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Kyle D. Logue
University of Michigan Law School, klogue@umich.edu

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Solving the Judgment-Proof Problem

Kyle D. Logue[*]

A tortfeasor[1] who cannot fully pay for the harms that it causes is said to be "judgment proof." Commentators have long recognized that the existence of judgment-proof tortfeasors seriously undermines the deterrence and insurance goals of tort law.[2] The deterrence goal is undermined because, irrespective of the liability rule, judgment-proof tortfeasors will not fully internalize the costs of the accidents they cause. The insurance goal will be undermined to the extent that the judgment-proof tortfeasor will not be able to compensate fully its victims and that first-party insurance markets do not provide an adequate response.[3] Liability insurance can ameliorate these so-called judgment-proof problems in two ways: First, if liability insurance is "experience rated" or "feature rated,"[4] the presence of such insurance can induce tortfeasors to take appropriate steps to prevent

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* Assistant Professor, University of Michigan Law School. B.A. 1987, Auburn University; J.D. 1990, Yale Law School. I am grateful to Steve Croley, Jon Hanson, Avery Katz, Charles Silver, and Kent Syverud for their comments and to Marta Almli for research assistance.

1. A "tortfeasor" in this context is a party who has been involved in an accident that results in an injury to another and who has some chance of being held liable in tort for causing that injury.

2. For a discussion of the deterrence and insurance goals of tort law, see *infra* text accompanying notes 63-64. For examples of scholarly works that address, directly or indirectly, the effects of the judgment-proof problem on the deterrence and insurance goals of tort law, see Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. LAW & ECON. 45 (1986) (noting that judgment-proof parties do not have the appropriate incentive either to prevent accidents or to purchase liability insurance); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882-83 (1991) (discussing the implications of judgment-proof problems that arise in the context of the limited liability of corporate shareholders); John G. Fleming, *Report to the Joint Committee of the California Legislature on Tort Liability on the Problems Associated with* American Motorcycle Association v. Superior Court, 30 HASTINGS L.J. 1465, 1470 (1979) (noting the role of liability insurance in alleviating the judgment-proof problem); William R. Keeton & Evan Kwerel, *Externalities in Automobile Insurance and the Underinsured Driver Problem*, 27 J.L. & ECON. 149, 149-50 (1984) (documenting the extent of judgment-proof-driver problems and examining their effect on the demand for liability insurance); John Summers, Comment, *The Case of the Disappearing Defendant: An Economic Analysis*, 132 U. PA. L. REV. 145, 145 (1983) (noting both the deterrence and the insurance aspects of the judgment-proof problem).

3. A "victim" in this context is a party who has suffered an injury as a result of an accident that involved another party.

4. Insurers feature-rate when they adjust premiums to reflect the safety-level of an insured's activities. Insurers experience-rate when they adjust premiums to reflect the actual loss experience of the insured. KENNETH S. ABRAHAM, DISTRIBUTING RISK 46 (1986).

accidents.[5]   Second, the presence of liability insurance increases the
amount of assets available to compensate plaintiffs. This is because when
a judgment-proof tortfeasor has purchased liability insurance, not only the
tortfeasor's assets but also the assets of the insurance company can poten-
tially be used to compensate tort victims.. However, because virtually all
liability insurance policies contain policy limits and because only some
liability insurance policyholders have sufficient assets to cover tort
judgments that exceed those policy limits, some liability insureds will
nevertheless be judgment-proof.

In his paper, *Judicial Limitations on the Discretion of Liability
Insurers to Settle or Litigate: An Economic Critique,*[6] Alan Sykes identifies
some interesting ways in which the existence of judgment-proof insureds
affects the decisions of liability insurance companies regarding whether to
settle or litigate claims that have been brought against their policyholders.[7]
Relying on these observations, Sykes suggests that the problem of
judgment-proof insureds provides an argument against judicially imposed
limits on insurer settlement discretion, such as the "duty-to-settle"
doctrine.[8]   Sykes's paper thus makes a useful contribution both to the
literature on the judgment-proof problem and to the literature on the duty
to settle.[9]

This Comment first explains the judgment-proof-insured problem that
Sykes has identified and describes how that problem bears on the debate

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5. *See id.* at 44 (discussing the beneficial deterrence effects of liability insurance, assuming that
the insurer successfully classifies risks and adjusts premiums according to the insured's levels of care
and activity); Gary T. Schwartz, *The Ethics and the Economics of Liability Insurance,* 75 CORNELL L.
REV. 313, 337-38 (1990) (suggesting reasons why liability insurers may develop expertise in accident
avoidance that can be passed on to the insured); Shavell, *supra* note 2, at 54 (discussing how liability
insurance can ameliorate the effects of the judgment-proof problem). To the extent liability insurance
premiums are not linked, or are imperfectly linked, to changes in the insured's level of care and
activity, liability insurance can, for obvious reasons, blunt the deterrence effect of tort law. ABRAHAM,
supra, at 17, 44, 46; RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 202-03 (4th ed. 1992);
Steven Shavell, *On Liability and Insurance,* 13 BELL J. ECON. 120, 120 (1982); Stephen D. Sugarman,
Doing Away with Tort Law, 73 CAL. L. REV. 555, 574-76 (1985). For a discussion of why, at least
in the context of products liability, liability insurance might be expected to further the deterrence goal,
see Hanson & Logue, *supra* note 2, at 193 n.247.
6. Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate:
An Economic Critique,* 72 TEX. L. REV. 1345 (1994).
7. *Id.* at 1361-63; *see also* Alan O. Sykes, *"Bad Faith" Refusal to Settle by Liability Insurers:
Some Implications of the Judgment-Proof System,* 23 J. LEGAL STUD. 77 (1994) (providing a formal
proof of the judgment-proof problem that can arise in duty-to-settle cases).
8. Sykes, *supra* note 6, at 1363-65. Liability insurance policies often allocate to the insurer
unfettered discretion regarding whether to settle or litigate claims that have been brought against the
insured. *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 7.8(a), 875 (student's ed.
1988) (noting that a typical provision will state that the insurer "may make such investigation,
negotiation, and settlement of any claim or suit as it deems expedient").
9. For a thorough discussion of the duty-to-settle doctrine and related issues, see Kent D. Syverud,
The Duty to Settle, 76 VA. L. REV. 1113 (1990).

concerning judicially imposed limits on insurer settlement discretion. Second, this Comment expressly, if only temporarily, adopts the normative criterion that animates much of the judicial and scholarly analysis in the duty-to-settle area—that is, the policy objective of encouraging insurer settlement decisions that maximize the combined expected wealth of liability insurers and their insureds[10]—and suggests a reform proposal that might eliminate this judgment-proof problem. If this proposal were to eliminate the judgment-proof problem, it would strengthen the case for extracontractual limits on insurer settlement discretion in some contexts. Next, this Comment briefly reexamines the duty-to-settle doctrine, this time taking into account additional normative criteria: the deterrence and insurance goals of tort law. Put differently, this Comment expands the standard analysis of the duty to settle by taking into account how alternative formulations of that rule affect an important class of parties not privy to the liability insurance contract—namely, tort victims. Finally, this Comment concludes with the following question, which is intended to be more provocative than illuminating: Would all problems associated with judgment-proof tortfeasors disappear if we simply adopted a regime of universal, unlimited, mandatory liability insurance?

