raised contradictory concerns of moral hazard—overprovision of insufficiently verified information—as well as for excessive care due to insurer monitoring, which results in avoiding publication of sufficiently verified statements.[215] Besides, it should be noted that the solvency-assurance virtue of insurance should play no role in the context of defamation. We typically discuss the grave concern of a judgment-proof injurer when the relevant counterparty *is also the victim* of a potentially risky behavior. With defamatory publication, however, the credibility-demanding counterparty is the audience, not the subject of publication that seeks compensation and thus largely cares about solvency. All is encompassed by Table 1.8, below.

Table 1.8. The Effect of Defamation Liability Insurance on Reliability

Positive Effects		Negative Effects		Overall
Governance	Solvency	Moral Hazard	Excessive Care	
✓	✗	✓	✓	?

[214] For some prominent accounts see, e.g., David A. Anderson, *Libel and Press Self-Censorship*, 53 TEX. L. REV. 422 (1975); Frederick Schauer, *Fear, Risk and the First Amendment: Unraveling the Chilling Effect*, 58 B.U. L. REV. 685 (1978).

[215] Massing, *supra* note 213.

This concludes the descriptive part of the analysis of insurance and reliability. In the ensuing Part, I accord by offering a normative discussion on the appropriate policy responses to this relationship.

III. OPTIMAL POLICY RESPONSES

Part II uncovered a fragmented world of insurance that carries divergent effects on reliability, based on the peculiarities of the relevant industry. Nevertheless, the present Part takes the challenging task of offering general policy recommendations that would enable counterparties to extract the full informational value of insurance or lack thereof.

The two main regulatory mechanisms in insurance law are considered here – compulsory (or ban on) insurance, and mandatory disclosure of insurance or its absence. The goal is twofold: minimizing the perverse effects of the existence of disadvantageous insurance and the lack of socially desirable one, both scenarios seen in various contexts in the preceding Part. Undesirably *purchased* insurance allows the insured to externalize the risk of her actions onto counterparties. Undesirably *avoided* insurance allows the insured to engage in a strategic self-imposition of insolvency in order to deter victims from claiming their losses. The key to understanding the optimal choice of regulatory means is by dividing interactions based on the relevant market conditions. As I demonstrate in Section III.A, regulatory interventions are required only when counterparties lack the ability to "punish" an insured (resp. uninsured) party for purchasing (avoiding) socially undesirable (desirable) insurance, namely, only when the reliability discount that counterparties ascribe does not feed back into the injurer's set of considerations. In Sections III.B and III.C, I consider market failures that may warrant regulatory interventions. Section III.D caveats the general insights.

A. *Perfectly Functioning Markets*

Perfectly functioning markets invariably extract the full informational value of insurance. When markets operate perfectly—no competition constraints, no information asymmetries regarding the presence of insurance or its ability to discipline insureds, and no risk of insolvency—we should have no particular interest in regulating insurance-inhabiting interactions, as market mechanisms would do well in handling the reliability problem. The reason is that in such transactional interactions, counterparties' anticipated deterrence by the existence of insurance would inevitably impact the insured's initial decision on either purchasing it or suffering the consequences of reduced reliability. She would ultimately decide based on the value she ascribes to insurance—indeed, her risk attitude.

The capital market is a good example. Griffith, for instance, attests that in the likely scenario where the problem of credible commitment resurfaces, corporations might decide to abandon R&W insurance in its entirety, putting an end to this institution.[216] In other cases, such as D&O insurance, the negative relationship between the magnitude of coverage and stock prices illustrates exactly this—companies must choose between losing credibility that ultimately harms them economically or withdrawing insurance and subject their officials to higher risks.[217] The whole idea basically captures the time-honored Coase theorem, meaning that in contractual settings involving no transaction costs or major informational gaps, the burden of eliminating risks will be incurred by the lowest-cost avoider, which manifests by the price system.[218]

[216] Griffith, *supra* note 77 at 1920.
[217] *Supra* notes 61-76 and accompanying text.
[218] *See generally* Coase, *supra* note 10.

In short, then, market actors oftentimes choose to purchase insurance because they are willing to concede the loss of reliability for the sake of averting the risk of liability. As long as counterparties are aware of that decision and can accordingly reduce the credibility that they associate with the insured, the market converges into an equilibrium featuring this exact reliability discount. When the market is competitive as assumed, it is virtually impossible that insurance would weaken reliability to an untenable level. Consider again the capital market. If a sufficiently sizable share of investors would be deterred by the presence of D&O insurance, for example, corporations would again confront the choice of competing over them by reducing coverage or suffering the loss by means of a drop in their stock price. These dynamics would recur until the market reaches a steady equilibrium that reflects the positive value of insurance to corporations and its negative value to investors.

In terms of policy reactions, mandatory disclosure is useless in this regard, as we now spotlight markets that feature no information asymmetry regarding the existence of insurance. Similarly, mandatory insurance would be harmful, impeding the ability to retain credible commitment by *avoiding* insurance. This disadvantages market actors by depriving them of voluntarily opting for a "right to be sued," for instance in the case of foregoing R&W insurance or signaling lower riskiness by narrowing D&O coverage. Similarly, in cases where insurance serves as a stamp of responsibility and careful conduct, counterparties would punish any actor that allows itself to go "bare" and immediately switch to competitors, leaving it with a choice between purchasing insurance or running out of business. Either mandating "good" insurance policies or banning "bad" ones is unnecessary so long as the market adequately punishes the purchasing of socially undesirable insurance or the avoidance of socially desirable coverage.

B. *Imperfectly Competitive Markets*

When markets are imperfectly competitive—namely, when the potential insured belongs to a small group of sellers, product manufacturers or service providers—the bargaining standpoint is uneven at the outset. This implies that counterparties' ability to punish the acquisition of an undesirable, risk-enhancing insurance policy or the avoidance of a desirable, risk-mitigating one is limited. Consider EPL insurance. If the insured is the only employer in a given area, job candidates confront no viable alternatives. In those instances, even if EPL impairs the reliability of the relevant workplace by introducing increased risks,[219] job candidates as the relevant counterparties would be the ones to suffer this risk enhancement. When the market fails to function perfectly and confers an elevated bargaining power upon the insured, this would allow her to engage in excessively risky behavior and transfer this risk onto the insurer and counterparties.

Defamation is another case-in-point. It is possible that audiences should and would have rewarded media outlets that go "bare" and subject themselves to defamation liability for any false publication. But considering the market concentration of mainstream media outlets and the fact that acquiring defamation insurance has become a common practice among them,[220] there is little incentive to deviate from the standard practice of getting insurance and call out the problems coupled with defamation coverage, be it for motivating false publications by affording moral hazard or for discouraging even true publications by channeling media outlets toward excessive care.

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[219] *Supra* notes 98-111 and accompanying text.

[220] *See* Morrow, *supra* note 206. For competition between media outlets see generally Matthew Gentzkow & Jesse M. Shapiro, *Competition and Truth in the Market for News*, 22 J. ECON. PERSPS. 133 (2008).

Now, whether the purchasing of socially undesirable insurance in imperfectly competitive markets warrants regulatory intervention depends on two questions: the reaction of insurers and the amount of risk that society is ultimately willing to endure. First ask how insurers would respond to such market structures. For instance, if EPL insureds are prone to moral hazard, and the fact that they are insulated from competition implies reduced job-candidate ability to counterbalance this moral hazard by preferring safer workplaces instead, this implies increased likelihood of loss. Consequently, insurers have a stronger incentive to increase their monitoring and other loss-preventing measures in commensuration.

Nevertheless, it is entirely possible that the stronger incentives of insurers are still insufficient. What is more, in some cases—like medicine or, indeed, defamation—those incentives might already be excessive, resulting in overprudence. So, to allow for the level of risk-taking that *society* considers optimal, regulation might be required. Begin with acquiring "bad" insurance, namely, coverage that would have undermined the insured's reliability had the market in question functioned perfectly. The most radical form of regulation here would be to ban socially undesirable insurance when the market is imperfectly competitive, on par with the understanding that the market cannot adequately correct itself by punishing injurers who acquire it, nor can it reward those who avoid it. But one should be hesitant when considering such a step, mainly for the reasons that I detail in Section III.D. A more moderate solution would be to raise the stakes for insurers and increase their incentives to take measures that would eliminate moral hazard. This can be done by long overdue civil litigation reforms that have been discussed in the past—ones that would alleviate structural burdens that the civil system imposes on victims—including simplified causes of actions, reduced-form liability standards, expedite litigation processes, and enhanced remedies.[221] All proposals have been introduced before, but an important implication they failed to address is their positive effect on the incentives of insurers to further their regulatory role.

The problem is that raising the stakes would only aid against moral hazard, but is rather counterproductive in cases where insurance incentivizes excessive care. So, a more general solution—which at once addresses the opposite problems of insufficient prudence (moral hazard) and excessive care—would involve the imposition of regulatory limitations on insurance contracts, primarily by mandating minimum deductibles, known as "coinsurance."[222] Maintaining deductibles above the rate set by the market would admittedly lower the stake of insurers in any prospective harm. Accordingly, it would attenuate their incentives to monitor the insured's behavior. But there are two major upsides that may well offset this apparent drawback. First, it would likewise reduce the possible adverse implications of "insurance as governance," the ones leading to excessive prudence,[223] chilling effects on socially beneficial publications,[224] defensive medicine and lawyering,[225] tax overcompliance,[226] and more. Second, the decline of incentives to monitor would be counterbalanced by an increase in the insured's private incentive to exercise care, for internalizing a larger part of the expected loss that her risky activity creates. For this reason, Meyers and Hersch support the adoption of such legislative intervention in EPL insurance contracts, as present policies regularly feature zero risk sharing by the insured.[227] At core, mandating a minimum deductible rate is tantamount to setting a *partial ban* on insurance—

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[221] *See generally* Gideon Parchomovsky & Alex Stein, *Empowering Individual Plaintiffs*, 102 CORNELL L. REV. 1319 (2017) (proposing comprehensive solutions to remove the obstacles that the civil system erects against victims seeking compensation).

[222] *See, e.g.*, Baker & Swedloff, *supra* note 28 at 1420 (naming coinsurance as a mechanism that forces insureds to "keep[] their skin in the game.").

[223] *See generally* Part II.

[224] *Supra* Section II.G.

[225] *Supra* Section II.D.

[226] *Supra* notes II.F. and accompanying text.

[227] Meyers & Hersch, *supra* note 94 at 979.

requiring that insurance would not fully cover the injurer, for knowing that this might create perverse effects in uncompetitive market settings.

Next, what about the equivalent problem that uncompetitive markets may surely feature—the one of *not* acquiring socially desirable insurance? Some have pointed out this problem in the context of legal insurance,[228] as well as medical insurance, particularly the New York hospitals which opted out of insurance in an allegedly strategic attempt to self-impose insolvency.[229] It has been argued that this step was taken primarily by hospitals that are located in poor areas, where the choice between healthcare institutions is rather limited.[230] In those cases, the intuitive solution is mandatory insurance, which many states adopt in the context of medical and legal insurance.[231] Another example is Amazon's requirement of all major sellers on its platforms—those earning more than $10,000 a month in sales—to purchase products liability coverage.[232]

Mandatory insurance is, of course, only justified once we have clearly established that the existence of insurance—for instance medical and legal insurance—indeed works in the best interests of patients and clients. Another noteworthy reservation is that mandatory insurance might harm consumers when the market for insurance is insufficiently competitive.[233] One must not overlook the argument—be it justified or not in the case of the New York hospitals—that highlights the effect of insurance on the quality of services. When insurance markets are uncompetitive, premium prices would not reflect the actual risk posed by an activity, but one

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[228] *Supra* notes 145-148 and accompanying text.

[229] Hartocollis, *supra* note 134.

[230] *Id*.

[231] *See, e.g.* Leslie C. Levin, *Lawyers Going Bare and Clients Going Blind*, 68 FLA. L. REV. 1281 (2016) (arguing that mandated disclosure requirements generally fail to reach desirable outcomes and calling for compulsory legal malpractice insurance).

[232] Jason Metz, *How to Get Product Liability Insurance*, FORBES (Feb. 14, 2024), https://www.forbes.com/advisor/business-insurance/product-liability-insurance/.

[233] *See, e.g.*, Avraham & Gilo, *supra* note 140.

exceeding the real value of the risk premium—which provides insurance companies with increased profit margins.[234] The enhanced premium prices would force injurers to overpay for coverage, which may ultimately harm counterparties, i.e., potential patients. Consider the case of New York hospitals that outcried the inflated premium pricing which, as they contend, comes at the expense of "pay[ing] for nurses" and the provision of other related services.[235] Although insurance markets are normally regarded as competitive,[236] irregular settings where the contrary is true should also be accounted for. Before mandating insurance in those cases, policymakers would be well-advised to consider the tradeoff between assuring solvency and all other benefits that society reaps from the presence of insurance, and the reduced quality of goods and services that such step might generate. The latter outcomes may likewise be averted by devising well-functioning public liability insurance options.

C. *Uninformed Markets*

The final set of circumstances in which insureds are inadequately punished or rewarded by market forces involve, of course, cases where counterparties are oblivious to the existence of insurance or its absence. This could emanate from counterparties' naivety or unsophisticatedness, from the cost or effort entailed in acquiring such information, or from the potential injurer's deliberate obscurity. Job candidates, for instance, might be insufficiently aware of the institution of EPL insurance and its potential to increase risk, and therefore fail to ask about it or otherwise make an adverse inference against an insured employer. Most consumers are probably ignorant as

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[234] *See, e.g.*, Peter Siegelman, *Information and Equilibrium in Insurance Markets with Big Data*, 21 CON. INS. L.J. 317, 332 n. 42 (2014) (explaining that uncompetitive insurance markets are characterized with premiums priced above the actuarily fair level).

[235] Hartocollis, *supra* note 134.

[236] *See, e.g.*, Abraham, *supra* note 28 at 673 ("In many settings the insurance market is highly competitive, and in any event certainly does not resemble the classic natural monopoly that characterizes public utilities.").

to whether the seller of the product they have just purchased is insured against products liability, and regrettably, so as many patients receiving health treatments.[237] And, sure enough, Fox News were utterly reluctant to reveal insurance policies that apply to the Dominion case.[238]

When lack of information is the only thing precluding counterparties from discounting reliability against those who acquire socially undesirable insurance or who fail to purchase advantageous policies, it is tempting to call for the adoption of a mandatory disclosure regime that would eliminate this obstacle. To justify this step, however, what should be answered is why doesn't *voluntary* disclosure work in those markets. At least on the surface, it seems that owners of socially desirable—and, therefore, reliability-enhancing—policies have strong incentive to disclose this fact, and so do injurers who avoid socially undesirable—reliability-reducing—coverage. Those disclosures, the argument goes, would create the requisite separating equilibrium and allow counterparties to avoid interactions with, for example, uninsured hospitals, uninsured lawyers, or EPL-insured employers—those who cannot engage in such disclosure—or at least reduce the credibility that they ascribe them.

The voluntary disclosure analysis might sound compelling, but is critically predicated on the dubious assumption that counterparties actually draw adverse inference from the *lack* of disclosure. Literature on behavioral law and economics have long debunked this premise as unrealistic.[239] It seems that in the absence of insurance-related disclosure, many counterparties—

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[237] Hartocollis, *supra* note 134.

[238] Morrow, *supra* note 206 ("[D]etails of Fox's coverage aren't known."); Snodgrass, Atkinson & Shamsian, *supra* note 204 (reporting that Fox News "declined to answer [...] questions on their libel insurance.").

[239] A recent study on disclosure regime, for example, has compared mandatory warnings for low-quality products and a caveat emptor regime, under the assumption that the latter incentivizes sellers of high-quality products to engage in voluntary disclosure. The authors note that "[i]n a warning regime, an absence of warning tells buyers that the product is high quality" whereas "[u]nder a caveat emptor regime, an absence of high-quality disclosures reveals the product to be low quality." *See* Oren Bar-Gill & Omri

those who are not especially legally oriented or commercially sophisticated—would not draw an adverse inference, but may simply fail to pay attention to the aspect of insurance despite its possible pertinence to the relevant transaction. For this reason, some states require lawyers to notify clients if they do *not* have malpractice insurance coverage.[240] This is structured on the understanding that clients do not possess enough knowledge or awareness to positively ask,[241] *a fortiori* to draw an adverse inference from the fact that insured lawyers have an incentive to disclose that fact voluntarily. Thus, mandatory disclosure on avoidance of reliability-enhancing insurance—e.g., requiring relevant New York hospitals to disclose their decision to go "bare" to any patient—as well as on purchasing of reliability-reducing one (EPL insurance, for example), seems warranted in this regard.

Another challenge that may be introduced against mandating disclosure would probably suggest that such a regime is doomed to failure. Rigorously delving into the world of mandated disclosure, Ben-Shahar and Professor Carl Schneider find that since the law is rife with disclosure requirements, individuals confront an informational affluence that might ultimately result in them missing the forest for the trees, and consequently, "mandated disclosure […] chronically fails to accomplish its purpose."[242] Why would mandatory disclosure about insurance or its absence be any different?

Ben-Shahar, *Misprioritized Information: A Theory of Manipulation*, 52 J. LEGAL STUD. 305, 311 (2023). Importantly, however, the authors acknowledge that consumers' limited capacity to process information and draw rational inference from the *absence* of warnings or disclosure, undermines this conclusion. *Id*., at 307.

[240] *See* Levin, *supra* note 231 at 1297.

[241] For a taxonomy of the law's mandated disclosure regimes given that counterparties fail to require relevant information see Adam M. Samaha & Lior Jacob Strahilevitz, *Don't Ask, Must Tell—And Other Combinations*, 103 CAL. L. REV. 919, 941 (2015)

[242] Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PENN. L. REV. 647, 651 (2011).

Actually, there are good reasons to believe that it would. First, in terms of designing the mandate, the disclosure requirement must not leave any room for discloser discretion,[243] and should clarify the exact meaning of insurance or its absence. Specifically, when requiring a hospital to disclose the absence of insurance, patients ought to be clearly explained with the possible adversary consequences of the hospital's decision to go "bare," especially those concerning the higher risk of insolvency in case of medical malpractice. When requiring an employer to disclose its EPL coverage, the negative effects—mainly that the employer does not bear full economic responsibility for mishandling employee complaints—should be soundly underscored. The required disclosure format must likewise guarantee that the presence or absence of insurance is brought to the counterparty's attention, to avert strategic bypasses by the mandate's subjects.[244]

This might not suffice though. As Ben-Shahar and Schneider contend, even the meticulously formulated *Miranda* warning fails to ascertain that individuals taken into custody are actually informed regarding their rights.[245] But in the context of insurance, the fundamental question is whether we really need each and every counterparty to properly understand the subject of disclosure in order for such a mandate to prove itself effective. Surprisingly, the answer could be negative. In a recent study, Professors Yonathan Arbel and Roy Shapira argue that sellers' and injurers' compliance with market norms is ordinarily enforced by a small subset of consumers and counterparties—those who care enough about providing public goods in the form of filing

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[243] *Id.*, at 692-95 (naming disclosers' taking advantage of the vague nature of mandates as one reason for the failure of compulsory disclosure).

[244] *See, e.g.*, Levin, *supra* note 231 at 1299-1302 (noting how lawyers readily overcome a disclosure requirement for the absence of insurance by, for example, simply posting it on an official website).

[245] Ben-Shahar & Schneider, *supra* note 242 at 678.

complaints, posting online reviews, reading consumer contracts—who they call "nudniks."[246] Nudniks are a blessing to regulators, especially in the context of mandatory disclosure.[247] If the objective is to keep counterparties informed of the potential consequences of insurance and allow them to punish certain purchasers or avoiders, then all it takes—according to Arbel and Shapira's full-fledged analysis—is to make sure that activist counterparties are sufficiently cognizant of the potential effects of insurance.[248] The core problem here is that at present, the insurance-reliability relationship is understudied in academic circles and underattended in popular debates. It would be sufficient if mandatory disclosure of insurance or lack thereof would permeate transactional reality and simply make individuals notice. This change alone can put the insurance-reliability relationship to the epicenter of legal discourse.

Indeed, discourse is the key here. Exactly because the insurance-reliability interaction is a rather underdeveloped topic, mandatory disclosure serves as a launching pad for bringing the ubiquity of liability insurance to the public's attention. Consider defamation insurance. We cannot have a serious empirical discussion about its actual effects on reliability when the public—and even journalists—are utterly unaware of its existence.[249] Requiring Fox to reveal the actual involvement of insurance in the Dominion saga, and demanding media outlets to disclose their defamation insurance policies more broadly, would finally subject this institution—which might play a key role in designing and spreading information in society—to public scrutiny. Concurrently, it would invoke a first-in-kind public and academic discussion concerning the effect of defamation insurance on the trustworthiness of insured media outlets.

[246] *See generally* Yonathan A. Arbel & Roy Shapira, *Theory of the Nudnik: The Future of Consumer Activism and What We Can Do to Stop It*, 73 VAND. L. REV. 929 (2020)

[247] *Id*., at 951.

[248] *See generally id*.

[249] Bowley & Ember, *supra* note 195.

D. *Caveat*

When devising a policy measure, such as compulsory insurance or mandated disclosure, one must account for the market's entire reaction to this step and anticipate the *general equilibrium* toward which the relevant market converges.[250] While our objective is to extract the informational value of insurance—enhancing or undermining reliability—it is possible that this informational value would change *due to the chosen policy*. To see this concretely, consider the example of tax insurance. The main drawback that Logue associates with tax insurance is the following:[251]

> "The concern is that such insurance will not be sold to cover positions about which there is legitimate legal uncertainty, but for positions that are more likely than not to be rejected by the [IRS] and the courts if examined. For those positions, tax insurance would be, in effect, audit or detection insurance; that would be bad."

To alleviate this justified fear, Logue proposes mandated disclosure. Specifically, Logue suggests to "compel taxpayers who purchase tax risk insurance from a private insurer to disclose that fact on their return."[252] This, in turn, would allow the IRS to decide whether to pay extra attention to insured taxpayers and perhaps adopt a new policy regarding audits directed against policyholders.[253] But this argument fails to account for the dynamics of the threefold of IRS, taxpayer, and insurer. If, as Logue suggests, tax insurers manage to effectively regulate taxpayer behavior and eliminate aggressive tax positions taken by policyholders, then the IRS has no reason

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250 *See* Parchomovsky & Siegelman, *supra* note 19 at 124 (underscoring the need for a general equilibrium understanding of insurance-inhabiting markets).

251 Logue, *supra* note 171 at 413.

252 *Id*.

253 *Id*., at 400-01.

to enhance the frequency of audits directed against insured parties, as the insurer does quite well in monitoring undercompliance. The resulting *reduced* likelihood of audited insureds might then, however, undermine insurers' extant incentives to regulate as intensely as before, thus reintroducing the problems of moral hazard and "detection insurance." On the other hand, if the IRS would increase the scrutiny of insureds, then insurers would likely react by engaging in more intense effort to enhance insureds' prudence, compelling policyholders to take even less aggressive tax positions and, potentially, exacerbating the problem of overcompliance. Logue does note that mandated disclosure to the IRS would inhibit the development of the tax insurance market, but states that "if there is strong demand for tax law uncertainty insurance—not just for detection-risk insurance—the market should survive and grow."[254] Yet such growth might, in the end of the day, reveal itself as socially harmful for only deepening insurers' desire to eliminate losses and, consequently, retain overcompliance among risk averse insureds.[255]

In conclusion, the appropriate policy reaction to the presence of tax insurance hinges on various factors, including the distribution of risk aversion tendencies among taxpayers and their demand for insurance. But first and foremost, it depends on whether insurance bolsters or erodes the reliability of insured taxpayers in the eyes of the IRS, namely, whether it induces over- or undercompliance. This would allow us to predict the consequences of mandatory insurance. At this point, however, there is no straightforward answer.

Moreover, those perverse outcomes might emerge even when we know which effect—the one that empowers or diminishes reliability—generally prevails. Consider the environmental liability realm, where the reliability-enhancing effects of insurance apparently dominate.[256] We

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[254] *Id.*, at 414.
[255] *Supra* Section II.F.
[256] *Supra* notes 185-191 and accompanying text.

might think of appropriate policy responses, for example mandatory insurance or, at the very least, disclosure requirements. But again, policy shift in light of reliability might ultimately channel the market toward a new equilibrium. To see why, suppose that, with the understanding that environmental liability insurers vigorously monitor the behavior of insureds and induce optimal conduct, all jurisdictions were to mandate such coverage. This might result in regulators' declining their supervision—basically exhibiting "regulatory moral hazard"[257]—which might eliminate insurers' incentive to monitor as intensely as they do at present, thus shifting toward reduced credibility. The same is true for mandatory disclosure of insurance, rather than compulsory coverage. As in the field of tax liability, the reliability effect of insurance might result in regulators concentrating enforcement effort against uninsured party, which again disincentivizes insurers to regulate optimally, as the a priori probability of loss declines.

To conclude, one must beware of the unintended consequences that mandating insurance or insurance-related disclosure might have on market equilibrium and the informational value of insurance. To implement a responsible policy, we must first be able to unequivocally determine the social desirability of a given type of liability insurance, in that its effect on reliability is clear-cut (which is not the case in many settings discussed above). Similarly, social planners ought to foresee the reaction of all relevant market actors and make sure that markets do not converge into an unanticipated equilibrium that might at once be less efficient and equitable than the one that preceded it. Both tasks are rather challenging.

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[257] The public choice approach generally advances the argument that regulators' aspiration is to exert less effort and subject industry participants to lax environmental standards, due to the involvement of various interest groups. For a formulation of the argument see Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553, 559-60 (2001).

CONCLUSION

The Article presented the first comprehensive analysis of how insurance impacts individuals' trustworthiness, filling a significant gap in scholarly discussions that addressed this relationship in a fragmented and incomplete manner. It highlighted the complexity, ambiguity, and multifaceted nature of the interface between insurance and reliability. The Article laid out the theoretical foundations for understanding how insurance reshapes trust-based market interactions, revealing the contradicting forces it may carry on reliability.

Upon establishing this analytical framework, it examined various types of liability insurance, distinguishing those that impair reliability from those that strengthen it. This divergence stems from varying market characteristics, where some relationships are predominantly influenced by the credibility-eroding features of insurance, whereas others are governed more powerfully by its reliability-enhancing powers. Drawing on this conceptual blueprint, the Article introduced the entire panoply of normative considerations that should be taken into account when tailoring appropriate policy responses to the intersection of insurance and reliability.

Insurance Settlements and the Perpetuation of Legal Risks

ABSTRACT

When a legal action is brought against a policyholder, the insurer is the one that regularly controls litigation strategies—chief among them is the decision on whether to litigate or to settle. The problem is that insurance companies might prefer litigating instead of settling when the latter option benefits mostly the policyholder. This conflict of interest has led legislators to impose a duty to settle, which generally forces insurers to accept any commercially reasonable settlement proposal, even if the one who mainly enjoys this settlement is the insured. The anti-settlement tendencies attributed to insurance companies have come to dominate legal and economic thought, resting at the basis of rich academic literature and voluminous case law.

Going against the conventional wisdom that insurers wish to litigate and avoid socially desirable settlements, the present Article identifies a hitherto overlooked phenomenon that introduces a mirror-image problem: insurance companies' propensity to settle and avoid socially desirable litigation. The Article demonstrates that in contrast to the accepted lore, certain settlement agreements actually cater to a broader, long-term interest of insurers. To see why, it is important to bear in mind that demand for insurance is first and foremost predicated on the presence of risk. This means that if insurance companies wish to maintain the attractiveness of their products, a nonnegligible amount of risk in society must be constantly preserved. It is for this reason, for example, that insurance companies have been persistently lobbying to block risk-reducing technologies from entering certain markets, or actively combating the adoption of antismoking regulations. As is well-known by now, the insurance industry routinely employs various means and methods in order to keep our daily life sufficiently risky.

Equipped with this understanding, the Article contends that settling lawsuits is a central risk-preserving tactic deployed by insurers. Contemporary legal commands, especially those governing insurance-related environments, are rarely structured on bright-line rules that provide clarity. For the most part, they consist of nebulous, open-ended standards that transfer the task of elucidating the law to courts, whose rulings provide clearer guidelines to individuals that would confront similar circumstances in the future. Yet settlements preclude courts from fulfilling this designation and consolidating a coherent, informative jurisprudence that infuses predictability into the legal system. From insurers' perspective, then, settlement is perhaps the most useful mechanism for maintaining legal risks that increase the value of insurance policies: settlements avert court judgments and deprive society of their informative value; thus, ambiguity prevails, legal risks are sustained, and demand for insurance is alive and well.

Upon mapping the macro-incentives of insurance companies to preserve risks and explaining how they translate into micro-incentives to settle and withhold courts from reducing the vagueness that envelops legal doctrines, the Article turns to ground the theory in practice by analyzing concrete case studies in which settlements serve insurers to prevent rulings that could alleviate uncertainty, abolish the legal risk it involves, and in turn reduce demand for insurance. It concludes that the duty to settle in insurance law—that has been originally espoused due to the traditional fear of insurers' desire to avoid settlements to the detriment of insured defendants—may carry unintended adverse consequences for inducing settlements that distort insurance markets and disadvantage future policyholders. Finally, the Article places its insights within the broader scholarly discourse on the social costs and benefits of insurance, and discusses possible solutions to the problem of strategic insurance settlements.

