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RECONSIDERING INSURANCE FOR PUNITIVE DAMAGES

TOM BAKER*

I. INTRODUCTION

Many courts refuse on policy grounds to enforce contracts to provide insurance for punitive damages, to the general applause of academic commentary.¹ According to the conventional wisdom, insurance for punitive damages defeats the purposes of those damages and therefore courts should prohibit that insurance. This Article reexamines the conventional wisdom in light of basic information about the liability insurance market and concludes that there is little evidence of a need for this particular form of judicial regulation.

The next two parts of this Article set the scene for the main discussion in Part IV. Part II reviews the deterrence and retribution objections to insurance for punitive damages. Part III then describes restrictions that insurance companies have placed on the insurance they offer for punitive damages and explains those restrictions as efforts to control moral hazard and adverse selection.

Part IV considers the case for judicial regulation of punitive damages insurance in light of these market restrictions. Part IV argues that the twin problems of moral hazard and adverse selection provide insurance companies with adequate incentive to address the deterrence objection to punitive damages insurance and that the companies' control over underwriting and contracting places them in a better position than courts to address that objection. Therefore, there is no need for courts to act on deterrence grounds to prohibit insurance for punitive damages.

The incentives of insurance companies do not mesh as neatly with the retributive objectives of tort law. Accordingly, retribution provides a somewhat stronger case for judicial regulation of punitive damages

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1. See, e.g., W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 2 (5th ed. 1984); Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1, 73-76 (1982); Alan I. Widiss, *Liability Insurance Coverage for Punitive Damages? Discerning Answers to the Conundrum Created by Disputes Involving Conflicting Public Policies, Pragmatic Considerations and Political Actions*, 39 VILL. L. REV. 455, 462 (1994).

insurance (as well as other aspects of liability insurance). Nevertheless, even with punitive damages insurance, tort law in action will calibrate the sting of a tort action according to the culpability of the defendant, and insurance underwriting practices reduce the ability of repeat offenders to use insurance to insulate themselves from the retributive aims of tort law. Moreover, because there is nothing a court can do to stop an insurance company from paying a punitive damages claim, particularly at the settlement stage, there is little reason to believe that judicial regulation of punitive damages insurance will have a significant impact on the retributive function of tort law. Thus, even the retribution-based case for implying a punitive damages exclusion in liability insurance policies is at best a weak one.²

Part V addresses the implications of this analysis for tort and insurance policy. As this Article illustrates, a primary function of insurance institutions is constructing insurance relationships that minimize the insurance-deterrence tradeoff predicted by economic theory.³ Thus, when discussing “insurance” in the context of tort policy, we have to be careful to distinguish between theoretical conceptions of insurance and insurance as it is actually provided through insurance institutions.⁴ Similarly, when discussing insurance policy, we cannot forget that insurance institutions play an important role in furthering the objectives of tort policy.

This Article illustrates the point most concretely by using the existence of intentional harm exclusions as the primary basis for the

2. In reaching this conclusion, I do not consider the claim by some courts that insurance for punitive damages should be permitted on the grounds that punitive damages do not serve their intended function. See *Lazenby v. Universal Underwriters Ins. Co.*, 383 S.W.2d 1, 5 (Tenn. 1964). I agree with Dean Ellis that if these courts are right, the better approach is to address punitive damages directly. See Ellis, *supra* note 1, at 75.

3. See Joseph E. Stiglitz, *Risk, Incentives and Insurance: The Pure Theory of Moral Hazard*, 8 GENEVA PAPERS ON RISK & INS. 4, 6 (1983) (“[T]he more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the full consequences of their actions.”).

4. A nice example of the importance of paying attention to this distinction appears in Jon D. Hanson and Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129 (1990) (criticizing tort theorists for failing to consider the fact that first party insurance for individuals is rarely experience-rated). Two theoretical papers that simultaneously illustrate the importance of paying attention to insurance institutions and the difficulty of doing so within the bounds of economic theory are Seth J. Chandler, *The Interaction of the Tort System and Liability Insurance Regulation: Understanding Moral Hazard*, 2 CONN. INS. L. J. 91 (1996) [hereinafter Chandler, *Understanding*] and Seth J. Chandler, *Visualizing Moral Hazard*, 1 CONN. INS. L.J. 97 (1995) [hereinafter Chandler, *Visualizing*].

conclusion that there is little to gain by prohibiting insurance for punitive damages. Because of intentional harm exclusions, the liability insurance that is actually provided through the insurance market poses much less an insurance-deterrence tradeoff than the simple model of insurance that is employed in most economic theory.⁵ Furthermore, the significance of these exclusions to that tradeoff means that insurance companies that (properly) deny claims on intentional harm grounds serve important deterrence and retribution functions that further the objectives of tort law.

II. A THEORETICAL PERSPECTIVE ON INSURANCE FOR PUNITIVE DAMAGES

It is well established in the theoretical literature that there are two primary justifications for punitive damages: retribution and prevention.⁶ As Ellis has shown, the remaining justifications, such as compensation or legitimation, depend on theories of retribution or prevention to explain why punitive damages should be assessed in one case but not another.⁷

It is commonly observed that insurance for punitive damages defeats the purposes of those damages.⁸ If we understand retribution to require

5. See, e.g., Stiglitz, *supra* note 3. This is not a criticism of economic theory, but rather a call for careful application of that theory in the context of insurance institutions. See Chandler, *Visualizing*, *supra* note 4 for a formal demonstration, using computer-assisted mathematical modeling, of the theoretical ability of insurance contract provisions to reduce the insurance-deterrence tradeoff.

6. See Ellis, *supra* note 1 (Following the conventions of law and economics scholarship, Ellis uses the term "deterrence," rather than "prevention.").

7. See *id.* at 10-12. For example, the fact that punitive damages serve to compensate plaintiffs for otherwise non-compensable harm does not tell us which plaintiffs are entitled to those additional damages. We need notions of retribution or deterrence to explain why providing greater than the usual compensatory damages is best in one case and not another. We accept less than complete compensation generally, perhaps because we are uncomfortable with requiring negligent or strictly liable defendants to bear the entire cost of their injury causing activity, or because we want to encourage people to "lump it" to some degree in order to discourage claiming. But, when a defendant behaves in a sufficiently flagrant fashion, we are less uncomfortable with requiring that defendant to bear the full costs (or more) of his or her conduct and we no longer believe that the plaintiff should "lump it." If we explore why our feelings are different for the flagrant defendant, we will see that the reasons track those that will be discussed in the paragraphs on retribution and deterrence below. See *infra* Parts II.C-D.

Ellis did not address directly the legitimation purpose of punitive damages: for example, convincing us that tort law is in fact capable of constraining the behavior of powerful economic actors. Nevertheless, his analysis applies to that purpose as well: legitimation may well be the most important purpose of punitive damages, but that purpose cannot tell us when to assess those damages.

8. See Widiss, *supra* note 1, at 465-66. The courts of many jurisdictions, including such populous states as California, Florida, Illinois and New York, forbid the

the deprivation of something that the offender values, then the tension between punitive damages and insurance is obvious. A money judgment hardly stings the defendant when it is an insurance company that pays. Similarly, if we understand prevention to require imposition of the cost of harm on the offending party, the tension between insurance and punitive damages is equally obvious. The higher, and perhaps prohibitive, price that the offender must pay to purchase insurance in the future pales in comparison to the punitive damages judgment thereby avoided. The standard theoretical analysis criticizes insurance for punitive damages on just these grounds.⁹ While I do not entirely dispute this analysis, the theoretical case against enforcing contracts to insure punitive damages is not as strong as commonly understood.

