A NO-FAULT APPROACH TO THE DUTY TO SETTLE

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This Article takes another look at an old question: whether liability insurers' "duty to settle" should be governed by a fault standard, as it presently is, or should instead be governed by a no-fault standard. Under the current law, an insurer breaches its duty to settle, and is liable for any resulting damage award exceeding policy limits, only if it unreasonably (or in "bad faith") refuses a claimant's offer to settle for an amount within those limits.[1] Over the years, however, courts and commentators have occasionally suggested that an insurer's rejection of a within-limits settlement offer should trigger liability without proof of fault, meaning that the insurer would have to pay any resulting judgment above policy limits regardless of whether its decision not to settle was reasonable (or in "good faith").[2] In this Article, I revisit the

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1. *See* RESTATEMENT OF THE LAW OF LIAB. INS. §§ 24, 27 & accompanying reporters' notes (AM. LAW INST., Discussion Draft 2015) (summarizing contemporary legal doctrine).

2. In *Crisci v. Security Insurance Co. of New Haven*, 426 P.2d 173, 177 (Cal. 1967) (in bank), the California Supreme Court spoke approvingly of, but did not adopt, a rule that "whenever an insurer receives an offer to settle within the policy limits and rejects it, the insurer should be liable in every case for the amount of any final judgment whether or not within the policy limits." Other courts have also discussed possible advantages of such an approach, without adopting it as a rule of decision. *See, e.g.*, Tri-State Ins. Co. v. Busby, 473 S.W.2d 893, 896 (Ark. 1971); Rova Farms Resort, Inc. v. Inv'rs Ins. Co. of Am., 323 A.2d 495, 510 (N.J. 1974).

The idea received widespread advocacy from commentators in the 1970s. *See* Phillip J. Deaver, Note, *Insurer's Liability for Refusal to Settle: Beyond Strict Liability*, 50 S. CAL. L. REV. 751, 752 n.11 (1977) (citing previous work). Treatments of the subject from subsequent decades include KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 193–95 (1986); David A. Hyman, Bernard Black & Charles Silver, *Settlement at Policy Limits and the Duty to Settle: Evidence from Texas*, 8 J. EMPIRICAL LEGAL STUD. 48, 79–80 (2011); Richard Squire, *How Collective Settlements Camouflage the Costs of Shareholder Lawsuits*, 62 DUKE L.J. 1, 18–23, 45 (2012); Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1168–71 (1990).

issue from an economic point of view, setting forth what I think is an underappreciated case for the no-fault approach.[3]

The main hypothesis of the Article is that adoption of no-fault liability would produce lower joint costs for insurer and insured.[4] I explore that hypothesis in three stages. In Part I, I clarify the structure of the fault and no-fault approaches, emphasizing two differences between them: the likelihood of insurer liability for refusal to settle, and the sanctions imposed in the event it is found liable. A shift to no-fault would increase the likelihood of liability for non-settling insurers, because they would not be able to plead that their actions were reasonable. At the same time, however, it would reduce the sanctions imposed on them, because the compensatory and punitive damages currently awarded under the fault system would no longer be necessary; non-settling insurers would be liable for the resulting judgment, but generally nothing more. That is the key premise of the analysis in this Article: no-fault approach dispenses not only with the reasonableness standard, but also with the augmented damage awards that characterize the fault rule.

Part II compares the two approaches' effects on insurer settlement decisions. In deciding whether to settle a case, the liability insurer essentially acts as the insured's agent, and the central question to be asked is how well the two approaches align the interests of principal and agent; that is to say, how well they discourage the insurer from making settlement decisions that subordinate the insured's interests to its own. The fault approach, I suggest, is unlikely to achieve this as effectively as the no-fault alternative. Depending on the likelihood and severity of the sanctions for "unreasonable" decisions, the fault rule may over-encourage or under-encourage settlement, leading the insurer to accept settlements it should reject, and vice versa. A no-fault approach eliminates these

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3. Previous economically-oriented studies of the duty to settle include Hyman, Black & Silver, *supra* note 2; Michael J. Meurer, *The Gains from Faith in an Unfaithful Agent: Settlement Conflicts Between Defendants and Liability Insurers*, 8 J.L. ECON. & ORG. 502 (1992); Charles Silver, *A Missed Misalignment of Interests: A Comment on Syverud,* The Duty to Settle, 77 VA. L. REV. 1585 (1991); Alan O. Sykes, *"Bad Faith" Refusal to Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem*, 23 J. LEGAL STUD. 77 (1994). The present Article adds relatively little to the insights of these earlier analyses. Its main purpose is to offer a relatively accessible, streamlined presentation of the economic case for the no-fault approach.