INTRODUCTION

Liability insurance covers policyholders against losses that their risky activity has inflicted on third parties.[1] Insurance is involved in any ordinary tort liability case:[2] from a doctor that negligently harms a patient,[3] to a driver that recklessly causes an accident;[4] from a factory that emits pollutants into the neighboring property,[5] to a manufacturer whose product turns out to be deficient.[6] In those and many other settings, victims seeking compensation would file a suit and invariably confront an insurance company, rather than an individual tortfeasor. Hence, if the latter is found liable, it is the insurance company that pays (at least some of) the damages that the court awards the victim. And since the insurer is responsible for payment if the court finds for the plaintiff, the insurer is normally the one that also controls litigation strategies—chief among them is the decision on whether to litigate or to settle.[7]

As has long been identified, the fact that insurance companies are the ones deciding to litigate or to settle creates a structural conflict of interest between insurers and policyholders.

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[1] RESTATEMENT OF L. OF LIAB. INS. § 1(7) (AM. L. INST. 2019) (defining liability insurance as "insurance that exclusively or primarily covers risks related to the liability of an insured to third parties….").

[2] *See* Kenneth S. Abraham & Catherine M. Sharkey, *The Glaring Gap in Tort Theory*, 133 YALE L.J. 2165, 2169 (2024) ("[L]iability insurance plays a substantial role in the life cycle of tort claims... pay[ing] as much as eighty to eighty-five percent of all tort damages.").

[3] *See, e.g.*, Daniel P. Kessler, *Evaluating the Medical Malpractice System and Options for Reform*, 25 J. ECON. PERSPS. 93, 94 (2011) ("Most physicians carry malpractice insurance that covers the defense costs of claims as well as any award that is paid....").

[4] States normally adopt a compulsory regime of automobile liability insurance. For a survey see Alma Cohen & Rajeev Dehejia, *The Effect of Automobile Insurance and Accident Liability Laws on Traffic Fatalities*, 47 J. L. & ECON. 357 (2004).

[5] *See, e.g.*, Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 225 (2012) (noting that environmental liability insurance is prevalent and, in some cases, mandatory).

[6] *See, e.g.*, A. Mitchel Polinsky & Steven Shavell, *The Uneasy Case for Product Liability* 123 HARV. L. REV. 1437, 1462-63 (2010) (demonstrating the centrality of insurance in compensating users of deficient products).

[7] *See, e.g.*, TOM BAKER, KYLE D. LOGUE & CHAIM SAIMAN, INSURANCE LAW AND POLICY: CASES AND MATERIALS 578-79 (5th ed. 2021).

Specifically, commentators highlight insurance companies' incentive to litigate and avoid socially desirable settlements, since the one who benefits from settlements is mainly the insured.[8] The reason is straightforward, originating first and foremost from the fact that almost all insurance policies include a cap on the amount of coverage.[9] This means that if the court awards a victim damages that exceed the coverage limit, the insured injurer is the one responsible for paying the excess. If the cap on coverage is x dollars, and the court entitles the plaintiff to $x + y$ in damages, it is the policyholder who pays the extra y. Settlement incentives might not align because in making the decision on whether to litigate or to settle, the insurer disregards the benefit that a settlement would confer upon the insured. In this example, the insurance company only accounts for a potential payment of x in case of losing at trial, and consequently, has no interest to settle for any amount equal to or higher than x—settling for such an amount would only benefit the policyholder, who has to pay by herself every dollar beyond the x dollars of coverage limit. In short: since settlement mostly saves the off-coverage cost incurred by the insured and only a fraction (if any) of the amount that insurance covers in case of a proplaintiff verdict, the insurer basically has nothing to lose from rolling the dice at trial.[10] Because losing at trial increases primarily the off-coverage damages amount that the policyholder pays, insureds would strongly prefer to settle whereas insurers—per conventional wisdom—are more reluctant to do so.

This well-known conflict of interest has led courts and legislators in most U.S. jurisdictions to establish a "duty to settle" in insurance law.[11] The duty to settle forces insurers to make reasonable settlement decisions, requiring them to accept any commercially sensible settlement

[8] *See infra* Section I.A.
[9] *See infra* notes 22-24 and accompanying text.
[10] Aside from litigation costs. *See infra* note 24.
[11] *See infra* Section I.B.

proposal. At its core, this duty mandates insurers to ignore coverage limits and, in deciding whether to litigate or to settle, act as if they are the ones responsible for the entire amount that the court awards the plaintiff in a final judgment.[12] The duty to settle is enforced by vesting upon policyholders the right to initiate a legal action against their insurer for breaching its legal obligation to make a reasonable settlement decision.[13] The anti-settlement tendencies attributed to insurance companies have come to dominate legal and economic thought, resting at the basis of rich academic literature and voluminous case law.[14]

Against conventional wisdom which states that insurers wish to litigate and avoid socially desirable settlements, the present Article identifies a hitherto overlooked phenomenon that introduces a mirror-image problem: insurance companies' propensity to settle and avoid socially desirable litigation. Specifically, the Article sets out to demonstrate that in contrast to the accepted lore, certain settlement agreements actually cater to a broader, long-run interest of insurers. The argument is predicated on two main strands. The first is that insurance companies are motivated to make sure that a certain amount of risk would keep enveloping commercial and even regular, day-to-day activities. Demand for insurance is first and foremost predicated on the presence of risk, which means that if insurance companies wish to maintain demand for their products, a nonnegligible amount of risk in society must be constantly preserved. It is for this reason, for example, that insurance companies have been persistently lobbying to block risk-reducing technologies from entering certain markets, or actively combating the adoption of antismoking regulations.[15]

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[12] *See infra* notes 28-43 and accompanying text.
[13] *Id*.
[14] *See infra* Section I.A.
[15] *See infra* notes 67-86 and accompanying text.

The second strand on which this Article builds is that the legal framework governing business, commercial, economic, as well as simple daily activities, is typically rife with uncertainty. Contemporary legal commands, especially the ones governing insurance-related environments, are rarely structured on bright-line rules that provide clarity. For the most part, they consist of vague, open-ended standards that shift the responsibility of interpreting and specifying the law onto courts, whose rulings then provide clearer guidelines and concrete directions for individuals who may face similar situations in the future. For this reason, settlements might be socially detrimental, precluding courts from fulfilling this designation and consolidating a coherent, informative jurisprudence that infuses predictability into the legal system.[16]

This brings us to the gist of the argument. Settling lawsuits, this Article contends, is a central risk-preserving tactic deployed by insurance companies. From insurers' perspective, settlement is perhaps the most useful mechanism for maintaining legal risks which increase the attractiveness of insurance policies: settlements avert court judgments and deprive society of its informative value; thus, ambiguity prevails, legal risks are sustained, and demand for insurance is alive and well. Upon mapping the macro-incentives of insurance companies to preserve risks and explaining how they translate into micro-incentives to settle and keep courts from reducing the vagueness that envelops legal doctrines in general and liability standards in particular, the Article turns to ground the theory in practice by analyzing concrete case studies in which settlements serve insurers to prevent rulings that could alleviate uncertainty, abolish the legal risk it involves, and in turn reduce demand for insurance. It concludes that the duty to settle in insurance law—which has been originally espoused due to the traditional fear of insurers' desire to avoid settlements to the detriment of insured defendants—may carry unintended adverse consequences for inducing

[16] *See infra* notes 116-124 and accompanying text.

settlements that distort insurance markets and disadvantage future policyholders. Finally, the Article places its insights within the broader scholarly discourse on the social costs and benefits of insurance, and discusses possible solutions to the problem of strategic insurance settlements.

Structurally, this Article unfolds in five main parts. Part I introduces the standard analysis of insurance settlements. It focuses on the insurer-insured incentive misalignment that has been identified in the literature, and the resulting regulatory response that adopted the duty to settle. Part II puts forth the Article's argument which, against the anti-settlement approach attributed to insurers, uncovers insurance companies' hitherto overlooked settlement incentives. To this end, it first shows that the insurance industry routinely employs various means and methods for keeping our daily life sufficiently risky. Thereafter, it demonstrates that since insurance-related activities are governed mainly by open-ended standards, rather than well-defined rules, insurers may preserve legal risks by avoiding interpretive court jurisprudence, namely, by aspiring to reach a settlement that would thwart a guiding judgment. Part III accords with case studies that illustrate the argument and support it with real-world examples. Part IV offers a normative discussion, proposing to reexamine the duty to settle given the new understanding that insurance settlements could benefit insurers at the expense of future policyholders and society at large. It likewise integrates the Article's finding into the general academic debate on the role insurance should play in various legal areas. Part V establishes the argument formally. Concluding remarks then follow.

I. THE STANDARD ANALYSIS OF INSURANCE SETTLEMENTS

A. *Conflict of Interest and Insurers' Incentive to Litigate*

To get a good grasp of the disparity between insurers and insureds' settlement incentives, it is first necessary to say a few words on the classic economic approach to pretrial settlement.

Very broadly stated, canonic literature in litigation theory dictates that parties to a legal dispute would settle so long as their assessments of the suit's merits are identical or close enough.[17] In those cases, such a settlement is mutually beneficial—in that it saves litigation costs for both parties—and the settlement amount would be equivalent to the suit's expected value (or to an amount averaging both parties' diverging assessments of this value, provided that this divergence is small enough).[18] Suppose, for example, that the plaintiff files a suit against the defendant. With probability 0.5, the court finds for the plaintiff and awards her $2 million in damages, but with the same probability, the court would find the defendant not liable. This means that the suit's expected value is $1 million. If both the plaintiff's and the defendant's assessment are equivalent, they would choose to settle and agree on a $1 million payout so long as litigating is even slightly costly.[19] This is perhaps the most basic idea in the economics of litigation and settlement,[20] and the main takeaway is that when a settlement benefits both parties—meaning that it entitles the plaintiff to her suit's (agreed-upon) expected value without burdening both parties with the cost of litigating—it will invariably be reached.

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[17] *See, e.g.*, J.J. Prescott & Kathryn E. Spier, *A Comprehensive Theory of Civil Settlement*, 91 N.Y.U. L. REV. 59, 60-61 (2016) ("If the two parties to a litigation largely agree about the likely outcome of a trial [...] full settlement is extremely likely....").

[18] *Id*., at 61.

[19] Latent assumptions here are of risk neutrality and equal bargaining power. Without those postulates, a settlement agreement may still be reached but the settlement would rest somewhere within a "bargaining zone" surrounding the suit's expected value. *See, e.g.*, Russell Korobkin, *Aspirations and Settlement*, 88 CORNELL L. REV. 1, 5-6 (2002).

[20] *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 401 (6th ed. 2016) (noting that the proposition that when parties will settle for the suit's expected value when they have similar expectations about a trial outcome "is fundamental to the analysis and design of legal procedures."). Indeed, this understanding rests at the foundation of many important contribution to the economics of civil procedure. *See generally* William L. Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); Steven Shavell, *Suit, Settlement and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982).

But this optimistic prediction might not hold if liability insurance is part of the picture. When the defendant holds a liability insurance policy, we must account for two additional features that complicate the baseline settlement framework portrayed by economists. First, it is a third party (the insurer), rather than the defendant (the insured), who decides whether to litigate or to settle with the plaintiff;[21] second, because insurance contracts almost always limit the amount of coverage, the defendant would be required to participate and pay by herself any dollar amount above the policy limit.[22] This setting, which characterizes any typical lawsuit filed against an insured defendant,[23] may actually thwart advantageous settlements that would have been reached in the absence of insurance. Consider the same story wherein the plaintiff prevails and receives $2 million in damages with probability 0.5. Assume for starters that the coverage limit is $800,000. This means that the insurer's expected loss from litigating the case is $400,000—paying $800,000 with probability 0.5, and with the same probability paying nothing. The insured's expected loss is higher and amounts to $600,000—paying $1.2 million with probability 0.5, and again, with the same probability paying nothing. Suppose that the plaintiff proposes a settlement agreement that manifests the suit's total expected outcome: $1 million. As noted previously, this settlement is socially desirable as it reflects the suit's expected outcome while saving litigation costs—the resources required to actualize this outcome.[24]

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[21] *See* BAKER, LOGUE & SAIMAN, *supra* note 7.

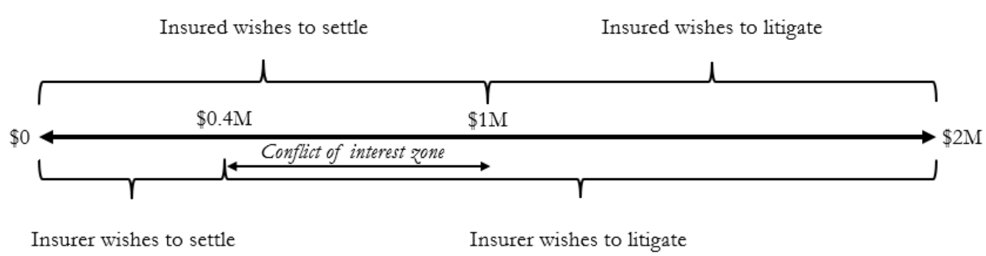
[22] *Id*. *See also* Peter Siegelman, *A Primer on the Economics of Conflicts of Interest*, 30 CONN. INS. L.J. 58, 60 (2023) (attesting that liability insurance policies "almost always contain limits on coverage" and that "the insurer usually has control over most aspects of the litigation strategy, including the decision about whether to settle a claim....").

[23] Siegelman, *supra* note 22 at 60.

[24] Suppose that in this story neither party bears litigation costs, hence the only social cost emanating from litigation is the administrative operation of the legal system (judicial time, court resources, etc.). This unrealistic assumption is adopted just to plainly illustrate the conflict of interest without encumbering the analysis. It does not qualitatively change the results, nor the logic underneath the argument. A general model that accounts for parties' litigation costs is provided in Part V.

Be that as it may, the insurer has no real incentive to assent to such a settlement: since the policy limit is $800,000 and the settlement amount is $1 million, the insurer gains nothing from settling—it pays exactly what it would be required to pay if the plaintiff prevails. Same goes for an offer to settle on $800,000—a prodefendant agreement that specifies an amount below the suit's expected value, which entails no policyholder participation—and even for a settlement on, say, $600,000, which would save the insurer $200,000 if the defendant is found liable. As a matter of fact, the insurer is better off rejecting any settlement offer whose stipulated payout exceeds $400,000—the expected loss it incurs from litigation. It bears emphasis that an uninsured defendant (or, alternatively, any insurer whose coverage is unlimited) would have immediately accepted any settlement amount between $400,000 and $1 million. But due to the presence of insurance which invariably involves caps on coverage, the insurer would reject it since such a settlement would benefit mostly (or exclusively, if the amount is between $800,000 and $1 million) the policyholder. This is precisely the failure that emanates from the conflict of interest between insured and insurer. Figure 2.1 provides a sketched illustration.

Figure 2.1. Misaligned Settlement Incentives: An Illustration



B. Crisci *and the Duty to Settle*

To be sure, this concern is by no means a mere theoretical exercise. Case law routinely features akin circumstances.[25] As Kent Syvernud's full-fledged account suggests, "[f]or 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."[26] But since the rich historical origins of the duty to settle are beside the point,[27] let us turn immediately to the oft-cited *Crisci v. Security Insurance, Co.*,[28] which is often regarded as the imprimatur of courts' regulation of insurance settlements.[29] Facts are as follows. Mrs. Crisci was the owner of an apartment building with a wooden outside staircase.[30] Her tenant, Mrs. DiMare, fell through a breaking step.[31] Suffering subsequent physical and mental injuries, Mrs. DiMare filed a suit against Mrs. Crisci, asking for $400,000 in damages.[32] Mrs. Crisci owned a liability insurance policy covering such situations, with an upper limit of $10,000.[33] In studying the claim and assessing its expected loss, the insurance company has come to conclude that the jury will award much less than $10,000 in damages for the physical harm suffered by Mrs. DiMare.[34] Her mental harm, on the other hand, was severe enough to justify a much higher amount in damages, but it was not clear whether the

[25] *See, e.g.*, Siegelman, *supra* note 22 at 59 (noting that the conflict of interest between insurers and insureds in the context of settlement decisions have been discussed in hundreds of state and federal cases as well as in hundreds of law review article, also noting that "[t]his complex and important topic has been the subject of voluminous litigation and has attracted considerable attention from sophisticated legal scholars and policymakers.").

[26] Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1116 (1990)

[27] The article that has originally identified the problem and studied it comprehensively is Robert Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954).

[28] 66 Cal.2d 425 (1967).

[29] Though prior cases have addressed this issue. *See, e.g.*, Communale v. Traders and General Ins. Co. 50 Cal. 2d 654 (1958); Venturi v. Zurich General Accident and Liability Co. 14 Cal. A. 2d 89 (1936).

[30] *Crisci*, *supra* note 28 at 427.

[31] *Id*.

[32] *Id*., at 427-28.

[33] *Id*., at 428.

[34] *Id*.

plaintiff would manage to establish a causal connection to the accident in question.[35] Against this backdrop, the plaintiffs' attorney offered a settlement agreement of $10,000, a proposal that he later reduced to $9000.[36] The insurance company rejected them both, which resulted in the case going to trial.[37] The jury awarded Mrs. DiMare $101,000 in damages.[38] The insurance company paid $10,000—the policy limit—whereas Mrs. Crisci, who did not have the financial wherewithal for paying the remaining amount in its entirety, settled the judgment debt with Mrs. DiMare.[39]

Thereafter, Mrs. Crisci turned to sue the liability insurer for failing to settle a claim within the policy limits. California courts did acknowledge this possibility in previous rulings, albeit in a sporadic, incohesive manner.[40] The *Crisci* decision clarified the circumstances under which an insurer may be held liable for damages in excess of policy limits for avoiding pretrial settlement. In *Crisci*, the court held that while the policy allowed the insurance company to settle whenever it sees fit, there is an overarching duty to exercise the prerogative with good faith. This duty implies that on occasion, the insurer would be *required* to settle. Specifically, the court explained that:[41]

> "[i]n determining whether to settle the insurer must give the interests of the insured at least as much consideration as it gives to its own interests […] when "there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a

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[35] *Id*.
[36] *Id*.
[37] *Id*.
[38] *Id*., at 428-29.
[39] *Id*., at 429.
[40] For a review of the case law predating *Crisci* see generally Bert W. Levit, *The* Crisci *Case – Something Old, Something New*, 1968 INS. L.J. 12 (1968).
[41] *Crisci*, *supra* note 28 at 429.

> consideration in good faith of the insured's interest requires the insurer to settle the claim.""

The court then proceeded to offer a test for delineating the insurer's duty to settle, requiring the insurer to disregard the policy limits and decide whether to litigate or to settle as if the insurer is liable for the entire court judgement. The test for breaching the duty to settle, therefore, is "whether a prudent insurer without policy limits would have accepted the settlement offer."[42] The court's interpretation in *Crisci* has been widely influential, currently recognized as the standard treatment of the duty to settle,[43] which is the main legal apparatus for overcoming the litigation-seeking incentives ascribed to insurers. This approach has been likewise adopted by the Restatement of the Law of Liability Insurance, according to which the insurer must make reasonable settlement decisions, defined as ones "that would be made by a reasonable insurer that bears the sole financial responsibility for the full amount of the potential judgment."[44]

Although the duty to settle has been imposed on insurers by virtually every state,[45] it has attracted certain amount of criticism. Owing to its extracontractual nature—i.e., ignoring the settlement terms stipulated in the insurance policy—commentators have argued that by mandating cost-justified settlements within coverage limits, the law discourages the insurer and the insured to renegotiate and ameliorate the ascribed conflict of interest.[46] For instance, the insured may offer

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[42] *Id.*

[43] *See, e.g.*, KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 664-65 (5th ed. 2010) ("The *Crisci* rule is standard law in most jurisdictions....").

[44] *See* RESTATEMENT OF L. OF LIAB. INS., *supra* note 1 at § 24(2).

[45] *See, e.g.*, David A. Hyman et al., *Settlement at Policy Limits and the Duty to Settle: Evidence from Texas*, 8 J. EMP. LEGAL STUD. 48, 49 (2011) ("In response to insurer incentives to reject at-limits settlement offers, even where the expected damages exceed the settlement offer, almost all states impose a duty to settle on insurers.").

[46] *See* Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1353-54 (1994) ("If settlement is joint-wealth-increasing,

to participate by paying an agreed-upon share of the settled amount, which might induce the insurer to settle nonetheless.[47] Some have likewise pointed to reputational harm that a settlement-refusing insurance company could suffer, which may also eliminate its structural incentives to litigate. Others have highlighted the distortive effects of such a duty, contending that it affects the design of insurance policies ex ante, in a manner that ultimately disadvantages insureds. For instance, when accounting for the fact that future rejection of within-limits settlement proposals create risk of liability, insurers may have an incentive to reduce the policy limit at the outset,[48] or alternatively to set higher premiums as a prerequisite for coverage.[49] It has also been pointed out that while conflict of interest may harm the insured ex post, an insurance policy that both limits coverage and allows the insurance exclusive control over settlement decisions works to the insured's advantage ex ante, signaling to plaintiffs that the insurer is committed to be "tough" in settlement negotiations, thus reducing the reservation price of a settlement-seeking plaintiff.[50]

Crucially, however, none of the criticisms that contributors have directed against the duty to settle seeks to shed a new light on the problem it is designed to solve. Despite reservations on

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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 to induce settlement by the insurer.").

[47] *See id*. Note that this approach raises concerns regarding distributional inequities between the insured and insurers. Furthermore, liquidity constraints may well impede such bargaining, as insureds might not be able to pay the amount required to induce the insurer to settle. This was the case in *Crisci*, where Mrs. Crisci offered to pay $2500 of the settlement in exchange for the insurer accepting the plaintiff attorney's settlement proposal of $9000. The insurer declined. *Crisci*, *supra* note 28 at 428. *See* Alan O. Sykes, *"Bad Faith" Refusal to Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem*, 23 J. LEGAL STUD. 77, 81-82 (1994) (explaining that when the insured's solvency is limited, the *Crisci* rule that establishes a duty to settle could be beneficial).

[48] *See, e.g.*, Hyman et al., *supra* note 45 (noting that the policy limit almost always serves as a benchmark for settlement, in that the ultimate settlement amount is identical to the policy limit).

[49] *See* Sykes, *supra* note 46 at 1363 ("[T]he 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.") (emphasis omitted).

[50] *See* Michael J. Meurer, *The Gains from Faith in an Unfaithful Agent: Settlement Conflicts between Defendants and Liability Insurers*, 8 J. L. ECON. & ORG. 502, 510 (1992).

the appropriateness of the duty to settle, there is a broad scholarly consensus that liability insurers invariably favor litigation over settlement, even though settlement might be the socially desirable outcome. The present Article takes issue with this very understanding, arguing that it confines its attention to narrow, case-specific pecuniary interests of insurers. For sure, insurance companies may prefer to litigate claims when only the insured suffers the risk of an above-limit verdict, but in other cases, settlement actually caters to their broad aspirations. This is especially so when litigation could generate substantial benefits to the entire population of insureds, which may carry adverse implications on the insurance industry. Part II gradually constructs this argument.

II. A NEW ANGLE: INSURERS' HIDDEN SETTLEMENT INCENTIVES

A. *The Risk-Preservation Interest of Insurers*

Insurance companies have one—and one only—overarching goal: profit maximization. The bottom line of insurers is affected by two interrelated components: by the presence of risk, which impacts the demand for insurance policies ex ante and, in turn, defines the *revenues* elicited by insurers; and by the realization of risk into loss ex post, which defines the *costs* that insurers ought to incur. This means that insurers have two competing incentives: to preserve the expected risk ex ante (before an insurance policy is signed) but to eliminate it ex post (once the policy is signed). Either one of the extreme scenarios would collapse an insurance market. An excessively risky society would feature exceedingly strong demand for insurance but result in insurers' inability to profit due to consistent losses.[51] An excessively safe society would feature no such losses, but demand for insurance would compatibly drop to zero, again leaving no room for

[51] In the 1980s, for example, tort liability reforms resulted in enhanced liability for harms emanating from various economic activities, which resulted in the unavailability of insurance for those activities. *See generally* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987).

profiting.[52] Overall, then, insurers exhibit an ambivalent approach toward risk and wish to find the delicate balance between preserving risks ex ante and mitigating them ex post. As demonstrated in the lines to come, the insurance industry works along those lines with the objective of enhancing revenues by sustaining risks, on the one hand, and cutting costs by reducing losses, on the other hand.

Begin with loss-prevention. Insurance companies work vigorously to eliminate losses.[53] Since any loss that occurs immediately translates into coverage by the insurer, the latter is induced to exert effort to avert it.[54] This results in a socially valuable phenomenon whereby liability insurers function as quintessential regulators, channeling insureds toward benign types of behavior.[55] The regulatory role of insurance has been praised by academics for generating ample favorable outcomes, ranging from ensuring product safety[56] to reducing environmental harm,[57] from ingraining prudence in health treatment[58] to increasing tax compliance,[59] from avoiding

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[52] *See, e.g.*, Liran Einav & Amy Finkelstein, *Selection in Insurance Markets: Theory and Empirics in Pictures*, 25 J. ECON. PERSPS. 115, 116 (2011) (demonstrating that the presence of a "probabilistic" loss is a prerequisite for the existence of any standard insurance market).

[53] *See generally* RICHARD V. ERICSON ET AL., INSURANCE AS GOVERNANCE (2003).

[54] Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers Professional Liability*, 60 UCLA L. REV. 1412, 1415 (2013) ("Once an insurer underwrites a risk, the insurer has every reason to try to reduce its payouts by encouraging insureds to prevent the potential loss from materializing. That can, and sometimes does, lead insurers to attempt to regulate loss-producing activities.").

[55] *Id. See also* Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PENN. L. REV. 653, 683-97 (2013) (discussing the "regulatory conception" of insurance).

[56] *See* Ben-Shahar & Logue, *supra* note 5 at 218-19 ("Insurers inquire as to whether the manufacturer is in compliance with international and domestic standards of design and production, and advise them regarding how to protect against malicious tampering, how best to label products to minimize the risk of accidents, and even when to issue recalls.").

[57] *Id.*, at 226 ("[environmental liability insurance] reinforces existing government regulation by inspecting that policyholders comply with licensing conditions and other environmental regulations.").

[58] *See, e.g.*, Baker & Swedloff, *supra* note 54 at 1434-38; William M. Sage & Kristen Underhill, *Malpractice Liability and Quality of Care: Clear Answer, Remaining Questions*, 323 JAMA 315, 315-16 (2020) (explaining the role of insurance in eliminating physicians' riskiness).

[59] *See generally* Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339 (2005) (discussing the workings of tax insurance at monitoring and regulating the activity of taxpayers).

automobile accidents[60] to deterring police misconduct.[61] Fundamentally, an insurer is an economic actor aiming to limit losses that arise from policyholders' risks. An insurer is likewise uniquely positioned to influence the degree of risk taken by the policyholder. For instance, an insurer could manage risks by conditioning coverage on policyholders' due diligence, their adoption of safety measures and mandatory disclosures;[62] by engaging in monitoring and providing trainings that reinforce risk-reducing practices;[63] and by consistently adjusting premiums to reflect the risk levels posed by the individual policyholder.[64] According to John Rappaport, who studied the workings of insurance in the context of police misconduct, "[w]hen the insurer assumes the risk of liability, it also develops a financial incentive to reduce the risk through loss prevention. By reducing risk, the insurer lowers its payouts under the liability policy and thus increases profits."[65] Omri Ben-Shahar and Kyle Logue elaborate on this point:[66]

> "[I]n a variety of areas private insurance companies can, and already do, replace or augment the standard setting and safety monitoring

[60] *See* Baker & Swedloff, *supra* note 54 at 1427-31; Omri Ben-Shahar, *Privacy Protection, at What Cost? Exploring the Regulatory Resistance to Data Technology in Auto Insurance*, 15 J. LEGAL ANALYSIS 129 (2023) (noting how the use of AI technologies allows auto insurance companies to ascribe personal risk scores to drivers and adjust insurance premiums in accordance with such scores).

[61] *See generally* John Rappaport, *How Private Insurers Regulate Public Police*, 130 HARV. L. REV. 1539 (2017).

[62] *See, e.g.*, Nathaniel Hendren, *Private Information and Insurance Rejections*, 81 ECONOMETRICA 1713, 1713-14 (2013) (explaining that individuals who are perceived by insurers as excessively risky are denied coverage); Anthony T. Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, 7 J. LEGAL STUD. 1, 26-27 (1978) ("[I]f an applicant has a history of heart trouble [...] and he does not disclose the problem itself, the insurance company will usually be permitted to set the contract of insurance aside.").

[63] *See, e.g.*, Steven Shavell, *On Moral Hazard and Insurance*, 92 Q. J. ECON. 541, 550-52 (1979) (noting that insurance observance can reduce risk). *See also* Rappaport, *supra* note 61 at 1576-82 (discussing education and training as important function of insurers' regulation of police misconduct).

[64] *See, e.g.*, Ben-Shahar, *supra* note 60; Ariel Rubinstein & Mehahem Yaari, *Repeated Insurance Contracts and Moral Hazard*, 30 J. ECON. THEORY 74 (1983) (suggesting that repeated periodical interactions between insurers and policyholder reduce riskiness).

[65] Rappaport, *supra* note 61 at 1543.

[66] Ben-Shahar & Logue, *supra* note 5 at 199.

> currently performed by government. And they do so in ways that may increase social welfare. Insurance is often thought of as an institution intended only for ex post indemnification, working to reduce the cost of risky activities through risk pooling and risk shifting. But insurance also performs other important functions: risk reduction and risk management. Insurance arrangements-by using such tools as deductibles, exclusions, and experience rating-give private parties the incentive to reduce risks. Insurance is a business that specializes in risk management. Insurers assemble large actuarial databases and use them both [...] in underwriting (that is, in classifying and pricing) the risks they insure and [...] in verifying claims by separating valid from frivolous ones."

