Insurance Law and Policy

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Cases and Materials

Fifth Edition

TOM BAKER
William Maul Measey Professor of Law
University of Pennsylvania Law School

KYLE D. LOGUE
Douglas A. Kahn Collegiate Professor of Law
University of Michigan Law School

CHAIM SAIMAN
Professor of Law and Chair in Jewish Law
Villanova University Charles Widger School of Law

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For Sharon, Matthew, Rachel, and Noa
For Ruth Ann, Hannah, Molly, Thomas, Caroline,
Mary Claire, and Feleke
and
For Eva, Ayala and Annael

Insurance ideas and practices define central privileges and responsibilities within a society. In that sense, our insurance arrangements form a material constitution, one that operates through routine, mundane transactions that nevertheless define the contours of individual and social responsibility. For that reason, studying who is eligible to receive what insurance benefits, and who pays for them, is as good a guide to the social compact as any combination of Supreme Court opinions.

Tom Baker, *On the Genealogy of Moral Hazard,*
75 Tex. L. Rev. 236, 291 (1996)

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Preface

This casebook invites students and teachers to reimagine the field of insurance law, reflecting the centrality of insurance to American law, business, and society.

Insurance is already in the mainstream of U.S. law and policy, as well it should be. Entire sectors of the U.S. economy depend on insurance: health care, the housing market, and the civil justice system, to mention just three with particular significance for new lawyers. A large share of federal tax payments goes toward funding government insurance of one form or another. The average American family pays almost as much to purchase the various forms of insurance that make up the private safety net. And for most organizations, insurance is a substantial budget item. As a result, tens of thousands of lawyers make decisions every working day that require a detailed understanding of one form of insurance or another.

The importance of insurance is increasingly recognized increasingly in torts and health law classes and in legal scholarship, and, because of the importance of insurance to civil litigation, insurance cases have long been featured in civil procedure and conflict of law casebooks. Yet insurance law remains on the margin of the curriculum in most law schools. This marginal status hurts law students by sending them out into practice without a broad, conceptual understanding of insurance law and institutions to help guide them in their work. Further, it deprives the legal profession of the depth of understanding that law teachers have brought to the fields of law at the core of the law school curriculum.

Courses like contracts, torts, civil procedure, property, and criminal and constitutional law are rich intellectual experiences largely because they have been taught by generations of law professors who labored in those fields. The U.S. legal system is among the few in the world that compensates law teachers well enough to free them from the demands of the active practice of law. What the system gets in return is not only well-educated new lawyers, but also legal scholarship and other forms of academic knowledge.

Insurance Law and Policy: Cases, Materials, and Problems aims to make insurance law enjoyable and interesting to teach and learn, so that professors who usually teach torts, contracts, business organizations, health law, civil procedure, and other law school courses will embark into an insurance course—and so that the students who go on that journey will have a worthwhile experience, too.

The goal is to encourage more people to think and write about insurance, risk, and responsibility, so that the field develops the depth of law school subjects traditionally understood to form the core of the curriculum. Tom Baker and Kyle Logue are very pleased that one law professor who began his insurance law journey by teaching with our book — Chaim Saiman — has joined us as a co-author on this edition. Chaim is responsible for much of we believe are improvements in the insurance contract and liability insurance chapters of this edition.

So what does this casebook do differently? There are four main things.

First, the book pares down, and in some cases eliminates, some of the arcane aspects of insurance law in favor of presenting a broad and conceptual overview of the field. Lawyers can teach themselves the details when they need to know them. This book focuses on the essential institutional arrangements and enduring tensions that animate the field.

Second, the organization of the book locates insurance law in the law school curriculum. As the book makes clear, insurance is both an upper-level contracts course (see Chapter 2) and an upper-level torts course (see Chapters 5 and 6). Insurance is also a regulated financial service, like banking and securities (see Chapter 3), but insurance regulation poses a challenging variation on the usual pattern of federalism (see Chapter 3). In addition, insurance provides a window on the distribution of benefits and responsibilities in the United States (see, especially, Chapter 1, but also Chapters 3, 4, and 5). In that sense, an insurance law course has much in common with a tax law course. It is the rare social issue that cannot be seen through a tax or an insurance lens. The difference is, however, that insurance law is more accessible to teachers whose core expertise lies in an allied field.

Third, the book introduces into insurance law many successful innovations from other law school casebooks. There are carefully constructed problems throughout, with several that are new to this edition (including one that addresses coverage for Covid-19 related business interruption losses). There are fewer and longer cases, providing students better grounding in the art of extracting useful knowledge from judicial opinions. There are more extensive and pervasive statutory materials, presenting students with a more realistic understanding of the importance of statutes and more practice working with them. There are extensive excerpts from the recently completed Restatement of the Law, Liability Insurance, for which Baker and Logue were reporters and Saiman a helpful interlocutor and interpreter. There are fresh, contemporary cases, reflecting the major insurance law controversies of the past thirty years, such as environmental liability coverage, cyber coverage, stranger-owned life insurance, the scope of ERISA's preemption of state insurance law, and the courts' response to insurers' efforts to manage their exposure to catastrophic losses.

Finally, although the book continues the trend in insurance law casebooks of organizing teaching units around lines of insurance (e.g., property, life, liability), it integrates topics to a greater extent. First party insurance topics are addressed in a single Chapter, with separate sections for different lines of insurance and a single comprehensive subrogation unit at the end. Similarly, after introducing the main types of liability insurance in separate sections in Chapter 5, the book presents liability insurance relationship issues in an integrated fashion in Chapter 6.

Tom Baker, Kyle Logue, and Chaim Saiman

October 2020

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Notes on the Text

All omissions from judicial opinions and other materials, except omissions of footnotes and other citations, are indicated by ellipses. Some internal citations and footnotes within cases and other materials have also been removed. All footnotes, including those in the cases and other excerpted materials, are numbered consecutively from the beginning of each chapter.

Insurance Law and Policy

CHAPTER 1

Insurance, Law, and Society

I. INTRODUCTION

For most people, most of the time, insurance operates in the background of everyday life, a dimly understood part of the social infrastructure that is often taken for granted. We have limited attention spans and cannot focus on the inner workings of more than a small fraction of the institutions that we come across. We are content to ignore these inner workings until we need them or are forced to engage with them. Insurance is one such institution.

In fact, the effect of insurance on our lives is profound and pervasive. The vast majority of us are covered by one type of insurance or another, and usually several types. When we buy or rent a home, we purchase insurance against the possibility that the house will be destroyed by fire, wind, or meteorite. We also purchase coverage for the potential lawsuit that might arise if our neighbor slips on the ice on our front porch. When we buy or rent a car, we buy auto insurance to protect us against the possibility of a crash. If there are people depending on our incomes, we get life insurance to replace our earnings. Most of us have some type of health insurance, which—in part because of a subsidy built into the federal income tax laws long ago—is usually provided through our employers. Long-term disability insurance is also sometimes offered as an employee benefit, although surprisingly few employees actually take advantage of it. An annuity is a type of insurance against living beyond one's earning capacity (it might be called longevity insurance) and is also sold by private insurance companies either directly to individuals or through employer-provided benefits.

All of these types of insurance are private, in the limited sense that they are the result of contracts between insurance companies and individuals or firms. There is also government-provided insurance. Health, disability, life, and retirement insurance are provided through government programs such as Medicaid, Medicare, and Social Security. And in the unlikely (though perhaps increasingly likely) possibility of a catastrophe—such as earthquake, hurricane, tornado, or terrorist attack—there is government-provided relief of one form or another. For example, the National Flood Insurance Program, provided through the U.S. government, offers policies that cover homes in flood-prone areas against the risk of flood damage; and there are state-run insurance institutions that provide coverage for severe wind or earthquake risks. No one would be surprised to hear that similar arrangements are under serious consideration for pandemic-related losses.

For lawyers, insurance has special significance. Insurance is obviously deeply tied up with *risk,* and risk lies at the heart of what lawyers do. Transactional lawyers help their clients plan for the risks of the future. Every contract allocates risks between the parties. Thus, lawyers who draft contracts can be understood as risk managers for their clients. Litigators in turn help their clients address those risks that have matured into harm. In addition, because many lawsuits trigger some form of liability insurance, insurance companies often end up controlling the conduct of civil litigation. For that reason, insurance shapes how the law is administered on the ground: which cases go to trial, which cases settle and on what terms.

