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Regulation by Liability Insurance: From Auto to Lawyers Professional Liability

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Regulation by Liability Insurance:
From Auto to Lawyers Professional Liability

Tom Baker[†] *and Rick Swedloff*[††]

Liability insurers use a variety of tools to address adverse selection and moral hazard in insurance relationships. These tools can act on insureds in a manner that can be understood as regulation. We identify seven categories of such regulatory activities: risk-based pricing, underwriting, contract design, claims management, loss prevention services, research and education, and engagement with public regulators. We describe these activities in general terms and then draw upon prior literature to explore them in the context of five areas of liability and corresponding insurance: shareholder liability, auto liability, gun liability, medical professional liability, and lawyers' professional liability. The goal is to develop a conceptual framework to guide qualitative research on liability insurance as governance.

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I. Introduction

It is a privilege to participate in a symposium that honors the career and contributions of Professor Stephen Yeazell – a legend in the field of civil procedure – by asking a diverse group of legal scholars to think about the next hundred years of litigation. As Professor Yeazell's work has emphasized, civil procedure is not an end to itself and litigation is not merely a way to channel dispute resolution. Civil procedure and litigation matter because this country "relies on civil lawsuits rather than regulatory or social welfare regimes … to assign responsibility and pay compensation in a wide variety of circumstances."[1]

Throughout his career Professor Yeazell has encouraged civil procedure scholars to look in places that might previously have been unfamiliar to them: "in social and economic developments outside law and within law, in the business and financial structure of practice."[2] One of these "economic developments outside of law" that has transformed the shape of litigation generally and tort in particular is the availability and prevalence of liability insurance.[3] As he observes, "No one working on a contingent fee intentionally sues an insolvent defendant"[4] and "liability insurance directly produces a solvent prospective defendant and given liability and injury, obviously increases prospective recovery."[5] Liability insurance affects who litigates against whom, for what, and how much.[6]

Thanks to Professor Yeazell and a few others, civil procedure scholars and students alike already understand this part of the governance role of liability insurance, along with one very important corollary: the control that liability insurers exercise over the defense and settlement of

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[1] Stephen C. Yeazell, *Transparency for Civil Settlements: NASDAQ for Lawsuits?* in CONFIDENTIALITY, TRANSPARENCY, AND THE U.S. CIVIL JUSTICE SYSTEM (Joseph Doherty, Robert T. Reville, and Laura Zakaras, eds., 2012)

[2] Stephen C. Yeazell, *Re-financing Civil Litigation*, 51 DEPAUL L. REV. 183, 186 (2001) [hereinafter Yeazell, *Re-financing*] (making the further point that even where "legal rules have changed, the interaction of the changes with the business and financial structure, rather than the substantive changes themselves, has produced the most dramatic results").

[3] *Id. See generally* KENNETH S. ABRAHAM, THE LIABILITY CENTURY: INSURANCE AND TORT LAW FROM THE PROGRESSIVE ERA TO 9/11 (Harvard University Press 2008) (describing the inextricable relationship between tort and insurance).

[4] Yeazell, *Re-financing, supra* note 2, at 186.

[5] *Id* at 189. *Cf.* Kent Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629-54 (1994)

[6] *See* Tom Baker, *Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law*, 12 Conn. Ins. L. J. 1 (2006).

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insured litigation.[7] Liability insurance contracts typically give the insurer the right to defend any covered claim and the discretion to settle the claim or not, without the consent of the nominal defendant.[8] This is hardly surprising, since it is the insurer's money at stake, but it means that, even in a case against an individual defendant, the plaintiff's real adversary is a massively repeat player, with all the consequences that entails for the litigation and legal developments.[9]

As even a moment's reflection would suggest, the regulatory potential of liability insurance extends well beyond litigation and settlement. Once insurers accept the financial responsibility for civil liability, they not only have an incentive to manage the defense and settlement of liability claims, they also have an incentive to reduce the likelihood that those claims arise in the first place. This is simply the liability insurance instance of the larger loss prevention incentive of insurance.[10] Once an insurer underwrites a risk, the insurer has every incentive to reduce its payouts by encouraging the insured to keep the potential loss from materializing. That incentive can, and sometimes does, lead insurers to attempt to regulate loss-producing activities.

We are in the early stages of qualitative research exploring this regulatory role in the context of lawyers professional liability (LPL) insurance. Lawyers' incentives and the organizations in which they work affect how they practice, including whom they choose to represent, the kinds of services they provide, and how they provide those services to their clients. Some prior literature asserts that insurers can play an important role in shaping these incentives and organizations, but there has been no systematic empirical investigation of such regulation by insurance.[11] We use the opportunity provided by this Symposium to lay a conceptual foundation

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[7] Yeazell, *Re-financing*, *supra* note 2, at 189. *See also* Samuel R. Gross and Kent Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial,* 90 MICH. L. REV. 319 (1991); Samuel R. Gross and Kent Syverud *Don't Try: Civil Jury Verdicts in a System Geared to Settlement,* 44 UCLA L. REV. 1 (1996).

[8] Liability insurance policies sold to large organizations are the exception.

[9] Cf. Marc Galanter, *Why the Haves Come Out Ahead: Speculations on the Limits of Legal Change*, 9 Law and Soc. Rev. 1 (1974) (drawing a distinction between repeat players and one shotters and describing the significance this has for the development of law).

[10] *See* Omri Ben Shahar & Kyle Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard,* 111 U. MICH. L. REV. 197 (2012). *Cf.* RICHARD ERICSON, AARON DOYLE, AND DEAN BARRY, INSURANCE AS GOVERNANCE (2003) (taking a sociological perspective that would be critical of the present functionalist account).

[11] *See, e.g.*, Anthony E. Davis, *Legal Ethics and Risk Management: Complementary Visions of Lawyer Regulation*, 21 GEO. J. LEGAL ETHICS 95 (2008) [hereinafter Davis, *Complementary Visions*] (arguing that insurance risk management devices can enhance ethical decision making); Anthony V. Alfieri, *The Fall of Legal Ethics and the Rise of Risk Management*, 94 GEO. L.J. 1909 (2006) (arguing that risk management techniques designed to avoid liability undermine individual ethical decision making); Milton C. Regan, *Risky Business*, 94 Geo. L.J. 1958 (2006) (responding to Alfieri's concerns about the governance implications of risk management); James M. Fischer, *External Control Over the American Bar*, 19 GEO. J.

for our empirical research. We first describe the main activities through which liabilty insurers might be said to "regulate" the people and organizations that they insure. We then explore those activities in the context of four other fields of liability and insurance: shareholder liability, auto liability, gun liability, medical malpractice, and legal malpractice. We then turn to LPL insurance, drawing on the prior literature to suggest some ways that liability insurers may regulate law practice and to develop questions to be investigated in the ongoing research.

II. Regulatory Activities of Liability Insurers

As Professor Yeazell would be among the first to point out, liability insurance has proven to be central to nearly every field of liability that has been the subject of even casual empirical analysis, including automobile liability,[12] workplace liability,[13] environmental liability,[14] corporate and securities liability,[15] medical liability,[16] products liability,[17] and media liability.[18] There are exceptions to be sure, such as patent infringement[19] and contract litigation,[20] but

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LEG. ETHICS 59, 63-64, 64 n.23 (2006) (arguing that lawyers are increasingly subject to regulation by external sources, including insurance); Elizabeth Chambliss & David B. Wilkins, *The Emerging Role of Ethics Advisors, General Counsel, and Other Compliance Specialists in Large Law Firms*, 44 ARIZ. L. REV. 559 (2002) (describing the results of a series of interviews about the regulatory impact of the increasing prevalence of general counsels and other compliance specialists at law firms); George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 Conn. L.J. 305 (1997) (laying out the economic framework under which liability insurance could regulate lawyers); Anthony E. Davis, *Professional Liability Insurers as Regulators of Law Practice*, 65 FORDHAM L. REV. 209 (1996) [hereinafter Davis, *Regulators*] (providing an on-the-ground account of the ways that insurers attempt to regulate legal practice); Charles Silver, *Professional Liability Insurance as Insurance and as Lawyer Regulation: Response to Davis*, 65 Fordham L. Rev. 233 (1996)..

[12] H. LAURENCE ROSS, SETTLED OUT OF COURT (1970).

[13] Abraham, *supra* note 3, at 39 (2008); Tom Baker, *Insurance and Social Construction of Responsibility*, in EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY 33, 42-43 (Tom Baker & Jonathan Simon, eds. 2002).

[14] *See, e.g.*, KENNETH ABRAHAM, ENVIRONMENTAL LIABILITY INSURANCE LAW (1991); Haitao Yin, Howard C. Kunreuther, and Matthew W. White, *Risk-Based Pricing and Risk-Reducing Effort: Does the Private Insurance Market Reduce Environmental Accidents?* (September 9, 2008), *available* at http://ssrn.com/abstract=1265592

[15] TOM BAKER AND SEAN GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION (2010).

[16] ABRAHAM, *supra* note 3, at 104-138; Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DEPAUL L. REV. 393 (2005).

[17] Abraham, *supra* note 3, at 139-170; Ben Shahar & Logue, *supra* note 10.

[18] Thomas Plotkin & Tarae Howell, *"Fair is Foul and Foul is Fair:" Have Insurers Loosened the Chokepoint of Copyright and Permitted Fair Use's Breathing Space in Documentary Films?*, 15 CONN. INS. L. J. 407 (2009); Hubbart, Elizabeth O. Hubbart, *When Worlds Collide: The Intersection of Insurance and Motion Pictures*, 3 CONN. INS. L.J. 267 (1996).

[19] CJA Consultants Ltd, Patent Litigation Insurance: A Study for the European Commission on the Feasibility of Possible Insurance Schemes Against Patent Litigation Risks Final Report (2006) available at http://ec.europa.eu/internal_market/.../patent/studies/pli_report_en.pdf. (Last visited February 4, 2013).

liability insurance stands behind such a large, if not precisely determinable, proportion of civil liability in the United States that liability insurance data regularly are regularly used to estimate the size and reach of the U.S. civil justice system.[21]

Appreciation of the strength of the link between liability and liability insurance was slow in coming, and certain aspects of that link remain controversial.[22] Nevertheless, the challenge today lies less in measuring the overall strength of the link than in charting the details across different fields and reflecting on their meaning.