But as noted, the incentive structure of insurers does not boil down exclusively to risk-reduction; far from it. Despite impressive risk-reducing effort, we should always bear in mind that the presence of risk is what fuels the engine of the entire insurance industry. In the absence of risks, demand for insurance would cease to exist—and insurers are well aware of that. This brings us to the much less agreeable side of the insurance industry: risk-*preserving* strategies. Against the local, short-term tactics that insurers deploy for mitigating the risk that originates from the conduct of a given policyholder, insurers also dedicate a substantial amount of effort to cater to their long-term interest of upholding risks, which maintains demand for insurance.

The seemingly zealous risk-reducing actions of insurance companies pale compared to their risk-preserving strategies. So much so, that some have termed the loss-reduction aspirations ascribed to insurance "a myth."[67] A representative example is the regulation and limitation of ransomwares use, which has been initiated to reduce the risks of hacks and cyber-attacks, yet cyber insurers actively opposed them.[68] The reason? Business, of course. After all, cyber insurers are the main beneficiaries of the risk of hacking, and any attempt to impose ransomware regulation to eliminate this risk puts their business model in jeopardy.[69] And this is hardly a rare exception. Two recent contributions, one by Ronen Avraham and Ariel Porat[70] and another by Kenneth Abraham and Daniel Schwarcz,[71] take a deep dive into the ubiquitous risk-preserving operations of insurers.[72] Avraham and Porat, for instance, highlight that insurance companies routinely object to safety technology due to the long-term interest in the persistence of risks.[73] Again, the reason is that at the end of the day, insurers "might be better off with a more dangerous world."[74] Conceptualizing those efforts as "the dark side of insurance," Avraham and Porat report that insurers attempt to push against the advancement of autonomous vehicles, even though—or to be precise, exactly because—those vehicles have the potential of nearly eliminating fatal traffic accidents, which would reportedly drop insurance profits by about 60%.[75] The authors attest that in order to thwart their expansion, insurance companies are charging exceedingly higher premiums

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[67] *See* Ronen Avraham & Ariel Porat, *The Dark Side of Insurance*, 19 REV. L. & ECON. 13, 19 (2023).

[68] *Id.*, at 15.

[69] *Id.*

[70] *See generally id.*

[71] *See generally* Kenneth S. Abraham & Daniel Schwarcz, *The Limits of Regulation by Insurance*, 98 IND. L.J. 215 (2022).

[72] For an earlier identification of the problem see Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 357 (1990) ("[T]he incentive of the insurer [to entrench risk-reducing practices] is problematic, since any reduction in its eventual payouts is offset by a reduction in its [future] premium income.").

[73] Avraham & Porat, *supra* note 67 at 33.

[74] *Id.*, at 34.

[75] *Id.* (citing Tom Hammond, *Where Are Driverless Cars Taking Industry?*, INS. THOUGHT LEADERSHIP (Oct. 1, 2018), https://www.insurancethoughtleadership.com/emerging-technologies/where-are-driverless-cars-taking-industry).

for autonomous vehicles.[76] Insurers have likewise been lobbying for regulations that would inhibit the marketing of autonomous vehicles, and for mandating a host of encumbering and seemingly redundant safety features—just to erect further entry barriers before them.[77]

Seatbelts introduce yet another illustration of the problem. Pursuant to a Department of Transportation decision that required auto manufacturers to devise a passive restraint in any newly developed vehicle, carmakers preferred to install seatbelts, being at once the safest and cheapest available option.[78] But insurers oddly pushed toward airbags, to which academics suggest a striking explanation.[79] Both safety measures would reduce bodily injuries in case of an accident, but only airbags assure that an accident would result in an actual (insurable) loss. The reason is that upon the deployment of an airbag, a car is deemed "total loss" on account of the need to repackage it.[80] This means that if we compare a seatbelt-inhabiting and an airbag-containing vehicles that are each involved in a major accident, the former may or may not result in a loss—bodily injuries vary widely from one case to another—but the latter guarantees property loss at the value of the car.[81] Insurers thus preferred airbags because they increase losses both in number and in certainty.[82]

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[76] *Id*.
[77] *Id*.
[78] *Id*., at 35.
[79] *Id*. For a comprehensive discussion see Robert Kneuper & Bruce Yandle, *Auto Insurers and the Air Bag*, 61 J. RISK & INS. 107 (1994).
[80] Avraham & Porat, *supra* note 67 at 35.
[81] *Id.*
[82] *Id*.

We could pile up more and more examples in this vein—from health insurers' support of tobacco companies[83] to the industry's battle against potentially lifesaving genetic tests[84]—but the point is probably clear enough at this point. While insurers are well-incentivized to take actions to assure that, at the individual level, their insureds would not suffer losses, it seems that at the global level, insurers aspire to enhance risks.[85] This is perhaps best epitomized in Avraham and Porat's grim conclusion:[86]

> "[I]nsurers have an individual short-term interest in providing their insureds with incentives to reduce risks. But all insurers as a group have a long-term interest to provide all insureds with incentives not to reduce risks and sometimes even to increase them. In short, if we imagine that insurers could collectively control a know that sets the level of risks in society, we claim that they have an interest to turn it a few notches above the socially optimal level, or at least make sure it is turned to that point or merely not prevent it from being turned to that level. Bluntly put: a private, profit-driven industry has

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[83] *See, e.g.*, David Hilzenrath, *Health Insurance Firms Found to Often Hold Tobacco Company Stocks*, WASH. POST (July 7, 1995), https://www.washingtonpost.com/archive/business/1995/07/07/health-insurance-firms-found-to-often-hold-tobacco-company-stocks/48f18e50-3251-4a54-a18c-04b22922c1be/; Morton Mintz, *Insurers' Hazy Relationship with Tobacco*, WASH. POST (Apr. 7, 1990), https://www.washingtonpost.com/archive/business/1990/04/08/insurers-hazy-relationship-with-tobacco/f0ea0074-eef3-40e3-887c-51195009ce99/. For a detailed database see J. Wesley Boyd et al., *Insurance-Industry Investment in Tobacco*, 360 NEW ENG. J. MED. 2483 (2009).

[84] Avraham & Porat, *supra* note 67 at 35-37.

[85] *See* Abraham & Schwarcz, *supra* note 71 at 227 (contending that while insurers work individually to reduce their own insureds' riskiness, they have an incentive to maintain long-term losses that would enhance the attractiveness of policies and increase demand for coverage).

[86] Avraham & Porat, *supra* note 67 at 16.

> an incentive to maximize its profits, even if that means externalizing costs onto others."

The present Article joins existing accounts on the risk-enhancing deeds of the insurance industry yet illuminates the phenomenon throughout a different viewpoint. While the relevant literature has focused in its entirety on how insurers operate to maintain or exacerbate economic and physical risks, this Article is the first to concentrate on insurers' efforts to sustain *legal* risks by means of an out-of-court settlement. Settlements preserve uncertainty as to the lawfulness of certain types of behavior and inhibit the development of a coherent, guiding jurisprudence by courts. Settlements thus cater to insurers' long-term interest in retaining ambiguity, which is constitutive to risk. The next Section develops this argument by first identifying the dynamics required to infuse clarity and predictability into the legal system, and then demonstrating how insurance companies could use settlements to distort this process.

B. *Settlement as a Risk-Preservation Mechanism*

1. Rules, Standards, and Legal Uncertainty

Scholars, students, lawyers, judges, and essentially any actor within the legal cohort is aware of the time-honored distinction between two prototypical legal norms: rules and standards.[87] Both types of norms are designed to regulate some proscribed conduct but differ in their actual formulation. Rules ("drivers may not exceed a speed of 55 miles per hour") establish rigorously specified definitions, tailoring the precise contours of prohibited and permitted behaviors.[88] Standards ("drivers may not drive at an excessive speed") only proffer opaque descriptions that

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[87] *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985).

[88] *See, e.g.*, Kaplow, *supra* note 87 at 559-60.

fail to delineate the boundaries of permissible acts with precision.[89] The rules-versus-standards distinction is among the cornerstones of legal theory, and has been the subject of countless academic contributions.[90]

The rules-standards dichotomy likewise establishes the division of labor between legislators and courts. The degree of accuracy that legal commands exhibit is what determines the court's discretion level. Rules are traditionally thought of as explicitly embedding the goals that the legislator seeks to promote.[91] Since they define the proscribed conduct in a precise and meticulous manner, the argument goes, courts are granted with minimal judgmental leeway.[92] To fulfill the legislator's objective, courts should simply apply rules automatically. Under a rule-based speed limit, for instance, courts would convict a driver who exceeded 55 miles per hour and acquit her otherwise; discretion is hardly ever required. Standards, on the other hand, only reflect the legislator's overarching aspirations without unfolding them into concrete, fulfillable goals.[93] When the law stipulates that those who drive at an excessive speed should be penalized, it is rather unclear whether the legislator intended to punish those who exceed 50, 55 or 60 miles per hour. Because standards fail to equip society with precise information on the lawfulness of a given conduct, affording them workable content is largely considered the role of courts, who are in those cases provided with heightened level of discretion.[94]

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[89] *Id*.

[90] *See* Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 167-68 (2015) ("The distinction between rules and standards has preoccupied scholars from different methodological persuasions, spawning a voluminous theoretical literature with many important insights.").

[91] Kennedy, *supra* note 87 at 1697-98.

[92] Kaplow, *supra* note 87 at 559-60 ("[A] rule may entail an advance determination of what conduct is permissible, leaving only factual issues for the adjudicators.").

[93] Parchomovsky & Stein, *supra* note 90 at 172-73.

[94] Kaplow, *supra* note 87 at 1698 ("A standard may entail leaving both specification of what conduct is permissible and factual issues for the adjudicator.").

Thus, while rules employ a perspective that details permitted and forbidden behaviors ex ante and are thus considered the domain of the legislator, in employing standards the legislator uses vague terminology and ambiguous orders, thus delegating the authority to determine their actual meaning to courts ex post, that is, after cases arise.[95] Those characteristics offer both costs and benefits: rules assure legal certainty, but for them to be comprehensive and effective, the legislator must be able to predict in advance the entire array of contingencies that subjects would confront—a mission that in the majority of cases is utterly impossible.[96] Just try defining what kind of behavior amounts to negligence by a predetermined set of rules. Standards spare the (often prohibitively high) cost of foreseeing any variegated incident in advance, but deprive actors of the ability to rely on the law and create a legal system ridden with uncertainty.[97] The aspiration to strike the optimal tradeoff is the lot of any legal area: from tort[98] to tax law;[99] from intellectual

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[95] *Id*., at 1697 (explaining that the core distinction between rules and standards is whether the law is given concrete content ex ante or ex post).

[96] *See generally id* (offering a cost-benefit analysis of the choice between rules and standard based on lawmakers' ability to predict contingencies in advance). *Cf*. Parchomovsky & Stein, *supra* note 90 at 171 ("No matter how hard legislatures try, they will fail to come up with fully specified rules that accurately represent every possible contingency in all future states of the world.").

[97] *See generally* Kaplow, *supra* note 87. *See also* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984) (discussing the problematic aspects of standards that impose uncertain legal outcomes).

[98] *See, e.g.*, Alex Stein, *The Domain of Torts*, 117 COLUM. L. REV. 535, 560 (2017) (discussing the structure of tort law in light of the rule-standards distinction).

[99] *See generally* Yehonatan Givati, *Walking a Fine Line: A Theory of Line Drawing in Tax Law*, 34 VA. TAX REV. 469 (2015).

property[100] to criminal law;[101] from administrative[102] to contract law;[103] from environmental[104] to corporate law.[105]

But while analytically useful, the battle between rules versus standards has long been decided in practice, and standards have clearly won. This is not to say that standards per se are more widespread than rules. It just means that the dichotomy that theorists consistently entertain is quite misleading, as legal norms ordinarily contain some combination of the two prototypes. Like rules, they point to some prespecified goals by which judicial rulings must abide; and like standards, they leave much room for judicial discretion to decide on a case-by-case basis. As Cass Sunstein's famous taxonomy of rules suggests:[106]

> "In the extreme case, all of the content of the law is given before cases arise. This is an ambitious goal—impossibly ambitious. […] [N]o approach to law is likely to avoid allowing at least *some* legal judgments to be made in the context of deciding actual cases. Rules

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[100] *See, e.g.,* Niva Elkin-Koren & Orit Fischman-Afori, *Rulifying Fair Use*, 59 ARIZONA L. REV. 161, 165 (2017) (arguing that the dilemma on whether to define bright-line or open-ended exceptions to copyright owners' right to exclude the public from using protected content "resembles the classic debate on rules versus standards.")

[101] *See, e.g.*, Rachel E. Barkow, *Separation of Powers and the Criminal Law*, 58 STAN. L. REV. 989, 1036 (2006) (addressing the advantages associated with predicating criminal law on rules, which include predictability and lower decision costs by courts).

[102] *See generally* Colin S. Driver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983).

[103] *See, e.g.*, George S. Geis, *Economics as Context for Contract Law*, 75 U. CHI. L. REV. 569, 590 (2008) (reviewing VICTOR GOLDBERG, FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE (2006)) (contending that some debates over the clarity of contract law are "just a variant of the classic rules versus standards problem....").

[104] *See, e.g.*, Alex Raskolnikov, *Probabilistic Compliance*, 34 YALE J. REG. 101, 133 (2017) (explaining that in environmental regulation, among other areas, actors may prefer rules to standards due to the greater certainty that they provide).

[105] *See, e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1829-30 (2006) (noting that corporate regulation relies heavily on standards, which might be disadvantageous).

[106] Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 961 (1995).

do not, and indeed cannot, contain all of the instructions necessary for their own interpretation."

Sunstein continues by dismantling the traditional rules-standards binarity into a more nuanced menu that includes presumptions (assumptions made by the legislator regarding a particular conduct, which may be rebuttable in court on a case-by-case basis),[107] factors (limiting the discretion of courts by establishing ex ante a set of considerations that ought to be accounted for, without infusing precise content into them),[108] guidelines (mandatory or suggestive ceilings and floors for courts),[109] principles (obscure legal fundamentals on which courts may rely),[110] and more.[111] Gideon Parchomovsky and Alex Stein have accorded with this line of reasoning by suggesting that the law is actually structured foremostly on "catalogs"—lists of specific behaviors that the legislator explicitly addresses, that are accompanied by residual categories (typically captured by phrases of "and the like" or "such as") that authorizes courts to address unenumerated behaviors that the legislator has failed to predict in advance.[112]

So, why say that standards have won the battle? The reason is that Sunstein, Parchomovsky and Stein, and later accounts have demonstrated that the main virtue of rules—the one of complete legal clarity—is just unobtainable.[113] In reality, the choice is not between standards and rules; it is between quintessential standards and somewhat less ambiguous ones. This understanding is of

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[107] *Id*., at 963.
[108] *Id*., at 963-64.
[109] *Id*., at 965-66.
[110] *Id*., at 966-67.
[111] *See generally id*.
[112] *See generally* Parchomovsky & Stein, *supra* note 90.
[113] *See, e.g.*, Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1177 (1989) ("[N]ot relying upon overarching generalizations, and thereby leaving considerable room for future judges is thought to be the genius of the common-law system. The law grows and develops [...] not through the pronouncement of general principles, but case-by-case, deliberately, incrementally, one-step-at-a-time.").

substantial importance for our discussion, because it means that in general, the task of streamlining clarity into the legal system—thus providing society with the ability to distinguish between the permitted and the forbidden—rests on the shoulders of courts.[114] Legislators invariably choose to use nebulous, open-ended standards that transfer the task of elucidating the law onto courts, whose rulings provide clearer guidelines to individuals that would confront similar circumstances in the future.[115] Insurers, who have a strong interest in preventing courts from doing so, may subscribe to a simple strategy: settling a case before the court gets the chance to form a decision.

2. Settlements and the Persistence of Unpredictability

Courts do not always manage to elucidate legal norms. In some cases, this emanates exclusively from strategic considerations: courts may deliberately avoid shedding clarity upon opaque standards in order to retain interpretive leeway for future disputes they might confront.[116] In other instances, the reason is institutional: the proliferation of state judiciaries within the U.S., along with the ubiquity of horizontal incongruence in federal courts, might add ambiguity instead of eliminating it and provide bright-line guidance.[117] Even without those barriers, legal disputes often generate complex and multifaceted court decisions, resulting in individuals, corporations,

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[114] *See, e.g.*, Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 17 (1967) (noting that since bright-line rules are hardly ever exhaustive, cases cannot be decided by simply "applying the law," but rather by a judge exercising discretion, thus "manufacturing a fresh legal rule or supplementing an old one.").

[115] Meir H. Yarom, *Positivism and Unity*, 36 CAN. J.L. & JURIS. 241, 261 (2023) ("[Court] determination becomes a line in the chain of dynamic law creation, concretizing the legal norm as it journeys down from the upper, abstract echelons of the system.")

[116] On strategic considerations in precedent setting see, e.g., Adam B. Badawi & Scott Baker, *Appellate Lawmaking in a Judicial Hierarchy*, 58 J. L. & ECON. 139 (2015); THOMAS H. HAMMOND ET AL., STRATEGIC BEHAVIOR AND POLICY CHOICE ON THE U.S. SUPREME COURT (2005); Jeffery R. Lax, *Political Constraints on Legal Doctrine: How Hierarchy Shapes the Law*, 74 J. POL. 765 (2012).

[117] *See generally* Amanda Frost, *Overvaluing Uniformity*, 94 VA. L. REV. 1567 (2008) (reviewing divergence of interpretation of federal law); Eric A. Posner & Cass R. Sunstein, *The Law of Other States*, 59 STAN. L. REV. 131 (2006) (reviewing divergence in state laws). Both accounts, however, point to certain institutional advantages in the proliferated structure of the legal system.

government agencies, repeat litigants and any other subject of the law—including lower jurisdictions—struggling to understand what is the actual legal precedent by which they should abide.[118]

But the main impediment erected before courts is *the lack of any opportunity* to contextualize legal standards and afford them precise, concrete substance. This happens when a dispute is not even brought before the court for a final judgment, namely, when parties reach a settlement agreement. Legal theorists, most prominently Owen Fiss, have identified this problematic aspect of civil settlements. In an immensely influential article, *Against Settlement*, Fiss ascribes two competing objectives to civil litigation: the private one of dispute resolution, and the public one of norm elaboration.[119] Adjudication provides a verdict to the parties at hand and guidance to society at large.[120] But litigants, for their part, can achieve the former without investing costly resources: they can bargain in the shadow of the court's anticipated judgment, and reach a settlement that reflects it.[121] In so doing, they resolve their dispute without incurring the costs of litigating a case. Fiss and subsequent works thus perceive litigation to a final judgment as an

[118] The cornerstone theoretical accounts on fragmented court decisions remain Frank H. Easterbrook, *Ways of Criticizing the Court*, 95 HARV. L. REV. 802 (1982) and Lewis A. Kornhauser & Lawrence G. Sager, *The One and the Many: Adjudication in Collegial Courts*, 81 CAL. L. REV. 1 (1993). In *Marks v. United States*, 430 U.S. 188 (1977), the Supreme Court held that when a fragmented court decides a case without a single underlying rationale upon which a majority of Justices agree, the precedential takeout should be "that position taken by those Members who concurred in the judgment on the narrowest grounds...." Ever since, the *Marks* rule has been bewildering the legal system's constituents for decades. For an empirical review see generally Richard M. Re, *Beyond the* Marks *Rule*, 132 HARV. L. REV. 1942, 1946 (2019) (suggesting that lower courts struggle at understanding the precedent generated by a fragmented Supreme Court decision based on the *Marks* rule, thus concluding that it offers a "fundamentally broken test" and calling for its abolition).

[119] *See generally* Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

[120] *Id*., at 1085.

[121] *Id*. *See also* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979) (demonstrating that the legal system should be thought of as resting the foundations for private bargaining and consensual dispute resolution, rather than as adjudication mechanism).

underprovided public good: court decisions are imperative for guiding behavior, hence their main beneficiary is society at large rather than the litigants themselves.[122] This results in the undersupply of legal clarity. As Carrie Menkel-Meadow notes:[123]

> "Those who critique the lack of rules and principles and the "mushiness" of nondefinitive rulings also lament what they perceive to be the absence of precedent in settlement processes…. [T]oo many settlements will reduce the making of law or provide an insufficient "sample" of cases from which the courts will draw to fashion rules to govern human behavior."

This is where the present contribution stands. When insurers substitute the policyholder and litigate against the plaintiff, their inclination to settle originates not only from their desire to save litigation cost, but rather, from their substantial interest in *not* supplying the public good of behavior guidance and norm clarification. The logic is exactly the one that led insurance companies to object to safety regulations and other socially beneficial initiatives: their aspiration to maintain risk, which is the industry's raison d'etre.[124] Guiding judicial decisions, as noted, is the legal system's main path for eliminating legal risks. But if legal risks had in fact been abolished and individuals would have known, at any given point, whether their particular conduct is perceived by courts as negligent, unreasonable, or otherwise culpable, demand for insurance would substantially decline. The standard analysis that points to insurers' interest in litigating due to coverage limit, has missed the profoundly rooted motivation to keep legal norms sufficiently

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[122] *See, e.g.*, Leora Bilsky & Talia Fisher, *Rethinking Settlement*, 15 THEORETICAL INQ. L. 77, 81-84 (2014) (discussing the public-good characteristics of guiding legal precedents, and submitting that they are undersupplied due to parties' decision to settle).

[123] Carrie Menkel-Meadow, *Whose Dispute Is It Anyways?*, 83 GEO. L.J. 2663, 2679 (1995).

[124] *Supra* notes 67-86.

vague. The ensuing Part demonstrates that the latter interest may well override the former one, resulting in insurers reaching a settlement that, in the long term, harms policyholders by keeping them in the dark. Just to illustrate this plainly, consider some stylized toy examples to make the idea more concrete.

C-Section. An obstetrician performs a C-section at the 36th week of pregnancy (that is, before full term) due to ambiguous medical reasons, and the baby subsequently suffers complications. The mother files a negligence suit. The insurance industry as a whole is worse off with a definite judgment in either direction. If the court finds that performing a C-section as early as the 36th week of pregnancy is never negligent, doctors will not need malpractice insurance for this procedure. Conversely, if the court rules it is indeed negligent in the absence of medical emergency, doctors will simply avoid those preterm C-sections altogether, once again reducing the need for insurance coverage.

Financial Advice. A financial advisor recommends a client on the verge of retirement to invest in a high-risk stock. The client accedes, but the stock price then drops and causes him a substantial financial loss. He sues, claiming that the recommendation was negligent given his nearing retirement status. As is customary, the advisor is covered by an error and omission (E&O) insurance policy. If the court finds for the defendant and rules that financial recommendations could hardly ever amount to negligence irrespective of the client's age and status, advisors could freely recommend such investments without the need to insure against the risk they create. If it finds that high-risk recommendations to certain clients are, in fact, negligent, advisors will know to adjust their behavior from now on, avoiding referring their clients to risky opportunities, likewise rendering insurance much less necessary.

Construction Standards. A construction company builds an office complex without using extensive earthquake-resistant materials. A moderate earthquake causes structural damage and physical harm to some tenants who subsequently sue, claiming that the building process was negligent. A court decision holding that such construction decision is negligent would induce builders to uniformly adopt the new building standards detailed in the ruling, possibly reducing the need for liability insurance for such projects and, in any event, the premiums insurers will be able to collect due to the reduced risk of loss. An obverse decision would have the same effect: reducing demand for the risk of an earthquake harm in its entirety.

Injury Prevention. A retail chain employee is injured after lifting heavy boxes without designated equipment. The employee sues, pointing to the employer's purportedly negligent failure to provide specialized lifting equipment as the reason for the injury. In ruling that employers are negligent under those circumstances, the court would push retailers to provide lifting equipment across the board, reducing injury risks and, consequently, the value of insurance. If the court absolves the employer, it will likewise obviate the need for coverage in those scenarios.

Off-Label Prescription. A doctor routinely prescribes medication for off-label use, genuinely believing that this is in patients' best interest. On one occasion, it causes unanticipated side effects to a patient. The harmed patient sues, alleging negligent prescription. If the court holds the doctor's behavior reasonable, she may keep prescribing medications for off-label uses with impunity. If not, she will stick to the label. In either case, unambiguous standards would reduce the value of malpractice insurance for her.

The common denominator of these examples is evident. In all scenarios, the ideal result for an insurer is that the court avoids a clear precedent in either direction, keeping potential injurers uncertain about the risk of liability. A guiding decision would eliminate risks, thus significantly diminishing the value of insurance for injurers and, in turn, demand for coverage. To evade the establishment of a safe harbor that sheds clarity and reduces the attractiveness of insurance policies, insurers might be incentivized to push toward settlement. In simpler terms, the best outcome from insurers' perspective is always "maybe," which keeps injurers unsure as to whether their practices may be regarded as negligent by courts if they ever result in harm. For the legal outcome to remain in this gray area, the insurer may aspire to cut a settlement agreement with the plaintiff, thus guaranteeing the persistence of "maybe," sustaining legal risks, and keeping insurance valuable. The next Part presents and discusses real-world evidence from insurance companies' practice, attesting that insurers often wish to settle to perpetuate unpredictability and maintain legal risks.

III. STRATEGIC INSURANCE SETTLEMENTS IN PRACTICE

A. *The Jurisprudence of Intent*

Not all losses are insurable; only the ones that arise from uncertain contingencies, that is, from risks. Some losses originate from decisions, rather than risks—the result of intentional, rather than accidental, actions. A liability insurance policy term that provides coverage for intentional acts is, generally speaking, unenforceable.[125] Although policies do not always contain explicit exclusion of intentional acts, state legislation or insurance case law regularly void any contract that pertains to them—especially ones that cover morally egregious actions or one that are criminal

[125] *See, e.g.*, Century-National Ins. Co. V. Garcia, 51 Cal. 4th 564 (2011); Concord Gen. Mut. Ins. Co. v. Madore, 882 A.2d 1152 (Vt. 2005); Hedtcke v. Sentry Ins. Co. 109 Wis. 2d 461 (1982); Preferred Mut. Ins. Co. v. Gamache 426 Mass. 93 (1997); Safeco Ins. Co. Am. V. Liss 2000 Mt. 380 (2000); Tower Ins. Co. v. Judge, 940 F. Supp. 679 (Min. 1993); Trinity Universal Ins. Co. v. Kirsling 139 Id. 89 (2003); Unitrin Auto and Home Ins. Co. v. Sullivan, 179 A.D.3d 970 (N.Y. 2020).

in nature.[126] According to the Restatement, "[a] liability-insurance-policy term is unenforceable if: (a) legislation prohibits enforcement, or (b) the interest in its enforcement is clearly outweighed in the circumstances by a public policy against enforcement."[127] It is extremely difficult to imagine a court validating an insurance coverage against liability for, say, assault or sexual harassment.[128] Insurance coverage of such intentional acts, then, is normally impermissible.[129]

But intent is a tricky concept. Its precise definition and actual meaning are consistently bedeviling courts and academics in multiple legal areas,[130] and insurance law is no different. Specifically, between the two extremes of purely intentional and obviously inadvertent acts, lies an array of borderline behaviors that may fall within either category. Sexual misconduct by an employee is surely an intentional act, and an individual insurance policy that covers a harasser from liability would not withstand judicial scrutiny.[131] But the employer is also part of the picture: under current law, the upper management confronts potential liability for the employee's

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[126] 1 BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 8.02(a) (20th ed. 2020) ("The overwhelming majority of courts, including the Supreme Court of the United States, have adopted the fortuity doctrine and have limited insurance coverage, regardless of the language of the particular policy, to fortuitous or accidental events.").

[127] RESTATEMENT OF L. OF LIAB. INS., *supra* note 1 at § 44(2) (AM. L. INST. 2019).

[128] *See, e.g.*, Christopher C. French, *Insuring Intentional Torts*, 83 OHIO ST. L.J. 1069, 1090 (2022). *But see infra* notes 134-143 and accompanying text.

[129] French, *supra* note 128, at 1071 ("The conventional wisdom is that liability insurance does not cover intentional torts [...] or other injuries intentionally caused by an insured.").

[130] For a general conceptual analysis see Roderick M. Chisholm, *The Structure of Intention*, 67 J. PHIL. 633 (1970). For specific interplays with various legal domains see, e.g., Cathy Hwang, *Collaborative Intent*, 108 VA. L. REV. 665 (2022) (corporate law); Kimberly Kessler Ferzan, *Beyond Intention*, 29 CARDOZO L. REV. 1147 (2008) (criminal law); Gregory Klass, *Intent to Contract*, 95 VA. L. REV. 1437 (2009) (contract law); William M. Landes & Richard A. Posner, *An Economic Theory of Intentional Torts*, 1 INT'L REV. L. & ECON. 127 (1981) (tort law); John F. Manning, *Without the Pretense of Legislative Intent*, 130 HARV. L. REV. 2397 (2017) (constitutional law).

