Unlocking Exchanges

Brendan S. Maher

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SYMPOSIUM

Unlocking Exchanges

Brendan S. Maher

Improving State Regulation of Homeowners Insurance: The Essential Protections for Policyholders Project

Jay M. Feinman
Top law firms are notoriously competitive, fighting for prime clients and matters. But some of the most elite firms are also deeply cooperative, willingly sharing key details about their finances and strategy with their rivals. More surprisingly, they pay handsomely to do so. Nearly half of the AmLaw 100 and 200 belong to mutual insurance organizations that require member firms to provide capital; partner time; and important information about their governance, balance sheets, risk management, strategic plans, and malpractice liability. To answer why these firms do so when there are commercial insurers willing to provide coverage with fewer burdens, we talked to dozens of people in large law firms and the insurance industry, including those at the notoriously secretive mutual insurers. We developed a unique, qualitative data set that sheds important, new light on the legal industry, insurance markets, and the mutual insurers that protect many large law firms from malpractice risks.

We show that many of the most elite firms prefer the mutuals, in part, because they help solve traditional insurance market failures like adverse selection, moral hazard, and long-term contracting. But this only tells part of the story. We also provide an important and novel autonomy explanation. Many lawyers prefer mutual insurance because they perceive that it promotes professional independence in the face of the social control imposed by liability and insurance.

Our data also reframes the traditional understanding of organizational forms in the commercial insurance market. Most prior literature describes mutual and stock insurers as competitors. We show that stock and mutual insurers play complementary and symbiotic roles. Mutuals

‡ William Maul Measey Professor of Law and Health Sciences, University of Pennsylvania Law School; Professor of Law, Rutgers Law School. Thanks to Kenneth Abraham, David Hoffman, John Rappaport, Dan Schwarcz, and Peter Siegelman for helpful comments and to participants in the law and economics workshop at Northwestern Law School, the faculty workshop at Penn Law School, the Liability and Insurance Seminar at Penn Law School, and the Insurance Section at AALS. Thanks also to Luman Yu for excellent research assistance.
help manage access to the powerful risk-distributing potential of stock insurance through reinsurance and excess coverage, thus creating mutual-stock hybrids. Further, we provide evidence that suggest that even outside of this relationship, mutuals favorably affect the behavior of stock insurers, indicating that these mutual arrangements produce positive externalities that benefit other lawyers and law firms in similar practice contexts.

I. INTRODUCTION

The top law firms in the nation are fierce competitors. High-paying clients and high-profile matters are a scarce and precious resource in the quest for prestige and ever-greater per-partner-profits. They are the key to the financial health of firms and the wealth of individual partners. Thus, it is only natural that firms regularly compete for matters and clients.

This should not be a surprising or contentious claim. What is surprising is that, despite this fierce competition, a large number of the elite firms in the nation are members of mutual insurance organizations. These organizations allow partners from each of the members to learn intimate details about each other, including their governance structures, financial health, risk management, strategic growth plans, and potential malpractice liability.1 Further, these mutual insurers require firms to devote significant senior partner time and money to participate in the making of their liability insurance. Firms that belong to mutual professional liability organizations contribute capital to, and have professionals that work on committees for, and attend meetings of their mutuals, despite the availability of commercial malpractice insurance that does not require law firms to make the same kind of commitments.

The extent of this mutual insurance presents a second puzzle. In contrast to commercial or stock insurers, which can access all the forms of capital available in the market, mutual insurers are owned wholly by their policyholders.2 As a result, mutual insurers cannot, on their own, distribute the risk of loss beyond their members, which should be a comparative

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1 See infra Part I.
2 We take a functional approach to what constitutes a “mutual” insurer, not an insurance regulatory approach, with the result that, for us, member-owned captive insurance companies, member-operated risk retention groups, and even member-operated risk purchasing groups all qualify as mutual insurers, subject to differences that we will highlight as appropriate.
disadvantage in the market. Because of their greater access to capital, stock insurers should be able to more fully and cheaply distribute risk and thus out-compete mutuals. Yet, mutual insurers not only continue to exist; they are thriving. In very rough terms, lawyers-only mutual insurers cover the malpractice risks of more than 40% of all lawyers practicing in firms in the United States with over 50 lawyers. The law firms that belong to these mutual insurers are an elite group, including about half of the 100 and 200 most profitable law firms in the U.S.

In this Article we use qualitative empirical research methods to better understand the comparative advantages of mutual insurers. In doing so we make five main contributions.

First, we provide previously unpublished detail on the mutual insurance organizations operating in the medium- to large-firm lawyers’ professional liability (LPL) market. These organizations are notoriously protective of their operations. Outside of a small group of LPL insurance brokers and reinsurers, and, perhaps, a few lawyers, no one else has the detailed information that we have collected. Further, the organizational details that are available in the public domain have never been the subject of the kind of comparative analysis we provide here, shedding new light on the risk management of many large law firms in this country.

Second, we critically evaluate and find evidence consistent with the prevailing “market failure” explanations offered for the presence of mutual

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3 Of course they can and do purchase reinsurance and, in theory, they could issue debt, but stock insurers can do so as well; and stock insurers can also sell equity.

4 See infra note 19 for how we made this calculation.

5 We determined the number of mutual insurers’ members in the AmLaw 100 and the AmLaw 200 by adding up the number of ALAS, BAR, MPC, and AIM members in the AmLaw 100 and the AmLaw 200, respectively. Compare Growth Falls Slightly, AM. L., Jun. 1, 2015, at 83, and A Healthy Gain, AM. L., May 1, 2015, at 146, with ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 2013 ANNUAL REP. 23 (2014) [hereinafter ALAS 2013 REP.], ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 2014 ANNUAL REP. 79–83 (2015) [hereinafter ALAS 2014 REP.], and List of BAR Members (confidential and incomplete list, on file with authors); List of MPC Members (confidential and incomplete list, on file with authors); List of AIM Members (confidential and incomplete list, on file with authors).

6 See also Rick Swedloff & Tom Baker, Insurers as Bumblebees in the Garden of Law Firm Norms (working paper 2016).
insurers in other contexts: adverse selection, moral hazard, and long-term contracting problems.7

Third, we present evidence of a previously unexplored autonomy explanation for the success of mutual insurers. We find the desire for professional independence to lie at the core of several of the most common reasons that the participants in the mutuals gave to us for preferring mutual insurance arrangements: long-term, stable insurance relationships; a peer-reviewed claims experience; and peer-based loss prevention.8 Many lawyers, and presumably doctors and other professionals, perceive that mutual insurance arrangements help them retain greater professional independence in the face of the social control that may be imposed by liability and liability

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8 See infra Part II.
insurance. This explanation dovetails with prior work describing autonomy and independence as animating principles of the legal profession.

Fourth, our findings significantly reframe the scholarly understanding of the relationship among organizational forms in the commercial liability insurance market. Corporate law and insurance literature typically views mutual and stock insurers as competitors, not complements. We show that, while there is spirited competition between

9 GEOFFREY C. HAZARD JR. & ANGELO DONDI, LEGAL ETHICS: A COMPARATIVE STUDY 146 (2014) (“A second norm of professional ethics, which for many lawyers would be the first principle, is independence.”).

10 E.g., id. at 146-47 (recognizing professional independence as one norm of lawyers’ professional ethics); RICHARD L. ABEL, AMERICAN LAWYERS 35 (1989) (“An essential foundation of structural functional theories of the professions is the belief that, if protected from outside interference, they will use their expertise for the general good.”); Susan P. Koniak, Law between the Bar and the State, 70 N.C. L. REV. 1389, 1450 (1992) (identifying nomic autonomy as one aspect of the bar’s nomos).

stock and mutual insurers and some ebb and flow in the relative market shares of the different kinds of organizations, the different organizational forms play complementary roles. 12 For example, the mutual insurers all purchase reinsurance from stock insurers (or from syndicates in the London market that have access to the same or similar equity markets as stock insurers), and most of the mutuals also arrange their members’ purchase of insurance from these commercial insurers for higher-level excess layers of protection. 13 Thus, the choice in the LPL insurance market is not between purely stock and purely mutual insurance, but rather between stock and mutual/stock hybrids, with the degree of mutualization differing among the hybrids that presently exist.

Finally, and perhaps most importantly, we provide a basis for concluding that lawyers’ participation in their mutual insurance organizations provides benefits for other lawyers and law firms engaged in similar kinds of legal practice. Just as the mutuals hybridized to provide the risk spreading offered by commercial insurers, so too have the commercial insurers adapted to compete with the mutuals. With the assistance of insurance brokers and other third-party service providers, the commercial insurers claim that they are now able to offer similar loss prevention services, similar quality claims services, and similarly stable, long-term relationships. Further we find that commercial insurers do so because they must to compete with the mutuals. Whether they would continue to do so in the absence of the mutuals is, of course, impossible to know. And given the commitment of many law firms to their mutuals it is unlikely that we will find out anytime soon.

This article proceeds as follows. After describing our research methods in Part I, we introduce in Part II the forms of mutual insurance presently operating in the medium to large LPL market. The largest mutual LPL insurer is the Attorneys Liability Assurance Society, commonly referred to as ALAS. There are three smaller mutuals that, to a significant degree, owe their existence to an early decision by ALAS to exclude Wall Street firms and to discourage California firms from joining. In addition, there is a risk purchasing group for mid-sized law firms that could serve as an easier-to-implement model for other firms. While there are important differences among these organizations, they are all owned by their law firm members and they all engage in a variety of loss prevention, claims management, and other member service activities that assume that the members have joined the mutual for the long run.

12 See infra Part III.
13 Id.
In Part III, we report what we learned from our qualitative research about the demand for mutual insurance. There are three aspects of the prevailing market failure explanations for the comparative advantages of mutual insurers that appear to fit reasonably well within the context of the LPL market. The first two are the well-known and deeply-researched information problems of adverse selection and moral hazard. The third is a long-term contracting problem that, previously, has been used in the insurance literature primarily to explain the success of the mutual form in the life insurance market.\footnote{See generally Hansmann, The Organization of Insurance Companies, supra note 7 (explaining the uncertainties of long-term contracting for life insurance).}

We then introduce and explore a complementary, professional independence explanation for the success of mutual insurance arrangements in the LPL market. This explanation is complementary to the market failure explanation because insurers’ classic response to these market failures is various forms of social control – “insurance as governance” or “insurance as regulation” – that law firms easily could experience as a threat to professional autonomy.\footnote{See Tom Baker, On the Genealogy of Moral Hazard, 75 TEX. L. REV. 237, 280-82 (1996) [hereinafter Baker, On the Genealogy of Moral Hazard] (arguing that insurance is often conditioned on both the care to prevent a loss and insurers’ controls over insureds’ ability to recover loss); Tom Baker & Rick Swedloff, Regulation by Liability Insurance: From Auto to Lawyers Professional Liability, 60 UCLA L. REV. 1412, 1418-23 (2013) (noting that insurance contract design, claims management, loss prevention services, are among the most important tools that insurers use to regulate their insureds). See generally RICHARD V. ERICSON ET AL., INSURANCE AS GOVERNANCE (2003) (developing the concept of insurance as a form of governance beyond the state and providing examples from a variety of fields); Kenneth S. Abraham, Four Conceptions of Insurance, 161 U. PA. L. REV. 653, 657 (2013) ("Finally, the governance conception views insurance as a surrogate for government in controlling behavior and protecting against misfortune, as well as an organizational arrangement among policyholders. These governance relationships create the risk of abuse by the insurer for its own ends, and for the ends of the majority of policyholders at the expense of the minority"); Omri Ben-Shahar & Kyle D. Logue, Outsourcing Regulation: How Insurance Reduces Moral Hazard, 111 MICH. L. REV. 197 (2012) (providing examples of...}

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insurance relationship are more readily seen as furthering lawyers’ professional independence when the entity filling the insurance function is a mutual insurer composed of and directed by fellow law firms, not an outside entity seeking profits at law firms’ expense. In the words of one of the law firm general counsels we interviewed, “You could say [mutual insurer] – which has its own officers and directors – pushes things to us, but we own it, and we direct it to do so.”

In Part IV we first describe and assess contradictory reports from suppliers and purchasers of the commercial LPL insurance provided by large, publicly traded insurance companies, who assert that this more commercial form of LPL insurance can meet the needs of medium to large law firms just as well as the mutual insurance arrangements, often at lower cost. We then examine more closely the financial relationships between the LPL mutual insurers and the commercial insurance market. We find that all the mutual LPL insurers purchase reinsurance and all of them, except ALAS, go to the commercial market to obtain excess insurance for their members. Moreover, the commercial insurance market has adapted to provide benefits that commercial insurers did not provide when the mutuals were formed. Thus, the LPL insurance choice that law firms face is not between purely mutual and purely commercial insurance arrangements but rather between mutual/commercial hybrids and commercial insurers that have consciously adapted to compete with the hybrids.


See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #26, at 6 (Jul. 12, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #26]. Much of the evidentiary base for our research comes from a series of over 50 semi-structured interviews with participants in the medium to large law firm LPL market and from participant observations in law firm and insurance settings. Our interviews were confidential. When we quote our respondents, we identify them only by number and, where appropriate, by title. We identify details of the operation of specific organizations only as necessary and, with regard to information that we understand to be sensitive, only if we were able to obtain that information from public sources or from respondents who were not closely connected to that organization.
We conclude that the LPL mutual advocates and their critics are, to a substantial degree, both right. From a risk spreading perspective, there is less difference than the LPL mutual advocates suggest. On the other hand, there do appear to be real differences in the approach and commitment to loss prevention among mutual and commercial insurers, and the mutuals do appear to offer law firms a qualitatively different claims handling experience. But LPL brokers are working hard to reduce that gap, both to entice the occasional mutual member to leave the fold and to discourage existing customers from joining the fold.

As this latter point illustrates, to the extent that mutual insurance arrangements in fact promote professional independence, they do so both directly and indirectly. Mutual insurers promote professional independence directly by granting their member law firms significant control over risk distribution and management, and they promote professional independence indirectly by serving as a model that the brokers and stock insurance arrangements emulate. Accordingly, our research provides reasons for lawyers and the organized bar to promote mutual insurers even if most law firms are likely to continue to purchase all their LPL insurance from the commercial market.

II. RESEARCH METHODS

This Article is based on qualitative research into lawyers’ liability and insurance, consisting of in-depth, semi-structured interviews and participant observation in LPL insurance programs. We interviewed professionals involved in pricing and selling LPL insurance (brokers, underwriters, actuaries, and senior executives in insurance companies); lawyers involved in buying and managing LPL insurance (general counsels, insurance partners, and risk managers); professionals who provide risk management services as part of LPL insurance arrangements (employed by brokers, insurers, and law firms); and, to a lesser extent, professionals involved in the LPL insurance claims process (both lawyers and insurance company personnel).

The interviews were semi-structured, meaning that we followed an organized research protocol, but we allowed the interviews to unfold variably based on the expertise and interests of the respondents. Interviews typically lasted between thirty minutes and one hour, and we often followed up to ask clarifying questions as the research progressed. We recorded and transcribed the interviews and coded them by themes and topics using Nvivo coding software. Each principal investigator conducted about half of the interviews; each read the transcripts of the other almost immediately after
each interview; and we discussed our impressions and interview techniques continuously through the research period before beginning coding. We interviewed a total of 53 respondents in the following categories: actuaries (2); brokers (9); loss prevention specialists (4); C-suite insurance company executives (5); insurance and reinsurance underwriters (8); law firm general counsels or associate general counsels (16); law firm insurance partners (4); monitoring counsel (4); and claims professionals (4). The subcategories total more than 53 because some respondents have held more than one of these positions in their careers.

We identified our prospective interviewees from leaders in the LPL insurance market. We then expanded outward to references from the initial interviewees. This snowball method has obvious limitations: it does not produce a random sample; it cannot include people who are unwilling to be interviewed; and, because we learn a great deal over the course of the research, our early interviews differ significantly from our later interviews. With that said, we are confident that what we have learned represents an objective, valid, and shared understanding of the LPL insurance market. The LPL market is reasonably concentrated, especially among insurers for large law firms. There are a limited number of insurers, reinsurers, and brokers active in the market. We have interviewed or otherwise interacted with people who worked in most of the leading insurance organizations during the period of the research. We interviewed lawyers in a cross section of the medium to large firm market that was weighted to the AmLaw 200. Finally, we sent preliminary drafts of this article to a cross section of our respondents, offering them the opportunity to correct any mistakes or misimpressions.

III. MUTUAL INSURANCE ORGANIZATIONS IN THE LPL MARKET

For law firms in the United States that have more than 35 lawyers, there are three alternatives to purchasing a primary insurance policy directly from commercial insurers (i.e. stock insurers and Lloyd’s of London syndicates):17 (1) a relatively large, national mutual insurance company that

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17 Except for Liberty Mutual, the large, general-purpose mutual property casualty companies do not provide LPL insurance. Liberty Mutual’s participation is reportedly indistinguishable from its stock insurer competitors. See Tom Baker & Rick Swedloff, Email from Respondent #5 (July 5, 2016) (on file with author). Separate treatment of the stock insurance companies and the Lloyd’s syndicates awaits future work.
is the largest insurer of such law firms in the U.S.; (2) three smaller and more geographically focused mutual insurance arrangements; and (3) a risk purchasing group for mid-sized law firms. Not all law firms have these mutual insurance options, and not all law firms that have these options use them, but altogether these organizations provide insurance for over 80,000 lawyers including about half of the AmLaw 100 and 200, and a sizeable number of smaller, high-quality boutique and regional law firms. Extrapolating from the available lawyer demographics, these 80,000 lawyers comprise over one-third of all lawyers working in firms larger than twenty lawyers and about forty percent of all lawyers working in firms larger than fifty lawyers, as very rough approximations.

Historically, Lloyd’s syndicates were owned by their managers, who obtained the necessary capital from individuals who were completely passive, as distinguished from stock insurance companies, which were owned by the individuals who provided the capital, i.e. the shareholders. Today, we suspect that institutional investors own most of the shares in the insurance companies and also supply most of the capital to Lloyd’s, indirectly through their ownership of the shares of the companies that directly provide capital to Lloyd’s. Lloyd’s became predominantly corporate in the years following the Reconstruction and Renewal process of the early 1990s.

18 Supra note 5.

19 The most recent year for which there are data that break down private law practice by size of firm is 2005. Of the lawyers in private practice, about half worked as solo practitioners in 2005, 16% worked in firms of 100 lawyers or more, and 10% worked in firms of 21-100 lawyers. CLARA N. CARSON & JEEYOUN PARK, THE LAWYER STATISTICAL REPORT: THE U.S. LEGAL PROFESSION IN 2005, at 5-6. As of 2005, there were 111,523 lawyers in firms with more than 100 lawyers, 26,467 lawyers in firms with 51-100 lawyers, and 41,833 lawyers in firms with 21-50 lawyers. Id. The ABA reports that the total population of lawyers grew by 15% in the 2005 to 2015 period. 2015 National Lawyer Population Survey: Historical Trend in Total National Lawyer Population 1878-2015, A.B.A., http://www.americanbar.org/content/dam/aba/administrative/market_research/total-national-lawyer-population-1878-2015.authcheckdam.pdf (last visited June 3, 2016). Because ALAS, AIM, and PilotLegis includes some law firms with fewer than 50 lawyers, the one third and one-half shares referred to in the text should be taken as rough approximations. Moreover, American Bar Foundation reports that the trend has been for a larger share of lawyers to
While these insurers are not formally organized as mutual insurers for insurance regulatory purposes, in each case the members are both policyholders and owners, and there are no shareholders or other outside investors with an ownership interest. Three of the four are group “captive” insurers, and the fourth is a “risk retention group.” The differences between these forms of organization and that of mutual insurance companies like State Farm or Liberty Mutual relate primarily to capital requirements and other aspects of state regulatory supervision, not to things that make an organization a “mutual” for economic purposes. As a practical matter, the regulatory differences mean that the LPL mutuals are even more truly mutual organizations, because the lower regulatory scrutiny of group captives and risk retention groups requires greater self-regulation by members.

The sections that follow describe each of these mutual insurers. Readers who are focused primarily on how our investigation of the LPL market advances the law and economics understanding of liability insurance might wish to skim, or even skip over, this section. Of course, for readers who are interested primarily in the LPL market, this is the most important section of this Article. Much of what we report here has never been

work in larger firms, so the 15% growth rate is unlikely to be constant across the size of firms. \textit{Id.}

\textit{Id.} 20 ALAS 2013 \textit{Rep., supra} note 5, at 9. The concept of a “captive” insurer began as a mechanism for large corporations to adapt the insurance form to what is functionally a self-insurance program, with minimal regulatory oversight. There then developed multi-member captives, which, for present purposes, can be understood as lightly regulated, non-transparent mutual insurance companies. \textit{Advantages of Captive Insurance}, VT. DEP’T OF FIN. \textit{REG., http://www.dfr.vermont.gov/captives/advantages-captive-insurance} (last visited June 5, 2016) (listing the advantages of Vermont domestic captive insurance). The International Risk Management Institute defines a risk retention group as follows:

An insurance company formed pursuant to the federal Risk Retention Act of 1981, which was amended in 1986 to allow insurers underwriting all types of liability risks except workers compensation to avoid cumbersome multistate licensing laws. An RRG must be owned by its insureds.

published, and none of it in this consolidated, comparative form. Some additional detail about the LPL mutuals appears in Part III.D.

A. **THE BIG LAWYERS’ MUTUAL: ALAS**

ALAS is short for the Attorneys’ Liability Assurance Society, the largest, best-known, and most public mutual insurer in the LPL market. ALAS was formed by about 30 large U.S. law firms in 1979, in the wake of the mid-1970’s availability crisis in the U.S. liability insurance market. Donald Breakstone, a former ALAS general counsel and former partner in a large Chicago law firm who helped to create ALAS, described the origins of ALAS and the central goals and beliefs of ALAS members as follows:

ALAS’s core purpose for existing, and the need that brought its member firms together in 1979, was to provide stable and high quality professional liability coverage to its large law firm members. What drew the initial 31 member law firms together were several commonly held goals and beliefs, namely that:

- Commercial insurers providing professional liability coverage to large law firms were unstable and inconsistent providers - insurers could and did enter and leave that market at will, making it difficult, if not impossible, for large law firms to count on the continual availability of needed coverage;
- Large law firms were not rated by commercial insurers as an independent risk class - instead large law firms were lumped together with individual lawyers, small law firms, individual

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21 *About the ALAS Companies, ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD.*, http://www.alas.com/public/about.aspx (last visited June 7, 2016) (reporting that the initial number of firms was 35, which is inconsistent with the number – 31 – given in the Breakstone article, infra note 23).

accountants, small accounting firms, and the then Big 8 accounting firms in assessing risks and establishing "proper" premiums; and

- Large law firms, bound together in their own mutual facility, were in a much better position than commercial insurers to understand and meet the professional liability needs of their own profession through a broad policy form, fair claims management, and a state of the art loss prevention program.23

As of January 1, 2017, ALAS had grown to 213 member firms, with 60,507 practicing attorneys.24 ALAS describes its membership philosophy as one of "preferred risk underwriting."25 Membership is limited to high quality firms of at least 35 lawyers (many significantly larger) with an acceptable "management structure, claims history, and approach to loss prevention."26 The law firms that are ALAS members tend to have an elite reputation. ALAS members include 77 of the AmLaw 200, 28 of the AmLaw 100,27 and 6 of the 22 firms with more than 1000 lawyers, with a conspicuous under-representation of California and New York City law firms that is the result of underwriting decisions made in the early years of ALAS’ existence.28

25 ALAS 2016 REP., supra note 5, at 21 (noting that ALAS has remained committed to applying its “preferred risk underwriting” standards in a uniform manner).
26 In correspondence, Hebert Kritzer reports that, as part of his research for work in progress, he has compiled the number of lawyers in ALAS firms and that there are 5 firms in ALAS with fewer than 35 lawyers, the smallest with 16 lawyers, possibly as a result of firms having joined ALAS before ALAS established the rule that member firms must have at least 35 lawyers. ALAS 2014 REP. supra note 5, at 22 (“We continue to maintain a selective approach to new firm recruiting. . . . We review a firm’s application with particular focus on the applicant’s management structure, claims history, and approach to loss prevention.”).
27 Supra note 5.
ALAS is governed through a committee structure staffed by partners of the member firms. These committees oversee core functions such as claims, underwriting and member services, loss prevention, investments, and reinsurance. ALAS has an active loss prevention program. The program is traditionally run by former partners from member firms in “communication and interaction with” a partner in each member firm that is designated as a “Loss Prevention Partner.”29 The Loss Prevention Partner in each firm serves as a conduit to the rest of the firm about loss prevention best practices. ALAS also has an active claims management program; it has the right to approve members’ selection of claims counsel, and it participates actively in the management of claims.30

In addition to its size, there are several characteristics that distinguish ALAS from the three small mutuals that we describe next. First, ALAS has a significant permanent staff, the senior members of which have traditionally been drawn from member law firms, with a large percentage of lawyers involved in claims management, loss prevention, underwriting, and general management.31 Second, ALAS engages in “unitary pricing,” meaning that all member firms are charged the same per lawyer price for a given combination of “self-insured retention” (similar to a deductible) and limit of coverage. Because of differences in firm size, retentions and limits,

29 ATTORNEYS’ LIABILITY ASSURANCE SOCIETY LTD., 2001 ANNUAL REP. 21 (2002) (“[T]he ALAS loss prevention program is a cooperative endeavor that involves Loss Prevention Counsels in regular communication and interaction with the designated Loss Prevention Partners in each Member Firm.”); Loss Prevention, ATTORNEYS’ LIABILITY ASSURANCE SOCIETY LTD., http://www.alas.com/public/about_lp.aspx (last visited June 7, 2016) (“ALAS loss prevention counsel, all former partners at established, high-quality firms, provide a wide range of services to meet this need.”).

30 See id.

member firms pay different total premiums, however. Third, ALAS issues insurance policies directly to its members with limits up to $75 million (increased to $100 million in 2017), which is an extraordinarily high level of insurance coverage from a single source in the liability insurance market as a whole, not just LPL insurance. This means that many ALAS members do not need to buy any additional excess LPL insurance from the commercial market. Finally, ALAS does not arrange for the purchase of higher levels of excess coverage by its members, which means that the largest law firm members of ALAS must use commercial insurance brokers to arrange their excess insurance each year, giving them regular, direct exposure to the commercial market.

B. THE SMALL LAWYERS’ MUTUALS

To a significant degree, the three smaller mutual LPL insurance organizations owe their existence to underwriting decisions made by ALAS in the early years. At inception ALAS members elected to exclude New York City firms and to discourage the participation of California firms, among other ways by charging California firms higher premiums.32 A senior LPL broker explained to us that this ALAS policy was the result of an underwriting policy of ALAS’s most important reinsurer.33 This meant that firms in New York City and California that wanted access to mutual insurance had to create their own mutual insurers. The three mutuals we describe here – BAR, MPC and AIM – were the result.

These three small mutual insurers are even more protective of their organizational details and practices than ALAS. They do not release annual reports and, as a rule, neither the organizations nor their members make public statements about their operations. Ours is the most detailed public report of their organization and practices, and we learned many additional

32 See ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 1987 ANNUAL REP. 13 (1988) (showing differential rates for California member firms on a per attorney basis); See also LPL Ins. Interviews, Interview with Respondent #12, supra note 28, at 4 (“When ALAS was founded—the owners of the company—there was a bylaw provision that prohibited the admission of New York-based firms.”).

33 Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #6, at 2, 13 (Dec. 6, 2013) (unpublished interviews, on file with authors).
details that we cannot describe publicly in order to protect the confidentiality of our sources.

The oldest of the three, Bar Assurance and Reinsurance Limited (“BAR”) was organized in 1979 by 21 New York City firms. Bar now has just under 20 member firms, all still based in New York City, with about 12,000 practicing lawyers. The second smaller mutual, MPC, was organized in the early 1980s by San Francisco firms. Originally known as the “Managing Partners Council,” MPC now has 9 member firms, with more than 7000 practicing lawyers. While the center of gravity remains San Francisco, MPC members include at least two large firms that are based

34 The National Law Journal reported in 1992 that the following firms were members: (1) Cadwalader, Wickersham & Taft; (2) Chadbourne & Parke; (3) Cleary, Gottlieb, Steen & Hamilton; (4) Cravath, Swaine & Moore; (5) Davis Polk & Wardwell; (6) Debevoise & Plimpton; (7) Dewey Ballantine; (8) Donovan Leisure Newton & Irvine; (9) Fried, Frank, Harris, Shriver & Jacobson; (10) Kaye, Scholer, Fierman, Hays & Handler; (11) Lord Day & Lord, Barrett Smith (12) Milbank, Tweed, Hadley & McCloy; (13) Mudge Rose Guthrie Alexander & Ferdon; (14) Paul, Weiss, Rifkind, Wharton & Garrison; (15) Proskauer Rose Goetz & Mendelsohn; (16) Rogers & Wells; (17) Shearman & Sterling; (18) Simpson Thacher & Bartlett; (19) Sullivan & Cromwell; (20) White & Case; and (21) Winthrop, Stimson, Putnam & Roberts. Edward A. Adams, N.Y. Firms are Hit First; Malpractice Hikes to Spread?, NAT’L L.J., Oct. 26, 1992, at 15.

35 Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #32, at 8 (June 7, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #32] (“BAR is, it’s a group that consists of 16 or I believe it’s now 16. It might be 17 of the leading New York firms.”).


37 See http://www.reedsmith.com/thomas_igoe/ [https://perma-archives.org/warc/RSV6-N8RZ/http://www.reedsmith.com/thomas_igoe/ ] (last visited June 12, 2016), (identifying Mr. Igoe as of counsel to Reed Smith and President and Chairman of MPC Insurance, Ltd. and reporting that MPC is “a Vermont captive insurance company owned by 9 national and international law firms that provides professional liability insurance coverage for more than 7,000 attorneys practicing in the United States and in many foreign jurisdictions.”).
elsewhere.\textsuperscript{38} The third, Attorneys Insurance Mutual Risk Retention Group (AIM), was formed in 1985 by a group of 21 California-based law firms with about 1500 lawyers.\textsuperscript{39} AIM now has 13 law firm members with about 2600 lawyers.\textsuperscript{40}

The three differ from ALAS in a variety of other ways in addition to their size and geographic concentration. First, rather than an internal staff, they are staffed by people from a major insurance brokerage firm, with leadership and assistance from committees primarily composed of partners from member firms.\textsuperscript{41} Aon manages BAR and AIM; Marsh manages MPC.\textsuperscript{42}

\textsuperscript{38} Dorsey & Whitney, which is based in Minneapolis, has publicly identified that it is a member of MPC. Jay R. Lindgren, \textit{Building the People’s Stadium: Dorsey & Whitney LLP’s Response to Request for Qualifications/Proposals to Serve as Legal Counsel to the Minnesota Sports Facilities Authority}, DORSEY & WHITNE Y LLP 10, https://www.scribd.com/doc/110875888/Dorsey-Whitney-legal-services-proposal (last visited June 12, 2016). We infer that Reed Smith, which is based in Pittsburgh, is a member from the fact that the firm website indicates that the COO is a member of the MPC finance committee and a senior lawyer who is of counsel is President and Chairman of MPC.


\textsuperscript{40} LPL Ins. Interviews, Interview A with Respondent #10, supra note 39, at 9; Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview B with Respondent #10, at 7 (Sept. 16, 2014) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview B with Respondent #10]; See also \textit{California Lawyer’s Annual Professional Liability Insurance Report}, CAL. LAW., Feb. 2010 at 28, 28-29.

\textsuperscript{41} See email from Respondent #16 (Jan. 5, 2015) (on file with authors) (confirming that Aon’s role in managing BAR is widely known among LPL insurance professionals).

\textsuperscript{42} Aon’s large presence in the LPL market is attributable to Aon’s acquisition of the Minet brokerage, which was originally based in Montreal, where it served as the North American point of contact for the London Market’s extensive U.S. professional liability insurance customer base. The Business Insurance directory
In each case, the broker arranges for all of the LPL insurance of the member firms. Second, all three have departed from strict unitary rating. Premiums for the lower levels of coverage start with a per lawyer unitary rate, but are adjusted using debits or credits that reflect unusually poor or unusually good claims experience. Third, consistent with the active involvement of major brokers, all three provide access to higher level excess insurance; firms pay an individualized, risk-rated price for that coverage, with the mutual functioning as a purchasing group that seeks to ensure consistent access to the high levels of insurance needed, especially by many of the BAR and MPC member firms.

The three also differ from each other in some ways. For example, the BAR insurance program consists of three-year LPL insurance policies, typically rolled over each year (meaning that members get new three-year policies every year).

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43 See Id. (“Well, they’re arrangers, I guess is the way I’d put it. They arrange different layers of insurance”); Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #5, at 17 (Nov. 7, 2013) (unpublished interviews, on file with authors).

44 LPL Ins. Interviews, Interview with Respondent #32, supra note 35, at 11 (“[T]he way it basically works is that there is a unitary rating by the insurers across the group, but we have firms that have particularly favorable claims history effectively get a rebate that’s paid by firms that have particularly less favorable claims history.”).

45 Tom Baker & Rick Swedloff, *Liability Insurer Data as a Window on Lawyers’ Professional Liability Liability*, U.C. IRVINE L. REV. 1273, 1287 n.44 (2016). While the total limits available to the firms are highly confidential, we can report that the amounts available are in the hundreds of millions of dollars. See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #5, at 17 (Nov. 7, 2013) (unpublished interviews, on file with authors).
policies each year). BAR has the option in any particular year not to roll over the policy into a new three-year policy with a new price, but rather to keep the same policy at the same price for one or two more years, providing protection against short term price increases. In addition, BAR does not provide its member firms a complete layer of either primary or excess insurance. Instead, BAR participates as a minority interest in “quota share”

46 Adams, supra note 34, at 21; LPL Ins. Interviews, Interview with Respondent #32, supra note 35, at 8.

47 As one of our respondents explained,

[I]t’s understood that [the three-year policy is] there basically to guard against what we would consider misbehavior by the insurers, mainly refusing to reduce rates during periods where clearly claims experience and their profitability merits it, or trying to make up in one year for losses.

We have an understanding with our insurers that the objective is that when they’re incurring losses, they will get premium increases, but they will have to be patient, and not try and make it all back in one year—that they’ll have to do it somewhat gradually—but that on the flip side, in a soft market, we will not try and extract for that one huge premium decrease in a space of a year. We will be patient on that end so that it does not shock them with the huge loss of income, premium income.

Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #19, at 11 (June 18, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #19]. Another respondent told us an instructive story about a meeting with BAR members and Hank Greenberg, former head of AIG, at a time when Greenberg wanted to substantially increase premiums. Apparently, no one told Greenberg that the BAR had a three-year policy, so his attempted bullying was ineffective: the BAR firms responded, first, by exercising the option to keep the AIG coverage in place at the then current price and, soon after, by replacing AIG in the BAR program. See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #34, at 4-6 (June 18, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #34].
primary and excess layers of insurance, with the majority interest provided by commercial insurers – either stock companies or Lloyd’s syndicates.\textsuperscript{48} The “lead insurer” sets the price for each layer.\textsuperscript{49}

MPC provides its primary layer of insurance through a commercial insurance policy issued by Lexington Insurance Company, a company in the AIG insurance group with a very high credit rating, that is 100\% reinsured by MPC.\textsuperscript{50} In this kind of “fronting” insurance arrangement (which is a relatively common approach for large scale commercial enterprise), the law firms get the benefits of mutual insurance and a high credit rating, without the mutual needing to go through the effort required to get its own credit rating. In addition, MPC has an annual member auditing process that is more extensive than the others.\textsuperscript{51}

\textsuperscript{48} LPL Ins. Interviews, Interview with Respondent #32, \textit{supra} note 37, at 9 (“There is a piece of every firm’s cover that is actually written and retained by BAR.”). In a quota share insurance arrangement, a group of insurers each takes a share of the risk in a layer of insurance, similar to the way that a Lloyd’s syndicate operates. For example, the New York Law Journal reported in 1993 that BAR was responsible for 10\% of the $20 million primary insurance lawyer, 7.5\% of the first layer excess insurance policy of $20 million, and 15\% of a second layer excess insurance policy with an unspecified limit. Edward A. Adams, \textit{Paul Weiss Payout in RTC Accord Put at $2 Million}, N.Y. L.J., Oct. 1, 1993, at 21.

\textsuperscript{49} See Edward A. Adams, \textit{Lawyers’ Malpractice Premiums Drop at Last; Decline, First in 10 years, after 1,000\% rise}, N.Y.L.J., Dec. 12, 1994, at 21 (reported that BAR switched the lead primary position from one Lloyd’s syndicate to another in 1993 because the former syndicate refused to continue to offer three-year policies).

\textsuperscript{50} \textit{Financial Data for Lexington Insurance Company}, FLA. SURPLUS LINES SERVICE OFFICE, http://industrydata.fslso.com/InsurerFinancials/findata.aspx?id=57 (last visited June 12, 2016) (reporting that Lexington Insurance Company was rated A by A.M. Best Rating in 2015). Lindgren, \textit{supra} note 38, at 10 (“Dorsey’s professional liability insurance carrier is MPC Insurance Ltd, with the front carrier being Lexington Insurance Company and excess policies written by many other insurers.”).

\textsuperscript{51} A respondent who is not associated with MPC described the process to us as follows:
Finally, AIM retains significantly less risk than MPC or BAR. Although AIM offers its members a $9 million primary insurance policy, it supports that policy by buying reinsurance in the commercial insurance market. Thus, as compared to the other small mutuals, AIM’s risk transfer arrangements are more like a group purchasing service than a mutual insurer.

C. THE RISK PURCHASING GROUP: PILOTLEGIS

PilotLegis is the trade name of a risk-purchasing group that functions in many ways like the three smaller mutual insurers. Unlike the other groups, however, PilotLegis does not assume any risk, though it reportedly has an

It’s pretty intrusive. They have sit-down meetings with people and they can walk through the hallways, apparently, and pick somebody out of thin air and start interviewing them, asking them if they’ve read the manual, do they understand whatever issues they’re dealing with at the time.

LPL Ins. Interviews, Interview B with Respondent #10, supra note 40, at 4. A commercial insurance executive provided a similar account:

I will tell you that if you talk to the MPC people—and you probably can—they’ve had unbelievably good results, at least they had when I was looking at them—even though some of their firms like [] have seen some tough days, they would argue that it was all about peer review. It was all about their ability to ask questions that no firm was gonna answer an insurance underwriter about. Now I would argue you can ask those questions if there’s ten of you and you’re all going to the Olympic Club together.

Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #16, at 20 (November 16, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #16]. ALAS also has extensive member audits, but on a less frequent basis.

LPL Ins. Interviews, Interview B with Respondent #10, supra note 40, at 16.
organizational structure in place that would allow it to assume risk if it were unable to obtain adequate insurance in the commercial market.\(^{53}\)

PilotLegis has 39 member firms, all of which are mid-sized law firms (20-200 lawyers), with a total of about 1600 lawyers, with about half practicing in California.\(^{54}\) Aon manages PilotLegis.\(^{55}\) Aon plays a larger role in setting the agenda for PilotLegis than the broker/manager in any of the small mutuals, but law firm members are actively involved in creating and maintaining the culture.\(^{56}\)

The PilotLegis website contains the following statement from its chairman (Jeffrey Sharp, managing partner of a Chicago-based intellectual property firm) about the group’s approach:

Through group purchasing power, our members enjoy preferential treatment in the LPL marketplace, more predictable pricing, and a stable source of insurance. Member firms also learn from each other in a myriad of ways, including the sharing of risk management and practice management procedures, a cornerstone of the program.\(^{57}\)

The website describes the group’s pricing approach as follows:

PilotLegis was not designed to “beat the market,” but rather, offers stability through both multiyear and annual policies at competitive, intelligent terms. Where PilotLegis is different is in our approach to risk management. We have a passion for helping law firms identify and reduce their risk, leading to fewer claims, better service for claims when they do arise, and stronger long-term relationships with


\(^{55}\) *See generally AonPartnership with PilotLegis RPG, PilotLegis, http://www.pilotlegis.com/Templates/media/PDF/AonDescription.pdf* (describing the services Aon provides for PilotLegis).

