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ARTICLES

A CLASH OF TWO CULTURES: WILL THE TORT SYSTEM SURVIVE AUTOMOBILE INSURANCE REFORM?

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There are two possible ways to approach the general questions of tort law. The first is theoretical: the analyst begins with some abstract model of human behavior, usually one that posits individuals who seek to maximize their self-interest, and then seeks to fashion from that model the set of ideal tort rules that seek to achieve some stated social end, most typically either corrective justice or the minimization of the sum of the costs of accidents, their prevention and the administrative costs necessary to operate the system. Looked at in this way, it is possible to make a comparison between rules of negligence and strict liability, to examine the choice between contributory negligence as an absolute defense and comparative negligence, to probe the various formulations of proximate cause, to ask about the optimum rules of tort damage, and, moving a bit further from the center, to decide whether the whole tort system in any of its permissible permutations is superior or inferior to some system of automobile no-fault insurance, with its reliance on (mandatory) first-party insurance and limited damage awards.

That set of issues is a fascinating and important one and it has preoccupied academic debates over tort liability. Nonetheless it is not the subject of this lecture. Rather, I want to take on a second and more prosaic approach to tort liability. Thus I begin with the day to day operation of the system, and the efforts to fund the liabilities it generates through the insurance mechanism. As stated even this inquiry is too broad for present concerns because tort insurance, as such, is not sold under that broad classification. Instead the market is divided into a set of multiple lines: products, professional liability (by specialty),

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occupier's liability, and automobile insurance. Each of these lines has its own special problems stemming both from the nature of the underlying risks and from the financial and legal position of the insured population. In part the differences across separate lines depend upon the nature of the underlying cases. The typical issues in a medical malpractice case are likely to differ substantially from those in a collision case, even if both malpractice and collision cases fall at some level of abstraction under the general rubric of negligence actions.

The relevant differences extend, moreover, beyond evidentiary and doctrinal concerns. There is a political dimension as well. Medical malpractice is an issue of a local nature. In turn, medical malpractice insurance is sold to a small professional group that does not command anything close to a dominant electoral position, but which might be effective in local legislative fights. Product liability is an issue that pits local consumers against out of state producers, and their out of state insurers. But the purchasers of the insurance are not heavily represented in the ranks of voters. Automobile insurance is the one line of insurance which is subject to mass marketing within any given state, with large numbers of out of state producers. Automobile insurance is the one issue on which it is possible to mount an effective state wide campaign for reform, be it through legislation as in New Jersey and Pennsylvania, or through the referendum, as in California.¹

Owing to the cumulative impact of these various differences, any comprehensive analysis that starts with doctrine and moves through politics will have to be cognizant of the different overall environments across different areas of tort exposure. The issues of insurance as it related to the products and medical malpractice issues have been extensively studied,² as one would expect with systems under stress. And in this paper I shall respond to a stress from another quarter, and concentrate on the automobile line of insurance, which is now subject to major regulatory initiatives as noted above.

Although confined to automobile insurance, the inquiry here is in its own way a broad one, and may be divided conveniently into a number of related parts. The first part examines the question of how the institution of insurance is integrated into a general tort theory. The second part then examines the

1. See The Fair Automobile Insurance Reform Act of 1990, 1990 N.J. Sess. Law Serv. 8 (West) [hereinafter FAIRA]; 1990 Pa. Legis. Serv. 6 (Purdon); Proposition 103 (codified as amended at CAL. INS. CODE §§ 1861.01-1861.16 (West Supp. 1991)). There was also a referendum calling for a 20 percent rollback of automobile insurance premiums in Arizona, which failed in the November, 1990 election. See N.Y. Times, Nov. 3, 1990 at 1, col. 1.

2. See, e.g., P. DANZON, MEDICAL MALPRACTICE: THEORY, EVIDENCE, AND PUBLIC POLICY (1985); Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987); Priest, *Modern Tort Law and Its Reform*, 22 VAL. U.L. REV. 1 (1987) (the 1986 Monsanto lecture).

political pressures that are necessary to handle the cost of insurance through various systems of state regulation, and the responses that the insurance industry and the courts have made to those forms of regulation. The third part examines the way in which the systems of regulation, especially those imposed as of late, feed back into the deterrent and compensation functions of the tort law.

I choose this topic for two reasons. One as a general matter, I think that the success of the tort system in achieving any of its primary social goals, moral or economic, depends more heavily on the selection of sound regimes of insurance regulation than it does on the "optimal" set of rules internal to the liability system. The differences between first and second-best solutions on matters of insurance and liability are often very small. It is a common feature of the models developed, for example, in Professor Shavell's masterful economic analysis of accident law, that the differences in utility levels between various outcomes are less than one-percent³ -- figures that are swamped by administrative costs and various forms of uncertainty. Second, the sweeping legal changes in the institution of insurance in California, New Jersey and Pennsylvania are too central to the operation of the tort system for automobile accidents to be ignored. State regulation has already led to major litigation⁴ and jockeying in both state and federal courts.⁵ In addition, state regulation has brought to the fore hard questions of constitutional law as they relate to the scope of the takings, due process, and contracts clauses, insofar as these protect the invested capital that insurance companies must place at risk in order to back up their insurance obligations. It is all too easy to think that questions of tort liability and insurance remain constant across different areas, when they do not. With automobile insurance, the structure of the underlying markets has dictated the path of reform. Yet even though many of the conclusions about this particular exercise in social regulation are specific to one industry, broader lessons can still be learned. Insurance reform is always perceived of as an option to, or a companion for tort reform: the reform of medical malpractice liability is coupled with the formation of bedpan mutuals. The alteration of product liability law is coupled with the recognition of industry wide risk retention groups. The interaction between the political process and the insurance markets may take one form with automobile insurance and quite another form with some other line of insurance, and one must be cautious about making

3. See, e.g., S. SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* (1987), ch. 8, table 8.1, in which differences in risk aversion typically yield to outcome differences of less than one percent.

4. See, e.g., *State Farm Mut. Auto. Ins. Co. v. Fortunato*, No. C-90-0085 (Mercer County Ct. May 31, 1990)(denying a preliminary motion to enjoin enforcement of FAIRA).

5. See, e.g., *Allstate Ins. Co. v. The 65 Security Plan*, 879 F.2d 90 (3d Cir. 1989) (denying an insurance company's attempt to have a state court action removed to federal court on the grounds that the state insurance regulations were preempted by the Employer Retirement Income Security Act).

generalizations that are insensitive to the specific nature of given markets. The story of legislative reform in this context is not a happy one, but there is no guarantee that the same outcome will arise in other areas.

The charter of the Monsanto Lectures asks that one talk about deep issues of tort reform and insurance. I do not know whether the issues that I am about to speak of here qualify as deep, given its institutional focus. Nonetheless I think that it is useful to follow a single dispute to its final conclusion, because the level of institutional detail that is available on the question of automobile insurance should be of great interest to anyone who wants to place the question of tort liability in its broader social setting. I should also state at the outset that I am not a disinterested bystander in the entire matter, as for the past year I have worked (given my interest in takings, torts and insurance law) as an outside consultant for Allstate Insurance Company in its legal struggles in California, New Jersey, and Pennsylvania. But my purpose here is not to repeat the war stories of the embattled litigant, but to examine the relationship between the liability and the insurance market, both regulated and unregulated, with respect to automobiles. There can be enormous dislocations in the operation of a tort system even where its liability rules are sound, for a poor system of insurance can undermine the desirable features of the tort law.

I. TORT, WITH OR WITHOUT INSURANCE

The normal model of tort liability seeks at reasonable costs to induce all automobile drivers to take precautions to minimize the level and severity of accidents that they cause.⁶ Notwithstanding the extensive debate over negligence and strict liability, the differences between these two regimes loom small within the context of automobile accidents. While negligence liability is ordinarily conceived of as comparing the costs and benefits of different precautions under the lens of the Learned Hand formula,⁷ practical litigation on the highway normally dispenses with so fine-spun an inquiry and will impose liability where a defendant has deviated from the rules of the road.⁸ In occasional cases there may be an exotic set of excuses -- insanity⁹ or necessity¹⁰ come most quickly to mind -- that do raise genuine intellectual puzzles, but the infrequency of the problem means that the basic structure of the

6. For the early statement of the principles, see G. CALABRESI, *THE COSTS OF ACCIDENTS* (1970). For the most recent formal efforts to work out the arrangements, see W. LANDES & R. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* (1987); S. SHAVELL, *supra* note 3. The later contains an explicit formal explanation of the logic of insurance. *Id.* at ch. 9, 10.