A. *Punitive Damages as Prevention*

“Prevention” is a term that I have borrowed from Professors Galanter and Luban in place of the more commonly used term “deterrence.”¹⁰ By using “prevention,” Galanter and Luban intend to capture, not only the idea that punitive damages can prevent loss by subjecting people to severe financial consequences for causing loss, but also the idea that punitive damages can prevent loss by making a strong statement that certain conduct lies well outside the bounds of the acceptable.¹¹ I prefer Galanter and Luban’s “prevention” because it helps to remind me (and may help remind others) of this norm projection function of punishment, which has not been emphasized in the economic analysis of law.¹² As Galanter and Luban recognize, human behavior

insurance of direct punitive damages on public policy grounds. All states permit the insurance of punitive damages that are assessed vicariously. *See id.*

9. *See, e.g.,* Robert D. Cooter, *Economic Analysis of Punitive Damages*, 56 S. CAL. L. REV. 79, 96 (1982) (arguing that this criticism should give way because insurance makes both victims and tortfeasors better off); Ellis, *supra* note 1, at 73-76. While I agree with the conclusion that punitive damages insurance should not be prohibited, I disagree strongly with Cooter’s reasoning because it takes an *ex post* approach to victim welfare that fails to acknowledge victims’ autonomy. For a critique of *ex post* approaches to victim welfare, see Mark Geistfeld, *Placing a Price on Pain and Suffering: A Method for Helping Juries Determine Tort Damages for Nonmonetary Injuries*, 83 CAL. L. REV. 773 (1995).

10. *See* Marc Galanter & David Luban, *Poetic Justice: Punitive Damages and Legal Pluralism*, 42 AM. U. L. REV. 1393, 1429 (1993).

11. *Cf.* David G. Owen, *A Punitive Damages Overview: Functions, Problems and Reform*, 39 VILL. L. REV. 363, 374 (1994) (referring to the “education” function of punitive damages).

12. I do not want to suggest, however, that this function cannot be accommodated within the concept of deterrence as it is used in economic analysis. From an economic perspective, Galanter and Luban are simply highlighting the fact that people have

is strongly conformist. In most situations, we decide on the appropriate level of care, not by making an explicit cost-benefit calculation, but rather by observing whether there is a rule or norm that applies to a given situation.¹³ If so, we typically orient our behavior to that rule or norm. One way punitive damages awards prevent harm is by reminding people that norms of safety or care exist and stigmatizing flagrant violation of them.

Whether we focus on the financial or norm projection aspects of punitive damages, however, the difficult theoretical question is why we need punitive damages to prevent harm, when compensatory damage awards already project norms and create financial incentives for conforming to those norms. Why, in other words, *punish* defendants to prevent harm when we already attempt to *compensate* plaintiffs at the level that is (at least theoretically) appropriate for preventing harm?

Ellis has explained that punitive damages are an efficient complement to compensatory damages in three situations:

- (1) When the probability of being held liable for breach of a legal standard is less than the probability of loss resulting from that breach;
- (2) When there are important harms that would not be considered in computing a compensatory damage award; and
- (3) When the actor derives an illegitimate benefit from the harmful act.¹⁴

preferences for things other than money. Fining Bob for doing *X* will affect the behavior of Alice, a rational conformist, not simply because she wants to avoid the fine imposed on Bob, but also because she values living her life in a socially acceptable way. In other words, she is deterred from doing *X*, not only by the probabilistic costs attributable to the risk of being fined, but also because of the value she places on living in a socially responsible manner (and the corollary of that value, the loss to her self-understanding attributable to engaging in stigmatized behavior—a loss that will occur whether or not she is caught).

13. It is possible that the norm or rule will itself be the result of a cost-benefit analysis. To the extent individuals make a cost-benefit calculation, however, the costs and benefits are assessed, not with reference to the probability of loss that may be imposed on others (Learned Hand's BPL, *see* *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947)), but with reference to what there is to gain or lose by breaching the applicable norm.

14. *See* Ellis, *supra* note 1, at 25-33.

The first situation results from what I will call the “underenforcement” problem; the second situation results from what I will call the “externalities” problem; and the third situation, from what I will call the “deviance” problem. While these categories may be criticized as overbroad,¹⁵ they provide a helpful framework for discussing whether punitive damages insurance is consistent with the prevention justification for punitive damages.

1. UNDERENFORCEMENT AND EXTERNALITIES

The underenforcement and externalities problems are alike in that they highlight the failure of the compensatory damages regime to impose the full costs of harm on those who are liable for causing that harm. The underenforcement problem means that some people who should be held responsible for causing harm are not. The externalities problem means that those who are held responsible are not required to compensate all those harmed for all the harm suffered. Both problems threaten the prevention function of the legal regime.

Negligence regimes can in theory withstand substantial uncompensated harm with no loss in their deterrent effect.¹⁶ Nevertheless, there is a tipping point below which it would be rational for the actor to ignore the legal standard.¹⁷ Punitive damages can move that tipping point downward, compensating for underenforcement and undercompensation. We know from empirical research that the U.S. legal system is characterized by massive underenforcement and substantial undercompensation.¹⁸ Were damages limited to compensation, a rational actor who was not constrained by the conscience, stigma, or good will costs that typically accompany the violation of social norms would often be better off ignoring legal standards governing caretaking conduct. Punitive damages assessed when a defendant deliberately ignores a legal standard can discourage actors from deliberately taking advantage of the underenforcement and externalities problems.

15. See David G. Owen, *Civil Punishment and the Public Good*, 56 S. CAL. L. REV. 103, 113 (1982) (“each of Professor Ellis’ categories seems all-inclusive or almost so: none of the categories appear to exclude many, if any, cases.”).

16. See Cooter, *supra* note 9, at 80-81.

17. See *id.* Using the numbers provided in Cooter’s exploding pop bottle hypothetical, I was able to calculate a “tipping point” that occurs when the bottler is held liable for thirty percent or less of the costs of exploding pop bottles.

18. See Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—And Why Not?*, 140 U. PA. L. REV. 1147 (1992) (an exhaustive review of the empirical literature and findings in the tort field).

In theory, strict liability regimes are much more sensitive to underenforcement and undercompensation problems than negligence regimes.¹⁹ Indeed, as Cooter has shown, any reduction in enforcement or compensation will result in reduced care.²⁰ Although this analysis can be understood as a reason for preferring negligence to strict liability, it also provides a theoretical justification for the use of punitive damages within a strict liability regime. Given that we know that only a fraction of injured individuals makes claims, we can confidently say that all real world strict liability regimes will be characterized by underenforcement. Within a strict liability regime, punitive damages could create the same threshold effect as the negligence standard,²¹ thereby increasing the level of safety under strict liability. Thus, rather than being incoherent,²² the imposition of punitive damages in an appropriate strict liability case may serve a useful prevention function.

2. DEVIANCE

The “deviance” problem arises from the actor who is unable or unwilling to act in accordance with the values that are recognized as legitimate by the prevailing legal regime. Ellis uses as his example a man who engages in violence because of the infidelity of his spouse. Compensatory damages are not an adequate deterrent in Ellis’s example because the husband derives satisfaction from inflicting injury on the spouse or her sexual partner. Other examples of the deviance problem include violence by members of groups committed to an alternative social order. At least formally, the satisfaction that results from self-help violence is not recognized as legitimate in the U.S. legal regime,²³ and punitive damages are one way to make that point.

19. See Cooter, *supra* note 9, at 91. For an analysis that suggests that this difference between negligence and strict liability disappears when insurance companies specify precaution conditions, see Chandler, *Understanding*, *supra* note 4, at 138-40.

20. See Cooter, *supra* note 9, at 91.

21. An alternative, and more practically important threshold, is provided by insurance contract provisions that specify the precautions that insureds must take to avoid harm. See generally Chandler, *Understanding*, *supra* note 4; Chandler, *Visualizing*, *supra* note 4. The intentional harm and accident provisions discussed in Part III of this paper are two examples of such provisions.

22. See, e.g., Ellen Wertheimer, *Punitive Damages and Strict Products Liability: An Essay in Oxymoron*, 39 VILL. L. REV. 505 (1994).

23. The reluctance of some legal authorities to police domestic violence could well lead one to conclude that the “law in action” does not regard such violence as entirely illegitimate. See RICHARD J. GELLES & MURRAY A. STRAUSS, *INTIMATE VIOLENCE* 20-25 (1988).