For these practical reasons, spending a semester focusing on risk in general and on insurance law and policy in particular is a sound use of time for almost any law student. Most likely, you will run across at least some insurance matters in your professional life. If you are a commercial litigator, you will need to know how the standard commercial general liability insurance policy works. If you advise corporate directors or officers, you would do well to understand the basics of directors' and officers' (D&O) coverage. All lawyers will be purchasing professional malpractice insurance; maybe you should know what the language in those policies means. In your personal life, you will be a significant consumer of insurance and related financial services. Moreover, because the law that governs private and public insurance programs contributes significantly to the type of society we have, every informed citizen should understand the basics of how insurance works. Indeed, with the prominence of public policy issues relating to tort liability, health care, aging, and retirement, we all benefit when more people have a deeper understanding of the insurance systems that finance and, as you will soon come to appreciate, *regulate* these and other important areas of life.

Before diving into insurance law and policy, however, there are some risk, insurance, and responsibility basics that are helpful to understand. This chapter will race you through them. This material is presented up front to help you develop an appreciation for the economic and social functions of insurance as background for the intensely *legal* materials that fill up most of the rest of this book. The goal here is a common vocabulary and a brief preview of what will be found in the materials that follow. If this chapter does that for you, great! If not, don't worry. Just use the chapter to develop a rough sense of the basic points about risk and insurance, as well as the role of insurance in society, and move on from there. There's plenty of law in Chapter 2 and in every chapter that follows it. One piece of advice, though: After you have finished the casebook (but maybe before the exam), reread this introductory chapter. We suspect that you may have a renewed appreciation for the material that is presented here.

II. RISK AND INSURANCE 101

Risk. A risk is something that *can* happen but is not *certain* to happen. A home may be struck by lightning, or it may not. A person may fall from a ladder and injure his back, leaving him unable to work and in need of expensive medical care, or he may step down from the ladder without incident, as he has a thousand

times before. A new consumer product may perform exactly as designed and thus make modern life easier, more comfortable, or more interesting; or it can malfunction and explode when plugged into the wrong type of wall socket or fed the wrong fuel, injuring its user and subjecting its maker to a products liability claim. All of these are risks. All are potentially insurable, in part because they are uncertain or probabilistic. Even death, though certain to come eventually to us all, comes at an uncertain time, which makes death itself an insurable risk.[1]

In the insurance field, the word "risk" is sometimes used in more than one way. As just explained, it can be used to signify the possibility of harm to person, property, or enterprise. But risk is also sometimes used to mean the person, property, or enterprise that is subject to the harm. Thus, insurance protects *risks* (in the second sense, the persons or things being insured) against *risks* (in the first sense, the possibilities of harm). In general, these materials will use "risk" in only the first sense—the possibility of harm. We will be concerned with what kinds of risks—what kinds of harm—insurance covers, and for whom; and we will be concerned with how insurance law itself, the rules and doctrines we will be studying, allocates and creates risk.

Risk aversion and risk transfer. Risk aversion helps explain the appeal of insurance. "Risk aversion" is the name given to the preference that most individuals have for certainty over uncertainty with regard to future losses. More technically, a risk-averse individual is one who prefers a certain cost to an uncertain possibility of equal expected value. It is risk aversion that makes people willing to pay a relatively small insurance premium today in exchange for protection against having to bear the financial costs of a much larger loss in the future. The concept of risk aversion is very important to an economic understanding of insurance because it helps explain why insurance is socially beneficial. Without understanding risk aversion, the institution of insurance may seem like a waste of resources. To pay salaries and other administrative expenses, as well as to pay the stockholders a fair rate of return, insurance companies have to charge more in premiums than they pay out in claims.[2] Because of these additional expenses, there are more social resources devoted to losses covered by insurance than to losses not covered by insurance, putting aside for now the possibility that insurers might actually help reduce losses. The concept of risk aversion helps us understand why these additional resources are not wasted. They are a necessary component of commercial arrangements that provide people with something of great value: security.

To see this basic point about risk aversion, consider the following stylized example. Imagine that you own a home that has a replacement cost of $100,000. And say that the likelihood of the house being destroyed during a particular year from any cause is 1/1,000. (This assumed probability is unrealistically high,

1. Although risk can have an upside as well as a downside, insurance typically addresses only downside risk. One exception is when insurance products are bundled with investment products. For example, some annuities, which are a type of insurance against living longer than one's assets can sustain, promise returns that vary with the market. Such annuities present some upside risk.

2. This explanation ignores investment gains (i.e., the money the insurance company makes by investing the premiums in the period before paying claims), but it also ignores the benefit that people would have derived from keeping their premium dollars rather than giving them to insurance companies. At the level of generality we're engaged in here, we can think of those two as canceling each other out.

but it will do for the purpose of our illustration.) Thus, for the relevant policy period, you face a 1/1,000 chance that you will suffer a $100,000 loss due to the loss of your home, and a 999/1,000 chance that no such loss will occur. This means that the expected cost of the risk (the probability-weighted sum of the two possible outcomes) is $100. If you are risk averse, you would by definition rather pay $100 up front and out of pocket than face this uncertain contingency, whose expected cost is also precisely equal to, again, $100. Indeed, depending on how averse you are to risk, you would be willing to pay something greater than $100 to *transfer the risk* to an insurer. This additional value to you of certainty or security is part of what makes insurance worthwhile. This simple example can be generalized to all forms of insurance.

The next obvious question is why people are risk averse in the first place.[3] One possible explanation draws on the concept of the declining marginal utility of money. This concept says that in most circumstances, each additional dollar that you receive, through earnings or gifts or whatever, is worth slightly less to you than the previous dollar received. With your first dollars, you buy the things you really need, necessities such as food, clothing, and shelter. Then, as more money comes in, you buy the things you need somewhat less. When all your so-called needs are met, you buy things you don't really *need* but just want. Next come things you just barely want, and so on. But if something bad happens and you suffer a major financial loss, you suddenly *need* more money: to rebuild your house after a hurricane, to pay for your hospital bills after a heart attack, or to replace the income that you lost when you couldn't work. Because the loss is substantial, you have lost not only the dollars used for trivial things, but also the dollars used for necessities. Thus, the act of buying insurance when times are good, when one is relatively flush with cash, shifts dollars of relatively little value (that is, dollars that might be spent on smartphones or caramel vanilla lattes) to a future state of the world in which the dollars can be spent on absolute necessities, such as food, shelter, and medical care.[4]

Risk spreading. If risk aversion helps to explain why individual insureds are willing to pay something greater than the expected value of their potential losses to transfer risks from themselves to insurance companies, what explains why insurance companies are willing to accept those risks? Put differently, why are insurance companies not also risk averse? The answer is found in the concept of risk spreading. Risk spreading occurs whenever a group of people or firms pool their individual risks in a way that reduces the risk to everyone in the pool. The practice of risk spreading has been around forever. The institution of the family has long provided a way for individuals to share risks with each other. If one

3. Of course, not everyone is risk averse with respect to all types of risk. Some people are risk preferrers, in the sense that they would rather go uninsured than pay the premium to shift the risk of a large loss to an insurer. But that does not seem to describe most people. It does seem to be the case, however, that many individuals are risk preferrers when it comes to small bets with large upsides. That helps to explain why lotteries, even actuarially unfair lotteries (where the ticket prices exceed the expected value of the potential winnings), are so popular.

4. You can also think of this as a form of intrapersonal redistribution: shifting dollars from the rich me to the poor me through insurance. Indeed, this same sort of argument is the primary justification offered for interpersonal redistribution, such as the progressive income tax-and-transfer system: taxing the richer taxpayers to help the poorer taxpayers because the latter need the money more.

family member gets sick and can't work, the others take up the slack, providing a form of informal disability insurance. If a family member dies, the surviving children are taken care of in what amounts to an ancient form of life insurance. Insurance contracts between policyholders and insurance companies provide a way for this sort of risk spreading to be provided on a broader scale, for larger losses to a wider swath of the population.

Although risk spreading can be understood intuitively, it wasn't until the concept of risk spreading was mathematized that modern insurance markets were able to emerge. The basic statistical principle that underlies risk spreading is sometimes referred to as *the law of large numbers*. Put somewhat technically and in terms of insurance, this law means that, up to a point, the larger the pool of insured risks is, the smaller the risk will be to everyone in the pool, on average.

Consider the hypothetical homeowner from above who faced two possible outcomes: loss of house or no loss of house. The expected value of that risk was $100, but the disparity or variance in possible outcomes for the individual insured was huge: she could either suffer a loss of $100,000 or suffer no loss at all. If the homeowner wanted to have "security" for the $100,000 loss without purchasing insurance, she has to put $100,000 in the bank. The same would be true of every individual homeowner. Pooling their risks together through insurance, however, a group of homeowners can substantially reduce their overall risk. This is because if we pool together through an insurance company (say, 50,000 individuals facing precisely the same risk) and we collect $100 in premiums from each of them, the amount of money collected would closely approximate the amount needed to make payouts for actual losses experienced by all members of the pool during the period. (The actual payout for losses would come close to the $5 million of premiums collected from the 50,000 members of the pool.) This is why insurers are willing to accept risk transfers from large numbers of insureds. By providing this risk-pooling function, they are actually reducing the risk to the pool and thus to themselves.

