

OUTSOURCING REGULATION: HOW INSURANCE REDUCES MORAL HAZARD

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This Article explores the potential value of insurance as a substitute for government regulation of safety. Successful regulation of behavior requires information in setting standards, licensing conduct, verifying outcomes, and assessing remedies. In various areas, the private insurance sector has technological advantages in collecting and administering the information relevant to setting standards and could outperform the government in creating incentives for optimal behavior. We explore several areas that are regulated more by private insurance than by government. In those areas, the role of the law diminishes to the administration of simple rules of absolute liability or no liability, and affected parties turn to insurers for both risk coverage and safety instructions. This Article examines the methods used in regulation-through-insurance, and then explores the potential regulatory role of insurance in additional, yet unutilized, areas: (1) consumer protection, (2) food safety, and (3) financial statements.

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INTRODUCTION

Legal regulation of behavior requires information. Someone—a regulator or a judge—has to inspect the conduct of the regulated party and determine the legal consequences that will attach. Acquiring information about the conduct, setting benchmarks by which the conduct is measured, and establishing the correct scale of payoffs are costly and require expertise and motivation. Thus, economic theories of rulemaking are often based on the relative informational advantages that different regulatory bodies have and how this information can be harnessed to enhance incentives and thereby improve welfare.¹

There are plenty of reasons to worry that government regulators will make mistakes. First, they are not paid for performance and thus may lack adequate incentives. They are not disciplined by market forces and only imperfectly disciplined by career concerns and the political process. Moreover, they commonly lack the most advanced tools for information acquisition, aggregation, and prediction. Courts, for example, do not search for information independently but rather receive only what parties present to them

1. See, e.g., Louis Kaplow, *General Characteristics of Rules*, in 9 *ENCYCLOPEDIA OF LAW AND ECONOMICS* 510–11 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000); Steven Shavell, *A Model of the Optimal Use of Liability and Safety Regulation*, 15 *RAND J. ECON.* 271 (1984); Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 *J.L. & ECON.* 255 (1993).

through the litigation process, which is costly, ad hoc, and as a result often bypassed by crude settlements. Courts are also ill equipped to recognize the distribution of characteristics from which any given case is sampled. Government agencies too have limited resources to monitor and anticipate patterns in the behavior of sophisticated industries, often inspecting only a small sample of the regulated conduct. They may be plagued by internal principal-agent problems, and they are often outpaced and outsmarted by the regulated parties. This raises the following question: can anyone regulate risky behavior better than the government?

This Article develops the claim that in a variety of areas private insurance companies can, and already do, *replace or augment* the standard setting and safety monitoring currently performed by government. And they do so in ways that may increase overall social welfare. Insurance is often thought of as an institution intended only for ex post indemnification, working to reduce the costs of risky activities through risk pooling and risk shifting. But insurance also performs other important functions: risk reduction and risk management.² Insurance arrangements—by using such tools as deductibles, exclusions, and experience rating—give private parties the incentive to reduce risks. Insurance is a business that specializes in risk management. Insurers assemble large actuarial databases and use them both ex ante in underwriting (that is, in classifying and pricing) the risks they insure and ex post in verifying claims by separating valid from frivolous ones.

To most readers, this claim—that insurance regulates safety—seems remarkably counterintuitive. In much of the economic literature, insurance is seen as antithetical to risk reduction. Indeed, one of the cornerstones of the economics of information, regarded by many as axiomatic, is the moral hazard problem—the idea that a party who is insured against risk has a suboptimal incentive to reduce it. Rivers of ink have been spilled discussing the moral hazard problem of insurance and ways to mitigate it.³ A fundamental insight of this literature is that insurance must be partially pared down to give people incentives to prevent harms.⁴ Copayment requirements and deductibles are thus ways to reduce insurance coverage in order to stimulate precaution. This Article develops the opposite proposition—that insurance can reduce and in some cases solve, rather than create or exacerbate, the moral hazard and related incentive problems. When people create risk to others (or themselves), insurance is the mechanism that converts

2. See generally DAVID A. MOSS, *WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER* (2002).

3. For the origins of the concept, see KENNETH ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* (1971), and Bengt Hölmstrom, *Moral Hazard and Observability*, 10 *BELL J. ECON.* 74 (1979). For its relevance to law, see KENNETH S. ABRAHAM, *DISTRIBUTING RISK* (1986), and Tom Baker, *On the Genealogy of Moral Hazard*, 75 *TEX. L. REV.* 237 (1996).

4. Kenneth J. Arrow, *Insurance, Risk and Resource Allocation*, in *ESSAYS IN THE THEORY OF RISK-BEARING* 134 (1971); Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 *AM. ECON. REV.* 531 (1968); Steven Shavell, *On Moral Hazard and Insurance*, 93 *Q.J. ECON.* 541 (1979).

concerns about loss or the vague threat of liability into a concrete set of harm-reducing measures. It supplies both the incentive and the know-how that individuals and firms often lack, resulting in a more efficient level of accidents.

To appreciate the role of insurers in reducing moral hazard, the methodology this Article pursues is comparative: we line up insurers versus government as regulators of safety. We show that insurers perform tasks that are comparable to the public regulation of safety. Like a regulator setting standards of conduct and monitoring behavior, insurers have to assess the distribution of harm and determine the desirability of safety measures. And like courts adjudicating liability and awarding damages, insurers have to administer claims, verify harms, and determine the comparative causation of other parties. If insurance has better information and better incentives to set efficient standards of conduct and enforce them, it would be beneficial as a matter of comparative institutional competence to “outsource” to the insurance sector various regulatory functions that are ordinarily performed by government.⁵

Regulation-through-insurance is a notion that has been widely recognized in the literature. Steven Shavell’s work on the relationship between insurance and tort liability demonstrated the potential for insurers to create optimal incentives for care.⁶ Kenneth Abraham coined the term “surrogate regulation” when describing the (then new) regulatory role being foisted on liability insurers to regulate toxic tort and environmental risks.⁷ Tom Baker, Victor Goldberg, Howard Kunreuther, and others have written about the various regulatory methods that liability insurers use to reduce the risks that they insure.⁸ In addition, scholars have made proposals to increase the role of particular forms of insurance as substitutes for specific types of agency-

5. We use the term “outsource” to mean the “farming out” of particular government functions to third parties. The term is often used to refer to a firm’s choice to contract out for some production rather than generate it in-house. The same principle, however, can be applied to government functions.

6. Steven Shavell, *Minimum Asset Requirements and Compulsory Liability Insurance as Solutions to the Judgment-Proof Problem*, 36 RAND J. ECON. 63, 63–64 (2005); Steven Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120, 120–22 (1982); Steven Shavell, *On the Social Function and Regulation of Liability Insurance*, 25 GENEVA PAPERS ON RISK & INS. 166, 168–69 (2000).

7. See ABRAHAM, *supra* note 3, at 57.

8. Tom Baker & Thomas O. Farrish, *Liability Insurance and the Regulation of Firearms*, in SUING THE GUN INDUSTRY 292 (Timothy D. Lytton ed., 2005); Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance*, 5 REV. L. & ECON. 541 (2009); Haitao Yin, Howard Kunreuther & Matthew White, *Risk-Based Pricing and Risk-Reducing Effort: Does the Private Insurance Market Reduce Environmental Accidents?*, 54 J. L. & ECON. 325 (2011); see also Michelle E. Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 841 (2005); Carol A. Heimer, *Insuring More, Ensuring Less: The Costs and Benefits of Private Regulation Through Insurance*, in EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY 116 (Tom Baker & Jonathon Simon eds., 2002).

based government regulation.⁹ And others have gone so far as to assert that, since private insurance companies share some of the objectives of the state (such as the reduction of risk and the sorting of people into patterns of conduct), private insurance can be understood as an implicit form of government.¹⁰

Our claim in this Article builds on that prior work, but is different. We develop the claim that private insurance companies, utilizing the methodologies of actuarialism, private contracting, and ex post claim investigation, can and already do perform some rulemaking and adjudication, thereby replacing or complementing government regulation. We further show that, where insurance is offered, it develops templates to regulate behavior in ways that are potentially more finely tuned and information sensitive than some forms of government control. Moreover, even when government regulation is needed to overcome insurance market failures, the private insurance industry sometimes provides the necessary information and motivation to induce government regulators to act.

We contend that private insurance markets can and sometimes do outperform the government in regulating conduct because of both superior information and competition. In many areas, insurance markets are fiercely competitive, especially with respect to price.¹¹ Insurers that can offer more coverage at lower premiums will attract customers, even when they require

9. See, e.g., Tom Baker, *Bonded Import Safety Warranties*, in *IMPORT SAFETY: REGULATORY GOVERNANCE IN THE GLOBAL ECONOMY* 215 (Cary Coglianese et al. eds., 2009) (arguing for reliance on insurers to police food safety); Omri Ben-Shahar, *One Way Contracts: Consumer Protection Without Law*, 6 *EUR. REV. CONT. L.* 221, 240 (2010); Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 *CORNELL L. REV.* 129, 145–53 (1990) (arguing for shifting the regulatory function of product safety to products liability insurers through adoption of strict products liability); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Revisited*, 8 *STAN. J.L. BUS. & FIN.* 39, 48–60 (2002) (arguing for use of insurance to regulate accuracy of financial statements). For a detailed proposal to privatize the regulation of medical care, discussing many of the same reasons that we argue for outsourcing safety regulation to insurers, see Ronen Avraham, *Private Regulation*, 34 *HARV. J.L. & PUB. POL'Y* 543 (2011).

10. As one sociologist has put it, “The insurance industry is a key institution in this society because it serves many of the same purposes as the state, and it is uniquely placed to foster governance based on local knowledge of risk.” RICHARD V. ERICSON ET AL., *INSURANCE AS GOVERNANCE* 12 (2002); see also RICHARD V. ERICSON & AARON DOYLE, *UNCERTAIN BUSINESS: RISK, INSURANCE, AND THE LIMITS OF KNOWLEDGE* (2004); PAT O’MALLEY, *RISK, UNCERTAINTY AND GOVERNMENT* (2004); Tom Baker, *Insurance in Sociolegal Research*, 6 *ANN. REV. L. SOC. SCI.* 433, 438–45 (2010).

11. It is generally believed that insurance markets tend to be highly competitive with respect to price. See, e.g., Daniel Schwarcz, *Regulating Consumer Demand in Insurance Markets*, 3 *ERASMUS L. REV.* 23, 43 (2010) (citing Scott Harrington, *Effects of Prior Approval Rate Regulation in Auto Insurance*, in *DEREGULATING PROPERTY-LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY* 248 (J. David Cummins ed., 2002)). It is also the case, however, that some insurance markets—in particular, the property-casualty insurance market—tend to be characterized by pricing cycles, which is not necessarily consistent with a perfectly competitive market. For a summary of the various explanations of the cyclical behavior in property-casualty insurance markets, see Kyle D. Logue, *Toward a Tax-Based Explanation of the Liability Insurance Crisis*, 82 *VA. L. REV.* 895 (1996).

customers to modify their conduct in a costly way. As long as the standards imposed by the insurers are efficient, customers should be lured by the discounts. Moreover, insurers' concern with affordability—increasing the pool of its clientele—is another force pushing for increased conduct regulation. Safe behavior by insureds reduces the cost of premiums and increases the size of the insurers' market.

This does not mean, of course, that insurance companies are always superior to government agencies and courts as safety regulators. In some situations, insurers' incentives will not be aligned with those of society generally. The profit motive is not a panacea. However, in a remarkable range of situations, the interests of insurers and of society are aligned, at least enough so that through competition insurers are induced to find effective ways to reduce overall accidents and safety costs.

Part I presents the basic conceptual claim of this Article: that much of the insurance business is regulatory in nature and could be viewed as a substitute for or complement to government safety regulation. We describe the various techniques insurers use to affect the safety choices of their insureds. This is not a claim that insurers are always better regulators than the government. Rather, by showing the various ways in which safety incentives are set by insurance contracts, we are able to identify ways in which the regulatory mission can be partially outsourced to private insurers.

Our second main claim, set out in Part II, is descriptive. In almost every sector of the economy and in numerous ways, insurance does in fact regulate the behavior of the policyholders beyond what governments do. Driving safety, for example, is a well-known example of insurers playing a crucial role in directly regulating the safety choices of drivers, arguably a role more significant than that played by the judicial system. Likewise, workplace safety is regulated at least as much by workers' compensation liability insurers as it is by Occupational Safety and Health Administration ("OSHA") regulators; and household safety is regulated as much, if not more, by homeowners' insurance than it is by municipal regulators.

Tying together the conceptual and descriptive analysis, Part III then compares regulation-through-insurance to government regulation. It identifies patterns in the division of regulatory work between insurers and government regulators, highlighting the advantages that insurers have in creating menus of safety choices, levying Pigouvian taxes, disseminating bright-line safety rules, and monitoring conduct. This Part also highlights where we might expect private insurers to have a comparative advantage in regulating safety over government agencies (e.g., when insurance markets are competitive and insurers do not face coordination problems) and where the reverse might be true (e.g., when insureds are judgment proof or cause harms intentionally). Part III also highlights the ways in which the incentives created by tort law are filtered through liability insurance.

Finally, in Part IV, we turn to a normative perspective: insurance as regulation could be imported into areas in which the government has, until now, regulated alone—areas such as consumer protection, food and import safety, and financial markets. In these areas, parties who cause or suffer harm

would have to purchase insurance, and insurers would perform the task of monitoring behavior and requiring compliance with harm-reduction standards. Depending on the liability regime in place, either first-party or liability insurers would instruct people on how to reduce harms, inspect their precautions, and price their behavior accordingly.

I. REGULATORY TECHNIQUES IN INSURANCE

The typical explanation for the existence of insurance involves the concepts of risk shifting and risk spreading. Risk-averse parties are willing to pay an insurance premium that is greater than the expected value of a given risk in order to transfer that risk to an insurance company. The insurer is willing to accept the risk, in exchange for the premiums, in part because of its ability to exploit the Law of Large Numbers (that is, reducing the variance by increasing the size of the pool) and in part because the insurer has access to reinsurance markets and other risk-spreading techniques.¹²

Information is critical to the business of insurance. Insurers use information in performing their risk-spreading and risk-shifting functions. Information is necessary in pricing policies, assembling insurance pools, and verifying claims. Actuarialism—the basic methodology in insurance—is the skill of computing premiums according to information about probabilities and harms.

But insurers use information for another more subtle and less familiar purpose: to induce efficient risk-reducing behavior. The same data that goes into the risk-spreading and risk-shifting computations are relevant and informative in determining how to reduce risk. Insurers, therefore, perform the additional information-heavy function of identifying and administering a system of safety improvements. We view this function as a form of privatized safety regulation. In this Section, we show the various ways in which insurers use information to incentivize individuals and firms to reduce safety risks.

Before we describe these methods, a preliminary question looms over the entire project: why are insurers interested in risk reduction? It is obvious why policyholders want to buy risk-reduction expertise from insurers. The cost of added safety is more than offset by the reduction in expected losses, and thus is more than paid for by the reduction in insurance premiums. But this only heightens the puzzle on the insurer side: if insurers are good risk regulators, expected losses diminish and less premium revenues are collected. Doesn't less risk mean less business for insurers? Why would they want to reduce the very element that gives rise to their existence in the first place?

While it is true that in a world without risk, insurers would be out of business, there are several reasons why insurers want to reduce the risk their

12. For a general discussion of the basic economics of risk and insurance, see ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 49–55 (4th ed. 2004). For an accessible explanation of history and the Law of Large Numbers as a concept, see Moss, *supra* note 2, at 27–30.

policyholders face. The first is competition. In almost every insurance sector, insurers face competitive pressures to encourage their insureds to adopt good risk-management practices. For private insurers, unlike government regulators, a failure to induce efficient care on the part of the regulated parties can result in the loss of business. Insurance purchasers naturally gravitate toward insurance policies that offer the most desirable combination of price and product (quality and quantity). Therefore, insurers that can identify cheap risk-reduction measures can mandate adherence to those measures and attract more business by offering lower premiums that more than offset the cost of the mandated measures.