\(^{56}\) *Letter from our Chair, PILOTLEGIS, http://www.pilotlegis.com/who/letter* (last visited June 7, 2016) (describing the important role PilotLegis’s members have played in creating and maintaining its culture).

\(^{57}\) *Id.*
underwriters. … Members understand that PilotLegis is not just an insurance product, but also a better way of doing business.\textsuperscript{58}

D. \textbf{PLUG – THE PROFESSIONAL LIABILITY UNDERWRITING GROUP}

The final LPL mutual is the Professional Liability Underwriting Group, which issued insurance policies from the mid-1980s liability insurance crisis through 1991. PLUG was a captive insurer organized for a group of about 15 large law firms during the insurance crisis to plug a gap in a tower of insurance.\textsuperscript{59} The choice of the name – PLUG – was intentional. The broker for the law firms involved – Minet, which is now owned by Aon – was unable to obtain coverage for the law firms in the commercial market for what was at the time a relatively high level excess layer of insurance. With Minet’s help, the law firms created a captive that provided the missing layer of insurance, with the expectation that the captive would be used to “plug” the hole only as long as that layer could not be placed in the commercial market. As of 1992, the firms were able to obtain the coverage on acceptable terms in the commercial market, so PLUG stopped issuing new policies to its members.\textsuperscript{60} Because PLUG was a short-term solution to a capacity limit in the commercial market, it did not have the other features of the other mutual insurers described in this section.

We include PLUG in our description of the forms of mutual insurance presently available in the LPL market because, once Minet (now part of Aon) paved the way, forming an entity like PLUG is always an option for a group of law firms. The fact that law firms have not done this in the 30 years since the liability insurance crisis strongly suggests that the commercial market is working adequately for the law firms that have chosen not to join, or are unable to join, one of the LPL mutuals. We return to what this means in Part V. In the next section we report what we have learned

\textsuperscript{58} \textit{Id.} (answering the question of whether PilotLegis’ insurance products are more affordable than competing products in the marketplace).

\textsuperscript{59} The National Law Journal reported in 1992 that the members of PLUG were: Bingham, Dana & Gould; Breed, Abbott & Morgan; Cahill Gordon & Reindel; Dechert Price & Rhoads; Eckert Seamans Cherin & Mellott; Hale and Dorr; Irell & Manella; Kelley Drye & Warren; Latham & Watkins; McGuire, Woods, Battle & Boothe; Piper & Marbury; Skadden, Arps, Slate, Meagher & Flom; Thelen, Marrin, Johnson & Bridges; and Weil, Gotshal & Manges. \textit{See Adams, supra} note 34, at 15.

\textsuperscript{60} \textit{Id.}
from our qualitative research about why law firms remain in the LPL mutuals.

IV. THE DEMAND FOR MUTUAL LPL INSURANCE

The first puzzle of mutual insurance in economic theory is easily stated: Because stock insurers are able to access all of the forms of capital available on the capital markets, they should – absent a market failure – be better able to spread risk than mutual insurers, which have access to more limited capital market instruments because of the requirement that mutuals must be owned by their members. The “puzzle” is: why are mutuals so prevalent in parts of the insurance market, given that they face this disadvantage?

The traditional answer is market failure. As insurance economics has long held, and as insurance professionals have understood for even longer, insurance markets are prone to market failure.61 Prior work in the law and economics literature, most notably by Henry Hansmann, has identified a variety of market failure explanations for the formation and success of mutual insurance companies.62 Our research suggests that three of these reasons apply to the LPL insurance market: adverse selection, moral hazard,63 and a long-term contracting problem exacerbated by the claims-  

61 See generally Baker, On the Genealogy of Moral Hazard, supra note 15 (discussing the history of the insurance market understanding of the problem of moral hazard and the importation of the concept into economics); Tom Baker, Containing the Promise of Insurance: Adverse Selection and Risk Classification, 9 CONN. INS. L.J 371, 374-76 (2003) [hereinafter Baker, Containing the Promise of Insurance] (discussing the history of the insurance market understanding of adverse selection and the importation of the concept into economics).

62 See sources cited supra notes 7, 11.

63 For discussions on the problem of moral hazard, see, e.g., Kenneth Arrow, Uncertainty and the Welfare Economics of Medical Care, 53 AM. ECON. REV. 941, 961 (1963) (noting the problem of moral hazard as a major argument in favor of governmental provision of health insurance); KENNETH ARROW, ESSAYS IN THE THEORY OF RISK BEARING 142 (Markham Publ'g Co. 1971) (“[B]ut the insurance policy may, as we have seen, lead to a motive for increased loss, and then the insurer or risk-bearer is bearing socially unnecessary costs.”). For discussions on the problem of adverse selection, see, e.g., George A. Akerlof, The Market for “Lemons”: Quality
made form of liability insurance that became the prevailing form of professional liability insurance in the U.S. in the late 1970s. In this section we report what we learned from our respondents about how the LPL mutuals address these problems. We then provide a new, autonomy explanation for the success of the mutuals that has not previously been reported in the literature.

A. LONG-TERM CONTRACTING

We begin with the mutuals’ apparent comparative advantage in addressing the long-term contracting problem because that was what our respondents most emphasized about the benefits of belonging to a mutual: a long-term relationship with an insurer that would remain in the LPL market no matter what. The long-term, contingent nature of insurance relationships creates a number of challenges for both insurers and policyholders. Policyholders pay premiums for a promise that insurers will provide coverage when called upon. But, because policyholders have infrequent claims, it is often difficult to judge the value of the promise that insurance companies provide. Policyholders need to have insurance in place over

Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488, 492-93 (1970) (noting that absent countervailing efforts by insurance companies, the insurance pool will consist disproportionately of “lemons”—people with undesirable risk characteristics—due to adverse selection); But see Peter Siegelman, Adverse Selection in Insurance Markets: An Exaggerated Threat, 113 YALE L.J. 1223, 1224 (2004) (recognizing that the problem of adverse selection insurance markets may have been exaggerated since some features of insurance demand may undercut or reverse the typical adverse selection results). For historical review, see Baker, On the Genealogy of Moral Hazard Genealogy, supra note 15; Baker, Containing the Promise of Insurance, supra note 61.

64 See George L. Priest, The Current Insurance Crisis and Modern Tort Law, 96 YALE L.J. 1521, 1526 (1987) (“At about the same time, in the early 1980's, insurers initiated efforts to restrict coverage levels in certain commercial lines by changing the terms of the basic policy from an occurrence to a claims-made basis.”); Hansmann, The Organization of Insurance Companies, supra note 7, at 129 (noting that the central problem of long-term contracting in life insurance “lies in making provision for the insurance company to maintain financial reserves adequate for paying off claims”).
periods for which it is not possible to have a fully specified contract. There are too many things that could change to allow insurers to provide a fixed price in advance, and specifying a formula in advance to account for all the potential changes seems to be nearly as difficult. Accordingly, policyholders worry that insurers will not stand by them if claims emerge, that prices will spike for either endogenous or exogenous reasons, or that insurers will drop the line of insurance altogether. Insurers, on the other hand, worry about the adverse selection that results when the good risks drop out of the insurance pool over time.

Many of our respondents report that they believe mutual insurance solves some of these problems. A general counsel who was involved in the founding of one of the small mutuals put it this way:

By grouping together we could, and acting as a buyer group we would, have greater market power than each firm does individually. The animating principal behind [mutual] is very much one of creating a stable insurance environment for all of its members. I think we all accept that we may be paying a little bit of a premium over what at least those of us that have better claims records could get in the open market for the benefit of having that stability.

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66 This concern, first expressed by life insurance companies in the 19th Century, is the source of the label “adverse selection.” Life insurance underwriters wondered why the mortality of their carefully “selected” policyholders turned out to be no different than that of the population as a whole. They reasoned that there was a contrary “adverse selection” force operating on their policyholder pool over time, as the healthy people dropped out and bought new policies that required a new medical exam. See Baker, *Containing the Promise of Insurance*, supra note 61.

A second law firm general counsel reported:

I’ve never made a close study of the commercial premiums that we would pay versus what we’re paying with [mutual], because I think … it’s the wrong question to ask. … The question to ask is: Will this carrier be there when the crunch comes?68

A long time LPL insurance broker concurred:

I mean, the market’s been so soft for so long. I mean, any law firm could pick up the phone, probably save ten percent just by making one phone call. It’s kind of just the way the market is. No, they’re—the idea with [mutual] and the other groups is they’re pitching stability and sort of pricing continuity and your ability to buy the coverage so you’re not going to find yourself whipsawed in a market that, where—as you used the example of the PLUG group, where you got capacity one day and the next day it’s gone.69

Finally, yet another law firm general counsel explained, “there are plenty of terrific commercial insurers out there,” but “they have varying degrees to which they are committed to the professional liability market,” and “you don’t want to be hooked up in a substantial way with an insurer that decides it doesn’t want to write this kind of insurance anymore or having nothing to do with your particular firm.”70

Prior work has examined the long term contracting problem in relation to life insurance, but, as our respondents emphasized, liability insurance presents this problem, too. Indeed, if there is a single dominant theme about the benefits of belonging to an LPL mutual insurer, it is stability. This emphasis on stability addresses three interrelated concerns: 1) that

("[U]nlike the commercial insurers, which come and go from the market as they ride the insurance cycle, pools are there ‘through thick and thin.’")

68 Interview with Respondent #24, LPL Ins. Interviews, at 6-7 (July 12, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #24, LPL Insurance Interviews].


70 Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #30, at 10 (May 29, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #30].
short-term idiosyncratic events will change the price that a firm pays for insurance; 2) that insurers will act opportunistically or leave the market if a “hard market” arises; and 3) that changing insurance policies or insurance carriers, whether in a hard market or otherwise, will expose firms to uncovered losses.

**More stable pricing.** Liability insurance pricing is a very complicated topic that does not need to be probed deeply to understand the mechanism by which mutual insurers provide stable pricing and why law firms value that stability. The two main mechanisms are the unitary (or quasi-unitary) pricing described earlier and the mutuals’ willingness to lag the pricing changes in the commercial LPL market as liability insurance prices move through the “boom” and “bust” swings of the liability insurance underwriting cycle.\(^\text{71}\) Unitary or quasi-unitary pricing moderates the short-term impact that a large claim or set of claims could have on the price of any individual law firm. The willingness to lag the market through the underwriting cycle means that law firms have time to adjust to long term changes in the liability insurance prices. Both of these mechanisms are only sustainable when the members of an insurance pool credibly commit to remain in the pool even when some members of the pool are thereby required to pay more for their insurance than they could pay elsewhere.\(^\text{72}\)


\(^{72}\) This commitment to the pool is credible given the stability of the membership of ALAS, BAR, and MPC since their genesis regardless of the difference in claims experience. The extent of the commitment to ALAS, for example, which has the purest unitary pricing regime, can be seen in the report from a senior executive at a leading commercial insurer who said that “squeaky clean firms” – i.e., “a firm [with] 10 years of loss experience and never had a claim over the retention” – that bought insurance in the commercial market in 2014 were “probably paying about 30, 35 points off the ALAS rate.” Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #18, at 11 (Dec. 20, 2013) [hereinafter LPL Ins. Interviews, Interview with Respondent #18]. Our sense is that the LPL mutuals do not attempt to protect firms from changes in industry-wide risk, except as part of an overall effort to smooth year-to-year changes in
The long-term commitment of their members allows the mutuals, in turn, to commit to long term relationships with the commercial insurers and reinsurers in their program. The general counsel in a firm in one of the small mutuals explained this benefit as follows:

[Remember, in the [small mutual] context, I am looking to have a viable commercial insurer forever. I’m not looking to hit the insurer for a big loss. Then they up my premium, and I say, “Sayonara, it was nice to know you,” and I give my business to somebody else. I am looking for them to make a reasonable level of profit. We can argue over reasonable, but a reasonable level of profit over a sustained period, hopefully with minimum losses, so that everyone in their shop is usefully employed and happy, and that I am not subject to the vagaries of folks that can hurt me in knowing that I’ve got cover by taking unreasonable positions that I’m not covered at all.]

The program administrator from PilotLegis made this point directly in an interview with the trade press: “In times when premiums are low, we are not going to be paying the lowest, but in hard times, we will not be paying the highest.”

In that regard, the LPL mutuals follow what sociologists Richard Ericson and Aaron Doyle described as an “absorbing risk” approach to risk management, helping the members of the mutual prepare for and bear their share of non-firm specific increases in lawyers’ liability risk. See Richard V. Ericson & Aaron Doyle, Uncertain Business: Risk, Insurance, and the Limits of Knowledge 180 (2004) (noting that one approach insurers used to deal with the uncertainties of earthquake is to absorb its risk in advance, through capital protection, capacity building, and the design and construction of the built environment).

73 LPL Ins. Interviews, Interview with Respondent #34, supra note 47, at 15.

74 Margaret Hepper, PilotLegis’s program administrator, explains how PilotLegis has focused on the good underwriting results, even with the pressure of the soft market:

“When Pilot formed,” says Hepper, “the members wanted to control how they purchased insurance.” She notes that the founders of PilotLegis sought to establish predictability and stability in professional liability insurance irrespective of market conditions and
Commitment to the market. The most important aspect of the stability provided by mutual insurers, according to our respondents, is long term commitment to the LPL market, regardless of insurance market conditions. Law firms express concerns about insurers’ long term commitment to the LPL market particularly because of a concern that there could be another liability insurance crisis.\textsuperscript{75} ALAS, MPC, AIM and BAR were formed when the liability insurance crisis of the mid 1970s was a recent memory, and they famously protected their members in the liability insurance crisis in the mid-1980s, which was the most extreme event in the U.S. liability insurance market since industry wide data have been collected.\textsuperscript{76}

formulated an agreement with its underwriters that the group's premiums would experience controlled changes thereby avoiding the severe price swings of the open market. Hepper says that, "In times when premiums are low, we are not going to be paying the lowest, but in hard times, we will not be paying the highest."

Attorneys’ PG Positioned to Become RRG When Market Hardens, supra note 53.

\textsuperscript{75} See sources cited supra note 71.

\textsuperscript{76} From Industrial Insured Captive to Risk Retention Group: What’s Life Like Now?, 11 RISK RETENTION REP. Feb. 1997 (introducing the historical background on the evolution of ALAS); Baker, The Shifting Terrain of Risk and Uncertainty, supra note 22, at 33 fig.3 (showing that the mid-1980s experienced the most dramatic changes in real aggregate premiums for liability insurance). In the “non-statutory” lines of liability insurance (i.e. other than auto and workers compensation) the total amount of premiums collected in the U.S. market as a whole at that time more than doubled over a two-year period. This statistic understates the increase in insurance prices during that period, because the supply of insurance – i.e. the amount of insurance that the publicly reporting insurers could write at any price – shrunk during this period. This means that insurance prices increased by more than the total amount of premiums paid and, thus, that insurance purchasers paid much higher premiums for less total coverage. Id. at 536 (“During a ‘hard market,’ prices significantly exceed costs and insurers can implement new restrictions on coverage and underwriting.”). The publicly available information about insurance premiums is taken from financial reports that provide only the aggregate premiums collected, not the prices charged for that insurance.
This commitment is credible because, unlike the stock insurers and London Market syndicates that constitute the commercial insurance market, the mutual insurers do not have the option of withdrawing their capital from LPL insurance and moving into another market. Moreover, because the members own the mutual, there is less concern that the insurer will behave opportunistically vis-a-vis the policyholders when things change either with the firm or with the market. This stability allows the mutual insurers and their (re)insurance partners to adjust prices over time to bring long-term losses and premiums into alignment despite unanticipated changes in law firm or underwriting cycle risks.

**Protection from continuity risk.** A third aspect of the stability provided by mutual insurers is protection from what the insurance trade literature refers to as “continuity risk.” This is the risk that a claim may fall into a coverage gap created by the fact that liability insurance policies provide coverage for a comparatively short period. This risk comes from the structure of claims-made liability insurance. Claims-made policies generally includes policy provisions that are intended to protect insurers against adverse selection, but that can be invoked in situations in which that underlying purpose does not apply, especially if a law firm switches from one insurer to another. To illustrate that concern, one general counsel referred to the “horror story” of the Philadelphia law firm Pepper Hamilton, which had a coverage dispute with its commercial insurers about whether a claim should have been filed in a prior year.

The mutual insurers address continuity risk by keeping the same primary insurance contract in place for a very long time, by credibly committing to avoid contesting coverage for a claim based on the kinds of technicalities that produce continuity risk, and by making sure that the

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79 Because the mutuals purchase reinsurance from the commercial market and, except for ALAS, arrange excess insurance on behalf of their
excess policies that their members purchase are true “follow form” policies — meaning that the excess policies have exactly the same terms and conditions as the primary policy. Notably, the one large law firm mutual that doesn’t provide its own primary layer of insurance — BAR — buys three year policies and takes a significant share of the risk under those policies as a way to obtain favorable, consistent policy terms and favorable, consistent insurance coverage determinations by the commercial insurers in their program.80

Summary. Whether our explanation is accurate or not, the stability the mutuals have experienced is remarkable. Above all, members tend to remain members. As an illustration, ALAS reports that the decline in the number of law firm members from a high in 1991 is largely attributable to consolidation among member firms (the total number of lawyers ALAS insures has increased since then), and that when non-member firms merge with member firms the resulting merged firm almost always remains an ALAS member.81 BAR members appear to be as loyal, or perhaps even more loyal than ALAS members. While 4 of the original 21 member firms have dissolved and two other member firms merged with firms that have different LPL insurance traditions, the rest remain BAR members — a full 36 years

members, they cannot ignore contractual requirements, but what they can do is to employ the most favorable continuity risk conditions and exclusions in their policies, conduct regular counseling on how to comply with the continuity risk conditions, take the most favorable position on what constitutes compliance with those conditions and, in general, look for coverage. See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #52, at 10-11 (June 21, 2016) [hereinafter LPL Ins. Interviews, Interview with Respondent #52].

80 See supra Part III.B.

81 The current count of member firms is down from a high of 374 firms in 1991, largely as a result of the consolidation of the legal market during that period, rather than the loss of members to the commercial market. ALAS reports that most of the reduction in member firms is attributable to mergers, and that, on the whole, mergers have resulted in an increase in the number of lawyers that ALAS insures. The current count of lawyers is down from a high point of 63,420 in 2008, largely as a result of attrition at member firms following the financial crisis of 2008. ATTORNEYS’ LIABILITY ASSURANCE SOCIETY LTD., 2010 ANNUAL REP. 5 (2011). (notes on “Membership Activities”).
after formation.\textsuperscript{82} MPC appears to have a similar record. Two members left to join AIM (reportedly because they were more similar to the mid-sized firms in AIM than the very large firms that predominated in MPC), and other firms have failed, but no firm has left for the commercial market or to join ALAS.\textsuperscript{83} Indeed, when MPC members have merged with or joined other firms, the combined firm has remained an MPC member.\textsuperscript{84}

\textbf{B. ADVERSE SELECTION}

From an insurance economics perspective, the long-term contracting problem is one kind of adverse selection problem. Nevertheless, we addressed it separately and first because that is how our respondents explained the benefits of mutual LPL insurance to us. The insurance economics explanation is as follows. Insuring against legal malpractice risks requires longer term relationships than are possible to fully specify in advance. Law firms rationally worry that their insurers will turn out to be “lemons” – abandoning them if claims emerge, unreasonably or

\textsuperscript{82} Of the original 21, the four that dissolved are Dewey, Donovan, Lord Day, and Mudge Rose; the two that merged with firms known to obtain their insurance in other ways are Rogers & Wells (merged with the UK firm Clifford Chance) and Winthrop Stimson (merged with Pillsbury, which remains a member of MPC, as indicated by the report on the firm’s website that the General Counsel is on the board of directors of MPC). We understand that at least one firm has joined since the list was published in 1992.

\textsuperscript{83} LPL Ins. Interviews, Interview A with Respondent #10, \textit{supra} note 39, at 10 (reporting on firms leaving MPC for AIM).

\textsuperscript{84} We infer that Reed Smith joined MPC when it absorbed a group of lawyers from Thelen. \textit{See} Christie Smythe, \textit{Thelen Secures Exit from Loewens Bond Offering Suit}, LAW360 (June 2, 2010, 5:50 PM EDT), https://www.law360.com/articles/172529/thelen-secures-exit-from-loewen-bond-offering-suit (reporting that MPC was Thelen’s insurer). Pillsbury Winthrop Shaw Pittman is a member of MPC. Pillsbury was a founding member of MPC that later merged with BAR member Winthrop Stimson and ALAS member Shaw Pittman. \textit{See} ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 1998 ANNUAL REP. 55 (1999) (listing Shaw, Pittman, Potts and Trowbridge as an ALAS member); List of BAR member, \textit{supra} note 5 (listing Winthrop Stimson as a BAR member).
unexpectedly raising prices, or exiting the legal malpractice insurance market altogether. Insurers, on the other hand, rationally worry that the good law firm risks will drop out of the insurance pool leaving them with the “lemon” law firms. The LPL mutual insurers address this adverse selection problem by credibly committing to remain in the market and by formal and informal structures that sufficiently commit the low risk firms to long term membership, as we explained in the prior section.

The LPL market also faces a more general adverse selection problem that is present in insurance markets even when there is no long term contracting problem. Given the potential information asymmetry between insurer and policyholder, insurance companies cannot perfectly differentiate between good risks and bad risks, with the result that they need to charge higher prices and provide less complete insurance than they would if they had better information.\(^85\) Prior work has suggested that mutual insurers may have a comparative advantage over stock insurers in this regard because the members of a mutual may be better able to assess the risk posed by their fellow members and, correspondingly, more willing to open up to the mutual about their own risks. For example, Henry Hansmann theorized that firms that are part of an industry would be better at assessing the risk of other members of that industry than an insurer would be. Hansmann argued that “the cost of information about the riskiness of individual insureds [is] lower to firms within the industry than to those outside of it.”\(^86\)

We find some evidence to support this theory in the structure of the mutual insurers, especially the smaller ones. The participating law firms know a great deal about each other outside of the membership and underwriting process, and they are better positioned than an insurance underwriter to use that process to uncover weaknesses that pose unusual liability risks. A partner in a small group mutual member firm described their comparative advantage as follows:

\(^{85}\) 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) (noting that “those with high accident probabilities will demand more insurance than those who are less accident-prone”); Akerlof, *supra* note 63, at 493 (noting that “insurance companies are particularly wary of giving medical insurance to older people due to the problem of adverse selection,” and that this “principle of ‘adverse selection’ is potentially present in all lines of insurance.”).

\(^{86}\) Hansmann, *The Organization of Insurance Companies*, *supra* note 7, at 146.
If I were a senior executive of a big [insurance] company in Europe, ... [and] could look at everything about the US market and say, “How do I judge which firms are good risks, which firms are not good risks?” It just so happens because of our group, we know how to make those judgments quite well, because we’re dealing with people in our group that we’ve known for decades and we’ve all helped each other deal, or create first-rate risk management programs and claims handling programs and policy form. ... But I don’t know how Swiss Re goes to New York and looks at—I’ll just pick a name, cause they don’t exist anymore—Dewey. I don’t know how they do it. I’ll never have to worry about it, cause we’re just ahead of the curve. That’s what we think.87

An executive in a commercial insurance company also observed that the smaller mutual insurers have an advantage over commercial insurers in underwriting:

I will tell you that if you talk to the MPC people—and you probably can—they’ve had unbelievably good results, at least they had when I was looking at them—even though some of their firms like [] have seen some tough days, they would argue that it was all about peer review. It was all about their ability to ask questions that no firm was gonna answer an insurance underwriter about. Now I would argue you can ask those questions if there’s ten of you and you’re all going to the Olympic Club together.88

A related selection advantage of the mutual follows from the time and energy that the mutuals demand of their members, especially in relation to loss prevention and claims review. Firms with a greater willingness to engage in these time consuming loss prevention activities may be more likely to join the mutual and more likely to stay in the mutual.89 As one general

88 LPL Ins. Interviews, Interview with Respondent #16, supra note 51, at 20.
89 An economist would call this propitious selection on moral hazard. See Liran Einay, et al., Selection on Moral Hazard in Health Insurance, 103 AM. ECON. REV. 178, 178 (2013) (presenting empirical evidence) (“[I]ndividuals may select insurance coverage in part based on
counsel explained in response to our question about why he had not recommended that his firm join ALAS, “Joining ALAS meant a kind of commitment of time and energy that I think a lot of people just didn’t feel like making.” The willingness to make that commitment may signal that the firm is a better fit for ALAS, both in terms of commitment to loss prevention and to a long-term relationship with ALAS.

In addition to engaging in careful selection of its members, a mutual insurer could also combat adverse selection by promoting a sense of solidarity among its members that makes them more willing to share information about their risks and more willing to make a long-term commitment to remain in the mutual. Consider the makeup of the mutuals as described above. BAR and MPC are a veritable who’s who of top firms in New York City and San Francisco. Over one-third of ALAS members are on the AmLaw 200 and they represent one-quarter of all firms over 1,000 lawyers. Further, AIM and ALAS (which appear to be more actively interested in new members than BAR or MPC) are notoriously careful in selection, which provides some support for this theory. This selectivity creates a sense that member firms are living up to certain professionalism standards and promotes a sense of solidarity that encourages the sharing of risk-related information:

You probably have a conception of your peer group—either your Penn Law peer group or in-your-field peer group. We probably have a view of that, that cuts across quality, the competence, and there is a kind of a view that there’s a slight—we’re still a little old-fashioned—where culture actually matters. It’s thought to be a good thing that when you have a partners’ meeting, everyone actually can sit around the same table. … There is this sense in which a little pride of culture matters. The profession has actually been experiencing a

their anticipated behavioral (‘moral hazard’) response to insurance, a phenomenon we label ‘selection on moral hazard.’”); David Hemenway, Propitious Selection, 105 Q.J. ECON. 1063 (1990).

90 Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #21, at 10 (Dec. 18, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #21].

91 See supra note 5.

92 For a discussion on ALAS’s selectivity, see supra note 26. See also LPL Ins. Interviews, Interview A with Respondent #10, supra note 39, at 8.
decline in professionalism and becoming more and more like accounting firms. That’s a bad thing. It’s bad for the quality of life. It’s bad for the quality of representation. It’s bad for risk. It’s terrible for associates. I would say there’s a certain way in which there’s a high degree of homogeneity on that, as expressed.93

I mean one of the reasons that these firms are comfortable with each other is we’re all comfortable that each of us values our reputations. Putting aside claims experiences, etc., we’re all comfortable that each of the members of the group believes in risk management, simply in terms of preserving their reputations as firms that don’t do the sorts of things that expose them to malpractice claims.94

[W]e created the [mutual] because of our desire to be able to control our own at least primary layers of insurance, control the terms and conditions of our policies and see that all the members of the group lived up to the kind of risk management that we all believe in. That’s exactly why we did it.95

ALAS, as you probably know, but if you don’t, I can give you all this information about it—that’s really kind of a band of brothers type approach. They would do a lot of peer review and those sorts of things.96

Of course, this is not solidarity with the legal profession as a whole, but rather solidarity with the slice of the legal profession that forms the

94 LPL Ins. Interviews, Interview with Respondent #19, supra note 47, at 12.
96 LPL Ins. Interviews, Interview with Respondent #16, supra note 51, at 4.
membership of the mutual. That slice is a comparatively elite one, with the associated elitism serving as part of the attraction of the mutual.  

C. MORAL HAZARD

This solidarity is also part of the reason why mutual insurers may also be better at managing the potential moral hazard of LPL insurance. As insurance scholars know well, moral hazard presents potential problems for both the insurer and the policyholder. Insurers worry that indemnification will cause policyholders to take less care to avoid causing harms and will take less care to minimize those harms that do materialize. Policyholders worry that insurers will take their money up front and then, when claims come in, refuse to provide, or only reluctantly or partially provide, the coverage for which the parties bargained. We find evidence that the LPL mutuals may have a comparative advantage in addressing both these aspects of moral hazard.

Loss Prevention. Insurers have a number of tools to manage policyholder moral hazard, including pricing on risk, underwriting, contract design, claims management, loss prevention, research and education, and engagement with policy makers, as we’ve discussed elsewhere. Although

97 One law firm general counsel, not an ALAS member firm, described the attraction of ALAS, only partly tongue in check, as follows: “It’s a cool thing to be a part of. ALAS is for the study firms.” See notes from conversation with Respondent #35 (Nov. 10, 2015) (on file with authors). See also LPL Ins. Interviews, Interview with Respondent #35, supra note 93, at 3 (“[I]t’s a good idea to be a part of it, but I think that’s what it is. It's not a brand. I would guess some people are all proud that they’re members of ALAS, it means they’re one of the big boys.”). For a recent review of the stratification of the U.S. bar, see JOHN P. HEINZ & EDWARD O. LAUMANN, CHICAGO LAWYERS: THE SOCIAL STRUCTURE OF THE BAR 37-45 (Am. B. Found. 1994).

98 See generally Baker, On the Genealogy of Moral Hazard, supra note 15; CAROL A. HEIMER, REACTIVE RISK AND RATIONAL ACTION: MANAGING MORAL HAZARD IN INSURANCE CONTRACTS 29-31 (U.C. Press 1985) (noting that the moral hazard contains a matter of choice and can affect the policyholder’s action, which will further change the odds and severity of a covered peril and lead to different reactions of the insurer).

99 Baker & Swedloff, supra note 15 (identifying risk-based pricing, underwriting, insurance contract design, claims management, loss
LPL insurers use these tools to varying degrees, our respondents report that they believe that one of the primary benefits of being part of ALAS—and most of the smaller mutual insurers—is superior loss prevention services.

Our research suggests that law firms want help with loss prevention and that the provision of those services binds the members to the mutual. In that regard, it is important to be clear that none of our respondents suggested that there is a classic *ex ante* moral hazard problem with regard to LPL insurance. If anything, the emphasis that law firms place on LPL insurers’ commitment to loss prevention suggests to us that, to the extent that lawyers think about LPL insurance at all, those thoughts encourage greater care, not less.\footnote{See also Baker & Swedloff, *supra* note 15.} Thus, the potential difference between stock and mutual insurers lies not in their ability to prevent lawyers from “slacking off” because of insurance but rather in their ability to encourage lawyers to do more.

ALAS, especially, has a reputation for providing high quality loss prevention services:

> They’re the best in loss prevention support and assistance. … Not only their publications, they have seven or eight loss-prevention counsel who are all former partners in ALAS firms and are very experienced in the area. … [Y]ou just call up, and you get an ALAS—sophisticated ALAS person—who will work through a problem with you; and if he or she doesn’t know the answer, they’ll caucus and get back to you.\footnote{LPL Ins. Interviews, Interview with Respondent #24, *supra* note 68, at 6. *See also*, LPL Ins. Interviews, Interview with Respondent #30, *supra* note 70, at 10 (“We’re very satisfied with ALAS and I think it does a terrific job not only with respect to clients but with respect with loss prevention programs and so forth.”).}

Why do we stay with ALAS? It’s a couple of things. One is that they have outstanding loss prevention resources. I mean better than any other carrier or any other source we can imagine. They provide a lot of educational and a lot of backstopping, a lot of counseling, a lot of support for prevention activities. If I get a really thorny conflict question that I’m having difficulty with I can call any one of a
number of people up there and get a really, really thoughtful answer. That’s nice.\textsuperscript{102}

The smaller mutuals do not have the same internal loss prevention staff, but the three that are managed by Aon – AIM, BAR, PilotLegis – have access to Aon’s loss prevention unit, which Aon created to compete with ALAS. In addition, the smaller mutuals hold loss prevention meetings and share loss prevention information. Moreover, the annual member-run audits of other member firms, especially those from MPC, provide opportunities for feedback on loss prevention practices. An attorney in one MPC member firm who claimed to be knowledgeable about ALAS loss prevention efforts, asserted that MPC’s loss prevention efforts were more cutting edge and better tailored to the firms in MPC.

The ALAS firms have many programs, but I think we’re just a little more nimble due to our small size, and we’re very, very interested in the subject. Always have been. That’s why we did it this way, so we—I think we stayed with the cutting edge of what’s going on in law firm risk, as well as just good practices. Not just avoiding risk, but good practices that promote the highest ethical behaviors and identifying issues as they come along.\textsuperscript{103}

For our purposes the truth of this assertion is less important than the value that it suggests MPC places on loss prevention. Actively participating in any of the LPL mutuals builds structured attention to loss prevention into the busy professional lives of the law firm partners charged with carrying out the firms’ obligations to the mutual.\textsuperscript{104}

\textsuperscript{102} Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #28, at 11 (May 8, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #28].

\textsuperscript{103} See LPL Ins. Interviews, Interview with Respondent #26, supra note 16, at 14.

\textsuperscript{104} One law firm general counsel made the point this way:

\begin{quote}
\textldots Let me go a different way. If you ask the question, "What does a board of directors do for a corporation to management?” \ldots There's a lot of different kinds of things you can say. One of the things that happens is management has to show up on a periodic basis and just explain why it's doing what it's doing\ldots I have come
\end{quote}
Law firms that buy strictly commercial report a different approach to loss prevention by their insurers, with less insight and fewer structured opportunities for firm lawyers to focus on risk management:

[Y]ou know about ALAS right, the co-op group? We’ve never been an ALAS firm. I have the impression just anecdotally that ALAS is much more hands on about stuff that its insureds do. I think they've expressed a view about whether you should have a mandatory arbitration provision in your engagement letter. Those are subjects that I’ve just never seen come up in some years I’ve been dealing with the insurers.\textsuperscript{105}

\begin{flushright}
to believe that having, if you're management, having to come and just sit down and explain why you're doing what you're doing makes you better at what you do, in a pretty big way.
\end{flushright}

What's the analogy here? I can only go to two meetings a year. I listen to some stuff probably that I wouldn't hear otherwise. I think a little bit more about it. My firm wants me to write a one-page summary to report to the board. Just that attention focuses people to do a little better than they might otherwise. It doesn't actually take a great idea. That's sort of my point.


\textsuperscript{105} Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #31, at 5 (June 4, 2013) (unpublished interviews, on file with authors). \textit{See also} Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #33, at 9 (June 10, 2013):

Occasionally they make suggestions, although we are pretty far ahead of the curve, at least that’s our perception, and that’s reinforced by the carriers. It’s fairly rare that we have a carrier pushing us to take a risk management step that we don’t. It’s more that they like to hear it and know what we’re doing, so that they can calibrate how much capacity they wanna allocate to us, and what rates they feel like they need to justify that, I guess, the risk that we present.
It makes economic sense that the mutuals invest more in loss prevention than the commercials. First, the solidarity fostered by the mutuals make them better able to motivate meaningful risk reduction, increasing the return on their investment in loss prevention research and development. In that regard one respondent noted:

[I]n a group there’s more likely to be peer pressure to do a better job and have fewer claims. I’ve seen it in real—these guys do not want to sit in a meeting and have their claim information up on the board. There’s an incentive for them to go back to their firms and—I know a couple of firms that have taken all the information back to their partnership meetings and kind of laid it out there and said, “I don’t want to be the poster child at the next board meeting. We got to do it better the next time.” That sort of thing.106

Second, to the extent that there are longer-term relationships between the mutuals and their members the mutuals can expect to earn a greater return, in the form of lower losses, from a given investment in loss prevention.

Policyholder Trust in the Claims Experience. With regard to moral hazard by insurers, law firms report higher levels of trust that mutual insurers will whole-heartedly perform when claims come it and, correspondingly, greater levels of concern about hesitation or outright opportunism by stock insurers.107 Mutual members report that they value their membership in large part because of the high quality claims handling experience—both because they do not have to fear that the mutuals will deny their claims and also because of the manner in which the claims are handled.108 In the words of one law firm general counsel, “[T]he intangible is the claims control. …. Who’s your lawyer, and how much are they [the insurers] gonna screw

107 See, e.g., LPL Ins. Interviews, Interview with Respondent #28, supra note 102, at 12 (“I am . . . aware of just enough contrast in the commercial market that, to us, the way that [the mutual] handles claims is extremely important”).
108 See, e.g., id.; See also LPL Ins. Interviews, Interview with Respondent #23, supra note 42, at 19 (“I mean it’s not—not to trash another company too much, but it’s not like you hafta’ call National Union and say, ‘Help us settle this case.’”).
around with your lawyer?”109 Although there are significant differences in the claims handling approaches of the mutuals – with ALAS said to exercise the most centralized control over claims – our respondents who are members of, or work with, the mutuals stressed the quality of the claims experience.110

A general counsel of an ALAS member put it this way:

Even more important than [their outstanding loss prevention resources] is the claims handling function. I know all the ALAS claims attorneys. I’ve known them for years. They worked our claims, I worked with them when I represented other ALAS firms. I’ve seen them as outside counsel and inside counsel. They’re highly professional, very intelligent and they also are very supportive; … they handle claims in a very good way. I just am aware of enough contrast in the commercial market that, to us at least, the way ALAS handles claims is extremely important. That relationship is worth it to us.111

Another general counsel in an ALAS member firm referred to the “horror story” of the Philadelphia law firm Pepper Hamilton, referred to earlier in our discussion of continuity risk.112 He contrasted that experience with firms in ALAS:

There’s not the risk of coverage denial. There’s not the risk of being caught between years. … It’s not the case with ALAS that when you

109 LPL Ins. Interviews, Interview with Respondent #35, supra note 93, at 18.
110 See, e.g., LPL Ins. Interviews, Interview with Respondent #23, supra note 42, at 18-19 (“I think we get a lot of the benefits in how the claims are administered. . . . You get a very—it’s self-administered, meaning that there are no employees with this company. . . . They are very supportive and helpful.”); LPL Ins. Interviews, Interview with Respondent #26, supra note 16 and accompanying text.
111 LPL Ins. Interviews, Interview with Respondent #28, supra note 102, at 12.
112 See LPL Ins. Interviews, Interview with Respondent #52, supra note 79, and accompanying text.
give them a claim that they’re looking at the claim with a reason to turn it down. They are in it for the long term.\footnote{Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #27, at 2 (Dec. 20, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #27].}

Criticizing commercial insurers’ claims practices is one topic on which the members of ALAS and the smaller mutuals agree. The general counsel of one member of a small mutual reported:

\begin{quote}
[Mutual] is . . . very supportive and helpful. I mean it’s not—not to trash another company too much, but it’s not like you have to call National Union\footnote{National Union is the name of a prominent commercial insurance company in the AIG group of companies.} and say, “Help me settle this case.” If you’re calling on one of your colleagues in another firm that you’ve been working with for the last 25 years—and so it’s a very interactive approach to claims handling.\footnote{LPL Ins. Interviews, Interview with Respondent #23, \textit{supra} note 42, at 18-19.}
\end{quote}

While it is not possible for our qualitative research to prove or disprove these accounts, the money-for-promise nature of insurance can create an incentive for opportunistic behavior at the point of claim.\footnote{Tom Baker, \textit{Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages}, 72 TEX. L. REV. 1395, 1401-02 (1994) (explaining the tension in the relationship between insurance companies and their insureds within the money-for-promise arrangement).} Insurance law and regulation attempt to reduce that opportunism, and insurance marketing is directed at alleviating policyholder concerns.\footnote{Id., at 1403-07 (discussing how insurance advertisements address the theme of trust and dependence differently).} The fact that mutuals are owned by their members may reduce the opportunism incentive, because there are no shareholders whose interests are in conflict with the policyholders. While, of course, the membership as a whole may have adverse interests to the member with a particular claim, each of the members may face a claim in the future.\footnote{A general counsel in another ALAS member firm expressed that point indirectly as follows:}
Two corollaries to this point are the following. First, because of the long-term stability of their membership and their law firms’ demonstrated willingness to pay a higher price for what is understood to be a higher quality relationship, mutuals have less concern that the higher costs associated with high quality claims handling will drive members away. Second, as discussed above, the relative homogeneity of the pool may make law firm members less concerned about ex post moral hazard, i.e. that certain members may take advantage of the high-quality claims experience by demanding more, or more expensive, defense services than reasonable.

