Reliability Insurance

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

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

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

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

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INTRODUCTION

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

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

Examples are of course myriad and go far beyond doctors, which implies that the reliability-enhancing role of liability is epicentral to day-to-day human interactions. Manufacturers' liability for deficient products increases consumers' willingness to purchase their products.[5] Directors' and officers' accountability for the corporation's performance is a *sine qua non* for investors' trust.[6] Holding an employer liable for her failure to take preventive measures against employees' sexual misconduct is what allows job candidates to assume that the workplace

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

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

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

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

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

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

would not tolerate such behavior.[7] Liability for deception and misrepresentation—conveying false information or failing to communicate relevant facts in negotiations—bolsters the credibility of the information that a contracting party provides.[8] Liability for defamatory, slanderous and libelous speech makes individuals' statements against other people more credible.[9]

The reliability-enhancing function of liability is well-established, time-honored, and has been espoused in the academic literature even before the now-standard conception of liability as a legal instrument that incentivizes efficient care and guarantees adequate compensation to victims.[10] Its origins trace back to Nobel laureate Thomas Schelling, who famously framed liability as "the right to be sued." In his pioneering treatise, *An Essay on Bargaining*, Schelling highlighted:[11]

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

Equipped with this understanding—that liability is constitutive to reliability—the present Article sets out to introduce a simple but hitherto unstudied question. It inquires why individuals and businesses regularly choose to waive their "right to be sued" by purchasing *liability insurance*. Insurance, at least on the surface, seems to hinder the reliability-producing function of liability. Liability establishes reliability in the eyes of counterparties exactly because it forces injurers to internalize any cost caused by reckless, malevolent or excessively risky behavior. In transferring this cost to an insurer, then, individuals seem to forego the credibility signal they could have enjoyed had they subjected themselves to liability. One may therefore wonder, for example, why contracting parties acquire insurance against misrepresentation,[12] why employers insure themselves against liability for overlooking sexual misconduct in the workplace,[13] why firms extensively insure executives against liability for losses resulting from their imprudence,[14] why media

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

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

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

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

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

[12] *See infra* notes 77-91 and accompanying text.

[13] *See infra* notes 92-119 and accompanying text.

[14] *See infra* notes 61-76 and accompanying text.

outlets choose to insure themselves against liability for defamation,[15] or how come insurance against medical malpractice has become standard among physicians.[16] In those and many other environments, liability insurance might undermine credibility and attenuate policyholders' reliability in the eyes of actors with whom they interact—business counterparties, vulnerable employees, investors, audiences, or patients. If liability indeed embodies a "right to be sued" and insurance eliminates it, it seems that counterparties might respond by declining their willingness to engage or interact with insured parties.

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

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

Upon establishing the theoretical blueprint of the so-far overlooked relationship between insurance and reliability, the Article turns to portray the insurance-reliability landscape in practice, analyzing various types of liability insurance and evaluating the reliability effect—positive or negative—generated by each of them in real-world interactions. It offers a detailed discussion on each type of liability insurance based on the analytical framework developed here, showcasing some that manifest the positive weight that insurance carries on reliability, and juxtaposing them along others that illustrate the negative effect. The Article suggests that the reason for the disparate influence of insurance on reliability across

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[15] *See infra* notes 194-214 and accompanying text.

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

different industries is that some market relationships are dominated primarily by the credibility-eroding, rather than the reliability-advancing characteristics of insurance, whereas others are governed more prominently by the latter ones. The Article likewise offers a normative framework for policy measures that could extract the informational value of insurance.

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

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

I. INSURANCE AND RELIABILITY: A THEORETICAL PREFACE

Intuitively, it might seem that the effect of insurance on policyholders' reliability should simply boil down to the question of how insurance influences the insured party's riskiness. Counterparties, after all, would probably prefer to interact with potential injurers whose activity creates a lower expected loss. If so, the answer to the question stated above—whether, for example, a patient would rather be treated by an insured or an uninsured physician—is just tantamount to asking whether insurance reduces or enhances this physician's riskiness.

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

the mirror-image scenario, where insurance reduces potential injurers' risk and counterparties would nonetheless be worse off when confronting an overly prudent actor.

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

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

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

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

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

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

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

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

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

This insight is undergirded by an additional, closely related academic paradigm that associates insurance with enhanced riskiness: the one known as "adverse selection."[22] The gist of the idea is that the riskier is an injurer, the more valuable is insurance for her. Consequently, we may witness a greater turn to insurance among riskier actors, and if so, the fact that an individual is insured might signal to counterparties her a-priori proneness to riskiness.[23] As opposed to moral hazard that indicates weaker *incentives* to exercise care *ex post*—that is, once insurance has been acquired—adverse selection conveys information about the *nature* of the actor's risky activity or her inability to exert sufficient prudence, which is likely the reason for her decision to insure herself *ex ante*.[24] Moral hazard and adverse selection are the twofold cornerstone of the traditional approach to insurance, which perceives it as a risk-enhancing social institution.[25] Thus, if this approach is the one that prevails in certain marketplaces—which is indeed the case, as will be shortly noted—insurance clearly undermines the reliability signal that potential injurers could have communicated by subjecting themselves to liability. Injurers who nonetheless decide to acquire an insurance policy basically trade off reliability for coverage.[26]

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

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

[23] *See* Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629, 632 (1976) ("[T]hose with high accident probabilities will demand more insurance than those who are less accident-prone."). For the classic description of an adverse selection problem see generally Akerlof, *supra* note 5.

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

[25] *See generally supra* note 17.

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

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

What the classic line of literature has generally ignored is the fact that an insurer is an economic actor who, at the end of the day, simply wishes to minimize losses caused by insureds' risky activity. In many cases, insurers also occupy a position that allows them to control policyholders' level of riskiness.[28] Insurers could—and often do—utilize their status as a powerful, deep-pocket entity and function as a quintessential regulator of risky behavior; a regulator with strong pecuniary incentives to prevent losses.[29] This manifests ex ante in conditioning insurance upon due diligence,[30] the adoption of private precautions by the insured,[31] and disclosure requirements,[32] as well as in tailoring premiums in commensuration with the assessed risk;[33] ex interim in insurer-intensified monitoring and supervision,[34] and even trainings for the sake of entrenching risk-reducing practices;[35] and ex post—once the risk is realized into loss—in updating the rate of deductibles and risk premiums in the course of policy renegotiations.[36]

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

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

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

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

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

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

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

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

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

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

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

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

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

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[37] *Supra* note 27-28.

[38] *Infra* Part II.

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

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

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

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

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

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

> "[M]any insurance markets are actually characterized by "propitious," rather than adverse, selection. Propitious selection, as its name suggests, implies that insurance is most attractive to the lowest-risk individuals among those eligible to buy it, not to those with the highest risks…. [In those markets,] there is a negative correlation between risk aversion and riskiness. In other words, the "belt-and-suspenders" types are not only more averse to financial risks—and hence more willing to pay to eliminate such risks through insurance—but they are also more likely to reduce risks on their own by, for example, taking precautions or refusing to engage in physically risky activities."

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

The unorthodox, risk-reducing view of insurance offers a fundamentally different take on the purportedly negative signal that insurance delivers with respect to reliability. If an insurer is a powerful entity that captures an advantageous position to scrutinize individuals' riskiness—be it by assessing their a-priori harmfulness or by requiring the adoption of various risk-mitigating measures as a precondition for coverage—then counterparties might actually find it preferable to interact with a policyholder, rather than with an uninsured actor. Consider again the physician hypothetical, which will be discussed in a real-world setting in the ensuing Part. A patient might reasonably assume that a well-informed insurer—who, again, possesses the best means and methods for preventing loss—would not have insured an excessively risky doctor in the first place, nor would it have insured at all had it believed that coverage substantially distorts policyholders' incentives to exercise care. The involvement of an insurer may therefore serve as an expression of faith—indeed, a signal of nonharmful conduct—and, in turn, enhance the reliability that counterparties ascribe. Substitute the moral-hazard approach with the incentives of insurers to constantly monitor and eliminate risky behavior, couple this insight together with the theory of propitious selection that counters the standard premise of adverse selection, and conclude that liability insurance may well contribute to—rather than undermine—the insured's reliability. All is encapsulated tabularly below.