4. I employ the term "no-fault" rather than "strict liability" because to many readers the latter implies "more liability," i.e., more money paid to plaintiffs. A crucial claim developed here is that eliminating the fault standard may reduce, not increase, the overall exposure of insurers.

problems, which should result in savings that can be shared by insurers and insureds.

In Part III, I consider several possible objections to the preceding analysis. The first is that the no-fault approach would lead claimants to make inflated settlement demands, thus leading to greater costs for insurers and insureds. There is, however, no general reason to expect this. The second is that no-fault would effectively eliminate coverage limits, forcing insureds to purchase more coverage than they want. This objection overlooks the fact that under no-fault, an insurer would only be liable for refusing below-limits settlement demands; policy limits would thus retain a binding effect, and different limits would continue to carry different prices. The third is that no-fault would reduce the insured's incentive to assist in the defense of cases that go to trial, which would result in greater trial losses and, over time, greater insurance costs. It is an empirical question whether these costs outweigh the savings identified in Part II. Finally, I consider the objection that no-fault must be disadvantageous to insurers and insureds, because if it were beneficial, we would see it being adopted in insurance policies. Part IV concludes.

I.

To get our bearings, we can begin with the classic case *Crisci v. Security Insurance Co. of New Haven*,[5] in which a tenant sued her landlord for injuries caused by a collapsing staircase in a rented house. The claim was handled by the landlord's insurer, with whom she had a $10,000 liability policy. The tenant offered to settle the case for $9000; the insurer declined, despite its lawyer's warning that the plaintiff's case was very strong and that a jury would probably award damages much greater than the requested settlement figure.[6] The case went to trial, resulting in a verdict for the tenant for an amount just above $100,000. The insured, left indigent by the judgment against her, then successfully sued the insurer for its refusal to accept the plaintiff's settlement offer. The insurer was ordered to pay the entire judgment amount, along with other consequential damages the insured had sustained.[7]

The basic rationale for judicial action in this sort of situation, as courts have long understood, is that liability insurers face an acute conflict of interest in deciding between settlement and trial. The conflict

5. 426 P.2d 173 (Cal. 1967) (in bank).
6. *Id.* at 175–76.
7. *Id.* at 178.

arises when two conditions hold: (1) the insurer has the opportunity to settle a claim against the insured for an amount within policy limits,[8] and (2) trial may result in a damage award that exceeds the policy limits. In taking such a case to trial the insurer is, in effect, "gambling with the insured's money," because the insured bears the risk of the excess judgment amount. The numbers in *Crisci* vividly illustrate the point: in going to trial, the insurer might win a defense verdict and pay $0; if it loses, the most it has to pay is $10,000. Looking solely at its own interests, the insurer might easily conclude that the trial gamble is preferable to a $9000 settlement, notwithstanding the exposure this creates for the insured.[9] Aside from being disloyal, such insurer behavior is wasteful; the insured loses a lot more than the insurer gains by going to trial.[10]

The judicial response to this problem is the doctrine of the duty to settle, perhaps more accurately labelled the liability "insurer's duty to make reasonable settlement decisions."[11] Courts typically treat the doctrine as part of the insurer's more general duty of good faith and fair dealing, which they construe as prohibiting the insurer from putting its own interests ahead of those of the insured, to whom it has promised effective legal representation as part of the liability insurance contract.[12] Operationally, this translates into something like the following rule: when it has the opportunity to settle a case against the insured for a figure within policy limits, the insurer should take the same action that it would if there were no policy limit in place. In other words, the insurer should evaluate a possible settlement just as it would if, hypothetically, it alone were financially responsible for the entire judgment in the event of

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8. For the sake of clarity, I assume throughout this analysis that the insurer controls the defense of the case, including the decision whether to settle, and that the insurer pays the settlement without any contribution from the insured.