D. PROFESSIONAL INDEPENDENCE

Our final explanation for the success of the mutual insurers is that member firms believe that participating in an LPL mutual promotes professional independence to a greater extent than buying purely commercial insurance. This professional independence explanation is complementary to the traditional market failure explanations just explored because it helps to explain why law firms might find it easier to accept a mutual insurers’ efforts to manage moral hazard, adverse selection, and the long term contracting problem. To at least some degree, such efforts by insurers require asserting some control over, and thus limiting the autonomy of, their insureds. Adverse selection and the related long-term contracting problem leads insurers to

I think there is—one of the arguments that commercial carriers make—we get solicited a fair amount—is, “If you come with us, you’re going to pay X dollars a lawyer, and that’s Y dollars less than what you’re paying at ALAS.” Well, that may be, but that doesn’t take into account the question as to whether or not this carrier is going to be there when a claim comes in. It doesn’t take into account the loss-prevention services. ... Do we pay for the loss-prevention services? Sure. We pay for it, but we’re not paying for Chubb’s—we’re not paying out anything to Chubb stockholders.

LPL Ins. Interviews, Interview with Respondent #24, supra note 68, at 6.
create structures that bind insureds to the pool.\textsuperscript{119} Moral hazard leads insurers to emphasize loss prevention and claims control.\textsuperscript{120}

When the insured and the insurer are part of the same profession, accepting some degree of control by the insurer – engaging in recommended loss prevention efforts, accepting control over the claims settlement process, and agreeing to organizational rules and contract terms that limit the freedom to change insurers – is likely to be less threatening to the insured. In that context, these apparently autonomy-reducing efforts can easily be understood and explained to recalcitrant partners as professional self-regulation or, less grandly, simply as smart law firm risk management.\textsuperscript{121}

Whether this professional autonomy appeal is understood as a separate explanation or simply as a reason for the mutuals’ comparative advantage in addressing the market failures as traditionally understood is less important to us than the resulting focus on the law firms participating in the mutuals. Loss prevention, solidarity, and long-term contracts are not something that the mutuals impose on recalcitrant members in return for providing risk distribution services. Instead, “You could say [mutual insurer] – which has its own officers and directors – pushes things to us, but \textbf{we} own it, and \textbf{we} direct it to do so.”\textsuperscript{122} One of the themes of our larger LPL research project, and a distinction between our work and much of the prior work in both the insurance as governance and the law and economics traditions, is

\begin{itemize}
  \item \textsuperscript{119} Baker, \textit{Containing the Promise of Insurance}, supra note 61, at 375-76 (discussing the four approaches that insurers usually use to bind insureds to the pool as a solution to the problem of adverse selection).
  \item \textsuperscript{120} Baker, \textit{On the Genealogy of Moral Hazard Genealogy}, supra note 15, at 280-82 (arguing that insurance is often conditioned on both the care to prevent a loss and insurers’ controls over insureds’ ability to recover loss).
  \item \textsuperscript{121} Interestingly Rappaport reported that some municipalities prefer to buy commercial rather than join municipal liability pools because the commercial insurers “tend to be less aggressive about loss prevention” and thus “leave them greater autonomy over their policing operations.” See Rappaport, supra note 15, at 1566. In the LPL context, mutuals promote this kind of autonomy to the extent that they grant the law firms greater control of the defense of claims than the commercials.
  \item \textsuperscript{122} LPL Ins. Interviews, Interview with Respondent #26, supra note 16, at 6.
\end{itemize}
this focus on the demand side of the governance aspects of the insurance relationship.123

Among all of our respondents who are involved in the LPL mutuals, and even some who are not, there was remarkable uniformity about the benefits we just described: stability in LPL insurance relationships; a high-quality claims experience; a commitment to loss prevention; and the professional development that comes from being part of a larger group of quality law firms. 124 All of these reasons connect to professional independence.

Stable insurance relationships free law firms from the worry that a commercial insurer will decide to leave the LPL market or make other dramatic changes that would interfere with the firm’s ability to obtain reliable LPL insurance. Scrambling to fill a gap in an insurance program in a hard market interferes with professional independence by taking time away from the partner(s) involved in that effort and distracting other lawyers in the firm. Avoiding that distraction is part of the appeal of belonging to a mutual.125


124 See A Legal Mindset Permeates ALAS, supra note 31 (describing the benefits of ALAS as: “stable rates, good claims service, proactive loss prevention, and pride in participating with other prestigious firms”). See, e.g., the quotes from LPL Ins. Interviews, Interview with Respondent #23, supra note 42; LPL Ins. Interviews, Interview with Respondent #24, supra note 68; LPL Ins. Interviews, Interview with Respondent #26, supra note 16; LPL Ins. Interviews, Interview with Respondent #28, supra note 102; LPL Ins. Interviews, Interview with Respondent #32, supra note 35; LPL Ins. Interviews, Interview with Respondent #34, supra note 47. See also LPL Ins. Interviews, Interview with Respondent #35, supra note 93, at 5 (“there is some preservation of control of the claim process”).

125 As one respondent explained:

You could save money in most years anyway you could probably get insurance cheaper elsewhere. The combination of claims and loss prevention service, the stability, the commitment to the market are all very attractive and substantial features of that. I mean there are plenty of terrific commercial insurers out there, sometimes they have varying degrees to which they are committed to the professional liability market or at least at a certain capacity and so forth.
Trust that there will be a high-quality claims experience frees law firms from the worry that their insurer will disappear when a large claim arrives. Moreover, because the “claims are administered by lawyers from other firms that you know” or in the case of ALAS former partners in member law firms, the claims experience bears more in common with peer review than most general counsels’ understanding of the commercial insurance claims process. A senior lawyer with experience in firms that were members of two different mutuals made this point as follows:

The reason that [firm A] and [firm B] and the firms in [mutual] are in mutuals, in my opinion, would be, one, dealing at arm’s length with the commercial insurer is different than dealing with an organization that you have a stake in and probably have a general counsel seated at the board of directors in the company or doing something within the company. You’re just treated differently. It’s not an arm’s length transaction where, when you report the claim, you get a 40-page reservation of rights letter and they start looking at ways to get out of coverage. We don’t—I’ve always felt the proper approach to a legal malpractice claim for a carrier is you look for coverage. Somebody’s paid a premium. They bought insurance for this. If there is potential for coverage or reasonable interpretation that provides potential for coverage it’s covered until it’s not. I mean commercial insurers, this is my bias, they approach it entirely differently. They get a claim in and the first resistance, how can we avoid covering this.126

The general counsels’ discussion of loss prevention similarly emphasized the quality of the service and the fact that it came from peers, not from a “big outside insurance company … coming to us and saying, ‘Run yourself this way.’”127

The thing you don’t want is to be hooked up in a substantial way with an insurer that decides it doesn’t want to write this kind of insurance anymore or having nothing to do with your particular firm. There’s no risk of that with ALAS.

LPL Ins. Interviews, Interview with Respondent #30, supra note 70, at 10.

126 LPL Ins. Interviews, Interview with Respondent #52, supra note 79, at 6.

127 LPL Ins. Interviews, Interview with Respondent #26, supra note 16, at 6, 12.
Finally, although few of our general counsel respondents spoke explicitly about the professional development aspects of participation in the mutuals, it was clear that most of them regarded the lawyers from other firms who participated in their groups as potentially valuable peers and that they valued their participation in the group experience for reasons that went beyond just risk transfer, loss prevention, and good claims handling. As the general counsel from one ALAS firm described:

ALAS only does legal malpractice for a certain kind of practice, a corporate practice, not a money-center practice, a practice of good quality firms in cities like Philadelphia, Cincinnati, but not cities like New York, Chicago, L.A., San Francisco, although that’s changing. … Their expertise is right for what we do. … [It’s notable there is] a very high percentage of the firms who are members, who are represented at the annual meeting. … They’re all like you are. … People who work at ALAS in both claims and loss prevention are also people from our background, people who came out of corporate law firms.

V. ASSESSING THE CONTRARY REPORTS

To this point we have reported what our respondents who are involved in the LPL mutuals have told us about the benefits of that involvement. Perhaps not surprisingly, respondents who work in the commercial market report that the differences between buying purely commercial and participating in the mutuals are less than the members of the mutuals report. In this part we examine and find significant justification for their skepticism. We find this skepticism credible for three reasons. First, as most participants in the purely commercial market report, the commercial market has developed its own mechanisms to deal with the problems of long-term contracting, adverse selection, and moral hazard. Second, there are no purely mutual insurance relationships. All of the mutuals have a significant commercial component. Third, the large market share of the mutual insurers, and their demonstrated ability to expand when needed, forces the commercial insurers to act more like mutual insurers in at least certain respects.

128 Note that ALAS has long had many member firms in Chicago, but not from New York, Los Angeles or San Francisco.
A. ADDRESSING MARKET FAILURES IN THE COMMERCIAL MARKET

Members of the commercial market report that they provide similar benefits to their mutual peers in the form of stability in insurance relationships, commitment to the LPL market, and access to those loss prevention services they deem necessary.

**Stability.** Commercial brokers report that long term relationships with insurers are not unique to law firm mutuals. Commercial brokers work to provide the same long-term relationships and stability for their purely commercial customers that mutuals provide to their members. As one broker stated: “The bottom line is we like keeping the same carriers on a firm’s program for a long period of time, so long as the pricing is right, because there’s stability there that’s good for everybody.”

Moreover, a long-term relationship with a broker might provide similar stability to large law firms as membership in a mutual, perhaps even at a lower cost, especially when that cost is understood to include the time that lawyers in the firm devote to the mutual. For law firms that buy strictly commercial there are no boards or committees, no member surplus accounts, and certainly no unitary or quasi-unitary pricing. One law firm general counsel put it to us this way:

I was always perfectly content to leave the insurance to the insurance people and to leave the law to the law people, and I always felt that— I mean, Minet was looking out after our interests, and later Minet was purchased by Aon, so now it’s Aon. We’re still customers of Aon. We’ve been basically represented by the same entity since 1976 when Minet first got us as a client. I just don’t see the point of spending a lot of time and energy. I’m glad that ALAS exists because the insurance market is very oligarchic, and there’s really just Aon and Marsh, and there really isn’t anybody else. I think it’s healthy to have more competitors in that market … Joining ALAS meant a kind of commitment of time and energy that I think a lot of people just didn’t feel like making.

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130 Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #8, at 15 (Sept. 25, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #8].  
131 LPL Ins. Interviews, Interview with Respondent #21, supra note 90, at 5.
Whether the brokers would be able to provide this same comfort in a market without ALAS, MPC, BAR, AIM or PilotLegis is, for us, the key question. The presence of these options clearly gives brokers negotiating leverage when going out into the commercial market to obtain coverage for the law firms that they represent. The difference that leverage makes in the pricing and other terms of the coverage, however, is not a question that this form of research can definitely answer.

Further adding to the credibility of the stability claim is the expectation in the commercial market – even if sometimes honored in the breach – that for law firms above a certain size, LPL insurance should primarily function to spread risk across time, and not in the long run across law firms. That is possible only with long-term relationships. In contrast to other commercial insurance arrangement with which we are familiar from research and practice, there appears to be greater agreement among buyers and sellers about the importance of long-term relationships and about the principle that a good long-term relationship means that primary insurers will make a reasonable profit at the individual law firm level, at least for large firms. The concept that our respondents used to explain how this principle works in practice is “payback,” which refers to paying above market premiums after a loss, so that, “In the long run your premiums are 120 percent of your claims.” Significantly, commercial insurance underwriters report that they enforce this principle by refraining from undercutting the premium of an insurer receiving payback.

132 Note that this expectation does not mean or require that individual excess insurers will have a good underwriting ratio at the individual firm level. The number of very large claims is simply too small for that to occur. The most that a high level excess insurer can expect is to earn a reasonable profit on its entire book over time.

133 A CFO put it this way: “[Legendary broker] was very good on this. He would always say, ‘In the long run your premiums are 120 percent of your claims.’” Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #50, at 11 (June 11, 2013) (unpublished interviews, on file with authors). An actuary put it this way: “This ties back into the size of the account. If it was a truly large firm, I might expect it to be profitable on its own.” Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #39, at 6 (Nov. 1, 2013) (unpublished interviews, on file with authors).

134 A senior executive at a commercial insurer explained this to us as follows:
Part of what makes this claim credible is that the commercial LPL insurance market is significantly smaller than the D&O insurance market, which, as prior research reports, is able to enforce norms that require collective effort to maintain.\textsuperscript{135} There are fewer than ten commercial insurers

Now, I’m also not going to come in and just bid against a firm that needs to get what we call payback. If you’re on the losing end on a firm and they need to start to payback because you’ve lost money on them, I think most responsible markets would turn and say, “Yeah, that’s part of the deal.” You can’t hit somebody up with a big loss and then say, “I want a rate reduction cuz we’re gonna change things.” Even if you’re changing things, there has to be some consistency. There has to be some loyalty to the market cuz, otherwise, I know that when I get banged around, my guys are just gonna walk away, so I’m not there to just do that.

LPL Ins. Interviews, Interview with Respondent #18, \textit{supra} note 72, at 8-9. Another respondent put it this way:

Q: Can I just ask a follow up question about that? When you were saying that the large firms aren’t a traditional insurance transaction—in other words, for them, they’re big enough that it’s more that they’re managing their cash flow than that they’re actually—

R: Yeah, I think that’s a good description. It was more kind of a—oh, what’s it called. You know you’d price it at year-end and look back and say, “Losses exceed what we—the expected loss or not,” and it was kind of a, “Let’s split the difference with your carrier.” As opposed to a premium up front, it was more of a retro price contract.

\textsuperscript{135} \textit{See generally} Tom Baker & Sean Griffith, \textit{Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation} (Univ. of Chicago Press, 2010) (noting that D&O insurers can reintroduce the deterrence function of shareholder
at any time that are willing and able to take a “lead” position in a large law firm LPL insurance program. One insurance broker – Aon – services a large percentage of the large law firm LPL market, putting it in a good position to enforce this norm. A law firm that needs $100 million or more coverage from insurers that will not provide more than $10 million each cannot afford to alienate very many insurers. And the people responsible for purchasing insurance in large law firms are partners in those firms (typically litigation partners), with the intelligence and the paranoia needed to appreciate how changing insurers exposes their law firms to continuity risk. Taken together, all these factors provide support for the existence and force of the payback norm and, thus, the brokers’ and commercial underwriters’ assertion that large law firms don’t have to belong to a mutual to have stable insurance relationships, at least as long as the presence of the mutuals provides a credible alternative for a significant share of the law firms buying purely commercial.

At the same time, the flexibility of commercial pricing provides an opening for the commercial market to try to recruit lower risk firms to leave the mutual. As brokers and commercial underwriters emphasize, the unitary and quasi-unitary pricing of the mutual insurers works to the advantage of members with poor claims histories and to the disadvantage of the “squeaky clean” firms:

There is a figure, which is a per-lawyer charge. The big problem there is: that’s great if you’re not a very good law firm. If you have lots of losses, that’s great, isn’t it? Basically, the good guys are subsidizing you. Conversely, if you’re an extremely professionally run and you’re as clean as a whistle, you’re helping to pay the losses of other firms for which you receive nothing. There are arguments, and ALAS will make them quite strongly, where they’ll say,

litigation through pricing, insurance monitoring and loss-prevention programs, controls over defense settlements, and coverage defenses).

See E-mail from Respondent #18 (Jun. 15, 2016) (on file with authors).

DOUGLAS R. RICHMOND ET AL., AON RISK SOLUTIONS, QUALITY ASSURANCE REVIEW: A TIMELY REVIEW OF PRACTICE MANAGEMENT ISSUES AFFECTING THE LEGAL PROFESSION (2015) (noting that Aon had served approximately 275 firms over the past 10 years).

See Baker & Swedloff, supra note 45, at 1282 nn.24-25 and accompanying text.
“There’s no such thing as an entirely clean law firm. Therefore, the mutuality is more important, this idea of being a strong group. It gives us purchasing power. It allows us to remain stable through all markets.” The truth of the matter is, mutuals are better for bad insureds. If you’re clean as a whistle, you’re better off out there in the market.139

Of course, as this last statement reflects, the advocates of the purely commercial approach are trying to have their cake and eat it, too, reporting that they are able to provide the stability and loss prevention benefits of the mutuals, but at the lower cost that reflects the risk of the “squeaky clean” members of the mutual organizations.140 That may be the case for those squeaky-clean members, and as long as there is no liability insurance crisis. Law firms with more difficult claims histories, however, will not receive that preferred pricing. Moreover, LPL insurance policies get re-priced every year, renewal is not guaranteed, and the premium increases and market share shake-up during the early 2000 hard market suggest that there remains a risk that commercial insurers could leave the market.141

Of course, commercial brokers downplay this risk, asserting that there is little reason to fear that commercial insurers will abandon the LPL market and that customers are not really worried about that eventuality. Noting that 30 years have passed since the mid-1980s liability insurance crisis, one broker reported that law firms’ concerns about commercial insurers lack of long-term commitment to the LPL market “has dissipated”:

Most of those people who were involved in that [crisis] don’t even believe there’s a possibility that they could be left without insurance, so the continuance of the relationship of insurance slides down the agenda, I think, from the managing partner to other partners. It is no longer one of the vital relationships that the managing partner thinks he has to preserve, as he becomes managing partner, because it’s

139 Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #48, at 7 (Nov. 6, 2013) (unpublished interviews, on file with authors).

140 See LPL Ins. Interviews, Interview with Respondent #18, supra note 72 (reporting that “squeaky clean” firms can save 30-35% by leaving ALAS and buying purely commercial).

been a stable relationship, ever since. … I think, the likelihood that that complete disappearance will occur again is extremely remote. Anyway, it hasn’t happened. These guys were in high school, when that happened.\textsuperscript{142}

Although it is obviously the case that the market has performed adequately for a long time and, thus, the strength of the underwriting cycle explanation for the continuing need for LPL mutual insurance has waned, count us as among those skeptical that the liability insurance industry has sufficiently tamed the underwriting cycle to eliminate the need for LPL mutual insurance organizations.

\textbf{Loss Prevention Services.} Mutual members report that they value loss prevention services and those services could help mitigate moral hazard. We find evidence that commercial insurers have hedged their bets on this front. On the one hand, some of our commercial insurance respondents question whether the greater attention to loss prevention by the mutuals makes any difference at this point, given that most firms have adopted significant risk management structures through centralization:

To be frank with you, I think there are clearly the nuts and bolts of risk management that all firms have to have done and do properly. They have to have conflicts of interest systems in place. They’ve got to have good diary and calendar systems. They have to have some type of peer review where they’re watching what their partners do. They have to have somebody look over tax opinion letters. They need to have some sort of system in place to make certain that their partners don’t have substance abuse problems and that the checks are being countersigned. When you get to a firm of a certain size, they have all that down. They know what they’re doing. I always find it interesting that the outfit that has the greatest loss prevention and risk management out there, that people just tout constantly, is ALAS. That’s what they’re known for in the industry is how good their risk management and loss prevention is. Interestingly, their loss

\textsuperscript{142} Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #7, at 16 (May 29, 2013) (unpublished interviews, on file with authors).
history is no different or no better than, no worse, than the commercial market. 143

On the other, commercial insurers can and do fill this gap by partnering with other providers in the market to provide loss prevention services. For example, the large LPL broker, Aon, has its own loss prevention experts, who, like the ALAS loss prevention experts, are also former partners in law firms. 144 Through these experts, Aon puts on programming about setting up and maintaining loss prevention structures and cultures in law firms. 145 For law firms working with other brokers, there are independent loss prevention experts, and commercial insurance companies sometimes provide credits that help law firms offset the price of hiring those experts. 146

B. HYBRIDS

Another part of what makes the commercial brokers’ skepticism credible is the fact that, especially in terms of risk distribution, the differences between buying purely commercial LPL insurance and participating in a mutual are less stark than reading either the insurance literature or the law and economics literature might suggest. The reason is that there are no purely mutual LPL insurance arrangements. All of the LPL mutuals – especially ALAS – purchase significant reinsurance, and their reinsurers are part of the same insurance capital market as the commercial insurers. Moreover, apart from ALAS, all of the mutuals purchase commercial excess insurance for their members, and the largest ALAS members do so on their own.

This means that all of these mutual insurance arrangements have significant commercial insurance aspects. At one end of the continuum there is PLUG: a short-term, broker-driven mutual component in an otherwise purely commercial LPL program. At the other end is ALAS: a large LPL mutual with a sizeable staff that uses the reinsurance capacity of the

143 LPL Ins. Interviews, Interview with Respondent #18, supra note 72, at 18-19.
144 The head of Aon’s loss prevention group is a former partner in an ALAS member firm.
145 LPL Ins. Interviews, Interview with Respondent #8, supra note 130, at 2.
commercial insurance market and whose larger members buy high-level excess insurance on the commercial market on their own, without assistance from ALAS. The other mutual insurers occupy intermediate positions on this continuum:

- PilotLegis is a risk purchasing group, so all of its members are entirely insured by the commercial insurance that PilotLegis and Aon arrange for them. Nevertheless, because PilotLegis has committees, audits, and an expectation of permanence, the LPL arrangements of PilotLegis members are more mutual in nature than those of the firms in PLUG. While PilotLegis doesn’t presently assume risk, it claims to be ready to do so.
- AIM differs from PilotLegis in being less broker-driven and, of course, it already bears risk, so AIM is a step further along the mutual continuum. Nevertheless, at least in terms of risk transfer, it functions primarily as a buying service for commercial insurance.
- BAR takes on much greater risk than AIM, but it relies on commercial insurers to take the lead in underwriting and pricing. In addition, BAR members obtain all of their higher-level excess insurance from the commercial market.
- MPC has a more arms-length relation with its brokers than BAR or AIM, and its members have a more active involvement in pricing than BAR, but MPC’s substantial layer of primary “insurance” is actually reinsurance that backs a primary insurance policy provided by a commercial insurance company. While that commercial insurer hopes never to have to pay its own money, it would have to do so if MPC were to become insolvent. Like BAR, MPC functions as a buying service for higher-level commercial excess insurance.

Figure 1 shows the spectrum visually for the five currently operating mutual LPL insurance arrangements, using a stylized image that is not drawn to scale. Each of these arrangements involves commercial insurers. In terms of risk distribution, ALAS is the most mutualized of the insurers. As a formal matter, its members retain the risk of the first $75 million for each policy ALAS writes. Even ALAS members, however, have a relationship with the commercial market because ALAS purchases reinsurance for losses above $5 million, and members that want limits above $75 million purchase excess insurance on the commercial market. PilotLegis is on the other end of the
What all this means is that, at least in the LPL market, mutual and commercial insurance are complements. Except for those ALAS member firms, if any, that buy limits of $5 million or less, the members of all of these mutual insurers are shifting a substantial share of their LPL risks into the commercial liability insurance market. And even an ALAS member that bought such a low level of coverage would depend on the participation of larger firms in ALAS. Those larger firms would be quite unlikely to remain in ALAS if there were there no higher, reinsurance-facilitated levels of coverage. Thus, for firms with the option to join a lawyers’ mutual insurance organization, the choice is not between mutual and commercial insurance, but rather between a mutual/commercial hybrid and commercial insurance.

Indeed, as a result of this research we think about mutual LPL insurance as not simply an alternative to the commercial insurance market, but rather as a mechanism for managing law firms’ access to that market. The mutuals facilitate a risk management and transfer approach in which (1) the partners of individual firms share the lowest, most likely to be accessed layer of exposure through the firms’ self-insured retentions, (2) the member firms share the next exposure layer through the insurance issued by the mutual that is not reinsured, and, (3) beyond that, the firms shift their risks to the commercial (re)insurance market.

Accordingly, we agree with the advocates of the purely commercial approach that the differences between buying commercial and joining a
mutual are not as stark as the mutual advocates (and the usual academic literature) suggest, especially when it comes to risk distribution. The hybrid nature of the mutual insurance arrangements clearly reduces the risk distribution differences as compared to a hypothetical, purely mutualized arrangement.

On the other hand, the mutual LPL advocates are also right. Competition has not eliminated the differences between them. The mutuals offer member-directed operating committees, member control over claims settlement at lower levels, a strong member voice in settlements at higher levels, and a sense of participating in a common enterprise. The commercials do not. Moreover, the mutuals can commit, to a degree that no commercial insurer ever can, that they will never leave the LPL market. These are real differences. Lastly, because the mutuals can access the commercial market directly or through reinsurance, they are not as capital constrained as the theoretical literature’s focus on purely mutualized arrangements would suggest. The LPL mutuals can thus diversify their risks to a significant degree and, thus, are not particularly vulnerable to competition on that basis from the purely commercial market.

VI. CONCLUSION

Our respondents reported a variety of benefits to belonging to a mutual insurer: stability in LPL insurance relationships, a high-quality claims experience, high quality loss prevention services, stable pricing, and, for some of them, participation with like-minded law firms that provide opportunities for professional development. These reports match reasonably well with economic theory. Stability in relationships and stable pricing are the desired result of addressing the long-term contracting problem. The perception that key aspects of the relationship are high quality can be understood as both cause and effect of the mutuals’ comparative advantage in addressing that contracting problem. The sense of solidarity and professional development can be understood as both cause and effect of mutual insurers’ comparative advantage in addressing adverse selection. Loss prevention and claims handling both implicate moral hazard – ex ante moral hazard in the case of loss prevention and ex post moral hazard in the case of claims handling. Finally, the reports from the legal profession literature about the norms of professional autonomy and independence help explain why a law firm might prefer that a lawyer owned and operated mutual engage in the efforts required to manage moral hazard, adverse selection and the long term contracting problem.
Based on the fact that most lawyers in medium to large law firms are not part of an LPL mutual, however, it is obvious that the commercial insurers – stock companies and the London Market syndicates – have been able to adequately address the potential market failures that could result from moral hazard, adverse selection and the long-term contracting problem. It is of course possible that another liability insurance crisis that is as severe as that of the mid-1980s could drive the commercial insurers sufficiently out of the market to change that analysis. But, even in that event, history suggests that significant numbers of the law firms that prefer to buy commercial insurance will be able to “PLUG” the gap with the assistance of their insurance brokers, so that they will remain primarily in the commercial market.147

For us, the image that best captures this situation is that of law firms arrayed on a risk mutualization continuum. At one end are long-term members of ALAS whose perceived liability risks are small enough that they have been able to obtain all their insurance from ALAS. At the other end are law firms that have never participated in a mutual – not even PLUG. There is some movement of firms on that spectrum that is likely to be correlated with, but not entirely driven by, the liability insurance underwriting cycle. But, just as law firms differ along other dimensions that resist simple explanation, firms differ in the degree to which they find the mutuals appealing. Moreover, if the cream-skimming ability of the mutuals is real (we believe it is), then there always will be law firms unable to join them. At the same time, however, both the risk profile of the firms and the mutuals’ standards seem likely to change over time, providing further reason to expect movement along the continuum.

Importantly, every place on that continuum implicates both mutual and stock insurance arrangements. Even an ALAS member that bought all of its LPL insurance from ALAS would benefit from the risk distribution provided by ALAS’s commercial reinsurers. And even the law firms that have never mutualized their liability risks benefit from the market shaping practices of the LPL mutual insurers. As our research shows, mutual and commercial insurers are not just competitors, they are also complements. Indeed, it would be better to think of mutual insurance arrangements in the professional liability context, not as an alternative to stock insurance, but rather as a mechanism for managing firms’ access to the powerful risk distributing potential of stock insurance. Moreover, even this framing may overstate the separation between commercial and mutual insurance and

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147 See supra Part III.D.
obscure the degree to which the availability of mutual insurance affects the behavior of the commercial insurance companies.

Accordingly, we conclude that the mutuals provide benefits even for the law firms that buy purely commercial. While qualitative research cannot prove that law firms’ experience with the commercial market would be less satisfactory in the absence of a strong mutual LPL sector, our judgment is that a significant decline of the mutual sector would lead to a decline in the quality of the insurance relationships in the commercial LPL sector. The presence of the mutual insurance option – not just the existing insurers but also the knowledge that Aon or Marsh or a well-connected specialty broker could help another group of law firms create a new PLUG or AIM or PilotLegis – cannot help but act as a check on commercial insurers, even in their dealings with law firms that exclusively buy commercial insurance.

Thus, our research supports efforts to promote LPL mutual insurance arrangements. It also provides a basis for the law firms that belong to the LPL mutuals to view their lawyers’ participation not only as a service to the mutual and the firm but also as service to the legal profession.

148 This is, admittedly, an impression formed on the basis of less than complete information. It is not a judgment that is subject to proof, at least in the absence of a decline in the mutual sector, and, even then, there likely would be too many confounding factors to allow proof of causation. Moreover, as long as there remains the perception among a significant share of the bar that law firm mutuals promote professional autonomy, that judgment will never be put to proof.

149 Creating a new MPC or BAR would be more difficult because of the amount of capital that those two insurers have accumulated. Creating a new ALAS would have that problem, plus the challenge of creating such a significant organizational structure.
I. INTRODUCTION: THE ISSUE OF THE SPOLIATION TORT

Thousands of automobile accidents occur on public roadways each year, leaving behind totally and partially damaged cars, trucks, motorcycles and other motor vehicles. Personal injuries and property damage arising from each accident have the potential to produce a lawsuit. The potential lawsuits encompass a myriad of parties, claims, and cross-claims which may or may not be known and/or foreseeable. Against this vast expanse of potential litigation, the following question arises: what is the duty of an insurance company that may possess or control one of the totally or partially damaged vehicles or vehicle components to preserve that evidence for future potential litigation involving lawsuits brought by insureds against alleged tortfeasors?

Part II of this Article provides a general background of the spoliation of evidence tort along with the current trend of adopting the tort amongst the states. Part III provides insight into the numerous approaches courts have employed in fixing the spoliation problem. The problematic issues that arise with imposing an independent tort on third parties, specifically insurance companies, are analyzed in Part IV. Part V offers recommendations for the future to resolve the spoliation tort dilemma efficiently and effectively.

1 Steven Plitt is an Assistant Adjunct Professor of Law at the University of Arizona College of Law. Professor Plitt is the current revising author for COUCH ON INSURANCE (3rd ed. 1995). He has written numerous books, law reviews, and other professional publications in the field of insurance law. Mr. Plitt is a nationally recognized commentator on insurance law issues and has been retained in 33 states as an expert witness and consultant regarding insurance law issues and claims.

2 Jordan Plitt is a Member at The Cavanagh Law Firm located in Phoenix, AZ. His practice includes complex insurance coverage, bad faith litigation and professional liability defense. He is an associate author for COUCH ON INSURANCE (3rd ed. 1995) and PRACTICAL TOOLS FOR HANDLING INSURANCE CASES (2011).
II. OVERVIEW-THE SPOLIATION OF EVIDENCE TORT IN GENERAL

A. THE NATURE OF THE SPOLIATION TORT

The spoliation tort emerged in reaction to widespread discovery abuse where litigants render discoverable evidence permanently unavailable to both the court and the adverse party.3 “Spoliation” has been defined as the “failure to preserve property for another’s use in pending future litigation.”4 Derived from the Latin phrase “contra spoliatorum omnia praesumuntur;” or “all things presumed against the destroyer,” spoliation encompasses the loss, destruction, or material alteration of evidence.6 This goes beyond concealment or suppression of evidence because the evidence

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4 Solano v. Delancy, 264 Cal. Rptr. 721, 724 (Cal. App. 1989); see also West v. Goodyear Tire & Rubber Co., 167 F.3d 776, 779 (2nd Cir. 1999) (defining spoliation as “the destruction or significant alteration of evidence or the failure to preserve property for another’s use as evidence in pending or reasonably foreseeable litigation”); Powers v. S. Family Markets of Eastman, LLC., 740 S.E.2d 214 (Ga. Ct. App. 2013) (“Spoliation refers to the destruction or failure to preserve evidence that is necessary to contemplated or pending litigation.”); Kroger Co. v. Walters, 735 S.E.2d 99 (Ga. Ct. App. 2012) (reiterating that “[s]poliation refers to the destruction or failure to preserve evidence that is necessary to contemplated or pending litigation).


6 Foster v. Lawrence Mem’l Hosp., 809 F. Supp. 831, 836 (D. Kan. 1992) (citing BLACK’S LAW DICTIONARY 1401 (6th ed. 1990)) (“‘Spoliation’ has been defined as the intentional destruction or alteration of evidence.”).
is lost.\textsuperscript{7} The spoliation tort is an interference tort involving protected expectancies\textsuperscript{8} with prospective civil action through the destruction of evidence. This tort “is based on the premise that the destroyed evidence is adverse to the spoliation\textsuperscript{9} and that a party who has negligently or intentionally lost or destroyed evidence known to be relevant to an upcoming

\textsuperscript{7} Nix v. Hoke, 139 F. 2d 125, 135 (D.D.C. 2001) (observing that concealment and alteration are within the definition of “willful destruction of evidence”).

\textsuperscript{8} The California Court of Appeals became the first to explicitly recognize spoliation of evidence as an independent tort in, \textit{Smith v. Super. Ct.}, 198 Cal. Rptr. 829 (Cal. Ct. App. 1984), \textit{overruled by Cedars-Sinai Med. Ctr. v. Super. Ct.}, 954 P.2d 511 (Cal. 1998). In this case, the plaintiff suffered injuries after an oncoming truck’s wheel disengaged causing a collision. Shortly after, the truck was towed to a dealer who had previously customized it with deep-dish mag wheels. The dealer agreed with plaintiffs’ attorney to preserve the evidence including the wheel and related parts for an expert to examine and inspect them for the plaintiff. The dealer disposed of the evidence knowing how critical the parts were to the plaintiffs’ case. Noting that “[t]he common thread woven into all torts is the idea of unreasonable interference with the interests of others,” the Court analogized spoliation to the tort of intentional interference with prospective business advantage. As such, the California Court of Appeals created the intentional tort of spoliation, holding that a potential products liability case is a valuable probable expectancy justifying legal protection from interference. \textit{Id.} at 836-837; \textit{See also W. Page Keeton et al., Prosser and Keeton on the Law of Torts} 140-41 (5th ed. 1984) (explaining courts' recognition of spoliation as another noncommercial expectancy that deserves protection).

\textsuperscript{9} \textit{See also} Sullivan v. General Motors Corp., 772 F. Supp. 358, 360 (N.D. Ohio 1991) (discussing that "[a]t common law, it was proper to presume that evidence which had been destroyed, or ‘spoliated,’ could be construed against the party responsible of the destruction of that evidence.”); Warner Barnes & Co. v. Kokosai Kisen Kabushiki Kaisha, 102 F.2d 450, 453 (2d Cir. 1939), \textit{modified}, 103 F.2d 430 (2d Cir. 1939) (“When a party is once found to be fabricating, or suppressing, documents, the natural . . . conclusion is that he has something to conceal, and is conscious of guilt.”).
legal proceeding should be held accountable for any unfair prejudice that results.\textsuperscript{10}

The willful\textsuperscript{11} and bad faith destruction of evidence threatens the integrity of a trial, undermining a party’s opportunity for justice.\textsuperscript{12} In the absence of such relevant evidence, a party’s ability to prove a valid claim or defense is dramatically diminished.\textsuperscript{13} Spoliation of evidence, whether intentional and/or negligent, has consequential effects on the public’s


\textsuperscript{11}See also Greenleaf Nursery v. E. I. DuPont De Nemours & Co., 341 F.3d 1292, 1308 (11th Cir. 2003) (explaining that spoliation is not the equivalent to the concealment or suppression of evidence); Steffen Nolte, The Spoliation Tort: An Approach to Underlying Principles, 26 ST. MARY’S L.J., 351, 408 (1994) (noting that the distinction lies within the fact that evidence may still be produced at trial with concealment or suppression).

\textsuperscript{12}See Boldt v. Sanders, 111 N.W.2d 225, 228 (Minn. 1961) (“It is essential to the achievement of justice that all of the admissible evidence be brought . . . for trial or settlement with full knowledge of the facts.”). See also Viviano v. CBS, Inc., 597 A.2d 543, 550 (N.J. Super. Ct. App. Div. 1991) (noting that the “destruction of evidence manifests a shocking disregard for orderly judicial procedures and offends traditional notions of fair play.”); Federated Mut. Ins. Co. v. Litchfield Precision Components, Inc., 456 N.W.2d 434, 439 (Minn. 1990) (finding that destruction of evidence disregards judicial procedures and offends notions of fair play); Petrik v. Monarch Printing Corp., 501 N.E.2d 1312, 1319 (Ill. App. Ct. 1986) (“This state's system of civil litigation is founded in large part on a litigant's ability, under the authority of the Supreme Court rules, to investigate and uncover evidence after filing suit. Destruction of evidence known to be relevant to pending litigation violates the spirit of liberal discovery.”); Wichita Royalty Co. v. City Nat'l Bank of Wichita Falls et al., 109 F.2d 299, 302 (5th Cir. 1940) (defining spoliation as being “synonymous with pillaging, plundering and robbing”).

\textsuperscript{13}Telectron, Inc. v. Overhead Door Corp., 116 F.R.D. 107, 128 (S.D. Fla. 1987) (noting that a defendant “having purposefully, willfully, and in bad faith destroyed” relevant documents injured the plaintiff's “right to a full and fair adjudication of its claims on the merits.”); Cedars-Sinai, 954 P.2d 511 (Cal.1998) (stating “[t]he intentional destruction of evidence is a grave affront to the cause of justice and deserves our unqualified condemnation.”)
confidence in the judicial system. Courts have recognized that the “preservation of ... [potential] evidence ... presumably increase[s] the likelihood of a true and just verdict,” therefore, preservation of evidence warrants legal protection as an injury to a property interest.


15Edwards v. Louisville Ladder Co., 89-1697-LC (W.D. La. 6/19/92); 796 F. Supp. 966, 969 (“It is obvious that the preservation of items which might be relevant evidence in either prospective or ongoing litigation is desirable.”).

See also Kammerer v. Sewerage Water Board of New Orleans, 93-1232 (La. App. 4 Cir. 3/15/94); 633 So. 2d 1357, 1362 (Justice Waltzer concurring) (“The process itself is fair and the result presumably just where the parties have open opportunity to plead, discover, present and impeach evidence and argue alternative theories of the case. Where material evidence has been lost, the veracity and justice of the ultimate decision will of necessarily suffer.”).

The issues surrounding the spoliation of evidence and how to remedy the loss of relevant evidence has been vetted thoroughly throughout the commentary. Commentators and courts have furnished various
explanations as to why recognition of an independent spoliation tort acts as an essential beneficial component within the judicial system: (1) the probable expectation of a favorable judgment or defense in future civil litigation are safeguarded by the tort;\(^{18}\) (2) traditional evidentiary remedies are not deterred by the spoliator of evidence;\(^{19}\) and (3) testimonial candor is preserved by the tort.\(^{20}\) However, the majority of jurisdictions that have


\(^{20}\) Petrik v. Monarch Printing Corp., 501 N.E.2d 1312, 1319 (Ill. App. Ct. 1986) (“This state's system of civil litigation is founded in large part on a litigant's ability, under the authority of the Supreme Court Rules, to investigate and uncover evidence after filing suit... Any duty to preserve
examined the issue have rejected the recognition of a spoliation tort. Those states that have recognized and created the tort of spoliation in some form, limit such an action to spoliation of evidence related to actual litigation.

Courts are in disagreement on what constitutes spoliation and vary on how to apply the tort when the spoliator is a third-party, who is not a party to the underlying civil action. This divergence has produced a variety of approaches to the spoliation of evidence dilemma.