Table 1. The Competing Effects of Insurance on Riskiness

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

[45] *See generally* Hemenway, *supra* note 42. *See also* David Hemenway, *Propitious Selection in Insurance*, 5 J. RISK & UNCERTAINTY 247 (1992).
[46] Siegelman, *supra* note 44 at 1266.

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

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

1. Reliability *Despite* Moral Hazard

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

In those cases, the reason for preferring an insured—beyond the trivial one of guaranteeing compensation—is twofold. First and foremost, as the legal and economic literature has long established, the judgment proof problem not only carries detrimental distributional effects by leaving victims bereft of the ability to receive adequate compensation for their losses, but also creates perverse incentives to potentially insolvent injurers. Judgment-proof actors are discouraged from exerting optimal prudence since they, too, enjoy the full benefits of their risky activity but would not suffer the full cost of harm, if ever realized. Best illustrated by Professor Steven Shavell:[49]

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

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[47] *See generally* Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986).
[48] *See* Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375, 1375 (1994) ("Liability insurance can ameliorate […] judgment-proof problems….").
[49] Shavell, *supra* note 47 at 45.

> $30,000. Hence, injurers' expected penalty may be less than the expected losses for which they are liable."

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

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

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

2. Unreliability *Due to* Insurer Monitoring

The argument that increased prudence enhances reliability hinges on the intuitive premise that elevated care is correlated with lower expected harm. As stated below, however, the impetuses that prompt enhanced care—insurer monitoring and propitious selection—might ultimately result in injurers exercising *excessive* care to avert losses. In some cases, insurer-induced overprudence might undermine reliability just as much as underprudence does. Counterparties might wish to avoid engaging with an excessively careful actor for two related reasons. First, excessive

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

[51] *Infra* Part II.

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

prudence might deprive counterparties of the full benefit they could elicit from potentially harmful market interactions. An overly prudent physician, for example, might fail to prescribe patients even with desirably risky treatments to avoid the harm they may inflict.[53] Second, and by the same token, she is more likely to engage in the omnipresent practice of "defensive medicine," whereby doctors recommend patients to undertake cost-unjustified treatments or diagnoses just to avoid the occurrence of a harm that might pave the way for a future suit.[54] In other words, an overcareful doctor's objective is "to address every possible risk for the patient, no matter how small it is."[55]

The problem of excessive prudence is not limited to defensive medicine. An overcareful contracting party who worries too much about failure to disclose relevant information might overburden her correlative with unnecessary information—"spam"—just to be on the safe side of the disclosure requirement.[56] Overcareful employers who are worried about liability for employees' workplace behavior might set exceedingly stringent standards that reduce their attractiveness in the eyes of job candidates.[57] An overcareful corporate executive would avoid taking risks that may well be beneficial from investors' perspective.[58] A media outlet might avoid even the socially desirable risk of a potentially defamatory publication.[59]

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

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

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

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

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

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

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

In terms of reliability, then, the scenario in which insurers channel injurers toward carefulness—or attract more careful ones at the outset—does not in itself contribute to credibility. If insurers tend to intensely monitor policyholders and induce them to exert inordinate loss-prevention effort or, say, condition policies upon excessive precautionary measures—a requirement to which sufficiently risk-averse actors would accede—then the presence of insurance would beget excessive care. In that case, the very regulatory role of insurance—which might intuitively be thought of as enhancing the insured's credibility for reinstating her incentive to prevent harm—actually undermines reliability, causing counterparties to favor interactions with uninsured actors.[60]

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

II. From Theory to Practice

A. *Directors' and Officers' Liability Insurance*

In most cases, there is contradictory evidence on whether insurance carries perverse or favorable effects on reliability. Hence, it might be useful to start with a market setting in which this effect is unequivocally distortive—directors' and officers' (D&O) liability insurance. In finance literature, D&O insurance against claims made by shareholders or other third parties is consistently regarded as a facilitator of distrust. Considering the excessive risk-taking associated with D&Os coverage[61]—mainly in the context of investment decisions,[62] loan spreads,[63] or higher likelihood of suits[64]—firms whose officials are extensively insured from liability are routinely treated with increased suspicion by market participants.[65] Voluminous empirical literature attests, for example, that analysts exhibit repeated pessimism with respect to the performance of firms with high-level D&O

[60] *Infra* Part II.
[61] *See, e.g.*, M. Martin Boyer & Sharon Tennyson, *Directors' and Officers' Liability Insurance, Corporate Risk and Risk Taking: New Panel Data Evidence on the Role of Directors' and Officers' Liability Insurance*, 82 J. RISK & INS. 753, 781 (2015) (contending that the data "strongly favor the hypothesis that D&O insurance leads to more aggressive earnings management, suggesting moral hazard effects of insurance.").
[62] *See generally* Chen Lin et al., *Directors' and Officers' Liability Insurance and Acquisition Outcomes*, 102 J. FIN. ECON. 507 (2011).
[63] *See generally* Chen Lin et al., *Directors' and Officers' Liability Insurance and Loan Spreads*, 110 J. FIN. ECON. 37 (2013).
[64] *See generally* Stuart L. Gillan & Christine A. Panasian, *On Lawsuits, Corporate Governance, and Directors' and Officers' Liability Insurance*, 82 J. RISK & INS. 793 (2015).
[65] For a literature review see Ning Jia & Xuesong Tang, *Directors' and Officers' Liability Insurance, Independent Director Behavior, and Governance Effect*, 85 J. RISK & INS. 1013, 1013-18 (2018).

insurance.[66] Additional effects include generally negative market reactions,[67] as well as poorer stock performance.[68] Similarly, corporations whose directors and officers enjoy enhanced coverage are reportedly offered lower bid premiums in mergers and acquisitions (M&A) negotiations,[69] and substantially higher audit fees.[70] The striking empirical evidence corresponds to the previous theory of the insurance-reliability interface. According to studies, the negative market response to extensive D&O insurance emanates from concerns over the excessive risk-taking notoriously associated with executives who are insured from liability.[71]

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

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

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

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

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

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

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

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

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

[73] *Id.*, at 2.

With this in mind, Baker and Griffith inquire to what extent D&O insurance indeed serves as a regulatory apparatus. After conducting a thorough research which included interviews with relevant professionals, they submit the gloom conclusion that "D&O insurers do almost nothing to monitor the public corporations they insure, and D&O insurers do not condition the sale of insurance on compliance with loss-prevention requirements in any systematic way."[74]

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

Table 2. The Effect of D&O Insurance on Reliability

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

B. *Misrepresentation Liability Insurance*

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

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

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

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

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

[77] *See* Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839 (2020).

[78] *Id.*, at 1843-44.

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

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

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

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

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

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[79] *Id.*, at 1892.
[80] *Id.*, at 1886.
[81] *Id.*, at 1899.
[82] *Id.*, at 1884.
[83] *Id.*, at 1920.
[84] *See* Robert Cooter, *Punitive Damages, Social Norms, and Economic Analysis*, 60 L. & CONTEMP. PROBS. 73, 76 (1997) ("In economic models, "perfect compensation" leaves the victim indifferent between no harm and harm with compensation.").