7. See *United States v. Carroll Towing*, 159 F.2d 169 (2d Cir. 1947).

8. See H. L. ROSS, *SETTLED OUT OF COURT* (1970).

9. See, e.g., *Breunig v. American Family Ins.*, 45 Wis. 2d 536, 173 N.W.2d 619 (1970).

10. *Vincent v. Lake Erie Transp. Co.*, 109 Minn. 456, 124 N.W. 221 (1910).

system (certainly within a tolerance of one percent) is the same no matter how these marginal cases are resolved. The big issues on negligence liability, infancy and drunkenness do occur in many cases, but these are generally held to be irrelevant just as if the legal system itself adopted a strict liability norm.¹¹ In the large run of cases liability is determined by application of simple rules of thumb which in practice approach a system of strict liability, although a bit less favorable to recovery and a bit more expensive to operate. I should switch to the strict liability system for highway accidents if given my druthers, but regard the change as an incremental improvement, not a fundamental shift in orientation. (Indeed for the present tale, even the more indirect choice between tort and no-fault systems is of minor consequence.¹²) There are of course other contexts in which a shift in liability regimes, say from negligence to strict liability or the reverse, could have far more dramatic consequences, as with liability for bad blood, for which the negligence standard tends to insulate the defendants for liability except in infrequent cases where customary standards are not followed,¹³ and for retailers' liability, which likewise is difficult to establish in many areas, *e.g.* defective testing of dangerous drugs.¹⁴ But in the context of automobile liability the convergence of the two systems is powerful, although not complete.

The liability system, however, fares no better than the resources available to back it. And these resources are usually in short supply, at least with respect to private passenger drivers. A serious injury on the highway is every bit as debilitating as the identical injury sustained from the use of a defective product or from a careless surgery. Yet the typical individual driver's total net worth is only a tiny fraction of the harm in question and is usually insufficient to cover lost earnings or medical expenses, let alone pain and suffering. If the sting of the tort system is supposed to induce precautions (and that proposition holds regardless of whether we deal with strict liability or negligence), then the insolvent defendant cannot be made to pay the price for his mistakes, so why take care? And if the compensation required to make the plaintiff whole (or even to tend to wounds and losses) is not forthcoming, then the tort system fails in its task of redress as well. Liability rules have no teeth if defendants have no assets.

11. *See, e.g., Daniels v. Evans*, 107 N.H. 407, 224 A.2d 63 (1966).

12. *See Epstein, Automobile No-Fault Plans: A Second Look at First Principles*, 13 CREIGHTON L. REV. 769 (1980).

13. *See, e.g., ILL. REV. STAT. ch. 111½ §§ para. 5101-03* (1981). For a critical account of the blood statutes, urging a return to strict liability, *see, R. Eckert, The AIDS Blood Transfusion Cases: A Legal and Economic Analysis of Liability* (July 31, 1990).

14. *See, e.g., Murphy v. E.R. Squibb & Sons, Inc.*, 40 Cal. 3d 672, 710 P.2d 247, 221 Cal. Rptr. 447 (1985).

There is, I think, a widespread agreement that this solvency problem is potentially explosive. Fortunately, safety on the highway is not solely dependent upon imposing financial sanctions. Three other sets of social controls are relevant as well.

First, there are enormous investments in highway safety and automobile design, which seek either to minimize the likelihood of an accident or its expected severity. To the extent that one can fund these inputs through taxes and other systems, it is possible to both reduce the level of accidents and the need for compensation, and thereby to take some of the pressure off the tort system. Automobile insurance companies, for example, have long been in favor of requiring airbags,¹⁵ and they have traditionally been opposed to the minimum mileage requirements for fleets, because smaller cars (even in collisions with smaller cars) produce higher levels of accidents.

Second, other systems of social control also impose losses on the errant driver, even if they do not provide compensation to the injured party. Thus a system of licensure (or, I shall return to it later, compulsory insurance) can keep people off the highway, and thus reduce both the frequency of accidents and their severity. As before, protection from losses *ex ante* operates a substitute for compensation *ex post*, and thus reduces the dollars that have to pass through the insurance system. Similarly even people who have no money can be sent to jail for drunk driving, reckless misconduct, just driving without a license. The criminal law thus kicks in because it too is not hampered by a solvency constraint, even though it is intrinsically costly for the state to operate. But lest one be too optimistic, all offenders are not caught, and, if caught, they are not necessarily made to suffer a severe sentence.

Third, the individual driver is not in the same position as the physician in a malpractice case or the manufacturer in a product liability action. Reckless or dangerous conduct that increases the risk of loss on strangers will normally increase simultaneously the risk of loss on the driver and passengers in a car. The diminution of life's pleasures looms large even for a driver with a tiny bank account. The need for self-protection (or protection of one's one car or house) thus induces persons to take precautions that in the broad run of cases inure for the benefit of strangers as well: driving slower is in a sense a public good, because it protects the driver and pedestrian alike. A person who runs the risk of a crippling injury himself is apt to be a bit more careful than a person who knows that he is invulnerable to loss no matter how he drives. So the instinct of survival leads many people not to run red lights, even if they are judgment-

15. See *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins.*, 463 U.S. 29 (1983) (pitting the insurance companies against the automobile companies who resisted mandatory rules for their installation all through the 1980s).

proof. Yet here the self-protection proxy is again imperfect, for public goods, even though they are produced are usually underproduced.¹⁶ And some type of precautions do not operate like public goods; they may help the actor more than an outside victim. It is very easy to kill or maim a pedestrian in an accident that leaves the driver of an automobile unhurt, especially if the driver takes a (separable) precaution of wearing seatbelts, which if anything might induce faster or less attentive driving.¹⁷ There are then imperfect ways to cover the gap between what the tort system provides and what is needed to secure prudent conduct on the highway.

It would be a mistake, however, to assume that these three regulatory mechanisms, taken together, are powerful enough to obviate the need for any system of tort liability. The current organization of the system reflects the common judgment that compensation from the wrongdoer to the victim forms at least a part of the overall picture; the liability of the defendant is a deterrent, and vesting the right to compensation with the injured party increases the likelihood that it will be imposed. The tort system then remains part of the overall strategy of accident prevention. But in order for tort liability to do its job, there typically has to be insurance for otherwise a judgment proof defendant is totally outside the scope of the tort system. Yet the very act of providing insurance helps to insulate the driver of the car from the consequences of his action, for now someone else has to foot the bill for the negligence. The effort to secure compensation dulls the incentives to take care, and many of the early discussions of the enforceability of insurance contracts for third party liability turned on this moral hazard question.¹⁸

That the reduction in expected liability will yield to an increase in expected losses is surely one feature of the liability system, for it is well established that the built-in moral hazard situation (I act, you pay) always threatens to undermine insurance contracts, and it becomes critical to understand what, if anything, is an optimal response to it.¹⁹ In part the insurance company relies upon the three features mentioned above (highway and car design, licensure and criminal

16. See M. OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965).

17. On which see Peltzman, *The Effects of Automobile Safety Regulation*, 83 J. POL. ECON. 677 (1975).

18. See the exhaustive debate on the subject in *Breeden v. Frankford Marine, Accident & Plate Glass Ins. Co.*, 220 Mo. 327, 119 S.W. 576 (1909), which is analyzed elaborately in Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313 (1990).

19. See Schwartz, *supra* note 18, n. 118, noting genuine instances of moral hazard: obtaining insurance against the costs of strike induced the baseball owners to take a tougher stand in negotiation; the insurance made available to pay for the lavish expenditures that Japanese golfers are by custom obliged to provide their business associates induced caddies and golfers to collude in claiming falsely that holes-in-one had been made. More centrally, the presence of health insurance can induce high levels of use of the health services.

liability, and risk of injury to one's own person and property) to reduce the likelihood of injury enough for its (reduced) premium to cover its expected payouts. In part an insurance company relies upon a fourth feature that is easy to overlook. The existence of any system of liability insurance does not fully insulate the insured party from the consequences of his own negligence. The private assets, if any, of the insured still provide an "excess" layer of insurance over the primary levels of insurance afforded by the carrier. As reckless conduct tends to increase the severity as well as the frequency of accidents, the insured has some incentive to take care that its conduct does not generate losses that spillover the level of protection obtained, at least if there are assets worth protecting.

These multiple factors taken together, however, do not allow an insurance company to be indifferent to its book of business or to its premium rates. Underwriting and rate selection are essential tools for insurer self-protection. A bad book of business at insufficient prices is a sure way to go bankrupt in the short run, notwithstanding the comfort of the occasional bull market. Insurance companies do more than jealously contest liability and damages after the accident occurs. For their own protection they must also select their insureds, and their level of exposures for those insureds. With some lines of coverage the effective control on risk can come after the insurance policy is written. Thus where insurance companies write boiler insurance or premises insurance, a huge portion of the premium goes to the inspection of boilers to see that they do not malfunction. Similarly, premises insurance is designed to cover the losses associated with the present condition of the premises, which insurance companies can then inspect with relative ease.²⁰ But with certain lines of insurance, most notably automobile, there is little that an insurance company can do to monitor its insureds when they are driving on the highway. Of necessity insurer efforts to control risk must take place earlier in the process, most critically in the selection of whom they will insure and the rates that they charge.