9. In addition, because the insurer pays only a fraction of the judgment in the event of a trial loss, it will invest less in defending against the claim than it would otherwise.

10. My focus here is on the impact on the welfare of the parties to the insurance contract. A fuller accounting would have to consider effects on plaintiff recoveries, judicial resources, and so forth. I leave these complexities out of the present analysis.

11. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 24 (AM. LAW INST., Discussion Draft 2015) (employing the latter label).

12. *See, e.g.*, Wood v. N.J. Mfrs. Ins. Co., 21 A.3d 1131, 1140 (N.J. 2011) (discussing the doctrine's roots in implied covenant of good faith and fair dealing). Despite its contractual foundations, most courts characterize duty-to-settle claims as tort actions, which has significance for the availability of nonpecuniary and punitive damages. *See generally* JEFFREY W. STEMPEL, 1 STEMPEL ON INSURANCE CONTRACTS § 10.02[A] (3d ed. Supp. 2007) (surveying judicial characterizations of the cause of action).

a loss at trial.[13] It should not exploit the fact that its insured will have to pay the above-limits portion of a judgment.

For our purposes, this doctrine has two critical components. The first is the use of a fault requirement: to recover against an insurer for refusing to settle a claim, the insured must establish that the insurer has—in some sense—acted improperly. This is something all courts agree on, though they differ on the nature and degree of fault needed to trigger liability. Some jurisdictions use a negligence standard, typically asking whether a reasonable carrier, acting with ordinary prudence and expecting to be responsible for any eventual judgment, would have accepted the offer in question. If the claimant's within-limits demand is reasonable in relation to the expected trial judgment, the carrier ordinarily breaches its duty in refusing it, and is liable for any resulting excess judgment.[14] Other jurisdictions require proof that the insurer has acted in "bad faith," understanding that term to mean something worse than simple negligence; these jurisdictions ask not only whether a claimant's settlement demand fell within a reasonable range but also, in varying formulations, whether the insurer showed an unacceptable level of indifference to its insured's interests, knowingly or recklessly flouting its obligation to treat the insured's financial exposure as if it were its own.[15]

The second component of the doctrine is the potential availability of damages above and beyond the amount of the excess trial judgment, including damages for noneconomic losses sustained by the insured (such as emotional distress) and punitive damages. *Crisci*, discussed above, furnishes an example: having unreasonably refused the claimant's within-limits demand, the insurer was held liable not only for the entire judgment,[16] but also for a substantial award of damages for the emotional

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13. *See, e.g.*, Princeton Ins. Co. v. Qureshi, 882 A.2d 993, 997 (N.J. Super. Ct. App. Div. 2005) ("[T]he carrier can justly serve its interests and those of its insured only by treating the claim as if it alone might be liable for any verdict which might be recovered." (quoting Rova Farms Resort, Inc. v. Inv'rs Ins. Co. of Am., 323 A.2d 495, 505 (N.J. 1974))).

14. *See, e.g.*, Hartford Cas. Co. v. N.H. Ins. Co., 628 N.E.2d 14, 18 (Mass. 1994) (explaining that an insurer is liable if "no reasonable insurer would have refused the settlement offer" in the absence of policy limits); Asermely v. Allstate Ins. Co., 728 A.2d 461, 464 (R.I. 1999) ("[I]f a plaintiff has made a reasonable written offer . . . within the policy limits, the insurer . . . must assume the risk of miscalculation if the ultimate judgment should exceed the policy limits.").

15. *See, e.g.*, Pavia v. State Farm Mut. Auto. Ins. Co., 626 N.E.2d 24, 27 (N.Y. 1993) ("[T]he plaintiff must establish that the insurer's conduct constituted a 'gross disregard' of the insured's interests—that is, a deliberate or reckless failure to place on equal footing the interests of its insured with its own interests when considering a settlement offer." (citation omitted)).