Though observable in the context of R&W insurance, the perfect compensation equivalence is hardly plausible in real-world settings for many practicability constraints that economic theory oftentimes fails to embed.[85] In practice, given the choice, individuals normally prefer avoiding harm ex ante to being compensated for such harm ex post, for a variety of reasons. To name just a few, individuals' basic intuitions tend to prioritize the preservation of bodily integrity or personal autonomy, rather than compromising it and receiving an equivalent economic value.[86] The argument is even sounder when accounting for physical or mental injuries, whose avoidance ex ante is perhaps instinctively preferred by individuals.[87] Besides, as has long been recognized, individuals tend to exhibit loss aversion,[88] namely, the value they ascribe to losses exceeds the one they associate with profits, which implies that by being harmed and then compensated (namely, loss followed by profit), they are worse off compared to avoiding harm in the first place.[89]

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

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

Table 3. The Effect of R&W Insurance on Reliability

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

[85] *See, e.g.*, ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 203 (6th ed. 2016) (acknowledging that the perfect compensation assumption is unrealistic and is adopted mainly for being analytically useful).
[86] *See, e.g.*, Gideon Parchomovsky & Alex Stein, *Autonomy*, 71 U. TOR. L.J. 61 (2021) (arguing that any harm involves a separate violation of victims' autonomy, but that this distinct wrong is not recognized by courts).
[87] For example, some have identified the inherent problem of the perfect compensation principle for risks of death. *See generally* Ariel Porat & Avraham Tabbach, *Willingness to Pay, Death, Wealth and Damages*, 13 AM. L. & ECON. REV. 45 (2011).
[88] *See generally* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) (introducing the concept of loss aversion).
[89] Indeed, the law tends to punish acts that caused losses more severely than ones that prevented profits. *See generally* Eyal Zamir, *Loss Aversion and the Law*, 65 VAND. L. REV. 839 (2012).
[90] *See, e.g.*, Yotam Kaplan & Ittai Paldor, *Social Justice and the Structure of the Litigation System*, 101 N.C. L. REV. 469, 477-89 (2023) (addressing the often-insurmountable costs of litigating a lawsuit).
[91] *See id.*

C. *Workplace Liability Insurance*

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

For understandable reasons, perhaps, EPL insurance has been viewed by commentators as antithetic to integrity and social justice, undermining the objectives of employment law, and moreover, as distorting incentives for optimal conduct for igniting the problem of moral hazard among employers.[93] Professors Erin Meyers and Joni Hersch, however, identify that EPL insurance by-and-large reinforces accountability.[94] In correspondence to the "insurance as governance" paradigm, Meyers and Hersch note that insurers employ various means and methods designed to reduce employers' moral hazard,[95] including deductible and coverage limits which guarantee that insureds have sufficient "skin in the game" of loss prevention.[96] EPL insurers likewise offer a host of loss-prevention measures, *inter alia*, training programs and HR consultancy.[97]

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

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[92] *See, e.g.*, NATIONWIDE MUTUAL INSURANCE COMPANY, *Employment Practices Liability Insurance*, https://www.nationwide.com/business/insurance/employment-practices-liability/.
[93] *See, e.g.*, Joan T.A. Gabel et al., *The Peculiar Moral Hazard of Employment Practices Liability Insurance: Realigning the Incentive to Transfer Risk with the Incentive to Prevent Discrimination*, 20 NOTRE DAME J. L. ETHICS & PUB. POL'Y 639. 641 (2006) (stressing that employers' moral hazard "is particularly troubling given the way in which the law has come to specifically protect employees by emphasizing that employers actively engage in prevention."). *But see* Francis J. Mootz III, *Insurance Coverage of Employment Discrimination Claims*, 52 U. MIAMI L. REV. 1, 78 (1997) (arguing that despite the "dubious motivation" behind acquiring EPL insurance, insurer involvement might actually reduce the risk of discrimination).
[94] *See* Erin E. Meyers & Joni Hersch, *Employment Practices Liability Insurance and Ex-Post Moral Hazard*, 106 CORNELL L. REV. 947, 950 (2021).
[95] *Id.*, at 972-74.
[96] *Id.*, at 962.
[97] *Id.*, at 965.
[98] *Id.*, at 949.
[99] *Id.*
[100] *Id.*, at 950.
[101] *Id.*, at 974-77.
[102] *Id.*, at 950-51.

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

The immediate question that follows is what singles out deliberate from unintentional practices. Specifically, why do insurers vigorously operate to eliminate moral hazard in cases of unwilful employer actions, yet completely fail to induce adequate business' reaction to wrongs in which executives took active part? If EPL insurers work so well in motivating employers to properly handle EPL-related claims, how come Harvey Weinstein's deeds remained covered up for decades? Meyers and Hersch point to a surprising explanation, which pertains to uncertainty regarding the legal enforceability of the insurance contract.[103] Since insurance law regularly limits actors' ability to secure coverage against intentional wrongs—and in many cases prohibits such practice altogether[104]—the expected loss confronted by insurers in case of EPL harms that originate from employer-facilitated wrongs becomes paradoxically lower.[105] The reason is that plaintiffs who sue for damages against an employer-facilitated wrong, confront the threat that courts would invalidate insurance coverage.[106] This plausible contingency attenuates their bargaining power and allows insurers to extract settlements for lower-than-deserved payments.[107] Because courts lack coherent jurisprudence on the validity of such insurance contracts, the practice of insuring against employer-facilitated wrongs becomes lucrative: insurers receive premiums from businesses, but when harm is caused by the employer, the insurer only covers it partially.[108] In short, due to the uncertainty that surrounds the validity of such agreements, less is at stake for insurer—in terms of both revenues and losses. This reduces its incentives to engage in loss-preventing activities at a desirable level.[109] The vague validity laws thus result in the insurer externalizing part of the loss onto victims. In a separate project, I offered an economic model explaining those dynamics—whereby insurers underinvest in monitoring for knowing that third parties would bear part of the loss—and termed it "insurer moral hazard:"[110] basically, an inverse phenomenon is created, so that the insurer is partially insured by potential victims, and therefore, fails to exert optimal risk-reducing effort.[111]

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[103] *Id.,* at 974-77.
[104] *Id.*, at 949.
[105] *Id.,* at 974-77.
[106] *See generally id.*
[107] *See generally id.*
[108] *See generally id.* For an early review of courts' validity decisions see Sean W. Gallagher, *The Public Policy Exclusion and Insurance for Intentional Employment Discrimination*, 92 MICH. L. REV. 1256 (1994).
[109] Meyers & Hersch, *supra* note 94 at 974-77.
[110] *See* Roy Baharad, *Deterrence by Insurance*, J. LEGAL STUD. (Forthcoming, 2024).
[111] *Id.*

This brings us to the related question of solvency. Even though EPL cases typically involve large-scale entities and major corporate actors,[112] they might occasionally introduce plaintiffs with a judgment-proof employer. Meyers and Hersch's review briefly addresses this point when highlighting that insurers have acquired a stronger bargaining position by dint of "[t]he combination of Weinstein's apparent bankruptcy and the insurers' threat of disputing coverage."[113] So, it is unclear whether the securance of injurer solvency enhances reliability in the context of EPL. On the one hand, in cases where insolvency is a viable concern, insurance does provide some assurance of compensation. On the other hand, since there is a nonnegligible likelihood that courts would invalidate coverage on account of the act in question being intentional, the insurer could exploit uncertainty and force plaintiffs into settlement for reduced damages.

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

First, as stated above, the insurer might take advantage in those instances and make victims accede to rather unfavorable settlements, lest insurance coverage would be invalidated altogether by the court. Second, and also noted previously, considering the fact that EPL insurance is mostly acquired by large-scale businesses and corporations,[114] insolvency should not normally be a major concern compared to, say, cases of automobile or mortgage insurance.[115] Third, relating to the abovementioned point on the economic tenet of "perfect compensation," it seems that individuals' tendency to avoid harms ex ante instead of suffering them and recovering damages ex post is particularly apt in EPL cases. This tendency is most natural considering the disadvantages that plaintiffs appear to face in lawsuits against employers in discrimination cases—the focal point of EPL. As Professors Sandra Sperino and Suja Thomas report:[116]

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

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[112] *See* Meyers & Hersch, *supra* note 94 at 960-61.
[113] *Id.*, at 977.
[114] *Id.*, at 960-61.
[115] *See, e.g.*, Gilles, *supra* note 50 at 615, 664 (naming both auto and mortgage insurance as an instrument for assuring solvency).
[116] SANDRA F. SPERINO & SUJA A. THOMAS, UNEQUAL: HOW AMERICA'S COURTS UNDERMINE DISCRIMINATION LAW 4 (2017).