We begin here with a simple law and economics framework for analyzing and comparing regulation by liability insurance. In that framework, tort liability exists for a single purpose, deterrence—tort liability (or the threat of tort liability) forces potential tortfeasors to internalize the harms they cause.[23] This, in turn, encourages efficient levels of loss prevention.[24] By insulating people from the financial sting of liability, liability insurance might seem to frustrate that purpose – hence the familiar insurance/deterrence tradeoff from law and economics. Indeed, there is evidence that insurance does change incentives – does create a moral hazard – in relation to at least some kinds of liability.[25] But, at least in theory, liability insurance institutions have the capacity to manage that moral hazard.[26] If so, "the success of insurers in managing insurance incentives may well mean that the most important 'moral hazard' effect is not increased loss, but rather increased social control" by insurers.[27]

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[20] Many tort cases can also be brought as contract cases and are covered by the applicable liability insurance either way. Products liability cases can also be brought as breach of the implied waiver of merchantability, and professional liability cases can also be brought as breach of contract cases. Of note, the single larges category of breach of contract cases is insurance. See Eisenberg article.

[21] *See* Tom Baker, Transpa*rency Through Insurance: Mandates Dominate Discretion*, in CONFIDENTIALITY, TRANSPARENCY AND THE U.S. CIVIL JUSTICE SYSTEM 184, 188-89 (Joseph W. Doherty, Robert T. Reville, & Laura Zakaras, eds. Oxford U. P. 2012); Kenneth Abraham & Lance Liebman, *Private Insurance, Social Insurance, and Tort Reform: Toward a New Vision of Compensation for Illness and Injury*, 93 COLUM. L. REV. 75 (1993).

[22] Jean Stapleton, *Tort, Insurance and Ideology*, 58 MODERN LAW REVIEW 820 (1995); Gerhardt Wagner essay in Liability in Tort and Liability Insurance, Gerhard Wagner, ed. (European Centre for Tort and Insurance Law 2005).

[23] ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS ___ (6th ed. 2012).

[24] *See* Steven Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120 (1982). For a review of the literature, *see* Tom Baker and Peter Siegelman, *The Law and Economics of Liability Insurance: A Theoretical and Empirical Review*, in HANDBOOK ON THE ECONOMICS OF TORTS (Jennifer Arlen, ed., forthcoming).

[25] Baker and Griffith, *supra* note 15 at 72-79 (concluding that, as presently structured, directors and officers insurance imposes agency costs on publicly traded corporations).

[26] Ben Shahar & Logue, *supra note* 10; Steven Shavell, *On Moral Hazard And Insurance*, 93 Q.J, OF ECON. 541 (1979).

[27] Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 282 (1996).

Accordingly, one important strand of empirical research on insurance investigates how insurers manage the moral hazard of insurance, and hence how they control or regulate their insureds.[28] The research has identified five main tools that almost all insurers use to one degree or another: risk-based pricing, underwriting, insurance contract design, claims management, and, less frequently, loss prevention services. In addition, some insurers and their trade associations also engage in research and education and, sometimes, even promote public safety regulation.[29]

Our characterization of all of these activities as moral hazard management tools should not be misunderstood to suggest that we contend either that insurers engage in these activities exclusively for the purpose of managing moral hazard or that the concept of moral hazard management provides an adequate description of the meaning of these activities in the liability insurance field. Individuals and organizations do things for all kinds of reasons and, once employed for a particular purpose, an activity will have different effects and even different purposes across time and place. In this Article, and at this early stage in our research, we are using the concept of moral hazard management as a narrative device, part of an admittedly thin conceptual framework that allows easy comparison across subfields of liability insurance. One of the goals of our ongoing empirical research on lawyers' professional liability is to thicken our understanding through interviews and observation.[30]

A. Risk-Based Pricing.

Except when prohibited from doing so, insurers operating in a competitive market attempt to price on the basis of the risks insured.[31] Their reasons for doing so are straightforward. Insurance is a bet about the probability of an event occurring. Riskier bets have a higher probability of requiring the insurer to to pay. A higher premium for these higher risks allows the insurer to cover the anticipated additional payouts. An insurer that can better distinguish the

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[28] See, e.g., Carol Heimer, Reactive Risk and Rational Action: Managing Moral Hazard in Insurance Contracts (1985)

[29] Our description of these moral hazard management activities as a form of regulation builds on a recent article by Omri Ben Shahar and Kyle Logue,, Ben Shahar and Logue, *supra* note 10, which generalized and improved a conceptual approach developed by Tom Baker and Thomas O. Farrish in the context of their research on liability insurance and the regulation of firearms. Tom Baker & Thomas O. Farrish, *Liability Insurance and the Regulation of Firearms*, in SUING THE GUN INDUSTRY 292 (Timothy Lytton, ed. 2005).

[30] Clifford Geertz. "Thick Description: Toward an Interpretive Theory of Culture," in Geertz, The Interpretation of Cultures: Selected Essays. New York: Basic Books, 1973. For a recent example of thick explanation in the financial services context, *see* ANNELISE RILES, COLLATERAL KNOWLEDGE (2011).

[31] For example, insurers may be prohibited from using race or gender as a proxy for riskiness in particular markets. *See generally* Ronen Avraham, Kyle Logue, Daniel Schwarcz, *The Anatomy of Insurance Anti-Discrimination Laws*, *available at* http://ssrn.com/abstract=2135800.

"good" from the "bad" risks improves its competitive position by lowering its own average risk of paying out and, potentially, raising the average risk of the competition.[32]

Risk-based pricing provides an incentive for people to do what they can to reduce exposure to liability claims, in order to avoid higher insurance prices in the future. This is moral hazard mitigation, plain and simple. Risk-based pricing also can make people aware of loss prevention measures and incentivize corresponding changes to behavior. Insurance prices are highly credible loss prevention signals, because insurers have an incentive to get those signals right and a feedback mechanism – insurance claims – to assess how they are doing in that regard. People who are motivated to avoid liability claims might actually take more care if they have access to insurance than if they don't, because loss-prevention based discounts can educate them about, or make more salient, ways to take care. This risk communication aspect of insurance pricing leads directly to the next moral hazard management tool: underwriting.

B. Underwriting.

Insurance underwriting is the process of evaluating which risks to insure and at what price.[33] We discuss underwriting separately from pricing to emphasize that insurers can collect and provide loss prevention information that may not be reflected in price differentials. Insurers do this to assess whether to provide insurance at all, to meet purchasers' demand for loss prevention advice, or to encourage loss prevention behavior that insurers believe to be beneficial even though they do not offer premium discounts. (It may be too costly to monitor whether the insured complies with the loss prevention advice, or the insurer may not have sufficient information to calculate the value of the loss prevention.) Whether purchasers act on that information is up to them, but someone who is motivated to avoid liability claims, or the mistakes or injuries that lead to claims, will take credible loss prevention advice from wherever it comes.

C. Contract design.

Insurers use contract design to mitigate moral hazard in several ways. They use contract provisions like limits, deductibles, and coinsurance so that the insurance does not fully insulate

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[32] Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371 (2003).

[33] SCOTT E. HARRINGTON AND GREGORY R. NIEHAUS, RISK MANAGEMENT AND INSURANCE 141(2d ed. 2004) ("[T]he overall process of assessing the expected claims costs for buyers, determining the applicable rate, and deciding whether to offer coverage is known as underwriting.").

people from their losses, keeping their skin in the game.[34] (Limits keep insureds' skin in the games at the high end, deductibles at the low end, and coinsurance throughout.) Insurers also use contract provisions that eliminate or reduce coverage for claims thought to pose a high degree of moral hazard. For example, most general liability insurance policies exclude from coverage harms that are "expected or intended" by the insured.[35] In addition, insurers in the large commercial market also use targeted exclusions – sometimes called "laser exclusions" – to exclude particular kinds of claim from coverage, thereby placing a cap on the total amount of coverage for that kind of claim that any particular insured can get over time.[36] These contract designs "regulate" indirectly. By leaving a greater share of certain liability risks on the insured, they encourage greater vigilance over those risks.

D. Claims management.

The contract provisions described above manage moral hazard by selectively limiting the extent of insurance. Insurers also can use contract provisions to give them control over claims management. In the liability insurance context, these provisions may give insurers control over the defense and settlement of the underlying insured claims.[37] Insurer control over claims management mitigates ex post moral hazard (a policyholder's lack of concern over the cost of a claim once it occurs).[38] Consumer and small business liability policies generally give insurers exclusive control over the defense and settlement of claims.[39] Commercial policies sold to larger entities often allow the entities to control their own defense, but the insurer has a voice in that defense and significant control over settlement.[40] Insurers' claims management directly regulates the litigation process, but it also promotes other aspects of regulation through insurance by providing an opportunity for insurers to learn about liability risks, both in general and in relation

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[34] *See, e.g.*, Baker & Griffith, *supra* note 15 at 220.

[35] *See* Rick Swedloff, *Uncompensated Torts*, 28 GA. ST. U.L. REV. 721, 739 (2012).

[36] *See* Baker & Farrish, *supra* note 8, at 297.

[37] American Law Institute, Principles of Liability Insurance Project (Tent. Draft No. 1 2013).

[38] Tom Baker, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 CONN. INS. L.J. 101 (1998).

[39] ALI, supra note 37, at Section --.

[40] Id. at Section __.

to the particular insured. Insurers can use this information in pricing, underwriting, and, the next moral hazard management tool, loss prevention services.[41]

E. Loss prevention services.

Loss prevention services may be the easiest aspect of the insurance business to understand as a form of regulation. In theory, insurers should be, and sometimes are, highly sought after sources of loss prevention services.[42] Unlike other sources of loss prevention services, however, insurers *bond* their advice. If a loss occurs, they pay, whether their advice was good, bad or indifferent.[43] The same cannot be said of accountants, consultants, lawyers, or other purveyors of loss prevention services. Making them pay requires proving negligence and a causal link between that negligence and the loss. Making the insurer pay requires only proving the loss (and sometimes that the loss is covered by the policy).[44]

Although insurers provide loss prevention services for other reasons as well (marketing, public relations, buyer demand), there is at least some moral hazard management involved. Insurers can use the information gained from the loss prevention activity to fine-tune their underwriting and perhaps even their pricing. Moreover, active engagement in loss prevention may identify a firm as posing lower than average moral hazard, possibly allowing the insurer to offer the firm a better price, better contract terms, or more autonomy in the claims process.