While it seems unlikely that the *threat* of a punitive damages judgment will do much to prevent such harm, an actual punitive damages judgment may at least partially incapacitate organized groups in conflict with the existing social order. The punitive damages judgments obtained by the Southern Poverty Law Center against the Klu Klux Klan and other white supremacists represent one attempt to use punitive damages for this specific deterrence purpose.²⁴

*B. Considering Punitive Damages Insurance in Light of the
Prevention Justification*

Like the uncompensated harm that results from underenforcement and externalities, liability insurance lowers the cost of violating a legal standard. Accordingly, liability insurance is subject to the same tipping point analysis.²⁵ In theory, the incentive effects of insurance and uncompensated harm are additive. Thus, given the problems of underenforcement and externalities, one might wonder how much deterrence insured damages really provide.²⁶ For compensatory damages, this insurance-deterrence tradeoff²⁷ is widely tolerated. Thus, the theoretical possibility of the tradeoff cannot itself be a serious objection to punitive damages. What might be different about punitive damages?

One answer turns on the theoretical purposes of compensatory and punitive damages: both compensatory and punitive damages are intended to prevent harm, but only compensatory damages are intended to provide compensation for victims, and only punitive damages are intended to provide retribution. In light of this distinction, we could say that the insurance-deterrence tradeoff is tolerated for compensatory damages because insurance for compensatory damages enhances tort law's compensation function without undercutting its retribution function. Insurance for punitive damages, on the other hand, appears to undercut tort law's retribution function without providing any necessary benefit in terms of compensation.²⁸

24. See Morris Dees, *Finding the Forum for a Victory*, NAT'L L.J., Feb. 11, 1991 at S3 (describing the Southern Law Poverty Center's strategy of bankrupting white supremacists).

25. See Chandler, *Visualizing*, *supra* note 4, at 123 (using computer-assisted modeling to estimate a tipping point that occurs, in the absence of precaution conditions in the insurance contract, at an indemnification level of twenty percent).

26. See Gary T. Schwartz, *Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 UCLA L. REV. 377 (1994).

27. See Stiglitz, *supra* note 3.

28. See text accompanying notes 42-45 (discussing insurance and retribution).

Punitive damages also differ from compensatory damages in a manner more directly related to the prevention rationale. Recall Galanter and Luban's observation that tort damages prevent harm, not only through financial incentives, but also through norm projection. Clearly, insurance reduces the financial incentives created by tort damages; this is so for both compensatory and punitive damages. Insurance does not undercut so fundamentally, however, the norm projection aspect of tort damages. Indeed, insurance may improve the norm projection aspect of tort law: the existence of insurance makes it more likely that damage awards will be paid, thereby increasing the ability of plaintiffs to vindicate their rights through tort law. Moreover, the existence of insurance institutions facilitates the dissemination of the norms created and reflected in tort law.²⁹

Nevertheless, it seems likely that norm projection will have less effect on behavior that meets the standard for punitive damages awards than on behavior that does not meet that standard. Defendants who are liable for punitive damages are more likely to have known that their conduct violated (or was likely to violate) the relevant standard of care than defendants who are not held liable.³⁰ Those who are willing to violate a legal standard are unlikely to be deterred from violating it again simply by being reminded of the standard. Indeed, given the underenforcement and externalities problems discussed above, a rational actor may be better off ignoring legal standards governing caretaking conduct. Punitive damages can change this conscious cost-benefit calculus only if the actor expects to bear the costs of those damages.

Insurance for compensatory damages does not undercut the prevention rationale of tort damages to the same extent, because those who violate legal standards inadvertently are governed more by tort law's norm projection function than those who violate legal standards deliberately.³¹ As this suggests, the lower the level of intent required for punitive damages, the weaker the prevention-based objection to insurance for those damages. Thus, it is not surprising that U.S. courts

29. Indeed, as Kent Syverud has suggested, at times insurance institutions can anticipate legal norms. See Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629, 1638 n.33 (1994).

30. Note that this is a probabilistic statement; not an assertion that all those subjected to an award will have this level of intent. Unless we deny that the standard for punitive damages has anything to do with intent (or that fact finders are more often right than wrong), this probabilistic statement will be true regardless of the precise standard for punitive damages. For a listing of various standards employed by courts, see Michael Rustad & Thomas Koenig, *The Historical Continuity of Punitive Damages Awards: Reforming the Tort Reformers*, 42 AM. U. L. REV. 1269, 1317 n.240 (1993).

31. Cf. Cooter, *supra* note 9, at 85-86 (suggesting that the imprecision of legal standards explains much of the inadvertent violation of those standards).

universally enforce contracts to provide insurance for vicarious punitive damages.³² Vicarious punitive damages are assessed against a principal who was merely negligent in the supervision of her agent.³³ For that reason, the insurance-deterrence tradeoff for vicarious punitive damages should be similar to that for compensatory damages. Moreover, insuring vicarious punitive damages enhances the norm projection aspects of tort law by providing an incentive for plaintiffs and their lawyers to bring to public attention flagrant breaches of legal standards.³⁴

C. Punitive Damages as Retribution

Using work by the philosopher Jean Hampton, Galanter and Luban have offered a strong retribution-based defense of punitive damages.³⁵ Following Hampton, they explain that the purpose of retribution is to express “public commitment to the value of persons.”³⁶ A public commitment to the value of persons requires a public response when a person acts deliberately to cause harm (or in a way known to have a very high probability of causing harm), because that person has denied the value of those he has harmed. In effect, his actions say to his victims, “You are worth so much less than I that I can hurt you deliberately.”

As Galanter and Luban explain, the retributive purpose of punitive damages “is to reassert the truth about the relative value of wrongdoer and victim by inflicting a publicly visible defeat on the wrongdoer.”³⁷ For this reason, they describe punitive damages awards as a form of “expressive defeat.”³⁸

Yet, compensatory damage awards also can be understood as a form of expressive defeat. After all, the victim wins the lawsuit and the perpetrator is required to pay the victim for the harm caused. Thus, as

32. See Widiss, *supra* note 1, at 482.

33. See, e.g., 2 STUART M. SPEISER ET AL., *THE AMERICAN LAW OF TORTS* § 8:50 (1985) (describing standards for the imposition of vicarious punitive damages, some of which require a considerably lower level of fault than negligence). Absent vicarious liability for punitive damages, principals would have an incentive not to monitor their agents' behavior so as not to have the knowledge necessary to support a direct punitive damages award.

34. For an argument that the deterrent purposes of punitive damages is satisfied by compensating only the lawyer (and not the plaintiff), see Note, *An Economic Analysis of the Plaintiff's Windfall from Punitive Damage Litigation*, 105 HARV. L. REV. 1900 (1992). This argument ignores the conflicts of interest between plaintiffs and their lawyers that would result from compensating lawyers but not their clients.

35. See Galanter & Luban, *supra* note 10, at 1432.

36. *Id.* at 1434.

37. *Id.* at 1432.

38. *Id.* (internal quotations omitted).

with prevention, one might reasonably ask why we need punitive damages for retribution, when we already compensate in a manner that appears to serve this retributive purpose? The answer must be that the relative value that would be asserted in a legal regime that limited damages to compensation would be false.

There are (at least) two reasons why the relative values would be false. The first dovetails with Ellis's deterrence justifications for punitive damages. The second follows from the relatively low level of moral culpability that is required for compensatory damages.

First, as the underenforcement and externalities problems reveal, perpetrators as a class wrongfully cause more harm to victims than they are required to pay as compensation. The presence of this substantial uncompensated harm defeats the compensatory damages regime's claim to an efficient result (i.e., one in which the benefits to society of an activity that causes harm exceed its costs). Moreover, as the deviance problem reveals, damages that are based solely on compensation can encourage the use of harm to achieve improper ends. For both these reasons, a legal regime that limited damages to compensation would systematically privilege perpetrators over victims and would encourage perpetrators to treat victims as means to achieve ends that are illegitimate within the logic of the legal regime.

Second, compensatory damage awards do not adequately satisfy the moral requirement that the consequences of action turn on moral culpability. Think of the distinction that young children learn between hurting someone "by accident" and hurting someone "on purpose." The higher level consequence given to children for hurting someone "on purpose" represents an effort to teach them about the value of persons and—this is the crucial point—the role that distinctions made on the basis of the actor's state of mind play in maintaining that value.

