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The Unappreciated Inportance, for Small Business Defendants, of the Duty to Settle

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THE UNAPPRECIATED IMPORTANCE, FOR SMALL BUSINESS DEFENDANTS, OF THE DUTY TO SETTLE

Robert Heidt

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THE UNAPPRECIATED IMPORTANCE, FOR SMALL BUSINESS DEFENDANTS, OF THE DUTY TO SETTLE

*Robert Heidt**

I. INTRODUCTION

This paper suggests how the duty to settle, which requires liability insurers to pay damages awarded against their insured in excess of the policy limits[1] when the insurers reject a reasonable settlement offer within the limits, may have indirectly led certain of their insureds—small business recreational vendors like horse riding stables or some motels offering swimming pools with diving boards—to sanitize the recreational activities they offer. For example, horse riding stables, which before the duty to settle routinely offered their customers the opportunity to ride unaccompanied the horse the customer rented, now generally insist that all riders be accompanied. Similarly, small motels[2] no longer offer their customers Type II swimming pools—pools whose depth varies along a transition slope and which feature a one-meter diving board at the deep end.[3] Instead, these motels either offer no pool or a relatively flat-bottomed shallow pool, and in no instance do such motels offer a pool with a diving board. More generally, the duty to settle's effect on the lawsuits injured customers brought against small business recreational vendors may have led a wide variety of such vendors to sanitize activities the vendors previously offered in a manner that disassociates the activities from the most severe injuries, but leaves them less enjoyable for many.[4] While the loss of

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1. The limits are the dollar maximum of the insured's tort liability that the insurer will pay to plaintiffs who sue the insured. Virtually all commercial and individual liability insurance policies sold in the U.S. contain such aggregate limits. Liability insurance sold abroad typically contains no limits. For example, the minimum car liability insurance offered in England provides unlimited coverage for personal injury. Jörg Fedtke, *Strict Liability for Car Drivers in Accidents Involving "Bicycle Guerillas"? Some Comments on the Proposed Fifth Motor Directive of the European Commission*, 51 AM. J. COMP. L. 941, 953 (2003).

2. The assumption here is that the small motels, whether individually owned or incorporated, are financially structured such that a tort judgment creditor of the motels cannot reach the assets of any of the wealthiest of organizations. If the day arrives when such a creditor can reach the assets of large motel chains, typically among the wealthiest of organizations, this assumption will cease to be realistic. This paper has no application to the wealthiest of organizations, many of which self-insure.

3. The National Spa and Pool Institute (NSPI) classifies and sets minimum dimensions, including the minimum transition slope, for pools. The NSPI also identifies what diving boards are appropriate for use in each class of pool. A Type II pool, also known as a "hopper bottom" pool, can accommodate a range of one-meter diving boards. *See generally* Meneely v. S.R. Smith, Inc., 5 P.3d 49 (Wash. Ct. App. 2000) (describing NSPI services and Type II pools).

4. Other activities offered less often by small businesses recreational vendors include: rental of power equipment for waterskiing or jet skiing, rental of time on trampolines, rental of equipment for hang gliding and kite gliding, and rides on artificial bulls and snowmobiles. In addition, day care centers are less likely to offer "adventure playgrounds" or any playgrounds whatsoever. Special

such recreational activities in the modern era is commonly observed, no one has yet connected that loss to the duty to settle. The hypothesis that the judicial embrace of the duty to settle has affected the activities recreational vendors offer, and thus affected the allocation of societies' resources, warrants consideration, and not merely because the Coase Theorem maintains that in a first best world without transaction costs no legal rule should carry such an effect.[5]

This paper's scope is narrow. Others have discussed thoroughly whether the duty to settle is optimal in reducing the total amount jointly paid by tort defendants and their liability insurers.[6] Still others have touched on whether the duty to settle is socially optimal when the interests of injured plaintiffs are also considered.[7] This paper remains agnostic on both matters. Even the insight advanced here—that the duty to settle has led to the elimination of recreational activities that were enjoyed by many but in which a few were severely hurt—does not unequivocally support or oppose that duty.

For the underlying insight, imagine a drunken motel customer who aggressively dives off a one meter diving board in a Type II pool, makes no effort to slow his descent through the transition slope, and continues his dive underwater into the shallow part of the pool until he crashes into the pool's bottom and emerges a quadriplegic. The customer then sues the motel, claiming its negligent design or operation of the pool, or its negligence in some other respect, caused his injuries. The terrible nature of the customer's injuries creates a potential damage award of eight figures, say $10 million. Assuming the motel took all the cost-justified precautions available to it that would have avoided this tragedy,[8] we could

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statutes, rather than the common law, increasingly govern the liability of snow skiing areas and help to account for the continued availability of such areas.

5. Under the Coase Theorem, the defendant vendors should supply, and the plaintiff customers should buy, the socially optimal amount of the recreational activity regardless of the liability rule, as long as the plaintiff appreciates the risks of the activity. However, this assumes that the amount of liability, when it is imposed, equals the plaintiff's actual losses. As we will see, the duty to settle affects the amount of liability, and there is no reason to believe the resulting amount equals the plaintiff's actual losses. Hence, it is consistent with the Coase Theorem that the duty to settle may have affected the allocation of resources. *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 53, 127-31 (1987) (applying Coase Theorem). That the duty to settle leads to a result different from what would be expected in a world without transaction costs is unexceptional and without policy implications. In such a world, there would not even be an economic rationale for firms.

6. *See generally, 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 (1994) (positing situations where the duty to settle fails to maximize the joint expected wealth of liability insurers and their insureds). Insofar as the duty to settle leads the lawyer hired by the insurer to deviate from the goal of maximizing the joint expected wealth of his clients, the insurer and the insured, the duty to settle conflicts with agency principles. *See* Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part I—Excess Exposure Cases*, 78 TEX. L. REV. 599, 613 (2000).

7. *See generally* Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375 (1994) (considering how the duty to settle affects injured plaintiffs); 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) (considering whether the duty to settle is optimal when the interests of injured plaintiffs are also taken into account).

8. More generally, the assumption is that the motel would not be liable if the formal law was applied correctly. For the motel to be liable under the formal law, the motel must be negligent, and its negligence must be the cause-in-fact and proximate cause of the customer's injury. In addition, when the

estimate the customer's chance of obtaining a judgment for $10 million to be as low as one percent, which may represent nothing more than the risks of legal system error. Even with this remote chance of success, the expected value of the customer's case would still be $100,000. Realizing this, the customer may offer to settle for $100,000, which, let us assume, happens to be the limit of the motel's liability insurance policy.

Before the duty to settle,[9] the liability insurer for the motel might well decide to refuse to settle for the $100,000 limits. The liability insurer could comfortably refuse the settlement offer because the policy limits protected it against ever paying more, in indemnity at least,[10] than $100,000. Less obviously, the motel, while formally objecting to its insurer's refusal to settle, might not be alarmed at that refusal because it can protect its assets against a small risk of a $10 million judgment (on which it would owe $9.9 million and its insurer $100,000), thanks both to the protections provided by the widespread assumption that for claims against all but the wealthiest organizations, liability insurance limits amount to a de facto cap on tort damages,[11] and to the protections provided by pro-debtor laws.[12]

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customer is contributorily negligent, his responsibility for his injury compared to the responsibility of the motel must not be so great as to eliminate the motel's liability under the jurisdiction's comparative negligence rule. *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL HARM §§ 6, 25 (Proposed Final Draft No. 1, 2005).

9. The rule that prevailed before courts embraced the duty to settle was called the laissez-faire rule because it reflected the terms of the insurance policy. Those terms gave complete discretion to settle to the insurer. *See* Meurer, *supra* note 7, at 507.

10. The insurer's defense costs if the case went to trial could drive the insurer's total payment beyond the policy limits. Naturally, the insurer's wish to avoid paying the extra defense costs it would incur if the litigation continues gives it some reason to accept plaintiff's offer to settle at the limits, with or without the duty to settle. On the other hand, plaintiff's wish to avoid the legal expenses plaintiff will incur by continuing gives plaintiff a reason to accept less than the limits once the defendant rejects its offer to settle at the limits.