F. Research and education.

All of the activities discussed so far hold out the possibility of reasonably identifiable payoffs to the contracting parties: lower prices or better terms for purchasers and lower or more predictable claim costs for insurers. Insurers also engage in loss prevention research and education that appears to have more of a public good character, with benefits that extend beyond the specific insurer or its policyholders.[45] As Ben Shahar and Logue describe, this research and

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[41] *Cf.*, Margo Schlanger, *Operationalizing Deterrence: Claims Management* (in Hospitals, a Large Retailer, and Jails and Prisons), 2 Journal of Tort Law (Aug. 2008); Joanna Schwartz, *A Dose of Reality for Medical Malpractice Reform* 88 NYU L. Rev. --- (2013).

[42] George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 305 (1997-98)

[43] *Id*.

[44] *Cf.* Kenneth Abraham, *The Rise and Fall of Commercial Liability Insurance*, 87 VA. L. REV. 85 (on the implied "big claim exclusion").

[45] *See, e.g.*, Ben Shahar and Logue, *supra* note 10, at 212

education can lead to regulatory techniques such as private safety codes, loss control toolkits, and safety coaching.[46]

Presumably, insurers believe that such activities offer them private benefits, such as brand recognition, customer loyalty, or preferential treatment from their regulators. Or perhaps these activities identify them at the cutting edge of loss prevention, attracting loss prevention minded customers who are low risk ("propitious selection").[47] Whatever the motivation, loss prevention research and education may help to offset the aggregate moral hazard impact of liability insurance by reducing the frequency or severity of liability claims. In addition, the research may inform insurers' pricing, underwriting, and claims management efforts in a manner that can be targeted to specific insureds.

G. Engagement with public regulation.

This final moral hazard management tool is a logical extension of loss prevention research and education. Sometimes a loss prevention measure may make so much sense to insurance industry leaders that they are motivated to engage with public regulators, whether to increase the likelihood that insureds will undertake these measures or to recruit the government into overseeing enforcement. There are many examples in the automobile context, some of which seem likely to affect auto liability claims (such as airbag and seatbelt regulation).[48] Like research and education, engagement with public regulation does not directly affect the moral hazard of any particular insurance contract, but it may have aggregate loss prevention benefits that reduce whatever overall moral hazard impact of liability insurance there may be.

III. Regulation by Liability Insurance in Other Fields

To set the stage for our ongoing research on lawyers' professional liability insurance, we will next describe what we can discern about how insurers use these tools in four other liability areas: shareholder liability, automobile liability, gun liability, and medical professional liability. As these examples will show, there is wide variation in the nature and extent of regulation through liability insurance across and within fields of liability.

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[46] Ben Shahar & Logue, *supra* note 10, at 210-13.

[47] *See* David Hemenway, *Propitious Selection*, 105 Q.J. ECON. 1063 (1990). For a review of the literature on adverse selection, *see* Peter Siegelman, *Adverse Selection: An Exaggerated Threat*, 113 YALE L. J. 1223 (2004).

[48] Ben Shahar & Logue, *supra* note 10, at --. Mothers Against Drunk Driving reports that two of the first major financial contributors to that organization were insurance industry executives who had lost family members to drunk driving. *See* Laurie Davies, *25 Years of Saving Lives*, DRIVEN, Fall 2005 9, 11.

A. Shareholder Liability and Insurance

We begin with shareholder liability and insurance, not because it is the best comparison for lawyers liability and insurance, but rather because it is the field that has been the subject of the most directly analogous research project, conducted by Tom Baker and Sean Griffith during the 2005-2010 period.[49] There is much publicly available information about the other kinds of liability and insurance, but that information has not previously been collected in a manner that fits as well with our conceptual framework.

Public companies and their officers and directors protect themselves from the financial consequences of shareholder liability through the purchase of Directors and Officers Liability Insurance – "D&O insurance." The research on D&O insurance as governance reaches decidedly mixed conclusions about how insurers manage the moral hazard of public company D&O insurance. Our discussion here, like Baker and Griffith's research, focuses exclusively on the D&O insurance sold to public companies (those with publicly traded shares). Many other kinds of organizations also purchase D&O insurance. We don't have anything to say about them.

Risk-Based Pricing. On the one hand, D&O insurers report that they work hard to price on the basis of risk.[50] They have every incentive to do so, and no legal or other institutional restrictions on risk-based pricing that the researchers could find. On the other hand, there is substantial evidence that insurers are not very confident about their ability to price on risk given that the pricing differentials are small in relation to the insured liabilities.[51] Moreover, insurers do not provide discounts for companies that undertake specific loss prevention activities.[52] Thus, at best, risk-based pricing mitigates the moral hazard of D&O insurance by providing a modest incentive for avoiding claims.

Underwriting and ex ante loss prevention services. The D&O insurance underwriting process does not provide significant, useful loss prevention information to public companies.[53] D&O insurance companies do not condition the provision of insurance on the basis of any loss prevention commitments by public companies or their officers and directors, nor do D&O

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[49] *See generally* Baker & Griffith, supra note 15.

[50] *Id.* at 79.

[51] *Id.* at 78 ("athough D&O insurers do seek to price on the basis of risk, their efforts are unlikely to be sufficient to reinvigorate the deterrence function of shareholder litigation") and 203

[52] *Id.* at 112.

[53] *Id.* at 105.

insurers provide significant loss prevention services.[54] For the fully nuanced explanation, there is no shortcut to reading the research, but here is the punch line:

> [W]e find the agency cost explanation most compelling. Top executives buy D&O insurance, with their shareholders money, so that all but the most extraordinary securities class actions will be a "nonevent" in the life of a publicly traded company. And, it would be easy to argue, they do not want to allow an insurer's concern about the possibility of a securities class action to be an event that interferes with their freedom. Thus, the absence of insurance monitoring … is an agency cost – a "perk" that managers buy to make it easier, and more profitable, for them to keep their jobs, at the expense of the shareholders who own the company. Top executives in public corporations are thus able to purchase income-smoothing insurance without ceding any governance authority to insurers because this purchase, like all such decisions, is insulated from shareholder challenge by the business judgment rule.[55]

Contract design. Although D&O insurers may not exercise much governance authority directly, D&O insurance contracts contain a variety of moral hazard control features. There are substantial deductibles in the D&O coverage provided to the insured companies.[56] These deductibles provide some incentive for public companies to manage the costs of defense and to resist paying nuisance settlements. Perhaps more importantly, the total amount of coverage that D&O insurers are willing to provide is much less than the potential damages that could be awarded in securities class action involving egregious fraud, with the result that D&O insurance protects public companies from what might be thought of as "ordinary" or "run of the mill" securities fraud, leaving them exposed to the really serious cases.[57]

Consistent with that dynamic, D&O insurance policies contain fraud exclusions that contain a "final adjudication" requirement, so that claims are covered unless and until there is a final adjudication of fraud in the case for which coverage is sought.[58] Other moral hazard control

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[54] *Id.* at 110-113. The following story is instructive:

> [A] long time top official in the D&O insurance industry described a time that he and another senior official prepared a detailed set of loss-prevention recommendations for a customer in the early days of what was then their new company. …. Very pleased with their work, they mailed it off to the customer. "We got it back," he reported, "almost like it was something we sent them in a brown envelope. They didn't want it. And they didn't want it in their files. We learned that's not what they want from us."

Id. at 126.

[55] *Id.* at 126-27.

[56] *Id.* at 47. Note that the coverage provided directly to their directors and officers, which kicks in only if the company cannot pay, typically does not have deductibles. *Id.*

[57] *Id.* at 20.

[58] *Id.* at 186-88. Id. at 186, quoting a D&O insurance claims manager:

> We may insure securities fraud but not real fraud. … If you are going to be out and out fraud, that is uninsurable, okay. And that's the paradox of the insurance. Everybody

features in D&O insurance contracts include exclusions for claims brought by one insured against another (which could be collusive) and for claims based on illegal profits received by an insured.[59]

Claims management. D&O insurance contracts give insurers limited control over claims management. D&O insurance policies are "defense cost payment" policies, rather than "duty to defend" policies, so that someone insured by a D&O policy gets to choose their own defense lawyer and direct their own defense.[60] The D&O policy also gives insureds significant control over the settlement process, subject to the obligation to obtain the insurer's consent, with the result that the insurer's protection against ex post moral hazard consists only in the right to refuse to reimburse unreasonable defense costs and to refuse to consent to an unreasonable settlement.[61]

Research and education and engagement with public regulation. With the exception of one D&O insurance company that subsequently went out of business,[62] D&O insurance companies do not engage in significant loss prevention research and education efforts, nor do they engage significantly with public regulation. D&O insurers have newsletters and brochures that contain loss prevention information, but "underwriters and brokers uniformly describe this literature as marketing material."[63] Some insurers support organizations that promote good governance, such as Institutional Shareholder Services, and participate in directors' and officers' training efforts, but there is nothing that approaches the focused loss prevention research and education efforts by the automobile insurance industry.[64] Similarly, D&O insurers do not typically engage with public regulation of corporate governance or financial disclosure, for example through government relations efforts targeted at the Securities Exchange Commission or Delaware law reform.[65]

> buys the policy for when they get hit with securities fraud allegations, and if it weren't for the fact that recklessness is a standard there, we probably wouldn't be able to insure it an all, because if you had to prove outright fraud in every case, it would be uninsurable in every case.

[59] *Id.* at 49.

[60] *Id.* at 129.

[61] *Id.* at 129-33. As a practical matter, the right to refuse consent to a settlement may provide only limited protection, however, because policyholders regularly settle cases when the insurer refuses to consent, and then bring a breach of contract action against the insurer on the grounds that the insurer unreasonably withheld consent. *Id.* at 140.