I.   The Inevitable Conflict of Interest Between Liability Insurers and Their Insureds

The judgment-proof problem that Sykes has identified arises in the context of a well-known conflict of interest between liability insurance companies and their policyholders. To understand this conflict, it will be helpful to work through a slightly modified version of Sykes's numerical illustration.[11] Suppose an insured is involved in an accident in which a third party is injured, and the victim sues the insured for $100,000 in damages.[12] Suppose further that the insured's liability insurance policy covers this sort of claim, but limits the amount of coverage to $50,000. Assume also that the policy allocates to the insurer complete discretion regarding whether, and under what circumstances, to settle or litigate the

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10. *See, e.g.*, Sykes, *supra* note 6, at 1352 ("[Sykes's] numerical example hints that the insurer should be induced to accept all settlement offers that are joint-wealth-increasing, even if the insurer's selfish interests at the time the offer is made would lead the insurer to litigate."); *see also* Sykes, *supra* note 7, at 77 (suggesting that a "first-best contract" between insurers and insureds would achieve the joint-wealth-maximizing outcome).

11. For Sykes's illustration of the judgment-proof problem, see *id.* at 1362. The principal modification this Comment makes to Sykes's example is the addition of two simplifying assumptions: that litigation costs are zero and that insureds are risk-neutral with respect to the possibility that, if the case were to go to trial, the plaintiff would win. If these assumptions were relaxed, as they are in Sykes's paper, the analysis would not change in ways that would alter the analysis of this Comment.

12. In this Comment, the term "insured" refers to a tortfeasor that has liability insurance coverage.

claim. Next, assume that at some time after the complaint is filed, but before trial, an objective appraisal of the case reveals that there is a 50% likelihood that a court would hold the insured liable for the full $100,000 if the suit were tried. Thus, the expected trial judgment is $50,000.[13] Further, assume that if the court were to hold in favor of the plaintiff, the insured would have assets sufficient to cover the excess judgment—here, $50,000. In other words, assume for the moment that there is no judgment-proof-insured problem. Assume finally that the plaintiff makes a settlement demand of $40,000.[14] Note how at this point the incentives of the insurer and the insured diverge:

> (1) If all else were equal, the insured would prefer to accept the settlement demand, because that demand falls within the policy limits, and hence is fully covered by the insurer. On the other hand, if the settlement were rejected and if the plaintiff were to win at trial, the insured would incur an uninsured liability of $50,000—the difference between the policy limit and the amount of the potential judgment. Generally, the insured would rather accept any settlement that is within the policy limits than try the case.[15]

> (2) The insurer, however, would prefer to reject the $40,000 settlement demand and proceed to trial. Indeed, the insurer would rather go to trial than accept any settlement demand that is greater than $25,000, which is the insurer's expected cost of going to trial under the assumptions of the example.[16]

> (3) Note also that the combined expected wealth of the insurer and the insured would be increased by their agreement to a $40,000 settlement demand, which is $10,000 less than the combined expected cost to the insurer and the insured of going to trial— $50,000 in this example. In fact, the insurer and the insured would increase their combined expected wealth by accepting any settlement between $25,000 and $50,000. Even though the insured, to secure such a settlement, would be willing to contribute up to $25,000—the expected cost to the insured of going to trial—to the deal, the insurer would have a strong incentive to use its unfettered contractual discretion over the settlement decision to reject the $40,000 demand.

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13. The expected judgment is the product of the 50% chance of recovery and the $100,000 anticipated judgment.

14. I will follow the custom among plaintiffs' attorneys and claims adjusters of referring to settlement proposals from plaintiffs as "demands" and settlement proposals from defendants as "offers." Syverud, *supra* note 9, at 1120 n.12.

15. This conclusion assumes that the liability policy in the example contains no deductible.

16. The $25,000 is the product of the 50% chance of the court awarding damages to the plaintiff and the $50,000 anticipated judgment.

In general terms, therefore, a conflict of interest exists between the liability insurer and its insured that may induce the insurer to reject settlement demands that, if accepted, would have increased their combined expected wealth. Put differently, this conflict of interest provides insurers with an incentive to reject some joint-wealth-increasing settlement demands.[17]

Most courts that have addressed this conflict of interest have responded by imposing a duty to settle on liability insurers. Although the precise statement of this duty varies,[18] most courts require that the insurer give "equal consideration" to the interests of insureds when deciding whether to settle or litigate a claim.[19] In applying this standard, a significant number of courts have used a formulation known as the "disregard-the-limits" rule.[20] This rule requires the insurer in settlement negotiations to act as a reasonable insurer would act in the absence of policy limits. As this standard is understood by courts and commentators, the reasonable insurer would, in theory, accept any settlement demand that is less than the expected trial judgment.[21] Applying this rule to our example, if the insurer had rejected the plaintiff's settlement demand of $40,000 and the plaintiff had won the $100,000 judgment at trial, then the insured[22] would have been able to recover from the insurer the difference between the policy limits and the judgment. In the example, that difference is $50,000.

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17. An insurer makes a "joint-wealth-increasing" or "joint-weslth-maximizing" settlement decision when it either accepts a settlement demand that would increase, or rejects a settlement demand that would decrease, the combined expected wealth of the insurer and the insured. Sykes discusses two reasons why, notwithstanding the potential conflict of interest, the market alone might give insurers an incentive to accept joint-wealth-increasing settlement demands. First, insurers who reject such settlements will suffer reputational costs. Sykes, supra note 6, at 1353. Sykes views this reputational · penalty, however, as an incomplete solution at best, because information of this type might be slowly or inaccurately disseminated. Id. What he does not discuss, however, is the extent to which the reputational costs might differ depending on the type of insurance and the type of insured involved. For example, I would have a comparatively greater degree of confidence in the beneficial effects of reputation in contexts involving sophisticated commercial insureds. Cf. Syverud, supra note 9, at 1199 (noting that because the parties to reinsurance contracts are sophisticated, an "insurer that abuses a reinsurer in settling cases must expect to pay for that abuse in its reputation among other reinsurers"). This observation strengthens the argument made later in this Comment that some type of limit on insurer settlement discretion might be appropriate in contexts involving commereially unsophisticated insureds, but not in other contexts. See infra notes 31-38. The remainder of this Comment will assume that reputational effects are absent.