B. THE CURRENT JUDICIAL LANDSCAPE OF THE SPOLIATION OF EVIDENCE TORT

Initially, the tort was not embraced by the courts. However, the spoliation issue has recently attracted greater attention. A current split exists between those jurisdictions that recognize a secondary cause of action for spoliation of evidence and those that reject the tort altogether. Because of this split, the outcomes of such actions can be diverse depending on the state and the law it applies. Four possible varieties of the tort of spoliation of evidence exist: (1) intentional spoliation of evidence by an adverse party.

such items would undoubtedly be tempered by what a reasonable person would expect to be sought as evidence.”).

21 Edwards v. Louisville Ladder Co., 89-1697(W.D. La. 6/19/1992), 796 F. Supp. 966, 968 (citing Pirocchi v. Liberty Mutual Ins., 365 F.Supp. 277 (E.D. Pa. 1973) (“Despite the fact that the origins of a tort for spoliation of evidence trace back to at least 1973 no general consensus has developed as to the basis, essential elements, or even existence of such a tort.”); Coleman v. Eddy Potash, Inc., 905 P.2d 185 (N.M. 1995) overruled on other grounds by Delgado v. Phelps Dodge Chino, Inc., 34 P.3d 1148 (N.M. 2001) (“In general ... the tort of spoliation of evidence has not been widely adopted in other jurisdictions, nor has much agreement emerged on its contours and limitations.”).

22 See Henderson v. Tyrrell, 910 P.2d 522, 531 (Wash. Ct. App. 1996) (“[d]estruction or loss of potentially relevant evidence is a long-standing problem, but it has attracted increased attention in the past . . .”).

23 While the elements of a prima facie case for intentional spoliation of evidence by a defendant vary from state to state due to each states’ public policy considerations, as a general rule the tort requires: (1) pending or probable litigation involving the plaintiff; (2) knowledge by the defendant of the existence or likelihood of the litigation; (3) intentional acts of spoliation by the defendant designed to disrupt the plaintiff’s case; (4) disruption of the plaintiff’s case; and (5) damages proximately caused by the defendant's
(2) intentional spoliation by a disinterested third party;\textsuperscript{24} (3) negligent spoliation of evidence by an adverse party;\textsuperscript{25} and (4) negligent spoliation of evidence by a disinterested third party.\textsuperscript{26} Spoliation of evidence committed by an adverse party to a lawsuit, is referred to as “first-party spoliation.”\textsuperscript{27} Regardless of whether classified as intentional or negligent, the elements of these iterations of the tort are very similar\textsuperscript{29} with the main difference seen in the level of culpability.


\textsuperscript{25} While the elements of negligent spoliation of evidence also vary, the general consensus delineated for a cause of action for negligent destruction of evidence are as follows: (1) existence of a potential civil action; (2) a legal or contractual duty to preserve evidence which is relevant to the potential civil action; (3) destruction of that evidence; (4) significant impairment in the ability to prove the lawsuit; (5) a causal relationship between the evidence destruction and the inability to prove the lawsuit; and (6) damages. See, e.g., Continental Ins. Co. v. Herman, 576 So. 2d 313, 315 (Fla. Dist. Ct. App. 1991); Holmes v. Amerex Rent-A-Car, 710 A.2d 846, 851-54 (D.C. 1998).


\textsuperscript{27} See Johnson v. United Serv.’s Auto Assn., 67 Cal. App. 4th 626, 628 (Cal. Ct. App. 1998) (explaining that a first party spoliator is a party to the litigation in which the spoliation evidence is deemed relevant).


1. Intentional Spoliation

The intentional form of the tort requires that the evidence be willfully destroyed by the spoliator. A small minority of states (seven) have recognized an independent tort for intentional spoliation. Of those states that have recognized a tort for intentional spoliation, most of them permit the tort in both a first-party and third-party context. A couple of

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30 See, e.g., Coleman, 905 P.2d at 189.


states permit intentional spoliation as an independent tort in the third-party context, but not the first party context.  

2. Negligent Spoliation

The majority of states (23) that have considered the question of spoliation as a tort have rejected negligent spoliation claims. Many states


have rejected the concept of negligent spoliation under ordinary negligence principles, i.e., the duty to preserve evidence, breach of that duty, causation, and injury.\textsuperscript{35} A small minority of jurisdictions (9 states) have allowed claims for negligent spoliation.\textsuperscript{36} Of this small handful of jurisdictions recognizing negligent spoliation under ordinary negligence principles, only four recognize negligent spoliation for both first-party and third party claims.\textsuperscript{37}

3. Spoliation by Third Parties

Within the tort of spoliation is the controversy of whether to impose a duty when the spoliator is not a party to the underlying litigation. Of the nine states recognizing negligent spoliation under general negligence principles, only five states permit negligent spoliation claims to be brought against third parties.\textsuperscript{38}


\textsuperscript{35} See cases cited \textit{supra} note 34.

\textsuperscript{36} See \textit{infra} note 37 (Illinois, New Jersey, New Mexico, and Pennsylvania); \textit{infra} note 38 (Alabama, Florida, Indiana, Montana, and West Virginia).


\textsuperscript{38} The following states recognize negligent spoliation under general negligence principle against third-parties: Alabama - Smith v. Atkinson, 771 So. 2d 429 ( Ala. 2000) (negligence permitted against a third party who was
4. Policy Considerations

Liability for spoliation of evidence arises from a party’s duty to preserve evidence.49 Whether a duty is owed is a legal question, decided by the court.40 The duty element of the spoliation tort has perplexed the majority of courts, especially in the context of third-parties.41 There exists an amorphous body of negligent spoliation of evidence law that determines when a third-party can be liable in civil litigation. Therefore, where adopted, the outcomes of such actions can be diverse depending on the state and the law applied. As an example, a duty to preserve evidence before allowing spoliation claims under general concepts of negligence is required in three


states. One court found that a duty to preserve evidence existed where the duty arose out of “agreement, contract, statute, special circumstance, or voluntary undertaking” and required an objective foreseeability element where a reasonable person could have foreseen that the evidence in question was material to a potential civil action.

Absent clear legislative direction in determining whether a cognizable duty should exist, courts have focused on a variety of policy considerations for refusing to recognize an independent spoliation tort, such as: (1) the fact that remedies are already in place to rectify the problem; (2) the damages produced are inherently speculative; (3) adjudicated matters

42 See Florida - Royal & Sun Alliance, 877 So.2d at 846 (third party spoliation requires a duty to preserve evidence); Illinois – Dardeen v. Kuehling, 821 N.E.2d 227, 231 (Ill. 2004) (duty to preserve evidence required); New Mexico - Coleman, 905 P.2d (special circumstances must exist under which there is a duty to preserve the evidence).

43 See Dardeen, 821 N.E.2d at 231.

44 See Reynolds v. Bordelon, 172 So. 3d 589 (La. 2015).

45 “It seems likely that in a substantial proportion of spoliation cases the fact of harm will be irreducibly uncertain. In these cases, ‘there will typically be no way of telling what precisely the evidence would have shown and how much it would have weighed in the spoliation victim's favor.’ The elements of causation and damages, therefore, in the continuing absence of the spoliated evidence, would be nearly impossible to prove, and permitting a cause of action that necessarily would be based upon speculation and conjecture could burden the courts with claims that may be peculiarly productive of arbitrary and unreliable verdicts.” Temple Cmty. Hosp. v. Super. Ct. of Los Angeles, 976 P.2d 223, 228 (Cal. 1999) (citing Cedars-Sinai Med. Ctr. v. Super. Ct. of Los Angeles, 954 P.2d 511 (Cal. 1998). See also Smith v. Super. Ct. of Los Angeles, 198 Cal. Rptr. 829, 833-34 (Cal. Ct. App. 1984), overruled by Cedars-Sinai Med. Ctr., 954 P.2d (recognizing that the damages for spoliation tort were inherently speculative because, in order to state a claim, the relevant evidence must be missing but finding it would be a great injustice to prevent an injured party from recovering at all, then to reduce the certainty of damages requirements); Reilly PPA v. D'Errico, No.. CV93 0346095S, 1994 WL 547671, at *6 (Conn. Super. Ct. Sept. 21, 1994) (Stating that “the inherently speculative nature of the spoliation tort militates against adopting such a cause of action”); Larison v. City of Trenton, 180 F.R.D. 261, 265-66 (D.N.J. 1998) (failing to adopt an independent spoliation tort partly because the court was unwilling “to
may need to be re-litigated; (4) there is the potential for jury confusion and inconsistency, and, (5) there is always the possibility of interfering with a person’s private property rights. However, the bulk of the case law on this subject focuses upon the availability of alternative remedies to rectify the spoliation problem.

engage in speculation and conjecture” in regards to the damages requirement).

46 See, e.g., Temple Cmty. Hosp., 976 P.2d at 228 (Cal. 1999) (“[I]f the spoliation claim were brought after the conclusion of the underlying litigation, the result would be ‘duplicative proceedings’ involving a ‘retrial within a trial’ and carrying the potential for inconsistent results.”).

47 See Edwards v. Louisville Ladder Co., 796 F. Supp. 966, 971 (W.D. La. 1992); Murphy v. Target Prods., 580 N.E.2d 687, 690 (Ind. Ct. App. 1991); Trevino v. Ortega, 969 S.W.2d 950, 957 (Tex. 1998); Cedars-Sinai Med. Ctr., 954 P.2d 511; Id. at 518. (“Without knowing the content and weight of the spoliated evidence, it would be impossible for the jury to meaningfully assess what role the missing evidence would have played in the determination of the underlying action.”); Reilly, 1994 WL 547671, at *6; Reynolds, 172 So. 3d at 598 (a spoliation tort “could create confusion for fact-finders, particularly juries, inasmuch as it allows a trial within a trial.”); Temple Cmty. Hosp., 976 P.2d at 228 (“if the spoliation claim were tried concurrently with the underlying litigation, there would be ‘a significant potential for jury confusion and inconsistency’... ”).

48 See, e.g., id. at 228 (Cal. 1999) (“[T]he threat of liability might cause individuals and entities to engage in unnecessary and expensive record-retention policies.”); Louisville Ladder Co., 796 F. Supp. at 970 (“[C]ourts must also be concerned with interference with a person's right to dispose of his own property as he chooses.”); Koplin v. Rosel Well Perforators, Inc., 734 P.2d 1177, 1183 (Kan. 1987) (recognizing an independent spoliation tort would cause “[T]he unwarranted intrusion on the property rights of a person who lawfully disposes of his own property.”).

49 See, e.g., Petrik v. Monarch Printing Corp., 501 N.E.2d 1312, 1319 (Ill. App. Ct. 1996) (discussing that sanctions for spoliation of evidence in violation of discovery rules promote orderly judicial procedures and fair play); Cedars–Sinai, 954 P.2d 511 (emphasizing that sanctions within the original proceeding, disciplinary and penal sanctions are preferable in derivative litigation).
III. DIFFERENT APPROACHES TO DISINCENTIVIZING THE SPOLIATION OF EVIDENCE

Although some jurisdictions have begun to recognize a new, independent tort for the spoliation of evidence in civil litigation, a majority of courts have found the adoption of an independent tort is unnecessary due to a variety of existing non-tort remedies and sanctions already in place acting as effective measures in addressing the misconduct of spoliation.\textsuperscript{50} Traditionally, courts utilized adverse inferences, presumptions, and other actions as the main determents in preventing a party from destroying evidence.

Finding that the additional benefits of a tort remedy are not great in comparison to the significant burdens it would create, various courts have employed a myriad of traditional remedies to combat spoliation.\textsuperscript{51} Any remedy a court imposes should serve one of three purposes: deterrence, punishment, or remediation\textsuperscript{52} and the evidence allegedly lost or destroyed must be relevant to a material fact in the litigation.\textsuperscript{53} To fix pre-litigation spoliation, state courts have relied on their inherent power to control the

\begin{footnotesize}
\textsuperscript{50} See, e.g., Miller v. Montgomery Cty., 494 A.2d 761, 768 (Md. Ct. Spec. App. 1985) (“In either event, the remedy for the alleged spoliation would be appropriate jury instructions as to permissible inferences, not a separate and collateral action.”).

\textsuperscript{51} See, e.g., Telecom Int'l America, Ltd. v. AT&T Corp., 67 F. Supp. 2d 189 (S.D.N.Y. 1999) (noting that dismissal may be an appropriate remedy where a party demonstrates bad faith in the destruction of evidence); See Telectron, Inc. v. Overhead Door Corp., 116 F.R.D. 107, 128 (S.D. Fla. 1987) (entering a default judgment when documents were willfully destroyed causing prejudice to the case); Metropolitan Dade County v. Bermudez, 648 So. 2d 197, 200 (Fla. Dist. Ct. App. 1994) (weighing the willfulness and extent of prejudice in deciding the appropriate sanctions for the destruction of evidence); Farley Metals, Inc. v. Barber Colman Co., 645 N.E.2d 964, 968 (Ill. App. Ct. 1994) (holding that where critical information is destroyed, the prejudice to the non-offending party is the courts focus for imposing sanctions).

\textsuperscript{52} See, e.g., National Hockey League v. Metropolitan Hockey Club, Inc., 427 U.S. 639, 643 (1976) (“[T]he most severe in the spectrum of sanctions … must be available … not merely to penalize those whose conduct may be deemed to warrant such a sanction, but to deter those who might be tempted to such conduct in the absence of such a deterrent.”).

\end{footnotesize}
judicial process in litigation and to sanction parties for the spoliation of evidence. Courts have broad discretion in imposing sanctions for the

54 Chambers v. Nasco Inc., 501 U.S. 32; Dillon v. Nissan Motor Co., 986 F.2d 263 (8th Cir. 1993) (finding that court has inherent power in excluding plaintiff’s experts’ testimony where the expert failed to preserve evidence); Unigard Security Insurance Co. v. Lakewood Eng. & Manuf. Corp., 982 F.2d 363 (9th Cir. 1992) (excluding testimony of plaintiff’s expert without showing of bad faith was proper use of court’s inherent powers); Northern Assurance Co. v. Ware, 145 F.R.D. 281 (D. Me. 1993).

spoliation of evidence.\textsuperscript{56} Federal District Courts have relied on their inherent authority to impose sanctions to help combat spoliation.\textsuperscript{57} However, the United States Supreme Court has cautioned District Courts to exercise restraint in the use of their inherent power for imposing sanctions.\textsuperscript{58}

The most commonly utilized sanction is an adverse inference jury instruction to attempt to cure prejudice involving spoliated evidence.\textsuperscript{59} Many

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\item \textsuperscript{57} See, e.g., Carlucci v. Piper Air Craft Corp., 775 F.2d 1440, 1447 (11th Cir. 1985); Capellupo v. FMC Corp., 126 F.R.D. 545, 551 (D. Minn. 1989).
\item \textsuperscript{58} Roadway Express, Inc. v. Piper, 447 U.S. 752, 764 (1980).
\end{enumerate}
\end{footnotesize}
states have pattern jury instructions that address spoliation of evidence.  All of the Federal Circuit Courts of Appeals have permitted adverse inference jury instructions.  


61 First Circuit - Testa v. Wal-Mart Stores, Inc., 144 F.3d 173, 177 (1st Cir. 1998), Nation-wide Check Corp. v. Forest Hills Distrib., Inc., 692 F.2d 214, 217 (1st Cir. 1982); Second Circuit - Residential Funding Corp. v.
Other deterrents exist to ensure that relevant evidence is available at trial. While appellate courts have provided guidance to the trial court as to when a sanction for spoliation of evidence is appropriate, the imposition of sanctions is often left to the discretion of the trial court.


As an alternative to bringing an independent case for negligent spoliation of evidence, some courts have permitted a party to pursue discovery sanctions for the spoliation of evidence within a pending lawsuit. In addition to discovery sanctions, the trial court can order dismissal of the case, enter a default judgment, strike pleadings, grant summary

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66 See, e.g., Carlucci v. Piper Aircraft Corp., 102 F.R.D. 472 (S.D. Fla. 1984) (entry of default judgment against defendant who intentionally destroyed relevant documents); Sponco Mfg., Inc. v. Alcover, 656 So. 2d 629, 630 (Fla. Dist. Ct. App. 1995) (holding that a default judgment against a civil defendant who intentionally destroyed evidence essential to the plaintiff's case was appropriate); Mercer v. Raine, 443 So. 2d 944, 946 (Fla. 1983) (“[D]eliberate and contumacious disregard of the court's authority will justify [the striking of pleadings or entering a default], as will bad faith, willful disregard or gross indifference to an order of the court, or conduct which evinces deliberate callousness.”); Rockwell Int'l. Corp. v. Menzies, 561 So. 2d 677, 679 (Fla. Dist. Ct. App. 1990) (finding no bad faith in the defendant's intentional destruction of evidence, however still affirming a default judgment against the defendant).

judgment, grant continuances, issue contempt orders, order evidence preclusion, order expert witness preclusion, award attorneys’ fees, allow punitive damages, allow awards of the compensatory damages that would have been available if the claimant had won at trial, make referrals for

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70 See, e.g., Cedars-Sinai Med. Ctr. 954 P.2d 511, 517 (Cal. 1998); Dowdle Butane Gas Co. v. Moore, 831 So.2d 1124, 1127 (Miss. 2002).


75 See, e.g., Rizzuto v. Davidson Ladders, Inc., 905 A.2d 1165 (Conn. 2006) (intentional first party spoliation); Petrik v. Monarch Printing Corp., 501 N.E.2d 1312, 1320 (Ill. App. Ct. 1986) (“Assuming that it is impossible to know what the spoliated evidence would have shown, perhaps the plaintiff should be awarded the full measure of damages that he would have obtained had he won the underlying lawsuit.”).
criminal prosecution,76 issue criminal penalties,77 and make a referral for attorney disciplinary action.78 Courts that have declined to recognize an independent spoliation tort have found the foregoing options sufficiently effective to deter potential spoliation.79 However, proponents of the


78 See, e.g., Cedars-Sinai, 954 P.2d at 518; Dowdle Butane Gas Co. v. Moore, 2000-IA-01884-SCT (¶ 8) (Miss. 2002), 831 So. 2d 1124, 1127.

79 See, e.g., Reynolds v. Bordelon, 172 So. 3d 589 (La. 2015).
independent tort’s recognition criticize these traditional remedies arguing that they fail to adequately address willful spoliation and the suppression of evidence impacts the proper adjudication of claims.\textsuperscript{80} One commentator has argued, “traditional procedural and nonprocedural remedies are flawed by their limited scope, their inadequate preventive effect, and their failure to provide the victim with just compensation.”\textsuperscript{81}

Where the spoliator is not a party in the underlying suit,\textsuperscript{82} court sanctions do little to deter spoliation. Adverse inferences, default judgments and stricken pleadings do not apply to third-party spoliators.\textsuperscript{83}

Despite the continuing efforts of parties seeking an adequate remedy for spoliation problems, courts are struggling with the question of whether there should be a tort for third-party spoliation of evidence, and, if so, what the scope of the tort should be. While legal scholars fervently debate over the proper methodology to resolve these conflicts, courts have developed a body of case law discussing the issues relating to the adoption of an independent spoliation of evidence tort claim on third-parties.


\textsuperscript{81} Nolte, supra note 11, at 355.


\textsuperscript{83} See Cedars-Sinai, 954 P.2d at 521 n.4 (Cal. 1998) (declining to address whether the independent tort for the intentional spoliation of evidence against a third party the underlying civil litigation should also be struck); Holmes, 710 A.2d at 848 (D.C. 1998); Callahan v. Stanley Works, 703 A.2d 1014, 1017 (N.J. Super. Ct. Law Div. 1997) (stating that recognition of the tort would signal “acceptable societal behavior.”); Coleman v. Eddy Potash, Inc., 905 P.2d 185, 189 (N.M. 1995).
IV. INSURANCE COMPANIES ACTING AS A THIRD-PARTY IN THE NEGLIGENT SPOLIATION OF EVIDENCE CONTEXT

Third-party spoliators are oftentimes insurance companies entrusted with the investigation of evidence related to the underlying action. Recently, insurance companies have come into the crosshairs of claimants who argue that insurance companies should owe independent duties to policyholders/insureds and be held liable to policyholders/insureds for negligent spoliation of evidence. Courts and practitioners have wrestled with spoliation of evidence in the context of civil litigation when the alleged spoliator is an insurance company. Acting as a third party, an insurance company is placed in a unique position when it comes to the negligent spoliation of evidence tort. As an example, insurance companies regularly modify or destroy potential evidence every time a vehicle is repaired. Insurance companies frequently acquire title to an insured’s vehicle after the vehicle has been totaled in an accident, and will either re-sell the vehicle with a salvage title or have the vehicle parted-out. This is appropriate and allowed by the insurance policy.

A. THE PROBLEMATIC ISSUES IN IMPOSING A DUTY TO PRESERVE EVIDENCE ON A THIRD-PARTY INSURANCE COMPANY

To date, the general rule is that a third-party insurance company does not owe a general duty to preserve evidence, and therefore cannot be held liable to the insured for negligence as a matter of law. Courts that have

84 Michael D. Starks, Spoliation or Destruction of Evidence and the “Duty to Cooperate” with Third Party Claims, 10 Fla. Prac., Worker’s Comp. with Forms § 22c:6 (2014 ed.).
86 See, e.g., Wilson v. Beloit Corp., 921 F.2d 765, 767 (8th Cir. 1990) (finding that no duty exists in the absence of a special relationship); Koplin v. Rosel Well Perforators, Inc., 734 P.2d 1177, 1179 (Kan. 1987) (stating that no duty for a third party to preserve evidence exists “[a]bsent some special relationship or duty arising by reason of an agreement, contract, statute, or other special circumstances.”); Hannah v. Heeter, 584 S.E.2d 560 (W. Va. 2003); But see Smith v. Atkinson, 771 So. 2d 429, 433 (Ala. 2000) (With a few exceptions, there is no general duty to preserve evidence) (“[R]ecogniz[ing] the doctrine that one who volunteers to act, though under no duty to do so, is thereafter charged with the duty of acting with due care and is liable for
held insurance companies to a duty to preserve evidence have differed in choosing when to attach the duty element leading to a divergence of numerous combinations of circumstances within the reported cases. The courts are split on the test they apply; however, in some jurisdictions a duty to preserve evidence may arise in relation to a third-party spoliator where: (1) the spoliator voluntarily undertakes to preserve the evidence and a person reasonably relies on that undertaking to his detriment; (2) the spoliator entered into an agreement to preserve the evidence; (3) there has been a specific request to the spoliator to preserve the evidence; or (4) there is a duty to do so based upon a contract, statute, regulation, or some other special circumstance/relationship. Each element will be considered in turn.

1. The Spoliator Voluntarily Undertakes to Preserve the Evidence and Detrimental Reliance

Alabama has recognized that a duty to preserve evidence may arise when “one who volunteers to act, though under no duty to do so, is thereafter charged with the duty of acting with due care and is liable for negligence in connection therewith.” This principle “applies to insurance companies and their agents.” With a voluntary assumption of a duty, a third party has knowledge of potential or pending litigation and accepts responsibility for evidence to be used in that litigation and thus could be found liable for damages for the loss or destruction of the evidence.

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87 See Oliver v. Stinson Lumber Co., 993 P.2d 11, 20 (Mont. 1999); See also Smith, 771 So. 2d at 433 (“[L]imiting the usual duty in third-party negligent spoliation to an agreement to preserve, or a voluntary undertaking with reasonable and detrimental reliance, or a specific request, ensures that such a spoliator has acted wrongfully in a specifically identified way.”).

88 Smith, 771 So.2d at 433 (quoting Dailey v. City of Birmingham, 378 So. 2d 728, 729 (Ala. 1979)). See, e.g., Beasley v. MacDonald Eng’g Co., 249 So. 2d 844, 846-47 (Ala. 1971); U.S. Fid. & Guar. Co. v. Jones, 356 So. 2d 596, 598 (Ala. 1977); Dailey, 378 So. 2d at 729.

89 Smith, 771 So. 2d at 433 n.3 (citation omitted).

90 Id. at 433.
2. Specific Request to the Spoliator to Preserve the Evidence

An appellate court in California held as a matter of law, “in the absence of a specific request by either the insureds or plaintiffs, defendants had no duty to preserve [a] vehicle part.”\(^{91}\) Alabama has recognized an additional condition to a specific request in that “[t]he specific request to preserve must be accompanied by an offer to pay the cost or otherwise bear the burden of preserving. We do not think a tort duty to preserve should be created simply by someone specifically requesting a third party to preserve something.”\(^{92}\)

3. Duty Based Upon an Agreement, a Contract, Statute, Regulation, or Some Other Special Circumstance/Relationship

\(\text{a) The Spoliator Entered Into an Agreement or Contract}\)

In a Massachusetts case, the Court stated “[a] third-party witness may also agree to preserve an item of evidence and thereby enter into an enforceable contract.”\(^{93}\) A California court determined that when an

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\(^{92}\) See Smith, 771 So. 2d at 433; see also Johnson v. United Serv. Auto. Ass’n, 79 Cal. Rptr. 2d 234, 239 (Cal. Ct. App. 1998), abrogated by Lueter v. California, 115 Cal. Rptr. 2d 68 (Ct. App. 2002). But see Oliver, 993 P.2d at 20 (“We see no need to require the requesting party to include an offer to pay reasonable costs of preservation in the request. … [P]articularly where the evidence is small in size and manageable, there will be no costs associated with the preservation.”). The Oliver court contended that the third party may demand the costs but ultimately it will be left to the requesting party to decide if he or she wants to incur those costs. Id.

\(^{93}\) See Fletcher v. Dorchester Mut. Ins., 773 N.E.2d 420, 425 (Mass. 2002) (recognizing a duty to preserve evidence by reason of agreement, contract, statute, or other special circumstance) (“Remedies for
insurance company made a promise to preserve the evidence, a duty was imposed on that insurance company. The insurance company’s promise may create a contract to preserve. While there may be no tort duty to preserve evidence, that situation “does not preclude the existence of a duty based on contract.” In general, “an action in contract differs from an action in tort in that the former is based on the breach of a duty imposed by agreement while a tort action is based on the breach of a duty imposed by law.” Another court has held that where a party anticipates litigation, a contract can be created with a duty to preserve evidence whereby contractual remedies will be available with a breach. In a Florida case, the court determined it would not create a contractual duty absent an explicit agreement providing that such a duty exists.

breach of such an agreement are found in contract law, not in tort law. … [W]here the source of a nonparty's duty to preserve evidence is one that already states a cause of action and provides its own remedies, we will not invent a separate, duplicate cause of action in tort.”

94 See Cooper v. State Farm Mut. Auto. Ins., 99 Cal. Rptr. 3d 870, 882 (Cal. Ct. App. 2009) (“[T]he duty to preserve evidence was independently assumed by State Farm when it made the promise to preserve the tire and plaintiff relied thereon.”). Cf. Lueter, 115 Cal. Rptr. 2d at 1288-89 (determining there was no tort duty for defendant to preserve evidence because there was no promise to preserve the evidence upon which the plaintiff relied nor any independent statutory duty to preserve the evidence).


96 Miller v. Allstate, 573 So. 2d 24, 27 (Fla. Dist. Ct. App. 1990) (citation omitted). See also Lueter, 115 Cal. Rptr. 2d at 79 n.3 (stating in cases addressing the question of a cause of action in torts a statute must impose a remedy but a cause of action in contract is not foreclosed) (“The decisional authorities do not foreclose an action in contract where the defendant is under a contractual obligation to preserve evidence.”) (citation omitted). Cf. Coprich, 95 Cal. Rptr. 2d at 891 (“While the existence of a tort duty in certain circumstances depends on policy considerations, those policy considerations do not negate the existence of a contractual obligation created by mutual agreement or promissory estoppel.”) (citations omitted).

97 Reynolds v. Bordelon, 172 So. 3d 589, 600 (La. 2015).

98 See, e.g., Silhan v. Allstate Ins., 236 F. Supp. 2d 1303, 1310 n.10 (N.D. Fla. 2002) (distinguishing Miller, 573 So. 2d 24, where there was an explicit agreement, whereas in Silhan there was not an explicit agreement between parties) (“Allstate had a contractual duty to preserve the
b) Statute/Regulation

The United States District Court for Florida found that there must be “a legal duty for the insurance company to conduct a reasonable investigation, [and/or] a duty to preserve potential evidence.” In addition, a frequency of actions to indicate a general business practice, may give rise to a statutory violation. Another California court determined that “a duty

vehicle as evidence that was essential to Miller's anticipated civil litigation.”). Cf. Timber Tech Engineered Bldg. Prods. v. The Home Ins., 55 P.3d 952, 954-55 (Nev. 2002) (declining to recognize an independent tort for first or third party spoliation of evidence but recognizing the preservation of evidence agreement created contractual rights and obligations between the parties but the court declined to reach the merits because the plaintiff failed to plead a breach of contract claim or raise the issue). See also Coprich, 95 Cal. Rptr. 2d at 891 (“A contractual remedy may give rise to some of the same burdens and costs as would a spoliation tort remedy, but we cannot negate a contractual obligation based on policy considerations other than specific grounds such as illegality and unconscionability.”).

99 Silhan, 236 F. Supp. 2d at 1311 (N.D. Fla. 2002) (noting the statute in this particular case did not “explicitly say this”) ("Instead, the statutes allow an insured to maintain a civil action against the insured's insurance company for denying claims without conducting a reasonable investigation."). See also Lueter, 115 Cal. Rptr. 2d at 79:

[T]he tort of negligent spoliation of evidence cannot be recognized against a private party [and it] follows that any liability for spoliation against a public entity and its employees must be created statutorily rather than judicially. In order to find a statutorily based cause of action for negligent spoliation, it is not enough to find that the public entity had a legal duty with respect to property. Even though a person may have a duty to preserve evidence, countervailing considerations dictate against an expansive, speculative tort of spoliation.

Id.

100 Silhan, 236 F. Supp. 2d at 1311 (citing Fla. Stat. § 626.9541(1)(i) ("Unfair claim settlement practices. 3. [c]ommitting or performing with such frequency as to indicate a general business practice any of the following: (a) [f]ailing to adopt and implement standards for the proper investigation of claims; (b) [m]isrepresenting pertinent facts
to preserve evidence should be addressed through other means, such as effective sanctions devised by the Legislature or by regulatory bodies [and] it follows that in order to establish a tort for spoliation of evidence, a statute must expressly impose a spoliation remedy.”

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c) Special Circumstance/Relationship

Under common law, there is generally no duty for a third party to preserve evidence.102 However, a special relationship may give rise to a duty to preserve evidence.103 A Florida appellate court has reiterated there is no general duty to preserve in a third-party situation absent the above stated factors. The Court noted that when a plaintiff establishes the existence of a special relationship between the parties, a duty to preserve the evidence is

or insurance policy provisions relating to coverages at issue; (c) [f]ailing to acknowledge and act promptly upon communications with respect to claims; (d) [d]eny[ing] claims without conducting reasonable investigations based upon available information.

101 Lueter, 115 Cal. Rptr. 2d at 79. Cf. Cooper, 99 Cal. Rptr. 3d at 882-83 (providing general principles of tort law when considering a tort remedy for spoliation of evidence) ("A tort, whether intentional or negligent, involves a violation of a legal duty, imposed by statute, contract or otherwise, owed by the defendant to the person injured."). Cf. Temple Cmty. Hosp. v. Super. Ct., 976 P.2d 223, 232 (Cal. 1999) ("We observe that to the extent a duty to preserve evidence is imposed by statute or regulation upon the third party, the Legislature or the regulatory body that has imposed this duty generally will possess the authority to devise an effective sanction for violations of that duty.").

102 See supra note 53.

103 See, e.g., Wilson v. Beloit Corp., 921 F.2d 765, 767 (8th Cir. 1990) (explaining that in the absence of a special relationship, the general rule is that one party does not need to preserve possible evidence for another party's future lawsuit against a third party); Edwards v. Louisville Ladder Co., 796 F. Supp. 966, 969 (W.D. La. 1992) (explaining that unless a special relationship exists between the parties, there is no duty to preserve possible evidence for future litigation). See generally Reid v. State Farm Mut. Auto. Ins., 218 Cal. Rptr. 913, 922-25 (Cal. Ct. App. 1985) (discussing the development of the special relationship doctrine); Harpole v. Arkansas Dep’t of Human Serv., 820 F.2d 923, 926 (8th Cir. 1987) (describing the special relationship doctrine's evolution).
A special relationship exists by a “special circumstance” where parties have knowledge that evidence is relevant to future litigation. Additionally, a special circumstance may arise where a defendant possesses the evidence, the plaintiff asks a defendant to preserve the evidence, and the defendant complies with this request.

In Illinois, courts have applied a two-prong test to any of the foregoing factors in determining whether a duty to preserve evidence exists. Under the first prong, if a plaintiff shows a duty was established by any of the foregoing factors, the first prong is satisfied, then the plaintiff must show that the duty extends to the evidence at issue “if a reasonable person in the defendant’s position should have foreseen that the evidence

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104 See Holmes v. Amerex Rent-A-Car, 710 A.2d 846, 849 (D.C. 1998) (defining the circumstances of a special relationship “when negligence is the basis of the suit alleging an economic injury resulting from the destruction of evidence, a duty on behalf of the defendant arising from the relationship between the parties or some other special circumstance must exist in order for the cause of action to survive.”) (quoting Koplin v. Rosel Well Perforators, 734 P.2d 1177, 1179 (Kan. 1987)). See also Cooper, 99 Cal. Rptr. 3d at 892 (finding State Farm “entered into a special relationship with its insured to preserve the [Continental] tires [and] violated its contractual and fiduciary obligations to plaintiff by losing, destroying, disposing of and/or failing to preserve the [Continental] tires [because] [p]laintiff reasonably relied to his detriment upon [State Farm's] voluntary undertaking to preserve the [Continental] tires.”).

105 Boyd v. Travelers Ins. Co., 652 N.E.2d 267, 271 (Ill. 1995), as modified on denial of reh’g (June 22, 1995). In Boyd, the Court determining there was a special relationship when the employees of Travelers Insurance went to Plaintiff’s home telling Fannie that they needed the heater to investigate Boyd's workers’ compensation claim. The heater belonged to Boyd. The employees knew that the heater was evidence relevant to future litigation. Under these alleged circumstances, Travelers assumed a duty to preserve Boyd's property.


107 A duty to preserve evidence may arise through voluntary assumption of a duty to preserve the evidence by affirmative conduct, an agreement, a contract, a statute or another special circumstance.

was material to a potential civil action.”109 If both prongs are not satisfied, there is no duty to preserve the evidence at issue.110

d) Control and Rebuttable Presumption

In determining liability in a third-party spoliation case, the Alabama Supreme Court announced a three-part test (“Smith test”) where, in addition to proving a duty, a breach, proximate cause, and damage, the plaintiff must also show: “(1) that the defendant spoliator had actual knowledge of pending or potential litigation; (2) that a duty was imposed upon the defendant through a voluntary undertaking, an agreement, or a specific request; and (3) that the missing evidence was vital to the plaintiff’s pending or potential action.”111 The Alabama Supreme Court determined by “[l]imiting the usual duty in third-party negligent spoliation to an agreement to preserve, or a voluntary undertaking with reasonable and detrimental reliance, or a specific request, ensures that such a spoliator has acted wrongfully in a specifically identified way.”112

When a plaintiff establishes the third party had notice and knowledge of a potential or underlying action, meaning “the third party assumed control over the evidence, and that the lost or destroyed evidence was ‘vital’ to his claim in the underlying action or potential action, a rebuttable presumption arises in favor of the plaintiff.”113 Under the Smith test, a rebuttable presumption arises once all three elements are satisfied for which the defendant must overcome or subsequently be liable for damages.114 The defendant may rebut this presumption by “producing evidence showing that the plaintiff would not have prevailed in the underlying action even if the lost or destroyed evidence had been available.”115

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109 Boyd, 652 N.E.2d at 271.
110 Id.
112 Id. at 433.
113 Id. at 435.
114 Id. See also Hannah v. Heeter, 584 S.E.2d 560, 573 (W. Va. 2003) (“[o]nce the [elements of the tort of intentional spoliation of evidence] are established, there arises a rebuttable presumption that but for the fact of the spoliation of evidence, the party injured by the spoliation would have prevailed in the pending or potential litigation.”).
115 Smith, 771 So.2d at 435.
The duty element of the tort has proved particularly troublesome for courts and commentators. Courts have increasingly been confronted with the same question in addressing the issue: what duty should be imposed on an alleged third-party spoliator who possesses or controls one of these totally or partially damaged vehicles?

In total loss situations, insurance companies acquire possession of the motor vehicle retaining exclusive control over the motor vehicle. In total loss situations, many vehicles are damaged beyond the extent of reasonable repair. In total loss situations, an insurance company compensates the policyholder for what their coverage allows and subsequently sells the vehicle to automobile wholesalers or distributors for re-sale with branded titles or to salvage the remaining usable parts to assist in the loss recovery. This process helps ensure that insured customer’s policy premiums can remain low in the growing demands of our economy. This orderly process of logging the true cost of losses (payout minus salvage recovery) in the year incurred would be greatly disrupted if third-party spoliation claims against insurance companies were liberally allowed. It is impractical for insurance companies to store each potential item that might lead to litigation in the future. To do so would impose high costs on insurance companies to acquire storage space to preserve various evidence at least for as long as the applicable statute of limitations period for a multitude of possible causes of actions. Despite the statute of limitation periods, an additional element

116 See Dowdle Butane Gas Co., Inc. v. Moore, 831 So. 2d 1124, 1131 (Miss. 2002) (quoting Cedars-Sinai Med. Ctr. v. Super. Ct., 954 P.2d 511, 519 (Cal. 1998) (discussing the implications on a third party if the court were to require it to “preserve for an indefinite period things of no . . . value solely to avoid the possibility of spoliation liability in future litigation.”)).

117 Only a few courts have addressed the issue of the applicable statute of limitations to spoliation of evidence claims providing for a two-year - Gicking v. Joyce Intern., Inc., No. 93-00434, WL 942114 at *4 (Pa. Com. PL. Mar. 22, 1996) (two years from the date plaintiff should have recognized a cause of action); Vedder v. Zakib, 618 S.E.2d 537 (W. Va. 2005). Cf. Wofford v. Tracy, 48 N.E.3d 1109, 1117-1119 (Ill. App. Ct. 2015), appeal denied, 48 N.E.3d 678 (Ill. 2016) (disagreeing with Plaintiffs’ argument that the five-year limitations in the Code applies because a spoliation action arises from a destruction in property, not personal injuries. The Court disagreed concluding the two-year limitations period for personal injuries applied because the “Plaintiffs’ underlying negligence claims are the proper focus and, in those counts, plaintiffs seek recovery only for personal injuries.”); three-year - Daoust v. McWilliams, 716 A.2d 922, 925-
within the spoliation tort should be applied before imposing liability on an insurance company: a notice requirement.

B. NOTICE REQUIREMENTS

Courts have considered various other factors in the determination of when it can be appropriate to place a duty to preserve evidence on a third party involved in spoliation. In one case, the Supreme Court of Wisconsin held:

[A] party or potential litigant with a legitimate reason to destroy evidence discharges its duty to preserve relevant evidence within its control by providing the opposing party or potential litigant:

(1) Reasonable notice of a possible claim;
(2) The basis for that claim;

27 (Conn. App. Ct. 1998) (discussing application period for intentional spoliation), and five-year limitation period before a civil action claim is barred. Schusse v. Pace, 779 N.E.2d 259, 267 (Ill. App. Ct. 2002) (noting a five year statute of limitations beginning from the time the evidence is destroyed). In determining the accrual date for the statute of limitations, courts vary. After the plaintiff should have recognized a cause of action for spoliation, on the one hand (Gicking, WL 942114 at *4), and when a cause of action does not accrue until the underlying action in the third party context was completed or the other. See, e.g., Lincoln Ins. Co. v. Home Emergency Serv., Inc., 812 So.2d 433 (Fla. Dist. Ct. App. 2001).