[131] French, *supra* note 128 at 1090.

behavior.[132] Whether the employer's liability is insurable depends on the specifics of the case.[133] In some instances, the employer is genuinely unaware of the employee's behavior, and despite the employer's utmost dedication to creating a safe workplace environment, there is an inevitable risk that one employee would nonetheless harass another worker. This is the result of an exogenous occurrence and is therefore insurable, just as any other risk that the employer confronts in operating his business.[134] But what if the employer is aware of the employee's harassing behavior and—due to this employee's productivity—decides to look the other way? And what about more ambiguous circumstances, for instance if the employer has only heard rumors but never looked into them, or if the employer failed to establish a functioning human resources system, never enforced employee participation in sexual harassment seminars, and failed to address other types of inappropriate behaviors? In those scenarios, known as "employer-facilitated wrongs," it is unclear whether the employer's oversight would be regarded as intentional and thus uninsurable for such cases.[135]

This is the world of employment practices liability (EPL) insurance, which covers companies against claims arising from such incidents—most prominently oversight.[136] When it comes to oversight, such as those involving board members overlooking workplace harassment or institutional inaction toward vaguely known misconduct, the line between supervisors' intent and

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[132] Either vicariously or on a negligence basis, whereas the latter is predicated on their failure to take sufficient preventive measures. *See Faragher v. City of Boca Raton*, 524 U.S. 775 (1998) (setting the standard for vicarious liability for sexual harassment); Wantou v. Wal-Mart Stores Tex., LLC., 23 F.4th 422 (5th Cir. 2022) (setting standard for negligent-based liability for sexual harassment by employees). For a discussion see Kassandra Fotiadis, *#EmployersToo: Expanding Vicarious Liability for Sexual Harassment in Title VII and Tort Law*, 123 MICH. L. REV. (Forthcoming, 2025).

[133] French, *supra* note 128 at 1089-90.

[134] *See* Erin E. Meyers & Joni Hersch, *Employment Practices Liability Insurance and Ex Post Moral Hazard*, 106 CORNELL L. REV. 947, 950 (2021) (noting that in such instances, "the employee's behavior becomes more akin to an unanticipated risk and similar to the type or risks that insurance is intended to, and does, protect.").

[135] *Id*., at 950-51.

[136] *See generally id*.

negligence becomes blurred, and legal uncertainty exists regarding insurability.[137] The reason for uncertainty? EPL insurers aggressively push toward settlement in cases involving those borderline cases, resulting in "the lack of case law surrounding insurability for employer-facilitated wrongs."[138] Consider the case of the Weinstein Company. Harvey Weinstein's behavior was known within the corporation, at least to an extent, but has been routinely overlooked.[139] In a class action brought against the Weinstein Company due to Harvey Weinstein's serial sexual assault, the insurers took in to defend the suit and, not so long afterwards, offered a settlement that has been ultimately reached.[140]

This is hardly an isolated incident, as will be shown momentarily. The nonexistent jurisprudence on the exclusion of intentional acts is simply beneficial to insurers. Well-established case law that sheds clarity and categorizes certain employer-facilitated wrongs as uninsurable would diminish the value of EPL insurance policies to businesses. Knowing that insurance cannot fully cover them, some companies would forego EPL insurance altogether; others would still

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[137] *Id.*, at 950-51.

[138] *Id.*, at 974.

[139] *See id.*, at 951. *See also* Ronan Farrow, *From Aggressive Overtures to Sexual Assault: Harvey Weinstein's Accusers Tell Their Stories*, NEW YORKER (Oct. 10, 2017) https://www.newyorker.com/news/news-desk/from-aggressive-overtures-to-sexual-assault-harvey-weinsteins-accusers-tell-their-stories ("Sixteen former and current executives and assistants at Weinstein's companies [...] said that the behavior was widely known within [the companies].").

[140] *See* Duffie Osental, *Insurance Firms to Pay Out as Harvey Weinstein Settlement Revealed*, INS. BUS. (Dec. 12, 2019), https://www.insurancebusinessmag.com/us/news/breaking-news/insurance-firms-to-pay-out-as-harvey-weinstein-settlement-revealed-194652.aspx; Megan Twohey & Jodi Kantor, *Weinstein and His Accusers Reach Tentative $25 Million Deal*, N.Y. TIMES (Dec. 11, 2019), https://www.nytimes.com/2019/12/11/us/harvey-weinstein-settlement.html ("The settlement [...] would be paid by insurance companies representing the producer's former studio, the Weinstein Company."). The original settlement proposal has been initially—see, e.g., Jodi Kantor & Megan Twohey, *Judge, Expressing Skepticism, Upends $25 Million Harvey Weinstein Settlement*, N.Y. TIMES (July 14, 2020), https://www.nytimes.com/2020/07/14/us/harvey-weinstein-settlement.html—but a new one has been ultimately reached. *See* Melena Ryzik & Cara Buckley, *Harvey Weinstein Accusers Agree to $17 Million Settlement*, N.Y. TIMES (Jan. 27, 2021), https://www.nytimes.com/2021/01/27/movies/harvey-weinstein-settlement.html ("[The] total bankruptcy settlement will be covered entirely by insurers: $17 million will go to the sexual misconduct claims fund....").

purchase but their willingness to pay would drop. Ambiguity is thus crucial for the growth of the EPL insurance market—companies and organizations purchase policies covering claims that fall exactly into this legally gray area. The industry's reliance on settlements allows insurers to keep the line unclear, preserving demand for EPL policies by corporations that seek to mitigate the uncertain risk of liability for oversight failures.

At first glance, it seems that an EPL insurer confronting a seemingly uninsurable act could dispute coverage in court. A court finding that excuses insurers from coverage would save them substantial amounts—for instance, $35.2 million in the Weinstein settlement.[141] But insurers rarely do so, bearing in mind their long-term interest in keeping demand for insurance alive. And there is more to it. Specifically in the context of EPL, the insurer could also compel plaintiffs into a defendant-favorable settlement. Because the insurer could threaten to dispute coverage, which would consequently leave the plaintiff against a possibly insolvent and thus judgment-proof defendant, this translates into increased leverage in settlement negotiations.[142] In the Weinstein case, for instance, Erin Meyers and Joni Hersch contend that "[t]he combination of Weinstein's apparent bankruptcy and the insurers' threat of disputing coverage reduces the value of the settlement by taking away bargaining power from plaintiffs."[143]

This is also the case with directors and officers (D&O) liability insurance, which covers the risk of shareholder litigation.[144] D&O coverage includes one prominent exclusion, in claims

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[141] Ryzik & Buckley, *supra* note 140 (noting that the total amount paid by insurers—to victims, creditors and as litigation costs—amount to $35.2 million).

[142] *See, e.g.*, Lyle Adriano, *Harvey Weinstein Accusers Fear Insurers Could Be Shielded from Big Payouts*, INS. BUS. (July 14, 2020), https://www.insurancebusinessmag.com/us/news/breaking-news/harvey-weinstein-accusers-fear-insurers-could-be-shielded-from-big-payouts-227774.aspx.

[143] Meyers & Hersch, *supra* note 134 at 977.

[144] *See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 2 (2010) (explaining that D&O insurance "insulates (corporate executives) from personal liability in the event of shareholder litigation.").

involving fraudulent intent by corporate officials.[145] But the definition of fraudulent intent is rather nebulous, especially when pertaining to questions of oversight failure, indirect involvement, or suggestive evidence of fraud that nonetheless fails to offer clear-cut proof of willful misconduct.[146] Consider cases where directors or officers fail to prevent fraud within the company, overlook financial misstatements, or other deeds that rest somewhere in between reckless behavior and willful wrongdoing.[147] This ambiguity allows insurers to maintain a prosperous market for D&O coverage even in high-risk environments, where companies seek comprehensive protection against claims involving managerial actions or omissions.[148]

What facilitates this legal uncertainty? Above all, it is the absence of sizable and coherent case law. If courts were to clearly define negligent oversight as tantamount to fraudulent intent, corporations would be less inclined to rely on D&O coverage due to an expansive interpretation of what conduct is uninsurable, which means that the value of policies would drop and so as the premiums that companies are willing to pay. Same is true of the opposite case. If courts were to create an informative, well-defined distinction between negligent oversight and the threshold for fraud, this would generate a safe harbor that eliminates legal risks and again reduces the perceived value of D&O insurance coverage. The uncertain definition of fraudulent intent in the context of D&O insurance owes its origins to the lack of a cohesive jurisprudential framework, which in turn owes its origins to the abundance of settlements. According to Tom Baker and Sean Griffith, "nearly all shareholder litigation settles within the limits of [D&O insurance] policies"[149] and

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[145] *Id*., at 48-50.

[146] *See generally* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511 (2011).

[147] On the definitional problem of fraud see *id*., at 520-40.

[148] *Id*., at 552 ("That the insurance market recognizes and even welcomes [the ambiguous definition of fraud] reveals the lack of conceptual coherence in this area of law.")

[149] Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 487-88 (2007).

"research has shown that settlements have correlated […] closely with evidence of fraud."[150] Samuel Buell is even more explicit:[151]

> "[C]overage [is excluded] for what the industry calls "real fraud," by which it means, roughly, intentional fraud. Meanwhile, the fact that private liability can be established based on recklessness—and the fact that almost all suits settle—allows insurers to pay claims for securities fraud liability without admitting to covering real fraud, even in cases where real fraud was committed and ultimately could have been proven. This slippage sustains the status quo in the existing market for D&O policies… [which may be] beneficial for the D&O insurance market…."

Intent is not only relevant to insurance in the business world. Consider defamation liability insurance, which typically resides under umbrella insurance policy for wealthy homeowners, or as part of media outlets' professional E&O insurance policy.[152] Defamation insurance played a role in high-profile libel and slander cases, including the dispute between actors Johnny Depp and

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[150] *Id.*, at 537-38. *See also* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1805 (2007) ("Because shareholder litigation almost always is settled—and, therefore, not adjudicated in the proceeding for which coverage is sought—the "Fraud" exclusion has not had the impact that a simple reading of the D&O insurance policy might suggest.").

[151] Buell, *supra* note 146 at 552-53.

[152] *See* Graham Bowley & Sydney Ember, *To Defray Legal Costs in Defamation Suits, Bill Cosby Turns to His Insurance*, N.Y. TIMES (Mar. 13, 2016), https://www.nytimes.com/2016/03/14/arts/television/to-defray-his-legal-costs-in-defamation-suits-cosby-turns-to-his-insurance.html.

Amber Heard,[153] Bill Cosby's statements against accusers,[154] Paula Corbin Jones' suit against Bill Clinton,[155] and former Baseball pitcher Roger Clemens' dispute with a former trainer.[156]

A handful of court decisions have recognized that defamatory statements could be made negligently.[157] Pursuant to the landmark ruling in *New York Times v. Sullivan*, they draw a distinction between defamatory statements made with "actual malice," on the one hand and ones delivered under "reckless disregard," on the other hand.[158] Although defamatory publications could on occasion fall closer to the latter category, this is hardly the common case. Defamation disputes typically involve the knowing and purposeful assertion of falsehoods.[159] And as established before, the intentional infliction of harm is uninsurable, that is, excluded from coverage.[160] Yet, according to Kenneth Abraham, the insurance industry can oddly supply this product nonetheless, as "[P]olicyholders and insurers seem to understand that, notwithstanding the [intentional acts] exclusions, the basic coverage provided by medial liability insurance includes

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[153] Erin Mindoro Ezra, Jamie L. Rice & Tyler J. Angelini, *How Insurance Plays into the Johnny Depp v. Amber Heard Defamation Trial*, REUTERS (Feb. 10, 2023), https://www.reuters.com/legal/legalindustry/how-insurance-plays-into-johnny-depp-v-amber-heard-defamation-trial-2023-02-10/.

[154] Bowley & Ember, *supra* note 152.

[155] *Id.*

[156] *Id.*

[157] *See, e.g.*, Baumann v. Elliot, 286 Wis.2d 667 (2005); Grange Ins. V. Lintott, 77 F. Supp. 3d 926 (2015); Hearst Corp. v. Hughes, 297 Md. 112 (1983); Moss v. Stockard, 580 A.2d 1011 (1990); Rozanski v. Fitch, 113 A.D.2d 1010 (1985).

[158] *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964). Note that "malice" refers to awareness of falsity, rather than the speaker's subjective attitude toward the statement. *See* Yonathan A. Arbel & Murat Mungan, *The Case Against Expanding Defamation Law*, 71 ALA. L. REV. 453, 465 n.64 (2019).

[159] *See, e.g.*, *Herbert v. Lando*, 441 U.S. 153, 176 (1979) (noting that in almost every defamation case involving media outlets, the plaintiff is required to point to the intentional spread of falsities).

[160] *Supra* notes 125-129.

coverage against liability for defamation committed with actual malice in the *New York Times v. Sullivan* sense."[161]

As a matter of fact, the insurability of intentional defamatory statements has yet to be addressed by courts, and this is simply because they never had the chance to do so: no available case law—let alone prominent, precedent-setting decisions—have thus far addressed the issue.[162] And avoidance of such case law is arguably in insurers' best interest: the absence of court invalidation of this form of coverage keeps the market for defamation insurance alive, allowing for coverage in what seems to be the bulk of defamation claims. Avoidance is secured, of course, by dint of settling those claims.

The incentive to settle intentional defamation claims instead of subjecting coverage to judicial scrutiny is best manifested in the Fox News saga of 2020. Fox made false claims that Dominion's voting machines were rigged in favor of the Democratic Party and its presidential candidate Joe Biden.[163] What has furthermore been proven is that Fox News anchors did so knowingly, with complete awareness that they are spreading false accusations.[164] By all indications, then, Fox News' insurers could have disputed coverage and likely be released of their contractual obligation to cover defamation liability, due to the intentional nature of the harm at hand. But they never did. On the contrary, for that matter: the case has been settled for an

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[161] Kenneth A. Abraham, *Free Speech, Breathing Space, and Liability Insurance*, 111 Va. L. Rev. *11 (forthcoming, 2025). Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4820245.

[162] *Id.*, at *12 (attesting that no case law addressing the insurability of intentional defamatory statements is available).

[163] *See* US Dominion, Inc. v. Fox News Network, LLC, No. N12C-03-257 EMD, 2022 WL 100820 (Del. Super. Ct. Mar. 26, 2021).

[164] *Id.*, at 23-28. *See generally* Jeremy W. Peters & Katie Robertson, *Fox Stars Privately Expressed Disbelief About Election Fraud Claims. 'Crazy Stuff.'* N.Y. TIMES (Feb. 16, 2023), https://www.nytimes.com/2023/02/16/business/media/fox-dominion-lawsuit.html.

unprecedented amount—$787.5 million[165]—with a substantial share paid by Fox's insurers.[166] A costly settlement, indeed; but one that has possibly stopped courts from nullifying coverage and destabilizing the entire market for defamation liability insurance.

Before proceeding, a caveat is in order. The analysis above does not pretend to argue that insurers are never interested in defining intent and delineating the boundaries of coverage. In some cases, they very much do. Consider the Catholic Church's clergy abuse crisis. Most parishes possessed a general liability insurance policy against potential lawsuits.[167] At the beginning, which traces back at least to 1984 Louisiana, insurers sought—and indeed managed—to settle nine sexual abuse claims brought against one priest.[168] Shortly thereafter, upon realizing the inconceivable magnitudes of such incidents, "insurers were aware that they had a problem."[169]

Indeed, insures began contesting coverage, arguing that the abuse claims fell under an intentional acts exclusion.[170] Due to insurers' insistence on taking certain claims to court in an attempt to contest coverage in those lawsuits, courts were in fact able to consolidate a coherent

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[165] *See, e.g.*, Erin Mulvaney, Joe Flint & Isabella Simonetti, *Fox to Pay $787.5 Million to Settle Dominion's Defamation Lawsuit*, WALL ST. J. (Apr. 19, 2023), https://www.wsj.com/articles/fox-news-dominion-defamation-trial-set-to-begin-d5c7293a.

[166] Mae Anderson, *Fox Probably Won't Pay Anything Near $787.5 Million for its Settlement with Dominion Voting Systems*, FORTUNE (Apr. 24, 2023), https://fortune.com/2023/04/24/fox-7875-million-settlement-dominion-voting-systems-insurance-tax-deductions/; Erin Snodgrass, Claire Atkinson & Jacob Shamsian, *Fox News Is Unlikely to Feel the Pinch from its Record $787.5 Million Payout to Dominion*, BUS. INSIDER (Apr. 18, 2023), https://www.businessinsider.com/fox-news-payout-big-for-company-but-insurance-may-help-2023-4.

[167] *See* Alana Bartley, *The Liability Insurance Regulation of Religious Institutions after the Catholic Church Sexual Abuse Scandal*, 16 CONN. INS. L.J. 505, 515-16 (2010) ("As most parishes only carried general liability insurance when the initial wave of claims of clergy sexual abuse arose, courts were forced to use definitions, exclusions and insurance provisions to decide whether and how much church insurance policy language applies in cases where victims of clergy sexual abuse were awarded civil damages.").

[168] JAMES T. O'REILLY & MARGARET S.P. CHALMERS, THE CLERGY SEX ABUSE CRISIS AND THE LEGAL RESPONSES 81 (2014).

[169] *Id.*

[170] Bartley, *supra* note 167 at 520-28 (reviewing insurers' litigation strategy of disputing coverage and courts' responses).

jurisprudence on insurance coverage in cases involving the clergy abuse crisis.[171] To this end, courts have developed creative legal interpretations, often distinguishing between acts of individual perpetrators and the broader institutional failures within the Catholic Church that enabled abuse.[172] Ultimately, coverage for those incidents was in part validated, and courts provided concrete, workable guidelines for examination.[173] Even today, according to James O'Reilly and Margaret Chalmers, decades after the revelation of the clergy abuse scandals by the media, insurers continue to contest coverage, and based on the nuances of those precedents assert that the abuses in question fall within the intentional act exclusion.[174]

To be sure, this understanding by no means undermines the insight that insurers often benefit from legal ambiguity. It actually complements it, demonstrating when the scale of claims reaches a tipping point that makes coverage unworthwhile and the relevant insurance area unprofitable. The insurance market for institutions like the Catholic Church—that has been initially believed to pose negligible liability risks, being quite unlikely to inflict harm on third parties[175]—was not originally predicated on legal ambiguity surrounding intentional acts, as such acts were presumed to be excluded outright.[176] But as the scope of abuse became widely known

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[171] *See generally id*. *See also* Peter Nash Swisher & Richard C. Mason, *Liability Insurance Coverage for Clergy Sexual Abuse Claims*, 17 CONN. INS. L.J. 356, 375-402 (2011).

[172] *See generally* Bartley, *supra* note 167 at 520-28; Nash Swisher & Mason, *supra* note 171 at 375-402.

[173] *See generally* Bartley, *supra* note 167 at 520-28; Nash Swisher & Mason, *supra* note 171 at 375-402. For invalidation of certain coverage, see O'REILLY & CHALMERS, *supra* note 168 at 83.

[174] O'REILLY & CHALMERS, *supra* note 168 at 82.

[175] *Id*. (noting that historically, sexual abuse by priests has been perceived by insurance underwriters as "a relatively rare claim.").

[176] *See* Nash Swisher & Mason, *supra* note 171. The authors attest that outside the realm of clergy sexual abuse, courts regularly excluded coverage for insured employers and supervisors of the abuser that were sued for negligent oversight, concluding that sexual abuse cannot qualify as an insurable accident "even if such an injury was not expected or intended by the supervisor-insured." *Id*., at 380. Yet, they likewise note that in most lawsuits filed against clergy for negligent supervision, the underlying legal requirement was whether the supervising church and churchmen "knew or should have known of the offender's sexual abuse...." *Id*., at 381.

and claims started multiplying, insurers recognized their immense financial exposure—an exposure that has not been reflected in the premiums of the original insurance policies, as they were tailored to a non-risky institution.[177] While theoretically there could have been long-term interest in preserving legal ambiguity by settling each and every claim and adjust premiums in the future, this consideration was eclipsed by the scale of these cases which prompted insurers to adopt a more immediate, exclusion-centered strategy.[178]

This highlights how, when claims are of sufficiently high volume and stakes, insurers may after all prioritize litigating with the objective of clarifying the law and possibly avoid coverage, even if that means potentially sacrificing the benefits of ambiguity that sustains demand in more conventional contexts.

B. *Professional Standard of Care*

Although an overwhelming majority of the medical malpractice claims involving insurers never reach a final court decision,[179] precluding courts from adjudicating medical malpractice cases altogether is an impossible mission, primarily due to the volume of claims.[180] Insurers' settlement incentives here are more nuanced: the interest in ambiguity mostly translate into

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[177] *See* O'REILLY & CHALMERS, *supra* note 168 at 82-83 (noting that once the magnitude of the phenomenon has been realized, "the market for commercial coverage would soon after evaporate, leaving dioceses to form risk pools to bear their collective losses from abuse cases that conventional insurers refused to cover.").

[178] *Id*., at 81-83.

[179] *See, e.g.*, Ronen Avraham, *An Empirical Study of the Impact of Tort Reforms on Medical Malpractice Settlement Payments*, 36 J. LEGAL STUD. 183, 187 (2007) ("More than 90 percent of the medical malpractice cases are settled.").

[180] *See, e.g.*, Anupam B. Jena et al., *Malpractice Risk According to Physician Specialty*, 365 N. ENG. J. MED. 629, 633 (2011) (studying the volume of malpractice suits, and ultimately concluding that by the age of 65, 75% of physicians in low-risk specialties and 99% of physicians in high-risk specialties are expected to face a malpractice claim).

aggressive settlement tendencies within a specific subsector, preferably a legally underdeveloped one. Telemedicine is a case in point.

In the realm of healthcare, the rise of direct-to-consumer (DTC) telemedicine in the early 2000s, which at present accommodates millions of patient visits,[181] has further complicated the standard of care. As opposed to traditional, in-person medical consultations, DTC telemedicine often lacks thorough physical assessments that doctors may perform face-to-face.[182] This emerging form of treatment raises serious questions about the adequacy of diagnosis and treatment provided via virtual platforms, and telemedicine has become a risky business for telemedicine providers, due to the "increased chance of misdiagnosis" that is inherent to the platform.[183]

While the medical malpractice realm has recently been enjoying an infusion of clarity as states have been moving toward federal uniformity in the required standard of care after years of disparity,[184] the opposite is true of telemedicine.[185] Cases involving alleged negligence in telemedicine rarely reach a verdict; frequent settlements in those claims avoid establishing a clear, coherent judicial guidance on the standard of care in virtual consultations.[186] This leaves

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[181] Tania Elliot & Margot C. Yopes, *Direct-to-Consumer Telemedicine*, 7 J. ALLERGY & CLINICAL IMMUNOLOGY 2546, 2547 (2019) (noting that the industry has grown exponentially in recent years, and that telemedicine providers "account for millions of visits per year."). *See also* Tara Jain, Richard J. Lu & Ateev Mehrotra, *Prescriptions on Demand: The Growth of Direct-to-Consumer Telemedicine Companies*, 322 JAMA 925 (2019).

[182] *See* Lori Uscher-Pines et al., *Access and Quality of Care in Direct-to-Consumer Telemedicine*, 22 TELEMEDICINE & E-HEALTH 283, 283 (2016) (reporting that DTC telemedicine provides care of poorer quality, owing to "the lack of physician-patient relationship, limited or no access to medical records, limitations of what can be done in a virtual physical examination, and barriers to diagnostic testing.").

[183] *See* Tyler D. Wolf, *Telemedicine and Malpractice: Creating Uniformity at the National Level*, 61 WM. & MARY L. REV. 1505, 1515 (2020). *See also* Uscher-Pines et al., *supra* note 182 at 283 (explaining that the limitations of DTC telemedicine may well result in misdiagnosis).

[184] Wolf, *supra* note 183 at 1517.

[185] *Id*., at 1506 ("[M]any legal uncertainties exist in the realm of telemedicine, particularly in regard to medical malpractice.").

[186] *See generally* Alexander L. Fogel & Joseph C. Kvedar, *Reported Cases of Medical Malpractice in Direct-to-Consumer Telemedicine*, 321 JAMA 1309 (2019) (gathering data on lawsuits in DTC

telemedicine providers uncertain about the liability they may face for misdiagnoses or inadequate care in online settings.[187]

For insurers, this is a net benefit. One study that pointed to the dearth of case law in the context of telemedicine malpractice has asserted that since the lack of clear guidelines increases exposure to malpractice risk, demand for liability insurance by telemedicine providers has enhanced.[188] Legal ambiguity thus creates a steady demand for malpractice coverage within telemedicine. Definitive court rulings clarifying the required standard of care in telemedicine could either impose stringent standards that physicians would deem unworkable and avoid the practice of online treatments altogether, or indeed limit the scope of liability. In any event, clarity would lead to a decline in demand for malpractice insurance in the telemedicine sector. Although an explicit empirical attempt to demonstrate insurers' role in settling telemedicine suits has yet to be made, existing evidence certainly points to this direction: along with the prosperity of the telemedicine malpractice insurance industry, we also know that to date—almost a quarter of a century after DTC telemedicine gained prominence and permeated into the mainstream as a legitimate, convenient medical tool—a handful of cases, if any, have reached a final court decision.[189]

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telemedicine, finding that no case involved malpractice claims, yet acknowledging the inability to assess the actual magnitude of the phenomenon due to the high volume of unreported out-of-court settlements).

[187] *See* Bonnie G. Ackerman, *Is the Doctor In? Medical Malpractice Issues in the Age of Telemedicine*, NAT'L L. REV. (Apr. 17, 2019), https://natlawreview.com/article/doctor-medical-malpractice-issues-age-telemedicine ("Providers should seek advice from counsel to best understand potential liability as telemedicine poses unique medical malpractice risks and complicates traditional medical malpractice claims due to distinct issues regarding jurisdiction, procedure and duty of care.").

[188] Fogel & Kvedar, *supra* note 186 at 1309.

[189] *See id* (finding no cases); Wolf, *supra* note 183 (discussing two state cases that are only loosely related to telemedicine malpractice per se). *See also* Ackerman, *supra* note 187 (reporting that there are only a "few legal opinions that specifically address telemedicine malpractice....").

The legal profession faces similar ambiguities in defining the standard of care for attorneys.[190] Legal malpractice cases are no different than any other malpractice claim, and as such they hinge on whether an attorney's conduct falls within the boundaries of reasonable competence or amounts to negligence.[191] But little can be said about the required level of care. Given the volume of cases settled, no coherent guiding jurisprudence exists on what constitutes professional malpractice by lawyers. Indeed, "our perception of legal malpractice […] has been highly distorted by secretive insurance companies [and] confidential settlement agreements."[192]

Insurance companies are not the only ones to blame, of course. The settlement propensities start at the bottom, with law firm partners who adjust the bills to satisfy an aggrieved client,[193] clients who choose to abandon claims to save the trouble of litigating,[194] and settlement payouts before a suit is filed.[195] But then, there are insurance settlements, whose numbers—though difficult to quantify—are reportedly skyrocketing.[196] Naturally, there are multiple reasons that might drive

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[190] This uncertainty has been studied by academics for decades. *See, e.g.*, Note, *Improving Information on Legal Malpractice*, 82 YALE L.J. 590 (1973); Manuel R. Ramos, *Legal Malpractice: Now Lawyer or Client Is Safe*, 47 FLA. L. REV. 1 (1995).

[191] *See, e.g.*, Greycas v. Proud, 826 F.2d 1560 (1987) (discussing legal malpractice as lawyers' violation of their standard of care toward clients or third parties).

[192] Manuel R. Ramos, *Legal Malpractice: The Profession's Dirty Little Secret*, 47 VAND. L. REV. 1657, 1659 (1994).

[193] *See* Michael Moffitt, *Settlement Malpractice*, 86 U. CHI. L. REV. 1825, 1834-35 n.19 (2019) ("[F]irms […] commonly adjust bills in the face of unhappy clients—a result that would produce no public paper trail.").

[194] *See, e.g.*, HERBERT M. KRITZER & NEIL VIDMAR, WHEN LAWYERS SCREW UP: IMPROVING ACCESS TO JUSTICE FOR LEGAL MALPRACTICE VICTIMS 19 ("[A] large proportion of claims against lawyers are resolved without a lawsuit being filed.")

[195] *See, e.g.*, Tom Baker & Rick Swedloff, *Liability Insurer Data as a Window on Lawyers' Professional Liability*, 5 U.C. IRVINE L. REV. 1273, 1293 (2015) (providing data on the rate of cases abandoned, dismissed, settled before trial, settled during trial, and adjudicated).

[196] *See generally id*. (using insurance data demonstrating that the proportion of cases litigated into a final judgment is extremely low). *Cf*. Ramos, *supra* note 192 at 1664 n.37 ("[M]ost legal malpractice insurance claims against insured lawyers never mature into actual lawsuits....").

insurers to settle, perhaps chief among them is their desire to avoid litigation expenses.[197] But those settlements undoubtedly avail at maintaining uncertainty around what constitutes a breach of duty in legal practice. Cohesive jurisprudence on malpractice standards could reduce variability in claims and weaken demand for insurance. This is especially true of legal malpractice insurance, which is not well-entrenched in the profession and thus introduces a relatively underdeveloped market.[198] Lawyers increasingly decide to go "bare" and eschew malpractice insurance—only Oregon mandate insurance coverage for lawyers and another few states require uninsured lawyers to disclose this fact to clients.[199] The lax regulatory treatment of legal malpractice—manifesting also in ambiguous ethical codes and flawed self-governance within the profession[200]—has thereby resulted in the insurance industry "largely giv[ing] up on education and prevention programs to reduce the risk of malpractice,"[201] instead choosing to further limit coverage.[202] What keeps the market alive is the uncertain legal environment in which attorneys operate—uncertainty that exists due to the relative paucity and contradictory nature of extant guiding case law.[203]

Interestingly, as with the Catholic church example in the preceding Section, we may also witness the antipode where the cost of uncertainty is large enough to induce insurer *litigation* that clarifies the required standard of care, rather than settlement that obfuscates it.[204] As highlighted

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[197] *But see id*, at 1299 (identifying that the vast majority of legal malpractice claims belong to the category of "de minimis" expenses, involving less than $1000 for both defense costs and indemnity payments).