[62] *Id.* at 111-12.

[63] *Id.* at 111.

[64] *Id.*

[65] This type of activity is so infrequent that it did not come up in the D&O insurance research effort. Subsequently we corresponded with the leading D&O insurance industry commentator and confirmed this to be the case. See email from Kevin LaCroix, RT ProExec (January 29, 2013) ("There is not so far as I am

B. Auto Liability and Insurance

Automobile liability may well be the part of the liability field most completely tied up with liability insurance.[66] Thanks, first, to the insurance requirements contained in automobile insurance finance contracts and, second, to state automobile financial responsibility laws, automobile liability insurance became ubiquitous by the mid 20th Century.[67] Absent liability insurance, most individual drivers and even many commercial drivers would not be worth pursuing and, thus, not as a practical matter subject to civil liability.[68] Although automobile liability has not been the subject of systematic qualitative research that explicitly examines regulation by insurance,[69] there is a substantial body of empirical research on auto liability and other public information that we can draw from to make useful generalizations.

Risk-Based Pricing. By all accounts, auto insurers take a highly data driven approach to auto insurance pricing that is not directed at moral hazard management but nevertheless may have some regulatory impact.[70] The best candidates are differential pricing by auto type (e.g., sports car vs. minivans), accident record, the amount of miles driven in a year, auto safety features, and whether teen drivers have completed drivers' education courses. We have been unable to find

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aware any organized effort by the D&O insurance industry or individual companies within the industry to shape regulation or policy").

[66] Abraham, supra note 3 at 69. *See generally* Jonathan Simon, *Driving Governmentality: Automobile Accidents, Insurance and the Challenge to Social Order in the Inter-War Years, 1919-1941*, 4 CONN. INS. L.J. 521-588 (1998).

[67] Yeazell, *Re-financing supra* note 2, at 188-89. Yeazell usefully points out that, thanks to the insurance industry's practice of bundling first party property coverage for automobiles with liability coverage, automobile financing made automobile liability insurance mandatory as a de facto matter for large segments of the public well before mandatory liability insurance laws were enacted.

[68] Steven Gilles, *The Judgment Proof Society*, 63 WASH. & LEE L. REV. 603, 606 (2006) ("[M]any Americans are 'judgment proof': They lack the sufficient assets (or sufficient collectible assets) to pay a judgment in full (or even in substantial part)."); Tom Baker, *Blood Money, New Money and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275 (2001). For that reason, it makes little sense to think about the moral hazard effect of liability insurance, except in terms of social control. Of course there are large, solvent organizations with cars, just as there are wealthy individuals, but they do not represent the mass of automobile liability claiming. As the designers of mandatory automobile liability insurance well understood, tort liability cannot function as a form of governance for ordinary people unless it is accompanied by liability insurance.

[69] Partial exceptions include Jonathan Simon, Driving Governmentality, and H. Laurence Ross, Settled Out of Court (1970).

[70] See, e.g., Segovia-gonzalez, M M; Contreras, I; Marmolinero, C. , A DEA analysis of risk, cost, and revenues in insurance, The Journal of the Operational Research Society, suppl. Part Special Issue: Data Envelopment Analysis: Theory and 60. 11 (Nov 2009): 1483-1494; Krikler, Samuel; Dolberger, Dan; Eckel, Jacob, Method and tools for insurance price and revenue optimization;. Journal of Financial Services Marketing 9. 1 (Sep 2004): 68-79; Malia Wollan, DATA DRIVEN, Fast Company 156 (Jun 2011): 46,48 (reporting data driven nature of Progressive Insurance Company).

much econometric research documenting the effects of these practices,[71] but automobile insurance is such a salient cost of auto ownership that we expect that higher prices can have significant effects, for example by encouraging the purchase of cars that are cheaper to insure.[72]

Discounts for safety features are likely to have an even larger effect on accidents, because safety has value for consumers well beyond any reduction in insurance premiums. After all, the same activity that exposes people to a risk of auto liability also exposes them to hurting themselves. Discounts for drivers' education are similarly likely to pay off to an extent that goes beyond the value of the discount. There is significant evidence that the price of auto insurance affects the rate of teen drivers.[73] Discounts for drivers' education reduce the effective price, and, presumably, provide safety benefits that parents, and maybe even some teens, value even apart from the reduction in price.

Underwriting. Because automobile insurance is sold on such a mass market, data-driven basis, we doubt that the underwriting process provides individuals with loss prevention information (except as reflected in discounts or other features of the price), but this should be regarded as an open question. Our own experience is that generic loss prevention information comes in the mail only after we had already been approved for and purchased the policy.

Contract design. Apart from contract provisions giving the insurer control over claims management, auto liability insurance contracts do little to address moral hazard. This makes sense because auto liability insurance seems quite unlikely to reduce whatever safety motivation drivers would otherwise have. Auto accidents pose nearly as much risk of death as injury to the insured driver as to others. Fear of liability is unlikely to add to the fear of pain and death that should accompany unsafe driving. While auto insurance policies do contain an exclusion for

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[71] Cf., Mary A. Weiss, Tennyson, Sharon; Regan, Laureen THE EFFECTS OF REGULATED PREMIUM SUBSIDIES ON INSURANCE COSTS: AN EMPIRICAL ANALYSIS OF AUTOMOBILE INSURANCE Journal of Risk and Insurance77. 3 (Sep 2010): 597-624 (showing that rate suppression increases accident rates); Tennyson, Sharon. Incentive Effects of Community Rating in Insurance Markets: Evidence from Massachusetts Automobile Insurance, Geneva Risk and Insurance Review35. 1 (Jun 2010): 19-46 (same); Dionne, Georges; Dostie, Benoit, Estimating the effect of a change in insurance pricing regime on accidents with endogenous mobility. 1 HEC Montreal, Institut d'economie appliquee, Cahiers de recherche: 07-11, 2007 (showing that the introduction of a bonus-malus reduces accident rates).

[72] See, e.g., Jenny Zhan & Brenda Vrkljan, *Exploring Factors that Influence Vehicle Purchase Decisions of Older Drivers: Where Does Safety Fit In?*, Proceedings of the Sixth International Driving Symposium on Human Factors in Driving Assessment, Training and Vehicle Design (2011) (reporting that "[p]articipants … accounted for long term costs of vehicles in their vehicle selection, including insurance and fuel"); Frederick P Rivara, Matthew B Rivara, Keith Bartol - Pediatrics, *Dad, may I have the keys? Factors influencing which vehicles teenagers drive*, 102 Pediatrics e57 (1998) (listing insurance costs as an important factor).

[73] See, e.g., Rose Anne Devlin, Liability Versus No-Fault Automobile Insurance Regimes: An Analysis of the Experience in Quebec, in Contributions to Insurance Economics 499, 512-12 (Georges Dionne ed., 1991).

intentional harm, we doubt that eliminating that exclusion would do much to increase intentional auto injuries because of the close monitoring of driving by police and the resulting high probability of criminal prosecution.[74]

As with D&O insurance, most people buy automobile liability insurance limits that are much less than the potential damages in a serious claim. Those limits seem quite unlikely to serve a moral hazard management function in the auto liability insurance context, however. Research suggests that people are almost never required to pay their own money in an auto liability claim and, when they do, the amount typically is a token "blood money" payment.[75] Of course, ordinary people are unlikely to understand this situation in any detail, but the absence of such cases means that they are very unlikely to hear about anyone suffering negative consequences from being under-insured. Moreover, those rare individuals who are concerned about excess liability can take care of this concern by buying umbrella and excess auto liability insurance policies.

Auto insurance deductibles do not apply to the liability coverage in an auto policy (perhaps because insurers do not want to do anything to discourage people from promptly reporting potential liability claims) and, thus, cannot serve a moral hazard management function, either. The one auto insurance contract provision that, apart from the claims management provisions, may have some moral hazard management impact is the family member exclusion, which is thought to reduce the likelihood of collusive lawsuits among family members, similar to the insured versus insured exclusion in D&O insurance policies.[76]

Claims management. Except for auto insurance policies sold to large organizations with special self-insurance arrangements, automobile liability insurance policies assign the insurer complete control over defense and settlement of claims. This means that auto liability insurers hire, fire, and direct the defense lawyers and decide whether and when to settle the claim, without any need to consult with the nominal defendant.[77] Among other consequences, insurers' control

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[74] *Cf.* Tom Baker, *Liability Insurance at the Tort-Crime Boundary*, in FAULT LINES: TORT LAW AS CULTURAL PRACTICE, (David M. Engel and Michael McCann, eds. 2009); Tom Baker, Alon Harel, Tamar Kugler, *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443 (2004) (reporting experimental research showing that increasing the probability of detection decreases the likelihood of violating a norm).

[75] Baker, *Blood Money*, *supra* note 68.

[76] See Couch on Insurance § 114:24 (describing family member exclusions). Couch reports, "The trend is to find that clauses expressly excluding coverage of relatives of the insured are void and unenforceable. The reason for voiding the clause is that is violates the statutory schem of comprehensive liability coverage." *Id.* at § 114:25.

[77] *See* Robert H. Jerry II and Douglas R. Richmond, Understanding Insurance Law 832 (5th Ed.) (reporting that insurer has discretion to settle without consent of insured); ALI, *supra* note – at --.

over claims management means that the real party in interest in automobile liability claims is a massively repeat player managing the defense of any particular claim as just one in a portfolio of cases.[78] This practical reality makes automobile liability insurers very important players in the civil justice arena and worth careful study for reasons that go well beyond the role of liability insurance as regulator of drivers.[79]

Loss prevention. We have not found any examples of auto insurers providing tailored loss prevention services targeted to the specific situation of individual insureds. What we find, instead, are generalized exhortations to employ safe driving practices, such as using seatbelts and child safety seats and supervising teenagers while they learn how to drive.[80] On the whole, auto insurers most significant loss prevention efforts appear to be directed at reducing the frequency and severity of auto accidents more generally, through research and education and engagement with public regulation, as discussed next.