18. See KEETON & WIDISS, supra note 8, § 7.8(b)(1), at 880-83 (surveying various formulations of the duty-to-settle doctrine).

19. Id. § 7.8(b)(2), at 884; Syverud, supra note 9, at 1122.

20. See Robert E. Keeton, Liability Insurance and Responsibility for Settlement, 67 HARV. L. REV. 1136, 1146-48 (1954) (introducing the disregard-the-limits conception of the duty-to-settle doctrine). Syverud noted that, at the time of his writing, 16 states were using the disregard-the-limits formulation. Syverud, supra note 9, at 1122-23 n.23.

21. If we were not assuming away litigation costs, the theoretically correct rule would be that the insurer should accept any settlement demand that is less than the sum of the expected trial judgment and the anticipated litigation costs.

22. In states that permit assignment of duty-to-settle claims, this party could also be the tort victim.

II. Applying the Joint-Wealth-Maximization Goal: Should the Law
     Impose Extracontractual Limits on Insurers' Discretion to Reject
     Settlements?

As described in the previous part, courts have in fact imposed extra-
contractual limits on liability insurers' discretion to reject settlement
proposals. Whether the law *should* impose such limits is the subject of
Professor Sykes's paper. In answering this question, Sykes first analyzes
several market-failure rationales that might be offered in defense of judi-
cially imposed restrictions on insurer settlement discretion, restrictions such
as the disregard-the-limits rule.[23]   Sykes then concludes that market-
failure rationales for limiting insurer settlement discretion are, "at best,
uneasy."[24] Sykes then describes the judgment-proof-insured problem and
explains how that problem provides an additional reason to be suspicious
of judicially imposed restrictions on insurers' settlement authority.[25] Part
II of this Comment addresses the one market-failure rationale that I con-
sider a persuasive theoretical argument—albeit a less persuasive empirical
argument—for imposing some type of limit on insurer settlement discretion.
Part III explains the judgment-proof-insured problem that Sykes correctly
identifies. Finally, Part IV discusses an alternative formulation of the
disregard-the-limits rule that may ameliorate this problem.

Sykes asks the following question: "If restrictions on settlement dis-
cretion are such a good idea, why do insurance policies omit them?"[26]
To put the same question differently, assuming restrictions on insurer
settlement discretion are joint-wealth-maximizing and assuming insurers
and insureds are rational,[27] why do liability insurance policies in fact
allocate unfettered settlement discretion to insurers? One response appeals
to the concept of market failure—that is, one could argue that market
failures prevent insurers and insureds from reaching a joint-wealth-
maximizing outcome on this issue. If this were true, the absence of terms
in insurance contracts limiting insurer settlement discretion would not
imply that such limits are joint-wealth-decreasing. Sykes considers and
rejects several such market-failure arguments.[28]

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23. Sykes, *supra* note 6, at 1349-53.

24. *Id.* at 1348.

25. *Id.* at 1361-65.

26. *Id.* at 1356.

27. Sykes's article implicitly relies on a rational actor model of human behavior, a model which
has become standard in the conventional law and economics literature. *See* Robert C. Ellickson,
Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics,
65 CHI.-KENT L. REV. 23, 23 (1989) (noting that traditional law and economics analysis is based on
the rational actor model of human behavior). For the sake of simplicity, this Comment will adopt the
same model.

28. Sykes, *supra* note 6, at 1356-61.

The one market-failure rationale for limits on insurer settlement discretion that Sykes characterizes as "plausible" involves the assumption that at least some insureds are poorly informed about, or do not fully understand, the benefits of contractual provisions limiting insurer settlement discretion.[29] If this assumption holds, insureds would not be willing to pay the increased premium necessary to compensate insurers for including such a term in their policies. By assumption, the insureds would not recognize that the additional premium would be more than offset by the reduction in the insureds' expected liability costs resulting from the restriction of the insurers' ability to reject joint-wealth-maximizing settlements. This argument implicitly depends on the further assumption that the insurance companies themselves would not, or could not, effectively inform insureds of the benefits of such contractual provisions. This latter assumption seems plausible, given the initial assumption of ill-informed insureds is accurate, because no single insurer would have an incentive to restrict its own discretion over settlement. Any insurer that offered such a restriction in its policies would face the threat of being underpriced by its competitors, given that insureds would not recognize the difference in the products being offered.[30]

This information-cost argument is most persuasive in contexts involving classes of insureds who are likely to be relatively unsophisticated in commercial matters—that is, insureds who would not recognize the benefits of contractual limits on insurer settlement discretion. Therefore, judicially imposed limits on such discretion have the greatest chance of increasing the combined expected wealth of insurers and insureds in the context of automobile insurance or homeowners' insurance, both of which involve large groups of insureds who may be relatively unsophisticated in commercial matters and who do not typically bargain over the terms in their insurance contracts. In contexts involving commercially sophisticated insureds, however, the case for imposing limits on insurer settlement discretion is much weaker, because sophisticated insureds are more likely to understand the full benefit to them of such contractual limits and are more capable of negotiating the inclusion of such limits in their policies.

This information-cost argument, if persuasive, supports the imposition of certain types of extracontractual restrictions on insurer settlement discretion in contexts involving commercially unsophisticated insureds, but

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29. *Id.* at 1358.

30. *See id.* ("[A]n insurer who includes [such a term] in a policy will incur costs that cannot be recouped through higher premiums. . . . Likewise, there will be no incentive for industry associations to include [these terms] in their standard forms because they will recognize that, ultimately, insurers will not use them." (citing George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970))).

only in those contexts.[31] The argument can be summarized as follows: Because of the conflict of interest that arises as a result of the presence of policy limits and the allocation of settlement authority to the liability insurer, the joint gain to the insurer and the insured will sometimes be maximized by the inclusion in the contract of a term that limits the insurer's settlement discretion. Moreover, the fact that contracts between insurers and commercially unsophisticated insureds usually allocate unfettered settlement discretion to the insurers is entirely consistent with the theoretical argument that contractual limits on insurer discretion are joint-wealth-maximizing. Indeed, in such circumstances one would not expect to see such provisions in insurance contracts even if the provisions would be joint-wealth-maximizing. Therefore, to the extent one is persuaded that limits on insurer settlement discretion are joint-wealth-maximizing, one should be receptive to the suggestion that courts should imply such terms into insurance contracts when the terms are absent, at least in contexts involving unsophisticated or poorly informed insureds.