11. Amounts to be paid from the assets of the small business defendant, whether the small business is individually owned or incorporated, are referred to hereafter as "blood money." Amounts to be paid by the defendant's liability insurance are referred to hereafter as "insurance money." Although all money ultimately comes from the insured, much recent scholarship contends that modern tort law is driven almost entirely by the wish to collect insurance money. While suits for blood money occur, they are exceedingly rare. *See* Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275, 289-90 (2001). To be sure, Professor Baker describes blood money as money coming from the pockets of individual, rather than small business, defendants. However, suits for excess judgments to be paid by the assets of small businesses, whether individually owned or incorporated, are nearly as rare. TEX. DEP'T. OF INS., THE 2002 TEXAS LIABILITY INSURANCE CLOSED CLAIM ANNUAL REPORT, at 4 fig.3 (2002), http://www.tdi.state.txus/reports/pd/taccar2002.pdf (reporting that there was a payment in excess of policy limits in only 31 out of 9,723 claims paid by liability insurance in 2002 and that the amount paid above the limits was approximately $9.5 million, compared to approximately $1.8 billion in total liability payments in Texas in 2002). *See also* US TORTS COSTS: 2004 UPDATE 17 app.4 (2004), http://www.towersperrin.com/tillinghast/publications/reports/Tort_2004/Tort.pdf (confirming the low percentage of liability payments that come from the assets of the underinsured, both individual and corporate); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 40 n.176 (1996) ("There is little reason to expect that judgments in excess of policy limits are any more collectible from [small businesses] than from automobile owners and drivers."). Uninsured sources account for only about one percent of automobile accident liability payments. *See* ALFRED F. CONARD ET AL., AUTOMOBILE ACCIDENT COSTS AND PAYMENTS 48 (1964).

12. For the pro-debtor laws protecting individually owned small businesses, see generally Stephen G. Gilles, *The Judgment-Proof Society*, 63 WASH. & LEE L. REV. 603 (2006) (laws allowing

These two sources of protection render the motel and other small business defendants at least partially judgment-proof, should a tort judgment in excess of the limits materialize.[13] Realizing that these protections afforded to the motel, along with the limits of the liability insurance policy, destroy his chance of actually collecting any judgment much beyond the limits, the injured customer can only react to the liability insurer's refusal to settle for $100,000 by resigning himself to settling for less. The costs of the motel's liability insurer stay low, the premiums it charges the motel stay low, the coverage it offers remains available, and the insurer has little reason to pressure the motel to dismantle or redesign its Type II pool. The motel and liability insurer together, one could say, have taken advantage of the policy limits, and, more fundamentally, of the judgment-proof status of the motel[14] to nullify the risk of actually having to pay a judgment much beyond the limits, and, likewise, to nullify the plaintiff's advantages in negotiating a settlement which arise from that risk.

After the duty to settle is imposed, the liability insurer for the motel no longer finds it in its interests to reject this offer to settle for the $100,000 policy limits. This is so because rejecting the offer would now expose the liability insurer to the risk of liability for the entire $10 million tort judgment.[15] The insurer who rejects

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bankruptcy, exempting various types of assets and income from collection, and giving secured creditors priority over tort claimants, as well as other pro-debtor laws, render judgment-proof even individuals with substantial assets). For the pro-debtor laws protecting small businesses that are incorporated, see Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1903-06 (1994) (laws allowing limited liability, secured debt strategies, exemption strategies, and Chapter 11 bankruptcy render judgment-proof incorporated small and medium size businesses); LoPucki, *supra* note 11, at 14-19 (debtors can defeat enforcement of money judgments by using secured debt, third-party ownership, foreign haven, and exemption as judgment-proofing strategies). While LoPucki's claim that even the wealthiest organizations may soon become judgment-proof is highly controversial, no one has challenged his claim that the large majority of small and medium size corporations have long been judgment-proof in regard to tort creditors.

13. All defendants who are judgment-proof in part, that is, all who will present the plaintiff with significant collection problems as a practical matter for any part of a judgment, are referred to as judgment-proof. This is an unusually broad meaning of judgment proof, which sweeps within its reach many small businesses not usually put in that category. This broad meaning is justified by the scholarship suggesting that suits to collect blood money are rare and futile, even when suits are brought against firms and individuals with substantial assets. *See supra* notes 11-12. *See also* Tom Baker, *Liability Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law in Action*, 12 CONN. INS. L.J. 1, 6-7 (2005).

14. The limits arise in the first place only because the motel's knowledge of its partial judgment-proof status leads it to prefer a policy with limits over a policy without limits. It does not pay to buy unlimited liability insurance for a substantial yearly premium when the total amount that a judgment of liability will require one actually to pay is sharply limited by one's assets or by the costs of invoking pro-debtor laws.

Because a surprising number of defendants are judgment-proof, the number of instances in which these defendants and their liability insurers—in the absence of the duty to settle—could take advantage of the defendant's judgment-proof status to negotiate a settlement well below the limits, as described in the example in the text, is also surprising. By helping to neutralize this advantage, the duty to settle plays an important role.

15. Because a violation of the duty to settle may subject the liability insurer to a further judgment for bad faith in addition to a judgment in excess of the limits, the liability insurer has still more reason to accept the plaintiff's offer. *See, e.g.*, Birth Center v. St. Paul Cos., 787 A.2d 376, 379 (Pa. 2001) (liability insurer who failed to settle at the limits made to pay $700,000 in addition to the excess

the settlement offer cannot eliminate the risk of such massive liability. If the $10 million judgment eventuates, there is a substantial risk that a court will find that the insurer's rejection of the customer's offer to settle for $100,000, merely one percent of that judgment, violated the duty to settle.[16] Indeed, that offer, under the posited facts, approximates the expected value of the customer's case.[17] Nor would the insurer facing the $10 million judgment be able to avail itself of the protections afforded the motel. The insurer would draw comfort from neither the hostility to collecting "blood money" from all but the wealthiest organizations nor from any pro-debtor laws.[18] Because of the duty to settle, the insurer's rejection of this offer to settle would likely even lose the loyalty of its insured, the motel, during the ensuing litigation.[19] That rejection gives the defendant motel reason to enter an agreement with the plaintiff customer, called an assignment and covenant not to execute, whereby the motel assigns its rights against its insurer to the customer and

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judgment); Ecotech Int'l, Inc. v. Griggs & Harrison, 928 S.W.2d 648-50 (Tex. App. 1996) (insurer's failure to settle forced insured to defend an execution proceeding, thus justifying, in part, a suit against insurer for more than the excess judgment).

Still further pressure to accept a plaintiff's offer comes from statutes in a number of states that begin awarding a plaintiff interest from the moment a settlement offer within the limits is rejected. *See*, *e.g.*, CONN. GEN. STAT. ANN. § 52-192a(c) (West 2005 & Supp. 2009).

16. Jurisdictions differ on what, if any, culpability on the part of the insurer who rejects a settlement at the limits must be shown before it will be liable for the judgment in excess. The literature on this subject is extensive. *See infra* note 61. As others have pointed out, the hindsight bias, arising from a sustainable trial verdict in excess of the limits, creates a virtual presumption that the insurer's failure to accept plaintiff's offer to settle at the limits was sufficiently culpable to trigger the duty to settle and thus hold the insurer liable for the judgment in excess. *See, e.g.*, Loudon v. State Farm Mut. Auto. Ins. Co., 360 N.W.2d 575, 581-82 (Iowa Ct. App. 1984). *See also* Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990).

> We believe that wherever there is a failure on the part of an insurer to settle within policy limits where there exists the opportunity to so settle and where such settlement within policy limits would release the insured from any and all personal liability, that the insurer has prima facie failed to act in its insured's best interest and that such failure to so settle prima facie constitutes bad faith towards its insured.

Id.

17. The duty to settle is sometimes restated as the duty to accept settlement offers equal to the expected value of the plaintiff's case. *See* Logue, *supra* note 7, at 1391. Estimating the expected value of a case is no simple matter. It requires aggregating a series of potential outcomes by weighing the range of potential verdicts by their probability. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 6-12 (1984). *See also* Merritt v. Reserve Ins. Co., 110 Cal. Rptr. 511, 518 n.2 (Ct. App. 1973) (noting in dicta that when the insured faces a remote possibility of very great liability, the duty to settle may require an insurer to settle in an amount that substantially exceeds the expected judgment).