16. *See supra* text accompanying notes 5–7.

distress the insured suffered as a result of being made indigent.[17] The best-known recent instance is *Campbell v. State Farm Mutual Automobile Insurance Co.*,[18] in which an auto liability insurer turned down an offer to settle for policy limits of $50,000, which resulted in a ruinous excess judgment of $135,000; concluding that the insurer had behaved egregiously toward its insured, the trial court awarded the insured $2.6 million in compensatory damages, most of it for nonpecuniary losses, and $145 million in punitive damages (a figure eventually reduced to $9 million after appeals).[19] While that is an extreme case, it is not unusual to find compensatory and/or punitive damage awards that run to several times the amount of the excess judgment.[20]

A no-fault approach to the duty to settle would dispense with both of these components. Most obviously, it would eliminate the fault element: under no-fault, if the insurer turns down a within-limits demand, it is liable for the entirety of the resulting judgment, regardless of the reasonableness (or "good faith") of its decision. Adoption of the rule would thus reverse the result of a case like *Christian Builders, Inc. v. Cincinnati Insurance Co.*,[21] in which the insurer refused a demand of $2 million (the policy limit), leading to a trial verdict of $3 million. The ensuing duty-to-settle suit failed on the ground that the insurer had not acted unreasonably; the court agreed with the insurer that the claimant's demand was well above the range of reasonable settlement amounts, which would have been around $500,000.[22] Under a no-fault approach, the insurer in this case would be liable for the excess judgment, with no judicial inquiry into whether its decision was reasonable. In effect, a no-fault approach tells insurers that, in declining a within-limits offer, they proceed at their own risk.

Less obviously, but just as importantly, no-fault would do away with the augmented damage awards imposed under the fault-based system. Under no-fault, the insurer that turns down the chance for a within-limits settlement would be liable for the resulting judgment, but that

17. *See* Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 178 (Cal. 1967) (in bank).
18. 538 U.S. 408 (2003).
19. Campbell v. State Farm Mut. Auto. Ins. Co., 98 P.3d 409, 410–11 (Utah 2004).
20. *See, e.g.*, Rinehart v. Shelter Gen. Ins. Co., 261 S.W.3d 583, 589 (Mo. Ct. App. 2008) (following a $4.7 million verdict against defendants insured for $100,000, insurer that declined within-limits demand was held liable for $6.3 million in compensatory damages and $3 million in punitive damages).
21. 501 F. Supp. 2d 1224 (D. Minn. 2007).
22. *See id.* at 1233–36. The $500,000 figure was based on data about the amounts recovered in comparable cases. The insurer's attempts to persuade the claimant to lower its $2 million demand were unavailing.

would probably be the full extent of its exposure. There would be no emotional distress for the insurer to compensate, because it, not the insured, would be on the hook for any eventual verdict; the insureds in the *Crisci* and *Campbell* cases, for example, would not have gone through their post-trial ordeal of trying to pay the excess judgment, and therefore would not have recovered the considerable consequential damages they ultimately received on their duty-to-settle claims. For similar reasons, no-fault would probably eliminate the occasion for punitive damages, which in duty-to-settle cases are typically awarded on the ground that the insurer has callously or maliciously exposed the insured to the risk of an excess judgment. Because insurers would now be gambling with their own money, they would no longer face such accusations. There would be nothing for courts to punish.

II.

So understood, adoption of no-fault would probably better achieve the central objective of the duty to settle. As we have seen, the courts' goal is to counteract the distorted incentives created by policy limits, and to encourage the insurer to act as if its own money were on the line in the event of trial. A no-fault rule would accomplish this in the most direct way possible, because it would actually *put* the insurer's money on the line; upon rejecting a within-limits settlement, the insurer would assume the entire risk of a trial loss. The prevailing doctrine, in contrast, can at best achieve a rough approximation of this result. In practice, fault-based liability is likely to either under- or over-correct the distortion courts are worried about.