It can also be argued that this claim finds additional support from the albeit scant empirical evidence that is available from insurance transactions involving commercially sophisticated insureds. In contracts between insurers and commercially sophisticated insureds, one sometimes *does* encounter restrictions on insurer settlement discretion. For example, physicians' professional liability policies have for decades contained "consent-to-settle" clauses, which typically require an insurer to get the insured's written consent before settling a claim that has been brought against the insured.[32] Similar restrictions on insurer settlement discretion have also become common in commercial and products liability insurance policies for large businesses.[33] Perhaps the better example appears in the

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31. *See* Syverud, *supra* note 9, at 1164, 1164-65 (finding "the benefits of [the] duty-to-settle doctrine significant in a typical personal injury suit" in which the insured is commercially unsophisticated, but noting that the "case for duty-to-settle liability weakens . . . in a context where the beneficiaries of the doctrine are persons who knowingly bargain over the contract terms governing settlement of claims").

32. Syverud, *supra* note 9, at 1175-76.

33. *Id.* at 1177. Admittedly, the existence of consent-to-settle clauses demonstrates only that some insureds demand policy terms that protect their rights to reject settlements. It does not demonstrate that insureds demand policy terms that limit insurers' discretion to reject settlements. In fact, one might argue just the reverse: that the existence of consent-to-settle clauses plus the absence of contractual limits on insurer discretion to reject settlement suggests that the latter would *not* be joint-wealth-maximizing. This argument is plausible, but, for several reasons, ultimately unpersuasive. First, the absence of disregard-the-limits clauses from liability insurance contracts could be entirely attributable to the existence of the duty-to-settle doctrine in the common law—there is little incentive to include such a term if it is by law implied in every insurance contract. Second, if insureds and insurers think that imposing a disregard-the-limits requirement on insurers is joint-wealth-decreasing, why do we see no serious effort by the parties to contract around this requirement—that is, why are there no efforts to eliminate contractually the bad-faith cause of action against insurers? Sykes responds to this point by asserting that such a contractual provision would likely be struck down by a court as being against

context of reinsurance contracts between a primary insurer, who generally controls the settlement decision, and its reinsurer, who bears the costs of excess judgments. As Syverud has noted, many reinsurance contracts respond to the conflict of interest that arises between the primary insurer and the reinsurer by placing restrictions on the primary insurer's settlement discretion.[34] For example, Syverud notes that excess-of-loss reinsurance contracts typically contain provisions requiring, among other things, "notice to the reinsurer of claims threatening to exceed the retention" and "consultation with the reinsurer about defense strategy in such cases."[35]

Hence, there is some empirical evidence, albeit weak, suggesting that commercially sophisticated insurers sometimes bargain for contractual restrictions on insurers' discretion with respect to settlement decisions.[36] Arguably, this evidence supports the theoretical information-cost argument for the imposition of extracontractual limits on insurer settlement discretion in contexts involving commercially unsophisticated insureds. I do not want to overstate the importance of this "empirical evidence," however. Professor Sykes and I agree that "inferences . . . drawn from the terms of insurance contracts are weak inferences."[37] On the basis of the inherent plausibility of the information-cost theory discussed above, however, I would be inclined to support some limits on insurer settlement discretion in the limited situations described in this Comment. Sykes, however, examines the same theoretical arguments and some of the same empirical evidence and quite reasonably concludes that the argument for such restrictions "is, at best, uneasy."[38] It is at this point in his argument that Sykes introduces the judgment-proof-insured problem, which, according to Sykes, further undermines arguments in favor of such limitations as the disregard-the-limits rule.

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public policy. Sykes, *supra* note 6, at 1361. Although this is a plausible possibility, Sykes has cited no case in which a court has struck down such a clause. Third, in situations involving highly sophisticated commercial actors, one does sometimes encounter certain types of contractual restrictions on insurer discretion to reject settlements.

34. Syverud, *supra* note 9, at 1200.

35. *Id.*

36. Admittedly, the contractual provisions from the reinsurance context that Syverud describes are not perfectly analogous to a disregard-the-limits requirement. But those provisions arguably limit the primary insurer's discretion to reject settlements. Moreover, the existence of such provisions is especially compelling evidence of the preferences of commercially sophisticated parties, given that in the reinsurance context, the duty-to-settle doctrine is virtually nonexistent. It is precisely in the reinsurance context, therefore, in which one might expect such a contractual limitation to appear if it were joint-wealth-maximizing.

37. Sykes, *supra* note 6, at 1361.

38. *Id.* at 1348.

III. The Judgment-Proof-Insured Problem

Under Sykes's view, the existence of judgment-proof insureds creates at least two problems for the disregard-the-limits rule. First, in a world with judgment-proof insureds, the disregard-the-limits rule will sometimes give insurers an incentive to accept joint-wealth-decreasing settlement demands.[39] Second, under those circumstances, liability insureds may respond by underconsuming liability insurance coverage, thereby externalizing additional accident costs onto tort victims.[40] Thus, Sykes strongly suggests that the judgment-proof-insured problem further undermines any argument in support of imposing the disregard-the-limits rule.[41] Part III describes this problem and suggests an alternative approach to the disregard-the-limits rule that offers a potential solution.

The judgment-proof-insured problem is essentially this: Under certain circumstances involving judgment-proof insureds, the disregard-the-limits rule—as it is applied in the majority of states—will induce the insurer, under certain circumstances, to accept joint-wealth-*decreasing* settlement demands. This result can be seen through our example. Recall that the insured in the example faces a 50% probability of a $100,000 tort judgment, and the policy limit is $50,000. Previously we assumed that if the tort suit resulted in a $100,000 judgment at trial, the insured would have sufficient assets to cover the $50,000 excess judgment. Now assume that the insured has only $10,000 of available assets—that is, $10,000 of assets available to satisfy a judgment in excess of the policy limits. Therefore, the insured is judgment-proof with respect to any judgment in excess of $60,000. Under these assumptions, although the expected trial judgment is $50,000, the expected *payment* to the plaintiff—that is, the expected enforceable judgment is only $30,000.[42] Note that under these circumstances and applying the traditional disregard-the-limits rule, the insurer would have an incentive to accept any settlement demand less than $50,000. Why? Because, as the disregard-the-limits rule has traditionally been applied, and is currently applied in a majority of states,[43] both the liability trigger and the amount of damages are calculated in a manner that ignores the value of the insured's available assets.