For good reasons, compensatory damages are assessed for much harm that is caused "by accident" and are not, as a formal matter, computed on the basis of moral culpability (beyond the requirement that the threshold liability standard is met).³⁹ Yet, public commitment to the morally appropriate value of persons requires that there be greater consequences for harm that is done "on purpose." I do not mean to suggest that the formulations used with children are adequate to describe the distinctions that tort law does or should make, but the point should be clear. In tort law, compensatory damages are assessed when harm results from an act of relatively low moral culpability. When the perpetrator's

39. See, e.g., JULES L. COLEMAN, *RISKS AND WRONGS* 218-19 (1992). As I will discuss in Part IV, tort law in action recognizes additional gradations in culpability, mainly because of insurance.

moral culpability significantly exceeds that level, there must be some additional consequence, or else tort law has failed to “right the wrong.”⁴⁰ Thus, without punitive damages (or some other additional consequence), tort law fails, because the “wrong” is a function, not only of the harm caused, but also of the moral culpability of the person who caused it.⁴¹

D. Punitive Damages Insurance and Retribution

Punitive damages can be justified on retributive grounds, then, because the relative value of persons asserted by compensatory damages is, in the sense described above, false. It is false because compensatory damages allow perpetrators to cause harm to achieve illegitimate ends. And it is also false because compensatory damages, alone, cannot right the wrong caused by perpetrators whose moral culpability significantly exceeds the compensatory damages threshold.

Does insurance for punitive damages undercut these retributive justifications? The quick answer is “of course.” If by retribution we mean hurting the perpetrator, how can money paid by an insurance company “right the wrong”? Although the insurance company may raise rates, refuse to provide coverage, or insert a restrictive exclusion, these are muted punishments, at least as compared to requiring the perpetrator to pay the punitive damages award directly.

Yet, as Hampton notes, retribution is not synonymous with punishment.⁴² Wrongs are made right in other ways as well. Public ceremonies, apologies, and financial payments all help to reassert the value of the person wronged relative to the person who committed the wrong. Indeed, whether or not a punitive damages award is insured, that award makes a public statement about the value of the victim that contradicts the private assessment of the perpetrator at the time the wrong was committed. Moreover, insured or not, a punitive damages award represents a consequence for extreme culpable behavior that goes beyond that for less culpable behavior. Although an insured punitive damages award clearly will hurt less than an uninsured one, it nevertheless does hurt: insurance is made more expensive and less available in the future; for commercial entities there is a loss of good will; and for any individuals involved, there are negative social consequences.⁴³

40. See Jean Hampton, *Correcting Harms Versus Righting Wrongs: The Goal of Retribution*, 39 UCLA L. REV. 1659, 1663 & 1691 (1992).

41. See *id.*

42. See *id.* at 1685, 1695.

43. In the context of groups or subcultures opposed to the prevailing legal regime, the social consequences of a punitive damages award may not be negative.

With that said, one cannot escape the fact that insurance for punitive damages would allow a perpetrator, in return for a fee paid in advance, to escape a significant part of the consequences for extreme, culpable behavior. Thus, even though the punitive damages award may reassert publicly the value of the victim, the fact that the perpetrator would not be the one who pays that award would at least partially defeat the “poetic justice” that Galanter, Luban and Hampton regard as one of the most attractive features of punitive damages.⁴⁴ Indeed, in the *Grimshaw* case described by these scholars,⁴⁵ were we to learn that the jury’s award was to have been paid, not by Ford, but rather by Aetna, Travelers, or Lloyd’s, we might wonder whether a significant part of the jury’s message might be lost on Ford (much as Galanter, Luban and Hampton wondered what message Ford received when the judge reduced the jury’s punitive damages award by ninety-seven percent).

E. Summary

The analysis thus far can be summed up as follows: the theoretical justifications for punitive damages are to prevent harm and to provide retribution for highly culpable harm. Insurance for punitive damages undercuts the prevention justification when it reduces the financial impact of those damages on defendants (and potential defendants) who are unlikely to respond adequately to the norm projection aspects of tort law. Moreover, insurance for punitive damages undercuts the retribution justification when it allows a perpetrator to escape responsibility for the consequences of egregious action. At the same time, however, by encouraging victims to seek and collect punitive damages, insurance for punitive damages enhances tort law’s capacity to project norms and to reassert publicly the value of those injured.

The lower the level of intent required for punitive damages, the weaker the theoretical objections to insurance for those damages. Thus, insurance for vicarious punitive damages does not seriously undercut the prevention justification, because vicarious damages are assessed against defendants who are no less likely to respond adequately to the norm projection aspect of tort law than defendants subjected simply to compensatory damages awards. Similarly, because vicariously liable

44. See Galanter & Luban, *supra* note 10, at 1440 (“High punitive damages awards hit *homo economicus* where it hurts: an eye for an eye, a tooth for a tooth, and a bottom line for a bottom line. It is poetic justice.”); Hampton, *supra* note 40, at 1688-89.

45. See *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 348 (Ct. App. 1981) (an appeal case where jury awarded \$125 million to a boy who was badly burned in an explosion of a Ford Pinto).

defendants are significantly less morally culpable than defendants subjected to direct punitive damages awards, insurance for vicarious punitive damages is less objectionable from a retribution perspective. Indeed, distinguishing between the insurability of direct and vicarious damages should facilitate the calibration of the “sting” of those damages to the culpability of the defendant.

III. OBSERVATIONS ON THE INSURANCE FOR PUNITIVE DAMAGES THAT IS ACTUALLY AVAILABLE ON THE U.S. INSURANCE MARKET

The preceding discussion has addressed the relationship between insurance and punitive damages from a simple (perhaps simplistic) theoretical perspective in which insurance is an all or nothing phenomenon. The insurance for punitive damages that is actually provided through the insurance market is more complex. This part of the Article will describe important aspects of the insurance that is actually available in order to lay the groundwork for considering whether insurance-in-action presents the theoretical problems addressed in the discussion above.

In the insurance field, the starting point for analyzing what insurance is provided in any insurance transaction is the insurance policy form used in that transaction.⁴⁶ Typically, that form is a standard form insurance policy drafted by an insurance trade association. Even when an insurance company chooses to use a form other than the industry standard, it would be unusual for that form to differ from the industry standard other than in detail.

As a result of this standardization, we can learn a great deal about the nature of the insurance that is actually available on the insurance market without undertaking an exhaustive market survey. Indeed, we can go a long way toward understanding what punitive damages insurance is actually available by focusing on the standard form policies used for the two types of liability insurance which comprise the vast bulk of what is sold in the United States: automobile liability insurance and general liability insurance.⁴⁷ Whether the policyholder is John Doe, Cafe

46. I start with the form, not because of a theoretical position that the interpretation of form contracts should start with the form, but rather because insurance practitioners do. See Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1409 (1994) [hereinafter Baker, *Stories*].

47. This Article will differ from what I understand to be insurance industry custom by including within the category of “general liability insurance” the liability insurance that is sold as part of residential insurance packages, such as homeowners, renters, condominium, and dwelling insurance. I do this because liability insurance in

Juanita, or Mega Chemical Company, the basic provisions of the applicable automobile and general liability insurance policy forms will be remarkably similar, particularly as regards insurance for punitive damages claims.

The central promise of the standard automobile and general liability insurance policies appears in what is called the “Insuring Agreement” of the policies. In general liability insurance policies, that promise is to pay “those sums the insured becomes legally obligated to pay as damages because of bodily injury, personal injury, or property damage.”⁴⁸ In automobile liability insurance policies, that promise is to pay “all sums which the insured shall become legally obligated to pay as damages by reason of bodily injury [or property damage] . . . sustained by any person, caused by accident.”⁴⁹

In both of these insuring agreements, the company promises to pay those sums “the insured shall become legally obligated to pay as damages.” The agreements do not distinguish among kinds of damages. Nor are there distinctions among kinds of damages elsewhere in the standard primary automobile and general liability forms used by most U.S. insurance companies.⁵⁰ Indeed, there is little dispute that, on their face, most primary general and automobile policies provide coverage for punitive damages.⁵¹

these packages provides the same kind of broad form protection—using much of the same policy language—as the popular Commercial General Liability insurance form.