The problem lies in the fact that the judicial determination of insurer fault is unpredictable and error-prone. It is difficult for insurers to predict whether a refusal to settle will, in hindsight, expose them to liability; and the inevitable flaws of adjudication mean that some insurers will mistakenly be held liable for reasonable decisions, while others escape liability for unreasonable ones.[23] When we put these facts together with the availability of augmented damages, it becomes evident that the fault approach exerts pressures to settle that, from the point of view of the courts' objectives, may be either insufficient or excessive. That is to say: in some instances, the threat of duty-to-settle liability may be

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23. *See, e.g.*, ABRAHAM, *supra* note 2, at 194 (explaining that given the uncertainties of a fault rule, "insurers may reject with impunity some offers that they actually would have accepted were there no policy limits"); Syverud, *supra* note 2, at 1168 ("Juries and judges may err, with the result that appropriate conduct is punished and inappropriate conduct excused.").

too weak, failing to counteract insurers' incentives to take inappropriate gambles with their insureds' assets. In others, the threat of liability may be too great, making insurers overly afraid of trial and inducing them to pay excessive amounts in settlement.

Let me illustrate the point with a simple numerical example.[24] Imagine a hypothetical claim against an insured defendant involving the following numbers, borrowed in part from the *Christian Builders* case mentioned above[25]:

Probability of trial loss	=	.5
Likely damage award	=	$3 million
Insurance policy limit	=	$2 million

By "probability of trial loss" I refer to the likelihood that the defendant will be held liable if the case goes to trial; by "likely damage award" I mean the amount that will be awarded to the claimant in the event the defendant loses at trial.

Using these numbers, we see that the expected judgment in the case is (.5)($3 million) = $1.5 million. If there were no policy limit in place, that figure would represent the insurer's expected loss from going to trial, and thus is the approximate figure that the insurer would be willing to pay to settle the case. That is to say, if no policy limit were present, the insurer would generally agree to a settlement demand at or below this $1.5 million figure, and would reject any demand significantly above it.[26] We can therefore treat $1.5 million as the benchmark for a "reasonable" settlement.

It is not difficult to construct a version of this example in which the fault approach under-encourages settlement. Assume that the claimant makes a settlement demand of $1.5 million. If the insurer rejects it, what is its expected liability? This depends on its chances of prevailing in a subsequent duty-to-settle case, and the magnitude of the damages it will have to pay. Let us suppose those are the following:

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24. For a formal model that yields similar conclusions, see Hyman, Black & Silver, *supra* note 2, at 82–83.

25. *See supra* text accompanying note 21. The $2 million policy limit and $3 million damage award are taken from that case; the rest of the numbers in the example to be examined here are made up.

26. For clarity's sake, I disregard the possibility of bargaining over offers and counteroffers. I also leave aside the legal expenses of going to trial on the underlying claim and of litigating duty-to-settle disputes, which would also influence the amount the insurer is willing to pay in settlement. Including these matters would complicate the analysis without affecting the basic point.

Probability of liability	=	.6
Additional damages	=	$400,000

By “probability of liability” I mean the likelihood that the insurer will be held to have breached its duty to settle; by “additional damages” I refer to the consequential and/or punitive damages the insurer will have to pay (in addition to the excess judgment itself) in the event that it is found liable for such a breach.

Given these numbers, the insurer will reject the settlement demand. In doing so, it runs the risk of a trial loss, which would force it to pay out the amount of the policy limit; it also exposes itself to possible duty-to-settle liability, which would force it to pay the excess judgment, augmented as indicated. Nonetheless, its overall expected liability from following this course of action is about $1.4 million,[27] which is less than the $1.5 million it would cost to meet the settlement demand.

In this version of the example, then, the threat of duty-to-settle liability fails to induce the insurer to accept a settlement that satisfies the courts’ reasonableness criterion. The insurer instead takes a trial gamble that, according to the doctrine, it ought not to take. The prospect of shifting part of a trial loss to the insured makes the gamble worthwhile, notwithstanding the possibility of being held liable for a breach.

It is also easy to construct a variant of the example in which, instead, the fault approach over-encourages settlement. Assume that, rather than making the demand just considered, the claimant demands the full $2 million policy limit. This is an “excessive” demand, in the sense of being well above the $1.5 million expected judgment on the claim, and an insurer who was responsible (only) for the full amount of the judgment would normally refuse it for that reason. Nonetheless, there is some possibility that, in hindsight, a court will find fault with such a refusal. If that possibility is sufficiently high, and the augmented damages are sufficiently great, the insurer may decide to accept it. Discarding the figures just employed, let us substitute these:

Probability of liability	=	.5
Additional damages	=	$4 million

27. There is a .5 probability of a trial loss; such a loss will result in a $2 million liability for the insurer (the policy limit), and will also result in a .6 probability that the insurer will be held liable for breaching the duty to settle, in which case it will have to pay the $1 million excess judgment and $400,000 in additional damages. The insurer’s overall expected liability is therefore (.5)[$2 million + (.6)($1.4 million)] = $1.42 million.