Research and education and engagement with public regulation. Although we have not found a comprehensive source, it is clear the auto insurance industry is deeply involved in auto safety research and education and deeply involved with public regulation of auto safety. [81] Auto insurers fund drivers' education programming and support public education efforts.[82] In addition, the auto insurance industry lobbies for auto safety regulation at all relevant levels of government.[83]

C. Gun Liability and Insurance

There are many parts of the liability field that are much more important than gun liability. Nevertheless, we discuss gun liability here for two reasons. First, the Connecticut field research on liability insurance and the regulation of firearms represents an early attempt to systematically analyze liability insurance as a form of regulation.[84] Second, even more than shareholder

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[78] For some potential negative consequences of that control for victims of auto accidents, see *State Farm v. Campbell*, 2001 UT 89, 432 Utah. Ad. Rep. 44 (2001).

[79] See Yeazell, *Re-financing, supra* note 2 at 188-89.

[80] See, e.g., [USAA, State Farm, Allstate websites]

[81] Ben Shahar & Logue, *supra* note 10 at 220-22.

[82] See, e.g., http://teendriving.statefarm.com; http://www.geico.com/information/safety/auto/teendriving/parents/; http://www.allstate.com/tools-and-resources/drivers-education.aspx.

[83] Ben Shahar & Logue, *supra* note 10, at 223. *See also* Insurers Battle On Two Fronts To Force High Safety Standards On Mexican Truck Traffic, 112 Insurance Advocate Issue 28 p 18 (7/21/2001); NAII Praises Enactment Of Laws That Promote Driver Safety, 111 Insurance Advocate Issue 20, p. 22 (05/13/2000).

[84] Baker & Farrish, *supra* note 29/.

liability, gun liability provides a cautionary example of some of the limits of regulation by liability insurance.

Despite the widespread attention given to gun violence, there is very little civil liability arising out of that violence.[85] One important reason is that liability insurance does not reach most gun violence claims.[86] Leaving aside the high profile mass shootings by troubled middle class young men, the people who perpetrate a large percentage of gun violence are unlikely to have homeowners or other general liability insurance. Even if they did, however, homeowners' and other general liability insurance policies exclude coverage for intentional injuries.[87] As a result, like domestic violence torts, gun liability is one of those "remote islands of tort liability that lawyers and law professors know about, but almost no one goes to visit."[88]

Risk-based pricing. Homeowners and other general liability insurance companies do not charge different prices to people based on gun ownership or use, except when selling commercial policies to gun related businesses such as sporting goods stores and gun clubs.[89] Apparently, lawsuits arising out of accidental gun injuries are sufficiently rare in other contexts that insurers do not take that risk into account in pricing.

Underwriting. Homeowners insurers do ask about gun ownership in the course of their underwriting, but they ask that question not for liability underwriting purposes, but rather to evaluate whether the applicant needs a special rider to cover the theft or damage of a valuable gun.[90] Insurers selling commercial insurance policies to gun retailers do consider loss prevention during their underwriting, but they are more concerned with safeguarding guns and weapons from theft or other property damage than reducing liability risks.[91] For policies sold to gunsmiths, the underwriting is directed primarily at risk of injuries to workers, rather than to customers or others.[92] For policies sold to gun clubs, the focus in underwriting is on reducing accidental injuries to members and guests, and it is possible that some clubs may at the margin decide not to engage in riskier activities (tree stands, shooting from horses) or decide to adopt and post safety

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[85] *Id.*.

[86] *See* Swedloff, *supra* note 35, 739-741.

[87] *See id.*; Baker, *supra* note 74.

[88] Baker, *supra* note 6, at 7. *See also* Jennifer Wriggins, *Domestic Violence Torts*, 75 S. CAL. L. REV. 121 (2001).

[89] Baker & Farrish, *supra* note 29, at 301-05.

[90] *Id.* at 299.

[91] Id. at 301-02.

[92] *Id.* at 302-03. Of note, an authoritative underwriting manual indicates that sporting goods stores pose greater liability risk than gunsmiths, consistent with the researchers' conclusion that gun liability risks do not loom large among liability insurance underwriters (since the big liability risks for sporting goods stores have little or nothing to do with guns).

procedures as a result of learning about the risks in the underwriting process. All of these concerns lie some distance from the gun violence that is the subject of so much attention today.

Contract design. For liability arising out of gun violence, the most important feature of liability insurance policies is the intentional harm exclusion and, in recent years, a broader version of that exclusion in many homeowners' insurance policies, which excludes coverage for claims arising out of criminal activities even if the injuries were accidental.[93] Because of these exclusions, liability insurers rarely have any financial responsibility to the victims of gun violence[94]

Claims management. Because gun violence claims almost always are excluded (except when a parent or employer is sued for failure to supervise), there is little occasion for liability insurers to be involved in the management of any civil claims arising out of gun violence. If the claim were to be crafted in a manner that obligated the insurer to provide a defense, that defense almost certainly would be subject to conflict of interest rules that prohibit the insurer from controlling the defense.[95]

Loss prevention. With the exception of liability insurance for gun clubs, insurers apparently do not engage in loss prevention efforts directed at gun liability. This makes sense because they have few covered losses to prevent.[96] As the gun liability situation highlights, we cannot expect liability insurers to do anything to prevent losses that lead to liabilities that are generally excluded from insurance coverage.

Research and education and engagement with public regulation. Not surprisingly, the Connecticut research concluded that the liability insurance industry was not engaged in research and education or public regulation of gun liability risks.[97] While insurers might have some reason to do so for gun clubs, that is a small market and the clubs apparently look to other sources for their primary loss prevention advice. With regard to public regulation of guns and gun violence, insurers likely conclude that, because they have little at stake, the public relations risks exceed any potential benefits and, thus, they stay on the sidelines.[98]

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[93] *Id.* at 299.

[94] *Id*. *Cf.* Peter Schuck, *Why Regulating Guns Through Litigation Won't Work*, in Lytton, ed., *supra* note 29.

[95] The insurer will reserve the right to refuse to pay the claim due to the intentional injury or criminal act exclusion, thereby becoming obligated to hire independent counsel. See Baker, *supra* note 38.

[96] Baker & Farrish, *supra* note 29, at 313 (drawing a comparison between the current absence of such activities and what could occur if "gun violence [could be brought] under the liability insurance umbrella").

[97] *Id.*

[98] *See id.* at 299 (reporting negative publicity for an insurer seen to be as "anti-gun").

D. Medical Professional Liability and Insurance

The extensive empirical research on medical malpractice has not systematically explored the regulatory role of medical malpractice insurance. Nevertheless, there is a substantial volume of quantitative research, some field research on personal injury claims that included medical malpractice liability, and mixed methods research on hospital risk management.[99]

As an initial matter, the research suggests that, similar to the situation for automobile liability, insurance is the asset that matters for claims brought against individual doctors. While doctors would seem to possess sufficient assets to make them viable defendants even in the absence of liability insurance, and to enable them to pay amounts in excess of their insurance, the available evidence strongly suggests that, as a practical matter, the liability of individual doctors is capped at their policy limits.[100] Perhaps as a result, many doctors underinsure relative to the potential damages in a significant claim.[101] There are press reports suggesting that insurance is just as important in lawsuits against hospitals (and, interestingly, that some thinly capitalized hospitals intentionally underinsure in order to drive harder settlement bargains with plaintiffs), but there has been no systematic research on this topic.[102]

Risk-based pricing. The general understanding is that these insurers and most of their commercial insurance competition price their insurance policies exclusively based on the type and location of each doctor's practice, without taking into account individual doctors' experience or loss prevention activity.[103] We understand that insurers use experience rating and take loss prevention efforts into account when selling professional liability insurance policies to larger group practices and hospitals, but, once again, we have been unable to find any systematic

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[99] *See, e.g.*, Bernard Black, David Hyman, Charles Silver, & William Sage, *Stability, Not Crisis: Medical Malpractice Claim Outcomes in Texas, 1988-2002*, 2 J. EMPIRICAL LEG. STUD. 207-259 (2005) (original study by the team using the Texas Department of Insurance closed claim database); Baker, *Blood Money*, *supra* note 28 (qualitative research including medical malpractice claims); Joanna Schwartz, *A Dose of Reality for Medical Malpractice Reform* 88 NYU L. Rev. --- (forthcoming 2013) (reporting results of interview and survey research on how hospital risk managers use information from medical malpractice claims).

[100] Baker, *Blood Money*, *supra* note 70; Kathryn Zeiler, Charles Silver, Bernard S. Black, David A. Hyman & William M. Sage, *Physicians' Insurance Limits and Malpractice Payments: Evidence from Texas Closed Claims, 1990-2003,* 36 J. Legal Stud. S9-S45 (2007)

[101] Zeiler et al, supra note 100. See also, Baker, Blood Money, supra note68 at 297.

[102] Anemona Hartocollis, Troubled New York Hospitals Forgo Coverage for Malpractice, July 15 2012. In the case study reported in Werth, supra note --, the hospital had a $17 million policy, and the insurer controlled the defense and settlement. The first author has reviewed on a confidential basis a liability insurance program issued to a major hospital with per claim limits in excess of $80 million.

[103] Fournier, Gary M; Melayne Morgan McInnes, The case for experience rating in medical malpractice insurance: An empirical evaluation, 68 Journal of Risk and Insurance 255 (2001).

research on this topic.[104] Our sense is that risk based pricing is unlikely to regulate individual doctors to any significant extent (with the potential exception of discouraging physicians from either delivering babies or conducting surgery on a part time basis),[105] but risk-based pricing may affect loss prevention behavior in larger medical organizations.

Underwriting. We have been unable to find any evidence that the medical liability insurance underwriting process provides loss prevention information to solo or small group practices. We have received reports of insurers conducting loss prevention focused underwriting inspections of hospitals and large group practices, and we understand that some insurers have medical personnel on their staff for this purpose, but, once again, we have not found systematic research on this topic. As with risk-based pricing, our sense is that medical professional liability underwriting does not do much to affect loss prevention by individual doctors, but it may affect the loss prevention efforts of larger medical organizations.