In Pirocchi v. Liberty Mutual Insurance Co., 365 F. Supp. 277 (East. Dist. Pa 1973), the plaintiff, a hotel employee, sustained injury when a chair in which he was sitting, collapsed. Liberty Mutual took possession of the chair so that it could conduct an investigation as to whether there were possible manufacturing defects in the chair. When the chair was returned to the hotel, it disappeared, precluding the plaintiff from pursuing the manufacturing tortfeasor. The plaintiff then brought a lawsuit against Liberty Mutual for failing to tag or mark the chair properly, failing to obtain a receipt following its delivery back to the hotel, and by failing to place the chair with the proper supervisor. Id. at 279. The Court denied Liberty Mutual’s motion for summary judgment concluding that factual issues existed regarding Liberty Mutual’s duty with respect to the chair. Id. at 282.
(3) The existence of evidence relevant to the claim; and
(4) Reasonable opportunity to inspect that evidence.  

Unfortunately, no uniform pattern of decisions has emerged from these cases. In addressing the first element in the Smith test, one focus is upon whether the third party possessed actual notice of the pending litigation or the potential for litigation. In determining what is sufficient notice, “[t]he textbook definitions of ‘actual’ and ‘constructive’ knowledge and notice are helpful guides in assessing the state of a third party’s knowledge and notice of pending or potential litigation.”

1. Actual Notice

Generally, when a lawsuit is served, a party has actual knowledge that litigation has begun and, thereby, may be obligated to preserve all discoverable evidence. Therefore, the duty to preserve evidence from spoliation can affect third parties who may be required to retain evidence in the event they are given proper notice of possible litigation. Absent notice

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120 Smith, 771 So. 2d at 433 (“When a third party has knowledge of a pending or potential lawsuit and accepts responsibility for evidence that would be used in that lawsuit, it should be held liable for damage resulting from the loss or destruction of that evidence.”); County of Solano v. Delancy, 264 Cal. Rptr. 721, 729 (Cal. Ct. App. 1989); Mace v. Ford Motor Co., 653 S.E.2d 660, 665 (W. Va. 2007) (providing that actual knowledge is a “direct and explicit notice” of a potential lawsuit).
121 Mace, 653 S.E.2d at 666.
123 See, e.g., In re Prudential Ins. Co. of Am. Sales Practices Litig., 169 F.R.D. 598 (D.N.J. 1997), rev’d on other grounds, 133 F.3d 225 (3d Cir. 1998) (insurer was sanctioned where company’s top management recognized the company’s obligation to preserve documents that were
of litigation, an insurance company and others generally possess the right to dispose of ones’ own property without facing liability. However, some related with particular lawsuits but failed to actively formulate or implement a document retention policy. See also Willard v. Caterpillar, Inc., 48 Cal. Rptr. 2d 607, 625-26 (Cal. Ct. App. 1995) (noting that some courts impose discovery sanctions only if a party is on notice that documents are potentially relevant); Baliaitis v. McNeil, 870 F. Supp. 1285, 1290 (M.D.Pa. 1994) (quoting Fire Ins. Exch. v. Zenith Radio Corp., 747 P.2d 911, 914 (Nev. 1987)) (“[L]itigant is under a duty to preserve evidence which it knows or reasonably should know is relevant to the action.”). Cf. Killings v. Enter. Leasing Co., 9 So. 3d 1216, 1223 (Ala. 2008) (finding leasing company was given notice that process could take several years when it assumed duty to preserve evidence) (“[I]t is ultimately of no import that approximately two and a half years passed between the date of the accident and the date the [evidence] was sold.”).

124 See, e.g., Burns v. Cannondale Bicycle Co., 876 P.2d 415, 419 (Ut. Ct. App. 1994); Zubulake v. UBS Warburg, LLC, 220 F.R.D. 212, 216 (S.D.N.Y. 2003) (“[I]t goes without saying that a party can only be sanctioned for destroying evidence if it had a duty to preserve it.”); Coleman v. Eddy Potash, Inc., 905 P.2d 185, 191 (N.M. 1995) (“[A] property owner has no duty to preserve or safeguard his or her property for the benefit of other individuals in a potential lawsuit” without the existence of a duty to preserve evidence). See also Lewy v. Remington Arms Co., 836 F.2d 1104, 1112 (8th Cir. 1988); Indem. Ins. Co. of N. Am. v. Liebert Corp., No. 96 CIV. 6675 (DC), 1998 WL 363834 at *3 (S.D.N.Y. June 29, 1998); Smith v. Superior Court, 198 Cal. Rptr. 829, 832-33 (Cal. Ct. App. 1984). See Reid v. State Farm Mut. Auto. Ins. Co., 218 Cal. Rptr. 913, 927 (Cal. Ct. App. 1985) (holding that without specific request, insurance company has no duty to preserve evidence); Mace, 653 S.E.2d at 666 (“[I]n order for a plaintiff to successfully pursue a claim against a third party for negligent spoliation of evidence, the plaintiff must show that the third party had actual knowledge, from whatever source, of the plaintiff’s pending or potential lawsuit.”). Cf. American Family, 768 N.W.2d at 737 (“[A] party or potential litigant with a legitimate reason to destroy evidence discharges its duty to preserve relevant evidence within its control by providing the opposing party or potential litigant: (1) reasonable notice of a possible claim; (2) the basis for that claim; (3) the existence of evidence relevant to the claim; and (4) reasonable opportunity to inspect that evidence.”).
courts have found a third party liable without notice. Another factor in determining whether a duty exists in the absence of actual notice is foreseeability of harm caused to the plaintiff as a result of the spoliation. A duty can arise if it’s reasonably foreseeable that a lawsuit will ensue and evidence will be discoverable in connection with that lawsuit.

For example, in *Reid v. State Farm Mutual Automobile Insurance Co.*, the notice and foreseeability factors were discussed at great length in the context of a third-party spoliator. In *Reid*, the plaintiff was injured in

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125 See, e.g., *Indem. Ins. Co. of N. Am.*, 1998 WL 363834, at *3. See also *Lewy*, 836 F.2d at 1112 (discussing that actual notice is not required to impose a duty to preserve evidence) (“[I]f the corporation knew or should have known that the [it] would be material at some point in the future then such documents should have been preserved.”).


129 *Id.*
a vehicle accident that damaged his car. Subsequently the insurance company settled the property damage claim, and it sold the car to an auto body company causing the plaintiff to be unable to bring a products liability suit against the manufacturer. Nineteen months after the accident, the plaintiff learned of the car’s destruction and sued the insurer. Applying the special relationship doctrine, the Court of Appeals emphasized that the foreseeability requirement was necessary to establish a special relationship and impose a duty on the insurer. The insurance company “had no actual knowledge of any unreasonable risk of harm to [the plaintiff] by disposing of the totaled [car] in the ordinary course of processing the claims ....” When “[the insurance company] sold the wreckage of the car, it simply did not know of any potential claims by or risk of harm to [the plaintiff].” The Court concluded that no such duty had been shown because the insurance company lacked actual knowledge of the potential claims and as a result could not foresee that selling the car could interfere with plaintiff’s interest in a prospective lawsuit. Therefore, the Court held “as a matter of law that, in the absence of a specific request by either [the insured] or [plaintiff], [the insurer] had no duty to preserve the . . . vehicle.” However, even

130 Id. at 917-18.
131 Id.
132 A special relationship may give rise to a duty to preserve evidence, see sources cited supra note 103.
133 Reid, 218 Cal. Rptr. at 923.
134 Id.
135 Id.
136 Id. at 922.
137 In Reid, 218 Cal. Rptr. at 927, it is established that a defendant charged with negligent spoliation has no duty to preserve evidence for the plaintiff’s use against a third party absent a “specific request” from the plaintiff to do so. The few published California decisions analyzing the tort of spoliation have held that “[b]oth negligent and intentional spoliation require the loss or destruction of physical evidence that a defendant had promised to preserve”. Anderson v. Rinaldo, No. C93–2213 WHO, 1994 WL 46728, at *7 (N.D. Cal. Feb. 2, 1994). See Dunham v. Condor Ins. Co., 66 Cal. Rptr. 2d 747, 749 (Cal. Ct. App. 1997), where a plaintiff cannot establish detrimental reliance without first requesting preservation of the evidence (quoting Reid, 218 Cal. Rptr. at 927). See also Murphy v. Target Prods., 580 N.E.2d 687, 688-89 (Ind. App. 1991) (holding that an employer owes an employee no duty to preserve possible evidence for the employee
where the third party spoliator has both notice of the pending lawsuit and foreseeability, courts may still find that a duty to preserve evidence has ended under the specific facts of the case.\textsuperscript{138} 

2. Constructive Notice

Some courts have employed a constructive notice approach in imposing a duty on a defendant to preserve evidence.\textsuperscript{139} Following the constructive notice theory, these courts find an obligation to preserve evidence is imposed once the plaintiff threatens the defendant with filing a suit which may be used by employee in some future legal action against a third party absent an agreement between the parties, a contract between the parties, a special relationship between the parties, or a statute). \textit{See also} Dunham, 66 Cal. Rptr. 2d at 750 (concluding absence of a specific request the defendants had no duty to take any steps to preserve the vehicle part and “there cannot be liability for spoliation where the defendant never had possession or control over the evidence and was not the one who destroyed it.”).

\textsuperscript{138} \textit{See} Murray v. Farmers Ins. Co., 796 P.2d 101, 103 (Idaho 1990) (duty to preserve the evidence ended when one year had passed since the promise to preserve the evidence had been made to the plaintiff’s attorney, and plaintiff’s attorney did not respond to the salvage yard’s notification that the evidence would be destroyed unless it received a request for an extension.). \textit{See id.}, where the plaintiff was involved in a single vehicle accident when a new Chrysler failed to negotiate a curve. The insurance company had the car towed to a salvage yard, but postponed salvaging it, because the plaintiff’s attorney requested time to have the car examined by an expert. \textit{Id.} The insurer notified the plaintiff’s attorney, after a year’s delay “that the car would be salvaged unless the attorney indicated that the wanted the vehicle preserved for an additional period of time.” \textit{Id.} After receiving no response, the insurer ordered the car destroyed. \textit{Id.} The Idaho Supreme Court found that the insurer’s notification to the insured, prior to destruction of the car shielded it from exposure to tort liability. \textit{Id. \textit{See also} County of Solano v. Delancy, 264 Cal. Rptr. 721 (Cal. Ct. App. 1989); and Reid, 218 Cal. Rptr. 913 (Cal. Ct. App. 1985).}

lawsuit relating to the evidence or in the event of a plaintiff filing a complaint. One proponent of the constructive knowledge requirement argues, “the constructive knowledge standard of conduct presents the most efficient allocation of transaction costs.” However, this approach has often been criticized as too broad in scope because it requires “property owners to make often-arbitrary determinations about what is relevant to a hypothetical lawsuit that has not, and may never be, filed.” Some courts have agreed with this contention.

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140 Wetzel, supra note 138, at 465.
141 Nolte, supra note 17, at 384 (“The insurer and the policyholder share the transaction costs involved in insurance-related spoliation cases. Resolution of the knowledge requirement problem should depend on the most efficient allocation of these costs”) (quoting Robert Cooter & Thomas Ulen, Law and Economics 477 (1988)):

"Prior to the conclusion of the insurance case, the insurance carrier bears no transaction costs except those created by its duty to investigate and appropriately consider the insurance case to the degree necessary to foresee its insured’s prospective third-party litigation. The policyholder, on the other hand, bears additional transaction costs for acquiring information from the insurer. If courts applied the constructive knowledge standard, the insurer would incur no additional transaction cost since the duty to foresee possible third-party action already exists. On the other hand, the policyholder would expend additional transaction costs if required to inform the insurer of prospective litigation."

Id. See Judge, supra note 17, at 452; County of Solano, 264 Cal. Rptr. at 731 (Anderson, P. J. dissenting) (stating “on a clear day you can foresee forever!”).
143 Johnson, 79 Cal. Rptr. 2d at 240; See also Hannah v. Heeter, 584 S.E.2d 560, 570 (W. Va. 2003) (providing a third party must have actual notice of a pending or potential litigation and asserting “[A] third party's constructive notice of a pending or potential action is not sufficient to force upon the third party the duty to preserve evidence.”) (quoting Smith v. Atkinson, 771 So.2d 429, 433 (Ala. 2000)); Mace v. Ford Motor Co., 653 S.E.2d 660, 666 (W.Va. 2007) (appellants arguing the insurance carrier was “on notice” because they had paid “500 claims” and filed their own product
3. Method of Notice

A subset of the notice requirement is the method of delivering that notice. In *American Family Mutual Insurance Company v. Golke*, the Court provided that “notice can be effectuated by first-class mail, and evidence of mailing creates a presumption of receipt that may create an issue for the fact finder only by denial of receipt.” However, Chief Justice Abrahamson, in her concurrence stated, “[i]n some circumstances first-class mail might be fine [and] in others, not.” She further noted that in a “technologically-advanced 21st century” it is more efficient to use a method of notice “that provides written evidence that he or she actually did give the notice and that the recipient actually did receive the notice.”

However, the majority in *Golke* determined that the method or frequency of notice is less important because ultimately it is left to the court’s judgment and discretion, under the totality of the circumstances to determine whether the content of the notice was sufficient. The Court noted that certain factors will be taken into consideration in determining the sufficiency of notice:

liability suit against Ford however the court stated, that with constructive notice, where there *may* or *might* be a cause of action, is insufficient to give rise to a third-party's duty to preserve evidence; there has to be a direct and explicit notice).


145 *Id.* at 738 (The majority noting that “[t]he legislature has long recognized that first-class mail service is an efficient mechanism that is reasonably calculated to provide actual notice of possible or pending litigation and effective alteration of substantive legal rights and interests.”). *See also* Oliver v. Stimson Lumber Co., 993 P.2d 11, 20 (Mont. 1999) (providing that a telefax of a request to preserve the evidence was a "usual and customary procedure" in delivering important letters and concluding that through a telefax and telephone conference “a jury may very well determine that Stimson had actual notice of the Olivers’ request to preserve the evidence.”).

146 *American Family*, 768 N.W.2d at 748 (Abrahamson, C.J., concurring).

147 *Id.*

148 *Id.*

149 *Id.* at 737-38.
(1) The length of time the evidence can be preserved;
(2) The ownership of the evidence;
(3) The prejudice posed to possible adversaries by the destruction of the evidence;
(4) The form of the notice;
(5) The sophistication of the parties; and
(6) The ability of the party in possession of the evidence to bear the burden and expense of preserving it.\(^\text{150}\)

In considering the sixth factor, the issue of cost arises when one party has the responsibility to bear the burden of expense in preserving the evidence. The Supreme Court of Alabama pronounced a specific request to preserve the evidence “must be accompanied by an offer to pay the cost or otherwise bear the burden of preserving [because the court did not consider] a tort duty to preserve should be created simply by someone specifically requesting a third party to preserve something.”\(^\text{151}\) Numerous cases have noted the high costs to insurance companies to locate and obtain the storage space needed to preserve evidence.\(^\text{152}\) One court has provided that it was “sensitive to the legitimate interests and rights of third parties who are in the possession of such evidence.”\(^\text{153}\) Because preservation may involve significant burdens, the request to preserve evidence must be accompanied by an offer to pay the cost of that preservation and also, the third party “can decline the responsibility, shifting the risk of loss back to the plaintiff.”\(^\text{154}\)

Alternatively, the Supreme Court of Montana found there is “no need to require the requesting party to include an offer to pay reasonable costs of preservation in the request [because] particularly where the evidence is small in size and manageable, there will be no costs associated with the preservation.”\(^\text{155}\) The Court further stated that the burden of preservation

\(^{150}\) *Id.*


\(^{153}\) *Oliver v. Stimson Lumber Co.*., 993 P.2d 11, 18 (Mont. 1999).

\(^{154}\) *Smith*, 771 So.2d at 433.

\(^{155}\) *Oliver*, 993 P.2d at 20.
should be on the person or entity requesting the preservation, and a third party can demand “reasonable costs” from the requesting party.\textsuperscript{156}

C. POLICY CONSIDERATIONS

1. Justifications

Although the courts have shown inconsistency in recognizing a cause of action for third party spoliation cases, some courts have announced compelling policy considerations for imposing a duty to preserve in third-party spoliation situations. For example, the Montana Supreme Court provided:

Relevant evidence is critical to the search for the truth. The intentional or negligent destruction or spoliation of evidence cannot be condoned and threatens the very integrity of our judicial system. There can be no truth, fairness, or justice in a civil action where relevant evidence has been destroyed before trial. Historically, our judicial system has fostered methods and safeguards to insure that relevant evidence is preserved. Ultimately, the responsibility rests with both the trial and appellate courts to insure that the parties to the litigation have a fair opportunity to present their claims or defenses.\textsuperscript{157}

The District of Columbia Court of Appeals determined despite the speculative nature of damages in spoliation of evidence cases, recovery should not be barred altogether and concluded “[w]here the tort itself is of such a nature as to preclude the ascertainment of the amount of damages with certainty, it would be a perversion of fundamental principles of justice to

\textsuperscript{156} Id. (stating “the person requesting preservation would have the option of deciding whether or not to incur such costs.”). But see Thompson v. Owensby, 704 N.E.2d 134, 139 (Ind. Ct. App. 1998) (providing, with respect for insurance companies, “the evidence must be maintained by someone, and a liability carrier can typically maintain evidence at a lower cost than an individual claimant because the carrier can distribute the cost among all policyholders.”). But cf. Killings v. Enter. Leasing Co., 9 So. 3d 1216, 1222-23 n.6 (Ala. 2008) (noting that a duty to preserve evidence can be established without the plaintiff offering to pay the cost or bear the burden of preservation if the defendant voluntarily agrees to preserve the evidence).

\textsuperscript{157} Oliver, 993 P.2d at 17.
deny all relief to the injured person, and thereby relieve the wrongdoer from making any amend for his act.”

2. Pitfalls

Most recently, the case of Reynolds v. Bordelon specifically addressed the issues in imposing a duty on an insurance company. In Reynolds, the issue was whether Louisiana recognized a claim for negligent spoliation. In this case, a motorist was involved in a vehicle accident and subsequently brought an action against the manufacturer of the vehicle’s airbags for failure to properly deploy during the accident. However, plaintiff’s insurer Automobile Club Inter-Insurance Exchange (“ACIE”) and the custodian of his vehicle after the accident, Insurance Auto Auctions Corporations (“IAA”), failed to preserve the vehicle for inspection purposes. Because of this, the parties could not determine whether any defects existed despite being put on notice of the need for preservation. Plaintiff brought a claim against the custodian of his vehicle and the insurer for negligent spoliation of evidence. The Court emphasized that the duty inquiry was central to its discussion on whether Louisiana recognized the tort of negligent spoliation of evidence. The Court then analyzed the duty requirement in terms of policy considerations.

The Court in Reynolds focused on several policy considerations in rejecting the tort of negligent spoliation of evidence. The Court specifically discussed: (1) that the recognition of the tort would not act to deter future conduct; (2) the compensation to victims was highly

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159 Reynolds v. Bordelon, 172 So. 3d 589 (La. 2015).
160 Id.
161 Id.
162 Id. (quoting Frank L. Maraist & Thomas C. Galligan, Jr., Louisiana Tort Law § 5.02 (2004)).
163 Id. at 596.
164 According to the Reynolds Court, “. . . the act of negligently spoliating evidence is so unintentional an act that any recognition of the tort by the courts would not act to deter future conduct, but would, rather, act to penalize a party who was not aware of its potential wrongdoing in the first place.” Reynolds, 172 So. 3d 589, 597 (2015). Emphasizing that
speculative;\textsuperscript{165} (3) flaws existed within the satisfaction of the community’s sense of justice and predictability;\textsuperscript{166} and, (4) the recognition of the tort would result in improper allocation of resources.\textsuperscript{167} The Court in Reynolds found that societal justice and predictability weighed heavily against the recognition of the tort of negligent spoliation of evidence.\textsuperscript{168} Adoption of the tort would place the imposition of a new duty on third parties to protect them from liability, “resulting in higher costs for the public” outweighing societal interest as a whole.\textsuperscript{169} Observing that if it were to recognize the tort of negligent spoliation, third parties would be left with the burden of adopting retention policies in fear of possible liability in the unknown future, which inadvertently leads to possible implications of property rights.\textsuperscript{170} Many other jurisdictions have also demonstrated reluctance in imposing unreasonable burdens on insurance companies to preserve and maintain evidence\textsuperscript{171} finding that “the burdens and costs of recognizing a tort remedy for third party spoliation are considerable — perhaps even greater than in the

\textsuperscript{165} “T]he parties and the trier of fact would be called upon to estimate the impact of the missing evidence and guess at its ability to prove or disprove the underlying claim, resulting in liability based far too much on speculation.” Reynolds, 172 So.3d at 598. The Court also reasoned that as a comparative negligence jurisdiction, liability would be highly speculative in determining the measure of the proportional fault of the spoliator and the likelihood of success of the underlying case. Id. at 597-98.

\textsuperscript{166} Id. at 598.

\textsuperscript{167} Id.

\textsuperscript{168} Id.

\textsuperscript{169} Id.

\textsuperscript{170} Id.

\textsuperscript{171} See, e.g., Cedars-Sinai Med. Ctr. v. Superior Court, 954 P.2d 511, 521 (Cal. 1998) (weighing the benefits of recognizing the spoliation cause of action against the burdens and costs it would impose).
case of first party spoliation.” Additionally, a vast expanse in the class of potential defendants and plaintiffs would result.

172 Temple Cmty. Hosp. v. Superior Court, 976 P.2d 223, 233 (Cal. 1999). (“In sum, we conclude that the benefits of recognizing a tort cause of action, in order to deter third party spoliation of evidence and compensate victims of such misconduct, are outweighed by the burden to litigants, witnesses, and the judicial system that would be imposed by potentially endless litigation over a speculative loss, and by the cost to society of promoting onerous record and evidence retention policies”). See also Coprich v. Superior Court, 95 Cal. Rptr. 2d 884, 890 (Cal. Ct. App. 2000) (the policy considerations compelled the court to assert that “the burdens and costs to litigants, the judicial system, and others if the courts were to allow a tort remedy for negligent spoliation of evidence would outweigh the limited benefits [and] conclude there is no tort remedy for first party or third party negligent spoliation of evidence.”). But see Smith v. Atkinson, 771 So. 2d 429, 433 (Ala. 2000) (where the court disagreed with the insurer’s argument that a third party “duty to preserve evidence could result in wasteful and unnecessary record- and evidence-retention practices [and contended] if the third party does not wish to take responsibility for evidence, it can decline the responsibility, shifting the risk of loss back to the plaintiff.”).

173 As one court put it:

It is common knowledge that thousands of accidents occur on California roadways each year, leaving behind totally and partially damaged cars and trucks. Every accident involving personal injury or property damage has the potential to be a lawsuit. These lawsuits could encompass myriad parties, claims, and cross-claims—known and unknown, foreseeable and unforeseeable.

Johnson v. United Servs. Auto. Ass’n., 79 Cal. Rptr. 2d 234, 241 (Cal. Dist. Ct. App. 1998); See also Temple, 976 P.2d at 229-30:

Third party spoliation of evidence is analogous to perjury by a witness, and the same endless spiral of lawsuits over litigation-related misconduct could ensue were we to recognize a tort cause of action for third party spoliation. As in the case of spoliation by a party, one party unfortunately may be deprived of critical evidence and of a defense, or remain uncompensated for an injury. This
D. DAMAGES AND PENALTIES/SANCTIONS

1. Damages

Calculating and estimating damages has shown to be one of the most difficult tasks for courts in third party spoliation of evidence cases. One court determined damages should be established by a “trial court and the trier of fact after a full trial on the merits.”\(^{174}\) However, damages are speculative potential injustice cannot be avoided, however, if we are to escape what we have identified as the greater harm of subjecting parties, witnesses, and the courts to unending litigation over the conduct and outcome of a lawsuit.

*But see Id.* at 237 (Kennard, J., dissenting):

[T]ort liability for third party spoliation does not pose a threat to the finality of adjudication . . . [a] third party spoliator by definition is not a party to the underlying cause of action to which the spoliated evidence is relevant, and the spoliator has not litigated with the spoliation victim any issue relating to that evidence or to the underlying cause of action [and] [a]ny judgment against the third party spoliator would not alter the previous determination of liability between the spoliation victim and the spoliation victim's opponent in the underlying action [thus] [a] tort remedy would therefore have no effect, either formally or practically, on the judgment rendered on the cause of action to which the spoliated evidence was relevant and would not clash with the public policy favoring finality of adjudication.


[W]ithout knowing the content and weight of the spoliated evidence, it would be impossible for the jury to meaningfully assess what role the missing evidence would have played in the determination of the underlying action . . . [thus] the jury could only speculate as to what the nature of the spoliated evidence was and what effect it might have had on the outcome of the underlying litigation.
due to the uncertainty of what the destroyed evidence would have shown. Addressing this uncertainty, courts have come up with possible solutions to calculate uncertain damages including: (1) awarding the plaintiff the entire amount of damages that the plaintiff would have received if the original lawsuit had been pursued successfully; (2) awarding the plaintiff any costs and fees incurred in pursuit of the original suit; and (3) discounting damages to account for uncertainties by balancing of interests by the damages that would have been obtained in the underlying lawsuit, multiplied by the probability that plaintiff would have won the suit had he possessed the spoliated evidence.

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175 See, e.g., Smith, 771 So. 2d at 436 (providing “the appropriate measure of damages is difficult to determine in spoliation cases because, without the missing evidence, the likelihood of the plaintiff’s prevailing on the merits cannot be precisely determined. “It would seem to be sheer guesswork, even presuming that the destroyed evidence went against the spoliator, to calculate what it would have contributed to the plaintiff’s success on the merits of the underlying lawsuit.”) (quoting Petrik v. Monarch Printing Corp., 501 N.E.2d 1312, 1320 (Ill. App. Ct. 1987); See also Story Parchment Co. v. Paterson Parchment Paper Co., 282 U.S. 555, 563 (1931) (contending speculative damages cannot be recovered because the amount is too uncertain and providing the general rule “that all damages resulting necessarily and immediately and directly from the breach are recoverable, and not those that are contingent and uncertain.”). Cf. Oliver v. Stimson Lumber Co., 993 P.2d 11, 21 (Mont. 1999) (providing “a plaintiff is required to prove damages with reasonable certainty . . . [but] when there is strong evidence of the fact of damage, a defendant should not escape liability because the amount of damage cannot be proven with precision.”).


177 Id.

178 Id. at 852-53 (choosing to adopt the third solution and holding “that in an action for negligent or reckless spoliation of evidence, damages arrived at through just and reasonable estimation based on relevant data should be multiplied by the probability that the plaintiff would have won the underlying suit had the spoliated evidence been available.”). See also Miller v. Allstate Ins. Co., 573 So. 2d 24, 27-28 (Fla. Dist. Ct. App. 1990) (providing the “harsh results of the application of the rule of certainty,
There are other courts that have applied the certainty requirement for damages more rigorously in contract cases compared to tort cases. One court provided the reason for this difference in application is that in tort “once the plaintiff is in the area of risk created by the defendant’s wrong, the defendant is usually liable for all injuries caused by his misconduct [where] in contract, undoubtedly out of concern for the impact on commerce, damages are limited to the types of loss the breaching party had reason to anticipate at the time the contract was made.” Alternatively, the District of Columbia Court of Appeals provided that damages should be tailored by estimating the likelihood of success in a potential civil action.

2. Penalties/Sanctions

One court determined that the “availability of punitive damages would only magnify the cost of erroneous liability determinations [and] [t]he risk of erroneous spoliation liability could also impose indirect costs by causing persons or entities to take extraordinary measures to preserve for an indefinite period documents and things of no apparent value solely to avoid the possibility of spoliation liability if years later those items turn out to have some potential relevance to future litigation.” Consequently, the result referred to as the ‘all-or-nothing’ approach, has led courts and scholars to criticize the rule and carve out exceptions and modifying doctrines.”

179 Miller, 573 So. 2d at 28-29.
180 Id. at 29.
181 Holmes, 710 A.2d 846; See also Oliver v. Stimson Lumber Co., 993 P.2d 11, 21 (Mont. 1999) (providing that even though damages should be proven with reasonable certainty, “a defendant should not escape liability because the amount of damage cannot be proven with precision . . . . [and held] that damages arrived at through reasonable estimation based on relevant data should be multiplied by the significant possibility that the plaintiff would have won the underlying suit had the spoliated evidence been available.”); Rizzuto v. Davidson Ladders, Inc., 905 A.2d 1165, 1181 (Conn. 2006) (stating that with the difficulty in calculating damages in a spoliation of evidence tort, the proper measure of determining damages is “guided by the purpose of compensatory damages, which is to restore an injured party to the position he or she would have been in if the wrong had not been committed.”).
182 See, e.g., Cedars-Sinai Med. Ctr. v. Superior Court, 954 P.2d 511, 519 (Cal. 1998).
would be endless, meritless litigation subject to abuse not necessarily for
evidence that was intentionally destroyed but for evidence that was
misplaced or discarded accidently in ordinary dealings or practice.183

Alternatively, once a party reasonably anticipates litigation, an
affirmative duty to preserve evidence may be relevant and subsequently
spoliation may be established.184 If spoliation is established, the spoliating
party may be vulnerable to sanctions including: “(1) dismissal of a claim or
granting judgment in favor of a prejudiced party;185 (2) suppression of
evidence; (3) an adverse inference, referred to as the spoliation inference; (4)
fines; [and/or] (5) attorneys’ fees and costs.”186

183 See id. at 519; See also Coprich v. Superior Court, 95 Cal. Rptr. 2d 884, 888 (Cal. Ct. App. 2000) (“The Temple Community court acknowledged that fewer sanctions are available to deter spoliation by third parties or to mitigate its effects, but it concluded that the burdens and costs on litigants, the judicial system, and others would outweigh the benefits of a tort remedy and that the limited remedies available are sufficient.”).


185 Cf. Garfoot v. Fireman's Fund Ins. Co., 599 N.W.2d 411, 422 (Wis. Ct. App. 1999) (declining to hold the requirement that “if the trial court determines a party destroyed evidence with a conscious attempt to affect the outcome of the litigation or a flagrant knowing disregard of the judicial process, the court does not have the discretion to impose a sanction of dismissal unless those acts resulted in prejudice to the opposing party.”).

186 See Paramount Pictures Corp. v. Davis, 234 F.R.D. 102, 110-11 (E.D. Pa. 2005). See also Mosaid Techs. Inc. v. Samsung Elecs. Co., 348 F. Supp. 2d 332, 335 (D.N.J. 2004) (“Spoliation sanctions serve a remedial function by leveling the playing field or restoring the prejudiced party to the position it would have been without spoliation [and] [t]hey also serve a punitive function, by punishing the spoliator for its actions, and a deterrent function, by sending a clear message to other potential litigants that this type of behavior will not be tolerated and will be dealt with appropriately if need be.”). Cf. Memorandum Opinion & Order, Travelers, CMR No. 12-13 (No. CIV. 05-CV-6399), WL 2571450 at *6 (providing that the “Court must consider the availability of sanctions less severe than the entry of judgment in Defendants’ favor that can adequately protect Defendants’ rights and deter future spoliation by Plaintiff or others . . . . [T]he sanction of default judgment should be employed only in the most egregious of spoliation
Mississippi courts have applied a balancing test to determine sanctions, established in a Third Circuit Court of Appeals decision, for both first and third party spoliation cases. The test to determine whether a sanction is appropriate includes: “(1) the degree of fault of the party who altered or destroyed the evidence; (2) the degree of prejudice suffered by the opposing party; and (3) whether there is a lesser sanction that will avoid substantial unfairness to the opposing party.” These alternative approaches do not work in third-party situations.

In evaluating these three considerations, the court can determine if an adverse inference instruction [to the jury] is the least severe and most appropriate sanction based on the circumstances of the case, with the purpose of deterring similar conduct in future cases. An adverse inference applies from the “common sense observation that when a party destroys evidence that is relevant to a claim or defense in a case, the party did so out of the well-founded fear that the contents would harm him.” However, there is a four-factor test that must be satisfied for the adverse spoliation inference to apply including: (1) the evidence in question must be within the party’s control; (2) it must show that there has been actual suppression or withholding of the evidence; (3) the evidence destroyed or withheld was

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188 See Ogin, 563 F.Supp.2d at 545-46 (the court applied the three key considerations and found 1) Defendants bear a high degree of fault for the destruction of the actual driver’s logs because the defendants received both notice of pending litigation and actual notice of litigation and they should have taken reasonable precautions to preserve the evidence; 2) the Defendants actions prejudiced the Plaintiffs because by destroying the driver’s logs it was difficult to discern whether there were any negligent conduct violations that may gave rise to punitive damages; and 3) an adverse inference instruction was the least severe and most appropriate sanction based on the circumstances because the Defendants unilaterally determined the relevance of the actual driver’s logs and destroyed the records.)

189 Ogin, 563 F.Supp.2d at 546.

190 Mosaid Tech. Inc., 348 F. Supp. 2d at 336 (citation omitted).
relevant to claims or defenses; and (4) it was reasonably foreseeable that the evidence would later be discoverable.\footnote{191 memorandum opinion & order, travelers, cmr no. 13-14 (no. civ. 05-cv-6399), wl 2571450 at *7; mosaid tech. inc., 348 f. supp. 2d at 336; see also scott v. ibm corp., 196 f.r.d. 233, 249 (d.n.j. 2000), as amended (nov. 29, 2000) (stating “while a litigant is under no duty to keep or retain every document in its possession, even in advance of litigation, it is under a duty to preserve what it knows, or reasonably should know, will likely be requested in reasonably foreseeable litigation.”).}

In \textit{Travelers Property Casualty Company of America v. Cooper Crouse-Hinds}, a fire damaged a building owned by a construction company.\footnote{192 memorandum opinion & order, travelers, cmr no. 1 (no. civ. 05-cv-6399), wl 2571450 at *1.} The building was insured through a policy purchased from Travelers Property Casualty Company of America \{“Plaintiff”\}.\footnote{193 id.} Subsequently, Plaintiff hired investigators to determine the fire’s cause and found suspicion with a fluorescent light fixture that was hanging above a set of wall shelving.\footnote{194 id.} Photographs were taken and the fixture was removed and sent to the Plaintiff’s laboratory for further investigation.\footnote{195 id.} After further investigation, photographs, and discovery of missing parts, it was determined the light fixture was the cause of the fire.\footnote{196 id.} After further investigation of the light fixture without the components documented as missing, by another hired examiner, the Plaintiff filed a complaint asserting claims of strict products liability, negligence, and breach of warranty against numerous Crouse-Hinds entities.\footnote{197 id. at cmr no. 3-4 (no. civ. 05-cv-6399), wl 2571450 at *2.} Crouse-Hinds \{“Defendants”\} filed a Motion for Summary Judgment claiming the Plaintiff did not provide an opportunity for them to examine the allegedly defective light fixture because: (1) Defendants received the light fixture almost two years after the Plaintiff’s anticipated a subrogation suit; (2) when the fixture was sent to Defendants’ counsel, it was missing an additional component; and (3) the components were in a substantially different condition than they were when Plaintiff and its experts examined the fixture.\footnote{198 id. at cmr no. 4 (no. civ. 05-cv-6399), wl 2571450 at *2.} Defendants’ argued that summary judgment should be ruled in their favor as a sanction against Plaintiff for...
spoliation of evidence. The Court determined that Plaintiffs were subject to sanctions because “a significant segment of Plaintiff’s daily operations includes conducting loss investigations for the purpose of subrogation actions [and] [they] knew that (1) fire-damaged materials are likely to deteriorate over time unless special precautions are taken to preserve them; and (2) it was imperative to contact the party potentially liable for the fire as soon as possible so that the fixture and its components could be examined.”

In considering sanctions, the Court applied a balancing test to the circumstances and found: (1) the Plaintiff was at fault for failing to timely notify Defendants that their product was the subject of a subrogation investigation, and for failing to provide Defendants with an immediate opportunity to examine the fixture; (2) Defendants suffered some prejudice from the spoliation of the light fixture but only a minimal amount; and (3) the appropriate sanction was less severe than the entry of judgment. The Court determined the most logical sanction was an adverse

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199 Id. at CMR No. 4 (No. CIV. 05-CV-6399), WL 2571450 at *4.
200 Id. at CMR No. 4-5 (No. CIV. 05-CV-6399), WL 2571450 at *2; but cf. id. at CMR No. 11 (No. CIV. 05-CV-6399), WL 2571450 at *5 n.28 (noting that “intentional or bad-faith destruction is not required for a finding of spoliation [and] [e]ven unintentional destruction, if the result of unreasonable conduct, subjects a party to sanctions.”).
201 Id. at CMR No. 10 (No. CIV. 05-CV-6399), WL 2571450 at *5.
202 Id.
203 Id. at CMR No. 11 (No. CIV. 05-CV-6399), WL 2571450 at *6 (providing that prejudice is less for design-defect cases because the Defendants could have inspected and tested multiple fixtures of the same design and also, examined all the photographs taken immediately after the fire).
204 Id. at CMR No. 13 (No. CIV. 05-CV-6399), WL 2571450 at *6 (recognizing the Plaintiffs did not intentionally destroy the evidence. Rather, the spoliation resulted from lack of care and failure to take reasonable precautions to protect the light fixture. Thus, the sanction “must remedy the injustice done to the injured party, punish the spoliator for its wrongful conduct, and deter the spoliator and other potential spoliators by alerting litigants before this Court that this type of behavior will not be tolerated in the future.”).
spoliation inference.\textsuperscript{205} Moreover, in applying the four-factor test, the Court found each factor was satisfied because (1) Plaintiff was in possession of the light fixture, and thus the fixture was within its control; (2) by not notifying Defendants of the subrogation suit in a timely manner, key components of the light fixture were destroyed before Defendants could examine them; (3) the destroyed components were relevant to causation issues in this case; and (4) as soon as Plaintiff began contemplating a subrogation suit against Defendants, it was reasonably foreseeable that the components would later be discoverable by Defendants in order to prepare their defense against Plaintiff.\textsuperscript{206} The Court declined to enter summary judgment against Plaintiff based on the spoliation of design-defect theory however, based on the Plaintiff’s failure to preserve the evidence, the Court concluded a spoliation inference was appropriate to instruct the jury.\textsuperscript{207}

V. RECOMMENDATIONS TO THE SPOLIATION OF EVIDENCE TORT

To ensure that a party’s property interest is protected while prohibiting a party from discarding evidence it knows to be relevant in a specific lawsuit, an appropriate approach is to apply the actual knowledge standard of conduct to an insurance carrier. Without proper notice of a lawsuit to the spoiler, an insurance company should be able to dispose of the property as they wish. An insurance company should be put on notice prior to a duty being imposed and, if so, then they should be able to negotiate costs.\textsuperscript{208} The mere fact that an insurance company takes possession of an automobile should not amount to the creation of a duty in itself to preserve evidence in possible civil litigation between a motorist and third party absent actual notice of the policyholder’s intent to sue. Notice requirements are not only necessary but vital to the interests of society as a whole in ensuring that premiums remain reasonably low and encouraging policyholders to remain insured. Imposing a duty of care, in the absence of such a requirement,

\textsuperscript{205} Id.
\textsuperscript{206} Id. at CMR No. 13-14 (No. CIV. 05 – CV – 6399), WL 2571450 at *7.
\textsuperscript{207} Id.
\textsuperscript{208} Johnson, 79 Cal. Rptr. 2d at 237 ("A similar uncertainty of the fact of harm, though, has been addressed in the prospective economic advantage arena … and the costs of preservation can be placed on the person seeking preservation.").
results in the negative consequences of leading a third-party to be in constant fear that their property might at some point be needed in a lawsuit, trampling traditionally well-protected property interests within our society. 209 Stockpiling property places a heavy burden on any third party, such as insurance companies, inevitably causing them to preserve evidence in the fear of facing liability in some unforeseen potential litigation in the near future. 210

Furthermore, another dilemma emerges because the insured ultimately decides whether or not to bring an action and when. As such, the transaction costs of storing particular items in an insurance company’s possession should be placed on the party making such a request for the preservation of evidence. 211 Thus, onerous retention policies are not the most cost-effective way in handling the negligent spoliation of evidence dilemma for a variety of reasons, which can be seen as the majority of the jurisdictions addressing the issue decline to impose such a standard on insurance companies.