18. The Michigan rule, an alternative version of the duty to settle, adopted only in Michigan, attempts to account for the defendant's judgment-proof status and thereby would lead to the insurer paying less than the full excess judgment. *See* Frankenmuth Mut. Ins. Co. v. Keeley, 461 N.W.2d 666, 667 (Mich. 1990). Administrative problems that arise from the difficulty of measuring the defendant's assets available for collection plague the application of the Michigan rule, and its operation and effect are beyond the scope of this paper.

19. The cooperation clause in the insurance policy imposes on the insured a duty to cooperate, which would constrain the insured's wish to assist the injured plaintiff in the ongoing litigation, except that the insurer's violation of the duty to settle changes the insured's obligations under the cooperation clause. *See* Damron v. Sledge, 460 P.2d 997, 999 (Ariz. 1969).

aligns itself for litigation purposes with the customer.[20]

The effects of the insurer paying the $100,000 limits of the policy in settlement, even when the merits seem so lopsided in the insured's favor, are predictable. The costs of the insurer increase, as must the premiums it charges the motel, and the motel has more difficulty finding coverage. Most of all, liability insurers pressure all motel owners to dismantle Type II pools and, more generally, to avoid offering customers any activity in which the customers *could* suffer such an expensive injury.[21] Given the risk of legal system error, the motel's liability insurer will now find it prudent to pay a considerable amount to virtually every customer who suffers an expensive injury and who offers to settle at the policy limits.

Granted, this effect of the duty to settle can be viewed positively by looking at the benefits the duty to settle confers on the plaintiff customer. The, perhaps surprising, litigation support the injured customer may receive from the defendant motel, should the liability insurer reject the settlement offer, is the least of those benefits. The much greater benefit is that the customer, once its offer to settle at the limits is rejected, will have on the hook for the full amount of any judgment a financially responsible party from whom the customer is virtually certain to collect without incurring any collection expense—the liability insurer.[22] Indeed, this article could just as well be entitled "The Unappreciated Benefit for Severely Injured Plaintiffs of the Duty to Settle."

In sum, the duty to settle helps the severely injured plaintiff, or, more precisely, any plaintiff whose suit might result in a large judgment, bargain for the limits of the defendant's liability insurance. The duty to settle achieves this effect by making it harder for the small business defendant and its liability insurer to exploit the advantages that arise from the defendant's judgment-proof status. True, the duty to settle does not change the small business defendant's judgment-proof status itself. But when the plaintiff offers to settle at the policy limits, the duty to settle changes the calculation of advantages and disadvantages pertaining to that settlement offer that face the defendant's liability insurer. The liability insurer can no longer take advantage of the plaintiff's knowledge of the defendant's judgment-proof status and of the ceiling that imposes upon the best possible outcome for a plaintiff continuing to litigate. Before the duty to settle, the liability insurer could

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20. In these agreements, the plaintiff promises not to attempt to collect blood money from the defendant in return for the defendant assigning to the plaintiff its action against its insurer for violating the duty to settle. Assignment and covenant not to execute agreements between the plaintiff and the insured defendant have become routine whenever a judgment in excess follows the insurer's failure to accept a settlement within the limits. The agreements amount to a procedural formality preparatory to a suit against the insurer for the excess judgment. By statute, one state, Florida, authorizes the plaintiff who obtains an excess judgment to sue the liability insurer directly without an assignment by the insured. FLA. STAT. ANN. § 624.155 (West through Jun. 2005 amendments).

21. They may do so through a refusal to write insurance for the motel altogether or through a significant increase in premium unless the motel dismantles the Type II pool. Telephone interview with Walter Bennett, Enumclaw Ins. of Tacoma, Wash. (July 9, 2008); telephone interview with Douglas Hamm, K&K Ins. of Ft. Wayne, Ind. (June 24, 2008) (attributing their companies' refusal to cover swimming pools with diving boards to the duty to settle).

22. Indeed, the insurer has a reputational interest in paying judgments promptly so as to keep its insureds happy.

reject plaintiff's offer to settle at the limits secure in the knowledge that defendant's judgment-proof status would prevent plaintiff from receiving much more. In turn, plaintiff, knowing he would not collect a substantial part of any tort judgment he might win, would realize that his best response to the liability insurer's rejection of his settlement offer was to accept a lesser settlement. After the judicial embrace of the duty to settle, the best possible outcome of continuing to litigate for the plaintiff is as large as the maximum possible judgment. The duty to settle deprives the liability insurer of a major advantage in negotiating for a settlement below the policy limits, an advantage that the insurer gains indirectly from the insured's judgment-proof status.

Accordingly, those who are confident that judgments for plaintiff are warranted and who, therefore, dismiss the risk of legal system error, or believe the risk of error cuts both ways equally, will applaud this effect of the duty to settle. From their perspective, the partial judgment-proof character of the small business defendant creates an obvious externality, which invites such defendants to underinvest in safety.[23] The wish to correct that externality provides a powerful reason for embracing the duty to settle, a reason not yet fully appreciated.[24]

On the other hand, the duty to settle forces recreational vendors and their liability insurers to come to terms with a harsh fact about our tort system. The harsh fact is that whenever a potential tort plaintiff suffers an expensive injury and whenever plaintiff (thanks, for example, to the duty to settle) can directly or indirectly sue a party, like a liability insurer, from whom a judgment can be fully and reliably collected without expense or delay, the risk of legal system error alone gives a tort claim for that expensive injury a significant expected value, and correspondingly creates significant tort exposure for the liability insurer.[25] While this harsh fact seems obvious, the significant tort exposure impacts recreational vendors (especially those whose activities are associated with expensive injuries) in various ways. One negative impact is that such vendors are pressured by their liability insurers to take precautions that disassociate their activities from severe injuries, even though the precautions are not cost-justified and, hence, are not socially desirable. The precaution of dismantling all formerly commonplace Type II pools with their one-meter diving board may be an example. Under the formal law, the recreational vendor should only be liable when it was negligent either in the manner in which it offered the activity or in offering the activity itself, its negligence was the cause-in-fact and proximate cause of the customer's injury, and any responsibility for the customer's injury arising from the customer's contributory negligence is not so great as to eliminate the recreational vendor's

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23. *See* Steve Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 45-46 (1986). Many others have commented on this externality and its tendency to discourage defendants from taking cost-justified precautions. *See, e.g.*, Alan O. Sykes, "*Bad Faith" Refusal to Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem*, 23 J. LEGAL STUD. 77, 81-82 (1994).

24. A few courts have discussed how the duty to settle can overcome problems presented by the defendant's judgment-proof status. *See, e.g.*, State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696 (Tex. 1996).

25. This generalization gains support from the medical malpractice literature. David A. Hyman, *Medical Malpractice and the Tort System: What Do We Know and What (If Anything) Should We Do About It?*, 80 TEX. L. REV. 1639, 1643-44 (2002) ("Indeed, the best predictor of the size of an award is the severity of disability, not whether there was negligence or an adverse event.").

liability under the jurisdiction's comparative negligence rule.[26] Imposing liability on the recreational vendor when these requirements are not supported by sufficient evidence plainly represents legal system error. Yet the many huge judgments for injuries in swimming pool and diving board cases suggest, in this context at least, that legal system errors are common and one-sided in favor of the plaintiffs.[27] One court has come close to expressly basing an eight-figure judgment for plaintiff on defendant's mere knowledge that a user of Type II pool can emerge from the pool as a quadriplegic.[28] Hence, despite being reasonably safe for those who use it with minimal care, the Type II pool's association with expensive tort injuries creates significant tort exposure for the liability insurer of the motel that offers the pool, as well as for the liability insurer of the pool's installer, manufacturer, and standards development organization.