In fact, even if a particular insurance market were not fully competitive, insurers would have an incentive to reduce risk in order to make premiums more affordable and thus increase the size of the market served. If insurance prices are too high, insureds may either opt to self-insure, reducing insurers' pool of customers, or lobby government regulators to intervene aggressively and sometimes unwisely.¹³ And this drive to increase demand applies not only in competitive insurance markets but also in monopolistic markets, and may explain in part why the industry as a whole, through its collective organizations, is busy developing safety improvements.

Another reason why insurers regulate the risk-reduction behavior of their customers is that the insurers are the ones primarily benefitting from any risk reduction that occurs after a policy is issued. Once the insured has paid the premium, any covered loss that is suffered is borne by the insurer; therefore, any loss prevented or reduced by care-level investments made by the insured is a net benefit to the insurer. It is true, of course, that insurers anticipate this effect and build it into their cost of coverage. But since such loss-reduction measures are often employed after the premium has been collected, the incentive for insurers to induce such measures and minimize the loss that they will have to bear remains active, no matter what premium is charged.

Furthermore, insurers regulate risk reduction in an attempt to attract "good risk." For example, experience rating of drivers creates incentives for safe driving, but also helps insurers identify and select the more profitable customers, those whose behavior is associated with fewer losses. In their relentless search for profitable subpools of insureds, insurers use their clients' propensity to reduce risk, or willingness to install safety measures, as a screening device.

13. Consider the example of California Proposition 103, passed in 1988 in response to what were perceived to be high auto-insurance rates, and which, among other things, required every insurer to reduce its rates by at least 20 percent and froze rates at those levels for two years, unless insurers could show that they were "substantially threatened by insolvency." See CAL. INS. CODE, § 1861.01 (West 2012). The California Supreme Court later struck down portions of the law and, in effect, rewrote it to allow insurers to increase rates as necessary to provide a "fair and reasonable" return on their investment. See generally Stephen D. Sugarman, *California's Insurance Regulation Revolution: The First Two Years of Proposition 103*, 27 SAN DIEGO L. REV. 683 (1990); Samuel H. Szewczyk & Raj Varma, *The Effect of Proposition 103 on Insurers: Evidence from the Capital Market*, 57 J. RISK & INS. 671 (1990).

Finally, in many areas, clients who are risk neutral and who can self-insure are nevertheless turning to insurers to purchase risk-reduction expertise. Here, the value that insurers create and sell is not risk spreading. Instead, the primary value they provide their clients is risk reduction. Victor Goldberg, for example, recounted the example of a Hartford boiler-insurance company, which began as an inspection (that is, safety-related) service.¹⁴ Likewise, many large corporations purchase liability insurance to reduce the risk of class actions, and large employers employ health insurers to administer and manage health-related expenses. This rationale for insurance as regulation is considerably greater for commercial insurance than for personal lines. Commercial clients are often risk neutral, whereas consumers are risk averse and would demand insurance even if it exacerbated, rather than reduced, moral hazard. And commercial clients are more sophisticated and recognize the value-increasing potential of insurance.

Insurers not only have the incentive, the demand, and the competitive pressure to collect and administer information about risk, but they also have the tools to do so. In the remainder of this Part, we describe the types of tools used by insurers to manage risk and incentivize risk reduction.¹⁵ While much of the literature on insurance has focused on the moral hazard problem—the idea that insurance diminishes the incentive to reduce risk—it is also widely recognized that insurers have the means to limit and overcome moral hazard.¹⁶ Insurers collect large amounts of information at both the front end and the back end of the insurance process, and they use that information to create incentives for risk reduction. In keeping with how scholars sometimes understand and categorize government regulation, we sort the regulatory techniques available to insurers into *ex ante* and *ex post* interventions, depending on whether they are used before or after the harm occurs and the insurance claim is filed.

A. *Ex Ante* Regulation

1. Underwriting Risk: Differentiated Premiums

At the front end of the insurance transaction, insurers' most basic tool for creating incentives to reduce risk is the setting of differentiated premiums. Insurers charge lower premiums to careful policyholders, those that can prove that they take effective measures to reduce the insured risks. To

14. Victor P. Goldberg, *Tort Liability for Negligent Inspection by Insurers*, 2 RES. L. & ECON. 65 (1980). Indeed, insurance coverage for commercial boilers and machinery is usually a combination of loss indemnification and loss prevention services.

15. Tom Baker and Thomas Farrish developed a taxonomy of types of "regulation by insurance" similar to the one we set out in this Part, and Victor Goldberg has illustrated some of these techniques in the area of liability insurance. See Baker & Farrish, *supra* note 8; Goldberg, *supra* note 8. We build on those prior taxonomies and highlight the advantages that insurance has relative to government regulation.

16. See *supra* note 4.

determine an insured's idiosyncratic level of care, insurers have to collect information, which they do in various ways.

First, during the underwriting process insurers often require their insureds to fill out lengthy insurance applications that provide the insurer with detailed information about their idiosyncratic risk characteristics.¹⁷ The credibility of the information acquired during the underwriting is bolstered by the use of verification methods, such as health screening tests for life insurance applicants or site surveys for environmental liability insurance. The credibility of the underwriting process is also protected by stiff sanctions on insureds who misrepresent information.

Second, insurers cooperate to pool and analyze risk-related information through various industry-owned insurance rating bureaus.¹⁸ These shared data and services, which are especially valuable to the smaller insurance companies that do not have large quantities of data of their own, make insurance markets more stable and more competitive.

Third, while insurers often use averages in underwriting and pricing policies (that is, estimates based on average accident costs for parties that are similar to the insured), they are also able to tailor and adjust their premiums according to each policyholder's risk characteristics and ongoing behavior, as well as their loss experience over time. When underwriting individual policies (as opposed to group policies), insurers can refine their premiums through the practice of "feature rating," in which they examine the insured's individual risk characteristics and adjust premiums accordingly.¹⁹ For example, environmental liability policies reward policyholders that replace fuel tanks constructed of corrosion-prone material with premium discounts that more than offset the cost of the added safety.²⁰

In addition, insurers gather information about the insured's loss experience during the course of the policy period and use that information, in a process known as "experience rating," either to make retroactive pricing adjustments or prospective pricing adjustments for future policy periods.²¹

17. Insurers gather detailed information on individual applicants only for "individually underwritten" insurance policies. When insurance is sold through "group policies," by contrast, there is no individualized application process. Rather, premiums are based on the expected payouts of the group. Individual screening could, however, be conducted when individuals join the group. Employers, for example, may decline to hire individuals who would burden the health insurance pool.

18. The Insurance Services Office ("ISO"), is the primary rating bureau for the property-casualty insurance industry. *See* INS. SERVS. OFFICE, <http://www.iso.com>. Every year, insurers send ISO approximately two billion detailed records of insurance premiums collected and losses paid. ISO then applies sophisticated statistical methods to turn this raw data into information that can be used by insurers both to set accurate prices for their policies and to engage in loss mitigation, discussed below. *Id.* For a general description of the role of insurance rating bureaus, see KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 34–36 (5th ed. 2010).

19. *See* ABRAHAM, *supra* note 3, at 71–72; Baker & Farrish, *supra* note 8, at 295.

20. Yin et al., *supra* note 8, at 333.

21. ABRAHAM, *supra* note 3, at 72. For a summary of the experience-rating process in workers' compensation insurance markets, see NAT'L COUNCIL ON COMPENSATION INS.,

Through these insured-specific premium adjustments over time, the insured is made aware of precisely what safety investments—both care level and activity level—correlate with particular reductions in expected accident costs.²² For example, under environmental liability insurance policies for fuel-tank owners, a prior leak raises premiums by 10 to 20 percent.²³ Also, as a result of experience rating in auto insurance, drivers are given incentives to avoid incidents that lead to premium hikes. Likewise, experience rating in workers' compensation insurance gives employers a strong incentive to keep workplace accidents to a minimum.

Differentiated insurance premiums provide explicit prices to people's choices of care in much the same way as Pigouvian taxes.²⁴ Thus, in contrast to traditional command-and-control rulemaking, where the government agency is faced with a binary choice between whether to *require* a particular safety measure or not (which, in turn, requires the regulator to compare the benefit of that safety measure with its cost), insurers need only price the expected risk reduction associated with the safety investment.²⁵ The insureds themselves then make the choice of whether that safety investment—given its present costs and a discounted stream of benefits—makes sense in their particular circumstances. Insureds for whom the cost of the safety measure is low relative to its benefits, or who have low discount rates and thus value the future premium discounts, will “buy” it; others will not. This sorting avoids the inefficiency of mandated, across-the-board safety requirements.

Differentiated premiums also affect the level of the insured's activity. Insureds for whom the activity provides high utility will purchase insurance

ABCs OF EXPERIENCE RATING (2011), available at https://www.ncci.com/documents/abc_Exp_Rating.pdf. Retroactive adjustments to premiums for the current policy period based on loss experience during the period, sometimes referred to as “retrospectively rated insurance,” are generally limited to large commercial insureds. Prospective experience rating, of course, is used in all types of insurance, including insurance sold to consumers.

22. Insurance premiums can serve to inform consumers of the risks they face. This can be especially useful if consumers are systematically biased in their decisions regarding risks. One study found evidence that actuarially fair insurance premiums have debiasing benefits with respect to individual consumer risk decisions. See Susan K. Laury & Melayne Morgan McInnes, *The Impact of Insurance Prices on Decision Making Biases: An Experimental Analysis*, 70 J. RISK & INS. 219 (2003).

23. Yin et al., *supra* note 8, at 334.

24. Under a Pigouvian tax, the government imposes on externalizing actors a levy that approximates the marginal harm caused by the actors' behavior, thus forcing them to take those costs into account in choosing their actions. HARVEY S. ROSEN & TED GAYER, *PUBLIC FINANCE* 82 (8th ed. 2008). For further discussion of how differentiated insurance premiums replicate the Pigouvian tax, see *infra* Section III.C.

25. There are counterexamples, where government regulation is not binary. One example would, of course, be a Pigouvian tax, such as a tax on carbon emissions. See *supra* note 23. Another from the environmental context would be so-called cap-and-trade regimes, under which the government limits the amount of emissions parties can produce but then allows parties to trade in emissions credits. The effect is similar to a Pigouvian tax because it promotes efficiency by allowing the regulated party to choose whether or how much to engage in the activity. See generally *Cap and Trade*, U.S. ENVTL. PROTECTION AGENCY, <http://www.epa.gov/captrade/> (last updated Aug. 12, 2010).

and engage in the activity. Others, for whom the activity provides only a low utility, will be priced out altogether. For example, the cost of auto insurance can filter drivers in and out of driving activity. By contrast, government regulation of drivers' licensing is limited to a binary yes-or-no determination that is done once, at the entry phase, and is revised only in extreme circumstances. Arguably, the insurers' continuous scale of prices provides a more efficient activity filter than government licensing.²⁶

A striking example of innovations in information-based differentiated premiums is the introduction of "usage-based insurance," sometimes called "pay-as-you-drive" auto insurance, which is a hybrid of care- and activity-level pricing schemes.²⁷ By installing "telematics" devices in cars and collecting microdata about driving patterns, insurers are able to price premiums based on the scope of activity (e.g., number of miles driven) and the degree of safety and care (e.g., speed and acceleration, time of travel), thereby reducing premiums and accidents.²⁸

2. Deductibles and Copayments

The moral hazard literature early on recognized the tradeoff between full insurance and optimal care-level incentives. The idea was simple: if the insured enjoyed only partial insurance coverage, some incentive to take care would be preserved. Thus, the literature demonstrated that the most efficient insurance contracts require some sharing of the loss between the insurer and

26. The government also regulates driving care levels, of course, through the enforcement of traffic safety laws. Traffic fines, however, do little to regulate activity levels. They do get incorporated into insurance pricing, as insurers adjust premiums based not merely on accident experience but on the driving record more generally. Thus, this aspect of auto safety regulation can be seen as an example of complementary interaction between government safety regulation and insurance as regulation.

27. A heavily advertised recent example of pay-as-you-drive auto insurance is the "Snapshot" program offered by insurer Progressive. With Snapshot, the insured agrees to drive with the device for thirty days and then sends the recorded information to the insurer, which then uses the information to determine what discount to give the insured, if any. To encourage use, the insurer promises not to use the information to raise the insured's premiums. *How Snapshot Works*, PROGRESSIVE, <http://www.progressive.com/auto/snapshot-how-it-works.aspx> (last visited May 1, 2012) (video explaining how Snapshot works).

28. It is reported, for example, based on a survey of 15,000 policyholders, that the installation of a "smartbox" by the insured leads to an average reduction of 40 percent in premiums and 20 percent in accidents, suggesting two effects of the smartbox: adverse selection (safer drivers are drawn to the program) and reduced moral hazards. See Stephen Womack, *Spy-in-the-Car Boxes for Young Drivers Slash Accidents by a Fifth and May Save 40% on Insurance After a Year*, THIS IS MONEY, <http://www.thisismoney.co.uk/money/cars/article-2123201/Monitoring-habits-young-drivers-reduces-accidents-fifth-insurer-analysis-found.html> (last visited Aug. 6, 2012).

the insured.²⁹ And insurers do, in fact, commonly share losses with insureds in various ways, including through deductibles and copayments.³⁰

With respect to some types of care-level investments, deductibles and copayments are not as efficient as premium differentials in creating optimal incentives for the insured. Deductibles and copayments give the insured only a weakened incentive to take care because the insured enjoys only part of the social benefit of making the investment. On the other hand, premium discounts, as noted, can internalize to the insured the full social benefit of any care-level investments. However, premium differentiation places a heavier informational burden on the insurer to observe the insured's level of care. The use of deductibles reduces this informational burden and can be comparatively efficient in inducing insureds to adopt relatively cheap and effective safety measures.³¹

3. Refusal to Insure

Some activities will not be undertaken without insurance, either because people are highly risk averse, or because insurance is mandated by law or contract. As a result, insurers have de facto control over access to some primary activities, and can leverage this power to induce safer behavior. For example, insurers often will not issue products liability coverage to a manufacturer that does not have a system in place for maintaining quality control with respect to safety issues or for safety testing its product. Likewise, liability insurers that cover ski resorts require insureds to have their lifts periodically inspected by the insurer's safety experts as a condition of obtaining a policy (which itself is usually a condition for getting a license to operate).

A common type of refusal to insure is the cancellation or rescission of, or refusal to renew, an existing policy. For most property-casualty insurance policies, insurers under state law have sixty days to cancel a new policy for any reason not explicitly prohibited by law, and the right to cancel or rescind the policy at any time if the insured made a material misrepresentation on its application on which the insurer relied. In addition, even if there is no misrepresentation in the application process, insurers can cancel or decline to renew a policy if they determine that an insured has engaged in some activity (or failed to take some safety measure) that results in a material increase in the hazard to the insured. Finally, through the use of exclusions, insurers can refuse to insure particular risks—e.g., intentional ones—for which coverage would destroy incentives for care.

29. Shavell, *supra* note 4, at 546.

30. Deductibles require insureds to pay a fixed amount "out of pocket" to cover insured losses before the insurance coverage kicks in to cover insured losses thereafter. Copayments typically require insureds to bear some fraction of each covered loss claim filed by an insured.

31. This point is illustrated in an example in Ronen Avraham, *The Law and Economics of Insurance Law—A Primer* 37–39 (Apr. 26, 2011) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1822330.

4. Coaching Safer Conduct

A standard assumption in the insurance literature on moral hazard is that insurers have less information about policyholders' idiosyncratic care levels and risk types than the policyholders themselves.³² This assumption is often contradicted by another widely held assumption about the insurance industry: that insurers have expertise in acquiring and sorting sophisticated information.³³ While it is true that insureds have some information that insurers cannot observe, insurers are likely to have significant advantages in understanding and calculating how different types of care and safety affect risk. While policyholders know which precautions they have taken, they often lack the expertise to quantify the effect of the precaution on risk reduction, and to ascertain whether the cost of the precaution is justified. Is it worthwhile to refit one's home with fire-extinguishing sprinklers? To install a car antitheft device? To take a particular medical screening test? Even commercial parties buying liability insurance may not realize how their expected cost could be reduced by taking simple precautions—until their insurer prices it.