48. See, e.g., 1 SUSAN J. MILLER & PHILIP LEFEBVRE, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 409 (1996). In the noncommercial, individual market, the primary bodily injury and property damage coverage is provided as part of the residential insurance package (i.e., homeowners, renters, condominium or dwelling insurance) and the primary personal injury coverage is provided by an umbrella insurance policy. See, e.g., ISO, HO3 and ISO personal umbrella forms.

49. IRVIN E. SCHERMER, AUTOMOBILE LIABILITY INSURANCE § 23.01 (3d ed. 1995).

50. “Primary” insurance is the first layer of insurance that covers a risk. “Excess” or “umbrella” insurance provides coverage once the primary insurance is exhausted (although in certain circumstances an umbrella policy may be primary). As discussed below, it is my working assumption that punitive damages exclusions are more common in umbrella and excess insurance policies.

51. But see Widiss, *supra* note 1, at 475 (collecting cases stating that the insurance policy is ambiguous on this point). The ambiguity doctrine (by which ambiguous policy provisions are interpreted to favor the policyholder) means that it makes no practical difference whether we conclude that the standard form policy unambiguously provides coverage for punitive damages or that the policy is ambiguous on this point. The “as damages” litigation in the environmental context makes clear that courts take a very expansive interpretation of the meaning of the word “damages” in liability insurance policies. See, e.g., AIU Ins. Co. v. Superior Court, 799 P.2d 1253 (1990).

Nevertheless, the insurance that is actually available for punitive damages is far from unlimited. Insurance companies limit the coverage provided for punitive damages by using the following four tools:

- (1) Underwriting practices intended to avoid providing coverage for some targets of punitive damages claims;
- (2) Insurance policies with dollar limits that are less than the amount of a likely punitive damages judgment;
- (3) Contract provisions intended to eliminate coverage for claims that are likely to result in punitive damage awards; and
- (4) Public policy based refusals to fulfill the promise to pay punitive damages claims.

Of course, these are in addition to the option of including an explicit punitive damages exclusion in the liability insurance policy. The sections that follow describe each of these tools.

A. Underwriting

Insurance underwriting is the process of deciding how much insurance to provide to whom, against what risks, and at what price. At least since the eighteenth century, one aim of underwriters has been to exclude from the insurance pool those members of a given rate class whose loss experience is expected to exceed that of the average for the class or, alternatively, to charge these higher risk individuals a higher premium (which, in effect, is to create a new rate class).

In identifying which potential insureds to exclude from the insurance pool on this basis, underwriters have been guided by the concept of moral hazard. As I have described in detail elsewhere, the insurance concept of moral hazard is similar to the concept of moral hazard developed by economists.⁵² But while economists understand moral hazard to be a property of institutional arrangements for the sharing of risk, insurance underwriters understand moral hazard also to be part of the character of the individuals or entities that participate in insurance arrangements.

In insurance practice, the differing loss experience of insureds within a given rate class is understood to be attributable, in significant part, to

52. See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996) [hereinafter Baker, *Genealogy*].

variations in this second, “individual,” sense of moral hazard.⁵³ Although it can be difficult to determine what exactly is meant by an individual’s moral hazard, there are least two components that are relevant to punitive damages: (1) the propensity to take care (or not) to avoid harm to the person and possessions of oneself and others, and (2) the degree of attachment to other conventional social norms.⁵⁴ Implicit in this understanding of moral hazard is the belief that, all other things being equal, people who are careful and who observe other conventional social norms are less likely to be the subject of punitive damages awards than those who are not careful or do not observe such norms.

As with many other aspects of insurance practice, we can understand insurance underwriting as an attempt to control the incentives created by insurance.⁵⁵ Insurance underwriting attempts to control insurance incentives by addressing the moral hazard of insurance applicants. Although I am sometimes skeptical of insurance underwriters’ ability to identify and exclude insureds on the basis of moral hazard,⁵⁶ whatever success they do enjoy in this regard will decrease the punitive damages exposure of their employers.

In this context, we can understand insurance underwriting as an attempt to exclude from the insurance pool people who are (1) less likely to be guided by the norm projection aspects of tort law; (2) more likely to respond to the incentives created by underenforcement, externalities or insurance; and (3) more likely to cause harm with the culpability deserving of retribution. As this description suggests, efforts by insurance companies to reduce or control the moral hazard of insurance will also tend to ameliorate the retribution and prevention objections to insurance for punitive damages.

One example of the effect that insurance underwriting can have on the actual insurance that is available for punitive damages comes from automobile liability insurance. Perhaps the most common punitive damages automobile accident case is that of the wrongful death caused by a drunk driver. According to plaintiffs’ lawyers, it is not unusual for

53. *See id.*

54. Insurance writers sometimes refer to moral hazard as a tendency toward fraud or destruction, but, given that honesty and avoidance of harm are conventional social norms, we can understand a tendency toward fraud or destruction as an example of a lack of attachment to conventional social norms. I use the word “conventional” so as not to suggest that dishonesty, destructiveness, violence and the like are not social norms in certain times and places.

55. For an extensive study of insurance companies’ efforts to manage the incentives created by insurance, see CAROL HEIMER, *REACTIVE RISK AND RATIONAL ACTION* (1985).

56. *See Baker, Genealogy, supra* note 52, at 238.

such drivers to have had a conviction for driving under the influence (DUI).⁵⁷ Insurance companies in the standard and preferred risk automobile insurance markets routinely refuse to sell insurance policies to people who have a DUI conviction. Those with a DUI conviction can obtain insurance in the substandard market or, failing that, from the residual automobile insurance pool. The policies sold in these other markets, however, provide low dollar coverage—often as little as \$25,000 per accident or less—that is well below the expected liability for any serious automobile accident. As a result, punitive damages insurance in fact is not widely available to those drivers believed to be most likely to be the subject of a punitive damages claim.

B. Dollar Limits on Insurance Coverage

As this automobile insurance example illustrates, dollar limits on coverage also serve to limit insurance companies' exposure to punitive damages claims, particularly for large punitive damages claims. Indeed, in the personal and small business markets, insurance against large punitive damages awards does not exist in any practical sense, because individuals and small businesses rarely purchase insurance with the kinds of limits that would be needed to cover multi-million dollar awards.⁵⁸

Of course, empirical research suggests that the far more common punitive damages award is well under \$100,000.⁵⁹ At least among the business and professional classes in the United States, automobile and general liability insurance coverage at that level is widely purchased. Thus, the available insurance limits would be insufficient to pay punitive damages only in the exceptionally egregious case—when the jury really became angry at the defendant. This suggests that insurance policy limits may function, in a very rough way, to ameliorate some of the prevention and retribution-based concerns about insurance for punitive damages. If the jury really wants to impose a million dollar punishment on an individual or a small business defendant, there is a good chance that award will exceed the available insurance limits.

57. These observations were related in the interviews reported in Tom Baker, *Transforming Punishment into Compensation: in the Shadow of Punitive Damages*, 1998 WIS. L. REV. 211 [hereinafter Baker, *Transforming*]. Given the addictive nature of alcohol, this is hardly surprising, but I would welcome suggestions of ways to test this assertion.

58. This "working assumption" is based on interviews with personal injury lawyers. See *id.* (reporting interviews).

59. See Stephen Daniels & Joanne Martin, *Myth and Reality in Punitive Damages*, 75 MINN. L. REV. 1, 42 (1990).

In the large commercial insurance market, substantial policy limits are far more common. Indeed, in commercial liability insurance cases in which I have participated, annual limits well into the hundreds of millions of dollars are not unusual.⁶⁰ This suggests that, except in the mass tort situation, dollar limits alone do not effectively limit the punitive damages insurance coverage available to corporate America.

Nevertheless, as discussed below, I have a working assumption that punitive damages exclusions are more common in umbrella and excess policies. To the degree this is so, the dollar limits on primary insurance coverage would tend to limit the punitive damages coverage for the large corporate market in much the same way as insurance purchasing patterns limit the punitive damages coverage in the personal and small business markets.