This basic point can be seen in numerous other contexts. Which of the following is more certain: (1) whether a particular 65-year-old male with heart disease will die this year or (2) whether the percentage of 65-year-old males with heart disease in the United States who will die this year will be approximately the same as last year? Or try this one. Which is more certain: (1) whether you will have an auto accident in the next year or (2) whether the number of auto accidents in your region will be approximately the same as last year? In both cases, the answer of course is (2) (though our recent experience with the COVID-19 pandemic reveals that, on rare occasions, (2) can be quite uncertain as well). As these examples suggest, the basic idea of the law of large numbers is that we can be more certain about the future experience of large groups in the aggregate than we can be about the future experience of any particular individuals in that group. Up to a point, the larger the group, the more certain we can be about the future aggregate experience of that group. Thus, the law of large numbers explains that insurance increases social welfare because it provides cheap security.

The law of large numbers does not always work perfectly, though. For example, if all 50,000 of the houses in our homeowners' insurance hypothetical were built on the same highly volatile fault line (and the insurer were including earthquake coverage in the policy), the law of large numbers in this case would *not* predict that grouping these individual risks together would reduce the overall

risk to the pool. Rather, the reverse would be true. Because a single earthquake could destroy all (or at least many of) the 50,000 homes in a single day, grouping the risks together actually concentrates rather than spreads the risk. That is an extreme example, but the point applies generally. And we will see that insurers attempt to deal with these sorts of "correlated risks" contractually, typically using exclusions in their policies. In addition to the problem of correlated risks, some risks are so unusual or infrequent that no reliable data have been gathered with which to make predictions. For these reasons, insurers have techniques other than the law of large numbers for spreading risk. For example, some insurance companies are owned by stockholders who *diversify* their stock portfolios. By owning shares in lots of different companies, whose risks are not correlated with each other, the investors avoid the problem of "putting all their eggs in one basket." Insurance companies themselves also engage in a form of diversification when they insure risks in several different parts of the country or sell several different types of insurance. Also, some insurers actually transfer some of the risk that they assume from their insureds to other insurers, who then slice and dice the risks into small pieces and spread them further over the reinsurance market.

In combination, the existence of risk aversion and the law of large numbers powerfully demonstrates the benefits of insurance. Risk aversion says that people really want protection. The law of large numbers says that insurance can provide that protection at a small fraction of the cost that it would take for people to protect themselves.

III. BEYOND RISK SHIFTING AND RISK SPREADING

The image of insurance painted so far is that of conduit for the transfer and spreading of risk. But insurance serves other functions as well. This section discusses how insurance performs a regulatory function and actually helps to reduce risk. It also covers some of the market failures and other problems that inhibit insurance from playing both its risk-spreading function and its regulatory function.

A. Insurance as Regulation

To understand how insurance operates as form of risk regulation, we first need to understand the concept of moral hazard.[5] In the insurance context, the term "moral hazard" typically is used to refer to the theoretical tendency for insurance to reduce incentives (1) to protect against loss or (2) to minimize the cost of a loss. An example of the former (which economists call *ex ante* moral hazard) is leaving a car door unlocked, comfortable in the knowledge that if the car is stolen, the insurance company will pay. An example of the latter (which

5. *See generally* Tom Baker, *On the Genealogy of Moral Hazard*, 75 Tex. L. Rev. 237 (1996).

economists call *ex post* moral hazard) is not caring very much about what it costs to repair a car as long as the insurance company pays for it. *Ex ante* moral hazard can take two general forms. First, an individual or firm can fail to take cost-justified steps to minimize the likelihood or potential magnitude of a loss. In that case, the party's *level of care* would be too low. Second, irrespective of the level of care, the individual might engage in too much of the risky activity. That is, the individual's *level of activity* might be too high. Both of these types of risk-increasing behavior can be caused, or at least made worse, by the presence of insurance.

Moral hazard can also be understood more broadly, as the general problem of individuals and firms failing to take all appropriate measures, in terms of increased care levels or reduced activity levels, to minimize risks. Viewed this way, insurance can actually help to reduce moral hazard.[6] When this happens, insurers perform many of the same functions that are performed by government agencies that are tasked with regulating risks. Indeed, an argument can be made that, at least in some situations, insurance (often together with tort law) provides a more effective form of regulation than does agency-based regulation. For example, some writers contend that liability insurers have been more effective regulators of fraternities than universities or public authorities.[7]

How can this be true? Why would insurers even have an incentive to reduce risks? Don't insurers' profits increase when there is *more* risk, not when there is less? When risks increase, can't they just raise their premiums? While it is true that insurers would be put out of business in the unlikely event that all risks were completely eliminated, there are several reasons why insurers actually have an incentive to help insureds reduce their risks. First, if an insurer can minimize loss payouts, it can hold down the overall cost of insurance for its policyholders, which in turn increases consumer demand for insurance from that insurer. Indeed, if insurance premiums rise too high, individuals and businesses simply will find insurance unaffordable and will, if possible, opt to self-insure instead. Second, keeping premiums within reasonable limits also helps insurers stave off potentially aggressive regulatory intervention. If insurance premiums get too high, ambitious state regulators or angry voters may take steps to force dramatic rate reductions, a possibility that insurers prefer to avoid. Finally, competition among insurers for relatively low-risk insureds forces insurers to try to find ways to distinguish low-risk insureds from high-risk insureds and to charge lower premiums to the former and higher premiums to the latter—a process that can

6. This section draws heavily from Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 Mich. L. Rev. 1 (2012). For an earlier, insightful analysis of insurance and loss prevention, *see* George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions,* 4 Conn. Ins. L.J. 305 (1997-1998). The literature on insurance as regulation has expanded considerably in recent years. *See, e.g.,* John Rappaport, *How Private Insurers Regulate Public Police*, 130 Harv. L. Rev. 1539 (2017); Shauhin Talesh, *Data Breach, Privacy, and Cyber Insurance: How Insurance Companies Act as "Compliance Managers" for Businesses*, 43 Law & Soc. Inquiry 417-40 (2018); Timothy Lytton, *Using Insurance to Regulate Food Safety: Field Notes from the Fresh Produce Sector* (ms 2020).

7. *See* Caitlin Flanagan, *The Dark Power of Fraternities*, The Atlantic (March 2014), *available at https://www.theatlantic.com/magazine/archive/2014/03/the-dark-power-of-fraternities/357580/. See also* Jonathan Simon,

create financial incentives for insureds to increase their care levels and reduce their activity levels.

When insurers take such steps to reduce moral hazard, they are in effect acting as private risk regulators. In some situations, insurance companies may actually be better at regulating risky behavior than a government agency would be. Given the nature of the insurance business, insurance companies often have an informational advantage over government regulators. Insurers gather a great deal of information in the normal course of their business in order to evaluate claims. As a result of that claims process, they have access to precisely the sort of information that is needed to regulate policyholders' care levels and activity levels, information that a government regulator often will not have. In addition, insurers are motivated by competition to find ever better ways of gathering risk-related information and better ways of using that information to reduce risks. And they are able to get away with some forms of information gathering that a government agency might find politically difficult to do. For one example, auto insurers have begun offering their policyholders the option of having special global positioning system (GPS) devices installed in their cars to gather information about the insureds' driving habits, monitoring both activity levels and care levels. This information can then be used to combat moral hazard and increase incentives to improve safety, as discussed further below.

In their role as private risk regulators, insurers have several strategies or techniques for reducing moral hazard.

1. *Premium differentials.* Insurers give premium discounts to insureds who take steps to reduce risks. Examples of such "premium differentiation" can be found in virtually every area of insurance. Homeowners' insurers give discounts to insureds who install wind-resistant roofing tiles or smoke detectors. Auto insurers charge different rates based on driving experience or on information gathered in other ways. Workers' compensation insurers base premium differentials on the experience of their insured employers. Life insurers charge higher rates to smokers than to nonsmokers. In addition, insurers will sometimes charge differential insurance rates based on an insured's level of care and activity—with auto insurance and the introduction of telematics-based premiums being the best example. That is, with telematically enhanced insurance pricing, insurers are able not only to charge prices that reflect accurate and detailed information about the insureds' driving habits, including how much and how carefully they drive, but also to adjust their premiums automatically in response to risk-reducing or risk-increasing behavior on the part of drivers. According to some reports, this "pay-as-you drive" or "usage-based" auto insurance has produced significant reductions in premiums and in insured accidents, with the biggest gains coming with respect to young drivers.[8] Of course, premium differentiation of this sort is not only about inducing insureds to reduce risks (and controlling moral hazard). Insurers also use

8. Lee Boyce, *Blackbox Insurance May Be Cutting Young Drivers' Costs, but I Still Worry About the Spy in the Car,* ThisIsMoney.co.uk, June 25, 2012, *http://www.thisismoney.co.uk/money/cars/article-2161658/Blackbox-insurance-helps-young-drivers-I-worry-spy-car.html.*

premium differentials to attract relatively low-risk and thus low-cost insureds into their risk pools.