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

The main conclusion as to employer-facilitated harm is that even the single contributor to reliability—the avoidance of a judgment-proof employer—is eclipsed by the perverse incentives insured businesses as well as insurers themselves seem to have. In this respect, EPL insurance appears to impair reliability, meaning that potential job candidates are better off working for an uninsured employer. But things might change in the foreseeable future. Referring to the Betterley Report, a project providing annual overviews of the EPL insurance market, Meyers and Hersch assert that EPL insurers increasingly exit the entertainment market on account of the risk they introduce in discrimination suits induced by the #MeToo movement.[118] The market may thus converge into a new equilibrium in which the presence of insurance is a stamp of reliability, signaling job candidates that an insured workplace is safer, whereas uninsured ones pose increased risk of discrimination, which therefore prompted insurers' reluctance to provide coverage. Table 4, below, summarizes existing evidence.

Table 4. The Effect of Workplace Liability Insurance on Reliability

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

D. *Professional Liability Insurance*

Begin with medical malpractice insurance. Scholars have been resonating with the argument that liability for medical malpractice enhances the quality of care provided by physicians,[120] but more important for the purposes of our discussion, retains the credibility that patients ascribe to doctors and enhances trust in modern medicine in general.[121] Some commentators do not seem to find insurance as antithetic to doctors' "right to be sued" for medical malpractice. According to Professors William Sage and Kristen Underhill, contemporary malpractice

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

[118] *Id.*

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

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

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

insurance is institutionalized—rather than individually-purchased—and serves as an effective regulator of riskiness.[122] As an anecdote that could perhaps qualify as a compelling testimony, the authors note that the Physician Insurers Association of America has recently rebranded itself, presently going by The Medical Professional Liability Association and "broadening its reach to include new types of risk bearing such as captive insurers, risk retention groups, and institutional self-funding."[123] Sage and Underhill likewise contend that the threat of premium increase in case of negligence serves as deterrent device, implying that insurance retains the objective of malpractice liability rather than undermines it.[124] This outlook highlights the governance role of insurance, and especially when coupled with the favorable trait of insurance as ensuring physician solvency in case of actual malpractice, it points to its reliability-enhancing role.[125]

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

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[122] *Id.*, at 315 ("Individual physicians working as small businesspeople who purchase their own malpractice insurance is a fading model for good reason. That model fails the basic tests of financial sustainability, responsible governance, and health system science.").
[123] *Id.*
[124] *Id.*, at 316.
[125] *See, e.g.*, Kathryn Zeiler et al., *Physicians' Insurance Limits and Malpractice Payments: Evidence from Texas Closed Claims, 1990-2003*, 36 J. LEGAL STUD. 9, 39 (2007) (attesting that "[m]any doctors have limited wealth, [...] or use asset protection strategies to insulate their wealth[.] One cannot squeeze blood from a stone....").
[126] *See* Baker & Swedloff, *supra* note 28 at 1434.
[127] *See, e.g.*, Michelle M. Mello & Troyen A. Brennan, *Deterrence of Medical Errors: Theory and Evidence for Malpractice Reform*, 80 TEX. L. REV. 1595, 1616 (2002) (noting that the existence of malpractice liability insurance "dampens incentives for taking safety precautions," and that due to insurance "the deterrent effect of malpractice litigation is greatly blunted."). *See also* Ronen Avraham & Max M. Schanzenbach, *The Impact of Tort Reform on Intensity of Treatment: Evidence from Heart Patients*, 39 J. HEALTH ECON. 273 (2015) (noting that imposing limitations on doctors' personal liability by capping damages has led them to choose riskier treatments).
[128] *Supra* note 54.
[129] *See* Daniel P. Kessler, *Evaluating the Medical Malpractice System and Options for Reform*, 25 J. ECON. PERSPS. 93, 95 (2011).
[130] *Id.*
[131] *Id. See also* Parchomovsky & Stein, *supra* note 54 at 545 (describing doctors' evidentiary considerations when choosing to engage in defensive medicine).

insurance premiums if a harm ever occurs as a central reason.[132] This lends real-world support to the hypothesis that the regulatory role of insurance, while eliminating moral hazard, might equivalently undermine reliability by encouraging excessive carefulness among the insured.[133]

The analysis is not confined to physicians as individuals. In the last decade, some hospitals across the country have decided to deliberately avoid malpractice coverage.[134] The subsequent suspicion is that this is a strategic decision to self-impose insolvency, and there are good reasons to believe this narrative. First, insurance executives submit that in general, "the uninsured hospitals are in areas where juries award big judgments."[135] This obviously raises the expected loss that may be caused by malpractice, which in turns raises insurance premiums and enhances policy burdens, making it more lucrative for hospitals to deflate their solvency rates. Second, and relatedly, it has been reported that the choice of going uncovered—"naked" or "bare," in the common jargon[136]—is not completely voluntary. In New York City, for example, the decision to forego coverage might emanate from multiple malpractice insurers' exiting the market exactly on account of a rise in the number of claims.[137] This indicates insurers' perception of increased riskiness of medical malpractice and, simultaneously, reduces competition in the liability insurance market, raising the prices of policies and again rendering insurance less attractive to hospitals. Finally, it seems that as in the case of D&O insurance, uninsured hospitals—if indeed perceived as less reliable—might lose consumers to insured ones, but such market reaction is less likely considering the fact that, at least in New York City, disclosure of the absence of insurance is not required.[138] Commentators have come to conclude that hospitals devoid of coverage is "a sign of […] trouble."[139]

Others have nonetheless adopted the opposing vantage point. It has been argued that when hospitals are required to pay overwhelmingly high premiums—which are not affected merely by insurers' adjustments to the industry's riskiness, but also by exogenous constraints such as the competitiveness of the liability insurance market[140]—this would inevitably come at the expense of consumers, maintaining that the ultimate choice might be between "pay[ing] for nurses versus fund[ing] for

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

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

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

[135] *Id.*

[136] *Id.*

[137] *Id.*

[138] *Id.*

[139] *Id.*

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

malpractice."[141] This implies that the lack of insurance might benefit some patients after all. It is perhaps for this reason that the trend of avoiding coverage is also observable among hospitals that are capable of covering their liabilities—hospitals for which the strategy of designed insolvency does not apply.[142]

Thus, in the world of medical malpractice liability insurance, the evidence points to the entire panoply of reliability-enhancing and reliability-weakening factors, which ultimately obfuscates the overall effect on credibility. We might still have an intuitively strong preference toward being treated by an insured, rather than an uninsured, physician or hospital. This sense presumably emanates from compliance with customary practice. As opposed to EPL insurance that is not widely prevalent,[143] medical malpractice liability insurance is omnipresent, regarded as "a standard safeguard across the country."[144] In this reality, any deviation from standard practice might signify idiosyncrasy at best and shadiness at worst, which would presumably deter risk averse parties—mainly patients—who are reluctant to roll the dice when it comes to their health.