C. Contract Provisions

Although insurance underwriting and dollar limits on insurance policies do restrict insurance for punitive damages in a manner that answers some of the theoretical objections to such insurance, these two aspects of insurance practice are hardly a complete answer to those objections. If there is to be a real answer—and I believe there is, especially for the prevention-based objections—it has to come from the insurance contract.

There are three types of contract provisions that reduce the insurance coverage that would otherwise be provided for punitive damages claims under standard liability insurance policies: intentional harm exclusions, punitive damages exclusions, and claim-specific exclusions. The paragraphs that follow describe each of these.

1. INTENTIONAL HARM EXCLUSIONS

Standard general liability insurance forms exclude coverage for bodily injury and property damage that is “expected or intended from the standpoint of the insured.”⁶¹ The requirement in the standard automobile liability policy that the injury or damage be “caused by accident” serves a similar function.⁶² Courts differ on the precise meaning given to these words, but the common idea is the elimination of liability insurance coverage in situations in which the insured knew or

60. See, e.g., *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, 26 Cal. Rptr. 2d 35 (Ct. App. 1995) (the consolidated asbestos insurance coverage cases).

61. See, e.g., *MILLER & LEFEBVRE*, *supra* note 48, at 409.

62. See *SCHERMER*, *supra* note 49, § 23.02.

should have known to a very high probability that harm would result.⁶³ Insurance companies have long included such exclusions in their policies because of concerns about moral hazard, in both the “situational” and “individual” senses of that term.⁶⁴

Insurance for intentional harm raises serious situational moral hazard concerns.⁶⁵ As discussed in the context of the prevention objections to insurance for punitive damages, there is good reason to believe that insurance for intentional harm poses a clearer insurance-deterrence tradeoff than insurance for inadvertent harm. Although certainly not all actors can or will act in the manner predicted by the theory of moral hazard, the insurance industry has made a collective decision not to provide insurance for intentional harm, except for certain narrow or specialized forms of coverage.⁶⁶ Thus, insurance is actually available for punitive (and, for that matter, compensatory) damages only in cases in which the defendant has not been shown to have intended the harm.

63. See ROBERT H. JERRY, UNDERSTANDING INSURANCE LAW 861-63 (2d ed. 1996).

64. See HEIMER, *supra* note 55.

65. What I refer to as “situational” moral hazard is that aspect of the insurance trade’s concept of moral hazard that coincides with the concept as it is used in economic theory: the effect on incentives whenever one person bears the costs of harm caused by another. In such a situation, the person causing the harm has less incentive to avoid that harm than if (all other things being equal) she bore the full costs of that harm herself. See Baker, *Genealogy*, *supra* note 52, at 238.

66. The insurance contract discussion in this paper is limited to automobile liability insurance and to the bodily injury and property damage coverage provided in general liability insurance policies. There are other forms of insurance that provide punitive damages insurance. The most significant of these other forms of insurance, in terms of the numbers of policies in force, is known as “personal injury” coverage. This coverage is commonly included in commercial general liability insurance packages and in umbrella insurance policies sold to individuals.

Personal injury coverage often is provided without an intentional injury exclusion, especially at the primary level. See, e.g., MILLER & LEFEBVRE, *supra* note 48, at 412. Personal injury coverage is “named-peril” insurance that, as that characterization suggests, provides coverage only against a number of specific kinds of claims (hence the term, *named perils*). Today, those claims include defamation, wrongful prosecution, and trespass. See Terri D. Keville, Note, *Advertising Injury Coverage: An Overview*, 65 S. CAL. L. REV. 919, 928 (1992).

Other forms of insurance that provide some coverage for punitive damages includes directors and officers liability insurance, errors and omissions insurance (for lawyers, accountants, and insurance agents), and reinsurance (insurance for insurance companies). I mention these forms of insurance only to make it clear that I am aware that the analysis in this Article is directed at coverage for bodily injury and property damage and that there may be forms of insurance coverage for which the market does not provide an adequate answer to the theoretical objections to insurance for punitive damages.

Insurance against intentional harm also raises individual moral hazard concerns because such insurance will be disproportionately attractive to those who are not constrained by conventional norms against causing harm. If insurance for intentional harm were available, anyone who was about to cause such harm would be well advised to buy that insurance. Conversely, anyone who was reasonably sure she was not going to cause harm intentionally would be well advised not to buy that insurance. Because we are talking about intentional harm, people can identify in advance (to a significant but not perfect degree) whether they will need the insurance, and they can hide that fact from the insurance company (at least the first time⁶⁷). Thus, insurance for intentional harm also presents an adverse selection problem,⁶⁸ with the result that insurance that excluded coverage for intentional harm would tend to drive out from the market insurance that offered such coverage.⁶⁹

As a result of the intentional harm exclusion in liability insurance, tort law in action addresses questions of fault, not only in a tort claim filed by a plaintiff, but also in the presentation of that claim to the defendant's liability insurance company. In the tort claim, the formal fault lines are two: between liability and no liability, and between compensatory and punitive damages. The insurance claim adds a third fault line—between intentional and unintentional harm.

The relationship between the punitive damages fault line and the intentional harm fault line is not straightforward. Not all cases of intentional harm will meet the applicable tort law standard for punitive damages,⁷⁰ nor will all punitive damages cases meet the applicable insurance law standard for intentional harm. The question of whether to enforce contracts to provide punitive damages matters only for cases in which the punitive damages standard is met, but the intentional harm standard is not.⁷¹

67. For a discussion of the repeat player, see *infra* text accompanying notes 75-76.

68. Adverse selection refers to the tendency for insurance to be purchased by people who are disproportionately likely to experience an insured-against event. 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).

69. See *id.*; George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 492-93 (1970).

70. Of course, there has to be some resulting bodily injury, personal injury, or property damage for there to be insurance coverage. For a listing of verbal formulations used by courts as the punitive damages standard, see Rustad & Koenig, *supra* note 30, at 1317 n.240.

71. At least outside of the specialized or narrowly targeted coverage discussed in *supra* note 66.

2. PUNITIVE DAMAGES EXCLUSIONS

The most straightforward way to eliminate insurance coverage for punitive damages is to include in the insurance policy a provision explicitly excluding coverage for punitive damages. The fact that punitive damages exclusions typically are not included in primary liability insurance policies represents a considered choice to offer that coverage. Indeed, efforts to include such exclusions in the industry-wide standard form primary policies have been rejected on marketing grounds.⁷² This suggests that most insurance companies prefer to sell, and most policyholders prefer to buy, primary liability insurance policies that do not contain a blanket exclusion for punitive damages. This suggests, as well, that intentional harm exclusions are an adequate solution to the moral hazard and adverse selection problems that are posed by insurance for punitive damages.

Nevertheless, it appears that punitive damages exclusions appear more often in umbrella and excess liability insurance policies.⁷³ If so, this may reflect a judgment that, in an excess policy, a punitive damages exclusion serves as a less expensive proxy for an intentional harm exclusion. A very large punitive damages award is quite likely to reflect the jury's conclusion that the defendant consciously caused serious harm. Nevertheless, an insurance company cannot avoid paying that claim, based on an intentional harm exclusion, without a second trial.⁷⁴ Avoiding coverage based on a punitive damages exclusion, in contrast, would require no second trial.

3. CLAIM-SPECIFIC EXCLUSIONS

Liability insurance policies also commonly contain claim-specific exclusions that limit indirectly the insurance that is actually available for punitive damages. Contemporary standard form examples of such exclusions include provisions relating to claims arising out of asbestos, sexual harassment and molestation, assault, and pollution. These are all liability claims that are disproportionately likely to arouse a strong sense of moral indignation on the part of juries and, thus, pose a disproportionate risk of punitive damages.

72. See Widiss, *supra* note 1, at 488.

73. This working assumption is based on my involvement over the last nine years in large commercial coverage cases.

74. Avoiding coverage on the basis of an intentional harm exclusion requires a factual finding that the insured committed the relevant act with the requisite intent. Since the standards for punitive damages and the intentional harm exclusion are not the same, there will have to be a second coverage trial.