Contract design. Medical professional liability insurance policies contain three types of moral hazard control provisions: deductibles, exclusions for kinds of claims that pose a higher degree of moral hazard, and claims management provisions. Our sense is that the deductibles are too small to have a significant impact on individual and small group practices, but that hospitals and other large organizations may have deductibles that are comparable to those in D&O insurance policies. We have seen five kinds of exclusions that could be understood to address moral hazard: an expected or intended exclusion that is similar to that present in general liability insurance policies, a criminal act exclusion, an exclusion for liability "arising from the willful violation of any stature or ordinance," an exclusion for sexual misconduct, and, in policies issued to groups, an exclusion for claims brought by one insured against another.[106]

We are skeptical that eliminating these exclusions would in fact increase the frequency or severity of the presently excluded activity (except, perhaps, for the insured versus insured exclusion). There are other mechanisms to prevent doctors from intentionally harming or

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[104] See Michelle M. Mello, Understanding Medical Malpractice Insurance: A Primer, 8 SYNTHESIS PROJECT 1, 1 (2006), available at http://www.rwjf.org/pr/product.jsp?id=15091 (last visited January 27, 2013) (reporting that hospital liability insurance is experience-rated).

[105] Tom Baker, MEDICAL MALPRACTICE MYTH 153-55 (2005) (making the point that another explanation for the decline of obstetrical work by family physicians is competition from obstetrical specialists).

[106] American Hospital Indemnity Company Doctors Professional Liability Insurance Policy (on file with first author) (limiting the application of the willful violation exclusion only when the statute or ordinance imposes criminal penalties; no insured v insured exclusion); Norcal Mutual Insurance Company, Sample Professional Liability Insurance Policy, available at: http://www.norcalmutual.com/coverages/NORCAL_Individual_Policy_Specimen.pdf (no expected or intended exclusion). See CILJ article about molestation claims.

criminally abusing their patients such as a social norms and a fear of criminal punishment. To the extent these other pressures do not control the behavior, it is unlikely that a fear of civil liability would prevent doctors from committing these excluded acts. Thus, we doubt that these contract provisions in fact regulate medical practice. What the provisions are quite likely to regulate, however, is tort litigation, by encouraging plaintiffs to shape their claims to avoid the application of these exclusions.[107]

Claims management. Like auto liability policies, medical malpractice insurance policies for doctors typically give the insurer complete control over the defense and settlement of the claim. [108] In the past many medical malpractice policies contained provisions that required the insurer to obtain the doctor's consent before settling; some policies still contain those provisions.[109] We expect that policies issued to large health systems, like liability policies issued to other large organizations with substantial deductibles, grant substantial control over the claims to the organizations, while giving the insurer the right to object to settlements that exceed the deductible, but we have not found research confirming this arrangement.

Loss prevention. While we have found no systematic research on the role of medical liability insurers in loss prevention,[110] some insurers report that they do provide loss prevention services, for example by providing courses that satisfy doctors' continuing medical education requirements.[111] We understand that CRICO, the captive insurance company organized by the Harvard hospitals, has an active loss prevention business "created in 1998 to extend the patient safety mission beyond the Harvard-affiliated organizations through effective products and services."[112] Since CRICO provides insurance only to the Harvard affiliated organizations, however, the loss prevention services it provides to other hospitals are, by definition, not packaged with insurance and, thus, not "bonded" in the sense discussed earlier. Some other insurers report that they provide loss prevention services to their own insureds.[113]

Research and education. Medical liability insurers were slow to pick up the patient safety mantle, preferring in early years to focus their efforts on limiting liability for their

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[107] *See* Baker, *supra* note 6.

[108] See, e.g., Norcal policy.

[109] See, e.g., AHI policy.

[110] Cf. Schlanger, supra note 41 (reporting on the use of claims information by a hospital system)

[111] See, e.g., http://www.thedoctors.com/KnowledgeCenter/index.htm.

[112] See CRICO Strategies, http://www.rmfstrategies.com/about-strategies (last visited January 27, 2013). See also Schwartz, supra note – at (describing the CRICO strategies work and reporting that CRICO now has closed claim files for 30% of the medical malpractice cases in the U.S.).

[113] Look at websites.

members rather than protecting patients.[114] There were some exceptions, however,[115] and in recent years medical liability insurers have been more involved in such efforts.[116]

Engagement with public regulation. Historically, medical malpractice insurers' primary engagement with public regulation has been supporting legislative efforts to make it more difficult for patients to bring medical malpractice claims, to place caps on medical malpractice damages, and to enact other tort reforms (such as the elimination of joint and several liability and repeal of the collateral source rule) that were believed to reduce medical liability exposure.[117] We are been unable to find any reports of medical malpractice insurers engaging with public regulation to promote patient safety in a manner that is analogous to the automobile insurance industry. Our speculation is that this focus on limiting liability rather than promoting patient safety results from medical liability insurers' historically close identification with the medical profession and the insurers' perception that doctors would prefer to buy insurance from insurers that are seen as fighting to preserve doctors' autonomy rather telling doctors how to practice medicine. Moreover, expenditures to reduce liability may offer better return on investment. Because of the low rate of medical malpractice claiming to medical malpractice injuries, investments in medical malpractice prevention do not lead to corresponding reductions in malpractice claims.[118]

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[114] Some medical liability insurers continue to focus substantial attention on limiting liability. For example, The Doctor's Company website emphasizes the historic role of that company in promoting tort reform.

[115] Much of the "closed claim" file research on medical malpractice was only possible because of the cooperation of medical liability insurers. Baker (MMM), *supra* , at 94-95.

[116] See Schwartz, supra note 99 at – .

[117] William Haltom and Michael McCann, Distorting the Law: Politics, Media, and the Litigation Crisis (2004)

[118] *See* Michelle M. Mello, David M. Studdert, Eric J. Thomas, Catherine S. Yoon, and Troyen A. Brennan, *Who Pays for Medical Errors? An Analysis of Adverse Event Costs, the Medical Liability System, and Incentives for Patient Safety Improvement*, 4 J. Emp. Leg. Stud. 835 (2007) (noting that hospitals only bear 22% of the costs of hospital injuries and that "legal reforms or market interventions may be required to address this externalization of injury costs"); Michelle M. Mello, David Hemenway, *Medical Malpractice as an Epidemiological Problem*, 59 Social Science and Medicine 39 (2004) (noting that "because medical malpractice claiming is rare event with many false positives, for the average hospital or group practice, even substantial improvements in rates of negligent injury will not lead to a large reduction in claims rates").

IV. Lawyers Professional Liability and Insurance

Malpractice insurance is increasingly a fact of life for lawyers. One state requires insurance for all practicing lawyers;[119] several states mandate insurance for lawyers who practice as part of limited liability entities;[120] and over half the states encourage liability insurance by requiring that firms disclose whether they have coverage or not.[121] But even beyond these requirements, liability insurance may be a business reality for a profession that has seen an expansion in the number and severity of malpractice claims over the past four decades.[122]

Although there has been much less research on legal malpractice than on medical malpractice, there is more prior writing on the potential regulatory impact of legal malpractice (LPL) insurance.[123] We begin our analysis of that potential impact by organizing what can be discerned from the prior literature into the categories we used for the other kinds of liability insurance above. We then compare LPL insurance with the other kinds of insurance and conclude by raising some questions about the degree to which this LPL insurance regulation may be resisted or transformed.

Two caveats before the categorization. First, although we are early in our research, it is already clear that the LPL market is not monolithic. Insurers segment the market based on the size of the firms. As a result, there are at least three distinct markets within the universe of LPL insurance: solo and very small firms, firms of up to 35-50 lawyers or so, and larger firms (recognizing that different insurers draw the line between those segments in different ways). Some insurers won't write insurance for small firms and solo practitioners.[124] Smaller firms are

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[119] Oregon requires "both that lawyers be insured and that the basic coverage be with the Professional Liability Fund, a state entity." 5 RICHARD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE §36:1, at 3-4 (2010); *see also* Or. Rev. Stat § 752.035.

[120] *See* MALLEN & SMITH, *supra* note 119, at 6 ("A common requirement [imposed by state statute] is for specified, minimum insurance limits in exchange for practicing in a limited liability entity, such as a corporation, limited liability corpoation or limited liability partnership.")

[121] *See, e.g.,* American Bar Association, Standing Committee on Client Protection, State Implementation of ABA Model Court Rule on Insurance Disclosure (August 9, 2011), http://www.americanbar.org/content/dam/aba/administrative/professional_responsibility/chart_implementation_of_mcrid_080911.pdf

[122] See Fischer, *supra* note 11 (citing empirical studies about the market penetration of LPL insurance); Manuel R. Ramos, *Legal Malpractice: The Profession's Dirty Little Secret*, 47 VANDERBILT L. REV. 1657, 1661 (1994) (arguing that between 1970 and 1994, there was "an unprecedented growth in legal malpractice claims and lawsuits"); George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 305, 307-09 (1997) (laying out changes in law and regulation of lawyers that led to more malpractice claims).

[123] *See supra* note 11.

[124] There is some debate about what constitutes a "small firm." For purposes of this article, it is enough to say that while different insurers think differently about what it means to be small, midsize, large, and international, most insurers seem to do some sort of segmentation based on size.

likely to be market takers, in that they are forced to accept the contract terms without any negotiation. They are, in the parlance, of LPL insurance, part of a "program." There may be more room for negotiation between insurers and medium-sized and larger firms. Thus, there may be more contract variability. Additionally, there may be differences in the amount of risk management services provided and the uptake of these services in these different markets, both because of the characteristics of the legal firms, apart from size, and because of the organizational forms or business approaches of the liability insurers.

Second, it is of course true that insurers do not design risk management to encourage changes in lawyer behavior as an end in itself, whether to enhance client experience, ennoble the legal profession, or promote another end of intrinsic interest to lawyers.[125] Rather insurers encourage changes in behavior to serve their interests, which at this point we take to be reducing payouts and maximize profits. For example, insurers design contracts to maximize the attractiveness of the coverage at the most profitable rate. They may write exclusions into contracts because the risk occurs too frequently or with too great a severity to be covered by premiums that insureds are willing to pay; because insurers cannot control the moral hazard of the risk; or because the risk is correlated with other risks making the excluded risk too expensive to cover in the aggregate (consider the risks associated with insuring a number of homes in the path of a hurricane). To the extent that law firms respond to insurers' bottom-line driven motives, that "effect" may have little or nothing to do with the insurers' motives. For present purposes we care mostly about effects, not motives, and we do not want to be misread as confusing the two.