In so doing, insurance companies act may be motivated by their own self-interest, but the consequences of that self-interest redound to the benefit of the public at large—at least, and it will become a very big if, if obtaining some level of liability insurance is made an explicit condition for using the public highway, if in other words there is in place a system of compulsory insurance.²¹ If

20. But they are unwilling to assume tort liability for negligent inspection, and typically contract out from it, see *Stacy v. Aetna Casualty & Sur. Co.*, 484 F.2d 289, 293 (5th Cir. 1973), or are protected by statute. ILL. REV. STAT. ch. 48, par. 138.5(a) (1989).

21. See, e.g., *In re Opinion of the Justices*, 251 Mass. 569, 147 N.E. 681 (1925), sustaining the power of the state to condition a license to use public highways on the condition of obtaining insurance.

insurance companies insist that bad drivers pay very high premiums, it creates a powerful incentive for individuals to become good drivers in order to reduce their own costs. They will take driver education classes, better maintain their own cars, and drive with greater caution than they otherwise would. Those actions of course reduce risks to other motorists and pedestrians, and thus have an external social benefit as well. Similarly, if an insurance company (or all insurance companies) decline to take a risk, they have done a social service as well, so long as the disappointed applicant is no longer able to drive.²² By keeping the worst drivers off the highway, insurance reduces the levels of fatalities, injuries and property damage below what they would otherwise be, and reduces the premiums that other drivers have to pay for their uninsured, or underinsured motorist coverage.²³

The monitoring and underwriting of the insurer, then, operates as a functional substitute for the incentives that the tort system imposes on all drivers, or at least that the tort system would impose upon them, if they were all solvent. The mere fact that so many drivers are insolvent, or practically so, suggest that the usual relationship between insurance and deterrence is inverted. When there is no liability insurance, there is a smaller deterrent for insolvent or poor drivers than when the liability insurance is in place. Insurance substitutes insurer monitoring for tort liability as the source of compliance with social norms. Where the tort liability is weak, the substitution is that more likely to produce appropriate levels of care, for a driver that faces the risk of higher premiums at renewal, and the risk of getting no renewal at all, will have a greater incentive to take care.

There is indeed a sense in which the insurance companies are not a perfect surrogate for the social concerns. The insolvency constraints that make it impossible for ordinary drivers to pay for serious accidents also operate at a lower level to constrain the market for insurance. The family with an income of \$50,000 per year cannot afford to spend all its income on insurance, or even

22. It is thus critical that there be a powerful system of sanctions against these drivers, for otherwise the mix of drivers on the road will not improve because insurers refuse to cover risks. It is an open question of what percentage of risky drivers who are refused coverage under an assigned risk plan, or cannot afford the coverage afforded under the plan, continue to drive without insurance. There is some reason to believe that these numbers will vary from jurisdiction to jurisdiction. It is certainly the case that the number of uninsured drivers on the highways continues to increase apace, and so too with the number of underinsured drivers. *See generally*, A. WIDISS, *UNINSURED AND UNDERINSURED MOTORIST INSURANCE* (1985).

23. Accident frequency depends both on what an individual driver does and on what others on the road do. A safe driver on a road populated with a group of reckless drivers has a higher rate of accidents (and will exercise a higher rate of diligence) than the same driver on a road populated with a group of equally careful drivers. Controlling the mix of drivers is of critical social importance.

a large fraction of it. The level of coverages that are required of drivers typically therefore are far lower than those which would be necessary to provide adequate compensation and deterrence in a first best world. In deciding whether it is good or bad for Jones to drive, the right question that the system has to ask is what is the comparative costs and benefits of letting Jones on the highway or keeping him off. If there is a one percent chance that Jones will cause a million dollar injury to someone this year, then the appropriate cost of personal liability insurance to Jones for driving (ignoring everything else) should be \$10,000.²⁴ But if Jones only has to purchase insurance for \$100,000 in losses, then the premium charged by the insurance company as a first approximation will be \$1,000, and Jones will drive if he can pay that amount. When the accident occurs, the insurer liability at \$100,000 is funded by the premium, but the social loss is (at least) ten times greater. It follows therefore that the major difficulty of a system of insurer scrutiny of driving risk is that it is *not* stringent enough. More precisely an insurer will take into account fully small risks covered by the policy, but will ignore those parts of the large risks that are above the policy limits. Their other sanctions mentioned above still have to kick in; yet even though they do, a well-functioning system of insurance may well leave too many drivers on the road.

At this point the case for stringent driver licensing (initially and by revocation) becomes still more powerful because the ability to obtain insurance up to some specified level does not provide complete assurance that a bad driver will internalize the costs of hurting another individual. To make the point clear, simply substitute for the phrase "risky driver" the phrase "operator of a nuclear power plant." These plants with current levels of risk could easily obtain insurance at quite substantial levels, say even several billion dollars through adroit syndication and reinsurance. Yet not even the most ardent defender of markets and nuclear power would take the position that once the private market generates insurance (even guarding against the risk that the insurance company could go belly up) that the license to operate the plant should be issued as a matter of course. The risks (*e.g.* the classic meltdown) that might come to pass are far in excess of those limits, so the insurance obtainable is rightly regarded only as a minimum condition for an operating license, and not as a sufficient

24. There is a further complication that I ignore here. The million dollar judgment is the amount of damages awarded *ex post*. It need not (often will not be) the same sum of money needed to bring the plaintiff back to the same level of utility enjoyed before the accident occurred. For parties in an injured state, the diminishing utility of money (at least after some certain stage) is so great that no amount of money will restore the plaintiff to the prior level of utility. If so, then whatever number is fixed by the tort system for solvent defendants still is below the level of the true social losses. The problem is independent of the one in the text, but reinforces the difficulty. On the implications of the diminishing marginal utility of wealth on selecting damage levels, see Friedman, *What is 'Fair Compensation' for Death or Injury?*, 2 INT'L. REV. OF L. & ECON. 81 (1982).

condition. Direct forms of safety standards, reviews and inspections are without question an essential part of the overall picture, and the only real debate is the exact form that these ought to take.²⁵ In principle this argument carries over to automobile drivers as well. The smaller risks of mayhem are counterbalanced by the smaller resources, even with insurance, to counter them.

II. ASSIGNED RISK POOLS: THE INSURER AS COMMON CARRIER

As a matter of theory, it has been established that insurance against losses wrongfully caused should not be a sufficient condition for the award of a driver's license, taking into account the chances of small, but catastrophic risks that their conduct can impose upon others. But while nuclear power plants do not vote, potential drivers and their families do, and their pressures are exerted at every stage of the political process. Licenses are not all that hard to acquire in the first instance, even for drivers in high risk groups, but they are not easily suspended or revoked, even after a history of serious accidents.²⁶ The political pressures are such that once the legal system imposes a requirement that there be compulsory insurance, it then raises the expectation that all licensed insurers are common carriers under an obligation "to take all comers" at a risk, even if they in their underwriting discretion would choose to turn it down.²⁷ While the basic theory of deterrence suggests that the willingness to provide insurance is not a sufficient condition to grant a license, in practice the ability to obtain limited automobile liability insurance in a voluntary market is not even a *necessary* condition for obtaining a license. Instead one of the dominant features of the insurance system is the assigned risk pool, whereby certain classes of eligible drivers are awarded insurance coverage at prices below what the insurance company would demand for the insured level of risk, and a fortiori below the level of insurance necessary to cover the full risks that the driving would impose upon the public at large.²⁸

25. A discussion of the current regulatory scheme is found in *Duke Power Co. v. Carolina Environmental Study Group, Inc.* 438 U.S. 59 (1978) upholding the Price-Anderson Act, 71 Stat. 576, 42 U.S.C. § 2210 with its damage limitation provisions, and describing the overall system of nuclear power regulation under the Atomic Energy Act of 1954, Act of August 30, 1954, ch. 1073, 68 Stat. 919, as amended, 42 U.S.C. §§ 2011-2281 (1970 ed. and Supp. V).

26. See, e.g., *Bell v. Burson*, 402 U.S. 535 (1971).

27. See FAIRA, *supra* note 1, § 27.

28. The basic mandate of the California Assigned Risk Pool reads as follows:

The commissioner, after a public hearing, shall approve or issue a reasonable plan for the equitable apportionment, among insurers admitted to transact liability insurance, of those applicants for automobile bodily injury and property damage liability insurance who are in good faith entitled to but are unable to procure such insurance through ordinary methods.

CAL. INS. CODE § 11620 (West 1988).

On the meaning of "in good faith entitled" to insurance, see *infra* note 34.