Query: To the extent that premium differentials are used primarily for this sort of "skimming" of relatively good risks, are they providing a beneficial regulatory role? Also, some have expressed privacy or "Big Brother" concerns about allowing insurers to have detailed information about precisely where an individual has driven. All existing telematics-enhanced auto insurance programs are voluntary, in the sense that each policyholder can decide whether to opt in or opt out. Does the voluntary nature of these programs fully answer the privacy/Big Brother concerns? What exactly are those concerns? How much of a premium reduction would you need to be willing to sacrifice your privacy with respect to where and how you drive?

2. *Deductibles and co-payments.* Another way that insurers reduce moral hazard is to include deductibles and co-payments in their insurance policies. Deductibles require insureds to pay a fixed amount "out of pocket" to cover insured losses before the insurance coverage kicks in to cover insured losses thereafter. Co-payments typically require insureds to bear some fraction of each covered loss claim filed by an insured. The effect of both deductibles and co-payments is to help align the insured's incentives with those of the insurer and thus to reduce moral hazard. There are limits, however, to the extent to which deductibles and co-payments can reduce moral hazard on the part of insureds. Can you see why? And can you see why they nevertheless often make good sense from the insured's perspective?

3. *Exclusions, cancellations, and decisions not to renew.* An "exclusion" is a term in an insurance contract that says that certain types of losses are not covered under the policy. Thus, whereas a deduction imposes on the insured some fixed amount of all insured losses, an exclusion results in the insured bearing *all* losses of a particular type—the excluded type. For example, most insurance policies contain a term that explicitly excludes payment for losses that are intentionally caused by the insured. How could such an exclusion be understood as a regulatory tool for reducing risky behavior by insureds? Think about the *ex ante* incentives created by the existence of the intentional-harm exclusion in the policy. Because the exclusion is present, the insured is discouraged from causing losses intentionally. Other types of exclusions can also have this beneficial incentivizing effect for insureds. Just as fear of the application of an exclusion can create beneficial incentives for insureds to reduce risks, so can the fear of having one's policy canceled for filing loss claims that are excessive in size or number. What are the potential downsides to insureds—and third parties—of the presence of exclusions in insurance policies? What does this suggest about the limits to the regulatory function of insurance exclusions and the threat of cancellation?

4. *Information production and the teaching of safer conduct.* It is often assumed that policyholders have better information about the risks they pose than insurers have, and this is sometimes true. (See the discussion of adverse selection below.) But that is not always the case. Often insurers have better information about the risks confronting particular insureds than the insureds do. This is in part because insurers in some cases have superior information-gathering

abilities and in part because insurers have more expertise in assessing the information. For example, the insurance industry established Underwriters Laboratories to test materials for resistance to fire and other hazards. Similarly, the auto insurance industry has long conducted its own crash testing of new automobiles. In addition, insurers, as previously mentioned, gather a great deal of information through the claims process. Some of this information (such as the safety ratings of automobiles) the insurers share with the general public. And some of the information is used by insurers with their own insureds, either through premium differentials (described above) or through programs designed to educate policyholders about how they can reduce their own risks. Most insurance companies have such "loss control" programs, which provide policyholders with various analytical tools for assessing their own liability risks and identifying ways of reducing them.[9] Despite the (sometimes deserved) bashing of managed health care companies, those same institutions have been behind efforts to develop and disseminate "best practices" in health care.

5. *Insurers as gatekeepers.* Obtaining insurance is often a prerequisite to other activities. You can't register a car without auto insurance, take out a mortgage without homeowners' insurance, obtain a commercial loan without business owners' insurance, bid on a government contract without a surety bond, advertise on network television without media liability insurance, finance a movie without cast insurance, sign a commercial lease without commercial property and liability insurance, get venture capital without "key-man" life insurance, obtain practice privileges at most hospitals without medical malpractice insurance, and so forth.

All these legal or institutional requirements make insurance companies important *gatekeepers* in large sectors of the U.S. economy (and undoubtedly in other parts of the developed world as well). Going through the gate requires meeting the insurance companies' standards, including not running afoul of exclusions within policy (discussed above), as well as paying the necessary premiums. This gatekeeping role gives insurance companies the potential to serve as very significant regulators, while at the same time making access to "private" insurance an intensely "public" issue.[10] One small but revealing example of this "regulation by insurance" came in the form of a report in *The New York Times* following the conviction of a San Francisco woman for murder when her dog killed a neighbor. (The conviction was later overturned.) The *Times* reported that some homeowners' insurance companies refused to issue insurance to people who owned certain breeds of dogs and described a family that gave up their Rottweiler to get insurance for their house.[11]

Because insurers sometimes have informational advantages over government regulators, there have been suggestions to expand the use of insurers as

9. Every major insurer offers such services, as advertised on their websites.

10. *See, e.g.,* Carol Heimer, *Insuring More, Ensuring Less: The Costs and Benefits of Private Regulation Through Insurance, in* Embracing Risk: The Changing Culture of Insurance and Responsibility (Tom Baker & Jonathan Simon eds., 2002); Elizabeth O. Hubbart, *When Worlds Collide: The Intersection of Insurance and Motion Pictures,* 3 Conn. Ins. L.J. 267 (1996-1997).

11. *See* Joseph B. Treaster, *Home Insurers Frown on Many Dogs,* N.Y. Times, Mar. 30, 2002, at A11.

gatekeepers, where government regulation is especially difficult. For example, some have proposed using a combination of tort liability and compulsory liability insurance to regulate the risks posed by imported food products[12] or even to regulate the risks associated with misrepresentations made in corporate financial statements.[13] Do you see how making the purchase of liability insurance mandatory for a given activity puts liability insurance companies in the position of being quasi-private risk regulators? What other advantages do you see in having insurers, as compared with government agencies, as risk regulators? What are the disadvantages? Contrast, for example, State Farm and Allstate with the National Highway Traffic Safety Administration as regulators of automobile safety.

While insurance companies have regulated the behavior of private actors for many years, a more recent development has been the role of liability insurers in regulating public police departments. A recent study, involving numerous interviews with insurance-industry representatives and city attorneys, found that municipal liability insurers — through premium differentials based on insurers' superior information from past claim experience — have been able to create incentives for improvements in police conduct. For example, liability insurers have been able to "get police agencies to adopt or amend written departmental policies on subjects like the use of force and strip searches, to change the way they train their officers, and even to fire problem officers."[14] The author of the study considered a number of innovations designed to enhance the regulatory role of police insurance, such as laws mandating the purchase police liability coverage or bans on "first dollar" liability policies (that is, policies with no deductibles). Why might these innovations be a good idea? What difficulties would they present? What about the idea, proposed recently in one state, of requiring police officers to carry police liability insurance, expressly for the purpose of recruiting insurers to regulate police?[15] What are the pros and cons of this approach, compared with liability insurance purchased at the department level or the city level?

B. Insurance Market Failures

Insurance can be very valuable, both as a system for spreading risk and as a system for regulating risk. This does not mean, of course, that insurance markets are problem free. Insurance too experiences market failures, which is why the insurance industry is regulated. Chapter 3 will address the regulation of insurance companies. Moreover, because many insurance transactions involve contracts between highly sophisticated insurance companies and unsophisticated

12. *See, e.g.*, Tom Baker, *Bonded Import Safety Warranties*, *in* Import Safety: Regulatory Governance in the Global Economy 215 (Cary Coglianese et al. eds., 2009).

13. Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited*, 8 Stan. J.L. Bus. & Fin. 39, 48-60 (2002).

14. *See, generally,* John Rappaport, *How Private Insurers Regulate Public Police*, 130 Harv. L. Rev. 1539 (2017) .