Compared to the previous variant of the example, we are now assuming a somewhat lower probability of liability, but considerably greater augmented damages.

Here, the insurer will accept the claimant's demand. If it does not, its expected liability is over $2.2 million,[28] which is greater than what it would cost to settle the case, so the insurer will prefer to avoid trial. What we are observing with this version of the example is the deterrent effect of augmented damages: I have made them large enough that the insurer is willing to pay a kind of "premium" to avoid trial. In this variant of the example, therefore, the insurer pays more than what the duty-to-settle doctrine considers a reasonable settlement amount. The magnitude of the augmented damage award, coupled with the chance of being found at fault for taking the case to trial, exerts an *in terrorem* effect that causes the insurer to pay "too much" in settlement, in the sense of paying more than would an insurer who was responsible for nothing more than the full judgment rendered at trial.

So long as the fault requirement is in place, there is no simple solution to the problems of over- and under-encouragement of settlement illustrated by this example. A court might, for instance, consider modifying the legal standard of fault in order to make it easier (or harder) to establish the insurer's liability; or it could modify the available remedies in order to make the measure of consequential and punitive damages more (or less) generous. But such measures are likely to alleviate one problem while worsening the other. Constricting the availability of consequential and punitive damages would make it less likely that insurers will overpay to settle cases, but would also make it more likely that they will take inappropriate trial gambles. In the first variant of our example, part of the reason the insurer turns down the settlement is that the augmented damages are on the low side; if they were higher, the insurer would comply with its duty to settle.

By the same token, changing the legal standard to make it easier to establish insurer fault would make it less likely that insurers will turn down reasonable settlement offers; but it also would make them more vulnerable to settlement demands that are excessive in relation to the actual trial value of the claim. In the second variant of the example, part of the reason the insurer overpays to settle is that it faces a substantial

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28. There is a .5 probability of a trial loss, which will result in a $2 million liability for the insurer (the policy limit); in addition, it will result in a .5 probability that the insurer will be held liable for breaching the duty to settle, in which case it will have to pay the $1 million excess judgment and $4 million in additional damages. The insurer's overall expected liability is therefore (.5)[$2 million + (.5)($5 million)] = $2.25 million.

probability of duty-to-settle liability if it goes to trial; were that probability lower, it would not accede to the claimant's excessive demand.

This line of analysis is obviously abstract and theoretical. I have no empirical basis for judging the real-life magnitude of the problems I have imputed to the fault regime. Moreover, I would not want to be understood as denying that some versions of the fault approach are probably better than others.[29] Here, I simply want to underscore that whatever their actual magnitude, the problems I have identified would be eliminated by adoption of a no-fault approach. Insurers cannot escape liability by convincing a court they were not at fault; for this reason the under-encouragement problem, which hinges on such a prospect of escaping liability, goes away.[30] They also do not face the augmented damages characteristic of the fault system; this means the problem of over-encouragement, which hinges on the *in terrorem* effect of such damages, also goes away. Thus, returning once again to our numerical example: under no-fault, rejection of a within-limits demand exposes the insurer to the full $1.5 million expected trial judgment, no more and no less. It will therefore be motivated to accept any demand near that figure, while refusing any demand substantially above it.

A further point worth emphasizing is that both of the problems I have identified have the effect of raising the cost of insurance. Over-encouragement of settlement means that insurers pay out more to settle cases than they would under no-fault, and these outlays must ultimately be incorporated into the premiums paid by policyholders. Under-encouragement of settlement means that insurers take wasteful gambles with the insured's money, generating losses that would be avoided if the insurer bore the full cost of going to trial. Doing away with these losses would raise the overall value of the liability insurance relationship, generating benefits for both of its parties.

III.