The actual operation of an assigned risk pool is tricky business because of the built-in shortfall between the premium charged and the risk that is covered. Since assigned risk pool business is losing business, no insurer will voluntarily undertake to insure it. Therefore some mechanism has to be developed at the state level to decide *who* will take which risks. The standard statutory response is to assign the risks by rotation, taking care to see that insurers are not required to enter into new lines of insurance or to write business in territories in which they do not participate in the voluntary market.²⁹ Thereafter the assignments are made so that the amount of business that one has to take in the assigned risk pool are roughly proportionate to the share of business that the insurance company has in the voluntary market.³⁰

This use of this scheme of assignment is critical for the ability to maintain a stable relationship between the voluntary and the assigned risk portions of the market. To see why this is the case, assume that the losses associated with an assigned risk pool were treated as a fixed charge (\$X dollars per year) against the income of any insurance company, wholly without regard to the amount of automobile insurance that it wrote or continues to write within the state. At that point there would be no way in which the insurers could recapture any portion of the assigned risk pool losses in the highly competitive, unregulated voluntary market.³¹ Thus suppose that a firm with a fixed bill of \$1,000,000 in the

29. See, e.g., CAL. CODE REGS. tit. 10, § 2445.1(a) (1991), which provides in relevant part: "Insofar as possible, assignments shall be consistent with the scope of operations and underwriting policies of each insurer, of which the Manager shall have been notified in writing." *Id.*

30. See CAL. CODE REGS. tit. 10, § 2430 (1991), which provides in relevant part:

As a prerequisite to consideration for assignment under the Plan an applicant must certify, in the prescribed application form, that he has attempted, within sixty days prior to the date of application to obtain automobile bodily injury and property damage liability insurance in the State and that he has been unable to obtain such insurance through ordinary methods. An applicant so certifying shall be considered for assignment upon making application in good faith to the Plan. An applicant shall be considered in good faith if he reports all information of the material nature and does not willfully make incorrect or misleading statements in the prescribed application form, or does not come within any of the prohibitions or exclusions listed below.

Id.; CAL. CODE REGS. tit. 10, § 2445(a) (1991) which provides in relevant part:

The manager shall assign the risks which are eligible for assignment in such sequence and number that, as far as practicable, each insurer shall in the long run be given that number of assignments which will develop automobile liability premiums bearing to the total automobile liability premiums developed on all assignments, the same ratio as the insurer's net direct automobile liability premiums in California bear to the total net direct automobile liability premium writings in California of all insurers.

Id.

31. Note that the insurance industry in California has some 3,600 different firms. See Zycher, *Automobile Insurance Regulation, Direct Democracy, and the Interests of Consumers*, REGULATION 67, 73 (Summer, 1990). The extensive use of brokers makes it relatively easy for consumers to obtain comparative quotations for coverage.

assigned risk pool believes that it will write 10,000 policies in the voluntary market. It therefore would have to charge \$100 per policy to cover its assigned risk losses. But the moment it includes that cost component in its rates, another company will realize that it can rake off additional business by asking for only \$50 from each customer in the voluntary market toward its assigned risk losses. But faced with a loss of all recoupment, the first firm will seek only \$25 until the premium is quickly bid down to zero.

Stated more technically, making the losses from the assigned risk pool a fixed charge on the business of an insurance company has no effect on its business decisions at the margin. Whatever prices maximized its profits before the fixed charge was imposed will continue to maximize its profits thereafter. The profits will be reduced by the full amount of the charge, just as if it were the payment of an unrelated tax or tort judgment. The long term position in the industry is therefore for some firms to exit because the combined rate of return from the voluntary and assigned risk markets is below the competitive rate of return on capital in some other line of endeavor.³² That in turn puts greater pressure on the remaining firms that have to absorb larger shares of the assigned risk pool.

We have of course had assigned risk pools in insurance for well over fifty years, and automobile insurance markets have not yet collapsed. The reason is that the costs of writing business in the assigned risk pool are not fixed but variable. The standard formula, set out above, in effect provides that the more business that is written in the voluntary market, the larger fraction of the assigned risk that must be taken. Each firm knows therefore that as it expands its scope of business it will be saddled with more of the loss -- a kind of perverse return for excellence. Once the assigned risk pool are parcelled out in this matter, the market should exhibit certain stabilizing features, for this tied price structure precludes the possibility that the necessary premium in the voluntary market will be bid down to zero, and it is important to note why.

The explanation goes as follows. So long as the share for each firm in the assigned risk market is fixed, anything it gets in the voluntary market will reduce that loss resulting in the predictable cycle of bidding down the surplus through competition. But if the share of the assigned risk market is tied to the

32. This discussion presupposes that it is costless to exit. In New Jersey FAIRA contains provisions that allow the Commissioner to order the exiting firm to continue to pay additional sums for past losses, and to surrender its licenses on other unrelated lines of business. If valid, these provisions effectively limit the exit option, and allow the state to confiscate a substantial portion of the insurance company's assets through regulation. Indeed even where there are no legal restraints or taxes on exit, the option is still costly, for it is no easy business to disentangle oneself from a myriad of ongoing obligations to insureds, landlord's, employees, pension funds and the like.

fraction of the voluntary market, then getting more business in the voluntary *increases* the costs to the carrier, for each new customer. The assigned risk pool obligation is no longer a fixed cost of doing business. It becomes a variable cost that has to be taken into account with each new policy that is written. To compensate for those variable costs, the carrier will have to price each of its policies in the voluntary market at a level that reflects the new exposure that it simultaneously incurs in the assigned risk market. If for each 10 policies in the voluntary market, the insurer gets an additional one in the assigned risk market, then a \$1,000 loss per assigned risk policy translates into an implicit \$100 tax on each policy in the voluntary market. The insurance firm therefore must price its voluntary policies to take into account that tax on additional sales, just as it takes into account any premium or other excise tax that is levied on the business that it does. As a first approximation, the voluntary market remains stable and can generate sufficient gains to offset the losses in the assigned risk market. As a kind of an added bonus, if the size of the voluntary sector increases, then the actual burden of writing any individual policy should be reduced at the margin.

It should not, however, be supposed that all is well with this system, for there are corrosive effects of this strategy for controlling assigned risks that have to be taken into account as well even in stable political environments. A tax (even if disguised as an obligation to assume losing business) creates a wedge between the amount that the seller of the good or service receives, and the costs that are paid. The former figure is always lower than the latter. In effect buyers of insurance act as though, for example, the cost is \$600 while sellers respond as if the amount received is \$500. It follows therefore that in those cases where the insurance would be available on mutually satisfactory terms for any figure between \$500 and \$600, the market will break down, as the seller will not supply at \$500 (plus the tax of \$100) the insurance at a price the buyer (under \$600) will pay.³³ It follows therefore that some additional individuals (who "in good faith are entitled to insurance in the voluntary market," i.e. without the tax) will be thrown into the assigned risk pool because of the presence of this implicit tax, and this will in turn increase the amount of the tax that has to be provided. It also follows that the profitability of the insurance business will be reduced, as is the case with all taxes. Nonetheless, it is clear that if the levels of participation in the assigned risk pool are limited, as by rules that require insureds to seek out coverage in the voluntary market,³⁴ and if the rates in that pool are kept high enough, then it is possible for both the voluntary and the assigned risk markets to be maintained at least in the short run, which

33. The point is but another illustration of the familiar problem of the resource loss caused by the "excess burden" of taxation. See generally, J. GWARTNEY & R. STROUP, *ECONOMICS, PUBLIC AND PRIVATE CHOICE* 110-11(4th ed. 1987).

34. See CAL. CODE REGS. tit. 10, § 2430 (1991), *supra* note 30.

is an outcome that is not possible if insurance companies that were assigned assumed a fixed fraction of the assigned risk pool debt.

There is, however, a structural risk that has to be taken into account as well, and in hard times it will (and has) proved enormous. The argument above assumed that the amount of loss for each policy in the assigned risk pool was a constant, so that firms with large books of business could estimate with a fair degree of precision their expected liabilities and respond to them accordingly. But the rates in the assigned risk pool are not set by private agreement, but rather by state fiat, and the size of the membership in the assigned risk pool may well vary with state regulations and underwriting practices. If the swings in a given year are great, then bad forecasting could result in substantial assigned risk pool losses that are not made up in the voluntary market.

The long term risk has immediate consequences for the behavior of insurance companies. Even if the piling on does not take place in each year, the risk of it can never be ignored. Insurance companies cast a watchful eye on their assigned risk burden, and have a strong incentive *not* to expand their customer base in any jurisdiction where the assigned risk pool liability could be increased through regulatory intervention. The upshot therefore is that regulation of the assigned risk pool sector can reduce the amount of competition in the unregulated sector, leading to a deterioration of price and quantity. The potential effects of regulation thus lead to a reduction in the price and quality of service, and for a call for further regulation.