One reason the motel's mere association with expensive injuries creates significant tort exposure arises from the weakness of the modern concept of negligence. While negligence at one time meant the failure to provide average care or the care that a reasonable person would have provided, it has evolved to mean the mere failure to provide any cost-justified precaution. However, one who takes every cost-justified precaution is acting not with average care, but with optimal (i.e., perfect) care.[29] Many older opinions, in which courts sharply distinguish negligent behavior from mere sub-optimal behavior, for which the defendant will

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26. *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL HARM §§ 6, 25 (Proposed Final Draft No. 1, 2005).

27. *See, e.g.*, Bunch v. Hoffinger Indus., Inc., 20 Cal. Rptr. 3d 780 (Ct. App. 2004) (affirming $12 million damage award when defendant was negligent in its signage against diving); Hendrickson v. King County, 2 P.3d 1006 (Wash. Ct. App. 2000) (defendant was negligent in its signage of pool depth); Ziecker v. Town of Orchard Park, 551 N.E.2d 99 (N.Y. 1989) (affirming $15 million damage award where defendant was negligent in its signage of pool depth); Hooks v. Wash. Sheraton Corp., 578 F.2d 313, 314 (D.C. Cir. 1977) (affirming damage award where defendant installed diving board with too much spring); Johnston v. Nebraska, No. A-00-373, 2001 Neb. App. LEXIS 189 (Neb. Ct. App. Aug. 28, 2001) (defendant negligent for signage and for having diving board with too much spring); Dodson v. Henderson Props., Inc., 708 P.2d 1064 (Okla. 1985) (reinstating $3 million damage award where defendant was negligent in its signage and fencing); Murray v. Ramada Inns Inc., 521 So. 2d 1123 (La. 1988) (defendant was negligent in its signage of pool depth and in its failure to provide lifeguard services); Jacques v. Vill. of Lake Placid, 332 N.Y.S.2d 743 (App. Div. 1972) (defendant was negligent in its signage); Pleasant v. Blue Mound Swim Club, 262 N.E.2d 107 (Ill. App. Ct. 1970) (defendant was negligent in not maintaining adequate depth under diving board).

28. Meneely v. S.R. Smith, Inc., 5 P.3d 49, 51, 57 (Wash. Ct. App. 2000) (affirming $11 million award and suggesting the mere knowledge of the standard development organization for the pool industry, the National Spa and Pool Institute, that a person who used a pool meeting its standards could strike the bottom forcefully enough to be severely injured rendered the NSPI negligent for promulgating those standards). *See also* King v. Nat'l Spa & Pool Inst. Inc., 570 So. 2d 612, 618 (Ala. 1990) (NSPI will be liable to injured diver if pool conformed to NSPI standards and NSPI was negligent in promulgating the standards). *Restatement (Third) of Torts* has adopted the rationale of King. *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL HARM § 43 cmts. c, e, f (Proposed Final Draft No. 1, 2005).

29. At least one Commentator recognizes how the adoption of the Learned Hand formula for negligence tends to impose strict liability. *See* Mark F. Grady, *Why Are People Negligent? Technology, Nondurable Precautions, and the Medical Malpractice Explosion*, 82 NW. U. L. REV. 293 (1988) (basing a finding of negligence on compliance errors amounts to strict liability).

not be liable, seem to be ignored.[30] One consequence is that in order to reach a jury, a customer need only advance sufficient evidence of some untaken precaution that would have been cost-justified and would probably have avoided or reduced the customer's injury. A motel customer who suffers a severe injury in the motel's Type II pool can produce sufficient evidence of the motel's negligence merely by adducing testimony from an expert witness identifying, for example, some cost-justified improvement in the signage indicating the depth of the pool at various points. Hence, defendant's signage could have been negligent because it was in the wrong location or in the wrong size print, was insufficiently specific or was too specific, or was insufficiently visible, intelligible, emphatic, or memorable.[31] The ease of advancing one of these theories of causal negligence—and modern procedure encourages a plaintiff to advance multiple, alternative theories—contrasts with the intellectual labor required of a conscientious trial judge to evaluate whether there is sufficient evidence in support of the theory and to explain why there is not. Moreover, the trial judge knows he must undertake this labor in the shadow of the deeply entrenched principle that negligence and cause-in-fact, whenever sensible minds can differ, are for the jury.[32] The weakness of the modern concept of negligence, combined with this commitment of the key elements in negligence cases to the jury, creates a risk of legal system error—in the form of sending meritless cases to the jury—that is substantial and one-sided.[33] Nor is the jury likely to correct these errors. At least when plaintiff emerges, as a quadriplegic, the severity of plaintiff's injury is all too likely to overthrow the

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30. *See, e.g.*, Saunders v. Boston & Me. R.R., 136 A. 264 (N.H. 1927) (finding defendant not negligent despite its failure to equip trolley with a jack); Cordas v. Peerless Transp. Co., 27 N.Y.S.2d 198 (City Ct. 1941) (defendant was not negligent despite his omission of a cost-justified precaution that would probably have avoided plaintiff's injury); Watkins v. Taylor Furnishing Co., 31 S.E.2d 917, 918 (N.C. 1944) (defendant was not negligent despite his failure to act as the "perfectly prudent" man); Porter v. Cook, 13 S.E.2d 486, 488 (S.C. 1941) (defendant "[was] not guilty of negligence if he [made] such a choice as a person of ordinary prudence placed in such a position might make, even though he did not make the wisest choice"). Professor George Priest described the pre-1960 notion of negligence as requiring "'clear moral culpability substantially antagonistic to social norms.'" Gary T. Schwartz, *The Beginning and the Possible End of the Rise of Modern American Tort Law*, 26 GA. L. REV. 601, 623 n.104 (1992).

31. Cases in which defendant's signage was deemed negligent include Falgoust v. Richardson Indus., Inc., 552 So. 2d 1348 (La. Ct. App. 1989) (damages of $975,000) and Gould v. Allstar Ins. Co., 208 N.W.2d 388 (Wis. 1973). *See also* cases cited *supra* note 27.

32. Determining whether a party's conduct is negligent requires evaluation, not just fact-finding. Courts have long assigned such determinations of mixed law and fact to the jury, provided only that there is sufficient evidence to sustain the jury's conclusion. *See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL HARM § 8 (Proposed Final Draft No. 1, 2005). The power thereby given the jury in negligence cases is so long-standing that its implications are rarely considered.

33. As one frustrated judge stated in dissent: "There can be nothing more tragic than quadriplegia . . . .The easiest and most natural inclination for a trial court in a swimming pool/dive case is to 'give the plaintiff a day in court.'" Jonathan v. Kvaal, 403 N.W.2d 256, 267 (Minn. Ct. App. 1987) (Randall, J., dissenting). For the unwillingness of courts to keep such cases from the jury, see Greg Sobo, Comment, *Look Before You Leap: Can the Emergence of the Open and Obvious Danger Defense Save Diving From Troubled Waters?*, 49 SYRACUSE L. REV. 175, 182 (1998); Saul Wilensky & Steven B. Getzoff, *The Shallow Dive: An Open and Obvious Danger*, FOR THE DEF., Nov. 1991, at 3.

requirement of causal negligence as the foundation for defendant's liability.[34]

One could say a Type II pool's association with such an expensive injury renders such a pool an example of what has been called a litogen.[35] A litogen is any aspect of an activity that causes more liability than would be warranted by the activities' dangerousness.[36] Without the duty to settle, liability insurers for small businesses could tolerate such a litogen in the businesses of their insureds. The judicial embrace of the duty to settle meant the end of such tolerance, and, hence, the disappearance of such activities.[37]

Society suffers when the law suppresses recreational activities merely because a customer can perform the activity in a way that leads to severe and, as measured by the tort system, expensive injuries. Absent proof of the elements officially required for liability, there is no more reason to "internalize" on those offering a Type II pool the injury costs associated with the pool than to "internalize" on surgeons the injury costs associated with surgery.[38] True, an occasional legal scholar calls for eliminating American football from society by imposing tort liability on those offering the sport for all injuries the sport engenders.[39] But that call—by ignoring the benefits of recreational activities, both internal to the participants and external to society—seems sure to continue unheeded.[40]

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34. Thus far no courts have considered the proposed changes in tort doctrine or procedure designed to reduce the risk of legal system error in suits against recreational vendors. For examples of these proposed changes, see Robert Heidt, *The Avid Sportsman and the Scope for Self-Protection: When Exculpatory Clauses Should Be Enforced*, 38 U. RICH. L. REV. 381 (2004); Donald P. Judges, *Of Rocks and Hard Places: The Value of Risk Choice*, 42 EMORY L.J. 1, 121-42 (1993).