It is the opinion of the authors that courts should make a categorical “no duty” rule regarding third-party spoliation claims involving insurance companies’ obligations to preserve auto related damage evidence. The


211 Oliver v. Stimson Lumber Co., 993 P.2d 11, 20 (Mont. 1999) (recognizing tort action for negligent or intentional third-party spoliation, but not for first-party spoliation and stating):

We see no need to require the requesting party to include an offer to pay reasonable costs of preservation in the request. In many instances, particularly where the evidence is small in size and manageable, there will be no costs associated with the preservation. However, after receiving such a request, the third party may demand the reasonable costs of preservation from the requesting party. Of course, the person requesting preservation would have the option of deciding whether or not to incur such costs. This condition places the burden of preservation where it rightfully belongs, on the person or entity requesting preservation.

Id.
analysis of adopting a “no duty” rule is best illustrated by the Louisiana Supreme Court’s decision in *Reynolds v. Bordelon*. In determining whether society is best served in recognizing a duty, and thus, a tort, the court in *Reynolds* made the following observation:

The same policy considerations which would motivate a legislative body to impose duties to protect from certain risks are applied by the Court in making its determination. “All rules of conduct, irrespective of whether they are the product of a legislature or a part of the fabric of the Court-made law of negligence, exists for purposes. They are designed to protect some persons under some circumstances against some risks. Seldom does a rule protect every victim against every risk that may befall him, merely because it is shown that the violation of the rule played a part in producing the injury. The task of defining the proper reach or thrust of a rule in its policy aspects is one that must be undertaken by the Court in each case as it arises. How appropriate is the rule to the facts of this controversy? This is a question that the Court cannot escape.”

Analyzing the duty requirement in terms of policy, the Court in *Reynolds* systematically walked through each of the policy goals that might exist regarding whether to adopt the tort of negligent spoliation in a third-party context.

Regarding the first factor—deterrence of undesirable contact—the Court found that “the act of negligently spoliating evidence [was] so unintentional an act that any recognition of the tort by the courts would not act to deter future conduct, but would, rather, act to penalize a party who was not aware of its potential wrongdoing in the first place.” The Court stated that this was “particularly true in the case of negligent spoliation by a third party, who is not vested in the ultimate outcome of the underlying case, and thus, has no motive to destroy or make unavailable evidence that could tend to prove or disprove that unrelated claim.” Therefore, the Court found that this factor weighed in favor of a no duty rule. Turning to the second factor—compensation of victims—was an issue that was strenuously debated

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213 *Reynolds*, 172 So. 3d at 597.

214 *Id.*
nationally among those states that did not recognize the tort because the damages were so highly speculative.\textsuperscript{215} In determining the proper measure of damages, the parties and the trier of fact would be called upon to estimate the impact of the missing evidence and then guess at its ability to prove or disprove the underlying claim, which involved too much speculation.\textsuperscript{216} Such hypothetical and abstract inquiries regarding damages weighed in favor of a no duty rule.\textsuperscript{217} Next, the Court in Reynolds focused on the third consideration—satisfaction of the community’s sense of justice—noting that because the reasonable person standard was inherent in the negligence analysis, it was prudent for the Court to ask whether reasonable persons would expect certain behavior and certain situations and, conversely, whether reasonable persons could be expected to be exposed to liability in certain situations.\textsuperscript{218} This part of the inquiry focused squarely on predictability.\textsuperscript{219} Commenting upon the policy considerations of social justice and predictability, the Court in Reynolds made the following insightful observation:

Recognition of the tort of negligence spoliation would place a burden on society as a whole, causing third parties who are not even aware of litigation to adopt retention policies for potential evidence in cases, in order to reduce their exposure to liability. There is simply no predictability in requiring preservation and recordkeeping for unknown litigation. Moreover, broadening the delictual liability for negligent spoliation would place restrictions on the property rights of persons, both natural and juridical insofar as the tort would act to limit the right to dispose of one’s own property. These policy concerns are readily apparent in the facts before this Court where [the insurance company] paid to the [insured] what was owed under his policy and received the title to the total vehicle. Then [the vehicle storer/custodian] in the normal course of its business, received the vehicle and disposed of it by auctioning it to a salvage yard for spare parts. To impose a requirement that all potential evidence be preserved for possible future litigation would wreak havoc on an industry whose very existence is sustained by destruction of possible subjects of litigation: totaled vehicles. It is

\textsuperscript{215} Id.
\textsuperscript{216} Id. at 598.
\textsuperscript{217} Id.
\textsuperscript{218} Id.
\textsuperscript{219} Id.
easy to imagine the trickle-down effect that a preservation policy would have on insureds themselves; the longer an insurer or auction company is required to store a vehicle, the higher the costs, and the more likely insurance premiums would be increased to absorb those costs. Moreover, the delay in proceeds being remitted to the insurer at the time of the auction prevents those funds from being immediately available to offset the total loss payout the insurer pays to the insured. Again, this practice could result in higher costs for the public.220

The Court in Reynolds found that the two factors of social justice and predictability, weighed heavily against broadening the delictual obligation for negligent spoliation.221

The Court in Reynolds identified five public policy considerations that had to be considered in creating a new duty: (1) deterrence of undesirable conduct; 222 (2) compensation of victims;223 (3) satisfaction of the community’s sense of justice and predictability;224 (4) proper allocation of resources, including judicial resources;225 and (5) deference to the legislature.226

The proper allocation of resources factor favored a no duty rule.227 Establishing a derivative tort would invite litigation and encourage parties to bring new lawsuits where the underlying lawsuit was unsuccessful.228 Such derivative litigation, according to the Reynolds court, could open the floodgates for endless lawsuits where the losses were speculative at best.229 These lawsuits would also create confusion for fact-finders, particularly juries, because it devolved into a trial within a trial.230

220 Id. (emphasis added)
221 Id. (emphasis added)
222 Id at 597
223 Id.
224 Id. at 598
225 Id.
226 Id. at 599
227 Id. at 598
228 Id. at 598
229 Id.
230 Id. The court in Holmes v. Amerex Rent-A-Car, 710 A.2d 846 (D.C. 1998), discussed the problems associated with determining proximate cause in spoliation of evidence of cases. The court concluded that the plaintiff was
Finally, the Court in *Reynolds* considered the position of the Louisiana Legislature. The Louisiana Legislature deferred to the courts on questions of fault and tort law in determining the viability of certain causes of action. Because of this, the *Reynolds* court concluded that the Louisiana Legislature did not require recognition of the tort of negligent spoliation.\(^\text{231}\)

Having considered all the policy factors and alternative remedies to plaintiffs,\(^\text{232}\) the *Reynolds* court observed as alternative remedies the required to show “based on reasonable inferences derived from both existing and spoliated evidence, that the underlying lawsuit was significantly impaired, that the spoliated evidence was material to that impairment and that the plaintiff enjoyed a significant possibility of success in the underlying claim.” *Id.* at 850. The court noted that it was “too heavy a burden on a plaintiff to show that he or she would have won with the missing evidence. Such a showing would be nearly impossible because judges and juries [could not] evaluate the value of evidence that they [could not] see.” *Id.* (quoting Petrik v. Monarch Printing Corp. 501 N.E.2d 1312, 1322 (Ill. App. Ct. 1986)). For a plaintiff to recover for the destruction of evidence, the plaintiff must likely first pursue and lose the underlying claim. To plead causation, the plaintiff must allege that an injury proximately resulted from the breach of a duty. Therefore, in a negligence action involving the loss or destruction of evidence, a plaintiff must allege sufficient facts to support a claim that the loss or destruction of the evidence caused the plaintiff to be unable to prove an underlying lawsuit. This is so because a threat of future harm, not yet realized, should not be actionable. The wrongful conduct must impinge upon a person. If the plaintiff is able to establish their claim in the underlying lawsuit without the missing evidence, then the plaintiff has not been injured by the loss of the evidence. It is easy to envision factual situations where a party has negligently lost or destroyed evidence, but that evidence was not critical or even material to the plaintiff’s underlying suit.\(^\text{231}\)

\(^{231}\) *Reynolds*, 172 So. 3d at 599.

\(^{232}\) Additionally, Louisiana recognizes the adverse presumption against litigants who had access to evidence and did not make it available or destroyed it. Regarding negligent spoliation by third-parties, the Plaintiff who anticipates litigation can enter into a contract to preserve the evidence and, in the event of a breach, avail themselves of those contractual remedies. Court orders for preservation are also obtainable. In this particular case, the Plaintiff also could have retained control of his vehicle and not released it to the insurer, thereby guaranteeing its availability for inspection. Furthermore, he could have bought the vehicle back from the insurer for a nominal fee. *Id.* at 600.
following: “discovery sanctions and criminal sanctions are available for first-party spoliators.

Decades ago, a wise court noted “[t]he risk reasonably to be perceived defines the duty to be obeyed….”\textsuperscript{233} When dealing with negligent spoliation claims involving third party insurance companies, there are no broad concerns of deterring wrongful but potentially profitable litigation-related conduct or of preserving the integrity of the civil justice system.\textsuperscript{234} The \textit{Reynolds} court properly noted the potentially harsh consequences facing unsuspecting third parties with regard to spoliation:

\begin{quote}
[T]he act of negligently spoliating evidence is so unintentional an act that any recognition of the tort by the courts would not act to deter future conduct, but would, rather, act to penalize a party who was not aware of its potential wrongdoing in the first place. This is particularly true in the case of negligent spoliation by a third party, who is not vested in the ultimate outcome of the underlying case, and thus, has no motive to destroy or make unavailable evidence that could tend to prove or disprove that unrelated claim.\textsuperscript{235}
\end{quote}

This limited risk calls for a limited duty.\textsuperscript{236} If a third party negligent spoliation duty is going to be imposed, such a duty should be limited to situations where there is an express agreement by the parties or a specific request that is made by the insured accompanied by an offer to bear the burden of preserving the evidence.\textsuperscript{237} In total vehicle loss situations, the insured can retain control of his vehicle and not release it to the insurer, thereby guaranteeing its availability for inspection. However, the policy’s implied covenant of good faith and fair dealing will require the insured to work out a financial arrangement with the insurer to pay the salvage value of the vehicle. Any request for preservation should be made in writing with proof of delivery to the insurance company. The so-called mailbox rule should not be utilized as a presumption of delivery. This approach secures the necessary predictability. If any duty is going to be imposed upon the insurance company, the cornerstone of the duty

\textsuperscript{233} Palsgraf v. Long Island R. Co., 162 N.E. 99, 100 (N.Y. 1928).
\textsuperscript{235} Reynolds, 172 S.3d at 597.
\textsuperscript{236} Johnson, 67 Cal. Rptr. 2d at 240.
\textsuperscript{237} Id.
should be actual, specific knowledge coupled with mutual agreement and a promise of payment for the relevant property. Otherwise, there is no predictability in requiring preservation and recordkeeping for unknown litigation.

VI. CONCLUSION

The words of the Louisiana Supreme Court encapsulate why an independent cause of action for negligent spoliation of evidence by insurance companies should not be adopted. The Court observed: “To impose a requirement that all potential evidence be preserved for possible future litigation would wreak havoc on an industry whose very existence is sustained by destruction of possible objects of litigation: [partially damaged or] totaled vehicles.”\(^\text{238}\) “[T]he act of negligently spoliating evidence is so unintentional an act [for insurance companies resolving automobile physical damage claims] that any recognition of the tort by the courts would not act to deter future conduct, but would, rather, act to penalize a party who is not aware of its potential wrongdoing in the first place and who had a contractual obligation to repair damaged vehicles and a contractual right to take the salvage of a totaled vehicle.”\(^\text{239}\)

\textit{Reynolds}, 172 So. 3d at 598.
\textit{Id} at 597.
UNLOCKING EXCHANGES

Brendan S. Maher *

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The fate of the Affordable Care Act is uncertain. Moreover, the nation is in an unusual state of political turmoil and may have no appetite for anything other than revolutionary changes to the ACA, if not its outright repeal. But press reports suggest even Republican officials formerly committed to its extirpation are now thinking instead about a measured path forward.

If so, one fact about the ACA should not escape the attention of serious reformers: the legislation has already accomplished the difficult task of laying the groundwork for a move away from employment-based (EB) insurance, a move scholars have urged for years. That said, not all features of employment-based insurance are undesirable, and certain reforms to the ACA could preserve those desirable features while nonetheless guiding the nation away from a flawed system.

For largely (but not entirely) political reasons, the ACA made it difficult for those receiving or providing EB insurance to migrate to the individual exchanges the Act took great pains to create. Yet if there is political will to modify the employer mandate and adjust the tax treatment of insurance purchases, access to the individual exchanges could be cautiously “unlocked,” and millions could migrate from EB insurance to individual, exchange-based insurance. With certain additional reforms, there is reason to believe that migration will lead to stronger, healthier exchanges; to a reduced regulatory burden on employers; to a clearer stakeholder understanding of the relationship between health insurance and wages; and perhaps a diminished need to rely on the controversial individual mandate, with individual States making that final assessment.

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* Professor of Law, Robert D. Paul Scholar, and Director of the Insurance Law Center, University of Connecticut School of Law; J.D. Harvard Law School; A.B. Stanford University. I would like to thank the workshop participants at Washington University and Harvard, as well as those affiliated with the University of Connecticut’s Insurance Law Center (especially Peter Siegelman), for their helpful comments.
I. INTRODUCTION

The fate of the Affordable Care Act\(^1\) is uncertain. Moreover, the nation is in an unusual state of political turmoil and may have no appetite for anything other than revolutionary changes to the ACA, if not its outright repeal. But press reports suggest even Republican officials formerly committed to its extirpation are now thinking instead about a measured path forward.\(^2\)

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\(^1\) The Affordable Care Act consists of both the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010), and the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029. I refer to them jointly as the “ACA.”

N.B.: This article was conceived before Donald Trump was elected, and largely finished in early 2017. To say the period since President Trump’s election and inauguration has been turbulent—both in terms of politics and policy—would be an understatement. I have not meaningfully revised this paper since then, having given up trying to predict the future. I thus consider this piece as much a time capsule as an idea.

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For largely (but not entirely) political reasons, the ACA made it difficult for those receiving or providing EB insurance to migrate to the individual exchanges the Act took great pains to create. Yet, if there is political will to modify the “employer mandate” and adjust the tax treatment of insurance purchases, access to the individual exchanges could be cautiously “unlocked,” and millions could migrate from EB insurance to individual, exchange insurance. With certain additional reforms, there is reason to believe that migration will lead to stronger, healthier exchanges; to a reduced regulatory burden on employers; to a clearer stakeholder understanding of the relationship between health insurance and wages; and, perhaps, a diminished need to rely on the controversial individual mandate, with individual States making that final assessment.

In Part II, I give some necessary background about individual and employment-based health insurance. In Part III, I describe how EB systems are best thought of as a form of government intervention to remedy market failures concerning the quantity, quality, or distribution of some socially desirable good, and describe the case for and against EB health insurance. In Part IV.A, I explain how the Affordable Care Act undertook a series of reforms to create insurance exchanges that would make previously deficient individual insurance markets stable, accessible, affordable, and comprehensible. In Part IV.B, I explain how and why Congress took legislative steps to forestall migration from the EB system to the newly-created individual exchanges. In Part V, I consider the preliminary case for taking regulatory steps to promote (rather than hinder) migration from EB insurance to exchange insurance, and then consider objections. In Part VI, I sketch two reform suggestions intended to encourage, or at least permit, migration to the exchanges.

published, the ACA may have already been reformed, or perhaps repealed. But whether such legislative action includes or ignores what is discussed herein, the Article will stand as a defense or criticism of what was done.
II. INSURANCE & EB BASICS

The United States is unique among advanced economies in its approach to health care. It uses a combination of public insurance programs and private insurance to finance, and thus deliver, care. While the elderly and the poor receive health care through public financing models (Medicare and Medicaid), persons outside those groups rely on private insurance to finance care, and they largely rely on a special type of private insurance: EB insurance. I discuss below some necessary basics of both individual and EB insurance.

A. INSURANCE BASICS

Insurance is an ancient means to trade and spread risk. Because the risk-averse insured fears the possibility of a large, unexpected loss, he is willing to pay the insurer a small, fixed amount (the premium) in return for the insurer agreeing to cover the loss if it occurs. The risk deal between the two is set forth in an insurance “policy.”

For a policy to be profitable for insurer, the premiums it collects (plus the investment return it earns on those premiums) must exceed the payouts associated with covered loss events. To charge a fair price for a policy, the insurer need engage in “underwriting,” i.e., it must determine, the best it can, the likelihood and magnitude the loss events it is agreeing to insure a particular insured for. Underwriting is a difficult task, even for insurance companies, because the true risk an insured poses can be different than the risk one would assign to the insured based on an evaluation of information the insurer has access to through underwriting.

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5 43 AM. JUR. 2D INSURANCE § 2 (explaining underwriting and risk transfer).

The problem is complicated by adverse selection, which is the term for the idea that those seeking to obtain insurance are those most likely to incur losses. Asymmetric information makes adverse selection dangerous. Because an insurer often has less information than a potential insured about the actual risk the insured poses, the insurer may charge an insufficiently high premium and incur losses on the policy. Should the insurer attempt to raise premiums the next time around, the higher premium may drive away potential insureds who lack the hidden risk justifying the higher premium, thus making the pool of insureds the insurer attracts riskier (and more costly to the insurer) overall. Adverse selection can damage or destroy insurance markets.

Health insurance is particularly challenging to underwrite. As opposed to other forms of insurance, where the likelihood and magnitude of loss events is relatively easier to calculate and predict (and thus price), health insurance is difficult to underwrite and issue. Even putting aside

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7 In a now-classic article, Professor Peter Siegelman explained that adverse selection’s threat to insurance markets often may be overemphasized by observers. See generally Peter Siegelman, Adverse Selection in Insurance Markets: An Exaggerated Threat, 113 YALE L.J. 1223 (2004) (concluding that propitious selection—an alternative method of selection—may be at least as common as adverse selection). That said, the consensus view is that adverse selection is a nontrivial threat to health insurance markets, and Siegelman’s article did point to some clear examples of adverse selection in health insurance.

8 JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 311-13 (2005) (explaining perils of adverse selection). The same is not true of broccoli markets, which is why that particular analogy, although colorful, was of limited appeal to insurance scholars who were following the famous NFIB v. Sebelius case involving, inter alia, the reach of the Commerce Clause. Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U. S. 519, 615 (2012) (Ginsburg, J., concurring in part, concurring in the judgment in part, dissenting in part) (rejecting broccoli analogy).

As a result, unlike markets in other goods, insurance markets (and particularly health insurance markets) need to be regulated with care. In the wild, health insurance markets are likely to be unstable, and market forces alone will probably not guarantee that insurance will be affordable and available to those whose need it. And health insurance is not an ordinary good. Because of the high cost of health care, insurance is the sole practical means to privately pay for most care, and thus the sole practical means to ensure, without recourse to the public fisc or charity, that people’s most basic needs—health and life—are addressed. There is thus a considerable societal interest in ensuring that people have access to some insurance mechanism to finance care.

Interestingly, in the United States, until the passage of the Affordable Care Act, the primary regulatory response to addressing the problems of the individual health insurance market was to sidestep the issue. This was accomplished by relying on insurance provided in connection with one’s job—i.e., “employment-based insurance”—to finance care for Americans outside of public programs like Medicare and Medicaid. To the EB world I turn to next.

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10 As for why health care is expensive, the explanations are many. See, e.g., Timothy Stoltzfus Jost, Our Broken Health Care System and How to Fix It: An Essay on Health Law and Policy, 41 Wake Forest L. Rev. 537, 547-49 (2006) (tying high cost of care to a variety of causes); Mark V. Pauly, The Economics of Moral Hazard: Comment, 58 AM. ECON. REV. 531, 535-36 (1968) (theorizing that moral hazard in health insurance leads to upward price pressure).


12 Indeed, prior to the Affordable Care Act, many people were saved from being exposed to the vicissitudes of the individual market by COBRA, which was enacted to allow those who had left a job with insurance to continue to buy into the employer policy for a period of time. Thus, the prior Congressional effort to deal with individual insurance market infirmity was not to solve individual market problems, but merely to use EB insurance to more aggressively sidestep the problem.
B. EB BASICS

EB insurance is far more than a fringe work benefit. It is massive in size and regulatory scope, covering over 150 million people and occupying countless pages of the United States Code, including the Internal Revenue Code, the Employee Retirement Income Security Act of 1974 (ERISA), and the Affordable Care Act.

The historical justification for the rise of EB insurance is well known: during World War II, wages were subject to wartime price controls, but benefits were not.\(^\text{13}\) Providing benefits (including health insurance) thus allowed employers to compete for workers by increasing their compensation without increasing their wages.\(^\text{14}\) The provision of health insurance through the workplace proved popular, and by the time of the passage of the Affordable Care Act in 2010, EB health insurance was a familiar fact of life to most Americans.\(^\text{15}\)

The theoretical appeal of EB insurance is a subject that has received uneven treatment. Part of that is attributable to the underlying evolution of both health care and insurance. Health insurance in the form we recognize it today—paying a premium to ensure that one could receive paid-for medical care—began in the late 1920s, less than ninety years ago.\(^\text{16}\) Medical care at the time was both far less effective and far less costly than today, and so the need to ensure proper financing for it was less pressing.\(^\text{17}\) But as the practice of medicine modernized and became more effective, health care


\(^{14}\) Id.


costs began to rise. And while the rate of health care cost increases had
begun to become worrisome by the early 1970s, the scope of the problem
was not broadly appreciated until later. For example, at the time of the
enactment of ERISA in 1974, Congress was not convinced that either health
care costs or health insurance was in crisis.18 By the late 1970s, however,
health care costs were rising fast enough to earn front-page treatment and
warnings of catastrophe.19

Like health care, insurance (and thinking about insurance) was also
evolving. “Major-medical” policies (policies that covered treatment for most
conditions) did not start to become widely offered until the 1950s;
previously, health insurance covered only a narrow set of conditions, often
those attributable to an injury suffered while working.20 And, while insurers
had been aware of the possibility of adverse selection for decades, only in
the 1970s did formal theoretical treatments of the subject appear.21 These

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18 Congress believed that “there was no crisis in health plans in 1974.”
Century, in EMPLOYEE BENEFITS LAW lxiii, lxviii (Steven J. Sacher et al.
eds., 2d ed. 2000). Yet health costs were already growing at accelerating
rates. See, e.g., Walter W. Kolodrubetz, Two Decades of Employee-Benefit
by 1970 “[t]he inflation of medical costs ... left its imprint on the rapidly
increasing [EB] expenditures for health care benefits”).

19 See, e.g., HENRY J. KAISER FAMILY FOUND., HEALTH CARE COSTS: A
PRIMER 4-5 (2012), http://kaiserfamilyfoundation.files.wordpress.c/2013/01/7670-
03.pdf (showing the rise in health care costs between 1960 and 2010); E. Kash Rose,
Bringing Costs Under Control, 126 WESTERN J. MED. 513 (1977) (“Between 1950
and 1976, the cost of a day in the hospital climbed five times as fast as the general
inflation rate, reaching an average of $175 last year, up from $16 a day in 1950.”).

20 See Scofea, supra note 16 at 3-4; see also Louis S. Reed, Private Health
Insurance in the United States: An Overview, SOC. SEC. BULL., Dec. 1965, at 3-

21 See generally George A. Akerlof, The Market for “Lemons”: Quality
not treated formally, adverse selection had been in the insurance vernacular
since at least the mid-19th century. See, e.g., G.E. Currie, THE UNITED
STATES INSURANCE GAZETTE AND MAGAZINE OF USEFUL KNOWLEDGE
132 (1869) (discussing adverse selection in life insurance policies). The first
model of adverse selection in insurance markets was offered in 1976.
Michael Rothschild & Joseph Stiglitz, Equilibrium in Competitive Insurance
theoretical tools provided observers with the tools to identify and catalogue the flaws of providing health insurance through private markets—whether individual or through the workplace.

While the story is more complex than described above, for a number of reasons—such as rising health care costs and the development of a more sophisticated understanding of health insurance markets—it was surprisingly late that the comparative worth of EB health insurance was evaluated and scrutinized by disciplined observers. Those evaluations, nonetheless, were largely disapproving. That negative critical consensus motivated many commentators to explain the United States’ then (and now) large scale reliance on EB health insurance not as something that made objective sense, but instead as an “accident of history.”

Scholarly disapproval of EB insurance, however, was not matched by a political or public desire to abandon it. Indeed, the prevailing view in the run-up to the Affordable Care Act was to the contrary: the public attachment to EB insurance was thought sufficiently strong that legislative


23 David Blumenthal, Employer-Sponsored Health Insurance in the United States—Origins and Implications, 355 NEW ENG. J. MED. 82, 82 (2006) (referring to the “many accounts” that have described the United States’ embrace of EB insurance as “an accident of history”).
moves to undermine it were seen as politically perilous. This likely (although not entirely) explains the curiously schizophrenic nature of the ACA, namely, the legislation created a regulatory super-structure that—by solving certain problems for those outside the EB health insurance system—could easily have served as a platform to transition most of the nation away from EB insurance to a different (but still private) system of insurance. But that did not occur—because Congress took steps to ensure that it would not. To that we will return.

III. THEORIZING EB INSURANCE

As mentioned above, on balance the scholarly consensus has long been that EB insurance is an undesirable way for a society to pay for health care for its members. But a conclusion that EB insurance is suboptimal is insufficient for our purposes here; when considering reform, it is preferable to be specific about what a disfavored approach does wrong, as well as—importantly—to acknowledge what it does right.

In previous work, I developed a framework that helps clarify the positives and negatives of using an employment-based mechanism to provide any socially desirable good, compared to using alternative regulatory approaches to do so. With some adjustments suitable for the special characteristics of EB health insurance, I follow that approach here.

A. EB SYSTEMS AS REGULATORY INTERVENTIONS

Markets are imperfect. Sometimes they are imperfect with respect to goods that are especially socially desirable—pensions, health care, home


25 See Blumenthal, supra note 23, at 82.

26 See generally Brendan S. Maher, Regulating Employment-Based Anything, 100 MINN. L. REV. 1257 (2016).
mortgages, education, etc.\textsuperscript{27} We might say that, for a given socially desirable good, a market may fail to (1) offer enough of the good at an accessible price; (2) provide a version of the good that is of sufficient quality; or (3) make that good available in sufficient amount or quality to certain segments of the population.

In response, the government has several options. One option is to do nothing. Another is for the government to provide the good in question itself. A third option is to regulate private markets (or private players in those markets) in the hopes of improving the quantity, quality, or distribution of the good. EB approaches are simply particular species of that third category; instead of regulating “open market” transactions regarding those goods, the government regulates (through both carrots and sticks) the provision of those goods as a component of the labor deal. Examples of EB regulations include tax incentives, deal prohibitions, funding requirements, liability standards, and damage limitations.\textsuperscript{28}

Whether the government is \textit{right} to choose to use an EB system—as opposed to some other regulatory intervention—is a complex subject incapable of resolution here. However, methodically thinking about why a government might reasonably \textit{believe} an EB approach is desirable can serve as a useful conceptual accounting of what an EB approach might do well and what it might do poorly. That accounting can, in a reasonably tidy fashion, be compared to a similarly organized review of an alternative regulatory approach.

Below I consider why, compared to not intervening in the market for health insurance at all, an EB approach might seem attractive. I then consider the shortcomings of an EB insurance approach.

\textbf{B. THE PRELIMINARY CASE FOR EB HEALTH INSURANCE}

Compared to an unregulated market, the general case for using an employment-based mechanism to improve the quantity, quality or distribution of any socially desirable good can be summarized as follows. EB mechanisms improve market problems by leveraging the advantages of group purchasing; by relying on employers as sophisticated agents; by using the labor deal as a behavioral fulcrum to focus attention and reduce the

\textsuperscript{27} Socially desirable goods are “those goods for which there is broad agreement that society is better off if most individuals have or are able to obtain them.” \textit{Id.} at 1276.

\textsuperscript{28} All of these are used under ERISA. \textit{See generally} PETER J. WEIDENBECK, ERISA: PRINCIPLES OF EMPLOYEE BENEFIT LAW (2010).
likelihood of poor decision-making; and by utilizing employers and the labor deal as a convenient regulatory nexus. All of these arguments apply with some force in the health insurance context.

**Group purchasing.** The central (although not only) advantage of EB health insurance is that it levers the power of groups to purchase insurance. With respect to any good, bulk purchasing reduces unit cost, but with respect to insurance, group purchasing is particularly valuable.

Using the employee group as the purchasing unit for policies is attractive on multiple grounds. First, it is easier to underwrite and insure a group than an individual; the larger the group, the more the risks of the group approach the risk of the community, for which reliable rating information is available (and for which adverse selection is not an issue). Not only does this make groups less risky to insure, it gives particularly large groups meaningful market power to negotiate. Put slightly differently, underwriting is more difficult (and thus more costly) to do properly the smaller the group. The larger the group, the more the group is a prize customer for the insurer, and thus the better suited the group is to negotiate attractive deal terms—e.g., broad doctor networks—that please group members. Thus, group power, combined with sophisticated employees that a large company may employ to oversee its insurance purchases, can often result in desirable policies whose generous coverage legitimately advantages employees.

Moreover, current law requires an insurer to offer the same rate for the whole group, i.e., to not price discriminate among different risks within the group. As a result, being a part of the group makes health insurance accessible to individuals who otherwise—in an unregulated, open market—

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29 See Maher, supra note 26, at 1275-90.

30 This assumes that the group is assembled for some reason other than to buy insurance; that is obviously the case with employee groups, who are assembled by dint of their decision to work for a given employer. See, e.g., Allison Hoffman, *Oil and Water: Mixing Individual Mandates, Fragmented Markets, and Health Reform*, 36 Am. J.L. & MED. 7, 28 (2010) (noting that there is “little concern of adverse selection with respect to large, employer-sponsored group insurance”); see also Hyman & Hall, supra note 6.


32 See Hoffman, supra note 30; See generally Hyman & Hall, supra note 6.
would have had to pay a very high price for insurance (or, who, with certain conditions, would have been unable to buy insurance at all).  

**Sophisticated agents.** Insurance, particularly, health insurance, is not a simple good to evaluate or purchase. An average worker may find researching, comparing, and consummating such a purchase to be difficult or time-consuming, and might make suboptimal choices. In contrast, company management is comparatively more sophisticated and has more resources to devote to understanding the purchase. To the extent EB insurance results in leveraging management’s sophistication to legitimately aid the employee in insurance procurement, that is a potential advantage over leaving employees to attempt to secure health insurance on the open market.

**Behavioral economic advantages.** Human beings are imperfect decision makers who fall victim to systematic errors. The purchase of complicated goods—such as health insurance, which involves pricing contingent events—is a context particularly likely to result in suboptimal outcomes like procrastination, refusal to purchase, or purchase by inefficient heuristic. Tying health insurance to the labor deal increases the likelihood that cost might be worthwhile if that person believes, at some point in the future, he will benefit from being in the group.

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33 *Cf.* Richard A. Posner, *Taxation by Regulation*, 2 BELL J. ECON. & MGMT. SCI. 22, 27-28 (1971) (explaining how regulation is needed to preserve internal subsidization). This cross-subsidy, of course, is a negative feature for those who would have paid less on the open market. But that cost might be worthwhile if that person believes, at some point in the future, he will benefit from being in the group.

34 *See generally* George Loewenstein et al., *Consumers’ Misunderstanding of Health Insurance*, 32 J. OF HEALTH ECON. 851 (2013) (consumers do not understand traditional health insurance plans).


36 *See* Hyman & Hall *supra* note 6, at 30 (arguing that with respect to health insurance decisions, employers have superior personnel resources).

37 *Id.* *See also* Maher, *supra* note 26, at 1278-80.


39 *See, e.g.*, George A. Akerlof, *Procrastination and Obedience*, 81 AM.
that it will be purchased, promotes the likelihood that individuals will pay attention to the insurance decision, and increases the chance the investment of attention by the employee will be worth it.\textsuperscript{40}

In addition, if we assume that (at least with respect to the insurance purchasing decision) employers are less subject to cognitive biases\textsuperscript{41} than individual workers, if the employer presents a default choice, that outcome is likely to be better than an individual would obtain on his own.\textsuperscript{42}

\textsuperscript{40}To elaborate, one is more likely to purchase an item if that item comes with something else than if one had to buy that item on its own. Second, people think more about decisions put in front of them; connecting insurance to the job essentially forces people to think about insurance when they take the job (and perhaps each time they see the paycheck deduction). Third, EB insurance is a constrained choice: if one wants insurance, one chooses among the options (if any) the employer has provided. That is much more likely to result in a decision—and to reward the investment of attention—than is an effort to buy health insurance in the open market, which can paralyze consumers with too many choices.

\textsuperscript{41}See Donald C. Langevoort, Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review, 51 VAND. L. REV. 1499, 1515 (1998) (“Because corporations and other business associations are so subject to market constraints, there have been longstanding doubts as to whether psychological biases, even if robust at the individual level, are likely to have much impact on organized economic behavior.”); See also Chip Heath et al., Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings, 20 RES. ORGANIZATIONAL BEHAV. 1 (1998).

\textsuperscript{42}See Cass R. Sunstein & Richard H. Thaler, Libertarian Paternalism Is Not an Oxymoron, 70 U. CHI. L. REV. 1159, 1196 (2003) (“[T]he more complex the decision, the less attractive it will be to force people to choose for themselves, as opposed to having the option of . . . receiving a default option that has been selected with some care.”).
EB settings can also influence decisions by constraining compensation; an employer may offer health insurance but refuse to increase wages by an equivalent amount if the employee declines the insurance. One way to view constrained compensation is as a commitment device that promotes good decisions. If one realizes that spending money on health insurance is the right decision, but worries that the freedom to spend wages as one likes will result in consumer electronics instead of health insurance, labor deals that come with constrained compensation are welfare-enhancing.

Regulatory amenability. All regulatory interventions must regulate some act, and impose upon some party a burden to comply. Providing health insurance through an EB system makes the labor deal the act that is regulated and the employer the primary compliance agent. Because labor deals are necessary elements of a market economy, they are unlikely to be abandoned if regulated, thereby reducing the chance that a significant segment of the population will dodge EB regulation by not working. In addition, employers have experience as compliance actors; drafting them could be more attractive than creating a new compliance structure from scratch (such as creating a federal agency to administer a national health service.) In other words, delivering and regulating health insurance through the work place utilizes a pre-existing structure (and familiar actors) as the attachment points for the government’s regulatory will.

43 See generally Ted O’Donoghue & Matthew Rabin, Doing It Now or Later, 89 AM. ECON. REV. 103 (1999) (discussing commitment devices). For the record, Maher prefers craft beer to consumer electronics, and does not believe it is a close call.

44 Maher, supra note 26, at 1288 (“Other bargains (or mere acts), in contrast, if burdened with interventionist regulation, might be more readily abandoned.”). There could, of course, be some employment effects.

C. THE PRELIMINARY CASE AGAINST EB INSURANCE

Having laid out the potential advantages of EB insurance, in this Part III.C. I consider the downsides.

Self-evident limitations. The first limitation is the most obvious: EB health insurance only reaches the employed and their dependents. Those outside the employed population must be reached in some other way. The second limitation relates to the labor deal itself: if wages are to be reduced to pay for the benefit of health insurance, that tradeoff has limits, based the cost of health insurance, the size of the wage, minimum wage laws barring wages from dropping below a certain level, and the preference of workers.\textsuperscript{46} Thus EB health insurance is not only not going to reach non-employees, it is also highly unlikely to reach all the employed. (Mandates\textsuperscript{47} are not cure-alls, as they generally do not reach part-time or “gig” workers.) Third, while the use of group purchasing benefits those who would otherwise be unable to purchase insurance on the individual market, it forces those who would have been able to do so to pay a higher price as a part of the group.

Myopic actors. Management may be more sophisticated than labor. But at least two concerns undermine one’s confidence that that comparative sophistication will be deployed to make employees better off. First, employers are not particularly sophisticated regarding health insurance, and often rely on third party providers—who are experts with respect to health insurance—to strike deals.\textsuperscript{48} Absent significant regulation, an employer could be exploited by a third-party provider, with the result being suboptimal insurance for workers. Put differently, even if employers hope to be good agents regarding procuring insurance for their employees, they may be victimized at the bargaining table by expert insurers.

Second, the reality is that insurance is compensation, and on the matter of compensation, employers and employees have an adversarial

\textsuperscript{46} See Maher, \textit{supra} note 26, at 1292-93.


Employers might be inclined to use their extra sophistication to offer health insurance with terms that an employee is unlikely to realize is undesirable. And even to the extent employees do realize that, in non-union settings, their power to alter the deal is likely modest.

Acknowledging employer power is not to impugn the character of employers. But the reality is that employers have objectives, and if the point of using an EB system is to deliver health insurance that approaches a version of health insurance that society believes is optimal, it is unlikely employers will, absent regulation, be inclined to offer health insurance that has those characteristics. And it is unlikely non-unionized employees will have the expertise or power to push back.

Consider the Hobby Lobby case. For present purposes, the issue can be stated fairly simply. Society—its preferences embodied in the Affordable Care Act’s requirements—determined that health insurance should cover contraception. The owners of Hobby Lobby, for religious reasons, did not wish to offer to their employees insurance that did so. While the resulting dispute over that particular insurance term attracted a lot of attention, there are many potential terms in insurance policies that employers—even those who generally prefer offering insurance as a benefit to their employees—might refuse to accept on economic or social grounds. Thus, absent regulation that limits what employers can offer employees as health insurance, the likelihood that employers will use their additional sophistication and superior bargaining power to offer health insurance worse than what society believes is optimal is significant.

In addition, the current regulatory set-up assigns liability to the employer for health insurance disputes. More generous policies correspondingly increase an employer’s liability risk. See Brendan S. Maher & Peter K. Stris, ERISA & Uncertainty, 88 WASH. U. L. REV. 433, 460-74 (2010).


42 U.S.C § 300gg-13(a)(4) (2012).

Hobby Lobby, 134 S. Ct. at 2759.

Examples might include coverage relating to assisted suicide, stem cell treatments, pre-natal genetic testing, or surrogate motherhood.
Regulatory fragility. While the labor deal might be a resilient regulatory target and employers experienced compliance agents, regulating employers comes with a cost. Employers are not in the business of providing health insurance; they are in the business of paying wages to workers to produce widgets or services for sale. To the extent the regulatory burden connected with providing health insurance becomes high, employers may choose to not offer it—or, in the case of a mandate, structure their affairs such that the mandate’s impact is minimized.

The practical consequence is regulations that make offering health insurance more onerous—which includes virtually any rule that favors employees and beneficiaries—can be met with a credible threat to stop offering health insurance. And because health insurance is very hard to come by in the open market—i.e., outside of an EB system, or absent some other government intervention—this threat is particularly powerful in the health insurance context. Employers thus hold tremendous leverage with regulators (and implicitly with the judges charged with interpreting the rules), and the result is that EB health insurance systems come with an inherent bias against regulators (and employees) in favor of employers.

Opacity. EB health insurance obscures the reality of health insurance in multiple ways. First, because health insurance is an employment benefit, the cost of the health insurance is generally obscured to the worker—at least as compared to how clear the cost would be if the worker acquired health insurance on the open market. Unlike in the past, now the “employer contribution must be shown on an employee’s W-2.” John Aloysius Cogan Jr., Health Insurance Rate Review, 88 TEMP. L. REV. 411, 424 (2016) (citing 26 U.S.C. § 6051(a) (2012)). As Professor Cogan points out, however, “it is not entirely clear that all employees fully understand or even notice this information.”