[198] *See, e.g.*, Debra Cassens Moss, *Going Bare: Practicing Without Malpractice Insurance*, 73 ABA J. 82, 84 (1987) (arguing that more than 50% of lawyers are uninsured). For an up-to-date survey that indicates the surprisingly common practice of lawyers' going uninsured see Leslie C. Levin, *Lawyers Going Bare and Clients Going Blind*, 68 FLA L. REV. 1281 (2016).

[199] *See generally* Levin, *supra* note 198 at 1284-85.

[200] Ramos, *supra* note 192 at 1686.

[201] *Id.*, at 1706.

[202] *Id.*

[203] *Id.*, at 1663 (highlighting insurers' interest in settling confidentially, thus avoiding the generation of information that would "educate or encourage consumers to sue lawyers.").

[204] *Supra* notes 167-178 and accompanying text.

before, an entirely predictable future liability would make insurance policies redundant and the market for insurance in the relevant area would disappear or shrink to an insignificant extent.[205] But a functioning insurance market is also impossible in an equivalent universe, where uncertainty is so well-entrenched to the point that the risk of liability is not even assessable by insurance underwriters and actuaries. Let us dwell on this insight for a moment and explain what we mean by risk that is not assessable.

In economics and decision theory, it is conventional to distinguish between risk, which features uncertainty about loss yet captures this uncertainty by an objective probability measure,[206] and what is known as "Knightian uncertainty," where even the probabilities of loss are unknown.[207] To get a good grasp of this unintuitive distinction, consider a simplified variation of the famous Ellsberg paradox.[208] You are asked to bet on heads before a coin toss. There are two

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[205] *Supra* notes 67-86 and accompanying text. *See also* Benjamin J. Richardson, *Mandating Environmental Liability Insurance*, 12 DUKE ENVT'L L. & POL'Y FOR. 293, 301 (2002) ("Complete uncertainty about the extent of the risks would resemble a naked gamble, while a future entirely predictable would make insurance superfluous.").

[206] *See, e.g.*, Daniel A. Farber, *Uncertainty*, 99 GEO. L.J. 901, 903 (2011) ("Our society has sophisticated techniques for analyzing risks that can be modeled and quantified. But other threats [...] do not fit the paradigm.").

[207] Originated from the seminal work of economist Frank Knight. *See generally* FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921). For a discussion see Itzhak Gilboa & Massimo Marinacci, *Ambiguity and the Bayesian Paradigm, in* 1 ADVANCES IN ECONOMICS AND ECONOMETRICS: TENTH WORLD CONGRESS 179, 181 (Daron Acemoglu, Manuel Arellano & Eddie Dekel, eds., 2013) ("Knight suggested to distinguish between "risk," referring to situations described by known or calculable probabilities, and "uncertainty," where probabilities are neither given nor computable.").

[208] *See* Daniel Ellsberg, *Risk, Ambiguity and the Savage Axioms*, 75 Q. J. ECON. 643 (1961). To convey the original paradox, Ellsberg pictured an urn containing ninety balls: thirty are known to be yellow, whereas the other sixty are either blue or red (the blue-red ratio is unknown). A decision-maker is asked to randomly take out a ball, and four lotteries are suggested. L_1: the decision-maker receives $100 if she draws a yellow ball (Y); L_2: the decision-maker receives $100 if she draws a blue ball (B); L_3: the decision-maker receives $100 if she draws either a yellow (Y) or a red ball (R); L_4: the decision-maker receives $100 if she draws either a yellow (Y) or a blue (B) ball. Ellsberg noted that subjects prefer L_1 to L_2 but L_4 to L_3. But this induces a paradoxical result of inconsistent preferences, where on the one hand, $L_1 \succ L_2$ implies $Y \succ B$, and on the other hand, $L_4 \succ L_3$ means $\frac{1}{3}B + \frac{1}{3}R \succ \frac{1}{3}Y + \frac{1}{3}R$, which in turn means $B \succ Y$. Ellsberg explained this inconsistency by fundamental differences in the lotteries at hand: both L_1 and L_4 feature a given probability of winning $100 (the probability of drawing Y, i.e. 33%, in L_1; the probability of drawing "not Y", i.e. 67%,

options: either bet on a coin you took out of your pocket, or alternatively use Andy's coin. You know that your coin is fair, namely, that the probability of heads is objectively 0.5, but you know absolutely nothing about Andy's coin: it is possible that his coin is biased in favor or heads, biased in favor of tails, or that it is also a fair coin. Now, would you prefer to use your coin or Andy's? Arguably, you should be indifferent, as both cases feature equivalently uncertain outcomes—the first coin provides you with even odds, and the second coin provides you with either higher odds, lower odds, or even odds as well, where each contingency occurs with an unknown probability. But you are probably not indifferent, because it feels rather different to make decisions based on known probabilities regarding uncertain outcomes, compared to decisions based on putative odds. Given the choice, most individuals prefer an environment where they are aware of the actual probability of an outcome, rather than a setting in which they ought to conjecture it.[209] This phenomenon is known in decision sciences as *ambiguity aversion*.[210] Even when individuals are equally likely to win in each setting, they do not hold both tantamount: in the first they take a calculated risk; in the second they just gamble.

Back to insurance. Insurers operate best under *known* probabilities. They work with those probabilities to develop actuarial models that estimate losses, assign optimal premiums to insureds, and diversify risk throughout the insurance pool.[211] Known probabilities, in other words, allow insurers to offer profitable risk-bearing services.[212] When insurers choose to strategically settle,

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in L_4), whereas both L_2 and L_3 entail unknown probabilities of winning $100. Ellsberg thus demonstrated that what guides individuals' choice is aversion to unknown probabilities.

[209] The coin analogy which simplifies the Ellsberg paradox has been originally proposed by mathematician David Schmeidler. *See* Itzhak Gilboa, *Introduction*, *in* UNCERTAINTY IN ECONOMIC THEORY 3, 4-6 (Itzhak Gilboa, ed. 2004).

[210] *Id*., at 16.

[211] *See* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 946-47 (1988).

[212] *Id*., at 947.

they do not do so in order to make the probability of the loss unknown, but to make sure that this probability is neither 1 nor 0, and preferably not anywhere near those values. The reason is that extreme probabilities involve no risks, thus making legal outcomes predictable, obviating the need for insurance, and reducing demand for policies. But the insurance industry cannot function when probabilities are utterly unknown, that is, when there are not even baseline liability rules that allow insurers to engage in any informative risk assessment. In those cases, insurance coverage may not be offered in the first place or, alternatively, insurance companies may attempt to litigate and allow courts to set up basic doctrinal building blocks that facilitate risk estimation by insurers.[213]

Environmental liability insurance, which mainly covers cleanup duties upon contamination events, provides a proper illustration.[214] The enactment of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) in the 1980s created an exogenous shock in the environmental liability insurance market.[215] CERCLA imposed strict, retroactive liability for abandonment of hazardous waste disposal on "responsible parties"—mostly industrial companies.[216] This created a twofold crisis in the insurance industry: one pertaining to future losses on account of the new liability regime, considering the sheer uncertainty surrounding future legal outcomes;[217] the other concerned the question of whether existing policies apply to retroactive

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[213] For an example outside the realm of liability insurance, involving the elucidation of contestability clauses in life and disability insurance policies, see Ronen Avraham & William H.J. Hubbard, *Civil Procedure as the Regulation of Externalities: Toward a New Theory of Civil Litigation*, 89 U. CHI. L. REV. 1, 36 n.73 (2022).

[214] *See, e.g.*, Environmental Insurance, AON, https://www.aon.com/en/capabilities/risk-transfer/environmental-insurance; Environmental Liability, LIBERTY MUTUAL INS. https://business.libertymutual.com/commercial-solutions/environmental-liability/.

[215] 42 U.S.C. § 9605-75 (1988).

[216] *See, e.g.*, Justin R. Pidot & Dale Ratiliff, *The Common Law of Liable Party CERCLA Claims*, 70 STAN. L. REV. 191, 200-15 (2018) (reviewing the main provisions of CERCLA).

[217] *See id.*, at 216-17 (explaining that CERCLA has been poorly drafted, and that legislators thought that "courts should fill gaps left in the statute based on common law principles [in accordance with] the traditional role assigned to courts interpreting statutes. This is particularly so where a statutory gap relates to a common law principle like liability.").

CERCLA liability for past contamination.[218] The crisis distorted the underwriting process: insurers could not have accurately estimated risks of losses, leading to many of them exiting the market for environmental liability coverage altogether.[219] The market has thus been tightening, ultimately resulting in the unavailability of certain coverage as well as inflated premiums.[220]

In response to this uncertainty, and following multiple claims brought against insurers by industry participants for coverage of retroactive liability, insurers repeatedly refused to settle CERCLA-related lawsuits and actively litigated claims for the sake of both disputing coverage of retroactive liability and developing the basics of environmental liability insurance doctrine post CERCLA.[221] As opposed to the examples discussed above, wherein insurers settled in order to obfuscate liability standards, insurers' underlying objective was to force courts into establishing foundational doctrines that would allow for more reliable risk assessment.[222] Insurers thus sought to define the contours of liability under CERCLA, creating rules that may be used as a baseline for underwriting decisions and actuarial models. Once preliminary judicial decisions—primarily by state courts—indeed provided doctrinal building blocks, settlements have in fact become more prevalent.[223] With the foundation of predictable probabilities, insurers could more effectively

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[218] *See* United States v. Ne. Pharm. & Chem. Co., 810 F.2d 726, 732-33 (8th Cir. 1986) (noting that "CERCLA does not expressly provide for retroactivity" and yet Congress clearly intended to apply it retroactively, and "[i]n order to be effective, CERCLA must reach past conduct.").

[219] *See, e.g.*, Abraham, *supra* note 211 at 943.

[220] *Id.*

[221] *See* Kenneth A. Abraham, *Cleaning Up the Environmental Liability Insurance Mess*, 27 VAL. U. L. REV. 601, 606 (1993) (arguing that insurers aspired to litigate since the abundant legal uncertainty resulted in a lack of any reference point to negotiate around policy terms).

[222] *See id* (tying the utterly unpredictable liability standard that pervaded following the enactment of CERCLA to insurers' desire to litigate).

[223] *See, e.g.*, Peri N. Mahaley & Brian G. Friel, *Silence Is Golden: In Support of Confidentiality Provisions in Insurance Settlement Agreements*, 8 ENVT'L CL. J. 127, 127 (1996) (detailing that "[s]ettlements in insurance coverage cases involving environmental and other long-term exposures are on the rise..." and adding that "[w]ith this increase in settlements has come an increase in the prominence of confidentiality provisions in settlement agreements."); Pidot & Ratiliff, *supra* note 216 at 196-97 (noting

manage risk and accurately price environmental liability policies. This illustrates the delicate balance that insurers must strike: while extreme probabilities (either 0 or 1) eliminate the need for insurance, probabilities that are entirely unknown make insurance unfeasible.[224] By litigating CERCLA, insurers sought to ensure a workable—rather than certain—legal environment.

Our general conclusion on liability standards is that insurers thrive in environments where probabilities are known but uncertain, allowing them to offer profitable risk-bearing services. When probabilities are either extreme or indeterminate, insurance markets struggle to function. Insurers strategize to preserve known and uncertain probabilities, and this requires combination of litigation and settlement. If doctrine is insufficiently developed so that risk is not assessable, litigation is the better option for insurers—which was indeed the case with CERCLA. But if the doctrine is threatening to develop to the point that legal outcomes become increasingly clear and predictable, risk might be eliminated, so settlement that precludes further development is advantageous from their perspective.

C. *Enforceability of Policy Clauses*

The next class of cases in which insurance companies strategically secure ambiguity by dint of settlement revolves around the preservation of unenforceable (or, at the very least, dubiously enforceable) policy terms. As opposed to the settlement incentives discussed previously, the motivation behind settling to avoid court determination on obscure policy clauses is not quite to sustain demand ex ante, but rather to leverage the unpredictable legal regime into a better negotiation standpoint with policyholders of aggrieved third parties. The Section concentrates

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that in the long run, the number of CERCLA cases filed annually declined substantially, and attributing this outcome to settlements).

[224] *See, e.g.*, Richardson, *supra* note 205 at 301.

mostly on liability insurance policies, but most of the examples it puts forth actually apply more broadly, encompassing first-party insurance as well.

Begin with terms that use vague language—the archetype of questionable policy clauses. To combat deliberately obscure language in uniform contracts—realizing that consumers hardly ever read the conditions stipulated in them but rather rely on their general understanding of the agreement[225]—courts apply the doctrine of *contra proferentem*, interpreting ambiguities against the drafter.[226] In the case of insurance, this leads them to find against the insurer and in favor of the policyholder.[227] As a result, vague clauses that aim to restrict coverage often fail when challenged in court.[228] The *contra proferentem* principle is designed to induce drafters of boilerplate contracts in general and insurers in particular to use clear, intelligible language, as any opportunistic attempt to wiggle themselves off their obligations will be denied by the court.[229] But insurers are hardly ever deterred by the prospect of adverse interpretation, and despite the *contra proferentem* doctrine, insurance policies routinely use vague language that obfuscates their coverage duties.[230] How come, despite the discouraging effect that the *contra proferentem* doctrine should have, ambiguity has become the widely recognized hallmark of insurance policies?

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[225] *See generally* Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545 (2014).

[226] *See, e.g.*, Shelby County State Bank v. Van Diest Supply Co., 303 F.3d 832, 838 (7th Cir. 2002) (explaining that *contra proferentem* is "the rule requiring that ambiguous language must be construed against its drafter" and providing rationales for its adoption).

[227] *See generally* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation* 95 MICH. L. REV. 531 (1996) (discussing the centrality of *contra proferentem* to the jurisprudence of insurance policy interpretation).

[228] *Id*., at 532 ("*Contra proferentem* [is] so frequently invoked by the courts in insurance cases that the casual observer might well suppose that the *true* first principle of insurance law is that insurance disputes are generally resolved in favor of coverage.").

[229] For a historical review see Joanna McCunn, *The* Contra Proferentem *Rule: Contract Law's Great Survivor*, 39 OXFORD J. LEGAL STUD. 483 (2019).

[230] *See, e.g.*, New Castle County, Del. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 243 F.3d 744, 755 (3d Cir. 2001) (noting that insurers keep using ambiguous terms despite legal decisions that render them opaque and thus subject to *contra proferentem*).

The key is insurers' strategic use of settlements. First, some have suggested that many of these opaque clauses are not even scrutinized by courts; insurers frequently settle disputes arising from ambiguous terms to prevent them from being invalidated outright.[231] Settlements preclude courts from ruling on the enforceability of these provisions, allowing insurers to retain them in future policies. So why use them? Because the mere presence of these clauses deters uninformed, legally disoriented insureds from pursuing claims, creating an appearance of limited coverage.[232] In other words, limiting terms serve as a costless instrument for deterring claims: insureds would either mistakenly believe that their coverage is limited or sue, in which case the insurer would opt for settlement. In any event, the insurer is better off with ambiguity, and what allows for it to persist is its desire to settle disputes with informed, sophisticated policyholders who know that vague coverage clauses would be invalidated once reaching judicial review.[233] And those vagueness-retaining settlements are potentially ubiquitous. Daniel Schwarcz, for instance, notes that "[c]overage disputes involving relatively important policy terms may be disproportionally likely to settle before any case is published, as insurers may fear that a negative precedent can have broad implication."[234]

This practice is not confined to mere ambiguous language. Sometimes the language of insurance-related agreements is plain and lucid but formulates a legally controversial term. Insurers' reliance on settlements actually serves to veil their routine use of debatably enforceable

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[231] *Infra* notes 232-257 and accompanying text. *See generally* Cathy Hwang, *Faux Contracts*, 105 VA. L. REV. 1025, 1068 (2019) (explaining the high rate of settlements in contract disputes involving sophisticated parties).

[232] *See* Charles A. Sullivan, *The Puzzling Persistence of Unenforceable Contract Terms*, 70 OHIO ST. L.J. 1127, 1136-37 (2009) (naming strategic settlement as a tactic deployed by drafters for preserving unenforceable clauses in contracts).

[233] For the distinction between sophisticated and unsophisticated consumers see generally Ezra Friedman, *Competition and Unconscionability*, 15 AM. L. & ECON. REV. 443 (2013).

[234] *See* Daniel Schwarcz, *The Role of Courts in the Evolution of Standard Form Contracts: An Insurance Case Study*, 46 B.Y.U. L. REV. 471, 499 n.144 (2021).

clauses in an attempt to dupe policyholders into believing that coverage is limited. Those who fall for the gambit believe that their coverage is barred and thus avoid claiming it in court; those who don't receive their deserved amount in settlement. A paramount example is liability waivers, which high-risk businesses such as gyms or adventure tourism regularly require clients to sign.[235] Although these agreements are potentially unenforceable—courts often perceive them as conflicting public policy and strike them down[236]—a recent study by Edward Cheng, Ehud Guttel, and Yuval Procaccia indicates that insurance companies consistently work to entrench the use of liability waivers among their insured businesses, just as another costless instrument for deterring lawsuits.[237] For instance, the authors cite insurance companies who bluntly recommend it, stating that despite their potential unenforceability, liability waivers "may have a psychological impact and actually deter some [injured parties] from filing lawsuits."[238] Insurers' recommendation to use those liability waivers certainly causes us inconvenience to a certain extent, but incentivizing them by reducing premiums to businesses who use them and even stipulating their use as a prerequisite for insurance coverage, is utterly unsettling. Cheng, Guttel, and Procaccia point to the remarkable pervasiveness of this phenomenon.[239] Specifically, they attest that:[240]

> "Insurance companies—perhaps for the […] psychological deterrence reasons—often either require policyholders to use

[235] *See, e.g.*, Mohler v. Kipu Ranch Adventures, LLC. Civ. No. 13-00611, 2014 WL 5817538 (D. Haw. Nov. 7, 2014); Royal Caribbean Cruises Ltd., 991 F. Supp. 2d 1171 (S.D. Fla. 2013); Walters v. YMCA 96 A.3d 323 (N.J. Super. Ct. App. Div. 2014).

[236] *See generally* Tunkl v. Regents of University of California, 383 P.2d 441 (Cal. 1963) (stipulating the conditions for the unenforceability of liability waivers based on the public policy doctrine). For a discussion see generally Keith N. Hylton, *Waivers*, 102 NEB. L. REV. 172 (2023).

[237] Edward K. Cheng, Ehud Guttel & Yuval Procaccia, *Unenforceable Waivers*, 76 VAND. L. REV. 571 (2023).

[238] *Id.*, at 589 (citing *FAQs*, SPORTSINSURANCE.COM, https://www.sportsinsurance.com/faqs/).

[239] *Id.*, at 591.

[240] *Id.*

> liability waivers in their activities, or make it a factor in determining premiums or coverage. Policyholders who neglect to obtain the required liability waivers run the risk of having their claims denied. Various industry or sporting associations also require waivers of liability for events associated with their organizations, sometimes purportedly for reasons connected with insurer requirements."

The psychological deception of injured third parties is thus dual. To recover damages, they need to realize that waivers are unenforceable vis-à-vis the insured as well as the insurer. In other words, they need to disregard both their signature on the original waiver—which seemingly withdraws their right to sue the business—as well as the insurance company's opportunistic attempt to dispute coverage and leave them in a legal dispute against a potentially insolvent injurer.[241] But even if third parties are sufficiently sophisticated to do so, insurers can settle to avoid a court ruling that proclaims their clause's general unenforceability. If courts were to definitively rule that a clause conditioning coverage on the use of waivers is invalid—which is tantamount to saying that the term in question is unenforceable—it would undermine insurers' ability to rely on these provisions to limit claims, because slowly but surely, businesses and third parties in general would assimilate those waivers' inconsequentiality. What makes their use attractive to insurers is the doubt—the risk that courts would find them enforceable after all—which is sustained due to the lack of coherent case law and the repletion of settlements.[242] Proposals to combat this kind of practice, chief among them is the call for punitive damages against

[241] *See also supra* notes 134-143 and accompanying text.

[242] *See* Daniel Wilf-Townsend, *Deterring Unenforceable Terms*, 111 VA. L. REV. *42 n.165 (forthcoming 2025) (highlighting that "a rational plaintiff [is incentivized to accept a settlement] that benefits both parties but leaves the defendant under-deterred.").

insurers that rely on unenforceable liability waivers,[243] may only exacerbate the problem: insurers would be further pushed into settling and avoiding conclusive court determinations.[244]

There are many examples of controversial policy clauses that are routinely in use, and their doubtful enforceability would remain so—to the benefit of insurers and the detriment of policyholders, especially unsophisticated ones—so long as settlements are omnipresent. Anti-assignment clauses, for instance, restrict policyholders' ability to transfer their policy rights to another party post loss without the insurer's consent.[245] Courts sometimes admit these clauses, but in many cases refuse to uphold them.[246] Yet insurers constantly include them in policies.[247] Interestingly, legal uncertainty is at once what allows them to use anti-assignment provisions and what motivates them to do so. Coverage-disputing insurers may assert those anti-assignment clauses against policyholders who do not possess the financial wherewithal required to claim coverage in court, settling for a reduced amount. By the same token, those clauses are there to

[243] *See* Cheng, Guttel & Procaccia, *supra* note 237 at 601 ("Punitive damages will deter defendants from using unenforceable waivers ex ante and provide well-tailored remedy when defendants attempt to dupe would-be plaintiffs ex post.").

[244] *See* Wilf-Townsend, *supra* note 242 at *42 ("[A] defendant facing potentially significant punitive damages would have a strong incentive to settle any disputes before they were adjudicated in court.").

[245] *See* RESTATEMENT OF L. OF LIAB. INS., *supra* note 1 at § 36(1). *See also* Paul MacMahon, *Contract Law's Transferability Bias*, 95 IND. L.J. 485, 486 (2020) (defining the law of assignment as "the body of doctrine mostly responsible for governing transfers of contractual rights....").

[246] *See generally* John T. Waldron, III & Andrew R. Stanton, *Assignment of Liability Insurance Rights for Latent Injury and Damage Claims*, 14 CONN. INS. L.J. 389 (2007) (surveying case law on the enforceability of anti-assignment clauses in insurance policies).

[247] *See, e.g.*, Quinton T. McNitt, *Derechos, Tornadoes, and Cyclones, Oh My: How Iowa Can Reform Assignment of Benefits Law in Property Insurance*, 109 IOWA L. REV. 403, 409 (2023) (explaining that anti-assignment clauses are included in policies due to the *contra proferentem* principle that would definitely invalidate any insurer claim for anti-assignment unless explicitly stated in the policy).

avoid encounters with sophisticated third parties, such as litigation funders, who may spot legally dubious terms, challenge them in court and receive full coverage.[248]

Notice-of-claim requirements offer yet another illustration of how insurers can take advantage of doctrinal uncertainty and thus aspire to preserve it. Notice-of-claim conditions impose strict deadlines for reporting losses, and late notice may void coverage.[249] Court determination on what constitutes "timely" notice is inconclusive, and according to Baker and Logue, notice requirements in general are "a matter of controversy in insurance law."[250] This ambiguity allows insurers to wield these clauses strategically, deterring naïve insureds and making sure that legal doctrine remains in the dark by settling with those who attempt to dispute a draconianly stringent notice requirement.[251]

Similarly, policies regularly preserve a broad and absolute subrogation right,[252] even though the enforceability of this right is obscure, unpredictable, and often depends on the specific circumstances of the claim.[253] But this unpredictability is again useful to insurers. Suppose, for

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[248] *See generally* Tom Baker, *What Litigation Funders Can Learn About Settlement Rights from the Law of Liability Insurance*, THEORETICAL INQ. L. (forthcoming, 2025). Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4638617.

[249] *See* RESTATEMENT OF L. OF LIAB. INS., *supra* note 1 at § 35(1). *See also* Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 134 (2008) (listing notice requirements among "procedural restrictions applicable generally to multiple lines of insurance....").

[250] Tom Baker & Kyle D. Logue, *Mandatory Rules and Default Rules in Insurance Contracts, in* RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 377 (Daniel Schwarcz & Peter Siegelman, eds. 2015). *See also* RESTATEMENT OF L. OF LIAB. INS., *supra* note 1 at § 35(1) (establishing that the insured's failing to satisfy a notice-of-claim policy condition excuses an insurer from coverage "only if the insurer demonstrates that it was prejudiced by the failure.").

[251] *See, e.g.*, ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW § 81[c], at 575 (5th ed. 2012) ("Most policies purport to require the insured to give the notice 'immediately,' 'as soon as practicable,' or 'as soon as possible,' but courts have interpreted this language as requiring notice to be given within a reasonable time in light of all the circumstances.").

[252] Subrogation is an insurer's right to recover payments that it transferred, either from the insured or from a third party. *See generally* Alan O. Sykes, *Subrogation and Insolvency*, 30 J. LEGAL STUD. 383 (2001).

[253] *See* Chaim Saiman, *Is Insurance "Just a Contact" Or a "Just Contract"?*, 83 MD. L. REV. 819, 846-48 (2024).

example, that a policyholder has inflicted harm on a third party, and this harm is dubiously intentional. We have already established that the jurisprudence of intent is vague exactly due to the routine use of settlements with victims,[254] but note that there is also the possibility that the court would allow coverage but let the insurer subrogate the claim against the policyholder.[255] If both the victim and the insured are risk averse, each of them is deterred by the prospect of a court judgment: the former by the excuse of coverage, the latter by the upholding of coverage along with the affirmation of the insurer's subrogation right. On occasion, this might result in the victim and the insured settling without even involving the insurer, and in any event, this dual uncertainty increases the insurer's bargaining power, paving the way toward a favorable settlement.

Another noteworthy point is that insurers can utilize their policy to maintain legal uncertainty without even resorting to settlements, by establishing mandatory arbitration clauses. These clauses require policyholders to resolve any coverage dispute through arbitration, rather than litigation.[256] Arbitration decisions are private and non-precedential, which means that even if an arbitrator interprets a provision against the insurer, the decision does not establish a rule that would affect future policies or disputes. This lack of transparency benefits insurers by allowing them to manage claims on a case-by-case basis, without the systemic impact of a judicial ruling. As Susan Randall stresses:[257]

> "The confidentiality of arbitration proceedings and awards shields an insurer's practices from the public scrutiny that accompanies the

[254] *Supra* notes 134-143 and accompanying text.

[255] *See* Baker & Logue, *supra* note 250 (discussing this possibility).

[256] *See, e.g.*, Omri Ben-Shahar, *The Paradox of Access to Justice, and Its Application to Mandatory Insurance*, 83 U. CHI. L. REV. 1755, 1795-1798 (2016) (discussing the difficulties and inequities that may arise from insurers' excessive use of mandatory arbitration clauses).

[257] Susan Randall, *Mandatory Arbitration in Insurance Disputes: Inverse Preemption of the Federal Arbitration Act*, 11 CONN. INS. L.J. 253, 258 (2004).

> judicial process and thus may permit continuation of those practices. Where confidentiality is required, an insurance company may avoid publicity which can result in similar claims, or a decrease in public confidence, minimizing and perhaps eliminating […] bargaining points important to policyholders in settlement negotiations. Thus, insurance companies have much to gain from confidentiality while individual insureds, and insurance consumers collectively, have a great deal to lose."

Before concluding, we should again caveat our discussion and underscore that the advantageousness of settlement from insurers' perspective does not imply that litigation incentives are eroded in their entirety. Some have argued on the contrary, noting that in order to perpetuate ambiguous coverage terms, insurers actually use anti-drafter doctrines such as *contra proferentem*, rather than evade it. Michelle Boardman's influential work demonstrates this surprising phenomenon.[258] Boardman emphasizes that insurers are not necessarily better off with a completely opaque clause because they themselves need to know how courts would treat such clauses. Recall the distinction made in the previous Section between known and unknown probabilities.[259] Insurers cannot properly calculate their steps when they confront the latter ones. In other words, they "care more that a clause have a *fixed* meaning rather than a *particular* meaning…."[260] Once a court interprets the clause in question, whether upholding or invalidating it, insurers keep using it exactly thanks to the clarity the court has now shed. According to

[258] *See generally* Michelle E. Boardman, *Contra Proferentem: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105 (2006).

[259] *Supra* notes 206-210 and accompanying text.

[260] Boardman, *supra* note 258 at 1107.

Boardman, this private communication between insurers and courts, which develops a well-organized jurisprudence on the actual meaning of recurring boilerplate policy clauses, incentivizes insurers to cling to those clauses rather than clarifying them.[261] The reason is that it creates inherent asymmetry between insurers and uninformed policyholders. For instance, whether loss of data qualifies as "property damage" under an insurance policy is unclear.[262] After a court ruling in favor of the first policyholder that sues, insurance companies know that "property damage" includes data loss.[263] This will *not* discourage insurers from disputing coverage against future claimants, but allow them to anticipate the outcome of a potential trial and calibrate themselves accordingly—to hoodwink naïve policyholders into believing that the harm at hand is uncovered, or to settle with litigious insureds. Insurers thus use settlement to avoid recurrence of litigation around clauses that courts have already found invalid. As Boardman explains, "[i]f new language is introduced, […] it likely will be litigated until a settled meaning until a settled meaning is found. This insurers do not want to do."[264]

So, the crux is ultimately the same. All the above exemplifies how insurers leverage ambiguity that surrounds the enforceability of policy clauses. Settlements prevent judicial determinations that could definitively strike down such clauses, preserving their utility in discouraging insureds and claimants from pursuing challenges. They thus sustain an insurance market wherein liability and coverage terms remain strategically uncertain.