The California situation is instructive of the nature of these persistent risks. Between 1983 and 1989, there were five hefty requests for rate increases in California, which were largely or completely denied.³⁵ At the same time there were massive increases in the number of new applicants into the assigned risk pool,³⁶ given that the rates were kept systematically below those in the

35. The tabular form of the data reads as follows:

Request Date	% Requested	% Authorized	Effective Date
April, 1983	33.7	8.4	March, 1984
July, 1984	15.0 + 15.0*	13.9	January, 1985
May, 1985	62	10.7	February, 1987
December, 1986	25.0 + 25.0*	18.5	December, 1987
February, 1989	112.3	denied	in litigation

* Single request for two increases over a six-month period.

Taken from Zycher, *supra* note 31. (His table is taken from LeBoeuf, Lamb, Leiby, & McRae).

36. The relevant numbers are as follows:

Year	Dollars (000)	Percentage Change
1983	94.4	-
1984	136.7	44.8
1985	329.3	140.9
1986	323.8	(1.7)

voluntary market.³⁷ The net effect was substantial losses in the assigned risk market, as the deficit increased from \$30 million in 1983 to about \$600 million in 1989,³⁸ and the overall rate of return on the entire book of business reduced sharply over that period. The problems on the rating side were compounded by the ever-increasing costs in the essential components of the basic coverage for both property damage and bodily injury.³⁹

Insurance is, moreover, no protection against either the regulatory or the cost risk. Any carrier therefore that has a large share of the market may find that it has not charged enough in the voluntary market to handle these unexpected swings in the assigned risk pool. Insurance works as a mechanism to overcome risk aversion where there are independent and uncorrelated risks,⁴⁰ but it cannot discharge that useful social function where systematic changes in the legal rules and cost structure effect all risks in the same fashion. Now its dominant effect is exactly the opposite. Insurance reduces the level of risk diversification below that which would be obtained if no one had any insurance.

There is another criticism applicable to the present method of funding the assigned risk pool. If there is some social determination that risky drivers should be left on the highways, then why should the cost of that decision (already concealed by insufficient levels of insurance) be further buried by building the cost into the premiums charged in the voluntary market? A simpler way to handle this question is to pass a direct financial appropriation, funded by general tax revenues, which pays to insurance companies a figure equal to the difference between the premium paid by the private buyer, and the amount demanded by the insurance carrier.⁴¹ Or if that proposal turns out to be too difficult to implement in practice, it becomes possible for the state to make a

1987	425.7	31.5
1988	781.2	83.5
1989	1,233.4	57.9

37. During 1990, there has been some stabilization in the new applications to the assigned risk pool in California because CAARP has been allowed to demand certification that new applicants were turned down in the voluntary market within the past 60 days. See *supra* note 34. But the underlying problem still exists, given that the voluntary market has higher rates than the CAARP market. The regulatory implications of the problem are discussed *infra* notes 66-74 and accompanying text.

38. Zycher, *supra* note 31, at 69.

39. See Zycher, *supra* note 31, at 67-68.

40. For the a discussion of the point, see Danzon, *Tort Reform and the Role of Government in Private Insurance Markets*, 13 L. STUD. 517, 536 (1984).

41. I have made the same proposals for insurance for AIDS patients, and for compensating landlords for rent control. See, Epstein, *AIDS, Testing and the Workplace*, 1988 U. CHI. L. FORUM, 33, 50-56; Epstein, *Rent Control and the Theory of Efficient Regulation*, 54 BROOKLYN L. REV. 741, 750-55 (1988). The same suggestion is made by Justice Scalia in *Pennell v City of San Jose*, 485 U.S. 1, 20-24 (1988).

direct payment of \$X million per year to insurance carriers in order that they write so many assigned risk policies at stipulated rates for a given period. The business goes to the company that makes the lowest bid. Finally, the state can run the assigned risk pool itself (with disastrous results), as the New Jersey experience reveals.⁴²

All of these alternative financing systems have one common feature that the traditional assigned risk pool lacked. They force the cost of subsidizing high driving risks into the political system where they must be taken explicitly into account. It is always easier to make A subsidize B than to provide that subsidy to B out of your own pocket. Likewise, it is always easier for legislators to force the costs on out-of-state businesses than to pass them back to their own electorate. Making decisionmakers bear the cost always has desirable, and sobering political consequences. But this desirable structural feature of any funding system has been its political undoing. It is not possible within ordinary legislative politics to transform an inchoate obligation into a direct tax liability.⁴³ But if the direct method is unsalable, then why should one wish, from a social perspective, to adopt other systems that conceal the true costs (and the true losses) associated with liability systems?

The total cost of the insurance is always a powerful concern because of the solvency constraints noted above, and the stability of the voluntary markets is compounded by the drag imposed upon them in the assigned risk pools. There have been strong, even violent, political responses to the rates that have been charged in both the voluntary and assigned risk markets. These rates have for the most part been set in highly competitive markets, and there has been no evidence that any insurance companies have earned any super-normal rate of return on their automobile lines.⁴⁴ Nonetheless, various forms of direct regulation have been tried to cap overall cost in both the voluntary and assigned risk markets, and it is instructive to review what has happened to them here. Indeed it can be said that in New Jersey and in California, the proper treatment of the assigned risk pool is one of the major pieces in the current wave of automobile insurance legislation. In both cases a fair bit of institutional detail must be set out before the legal and economic issues can be fully understood.

New Jersey. The situation in New Jersey is both dramatic and explosive. New Jersey is by population one of the densest states in the union, and its

42. See *infra* notes 45-65 and accompanying text.

43. Governor Florio's popularity in New Jersey has dropped, and other democratic candidates for office within the state have largely shunned him, in large part because he raised taxes within the state to fund education and other parts of his extensive reform agenda. See N.Y. Times, Nov. 3, 1990 at 27 col. 3.

44. Over the past few years in California, for example, the rate of return on insurance within the state has averaged 11.2 percent.

insurance rates have long been the at or near the highest in the nation. With high rates and a strong tradition of rate regulation, the proper treatment of the assigned risk pool and its anticipated losses has been an item of the highest priority. Before 1983, the assigned risk pool required that various high-risk drivers be apportioned among the insurers that did business within the state, but the market was unstable; several major insurers had left the state, and assigned risks were becoming ever harder to place. In 1983, the New Jersey state legislature responded to this problem by creating for automobile insurance a state wide Joint Underwriting Association that was to undertake the direct writing on assigned risk policies itself.⁴⁵ Under the provisions of the statute, the insurance carriers doing business in the state were kept on as "servicing carriers," who by contract were obliged to handle the paperwork with respect to parties coming into the assigned risk pool, and in the processing and paying out of claims, for which the companies were paid fees, based on the size of the premium collected or the settlement made.⁴⁶ The insurance risk, however, was left explicitly with the state. The statute provided that

No member company shall be liable for any losses, loss adjustment expenses, claims, or expenses of any kind incurred by or on behalf of the [JUA] The [JUA] shall have no power to impose such liability upon any member company by means of fees, assessments, or any other claim on the member company's income, assets or surplus.⁴⁷

The contracts between the individual carriers and the JUA reflected the underlying legal position by providing that the carrier "shall have no individual liability for claims or policies written by or on behalf of the [JUA]." The JUA was operated by a Board of Directors who, with the exception of an *ex officio* member, received their appointments from the Governor, the Speaker of the Assembly, or the President of the Senate. The decisions made by that Board was then reviewed by the Commissioner of Insurance who had the power to approve or override it, a conscious feature of institutional design that consigned the panel to a powerful, but nonetheless, advisory role. The statute also provided that the JUA was charged with developing appropriate standards for setting up "actuarially sound reserves" sufficient to account for both present and future claims (*i.e.* for incurred but not reported losses)⁴⁸ and the entire operation was to be run on a "no loss, no profit" basis.⁴⁹ The revenues to fund the JUA were to come from two sources, first the premiums charged to drivers insured by the JUA and second from a residual market equalization

45. See N.J. STAT. ANN. § 17:30E (West Supp. 1990).

46. See N.Y. Times, Aug. 21, 1990 at B1, col. 2 (providing an outline of the system).

47. JUA Plan of Operation, Art. Vi, ¶ 3.

48. See N.J. STAT. ANN. § 17:30E-7(r) (West 1985).

49. N.J. STAT. ANN. § 17:30E-3(o) (West Supp. 1990).

charge (the so-called RMEC) which could be imposed as a separate tax on drivers who were insured in the voluntary market.⁵⁰ As the it was quite clear from the outset that the premiums charged in the assigned risk market would have to fall short of covering all losses and expenses (for otherwise the voluntary market would continue to operate), the RMEC had to be a part of the system. The statute also authorized that the Commissioner imposed the RMEC if there was any loss existing within the system, and to increase that RMEC if the losses (as determined by reports filed by the JUA Board of Directors) continued.⁵¹ The Commissioner, over the objection of the board, refused to levy a RMEC when the first losses in the system were reported in 1985, and he was able to win a proceeding in the Superior Court⁵² which allowed (in apparent conflict with the statute) the Commissioner not to impose the RMEC so long as the pool was able to pay off its current debts. All future losses from past years were therefore unfunded, and it was only a matter of time before those losses poured in without the resources to meet them. If the normal standards of insurance accounting applied to the New Jersey assigned risk pool, it was in essence born in insolvency. As the political and economic pressures mounted, the Commissioner relented and imposed the RMEC, albeit in insufficient amounts in 1988, equal to about \$225 per car. But the initial shortfall was never negated by the subsequent assessments.