Next, consider legal malpractice. Although evidence is less abundant than in the area of physicians,[145] lawyer insurance seems to portray the very same landscape, unfolding the entire array of reliability-increasing and reducing factors. To begin, at least in certain cases, insurance is definitely useful in ascertaining solvency. In this vein, some have noted that solo and small-firm lawyers are hardly ever sued after alleged malpractice.[146] Specifically, experienced lawyers who specialize in malpractice suits are often reluctant to take the case exactly because those practitioners are typically uninsured,[147] thus lacking the financial wherewithal required for paying damages. Insurance is likewise perceived as advantageous in terms of regulating attorneys' riskiness. Professors Tom Baker and Rick Swedloff's comprehensive overview of the industry indicates that legal malpractice insurers exhibit impressive competence in adjusting prices to risks, and employ various regulatory techniques to avert moral hazard among insured lawyers.[148] These efforts notwithstanding, others keep expressing concerns of lawyer moral hazard which would, of course, come at the expense of clients.[149] The problem of "defensive lawyering" has likewise been acknowledged, and contributors have

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[141] Hartocollis, *supra* note 134.
[142] *Id.*
[143] *See* Meyers & Hersch, *supra* note 94 at 961.
[144] Hartocollis, *supra* note 134.
[145] *See* Baker & Swedloff, *supra* note 28 at 1438 ("[T]here has been much less research on legal malpractice than on medical malpractice….").
[146] *See, e.g.*, Leslie C. Levine, *When Lawyers Screw Up*, 32 GEO. J. LEGAL ETHICS 109, 113 (2019) (reviewing HERBERT M. KRITZER & NEIL VIDMAR, WHEN LAWYERS SCREW UP: IMPROVING ACCESS TO JUSTICE FOR LEGAL MALPRACTICE VICTIMS (2018)) (noting that in such cases, malpractice lawyers would not take the case as they "know that even if a case is meritorious, they will not receive their contingent fee because there will be no money to pay the judgment.").
[147] *Id. See also* Baker & Swedloff, *supra* note 28 at 1439 ("Some insurers will not write insurance for small firms and solo practitioners.").
[148] Baker & Swedloff, *supra* note 28 at 1440-45.
[149] *See, e.g.*, George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 321-22 (describing lawyers' moral hazard due to legal malpractice insurance).

particularly pointed to lawyers' need of frequently reporting to their insurer as a central cause of such practice.[150]

The results on reliability may ultimately pull in each direction. In legal malpractice insurance, too, abidance by custom in acquiring insurance might thus be the most effective tool in ultimately telling harmful from benign actors. Table 5 concludes this Section.

Table 5. The Effect of Professional Liability Insurance on Reliability

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

E. *Products Liability Insurance*

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

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[150] *See, e.g.*, Gary A. Grasso, *Defensive Lawyering: How to Keep Your Clients from Suing You*, 75 ABA J. 98, 98 (1989) (explaining how insurance carriers contribute to lawyers' decision to engage in "defensive lawyering").
[151] Although the negative effects are mutually contradictory, evidence indicates both of them in different contexts.
[152] *See generally* Akerlof, *supra* note 5. 489-92.
[153] *Id.*, at 489.
[154] *Id.*, at 489-92. For the sake of accuracy, Akerlof's main focus is warranty, framed as "guarantee." *Id.*, at 499. Warranty is tantamount to liability in our discussion.
[155] *Id.*, at 489-92.
[156] *Id.*
[157] *Id.*, at 499.

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

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

> "Products liability insurance is underwritten on a company-specific basis rather than a group basis. Products liability insurers have much at stake in the actuarial experience of each of their insured manufacturers, and so they collect detailed information about how the product is designed, inspected, and manufactured, what types of quality controls and manufacturing standards the insureds have in place, whether parts used in the production process contain dangerous inputs, whether those parts are warranted by suppliers, and much more. [...] These information inputs are then used by the insurers not only in pricing products liability policies, but also in training manufacturers on how to reduce their liability exposure. Insurers inquire as to whether the manufacturer is in compliance with international and domestic standards of design and production, and advise them regarding how to protect against malicious tampering, how best to label products to minimize the risk of accidents, and even when and how to issue recalls."

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

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[158] *See generally* Mark Geistfeld, *Manufacturer Moral Hazard and the Tort-Contract Issue in Products Liability*, 15 INT'L REV. L. & ECON. 241 (1995)
[159] *See generally id.*
[160] *See generally* Ben-Shahar & Logue, *supra* note 20.
[161] *Id.*, at 218-19.
[162] *See id.*
[163] *Id.*, at 244.
[164] *Id.*

them are just too small to care about the reputational damage that an injured consumer may cause them.[165] Liability insurance is the answer. Table 6 summarizes.

Table 6. The Effect of Products Liability Insurance on Reliability

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

F. *"Externality" Liability Insurance*

Thus far, the analysis has concentrated on cases that involve business counterparties who engage in a (direct or indirect) contractual relationship with the insured. But in many instances, liability insurance is not purchased against harms that injurers may inflict on counterparties as part of a business relationship—such as investment, negotiations, employment or the consumption of goods and services—but rather, for a loss they may cause to society at large. Two cases in point are failure to pay taxes and the emission of pollutants. The reason that tax liabilities and environmental harms are normally subject to public, regulatory scrutiny rather than private enforcement via the tort system is that typically, there are no victims who suffer sufficient individual harm that would justify their initiation of a suit.[167] Tax avoidance, for example, causes meager harm to each citizen individually, but constitutes potentially major collective loss to society as a whole.[168] Similarly, pollution of the public domain surely upsets each subject personally, but presumably not enough for her to be willing to pursue costly litigation against the polluter.[169] In those externality cases, the counterparty that injurers ordinarily confront is the regulator, which raises the question of whether government agencies should scrutinize insured injurers more or less intensely, depending again on the overall effect that insurance has on reliability.

Begin with tax liability insurance. The concept might sound perplexing but is surprisingly common among taxpayers.[170] Uncertainty is a widely recognized hallmark of the tax system.[171] The fact that tax reality is rife with ambiguity generally

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[165] *Id.*

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

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

[168] *See* A. Mitchel Polinsky & Steven Shavell, *The Theory of Public Enforcement of Law*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 403, 405 (A. Mitchel Polinsky & Steven Shavell, eds., 2007) (naming tax enforcement as a conventional form of public enforcement, and then justifying such enforcement using this argument).

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

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

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

hinders economic efficiency, as nebulousness poses major barriers against business transactions and commercial initiatives, even to the extent of thwarting them altogether.[172] Alas, in terms of policy measures, there is not much to do about tax law obscurity: formulating a comprehensive code that preempts all contingency in advance is an impossible mission, and the Internal Revenue Service (IRS) is generally reluctant to issue case-specific advance rulings that would shed clarity on the tax position taken in the transaction at hand.[173]

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

But even if private insurers manage to avert moral hazard—i.e., combat undercompliance with tax law—this does not imply that they necessarily incentivize taxpayers' *optimal* compliance. Not unlike the case of defensive medicine, there are good reasons to suspect that if private insurers indeed wish to minimize the loss associated with tax liability, they may channel certain taxpayers—especially those already predisposed to risk aversion—toward excessive prudence that manifests in overcompliance with tax law.[181] Overcompliance is a well-established problem in the law and economics of tax.[182] Individuals and businesses

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[172] Logue, *supra* note 171. *See also* Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 139 (2009) ("Uncertain tax consequences deter some taxpayers from carrying out contemplated transactions, while others, who do carry out the transactions, bear the risk of potential loss.").
[173] *See, e.g.*, Ben-Shahar & Logue, *supra* note 20 at 227.
[174] *See* Logue, *supra* note 171 at 395.
[175] *Id.*
[176] *Id.*, at 412 ("Insurance companies are especially adept at combating adverse selection and moral hazard.").
[177] *Id.*, at 387.
[178] *Id.*, at 390.
[179] *Id.*, at 388.
[180] Ben-Shahar & Logue, *supra* note 20 at 227.
[181] *See* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966 (1984) (establishing the problem of overcompliance with uncertain legal standards).
[182] *See, e.g.*, Jean-Louis Arcand & Grégoire Rota Graziosi, *Tax Compliance and Rank Dependent Expected Utility*, 30 GENEVA RISK & INS. REV. 57, 57-59 (2005) (describing the problem of tax overcompliance); Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX REV. 241, 295 (2007) (arguing that risk averse taxpayers "would have a tendency to over-comply....").