The focus of Part II was on the insurer's settlement incentives. Its argument was that a no-fault approach more effectively accomplishes the principal objective of duty-to-settle doctrine, namely to solve the conflict of interest introduced by policy limits. Even if that is true, however, it

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29. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 24 & accompanying reporters' note (AM. LAW INST., Discussion Draft 2015) (analyzing different formulations of the reasonableness approach).

30. In the first variant of our numerical example, the insurer turns down a reasonable settlement offer in part because of the substantial chance it enjoys of escaping duty-to-settle liability. If that chance were reduced or eliminated, the insurer would accept the offer.

might be objected that no-fault nonetheless would adversely affect liability insurance arrangements in other ways. I consider four such objections here.

The first concerns the effect of no-fault on the settlement decisions of claimants. No-fault, it might be objected, would encourage claimants to inflate their settlement demands against insurers, which if accepted would raise overall costs to both insurers and insureds. This objection is sound but incomplete. Under the prevailing fault rule, the potential insolvency of defendants (who may be unable to satisfy the above-limits portion of a judgment) exerts downward pressure of claimant demands;[31] that pressure is eliminated by no-fault, because the full trial judgment is collectible from the insurer.[32] It is therefore likely that in some cases settlement demands would rise under no-fault. It is also likely, however, that in other cases settlement demands would drop, because claimants could no longer use the threat of augmented damages as leverage in settlement demands.[33] There is no way of predicting in the abstract which of these effects would predominate.

A second possible objection concerns no-fault's effects on the market for insurance. It might be argued that no-fault would make insurance with policy limits unavailable: because limits would lose their binding effect, consumers would in practice have to choose between no insurance and unlimited insurance.[34] This objection overlooks the fact that even under no-fault, policy limits have a crucial binding effect: only a demand *within limits* triggers the duty to settle. If a claimant makes an above-limits demand, the insurer may reject it without facing liability for an eventual above-limits judgment. This means that insurers would face very different levels of exposure under policies with different limits, and there is no reason to think they would not continue to sell policies with limits priced according to the exposure they create.

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31. *See* Sykes, *supra* note 3, at 90–95.

32. In our numerical example from Part II, no-fault gives the claimant no incentive to demand less than $1.5 million, because that is the expected recovery from trial. (Once again, I ignore the influence of litigation costs, consideration of which would not affect the central point.) In contrast, under a fault rule, the claimant's expected recovery from trial may be less than that, because part of the judgment may be uncollectible from an insolvent insured. It is therefore possible the claimant would be willing to settle for less than $1.5 million under the fault rule.

33. The reasoning is similar to what we saw in the previous footnote. In our numerical example, no-fault gives the claimant no incentive to demand more than $1.5 million, because that is the most the insurer will pay. As we saw in Part II, however, if the threat of augmented damages is sufficiently great, the claimant can extract from the insurer a settlement for the full $2 million policy.

34. *See, e.g.*, Syverud, *supra* note 2, at 1170 (arguing that a rule of liability without fault would cause the price of low-limits coverage to approach that of unlimited coverage).

The point can be illustrated with our earlier numerical example in which (to remind the reader) the claimant has a fifty percent chance of winning a $3 million verdict at trial. If the insured has purchased a $2 million policy, as supposed above, then we would expect the case to settle for an amount roughly equal to the expected judgment of $1.5 million.[35] If, instead, the insured has purchased only a $1 million policy, then the case may settle for that policy amount;[36] should the case go to trial, the insurer either will lose and pay policy limits (with the insured on the hook for the remainder), or will win and pay nothing.[37] Doing the arithmetic, we find that in expected terms, the insurer's exposure under the $2 million policy is $1.5 million; under the $1 million policy, it is somewhere between $500,000 and $1 million.[38] This differential exposure implies that the two policies will yield very different costs for the insurer, and for that reason will be marketed at very different prices. The insured retains more risk under the lower-limits policy, and will therefore get it for less.