Small differences in institutional design had enormous consequences for the operation of the assigned risk pool system. In the ordinary assigned risk pool, individual carriers have every incentive to build the assigned risk losses into the price they charge in the voluntary market.⁵³ But with the RMEC, a political decision had to be made by the insurance commissioner to reach the same effect. Deferring the RMEC was politically preferable, and so the deficits became inevitable. By the time of the Fair Automobile Insurance Act of 1990, pushed through the legislature by recently elected Governor Florio, the JUA had an accumulated debt of some \$3.5 billion, which had to be paid off by someone somehow.

FAIRA imposed a welter of restrictions on the way in which insurance was to be sold within New Jersey. A special 5 percent surtax was added to the cost of insurance, and the statute contained a specific injunction that it could not be passed through to customers.⁵⁴ In addition, FAIRA levied a \$900 million special assessment against the former members of the JUA to reduce the prior

50. N.J. STAT. ANN. § 17:30E-8(b) (West Supp. 1990).

51. *Id.*

52. *New Jersey Auto. Full Ins. Underwriting Ass'n v. Gluck*, No. A-4870-84T1 (N. J. Super. Ct. App. Div.), *cert. denied*, 107 N.J. 41, 526 A.2d 133 (1986).

53. *See supra* pp. 13-14.

54. *See FAIRA*, *supra* note 1, § 78 ("The Commissioner of Insurance shall take such action as is necessary to ensure that private passenger automobile insurance policyholders shall not pay for the surtax imposed pursuant to section 76 of this 1990 amendatory and supplementary act.").

shortfall. The justification afforded for the charge was that the servicing carriers had made that amount in "overcharges" attributable to its "mismanagement."⁵⁵ The statute did not impose these charges direct against the companies but instead constituted them as a loan to the New Jersey Automobile Insurance Guaranty Fund, without obligation to be repaid, against the New Jersey Property-Liability Guaranty Association, which all automobile insurance writers are required to join.⁵⁶ The statute also provides that any insurance company that wishes to cease doing automobile business within the state "may" be required by the Insurance Commissioner to surrender its license to write any other line of insurance (e.g. homeowners) within the state,⁵⁷ a threat which when directed to the Hartford Insurance Company persuaded them to continue to write automobile insurance within the state in order to be allowed to continue to write its far larger and more profitable pension and health insurance.⁵⁸

The legal challenges that have been brought against this portion of the statute by the covered insurers have centered around two related ideas: the impairment of contract and the taking of property without just compensation or due process of law.⁵⁹ The basic argument with respect to the \$908 assessment is that it flies in the teeth of the original agreement under the 1983 statute in which the servicing carriers were ostensibly insulated from the losses incurred by the JUA. By imposing the tax, New Jersey has rewritten the terms of its

55. See FAIRA, *supra* note 1, § 21(a) which makes these findings in the body of the statute.

56. See N.J. STAT. ANN. § 17:30A-6 (West 1985).

57. See FAIRA, *supra* note 1, §§ 71, 72.

58. See N.Y. Times, Aug. 21, 1990 at B1, col. 2 (The Hartford wrote \$17 million in auto insurance and \$308 million in other coverage).

59. In *State Farm Mut. Ins. Co. v. Fortunato*, No. C-90-0085, slip op. at 6-11 (Mercer County Ct. May 31, 1990), the Court rejected any facial constitutional challenges. The relevant passage reads as follows:

That there is to be no liability on the insurance policies of the JUA by the servicing carriers is of no doubt. See *Bidnick v. Hanover Ins. Co., Inc.*, 230 N.J. Super. 111, 115 (App. Div. 1989). But should the State be permitted to break its word when their appears to be a financial gain, to its self-interest? Whether or not the JUA is a "state agency," the express terms of the agreement and the enabling statute led the servicing carriers, like plaintiff, to agree to service the JUA policies. If they overcharged while servicing the JUA, the Commissioner can seek to recover the overcharges he can prove. But the JUA was to operate on a no gain, no loss basis, and each insurance company was to collect the RMEC [Residual Market Equalization Charge] funds from its customers in order to make up any JUA losses. By changing the methodology of offsetting losses, FAIRA operates retroactively and says that the State's prior representations in that regard were meaningless. Is this basically unfair and unconstitutional pursuant to the rule of *United States Trust Co. [of New York v. New Jersey]*, 431 U.S. 1, 25 (1977).] This court thinks not.

Id. at 6-7. The opinion then explains that the state can nullify its contracts so long as it promises the carriers "a fair rate of profit." The feasibility of that argument is examined *infra* notes 59-60 and accompanying text. The basic test of *United States Trust* is "whether such an impairment is 'reasonable and necessary to serve an important public purpose.'" *Id.* at 3.

own contract, unless it could show that insurer mismanagement of underwriting and claims (instead of underfunding) was the source of the programmatic loss. But that finding (which seems hard to believe on the facts) would require a separate proof against each individual carrier, and there is no obvious reason to believe that the errors, if any, made by one carrier were of the same severity and magnitude made by any other carrier. In any event, if the state brought its claim as an ordinary breach of contract action, the entire matter would be subject proofs of the sort that were not involved in the "legislative findings" that accompanied the legislation.

One possible way to avoid the problem of contractual impairment is to argue that the assessment should not be linked to past performance under the JUA, but rather that it is a special tax imposed on the industry wholly without regard to past contractual performance. Emancipating the tax increase for past industry performance, however, only increases the returns to, and hence the scope of, factional conduct, for now the tax could be set for any amount at all, including sums larger than the \$900 sought in the present assessment, without even trying to "show cause" by linking the assessment to some past industry abuse.

Yet here the answer (at least in a world of fairly strong constitutional protection) is that the theory of taxation must be integrated with the general theory of regulation. If it is a constitutional norm that rate regulation requires the regulated entity to recover a just return on its invested capital,⁶⁰ then it *cannot* be the case that this requirement can be circumvented by granting rates at the permissible level only to subject to revenues so collected under the rate order to a special assessment that is not borne by any other industry. To tolerate that combination of taxing and regulatory policies is to authorize the state to take with one hand what it is required to give with the other, and to render pointless the constitutional protections against confiscation. The rate of return could be calculated at 100 percent in a fit of constitutional generosity only to be undermined by a 99 percent special tax which leads a net rate of return of 1 percent to the regulated industry. The only way to avoid that one/two punch is to prevent special assessments from being levied against the regulation industry, which can be made to pay only those taxes that are collected from other business entities within the state, on a general nondiscriminatory basis.

At some level it appears that New Jersey recognizes that it cannot ignore its constitutional obligation to provide its regulated insureds with a just rate of return. The issue therefore turns to the way in which this constitutional obligation is discharged. The simplest approach is to separate the losses from previous years from its present business, and to fund them separately by taxes

60. See *Smyth v. Ames*, 169 U.S. 466 (1898); *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591 (1944); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).
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raised out of general revenues.⁶¹ That approach, however, was rejected in the FAIRA legislation that sought to impose huge portions of the JUA losses on the insurers. The second alternative is to build the moneys taken by the special assessment back into the rate base, so that the insurers would in effect be allowed to price their product to recover a fair rate of return on the forced loans to the state. It was just that position on which the current litigation in New Jersey is now proceeding.⁶²

This approach is plagued, I believe, with fatal difficulties. In principle, if the system of rate regulation worked perfectly, then there should be no difference in outcomes between the two approaches. The rate regulation system would take into account the riskiness of the loans, and would ask whether or not the increase in insurance rates that would have to be authorized could in practice be recovered in the competitive market. The companies that paid today would get their money back with interest tomorrow.

But the world is full of institutional imperfections, and when these are taken into account, it is clear that adding the special assessments into the rate base is a poor substitute remedy for not making the assessments at all. If New Jersey could not make its special assessments and did not choose to levy taxes to cover the JUA shortfall, then it could go to the capital markets. Those markets would charge a rate of interest commensurate with the risks of the loan, which would depend upon its term of repayment and the security offered by the state. New Jersey would then have an incentive to obtain the best mix of low interest rates and favorable credit terms, and the past transactions would be off the books.