To see the effect of the traditional disregard-the-limits rule, assume that the insurer in our example were to reject a $40,000 settlement demand and the case were to result in a $100,000 trial judgment against the

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39. *Id.* at 1361-65.

40. *Id.* at 1365.

41. *Id.*

42. The $30,000 expected payment is the product of the 50% chance that the court would find for the plaintiff and the total value of the assets available to satisfy the judgment—which includes the $50,000 policy limit and the insured's $10,000 in assets.

43. *See infra* note 56.

insured. The insurer (1) would be liable to the tort plaintiff for the $50,000 policy limit; and (2) following a duty-to-settle suit, would be liable to the insured, or the insured's assignee, for the full $50,000 excess judgment, *irrespective of the fact that the insured had only $10,000 of available assets.* Thus, although the expected payment to the plaintiff at the time of the settlement demand is $30,000, the expected cost to the insurer of rejecting any settlement demand and going to trial would be $50,000.

The problem with this outcome is that, under the assumptions of the example, a $50,000 settlement—or any settlement greater than $30,000— *decreases* the combined expected wealth of the insurer and the insured. To see why, note that the insurer and the insured could have rewritten the contract *ex ante* to increase their joint returns from the transaction. In return for a lower premium, the insured would have been willing to limit the amount that it could recover from the insurer in a duty-to-settle cause of action. In theory, the insured would have been willing to reduce its maximum potential duty-to-settle award to the difference between the policy limits and the value of the insured's available assets. In turn, the insurer would have been willing to offer the insured the desired premium reduction in return for a limit on its potential duty-to-settle liability.

Sykes discusses the theoretical possibility of such a Coasean bargain, but he suggests that such bargains would never occur in practice because such agreements cannot be enforced in court.[44] Courts, according to Sykes, will not allow insureds to waive their right to bring a bad faith cause of action.[45] In any event, Sykes regards a contractual solution to the judgment-proof-insured problem as too costly for the parties to negotiate.[46] For both of these reasons, Sykes concludes that the application of the traditional disregard-the-limits rule in a world with judgment-proof insureds will probably cause insurers to accept some joint-wealth-decreasing settlement demands.[47]

Sykes argues further that one judgment-proof-insured problem may lead to another. In response to liability insurers' increased tendency to accept joint-wealth-decreasing settlement demands—induced by the application of the disregard-the-limits rule—liability insureds may have an incentive to reduce their policy limits and, in effect, to underconsume liability insurance.[48] Insureds would reduce their policy limits because,

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44. Sykes, *supra* note 6, at 1362-63.

45. *Id.* at 1360.

46. *Id.* at 1363.

47. *Id.*

48. *Id.* at 1364. Sykes formally proves this point in another recent paper, but this argument, by Sykes's own admission, requires a number of strong assumptions. Sykes, *supra* note 7, at 100-07. *But see* Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629, 1640-46 (1994) (arguing that, in part because of incentives facing plaintiffs' lawyers and liability insurance companies, the tort system results in overconsumption of liability insurance).

by doing so, they could induce plaintiffs to make lower settlement demands. Under the assumptions of Sykes's model, this strategy works for the following reason: Because a plaintiff's expected return from litigating a case decreases as the amount of the judgment that is potentially uncollectible increases, the plaintiff's settlement demand is a function of the policy limits in the defendant's liability insurance policy, assuming the insured is judgment proof. And to the extent that the disregard-the-limits rule causes insureds to underconsume insurance, it can shift costs onto tort victims.[49]

Taking into account both of these problems associated with the existence of judgment-proof insureds—the tendency of insurers to accept joint-wealth-decreasing settlements and the tendency of insureds to respond by underconsuming liability insurance—Sykes concludes that "the case for the disregard-the-limits rule—or any other simple rule that one might imagine—weakens greatly."[50]

IV. Solving the Judgment-Proof Problem: The Michigan Rule

There is a simple variation of the traditional disregard-the-limits rule that takes into account the existence of judgment-proof insureds and that may eliminate both of the judgment-proof problems that Sykes identifies. The proposal is this: Limit the amount of an insurer's potential duty-to-settle damages to the difference between the policy limit, which the insurer has presumably already paid out, and the value of the insured's available assets. In addition, the duty-to-settle liability rule itself could be designed so that liability is triggered only if the insurer rejects a settlement demand that is less than the expected enforceable judgment. If applied perfectly by courts, this rule would give insurers an incentive to make only joint-wealth-increasing settlement decisions. They would accept settlements that increase—and reject settlements that decrease—the combined expected wealth of themselves and their insureds. Also, because insurers under this rule would no longer have an incentive to accept joint-wealth-decreasing settlements, the insureds' incentive to underconsume liability insurance would likewise disappear. To that extent, this rule would lessen the cost-externalization effect of the judgment-proof problem that Sykes mentions. Note that this proposal essentially reflects the outcome that insurers and insureds would reach by Coasean contract if the law permitted. Therefore,

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49. Sykes, *supra* note 6, at 1364. In this part of his paper, Sykes begins to consider policy objectives other than the maximization of the combined expected wealth of liability insurers and their insureds. *See also* Sykes, *supra* note 7, at 79 ("A case for an extracontractual obligation on the insurer might somehow rest on the presence of externalities to the contract, but the courts do not offer this rationale." (footnote omitted)). For a more thorough discussion of how duty-to-settle rules can affect the deterrence and insurance goals of tort law, see *infra* Part V.

50. *Id.* at 1365.

one alternative to this proposal would be simply to allow insureds to limit their duty-to-settle remedy against the insurer contractually. However, to the extent one believes that information costs or other market failures are present, one might think that those same concerns would prevent the parties from reaching this contractual solution.