55 And those threats will have even more force in difficult economic times—precisely when health insurance is most needed—because that is when employers will be looking to trim costs, including by shedding the explicit and implicit costs of regulatory compliance.

56 Several scholars have suggested this is the reason the courts have trimmed ERISA’s remedies at every turn. See, e.g., Brendan S. Maher, The Affordable Care Act, Remedy, and Litigation Reform, 63 AM. U. L. REV. 649, 665-67 (2014); Paul M. Secunda, Sorry, No Remedy: Intersectionality and the Grand Irony of ERISA, 61 HASTINGS L.J. 131, 133-36 (2009).

57 Unlike in the past, now the “employer contribution must be shown on an employee’s W-2.” John Aloysius Cogan Jr., Health Insurance Rate Review, 88 TEMP. L. REV. 411, 424 (2016) (citing 26 U.S.C. § 6051(a) (2012)). As Professor Cogan points out, however, “it is not entirely clear that all employees fully understand or even notice this information.”
Second, this confusion goes beyond the micro-level. It is clear that many voters do not appreciate that health insurance is paid, not by the employer, but by the foregone wages of the employees. This means EB insurance has support based on a false premise. Believing EB insurance is paid for by the employer is equivalent to viewing the current system as providing workers with a gift. When one laboring under this misapprehension learns alternative health insurance approaches will no longer rely on employers, one will conclude that one is “losing” an employer gift, and resist any such change, leaving public support of EB insurance higher than it should be.

Third, EB insurance systems are likely to perpetuate mistaken beliefs about who deserves health insurance (and thus health care). Providing health insurance through the workplace was not done because only those employed deserved health insurance and health care; it was done because it was held to be an effective way to provide a significant population—the employed and their dependents—health care. But the dominance of an EB health insurance approach has led people to confuse cause and effect by concluding that health insurance and care are somehow morally linked to having a job, even though, upon inspection, that is not the case. No credible moral theory conditions the availability of health insurance and care upon having a job with health insurance benefits; that would exclude, just to name a few examples that come to mind, the young, the old, freelancers, entrepreneurs, the disabled, homemakers, and the unemployed.

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58 See Maher, supra note 26, at 1307 (arguing that the public largely misunderstands who pays for benefits). Cf. Uwe Reinhardt, The Illogic of Employer-Sponsored Health Insurance, N.Y. TIMES (July 1, 2014), http://www.nytimes.com/2014/07/03/upshot/the-logic-of-employer-sponsored-health-insurance.html (Professor Reinhardt argued that the Supreme Court itself failed to understand that employees, not employers, pay for benefits.).

59 Cf. Lauren R. Roth, Overvaluing Employer-Sponsored Health Insurance, 63 U. KAN. L. REV. 633, 647 (2015) (arguing that as a result of misunderstandings about EB insurance, “[t]he doubts that attachment to [EB insurance] is a significant impediment to a dramatic overhaul of our healthcare system”). Roth also argues that cognitive biases account for the nation’s attachment to EB insurance. Id. at 647-48 (arguing that prospect theory and the endowment effect illustrate why people are more attached to EB insurance than is objectively rational).

IV. THE AFFORDABLE CARE ACT

Although the ACA changed much about health care in the United States, for our purposes, the relevant question is what action it took (and did not take) with respect to the regulation of private insurance. As explained below, the Affordable Care Act took various steps with respect to both employment-based health insurance and individual health insurance. The technical particulars are quite complex, and federal agencies enjoy considerable power to promulgate implementing regulations.

For this Article, however, a detailed dive is not necessary. The relevant takeaways can be set forth with only modest reference to the underlying statutory and regulatory specifics. The first takeaway is that the Act implemented a series of reforms to fix the problems that have long bedeviled and rendered inaccessible individual insurance markets. The second is that Congress took steps to ensure that fixing the individual markets would not undermine the existing EB system.

A. FIXING INDIVIDUAL MARKETS

A central reason for the ACA’s enactment was to achieve near-universal coverage for Americans. Health care is so costly that it is not meaningfully available without some source of financing. Thus, prior to the Affordable Care Act, health care was reliably available only to those that had access to private or public insurance, namely the elderly (through Medicare), the poor (through Medicaid), or the employed (through EB coverage). Those outside those categories could only obtain insurance through the individual market, which was not accessible to most people. As noted in Part II.A. above, individual markets are plagued with administrative and adverse selection problems. The insurance industry response was to refuse to offer insurance at all to those with preexisting conditions, and otherwise only offer affordable policies to a small set of people.

61 Thus, the Act’s expansion of Medicaid, for example, is not of immediate concern here.

62 See Gruber, supra note 11 at 574-77; Diamond, supra note 11 at 1236-37 (discussing undesirable pre-ACA state of individual markets). See also
The Act addressed the problems of the individual market through several interrelated mechanisms. First, the ACA barred insurance companies from underwriting; any person seeking a policy would be charged the community rate, with premiums adjusted only for geographic area, family size, age, and tobacco use.63

Second, all individuals were obligated to obtain insurance coverage or pay a penalty.64 This “individual mandate” was and is designed to combat adverse selection that could destroy insurers writing community rated policies. If insurers are required to issue policies to all applicants at community rates, many healthy consumers might choose to not buy a policy until they were sick or likely to become sick. In that case, the insurer would be writing policies at community rates but only collecting premiums from the sicker part of the community, which is not sustainable. An individual mandate, by requiring all people (including healthy ones) to buy policies, allows the insurer to offer community rated policies without facing financial ruin.

Third, all policies offered must cover roughly the same “essential health benefits” that corresponded to ten categories of coverage.65 Those categories reflected Congress’s judgment about what a socially valuable health insurance policy must cover. Absent such a requirement, the Act risked creating no more than a market for empty policies that were useful health insurance in name only. The law allowed, however, for policies to vary in the level of coverage a policy provided. Policies were assigned colors (bronze, silver, gold, and platinum) based on the actuarial percentage of costs

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Amy Monahan & Daniel Schwarcz, *Will Employers Undermine Health Care Reform by Dumping Sick Employees?*, 97 VA. L. REV. 125, 134 (2011) (observing that “because the risks of some individuals can be difficult to predict or are predictably exorbitant” insurers may “refus[e] to insure certain individuals or insur[e] them only with respect to specific types of costs or conditions.”).

63 42 U.S.C. § 300gg(a)(1)(A) (2012) (listing the permitted rating factors); id. at §300gg-4 (prohibiting discrimination based on pre-existing conditions). Community rates are set by state regulation, and are intended to reflect a fair price to insure an average member of the community.


65 42 U.S.C. § 300gg-6(a) (2012) (providing that individual and small group plans must provide “essential health benefits”). The ACA also requires other consumer protections, such as no lifetime limits.
they would cover for an average patient.\textsuperscript{66} This kind of standardization often does not occur in markets operating on their own; thus, this reform can be thought of not only as one regulating quality but also as one that makes consumer choice easier.

Fourth, Congress did not create an unfunded individual mandate. Given the high cost of health care, for many even a community-rated policy is unaffordable. As a result, sliding subsidies were offered to enable low income persons, i.e., those whose income is 400\% or less of the poverty line, to purchase insurance.\textsuperscript{67}

Fifth, the ACA created insurance “exchanges” where customers could choose between policies, and where the relevant information regarding policy specifics was to be provided in an accessible, consistent way.\textsuperscript{68} The exchanges were to be run either by the State or the federal government, if the State declined to do so.

The foregoing changes were intended to fix the individual insurance markets by making them stable, accessible, affordable, and comprehensible.

\textbf{B. LOCKING INDIVIDUAL EXCHANGES}

Market economies are dynamic and change in response to legislation. As a result, some feared the ACA’s reforms would result in some employers no longer offering health insurance as a benefit to their workers. Offering health insurance imposes significant administrative, regulatory, and liability costs upon employers.\textsuperscript{69} Prior to the ACA’s reforms

\textsuperscript{66} 42 U.S.C. § 18022(d) (2012). The ACA also included reinsurance mechanisms to protect insurers who entered the markets as they equilibrated. See generally Mark A. Hall, \textit{The Three Types of Reinsurance Created by Federal Health Reform}, 29 HEALTH AFF. 1168 (2010) (explaining the ACA’s reinsurance provisions).

\textsuperscript{67} Amy B. Monahan & Daniel Schwarcz, \textit{Saving Small-Employer Health Insurance}, 98 IOWA L. REV. 1935, 1947-48 (2013) (explaining ACA purchase subsidies). The subsidies are only available to if one is unemployed or if one’s employer does not provide “minimum essential coverage.” I.R.C. § 36B(2)(C) (2012). That requirement pertains to affordability and value, not the benefit package.


\textsuperscript{69} See generally Maher & Stris \textit{supra} note 49 (describing costs and uncertainties associated with offering benefits).
of the individual markets, however, the inability of many employees (including management personnel) to obtain insurance outside the workplace was a strong incentive for employers to offer insurance as way to attract workers. Yet if workers could obtain insurance easily on the ACA individual exchanges, employers might feel less pressure to offer health insurance. Whether an employer deciding to drop EB insurance is actually undesirable is a separate matter (see below), but the structure of the Act (as well as one unmade change) functioned to forestall any migration to individual markets.

The employer mandate. The Act requires large employers to offer health insurance to its workers or pay a penalty. Importantly, the point of this mandate is very different than the individual mandate. The individual mandate was designed to ensure that the individual insurance market did not suffer collapse or severe impairment. See IV.A. above.

The employer mandate (as written) serves an entirely different end. Large employers—who use a group of employees as the insurance purchasing unit—do not face problems procuring insurance, because insurers do not face significant problems underwriting and pricing such policies. Thus, unlike the individual mandate, an employer mandate is not needed to improve the pool and stabilize the market. Instead, the employer mandate was apparently intended to perpetuate the pre-ACA system of EB health insurance. Given the ACA’s anticipated creation of a functioning individual market, legislators wanted to discourage employers from abandoning EB insurance, and the employer mandate was one way of doing so.

EB tax-bias preserved. EB health insurance is tax-advantaged; while employers may deduct the cost of the insurance from their income, employees do not pay tax on the value of the insurance. In contrast,


71 Large group rating either resembles community rating or is otherwise achievable through standard underwriting methods.

72 In addition, the Act contained an unusual feature: its much-touted requirement that insurance policies cover “essential health benefits” did not apply to large group plans. 42 U.S.C. § 300gg-6(a) (2012) (“essential health benefits” obligation does not reach large employers). Sparing large employers the obligation to offer policies with essential health benefits effectively permits them to whittle down the cost of the mandate by offering narrower policies than what exchange insurers must offer.

purchasing health insurance on the individual market is generally done with after-tax dollars—even if an employer wished to give an employee money for that express purpose. All things equal, an employee who pays any income tax would prefer to receive insurance through her employer.

Although it changed many things, the ACA did not abolish the tax-bias in favor of EB insurance. While it does award a sliding subsidy to

74 Utz, supra note 73, at 1233-34. The federal government has routinely rejected efforts to use any version of defined contribution health accounts to funnel an employee pre-tax money to spend on premiums outside of group coverage. See, e.g., Application of Mkt. Reform & Other Provisions of the Affordable Care Act to HRAs, Health FSAs, & Certain Other Employer Healthcare Arrangements, 2013-40 I.R.B. 288 (2013) (“In the HRA FAQs, the Departments state that an HRA is not integrated with primary health coverage offered by an employer unless, under the terms of the HRA, the HRA is available only to employees who are covered by primary group health plan coverage that is provided by the employer and that meets the annual dollar limit prohibition.”). See also generally Amy Monahan, The Use of Section 125 Plans for Individual Insurance Following the Enactment of Federal Health Reform, SHARE FOUNDATION (Oct. 2014), https://www.phs.wakehealth.edu/public/pub_insurance/125/125_plans_and_PPACA_formatv3%20revised.pdf (describing limits of using cafeteria plans to purchase individual exchange polices with pre-tax dollars). That said, in late 2016 Congress provided small employers with a limited ability to enable workers to purchase individual policies with pre-tax dollars. See Stephen Miller, New Law Lets Small Employers Use Stand-Alone Health Reimbursement Arrangements, https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/21st-century-cures-act-stand-alone-hras.aspx (last updated Feb. 2, 2017) (describing new QSEHRA option).

75 Observers have long complained that the tax code does not treat insurance purchases equally. Some have argued all health insurance purchases should be with after tax dollars, while others have argued that all health insurance purchase should be with pre-tax dollars. See Bradley W. Joondeph, Tax Policy and Health Care Reform: Rethinking the Tax Treatment of Employer-Sponsored Health Insurance, 1995 B.Y.U. L. REV. 1229, 1255 (1995) (arguing that the health insurance market will only be efficient if all purchases are made with after tax dollars); REPORT OF THE PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND
exchange purchasers at or near the federal poverty level, for most employees, losing EB health insurance would result in losing a significant tax break. That, in turn, meant labor pressure on employers to preserve EB insurance would remain significant. In contrast, had Congress, in enacting health reform, simply treated all health insurance purchases equally—whether eliminating the tax break or applying it to all insurance purchases—the market pressure on employers to offer EB health insurance would have decreased considerably, and increased the influx of people onto the individual exchanges.

The result of the foregoing is that the ACA was both a revolutionary and conservative statute at once. It was revolutionary in its efforts to fix individual insurance markets around the country. It was conservative in its efforts to preserve the basic system of EB insurance that preceded the ACA, and took steps to ensure that neither employers nor employees could easily migrate from EB health insurance to the exchanges. I next consider if and whether the ACA’s pro-EB measures should be modified.

V. UNLOCKING EXCHANGE INSURANCE

In this Part V I make two claims. First, I argue that, on balance, individual exchanges like those created by the ACA are superior to EB health insurance. That said, EB health insurance has some features with positive social value. Second, I argue that, a sensible choice for Congress is to “unlock” the ACA’s individual exchanges, i.e., to eliminate or modify the employer mandate and the EB tax-bias so as to promote the migration of employed persons to the individual exchanges.

A. THE PRELIMINARY CASE FOR UNLOCKING

The case for EB health insurance is a comparative one. One must ask not only how EB health insurance does against leaving people to fend for themselves in individual markets (against which it obviously compares well), but also against some other type of government intervention in the health insurance market—whether a single-payer system or insurance through regulated exchanges. Of course, the ACA chose to implement an exchange-based intervention while attempting to prevent migration into it

from an EB system. The most obvious comparison to make is between the current segregated EB system and one in which migration from EB to the exchanges is not constrained.

**Group advantage.** Compared to an unregulated market, the chief advantage of an EB system is that it gives employed individuals access to insurance (and thus health care) unobtainable on the individual market. The creation of community-rated, subsidized exchanges solves that problem.\(^{76}\)

**Sophisticated actors.** A second advantage of EB health insurance was that employees could benefit from having management act as a bargaining agent; management is more sophisticated than individual employees, and management purchases insurance for a large group, which means insurance companies could be more willing to offer terms that are, objectively speaking, better than what an individual could secure through the exchange. This advantage is one that critics of EB health insurance would be wise to not dismiss. Large employers—both as a result of controlling a large group of insureds and heightened sophistication—may very well strike insurance deals that employees would be hard pressed to obtain on their own. Reasonable evidence suggests that average EB health policies are more generous (in terms of percentage of actuarial value) than most exchange policies.\(^{77}\) And there is also evidence that EB policies offer more desirable doctor networks.\(^{78}\) That said, there are several countervailing considerations.

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\(^{76}\) And, of course, from society’s perspective, it solves the problem of coverage for those *not* employed. But that happens even when there is a wall between the EB and individual exchange world.


First, the most likely explanation for why EB insurance is more generous than exchange insurance is because EB dollars go farther. If one wants to get the best possible insurance for some set cost, then one will be able to get better insurance spending pre-tax rather than post-tax dollars.

Second, two salient characteristics about EB policies are worth considering, given the potential disadvantage they could work to employee interests. As discussed in Part III.C above, employers have some measure of religious freedom to refuse to provide policies with certain terms. Contraception was the first flash point, but there could easily be others relating to any number of controversial conditions or treatments.79

In addition, virtually all EB policies are governed by ERISA, whereas state law governs individual policies.80 Although ERISA was intended to protect beneficiaries, it has long been interpreted by the federal judiciary to do anything but.81 ERISA permits benefit determinations to be heard by conflicted decision-makers; requires exhaustion of internal appeals before suit; allows plans to shorten statutes of limitation; requires judicial deference to plan administrators—even when those administrators are conflicted or have already erred; and does not permit the recovery of consequential or punitive damages on benefit claims.82 Although that is a feature of federal law, not employer negotiating behavior, it closely resembles the very things an employer and insurance company (both of whom are defendants in benefit claims) would include as terms in a policy. State law is, generally speaking, far more favorable to claimants.

Third, perhaps the lesser quality of the policies on the exchanges may be the consequence of something other than the absence of employer involvement. Specifically, exchange policies may be less generous because the pool of individuals participating in the exchanges is smaller and sicker than originally predicted. That would lead to fewer insurers participating, and for participating insurers being stingier in the terms they were willing to offer. The worse-than-expected pool quality has at least two causes: first, the penalty for violating the individual mandate was not high enough.83

79 See supra note 54.
80 See Maher, supra note 56, at 662 (explaining that state law is generally more beneficiary friendly than ERISA).
81 Id. (describing ERISA) (“[O]ne of the most effective pieces of federal litigation reform legislation ever passed.”).
82 Id. at 661 (explaining limits on ERISA’s remedies).
Second, the employer mandate and the tax-bias artificially prevented millions of healthy people from migrating to the exchanges.

Imagine if, tomorrow, employment-based health insurance was forbidden, and all those insureds had to purchase policies on the exchanges or face a meaningful penalty. The individual market pools would collectively swell by 150 million people—leading, no doubt, to more insurers offering policies. Policies with desirable terms would attract large numbers of insureds, which means the exchange would see offerings closer to what large employers might have offered. Barring EB health insurance, of course, will never happen. But while, say, eliminating the employer mandate and the tax-bias would not necessarily result in a total migration to the exchanges, one imagines the migration would be significant enough to make the exchange offerings meaningfully better than they are today.

Behavioral economics. Another advantage of EB health insurance was that connecting health insurance to employment was desirable for behavioral reasons; it prevented employees from making cognitive errors they would make if left on their own. Yet the mandate and the exchanges address a significant number of these concerns. Some of the central behavioral difficulties afflicting insurance purchasing are that it addresses a future contingent need; it is a difficult good to value; and the many choices available to an unguided consumer might be so overwhelming as to paralyze the consumer into doing nothing or relying on an inefficient heuristic. See Part III.B above.

The mandate requires insurance be bought, and the exchange makes the purchasing process close-ended and constrained: one need check one website to see all the options, and the options are described in uniform, reasonably accessible terms. Purchasing assistance is also available. Admittedly, compared to a company purchaser, an exchange consumer still may use an inefficient heuristic, but that problem could be addressed in two ways. First, a default option could, by inertia, limit any decision-making (and thus limit bad decision-making). Second, plain English “FAQs” prepared by the exchange could steer those consumers who opt to move away from the default away from making decisional errors. Third, there is also no

fix-the-law-bigger-penalties/ (economist Jonathan Gruber arguing in favor of higher penalty as a means to draw more healthy people into the exchange pool).

84 See Maher, supra note 68, at 1108 (discussing how the exchanges were designed to promote simple and transparent choices).
85 Id. (noting availability of a toll-free hotline and knowledgeable intermediaries the Act calls “Navigators”).
reason an employer might not offer an advice benefit; i.e., instead of choosing, procuring, and providing health insurance; the employer’s experts would simply analyze the yearly exchange options and make recommendations for which plan it would have provided, were it doing the buying.

One EB advantage that is not readily apparent on the exchanges, however, is constrained compensation. Most EB health insurance includes some compensation that is only available to the worker if he elects to be on the company policy; otherwise, that money (or some of it) stays with the company. As explained above, that operates like a commitment device; a worker accepting a position with a company knows that some portion of his compensation must go toward health insurance or be forfeited. The exchanges lack such a feature. Any dollar not spent on the exchange for insurance can be used for something else.

Regulatory amenability. A regulatory advantage of the EB system is that it draped itself onto a pre-existing web of players to achieve its effects. And while the ACA illustrates the enormous effort and difficulty in creating a new structure—i.e., comprehensible, subsidized, community-rated exchanges—once that structure has been created, there is little regulatory advantage in preventing EB participants from flowing into it. The regulatory cost of additional participants is small.86 Moreover, because the exchanges cut out the employer as middleman, the relationship will not only be easier to regulate, but the regulations will be targeted at providers of health insurance, who, relative to employers, can make a less credible threat about refusing to offer health insurance in response to consumer protective legislation.87

86 It may even be negative. If healthier people flood the exchanges, the average cost of a policy should decrease, which could reduce the subsidy the government extends to low-income exchange purchasers.

Opacity. Finally, relaxing the pro-EB restrictions would do much to combat the confused view workers and stakeholders have regarding who pays for health insurance and the implicit connection some might believe exists between having a job with benefits and whether society should make insurance available.

That health insurance has a cost, and that in an EB system workers pay for it with foregone wages, is an economic reality that it is essential to convey. Stakeholder failure to internalize that reality means all reform that moves the nation away from EB health insurance will be perceived as a move away from a system that grants employees a gift. If opening up the exchanges has the effect of employers dropping insurance, wage theory predicts that the wages of workers at those companies would rise (although those workers would then have to buy insurance on the exchange). For employers that continued to offer health insurance, wages would be comparatively less, and it would be difficult for the public to avoid seeing, by experience, the connection between wages and health insurance, and that EB health insurance (whatever its other merits) is not free for employees.88

B. OBJECTIONS TO UNLOCKING

Stability concerns. One reason to keep EB insurance is because the ACA reforms of the individual market might take some time to result in stable markets. Whatever the flaws of EB health insurance, it was reasonably stable. Ensuring its preservation by restricting the ability of EB players to effect a migration into the exchange markets until after they were stabilized and/or flaws were rectified makes caution the better part of valor.

In fact, they continue to sell policies to employers. Interestingly, a federal judge recently held that Aetna’s withdrawal from the individual exchanges was motivated by a desire to obtain leverage over the government in connection with obtaining approval of a pending merger, as opposed to an inability to make money on the exchanges. Michael Hiltzik, U.S. Judge Finds that Aetna Deceived the Public About Its Reasons for Quitting Obamacare, L.A. TIMES (Jan. 23, 2017, 12:00 PM) http://www.latimes.com/business/hiltzik/la-fi-hiltzik-aetna-obamacare-20170123-story.html.

88 The point is not that this move would be free of political cost; the point is that the political cost would come with the benefit of educating stakeholders about economic reality. I realize that current times may favor neither education nor reality.
Ultimately, this objection is sensible, although it depends on empirical judgments, and comes with a time limit.

That said, the reported problems with the exchange markets largely revolve around them having too few and too sick people.\textsuperscript{89} Undertaking reforms that make it more likely that some of the comparatively healthy employed people would participate in the exchanges is likely to stabilize the exchange markets, not topple them. Indeed, even if reformers are committed to eliminating the individual mandate, finding other mechanisms to use in the exchange markets to ensure they remained stable and accessible would be easier if the exchange markets had more, and healthier, employees; it might take time to see which combination of mechanisms could work.\textsuperscript{90}

\textit{Compensation concerns.} Another reason to preserve EB health insurance might be that companies dropping EB coverage will not raise wages an equivalent amount, or will not do so with respect to more vulnerable segments of the working population. While that fear may prove unlikely in the long run, in the short term, many workers could be worse off.\textsuperscript{91}

One way to address this concern is to alter the mandate by permitting employers to satisfy it not only by offering insurance, but also by offering a stipend sufficient to buy a policy of some specified value (e.g., the median

\textsuperscript{89} See sources cited \textit{supra} note 87.

\textsuperscript{90} Some may object that I am failing to sufficiently appreciate the chaos of a large migration from EB to the individual exchanges. Perhaps; but it seems unlikely there is not some way to affect that migration—and benefit the exchanges with healthier people—in a way that would be less disruptive and worth the candle of largely removing employers from a system they have served in long enough.

\textsuperscript{91} Workers being worse off would be counterbalanced (in welfare but not distributional terms) by the employer being better off, as money saved via compensation reduction would stay with the company. With respect to the relationship between wages and benefits, and the reaction of the former to the elimination of the latter, I do not intend to imply the real-world economics of that are simple. But it would be surprising if compensation-equilibrium theory were utterly mistaken. Sherwin Rosen, \textit{The Theory of Equalizing Differences}, in 1 \textit{HANDBOOK OF LABOR ECONOMICS} 641 (Orley Ashenfelter & Richard Layard eds., 1986) (identifying tradeoff between benefits and wages).
gold policy) on the exchange.\footnote{How that minimum stipend would be calculated is no simple matter, but the details of doing so are not insurmountable.} I consider the effects of using such a compensation protection mechanism in Part VI.A. below.

**Underinsurance concerns.** The role of individual choice in health insurance is controversial. One side (“choice advocates”) offers classic arguments in favor of choice: choice is a good in and of itself; individual choice is most likely to lead to optimal outcomes because individuals best know their own preferences; and even individual choice that leads to bad outcomes is desirable because it serves as a necessary feedback mechanism for creating within citizens a sense of personal responsibility. The other side (“choice reformers”) offers behavioral arguments that unconstrained choice often does not, on balance, maximize welfare, and that therefore considerable care must go into limiting or guiding individual choice such that choice is preserved, but the likelihood of bad choices is meaningfully reduced.

Choice advocates will likely see exchanges as preferable to EB insurance. Although many employers offer some choice regarding insurance, those choices are fewer than what would be available on healthy exchanges.

Choice reformers might be more cautious, and particularly with respect to the possibility of underinsurance bias. Because employers likely have a superior understanding of risk and discounting, it seems they would be more likely to properly value (and thus buy more of) insurance than would an individual on his own, even if she faces the comprehensible and constrained choices an exchange offers. Put differently, while the exchanges significantly improve the ability of an individual to make an insurance purchasing decision, they might not sufficiently counter the inclination of the individual to purchase less insurance than is optimal.

Even granting the employer is not an ideal agent, its involvement might end up leaving most employees with more insurance than they would have if they were choosing to spend the money on their own, where, assuming average risk preferences, the optimal choice for an employee would be more, not less, insurance. In that case, even though the employer is otherwise imperfect, it will generally avoid purchasing the cheapest, least protective insurance, because it realizes that is not the best trade-off between price and risk; in contrast, an unguided exchange purchaser might overly prioritize low cost to the detriment to future risk.

Choice advocates might either deny this outcome—by insisting that the employee is a better determiner of his own preferences—or tolerate it as
a necessary consequence of the virtue of choice. But choice reformers might worry that moving away from the EB system might eliminate a meaningful paternalistic result. If individuals are inclined to severely underinsure, and EB insurance reduces or eliminates that problem, then the other negatives of EB health insurance might be worth the price, and barriers to prevent migration away from EB health insurance make objective sense. I consider potential ways to deal with this concern below.

VI. TWO REFORM POSSIBILITIES

In this Part VI, I consider two reform possibilities that center on relaxing the anti-migration features of present law. Both suggestions rest upon the idea that permitting a meaningful portion of the employed to participate in the exchanges would have salutary effects, particularly if measures were taken to preserve certain desirable features of traditional EB approaches. In both cases, while I sketch out the contours of the suggested reforms and consider their merits, I by design leave important implementation details for resolution in later work.

A. A DIFFERENT KIND OF EMPLOYER MANDATE

The reform proposed below is based on the intuition that while unlocking the individual exchanges is on balance attractive, we may wish to do so in a way that replicates some of the advantages an EB approach confers. Before discussing the proposal, I briefly note those advantages.

First, I suspect that providing employers with an incentive to offer health insurance makes it considerably more likely that employees will have health insurance than a pure exchange-based system, even one with stronger penalties than today. Management personnel benefits (and know they benefit) from having health insurance, so having in place legal rules that encourage them to do so—while requiring that their doing equally benefits their workers—is a more effective tool to increase the number of insureds than people commonly realize. An employer benefit is a powerful default—even when (and this is never the case) the benefit could be turned down in return for the total cash value of the benefit. It takes a lot of the work out of an otherwise complicated choice; it brings the issue directly to mind; and it operates as a ready default (rather than the exchanges, which depend on a penalty to stir affirmative action). In addition, it seems likely that employers are less likely to underinsure than employees, see above. There is a way, however, to (somewhat) leverage these EB advantages without requiring
employers to offer insurance. (The way I suggest below also addresses concerns that migration to the exchanges will result in workers’ compensation dropping.)

The animating idea is to convert the mandate into a funding mandate, that is, give employers the option of funding, for all fulltime employees, an exchange purchase account with an annual stipend equal to an amount set by the employer, but at no less than some minimum tied to buying a median value policy on the exchange. If no policy is purchased, the money returns to the company. If a less expensive policy is purchased, treat the difference between the policy price and stipend as taxable income to the employee. If a more expensive policy is purchased, require the additional price be paid with after-tax dollars.

The benefit of this approach is manifold. First, although it obligates employers to continue to “pay” for EB insurance, it frees them from any meaningful administrative or legal obligations—which, under both ERISA and the ACA, are significant. It would also prevent compensation declines, because, for companies that already are offering EB insurance, it amounts to little more than funding employee accounts with money that would have otherwise been paid to an insurance company.93 And not only would it make salient to employees the cost of health insurance, it would ensure that the collective foregone wages of the employees used to buy health insurance would—just as if the company obtained a group policy—redound to the benefit of all employees equally.94 Finally, if the employer mandate was ever lifted, companies that declined to offer exchange purchasing accounts (or health insurance) but did not raise wages would face immediate competitive pressure. It is easy for employees to realize their compensation has been cut when their exchange purchasing accounts go from having thousands of dollars in them to zero.

Second, it ties the insurance fortunes of labor to those of management while discouraging management to be stingy. A lower stipend denies all employees a tax-advantage when purchasing a more generous policy, and that tax-advantage is most valuable to highly compensated

93 It will, of course, lead to wage reductions for those companies that had not previously offered health insurance. But that is true of the current employer mandate.

94 One problem with relying on wages to rise if benefits are reduced is that the collective rise in wages might not be evenly distributed among employees. While that might not be a bad thing in terms of market efficiency, it might constitute an undesirable outcome for some on distributional grounds.
employees—such as management—which would incline them to set the size of the purchase account stipend with care.

Third, it is constrained compensation: the forfeiture and tax consequences of an employee purchasing a less generous policy combat an inclination to underinsure. At the same time, it would still allow for worker choice, but in a constrained, intelligible setting: through the exchanges.

Fourth, it imposes a tax on purchasers who want to buy a policy more generous than the company funds. The size of this tax would of course depend on the degree to which individuals purchased policies more generous than could be purchased with the company stipend.

This would undoubtedly swell the ranks of the exchanges and attract insurer participation that would lead to more and better policy offerings. Few employers would continue to provide, rather than fund, EB health insurance, as they would have little incentive to endure the hassle of doing so. Indeed, the likely enormous influx of the employed into the individual exchanges, combined with defaulting all non-employed into exchange policies and strictly limiting sign up periods,95 might very well make the exchange pools healthy and deep enough such that the individual mandate would be unnecessary to ensure stable markets.96 And the above could be combined with a federalism twist: states could be given the freedom to abolish the individual mandate.97

95See Allison Bell, 6 ACA Individual Mandate Replacement Ideas, LIFEHEALTHPRO (Jan. 24, 2017), http://www.lifehealthpro.com/2017/01/24/6-aca-individual-mandate-replacement-ideas?page=2&slreturn=1485733601. The idea is that defaulting those without EB insurance into exchange policies will improve the exchange pool because most individuals will be insufficiently motivated to decline a policy they are defaulted into. After all, they are not paying for nothing; they actually get insurance. The more costly the value of the policy people are defaulted into, of course, the more likely they are to modify the default. Proposals that would default people into non-exchange policies will not be useful to improving the exchange pool, obviously. See generally Joseph Antos et al., Improving Health and Health Care: An Agenda for Reform, AM. ENTER. INST., (2015), http://www.aei.org/wp-content/uploads/2015/12/Improving-Health-and-Health-Care-online.pdf.

96 I am meaningfully skeptical that this is the case; keeping the mandate would be better. But I do not share the profound distaste for the mandate those currently in power do.

97 Senators Collins and Cassidy suggested a reform proposal that gave States freedom to pursue various reform options, including keeping or rejecting the individual mandate. Press Release, Sen. Susan Collins, Cassidy
B. NO MANDATES AT ALL (MAYBE)

A second possibility would be to eliminate the employer mandate, but use the tax-differential and management’s self-interest as a way to motivate employers to fund exchange purchasing accounts for employees. Under this approach, no employer would be obligated to provide insurance or an exchange purchasing account; however, only insurance received through the workplace or acquired with an exchange purchasing account would be treated tax-preferentially, i.e., paid-for with pre-tax dollars.

While this would perpetuate the uneven treatment between EB and non-EB insurance purchases, it would drive some number of employees onto the exchanges, because many employers—not only to curry employee favor, but also to secure for management a tax break on its health insurance—would wish to fund exchange purchasing accounts in lieu of offering traditional health insurance. Although less employees would end up in the exchanges than under the proposal above, it might add to the exchanges a sufficient number of healthy workers that, combined with default enrollment of non-EB insureds and other measures, the need for an individual mandate might be avoided, or, as above, left to the decision of state officials.

This approach might raise two concerns. First, it does nothing to protect labor from losing some or all of a preexisting health insurance benefit; a company would be free to neither offer health insurance nor an exchange purchasing account, and workers losing health insurance would have to rely on market forces to replace their lost benefit with higher wages. Second, no employer mandate means no floor on the purchasing account amount an employer could establish; to the extent that some employers funded accounts insufficient to buy a level of policy society deems to reflect the proper amount of insurance, individual inclinations to underinsure would be free to operate. While an inclination to underinsure might be insufficiently strong to motivate a worker to move from a generous employer default to a bare bones policy, that inclination would certainly prevent a

converse move. On the other hand, if less generous insurance was in general purchased, that would save the public treasury money, because the tax expenditure would be smaller. In addition, if one believes, as many economists do, that the tax break leads people to buy more insurance than is necessary, the foregoing is a boon, not a flaw.

VI. CONCLUSION

The Affordable Care Act was so polarizing that sober discussions of its technical merits were rare and incomplete; too often it was simply cast as divine or diabolical and praised or cursed accordingly. Such dramatic appraisals make for good politics and entertaining television; and the election of Donald J. Trump suggests the latter and the former are one and the same. But the world is more than politics, and the fact that—depending on the whims of President Trump—the ACA may be wiped off the books does not mean scholarly attention should be permanently directed elsewhere. In fact, there is reason to believe that, behind closed doors, a variety of reforms are being seriously entertained. And even if the subjects and possibilities considered in this Article have truly been sidelined by politics, that should be no bar to serious scholarly debate about what should be. Times change, and often faster than we expect.

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99 See supra note 2.
I. INTRODUCTION

Homeowners insurance provides financial security for 70 million American households\(^1\) and stability to the communities in which they live—but only when it works. Homeowners insurance only works because it is supported and regulated by state law. This article describes the Essential Protections for Policyholders project, which aims to make state regulation, and therefore homeowners insurance itself work better.

As a project of the Rutgers Center for Risk and Responsibility at Rutgers Law School in cooperation with United Policyholders, Essential Protections for Policyholders draws on academic research, an extensive survey of state law, and practical experience.\(^2\) The Center explores the ways in which society makes choices about risk, its proper allocation, and compensation for the harm caused when risks materialize, especially the ways insurance and insurance law enable and constrain risk allocation.\(^3\) United Policyholders is a non-profit organization whose mission is to be an

\[\text{\textcopyright{} Distinguished Professor of Law, Rutgers Law School; Co-Director, Rutgers Center for Risk and Responsibility. This article was first presented at a University of Connecticut Insurance Law Center conference on "Insurance in the Age of Trump." My thanks to the sponsors and participants. Also thanks to Nancy Talley, Evan Kerstetter, Jessica O'Connor, Brian Portny, Adam Scales, and Rick Swedloff for their help. Above all, thanks to Amy Bach and Dan Wade at United Policyholders, my partners every step of the way.}

\(^1\) Claire Wilkinson, *How Many Homes are Insured? How Many are Uninsured?*, TERMS + CONDITIONS: INS. INDUSTRY BLOG (http://www.iii.org/insuranceindustryblog/?p=4339).

\(^2\) Rutgers Law School, ESSENTIAL PROTECTIONS FOR POLICYHOLDERS, https://epp.law.rutgers.edu/ (all project documents are available through this webpage).

\(^3\) Rutgers Law School, CENTER FOR RISK AND RESPONSIBILITY, http://crr.rutgers.edu/.
information resource and an effective voice for consumers of all types of insurance throughout the nation.4

State regulation of homeowners insurance includes the licensing of insurance companies and intermediaries, regulation of the solvency of insurers, ensuring that premiums are “adequate, not excessive and nondiscriminatory,” approval of policy forms, and the catch-all category of market conduct regulation which includes the marketing and underwriting of policies and claim practices.5 The Essential Protections for Policyholders project addresses this last area, focusing on key elements of the relationship between insurance companies and their policyholders.

A starting point is the market for homeowners insurance. For the market to achieve optimal results, when consumers shop for and purchase insurance they must have access to good information about the extent of coverage provided by different policies, the price of that coverage, and the quality of insurance companies offering the coverage.6 Good information produces good buying decisions, and better-informed consumers spur more competition among insurers, leading to better products. Better information also affects policyholders’ decisions about risk after they have purchased policies and empowers them in the event of a claim. The first category of Essential Protections—Essential Protections When Buying Insurance—addresses information problems in the market for insurance.

But the market for homeowners insurance, like other consumer markets, cannot be perfected by providing more information to consumers. Consumers possess limited ability and inclination to process the information because of its complexity and because of their own cognitive limitations and biases.7

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4 Its work includes Roadmap to Recovery, which provides policyholders tools and resources for solving insurance problems after an accident, loss, illness or other adverse event; Roadmap to Preparedness, which promotes disaster preparedness and insurance literacy; and Advocacy and Action, which advances pro-consumer laws and public policy related to insurance matters. See Our Programs, UNITED POLICYHOLDERS, http://uphelp.org/.


These information defects are market failures that preclude the efficient operation of the market, and they are failures in a different sense as well. Policyholders typically perceive the insurance contract as a relation of security, not a discrete transaction; the content of that relation is not fully presented in the explicit terms of the written policy form but also is constructed from general social perceptions about insurance and even insurance company advertising. The gap between the policy terms and the policyholders’ expectations presents a different kind of failure of the insurance market.

Essential Protections aims to correct both kinds of market failure by structuring coverage and processes in ways that more closely align with a well-functioning market and with the legitimate expectations of ordinary policyholders. Essential Protections for Coverage proposes key mandatory and optional terms and underwriting practices to cure information problems and to fulfill policyholders’ reasonable expectations. Essential Protections for Disaster Victims deals with the special versions of those problems that arise when, in catastrophes, many policyholders suffer losses during the same event.

When losses occur, disputes may arise between insurer and policyholder arising from the terms of coverage, the facts of loss, or the gap between policy terms and broader expectations. For insurance to work effectively, there must be mechanisms in place to resolve the disputes and of course there are. Internal company processes, appeals to state regulators, alternative dispute resolution, and ultimately litigation aim to validate the underlying relation by resolving disputes, but they do not always do so effectively. Essential Protections in the Claim Process defines insurers’ basic relationship to policyholders and provides remedies when disputes

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9 The term “reasonable expectations” has a variety of meanings as both principle and doctrine in insurance law. Christopher C. French, Understanding Insurance Policies as Noncontracts: An Alternative Approach to Drafting and Construing These Unique Financial Instruments, 89 TEMPLE L. REV. 535, 560-64 (2017). The usage here is the less technical and more generic usage of the term as the basis of contract law in general. See Jay M. Feinman, Good Faith and Reasonable Expectations, 67 ARK. L. REV. 525, 534-49 (2017).
Thus, the Essential Protections for Policyholders project addresses key areas of market conduct regulation of homeowners insurance. It aims to improve the market for insurance (discussed in Part II of this article), to address deficiencies in the market (Part III), and to provide effective means of validating the insurance relation in case of loss (Part IV).