Building on this informational advantage, insurers perform a regulatory function that public regulators rarely do: they “educate” their insureds on how to avoid and reduce risks. All major liability insurance carriers, as well as many insurance brokerage firms, offer risk management or loss control services. They provide programs and training to identify and control risks. They audit and inspect their clients, manage their prevention efforts, analyze their loss history, identify causes of accidents and how losses occur, and teach them how to avoid premium increases (or how to secure premium reductions).³⁴ They offer toolkits, information, and guidance that firms can use in making decisions affecting their exposure to loss. Commercial insurers also employ experts in all of the relevant fields—engineering, medicine, law—and provide these experts with information about the insured and data

32. See *supra* note 4. This same assumption is made in the economic literature on adverse selection in insurance markets. Adverse selection can in theory arise when insurers are not able to differentiate high-risk from low-risk insureds and thus charge the same premium to both. In such situations, relatively high-risk insureds—if they know that they are high risk—are disproportionately likely to purchase insurance, because the premium for them is a bargain. This phenomenon can push up insurance premiums, which can in turn induce low-risk insureds to drop out of the pool. At the extreme, adverse selection can lead to risk pools “unraveling” entirely. See Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976). Peter Siegelman has challenged the uninformed insurer assumption in the context of adverse selection. Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223 (2004).

33. See, e.g., Siegelman, *supra* note 32, at 1241–42 (noting that insurers may in fact have superior information than insureds about some aspects of the insured's risk profile).

34. See, e.g., *Loss Control*, HARTFORD, <http://www.thehartford.com/business/product/losscontrol> (last visited May 1, 2012); *Loss Control Solutions*, CHUBB, <http://www.chubb.com/businesses/chubb3242.html> (last visited May 1, 2012).

about the insured's industry, to help commercial insureds craft individualized risk-reduction plans.³⁵

Products liability insurers, for example, offer "product protection" plans that review the safety of product designs, the quality controls in manufacturing, and the warnings attached to the product.³⁶ Similarly, workers' compensation insurers coach employers how to refit and organize the workplace, and how to train their employees, with an eye toward avoiding costly accidents.³⁷ Environmental liability insurers make on-site visits and instruct policyholders on how to avoid costly damages and comply with (or exceed) environmental regulatory standards. Pollution insurance underwriters send engineers to the sites to examine how landfills are engineered and built, and how waste is disposed, and then to provide instruction where needed.³⁸

5. Implementing Private Safety Codes

In various areas, insurers implement codes of safety that policyholders must comply with—codes that impose standards that exceed the levels of safety required by government regulators. For example, environmental liability insurers require, or offer significant premium discounts for, compliance with private environmental safety codes that are managed and audited by third parties and that are stricter than government environmental regulation. Some even argue that, in certain areas of international environmental law, firms focus more on complying with private standards that their insurers adopt than they do on complying with public international treaties.³⁹ In the area of residential home-safety and construction standards, property insurers develop building code ratings that push for stricter standards for builders and stricter enforcement by localities.

Insurers are instrumental in disseminating efficient safety technology. Safety measures that create positive externalities—benefits to other policyholders—would be underutilized in the absence of insurance. However, since insurance aggregates the interests of dispersed policyholders, it helps to internalize such cross-insured benefits. For example, car owners can fit their cars with devices like LoJack, an antitheft transmitter that dramatically increases the chance of recovering a stolen car. LoJack creates a deterrent

35. See Baker & Farrish, *supra* note 8, at 298.

36. See, e.g., *Global Loss Prevention*, CHARTIS, http://www.chartisinsurance.com/us-glp-product-protection_295_243862.html (last updated Mar. 23, 2010).

37. This coaching incentive is disrupted if insurers are exposed to liability as codefendants in tort suits for their role in chaperoning the level of risk. In the workers' compensation area especially, this might increase the liability exposure, which is otherwise severely limited by statutory caps. See John Dwight Ingram, *Liability of Insurers for Negligence in Inspection of Insured Premises*, 50 *DRAKE L. REV.* 623, 635 (2002).

38. Corey Stein, *Pollution Insurance Comes Of Age: A Maturing Environmental Insurance Market Means Affordable Coverage Now Is Available for Most Localities*, *PUB. MGMT.*, July–Aug. 1999, at 14, 15–16.

39. See RONALD B. MITCHELL, *INTENTIONAL OIL POLLUTION AT SEA: ENVIRONMENTAL POLICY AND TREATY COMPLIANCE* 289 (Nazli Choueri ed., 1994).

effect that actually benefits others and, owing to transaction costs, the LoJack purchaser cannot capture the value of this benefit through a market transaction. This means that car owners will purchase LoJack less often than is socially desirable.⁴⁰ Insurance contracts offer a solution to this incentive problem. That is, insurers serve to collectivize the otherwise externalized benefit of the LoJack investment. Unsurprisingly then, insurers provide substantial premium discounts—often 20 percent—to auto owners who install LoJack.⁴¹ Some states cap the discount, but insurers lobby to increase the cap. In some places, insurers purchase and install LoJack in vehicles at their own cost, or donate the detection equipment to police cruisers.⁴²

6. Research and Development of Safety Methods

Insurers cooperate in identifying safety technologies and disseminating new risk-reduction methods. For example, the auto insurance industry has, for many years, funded research designed to identify ways to reduce the losses associated with automobile accidents. The industry operates an institute that tests and rates the crashworthiness of automobiles, and it organizes concerted efforts to lobby for mandatory safety devices (such as airbags).⁴³ Likewise, many of the standards relating to fire prevention and building fire codes were developed by the insurance industry and were subsequently accepted by builders, firefighters, courts, and lawmakers as being state of the art.⁴⁴ The homeowners' insurance industry has its own association researching and promulgating standards of safety with respect to property risks.⁴⁵

40. Ian Ayres & Steven D. Levitt, *Measuring Positive Externalities from Unobservable Victim Precaution: An Empirical Analysis of Lojack*, 113 Q.J. ECON. 43, 43 (1998); Omri Ben-Shahar & Alon Harel, *Blaming the Victim: Optimal Incentives for Private Precautions Against Crime*, 11 J.L. ECON. & ORG. 434, 435 (1995).

41. *Progressive and LoJack Offering Discount on Comprehensive Insurance and Stolen Vehicle Recovery System, Respectively*, THE AUTO CHANNEL, <http://www.theautochannel.com/news/2007/03/06/039261.html> (last visited Apr. 30, 2012) (up to 20 percent discount on comprehensive insurance).

42. Ayres & Levitt, *supra* note 40, at 73. It should be noted that not all insurers offer this discount, as insurers too suffer from an externality problem: the benefit of a subsidized LoJack in theft deterrence is only partially captured by the insurer; the bulk of it goes to other insurers and uninsured car owners. This problem is partially overcome by coordination. The LoJack company partners with large national insurers to offer standard discounts. Also, ironically, to help insurers overcome their collective action problem and regulate efficiently, some states have intervened and mandated premium discounts for the installation of LoJack. *See id.*

43. *See infra* Section II.C.

44. The National Fire Protection Association was established by insurance representatives to develop codes and standards relating to fire safety, most prominently the utilization of fire sprinklers. *See* Casey Cavanaugh Grant, *The Birth of NFPA*, NAT'L FIRE PROTECTION ASS'N, <http://www.nfpa.org/itemDetail.asp?categoryID=500&itemID=18020&URLAbout%20NFPA/Overview/History> (last visited Apr. 30, 2012).

45. The Insurance Institute for Business and Home Safety ("IIBHS") was created by the insurance industry to research various ways of making commercial properties and homes safer from all sorts of hazards. *About the Insurance Institute for Business & Home Safety*, INS.

7. Influencing Government Regulation

Insurers not only create their own private regulatory codes, as discussed above; they also on occasion work with government regulators to enhance the public regulation of safety. This can be seen in the efforts of insurers to upgrade and enhance the content and enforcement of state and local building codes. It can also be seen in the insurance industry's efforts to enhance automobile safety over the years, from the push in the early 1980s for compulsory airbags to the push more recently for better laws regarding driver licensing. We will document several such examples in Part II below. Just as the government in effect delegates some regulatory responsibilities to private insurers, insurers on occasion can provide public regulators with legislative blueprints to achieve society-wide improvements in risk reductions.⁴⁶

B. *Ex Post* Regulation

In addition to regulation prior to the loss, insurers also substitute for ex post regulation—the attachment of legal consequences to behavior *after* it has occurred. The most common form of ex post legal regulation is court-imposed sanction. A great body of literature explores the informational and administrative properties of ex post regulation.⁴⁷ In this Section, we are interested in identifying the informational tools that insurers have that government decisionmakers do not.

1. Claims Management

Every insurer operates some type of claims-management system, a network of adjusters who are employed to investigate claimed losses, measure them, and negotiate payouts. Claims departments then review the decisions of adjusters and provide greater uniformity and predictability. Liability insurers also use standardized charts and tables to quantify nonpecuniary losses, making them more predictable and reducing the chilling effect that uncapped nonpecuniary costs might create. There is also evidence that the magnitude of liability is determined as much by coverage limits in the defendants' policies as by the magnitude of loss incurred by the plaintiffs.⁴⁸ Moreover, insurers are sometimes retained as third-party administrators, providing claims administration services only, whereby another party (e.g.,

INST. FOR BUS. & HOME SAFETY, http://www.disastersafety.org/page?execution=e2s1&pageId=about_ibhs_ds (last visited Apr. 30, 2012).

46. See Baker & Farrish, *supra* note 8, at 295.

47. The best summary of this literature is still Kaplow, *supra* note 1.

48. Kathryn Zeiler, Charles Silver, Bernard 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 (2007).

the employer) bears the actual risk, but then relies on the expertise of the insurers to verify, quantify, and manage the claims and the payments.⁴⁹

Claims adjusters implement in a routine, uniform way the investigation and factfinding procedures that are designed centrally. They apply simple rules for determining fault and causation, quantifying losses, and settling disputes.⁵⁰ This process reduces delays in payments to claimants and, as we will argue later, transforms vague safety standards issued by law into clear, bright-line rules issued by insurers.

2. Mitigation of Loss

Another way in which insurers regulate losses *ex post* is by helping to mitigate covered losses. This can be seen clearly in contractual provisions, found in most insurance policies, that require insureds to take all reasonable postaccident steps to mitigate losses or else forfeit coverage.⁵¹ Insurers also help insureds mitigate losses by monitoring repair services. The most ubiquitous example of this occurs in the auto insurance context, as auto insurers often exercise strict control over the choice of companies to perform repairs. It is likely the case that environmental insurers likewise maintain control over the choice of contractors that insureds can hire to do the remediation or cleanup costs covered under environmental liability policies. By getting directly involved in this way, insurers both reduce the magnitude and gain an accurate estimate of the insured loss.

In addition, liability insurers help to control overall litigation costs *ex post* through their role as the financier of their insureds' legal defense. Liability insurance policies generally assign to insurers the contractual obligation and responsibility to provide a legal defense for their insureds. As a result, liability insurers have experience and expertise in selecting defense counsel and managing litigation expenditures, which leads to lower overall costs. Although this arrangement, where the insurer is both on the hook for loss claims (within the policy limits) and in charge of the litigation, can pose some conflicts of interest, it nevertheless leads to the reasonably low-cost resolution of legal disputes for the vast majority of liability insureds. More fundamentally, the role of insurers in litigation and settlement often overrides the effect of substantive compensation doctrines. For example,

49. These arrangements are common in health insurance, whereby insurers provide claims administration to self-insured employers, utilizing information systems and expertise in processing premiums, claims, eligibility, billing, coordination of benefits, and regulatory compliance. *See, e.g., Health Plan Administration*, AM. HEALTH GRP., http://www.americanhealthgroup.com/Default.aspx?area=srv-claims_admin (last visited Aug. 6, 2012).

50. *See* H. LAURENCE ROSS, *SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS* (2d ed. 1980).

51. *See* ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, *UNDERSTANDING INSURANCE LAW* 637 (4th ed. 2007) ("It is important to recognize that most insurance policies condition the insurer's obligations on the insured exercising reasonable care to minimize the extent of damage after a loss.").

insurance policy limits, not legal remedies, are found to dictate the settlement amount.⁵²

3. Exclusions

Perhaps the most common way in which insurers engage in ex post regulation is when they enforce exclusions contained in their policies.⁵³ Insurance policies contain exclusions for losses caused by certain types of activities. Sometimes, the exclusions relate to risks that are correlated, such as earthquake risks, where the spreading device is ineffective. Other times, the exclusions apply to activities for which coverage would create a severe moral hazard and where noncoverage is the only effective way to create harm-prevention incentives. For example, intentionally caused harms, criminal activity, and intentional violations of statutes or regulations are generally excluded from all liability insurance policies.⁵⁴ Likewise, many fire insurance policies exclude any loss resulting from “an increase in hazard, if increased by any means within the control or knowledge” of the insured. Referred to as “the moral hazard conditions,” this exclusion in effect levies a sanction on the insured in an amount equal to the amount of the loss and thus theoretically would deter fire-risky behavior.⁵⁵ Similarly, directors and officers (“D&O”) liability insurance policies have changed to exclude claims arising from resistance to takeovers or targeted share repurchases (“greenmail”),⁵⁶ which would affect directors’ engagement in these actions.

4. Ex Post Underwriting

Another type of ex post regulation by insurers, which has come under criticism from some commentators, consists of refusing to pay out claims based on policies that were issued after the insured materially misrepresented

52. Kathryn Zeiler et al., *supra* note 48, at S10.

53. Policy exclusions have both an ex ante and ex post regulatory component. They are obviously inserted into the policies ex ante, before any loss occurs or claim is filed. In that sense, they are a form of refusal to insure, which is discussed above. However, the decision to invoke the exclusion or interpret an exclusion as applying to a particular claim occurs ex post, often depending on the actual conduct of the insured.

54. Indeed, even if insurance policies did not contain such an exclusion, policies covering intentionally caused harms will often be considered unenforceable as against public policy. *See, e.g., Indus. Sugars, Inc. v. Standard Accident Ins. Co.* 338 F.2d 673, 676 (7th Cir. 1964); I ROWLAND H. LONG, *THE LAW OF LIABILITY INSURANCE* § 1.02 (2004); JERRY & RICHMOND, *supra* note 51, at 431.

55. George W. Goble, *The Moral Hazard Clauses of the Standard Fire Insurance Policy*, 37 COLUM. L. REV. 410, 415 (1937). Note that fire insurance policies are one type of insurance policy that tends to be governed more by state law than by competitive insurance markets, as states have often historically required that a particularly worded policy be used. Where that is the case, the government has, in a sense, chosen to regulate fire risks through the wording of the insurance policy.

56. Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT’L REV. L. & ECON. 115, 119 (1990).

some information at the underwriting phase.⁵⁷ The efficient functioning of insurance markets depends on insurers' ability to gather accurate information about insurance applicants.⁵⁸ To achieve this end, insurers have two general strategies. They can spend resources at the underwriting stage to investigate and verify the information given by insureds on their applications; and some of this they do. But exhaustive ex ante information verification can be very costly. A cheaper alternative is for the insurers to accept as true the answers given by the insureds on their applications when submitted (unless there is a red flag on the application that suggests further investigation is warranted), but then to examine more closely only the applications of the small subset of insureds who end up submitting a loss claim. Under this approach, only a fraction of the applications need to be thoroughly investigated. If a material falsehood is found, and if it can be shown that the insurer relied upon that falsehood in issuing or pricing the policy, the insurer can then rescind the policy and deny the insured's claim. The effect of this ex post denial of the claim is to improve the ex ante incentives of insureds to provide truthful information at the underwriting stage, and to improve incentives at considerably lower cost than would be the case with exhaustive ex ante investigations by the insurer of every single insured. While there is a risk of insurer opportunism (for example, insurers asking intentionally vague questions on the applications to create the opportunity for a misrepresentation defense ex post), those concerns can be addressed through common law doctrines such as *contra proferentem*, and bad-faith sanctions can be imposed on the worst-offending insurers when appropriate.⁵⁹

57. Although the majority rule is that even unintentional misrepresentations can give rise to rescission, some states limit ex post rescission of this sort to cases involving actual fraud on the part of the insurance applicant. *E.g.*, *Enserch Corp. v. Shand Morahan & Co.*, 952 F.2d 1485, 1496 (5th Cir. 1992) ("A misrepresentation defense under Texas law requires a showing that the misrepresentation was made willfully with the intent to deceive An applicant for insurance cannot willfully intend to deceive its potential insurer unless it actually, not constructively, knows that what it misrepresents is untrue"); *Middlesex Mut. Assurance Co. v. Walsh*, 590 A.2d 957, 963-64 (Conn. 1991) ("[I]n order to constitute a misrepresentation sufficient to defeat recovery on an automobile insurance policy, a material misrepresentation on an application for such a policy must be known by the insured to be false when made."); *Benton Casing Serv., Inc. v. Avemco Ins. Co.*, 379 So. 2d 225, 232 (La. 1979) ("Whether a statement made by the insured in the negotiation of an insurance contract . . . is labeled as a representation or as a warranty, the falsity of such a statement shall not be material and shall not defeat coverage, unless it is shown that the false statement was made with the intent to deceive." (emphasis omitted)).

58. Insurers' need to police the quality of the information they are given by insurance applicants is akin to a government agency's need to police the quality of the information provided to it by regulated parties. For this reason, the Food and Drug Administration has the power to punish drug companies that submit fraudulent studies when applying for approval of a new drug or device. Catherine M. Sharkey, *The Fraud Caveat to Agency Preemption*, 102 Nw. U. L. REV. 841, 843 n.12 (2008).

59. Another concern with ex post underwriting is the problem of innocent mistakes by (especially consumer) insureds in filling out the sometimes complex and confusing applications. The innocent-mistake problem too can be addressed, however, by limiting insurers to

II. INSURERS AS SAFETY REGULATORS: EXAMPLES

This Part demonstrates how the different regulatory techniques identified in the previous Part are already being used in various types of insurance. Our purpose here is to illustrate the prevalence of regulation by insurance and the advantage it could have over regulation by government. These illustrations do not prove any general claim about the superiority of insurance companies as regulators of safety. They merely highlight some of the ways in which insurance companies presently are induced by competition to exploit their informational comparative advantage to reduce risks. These illustrations serve as examples of insurance reducing, rather than creating, moral hazard.

A. *Products Liability Insurance*

Because consumers lack sufficient information to fully appreciate the risks of the products that they purchase, some form of product safety regulation is necessary. And regulation there is. Agencies such as the Consumer Product Safety Commission (“CPSC”), the Food and Drug Administration (“FDA”), and the National Highway Traffic Safety Administration (“NHTSA”) all, in one way or another, regulate the safety of products and product use. In addition to such *ex ante*, agency-based government regulation, product safety is also regulated *ex post* through the application of tort law by courts. Choosing the ideal regulatory role for these two institutions—agencies versus courts—is a familiar dilemma. But it cannot be adequately resolved without an account of how insurance arrangements support (i.e., either replace or complement) the regulatory function of tort and agency law.

To understand this point, it is first necessary to understand how the choice of a liability standard affects the type of insurance that would complement it as a regulator of risk. For example, under a tort regime of no liability for product-caused harms (for example, the old regime under which courts enforced product-warranty disclaimers for personal injuries caused by product accidents), the primary government regulator of product safety would be command-and-control government agencies, and the primary insurer-regulator will be first-party health insurers. By contrast, under a tort regime of strict products liability, the primary government regulator would be the courts and the primary insurer-regulator would be liability insurance companies. As a result, the view of insurance as regulation suggests that the choice between no liability and strict liability turns largely on the question of which type of insurance—first-party health, disability, and life insurance, or third-party liability insurance—is better at reducing product-related accidents.

As it turns out, the choice seems pretty clear: first-party insurers are poorly equipped, and liability insurers are relatively well equipped, to

some form of reformation remedy rather than the more draconian rescission remedy. *See, e.g.*, Brian Barnes, Note, *Against Insurance Rescission*, 120 YALE L.J. 328 (2010).

regulate consumer product risks. There is little that first-party insurers can do to regulate consumer product-injury risks.⁶⁰ Health, disability, and life insurers that would pay for harms caused to consumers by dangerous products under a no-liability regime do not ordinarily distinguish between, and charge different premiums to, consumers who purchase relatively safe products and those who purchase relatively dangerous products. They do not monitor which products their policyholders purchase and how safely they use those products (care-level concerns), or how often they use those products (activity-level concerns). Nor do first-party insurers deny claims on the grounds that the insured was contributorily negligent or assumed the risk.⁶¹ (One exception is life insurance monitoring of cigarette smoking.) In fact, first-party insurance is often sold on a group basis, which means that insurers do not gather detailed information about any individual risk characteristic of their insureds, including those related to product use. And even in policies that are individually underwritten, it is usually too costly for insurers to gather and update product-use information. The result of this dearth of first-party regulatory intervention is moral hazard with respect to consumer care and activity levels.⁶²

Can products liability insurers do better than first-party insurers at regulating product injury risk? Products liability insurance is underwritten on a company-specific basis rather than a group basis. Products liability insurers have much at stake in the actuarial experience of each of their insured manufacturers, and so they collect detailed information about how the product is designed, inspected, and manufactured, what types of quality controls and manufacturing standards the insureds have in place, whether parts used in the production process contain dangerous inputs, whether those parts are warranted by suppliers, and much more.⁶³ Products liability insurers also collect information about the insured manufacturers' activity levels (i.e., sales volume) with respect to particular product lines and about past marketing incidents. These information inputs are then used by the insurers not only in pricing products liability policies, but also in training manufacturers on how to reduce their liability exposure. Insurers inquire as to whether the manufacturer is in compliance with international and domestic standards of

60. See Hanson & Logue, *supra* note 9, at 145–53.

61. First-party insurers do gather information on which product caused the harm and bring subrogation claims against makers of defective products, but only under a tort liability regime.

62. This phenomenon has been called the “first-party insurance externality.” Hanson & Logue, *supra* note 9, at 166–68. The first-party insurance externality is largely limited to health and disability insurance (and to some extent life insurance) and the context of consumer product risks other than automobiles and home purchases. That is, first-party auto and homeowners' insurers do make efforts to regulate the risky behavior of their insureds with respect to auto-related and home-related risks, respectively. See *infra* Sections II.C–D (providing examples of this sort of first-party insurer regulation).

63. See, e.g., *Application for Specified Products and Completed Operations Liability Insurance*, VERACITY INS. SOLUTIONS, <http://www.veracityinsurance.com/applications/2010ProductLiabilityApplication.pdf> (last visited Apr. 30, 2012) (detailed online products liability application for Veracity Insurance Solutions, LLC).

design and production, and advise them regarding how to protect against malicious tampering, how best to label products to minimize the risk of accidents, and even when and how to issue recalls.⁶⁴ Thus, with this ability to hone in on particular products and specialize in their safety design, liability insurers are clearly more effective than first-party insurers at monitoring and regulating the safety of consumer products; hence the case for strict products liability as a form of product safety regulation, in contrast to a rule of no liability or even fault-based liability, is strengthened.⁶⁵

B. Workers' Compensation Insurance

Workplace safety is another area of regulation through insurance, where insurers play a major role in implementing and monitoring safety. Workers' compensation regimes, which have been adopted in all fifty states, constitute a form of no-fault strict liability.⁶⁶ States require employers to purchase insurance either from a private insurer or a state-run workers' compensation fund. Workers who are injured on the job recover from their employer's workers' compensation insurer. In managing claims, insurers collect information concerning the circumstances that gave rise to the injury and examine the medical records documenting the injury. As already mentioned, workers' compensation insurance is one of the areas where insurers "experience" premiums and have done so for many years; and the process is facilitated by various industry organizations that aid in the collection and analysis of data.

Although the move from a fault-based tort liability regime to a no-fault strict liability workers' compensation regime was originally primarily about

64. See, e.g., *Product Protection*, CHARTIS, http://www.chartisinsurance.com/us-glp-product-protection_295_243862.html (last visited Apr. 30, 2012) (listing ways that insurer helps insureds reduce product liability risks); *Products Liability Services*, CHUBB, <http://www.chubb.com/businesses/cci/chubb2492.html> (last visited Apr. 30, 2012 (same)).

65. Whereas no-liability and strict-liability tort standards represent the extreme positions with respect to the allocation of responsibility for product safety regulation between first-party and liability insurers, fault-based liability falls somewhere in between. Under a fault-based or negligence regime, liability insurers are the primary insurer-regulators with respect to harms that are deemed the insured-tortfeasor's fault, and the injured victims' first-party insurers are the primary insurer-regulators with respect to harms that are deemed not to be the injurer's fault. If, as discussed in the text above, liability insurers are better product-risk regulators than first-party insurers, the case for a strict liability rule is strengthened vis-à-vis a negligence rule in product-accident contexts. For the opposite argument that a no-liability rule is more efficient than a rule of strict products liability, see A. Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Products Liability*, 123 HARV. L. REV. 1437 (2010). In the context of automobile accidents, where the question is whether the driver-injurer (and her liability insurer) should be held liable or whether the driver- or pedestrian-victim (and her first-party insurer) should be responsible for the losses, the choice is between no-liability and fault-based liability. See *infra* Section II.C.

66. See generally DON DEWEES ET AL., EXPLORING THE DOMAIN OF ACCIDENT LAW: TAKING THE FACTS SERIOUSLY 387-96 (1996).

uniform and universal compensation, rather than safety regulation,⁶⁷ it has a regulatory effect as well. Studies have shown that workers' compensation regimes tend to have significant regulatory benefits, in terms of reducing worker injury rates. It has also been claimed, on the basis of existing evidence, that this effect is more pronounced than the deterrence benefits of the leading regulatory alternatives, including fault-based tort regimes and direct government regulation of workplace safety.⁶⁸ Indeed, there is some direct evidence that experience rating by workers' compensation insurers has improved workplace safety, especially among larger firms, where most individual workers are employed.⁶⁹

C. Auto Insurance

The regulation of automobile driver safety is divided between first-party and liability insurers. Some, but not all, losses are shifted from victims and their first-party insurers to drivers and their liability insurers.⁷⁰ States vary with respect to the amount of loss shifting they do through their tort systems. Most states have a tort-based auto insurance regime, in which victims can recover from negligent drivers and their liability insurers, or otherwise turn to their own first-party insurers.⁷¹ In those states, both first-party and liability auto insurers have an incentive to regulate the care levels of their insureds. In contrast, a minority of states has some type of no-fault regime (a misnomer, which really means "no-liability"), in which tort recovery is limited and injured parties (other than pedestrians, whose tort claims are not

67. See generally PAUL B. BELLAMY, A HISTORY OF WORKMEN'S COMPENSATION 1898–1915: FROM COURTROOM TO BOARDROOM (1997); Richard A. Epstein, *The Historical Origins and Economic Structure of Workers' Compensation Law*, 16 GA. L. REV. 775 (1982); Price V. Fishback & Shawn Everett Kantor, *The Adoption of Workers' Compensation in the United States, 1900–1930*, 41 J.L. & ECON. 305 (1998).

68. DEWEES ET AL., *supra* note 66, at 378–82 (summarizing various studies); *id.* at 382 ("We conclude that operation of the workers' compensation system does reduce worker injury rates and that for high-risk industries and risk-rated firms this reduction is substantial, although the absolute magnitude of the effect is subject to enormous uncertainty. We accept the evidence that this effect is greater than that created by the tort system or that created by U.S. federal occupational safety and health regulation.").

69. The degree of experience rating—the extent to which premiums are adjusted based on an insured's claims experience—is a direct function of size: the bigger employers are, the more their own experience will affect their rates. WORKERS' COMPENSATION INSURANCE PRICING: CURRENT PROGRAMS AND PROPOSED REFORMS 83 (Philip S. Borba & David Appel eds., 1985). There is evidence that workers' compensation has greater regulatory benefits with larger firms. See John W. Ruser, *Workers' Compensation Insurance, Experience-Rating, and Occupational Injuries*, 16 RAND J. ECON. 487, 488 (1985).

70. As discussed *supra* in Section II.A, some auto-safety risks are also shifted from victims and their first-party insurers to auto manufacturers and their liability insurers.

71. According to the Insurance Information Institute, currently twelve states have some form of no-fault auto insurance law, leaving the other thirty-eight states as fault-based auto states. *No-Fault Auto Insurance*, INS. INFO. INST. (Apr. 2012), <http://www.iii.org/media/hottopics/insurance/nofault/>.

limited) must rely primarily on their first-party auto insurers.⁷² In these states, therefore, first-party auto insurers are the primary regulators of driver care levels.

There are reasons to believe that the shift to no-fault regimes in some jurisdictions may on balance hinder the regulatory role of insurance. On the one hand, the absence of tort liability, and thus of liability insurers, does not eliminate the incentives of drivers to avoid accidents that harm others. There is, after all, a large overlap between the risks that lead to harm to others and the risks that lead to injury to oneself. Bad or excessive driving gives rise to an increased risk of both harms. Thus, when a first-party insurer takes steps to regulate driver conduct so as to reduce self-harm—for example, by experience rating and adjusting premiums—the risk to third-party victims is also reduced.⁷³

On the other hand, first-party auto insurers do not have an incentive to regulate driver decisions optimally. While it is true that the safety levels they regulate affect both the insured drivers and their victims, the insurers fail to take account of harm to others. Thus, in theory, first-party auto insurers would not have an incentive to require precautions that could be justified only by the total harm reduction to all potential injured parties. Those insurers do not make premium adjustments to account for the increase or decrease in risk to third parties attributable to their insured driver's behavior. By contrast, under a fault-based tort regime, in which drivers also purchase liability insurance, a more complete internalization of auto-accident risks is achieved. As a result, under a fault-based regime, some unsafe drivers would be priced out of driving—a form of continually adjusting, Pigouvian taxation through the liability insurance premium—that would not be priced out under a no-fault regime.⁷⁴

In addition, under a fault-based system, drivers' choices among types of cars are likely to be more efficient. First-party insurance creates incentives

72. A "pure" auto no-fault regime would completely eliminate the option of bringing a tort claim against another driver, but there is no such pure no-fault regime in the United States. Gary T. Schwartz, *Auto No-Fault and First-Party Insurance: Advantages and Problems*, 73 S. CAL. L. REV. 611, 616 (1999). Some states have a no-fault regime for economic losses and a fault and tort scheme for noneconomic damages such as pain and suffering. In Michigan, for example, victims may recover noneconomic damages in tort only for "serious impairment of a body function." *Id.* at 617. Other states have a no-fault scheme with respect to personal injury claims, and a tort-based scheme for property damage to the automobiles. *Id.* at 645. Some commentators have argued for so-called "choice" regimes, which allow drivers to choose between a no-fault option or a tort-based option. *See, e.g.*, Jeffrey O'Connell & Robert H. Joost, *Giving Motorists a Choice Between Fault and No-Fault Insurance*, 72 VA. L. REV. 61 (1986). At least one state has a no-fault system that can be characterized as a choice regime. *Id.* at 77 & n.50.

73. *See* Schwartz, *supra* note 72, at 641–42; *id.* at 641 n.123 (noting that a similar point was made in DEWEES ET AL., *supra* note 66, at 56, and in Michael J. Trebilcock, *Incentive Issues in the Design of "No-Fault" Compensation Systems*, 39 U. TORONTO L.J. 19, 20–21 (1989)).