35. The term was originally used by Robert L. Brent, M.D., to describe Bendectin, a drug used to combat nausea in pregnant women and the source of much litigation. As a result of the litigation, Bendectin was pulled off the market by its manufacturer in 1983 without ever being proven to cause birth defects. Benedictin Making a Comeback, March of Dimes, http://web.archive.org/web/20060213170440/http://www.marchofdimes.com/professionals/681_1820.asp (last visited Aug. 28, 2009). Hence, Dr. Brent called it a "litogen," (a substance that causes liability), a word similar to carcinogen (a substance that causes cancer), and teratogen (a substance that causes birth defects). *See* PHANTOM RISK: SCIENTIFIC INFERENCE AND THE LAW 28 (Kenneth R. Foster et al., eds., 1993).

36. In support of the claim that a pool with a diving board is a litogen, see Sobo, *supra* note 33, at 175-77 (describing how such pools trigger disproportionate litigation but never using the term "litogen").

37. *See* sources cited *supra* note 21 (attributing their companies' refusal to cover pools with diving boards to the duty to settle).

38. Indeed, there is less reason for liability here. In the surgery context, imposing liability on a defendant will not dilute the incentive for plaintiffs to take precautions to avoid injury to themselves because there is little, if any, role for plaintiff's precaution-taking. In the recreational activity context, on the other hand, maintaining proper incentives for the plaintiff to protect himself plays a much greater role in avoiding injuries. Imposing liability for plaintiff's injuries in that context threatens to dilute those incentives.

39. *See* RAYMOND L. YASSER, TORTS AND SPORTS: LEGAL LIABILITY IN PROFESSIONAL AND AMATEUR ATHLETICS 82 (1985) (maintaining that if the injury costs of football in U.S. society were internalized, the sport would disappear and that "this would surely be a healthy development"). Contrast the view of Justice Handler of the Supreme Court of New Jersey: "One might well conclude that something is terribly wrong [when] the most commonly-accepted aspects of play—a traditional source of a community's conviviality and cohesion—spurs litigation." Crawn v. Campo, 643 A.2d 600, 607 (N.J. 1994).

40. For classic discussions of the benefits of recreational activities that involve risk-taking, see KONRAD LORENZ, ON AGGRESSION 243-45 (Marjorie Kerr Wilson trans., Harcourt, Brace & World,

Part II of this Article explains more fully the duty to settle and surveys the considerations that support and oppose it. Part III anticipates a major objection to my hypothesis that the duty to settle has indirectly led small business recreational vendors to eliminate or sanitize the activities they offer. That objection maintains that in the era before the duty to settle was embraced the risk facing the defendant small business of an excess judgment for "blood money" was greater than I have suggested. As a result, I have overstated the bargaining advantage the liability insurer gained from the partial judgment-proof status of the defendant. This objection maintains that, even without the duty to settle, plaintiff's threat to press on after plaintiff's offer to settle at the limits was rejected needed to be taken more seriously. My response largely tracks the work of previous scholars who have emphasized the practical difficulties plaintiffs face in suing for and collecting blood money from all but the wealthiest organizations. These scholars argue persuasively that plaintiffs who sue small businesses rationally treat the limits of defendant's liability policy as a de facto cap on their recovery. In the absence of the duty to settle, or of some other method for giving plaintiffs access to unlimited liability insurance, the plaintiffs understandably resign themselves to bargaining down from those limits. By undermining the effect of those limits, the duty to settle dramatically increases the insurer's exposure, especially for severe injuries, and, hence, leads the insurer to pressure its insured to alter its activities so as to reduce the chance, for whatever reason, of a customer suffering a severe injury.

II. THE MERITS OF THE DUTY TO SETTLE

While courts have shown no inclination to reconsider their embrace of the duty to settle, the identification here of a previously unappreciated effect of that duty justifies a brief review of the duty's merits. The duty to settle maintains that a liability insurer, who refuses to accept a reasonable settlement offer from a tort plaintiff that is within the limits of the liability insurance policy between the insurer and the tort defendant, will be liable to its insured, the tort defendant, for the full amount of any tort judgment that the tort plaintiff may eventually win.[41] When the tort judgment exceeds the limits of liability set forth in the insurance policy, those limits are ignored. The insured tort defendant enforces the duty to settle through a post-judgment suit against its insurer, although the insured's right to bring that suit is often assigned to the injured plaintiff.[42]

Although the concept of the duty to settle predates it,[43] the case most associated with the duty to settle is *Comunale v. Traders & General Insurance*

Inc. 1966) (1963)); WHY MAN TAKES CHANCES: STUDIES IN STRESS-SEEKING 10 (Samuel Z. Klausner ed. 1968); M. J. ELLIS, WHY PEOPLE PLAY 80 (1973); MIHALY CSIKSZENTMIHALYI, FLOW: THE PSYCHOLOGY OF OPTIMAL EXPERIENCE 72 (1990).

41. *See* Comunale v. Traders & Gen. Ins. Co, 328 P.2d 198 (Cal. 1958). The duty to settle has been expressly recognized in forty-seven states. The District of Columbia, Hawaii, Nevada, and West Virginia have never addressed the cause of action. *See* STEPHEN S. ASHLEY, BAD FAITH LIABILITY: A STATE-BY-STATE REVIEW 89-134 (1987) (collecting citations).

42. Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1120 n.15 (1990). Florida provides by statute that the tort plaintiff can sue the defendant's liability insurer directly. FLA. STAT. ANN. § 624.155 (West, Westlaw through Jun. 2005 amendments).

43. *See* Wis. Zinc Co. v. Fid. & Deposit Co. of Md., 155 N.W. 1081 (Wis. 1916).

Co.[44] In *Comunale*, an insured car driver injured two pedestrians in a crosswalk.[45] The driver's insurer, Traders and General Insurance Co., refused to settle the pedestrians' negligence suits against the driver even after the pedestrians together offered to settle for $4,000, which was well below the policy limits of $10,000 per person and $20,000 per accident.[46] The ensuing tort litigation ended in judgment for the pedestrians against the driver for $25,000 for one pedestrian and $1,250 for the other.[47] When the judgment was not paid, the pedestrians entered an agreement with the driver, whereby they received an assignment of the driver's rights against its insurer, and then brought suits against the insurer to recover the full amount of the tort judgment, including the $15,000 in excess of the $10,000 limit per person.[48]

The Supreme Court of California upheld the claim of the pedestrians and of the car driver against Traders and General Insurance Co.[49] The court held that Traders and General Insurance Co. violated the implied covenant of good faith and fair dealing, implicit in their liability insurance policy with the car driver, when it refused to accept the pedestrians' offer to settle for $4,000.[50] The appropriate remedy for breaching this implied covenant, the court held, was to render the insurance company liable for the full amount of any judgment, even a judgment in excess of the policy limits, that its insured would eventually face.[51]

The court condemned the liability insurer's exercise of its right to refuse to accept the pedestrians' offer to settle, a right clearly granted the insurer by the terms of the policy, because it saw the refusal as opportunism designed to prefer the insurer's interests when they conflicted with the insured's.[52] The pedestrians' offer to settle within the limits brought into relief the conflict between the insured's indifference to any payment within the limits and his wish to avoid a judgment in excess of the limits, on the one hand, and the insurer's wish to avoid payment at the limits and its indifference to a judgment in excess of the limits, on the other hand. Obviously, it will always be in the insured's interest to settle within the policy limits when there is any danger, however slight, of a judgment in excess of those limits.[53] In stark contrast, once the settlement has consumed the limits of the insurer's potential liability, the insurer is indifferent to how much of the insured's assets a judgment or settlement above the limits will take. Hence, a settlement at

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44. 328 P.2d 198. *See also* Crisci v. Sec. Ins. Co. of New Haven, Conn., 426 P.2d 173 (Cal. 1967). The duty to settle is sometimes called the "*Comunale* duty." *See, e.g.*, Commercial Union Assurance Cos. v. Safeway Stores, Inc., 610 P.2d 1038 (Cal. 1980).