This alternative form of the disregard-the-limits rule is not merely a theoretical possibility. A version of it was recently adopted by the Supreme Court of Michigan in a case involving a bad faith claim brought by an insured against her liability insurer.[51] In *Frankenmuth Mutual Insurance Co. v. Keeley*, the insured, who was also the tort-defendant in the prior action, alleged that her liability insurer, by rejecting a reasonable settlement demand, had caused the tort case to go to trial, which resulted in a judgment against the insured. The insured sought damages equal to the difference between the policy limit and the amount of the tort judgment, although the value of the insured's available assets was considerably less than the amount of the judgment. One of the issues in the bad faith ease was whether the insured's duty-to-settle damages should be limited to the difference between the policy limit and the value of the insured's available assets plus the assets that the insured had reasonable prospects of acquiring in the near future.[52] On rehearing, the court held that duty-to-settle damages should be so limited and that therefore the insured should not be allowed to recover the full amount of the tort judgment. The court based this deeision on the theory that (1) the duty-to-settle remedy should equal the harm; and (2) the insured was harmed only to the extent of her available and soon-to-be-available assets.[53] Although this approach has been dubbed the "Michigan Rule,"[54] this alternative version of the disregard-the-limits rule has been suggested by commentators for many years.[55] Nevertheless, the majority of courts have rejected this approach and have instead held that the value of the insured's available assets should be ignored for the purpose of determining duty-to-settle damages.[56]

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51. Frankenmuth Mut. Ins. Co. v. Keeley, 461 N.W.2d 666, 667 (Mich. 1990) (adopting the dissent of Levin, J., in Frankenmuth Mut. Ins. Co. v. Keeley, 447 N.W.2d 691, 707-09 (Mich. 1989), *rev'd on rehearing and remanded*, 462 N.W.2d 750 (Mich. 1990)).

52. *Frankenmuth*, 447 N.W.2d at 707-08.

53. *Frankenmuth*, 461 N.W.2d at 667.

54. Medical Mut. Liab. Ins. Soc'y v. Evans, 622 A.2d 103, 114 (Md. 1993).

55. Victor E. Schwartz, *Statutory Strict Liability for an Insurer's Failure to Settle: A Balanced Plan for an Unresolved Problem*, 1975 DUKE L.J. 901, 913-14, 917-18 (proposing a statutory duty-to-settle scheme whereby insurers would be liable for either the full amount of the judgment or the value of the insured's assets, whichever is smaller); KEETON & WIDISS, *supra* note 8, § 7.8(i)(4), at 903-04 (proposing a similar limit on the insurer's duty-to-settle liability); Syverud, *supra* note 9, at 1169 n.145 ("In theory, the liability of the insurance company for a judgment in excess of the policy limits should be limited to the total assets of the insured, because the insured could lose no more than those assets in paying a final judgment.").

56. *See Medical Mut.*, 622 A.2d at 114, 114-15 (collecting cases applying the "majority rule" that the "measure of damages in a bad faith failure to settle case is the amount by which the judgment

The spirit of the Michigan Rule could be implemented either through a negligence duty-to-settle rule or through a strict-liability duty-to-settle rule. Under the negligence approach to the duty-to-settle question, the court—jury, judge, or other factfinder—would attempt, from an *ex post* perspective, to determine the reasonableness of the insurer's *ex ante* decision to reject the settlement demand. If the Michigan Rule were implemented through such a negligence approach, the court could ask whether the settlement demand that the insurer rejected was, at the time of the rejection, less than the value of the expected enforceable judgment. Under a strict-liability version of the Michigan Rule, if the insurer were to reject a settlement demand within the policy limits and the plaintiff were to win a judgment in excess of those limits, the insured would automatically be allowed to recover from the insurer the difference between the policy limit and the insured's available assets—limited, of course, by the amount of the judgment.[57]

Although all the courts that have adopted a duty-to-settle rule have used the negligence approach,[58] both the negligence approach and the strict-liability approaches have costs and benefits. Perhaps the most serious complaint that can be made about the negligence approach is that the court's *ex post* analysis of the insurer's *ex ante* settlement decision may be subject to certain types of systematic biases. For example, one might argue that jurors placed in the position of deciding this question would have a tendency to favor the plaintiff over the insurance company. This complaint, of course, would apply not only to the negligence rule proposed in this Comment, but also to any duty-to-settle rule that requires a court to undertake the negligence or reasonableness analysis. The complication that this Comment's proposal would add to the traditional negligence analysis is the problem of valuing the insured's available assets. This additional variable could prove quite burdensome for courts.[59]

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rendered in the underlying action exceeds the amount of the insurance coverage"); *see also* PAT MAGARICK, EXCESS LIABILITY § 15.07 (3d ed. 1989) (noting the majority rule against requiring a duty-to-settle plaintiff to prove evidence that the insured could in fact pay the judgment); Syverud, *supra* note 9, at 1169 n.145 (citing cases that apply the majority rule).

57. Note that in *Frankenmuth*, the court seemed to apply the traditional negligence trigger and then to limit the damages to the difference between the policy limit and the insured's available assets. *Frankenmuth*, 461 N.W.2d at 667.

58. KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 586 (1990) ("No court has squarely adopted the strict liability test . . . .").

59. *See* KEETON & WIDISS, *supra* note 8, § 7.8(i)(1), at 899-900 (noting the "considerable uncertainty [that would exist] in regard to predicting whether the insured may ultimately have resources or assets that may be taken to satisfy some portion of the judgment"). Another difficult question raised by my proposal is whether, in calculating the value of the insured's available assets, the value of the insured's right to bring the duty-to-settle claim against the insurer should be included. Often this right will be the most valuable asset the insured has when the judgment is rendered against it. The benefits of introducing this complication into the analysis, which are unclear, would likely be overwhelmed by

One factor that might favor a strict-liability approach to implementing this Comment's proposal is the reduction of juror discretion. If one believed that jurors were, for whatever reason, biased in one direction or another, it might be desirable to limit jurors' discretion by eliminating the *ex post* reasonableness analysis of the insurer's settlement decisions.[60] Another argument often made on behalf of the strict-liability approach is that it would reduce the costs of administering the duty-to-settle rule. However, although the administrative costs associated with any single strict-liability suit might be lower than under the negligence approach, under the strict-liability rule there likely would be more suits brought. Whether the "cost-per-case effect" would dominate the "quantity effect" is unclear.[61]

One might oppose a strict-liability duty-to-settle rule on the theory that such a rule would undermine the usefulness of coverage limits in insurance policies. This is because, under a rule that creates a potential duty-to-settle cause of action whenever an insurer rejects a settlement demand within the policy limit, the tort-plaintiff would have an incentive to make a relatively high settlement demand, one that the insurer would be likely to reject. Under this strategy, if the tort-plaintiff were ultimately to win a judgment against the tort-defendant, the liability insurer would be responsible for the full amount of the judgment and not merely for the amount of the policy limits. Note, however, that the Michigan Rule would mitigate this effect to some extent, because the maximum liability of the insurer would be limited by the value of the insured's available assets, which will sometimes be less than the policy limits. Also, under the strict-liability approach, arriving at a value for the insured's assets would be less of a problem than under the negligence approach, because under the strict-liability approach the value need only be determined *ex post*. Unlike the negligence approach, the strict-liability approach would not ask the factfinder to

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the costs. For instsnce, including the value of the duty-to-settle claim in the insured's assets could create new conflicts of interest between the insurer and the insured and new opportunities for bargaining strategies between the insurer and the plaintiff. *See id.* § 7.8(i)(4), at 903 (recommending that, when calculating the value of the insured's available assets for the purpose of determining the appropriate duty-to-settle damage award, the value to the insured of the duty-to-settle claim should not be includ)d

60. This argument depends on the assumption that eliminating the reasonableness inquiry would *in fact* reduce juror discretion.