15. *See* Ryan Tarinelli, *New York State Bill Would Require Police Officers to Carry Liabilit Insurance*, N.Y. L.J., July 10, 2020.

consumer insureds, there is a potential for insureds to be taken advantage of by insurers. Thus, these contractual relationships themselves require some form of regulatory oversight. Such regulatory oversight of insurance contracts, by insurance regulators, by courts, or both, will be a primary theme that is developed throughout the book. Among the market failures that inhibit market for insurance are the following:

1. *Insurer-side moral hazard.* Insurance can be understood as a form of principal-agent relationship, in which the insured is the principal who appoints the insurance company as the agent responsible for taking care of insured losses. This framework reveals that insurance institutions and intermediaries are also susceptible to moral hazard. For example, in deciding which insurance company to recommend to a client, an insurance broker might prefer the company that pays the higher commission. (In this example, the "principal" is the person seeking insurance and the "agent" is the broker.) Similarly, in deciding whether to pay a claim, or how much to pay, the insurance company cannot help but be affected by the fact that it gets to keep whatever money it does not pay. (Here, the "principal" is the person who bought the insurance protection and the "agent" is the company that provides it.) These are examples of moral hazard in the broader, principal-agent understanding of the term. As we will see, much of insurance law and regulation is directed at moral hazard by insurance companies and intermediaries.

2. *Insurer opportunism.* Insurance involves the exchange of money for a promise. You pay premiums today. The insurer promises to give you money (or services) in the event that certain bad things happen. The money-for-promise structure of insurance gives the insurer a structural advantage: When the bad thing happens, it is too late for the insured to switch insurers. And there is little that you can do on your own to make the insurer pay. The insurer could simply refuse to pay. As we will see, much of insurance law is directed at preventing insurers from engaging in this kind of opportunism. But the possibility for opportunism never can be completely eliminated, and consumers never will completely trust insurance companies. The potential for opportunism and the resulting lack of trust reduce the demand for insurance. Of course, there can also be opportunism on the part of insureds, such as when insureds misrepresent their risks to insurers, and this sort of opportunism can lead to increased premiums for all who are insured. As we will see, however, there are insurance law doctrines that protect insurers and innocent insureds from such behavior.

3. *Adverse selection.*[16] Another problem with some insurance markets is "adverse selection." In the insurance context, adverse selection typically refers to the (theoretical) tendency for high-risk people to be more interested in insurance than low-risk people are. For example, all else equal, someone with a history of medical problems is more likely to be concerned about losing health insurance than someone who has always been in good health. Similarly, a manufacturer

16. *See generally* Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification, in* Risk and Morality (Richard Ericson & Aaron Doyle eds., 2003); s*ee also* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 Yale L.J. 1223 (2004).

facing a wave of product liability claims will be more likely to look for very high insurance policy limits than will another, similar business (again, all else being equal). The theoretical result of adverse selection is that the average risk level of people who choose to purchase insurance will be higher than the average level of risk of the population as a whole.

Economists also regard adverse selection as an information problem, because insurance companies can address adverse selection if they are able to identify and act on the risk status of potential insureds. The classic illustration of this problem appears in an article on the "lemons problem" that helped George Akerlof win the Nobel Prize in economics: *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q.J. Econ. 488 (1970). Akerlof analyzed a hypothetical market in which used car buyers may buy "peaches" (i.e., good cars) and "lemons" (i.e., bad cars) without being able to determine whether any individual car is a peach or lemon. In that situation, the most that a rational buyer will pay is the average price, which is less than a peach is worth. So, owners of peaches will tend to keep them, with the result that the car market becomes disproportionately composed of lemons, so that people will pay even less for cars, driving even more peaches out of the market, and so forth. This "lemons problem" is an information problem because it would be solved if buyers could know whether a particular car was a "lemon" or a "peach." Substituting "low risks" for "peaches" and "high risks" for "lemons" provides the standard account of adverse selection in insurance.

Outside of some health insurance contexts, the evidence for adverse selection by insurance applicants is much thinner than many people think. One reason is that some forms of insurance are (legally or otherwise) mandatory, so that the low risks cannot drop out of the insurance pool. Another reason may be that people who voluntarily buy insurance are, in at least some circumstances, "better" risks from the insurance companies' perspective than people who do not. This latter phenomenon is referred to as "propitious selection." One theory behind propitious selection is that people who buy insurance may be on average more risk averse than people who do not and that higher levels of risk aversion are correlated with more safety-oriented behavior.[17] In other words, there may be a tendency for risk-averse (and therefore safety conscious) people to buy more insurance so that, in contrast to adverse selection theory, the people most likely to buy insurance are low risks, not high risks. For a game theoretic explanation and summary of relevant empirical research on propitious selection, *see* David de Meza & David C. Webb, *Advantageous Selection in Insurance Markets,* 32 Rand J. Econ. 249 (2001).

As with moral hazard, adverse selection can also affect the insurance institution side of the insurance bargain. Policyholders are not the only ones susceptible to adverse selection. The classic example of insurer-side adverse selection is the "race to the bottom" that took place in fire insurance policies before

17. *See* David Hemenway, *Propitious Selection,* 105 Q.J. Econ. 1063 (1990). An interesting new paper on "inverse selection" points out that insurers increasingly have better information about the risk status of their customers than the policyholders themselves, which permits insurers to price-discriminate based on customers' knowledge of their risk and willingness to shop. *See* Markus Brunnermeier, Rohit Lamba, Carlos Segura-Rodriguez, *Inverse Selection* (April 2020), *available at ssrn.com/abstract=3584331.*

the adoption of standard fire insurance policies in the late nineteenth century. Consumers were ill equipped to tell a "peach" fire insurance policy from a "lemon," and so were unlikely to pay a "peach" price, with the result that the "lemon" policies started to drive the "peach" policies out of the market. The better insurance companies organized and persuaded state legislators to enact state statutes requiring that insurers sell only "peachy" fire insurance policies. It is just this dynamic that many people cite to justify the regulation of mass market insurance contracts today and that, more broadly, explains why insurance regulation can—at least in theory—benefit both insurance consumers and insurance companies.

4. *Externalities.* An "*externality*" is a cost or a benefit that accrues to people who are not in a contractual relationship with the parties that produce the cost or benefit. Pollution is the classic *negative externality.* Pollution is a cost that polluters impose on others who are not in a contractual relationship with them and who, absent government regulation, are not able to make the polluters pay.

Insurance arrangements also can result in negative externalities. Perhaps the most significant potential negative externalities are costs imposed by behavior that undercuts public trust in insurance arrangements. Because of the money-for-promise nature of insurance just explained, insurance contracts are particularly vulnerable to a decline in public trust. For that reason, substantial aspects of insurance law and regulation are devoted to making sure that insurance companies live up to their promises. For example, much of insurance regulation is devoted to ensuring that insurance companies are financially capable of fulfilling their promises, and much of insurance contract law is devoted to ensuring that insurance companies in fact fulfill those promises.

Another type of externality involves information. As mentioned above, because of the nature of the insurance business, insurance companies have to be repositories of enormous amounts of information about their insureds. The insurers use this information for making important pricing and coverage decisions. This topic is discussed in more detail in "Knowledge Production" below.

C. Other Functions of Insurance

1. Redistribution and Social Stratification

There are several senses in which insurance is a form of redistribution. How so? First, insurance is at its core *intra*personal redistribution. Recall the discussion above about how insurance can be understood as a means of transferring money across states of the world—from the individual who has not suffered a major financial loss and thus for whom the value of the next dollar earned or spent is relatively small, to the same individual who has suffered a major financial loss and thus for whom the dollars are relatively more valuable. Thus, insurance permits individuals to make transfers from their unharmed selves to their harmed selves with an insurance company serving as the financial intermediary. Second, and relatedly, we can think of insurance as redistribution from the group of insureds who contribute premiums to whichever unfortunate members of the insurance pool happen to sustain a loss-triggering payment.

Both of these types of redistribution occur within the insurance transaction even if insureds are charged perfectly "accurate" or "actuarially fair" insurance premiums—that is, premiums that perfectly reflect the risk those insureds bring to the insurance pool.

A third type of redistribution through insurance occurs, however, when premiums are not set perfectly to reflect insureds' objective risk profiles. For example, the Affordable Care Act prohibits health insurance companies from engaging in health-based underwriting, for example by considering whether an individual applicant for insurance has a genetic predisposition to a particular illness that is highly correlated with very high lifetime medical expenses. Absent such a law, health insurers operating in a competitive market would likely be very interested in learning about such genetic predispositions, if doing so could be done relatively cheaply and reliably. The use of genetic markers for disease propensity would allow insurers to charge premiums that more closely approximate the actual risks insureds present to the insurance pool. This would thereby help insurers to prevent adverse selection by individuals who have the disease trait. From one perspective, charging such statistically accurate premiums is fair, because it means each insured pays the full costs associated with her participation in the insurance pool.