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

Things are different with environmental liability insurance. Another type of "externality" coverage, environmental liability insurance pertains to legal ramifications of various environmental harms caused by industry participants.[185] Chief among them is the cost of cleanup and restoration, which commentators have framed as sometimes insurmountable.[186] This brings us to the first and foremost value of insurance in the context of environmental liability, which is the assurance of solvency.[187] Absent any ability to bear the costs of harm-elimination, regulators would confront the familiar judgment-proof firm problem discussed above. Insurance provides an easy wat out of this scenario. Moreover, there seems to be a broad consensus regarding the ability of insurers to minimize moral hazard by insured firms.[188] Environmental liability insurers are argued to occupy a regulatory role against environmental risks, outperforming tort or criminal liability which might fail to do so efficiently. For instance, because some environmental harms remain latent for a long time before uncovered, ex-post liability might fail to achieve optimal deterrence: the procedural factfinding process is encumbered, and penalties are at best procrastinated and at worst never even imposed.[189] Wrongdoers would oftentimes prefer to trade off the present benefit from polluting for an obscure, uncertain sanction they may suffer in the future.[190] The moral hazard arguments that theorists have unfolded against the institution of environmental liability insurance at its inception,[191] at present pales against the overwhelming evidence on its ability to eliminate excessive riskiness. Finally, and as opposed to tax insurance, there is neither explicit nor implicit evidence of inducing excessive compliance.

In the environmental liability realm, then, the reliability-enhancing effects of insurance apparently dominate, and the effect is unclear in the context of tax. The question of pertinence in terms of reliability in "externality" insurance concerns

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[183] *See, e.g.*, Givati, *supra* note 172.
[184] Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1649-50 (2009).
[185] Ben-Shahar & Logue, *supra* note 20 at 225.
[186] *Id.*
[187] *See generally id* (describing the judgment-proof problem in the context of environmental liability, pointing out that "firms are often insufficiently capitalized to pay for [...] environmental costs....").
[188] *Id.* (arguing that environmental liability insurance is a "striking example[] of how insurance minimizes rather than exacerbates moral hazard problems…."). *But see* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 955-56 (1988) (warning against legal fluctuations toward uncertain environmental law that may undermine the regulatory function of insurance).
[189] Ben-Shahar & Logue, *supra* note 20 at 225.
[190] *See, e.g.*, Tomoya Tajika, *Concealment as Responsibility Shifting in Overlapping Generations Organizations*, 38 J. L. ECON. & ORG. 511, 512-14 (2021) (describing organizational incentives to procrastinate any corrective action against potentially tortious failures).
[191] *See, e.g.*, Abraham, *supra* note 188 at 945-49.

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

In summary, crafting the right policy response to insurance depends on various factors, including how risk aversion is spread among market participants and their desire for insurance coverage. However, the primary consideration is whether insurance strengthens or weakens the reliability of insured parties in the view of regulatory entities, namely, whether it leads to excessive or insufficient compliance. This distinction aids at predicting the outcome of requiring insurance or forcing disclosure. Table 7 concludes with respect to tax and environmental liability insurance.[192]

Table 7. The Effect of "Externality" Liability Insurance on Reliability

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

G. *Defamation Liability Insurance*

The final insurance industry discussed here is the one of defamation coverage. Defamation liability insurance is rather understudied in academic literature, but has recently garnered the attention of popular press due to its involvement in high-

[192] It bears emphasis that there are other types of liability insurance involving "externalities," for example automobile and police misconduct insurance. Those cases are unique in that insured parties may fail to account for the reaction of counterparties, as the nature of the interaction is compulsory and not mutually consensual. In M&A negotiations, for example, contracting parties' decision to insure largely depends on the prospective reaction of their counterparties, that is, on how they perceive reliability in the presence of insurance. Similarly, in the case of tax avoidance or environmental harm, individual victims normally lack sufficient incentives to react, but the regulator takes in instead. In the context of automobile or police misconduct, however, victims' response to insurance—the enhanced or reduced reliability they associate with policyholders—is just irrelevant in the eyes of potential injurers. Since counterparties do not directly interact with the insured, nor are they being replaced by a relevant regulatory authority that caters to the interests of the entire victim population, the role of reliability signaling is nullified. For the distinction see generally Baharad, *supra* note 110.

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

profile legal disputes. For example, after the Virginia court awarded actor Johnny Depp with $8.3 million in damages following a defamation suit against his ex-wife, actress Amber Heard, the latter one filed a suit against her insurance company, contending that her liability insurance policy covers defamation.[194] This sure sounds like a rare exception, but the phenomenon is not as uncommon as one might surmise. Bill Cosby, for example, has enjoyed AIG's coverage of his gargantuan legal expanses when sued for defaming women who accused him of sexual assault.[195] Bill Clinton was similarly covered when sued for defamation by Paula Corbin Jones, who accused him of sexual harassment and then suffered a slanderous denial by Clinton who framed her as a liar.[196] Former baseball pitcher Roger Clemens likewise aided defamation insurance when confronted a defamation lawsuit by a former trainer.[197]

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

But things get more intriguing when accounting for the fact that media outlets—whose entire business operation is predicated on the credibility of the information they communicate to the public—are covered as well, in part of their professional error and omission insurance policy.[201] In her coverage of the Clinton saga, then-Fox host Greta Van Susteren was wondering "[h]ow is it that someone has insurance to cover a defamation claim? […] I mean, where do you buy that, or how do you get that?"[202] Fair questions. Van Susteren, then, would surely be surprised

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[194] Erin Mindoro Ezra, Jamie L. Rice & Tyler J. Angelini, *How Insurance Plays into the Johnny Depp v. Amber Heard Defamation Trial*, REUTERS (Feb. 10, 2023), https://www.reuters.com/legal/legalindustry/how-insurance-plays-into-johnny-depp-v-amber-heard-defamation-trial-2023-02-10/.
[195] *See* Graham Bowley & Sydney Ember, *To Defray Legal Costs in Defamation Suits, Bill Cosby Turns to His Insurance*, N.Y. TIMES (Mar. 13, 2016), https://www.nytimes.com/2016/03/14/arts/television/to-defray-his-legal-costs-in-defamation-suits-cosby-turns-to-his-insurance.html.
[196] *Id.*
[197] *Id.*
[198] *See, e.g.*, Baumann v. Elliot, 286 Wis.2d 667 (2005); Grange Ins. V. Lintott, 77 F. Supp. 3d 926 (2015); Hearst Corp. v. Hughes, 297 Md. 112 (1983); Moss v. Stockard, 580 A.2d 1011 (1990); Rozanski v. Fitch, 113 A.D.2d 1010 (1985).
[199] *See* Bowley & Ember, *supra* note 195.
[200] *Id.*
[201] *See* Mae Anderson, *Fox Probably Won't Pay Anything Near $787.5 Million for its Settlement with Dominion Voting Systems*, FORTUNE (Apr. 24, 2023), https://fortune.com/2023/04/24/fox-7875-million-settlement-dominion-voting-systems-insurance-tax-deductions/ (noting that defamation liability insurance is part of media liability insurance); Medial Liability Coverage, IRMI https://www.irmi.com/term/insurance-definitions/media-liability-coverage (explaining that media liability insurance is part of error and omission insurance).
[202] Bowley & Ember, *supra* note 195.

to hear that defamation insurance is no stranger to Fox News itself. Most recently, Fox has settled a defamation lawsuit brought against it by Dominion Voting Systems, upon accusations of rigging the 2020 presidential election.[203] Per sources, at least a substantial part of the unprecedented amount—$787.5 million—had been paid by insurers.[204] And to be sure, Fox by no means deviates from industry standards here. In a famous defamation case brought by Disney against ABC network following publications that casted doubt on food safety, AIG paid part of the settlement on behalf of ABC.[205] Likewise, despite the competition between the two, CNN's report of Fox's settlement was honest enough to admit that "media companies typically have insurance that would cover defamation payouts."[206]

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

From a theoretical standpoint, contributors would presumably agree that the answer is affirmative. For example, in a recent study, Professors Daniel Hemel and Ariel Porat conceptualize defamation liability as a legal mechanism that advantages truthful speakers.[209] To plainly illustrate this point, Hemel and Porat depict the counterfactual: in a world without defamation liability, actors are devoid of any feasible way of reliability stating accusations against others—they are bereft of the ability to substantiate credible commitment.[210] In game-theoretic parlance, their statement is nothing but "cheap talk."[211] Indeed, without defamation liability, it costs nothing for Alice to assert that Bob is corrupt. But when individuals are categorically liable for false statements, this cheap talk turns into a "signal," that is, a message accompanied with cost to the speaker if proven false, which is therefore

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

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

[205] Anderson, *supra* note 201,

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

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

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

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

[210] *Id.*, at 69.