Some insurance policies also contain claim-specific exclusions that are specially drafted for the particular insureds to whom they apply. These “manuscript” exclusions are inserted into general liability insurance policies with some regularity once a product becomes the subject of mass tort litigation. Examples include exclusions relating to breast implants, IUDs and toxic shock syndrome.⁷⁵

It seems unlikely that claim-specific exclusions are inserted in liability insurance policies solely because of concerns about punitive damages. But the exclusions do have the effect of reducing insurance companies’ punitive damages exposure. More important, however, these exclusions highlight the fact that insurance is an iterative game.

Insurers have strong incentives to eliminate the disproportionately risky from their insurance pools. Thus, having insurance against claims during one policy period is no guarantee that there will be insurance against claims in the future. Indeed, this is becoming even more true as the insurance industry shifts from “occurrence” to “claims made” forms of coverage.⁷⁶ Consequently, regardless of the extent of the insurance for punitive damages that initially is offered for sale on the insurance market, the theoretical concern that punitive damages insurance would allow an insured to avoid all the financial consequences of egregious future action is unlikely to be borne out in practice for repeat players such as manufacturers and retailers.

D. Public Policy Based Refusals to Pay

Insurance companies largely have chosen to limit punitive damages coverage indirectly, rather than by explicitly excluding coverage for punitive damages. Notwithstanding the freedom of contract ideology that still animates much of insurance practice,⁷⁷ liability insurance companies regularly refuse to pay punitive damages claims on the grounds that public

75. I am aware of these examples from discussions with lawyers involved in these mass tort cases. We know that these manuscript exclusions exist because insurance coverage for a product that becomes the subject of mass tort claims typically ends shortly after the claims situation becomes acute, even though the manufacturer continues to have general liability insurance.

76. An occurrence policy is triggered by harm that takes place during the policy period, regardless when the claim is made; a claims made policy is triggered when a claim is made during the policy period, provided that claim arises from harm that took place after the “retroactive date” of the policy. See *Sparks v. St. Paul Ins. Co.*, 495 A.2d 406 (1985). Claims made policies give insurance companies a greater ability to terminate coverage when the number or type or size of claims becomes acute.

77. See Baker, *Stories*, *supra* note 46, at 1408, 1417; cf. Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

policy forbids it.⁷⁸ Today, about half of the U.S. jurisdictions are receptive to this defense, at least with respect to direct (as opposed to vicarious) punitive damages.⁷⁹ The merits of this defense are addressed in Part IV of this Article.

Recalling my earlier claim that insurance companies have concluded “that intentional harm exclusions are an adequate solution to the moral hazard and adverse selection problems that are posed by insurance for punitive damages,”⁸⁰ the careful reader may ask, “Why, then, do insurance companies regularly refuse to pay punitive damages on grounds of public policy?” After all, if an insurance company wants to pay a punitive damages claim, there is no one with standing to sue who will object: the insured gets the coverage and the victim gets the money.

Three possible explanations have occurred to me. The first follows from the internal division in insurance companies between claims departments and “production” departments (sales and marketing). The absence of an explicit punitive damages exclusion allows the production departments to sell the “broadest coverage available,” while the public policy against punitive damages insurance allows the claims department to avoid paying those damages. One reason that claims and production departments are separated bureaucratically in insurance companies is to minimize the ability of producers to pressure those who pay claims and, just as important, to permit the producers to say to their customers that they have no control over whether a claim gets paid, thus helping to preserve the personal relationship between producers and customers.⁸¹

The second reason follows from the divided nature of the industry’s decision not to include a punitive damages exclusion in the commercial liability insurance policy.⁸² Clearly, the dissenting companies did not agree that offering punitive damages coverage was a good idea. The

78. It takes some familiarity with insurance practice to fully appreciate the irony of insurance companies relying on public policy arguments to avoid paying claims otherwise covered by their insurance policies. The irony comes from the steadfast complaints of insurance interests about judges who “rewrite” insurance policies to provide coverage that the insurance companies did not sell. According to that same logic, a judge who refused to enforce an insurance company’s promise to pay a punitive damages claim would be “rewriting” the policy to take away coverage that the policyholder had bought. As my prior writing makes clear, I do not agree that judges who refuse to enforce standard form provisions are requiring insurance companies to provide insurance that they did not sell, nor would I seriously assert that, when a manufacturer purchases a liability policy covering risks in a state whose courts oppose such coverage, the manufacturer is buying punitive damages coverage for those risks. See Baker, *Stories*, *supra* note 46.

79. See Widiss, *supra* note 1, at 466-68.

80. *Supra* Part III.C.2.

81. See Baker, *Stories*, *supra* note 46, at 1416.

82. See Widiss, *supra* note 1, at 488.

implied exclusion allows those companies to achieve at least part of their goal of excluding punitive damages while still using the industry standard form.⁸³

The third reason is a game theoretic explanation. In the individual instance, it is almost always in the insurance company's interest not to pay a claim, provided it can do so without losing good will. The "public policy" against punitive damages insurance allows the insurance company to refuse to pay that part of the claim without appearing to exercise its discretion in so doing and, therefore, without sacrificing good will. Thus, even though offering the insurance may be in the best interests of the industry as a whole (a fact suggested by the absence of the exclusion in the standard policy), the contrary interests in the individual situations overwhelm that collective interest. This is another instance of the familiar prisoners' dilemma, in which individually rational action leads to a collectively irrational result.⁸⁴

Notwithstanding these explanations, interviews with personal injury lawyers (both plaintiff and defense) suggest that insurance companies in fact do pay punitive damages claims at the settlement stage even in states in which they are not required to do so.⁸⁵ Thus, the public policy against insurance for punitive damages does not mean that there is no punitive damages coverage, but rather that in an individual case insurance companies have the power to decide whether to pay or not.

A rational insurance company will make that decision in a manner that takes into account the size of the claim, the likelihood that the customer will be lost, the profitability of the account, and, perhaps most important, the size of the potential judgment it can avoid by paying some punitive damages "tribute" at the settlement stage.⁸⁶ In practice, this means that some punitive damages coverage in fact is provided in the settlement stage.⁸⁷

83. One of the most important benefits of using the industry standard form is gaining access to the collective loss experience of all insurance companies that use the form.

84. See DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW*, 48-49, 312-313 (1994) (providing a game theoretic account of the prisoners' dilemma). For a brief history of the dilemma, see *PARADOXES OF RATIONALITY AND COOPERATION* 3-4 (Richmond Campbell & Lanning Sowden eds., 1985).

85. See Baker, *Transforming*, *supra* note 57 (interviews with personal injury lawyers practicing in Florida, a jurisdiction that will not enforce contracts to insure punitive damages). Note that the moneys paid are not denominated as punitive damages.

86. See *id.*

87. See *id.*

E. Summary

When we examine insurance practice, we find that the insurance that is actually available on the insurance market is more restrictive than the unlimited insurance considered in the theoretical discussion. Except for specialized forms of coverage, insurance for intentional harm is not available. The insurance for unintentional harm that is available excludes some claims that pose a disproportionate risk of punitive damages. Moreover, insurance underwriters regularly restrict, or refuse to provide, coverage to insureds who pose a disproportionate risk of punitive damages. All these restrictions follow from insurance companies' efforts to combat moral hazard and adverse selection.⁸⁸ We also find that, even in states in which punitive damages are formally uninsurable, insurance companies regularly pay punitive damages claims at the settlement stage. Thus, punitive damages insurance does not pose all the problems suggested in the theoretical discussion, nor is prohibiting such insurance the panacea that a purely theoretical or doctrinal approach might suggest.

Clearly, this description has not demonstrated that "in fact" these market restrictions on insurance for punitive damages prevent that insurance from undercutting the prevention and retribution objectives of those damages. What it has demonstrated, however, is that insurance companies have a strong financial incentive to construct the insurance relationship in a manner that answers the theoretical objections to insurance for punitive damages and that insurance companies underwrite and draft insurance contracts in ways that appear to be consistent with that incentive. The next part of this Article discusses whether, in light of this incentive and those aspects of insurance practice, courts should nevertheless refuse to enforce contracts to provide insurance for punitive damages.