From another perspective, however, such a result is unfair—or distributively unjust—as the Affordable Care Act reflects. Why should an individual who, through no fault of her own, poses a higher risk to the insurance pool—and to society generally—be forced to bear the full brunt of that unfortunate roll of the dice? By forbidding insurers from using the genetic information and thereby forcing insurers to charge the same premiums to both those who have the unfortunate genes and those who don't, private insurance results in a redistributive transfer *from* the mass of insureds lucky enough not to have the trait *to* the relatively few insureds unlucky enough to have it.[18] *Query*: Under such a law, how should insurers, and how should society, deal with the obvious problem of adverse selection, where insureds are permitted to know their own genetic risk profile but insurers are not? Have you ever heard of the "individual health insurance mandate" and the "advanced premium tax credits" under the Affordable Care Act? The general topic of how the regulation of insurers' risk-classification practices can have distributional and efficiency consequences will be discussed at length in Chapter 3.

There is a flip side to the redistributive function of insurance. People who cannot get insurance occupy a different social position than those who can get insurance, and people who have to pay more for insurance have fewer resources to spend on other things. Insurance institutions are hardly the sole "cause" of this inequality, but they can play an important role. Insurance institutions both reflect and create the broader social conditions that lead to social stratification.[19]

18. In fact, an argument can be made that this type of redistribution is more efficient than trying to achieve the same distributive goals through the tax system. Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 Tax L. Rev. 147 (2002).

19. *See* Tom Baker, *Risk, Insurance, and the Social Construction of Responsibility*, *in* Embracing Risk: The Changing Culture of Insurance and Responsibility (Tom Baker & Jonathan Simon eds., 2002); Regina Austin, *The Insurance Classification Controversy*, 131 U. Pa. L. Rev. 517 (1983).

2. Capital Accumulation and Allocation

In thinking about insurance as a way to spread risk, it is easy to miss the role of insurance in capital markets. Insurance institutions hold enormous sums of money in reserve to pay claims as they become due. That money does not sit in piles in the basement of the insurance company home office. It is invested—in government bonds, real estate, commercial loans, the stock market, venture capital funds, and almost every place that capital can go in search of a return. This gives insurance companies the potential to exercise significant influence over capital allocation. For historical reasons, and because of government regulation limiting insurance company investment activity, insurance companies have largely been passive investors and lenders.[20] But even behaving in a passive role has significant consequences, for example magnifying the more active involvement of other investors.

Investment regulations can be used to steer capital into preferred fields. For example, French insurance companies are required to invest some of their funds in French real estate, with the interesting result that French insurance companies have become a major force in the French wine industry. On a larger scale, prohibitions on foreign investment in insurance in countries such as India, China, Brazil, and Argentina were long justified as a way to steer capital to indigenous insurance institutions (typically government-owned or authorized monopolies), which would invest the capital locally. The International Monetary Fund and the World Bank, along with the globalization of the economy, have been significant forces in opening up capital markets—including insurance—to foreign investment.

Understanding insurance as an institution for accumulating capital, it is no surprise to learn that insurance firms compete with banking and securities firms. Yet, banking, insurance, and securities traditionally have been subject to different regulatory regimes. The convergence of the insurance, banking, and securities industries in the financial services marketplace places great strain on the existing regulatory institutions, as they struggle with each other and the firms they regulate, both to achieve regulatory ends and maintain regulatory authority.[21] Convergence and the related trend toward globalization are likely to be among the primary economic forces driving the evolution of insurance regulation in the foreseeable future. This evolution will address such fundamental issues as whether, and to what extent, there will be democratic control over capital and the proper level of governmental control (local, federal, or international) over regulatory decisions.

It is not clear, however, that convergence has been all to the good. Perhaps the most significant event to affect capital accumulation of any kind over the last 80 years has been the "Great Recession," which began with the near collapse of the housing market and the banking industry in the fall of 2008, triggered in

20. *See* Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry,* 93 Colum. L. Rev. 639 (1993); *cf.* Gerald Rosenberg, Allianz and the German Insurance Business, 1933-1945, at 155-157 (2001) (explaining the importance of German insurance companies' purchase of government bonds to the buildup of the Nazi war machine).

21. *See* Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay,* 77 Wash. U.L.Q. 319 (1999).

part by the systemic failure of an innovative, widely held, and, as it turned out, disastrously risky financial instrument known as the "credit default swap" (which we discuss further in Chapter 3). Interestingly, the insurance industry on the whole, which has large amounts of money to invest, was not threatened by the crisis in the same way that banks were. This is largely because insurance companies, in part owing to state regulations, limit their financial holdings to relatively conservative investments. While it is true that insurance giant AIG required an enormous federal bailout to avoid bankruptcy, an event that would likely have had severe repercussions for the world economy, it was not because of AIG's core insurance operations. Rather, it was AIG's investment branch, which was deeply involved in the market for credit default swaps, and the investment side of AIG's insurance business, which engaged in the risky business of lending its securities as well as purchasing some of the most toxic investment products.

3. Knowledge Production

Insurance was among the earliest information businesses. Indeed, from a certain perspective, an insurance company is simply a tool for the collection, analysis, and use of information. The core analytical task of an insurance enterprise is identifying future losses, choosing which of those losses it is willing to insure, estimating the frequency and magnitude of those events, preparing insurance contracts that reflect those choices, and then deciding how much to charge which classes of people in return for this protection. In addition, insurance companies need to learn how to motivate people to buy their insurance, and they ought to learn as much as possible about how to prevent loss. All of this produces knowledge, much of which can have consequences beyond the insurance enterprise:

- A simple life insurance application has the potential to reveal the HIV status of an applicant. Should the insurer have an obligation to inform the applicant? If so, with what safeguards and counseling? How about the public health department?
- Large life and workers' compensation insurers allegedly learned a great deal about the dangers of occupational and other exposure to asbestos years before that knowledge was widespread. Did these organizations have an obligation to inform the public about the risks? Should they be required to contribute to the compensation of people who were subsequently exposed to, and injured by, asbestos?
- Health insurance companies are enormous repositories of health care data. Historically, they used the data largely to predict future costs. Increasingly, they are using the data in pursuit of "cost-effective" medicine and, in the process, altering the traditional relationship between doctor and patient, with significant social and legal consequences.
- Liability insurance companies are similar repositories of data about the tort system. Like health insurance companies, they have historically used the data largely to predict future costs. On the whole, they have been reluctant to provide that information to tort law researchers. When insurance companies join forces with the "tort reform" movement in support of legal reforms such as caps on damages, higher standards for pain and suffering damages,

and the like, should they be required to open their data files to disinterested researchers, who can evaluate whether their experience supports the claims they are making in the political arena?

IV. (WAY) BEYOND RISK SPREADING — INSURANCE AND SOCIAL RESPONSIBILITY[22]

Insurance, we all now know, transfers and spreads risk. Yet what we usually think of as a transfer of risk is also a transfer of responsibility. Without health insurance, we are responsible for our medical bills, our choice of doctors, and, in consultation with our doctors, our course of treatment. With health insurance, the insurer assumes some of that responsibility. Insurance, then, not only spreads risk, it also spreads responsibility.

A comparison of two families in quite different circumstances begins to illustrate the relationship between insurance and responsibility. Imagine, first, a professional couple living in Avon, Connecticut, and working in nearby Hartford. If they are typical of others in their social situation, we can easily identify more than 16 forms of insurance that address various risks in their lives. Through payroll taxes, they have rights to a basic level of unemployment and disability insurance, as well as a modest retirement annuity, some life insurance, and generous health insurance for their old age or upon disability (all of which are provided under the Social Security and Medicare Acts). From the private insurance market, they have homeowners' insurance, automobile insurance, term life insurance, and an annuity. Through employment, they have health insurance, sick leave, life insurance, workers' compensation, additional disability insurance, retirement savings plans with significant annuity features, and, possibly, employment severance arrangements that we can understand as a form of supplemental unemployment insurance.

All of this insurance transfers risk from the couple to an insurance fund and, therefore, changes the financial consequences of the events to which the insurance applies. A house fire remains a tragedy to the couple, even with insurance (because of the risk to life and the loss of irreplaceable items), but as long as the company comes through on its promise, the tragedy is not financial. Similarly, an extended illness remains an unhappy event for obvious reasons, but once again the financial effect is muted: Sick leave provides short-term income, disability insurance provides longer-term income, and health insurance covers the medical expenses. Whether living beyond working age is a blessing or a bane depends on many circumstances, but financial need is unlikely to be one of them; the couple will have an income and health insurance for life.