The moment these special assessments are included in the rate base, any independent assessment of their adequacy in the capital markets is necessarily sacrificed. Now the Insurance Commission, itself an interested party, has to determine the suitable rate of (risk adjusted) return, and to determine the set of rates that are necessary to sustain that return. The problem here is by no means an easy one if each company has a fixed obligation to pay some portion of the special assessment, based solely on its past business within the state. Even if high rates were authorized, there is no reason to believe that they would be collected, given market pressures. The companies would have an incentive to compete away the authorized gains, if (as discussed earlier with assigned risk pools)⁶³ their obligations do not vary with the number of policies they write or the premiums that they collect.

61. See discussion *supra* pp. 17-18.

62. This question was left open in *State Farm Mut. Ins.*, slip op. at 8. The decision concluded: "Therefore, there has to be a judicial hearing as to whether or not the plaintiff can get a fair rate of return via an application for a rate increase when the surtax it must pay is excluded from the rate base."

63. See *supra* pp. 12-13.

But suppose that the rate increase could not be competed away. Even then the proposed remedy is constitutionally defective. The rate of return offered under the regulation operates as the "just compensation" for the capital that is committed to the business. The relevant inquiry is, what is the likelihood that a correct rate determination will be made by the political process? Here there are three possible outcomes to the ratemaking determination: the state could set the rates too high, or too low, or just right. If one thought that the errors in the process were randomly distributed about the proper mean--the just rate of return--then there could be no principled objection to first adding the assessments into the rate base, and then compensating insurers for their capital conscripted into the state's business. The process would be a forced loan at the ideal market rate of return.

Owing to the inherent features of the political process, however, the errors of course will not be random. Take the possibilities in turn. New Jersey has no reason to allow rates that permit excessive rates of return on the forced loan; it would hardly expend resources to coerce a transaction from which it emerged the net loser. It is cheaper for the state to go into the capital markets on its own account, for it will obtain a lower interest rate and incur lower administrative costs. So with the one possibility out, New Jersey, with due regard to the welfare of its citizens, will either set rates just right or too low. But we can rule out the second possibility as well, for if the state sets them just right then the citizens of New Jersey will emerge the losers because they will have to pay in addition to the interest charges on the debt, the heavy administrative costs necessary to make this regulatory system work.

The only way therefore that New Jersey could come out ahead is for the state to provide a below market rate of return for its forced loan. It follows therefore that the regulatory process can at best yield outcomes that are equal to those of having New Jersey go to the capital markets, but that it is far more likely that it will use administrative delay and accounting wizardry to force down the rates of return below the constitutionally permissible level. Since money is fungible, the entire risk of systematic undercompensation could be avoided if New Jersey were forced, as a constitutional matter, to go to the capital markets to fund its own deficits. Since financial markets are always open, the courts should strike down a statute that allows money to be put into the rate base to pay off a past indebtedness. The incentives created by the regulatory structure will lead to systematic confiscation that no court can fully detect or prevent. This is not a case where the government power is invoked because private markets are not available to the state to meet its needs. It is a case where government regulation is invoked because the state does not like the message that it hears in private markets.

I have said enough to indicate that the political pressures generated in the attempt to gain control over the assigned risk markets are apt to lead to

systematically undesirable results, for insurers and the public at large. It must be stressed again, however, that any relaxation of the constitutional standards used to create weaknesses in funding the assigned risk pool are not solely on a concern of the insurance companies (and their multiple shareholders, including state pension funds) that bear the brunt of the state regulation. The present structure of takings law makes it difficult for any insurer to attack state regulation on the grounds that it creates distorted incentives in the underlying accident market. But nonetheless that precise effect takes place. The insistence that insurance be provided to assigned risk drivers at below market rates will result in a greater number of these drivers on the highway, with some predictable increase in accident and mortality rates.⁶⁴ The longer the state is able to extract a subsidy for the assigned risk pool, the greater the opportunities for these more dangerous drivers to inflict harm upon the person and property of other individuals.

The message should be clear. The distortions in the accident market go hand in hand with the distortions that are generated in the political markets that drive insurance regulation. Although the protection that is afforded to property holders under the constitution is for their benefit, one should not ignore, especially in this context, the close and intimate connection between the book of business that they are forced to write and anticipated increases in the frequency and severity of accidents that take place. Empirical evidence on this connection is doubtless hard to get, but in theory the direction of the effects is clear and as the size of the subsidy increases, so too should the magnitude of ensuing distortions. As a matter of first principle, there is a necessary linkage between the just compensation rule for regulatory takings and the efficient operation of the tort system. Affording insurers protection against regulatory confiscation is a good proxy for promoting the efficiency of the tort system. The system-wide changes that place outside the tort system have far more to do with the level of accidents that occur (I would hazard the guess) than any internal reformulation of the tort (or no-fault) law⁶⁵ that governs the underlying situation. It is a

64. The exact extent of the loss is difficult to calculate. As a first approximation, the increase in the percentage of high risk drivers should lead to an increase in the overall rate. That effect will be compounded because the accident rates of everyone should increase, given the larger percentage of poor drivers on the road. But the effects here will be reduced by some degree if the drivers who are unable to obtain insurance through the assigned risk pool drive without insurance in violation of state law. But given the criminal sanctions in place, at least some fraction of those drivers would probably exit the market, and others might drive somewhat less often given their fear of sanctions. Clearly any system of insurance regulation must be coupled with a set of sanctions against driving without a license.

65. For a comparative look, note that one estimate of the possible rate of accident increase from the automobile no-fault statutes placed it as high as 10 percent, see Landes, *Insurance, Liability and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault Accidents*, 25 J.L. & ECON. 49 (1982). Even if that estimate is high, an increase of the accident rate by 5 percent is still serious business. The assigned risk pool subsidy appears to work a greater change in composition of the driving pool than no-fault insurance, especially since no no-fault system has displaced the tort

mistake to concentrate too closely on the details of accident law to identify the determinants of accidents. The litigation of the assigned risk pool dominates the overall situation.

California. The proper treatment of the assigned risk pool is also critical for understanding the complex web of events in California. In order to understand the full set of relationships, it is necessary first to summarize the regulatory scheme in California under Proposition 103. Its central provisions called for (1) an immediate, one time, one year 20 percent rollback in all rates in the voluntary markets, and (2) implementing a general system of rate of return regulation in insurance markets, and (3) powerful restrictions on underwriting discretion. The first, contained in 1861.02, is directed to specific weighting factors

(a) Rates and Premiums for an automobile insurance policy, as described in subdivision (a) of Section 680, shall be determined by application of the following factors in decreasing order of importance:

- (1) The insured's driving safety record
- (2) The number of miles he or she drives annually
- (3) The number of years driving experience the insured has had.
- (4) Such other factors as the commissioner may adopt by regulation that have a substantial relationship to the risk of loss. The regulations shall set forth the respective weight to be given each factor in determining automobile rates and premiums. Notwithstanding any other provision of law, the use of any criterion without such approval shall constitute unfair discrimination....⁶⁶

In addition Proposition 103 contains a general section on discriminatory rates that is tied into section 1861.02. Section 1861.05 provides:

No rate shall be approved or remain in effect which is excessive, inadequate or unfairly discriminatory. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income.⁶⁷

Proposition 103 thus structures the rating process so that only those variables that fall within the "control" of the insured are taken into account in setting rates. Nonetheless there are serious, indeed insuperable objections to this rating system. First, the requirement that insurers use the specific factors in the

rules altogether.

66. CAL. INS. CODE § 1861.02 (West Supp. 1991).

67. CAL. INS. CODE § 1861.05 (West Supp. 1991).

order listed, with additional factors to be added by administrative regulation,⁶⁸ deviates from standard actuarial methods. Thus, the three factors that are explicitly listed account for less of the total variation in accident behavior than many of the factors that are kept off the list.⁶⁹ In addition, those factors which have proved most probative in traditional pricing schemes -- territory, age, gender and marital status -- have been explicitly repudiated by the Commissioner under the discretion vested in her by Proposition 103.⁷⁰

To make matters worse, Proposition 103 does not set the relative importance of the stated factors. Instead it only indicates their rank order significance. It is therefore an open question as to how much more important 1 is than 2 or 3 than 4. In addition, the priorities of the system are critically dependent upon the number of factors that are taken into account in 4. If each factor is weighted individually, then the priority system outlined by Proposition 103 can be undercut, for any close positive correlation between the separate factors makes their impact largely duplicative. To deal with this problem, the regulations under Proposition 103 take the other relevant factors into account on a "tempered" basis, that is one, where their combined influence was kept to a level lower of that of the third mandatory factor, even though it represented a substantial deviation from usual cost-based actuarial methods. The net effect of tempering the relevant cost variables has been to induce a rate increase in the non-urban areas and a corresponding decrease in the urban areas, itself a distortion of the underlying insurance markets. The Commissioner has taken the position that since the purpose of Proposition 103 is to benefit all Californians, the decreases should stand, but the increases should be disregarded. Accordingly, she has adopted a two-part strategy that in effect "forbids

68. The Commissioner has added a list of 19 factors, including such things as make and model of vehicle, its age, design characteristics, alterations, type of use, repair and medical rates, litigation rates, population and vehicle density. See CAL. CODE REGS., tit. 10, § 2632.6(c) (1991) (containing the complete list).