In each area, the project identifies a series of general principles that motivate the particular analysis and recommendations. These principles are for the most part noncontroversial. For example, in addressing the problem of improper nonrenewals and premium increases based on prior claims, it states the inarguable proposition that “Insurance companies must observe reasonable standards for canceling and renewing policies and reporting claims.” Then the principles are given more detail in recommendations about the direction state regulation should take. On this issue, the general recommendation states, “Insurance companies may not use an inquiry about a loss or a single claim as the basis for cancellation, nonrenewal or premium increase of a policy,” and the specific statutory recommendation is “States should prohibit insurance companies from refusing to issue, cancelling, surcharging increasing premiums, or refusing to renew policies because policyholders have made inquiries about coverage or potential claims or have filed one or a small number of claims.” In most cases, recommended statutory language is included. The recommendations are based on a discussion of the issue and a survey of current law. A unique feature of the project is that it rests on an extensive national database of state law regulating homeowners insurance. The database of law in the fifty-one jurisdictions also provides a basis for comparing and evaluating individual states’ current systems of regulation. Part of the project is to prepare scorecards comparing states’ homeowners protections on a variety of issues.

II. IMPROVING THE MARKET FOR HOMEOWNERS INSURANCE

Because homeowners insurance is a market good, the Essential Protections for Policyholders project recommends measures designed to improve the homeowners insurance market. A well-functioning market for homeowners insurance would offer consumers a variety of options of price, coverage, and quality, and consumers would have adequate information as to price, coverage, and quality to choose insurance that is appropriate for their needs. Currently, the market fails to provide two of those three elements.
Consumers generally have access to adequate information about the price of homeowners insurance. Consumers can easily obtain quotes from different insurance companies, increasingly through Internet tools as well as more traditional sources. Some states provide online premium comparison tools.

Comparing terms of coverage is more difficult. The traditional lore of insurance has been that policy forms are standardized, so homeowners insurance policies use the statutorily prescribed standard fire policy or ISO forms HO-3 or HO-5. If that was once true it is no longer the case; there is wide variation in the terms of policies. Terms of coverage are not easily available to consumers. Insurers and intermediaries usually provide summaries of some policy terms to shoppers but refuse to provide the actual policy language until after the policy has been purchased. Regulators in some states publish summaries of key policy provisions or the standard policies of leading companies online, but even then, consumers require diligence and expertise to discover and parse the relative merits of policy terms.

The quality of an insurance policy reflects two things: the ability of the insurer to pay claims, and its practices in doing so. The former is adequately addressed by the non-market solution of state solvency regulation, the area in which regulators have been most successful. The quality of claim practices, by contrast, is the area in which there is little information available to consumers. When choosing among insurers, consumers have few effective means of evaluating and comparing which insurer is more likely to pay promptly, fully, or at all for which type of claims.

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10 See French, supra note 9, at 546-48.
12 French, supra note 9, at 548-49.
A. IMPROVING INFORMATION ABOUT COVERAGE

Insurance policies are complex legal documents. For a policyholder to evaluate a policy being considered for purchase, to determine whether to file a claim, or to resolve a dispute with an insurance company, the policy must be clearly organized and written in plain, non-technical language. An Essential Protection is to require insurance policies to conform to minimum standards of organization, presentation, and readability. At a minimum, the standards should prescribe that policies use clear layout, font, headings, spacing, and other measures of legibility, meet defined tests for readability and plain language, and contain a table of contents and index.15

Even the clearest insurance policy will not aid consumers in their buying decisions unless its terms are readily available prior to purchase. Insurance is an unusual product in that consumers do not know what they are buying before they buy it. Insurance companies almost never provide

15 Many jurisdictions have Plain Language laws governing insurance policies. The NAIC’s Property and Casualty Insurance Policy Simplification Act sets a general standard requiring that policies be simplified, taking into consideration the following factors: (A) Use of simple sentence structure and short sentences; (B) Use of commonly understood words; (C) Avoidance of technical legal terms wherever possible; (D) Minimal reference to other sections or provisions of the policy; (E) Organization of text; and (F) Legibility. PROPERTY AND CASUALTY INSURANCE POLICY SIMPLIFICATION MODEL ACT § 6 (NAT’L ASS’N OF INS. COMM’RS 1993). The implementing Model Regulation adds requirements such as a table of contents, self-contained sections, legibility, and a minimum score on the Flesch Reading Ease Test of 40. PERSONAL LINES PROPERTY AND CASUALTY INSURANCE POLICY SIMPLIFICATION MODEL REGULATION § 3 (NAT’L ASS’N OF INS. COMM’RS 1993). The use of a Flesch score as a test of readability is common. E.g., COLO. REV. STAT. ANN. § 10-4-110.8 (2017) (discussing fifty, or tenth-grade reading level); CONN. GEN. STAT. ANN. § 38a-297 (1991); FLA. STAT. ANN. § 627.4145 (2017); TEX. INS. CODE ANN. § 2301.053 (2007) (establishing minimum score established by the insurance commissioner). Other typical requirements include avoiding “unnecessarily long, complicated, or obscure words, sentences, paragraphs, or constructions.” See, e.g., CONN. GEN. STAT. ANN. § 38a-297(a); § 627.4145(1)(d); See also N.J. STAT. ANN. § 56:12-10(a) (1982) (“[Prohibiting] sentences that contain double negatives and exceptions to exceptions [and] sentences and sections that are in a confusing or illogical order…”).
copies of policy language or complete summaries of policy terms to prospective policyholders. Essential Protections recommends that insurance departments should post online both the homeowners insurance policies of all insurance companies doing business in the state (or at least those companies that have a significant market share) and a policy comparison tool that enables consumers easily to compare key terms of insurance policies.\textsuperscript{16} The publication of policies and comparison tools would encourage better shopping by consumers. It also would encourage the development of concise ratings of different policies by consumer groups and websites as occurs in the United Kingdom, where the consumer organization, “Which?”, provides numerical ratings and five-star rankings of insurance policies and insurance companies.\textsuperscript{17}

Even policies that are freely available, well-organized, and written in non-technical language are forbidding to most homeowners. In policies that are long and complex, consumers are not likely to pay attention to the details of their policies until they have a potential claim, and they may be unable to understand the terms if they do.\textsuperscript{18} Therefore, an Essential Protection is that applicants and policyholders be provided accessible summaries of the terms that are likely to be most important to them.\textsuperscript{19}

\begin{footnotesize}
\textsuperscript{16}The National Association of Insurance Commissioners (NAIC) currently has in place a Transparency and Readability of Consumer Information Working Group. The charge of the Working Group is to “[s]tudy and evaluate actions that will improve the capacity of consumers to comparison shop on the basis of differences in coverage provided by different insurance carriers.” Transparency and Readability of Consumer Information, NAIC.ORG, http://www.naic.org/cmte_c_trans_read_wg.htm (Oct. 3, 2017); Transparency and Readability of Consumer Information (Property and Casualty), NAIC.ORG (Feb. 18, 2017), http://www.naic.org/cipr_topics/topic_transparency_readability.htm. However, the progress of the Working Group has been limited; it has produced generic shopping tools but has not acted to recommend the publication of policy forms.


\textsuperscript{19}An example in the health insurance context is the Summary of Benefits and Coverage mandated by the Affordable Care Act and developed by state insurance regulators; the Summary answers questions in a clear format, such as “[w]hat is the overall deductible?” and “[d]o I need
\end{footnotesize}
the time of renewal, policyholders especially need to be informed about changes in terms. The information should be provided in a standardized form prescribed by the state and should contain items such as the following information with understandable explanations of each:

- A simple explanation of the major coverages and exclusions of the policy.  
- Whether the policy covers damage from flood, earthquake, windstorm, or other catastrophic causes, and whether other insurance is available for such losses from such causes.  
- Whether the policy contains special deductibles such as a Hurricane Deductible.  
- Whether the policy contains Law and Ordinance or Building Code Upgrade coverage, and, if not, whether such coverage is available at an additional cost.

Consumers need the information at the times when the information is most useful—when they are shopping for insurance, when they are considering renewing their policies, and when they have a loss potentially covered by the policy. At the time of renewal, policyholders especially need to be informed about changes in terms. At the time of loss, the summary provides a convenient reference on key terms of coverage.

**B. IMPROVING INFORMATION ABOUT QUALITY**

Quality is an important attribute of any product, including insurance. The two measures of quality for insurance are insurance companies’ financial stability and their record of paying claims promptly


22 See, e.g., N.Y. INS. LAW § 3445 (2017).
23 See, e.g., COLO. REV. STAT. § 10-4-110.8(6)(a)(2017).
24 Many states require notifications that include some of this information. But typically, the required summary of information is provided with the policy, either initially or at renewal, which is too late.
and fairly. States do a good job of monitoring companies’ financial stability, and easy-to-understand financial ratings are widely available. Claim practices are less closely regulated and the information on which consumers can compare companies is not publicly available. An Essential Protection is to provide consumers information that enables them to compare companies as to how promptly and fairly they pay claims.

Statistics that would enable consumers to compare companies include what proportion of claims are denied, how long it takes to pay claims, and how many policyholders need to sue to receive payment. This information includes, by line and by year, information such as the following:

- Number of claims opened, closed with payment, and closed without payment.
- Median days to final payment.
- Number of claims closed with and without payment within 0-30 days, 31-60 days, and so on.
- Number of suits by policyholders opened and closed.

States currently collect this information and report it to the National Association of Insurance Commissioners, which aggregates the data and reports it to state regulators and insurance companies. However, the NAIC Market Conduct Surveillance Model Law[^25] and the National Conference of Insurance Legislators’ Market Conduct Annual Statement Model Act[^26] provide that claims data reported to or collected by the department are privileged and confidential[^27]. Therefore, the only people denied access to this information are the ones who need it most—consumers shopping for insurance. States should remove any privilege and should post online information about insurance companies’ practices in paying claims for consumers to view and compare.

[^25]: MKT. CONDUCT SURVEIL. MODEL LAW § 7 (MODEL REGULATION SERV. 2004).
[^26]: MKT. CONDUCT ANNUAL STATEMENT ACT § 8 (NAT’L CONFERENCE OF INS. LEGISLATORS 2015).
[^27]: The NAIC Model Law has been adopted in substantially the same form in many states. E.g., ARIZ. REV. STAT. § 20-158 (2017); HAW. REV. STAT. § 431:2D-107 (2007); OHIO REV. CODE § 3916.11 (2008); R.I. GEN. LAWS § 27-71-8 (2017); WASH. REV. CODE § 48.37.080 (2007). Other states have statutes in different form that are similar in effect. E.g., GA. CODE ANN. § 33-2-14 (2012).
As with information about coverage, many consumers will not closely examine statistics about claim payment practices, but consumer groups and websites can access the information to develop easily understandable ratings of insurance companies that consumers can use in shopping.

III. CORRECTING THE MARKET FOR HOMEOWNERS INSURANCE

Even if more and better information is provided to insurance consumers by insurance companies, state regulators, and intermediaries, the market for homeowners insurance will not work optimally. Consumers will not use the information to maximum effect in a way that will create an efficient market. Market failures will occur, and even an efficient market will not account for all the social objectives that are served by homeowners insurance. Therefore, direct regulation is necessary.

A. BASIC ELEMENTS OF PROTECTION

Essential Protections does not contemplate an ideal homeowners insurance policy. Homeowners insurance is not “one size fits all,” homeowners differ in what kind of insurance they need, want, or are willing to pay for. But for homeowners insurance to serve its purpose of providing basic financial security, all homeowners need certain basic coverage, and should have the opportunity to purchase other coverage that is best suited to them. Examples of basic coverage that states should mandate include provisions that effectuate the purpose of Replacement Cost coverage and adequate coverage for Additional Living Expense.

Replacement Cost, as it name suggests, covers the cost to repair or replace without a deduction for depreciation—often referred to as “new for old.”28 To fulfill policyholders’ expectations about Replacement Cost coverage, several Essential Protections are needed. First, Replacement Cost coverage typically is capped at a dollar amount stated in the policy limit. Extended Replacement Cost coverage provides an additional percentage that may be recovered. This protection is necessary if the estimate of the cost to repair that is the basis for the policy limit—an estimate that often is provided by the insurance company—is too low, and is especially important after catastrophes, when the cost of labor and materials typically rises. To make sure that policyholders know what they are buying,

28 BAKER & LOGUE, supra note 5, at 179.
Extended Replacement Cost should be offered at the time of purchase of Replacement Cost coverage. Second, if a homeowner chooses to rebuild or relocate at another location, the benefits of the policy still should be available, limited to the cost of replacement at the original location.\textsuperscript{29} Third, repair or rebuilding of damaged property often requires that the property be improved from its prior condition because building codes have changed since the original construction. A damaged property must be repaired or rebuilt to conform to the current building code, which may require additional expense. Policyholders with Replacement Cost coverage reasonably expect that this additional cost—“Law and Ordinance Upgrade”—will be part of their policy.\textsuperscript{30}

Homeowners’ policies typically include coverage for loss of use of the property, of which the most important component is Additional Living Expense (“ALE”). ALE coverage reimburses the homeowner for losses caused by the primary residence being uninhabitable, such as the cost of renting a comparable property. Because repairs can take time, policies should provide a minimum time period of twelve months during which ALE may be incurred. Homeowners who want additional protection should be able to purchase ALE coverage that extends for an additional twelve months.\textsuperscript{31}

B. “USE IT AND LOSE IT”

An important element of coverage is a policyholder’s ability to use the coverage when it is needed. An Essential Protection is to make sure that policyholders are not discouraged from filing claims or penalized for doing so by having their policies canceled or not renewed because they have filed a claim or even just have asked about coverage.

Insurance companies legitimately can use some elements of policyholders’ claims experience in deciding whether to issue or renew

\textsuperscript{29} The ability to replace property at a different location is specified by statute in California. \textit{CAL. INS. CODE} § 2051.5(C) (2006). It also is required by judicial interpretation of the insurance policy in other states. \textit{E.g.}, Huggins v. Hanover Ins. Co., 423 So. 2d 147, 150 (Ala. 1982); Blanchette v. York Mut. Ins. Co., 455 A.2d 426, 427 (Mont. 1983).

\textsuperscript{30} Several states require insurers to offer extended replacement cost and law and ordinance coverage. \textit{COLO. REV. STAT.} § 10-4-110.8(6)(a) (2017); \textit{FLA. STAT. ANN.} § 627.7011 (2017).

\textsuperscript{31} A few states specify by statute required ALE coverage. \textit{E.g.}, \textit{COLO. REV. STAT.} § 10-4-110.8; \textit{MD. CODE ANN, INSURANCE} § 19-208 (2017).
policies and how to price them. However, companies should not be able to use elements that are not strongly correlated with future risk or that discourage policyholders from pursuing legitimate claims. This practice—“use it and lose it”—imposes significant costs on policyholders, makes some of them uninsurable, and, as knowledge of the practice becomes widespread, deters many others from pursuing valid claims. The most extreme version of this practice occurs when companies impose a premium increase or surcharge on policies, or refuse to insure or renew merely because policyholders have inquired about coverage without actually filing a claim. The problem is made worse by companies’ reliance on centralized databases about policyholders. Policyholders’ inquiries are reported to all companies, even if the inquiries were unrelated to actual losses. An Essential Protection is prohibiting insurance companies from refusing to issue, canceling, surcharging, increasing premiums, or refusing to renew policies because policyholders have made inquiries about coverage or potential claims or have filed one or a small number of claims.


A number of states have adopted statutes that limit insurance companies’ ability to use inquiries as the basis of underwriting decisions. E.g., DEL. CODE ANN. tit. 18, § 4131 (2017) (making underwriting decisions); MINN. STAT. § 65A.285 (2014) (imposing surcharges or higher premiums); TEX. INS. CODE ANN. § 551.113 (2015) (issuing, declining to issue, non-renewing, or canceling). The statutes typically are limited to homeowners’ or other property insurance. E.g., HAW. REV. STAT. § 431:10E-124 (2012); N.J. STAT. ANN. § 17:29B-4 (2001). Some states also specifically prohibit insurance companies from reporting inquiries to national databases such as CLUE. E.g., ARIZ. REV. STAT. ANN. § 20-1652 (2017). Some states limit insurance companies’ ability to cancel or refuse to renew policies except for stated reasons. With reference to the “use it and lose it” concept, the most relevant language prohibits adverse action unless there is an event such as: “a material change in the risk being insured,” LA. REV. STAT. ANN. § 22:1265(D); “[I]ncreased hazard or material change in the risk assumed that could not have been reasonably contemplated by the parties at the time of assumption of the risk.” N.C. GEN. STAT. ANN. § 58-41-15(a)(3) (1986). Some states specify a minimum number of claims that may trigger cancellation or nonrenewal. E.g., LA.
C. IMPROVING PROTECTION FOR DISASTER VICTIMS

Often, disaster victims need more extensive protections because of the distinctive conditions created following disasters. After a disaster, policyholders may be unable to meet the ordinary conditions and time limits specified in insurance policies through no fault of their own. Entire communities may be inaccessible for periods of time, preventing policyholders from returning to their homes. Insurance companies are inundated with inquiries and claims, delaying communication with policyholders. Contractors are overwhelmed with work, delaying repairs, and rebuilding. In those circumstances, policyholders should be granted additional time for processing their claims. Some types of problems can be anticipated and specified in advance, such as the need to extend time limits for filing additional living expense and full replacement cost claims. Other types of problems depend on the situation and require action by insurance departments to make sure that insurance companies recognize the need to be flexible.

The Essential Protections for Disaster Victims mandate flexibility in the claim process, standards that prevent unexpected gaps in insurance due to unfair exclusions, and prevention of dislocation in the insurance market. States should adopt statutes that extend the time for Additional Living Expense and for filing claims after a disaster and that authorize insurance departments to extend other time limits. Insurance departments should exercise the authority granted to make sure that policyholders have adequate time to pursue claims after disasters.34

Following a wildfire, hurricane, or other disaster that causes a large number of losses to a community or region, insurance companies sometimes react—over-react—by canceling, failing to renew or imposing a

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34 The California Insurance Code permits extension of time or coverage following disasters. Cal. Ins. Code § 2051.5 (2005). Other states took similar action in response to particular events such as Hurricane Katrina, Superstorm Sandy, and the Louisiana flooding of 2016. Responses to particular disasters are helpful, but the enactment of statutes to deal with all disasters provides certainty for policyholders and insurance companies and avoids the need for hasty action.
surcharge on existing policies, and declining to offer new policies in the affected areas. Over time, the companies may moderate their positions as the extent of losses and likely future risks become clearer, but in the meantime, insurance may be unavailable or unaffordable. An Essential Protection is to ensure that catastrophes or other significant events do not cause a sudden and often unjustified dislocation in the insurance market. States should limit the ability of insurance companies to cause temporary dislocations in the market by failing to write or renew policies or imposing higher costs after a major disaster.\(^{35}\)

A particularly controversial issue that arises on a large scale after a disaster, but also occurs in other cases, concerns losses that arise from covered and excluded causes.\(^{36}\) Homeowners insurance policies cover losses caused by some risks and exclude coverage caused by other risks. For example, policies typically cover hurricane damage caused by high winds but exclude losses caused by flooding during a hurricane. In many cases, however, a loss will occur due to a covered cause and an excluded cause, acting either in sequence, together, or in a manner that cannot be determined after the fact. Many homeowners policies have language that attempts to deny coverage in these cases, even if it is clear that part of the damage was due to a covered cause of loss. Commonly used language bars coverage due to an excluded cause “regardless of any other cause or event contributing concurrently or in any sequence to the loss”—even if the

\(^{35}\) Many states have statutes that prohibit adverse actions after disasters or due to weather-related losses. A large number of states prohibit cancellation or nonrenewal due to weather-related events other than catastrophes, such as prohibiting cancellation or nonrenewal because of a claim resulting from an “act of God.” E.g., S.C. CODE § 38-75-790 (2017). By their terms, these statutes would include adverse action due to catastrophes. Statutes in other states refer specifically to disasters. E.g., CONN. GEN. STAT. § 38a-316d (2014); N.M. STAT. ANN. § 59A-16-20.1 (2017). A few states authorize the insurance department to declare a cooling-off period following a disaster during which cancellations and nonrenewal are suspended. E.g., FLA. STAT. ANN. § 627.4133 (2017); N.Y. INS. LAW § 3425 (2017). Or taking other actions. E.g., ALA. CODE § 27-12-1 (2017); R.I. INS. REG. § 110 (2013); ALA. DEP’T OF INS. BULLETIN 2010-10 (2010) (citing the Trade Practices Law).

“other cause” is covered under the policy. Terms such as this—known as “anti-concurrent causation clauses”—disappoint the reasonable expectations of policyholders that they will be compensated for losses due to covered causes, and can be particularly problematic after catastrophic events. An Essential Protection ensures that losses due to covered causes are covered by limiting the scope of anti-concurrent causation clauses.

IV. IMPROVING THE CLAIM PROCESS

The point of homeowners insurance from the perspective of the policyholder is two-fold: to provide a sense of security before a loss arises, and to pay for a covered claim if a loss does occur. Therefore, the protection and security that insurance policies provide is most effective—or it fails—when policyholders file claims. To provide this protection, insurance companies must process claims promptly and fairly. But disputes may arise about the facts giving rise to a claim, the extent of coverage

37 INFORMATION INSTITUTE, HO 00 03 10 00, INS. HOMEOWNERS SPECIAL FORM 11 (1999), https://www.iii.org/sites/default/files/docs/pdf/HO3_sample.pdf.

38 The majority of states observe the rule of “efficient proximate cause” in cases involving covered and excluded causes of loss. 5-44 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 44.03 (Matthew Bender & Company, Inc., 2017). Efficient proximate cause is often described as “the predominating cause of the loss” that “looks to the quality of the links in the chain of causation.” Murray v. State Farm Fire & Cas. Ins. Co., 509 S.E.2d 1, 12 (W. Va. 1998). Although a few statutes define causation under insurance policies, e.g., CAL. INS. CODE § 530 (2017); FLA. STAT. § 627.702(1)(b) (2017); and N.D. CENT. CODE § 26.1-32-01 (2017), it largely has been left to the courts (sometimes applying relevant statutes) to decide whether an anti-concurrent causation clause in an insurance policy can narrow the rule of causation that otherwise would be dictated by state law. The states are divided on this issue. Leading cases include: Safeco Ins. Co. of Am. v. Hirschmann, 773 P.2d 413 (Wash. 1989) (clause unenforceable), and State Farm Fire & Cas. Ins. Co. v. Bongen, 925 P.2d 1042 (Alaska 1996) (clause enforceable). See Dale Joseph Gilsinger, Validity, Construction, and Application of Anticoncurrent Causation (ACC) Clauses in Insurance Policies, 37 A.L.R. 6th 657 (2008).
under policy language, the policyholder’s conduct in response to the loss, the insurer’s processing of the claim, and more. A fair and efficient process that resolves disputes about claims provides the security that policyholders have purchased while it protects the interests of the pool of policyholders that the insurer represents.

The claim process is improved by many of the Essential Protections. Improving information about coverage makes consumers more aware of policies’ content so they can better evaluate their rights in the event of a claim. Preventing “use it and lose it” removes a disincentive for policyholders to assert rightful claims. But disclosure and stronger terms will not prevent all disputes. Essential Protections directed at the claim process itself, including the dispute resolution process, are needed as well.

The most basic promise in a policy concerns the insurer’s conduct in the event of a claim. The core requirement for insurance companies when handling claims is that they must act reasonably. An Essential Protection is to incorporate that requirement into law and to provide remedies for its violation. Reasonableness does not demand perfection; everyone makes mistakes, including insurance companies. Reasonableness does demand that insurance companies adhere not only to the express terms of policies but also to widely accepted industry standards of performance.39


Most states have adopted the NAIC’s Model Unfair Claims Settlement Practices Act (“UCSPA”) and the accompanying Unfair Property/Casualty Claims Settlement Model Regulation that define minimum standards of reasonableness. UNFAIR CLAIMS SETTLEMENT PRACTICE ACT (NAT’L ASS’N OF INS. COMM’RS 1997; UNFAIR PROPERTY/CASUALTY CLAIMS SETTLEMENT MODEL REGULATION (NAT’L ASS’N OF INS. COMM’RS 1997) For example, with respect to providing essential information about the claims process to policyholders, the UCSPA, §4.M requires insurance companies “to provide forms necessary to present claims within fifteen calendar days of a request with reasonable explanations regarding their use.”

The Model Regulation, § 6.D, further provides, “[e]very insurer, upon receiving notification of claim, shall promptly provide necessary claim forms, instructions, and reasonable assistance to first party claimants so that they can comply with the policy conditions and the insurer's reasonable requirements.” The UCSPA fails policyholders in one basic respect. It treats many unreasonable actions as if they were not violations of the statute, stating that insurance companies’ unreasonable actions are only
Policyholders typically are at a disadvantage in the claim process. They lack information and expertise about coverage under their policies and the claim process, and may be financially and emotionally vulnerable after a major loss. To correct this imbalance and to make sure that insurance companies honor their promises, an Essential Protection is that insurance companies provide adequate information to policyholders about the claims process and establish and implement reasonable standards for processing, investigating, evaluating, and paying claims.

A first step in redressing the information imbalance in the claim process is to require insurance companies to provide policyholders with information about the claim process and policyholder rights and, upon request, with a copy of the claim file. Policyholders are required to provide complete, accurate, and timely information in order to have their claims wrong if they are committed intentionally or as a general business practice. Actions that are unreasonable are unreasonable whether or not they have these added elements.

Some states have adopted statutes other than the UCSPA that define claims practices standards. E.g., COLO. REV. STAT. § 10-3-1115 (2017) (“A person engaged in the business of insurance shall not unreasonably delay or deny payment of a claim for benefits owed.”); LA. REV. STAT. ANN § 22:1973 (2017) (“The insurer has an affirmative duty to adjust claims fairly and promptly and to make a reasonable effort to settle claims with the insured or the claimant, or both. Any insurer who breaches these duties shall be liable for any damages sustained as a result of the breach.”); MD. CODE ANN., INS. § 27-1001 (Lexis 2016) (“‘Good faith’ means an informed judgment based on honesty and diligence supported by evidence the insurer knew or should have known at the time the insurer made a decision on a claim.”); MO. REV. STAT. § 375.296 (2017) (sanctioning refusal to pay that is “vexatious and without reasonable cause”); WASH. REV. CODE § 48.30.010(7) (2017) (“An insurer engaged in the business of insurance may not unreasonably deny a claim for coverage or payment of benefits to any first party claimant.”).

Courts in most jurisdictions also recognize that an obligation of good faith and fair dealing is embodied in every insurance policy as if it were written into the wording of the policy. The good faith obligation has been a major source of the law of claim practices, requiring the insurer to go beyond the letter of the insurance policy and to act fairly and reasonably in processing, investigating, evaluating, and paying a claim. See Feinman, supra note 39.

40 See Feinman, supra note 14, at 1323-26.
paid. Insurance companies have an obligation to assist policyholders in this process by giving them the information they need about policy terms, time limits, other requirements for pursuing their claims, and information the companies have received or developed about the claims. Relevant information about the process includes a copy of relevant state statutes and regulations concerning claim practices; forms necessary to present claims; explanations of time limits applicable to the claim including time limits for filing the claim and other time limits stated in the policy or by operation of law; explanations of the claimant’s rights in the event of a dispute including mediation and appraisal, and explanation of the availability and procedures for filing a complaint with the state insurance department.

Policyholders also should have full access to information relevant to their claims, including information the companies have received or developed about the claims. Insurance companies have a duty to conduct reasonable investigations and to assist policyholders in filing and documenting claims. To ensure that this duty is met, policyholders should have access to all information developed about their claims, commonly referred to as “the claim file.” In claim practices litigation, the claim file is routinely available to policyholders in discovery. Attorney work product, attorney-client privileged, and medically privileged documents are excluded, although those exclusions should be defined narrowly because “the payment or rejection of claims is a part of the regular business of an insurance company [so that] reports prepared by insurance investigators, adjusters, or attorneys before the decision is made

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41 Many of these obligations are defined in detail in state adoptions of the Unfair Claims Settlement Practices Act, e.g., UNFAIR CLAIMS SETTLEMENT PRACTICES ACT § 4.M (NAT’L ASSOCIATION OF INS. COMM’RS. 1997) and the Model Regulation, UNFAIR PROPERTY/CASUALTY CLAIMS SETTLEMENT MODEL REGULATION, supra note 39. Other state laws impose similar duties. E.g., CAL. INS. CODE § 10103 (2017).

42 The duty to provide a copy of the claim file on request is specifically mandated in the California Insurance Code. CAL. INS. CODE § 2071 (2017). A similar requirement is contained in LA. REV. STAT. § 22:41 (2017).

to pay or reject a claim are thus not privileged and are discoverable."

Often, the most controversial issue in homeowners insurance claims is determining the value of the loss. This should not be an adversarial process; insurance companies are obligated to act reasonably and in the interest of their policyholders to determine the fair value of claims. This requirement is an application of the general principle that companies are required to act in good faith toward their policyholders. In particular, an Essential Protection is to require companies to observe reasonable standards for determining and paying the Actual Cash Value or the Replacement Cost of the claim, as applicable under the policy. For example, under an Actual Cash Value policy, these standards dictate that a deduction for depreciation only applies to components “that are normally subject to repair and replacement during the useful life of that structure.” Likewise, under a Replacement Cost policy, in cases of partial loss homeowners expect that their policies enable them to repair or replace the damaged property without additional cost. Repair or replacement often requires matching the damaged part of the property to the undamaged part to restore the property to the condition prior to loss; for example, replacing only damaged shingles on a roof fails to restore the uniform appearance.

After a loss, policyholders need time to collect information, retain contractors and other experts, make repairs, and restore their standard of

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45 CAL. INS. CODE § 2051 (2017).
46 This represents a “functional conception” of indemnity rather than an “economic conception.” KENNETH S. ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION 263 (6th ed. 2015).
living, all while they are suffering the financial and emotional hardships caused by a loss. Insurance companies also need time to assist policyholders and to investigate and evaluate claims. These processes can take time, particularly where the losses are major or occur after natural disasters, where many losses place extraordinary demands on insurance companies, contractors, and others. Therefore, insurance companies must provide policyholders adequate time to make sure repairs are made, claims are fully documented, and the conditions for payment in insurance policies are fully complied with. If disputes arise, policyholders may require more time to retain legal representation and to initiate litigation. Time requirements in policies and statutes of limitations should recognize these considerations while balancing the need to prevent stale claims and to allow insurance companies to appropriately reserve for potential losses. An Essential Protection is to provide a reasonable statute of limitations, such as two years, and to prevent an insurer from attempting to shorten the period in which a suit may be brought that is specified in the statute of limitations. Policyholders may be unaware of time deadlines and their effect, so insurance companies should be required to give them timely and adequate notice so that they can comply with the deadlines.

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50 See NAIC Model Regulation § 5.D.; Okla. Admin. Code § 365:15-3-4 (2017); Ohio Admin. Code § 3901-1-54 (2017) (providing that “[n]o insurer shall deny a claim based upon the failure of a first party claimant to give written notice of loss within a specified time limit unless the notice is required by a policy condition, or first party claimant’s failure to give written notice after being requested to do so is so unreasonable as to constitute a breach of the claimant’s duty to cooperate with the insurer.”). The language “unless the written notice is a written policy condition” has the effect of permitting insurance companies to act unreasonably simply by including a boilerplate condition in the policy, even when the failure to give notice or file a proof of loss does not prejudice their interests. An Essential Protection is to remove the insurance companies’ ability to rely on policy language in this way, as other states do. See Utah Code Ann. § 31A-21-312 (West 2017); W. Va. Code R. § 114-14-4 (2017).
When a loss occurs, homeowners need to receive the benefits of their insurance policies quickly and fully in order to repair their property and begin rebuilding their lives. In order to facilitate rebuilding and to remove the pressure on a policyholder to prematurely conclude a claim, an Essential Protection requires companies to pay what they acknowledge they owe, even if other portions of claims are disputed, and not use the threat of litigation to coerce policyholders.51

When disputes arise, policyholders need efficient, effective, and expeditious means of resolving the disputes. Litigation ultimately may be necessary, but it is a last resort for policyholders because it takes time, delaying the process of recovery, and is financially and emotionally draining. Two alternatives to litigation that can be effective for homeowners are mediation and appraisal.

Mediation provides an informal but structured forum in which policyholders and insurers can meet with the aid of a qualified mediator to discuss and attempt to resolve disputes.52 There is widespread dispute among the policyholder bar, regulators, and insurers about the effectiveness of mediation. The imbalance of information and position inherent in the insurance relationship is reflected in mediation, too, and can prevent it from being effective. What is clear, however, is that mediation is effective if at all only if certain conditions are met. Essential elements of an effective mediation program include the following:

- Policyholders should be fully informed about their right to mediation and should be provided advice and counseling about

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52 Some states provide for mediation of insurance disputes, either in general or for claims arising after natural disasters. E.g., Fla. Stat. § 627.7015 (2017).
the process.

- Policyholders should be able to request non-binding mediation in which insurance companies are required to participate.
- Mediators should be qualified in both the mediation process and property insurance issues.
- The costs of mediation should be borne by the insurance companies.

Appraisal provides a process by which neutral parties can assess loss and determine the costs of repair. Homeowner policies typically provide for appraisal, and some states require that it be available. Courts are divided on the issues appropriate for appraisal—whether, for example, appraisal is limited to determining the amount of damage and cost of repair or whether appraisal also may determine the scope of loss and issues of causation.\(^\text{53}\) Appraisal is more effective if it includes both types of issues.\(^\text{54}\)

Companies sometimes attempt to prevent policyholders from having their day in court through forced arbitration clauses in insurance policies. Arbitration can be a fair and efficient means of dispute resolution if both parties agree to arbitrate a claim after a dispute has arisen, but it should not be imposed on policyholders by a policy term that is usually hidden in boilerplate or the consequences of which are not well understood. Arbitration often fails to protect policyholders because discovery is limited, arbitrators can be more favorable to insurance companies, arbitration rulings cannot be reviewed even for errors of law or fact, and the rulings are private, so they do not serve the public function of clarifying the law. Therefore, an Essential Protection is to bar the use of pre-dispute mandatory arbitration clauses in insurance policies.\(^\text{55}\)


\(^{54}\) See N.Y. INS. § 3408(c) (Consol. 2014).

\(^{55}\) More than a dozen states prohibit enforcement of arbitration clauses in insurance policies by statute or regulation. E.g., ARK. CODE ANN. § 16-108-201 (2017); HAW. REV. STAT. § 431:10-221 (2017). Another ten states restrict the use of arbitration. E.g., UTAH ADMIN. CODE R590-122 (2017); The Federal Arbitration Act as interpreted by the U.S. Supreme Court generally preempts state law that bars or limits arbitration, but state statutes should be upheld based on the reverse preemption provision of the McCarren-Ferguson Act under which states are permitted to regulate the business of insurance. E.g., Standard Security Life Insurance Co. v. West, 127 F. Supp. 2d 1064 (2000); Friday v. Trinity Universal of Kansas, 939
The protections that policyholders have are only as good as the means available to enforce them. Every state recognizes that policyholders can sue their insurance companies for failing to pay what is owed under insurance policies; these are ordinary breach of contract suits. Because insurance is not an ordinary commercial contract but rather one that provides security and for which ordinary contract damages are not sufficient to redress the breach of security, some states provide for the award of attorneys’ fees to a policyholder in the coverage case. Some states also permit interest on the unpaid amount at a higher than ordinary rate.

Where insurance companies act unreasonably, the amounts owed under the policies are inadequate either to compensate policyholders for their losses, or to deter companies from unreasonable conduct in the future. When insurance claims are improperly delayed or denied, policyholders may suffer other financial losses and emotional harm. For example, homeowners who do not receive prompt payment may have additional expenses due to being out of their homes and may suffer extreme aggravation and distress. If policyholders have to pay attorneys and incur other litigation expenses to get what they are entitled to, they are never fully compensated for their losses. Moreover, if insurance companies only have to pay what they originally owed under their policies even where they act wrongfully, they have much less incentive to pay claims promptly and fairly; delaying claims increases their investment income and denying claims adds directly to their bottom line.

Therefore, Essential Protections require insurance companies to act reasonably in processing, investigating, evaluating, and resolving claims, and give policyholders the right to sue for appropriate damages if the companies do not do so. Appropriate damages include the unpaid amount


56 E.g., GA. CODE ANN. § 33-4-6 (2017); WASH. REV. CODE § 48.30.015(2) (2017).

57 E.g., ME. STAT. 24-A § 2436 (2017) (1-1/2% per month); OKLA. STAT. 36, § 3629 (2017) (15% per year); 42 PA. CONS. STAT. § 8371 (2017) (prime rate plus 3%).

58 See generally JAY M. FEINMAN, DELAY, DENY, DEFEND: WHY INSURANCE COMPANIES DON’T PAY CLAIMS AND WHAT YOU CAN DO ABOUT IT (2010).

59 Most states provide a remedy for violation of claim practices standards, sometimes referred to as “bad faith.” In a majority of those states, insurance companies are liable only if they act unreasonably and if they know they have done so or acted in “reckless disregard” of the lack of a
of the clam, other actual damages, attorneys’ fees and costs, and extra-
compensatory damages such as interest at a higher than statutory rate, or
treble damages.

V. CONCLUSION

This article was first presented at a University of Connecticut Insurance Law Center conference on “Insurance in the Age of Trump.” In the early days of the Trump Administration, presidential advisor Stephen Bannon defined one of the administration’s objectives as the “deconstruction of the administrative state.” Whatever that phrase means

reasonable basis for their action. Other states only require unreasonable behavior for the cause of action. See Feinman, supra note 39, at 701-04.


61 E.g., ARK. CODE ANN. § 23-79-208 (2017); COLO. REV. STAT. § 10-3-1116 (2017); FLA. STA. § 627.428 (2017); MD. CODE ANN., CTS. & JUD. PROC. § 3-1701 (West 2017); N.M. STAT. ANN. § 39-2-1 (2017); 42 PA. CONS. STAT. § 8371 (2017).

62 E.g., ME. REV. STAT. ANN. 24-A, § 2436 (2017) (1-1/2% per month); MD. CODE ANN., CTS. & JUD. PROC. § 3-1701 (2017) (10% per annum); OKLA. STAT. 36, § 3629 (2017) (15% per year); 42 PA. CONS. STAT. § 8371 (2017) (prime rate plus 3%).

63 E.g., GA. CODE ANN. § 33-4-6 (2017) (“Additional damages up to 50% of the loss or $5,000, whichever is greater, plus attorney’s fees”); LA. STAT. ANN. § 22:1821 (2017) (“Double the amount of health and accident benefits plus attorney’s fees.”); LA. REV. STAT. ANN. § 22:1892(B)(1) (2017) (indicating a penalty of the greater of 50% of the amount owed or $1,000); WASH. REV. CODE § 48.30.015(2) (2017) (indicating up to three times actual damages, plus attorney’s fees). Other statutes authorize punitive damages, 42 PA. CONS. STAT. § 8371 (2017), or exemplary damages, MONT. CODE ANN. § 33-18-242 (2017), as determined by the trier of fact.

as a matter of national policy, homeowners insurance will continue to be heavily regulated by the states. Across the divides between Democrats and Republicans, progressives and conservatives, industry lobbyists and policyholder advocates, there is no disagreement that regulation must remain robust. The Essential Protections for Policyholders project surveys the state of key elements of homeowners insurance regulation across the nation and recommends how it can be improved in the interest of policyholders and the communities in which they live.
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