Now imagine a second couple living in the nearby Hartford neighborhood of Frog Hollow. One of them cleans houses in the first couple's neighborhood; the other works for a painting contractor. What insurance pads the sharp corners

22. Much of this section is adapted from Tom Baker, *Risk, Insurance, and the Social Construction of Responsibility, in* Embracing Risk: The Changing Culture of Insurance and Responsibility (Tom Baker & Jonathan Simon eds., 2002).

in their lives? Like the Avon couple, the painter has rights to basic social insurance financed by payroll taxes (unemployment insurance, disability insurance, health insurance in old age or disability, an annuity, and a limited form of life insurance). The house cleaner, however, is paid "under the table," so her only forms of social insurance are means-tested, noncontributory programs that provide a very low level of disability insurance and, in old age or disability, health insurance.[23] As long as both work, she is unlikely to qualify for these income-based benefits. Neither receives any private insurance through employment. They have purchased automobile and life insurance, but their life insurance pays only enough to cover the cost of a funeral and a few months' rent, and their auto insurance provides the mandatory minimum coverage, which does not cover losses to their own car. They don't own their home, and renters' insurance is a difficult-to-find extravagance in their neighborhood.

It takes little imagination to contrast the meaning that sickness has for the two couples. Unwelcome in both places, it is a financial disaster only in Frog Hollow. Because the Frog Hollow couple has less insurance, they bear more responsibility for the consequences of sickness and other unfortunate events. They have no health insurance, no sick leave, and no private disability insurance, and, as a result, all medical costs are their responsibility, as are the rent, the groceries, and the other routine expenses that must be paid in sickness and in health. In the Avon household, in contrast, health insurance, sick leave, and (depending on how long the illness persists) private disability insurance relieve the couple of much of that responsibility. Sickness, along with house fires, disabling injuries, old age, and perhaps even death have different meanings in the two households, according to the presence or absence of a collective, "insurance," that assumes responsibility for the financial consequences of those events. While not a complete explanation for the disparate impact that the COVID-19 pandemic is having on U.S. households, the disparities in the access to these forms of insurance (and the underlying social and historical dynamics that produced those disparities) go a long way toward that explanation.

All these forms of insurance depend on the participation of many to share the burden of those with a qualifying need. Thus, extending insurance asserts a degree of *social responsibility* over the insured against events. In a very important sense, insurance makes the Avon couple *less responsible* for the bad things that can happen in life than the Frog Hollow couple.

Thinking about insurance as a form of social responsibility often founders on the idea of the *social* part of that term. One impediment — an amorphous and confused notion of what "social" means — is readily dealt with by understanding "society" not as an abstract entity, but rather as the group of participants in any particular insurance arrangement. A second, more serious impediment is a vision of insurance as a series of independent, bilateral contracts that leaves out the collective dimension of insurance.

So hidden is this collective dimension in the American perspective on insurance that many people in the United States never realize that most of their premiums for most forms of insurance will go to pay other people's claims. Indeed, one of the most common images of insurance is quite similar to that of

23. If the couple is unmarried, she won't be eligible for social insurance benefits that are derivative of her partner's employment, either.

a savings account. People recognize that many forms of insurance differ from savings accounts in the degree of flexibility allowed in the timing of insurance withdrawals. Nevertheless, they often expect that over the course of a lifetime, the deposits made by each person should roughly equal the withdrawals on that person's insurance account.

Unless the insurance truly is a form of savings, however (as in the case of annuities and accumulating life insurance), or a very close substitute (as in the case of Social Security retirement benefits), it rarely is desirable for the "withdrawals" to equal the "deposits." Indeed, when it comes to health, disability, property, liability, and term life insurance, if your withdrawals equal your deposits, you have had, in at least some respects, a very unfortunate life. If you are fortunate, your insurance dollars go to pay other people's claims.

Another important stumbling block to understanding how insurance institutions distribute responsibility is the complexity of the set of ideas bound up in the concept of responsibility itself. We can begin with the commonsense notion that insurance is something that responsible people arrange to have. The link between insurance and this sense of responsibility was forged in the nineteenth century in response to strong moral and religious objections to insurance. Yet, if this history means that obtaining insurance is the responsible thing to do, then people with insurance should be *more* responsible than people without insurance, not (as in the comparison of the Avon and Frog Hollow couples) less.

Part of what is going on here is wordplay: "responsible," in the sense of "trustworthy, loyal, helpful" and the rest of the Boy Scout Law, being played off against "responsible," in the sense of obligated to pay or accountable. It is responsible—in the Scout Law sense—to get insurance precisely because not having insurance makes one responsible—in the financial accountability sense—for any number of bad things that can happen. The linking of these two meanings in the context of insurance, however, extends beyond wordplay. Historically, insurance institutions have tried to become responsible (accountable) primarily for people who are responsible (trustworthy) and to keep the irresponsible out. In the private insurance arena, that effort is manifested in admonitions to agents and underwriters and in opposition to efforts to curtail character underwriting (the latest being directed at the use of credit scores in insurance underwriting). In the social insurance arena, that concern is manifested in the concept of the deserving poor—the notion that children, the disabled, and the elderly poor deserve public support because their present need is not the result of irresponsibility on their part.

As this social insurance example suggests, there is a third, causal meaning to the word "responsible." The able-bodied poor are excluded from noncontributory social insurance programs in part because of a social judgment that they are responsible in this third, causal sense for their poverty, whether because of lack of effort or poor choices earlier in life.

"Responsible" also has a fourth meaning: "free, self-determining, or autonomous." "I'm responsible for *X*" means that *X* is my turf, an area in which I am free to act or not. Admittedly, this meaning is difficult to tease out from the first three. Self-determination can be an important element of what it takes to be a trustworthy person, and it can be hard to hold someone accountable for an act that was not self-determined. Yet we do find self-determining people who are not trustworthy, and we do at times hold people accountable for acts that

involved no autonomy or free choice. So, freedom is a distinct, if related, sense of the term.

Finally, there is a *relational* sense to the word "responsible" that is captured in the social insurance concept of solidarity. Although this relational meaning may be implicit in some of the other meanings of "responsible," it is also distinct. We can be responsible in this relational sense ("in solidarity with"), whether we are trustworthy or not, for things that we did not cause, and this solidarity is not necessarily coextensive with our moral or legal accountability or our degree of self-determination. Indeed, a mismatch between popular understandings of accountability and solidarity can be a strong social force pushing accountability in a broader or narrower direction.

From these five meanings of the adjective "responsible," we get five corresponding meanings of the noun "responsibility": trustworthiness, accountability, causality, freedom, and solidarity. Can insurance be said to *distribute* all five types of responsibility? To what extent can one or more of these conceptions of insurance as distributing responsibility be seen as overlapping, or perhaps conflicting with, the conception of insurance as regulating risky conduct discussed above?

A. Insurance and Accountability

The idea that insurance institutions distribute financial accountability may be the easiest of these aspects of responsibility to understand. Financial accountability for experimental medical procedures provides a ready example. A decision to include experimental medical procedures in health insurance coverage assigns the financial responsibility for these procedures to insurance institutions and, through the institutions, to the "members" of these institutions. A decision to exclude experimental medical procedures from covered health insurance benefits assigns the responsibility for funding experimental treatments elsewhere, either with individual patients or with some alternative medical research funding mechanism.

The health insurance context also helps us to see that insurance institutions distribute accountability in a broader sense than who pays for health care. To the extent that leading U.S. "health insurance companies" transform themselves into "managed care organizations," they assert more control over medical care and become more accountable — certainly in a moral sense and possibly also in a legal sense — for adverse medical outcomes. Similarly, the new phenomenon of "accountable care organizations" — large medical systems that that receive payments based in part on the health of the population and not simply on the amount of care provided — represents a combination of health care provider and insurer.

B. Insurance and Trustworthiness

Insurance institutions also mark people or organizations as responsible in the trustworthy sense. For example, it is nearly impossible in the United States to obtain financing for a home, a car, or other property without first obtaining insurance covering that property. Having insurance marks a potential borrower

as responsible in a sense that is very important to lenders: The borrower can be trusted to repay the loan even if disaster strikes. This is the reason insurance "redlining" (the practice of identifying geographic regions in which an insurance company prefers not to issue policies) is of such concern. A neighborhood redlined by insurance companies is a more risky place for banks to lend. Without good financing opportunities, fewer people invest in the neighborhood, and without investment, the neighborhood becomes an even more risky place for banks, causing further decline.

Insurance institutions also mark people as trustworthy (or not) at the claims end of the insurance relationship. In nearly any claim decision, deciding whether to pay involves a moral evaluation of the claimant. For example, in the workers' compensation insurance context, the question "Does this worker have a repetitive stress injury?" invariably involves the question "Can this worker's story be trusted?" If the answer to the second question is yes, the claim will be paid with less investigation than if the answer is no.