74. *See* WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 10–11 (1987).

to purchase large and heavy vehicles, such as outsized sport utility vehicles (“SUV”s) or trucks, in which drivers are better protected and their injuries are smaller.⁷⁵ Liability insurance offsets these distorted incentives. Heavy vehicles cause greater harm to others, and these costs in fault-based states are borne by liability insurers, which then price those risks accordingly. The result, in theory, should be not only a reduction in overall auto-accident risks but also an improvement in the market signals sent to product manufacturers regarding the relative total costs (including accident costs) of small vehicles, as compared to large vehicles.

Although the cost-internalization arguments tend to support a regulatory role for auto-liability insurers, there is not a great deal of evidence on point. There is, however, some evidence that generally supports fault-based liability regimes over the no-fault alternatives. According to a 1982 study, no-fault laws have actually increased auto-related deaths by as much as 15 percent.⁷⁶ Thus, a tort-based regime with dual insurer-regulators balances the benefits of safety to drivers and to others.

Auto insurance is also an area where insurance companies—liability and first-party insurers—work cooperatively to gather information that enhances the market for safety. For example, the Insurance Institute for Highway Safety (“IIHS”), a nonprofit organization wholly funded by the auto insurance industry and whose stated goal is to reduce the losses from highway crashes, has become famous for testing and rating the crashworthiness of new automobiles as they come on the market. IIHS ratings are issued long before and are arguably still better than the government’s NHTSA ratings.⁷⁷ These ratings help consumers choose safer cars and induce manufacturers to improve their designs.⁷⁸

Auto insurers have also played a role in encouraging safety regulation by the government. When there is a universal minimum level of care that all actors should meet, it can be efficiently mandated by government. But government regulators can be slow to act, especially if the regulated industry resists change. This was the case with frontal air bags, which are now a required part of all new automobiles. Auto insurers were the first to lobby for federal regulations, which were adopted despite opposition from the auto

75. Thus, the Personal Injury Protection (“PIP”) component of first-party auto insurance coverage for a large SUV should be relatively low, compared with smaller cars. PIP covers medical expenses and sometimes covers lost wages due to injury. See ABRAHAM, *supra* note 18, at 765.

76. Elisabeth M. Landes, *Insurance, Liability, and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault Accidents*, 25 J.L. & ECON. 49, 50 (1982).

77. See INS. INST. FOR HIGHWAY SAFETY, <http://www.iihs.org> (last visited May 1, 2012).

78. *Protecting People from Harm in Vehicles*, IIHS VEHICLE RES. CENTER 3, http://www.iihs.org/brochures/pdf/vrc_brochure.pdf (“Vehicles are rated for safety based on performance in front, side, rollover, and rear tests. Consumers compare the results, which often differ dramatically even among vehicles that are similar in size and price. Auto manufacturers heed the ratings, too, and improve the designs of their vehicles to earn higher marks than the competition. Then the automakers improve on the improvements. The result is that motorists now travel in safer vehicles than they used to.”).

industry.⁷⁹ Insurers also fought successfully a regulatory ruling that rescinded the original mandate.⁸⁰ More recently, the auto insurance industry has successfully lobbied for “graduated driver licensing” laws (under which driving privileges are introduced gradually),⁸¹ and issued ratings of states’ highway safety laws.⁸²

D. Homeowners’ Insurance

Residential property risk is another area where insurers regulate insured behavior. Most homeowners cannot ascertain the quality of the structure they are purchasing or the risks associated with inferior construction, especially risks under high-wind, fire, or earthquake conditions. And yet, except to the extent that the CPSC regulates household products, household risk is largely unregulated by the federal government.⁸³ Rather, building safety standards are left to state and local governments, which typically adopt some version of the model building codes written by private organizations.⁸⁴

79. See generally Robert Kneuper & Bruce Yandle, *Auto Insurers and the Air Bag*, 61 J. RISK & INS. 107 (1994). There was evidence at the time, based on studies from 1975 and 1980, that air bags would prevent as many as 9,000 fatalities and 65,000 injuries annually. *Id.* at 109 n.2 (citing Sam Peltzman, *The Effects of Automobile Safety Regulation*, 83 J. POL. ECON. 677 (1975), and Oscar R. Cantu, *An Updated Regression Analysis on the Effects of the Regulation of Auto Safety* (Yale Sch. of Mgmt., Working Paper No. 15, 1980)). More recent evidence puts the reduction in fatality risk at around 11 percent. CHARLES J. KAHANE, NAT’L HIGHWAY TRAFFIC SAFETY ADMIN., NHTSA REP. NO. DOT HS 808470, FATALITY REDUCTION BY AIR BAGS: ANALYSIS OF ACCIDENT DATA THROUGH EARLY 1996 (1996), available at <http://www.nhtsa.gov/cars/rules/regrev/evaluate/808470.html>.

80. *Motor Vehicle Mfrs. Ass’n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) (reinstating the original air bag requirement).

81. See, e.g., INS. INST. FOR HIGHWAY SAFETY, GRADUATED DRIVER LICENSING: QUESTIONS AND ANSWERS, available at http://www.iihs.org/brochures/pdf/gdl_brochure.pdf (noting that some form of the graduated driver licensing rule has been adopted in almost all fifty states).

82. ADVOCATES FOR HIGHWAY & AUTO SAFETY, THE 2012 ROADMAP TO HIGHWAY SAFETY LAWS (2012), available at http://www.saferoads.org/files/file/FINAL%20ROADMAP%20REPORT-%201_6_2012.pdf. The group Advocates for Highway and Auto Safety is an alliance of consumer groups, health and safety groups, insurance companies, and insurance agents. *Id.* at 60.

83. With relatively large home-health risks (such as radon gas), the Environmental Protection Agency (“EPA”) relies primarily on public education (through public service advertisements), required disclosures (at the point of sale), and loan programs for remediation. See ENVTL. PROT. AGENCY, <http://www.epa.gov/radon/> (last visited May 1, 2012). Also, the CPSC has been involved in regulating the quality of smoke detectors as consumer products. See *Voluntary Standards: Smoke Alarms*, CONSUMER PROD. SAFETY COMM’N (Mar. 6, 2008), <http://www.cpsc.gov/volstd/smokealarm/smokealarm.html>.

84. A prominent example is the International Building Code published by the International Code Council (“ICC”). *About ICC*, INT’L CODE COUNCIL, <http://www.iccsafe.org/AboutICC/Pages/default.aspx> (last visited May 1, 2012). The ICC is composed of state, county, and local code officials as well as fire officials, architects, engineers, builders, contractors, manufacturers, and others in the construction industry. *Id.* Conspicuously absent from the list of members is anyone from the insurance industry. The problem with such code-writing organizations is that, unless insurers are included in the decisionmaking processes, they will

Political pressures by the construction industry and short-term financial interests of homeowners operate to inhibit optimal standards and rigorous enforcement.

Insurance helps to remedy this regulatory inefficiency. First, homeowners' insurers engage in direct ex ante regulation through the use of premium discounts for homes equipped with safety measures, such as smoke detectors or sprinkler systems, which have been found to dramatically reduce the risk of fire-related death and property damage. Similarly, insurers in Florida and in other parts of the country prone to windstorms offer substantial premium discounts to homeowners who make special investments in wind mitigation, such as installing hurricane clips to secure the roof, anchoring the base of the home to the foundation, and using special storm shutters on the windows.⁸⁵

In addition to such direct regulation, insurers encourage more efficient government regulation of home-building standards. The insurance industry collects information regarding the building codes in different communities and how well those codes are being enforced. It then uses that information to generate building code-effectiveness ratings, which individual insurers may use to price their coverage.⁸⁶ The indirect effect of these ratings is to put pressure on state and local governments to tighten their building codes and their enforcement of these building codes. In the absence of such ratings, there is relatively little political pressure on state and local governments to improve building codes and building-code enforcement, except perhaps following natural disasters (such as hurricanes, earthquakes, and wildfires). However, the publishing of these ratings, which clearly indicate how various jurisdictions are doing relative to each other, and the effect these ratings have on insurance premiums, can produce pressure on local regulators to improve both codes and enforcement.

Homeowners' insurers also do something that government regulators do not: they generate large amounts of risk-related information through large-scale hazard simulations. The industry funds a massive research facility for simulating hurricanes and other perils, and studying how different construction techniques withstand wind, fire, water, and hailstorm damage.⁸⁷

have a tendency to externalize some of the costs of their decisions—the costs that are borne by first-party property insurers.

85. These steps can reduce insurance premiums significantly. To take one example, the addition of storm shutters can reduce the windstorm portion of a homeowners' premium by 30 percent. The windstorm premium in Florida constitutes 15 to 70 percent of the overall premium, depending on where within the state the home is located. *My Safe Fla. Home*, FLA. DEP'T OF FIN. SERVS., <http://www.mysafefloridahome.com/insurance.asp>. (last visited May 1, 2012).

86. This function, performed by the Insurance Services Office ("ISO") (the property-casualty insurance industry's main ratemaking bureau and research arm) is called the "Building Code Effectiveness Grading Schedule." *Building Code Evaluations*, INS. SERVS. OFFICE, <http://www.isogov.com/services/infrastructure/building-code-evaluations.html> (last visited May 1, 2012).

87. *IBHS Announces Grand Opening of Unique, World-Class Research Center*, PRWEB, (Oct. 20, 2010), <http://www.prweb.com/releases/IBHS/research-center-opening/prweb4678514.htm>.

Research conducted at this facility is intended to do for home-construction standards and reducing the losses associated with various natural hazards what crash testing conducted by the Insurance Institute for Auto Safety has done for crashworthiness in automobiles. Not only does this research enable the industry to improve its rating of building codes, but it also refines the premium discounts for various safety investments.

E. Environmental Liability Insurance

Striking examples of how insurance minimizes rather than exacerbates moral hazard problems can be found in the context of environmental liability insurance.⁸⁸ Under various federal and state laws, firms face enormous potential liability for the environmental harms they cause, including substantial cleanup costs.⁸⁹ Because firms are often insufficiently capitalized to pay for these environmental costs, and because many environmental harms become manifest only after long latency periods, environmental liability or other ex post fines may not provide optimal regulation of care levels and activity levels. However, because environmental liability insurance is prevalent—and in some areas, mandatory—insurance companies assume the role of private (ex ante and ex post) environmental regulators. In fact, specialized environmental insurers have taken over the role of insuring and regulating many environmental risks. That is, environmental coverage is no longer sold as part of the insurance offered under standard commercial liability policies, but rather as a special line of coverage—Environmental Impairment Liability Insurance (“EIL”). EIL is offered by specialized insurance companies that typically write specific EIL policies for specific sectors.⁹⁰ These EIL

88. See generally PAUL K. FREEMAN & HOWARD KUNREUTHER, *MANAGING ENVIRONMENTAL RISK THROUGH INSURANCE* (1997); Howard Kunreuther, Shelley H. Metzenbaum & Peter Schmeidler, *Mandating Insurance and Using Private Inspections to Improve Environmental Management*, in *LEVERAGING THE PRIVATE SECTOR: MANAGEMENT-BASED STRATEGIES FOR IMPROVING ENVIRONMENTAL PERFORMANCE* 137 (Cary Coglianese & Jennifer Nash eds., 2006).

89. See generally KENNETH S. ABRAHAM, *ENVIRONMENTAL LIABILITY INSURANCE LAW: AN ANALYSIS OF TOXIC TORT AND HAZARD WASTE INSURANCE COVERAGE ISSUES* (1991) (surveying the many ways in which liability insurers act as regulators in the environmental insurance context). The Comprehensive Environmental Response Compensation and Liability Act (“CERCLA”), sometimes referred to as “Superfund,” created the modern federal environmental liability regime. In response to this law, enacted in 1980 and revised and reaffirmed by Congress in 1986, the liability insurance industry became a major regulator of environmental risks. CERCLA creates retroactive, strict liability for the costs of cleaning up environmental waste and imposes those costs, jointly and severally, on all “responsible parties,” including the party who caused the pollution as well as the present and past owners of the property. *Id.* at 10–14.

90. See, e.g., Martin T. Katzman, *Pollution Liability Insurance and Catastrophic Environmental Risk*, 55 J. RISK & INS. 75, 87 (1988); *Site Pollution*, BEACON HILL ASSOCS., <http://b-h-a.com/site> (last visited May 1, 2012). Besides the general EIL policy, niche policies are also available for other sectors (e.g., construction, transportation). See, e.g., Susan Neuman, *Tailored to Fit*, BROWNFIELD NEWS, Dec. 1999, available at http://enviroinsurance.com/newsArticles/Tailored_to_Fit.pdf. Note, however, that insureds initially sought, and sometimes still seek, to have environmental or pollution costs covered by previous

policies are underwritten and issued on a site-specific basis. They generally exclude coverage for gradual pollution, which is more likely to be known or predicted by the insured (and thus more likely to be a source of moral hazard) than sudden, abrupt discharges of pollution.⁹¹

Insurance in this area reinforces existing government regulations by inspecting that policyholders comply with licensing conditions and other environmental regulations. Environmental insurance also goes beyond these minimal compliance checks by promoting higher safety standards. For example, insurers offer premium incentives (up to a 30 percent discount) for participation in private Environmental Management Systems that provide stricter codes of environmental compliance, perform on-site auditing, and evaluate performance.⁹² Insurers know better than firms how to assess environmental risks and the feasibility of alternative solutions, and offer this expertise to help their clients comply with environmental standards.⁹³

A recent study demonstrated that private insurance improved the safety of fuel storage tanks, compared to the incentives under government cleanup assurance funds. When a change of law forced owners to switch from government to private insurance, a new menu of differentiated premiums and experience rating induced owners of fuel tanks to improve safety, and accidents dropped by more than 20 percent. It was estimated that 3,000 fuel tank releases were avoided in Michigan alone over eight years, representing an aggregate cleanup-cost savings of \$400 million.⁹⁴

F. Tax Liability Insurance

Like environmental insurance, tax liability insurance responds to costs that firms face as a result of government regulations. Here, the cost faced is the cost of uncertain tax laws. This type of insurance covers liability for violations of the tax law, and thus tax insurers inspect and monitor the tax compliance of their insureds.⁹⁵ Imagine a taxpayer who wishes to engage in a transaction with highly uncertain tax consequences that depend on how the Internal Revenue Service (“IRS”) and ultimately the courts interpret a very complex combination of law and facts. For example, large tax payments can turn on whether a transaction is considered a tax-free reorganization, a termination that cannot be made with certainty prior to the transaction.

commercial general liability policies, whereas insurers seek to deny coverage, invoking among other provisions some version of the pollution exclusion.

91. Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 *COLUM. L. REV.* 942, 953 (1988).

92. See Benjamin J. Richardson, *Mandating Environmental Liability Insurance*, 12 *DUKE ENVTL. L. & POL'Y F.* 293, 316 (2002); *How to Open Pollution Coverage Market—Make Policy Contingent on Obeying Environmental Code*, *INS. ADVOCATE*, Apr. 5, 1997, at 10.

93. See Steven A. Kunzman, *The Insurer as Surrogate Regulator of the Hazardous Waste Industry: Solution or Perversion?*, 20 *FORUM* 469, 477 (1985).

94. Yin et al., *supra* note 8, at 327.

95. See Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 *VA. TAX REV.* 339, 394–95 (2005).

Uncertainty can be removed by requesting a private ruling from the IRS in advance, but the IRS often declines to do a thorough ex ante analysis of the proposed transactions, imposing on taxpayers the risk of an adverse determination upon auditing.