45. *Comunale*, 328 P.2d at 200.

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 203.

50. *Id.* at 200-02.

51. *Comunale*, 328 P.2d at 202.

52. *See id.*

53. I am referring solely to the financial interests of the insured in the particular suit against him. The insured who requests his insurer to pay the plaintiff the amount of the policy limits may injure his longer term interests in maintaining his reputation and in qualifying for lower premiums and better coverage. Implicit in that request, after all, is some admission of the insured's liability, and usually of his culpability.

the policy limits (before the duty to settle was recognized) represented the worst possible outcome for the insurer, with its only benefit for the insurer, beyond the reputational gain from protecting its insured, being the savings in defense costs from avoiding further litigation. Accordingly, rejecting a settlement at the limits furthered the insurer's interests, as long as that rejection reduced the insurer's expected payment to the plaintiff more than it increased the insurer's expected defense costs. The court in *Comunale* could not abide the insurer acting on these self-interested calculations. Doing so, the court felt, was wholly inconsistent with the implied covenant of good faith and fair dealing, and with the fiduciary relationship toward the insured that the court felt the policy created.[54] The court saw the duty to settle as a rule that would prevent the insurer from preferring its own interests in the face of this conflict.[55]

Subsequent courts have based the duty to settle on additional grounds as well. They have emphasized the insurer's total control, under the terms of the policy, of the disposition of suits against the insured and the consequent relinquishment by the insured of any right to negotiate with the plaintiff on his own behalf.[56] Courts—ignoring the possibility that the insured will be judgment proof—have also made much of the harm to the insured's interests from a judgment in excess of the policy limits and the resulting dependence by the insured on the insurer to see that this severe harm is avoided.[57] Citing these and other grounds, such as encouraging settlement,[58] courts have, without exception, held the insurer to the obligations of a fiduciary or an agent of the insured, brushed aside the contrary language of the policy,[59] and imposed on the insurer the duty to settle.[60]

The precise contours of the duty to settle still vary from state to state.[61] The plurality of states apply the duty to settle (with its resulting liability in excess of the policy limits) when defendant's rejection of plaintiff's offer to settle was negligent. In these states the court or jury must reconstruct ex post all the factors bearing on the insurer's judgment ex ante as to the expected outcome of the litigation. Merely ascertaining what information was available to the insurer at the time of the plaintiff's offer presents a challenge. Other states apply the duty to settle when an insurer of a policy without limits would have accepted plaintiff's offer to settle. In these states the duty to settle becomes even more difficult to apply. In dicta, the

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54. *Comunale*, 328 P.2d at 201-02.

55. *See id.* at 202.

56. *See* Syverud, *supra* note 42, at 1122.

57. *See, e.g.*, Georgetown Realty, Inc. v. Home Ins. Co., 831 P.2d 7, 14 (Or. 1992); Transp. Ins. Co., Inc. v. Post Express Co., Inc., 138 F.3d 1189, 1192 (7th Cir. 1998).

58. In fact, however, by increasing the variance in potential outcomes from the litigation, the duty to settle diminishes the likelihood of settlement. *See* Priest & Klein, *supra* note 17, at 15-16 (the greater the variance in expected outcomes, the less the chance of settlement).

59. Granted, the policy limits define the amount the insurer must pay to perform the contract, and, hence, do not necessarily define the amount for which the insurer may be liable upon breach of the contract. Lawton v. Great Sw. Fire Ins. Co., 392 A.2d 576, 579 (N.H. 1978).

60. For a review of cases, state by state, adopting the duty to settle, see Ashley, *supra* note 41.

61. For a review of those contours, see generally 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; Patrick F. Koenen, *Bad Faith and Negligence Approaches to Insurer Excess Liability for Failing to Settle Third-Party Claims: Problems and Suggestions*, 54 DEF. COUNS. J. 179 (1987).

court in the leading case of *Crisci v. Security Insurance Co. of New Haven, Connecticut*,[62] suggested an alternative strict liability standard that would apply the duty to settle whenever an insurer rejects a settlement offer within the policy limits.[63] Although no state has officially embraced the strict liability rule, the rules that have been embraced amount to virtual strict liability in their operation.[64]

The difficulty of applying the duty to settle is not the only argument against the duty that courts have ignored. For instance, courts rarely acknowledge the assumptions underlying the duty to settle. One assumption is that the reputational harm to liability insurers of exposing their insureds to an excess judgment fails to create an adequate incentive for the insurer to settle within the limits. Another assumption is that insureds at no time possess the ability and leverage to persuade their insurers to settle in order to further the insured's interests. Courts ignore the possibility that the insured may have consciously opted for a low-limit policy with full knowledge of the possible conflict of interest and the risk of opportunistic behavior by the insurer that a low-limit policy presents. After all, an insured with few assets or little reluctance to exploit pro-debtor laws like bankruptcy may feel that the risk of actually having to pay an excess judgment is so remote that a modest limit on her liability insurance will sufficiently protect her. She may feel the additional premiums she would need to pay for a policy with greater limits will swamp whatever reduced concern about her liability those premiums would provide. By imposing the duty to settle, courts reward such an insured for reneging on her bargain and for initially choosing to purchase a low-limit policy. The duty to settle then, by so rewarding the buyer of the low-limit policy, narrows the price differential between low and high-limit policies. [65]

Insureds in general also pay more because the duty to settle hinders insurers faced by an offer to settle within the limits from bargaining strategically so as to reduce the total payments of insurers, and thus, the future premiums of insureds. Both insurers and future insureds, for example, may benefit from the insurer rejecting a settlement offer within the limits in the hope of negotiating a lower settlement later. In other words, rejecting the plaintiff's settlement offer may improve the insurer's position in further negotiations regardless of whether it

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62. 426 P.2d 173 (Cal. 1967).

63. *See id.* at 177. Others have also called for strict liability whenever a refusal to settle within the limits is followed by a judgment in excess of the limits. *See, e.g.*, Robert W. Peterson, *Excess Liability: Reconsideration of California's Bad Faith Negligence Rule,* 18 STAN. L. REV. 475, 482-85 (1966).

64. *See, e.g.*, John A. Appleman, *Duty of Liability Insurer to Compromise Litigation*, 26 KY. L.J. 100, 109 (1938) (arguing that jurors are "totally incompetent" and "unqualified" to say whether a settlement offer was reasonable); Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1140-42 (1954) (expecting little difference in the result regardless of which test is applied, given the hindsight bias of the jury); 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES, § 5.12 (5th ed. 2007) (arguing that tests, however stated, lead to the same results); Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990) (holding that an award of damages beyond the limits creates a presumption that a settlement within the limits should have been accepted).

65. This narrowing of the price differential results primarily from the insurer's need to increase premiums for low-limit policies to reflect the unlimited liability risk that would often accompany such policies because of the duty to settle. *See* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW 889 (Student ed. 1988) (contending that the duty to settle may increase the insurer's cost of servicing low-limit policies).

makes sense in light of the expected outcome of the case overall. Another example of strategic bargaining which may reduce the overall payments of insurers and the future premiums of insureds would be rejecting an offer within the limits in order to deter similar claims in the future. Courts seem appalled when this strategic behavior results in an excess judgment against an insured. But by imposing the duty to settle, they prevent all insureds and insurers from realizing the savings this strategic bargaining by the insurer would allow.[66]

Other costs of the duty to settle include the legal expenses insurers incur in defending duty to settle cases. These expenses are part of the costs of claims administration, which in turn affect insurance premiums. Because the insurer's liability for an excess judgment is not strict, at least not officially, the liability insurer will predictably incur costs in attempting to show that its rejection of the plaintiff's settlement offer was not so culpable as to meet whatever legal standard for culpability will trigger the duty to settle in the relevant jurisdiction. Sowing the documentary seeds so it can later show its lack of culpability in rejecting the settlement offer will raise the liability insurer's costs. Insurers will artfully conduct negotiations, and prepare claims files, to build a record that establishes their lack of culpability. The insurer's attorneys and claims adjustors will respond to the plaintiff's settlement offers, and to their insured's request that the insurer settle, so as to justify their behavior in the eyes of the fact-finder at a later trial. Of course, these efforts to build a favorable record are wasted whenever no excess judgment ensues.[67]