Finally, and perhaps most importantly, insurance institutions distribute trustworthiness by structuring situations so that people act in a more or less responsible—in the Scout Law sense—manner. Workers' compensation insurance provides a number of useful examples of how insurance institutions structure situations in this manner. One common approach is to design and maintain workplaces so that it is difficult for workers to behave in an unsafe manner (and, conversely, easy to be safe). Workers' compensation insurance does this in a direct, command-and-control manner through teams of inspectors employed by insurance companies and consulting firms. It also does this in an indirect manner through experience-based premiums that give employers an incentive to prevent injuries. A second common approach to fostering responsible behavior focuses on injured workers and their return to work. Here, the responsible behavior being fostered is following through with the doctor's or therapist's orders and returning to work as soon as it is physically safe to do so.

A third, less easily documented approach to fostering "responsible" behavior is suppressing claims. Once again, workers' compensation insurance provides a ready example. From the perspective of the workers' compensation regime, an accident is a problem only if it produces a claim, and the size of the problem turns on the amount of benefits paid on the claim. Accordingly, suppressing claims may be the "responsible" thing to do. As this suggests—and this is a very important point—the responsibility fostered by an insurance institution is defined with respect to the internal logic of that institution and not according to an external perspective. In other words, insurance institutions not only structure situations so that people behave in a responsible manner, they also define what behavior is (and is not) responsible.

C. Insurance and Causation

Insurance institutions can also mark people or organizations as "responsible" in the third, causal sense of the word. In deciding when and whether to defend and pay claims, insurance claims personnel regularly decide who or what caused what. Workers' compensation insurance also illustrates this dynamic. Each compensation payment reflects a judgment that an illness or injury was caused by

the worker's employment. These judgments are affected by the nature of workers' compensation benefits and the availability of other forms of compensation.

One demonstration of this comes from a study of doctors' judgments about whether an injury or illness resulted from employment.[24] The study compared doctors in health maintenance organizations (HMOs) with those in private practice. The compensation incentives of the two groups differed in a crucial respect: Private health insurance paid more for a given illness or injury than workers' compensation insurance, but workers' compensation insurance paid more than the HMOs. This meant that if the illness or injury was work related, doctors in HMOs were paid more for treating the patient, while doctors in private practice were paid less than they would have been if the condition was not work related. Not surprisingly, the study showed that the HMO doctors were more likely than the doctors in private practice to diagnose an injury or illness as work related.

Of course, the study tells us nothing about which doctors were right. What it shows is simply that payment systems affect judgments about causation. When the payment system favored the work-related diagnosis, more injuries were work related. When the payment system favored a contrary diagnosis, fewer injuries were work related. Absent workers' compensation, even fewer injuries would be "caused" by employment because there would be even less occasion to link employment to work. Thus, workers' compensation produces injuries at work not (only) because of moral hazard, but rather because it gives us a reason to link an event (injury) with a cause (work), where otherwise that event might never have been linked to that cause.

A second example comes from an excellent book by Barry Werth, *Damages* (1998).[25] *Damages* reports the personal and legal saga leading up to the settlement of *Sabia v. Norwalk Hospital*, a medical malpractice case brought on behalf of Tony Sabia, who nearly died shortly before he was born. Tony's twin brother, Michael, did die, and whatever caused Michael's death starved Tony's brain of oxygen long enough to cause profound damage. The defendants in the case were Mary Ellen Humes, the doctor who delivered Tony and Michael, and Norwalk Hospital, the hospital where Tony was born and that ran the maternity clinic that treated Tony's mother.

It becomes clear to Tony's lawyers that (1) if the harm is shown to have been caused during delivery, the jury will put Dr. Hume on the hook and her insurance policy limits ($2 million) will be available to compensate the plaintiff; but (2) if the harm is shown to have been caused earlier, the hospital, with its $17 million of liability coverage, will be on the hook. So how does it turn out? Tony's lawyers skillfully manage this uncertainty about causation to get a settlement that included (1) a major contribution by Dr. Hume's insurer, as well as (2) a major contribution from the hospital's insurer. How do you think the plaintiffs were able to get both insurers to contribute to the settlement, given that the accident was caused either during the delivery or earlier? What

24. Richard J. Butler et al., *HMOs, Moral Hazard and Cost Shifting in Workers Compensation,* 16 J. Health Econ. 191 (1997).

25. This discussion is adapted from Tom Baker, *Teaching Real Torts: Using Barry Werth's* Damages *in the Law School Classroom*, 2 Nev. L.J. 386 (2002).

difference would it have made if Dr. Humes had an insurance policy with a $20 million limit? If she had no insurance?

In addition to such case-by-case approaches to causation, insurance institutions are also involved in shaping public opinion regarding causation. Beliefs about who or what tends to cause what can have a significant impact on political decisions allocating financial accountability. For example, much of the rhetoric of moral hazard in policy debates identifies people as "responsible" in a causal sense for their condition (and thus not deserving of insurance support). We can see this at work in such diverse fields as social insurance, workers' compensation, and products liability. The larger point is that causation and responsibility are *created,* not revealed. Even if we can imagine that there is some "real" or "essential" cause for an injury (or anything else for that matter), we can never even hope to see it except through the perspectives that our history and institutions offer us. Insurance powerfully shapes those perspectives.

D. Insurance and Freedom

Insurance can also affect responsibility in the freedom or self-determination sense. As discussed above, insurance is intimately tied up with social control. The more an insured loss lies within the control of the individual insured, the more strings an insurance company attaches to the promise to insure. What we described previously as "structuring situations so that people act in a more or less responsible—in the Scout Law sense—manner" is a form of social control.

Insurance-based limits on freedom, autonomy, and self-determination (but none of these terms is exactly right) affect not only insurance beneficiaries, but also people and institutions that provide insured services, such as doctors and lawyers. Indeed, both the medical and legal professions are currently engaged in a struggle to maintain their professional autonomy in the face of cost control efforts by insurers. Doctors and managed health care receive the most public attention, but the same dynamic affects tort defense lawyers and liability insurance. Liability insurance companies instruct defense lawyers whether and when to take depositions, whether and when to settle, whether and when to hire experts, and so forth. Moreover, the legal expense accounting systems used by some U.S. liability insurance companies apparently allow them to tell their law firms which lawyers within the firm are the most effective (from a cost efficiency perspective), thereby affecting compensation and promotion within the firms.

E. Insurance and Solidarity

Depending on the degree to which premiums or benefits are linked to individual characteristics or choices, the fortunes of members of an insurance group can be linked together to a greater or lesser extent. This sort of solidarity can also be seen as a form of redistribution from the better off (less risky) to the worse (more risky). As the differences between individual life insurance and U.S. Social Security benefits show, there are great variations in the degree of solidarity or redistribution that insurance institutions embody. Individual life insurance, with its underwriting guidelines, risk classifications, and investment choices, epitomizes the individualistic end of the insurance spectrum, and

Social Security, with its mandatory participation and income-based premiums and benefits, epitomizes the solidaristic end. A health care plan with "community rating" (everyone pays the same premium) and "open enrollment" (no one is turned away) is more solidaristic than a plan that charges the sick more than the healthy and turns the riskiest applicants away. Thus, the individual mandate and other aspects of the Affordable Care Act represent a significant effort to move health insurance in the United States toward greater solidarity. Efforts to repeal the Affordable Care Act represent, at least in part, a break down in social ties and a polarization that inhibits feelings of solidarity on a national scale.

To the extent that the government forbids insurers from engaging in risk classification, it is in effect compelling a greater degree of solidarity or redistribution than would otherwise exist in insurance markets. As it turns out, individual state governments in the United States differ significantly in their approaches to these risk-classification issues. Does this suggest that there is variation across states in terms of the citizens' desire for insurance solidarity/redistribution? Or does this suggest variation in the strength of insurers' ability to resist such rules? This topic is addressed at greater length in Chapter 6.

F. The Four Conceptions of Insurance

In yet another way of analyzing what insurance is, the following excerpt from an insightful article by Professor Kenneth Abraham describes "four conceptions of insurance." As you read it, think about how the taxonomy that Professor Abraham uses is consistent or inconsistent with the ideas of insurance as regulation, insurance as redistribution, insurance as social stratification, and insurance as responsibility.

> It is worthwhile at the outset to briefly summarize the four conceptions. The *contract conception* understands insurance as a voluntary agreement between an individual policyholder and an insurer, subject to the constraints and rules of construction that are ordinarily placed on such agreements by the law of contracts. This conception supplies the "literal" view of insurance to which the other conceptions, understood as metaphors or analogies, contrast themselves. Under the *public utility-regulated industry conception,* contracts are a mere tool for bringing the regulated relationship into existence. On this view, insurance is a cartelized industry selling a good sufficiently essential that it requires government regulation in the public interest. The *product conception* sees insurance as resembling a tangible good more than a promise to perform financial services, and therefore appropriately subject to rules analogous to those that govern defectively designed products. Tort rather than contract is the therefore core paradigm in this conception. 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. Insurance law rules analogous