Given this legal uncertainty, private insurance offers coverage against the possibility that the intended tax treatment will be denied ex post by the taxing authorities.⁹⁶ These policies cover excess taxes that are ultimately assessed against the insured, including grossed-up amounts (such as interest and noncriminal fines), as well as the cost of hiring outside tax experts to help resolve the disputes with the taxing authorities.⁹⁷ These policies are not offered on a standard-form basis, but are instead individually negotiated for each transaction that is being insured, based on ad hoc risks as determined by the insurer after an elaborate factgathering process.⁹⁸ As part of the underwriting process, the insurer enlists the help of outside tax counsel, often among the very best in the field, to offer an assessment of the likelihood of success of the desired tax treatment.⁹⁹

Effectively, the insurers become private tax law enforcers. The insurers are able to do what the government cannot afford to do: hire top lawyers to assess the tax validity of complex, fact-intensive commercial transactions before they are undertaken, and issue what amounts to a ruling on the question. The policy concern with this type of coverage, of course, is that, in extreme cases, parties will seek coverage for transactions that are clearly contrary to the tax laws, where the only significant uncertainty is the uncertainty as to detection. This would be the case if, for example, insurers were offering to cover abusive tax shelters.¹⁰⁰ As it turns out, however, insurers have thus far steered clear of offering tax shelter coverage.¹⁰¹

96. See, e.g., *Tax Liability Insurance*, CHARTIS, http://www.chartisinsurance.com/us-tax-liability-insurance_295_182188.html (last updated May 20, 2011).

97. See, e.g., *Tax Liability Insurance Coverage Highlights*, CHARTIS, http://www.chartisinsurance.com/neglobalweb/internet/US/en/files/Tax%20Liability%20Highlight%20Sheet_4_2010_tcm295-202209.pdf (last visited May 1, 2012) (explaining the “coverage highlights” of tax liability insurance offered by Chartis).

98. Among the pieces of information required to be submitted are these: a detailed description of the transaction and tax exposure, a list of all parties to the transaction, all available tax opinions and supporting documentation, all relevant private rulings from the IRS or any other taxing authority, all correspondence with the taxing authority, the taxpayer’s audit history, the taxpayer’s tax returns, and anything else that might be relevant. See, e.g., *Tax Liability Insurance: Questions and Answers*, AIG 3–4, http://www.aig.com/aigweb/internet/en/files/Tax%20Liability%20Insurance_%20Questions%20and%20Answers1_tcm20-74108.pdf (last visited May 1, 2012).

99. *Id.* at 5.

100. For Kaplow and Shavell’s works on the social value of legal advice, see generally Louis Kaplow & Steven Shavell, *Legal Advice About Acts Already Committed*, 10 INT’L REV. L. & ECON. 149 (1990); Louis Kaplow & Steven Shavell, *Legal Advice About Information to Present in Litigation: Its Effects and Social Desirability*, 102 HARV. L. REV. 565 (1989); Louis Kaplow & Steven Shavell, *Private Versus Socially Optimal Provision of Ex Ante Legal Advice*, 8 J.L. ECON. & ORG. 306 (1992).

101. Moreover, if tax insurers become more aggressive in the types of tax risks they were willing to insure, there are a number of regulatory responses that the government might

In each of these areas—products liability insurance, workers’ compensation insurance, automobile insurance, homeowners’ insurance, environmental liability insurance, and tax liability insurance—insurers already serve as quasi-private regulators of risk.¹⁰² Because of their superior access to information and their commercial sophistication, and because of the competitive pressure to find new ways to lower their costs and hence their prices, insurance companies employ a variety of strategies to improve the safety conduct of their policyholders. In many of these examples, the presence of insurance reduces, rather than creates, a moral hazard problem. It is still the case, of course, that some forms of insurance also occasionally create moral hazard and disregard for safety. The purpose of this survey is to highlight a few of the many examples where insurance has the opposite—and often underappreciated—effect.

III. INSURANCE AS REGULATION VERSUS GOVERNMENT REGULATION

The preceding Part demonstrated that insurance is a pervasive form of regulation in the modern economy. The fact that private insurance companies serve as private regulators of safety, however, does not diminish the significance of government regulation. The universe of government regulation is vast. In every sector of the economy and in every industry, there is some degree of government regulation. To name a few prominent examples, the Consumer Product Safety Commission, the National Highway Traffic and Safety Administration, the Food and Drug Administration, and the Environmental Protection Agency are all government agencies that regulate risks and mandate safety measures. This Part addresses how such government regulation compares and coordinates with insurance as regulation.

take to minimize the moral hazard–creating effects of such insurance, such as compulsory disclosure when tax liability insurance is purchased. *See* Logue, *supra* note 95, at 400–06 (explaining why insurers have declined to offer tax shelter coverage and noting ways in which the Treasury can combat tax shelter coverage insurance if it arises).

102. A type of insurance for which insurers do surprisingly little regulation is directors and officers (“D&O”) liability insurance. D&O policies are purchased by corporations to cover liability risks arising out of the official conduct of corporate directors and officers. In the context of public corporations, the primary risks covered under D&O policies are the lawsuits brought by shareholders against the corporation, or against directors and officers themselves, either for violation of common law fiduciary duties or for violation of federal securities laws. In a study of the extent to which D&O insurance facilitates or undermines the deterrence or regulatory function of shareholder litigation, Tom Baker and Sean Griffith found that D&O insurers do surprisingly little to monitor the behavior of their insureds. TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION* 109 (2010). Baker and Griffith offer a number of possible reasons for this anomaly that are peculiar to D&O coverage. *Id.* at 118–19 (listing factors such as the nature of shareholder litigation risks and the particular structure of D&O excess insurance programs). Interestingly, Baker and Griffith also find that D&O liability insurers do make extraordinary efforts to price their insurance policies accurately, thereby engaging in the sort of *ex ante* Pigouvian regulation that can affect both care levels and activity levels. *See id.* at 97–98.

A. When Government Action Alone Is Required

Let us consider at the outset the circumstances under which the government regulates without much involvement by insurers. First, some regulatory tools are available only to the government. Agencies can back their mandates with the threat of criminal sanctions; private insurance companies cannot make such threats. This is crucial to improve safety when risky conduct cannot be deterred or stopped other than by criminal sanctions (for example, judgment-proof actors intentionally imposing risks on others). Even without criminal sanctions, some harmful activities like dumping polluted chemicals into a river need to be stopped altogether. The government can use the police power to physically stop the polluters; private insurers cannot.

Second, there are various risks that insurers do not regulate because they do not insure such risks, and thus the government is the only regulator of such conduct, and sometimes also the only the insurer. Insurers, for example, do not offer coverage for correlated risks, such as nuclear wars or economic decline in home values. Insurers likewise do not cover “known unknowns”—contingencies that we know exist, but to which neither a probability nor a magnitude can be actuarially assigned. An example of a “known unknown” might be terrorism insurance coverage: insurers know that the risk of a terrorist attack exists, but they have difficulty predicting the probability or likely magnitude.¹⁰³ Moreover, insurers generally do not cover losses that are intentionally caused by insureds,¹⁰⁴ and insurers do not cover losses for which the affected parties cannot afford to purchase coverage. Thus, in those areas that insurers do not regulate, the government either works alone (e.g., to regulate civic preparedness for nuclear events) or in conjunction with other intermediaries (e.g., with large banks to affect regional home prices).

Moreover, the government is likely to regulate alone in situations in which insurers are trapped in a coordination problem. Insurers, as we have described, have an incentive to invest in safety regulation when their investment lowers the cost of the “product” that they sell. Hence, competition forces insurers to be risk regulators. But what if an individual insurer cannot

103. Boardman, *supra* note 8, at 786 (“The terrorism risk is a known unknown; we are aware of the risk but are still too ignorant to calculate and redistribute the risk in an insurance pool.”). Ironically, some so-called “unknown unknowns,” to use Donald Rumsfeld’s famous phrase, may be more easily insured, at least to the extent that insurers provide coverage in the form of all-risk policies—that is, policies that cover all losses except those expressly excluded. In the case of unknown unknowns, insurers would not even know enough to be able to draft an effective exclusion. It is in part because of unknown unknowns that insurers insist on policy limits.

104. Some losses that are labeled “intentional” can be, and sometimes are, insured. For example, corporations frequently purchase liability coverage claims resulting from the intentional wrongdoing of its employees. Discrimination claims, for example, are often covered under employment practices liability insurance (“EPLI”) policies. Francis J. Mootz III, *Employment Practices Liability Insurance and the Changing American Workplace*, 21 W. NEW ENG. L. REV. 245 (1999).

reap the value of improved safety standards through lower insurance costs? There are several externalities that might occur among insurers and which create a market failure in the form of underprovision of regulation.

One type of externality involves the production of knowledge. An insurer that innovates by developing new safety standards (say, testing and calibrating the premium reduction for home installation of hurricane-resistant roofing tiles) cannot exclude other insurers that did not share the cost of the investment from imitating this innovation and reaping its benefits. In general, there is no patent protection for improved safety methods innovated by insurers, although in some areas insurers do attempt to patent their safety innovations (notably, the patenting of data-recording devices in cars).¹⁰⁵ Other safety measures also have public-good characteristics. For example, we discussed above how installing a LoJack antitheft device in cars has a substantial deterrence effect, but because auto thieves cannot distinguish cars with from cars without LoJack, the installation of LoJacks is a benefit that accrues to other car owners, insured by other insurers.¹⁰⁶ Again, the result might be underinvestment in such devices. However, to the extent that the insurance industry can explicitly coordinate with each other, these public goods can be supplied. The “knowledge” public-good problem is indeed resolved by collectively funding research facilities like the Insurance Institute for Highway Safety.¹⁰⁷

Another type of externality that insurers must overcome to provide optimal regulation involves future and latent harms. Some of the risks that insurers regulate materialize into harms far into the future, which means that insurers’ efforts to reduce such risks will largely benefit future insurers. It has been argued, for example, that health insurers underprovide treatments with long-term impact, like bariatric surgeries for obese patients, even when the surgeries are cost justified, because the benefit in terms of reduced health costs will be reaped over the patients’ lifetime by the patients’ future health insurers.¹⁰⁸ Similarly, latent harms such as climate change can put insurers in a poor regulatory position. The costs of climate change will build up far into the future, for a large set of diffuse “victims,” many of whom will not be covered by the present insurers. Thus, even if the insurance industry as a whole will eventually bear much of the cost of climate change, it may be ill positioned to overcome the coordination-across-time problem, and will be a poor regulator of climate damage. To be sure, latent harms are a general problem of government regulation as well. In fact, we will argue below that in areas like climate change, political coordination across coun-

105. See, e.g., Press Release, Progressive Insurance, Progressive Receives Fourth Patent Related to Usage-Based Insurance (Jan. 9, 2012), available at <http://eon.businesswire.com/news/eon/20120109005268/en/Snapshot/discount/usage-based-insurance>.

106. See discussion *supra* Section II.A.5.

107. See *Insurance Institute for Highway Safety Vehicle Research Center Brochure*, INS. INST. FOR HIGHWAY SAFETY, www.iihs.org/brochures/pdf/vrc_brochure.pdf (last visited May 1, 2012).

108. Ronen Avraham & K.A.D. Camara, *The Tragedy of the Human Commons*, 29 CARDOZO L. REV. 479, 480–81 (2008).

tries and generations could lead governments to fail to act. Thus, despite its own coordination problems, insurance might be at a relative advantage. As long as individuals expect to bear some costs—either as a result of effects on their own property or as a result of tort liability—there will be demand for insurance, and as long as climate change is known to affect property-related perils (e.g., severe weather), people will have to pay higher premiums to insure their assets.¹⁰⁹

Notwithstanding these no-insurance situations, insurance is available and effectively required for many risks. And in those situations, insurers generally work alongside the government to regulate safety. In the remainder of this Part, we identify patterns in how regulatory work is divided between insurers and government regulators. Along the way, we emphasize the added value of insurance as regulation—incremental improvements in safety that go beyond what the government requires or encourages. This Part also specifically compares insurance as regulation with the government regulatory alternatives and finds, in many cases, that insurance provides the better approach.

B. Safety Standards: Mandates Versus Menus

Government regulation of safety often takes the form of mandatory safety standards. Cars must have seat belts and air bags, factories and fuel tanks must abide by environmental standards, drug companies must demonstrate the safety and efficacy of a drug, and commercial buildings must have fire sprinkler systems. Unless the regulatory safety threshold is met, the actor cannot engage in the regulated conduct. Regulated parties have no choice concerning how much of the safety measure to apply, whether it is worth the cost, and if other methods work better for them.

Insurers, on the other hand, often regulate the same conduct while offering a menu of safety choices and corresponding prices. Drivers who fail to wear seat belts will have their first-party insurance premiums adjusted through experience rating. Factories that maintain environmental standards above the government-mandated level will have their liability insurance premiums reduced. Manufacturers that follow guidelines for producing safer products will pay lower products liability insurance premiums. And homes that present greater fire hazards pay significantly higher property insurance. Largely through ex ante premium adjustments—offering policyholders clear pecuniary tradeoffs—insurers induce actors to self-select safety. Unlike government regulation, which institutes uniform safety levels, insurers' regulation results in a spectrum of decentralized choices, whereby people choose greater precautions when their costs are lower or when the risks they face are greater.

109. Howard C. Kunreuther & Erwann O. Michel-Kerjan, *Climate Change, Insurability of Large-Scale Disasters and the Emerging Liability Challenge*, 155 U. PA. L. REV. 1795 (2007).

In some areas, the government outsources safety regulation to insurers altogether. For example, California requires property insurers to offer homeowners' earthquake coverage.¹¹⁰ Insurers satisfy this mandate by offering special bare-bones "mini-policies," which are actuarially priced and thus very expensive in earthquake-prone areas.¹¹¹ And insurers regulate earthquake safety standards by providing a menu of discounts for various precautions and investments in reinforced foundations, frames, wall braces, shutoff valves, and more.¹¹²

C. Pigouvian Taxes: Pricing the Externality

Unsafe behavior causes an externality—harm to others. A basic regulatory tool for dealing with the failure of markets to solve this problem is the Pigouvian tax. This tax imposes on the externalizing party the external cost of its activity, thus reducing activity levels closer to the social optimum. The Pigouvian tax is often regarded in theory as an effective form of regulation, because, unlike the command-and-control alternative, the Pigouvian tax allows the regulated party to choose whether, how much, and how to engage in the regulated activity.¹¹³

But surprisingly, the government rarely employs Pigouvian taxes as a method of *ex ante* regulation. Even in an area like pollution and carbon emissions, in which the externality problem is acute, it is uncommon for regulators in the United States to use taxes as a means of internalization.¹¹⁴

110. *About Earthquake Insurance*, CAL. EARTHQUAKE AUTH., <http://www.earthquakeauthority.com/index.aspx?id=13> (last visited May 1, 2012) ("The law requires insurers that sell residential property insurance in California to offer earthquake coverage to their policyholders.").

111. *The Evolution of Earthquake Insurance*, INS. INFO NETWORK CAL. (Jan. 11, 2011), <http://www.iinc.org/articles/347/1/The-Evolution-of-Earthquake-Insurance/Page1.html> ("In 1995, the state Legislature passed Assembly Bill 1366, which authorized insurers to offer a 'mini' earthquake policy with substantially reduced policy limits to comply with the mandatory offer of earthquake insurance.").

112. *See Consumers Earthquake Insurance*, CAL. DEP'T INS., <http://www.insurance.ca.gov/0100-consumers/0060-information-guides/0040-residential/earthquake-insurance.cfm#special> (last visited May 1, 2012).

113. *See generally* JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 134 (2d ed. 2007); *Pigouvian Tax*, INVESTOPEdia, http://www.investopedia.com/terms/p/pigouvian_tax.asp (last visited Aug. 18, 2012).