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[261] *Id*., at 1111.
[262] *Id*., at 1115.
[263] *Id*.
[264] *Id*., at 1124-25.

IV. NORMATIVE TAKEAWAYS

A. *The Social Costs and Benefits of Insurance*

Insurance is traditionally perceived as an institution that removes risk, incentivizing loss-prevention through its quasi-regulatory influence: insurance induces policyholders to exercise care by adjusting premium levels to riskiness, conditioning coverage upon the exhibition of sufficient prudence, and educating insureds on the implementation of precautionary means and methods that would at once reduce the expected loss confronted by insurers and diminish premium rates.[265] If so, we may confidently state that insurance is a socially beneficial mechanism: the fact that large, deep-pocket entities actually have a skin in the game of loss-prevention, most naturally results in the elimination of risks.

But as it turns out, only half of this story is true. Insurers certainly lose when risk materializes, but bear in mind that the existence of risk is also their main source of income. This means that insurers would exert efforts against *materialization* to minimize losses but have a strong interest in maintaining or even exacerbating the *presence* of risks to maximize revenues.[266] This distinction—between the interest in preserving risks and the interest in avoiding their realization—is not easy to make, but it is crucial for the adequate understanding of the workings of insurers. Insurers aspire to strike some ideal balance between sustaining demand for their products and reducing their expenses, yet both are affected by the level of risk in society. When the environment is insufficiently risky, policies might not be attractive enough to acquire, and the insurance market

[265] *See generally* Ben-Shahar & Logue, *supra* note 5.
[266] *See generally* Avraham & Porat, *supra* note 67.

is doomed to collapse; when the environment is excessively risky, it might not be worthwhile to supply coverage against risk and the marketplace for insurance once again vanishes.[267]

Very broadly and somewhat oversimplistically, we may say that in order to preserve risks ex ante but avoid their materialization ex post, insurers work to uphold exogenous, ex ante foundation of risks—that is, the source of the risk which is outside the policyholder's control—but to eliminate any endogenous contribution the policyholder may have ex post, either on the magnitude or the likelihood of loss. Exogenous risks are sustained by insurers to preserve the need for their products; endogenous risks are reduced to minimize payouts and maintain profitability. For instance, insurers offering car accidents coverage would hardly ever want to get rid of the risk of accidents altogether.[268] But once insurance is acquired, they would work to remove any excess risk associated with the policyholder's contribution, such as unsafe driving, poor vehicle maintenance, and a host of other negligent practices that may be a source of increased expenses when claims arise.[269] So, insurers rely on the continuous presence of exogenous risks to sustain demand for their products while simultaneously seeking to control endogenous risks to minimize expenditures. This insight is not unique to insurers, of course. Anyone who profits from correcting, fixing or remediating adverse occurrences might ultimately suffer from the complete eradication of such occurrences. Pharmaceutical companies work vigorously to cure diseases, but if society could have eliminated any illness and secure health for all, there would be no further need for their products. Any major reduction in crime rates would result in lower profits for private prisons. And

[267] *See, e.g.*, Richardson, *supra* note 205.
[268] *Supra* notes 75-82 and accompanying text.
[269] Baker & Swedloff, *supra* note 54 at 1427-31.

the list goes on and on. But with insurance companies—some of the most powerful and highly influential economic actors—this understanding has stayed under the radar until quite recently.[270]

As the present contribution demonstrates, a prominent type of exogenous risks that insurers wish to preserve is the one of legal risks, doing so by dint of settlements. Insurers benefit from ambiguous legal commands that fail to provide clear directions and thus drive demand for insurance. Since liability insurers depend on the constant existence of legal uncertainties and third-party claims to justify the need for policies, they have a strong incentive to maintain those risks rather than eliminating them. The persistent work to uphold legal risks through settlements translates into loss to both policyholders and third parties.

1. Policyholders

At first blush, it might seem that policyholders benefit from insurers' inclination to settle cases that may clarify ambiguous liability standards. After all, this is the very objective of lawmakers' adoption of the duty to settle.[271] When insurers settle, they avoid the conflict of interest that arises when their incentives diverge from those of insureds. The insurer's desire to avoid judicial scrutiny realigns settlement motivations, counteracting its purported tendency to gamble at the expense of insureds by proceeding to litigation.[272] We may thus say that insurers' strategic reliance on settlement to preserve legal risks could neutralize the oft-cited tension between limited liability and insurers' duty to defend claims brought against policyholders.[273]

The problem is that this is only true when taken shortsightedly, because the long-term implications of insurers' settlement practices on the liability landscape is much less favorable to

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[270] *See generally* Abraham & Schwarcz, *supra* note 71; *cf.* Avraham & Porat, *supra* note 67.
[271] *Supra* notes 25-44 and accompanying text.
[272] *Id*.
[273] *Id*.

policyholders. In selectively settling the cases that could translate ambiguous liability standards into concrete legal directives on how to avoid liability, insurers manage to perpetuate a legal environment in which uncertainty reigns. This obscurity is strategically advantageous to insurers and, for the same reason, detrimental to current and future policyholders.

First, the persistence of legal risks increases dependency on insurance. The sustained ambiguity around key liability factors, such as the exact meaning of intent,[274] negligence,[275] and policy exclusions,[276] would inevitably compel policyholders to rely more heavily on liability insurance to hedge against unpredictable risks. Businesses and individuals confronting opaque liability standards—opaqueness that would have ideally been resolved or at least alleviated through litigation—must purchase more comprehensive and, as will be shown momentarily, costlier insurance policies. The maintenance of legal risks thus tightens the market grasp of insurers: enhancing the dependency of actors on insurance of course results in increased leverage enjoyed by insurance carriers. The market position wielded by insurers is likewise due to uncertain policy terms, that are also guaranteed by settlements.[277] The absence of a clear, bright-line distinction between the permissible and the forbidden in terms of coverage implies that what would determine the outcome of coverage negotiations after a loss occurs is the insurer and the insured's relative bargaining power and risk attitude—a scenario that typically provides an inherent advantage to the former one.[278] Insureds, particularly ones with limited financial and legal

[274] *Supra* notes 125-178 and accompanying text.
[275] *Supra* notes 179-224 and accompanying text.
[276] *Supra* notes 225-264 and accompanying text.
[277] *See generally id*.
[278] It is customary to treat insurers as risk neutral and insureds as risk averse. *See, e.g.*, Johannes G. Jaspersen & Andreas Richter, *The Wealth Effects of Premium Subsidies on Moral Hazard in Insurance Markets*, 77 EUR. ECON. REV. 139, 141-42 (2015); Rubinstein & Yaari, *supra* note 64 at 77-78. Similarly, the insurer is normally regarded as the party with elevated bargaining power. *See, e.g.*, Omri Ben-Shahar, *A Bargaining Power Theory of Default Rules*, 109 COLUM. L. REV. 396, 419 (2009) (attesting that the insured is the weaker party, i.e., "the party with the lesser bargaining power.").

resources, are left with little choice but to accept the insurer's position and settle for a less favorable outcome.[279]

Same with premium pricing. When there is complete knowledge of the enforceability or invalidity of certain policy terms, premiums reflect the objective risk of liability.[280] In the absence of complete knowledge, ambiguity once again allows relative bargaining power and risk attitude to dictate pricing dynamics—the cost of uncertainty is passed onto the weaker party or the one that is more risk averse, which in the insurance context implies increased premiums. In effect, policyholders end up subsidizing the insurer's strategy of maintaining legal uncertainty, bearing financial losses that are neither transparent nor proportional to their individual risk exposure.

2. Third Parties

In assessing the broad impact of insurance on social welfare, it does not suffice to discuss the bilateral relationship between insurers and insureds. A general-equilibrium analysis is required, spotlighting the costs and benefits of insurance to third parties, too.[281] The third-party paradigm in insurance scholarship is surprisingly young, and has been originally espoused by Gideon Parchomovsky and Peter Siegelman's 2022 article on "Third Party Moral Hazard."[282] Parchomovsky and Siegelman, as well as their followers, note that third parties tend to enhance

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[279] *See generally* John F. Nash, *The Bargaining Problem*, 18 ECONOMETRICA 155 (1950) (seminally demonstrating that relative bargaining power determines the division of a transaction surplus between contracting parties, with the stronger party receiving a greater share).

[280] *See, e.g.*, Peter Siegelman, *Information and Equilibrium in Insurance Markets with Big Data*, 21 CONN. INS. L.J. 317, 332 n.42 (2014) (explaining that in perfectly functioning insurance markets—markets without competition- or information-related failures—premiums are supposed to reflect expected risk).

[281] On the conceptual importance see generally Elhanan Helmpan & Jean-Jacques Laffont, *On Moral Hazard in General Equilibrium Theory*, 10 J. ECON. THEORY 8 (1975).

[282] Gideon Parchomovsky & Peter Siegelman, *Third-Party Moral Hazard and the Problem of Insurance Externalities*, 51 J. LEGAL STUD. 93 (2022).

their willingness to take risks in the presence of insurance.[283] The reason is that when a deep-pocket actor is involved, compensation is secured and thus third parties ignore any loss covered by insurers.[284] For instance, creditors were willing to grant irresponsible loans to "too big to fail" businesses prior to the 2008 financial crisis for anticipating governmental bailout—which is tantamount to bankruptcy insurance—if those businesses would ever become insolvent.[285] Similarly, the presence of D&O insurance often increases incentives for shareholder litigation.[286]

But while the third-party scholarly outlook centers on third party's opportunistic exploitation of insurance, it has become completely oblivious to the reverse problem whereby insurers opportunistically exploit third parties—mainly victims in the context of liability insurance.[287] Insurers' strategic use of settlements leaves these parties uncertain about whether they can secure full recovery for their losses. Facing the prospect of unclear liability standards and coverage terms, third parties often accept settlements for amounts lower than they could have been compensated if courts were to clarify the relevant legal principles.[288] Again—the burden of legal ambiguity is shifted onto the most vulnerable party, as in the case of EPL insurance.[289]

In maintaining legal ambiguity, insurers could negotiate from a position of strength. This phenomenon distorts the compensation process, which is at once unjust and inefficient. Unjust—because it leaves victims undercompensated and undermines core fundamentals of fairness under

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[283] *See generally id*.
[284] *See generally id*.
[285] *Id*., at 110.
[286] *Id*., at 97-99.
[287] An exception is Roy Baharad, *Deterrence by Insurance*, 54 J. LEGAL STUD. 239 (2025) (demonstrating that insurers might have weaker incentives to monitor and discipline insureds when the cost of their risky behavior is externalized on third parties rather than on insurers).
[288] *Supra* notes 134-143.
[289] *See, e.g.*, Meyers & Hersch, *supra* note 134 at 977.

the insurance system.[290] Inefficient—because it overdeters potential victims of tortious actions and thus induces them to take excessive precautions to avoid suffering a possibly uninsured harm.[291] In brief, while standard accounts suggest that third parties might create excessive risks and externalize it on insurers, the present framework of analysis notes that third parties are often the ones suffering from risk externalities created by insurers.

B. *Possible Solutions*

1. Establishing an Equivalent Duty to Litigate?

Against the common understanding that insurers might be reluctant to accept reasonable settlements that would primarily benefit policyholders, lawmakers have adopted the duty to settle, which mandates insurers to accept any commercially reasonable settlement offer.[292] The analysis in this Article reveals a complementary concern: insurers' willingness to pursue settlements that preserve legal ambiguity to their advantage, at the expense of broader social interests in litigation. Intuitively, we may say that in order to resolve a problem that mirror-images insurers' strategic avoidance of settlements, we need a doctrine that mirror-images insurers' duty to settle. So perhaps the most trivial solution involves the embracement of "a duty to litigate"—a doctrine that limits insurers' ability to settle cases where litigation could clarify ambiguous legal standards, benefiting society at large. As the duty-to-settle's counterparty, such a doctrine would not preclude settlements in their entirety, but allow policyholders to challenge strategic settlement decisions by insurers. In the exact same way that insurers' ability to strategically litigate is curbed by the duty

[290] *See, e.g.*, Jaspersen & Richter, *supra* note 278 at 142 (defining an "actuarily fair" environment as a one that generates an insurance contract whose expected value is zero, namely, individuals are charged with premiums equal to the expected risk they confront and receive compensation for a realized loss).

[291] *See, e.g.*, Baharad, *supra* note 287.

[292] *Supra* notes 28-43 and accompanying text.

to settle, insurer's propensity to strategically settle in order to perpetuate legal risks may be inhibited by an equivalent duty to litigate, ensuring that settlement incentives align with society's interests rather than with market-driven motivation for ambiguity. In the past, courts have expressed their willingness to consider such a doctrine. In light of the general duty to make "reasonable" settlement decisions, the Supreme Court of Florida once recognized that when a policyholder asks the insurance company to keep litigating, and the company in turn refuses and settles, the policyholder might be allowed to bring a suit against the insurer provided that the evidence indicates bad faith on part of the latter.[293]

But there are several problems in adopting a mirror-image doctrine that authorizes policyholders to sue whenever the insurer chooses to strategically settle with a view to retain vague liability standards. The first concerns policyholders' reluctance to exercise their right to sue for a socially undesirable settlement. The second involves adverse impact on claimants and tort victims. Consider those problems in sequence.

Begin with the former concern. Under a doctrine enshrining the so-called "duty to litigate," insureds are vested with the right to sue the insurer for settling in a manner that prioritizes its strategic interest in ambiguity over the public interest in clarity. Clearly, however, the policyholder's incentives may not align with the broader societal goal of securing judicial guidance on liability standards. In many cases, the specific policyholder—upon whom the right is bestowed—may certainly prioritize settlement over litigation, even when litigation would ultimately clarify nebulous legal standards. Previously, it was shown that insurers' settlement tendencies harm the insured population as a whole, but for the most part, it is rather beneficial for

[293] *See* Boston Old Colony Insurance Co. v. Gutierrez, 386 So. 2d 783 (Fla. 1980).

the policyholder as a defendant *in the specific case at hand*. The reason is that settlements, especially ones within policy limits, provide immediate financial relief without introducing the risk of an adverse judgment, which may exclude coverage or impose partial liability on the insured.[294] Simply put: for the same reason that the duty to settle exists—prioritizing the interest of the particular insured—the insured would be mostly reluctant to challenge the insurer's decision to settle, even if doing so would advance the broader societal goal of refining legal doctrine.

Moreover, the immediate victims of this "duty to litigate" are likely to be claimants or tort victims—those bringing cases against insured parties. Mandating litigation in cases that insurers might have otherwise settled invariably creates the risk of coverage exclusions even when the insured is held liable.[295] In those cases, the claimants are the main beneficiaries of settlement as a compromise, since a final judgment would result in them uncompensated, bearing the brunt of an unfavorable outcome. Consider the exclusion of intentional acts.[296] In cases involving such an ambiguous exclusion, litigation may well result in a ruling that denies coverage in its entirety.[297] This would clarify the scope of the exclusion for future cases, but leave the current claimant with no ability to recover compensation when the insured is uncovered. Anticipating this possible outcome, along with the insurer's ongoing threat to dispute coverage, claimants often aim for cutting a settlement agreement that would guarantee them at least *some* compensation. This was the case with the class action brought against the Weinstein Company and in a wealth of other suits brought against insurers for events that may or may not fall within the policy exclusions.[298]

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[294] *Supra* notes 125-133 and accompanying text.

[295] As noted, many policy clauses are questionably enforceable, rather than unenforceable as a categorical matter. *See, e.g.*, Cheng, Guttel & Procaccia, *supra* note 237 at 579-82 (discussing legal doctrine applicable to the enforceability of liability waivers).

[296] *Supra* notes 125-133 and accompanying text.

[297] *See generally id*.

[298] *Supra* notes 134-143.

Preventing those settlements, especially in cases where nullification of coverage is a feasible scenario, would only harm claimants by depriving them of the ability to secure the second-best outcome.[299]

2. Market-Based Mechanisms

Due to the difficulties that arise from enshrining a "duty to litigate" as the brethren of the "duty to settle," we need an alternative regime that, on the one hand, will align the settlement incentives of insurers with the ones of society and thus avert strategic settlements done exclusively for the sake of preserving legal risks and, on the other hand, will be operated by actors other than the insured and not inhibit compensation to victims. All point to a new approach to cases that raise suspicion for insurers' interest in strategically settling, which is to allow third parties—such as legal funding firms, public interest groups, or any individual who believes that the suit in question is an asset underpriced by the claimant—*to purchase the rights to the suit while waiving the right to resettle the suit with the insurer*.

This market-based mechanism introduces several important advantages over adopting a mirror-image doctrine that mandates litigation. First and foremost, it would enable entities with an interest in clarifying the law to take over cases that insurers would otherwise settle. In ensuring that unclear legal standards are brought before the court for resolution, it would counterbalance insurers' strong incentive to avoid the development of guiding jurisprudence. This may alleviate

[299] *See generally* Oren Bar-Gill & Omri Ben-Shahar, *Credible Coercion*, 83 TEX. L. REV. 717 (2005) (demonstrating that when threats to inflict an even worse outcome upon counterparties are credible (that is, when insurers are in fact better off with contesting coverage at trial), depriving counterparties of the ability to secure a second-best outcome (that is, to settle) means precluding them an opportunity to escape the worse result (that is, court invalidation of coverage)).

the problem of settlements that perpetuate unclear liability standards and enhance industry participants' dependency on insurers.

Another drawback that may be solved is insurers' taking advantage of vague policy clauses and uncertain coverage exclusions. Specifically, the proposed mechanism would allow actors that are both best positioned to assess a suit's expected value and have the required wherewithal to litigate—such as professional third-party litigation firms or major industrial actors—to opt for purchasing claims that are about to settle for an amount lower than its expected value.[300] This would prompt one of the following two outcomes: either that insurers offer a claimant-unfavorable settlement, which would result in a buyout that necessarily proceeds to a final judgment due to the ban on secondary settlement between the insurer and the third party, or that insurers offer the claimant a fair settlement proposal that reflects the claim's expected value at the outset. The former scenario eliminates legal uncertainty generated by insurer settlements, whereas the latter forces insurers to internalize the cost of such legal uncertainty, rather than leveraging their bargaining standpoint and extract settlements for low payouts. To see this, consider again the exclusion of intentional acts.[301] Two widely recognized yet mutually contradictory understandings in insurance law are that intentional acts are uninsurable and, at the same time, that courts would not interpret an insurance policy in a way that emasculates coverage altogether.[302] As noted, the two are hardly ever reconciled due to the ubiquity of settlements in cases that intersect them.[303] Claimants, as a matter of fact, are very likely to hold the upper hand, yet any plaintiff individually is reluctant to

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[300] *See* Gideon Parchomovsky & Alex Stein, *Empowering Individual Plaintiffs*, 102 CORNELL L. REV. 1319, 1323 (2017) ("[T]he vast majority of lawsuits brought against insurance companies by individuals settle below their expected value.")

[301] *Supra* notes 125-133.

[302] For a discussion see, e.g., Abraham, *supra* note 161 at *12.

[303] *Supra* notes 125-178.

be the one who rolls the dice in court and risks exclusion, and since a precedential judgment is a public good,[304] she is better off settling for less rather than litigating for more and risking the loss of any coverage. Insurers utilize this to force claimants into a settlement amount that falls short of the suit's expected value.[305] The win for insurers is therefore double: locally, they end up with a self-advantageous settlement; globally, they keep the legal standards governing the intentional acts exclusion sufficiently vague, which would allow them to extract such favorable settlements in the future. Under the proposed mechanism, the twofold win is out of their reach. If insurers do not settle for an amount that actually embeds the suit's expected value, the claim would become attractive to a litigious entity, and insurers in turn would not be able to retain legal ambiguity.

Noteworthy is that this mechanism reminisces several proposals offered in different contexts. In a recent contribution, Ronen Avraham and Issachar Rosen-Zvi proposed a general model that allows third parties that have an interest in either court judgment or a settlement to compete with both parties to a litigation by buying out either the plaintiff or the defendant in order to actualize their will.[306] Class actions is another legal area in which the problem of opportunistic settlements transpires. The main concern there is that a representative lawyer takes advantage of the class members' rational ignorance and settles in a way that guarantees her increased payouts at the expense of the group's profit.[307] In this regard, Ittai Paldor, Yuval Procaccia and Eyal Winter suggest an elegant solution that auctions out representation to new lawyers and allow those lawyers

[304] *Supra* notes 122-123.

[305] *See* Parchomovsky & Stein, *supra* note 300 at 1323.

[306] *See generally* Ronen Avraham & Issachar Rosen-Zvi, *The Problem of Biased Precedents*, 46 CARDOZO L. REV. (forthcoming, 2025).

[307] *See, e.g.*, Howard M. Erichson, *Aggregation as Disempowerment: Red Flags in Class Action Settlements*, 92 NOTRE DAME L. REV. 859, 860 (2016) (noting that too often, the reason for a class action settlement is not that settlement "provi[ded] added value to the class, but rather that it served the aligned interests of the defendant and the class counsel.").

to collect payments from the original representative that chose to settle if the initial settlement turns out to be opportunistic in a future proceeding.[308]

Finally, since we are dealing with equivalent problems of excessive insurance settlements in some cases and excessive insurance litigation in other scenarios, any attempt to solve the first might end up worsening the second, and vice versa. Under this market mechanism, we might be concerned with excessive incentives to litigate, potentially reintroducing the problem of opportunistic litigation at the expense of policyholders.[309] But importantly, the mechanism complements the duty to settle rather than competes with it. What bears emphasis is that under the duty to settle, insurers' opportunistic decision to litigate is *already* monitored by courts, due to the policyholder's right to challenge insurers' decisions not to settle.[310] The added mechanism essentially balances between insurers' tendency to take advantage of the insured and their propensity to take advantage of the claimant. A refusal to settle for an amount that reflects the suit's expected value or the initiation of a settlement proposal that requires the insured's participation is governed by the duty to make reasonable settlement decisions; a proposal to settle for an amount that is far below the suit's expected value should be governed by an equivalent legal construct that accounts for third parties' welfare, as well as the for the general public interest in legal clarity and the development of guiding jurisprudence.

V. FORMAL MODEL

This Part sketches the main argument in formal economic terms. It proceeds in accordance with the following outline. Section A introduces the conventional framework, which demonstrates

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[308] *See generally* Ittai Paldor, Yuval Procaccia & Eyal Winter, *Preventing Class Action Sellouts*, J. LEGAL STUD. (forthcoming, 2025).
[309] *Supra* Section I.A.
[310] *Id*.

analytically the conflict of interest between insurers and insureds and suggests that insurers prefer to litigate instead of reaching a socially desirable settlement, thus lending support to the duty to settle. Section B proceeds to formulate a model of injurer compliance with an uncertain standard of care, noting that injurers' demand for insurance is predicated on this uncertainty. Section C notes that when insurers are confronted with a choice between proceeding to a final judgment that would clarify the standard of care or settling and thus maintaining ambiguity, their incentives to settle exceed the socially optimal level, which implies that in contrast with conventional wisdom that highlights a conflict of interest that leads to the insurer's avoidance of socially desirable settlement in favor of wasteful litigation, we actually witness the obverse problem whereby insurers avert socially desirable litigation in favor of uncertainty-preserving settlements.

A. *Baseline Model: Socially Undesirable Litigation and the Duty to Settle*

Begin with the baseline conflict of interest and the duty to settle.[311] The plaintiff was harmed by an insured defendant. The insurance policy stipulates a coverage limit of $L \in \mathbb{R}_{++}$. If the case goes to trial, the court awards damages at the value of x, which is drawn from a certain distribution that has full support over $[0, \infty]$, density of $f(x)$ and expected value of $E(x)$. A trial likewise entails litigation costs to both the plaintiff and the insurer (who incurs the cost of defending the case, due to its duty to defend). Denote these costs by $c_p \in \mathbb{R}_+$ and $c_d \in \mathbb{R}_+$, respectively. The expected value that a trial provides the plaintiff is thus $E(x) - c_p$. If the insurer were to internalize the entire costs of proceeding to trial, it would have confronted an expected loss of $E(x) + c_d$. Under these circumstances, the parties would have agreed to settle for an

[311] For consistency and tractability, I follow the notations in Kathryn E. Spier, *Litigation, in* 1 HANDBOOK OF LAW AND ECONOMICS 259, 330-31 (A. Mitchel Polinsky & Steven Shavell, eds. 2007).

amount within the range $S \equiv [E(x) - c_p, E(x) + c_d]$, saving the pure social waste—the deadweight loss of litigation—which is $c_p + c_d$.

But the insurer does not internalize the entire costs that a trial inflicts on the defense side. Specifically, the insurer's loss from avoiding settlement and proceeding to trial is $\min\{x, L\} + c_d$, meaning that the expected loss is:

$$\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d$$

Where $\int_0^L xf(x)dx$ stands for the insurers' loss if the court awards the plaintiff $x < L$ and $\int_L^\infty Lf(x)dx$ is its loss if the court awards the plaintiff $x > L$. Note that due to the policy limit, the insured likewise suffers a loss of $\max\{0, x - L\}$ from going to trial, which means that her expected loss is given by:

$$\int_L^\infty (x - L)f(x)dx$$

Recall that the defense side's total expected loss from going to trial—that is, the aggregate expected loss of the insurer and the insured—is $E(x) + c_d$, but since

$$\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d = \int_0^\infty xf(x)dx - \int_L^\infty (x - L)f(x)dx + c_d$$

$$= E(x) - \int_L^\infty (x - L)f(x)dx + c_d$$

We obtain:[312]

[312] The inequality is strict rather than weak because we assume that the distribution of x has full support on $[0, \infty] \supseteq [0, L + \epsilon]$, which means that there is necessarily a positive probability for the damages to exceed the policy limit.

$$\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d < E(x) + c_d$$

Meaning that the new range of settlement, denoted by R, becomes:

$$R \subseteq \begin{cases} S, & E(x) - c_p \leq \int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d \\ \emptyset, & E(x) - c_p > \int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d \end{cases}$$

Since the range is narrower, settlement becomes less likely, and the expected loss of social welfare due to proceeding to trial is denoted by C^T:

$$C^T = \int_{L+c_d+c_p}^\infty f(x)\left(c_p + c_d\right)dx$$

To correct this conflict of interest, the duty to settle requires the insurer to incorporate the insured's loss, $\int_L^\infty (x - L)f(x)dx$, into the equation. In that case, the insurer's expected loss is $E(x) + c_d$, i.e., it internalizes the cost of a trial, and the settlement range is again S. This eliminates the loss of welfare society would have suffered in the absence of this duty.

B. *A Model of Injurer Compliance Under Legal Uncertainty*

Now introduce uncertainty. Suppose that a potential injurer may choose between two alternatives: A and B. Think of a factory that entertains the installation of two types of filters, or the implementation of two methods of manufacture. The injurer's baseline wealth from each alternative—measured in monetary units—is $w_A > w_B > 0$. This might be because using A is cheaper, because it is more compatible with the production process, or for any other reason. The injurer is risk averse, in that her utility function $U(\cdot)$ is increasing and strictly concave, that is, $U'(\cdot) > 0 > U''(\cdot)$. Assume that under alternative A, the injurer inflicts a certain harm whose value is x, distributed as defined above. The injurer will be held liable with some probability, to be defined momentarily. Alternative B causes no harm, thus involving no risk of liability. Further note that $\int_{w_A}^{\infty}(w_A - x)f(x)dx < 0$, which means that if the risk is realized into a harm under alternative A, the injurer may turn out to be judgment proof and may thus only partially compensate the relevant victim—transferring to her w_A. Naturally, this also implies that if the injurer knows she will be held liable for the harm she inflicts under alternative A, she is better off with alternative B, since $w_B > 0$.

Liability under A is not certain, but rather contingent on the injurer's compliance with some vague standard.[313] Let $a \in [0,1]$ denote the required standard of care for alternative A. The actual value of a is unknown to the injurer; only that a is drawn from some distribution with density $g(a)$ and full support on $[0,1]$. The injurer's chosen care is denoted by $y \in [0,1]$. The cost of care is $k(y)$, where $k'(y) > 0$, $k''(y) > 0$, $k'(0) = 0$ and $k'(y) \longrightarrow \infty$ as $y \longrightarrow 1$. The probability that the injurer will be held liable for a harm is captured by the distance between the chosen compliance level and the actual standard: $\max\{0, a - y\}$. Let us compare A and B and ask which alternative is more worthwhile to the factory.