61. *See* POSNER, *supra* note 5, at 560-61 (noting that under a strict-liability rule, the savings gained from simplifying the issues in individual tort cases could be off-set by the costs from increasing the number of claims likely to be brought once the scope of liability is expanded); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW § 11.1.3 (1987) (noting that a comparison of administrative costs under strict liability and negligence "is ambiguous as a theoretical matter"); Steven P. Croley & Jon D. Hanson, *What Liability Crisis? An Alternative Explanation for Recent Events in Products Liability*, 8 YALE J. ON REG. 1, 14-17 (1991) (noting the shortcomings of past analyses that have attempted to demonstrate that a strict-liability approach is demonstrably more costly than a negligence approach).

determine what the estimated value of the insured's assets would have been at the time the settlement decision was made and what, at that time, the value of those assets was expected to be in the future.[62]

V. Comparing the Effects of the Michigan Rule and the Majority Rule on the Deterrence and Insurance Goals

This Comment has advanced two propositions: First, although the empirical evidence is inconclusive, there is a plausible theoretical argument for imposing some type of extracontractual limit on liability insurers' discretion to settle claims against their insureds, at least in circumstances involving commercially unsophisticated insureds. Second, if the previous proposition is accepted, there is also an argument that this extracontractual limit should be tailored to take into account explicitly the existence of judgment-proof insureds. Accordingly, insurers' liability under such a rule should be limited to the difference between the policy limits and the value of the insured's available assets. This limit could take the form of a negligence rule, a strict-liability rule, or a variation of either.

It also has been assumed thus far that, in designing background rules to govern the settlement decisions of liability insurance companies, the only, or at least the dominant, normative criterion is the encouragement of insurer settlement decisions that maximize the combined expected wealth of the parties to the contract—the insurer and the insured. Thus, the effects on third parties of settlement decisions and the rules governing settlement decisions have both been largely ignored. Now consider how the analysis becomes more complicated if one tries to take into account the effects of these rules on a specific group of third parties, namely, tort victims. To that end, this Part addresses what the optimal settlement amount should be in terms of the deterrence and insurance goals of tort law. It then briefly examines how the two duty-to-settle rules—the majority rule and the Michigan Rule—compare in their respective tendencies to further those goals. It should be emphasized that this Comment does not attempt a comprehensive analysis of either of these questions. It merely suggests potentially fruitful areas of further inquiry.

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62. For a useful summary of the costs and benefits of various strict-liability approaches to the duty-to-settle question, see ABRAHAM, *supra* note 5, at 193-95. Syverud has proposed a modified version of the strict-liability rule that would eliminate some of the problems discussed in the text. Under his proposal, "[c]ourts could hinge strict liability not upon rejection of a plaintiff's demand, but rather upon refusal to offer what a neutral arbitrator, mediator, or settlement judge estimates is the value of the claim." Syverud, *supra* note 9, at 1170. That proposal would avoid some of the administrative costs of the negligence and the pure strict-liability approaches. Moreover, a well-chosen arbitrator or mediator may be less biased against insurers than the average juror is likely to be. This Comment's proposal—to take into account the value of the insured's available assets in determining duty-to-settle liability or damages—is consistent with Syverud's approach.

Legal economists generally agree that the principal economic goals of tort law are deterrence and insurance.[63] The deterrence goal of tort law is to give tortfeasors and victims the incentive to prevent all cost-justifiably preventable accidents—that is, all accidents that can be prevented at a cost less than the expected accident cost. The deterrence goal is satisfied when all parties bear the full, expected costs of the accidents they cause. The insurance goal, sometimes called the compensation goal, is to spread efficiently the risks of accidents that cannot cost-justifiably be prevented.[64]

Taking into account the goals of tort law, it might be possible to identify the optimal settlement decision with respect to any given tortfeasor and victim. That is, it might be possible to identify the circumstances in which the optimal result would be either settlement or litigation. Moreover, when settlement is preferable to litigation, it might be possible to determine what the optimal settlement amount, or the range of efficient settlement amounts, should be. Such a project is well beyond the scope of this Comment. However, under the highly stylized assumptions of our example, it can be said that the optimal settlement decision is either (1) a settlement precisely equal to the expected trial judgment; or (2) the decision to go to trial.

Once more, recall the assumptions: A plaintiff who suffered $100,000 in damages sues the insured in tort for that amount. All parties agree that there is a fifty percent chance that the court will either hold the insured liable for the full amount or leave the losses on the plaintiff. The insured has $50,000 of liability insurance coverage and $10,000 in available assets, and the insurance policy allocates settlement discretion to the insurer. Under the assumptions of this example, the optimal settlement, from the point of view of deterrence and insurance, would be precisely equal to the expected trial judgment of $50,000. This is because, under the current assumptions, requiring the insured—or the insurer, if the insurance premiums are perfectly experience-rated—to pay the *expected value* of the trial judgment fully internalizes the accident costs to the insured and fully compensates the injured plaintiff. This result follows because, in a probabilistic sense, the expected value of the trial judgment under these assumptions is precisely equal to the expected value of the plaintiff's damages that the insured caused.

This argument is an application of the concept of probabilistic causation, which has been applied, among other places, in the mass torts literature. In the most general terms, this concept suggests that, in

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63. *E.g.*, John E. Calfee & Clifford Winston, *Economic Aspects of Liability Rules and Liability Insurance, in* LIABILITY: PERSPECTIVES AND POLICY 16, 16-18 (Robert E. Litan & Clifford Winston eds., 1988); Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 135 (1990).

64. Calfee & Winston, *supra* note 63, at 16-18; Hanson & Logue, *supra* note 63, at 135.

circumstances involving uncertainty about whether a particular tortfeasor caused a harm, an efficient response can be—under strong assumptions—to impose liability and award damages equal to the expected value of the harm.[65] This Comment argues that the same principle can be applied to the uncertainty over whether a court will determine that the insured is liable for those injuries.[66] Therefore, based on the foregoing argument, one might contend that an optimal duty-to-settle rule would have a tendency to result in such settlements that approximate the expected trial judgment.