A third possible objection concerns no-fault's effect on the insured's incentives to cooperate with the insurer in defending the case at trial. Under no-fault, once the claimant makes a demand within policy limits, the case belongs entirely to the insurer, which must either reach a settlement or pay the entire judgment. The insured, having no further interest in the case, therefore may be unmotivated to assist in the defense (despite contractual obligations to do so) if the case does go to trial.[39] Adopting no-fault might thus increase the likelihood of trial

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35. If the claimant demands more than that figure, the insurer will prefer to go to trial. If the insurer insists on settling for less than that figure, the plaintiff will prefer to go to trial. In equilibrium, therefore, the claimant will demand $1.5 million and the insurer will accept.

36. The claimant might be willing to settle for $1 million, even though that is less than the expected judgment, if the insured's insolvency would make the above-limits portion of a trial award uncollectible.

37. If the claimant makes an above-limits demand, the insurer will refuse and go to trial, with an expected loss of (.5)($1 million) = $500,000. If, instead, the claimant offers to settle for policy limits of $1 million, the insurer will accept, because otherwise it would have to pay the entire expected trial judgment of $1.5 million.

38. From the analysis of the previous footnote, we have two possible outcomes: a settlement for $1 million, or a trial with an expected insurer liability of $500,000. Which of these materializes depends on the claimant's willingness to run the risk of defendant insolvency. *See supra* note 32. Overall, then, the insurer's expected exposure in this type of case will lie between $500,000 and $1 million.

39. This is a problem endemic to situations in which the risk of a loss (in this case, liability to a claimant) is influenced by the actions of more than one party. Shifting the risk to one party will ameliorate that party's "moral hazard" while exacerbating the other's.

losses, which in turn would raise settlement amounts,[40] which in the long run would raise costs for both insurer and insured. Whether these effects would outweigh the cost savings generated by the improvement of insurer settlement incentives discussed in Part II is an empirical question.[41]

A fourth objection concerns the insurance industry's ability to adjust contractual terms. If no-fault would benefit insurers and insureds, then why do we not see it being adopted in insurance contracts? This objection rests on the premise that insurers do not write contracts that gratuitously lower the value of their product.[42] If no-fault promised lower costs, then we should, on this line of thought, expect to see insurers including it in insurance policies; the fact that we do not see it suggests that it would, in fact, raise their and their customers' costs.

The difficulty with this argument is that insurers and insureds can only partially contract out of the fault system. Insurers can presumably include in their policies an enforceable term waiving their right to plead the reasonableness of their refusal to settle; a term, that is, providing that they will unconditionally pay any judgment resulting from their refusal of a within-limits offer. It is unlikely, however, that insureds could make an enforceable reciprocal promise not to seek augmented damages for unreasonable or bad-faith refusals to settle.[43] But as we have seen, the putative savings of no-fault depend on getting rid of both the fault inquiry and these augmented damages. Because this would probably take judicial or legislative action, we cannot read much into insurance contracts' silence on the subject.

IV.

I conclude by emphasizing what I said at the outset: adoption of no-fault would not necessarily result in an expansion of insurer liability, in

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40. As the insurer's exposure at trial increases, so does the amount it is willing to pay in settlement.

41. It is worth noting that the fault system invites, at least anecdotally, collusion between claimants and insureds to "set up" the insurer for a punitive damage award that they can split between them. In such an arrangement, the insured has a positive disincentive to cooperate in the defense. How often such collusion occurs in practice, and how much its possibility affects the costs of insurance, I do not know. A no-fault rule would eliminate any attraction it might have.

42. *See, e.g.*, Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1345, 1355–56 (1994) (arguing that insurers have a market incentive to include efficient duty-to-settle terms in contracts).

43. *See, e.g.*, Gessa v. Manor Care of Fla., Inc., 86 So. 3d 484, 492 (Fla. 2011) (refusing to enforce contractual provision that capped noneconomic damages and barred punitive damages).

the sense of increasing insurer payouts under the duty to settle. Though insurers would lose the "reasonableness" escape hatch that they enjoy under the fault system, they would also face lower damage awards. The net effect might be either an expansion or a contraction of insurer liability; there is no theoretical ground for knowing which would happen. In either event, however, no-fault would do a better job of solving the conflict of interest that the duty to settle is designed to remedy. The case for its overall superiority is far from certain, but perhaps it is strong enough that the fault approach should bear the burden of proof in future policy discussions.