Further evidence that the duty to settle fails to maximize the joint benefit of the parties comes from the parties' failure to impose the duty to settle on the insurer through voluntary agreement. Even in commercial policies, where the insured is apt to be a sophisticated buyer not subject to information failure or any monopoly power of the seller, the policy terms give full discretion over settlement to the insurer. The Coase Theorem suggests that the bargaining process between the insured and the insurer ought to yield jointly optimal policy terms. As Professor Sykes has written:

> [T]he prevalence of competition in the industry, a concern for reputation on the part of insurers, and insurer's desire to maximize customer willingness to pay in relation to costs all provide an incentive for [insurers] to offer jointly optimal terms. The absence of any contractual obligation [on the insurer] to the insured regarding the disposition of settlement offers then affords some evidence that such an obligation is undesirable from the parties' perspective.[68]

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66. Occasionally, the benefits to the liability insurers from bargaining strategically may lead them to refuse a settlement at the limits despite the duty to settle. Charles Silver, *A Missed Misalignment of Interests: A Comment on Syverud,* The Duty to Settle, 77 VA. L. REV. 1585 (1991) (positing when an insurer may sensibly reject a reasonable settlement demand at the limits).

67. These expenses, which are socially wasteful in any event, would be avoided by making the insurer strictly liable for rejecting a settlement within the limits. *See* Schwartz, *supra* note 61, at 910.

68. Sykes, *supra* note 23, at 79. Sykes has written elsewhere:

> If a simple constraint on insurer discretion such as the [duty to settle] rule were broadly valuable in insurance contracts, it could easily be included in standard forms among existing policy terms. Thus, for the transaction costs of drafting to explain the omission of constraints on insurer discretion in settlement, the

Professor Sykes has also pointed out that the usual grounds for explaining the parties' failure to bargain to optimal terms do not seem to apply here. He has emphasized the absence of transaction costs that would prevent the insured from appreciating the consequence of relieving the insurer of a duty to settle.[69] Indeed, because insurance contract provisions are standardized and must be approved by insurance regulators, the cost per customer of including optimal contractual terms is much less than with most contracts. Therefore, if a provision existed that was appropriate for most insureds and superior to the current one vesting authority to settle in the insurer, it could readily be incorporated.

III. THE UBIQUITY OF THE JUDGMENT-PROOF

This Article claims that the duty to settle drives a liability insurer to accept an offer to settle at the policy limit as long as the plaintiff's injury is severe and the potential judgment against its insured is correspondingly large, even in a case the insurers view as being without merit. As a result, liability insurers become especially motivated to suppress the risk of their insured's activity leading, however innocently, to a severe injury. One objection to this claim is that even without the duty to settle, the insurer's wish to protect its small business insured from having to pay blood money will lead it to accept these offers to settle at the limits. This objection collides head-on with a stubborn fact: the almost negligible likelihood that the small business will ultimately need to pay blood money.[70]

The assumption that for claims against all but the wealthiest organizations

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> appropriate constraints must vary across policyholders to such an extent that attempts to standardize them would be unproductive. Any universally applicable judicial default, such as the [duty to settle] rule, then becomes highly suspect.

Sykes, *supra* note 6, at 1357-58. Because courts will nullify any attempt by the insured and insurer to contract out of the duty to settle, one cannot cite the parties' failure to make such an attempt as evidence that they find the duty to settle worthwhile. *Id.* at 1359.

Granted, Sykes's focus is on whether the duty to settle maximizes the joint welfare of the insured and insurer, without regard to its effect on tort plaintiffs. In the example at the start of this Article of the quadriplegic plaintiff who sues the defendant motel with the Type II pool, the total payment by the motel and its liability insurer, in the absence of the duty to settle, was minimized by rejecting the plaintiff's $100,000 settlement offer at the policy limits and pushing for a settlement at a lower amount. Because the insurer would accept an offer to settle at the limits under the duty to settle and would not accept it in the absence of the duty to settle, the duty to settle leads to a result that is joint-wealth-decreasing for the liability insurer and its insured. *See* Sykes, *supra* note 6, at 1362. The Michigan rule, an alternative version of the duty to settle adopted only in Michigan, attempts to account for the defendant's judgment-proof status and might reduce the situations in which the duty to settle is joint-wealth-decreasing. *See* Frankenmuth Mut. Ins. Co., 461 N.W.2d at 667.

69. *See* Sykes, *supra* note 6, at 1357. *See also* Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 265 (1974) ("The costs of settling a dispute will be lower if the outcome is more certain, for there will be less disagreement over the outcome and this will facilitate the negotiation of a mutually satisfactory settlement price.").

70. Had plaintiffs, in the years before the duty to settle was embraced, pursued the blood money of small business defendants more often, more of those defendants presumably would have filed for bankruptcy in response. The increase in such filings compared to the filings in the years following the embrace of the duty to settle should have been measurable, or should have left at least some trace. The absence of any trace suggests that tort plaintiffs in the era before the duty to settle realized how little they would gain from forcing the small business defendant into bankruptcy and hence pursued blood money as rarely as they do now.

liability insurance limits amount to a de facto cap on tort damages is not a legal rule of any kind. Indeed, black-letter tort doctrine ignores the limits of liability insurance policies. Rather, the assumption is a feature of the operation of our tort system, of tort law in action, whose significance is increasingly appreciated. When individuals are sued, Professor Baker largely attributes this feature of the law in action to an unwritten "union rule" among the plaintiffs' bar not to seek blood money and to confine their reach to the amount of defendant's insurance.[71] Baker asserts that the plaintiffs' bar draws a moral distinction between blood money and insurance money and feels moral qualms about pursuing blood money.[72] As Baker has written: "It's not that defendants are without any assets . . . but rather that many plaintiffs' lawyers and their clients do not derive enough benefit from taking those assets to justify the cost involved. Significantly, that cost includes a psychological or moral component."[73] One might think the plaintiffs' lawyers' unwillingness to seek blood money puts them in conflict with the interests of their clients. But Baker describes how this conflict is finessed: "For those [clients] who are not able to see the wisdom of this approach, practical considerations are packaged with the moral ones, so that the client, who would like to go after blood money in a morally inappropriate case, is steered away."[74]

To some extent, Baker acknowledges this union rule reflects the self-interest of the plaintiff's bar. Because defendants resist more vigorously paying blood money than insurance money, going after blood money increases the chance of trial and, hence, involves far greater delay in collecting any money for the plaintiff. As a result, blood money cases are far more expensive and difficult to litigate. This union rule then effectively raises plaintiffs' lawyers' hourly wage in that it avoids lawyers spending time seeking money that would be more costly on their part to collect.[75]

Baker qualifies this assumption. Taken literally, after all, the assumption suggests that all but the wealthiest organizations are foolish to buy any liability insurance whatsoever, or at least to buy any policy other than the policy with the lowest limits. In response, Baker reports that the union rule will not apply to defendants, fortunately a small minority, who fail to purchase enough liability insurance to satisfy the professional expectations of plaintiffs' lawyers as to what is "adequate."[76] This failure to buy adequate liability insurance is viewed by the plaintiff's bar as a moral failing more serious than ordinary negligence and sufficiently serious, in some instances, to justify the plaintiff's pursuit of blood money. What the plaintiff's bar deems adequate liability insurance turns on several factors and is anything but clear. As Baker writes, the adequate amount "is whatever it takes to claim, credibly, that you have satisfied your moral obligation to

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71. *See* Baker, *supra* note 11, at 288-89.

72. *See id.* at 288-90. Among other effects, this distaste for pursuing blood money leads a plaintiff's attorneys to tailor the plaintiff's claim to fit the available liability insurance.

73. *Id.* at 290.

74. *Id.* at 283.