Now consider the extent to which the Michigan Rule and the majority rule have a tendency to achieve this result. If we maintain the assumptions of our example, it can be shown that the Michigan Rule, either in the form of a negligence rule or a strict-liability rule, will have a tendency to encourage settlements that either *under*deter accidents and *under*insure tort victims or will result in the case going to trial. The Michigan Rule would lead to litigation: First, the insurer would not accept any settlement greater than $30,000, because the insurer's expected cost of going to trial is only $30,000.[67] Second, the plaintiff would accept nothing less than $50,000, which is the plaintiff's expected benefit of going to trial. Under the majority rule, however, there would be a tendency for the parties to settle and for settlements to approach the expected trial judgment. This is because the insurer would be willing to pay $50,000—its expected cost of going to trial—but would be unwilling to pay more. The insured, on the other hand, would be unwilling to take any less. Interestingly, however, under a negligence version of the majority rule, the insured would have an incentive to contribute to the settlement negotiations an amount up to $5000[68] for a total possible settlement of $55,000. Under a strict-liability version of the majority rule, however, the insured would not be willing to contribute anything, as its expected cost of going to trial would be zero. Therefore, although a negligence version of the majority rule might result in settlements that provide *excess* deterrence and insurance—that is, settlements greater than the amount of the expected trial judgment—a strict-liability version of that rule would lead to settlements that approach the optimal amount. Obviously, if the assumptions of the example are relaxed,

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65. David Rosenberg, *The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Tort System*, 97 HARV. L. REV. 851, 859-60 (1984); Glen O. Robinson, *Probabilistic Causation and Compensation for Tortious Risk*, 14 J. LEGAL STUD. 779, 783-89 (1985); Shavell, *supra* note 61, § 5.3.2-.3.

66. This final claim depends on the assumption that the court will be applying the efficient liability rule and that the court's decision is not biased in any direction.

67. Recall that $30,000 is the product of (1) the 50% chance that the plaintiff will recover; and (2) the sum of the amounts the plaintiff would recover from the insurer—the $50,000 policy limit and the insured—the $10,000 in available assets—if the plaintiff wins the case.

68. The $5000 is the insured's expected cost of going to trial—the product of the plaintiff's 50% chance of recovery and the insured's $10,000 in available assets.

we might reach different conclusions with respect to the Michigan Rule and the majority rule. For example, if we were to assume that insurers and insureds have asymmetrical assessments of the likely trial outcome or asymmetrical tolerance for risk, the conclusions could change.

Moreover, even under the strong assumptions of our example, it is unclear whether the deterrence and insurance goals of tort law would be better served under the majority rule or the Michigan Rule. It may be that settlement decisions under the majority rule, at least a strict-liability version of the majority rule, have a greater likelihood of furthering deterrence and insurance goals than do settlement decisions under the Michigan Rule. However, under the majority rule, the insurance market would likely respond in a way that would actually increase the judgment-proof-insured problem. This argument goes as follows: The effect of the majority rule is essentially to eliminate the effect of policy limits—that is, the majority rule makes the insurer potentially liable for the full amount of any trial judgment against its insureds. One of the benefits of policy limits is to combat adverse selection.[69] Therefore, under the majority rule, insurers would have greater difficulty combatting adverse selection than they would under the Michigan Rule, which would lead to higher premiums and perhaps lower coverage for some liability insureds. Moreover, as premiums increased under such a rule—owing to adverse selection—some tortfeasors at the margin would be priced out of the insurance market altogether. With fewer tortfeasors purchasing liability insurance because of this effect, the beneficial deterrence and insurance effects of liability insurance would be diminished.[70]

In sum, whether the deterrence and insurance goals of tort law are better served by the majority rule or the Michigan Rule remains an empirical question. Indeed, the principal contribution of this Part of the Comment has been to hint at the complexity that one must consider in order to identify the "optimal" background rule to govern settlement decisions, if one opens the analysis to include normative criteria other than

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69. ABRAHAM, *supra* note 58, at 4. Adverse selection is the tendency of a party that faces a higher-than-average level of risk to have a greater demand for insurance than a party that presents a relatively low level of risk. Because a potential policyholder has better information about its risk of loss than the insurer has, the process of adverse selection forces the insurer to raise premiums and to set policy limits on the losses it will cover. *Id.* at 3-4.

70. As a result of this adverse selection under the majority rule, there would also be a general increase in the amount of risk borne by risk averse individuals, who, under the Michigan Rule, would have purchased insurance. That fact alone is a reason to be concerned about the majority rule. SHAVELL, *supra* note 61, § 8.1.4, at 192 ("It should also be emphasized that the allocation of risk is in principle just as important a determinant of social welfare as the . . . reduction of accident losses."). Sykes, in another recent article, shows that insureds may respond to the existence of the majority version of the disregard-the-limits rule *ex ante* by lowering the policy limits in the insurance they buy. Sykes, *supra* note 7, at 103. This result would also exacerbate the judgment-proof problem.

maximizing the combined expected wealth of the parties to the contract. However, to the extent one wants to limit the analysis to the joint-wealth-maximization criterion, there is a plausible argument for using the Michigan Rule, in contexts involving unsophisticated insureds, because of its ability to respond to the judgment-proof-insured problem.

VI. Conclusion

Consider the following question: Would any of the judgment-proof problems discussed in this Comment and in Sykes's paper remain if Congress enacted a regime of universal, unlimited, mandatory liability insurance? This regime would entail liability insurance that (1) has no policy limits, deductibles, or exclusions; (2) covers the risks of any tort judgment; and (3) must be purchased by everyone. What would the benefits of such a regime be? To the extent liability insurers can monitor their insureds and encourage them to take appropriate accident-avoidance measures—in return for premium breaks through feature or experience rating—tortfeasors would be given the appropriate incentive to prevent accidents. In addition, no tort victim would go uncompensated. Moreover, under this regime, unlike under the majority rule discussed in this Comment, there would be no adverse selection. After all, the regime would be both mandatory and universal.

Obviously, such a regime, at least the extreme version hypothesized here, would entail enormous potential costs. If, however, we treat this extreme version of universal, unlimited, mandatory liability coverage as our *conceptual* starting point, perhaps we will stumble upon a more realistic proposal for liability-insurance reform that would address the judgment-proof problems that undermine the goals of tort law and of insurance law. In any event, such a conceptual approach would inevitably improve our understanding of the largely nonuniversal, limited, and optional regime of liability insurance that we now have.