1. Injurers' Choice Between Risky and Safe Alternatives without Insurance

Under A, the injurer chooses her compliance level so as to maximize expected utility:

[313] For an extended discussion on the motivation behind models of compliance with uncertain standards see generally Scott Baker & Alex Raskolnikov, *Harmful, Harmless, and Beneficial Uncertainty in Law*, 46 J. LEGAL STUD. 281 (2017).

$$\max_y EU^A = \int_y^1 (a-y)g(a)da\left(\int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right)$$
$$+\left(1-\int_y^1 (a-y)g(a)da\right)U(w_A) - k(y)$$

Using the Leibniz rule for integral differentiation,[314] we obtain that the optimal y^A satisfies the following first-order condition:

$$y^A\colon k'(y) = \int_y^1 g(a)da\left(U(w_A) - \left(\int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right)\right)$$

Which means that the injurer's private decision is to select alternative A if and only if:

$$\int_{y^A}^1 (a-y^A)g(a)da\left(\int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right)$$
$$+\left(1-\int_{y^A}^1 (a-y^A)g(a)da\right)U(w_A) - k(y^A) > U(w_B)$$

Considering the social welfare perspective, the collective loss resulting from the injurer's choice of alternative B, denoted by C^B, would be the loss of wealth (which the injurer internalizes):

$$C^B = U(w_A) - U(w_B)$$

The expected social loss of the injurer's selection of alternative A is the expected level of externality that is creditable to her potential insolvency, as well as the cost of avoiding harm. This loss is denoted by C^A:

[314] *See, e.g.*, MICHAEL R. CAPUTO, FOUNDATIONS OF DYNAMIC ECONOMIC ANALYSIS 57 (2005).

$$C^A = \int_{y^A}^{1}\int_{w_A}^{\infty}(x - w_A)f(x)g(a)dxda + k(y^A)$$

The social desirability of the injurer's choice of alternative A depends on whether the inequality $\int_{y^A}^{1}\int_{w_A}^{\infty}(x - w_A)f(x)g(a)dx\,da + k(y^A) < U(w_A) - U(w_B)$ holds, namely whether $C^A < C^B$.

2. Injurers' Choice Between Risky and Safe Alternatives with Insurance

Now assume that the injurer can purchase an insurance policy under alternative A (insuring for B does not make sense as no risk is involved). Insurance covers a fixed value $L \in \mathbb{R}_{++}$ in case of liability, and receives some fixed premium $\pi \in \mathbb{R}_{++}$.[315] If $x \leq L + w_A$, then the insured is sufficiently solvent and pays the excess $x - L$. If $x > L + w_A$, it pays w_A. In short, the insured's participation in paying the damages awarded by court is $\min\{x - L, w_A\}$. In alternative A under insurance, the problem becomes:

$$\max_y EU^I = \int_y^1 (a - y)g(a)da\left(\int_0^{w_A} U(w_A - x + L - \pi)f(x)dx + \int_{w_A}^{\infty} U(-\pi)f(x)dx\right)$$
$$+\left(1 - \int_y^1 (a - y)g(a)da\right)U(w_A - \pi) - k(y)$$

The optimal y^I thus satisfies:

[315] The actual value of π depends on the state of competition in the insurance market. The model allows for moral hazard and thus assumes information asymmetry between the insurer and the insured, in that the insurer cannot observe the insured's level of care. *See, e.g.*, Jaspersen & Richter, *supra* note 278 at 142; Rubinstein & Yaari, *supra* note 64 at 79; Shavell, *supra* note 63 at 544.

$$y^I\colon k'(y) = \int_y^1 g(a)da\left(U(w_A - \pi)\right.$$

$$\left. - \left(\int_0^{w_A} U(w_A - x + L - \pi)f(x)dx + \int_{w_A}^{\infty} U(-\pi)f(x)dx\right)\right)$$

Which means that given the injurer's choice of alternative A, insurance will be purchased if and only if:

$$\int_{y^I}^1 (a - y^I)g(a)da\left(\int_0^{w_A} U(w_A - x + L - \pi)f(x)dx + \int_{w_A}^{\infty} U(-\pi)f(x)dx\right)$$

$$+ \left(1 - \int_{y^I}^1 (a - y^I)g(a)da\right)U(w_A - \pi) - k(y^I)$$

$$> \int_{y^A}^1 (a - y^A)g(a)da\left(\int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right)$$

$$+ \left(1 - \int_{y^A}^1 (a - y^A)g(a)da\right)U(w_A) - k(y^A)$$

From a social welfare perspective, the direct cost of insurance—generated by the expected value of residual externality (uncompensated harm) and the cost of avoidance—is:

$$C^I = \int_{w_A + L}^{\infty} \big(x - (w_A + L)\big)f(x)dx + k(y^I)$$

Whether $C^I < C^A$, which implies the social desirability of insurance, depends on the peculiarities of the distribution of x. Generally stated, probability distributions with substantial density around w_A and within the range $[w_A, w_A + L)$ will satisfy the inequality. The most prominent example is of uniform distribution on the interval $[\alpha, \beta]$, with $\beta > w_A + L$, due to the nonzero mass between w_A and $w_A + L$. We will regard the choice of alternative A with insurance socially optimal if $C^I < \min\{C^A, C^B\}$.

C. *Insurers' Settlement Incentives*

Now assume that rather than a static game, the choice is part of a dynamic interaction. Specifically, suppose that the injurer makes the choice between alternative A and B—and, if choosing A, to purchase insurance or not—on Date 0. On Date 1, a victim files a suit and, as a plaintiff, offers the insurer a settlement proposal. The insurer decides to settle or proceed to trial. A trial would uncover the actual value of a, and a settlement would keep it vague as before. On Date 2, the injurer once again makes the choice between alternative A and B and whether or not to insure under A.

A duty to settle would force the insurer to accept any settlement proposal that reflects the suit's expected value, $E(x)$. But we may now show that the insurer has a strong incentive to settle even for a higher amount. To see why, first ask what happens if the insurer refuses to settle and proceeds to trial. In that case, the insurer's direct expected loss would be:

$$\int_{y^I}^{1}(a - y^I)g(a)\left(\int_{0}^{L} xf(x)dx + \int_{L}^{\infty} Lf(x)dx + c_d\right)da + c_d$$

But importantly, the court would likewise define $a = \overline{a}$, affecting the injurer's future decision to keep purchasing insurance. When $a = \overline{a}$, we redefine the injurer's problem as:

$$\max_y EU^{\overline{A}} = \begin{cases} \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx - k(y), & y < \overline{a} \\ U(w_A) - k(y), & y \geq \overline{a} \end{cases}$$

The chosen $y^{\overline{A}}$ satisfies:

$$y^{\overline{A}} = \begin{cases} 0, & \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx > U(w_A) - k(\overline{a}) \\ \overline{a}, & \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx \leq U(w_A) - k(\overline{a}) \end{cases}$$

The injurer's expected utility under alternative A once a is clarified is therefore:

$$\max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right\}$$

Thus, alternative A will be chosen over B under the known standard of care $\overline{a}$ if and only if $\max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right\} > U(w_B)$.

The loss of welfare when A is chosen under a known a is:

$$C^{\overline{A}} = \int_{y^{\overline{A}}}^{1} \int_{w_A}^{\infty} (x - w_A)f(x)dx\, g(a)da + k\left(y^{\overline{A}}\right)$$

Which means that in comparing A to B from a social perspective under a known standard of compliance, the injurer's choice of A is desirable if and only if $\int_{y^{\overline{A}}}^{1} \int_{w_A}^{\infty} (x - w_A)\, f(x)\, g(a)dxda + k\left(y^{\overline{A}}\right) < \max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right\} - U(w_B)$.

What about insurance under alternative A when $\overline{a}$ is known? The injurer's problem will become:

$$\max_y EU^{\overline{I}} = \begin{cases} \int_0^{w_A} U(w_A - x + L - \pi)f(x)dx + \int_{w_A}^{\infty} U(-\pi)f(x)dx - k(y), & y < \overline{a} \\ U(w_A - \pi) - k(y), & y \geq \overline{a} \end{cases}$$

The chosen $y^{\overline{I}}$ would satisfy:

$$y^{\bar{I}} = \begin{cases} 0, & \int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx > U(w_A - \pi) - k(\overline{a}) \\ \overline{a}, & \int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx \leq U(w_A - \pi) - k(\overline{a}) \end{cases}$$

The injurer's expected utility if insuring when a is known is:

$$\max\left\{U(w_A - \pi) - k(\overline{a}), \int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx\right\}$$

It is easy to see why the injurer is never better off with insuring when a is known; going uninsured under alternative A would necessarily provide her with higher expected utility. Just compare her expected utility under insurance, which is $\max\left\{U(w_A - \pi) - k(\overline{a}), \int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx\right\}$, with her expected utility under A without insurance, which is $\max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x) f(x) dx + \int_{w_A}^{\infty} U(0) f(x) dx\right\}$. Note that $U(w_A) - k(\overline{a}) > U(w_A - \pi) - k(\overline{a})$ and that $\int_0^{w_A} U(w_A - x) f(x) dx + \int_{w_A}^{\infty} U(0) f(x) dx > \int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx$, which implies that even if $U(w_A - \pi) - k(\overline{a}) > \int_0^{w_A} U(w_A - x) f(x) dx + \int_{w_A}^{\infty} U(0) f(x) dx$, we still have $\max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x) f(x) dx + \int_{w_A}^{\infty} U(0) f(x) dx\right\} = U(w_A) - k(\overline{a}) > \max\left\{U(w_A - \pi) - k(\overline{a}), \int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx\right\} = U(w_A - \pi) - k(\overline{a})$. By the same token, even if $\int_0^{w_A} U(w_A - x + L - \pi) f(x) dx + \int_{w_A}^{\infty} U(-\pi) f(x) dx > U(w_A) - k(\overline{a})$, we still have $\max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x) f(x) dx + \int_{w_A}^{\infty} U(0) f(x) dx\right\} = \int_0^{w_A} U(w_A - x) f(x) dx +$

$\int_{w_A}^{\infty} U(0)f(x)dx > \max\left\{U(w_A - \pi) - k(\overline{a}), \int_0^{w_A} U(w_A - x + L - \pi)f(x)dx + \right.$

$\left.\int_{w_A}^{\infty} U(-\pi)f(x)dx\right\} = \int_0^{w_A} U(w_A - x + L - \pi)f(x)dx + \int_{w_A}^{\infty} U(-\pi)f(x)dx.$

This means that whenever the court clarifies the actual value of a, demand for insurance vanishes. The injurer will choose between alternatives A and B and her expected utility would become: $\max\left\{\max\left\{U(w_A) - k(\overline{a}), \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right\}, U(w_B)\right\}$.

Under this outcome, which captures the insurer's later choice to avoid insurance, the insurer loses an expected profit of:

$$\pi - \int_{y^I}^{1} (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^{\infty} Lf(x)dx\right)da$$

Assuming that this analysis applies to $n \in \mathbb{N}$ insureds for $\lambda \in \mathbb{N}$ future time periods, aggregate expected profit that is at risk is:

$$\lambda n\left(\pi - \int_{y^I}^{1} (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^{\infty} Lf(x)dx\right)da\right)$$

Which captures the indirect cost that the insurer suffers from avoiding settlement and proceeding to trial. Recall that the direct costs are the expected damages to be paid for the present harm as well as litigation fees, given by:

$$\int_{y^I}^{1} (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^{\infty} Lf(x)dx\right)da + c_d$$

The combined cost is thus $\lambda n\pi - \lambda n \int_{y^I}^{1} (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^{\infty} Lf(x)dx\right)da +$ $\int_{y^I}^{1} (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^{\infty} Lf(x)dx\right)da + c_d = \lambda n\pi - (\lambda n - 1)\int_{y^I}^{1} (a -$

$y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da + \int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \right.$

$\left.\int_L^\infty Lf(x)dx\right)da + c_d$. Recall that without a duty to settle in a static, one-shot game in which the insurer does not account for the effects of settlement on the future of the insurance market, the insurer is willing to settle for up to $\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d$. Under the assumption that insurance is profitable, namely that $\pi - \int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da > 0$, we obtain that any increase in $\lambda\pi$ generates a fixed increase in $\lambda n\left(\pi - \int_{y^I}^1 (a - \right.$ $\left. y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da\right)$. This means that:

$$\lim_{\lambda n \to \infty} \lambda n\left(\pi - \int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da\right) = \infty$$

Thus, as λ and n increase to some $\hat{\lambda}$ and $\hat{n}$, we necessarily obtain:

$$\begin{aligned}\hat{\lambda}\hat{n}\pi - \left(\hat{\lambda}\hat{n} - 1\right)\int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da \\ + \int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da + c_d \\ > \int_0^L xf(x)dx + \int_L^\infty Lf(x)dx + c_d\end{aligned}$$

Which points to the insurer's enhanced willingness to settle. For the same reason, as λ and n further increase, reaching some arbitrarily large values $\bar{\lambda}$ and $\bar{n}$, we would necessarily obtain:

$$\begin{aligned}\bar{\lambda}\bar{n}\pi - \left(\bar{\lambda}\bar{n} - 1\right)\int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da \\ + \int_{y^I}^1 (a - y^I)g(a)\left(\int_0^L xf(x)dx + \int_L^\infty Lf(x)dx\right)da + c_d > E(x) + c_d\end{aligned}$$

Which implies that the insurer would be willing to settle for an amount beyond the one mandated under the duty to settle. The ultimate settlement range thus becomes:

$$\Bigg[E(x) - c_p, \lambda n \pi - (\lambda n - 1) \int_{y^I}^{1} (a - y^I) g(a) \left(\int_0^L x f(x) dx + \int_L^\infty L f(x) dx \right) da$$

$$+ \int_{y^I}^{1} (a - y^I) g(a) \left(\int_0^L x f(x) dx + \int_L^\infty L f(x) dx \right) da + c_d \Bigg] \supset S, \forall \lambda n \geq \overline{\lambda n}$$

Finally, let us turn to assess the effect that such a settlement has on welfare. Previously, in the static one-shot framework that fails to account for the broad effects of settlement on the insurance market, we noted that the expected loss of social welfare due to proceeding to trial is denoted by C^T:

$$C^T = \int_{L+c_d}^{\infty} f(x) \left(c_p + c_d\right) dx$$

In our revised framework which attends the impact of settlement on demand for insurance, redefine this cost as C^{T^*}:

$$C^{T^*} = \int_{\lambda n \pi - (\lambda n - 1) \int_{y^I}^{1} (a - y^I) g(a) \left(\int_0^L x f(x) dx + \int_L^\infty L f(x) dx \right) da + \int_{y^I}^{1} (a - y^I) g(a) \left(\int_0^L x f(x) dx + \int_L^\infty L f(x) dx \right) da + c_d}^{\infty} f(x) \left(c_p + c_d\right) dx$$

On the other hand, consider the expected cost of settlement, C^S, which manifests in the persistence of legal uncertainty that maintains insurance-related externalities (that is, the expected level of uncompensated harm), net the cost of the injurer's selected alternative without insurance under clear a.

$$C^S = \lambda n \left(C^I - C^i\right) = \lambda n \left(\int_{w_A + L}^{\infty} \left(x - (w_A + L)\right) f(x) dx - C^i \right), i \in \{A, B\}$$

Where:

$$C^i = \begin{cases} C^{\bar{A}} = \int_{y^{\bar{A}}}^{1}\int_{w_A}^{\infty}(x - w_A)f(x)\,g(a)dxda + k(y^{\bar{A}}), & \max\left\{U(w_A) - k(\bar{a}), \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right\} > U(w_B) \\ C^B = 0, & \max\left\{U(w_A) - k(\bar{a}), \int_0^{w_A} U(w_A - x)f(x)dx + \int_{w_A}^{\infty} U(0)f(x)dx\right\} \le U(w_B) \end{cases}$$

Note that as λ and n increase, the expected social cost of litigation C^{T^*} becomes negligible, whereas the expected social cost of settlement C^S becomes substantial. This suggests that when settlement maintains legal uncertainty that mainly benefits insurers, those insurers pursue socially undesirable settlements at the expense of socially desirable litigation.

CONCLUSION

Conventional wisdom in insurance law concentrates on a common conflict of interest that leads to inefficient and inequitable outcomes: insurers' decision to avoid socially desirable settlements and proceed to wasteful litigation, since the amount jeopardized is mostly or exclusively in excess to the policy limit and thus comes from the insured. To remediate this failure, legislators set out to establish a legal requirement that insurers make reasonable settlement decisions, mandating them to ignore policy limits and operate as if they are the ones paying the damages that the court would award in future litigation, thus purportedly realigning the incentives of insurers, insureds and society at large when it comes to settlements. Voluminous literature has been dedicated to the study of insurers' interest in avoiding settlements and proceeding to litigation; virtually none discusses the obverse phenomenon that the present Article recognizes. The Article identifies and analyzes the equivalent problem, where insurers aspire to avoid publicly advantageous litigation and solicit socially undesirable settlements. The reason lies in insurers' latent interest in preserving doctrinal ambiguity, which translates into legal risks that enhance demand for coverage against uncertain outcomes. As demonstrated and documented throughout this Article, insurers routinely settle with a view to thwart the organic development of legal doctrine, by which courts interpret standards in a way that provides substantive guidelines, which in turn stream clarity into the legal system and eliminate uncertainty and associated legal risks. In maintaining vague liability standards, insurers enhance the attractiveness of their products and deepen industry participants' dependency on insurance coverage. The Article addresses the theoretical underpinnings of this phenomenon, discusses concrete real-world examples that indicate its scale and pervasiveness, identifies its normative implications and considers potential solutions to the problem that mirror-images the standard scholarly perception on insurance settlements.

Risk Allocation in a General-Equilibrium Model of Liability Insurance[*]

ABSTRACT

Conventional wisdom suggests that insured parties externalize the cost of their risk-taking onto the insurer, a practice known as "moral hazard." Recent contributions opt out of the bilateral insurer-insured relationship, demonstrating that third parties, too, transfer their risks onto insurers, a phenomenon they term "third-party moral hazard." The present paper extends the dynamics of risk transferring within the insurer, insured and third party triangle. While the theory of third-party moral hazard focuses on third parties who *decline* their risk-reducing effort in light of insurance, the article discusses a mirror-image phenomenon which it terms "third-party deterrence:" cases where third parties *enhance* their risk-reducing effort to counterbalance the insured's moral hazard. The article analyzes third-party deterrence as an equivalent category of risk-transferring that emanates from third parties' reaction to insurance. Interestingly, under third-party deterrence, this reaction either results in the cautious third party ultimately incurring the cost of the insured's increased risk-taking, or alternatively, induces (partial or full) risk internalization by the insured. Furthermore, it is shown that the precautionary reaction of third parties may prompt insurer moral hazard in monitoring the insured's behavior, since the likelihood of loss is reduced owing to third parties' increased cautiousness. This paper thus completes the picture and shows that *any* actor among the triangle of insurer, insured and third party, may exhibit moral hazard and transfer risks to others by exhibiting insufficient care. Similarly, any actor may be the one who ultimately bears the cost of increased risk-taking.

[*] The essay is based on Roy Baharad, *Deterrence by Insurance*, 54 J. LEGAL STUD. 239 (2025). While offering distinct insight and discussions of an independent topic, there are some duplications with the first essay in this dissertation.

INTRODUCTION

In a recent article, Gideon Parchomovsky and Peter Siegelman highlight a hitherto unnoticed aspect of insurance: its effect on the behavior of third parties.[1] They use numerous examples to demonstrate that insurance against an event may paradoxically increase the likelihood of this event's occurrence. This emanates from the reaction of malevolent (or simply reckless) third parties, who alter their behavior when knowing that the insured is covered by a deep pocket entity. Parchomovsky and Siegelman attribute various real-world antisocial behaviors to the desire to collect insurance payments: bad faith lawsuits,[2] rehabilitation frauds whose sole objective is to maintain or even exacerbate addictions,[3] and the response of kidnappers to kidnapping insurance in order to extract ransoms.[4]

The most important contribution of Parchomovsky and Siegelman is conceptual. The insurance literature—theoretical and empirical alike—has thus far studied the incentives of parties within the bilateral insurer-insured relationship.[5] A common failure this literature highlights is *moral hazard* – insureds' tendency to increase their riskiness for not fully internalizing the cost of their actions.[6] Parchomovsky and Siegelman illuminate the possibility of *third-party moral*

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[1] *See generally* Gideon Parchomvosky & Peter Siegelman, *Third-Party Moral Hazard and the Problem of Insurance Externalities*, 51 J. LEGAL STUD. 93 (2022).

[2] *Id.*, at 95 (suggesting the general conclusion that "the presence of insurance can create an incentive for loss creation or claim creation by those who are not party to the insurance contract.").

[3] *Id.*, at 102-103.

[4] *Id.*, at 104-105.

[5] *Id.*, at 94 ("[S]cholars and courts have focused exclusively on how insurance alters the insured policyholder's incentives for loss prevention.").

[6] For some of the foundational studies see generally Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963); Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL. J. ECON. 74 (1979); Ariel Rubinstein & Menahem Yaari, *Repeated Insurance Contracts and Moral Hazard*, 30 J. ECON. THEORY 74 (1983); Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541 (1979). For a literature review and historical background see Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

hazard, noting that if *A* is the insurer and *B* is the insured, then *C*, an uninsured individual who interacts with *B*, is likewise incentivized to increase her riskiness when knowing that *A*, an entity wealthier than *B*, would now bear the costs of *C*'s antisocial behavior. Parchomovsky and Siegelman deviate thus from the accepted lore, maintaining that third parties, too, exhibit moral hazard by transferring the costs of their risk-taking to the insurer.

Equipped with Parchomovsky and Siegelman's insights into risk dynamics among insurers, insureds, and third parties, I extend the analysis using general equilibrium principles. While Parchomovsky and Siegelman's perspective focuses on third parties' incentives to increase their riskiness due to the policyholder's coverage, I spotlight a counter phenomenon: *third-party deterrence*. The gist of the idea is that in the presence of insurance—which signals the insured's potentially risky behavior—third parties are expected to confront enhanced risk and may respond by increasing their level of care or reducing their level of activity in order to offset it.

Third-party deterrence is essentially the mirror-image of third-party moral hazard. In the latter case, third parties' reaction is *malicious or careless*: they take advantage of insurance and transfer the cost of their risky behavior onto the insurer, and in some cases onto the insured as well. In the former one, by contrast, third parties' reaction is *precautionary,* as they are the ones who confront an increased risk that originates from *the insured*'s risky behavior (moral hazard). I introduce the third-party deterrence phenomenon, and then consider two of its possible implications on risk-transferring, noting that third-party deterrence can result in either (i) the third-party, rather than the insurer, incurring the costs of the insured's moral hazard; (ii) the third-party's adjusted conduct inducing the insured to (fully or partially) internalize the costs of her increased risk-taking.

This new perspective pertains not only to Parchomovsky and Siegelman's third-party moral hazard approach, but also to customary thinking about the insured's moral hazard, as well as to modern outlooks that underscore the regulatory role of insurance. Conventional wisdom suggests that suboptimal outcomes arise from the insured externalizing costs on the insurer;[7] Parchomovsky and Siegelman illuminate the problem of third parties that externalize costs on the insurer;[8] the "insurance as governance" viewpoint suggests that the insurer may be efficient in monitoring the insured's excessive risk-taking and realign her level of care with social optimum.[9] The analysis here corresponds to all vantage points: it adopts Parchomovsky and Siegelman's methodology that centers on third-party reaction to insurance. It likewise conforms to conventional wisdom by studying this reaction in light of the insured's increased riskiness. Similarly, it provides an alternative view of insurance as governance, showing that the reaction of third parties—rather than the insurer's monitoring—may sometimes induce the insured to internalize risks.

[7] This is the entire premise of the moral hazard literature. *See generally supra* note 6.

[8] *See generally* Parchomovsky & Siegelman, *supra* note 1.

[9] For reviews of the regulatory function of private insurers see, e.g., Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers Professional Liability*, 60 UCLA L. REV. 1412 (2013); Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197 (2012); RICHARD V. ERICSON ET AL., INSURANCE AS GOVERNANCE (2003). *See also* Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PENN. L. REV. 653, 683-97 (2013) (discussing the "governance conception" of insurance).

Table 3.1. The Dynamics of Risk Transferring Within the Insurer-Insured-Third Party Triangle

Perspective	**Which Party Engages in Increased Risk-Taking?**	**Who Bears the Cost of Increased Risk-Taking?**	**What Causes this Outcome?**
Conventional Wisdom	The insured	The insurer	Insured's moral hazard
Insurance as Governance	None	The insured	Insurer's ability to monitor the insured's level of care
Third-Party Moral Hazard	Third parties	The insurer or the insured	Third parties' malicious reaction
Third-Party Deterrence	The insured	Third parties or the insured	Third parties' precautionary reaction

I. Framework and Examples

Third-party deterrence occurs when the outcome for *C* depends on both *C*'s and *B*'s risk-reducing effort. Such settings are rather common, suggesting that third-party deterrence is potentially widespread. Extant insurance literature has repeatedly demonstrated that since *B* is insured, she will modify her conduct, but has yet to ask how *B*'s modified conduct affects *C*'s behavior. As a simple example, consider driving. Insurance might make drivers less cautious, but an immediate question should follow: if an insured driver is indeed incentivized to drive recklessly, what would be the reaction of surrounding drivers?

This simple question highlights that Parchomovsky and Siegelman's theory of third-party moral hazard does not cover all possible reactions of third parties to insurance. In this hypothetical, third-party moral hazard would involve other drivers *deliberately colliding* with the insured to claim insurance payouts, or simply being indifferent to accidents. Admittedly, this might be the case in extreme, illicit circumstances,[10] but what seems to be a more common reaction among those who surround a reckless driver is simply *increased cautiousness*. In a risk-averse environment, individuals naturally respond with precautions to offset others' increased riskiness, a behavior observed in various real-world situations.

A clear example of third parties' cautious reaction to insurance can be seen in Directors' and Officers' (D&O) liability insurance. Traditionally, the principal-agent relationship studied in the corporate context is the one between shareholders and D&Os.[11] But to understand the impact of insurance, I follow Parchomovsky and Siegelman by studying the effect of the agency relationship constituted by *insurer and D&Os*. Interestingly, Parchomovsky and Siegelman perceive D&O insurance as a cause of third-party moral hazard, suggesting that this form of insurance encourages third parties to manufacture suits against corporate D&Os with intention to collect insurance payments.[12] But let us now shift the focus and consider the effect of insurance on *other* third parties—various market actors outside the insurer-insured interaction—be it

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[10] *See* Parchomovsky & Siegelman, *supra* note 1 at 100 (discussing criminal enterprises whose purpose is "to falsify and exaggerate [automobile liability] claims).

[11] *See generally* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983).

[12] Parchomovsky & Siegelman, *supra* note 1 at 97-99.

investors, analysts, or auditors. In that case, D&O insurance prompts third-party deterrence, as opposed to third-party moral hazard.

The analysis should begin by highlighting the enhanced risk-taking associated with high-level D&O insurance,[13] including in investment decisions,[14] loan spreads,[15] higher likelihood of lawsuits,[16] and D&Os' reduced attention to their obligations toward shareholders.[17] By dint of this moral hazard, scholars submitted that firms whose officials are extensively covered from liability are systematically treated by investors and other relevant actors with increased suspiciousness.[18] The literature suggests, for example, that analysts are routinely pessimistic with respect to the performance of firms with high-level D&O insurance.[19] Other outcomes attributable to increased D&O insurance include negative market reactions of various kinds,[20] as well as poorer stock

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[13] *See, e.g.*, M. Martin Boyer & Sharon Tennyson, *Directors' and Officers' Liability Insurance, Corporate Risk and Risk Taking: New Panel Data Evidence on the Role of Directors' and Officers' Liability Insurance*, 82 J. RISK & INS. 753, 781 (2015) (contending that the data "strongly favor the hypothesis that D&O insurance leads to more aggressive earnings management, suggesting moral hazard effects of insurance.").

[14] *See generally* Chen Lin et al., *Directors' and Officers' Liability Insurance and Acquisition Outcomes*, 102 J. FIN. ECON. 507 (2011).

[15] *See generally* Chen Lin et al., *Directors' and Officers' Liability Insurance and Loan Spreads*, 110 J. FIN. ECON. 37 (2013).

[16] *See generally* Stuart L. Gillan & Christine A. Panasian, *On Lawsuits, Corporate Governance, and Directors' and Officers' Liability Insurance*, 82 J. RISK & INS. 793 (2015).

[17] *See, e.g.*, John M. R. Chalmers et al., *Managerial Opportunism? Evidence from Directors' and Officers' Insurance Purchases*, 57 J. FIN. 609, 633 (2002) (concluding that "[c]onsistent with the managerial opportunism hypothesis, there is a negative association between the amount of D&O insurance coverage at the IPO and the three-year stock price performance of the firm."); Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT'L REV. L. & ECON. 115, 116 (1990) (noting that objectors maintain that "liability insurance largely nullifies the disciplining potential of litigation, causing directors and officers to be less attentive to their duties to shareholders."); Parchomovsky & Siegelman, *supra* note 1 at 98 ("Directors and managers who have insurance tend to be less diligent in the performance of their obligations.").

[18] For a literature review see Ning Jia & Xuesong Tang, *Directors' and Officers' Liability Insurance, Independent Director Behavior, and Governance Effect*, 85 J. RISK & INS. 1013, 1013-18 (2018).

[19] *See generally* Narjess Boubakri & Lobna Bouslimi, *Directors' and Officers' Liability Insurance and Analyst Forecast Properties*, 19 FIN. RES. LETTERS 22 (2016).

[20] *See, e.g.*, Michael Bradley & Cindy A. Schpani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989) (reporting empirical evidence on negative market reaction as a result of limitations on directors' personal legal liabilities); Zhihong Chen et al., *Directors' and*

performance.[21] Similarly, extensive D&O coverage is translated into bid premiums in mergers and acquisitions (M&A) negotiations,[22] and into substantially higher audit fees.[23] These findings lend support to the theoretical framework of third-party deterrence. The precautionary reaction of investors and their cohort originates from concerns about excessive risk-taking by officials who are protected from liability. The fact that *B* is insured discourages *C* from negotiating or engaging in commercial interaction; the insured's possible overinvolvement in risky activities results in third parties' reduced involvement in such.