69. See CAL. CODE REGS. tit. 10, § 2632.1 (1991). The Regulations refer to the results of a three member panel organized by the Commissioner to examine the rate structure. Its conclusion was as follows:

All three members agreed that the three Mandated Factors required by Proposition 103 were not necessarily those which would be the three dominant factors if the ratings were made purely on a cost-based approach. Further, all three members agreed that it was quite possible that one or more of the Optional Factors would, on a cost-based approach, warrant a greater "weight" than one or even all three combined of the three Mandated Factors. Based upon the evidence adduced in the hearings, the Commissioner finds this result very likely.

Id.

70. See *id.* The explanation given is that territory should not be used because of the "public resistance to "territory" as a simple "zip code" approach and to the potential for misuse of this factor by insurers." The statement is odd in all its aspects. The simplicity of the factor makes it more difficult to be a source of abuse, and reduces the cost of its administration. No explanation was offered for the exclusion of sex, age or marital status either.

substantial rate increases as a result of such tempering"⁷¹ while simultaneously endorsing the rate reductions that tempering will bring to urban areas.

Unfortunately, further difficulties take place in the effort to reconcile the specific demands of §1861.02 with the more general injunction that is contained in §1861.05. First, the very fact that the specific rating factors are accorded excessive significance under §1861.02 suggests that this section is itself unfairly discriminatory because it departs from the cost based rules mandated in §1861.05. To follow the factors set out in §1861.02 is to violate §1861.05 because it necessarily requires that some individuals with lower risk receive higher rates, and thus be subject to excessive rates, or unfairly discriminatory rates, or both. The two sections are in hopeless tension with each other.

Second, even if that objection is dismissed (on the ground that the specific trumps the general) the system, as applied, seems unfairly discriminatory because it uses one method to calculate the urban rates and another to calculate the nonurban rates. Urban rates are not subsidized by the nonurban ones under the Commissioner's two tier structure. But someone still has to subsidize the below market urban rates, and that only contender for that honor are the insurance companies that operate in the urban territories. Yet they can only make (at best) a competitive rate of return in the nonurban markets, where they compete with local carriers that do not have an urban book of business. They must therefore take large losses in the urban markets.

Given these constraints, it is most unclear how Proposition 103 allows insurers to receive the constitutionally protected rate of return guaranteed by the California Supreme Court's *Calfarm* decision, which threw out the mandatory 20 percent rollback for the 1988-1989 year. The Commissioner believes that it is possible for an irresistible force to meet an immovable object, but in the words of the song "something's got to give." There is no explanation as to how Proposition 103 can be implemented in the voluntary market and do these four things simultaneously: (a) reduce some rates, (b) hold other rates constant, (c) increase the costs of administration, (d) guarantee insurers a just rate of return on their invested capital. A massively inefficient system of regulation can make everyone worse off and no one better off, but it cannot make someone better and no one worse off.

But there is one further complication. Proposition 103 does not take into account the operation of the assigned risk pool, which as noted traditionally has been subsidized by the voluntary market. With proposition 103 in place, one question that arises is whether the voluntary market can be obligated to continue to subsidize the assigned risk pool. Judge Vogel, the trial judge in the

71. *Id.*

Proposition 103 cases, held that the voluntary market could no longer subsidize the assigned risk pool because to do so would be to require it to issue rates that are both excessive and nondiscriminatory.⁷² That decision has been challenged by the Insurance Commissioner on Appeal.⁷³ If the appeal loses, then the question assigned risk pool will have to be placed on its own footing, in which case the rates will have to increase dramatically, by well over 100 percent, to cover the anticipated losses. If not, then the traditional mechanisms of apportionment and assignment will have to take place in the voluntary market. Yet as that market itself is tightly regulated, rates can no longer freely move up to reflect the tied costs generated by the assigned risk pool. The Commissioner therefore has taken the position that it is possible, both to deny any immediate increases in the assigned risk pool *and* to keep the short term freeze on in the voluntary market, here by promising only to take assigned risk losses into account at some future time if rate increases are decreed there.⁷⁴ Yet no one in a voluntary market part with a dollar today on the strength of an unsecured promise to reconsider matters at some time in the future. Yet the administrative procedures continue forward on this (contested) footing.

The situation is in flux at every level, but as before the lesson must be clear. The battles between the Insurance Commissioner and the insurance companies has influence for the level and severity of accidents. By deciding to ignore age, sex, marital status and territory, there is an implicit subsidy for the most dangerous segments of the driving public by the least dangerous. Voluntary markets are highly sensitive to differences in territory, age, sex and marital status. To hold by general law that these must be ignored creates the following situation. There are two classes of person A and B. The As can be insured against a fixed class of risks for \$1000, and the Bs for \$2,000 because of any of the aforementioned characteristics. If the insurer is told that it must charge a single blended rate for As and Bs, say of \$1,500, the consequences should be clear. The A's will be in great demand, as insurers will stumble over their feet in order to get them into their group (perhaps with promise for deluxe service). The Bs will become orphans within their own time, especially when new customers, for whom there can be no obligation to renew, apply for insurance.⁷⁵ There will therefore have to be a steady stream of coercion

72. *Allstate Ins. Co. v. Gillespie*, No. C744670 (Los Angeles Super. Ct. 1989).

73. The Commissioner's Brief on Appeal was filed in Mar., 1990.

74. Referring to the argument that the assigned risk pool losses cannot be recovered in the voluntary market, the Commissioner's brief states: "These arguments should not be taken seriously because the Commissioner has repeatedly pledged, through her counsel for insurers, that any CAARP-related losses would be considered by the Commissioner in setting an individual insurer's fair rate of return." Brief of Appellant, *Allstate Ins. Co. v. Gillespie*, No. B 047071 (Cal. Ct. App. filed Dec. 21, 1989).

75. In practice the new business problem is even greater, because it applies not only to new customers who seek coverage, but also to existing customers who required changed coverage, say because a family member is added to or removed from a policy, or because of a change in car and

imposed upon the insurers to see that they take losing risks.

The same general lessons about regulation must be learned anew. A subsidy will not result in simple cash transfers, but will also change the mix of drivers on the road, from less to more dangerous. Owing to the powerful effects of the laws of large numbers, it is clear that the accident rates will change as well. Similarly the decision to underprice insurance in the assigned risk pool will compound the errors in the (once) voluntary market for the same reason. The ostensible end of these regulations is to control rates, and to protect the "working poor" who could not pay higher rates. But the costly and contentious statutory initiatives have had the same effect that they have had in New Jersey. They lead to a deterioration of market controls against accident rates. Major distributional initiatives always have undesirable allocative consequences.

There is of course a case for regulation where the regulated industry is a natural monopoly, for now the risks of excessive pricing (and the distortions it creates) may justify an effort to keep prices back at the competitive level. But the insurance industry is not a natural monopoly, so that the "enormous increases" in insurance rates cannot be attributable to monopoly pricing, but to underlying cost factors that are always at work.⁷⁶ It hardly does to say that there is a "crisis" because the rate of premium increases is above that of the rate of inflation: some variation of prices is inevitable even in an inflation-free economy and must be expected here. If tort damages continue to rise above the level of inflation, then the costs of insurance will follow suit. If traffic becomes more congested, cars smaller, and drivers worse, there are other reasons to expect a deterioration in the underlying primary activity. As a constitutional matter, the entire system of regulation should be swept away on its face, for there is no way that a regulated competitive firm can obtain just compensation if it cannot earn a competitive rate of return on equity.

But whatever the present constitutional law on this tangled subject, the invitation to regulate in this fashion should be resisted not only for the factional strife that it creates, but for the way in which it upsets the fragile accommodation between tort law and insurance that has existed over the generations. Most automobile accident cases are easy to decide on liability. What matters therefore most are not doctrinal refinements, but basic institutions. The most recent round of insurance reform has waved all the familiar populist banners. But in design and implementation it has been destructive of the salutary features that traditional rules in tort and insurance could generate.

address. The system of regulation works at the aggregate level and does a poor job in responding to these individual problems of risk.

76. N.Y. Times, Nov. 3, 1990 at 50, col. 4 (Insurance company insolvencies are increasing because insurance companies are subject to the effects of the economy.).