IV. RECONSIDERING INSURANCE FOR PUNITIVE DAMAGES

The prevention objection to insurance for punitive damages is an instrumental one. It says that insurance for punitive damages should be prohibited because that insurance will reduce the deterrent effect of those damages. Yet, all insurance reduces the financial impact of the insured-against event, a fact that has not prevented widespread acceptance of liability insurance. Thus, the prevention objection to insurance for punitive damages must turn on a significant difference between the effect of that insurance and the effect of insurance for compensatory damages.

38. An additional dynamic, not explored in the text, is the effort to define insurance as a culturally acceptable practice. See Baker, *Genealogy*, *supra* note 52.

There has to be, in other words, some basis for concluding that insurance for punitive damages undercuts tort law's prevention purpose more than insurance for compensatory damages.

Part II argued that this basis can be found by comparing the moral hazard and adverse selection problems posed by the two types of insurance. In theory, insurance for punitive damages poses greater moral hazard and adverse selection problems than insurance for compensatory damages, because defendants who are subjected to punitive damages awards are more likely than other defendants to have known that their conduct violated the applicable legal standard and to have predicted before buying insurance that this would be the case. Given their proven willingness to violate legal standards, we can reasonably conclude that these defendants are less able than other defendants to be governed by the norm prevention aspect of tort law. Thus, punitive damages insurance is objectionable from a prevention standpoint because it reduces the financial incentive of tort damages for those who need that incentive the most.

From a prevention perspective, the policy choice between permitting or prohibiting insurance for punitive damages comes down to a simple question: can insurance companies be counted upon to make adequate efforts to control the moral hazard and adverse selection problems posed by such insurance? As Part III discussed, insurance companies have great financial incentive to control the moral hazard of insurance, not only because of the increased loss that results, but also because of the accompanying problem of adverse selection. As a result, the insurance that is actually available for punitive damages is far more restrictive than what is assumed in the theoretical discussion. Indeed, when we look at insurance practice, we find that the insurance contract already attempts to eliminate insurance for those whom insurance companies have decided most need the financial incentive of damages.

Insurance practice is far more protective of the prevention objectives of tort law than the crude distinction in insurance law between compensatory and punitive damages. Through the use of the intentional harm exclusion, insurance practice regulates the prevention effect, not only of punitive damages, but also of compensatory damages. Given the incentive of insurance companies to control moral hazard and adverse selection, and their ability to do so through the use of underwriting and insurance contract provisions,⁸⁹ the best course for judges concerned

89. For examples of other contract provisions used to control moral hazard, see HEIMER, *supra* note 55.

about punitive damages, insurance, and the prevention objectives of tort law is to leave well enough alone.⁹⁰

With respect to the retribution objection to punitive damages, insurance practice provides a less definitive response. The intentional harm exclusion addresses part of the retribution objection. Indeed, because the intentional harm exclusion applies to all damages, insurance practice does a more thorough job in this respect than insurance law to further the retributive purposes of tort law. Nevertheless, the goals of insurance companies do not mesh as neatly with the retribution objectives of tort law as they do with the prevention objectives of tort law. Insurance companies seek to control moral hazard and adverse selection because, speaking metaphorically, that puts money in their pockets. Furthering the retribution objectives of the common law is less clearly in their self interest. Indeed, provided that the problems of moral hazard and adverse selection can be addressed, softening the retributive punch of the common law would seem to be good business. Thus, the more importance courts give to notions of retribution in developing their approach to punitive damages, the stronger the objection to insurance for punitive damages.

Nevertheless, once we acknowledge that the insurance market does not, in most cases, offer coverage for intentional harm, the remaining retribution objections to punitive damages insurance seem, from a practical perspective, minor. While we do not have good data on the frequency of punitive damages claims, there is a growing body of research on punitive damages awards that shows that such awards are rare⁹¹ and that they are often struck down on appeal.⁹² If and when the time comes to pay a punitive damages award, the insurance carrier is almost certain to claim that the insured defendant intended the harm and, therefore, that there is no insurance for the claim. Although insurance companies will not (and should not) win all those coverage cases, they will win some, and many more will be settled for a percentage of the amount claimed. The result is that even with insurance for punitive

90. In light of my earlier writing, I should clarify that I am advocating a judicial "hands-off" approach here because insurance companies' incentives and contracting practices are consistent with the objectives of the legal system and because enforcing contracts to provide punitive damages insurance is not inconsistent with insureds' expectations. See Baker, *Stories*, *supra* note 46, at 1420-22 (discussing how judges construct the insurance relationship).

91. See, e.g., Daniels & Martin, *supra* note 59; Michael Rustad, *In Defense of Punitive Damages in Products Liability: Testing Tort Anecdotes with Empirical Data*, 78 IOWA L. REV. 1 (1992); Rustad & Koenig, *supra* note 30.

92. See William M. Landes & Richard A. Posner, *New Light on Punitive Damages*, REGULATION, Sept./Oct. 1986, at 33.

damages, tort law in action calibrates the “sting” of a judgment according to the culpability of the defendant to a far greater extent than is acknowledged in the typical judicial decision prohibiting insurance for punitive damages.⁹³ Moreover, as interviews with personal injury lawyers suggest, efforts to improve the calibration of that sting by prohibiting insurance for punitive damages will have less of an effect on tort law in action than a judge or legislator might wish, because some insurance for punitive damages in fact is provided even when such insurance is prohibited.⁹⁴

V. IMPLICATIONS FOR TORT AND INSURANCE POLICY

There are several conclusions that follow from the above discussion. The first is that, from both a prevention and a retribution perspective, it makes little practical difference whether punitive damages are insurable or not. That does not mean, of course, that it might not make a great difference to individual parties in individual cases. But there is little reason to believe that prohibiting the insurance will have much effect on social welfare. Any assertion that permitting the insurance will increase loss by inhibiting the prevention aspect of tort law can easily be answered by reference to the strong incentive for insurance companies to control moral hazard and adverse selection and by the counter assertion that the availability of the insurance will enhance the norm projection aspect of tort law. Similarly, the intentional harm exclusion answers some of the retribution objections to insurance for punitive damages. Moreover, in some cases that do not involve intentional harm, the availability of the insurance will increase the likelihood that plaintiffs will file actions, thereby enhancing tort law’s ability to achieve its retributive ends.

The second conclusion follows from the first: if insurance for punitive damages is not of great practical importance to the prevention or retribution purposes of tort law, there must be some other explanation for courts’ efforts to prohibit that insurance. One plausible explanation lies in a combination of the legitimation function of courts and the dynamics of the prisoners’ dilemma described at the conclusion of Part III (in which the individually rational decision not to pay a particular punitive damages claims overwhelms the collectively rational decision to offer such coverage). The prisoners’ dilemma explains why insurance companies would repeatedly ask courts to refuse to enforce their promise, and the legitimation function explains why courts sometimes grant this request.

93. See Widiss, *supra* note 1.

94. See Baker, *Transforming*, *supra* note 57.

No judge likes the law to appear a fool, and the “sound bite” on punitive damages insurance can easily make the law appear a fool.

My final conclusion is hardly unique to this paper. Indeed, it is the common theme of much of the current insurance law scholarship: tort law cannot be fully understood without paying close attention to insurance, and insurance law cannot be understood without paying close attention to tort law.⁹⁵ The clearest demonstration offered in this paper lies in the centrality of the intentional harm exclusion to the conclusion that insurance for punitive damages does not significantly undercut the prevention and retribution objectives of tort law.

The intentional harm exclusion exists to enable insurance companies to make money by controlling moral hazard and adverse selection, but it also furthers important prevention and retribution purposes of tort law. As a result, the insurance company that denies a claim because of the intentional harm exclusion furthers the prevention and retribution goals of tort law nearly as much as the plaintiff who asserts the claim in the first place. Thus, the intentional harm battle that dominates much insurance coverage litigation has important consequences beyond the resolution of that litigation. Indeed, no less than the plaintiff who brings the claim, the insurance company that (properly) denies the claim on intentional harm grounds acts on behalf of all victims and potential victims of intentional harm to prevent loss and to achieve retribution.

95. See, e.g., KENNETH S. ABRAHAM, *DISTRIBUTING RISK* (1986); Chandler, *Understanding*, *supra* note 4; Chandler, *Visualizing*, *supra* note 4; Syverud, *supra* note 29.