[211] *Id.*

more credible.[212] With insurance, however, such a cost is not incurred by the speaker, implying that the credible commitment problem should resurface on account of prospective moral hazard—in the Dominion case, by Fox.

But then again, it could be argued that insurance provides an additional layer of regulatory oversight, ensuring that factual statements have been well-verified by media outlets before publication. So much so, that the scant evidence that exists with respect to defamation insurance actually points to the mirror-image problem: insurers subject journalists to an excessive level of verification effort, and following major libel cases, publications have reportedly "had to scramble for [publishers to receive insurance] coverage."[213] While we might intuitively think of the acquisition of defamation insurance as trading off reliability for the reduction of economic losses, reality confronts us with an inverse concept: with insurance as a supplementary regulator, media outlets essentially impose more substantial constraints upon publication in order to guarantee coverage. This excessive kind of "insurance as governance" might well be socially undesirable: while bolstering the reliability of statements that *are* published, it also eliminates statements that are highly likely to be true, implying excessive prudence and underprovision of relevant information to the public. In so doing, insurance might reinforce and even exacerbate the chilling effect that scholars have historically associated with defamation liability.[214]

Defamation insurance is a fascinating topic that has yet to receive its well-deserved academic attention. Sporadic treatments have raised contradictory concerns of moral hazard—overprovision of insufficiently verified information—as well as for excessive care due to insurer monitoring, which results in avoiding publication of sufficiently verified statements.[215] Besides, it should be noted that the solvency-assurance virtue of insurance should play no role in the context of defamation. We typically discuss the grave concern of a judgment-proof injurer when the relevant counterparty *is also the victim* of a potentially risky behavior. With defamatory publication, however, the credibility-demanding counterparty is the audience, not the subject of publication that seeks compensation and thus largely cares about solvency. All is encompassed by Table 8, below.

Table 8. The Effect of Defamation Liability Insurance on Reliability

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

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

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[212] *Id.*, at 68. *See also* Yonathan A. Arbel & Michael D. Gilbert, *Truth Bounties: A Market Solution to Fake News*, 102 N.C. L. REV. 509, 545 (2024) ("Knowing that lies get punished increases trust in information.").
[213] Michael Massing, *Libel Insurance: Scrambling for Coverage*, 24 COL. JOURNALISM REV. 35, 35 (1986).
[214] For some prominent accounts see, e.g., David A. Anderson, *Libel and Press Self-Censorship*, 53 TEX. L. REV. 422 (1975); Frederick Schauer, *Fear, Risk and the First Amendment: Unraveling the Chilling Effect*, 58 B.U. L. REV. 685 (1978).
[215] Massing, *supra* note 213.

III. OPTIMAL POLICY RESPONSES

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

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

A. *Perfectly Functioning Markets*

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

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

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

the burden of eliminating risks will be incurred by the lowest-cost avoider, which manifests by the price system.[218]

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

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

B. *Imperfectly Competitive Markets*

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

Defamation is another case-in-point. It is possible that audiences should and would have rewarded media outlets that go "bare" and subject themselves to defamation

[218] *See generally* Coase, *supra* note 10.
[219] *Supra* notes 98-111 and accompanying text.

liability for any false publication. But considering the market concentration of mainstream media outlets and the fact that acquiring defamation insurance has become a common practice among them,[220] there is little incentive to deviate from the standard practice of getting insurance and call out the problems coupled with defamation coverage, be it for motivating false publications by affording moral hazard or for discouraging even true publications by channeling media outlets toward excessive care.

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

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

The problem is that raising the stakes would only aid against moral hazard, but is rather counterproductive in cases where insurance incentivizes excessive care. So, a more general solution—which at once addresses the opposite problems of insufficient prudence (moral hazard) and excessive care—would involve the imposition of regulatory limitations on insurance contracts, primarily by mandating minimum deductibles, known as "coinsurance."[222] Maintaining deductibles above

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

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

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

the rate set by the market would admittedly lower the stake of insurers in any prospective harm. Accordingly, it would attenuate their incentives to monitor the insured's behavior. But there are two major upsides that may well offset this apparent drawback. First, it would likewise reduce the possible adverse implications of "insurance as governance," the ones leading to excessive prudence,[223] chilling effects on socially beneficial publications,[224] defensive medicine and lawyering,[225] tax overcompliance,[226] and more. Second, the decline of incentives to monitor would be counterbalanced by an increase in the insured's private incentive to exercise care, for internalizing a larger part of the expected loss that her risky activity creates. For this reason, Meyers and Hersch support the adoption of such legislative intervention in EPL insurance contracts, as present policies regularly feature zero risk sharing by the insured.[227] At core, mandating a minimum deductible rate is tantamount to setting a *partial ban* on insurance—requiring that insurance would not fully cover the injurer, for knowing that this might create perverse effects in uncompetitive market settings.

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

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

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[223] *See generally* Part II.
[224] *Supra* Section II.G.
[225] *Supra* Section II.D.
[226] *Supra* notes II.F. and accompanying text.
[227] Meyers & Hersch, *supra* note 94 at 979.
[228] *Supra* notes 145-148 and accompanying text.
[229] Hartocollis, *supra* note 134.
[230] *Id.*
[231] *See, e.g.* Leslie C. Levin, *Lawyers Going Bare and Clients Going Blind*, 68 FLA. L. REV. 1281 (2016) (arguing that mandated disclosure requirements generally fail to reach desirable outcomes and calling for compulsory legal malpractice insurance).
[232] Jason Metz, *How to Get Product Liability Insurance*, FORBES (Feb. 14, 2024), https://www.forbes.com/advisor/business-insurance/product-liability-insurance/.
[233] *See, e.g.*, Avraham & Gilo, *supra* note 140.

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

C. *Uninformed Markets*

The final set of circumstances in which insureds are inadequately punished or rewarded by market forces involve, of course, cases where counterparties are oblivious to the existence of insurance or its absence. This could emanate from counterparties' naivety or unsophisticatedness, from the cost or effort entailed in acquiring such information, or from the potential injurer's deliberate obscurity. Job candidates, for instance, might be insufficiently aware of the institution of EPL insurance and its potential to increase risk, and therefore fail to ask about it or otherwise make an adverse inference against an insured employer. Most consumers are probably ignorant as to whether the seller of the product they have just purchased is insured against products liability, and regrettably, so as many patients receiving health treatments.[237] And, sure enough, Fox News were utterly reluctant to reveal insurance policies that apply to the Dominion case.[238]

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

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[234] *See, e.g.*, Peter Siegelman, *Information and Equilibrium in Insurance Markets with Big Data*, 21 CON. INS. L.J. 317, 332 n. 42 (2014) (explaining that uncompetitive insurance markets are characterized with premiums priced above the actuarily fair level).
[235] Hartocollis, *supra* note 134.
[236] *See, e.g.*, Abraham, *supra* note 28 at 673 ("In many settings the insurance market is highly competitive, and in any event certainly does not resemble the classic natural monopoly that characterizes public utilities.").
[237] Hartocollis, *supra* note 134.
[238] Morrow, *supra* note 206 ("[D]etails of Fox's coverage aren't known."); Snodgrass, Atkinson & Shamsian, *supra* note 204 (reporting that Fox News "declined to answer [...] questions on their libel insurance.").