114. Although the U.S. government imposes an excise tax on gasoline sales, it has never adopted a carbon tax. Janet E. Milne, *Carbon Taxes in the United States: The Context for the Future*, 10 VT. J. ENVTL. L. 1, 18 (2008) ("The United States has a number of laws that address greenhouse gas emissions, but it does not have a comprehensive, integrated, nationwide legal regime for reducing its contribution to global carbon dioxide or other greenhouse gases."). Every state has a fuel tax of some sort, *Motor Fuel Taxes*, AM. PETROL. INST., <http://www.api.org/Oil-and-Natural-Gas-Overview/Industry-Economics/Fuel-Taxes.aspx> (last visited Aug. 18, 2012), but only a few jurisdictions have adopted taxes that purport to be carbon taxes. *See* Milne, *supra*, at 19–22. A number of other countries have adopted carbon taxes, including Denmark, Sweden, Finland, and, most recently, Australia. Mikael Skou Andersen, *Environmental and Economic Implications of Taxing and Trading Carbon: Some European Experiences*, 10 VT. J. ENVTL. L. 61, 65 (2008); *see also* Robert Stavins, *Experience with*

And when polluters do pay for engaging in pollution-causing activity, the rates are often uniform, one-size-fits-all, and do not vary with individual risk or harm, nor do they induce any incentive to take care.¹¹⁵ At the same time, most regulatory fines and liability laws operate like Pigouvian taxes. Tort law in general, products liability in particular, and any number of governmental fines (from traffic fines to environmental sanctions) are all internalization schemes that tax unsafe behavior at the level of the harm caused, whether the tax is collected by the government or the victims. Like Pigouvian taxes, these ex post sanctions internalize a cost to the harmful activity, thus encouraging optimal activity levels.

In the presence of government-imposed strict liability, insurance converts the ex post liability cost into an ex ante fee—the insurance premium—much resembling a pure Pigouvian tax, paid upfront and roughly equal to the externality. Risk-differentiated premiums cause parties to pay the expected external cost of their activity when choosing the activity's scope. Insurers thus play an important role in shaping levels of activity. By converting the uncertain expected cost of liability into a certain cost of the insurance premium, insurance premiums enable insureds to make more informed choices regarding activity levels. Since most regulated parties do not have the information necessary to accurately convert expected ex post liability awards and fines into an exactly equivalent Pigouvian tax, and since the government does not provide such estimates to help people plan, insurers fill this void.

Why does insurance succeed in pricing externalities in the Pigouvian manner, but government regulation does not? Besides the political opposition that exists to any type of reform that includes more taxation,¹¹⁶ insurers also have informational and administrative advantages. The data necessary for setting an accurate Pigouvian tax are not only the aggregate costs, which some regulators in some sectors have access to, but also the fine-grained, individually adjusted, feature- and experience-rated, and continuously updated costs that insurers uniquely collect. Thus, if the government attempts to price externalities ex ante, it must rely on thinner data, as compared to the data available to insurers. And Pigouvian taxes based on such rough aggregations would tend to overtax some parties and undertax others, thus diminishing the accuracy of the incentives to reduce harm and engage in efficient activity levels. To be sure, government agencies can also engage in information gathering. But unlike with insurers, the information practices of government agencies do not have to be accurate for the agencies to perform

Market-Based Environmental Policy Instruments, in 1 HANDBOOK OF ENVIRONMENTAL ECONOMICS 355 (2005).

115. Yin et al., *supra* note 8, at 326.

116. Political opposition can sometimes impede insurance-premium setting, if it has to be approved by state regulators. For example, California experimented with rate-setting by referendum in Proposition 103. However, even proponents of premium caps understand that insurers must cover their costs. By contrast, proponents of a new government-imposed Pigouvian tax do not benefit from this understanding because the government is not acting as an insurer.

their primary tasks. The agencies are not themselves insuring the externality, and thus they do not have to bear the costs of the harm or of imperfect tailoring.¹¹⁷ By contrast, insurers that set inaccurate premiums (inaccurate Pigouvian taxes, as it were) would suffer a loss of profit and, at the limit, would be competed out of business entirely.

D. *Converting Standards into Rules*

Insurance arrangements transform the standards enacted through government regulation into bright-line rules, thereby providing regulated parties (insureds) with concrete instruction regarding the choice of appropriate care levels. Negligence regimes in tort law, for example, set general “due care” standards; however, the determination of which particular safety measures are required by such standards is often left unclear to the regulated parties until a court resolves that question in particular cases *ex post*. Under such negligence regimes, liability insurers are often the agents that translate the vague legal standards into a set of concrete, sometimes very specific rules.¹¹⁸ A similar mechanism also operates under strict liability regimes, which do not mandate particular safety standards, but leave the regulated parties to determine the privately desirable risk-reduction measures. Under those regimes as well, it is often the liability insurer that instructs the regulated party regarding specific safety choices.

Under either type of tort regime, the origin of the incentive to take care is government-imposed liability and judicially (in some cases, legislatively) created standards of due care. In the absence of insurance arrangements, these standards would be put into practice and individualized over time through litigation, which would eventually produce a body of precedent. But even that decentralized process of litigation and precedent production may not produce clear and administrable rules, rules that can actually be followed by the regulated parties. Different courts generate inconsistent holdings, and the emerging body of commands, even when clear to legal experts, can be highly obscure to the general public. Insurance markets bolster this process of transforming vague standards into bright-line rules by employing a centralized network of agents. For example, insurance claims adjusters are taught to follow uniform guidelines developed by the insurers in consultation with their legal experts and cost-containment experts.

A prominent example of this collaboration between the standard-setting public regulators and standard-deciphering insurers is traffic safety. Tort law

117. Sometimes, of course, the government does act as an insurer. For example, the U.S. government provides medical insurance to the elderly through Medicare and the poor through Medicaid and is the primary insurer for flood risks in this country. However, such public insurance schemes are not constrained by actuarial fairness because they are often meant to be redistributive or achieve other nonactuarial goals, such as subsidizing conduct (e.g., building in flood-prone areas) or providing a social safety net.

118. Ross, *supra* note 50, at 8; see also Tom Baker, *Liability Insurance as Tort Regulation: Six Ways that Liability Insurance Shapes Tort Law in Action*, 12 CONN. INS. L.J. 1, 11 (2006).

and highway safety regulations establish a framework for determining reasonable care and accident liability. But it is the insurance process that often establishes which actor is responsible for the accident, based on “mechanical and superficial formulas.”¹¹⁹ Because insurers have to follow routines, because they have to constrain the discretion that low-level adjusters exercise, and because basic principles of fault and negligence are difficult to apply, insurers turn to “mechanical presumptions,” such as presumed liability for rear drivers in rear-end collisions or left-turning drivers in collisions with oncoming traffic.¹²⁰ The pressure to run an efficient claims bureaucracy and to “close cases” generates greater reliance on simple rules than the background legal system generates.

E. Stricter Codes of Safety

Another function that insurers perform is the design of safety mandates that *exceed* the government-regulated “floor.” Take building codes, for example. Although municipalities vary in the level of safety investments that they require in residential and commercial buildings, they often require very little. While it is true that electrical wiring is inspected for safety, and that commercial buildings must meet fire-safety and emergency standards, many of the safety-related elements of the design and construction process are left unregulated. Property insurers often step in and incentivize, and sometimes even require, adherence to stricter safety standards. They played a crucial role, for example, in the development of the American Society of Mechanical Engineers’s boiler code and the various state boiler regulations. Similarly, environmental regulations set various standards relating to environmental exposures and harms. Environmental liability insurers complement this regulatory floor by requiring their insureds to comply with stricter codes written by private groups. They go beyond minimal compliance checks by promoting, through discounts and mandates, participation in private environmental management systems that follow strict codes of environmental compliance.¹²¹

In performing this standard-setting and code-setting role, and going beyond government mandates, insurers are subject to a pressure that governments rarely experience: competition. Agency-based regulation faces no competitive pressures. Regulatory agencies receive their funding from the central government through an annual budgeting process; and they typically receive their marching orders from elected officials and attend to interest groups. Thus, for example, in regulating building safety, municipalities are pressured by the interests of builders who prefer less expensive building codes.

119. See Ross, *supra* note 50, at 99.

120. *Id.* at 100–01.

121. See *How to Open Pollution Coverage Market—Make Policy Contingent on Obeying Environmental Code*, *supra* note 92, at 10; Kunzman, *supra* note 93, at 477.

Insurers, therefore, can fill a regulatory gap that results from political failure. Populist politics, for example, can lead the government to over- or underregulate some areas. While there is little that insurance can do to correct for overregulation, it can eliminate distortions resulting from underregulation of safety. For example, flooding is a major and rapidly growing source of losses in coastal areas, and yet coastal populations continue to grow. In Florida, the population in coastal counties grew from 5.5 million in 1980 to 9.7 million in 2003. The government's disaster policies subsidize coastal residents by paying for some of the losses and destruction from floods, thus distorting private decisions to populate coastal areas and leading to excessive coastal investment. Private insurance, on the other hand, sets policy premiums that—if not capped by law—closely reflect the risk to which individual properties are exposed, thus providing optimal incentives to populate (or depopulate) coastal areas.

Climate change policy is a major area in which insurance can help correct political failure.¹²² On both national and international fronts, the political will to address climate change is weak, in part due to the discounting of future generations and in part due to present-day collective action problems. But to the extent that climate change is affecting insurable perils like floods, droughts, and severe weather, people will have to pay higher premiums to insure their assets. And unlike government regulators, private insurers do not have the luxury of allowing themselves to be stymied by political debates over the science that underlies climate change policy. Indeed, in anticipation of actuarial shifts in damages and liability costs, insurance premiums should rise. And when premiums rise as a result of the growing risks, the pressure from insureds to enact carbon emission standards and other abatement measures will increase.

F. Outsourced Monitoring

Implementing safety standards requires monitoring of the regulated activity. Much regulatory monitoring is done *ex ante*, for example, to confirm the installation of safety devices and inspect the conduct of regulated parties. But monitoring can also be conducted *ex post*, after harm occurs, to determine liability or coverage. Government agencies regularly inspect compliance with government safety standards *ex ante*, and courts verify compliance *ex post*.

Monitoring is often done more effectively by insurers that develop regulatory practices and technologies that the government lacks. Take, for example, the “telematics” technology (“Pay as you drive” or “PAYD”) being gradually adopted by auto insurers: data recorders are installed in cars to monitor patterns of usage.¹²³ The improved monitoring allows insurers to

122. See generally Kunreuther & Michel-Kerjan, *supra* note 109.

123. Todd Litman, *Pay as You Drive Insurance*, VICTORIA TRANSP. POLICY INST. (2011), available at http://www.vtpi.org/payd_rec.pdf; Chris Woodyard, *Drivers May Lower Insurance Premiums by Getting Monitored*, USA TODAY (Mar. 14, 2011), <http://www.usatoday.com/money/autos/2011-03-14-Progressive-electronic-check-system.htm>.

price policies to reflect individual risk more accurately. Since insurers offer this device as optional (in return for a premium discount), it might be selectively utilized by safe drivers. But regardless of the selection effect, it is plausible that drivers who recognize that they are being monitored—that every step on the accelerator is recorded, or that night driving affects their premiums—will drive more carefully and during safer hours.¹²⁴ Of course, privacy concerns may limit the implementation of such advanced tracking and monitoring devices. However, as long as such concerns impose a stricter constraint on the government than on private insurers, and as long as insurers have greater flexibility in offering such devices as *options*, insurers will be at the forefront of individualized monitoring technology.

Another example of combined *ex ante* and *ex post* monitoring is workplace safety. The Occupational Safety and Health Administration (“OSHA”) is the federal agency that adopts and, through inspections and fines, enforces various workplace safety and health regulations. The number and scope of federal workplace regulations are vast, but enforcement and monitoring are relatively thin. Although there is always the threat of an OSHA inspection, for most employers such on-site visits are rare.¹²⁵ By contrast, most employers throughout the country are required to purchase workers’ compensation insurance to cover any work-related harms that could befall their employees; and virtually all workers’ compensation insurers, in order to accurately price their policies, engage in a significant degree of either *ex ante* underwriting or *ex post* experience rating, or both. As a result, many employers regularly receive visits from insurance representatives seeking to monitor employers’ compliance with the various government-imposed (and insurer-imposed) safety codes and recommendations.

Monitoring is similarly outsourced to liability insurers in the area of product safety. Some inspection of product safety is conducted by courts in product liability suits and by the CPSC, but a large amount of product safety monitoring is done by product liability insurers.

G. Disseminating Information

Like the insurance industry, government agencies gather and use information as a basic tool in regulating safety. For example, NHTSA collects accident reports from traffic law enforcers around the country, as do

124. One survey found that the installation of a PAYD device led to an average reduction of 40 percent in premiums and 20 percent in accidents, suggesting that both a selection effect and a risk-reduction effect were happening. *See* Womack, *supra* note 28.

125. OSHA describes its own ability to cover workplace safety nationwide as follows: “OSHA is a small agency; with our state partners we have approximately 2,200 inspectors responsible for the health and safety of 130 million workers, employed at more than 8 million worksites around the nation—which translates to about one compliance officer for every 59,000 workers.” *OSHA Commonly Used Statistics*, OCCUPATIONAL SAFETY & HEALTH ADMIN., <http://www.osha.gov/oshstats/commonstats.html> (last visited Aug. 6, 2012).

insurers.¹²⁶ The FDA collects information about drugs, the CPSC collects information about risky products, the EPA collects information about the release of hazardous substances, and municipalities collect information about restaurants' hygiene.

Like insurers, the government disseminates this information about risk to help people make informed decisions. Thus, NHTSA publishes SUV rollover ratings, as well as many other auto safety facts. But safety ratings were prominently available long before the NHTSA began publishing SUV rollover ratings. For over fifty years, the auto insurance industry has been publishing well-known car safety ratings, often more stringent and covering more safety factors than NHTSA's. For example, the insurance industry's four-grade scale includes many safety attributes that go beyond rollover risk. It takes into account a car's roof strength and how much protection it provides in the event of a rollover. Experts can debate whether the insurance ratings capture a more or less important set of factors than the government's ratings, but it is likely that the more robust the ratings that insurers produce, the less necessary the government's scheme. Given the comprehensive data insurers have and their incentive to rate cars credibly, this particular safety-related exercise can probably be largely outsourced to the insurance industry.

IV. EXPANDING THE ROLE OF REGULATION THROUGH INSURANCE

This Part examines three areas in which insurance is currently not offered and where regulation is achieved largely through legal controls. The question we explore is how private insurance markets might profitably be used to supplement or even replace those legal controls. The first Section takes the example of the newly burgeoning market for first-party insurance coverage for consumer losses arising out of unperformed consumer contracts and argues that this type of insurance might serve deterrence functions better than traditional contractual remedies. The next two Sections review new ways in which liability insurance (even mandatory liability insurance) can be combined with new, relatively simple liability rules to deploy liability insurers as risk regulators in areas where government regulation has been notoriously lax.

A. Consumer Contracts

Consumer economic protection is advanced through two primary regulatory devices: liability in private law (mostly contract law, but occasionally tort law) and public regulation (mostly against unfair and deceptive practices). This Section explores the question of whether first-party insurance markets might supplement or substitute these regulatory techniques.

126. The NHTSA's collection of traffic-accident data is available online. See *SDS Overview*, NAT'L HIGHWAY TRAFFIC SAFETY ADMIN., available at <http://www.nhtsa.gov/Data/State+Data+Program+&+CODES/SDS+Overview> (last visited May 1, 2012).

Consumers require protection because they sometimes agree to bad terms in their contracts, not understanding in advance what it is that they have agreed to. Consumers also require protection because the promises that are made to them are sometimes broken: for example, products are not as described, merchandise is not delivered, and money is excessively charged. When these breaches occur, contract law provides remedies, but enforcement is costly and largely impractical. Individual consumers cannot credibly threaten to sue; as a result, businesses are undeterred. Class actions are one way to deal with this underenforcement problem, but impediments to such actions abound. Some claims cannot be aggregated into representative classes, some contracts waive class action rights, and attorney fee arrangements sometimes produce an imperfect selection of cases. The universe of contract claims that are too small or complex to pursue individually in litigation is vast. Often obscured by lengthy standard forms, consumers cannot distinguish their rights, or adequately seek redress, and have to rely on non-legal mechanisms (e.g., sellers' ratings, retailers' return policies) to steer clear of the risk of loss.