75. Over time, if blood money was regularly pursued, plaintiffs' attorneys would likely increase the contingent fee percentage they charge to reflect the higher costs of recovering blood money.

76. Baker, *supra* note 11, at 296-97.

insure."[77] However, the adequate amount typically falls far short of the amount needed to keep the defendant from being judgment proof when sued by a severely injured plaintiff. Indeed, the adequate amount can be as low as the amount the state legislature or some private gate-keeping institution requires the defendant to purchase as a condition of conducting their activities.[78] The upshot is that only defendants who grossly underinsure need fear an attempt to reach their blood money, and even those attempts that are undertaken are likely to be half-hearted.[79]

Professor Gilles embraces this assumption as well but attributes it not so much to a union rule among attorneys as to the practical difficulties and collection expenses of pursuing blood money given the protections individual defendants enjoy under a variety of pro-debtor laws.[80] These pro-debtor laws pose serious legal barriers to plaintiffs' lawyers in collecting blood money. Gilles also faults Baker for inferring from the existence of a credit industry dedicated to squeezing blood money out of the judgment-proof that the legal and practical obstacles to collecting that money are frequently overcome. As Gilles argues:

> [T]he question is not whether defendants could be "forced to pay *something*." . . . It is whether they could be forced to pay *enough* to justify the considerable costs of getting a judgment and then collecting a portion of it, in the teeth of exemptions from collection and the threat of bankruptcy.[81]

Injured plaintiffs who sue small businesses that have incorporated will also find that the business' liability insurance limits amount to a de facto cap on their tort damages.[82] The large majority of such small and medium-size corporations have long been able to judgment-proof themselves against having to pay tort judgments in excess of their insurance limits through what Professor LoPucki calls exemption strategies and secured debt strategies.[83] Most "have secured debt that exceeds the liquidation value of their assets."[84] While scholars debate whether the largest organizations will ever find it cost-effective to judgment-proof themselves through more expensive strategies, such as asset secularization or other ownership strategies,[85] small corporations rarely need to employ such methods. The median

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77. *Id.* at 297. This pressure on the insured to insure adequately offsets the pressure that the duty to settle puts on insureds to reduce their policy limit in the hope of inducing plaintiffs to demand less in settlement.

78. For example, most state parks require by regulation or statute that any recreational vendor offering an activity within the park possess some amount of liability insurance coverage. *See, e.g.*, N.M. STAT. ANN. § 19-5-5(10)(F) (West, Westlaw through Aug. 2009 amendments).

79. *See* Baker, *supra* note 11, at 288.

80. *See* Gilles, *supra* note 12, at 606-07. *See also* ROBERT J. MINTZ, ASSET PROTECTION FOR PHYSICIANS AND HIGH-RISK BUSINESS OWNERS (2008), *available at* http://www.rjmintz.com/apptoc.htm (describing the wide variety of judgment-proofing strategies available, many of which can be taken after being sued as long as judgment has not yet been entered).

81. Gilles, *supra* note 12, at 666 n.280.

82. Small businesses organized as partnerships present equally difficult collection problems. Family limited partnerships are especially resistant to judgments. Mintz, *supra* note 80, at 47.

83. LoPucki, *supra* note 11, at 14-19, 30-32. *See also* LoPucki, *supra* note 12, at 1903-06.

84. LoPucki, *supra* note 11, at 39.

85. *See* James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's* The Death of Liability, 107 YALE L.J. 1363, 1364 (1998) (arguing that the wealthiest organizations are not likely to judgment-proof themselves); Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52

corporation in the American economy is surprisingly small. For example, the median corporation proceeding under Chapter 11 of the Bankruptcy Code in the early 1980s had only approximately $250,000 in assets.[86] This would suggest that, after adjusting for inflation, the corresponding figure today would still be less than $500,000. "Even in the Central District of California, a district notorious for its large bankruptcy cases, approximately 45% of the [Chapter 11] cases fall in the under-$1-million categories."[87]

Of course, the duty to settle would lose relevance if the limits of the liability insurance of small business defendants were high enough. But the usual limit falls far below the typical tort recovery for a severely injured plaintiff. For example, Hansmann and Kraakman report, on the basis of interviews, that at least as of 1990,

> of the roughly 350,000 insurance policies that Aetna writes for the "standard market"—which includes all business firms except the Fortune 500—one-third have coverage limits of about $300,000 per accident, one-third have limits of about $500,000 per accident, and one-third have limits of about $1 million.[88]

Perhaps the major contribution of these authors lies in pointing out that a great many defendants who have substantial other assets are, nevertheless, de facto judgment-proof for amounts beyond the limits of their liability policies. Whether that is due to a "union rule" among the bar, as Baker claims, or unduly pro-debtor laws, as Gilles claims, all authors acknowledge that reality. Were it not for the duty to settle, therefore, many more defendants and their liability insurers than one might think would be able to exploit the defendants' judgment-proof status and comfortably reject an offer from a severely injured plaintiff to settle at the policy limits.

IV. CONCLUSION

This paper offers the hypothesis that the duty to settle has contributed to the disappearance of certain recreational activities associated with severe injuries and usually offered by small businesses. No matter how free from negligence the business offering such an activity might have been, the duty to settle greatly magnified the cost of liability coverage for the activity. Before the duty to settle, the policy limits protected the liability insurer against the risk of legal system errors resulting in large judgments against its innocent insured. But the duty to settle eviscerated that protection. While the probability of legal system error remained unchanged, the consequences for liability insurers of such errors became

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STAN. L. REV. 1, 3 (1999) (arguing that it is unlikely that innovative business transactions lead to judgment proofing). For LoPucki's response to White, see generally Lynn M. LoPucki, *The Essential Structure of Judgment Proofing,* 51 STAN. L. REV. 147, 148-49 (1998). For LoPucki's response to Schwarcz, see generally Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz,* 52 STAN. L. REV. 55 (1999).

86. U.S. DEP'T OF JUSTICE, EXECUTIVE OFFICE FOR U.S. TRS., AN EVALUATION OF THE U.S. TRUSTEE PILOT PROGRAM FOR BANKRUPTCY ADMINISTRATION 47 tbl.2.1 (1983).

87. Lisa Hill Fenning & Craig A. Hart, *Measuring Chapter 11: The Real World of 500 Cases*, 4 AM. BANKR. INST. L. REV. 119, 137 (1996).

88. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1898 n.25 (1991).

unmanageable. The duty to settle, therefore, drove liability insurers to insist, not just that their insureds be free from negligence, but that the insureds sanitize their activities so as to disassociate them, to the extent feasible, from any severe injuries to potential plaintiffs.

That an activity generates significant liability exposure does not in itself mean the activity will be driven out of existence, as these recreational activities have been. People still drive cars despite the chance of incurring massive liability and the resulting expense of liability insurance. Whether a risky activity survives its liability exposure depends on the robustness of the demand for the activity and the relative demand for the activity compared to the demand for its next best (and presumably safer) substitute, as well as on other factors. If the consumer demand for the recreational activities discussed here were as robust as the demand to drive, and the consumer demand for their sanitized substitutes as paltry in comparison as is the demand for driving substitutes such as bicycling or walking, perhaps recreational vendors would still offer the activities despite their liability.[89]

Granted, supporters of internalizing on an activity all the injury costs associated with that activity[90] would denounce the status quo that existed before the duty to settle was embraced. They would execrate the ability of small business recreational vendors, through their judgment-proof status, and the ability of their liability insurers, through the policy limits, to externalize the risk of liability for severe injuries. What the supporters of internalization fail to see, alas, is that there are many activities, and many other good things in life, that are only feasible if the threat of tort liability for the injury risks associated with them is somehow lifted.

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89. The paper does not claim to rule out other possible explanations for the disappearance of these activities. Changing consumer preferences and the general expansion of tort liability are plausible explanations as well. I have discussed before the simultaneity between the modern expansion of tort liability and the disappearance of recreational activities which seem reasonably safe, i.e., activities that would not seem to lead to liability under the correct application of negligence principles. *See* Heidt, *supra* note 34, at 414 (discussing possible legal and non-legal changes which may have contributed to the disappearance of certain recreational activities).

90. *See, e.g.*, GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 117 (1970).