A. Regulation by LPL Insurers

The prior writing suggests that LPL insurers use many of the tools described above – risk-based pricing, underwriting, contract design, loss prevention services, and research and education – and those tools can affect the practice of law.

Pricing. Our strong sense is that LPL insurers engage in risk-based pricing, taking into account such "demographic" factors as size of the firm, practice areas, and geography, as well as the claim history of a firm.[126] As we move deeper into the research we will be able to say more about these kinds of risk-based pricing, though it already is clear that there is substantial variation. For example, the largest mutual insurer – ALAS – charges a flat rate based simply on

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[125] *See generally, Silver*, *supra* note 11, at *234-35*

[126] *See* RONALD E. MALLEN, LEGAL MALPRACTICE: THE LAW OFFICE GUIDE TO PURCHASING LEGAL MALPRACTICE INSURANCE § 4.8 (2012).

the number of lawyers in the firm.[127] In addition to these more easily quantified aspects of law firm risk, insurers could base their pricing, in part, on certain governance structures in the law firm. For example, there are reports in the literature that some LPL insurers do take into account such things whether firms have

- a leadership team with an eye toward risk management and authority to implement change as needed;
- a general counsel who oversees risk management, acts as a lightening rod for problems that may arise in a firm and develops a plan for training all new lawyers at the firm;
- good centralized procedures for client intake and conflicts checks;
- management of the way the time is recorded, entered, and billed;
- significant financial controls;
- and a policy, procedure, and culture to deal with inevitable mistakes. [128]

Our research will investigate whether, when, and why insurers take such governance factors into account.

Underwriting. What loss prevention activities LPL insurers take into account in underwriting for purposes other than determining the price similarly remains to be determined. Insurers could refuse to sell insurance to law firms that fail to meet their standards along any of the dimensions listed in the pricing paragraph above, or for other reasons that we have not learned about. For example, the ALAS annual reports indicate that it has refused to renew certain law firms and that it has not accepted the applications of others.[129] Our research will subject these kinds of practices to more systematic review.

Contract Design. LPL insurers include a number of contract features that may have the effect of reducing moral hazard. Limits and deductibles seem likely to be an important element of moral hazard management, though we predict that their effect varies among firms. Further, like liability policies in other arenas, most LPL policies contain a provision that excludes coverage for

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[127] *See, e.g.,* 2011 ALAS ANNUAL REPORT 21 (laying out the per attorney premium rates based on size of policy and retention regardless of the risk profile of the insured).

[128] Davis, *Complementary Visions*, *supra* note 11, at 103- 107.

[129] *See, e.g.*, 2011 ALAS Annual Report, supra note 127, at 22-24 ("Since 1992, by recommendation of the Preferred Risk Committee, ALAS, Inc. has declined to renew 20 firms, including 11 since 2000.")

intentional, fraudulent, or criminal acts.[130] Once again, the practical effect of these provisions seems likely to vary among firms.

Additionally, LPL insurance contracts include a number of provisions that disclaim coverage for certain activities, potentially affecting law firms' incentives to engage in those activities. For example, some law firms may set up procedures designed to place checks on such activities to avoid the possibility of bearing the risk alone.[131] Three sets of examples follow.

First, many LPL policies exclude coverage for claims that arise from work lawyers do that is not directly related to the practice of law. This is true even if such work may be good for generating business for the law firm. For example, policies routinely exclude coverage for claims arising out of one of their insureds'

- Service as directors or officers for entities other than the law firm itself;[132]
- Promotion, sale or solicitation of the sale of "securities, real estate, or other investments;"[133] or
- Work in or ownership of a separate business.[134]

Second, as Anthony Davis notes, LPL insurers may also try to control certain strategic decisions of lawyers or firms. Insurers may try to limit coverage related to informal networks of lawyers who share space or advertising and regularly include provisions related to insureds hiring lawyers laterally, merging with other firms, or using temporary lawyers (lawyers hired on a contract basis, who are not associated with the firm). For example, insurers may

- Exclude coverage for vicarious liabilities that arise from the wrongful acts of attorneys with whom the insured shares office space, marketing materials, etc.[135]
- Exclude coverage for lawyers who are being sued for work that they performed before joining the insured; and[136]
- Limit the coverage of temporary attorneys only for claims arising out of "work done within the scope of their employment" for the insured.[137] This provision may limit

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[130] *See, e.g.,* Policy 3, at Exclusion A; Policy 1, at Exclusion 5; Policy 2 at Exclusion 5; *see also* Mallen & Smith, *supra* note 119, at § 36:22, p. 135 (noting that LPL policies exclude coverage for "'moral' risks, such as fraud, intentional, malicious and criminal conduct that no insurer intends to cover.").

[131] It is also possible that policy definitions and exclusions limiting coverage have a different impact: insureds will simply seek coverage from another source.

[132] *See, e.g.,* Policy 2, Exclusions 3; Policy 1, Exclusions 3; Policy 4 at Exclusions (II.7.a)

[133] Policy 4 at Exclusions (II.9.a).

[134] *See, e.g.*, Policy 1 at Exclusion 8.

[135] See Davis, *Regulators*, *supra* note 11, at 215

[136] *Id.* at 216.

[137] *Id.* at 218.

> coverage if claims arise out of "activities of the temporary lawyer unrelated to the matter for which the temporary lawyer was hired; claims from undisclosed conflicts introduced by the temporary attorney; and claims arising from difficulties in supervision and overseeing the activities of such temporary lawyers."[138]

These provisions may make sense from the perspective of the insurer. Activities like hiring new lawyers—even (or especially) on a temporary basis—can introduce risks that weren't present at the origination of the contract. Regardless of the motives, these provisions mean that firms are able to easily transfer less of the risk associated with of mergers, acquisitions, lateral hiring, and temporary hiring.

Third, again from Anthony Davis, LPL insurers may view certain transactions as particularly likely to generate malpractice claims, even if such transactions are not explicitly prohibited by rules of professional conduct. Thus, for example, insurers could exclude from coverage any

- Representation "where the lawyer or the firm has a personal, entrepreneurial or business interest in a client's business or affairs;"[139]
- Representation "involving conflicts of interest among multiple clients;" or[140]
- Claims arising out of claims brought by a law firm against a client for fees.

Even though lawyers may be allowed to represent clients with conflicts of interest or enter into transactions with clients under certain circumstances (such as with consent of the clients),[141] insurers view these representations and transactions as very risky.[142] When representations or transactions go poorly, clients have a built-in claim for malpractice. Likewise, while suits against clients aren't prohibited, they may be likely to generate malpractice counterclaims. It is easy to see why insurers would therefore exclude these kinds of behaviors from coverage. And it is easy to see why lawyers may choose to forgo these kinds of representations, transactions, and suits for fear of facing future liability without sufficient insurance.

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[138] *Id.*

[139] *Id.* at 212. *See also* Policy 3, V.E and H

[140] *Id.* at 213

[141] Under most rules of professional responsibility, these transactions are allowed under certain circumstances. For example, under the Model Rules of Professional Conduct, lawyers may represent conflicted clients if the lawyers obtain consent of both parties. They may enter into business transactions with clients, lawyers need to obtain written consent, to make sure the transaction is fair and reasonable, and give the client the opportunity to seek independent counsel. *See* Model Rule of Professional Conduct Rule 1.8

[142] Davis, *Regulators*, *supra* note 11, at 212-213

Loss Prevention Services. As with contract design, insurers could encourage specific behavior through different types of loss prevention services. There are a number of loss prevention services that could be offered to law firms. Insurers could offer educational services to firms in the form of seminars, CLEs, or newsletters, focusing on firm management issues like client intake, conflicts, and time and file controls that are prime generators of malpractice claims. These materials and programs could set out best practices, provide cautionary tales, or both. Insurers could create a "hotline" for firms to call when they have an issue emerging. More intrusively, insurers could audit a firm's management systems and require changes consistent with the audit findings. Once again, there are reports in the literature that some insurers do provide such services.[143] The holy grail for an LPL insurer is a law firm with "internally generated and effective peer review and practice oversight."[144] What insurers try to do to achieve that, and what lawyers think about their efforts, will be a significant focus of our research.

Research and Education and Engagement with Public Regulators. Insurer provided continuing legal education appears to be a significant aspect of the CLE landscape in some jurisdictions.[145] In addition, the NABRICO insurers (National Association of Bar Related Insurance Companies) have been cooperating since the 1980s with the American Bar Association on collecting legal malpractice claims information.[146] We have not found public sources reporting other engagement with research and education or engagement with public regulators. This is yet another subject for our continuing research.

C. Comparing LPL Insurance with Other Forms of Liability Insurance

The table that follows summarizes our overview of regulation by liability insurance across the five fields of liability that we have explored, recognizing that the information included in many of the cells has not been well documented and our research on LPL insurance has just begun.

Regulation by Liability Insurance Comparison Table

	Shareholder	**Auto**	**Guns**	**Medical Malpractice**	**Lawyers Professional**

[143] Davis, *Regulators*, *supra* note 11, at 220; Davis, *Complementary Visions*, *supra* note 11, at 112 (2008).

[144] Davis, *Regulators*, *supra* note 11, at 221

[145] See, e.g., [cite to a few State Bar association websites with links to CLE from insurers]

[146] *See, e.g.,* Characteristics of Legal Malpractice: Report of the National Legal Malpractice Data Center (1989); ABA Standing Committee on Lawyers' Professional Liability, Profile of Legal Malpractice Claims 2008-2011 (2012). See also http://www.nabrico.org

Overlap of liability and insurance	Substantial, except for the biggest claims	Practically complete	Very limited	Substantial. Some under-insurance.	Substantial. Small firms may go bare.
Risk-based pricing	Individualized. Some experiments with formulas.	Big data.	None, except for gun-related organizations	Scheduled for small. Otherwise individualized.	Varies from per capita to formulas to individualized
Loss prevention underwriting	Some	No	Only for gun-related organizations	No for small. Yes for large.	Varies from limited to extensive
Contracts address moral hazard?	Yes	Minimal (family member)	Yes: Deregulation by exclusion	Yes, but more for large organizations	Yes
Insurer control over claims management	Shared	Complete	Complete for accidents. None for intentional	Complete for small. Shared for large (?)	Shared (for all?)
Loss prevention services	Minimal	Limited	None	Varies from none to some	Varies from limited to extensive
Research and education	Minimal	Extensive	None	Some. Maybe increasing	Substantial
Engagement with public regulation	Minimal	Extensive	None	Some. But largely to limit liability.	Unknown

Gun liability is the outlier. The only "governance" activity is negative. Liability insurance contracts exclude the kinds of civil liability that might lead insurers to be motivated to do something about gun violence. Gun liability thus provides a useful, cautionary example of the limits of regulation by liability insurance. We cannot expect insurers to regulate risks that produce liabilities that usually are excluded from their insurance contracts.