Another example of third-party deterrence is a discount in the credibility third parties ascribe to the insured, which may arise in the context of Representation and Warranty (R&W) insurance. Extensively unfolded in Griffith's recent work, R&W insurance is used by corporations as part of M&A contracting.[24] Instead of bearing the risk of liability for disclosing false information or failing to disclose relevant facts, parties to M&A negotiations may turn to R&W insurance.[25] Griffith identifies, however, that the insured's counterparts may be deterred by the idea that such risk will be, at least in part, externalized on *them*.[26] Griffith consequently wonders how R&W insurance could be compatible with the insured party's aspiration to retain credible commitment, stressing that R&W insurance "suggests greater potential for misinformation… which might induce buyers to discount or abandon otherwise wealth-enhancing transactions.

Officers' Liability Insurance and the Cost of Equity, 61 J. ACC. & ECON. 100 (2016) (associating higher level of D&O insurance with increased cost of equity).

[21] *See generally* Chalmers et al., *supra* note 17.

[22] *See generally* Ines Aguir et al., *Liability Protection, Director Compensation, and Incentives*, 23 J. FIN. INTERMEDIATION 570 (2014); Lin et al., *supra* note (2011).

[23] *See generally* Hyeesoo H. Chung et al., *Directors' and Officers' Legal Liability Insurance and Audit Pricing*, 34 J. ACC. & PUB. POL'Y 551 (2015); Noel O'Sullivan, *The Impact of Directors' and Officers' Insurance on Audit Pricing: Evidence from UK Companies*, 33 ACC. FOR. 146 (2009).

[24] *See generally* Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839 (2020).

[25] *Id*.

[26] *Id*.

[R&W insurance,] in other words, threatens to recreate the very problem that [R&W] were designed to solve."[27] The credible commitment problem is remedied, per Griffith, by applying R&W insurance to diminution-in-value damages caused by misrepresentation.[28] Thus, since compensation for misrepresentation is guaranteed, buyers are essentially indifferent as to whether the insured is trustworthy or not. This implies that rather than eroding credibility, insurance might serve as a commitment device—a possibility that I address in Part II. Broader R&W insurance coverage might, on the one hand, substantially undermine trustworthiness, but on the other hand, can simply nullify the central role of trust in negotiations and obviate parties' need for substantiating credible commitment.

The phenomenon has far-reaching implications, extending well beyond capital markets. For instance, consider Employment Practices Liability (EPL) insurance, which covers claims of discrimination, wrongful termination, sexual harassment, and more.[29] As Meyers and Hersch point out, EPL insurance provides indemnification even for misconduct in which the upper management has actively participated or failed to adequately prevent, for example by setting up a functioning reporting system.[30] Moral hazard—the management's underreaction to complaints of wrongful acts—is the immediate upshot.[31] As Meyers and Hersch exemplify:[32]

> "Consider a situation wherein a company's upper management fails to address an employee's continuous racist comments because the

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[27] *Id.*, at 1843-44.
[28] *Id.*
[29] *See, e.g.*, NATIONWIDE MUTUAL INSURANCE COMPANY, *Employment Practices Liability Insurance*, https://www.nationwide.com/business/insurance/employment-practices-liability/.
[30] *See* Erin E. Meyers & Joni Hersch, *Employment Practices Liability Insurance and Ex-Post Moral Hazard*, 106 CORNELL L. REV. 947, 950 (2021).
[31] *Id.*
[32] *Id.*, at 950-51.

> employee's performance at work is especially valuable. Or consider the instance of [Harvey Weinstein], wherein his harassing behavior was "widely known" within The Weinstein Company, yet it went unaddressed for years. Providing full insurance coverage for these employer-facilitated wrongs introduces […] moral hazard."

Integrating a third-party perspective, one may wonder how moral hazard affects job candidates' and employees' willingness to engage with an insured employer. There are three possible contingencies: such willingness might increase, remain unchanged, or decline. Increased willingness would suggest third-party moral hazard, where job candidates maliciously seek employment to raise false accusations and extract insurance payments. Indifference is another option: the guaranteed compensation associated with a deep-pocket insurer, would result in the equivalence of averting harms ex ante and being compensated for such harms ex post.[33] Lastly, we might witness third-party deterrence: reduced willingness on account of increased risk, which emanates from the insured's (i.e., the employer's) moral hazard. After all, a workplace where employees can freely make racist comments or where sexual harassment claims are ignored will discourage job seekers, especially minorities and women. EPL insurance, by allowing these issues to persist, may make others hesitant to engage with the insured due to these risks.

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[33] This is the economic principle of "perfect compensation," which leaves individuals indifferent between avoiding a harm and suffering it and then recovering. *See* Robert Cooter, *Punitive Damages, Social Norms, and Economic Analysis*, 60 L. & CONTEMP. PROBS. 73, 76 (1997) ("In economic models, "perfect compensation" leaves the victim indifferent between no harm and harm with compensation."). *But see* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 203 (6th ed. 2016) (acknowledging that the perfect compensation assumption is unrealistic and is adopted mainly for being analytically useful).

II. Informal Treatment

Now ask how third-party deterrence affects risk-transferring. According to Parchomovsky and Siegelman, third-party moral hazard's effect on risk distribution is clear: the insurer incurs the cost of the enhanced risk taken by third parties. After all, the insurer's deep pocket is what incentivizes third parties to increase risk at the outset.[34] But the effect of third-party deterrence on risk allocation is much more complex. While third parties are *expected* to exhibit enhanced cautiousness, who ultimately bears the cost depends on whether the insured benefits from interactions with third parties. For this reason, let us divide insured and third-party interactions into two broad categories: transactional and non-transactional (externalities).

In transactional interactions, where third parties are reluctant to engage due to increased risk, insureds will inevitably need to alleviate this fear and convey their potential counterparties signals of reduced riskiness. Thus, third-party deterrence can function as a market mechanism that regulates insureds' riskiness—because of their need to retain credibility—thereby resulting in (partial or full) risk internalization. For this reason, Griffith suggests that in the likely scenario where the problem of credible commitment resurfaces, corporations might decide to abandon R&W insurance altogether.[35] This captures the more general Coasean idea that in a contractual setting, the burden of eliminating risks will be imposed on the lowest-cost avoider,[36] translating into the price system (as in the foregoing case of D&O insurance and stock pricing).[37]

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[34] *See* Parchomovsky & Siegelman, *supra* note 1 at 105 ("The most straightforward explanation of third-party moral hazard is that insurers are much wealthier than policyholders, which makes them more attractive targets for exploitation simply because they can cover larger losses.").

[35] Griffith, *supra* note 24 at 1843-44.

[36] *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

[37] *Supra* notes 13-23.

On the other hand, in an externality setting that does not involve contractual or other trust-based commercial relationships—e.g., car accidents that result from the insured's reckless driving—third parties' efforts to avoid any engagement with the insured will not feed back into the insured's conduct. In those cases, third-party deterrence does not induce the insured to internalize risks; third parties are expected to ultimately invest in precautions or reduce their level of activity, hence they are the ones who bear the cost of any increase in the insured's riskiness.

But a caveat is in order here. Third-party deterrence relies on the presence of moral hazard—the insured's excessive risk-taking due to guaranteed indemnification and limited insurer supervision.[38] A growing body of literature, however, challenges the notion that insurance inevitably leads to policyholders' moral hazard. This perspective emphasizes the regulatory role of private insurance companies.[39] Insurers, the argument goes, can utilize their status and basically act as regulators. This would manifest ex ante in conditioning insurance upon due diligence,[40] the employment of private precautions by the insured,[41] and disclosure requirements;[42] ex interim by

[38] *See, e.g.*, Shavell, *supra* note 6 at 550-52 (noting that insurance observance can reduce risk)

[39] *Supra* note 9.

[40] *See, e.g.*, Nathaniel Hendren, *Private Information and Insurance Rejections*, 81 ECONOMETRICA 1713, 1713-14 (2013) (noting that individuals who exhibit high-risk tendencies are often denied insurance).

[41] *See, e.g.*, Kenneth S. Abraham & Daniel Schwartz, *The Limits of Regulation by Insurance*, 98 IND. L.J. 215, 226 n. 46 (2022) ("Homeowners' insurance, for instance, exclude coverage for the freezing of plumbing, heating, and air conditioning systems unless the insured used reasonable care to maintain heat in the building or shut of the water supply.").

[42] *See, e.g.*, Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 26-27 (1978) ("[I]f an applicant has a history of heart trouble […] and he does not disclose the problem itself, the insurance company will usually be permitted to set the contract of insurance aside.").

monitoring and supervision,[43] and training in risk-reducing practices;[44] and ex post by adjusting the rate of deductibles and premiums in the course of insurance contract renegotiation.[45]

The regulatory conception of insurance presents an interesting disparity, highlighting two competing effects on policyholders: *risk-enhancing*, as insurance undermines internalization of costs by the insured; and *risk-reducing*, as private insurers perform a regulatory role. Determining which effect dominates is crucial for understanding insurance's impact on third parties. Consider all cases exemplifying third-party deterrence and note that if insurance functions as an adequate substitute of public regulation, the ascribed problem of third-party deterrence—as well as, although to a somewhat lesser extent,[46] Parchomovsky and Siegelman's problem of third-party moral hazard—vanishes together with the insured's moral hazard. Be that as it may, there are several other factors to consider.

First, the effectiveness of insurers in controlling insureds' moral hazard remains uncertain and lacks a cohesive theoretical framework. Scholars are routinely torn regarding which effect of insurance—risk-enhancing or risk-reducing—prevails. For example, against Rappaport's argument that risk-reduction might eclipse the rise of moral hazard in police misconduct insurance,[47] consider Baker and Griffith, who ask whether D&O insurance acts as a regulatory

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[43] *See, e.g.*, Ben-Shahar & Logue, *supra* note 9 at 236-37 ("The improved monitoring allows insurers to price policies to reflect individual risk more accurately.").

[44] Baker & Swedloff, *supra* note 9 at 1421-22 ("[L]oss prevention [training] services may be the easiest aspect of the insurance business to understand as a form of regulation, because the insurers are advising clients on how to modify behavior to avoid losses.").

[45] *See, e.g.*, Rubinstein & Yaari, *supra* note 6 (noting that repeated periodical interactions between the insurer and the policyholder reduce moral hazard).

[46] Parchomovsky and Siegelman discuss several examples that do not hinge on the insured's excessive risk-taking. For instance, the horrifying practice of organized criminals to purchase insurance policies in the name of homeless people or drug addicts, and then causing them significant injuries in order to extract insurance payments. *See* Parchomovsky & Siegelman, *supra* note 1 at 106.

[47] *See generally See* John Rappaport, *How Private Insurers Regulate Public Police*, 130 HARV. L. REV. 1539 (2017).

device.[48] After conducting thorough research which includes interviews with professionals, they report: "[t]he short answer: D&O insurers do almost nothing to monitor the public corporations they insure, and D&O insurers do not condition the sale of insurance on compliance with loss-prevention requirements in any systematic way."[49] Relatedly, the mere presence of risk-management measures does not imply the complete disappearance of moral hazard. Even if insurance manages to *mitigate* moral hazard, it will only *mitigate* third-party deterrence, but would not reinstate it to its initial level (that is, its level under complete risk-internalization by the insured).

Finally, although insurers are best positioned to oversee the insured's behavior and channel her toward optimal risk-taking, the incorporation of the theory of third-party deterrence into the accepted conception of insurance as governance, may uncover a counterintuitive outcome of *insurer moral hazard*. Note that even if the insurer could monitor and regulate the insured's behavior, third parties' increased cautiousness—which reduces the probability of loss—may result in her declining the intensity of monitoring and thereby transferring the costs of the insured's riskiness to third parties. This insight pertains to the theory of *double moral hazard*. Pioneered by Cooper and Ross,[50] this approach extends the textbook problem of moral hazard that emerges in a principal-agent model, considering cases where the probability of loss is affected by the level of care exercised by both parties to a contract.[51] Taking this idea one step further, it is easy to see that if a risk may be borne by a third party, then neither the insured (by exercising care) nor the insurer

[48] *See generally See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION (2010).

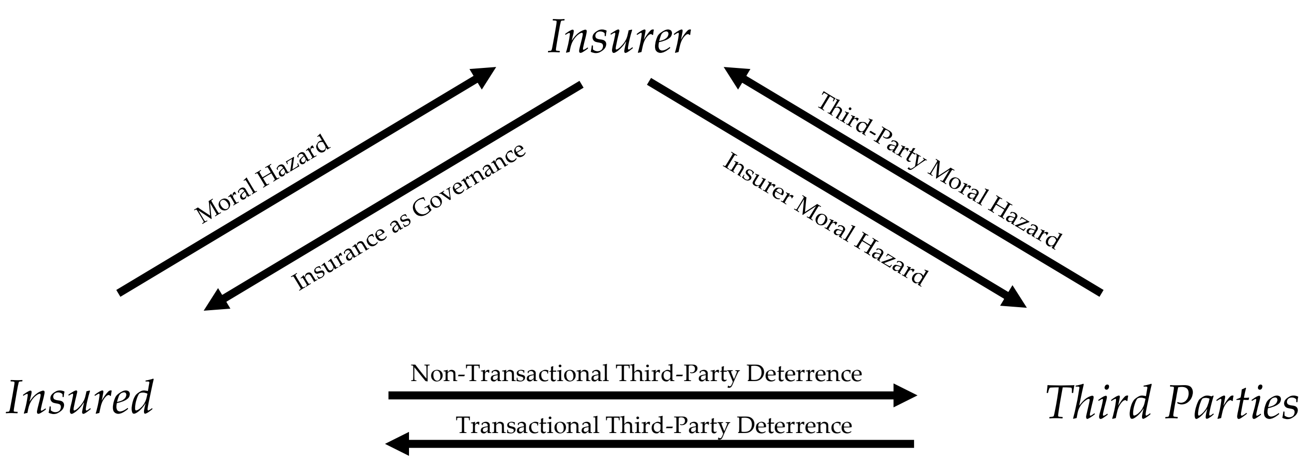
[49] *Id.*, at 109.

[50] *See generally* Russell Cooper & Thomas W. Ross, *Product Warranties and Double Moral Hazard*, 16 RAND J. ECON. 103 (1985).

[51] For a review see generally Baker, *supra* note 6 at 274 n. 181.

(by monitoring) might have sufficient incentives to exert optimal risk-reducing effort. Under this framework, *any* actor in the insurer, insured and third-party triangle may exhibit moral hazard and transfer risks to others by exercising insufficient care. Likewise, each party may be the one who ultimately bears the cost of increased risk-taking. To the best of my knowledge, the prospect of insurer moral hazard and its potential effects have not been thoroughly investigated thus far. The third-party perspective on insurance brings attention to many hidden aspects that have yet to be fully explored by commentators. The ensuing figure concludes by sketching the dynamics of risk transferring among the triangle of insurer, insured and third party.

Figure 3.1. A Taxonomy of Risk-Transferring



The theoretical blueprint unfolded here, together with real-world examples on which I draw, can hopefully facilitate future empirical analyses concerning the nature, scope and degree of third-party deterrence, as well as its interplay with the growing literature on the regulatory role of insurance, conventional wisdom on moral hazard, and the theory of third-party moral hazard.

III. Formal Treatment

A. *Setup*

This Part formally establishes third-party deterrence and its consequences. For simplicity, the exposition follows Jaspersen and Richter's model of moral hazard.[52] Let B denote a risk averse actor, whose utility function U_B is increasing and strictly concave, that is, $U_B'(\cdot) > 0 > U_B''(\cdot)$. B's wealth is a random variable. If a loss occurs (state L), which happens with probability $p \in (0,1)$, her wealth is x_L. With the complementary probability she avoids a loss (state H), and her wealth is $x_H > x_L$. B can exercise effort $e_B \in \mathbb{R}_+$, be it by increasing her level of care or declining her level or activity, to reduce the probability of loss. Assume $p''(e_B) > 0 > p'(e_B)$. The cost of efforts c are measured in utility units to allow for separability and is increasing convexly such that $c'(e_B) > 0$ and $c''(e_B) > 0$.

Without insurance, B chooses her optimal effort so as to maximize expected utility:

$$\max_{e_B} EU_B = \big(1 - p(e_B)\big)U_B(x_H) + p(e_B)U_B(x_L) - c(e_B) \qquad \textbf{(1)}$$

Denote by $U_H^N = U_B(x_H)$ and $U_L^N = U_B(x_L)$ her utilities in states H and L, respectively, with no insurance. Denote by e_B^N her optimal effort level without insurance. First order condition is:

$$e_B^N : p'(e_B) = -\frac{c'(e_B)}{U_H^N - U_L^N} \qquad \textbf{(2)}$$

[52] *See generally* Johannes G. Jaspersen & Andreas Richter, *The Wealth Effects of Premium Subsidies on Moral Hazard in Insurance Markets*, 77 Eur. Econ. Rev. 139 (2015). *See also* Rubinstein & Yaari, *supra* note 6; Shavell, *supra* note 6.

Which means that her optimal effort level is increasing in U_H^N, and decreasing in U_L^N and $c(e_B)$. This makes intuitive sense.

Now suppose that *B* can purchase an insurance policy against loss. Insurance entails paying a premium π in each state of the world. If a harm occurs, the insurance indemnifies q. Assume partial coverage, namely, $x_H > x_L + q$. The insurer thus offers B a pair (q, π). Assuming for simplicity that the insurer's expected profit is zero, the premium satisfies: $\pi = p(e_B)q$. *B* decides whether or not to accept and then sets her level of effort. Then, nature chooses a state.

To begin, assume asymmetric information such that the insured's level of effort is *unobservable* to the insurer, which gives rise to *B*'s moral hazard.[53] In particular, the insurer offers an insurance contract with fixed premium and level of coverage, and the insured's problem thereby becomes:

$$\max_{e_B} EU_B = \left(1 - p(e_B)\right)U_B(x_H - \pi) + p(e_B)U_B(x_L - \pi + q) - c(e_B) \qquad \textbf{(3)}$$

Denote by $U_H^I = U_B(x_H - \pi)$ and $U_L^I = U_B(x_L - \pi + q)$ her utilities in states H and L, respectively, under insurance. Denote by e_B^I her optimal effort level with insurance. First order condition is:

$$e_B^I\colon p'(e_B) = -\frac{c'(e_B)}{U_H^I - U_L^I} \qquad \textbf{(4)}$$

Here, too, the optimal effort level is increasing in U_H^I and decreasing in U_L^I and $c(e_B)$. Comparing the utilities with and without insurance, it can be verified that $U_H^N > U_H^I$ for losing π

[53] The case where the insurer can observe the policyholder's effort will be addressed momentarily.

and that $U_L^I > U_L^N$ for being indemnified $q - \pi$. Both yield $e_B^I < e_B^N$, which implies *B*'s moral hazard.

B. *Analysis*

1. Transactional Interactions

First, let us formalize third-party deterrence in the context of mutually wanted, contractual interactions between B and a third party, *C*, when the former is insured. This transactional description is sufficiently general to describe, for instance, the abovementioned examples of D&O or EPL insurance. In these cases, the nature of the interaction implies that *C* can reward care or punish recklessness by deprecating its valuation of *B*. These concerns feed back as costs into *B*'s objective function. More generally stated, in the transactional setting, the insured accounts for the translation of her effort level into the third party's willingness to engage.

The third party's ability to induce risk-internalization by the insured can be captured in our formal setup. Specifically, let $\delta_C(e_B)$ denote *C*'s depreciation function, denoting her willingness to interact with *B*.[54] Similarly, suppose that negotiations take place *after* the insured chooses her effort but *before* the state of the world is realized. While the policyholder's effort level is unobservable to the insurer at the stage of offering the policy (π, q), it is observable to *C* and therefore affects the negotiation process. Thus, upon *B*'s choice of effort, *C* responds with $\delta_C(e_B)$. Assume: $\delta_C: [e_B^I, e_B^N] \longrightarrow \mathbb{R}_+$, where $\delta_C'(e_B) < 0$ such that $\delta_C(e_B^N) = 0$ and $\delta_C(e_B^I) > 0$.

Equipped with this understanding, we can find *B*'s optimal effort level given its effect on *C*'s subsequent reluctance. *B*'s modified problem becomes:

[54] In other frameworks, one may modify the value of δ_C and interpret it as *B*'s reputation or *C*'s reservation price.

$$\max_{e_B} EU_B = \big(1 - p(e_B)\big)U_B(x_H - \pi) + p(e_B)U_B(x_L - \pi + q) - c(e_B) - \delta_C(e_B) \quad \textbf{(5)}$$

Let e_B^* denote *B*'s optimal effort when she accounts for *C*'s reaction. First-order condition is now:

$$e_B^*: p'(e) = -\frac{c'(e_B) + \delta_C(e_B)}{U_H^I - U_L^I} \quad \textbf{(6)}$$

Comparing expressions (6) and (4), we obtain $e_B^* \in (e_B^I, e_B^N]$. This result is summarized in the ensuing proposition.

Proposition 1. *In a transactional setting, where the third party's aspiration to avoid risks feeds back into the insured's problem, third-party deterrence results in the insured increasing her effort beyond the level she chooses in the absence of third-party deterrence, thereby (partially or fully) internalizing the cost of her excessive risk-taking.*

The underlying intuition is that the insured anticipates a decline in the third-party's willingness to transact, hence wishes to increase her effort level beyond the one that would have been chosen by her under insurance without any transactional interaction with a third party.

2. Externalities

In another type of interactions, *B* would be indifferent to *C*'s cautious reaction. This is the case whenever the relationship between both actors is a random occurrence, i.e., predicated not on trust or reputation, but rather originates in more casual encounters. Two pertinent characteristics of this non-transactional setting are, first, that interactions are avoidable by means of increased effort exerted by *either* party; and second, that while *C*'s expected utility is impacted by the *B*'s level of risk-reducing effort, this effect is only one-sided, namely, *C*'s deterrence does not feed back into the *B*'s endogenous choice of effort.

Consider driving. If *B* is expected to drive recklessly—not caring about an accident—her decision is clearly unaffected by *C*'s reluctance to drive in her vicinity. Along similar lines, if *B* is an enforcement official who increases her engagement in misconduct due to insurance, *B* need not substantiate any credibility or establish trust when interacting with *C*. Consequently, in the non-transactional setting, no internalization is expected to take place: being risk averse, *C* would simply increase her effort to avoid such risky interactions.

To formalize, let U_C denote *C*'s utility, where $U_C'(\cdot) > 0 > U_C''(\cdot)$. Denote *C*'s wealth in each state of the world H and L by w_H and w_L, respectively. Let $e_C \in \mathbb{R}_+$ denote *C*'s effort. *C*'s problem is:

$$\max_{e_C} EU_C = \big(1 - p(e_B, e_C)\big)U_C(w_H) + p(e_B, e_C)U_C(w_L) - c(e_C) \qquad \textbf{(7)}$$

Assume:

$$\frac{\partial p(e_B, e_C)}{\partial e_B} < 0, \frac{\partial^2 p(e_B, e_C)}{\partial e_B^2} > 0, \frac{\partial p(e_B, e_C)}{\partial e_C} < 0, \frac{\partial^2 p(e_B, e_C)}{\partial e_C^2} > 0, \frac{\partial^2 p(e_B, e_C)}{\partial e_B \partial e_C} = 0$$

And $c'(e_C) > 0, c''(e_C) > 0$. First-order condition is:

$$e_C^*: \frac{\partial p(e_B, e_C)}{\partial e_C} = -\frac{c'(e_C)}{U_C(w_H) - U_C(w_L)} \qquad \textbf{(8)}$$

Denote by e_C^N and e_C^I *C*'s chosen effort level given that *B* is uninsured and insured as in (2) and (4), respectively. This implies:

$$e_C^N : \left.\frac{\partial p(e_B, e_C)}{\partial e_C}\right|_{e_B = e_B^N} = -\frac{c'(e_C)}{U_C(w_H) - U_C(w_L)} \tag{9}$$

And:

$$e_C^I : \left.\frac{\partial p(e_B, e_C)}{\partial e_C}\right|_{e_B = e_B^I} = -\frac{c'(e_C)}{U_C(w_H) - U_C(w_L)} \tag{10}$$

Since

$$\left.\frac{\partial p(e_B, e_C)}{\partial e_C}\right|_{e_B = e_B^N} > \left.\frac{\partial p(e_B, e_C)}{\partial e_C}\right|_{e_B = e_B^I}$$

We obtain

$$e_C^I > e_C^N \tag{11}$$

While $e_B^I < e_B^N$. This result is stated in the following proposition.

Proposition 2. *In an externality setting, where the third-party's aspiration to avoid risks does not feed back into the insured's problem, third-party deterrence results in the third party incurring by herself the costs of the insured's increased risk-taking.*

Without any interest in alleviating third-party deterrence, the insured will retain an effort level that reflects moral hazard and take excessive risks, which simply results in third parties increasing their precautionary reaction by enhancing their effort level. In that case, the presence of insurance results in excessive riskiness being externalized on third parties.

3. Insurer Moral Hazard

I now show that even if the insurer can invest in cost-effective monitoring in order to incentivize the insured to exert first-best effort, she may fail to do so when knowing that third parties' precautionary reaction is expected to reduce the probability of loss, thereby exhibiting *insurer moral hazard*. Suppose that the insurer can invest $m \in \mathbb{R}_+$ in monitoring, thus inducing B to increase her level of risk-reducing effort: $e_B'(m) > 0 > e_B''(m)$. Further assume that rather than being a constant, the premium is determined according to the level of monitoring, i.e., $\pi: m \longrightarrow [0, p(e_B)q]$. Assume that $\pi'(m) > 0 > \pi''(m)$. Thus, by investing in m, the insurer can set a premium in commensuration with the policyholder's chosen level of effort. The monitoring cost function is $k(m)$, where $k'(m) > 0$ and $k''(m) > 0$.

Assumed risk neutral, the insurer chooses a monitoring level m so as to minimize her expected loss L:

$$\min_{m} EL = p\big(e_B(m)\big)q - \pi(m) + k(m) \qquad \textbf{(12)}$$

Since $e_B'(m) > 0$ and $p'(e_B) < 0$, the chain rule implies: $p'(m) < 0$. First-order condition can be written as:

$$m^*: p'(m) = -\frac{k'(m) - \pi'(m)}{q} \qquad \textbf{(13)}$$

Thus, from the insurer's perspective, the optimal level of monitoring is increasing in q and $\pi'(m)$, and decreasing in the monitoring cost which intuitively makes sense.

Things change dramatically, however, when the insurer anticipates the precautionary reaction of third parties. Under these circumstances, m indeed raises e_B which in turn reduces p, but on the other hand, by her investment in m to increase e_B, the insurer would substitute the upcoming risk-reduction which is due to an increase in e_C. In other words, the insurer can obtain the desirable decrease in p simply by *not* monitoring, allowing the policyholder to reduce her effort level, and consequently, third parties to take precautions instead.

To see this, we may consider p as a function $p\big(e_B(m), e_C(m)\big)$, whereas $e_B'(m) > 0$ and $e_C'(m) < 0$. Since we assume that the probability of loss is reduced independently by each parties' effort level, namely $\frac{\partial^2 p(e_B,e_C)}{\partial e_B \partial e_C} = 0$,[55] we can separate $p(\cdot)$ into $\beta\big(e_B(m)\big) + \gamma\big(e_C(m)\big)$ where $\beta'(e_B) < 0$ and $\gamma'(e_C) < 0$. By the chain rule, we obtain $\beta'(m) < 0$ and $\gamma'(m) > 0$. Rewrite the insurer's objective function as:

$$\min_m EL = \beta(m)q + \gamma(m)q - \pi(m) + k(m) \tag{14}$$

Denote by m^{TPD} the insurer's investment in monitoring when she anticipates third-party deterrence. First-order condition is:

$$m^{TPD}\!: \beta'(m) = -\frac{k'(m) - \pi'(m) + \gamma'(m)q}{q} \tag{15}$$

Assuming $\beta''(m) > 0$, and since $\gamma'(m) > 0$, we obtain $m^{TPD} < m^*$, which implies insurer moral hazard. The following proposition concludes.

Proposition 3. *When the insurer anticipates third parties' interest in avoiding risks, she reduces her investment in monitoring against the insured's excessive risk-taking, which transfers the cost of risk-reduction to third parties.*

Opting out of the insurer-insured relationship, it appears that insurers, too, can exercise insufficient effort to avert risks, for knowing that their lack of monitoring or unwillingness to

[55] This assumption is standard. See, for example, Yehonatan Givati & Yotam Kaplan, *Harm Displacement and Tort Doctrine*, 49 J. LEGAL STUD. 73, 79 (2020). For a different outlook see generally Ehud Guttel, Yuval Procaccia & Eyal Winter, *Shared Liability and Excessive Care*, 37 J. L. ECON. & ORG. 258 (studying the case of complementary loss-reducing efforts in the context of tort liability).

realign the policyholder with the socially optimal level of care, will be counterbalanced by third parties' increased investment at the sight of an insured that exhibits moral hazard.

Conclusion

Against the theory of third-party moral hazard—focusing on third parties who decline their risk-reducing effort in light of insurance—I analyze the mirror-image phenomenon of third-party deterrence: cases where third parties engage in activities designed to counterbalance the insured's moral hazard. I characterize the settings in which third-party deterrence replaces third-party moral hazard, address the economic foundations of this problem, and study its effects on risk transferring within the triangle of insurer, insured and third parties. I also point to additional frameworks that may give rise to third-party deterrence, discuss possible implications on the incentives of insurers, and identify countervailing forces that may alleviate the ascribed distortion.