The voluntary disclosure analysis might sound compelling, but is critically predicated on the dubious assumption that counterparties actually draw adverse inference from the *lack* of disclosure. Literature on behavioral law and economics have long debunked this premise as unrealistic.[239] It seems that in the absence of insurance-related disclosure, many counterparties—those who are not especially legally oriented or commercially sophisticated—would not draw an adverse inference, but may simply fail to pay attention to the aspect of insurance despite its possible pertinence to the relevant transaction. For this reason, some states require lawyers to notify clients if they do *not* have malpractice insurance coverage.[240] This is structured on the understanding that clients do not possess enough knowledge or awareness to positively ask,[241] *a fortiori* to draw an adverse inference from the fact that insured lawyers have an incentive to disclose that fact voluntarily. Thus, mandatory disclosure on avoidance of reliability-enhancing insurance—e.g., requiring relevant New York hospitals to disclose their decision to go "bare" to any patient—as well as on purchasing of reliability-reducing one (EPL insurance, for example), seems warranted in this regard.

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

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

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[239] A recent study on disclosure regime, for example, has compared mandatory warnings for low-quality products and a caveat emptor regime, under the assumption that the latter incentivizes sellers of high-quality products to engage in voluntary disclosure. The authors note that "[i]n a warning regime, an absence of warning tells buyers that the product is high quality" whereas "[u]nder a caveat emptor regime, an absence of high-quality disclosures reveals the product to be low quality." *See* Oren Bar-Gill & Omri Ben-Shahar, *Misprioritized Information: A Theory of Manipulation*, 52 J. LEGAL STUD. 305, 311 (2023). Importantly, however, the authors acknowledge that consumers' limited capacity to process information and draw rational inference from the *absence* of warnings or disclosure, undermines this conclusion. *Id.*, at 307.

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

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

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

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

soundly underscored. The required disclosure format must likewise guarantee that the presence or absence of insurance is brought to the counterparty's attention, to avert strategic bypasses by the mandate's subjects.[244]

This might not suffice though. As Ben-Shahar and Schneider contend, even the meticulously formulated *Miranda* warning fails to ascertain that individuals taken into custody are actually informed regarding their rights.[245] But in the context of insurance, the fundamental question is whether we really need each and every counterparty to properly understand the subject of disclosure in order for such a mandate to prove itself effective. Surprisingly, the answer could be negative. In a recent study, Professors Yonathan Arbel and Roy Shapira argue that sellers' and injurers' compliance with market norms is ordinarily enforced by a small subset of consumers and counterparties—those who care enough about providing public goods in the form of filing complaints, posting online reviews, reading consumer contracts—who they call "nudniks."[246] Nudniks are a blessing to regulators, especially in the context of mandatory disclosure.[247] If the objective is to keep counterparties informed of the potential consequences of insurance and allow them to punish certain purchasers or avoiders, then all it takes—according to Arbel and Shapira's full-fledged analysis—is to make sure that activist counterparties are sufficiently cognizant of the potential effects of insurance.[248] The core problem here is that at present, the insurance-reliability relationship is understudied in academic circles and underattended in popular debates. It would be sufficient if mandatory disclosure of insurance or lack thereof would permeate transactional reality and simply make individuals notice. This change alone can put the insurance-reliability relationship to the epicenter of legal discourse.

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

D. *Caveat*

When devising a policy measure, such as compulsory insurance or mandated disclosure, one must account for the market's entire reaction to this step and

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[244] *See, e.g.*, Levin, *supra* note 231 at 1299-1302 (noting how lawyers readily overcome a disclosure requirement for the absence of insurance by, for example, simply posting it on an official website).
[245] Ben-Shahar & Schneider, *supra* note 242 at 678.
[246] *See generally* Yonathan A. Arbel & Roy Shapira, *Theory of the Nudnik: The Future of Consumer Activism and What We Can Do to Stop It*, 73 VAND. L. REV. 929 (2020)
[247] *Id.*, at 951.
[248] *See generally id.*
[249] Bowley & Ember, *supra* note 195.

anticipate the *general equilibrium* toward which the relevant market converges.[250] While our objective is to extract the informational value of insurance—enhancing or undermining reliability—it is possible that this informational value would change *due to the chosen policy*. To see this concretely, consider the example of tax insurance. The main drawback that Logue associates with tax insurance is the following:[251]

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

To alleviate this justified fear, Logue proposes mandated disclosure. Specifically, Logue suggests to "compel taxpayers who purchase tax risk insurance from a private insurer to disclose that fact on their return."[252] This, in turn, would allow the IRS to decide whether to pay extra attention to insured taxpayers and perhaps adopt a new policy regarding audits directed against policyholders.[253] But this argument fails to account for the dynamics of the threefold of IRS, taxpayer, and insurer. If, as Logue suggests, tax insurers manage to effectively regulate taxpayer behavior and eliminate aggressive tax positions taken by policyholders, then the IRS has no reason to enhance the frequency of audits directed against insured parties, as the insurer does quite well in monitoring undercompliance. The resulting *reduced* likelihood of audited insureds might then, however, undermine insurers' extant incentives to regulate as intensely as before, thus reintroducing the problems of moral hazard and "detection insurance." On the other hand, if the IRS would increase the scrutiny of insureds, then insurers would likely react by engaging in more intense effort to enhance insureds' prudence, compelling policyholders to take even less aggressive tax positions and, potentially, exacerbating the problem of overcompliance. Logue does note that mandated disclosure to the IRS would inhibit the development of the tax insurance market, but states that "if there is strong demand for tax law uncertainty insurance—not just for detection-risk insurance—the market should survive and grow."[254] Yet such growth might, in the end of the day, reveal itself as socially harmful for only deepening insurers' desire to eliminate losses and, consequently, retain overcompliance among risk averse insureds.[255]

In conclusion, the appropriate policy reaction to the presence of tax insurance hinges on various factors, including the distribution of risk aversion tendencies among taxpayers and their demand for insurance. But first and foremost, it depends on whether insurance bolsters or erodes the reliability of insured taxpayers in the eyes of the IRS, namely, whether it induces over- or undercompliance. This

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[250] *See* Parchomovsky & Siegelman, *supra* note 19 at 124 (underscoring the need for a general equilibrium understanding of insurance-inhabiting markets).
[251] Logue, *supra* note 171 at 413.
[252] *Id.*
[253] *Id.*, at 400-01.
[254] *Id.*, at 414.
[255] *Supra* Section II.F.

would allow us to predict the consequences of mandatory insurance. At this point, however, there is no straightforward answer.

Moreover, those perverse outcomes might emerge even when we know which effect—the one that empowers or diminishes reliability—generally prevails. Consider the environmental liability realm, where the reliability-enhancing effects of insurance apparently dominate.[256] We might think of appropriate policy responses, for example mandatory insurance or, at the very least, disclosure requirements. But again, policy shift in light of reliability might ultimately channel the market toward a new equilibrium. To see why, suppose that, with the understanding that environmental liability insurers vigorously monitor the behavior of insureds and induce optimal conduct, all jurisdictions were to mandate such coverage. This might result in regulators' declining their supervision—basically exhibiting "regulatory moral hazard"[257]—which might eliminate insurers' incentive to monitor as intensely as they do at present, thus shifting toward reduced credibility. The same is true for mandatory disclosure of insurance, rather than compulsory coverage. As in the field of tax liability, the reliability effect of insurance might result in regulators concentrating enforcement effort against uninsured party, which again disincentivizes insurers to regulate optimally, as the a priori probability of loss declines.

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

CONCLUSION

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

Upon establishing this analytical framework, it examined various types of liability insurance, distinguishing those that impair reliability from those that strengthen it. This divergence stems from varying market characteristics, where some relationships are predominantly influenced by the credibility-eroding features of insurance, whereas others are governed more powerfully by its reliability-

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[256] *Supra* notes 185-191 and accompanying text.

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

enhancing powers. Drawing on this conceptual blueprint, the Article introduced the entire panoply of normative considerations that should be taken into account when tailoring appropriate policy responses to the intersection of insurance and reliability.