Although auto liability appears nearly as different from LPL as gun liability, we expect that, at least for solo and very small firm practitioners, auto and LPL insurance may have more in common than the table suggests. In both cases, the relatively small size of individual premiums prevents insurers from individualizing underwriting or loss prevention. Instead, insurers employ a "cookie cutter" approach. Important differences include the "big data" efficiencies made possible by the sheer size of the auto market, the lesser penetration of LPL insurance into the market, and the importance of lawyers' professional organizations, which may reduce the room for regulation by insurers.

Medical malpractice presents an interesting contrast to LPL. Medical providers likely segment for liability insurance purposes into small, medium, and large organizations, like law

firms. And medical providers have professional organizations that act on and for them. Yet LPL insurance appears to be both more and less regulatory than medical malpractice insurance. On the one hand, lawyers are less likely to be insured and, we believe at this early stage in the research, less likely to cede claims management control to insurers when they are insured. On the other hand, LPL insurers are reported to be more likely to be involved in loss prevention, and more likely to engage in research and education directed at reducing the extent of the underlying harm (as opposed to reducing liability without regard to harm).

As with auto liability, shareholder liability may prove to have more in common with LPL than the table suggests, at least for very large law firms. It seems likely that the liability faced by these firms has more in common with that of their public company clients than the liabilities of lawyers in solo and small firm practice. If so, the LPL insurance for these firms may be more similar to public company D&O insurance than to small firm LPL insurance. If, despite those similarities, insurers play a more active role in the regulation of these law firms than public companies, as some prior research suggests,[147] much can be gained from exploring why.

C. Effectiveness of Regulation by Liability Insurers

There is little doubt that LPL insurers could have some impact on the way their insureds practice law. What is less clear is how much or what kind of impact insurers really have. Lawyers may reject, ignore, or try to rationalize their way around risk management advice. Risk managers may for other reasons fail to instill a culture of risk management in firms. Moreover, law firms, especially large law firms, may already be so saturated with risk management advice that there is little room for governance from insurers. These are among the subjects of our ongoing research, so we will do little more than mention concerns raised by prior research here.

Lawyers and law firms may resist adopting insurers' risk management measures, perhaps because of cultural barriers within the practice of law, the structure of law firm management and compensation, or lawyers' preference for autonomy. Some scholars have suggested that there will be significant clash between lawyers' vision of themselves as autonomous actors and a need to centralize control to minimize risks. The fear is that historically lawyers have operated autonomously, and largely unsupervised within a law firm—individual lawyers, teams on a specific matter, or units of a firm to operate as individual fiefdoms resistant to top-down risk management.[148] This resistance to risk management may be exacerbated if the tools used by risk

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[147] Davis, *Regulators, supra* note 11; Alfieri, *supra* note 11.

[148] Silver, *supra* note 11, at 1958. ("Lawyers have sought jealously to guard their individual independence, notwithstanding the increasingly collective and interdependent nature of their practices."); *cf*

managers are presented as an instrumental set of rules.[149] As Milton Regan explains, given their self-image as autonomous actors, lawyer may be "susceptible to what they perceive as intrusive monitoring—perhaps quicker to construe supervision as excessive and to be more resistant to it."[150] Further, given their training, lawyers "are adept at creative interpretation of rules and at fashioning plausible arguments in support of their interpretations. This may enable them … to convince themselves that they are not violating a given rule, thus reducing any psychological dissonance that they might feel by engaging in a certain behavior."[151]

This concern is redoubled in light of the common eat-what-you-kill compensation model.[152] Under this model, lawyers are compensated based on the business they bring to the firm. As such, lawyers who generate business, so-called rainmakers, are prized possessions of firms and potentially above the structures of risk management. Conversely, lawyers who do not generate significant business may be incentivized to take on riskier clients or matters—those who may be conflicted with other clients or those who may not have the ability to pay—which, in turn, could lead to more malpractice claims.

It is also possible that law firms are already so saturated with risk management advice that insurers have little effect even on law firms that are ready, willing and able to implement insurers' risk management measures. Large law firms especially are likely to have adopted already the easier risk management techniques, such as creating a general counsel and employing a sophisticated conflicts management process. If this is true, there may be little room for additional or enhanced supervision from insurers.

Finally, the literature on the legal profession has raised enough questions about the ethical implications of the risk management approach promoted by liability and insurance that we need to consider whether LPL insurance governance should be resisted on these grounds. The concern is that a risk management approach could undermine other regulatory controls, including ethical regulation by codes of professional liability and independent, ethical decision-making by

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ANTHONY DAVIS, RISK MANAGEMENT: SURVIVAL TOOLS FOR LAW FIRMS 5 (1995) (Davis refers to this as the cottage industry model of law firms).

[149] Regan, *supra* note 11, at 1966 ("Rules, whether narrowly or broadly phrased, will not impose meaningful constraints on lawyers who do not have underlying commitment to moral force of the law.")

[150] *Id.* at 1972.

[151] *Id.* Regan argues that risk management will work better when the firms are able to instill a culture that reinforces ethical behavior—a culture that values ethical behavior not for instrument reasons, but for its own sake *Id.* at 1967

[152] *See generally* MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER (2004).

individual lawyers.[153] The leading proponent of this concern, Anthony Alfieri, argues, "the technology of risk assessment and regulation … subtly discounts the daily necessity of moral discretion and constant calling of public obligation. As a result, lawyers and law firms underestimate the burdens of moral agency in the discretionary decision making of advocacy and counseling."[154]

In this view, the rise of risk management techniques presents a number of dangers. First, risk management diminishes "the lawyer's individual responsibility for making moral choices," because ethical decision making (such as whether a conflict exists) is centralized to a firm bureaucratic structure like a general counsel or conflicts committee.[155] Second, where risk management is treated as a set of rules, rather than as part of the aspirational tradition of legal professionalism,[156] lawyers will further abdicate their role as ethical decision makers by viewing risk management as an obstacle to get around, rather than as a set of structures that encourages ethical behavior.[157] Third, risk management structures may allow lawyers to be willfully blind to their own, or other's, unethical behavior.[158]

Importantly, all of these concerns come against a backdrop of big changes in the legal profession. As law firms have become bigger and more bottom-line-driven, pressure has mounted for firms and individual lawyers to generate more revenue for the firm. These pressures—the competition among firms and attorneys—may play a significant part in changes in the norms of practice. [159]

What is missing is an on-the-ground, empirical account of the role that these concurrent trends actually play in governance of law firms. Is it true that ethical behavior has changed in law firms and, if so, does that change lie at the foot of risk management, the increasing commercialization of the practice of law, or some other unknown force? Alternatively, is it

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[153] Alfieri, *supra* note 11.

[154] Alfieri, *supra* note 11, at 1910-11.

[155] *Id.* at 1939

[156] *Id.* at 1939; *see also* Regan, *supra* note 11, (discussing the aspirational tradition)

[157] *See supra* notes 149 to 151 (discussing Regan's article).

[158] Anthony V. Alfieri, *Big Law and Risk Management: Case Studies of Litigation, Deals, and* Diversity, 24 GEO J. LEG. ETHICS 991, 1003-1008 (2011).

[159] Alfieri, in particular, harkens to long-gone yesteryear of practice when "law firm culture" imbued lawyers with "ideals of community and fraternity" and classical norms of lawyering "defined lawyer character and conduct in terms of wisdom, prudence, and craft-like virtuosity" and "cultivated the values of law firm loyalty and institutional consensus." Alfieri, *supra* note 11, at 1926. Alfieri cites ANTHONY KRONMAN, THE LOST LAWYER (1995); Robert Cover, *The Supreme Court, 1982 Term—Foreword: Nomos and Narrative*, 97 HARV. L. REV. 4 (1983); and selected works from Thomas Schaffer for the norms he ascribes to lawyers.

possible that risk management is enhancing ethical behaviors within firms? Is risk management creating additional deep governance at the firms?

Our research may help disentangle this complex set of questions. While our research likely will not uncover the root causes of any such changes, we may be able to see better what role lawyers' liability and lawyers' liability insurance companies have, if any, in creating a culture of risk management and what a such a culture means in practice.

V. Conclusion: Into the Field

In this Article we have laid out a simple framework for analyzing how liability insurance can serve as a form of regulation and, using information from prior research, applied that framework to five kinds of liability: shareholder, auto, gun, medical malpractice, and lawyers liability. Based on this analysis, there is good reason to believe that liability insurers, and the kind of risk management thinking that liability insurance promotes, may have a significant effect on law practice, as others suggested well before we got interested in LPL insurance. Nevertheless, legal scholarship has a long way to go in order to develop a systematic, thorough understanding of those effects and their variation across types of practice and organizational forms.

For that, we need to go into the field, interviewing and observing LPL personnel (underwriters, brokers, actuaries, loss prevention specialists, claims professionals), a cross section of lawyers working in different kinds of organizations and locations, risk management consultants, the lawyers who bring and who defend legal malpractice claims, the people active in lawyers professional associations who work on liability and insurance matters, and, no doubt, other categories of people we will learn about in the research. This is an enormous project, but one that has the potential to improve substantially our understanding of how liability and insurance affect law practice and the legal profession. Legal academics have devoted a great deal of energy in recent years to studying medical malpractice and shareholder liability. It's good for us to focus some of our research efforts closer to home.