The question we wish to explore here is whether first-party insurance arrangements might relieve some of the insecurity that consumers, deprived of de facto contractual remedies, experience in these contexts. And, further, could such insurance actually provide businesses with incentives to perform their promises?

Pockets of explicit first-party consumer protection insurance already exist, and it is not difficult to see why. Consider, for example, individuals who purchase cars on the website eBay Motors. In that market, consumers send money up front to sellers who often do not have a brick-and-mortar location, whose reputations are undeveloped, whose assets are limited, and who for all of these reasons might easily take the money and run.¹²⁷ Yes, buyers have legal remedies when eBay sellers breach their agreements, but the enforcement of such remedies is unlikely. Perhaps in response to this legal-remedial void, eBay Motors provides a number of options for insuring car buyers against the risk of non- or underperformance by car sellers. For example, eBay Motors provides disappointed buyers a fund from which they can recover the lost payment when the seller defrauded them, up to \$50,000.¹²⁸ Similarly, online purchasers of consumer electronics can use a service like SquareTrade to buy what amounts to first-party insurance against the types of risks that contractual seller-provided warranties would usually cover.¹²⁹ Credit card issuers often provide similar "purchase protection" to buyers of consumer products who use the issuer's credit card as the

127. See *Motors*, EBAY, <http://www.ebay.com/motors> (last visited May 1, 2012).

128. *Vehicle Purchase Protection*, EBAY <http://pages.motors.ebay.com/buy/purchase-protection/index.html> (last visited May 1, 2012).

129. See *The Best Warranty at the Best Price*, SQUARETRADE, www.squaretrade.com/pages/learn-more-warranty-buyer (last visited May 1, 2012).

form of payment.¹³⁰ PayPal likewise offers a “Buyer Protection Plan” that reimburses buyers for the full price and shipping costs of an item in the event that their complaint against the seller is found to be meritorious.¹³¹ PayPal, like eBay or Visa, sets up simple dispute resolution templates to verify that consumers’ complaints are not frivolous.¹³² In all of these cases, when there is a risk of the seller taking the money and running, the market makers, retailers, and payment intermediaries sometimes step in to offer bonds (or guarantee programs or recover funds) to induce buyers to enter their network.¹³³

The question we wish to pursue is whether such pockets of consumer protection insurance might be expanded and consolidated into a more general first-party consumer insurance product, and whether that form of insurance might have some of the beneficial regulatory effects—care-level and activity-level effects—that we have been discussing. Imagine, for example, a hypothetical first-party insurance policy, sold by private insurance companies, that covers the cost to repair or replace (or simply to refund the price of) various types of nonperforming or underperforming consumer products.¹³⁴ Unlike most existing warranty plans, this hypothetical insurance would be sold per consumer rather than per transaction. It could be sold, for example, as part of a homeowners’ insurance policy, as yet another type of “property coverage.” Indeed, standard homeowners’ policies already provide limited coverage for some consumer-related perils, such as the risk of damage to or theft of the insured’s “personal property” while that property “is anywhere in the world” as well as losses arising if someone makes unau-

130. For example, MasterCard offers several forms of insurance with purchases using its card. There is an “extended warranty,” which doubles the manufacturer’s original warranty, there is ninety-day coverage for lost, damaged, or stolen items, and there is a specific “satisfaction guarantee,” which provides limited coverage in the event that a store will not accept a return. See *Protections, Assistance and Savings*, MASTERCARD, <http://www.mastercard.us/card-benefits.html> (last visited Aug. 6, 2012).

131. See *PayPal User Agreement*, PAYPAL para. 13, <https://www.paypal.com/us/cgi-bin/webscr?cmd=xpt/UserAgreement/ua/USUA-outside#pbbp-policy> (last visited May 1, 2012).

132. See *id.* para. 12. For eBay’s policy, see *Your User Agreement*, EBAY, <http://pages.ebay.com/help/policies/user-agreement.html?rt=nc> (last visited May 1, 2012).

133. Other examples abound. For individuals booking a vacation rental property and worried about, among other things, the property being foreclosed on, double booked, or less desirable than represented, special first-party insurance products—or “guarantees”—can be purchased. See *e.g.*, *Protect Your Vacation Rental Payments*, HOMEAWAY, <http://guarantee.homeaway.com/vrbo/> (last visited May 1, 2012). Similarly, when a taxpayer fills out her tax return on TurboTax, if she is worried about the risk that the IRS will audit her, she can purchase what amounts to insurance for that risk from a separate company. See *Audit Defense Membership Agreement*, TURBOTAX, <http://turbotax.intuit.com/corp/auditdefense.jsp> (last visited May 1, 2012).

134. The policy might even include coverage for certain types of consumer service transactions as well, although insurers may find it more difficult to define the circumstances under which a triggering coverage event has occurred.

thorized use of the insured's credit card, forges one of the insured's checks, or pays the insured in counterfeit money.¹³⁵

Insurers selling such consumer transaction insurance would of course have to develop procedures for receiving claims and investigating their validity. Consumers could choose to have the policies cover only certain types of transactions (e.g., only transactions over \$250), thus eliminating the administrative costs of numerous small claims, or they could choose coverage only for certain classes of transactions or for purchases from certain sellers.

If such a product were to emerge, it is our prediction that insurers would, as they do in other contexts, have a role that goes beyond indemnity; that is, they would also engage in some degree of ex ante and ex post regulation. For example, one obvious ex post regulatory role for the insurer in this setting would be to manage claims, separating the valid from the invalid. One advantage that insurers' post-claim investigation has over court-administered, post-claim factfinding is the use of simplified procedures (similar to ones already implemented by, say, eBay). We discussed above how auto-insurance claim adjusters use simple rules to assess coverage, suggesting that similar practices could develop in the consumer loss area.

Consumer transaction insurance might also offer efficiencies in regulating the risk ex ante. In underwriting the policies, insurers would have more information about the likelihood of potential claims—the insured's "propensity" to file claims—than would existing guarantee and warranty programs, because insurers can keep records of the insured's rate of past claims. Also, whereas the SquareTrade-type warranty can, at most, aggregate information about a particular seller or product, an insurer can compare the same information with each insured's claim record in other areas. This richness of information creates a richness of possible plans and prices available for the insurer. Some consumers might prefer special endorsements to cover particular types of transactions, while others might prefer a pricier, "all-transaction" risk coverage. The choice can be made at the time the policy is purchased or refined at the time of purchase of the product; and it could even be further refined by coarrangements with credit card issuers or retailer loyalty plans.

Perhaps less obvious, this new type of first-party consumer transaction insurance could also deter opportunism on the part of businesses that sell to consumers. First, if the insurers are subrogated to their insureds' claims against the breaching sellers, the insurers can more effectively recover from

135. See, e.g., *Homeowners 3 Special Form*, INS. SERVS. OFFICE 5 (1990), available at <http://www.mullerinsurance.com/resources/Homeowners3SpecialForm.pdf> (discussing under "Section I—Property Coverages" the scope of coverage for credit card and fund transfer card transactions, forgery, and counterfeit money). Note that existing homeowners' policies clearly do not provide any coverage for under- or nonperforming consumer products, as those policies explicitly exclude all losses that arise out of "inherent vice," "latent defect," or "mechanical breakdown." *Id.* at 7 (under "Section I—Perils Insured Against"). Thus, as homeowners' policies are currently written, insurers have declined to substitute their coverage for consumer product warranties. Our argument is that this might change over time if consumer product warranties for a wide range of products continue to provide ineffectual remedies.

the defendants than can individual consumers bringing their own lawsuits. In a sense, subrogation claims brought by first-party insurers can substitute for class action lawsuits as a means of regulating bad behavior in circumstances in which individualized lawsuits are not cost effective.¹³⁶ And even if subrogation is ineffective—if, for example, the insurers pay claims that are not recoverable under contract or consumer law—insurers might nevertheless help to deter seller wrongdoing. For example, through various information aggregation techniques, insurers might be able to identify sellers who engage *systematically* in opportunistic or otherwise wrongful behavior and, in effect, “blacklist” them. Sellers that are repeat offenders (that produce unusually high numbers of claims brought by insureds under their policies) could be singled out by insurers and classified as bad risks. Insurers could in turn warn insured consumers not to purchase from these high-risk sellers and could in extreme cases exclude coverage for claims arising out of sales involving the worst-offending sellers. Exclusions that say things such as “this policy does not cover purchases from X” would serve the *ex ante* regulatory role of increasing the salience of those companies’ nonperformance risk and thereby deterring misconduct.

Insurers can even charge businesses directly to be covered. For example, eBay Motors provides an insurance-like buyer protection program without charging buyers any premium. Instead, it charges sellers for the cost of the buyer protection program, and it can differentiate the price according to the seller’s record or expel sellers who breach their obligations.

Because insurers can aggregate and share actuarial data on the nonperformance risk that businesses pose, these blacklists of “out-of-network” businesses could reliably reflect the incidence of harm; or, if the creation of blacklists are considered distasteful, a different practice could be to offer a menu of premiums. Rather than exclude products sold by company X altogether, the insurance premium could be increased to cover this company’s products. For example, a premium of \$400 could be charged to secure coverage for all purchases, whereas a premium of \$100 could be charged for a more restrictive policy that excludes coverage for products by a list of worst offenders. The threat of being on the list of businesses whose products are either not insured or cost more to be insured could provide more discipline than the threat of private lawsuits by aggrieved consumers. The accuracy of such a regime, in reflecting actual loss distributions, would be greater than that achieved through litigation.

Moreover, businesses could compete to have their products and transactions covered by reputable insurers. An entrant, for example, trying to break into a market in which established businesses have long-standing clientele, could pay insurers to be included in the coverage package they offer their insureds, and could advertise this feature. Insurance, that is, can operate as an implicit certification scheme, a private seal of quality, a rating service,

136. First-party insurers sometimes bring subrogation claims on behalf of large groups of insureds against a single defendant. Any judgment or settlement is then allocated among the first-party insureds according to the size of their claims.

generating much of the incentive effect usually attributed to these devices.¹³⁷ This is bonding, not corruption: so long as the coverage offered by the insurer covers losses arising from the sale of the “bribing” seller’s product, the system works like a prefunded warranty scheme. It would be superior to a seller-run warranty because insurer-intermediaries administer the actuarial soundness and claim management aspects of the fund. In short, the insurer would operate as the agent for consumers by aggregating data about the business, classifying the risk that the business poses, pricing this risk, and covering it.

Why is such an insurance product not already offered? We noted that miscellaneous first-party consumer insurance pockets exist through the efforts of market makers, payment systems, and warranty programs—all in areas in which the liability system is ineffective in shifting the costs to the wrongdoers. But the full-blown information tools of the insurance industry have not been harnessed to this end, perhaps because the demand for such coverage is already filled by the niche insurance products. What seems more likely, however, is that, until recently, it was assumed by insurers that the demand for coverage against the risks of consumer product under- or non-performance was met by the product sellers themselves through the sale of product warranties. It is also possible, then, that the American legal trend of businesses immunizing against court-imposed liability for breach of consumer product contracts through their effective use of mandatory arbitration clauses may dramatically increase the demand for first-party insurance coverage as a substitute for legal control of consumer product quality.

B. Food Safety

Regulating food safety is a daunting task for the government. Milk containing traces of melamine, peanuts contaminated with salmonella, and seafood containing mercury or other dangerous toxins all pose risks that are hard to monitor. These products often pass through many hands in the chain of distribution, with risks to human health every step of the way, often outside the regulatory jurisdiction of local government regulators. Food products are vulnerable to a wide variety of contaminants and toxins, which require specialized testing to detect. As a result, *ex ante* food safety monitoring must be done by sampling—there is simply too much food to test it all—and major hazards could go under the radar even if sampling is frequent.

Tort and products liability law provide additional venues of enforcement. Individuals who eat a contaminated meal at a restaurant or who consume tainted food that they purchased from a retail grocer have tort remedies. To the extent that the sellers in each case are large and fully solvent businesses (e.g., the McDonalds’ and Krogers of the world), the tort system

137. Notice that in this setting, if the product seller pays the insurer for a good rating, it is not an example of the system being corrupted through bribery.

provides an effective regulatory supplement to agency-based, ex ante quality control.

As discussed previously, product manufacturers and sellers purchase liability coverage from insurers that develop special expertise in regulating the risks in question. There are specialized “food product liability insurance” policies that help sellers manage the risk of tainted foods.¹³⁸ These policies may also provide food-safety regulatory insurance—coverage of the costs of complying with government enforcement actions, including food recalls.¹³⁹

This system of products liability law administered (or operationalized) through specialized liability insurers, however, cannot alone deal with the problem of small manufacturers, retailers, and importers of tainted food. Many of them are judgment proof and may sell imported products from wholesalers that are likewise small or difficult to identify (such as foreign suppliers). They do not have brand names to post as reputation bonds. An obvious solution would be compulsory liability insurance: require small sellers of food products to purchase enough liability insurance to cover them against the risk of food-borne illness. Such a mandate would effectively place liability insurers in the role of small-business licensers as well as food-safety regulators.

A somewhat less comprehensive approach would be not to apply the mandate to sellers of domestically grown and produced food, but to limit the compulsory insurance regime to importers of food products. This more limited approach might be preferred if it were determined that domestically produced food tended to be relatively safe, either because of the effect of ex ante regulation or reputational effects. Under such a regime, importers would be strictly liable for harms arising from the use of an imported product, as they are under current law; however, to guarantee the importers’ ability to pay, they would be required by law either to put up a bond or to purchase a liability insurance policy with policy limits sufficient to satisfy any potential tort judgments.¹⁴⁰

The role of government in setting up such a mandatory insurance scheme would be relatively limited. Although the government would need to monitor compliance with the mandatory insurance requirement, it would not have to monitor food production, sample products, send inspectors to

138. For a discussion of food product liability insurance, see ROB HOLLAND, CTR. FOR PROFITABLE AGRIC., CPA INFO NO. 128, FOOD PRODUCT LIABILITY INSURANCE (rev. 2007), available at <http://cpa.utk.edu/pdffiles/cpa128.pdf>.

139. JEAN C. BUZBY ET AL., FOOD & RURAL ECON. DIV., U.S. DEP’T OF AGRIC., AGRIC. ECON. REP. NO. 799, PRODUCT LIABILITY AND MICROBIAL FOODBORNE ILLNESS 9 (2001), available at <http://www.ers.usda.gov/publications/aer799/aer799.pdf>; see also Jerry R. Skees, Aleta Botts & Kimberly A. Zeuli, *The Potential for Recall Insurance to Improve Food Safety*, 4 INT’L FOOD & AGRIBUSINESS MGMT. REV. 99 (2001).

140. Tom Baker has recently proposed one such innovative scheme. See Baker, *supra* note 9, at 215. While Baker envisions insurance policies with limits equal to the retail value of the goods sold, a fully cost-internalizing plan would require policy limits that reflect the consequential harms from products. Unsafe food, for example, sells for a negligible retail price, but if contaminated could cause great harm.

the retail establishments, or intercept imports. The government's primary role would be to maintain the existing tort regime of strict products liability for harms caused by tainted food products, to mandate minimal policy limits, and presumably to continue some system for monitoring the solvency of participating insurance companies. To import food products, importers would be required to show the government regulator proof of insurance from a licensed and regulated insurer. In setting policy limits, the government would need to come up with tables of projected risks, which would depend on the type of food in question and the risks it normally poses.

This insurance solution would rely on the contractual agreement between the insurers and the food distributors or importers to generate incentives for optimal safety. For while the policy limits are mandated by the government, it is up to each insurer to price the coverage according to the idiosyncratic risk that each insured poses. It is here that the informational advantage of insurers could provide a unique advantage. To qualify for discounted premiums, importers of food would have to provide proof that they satisfy threshold standards of hygiene and food safety (as when product liability insurers insist on evidence of safety testing and quality control programs). The process of underwriting policies would harness information intermediaries—local inspectors and certifiers, trade associations, distribution networks—that are otherwise not used when it is the government that inspects imports at the border or other products at the factory.¹⁴¹

C. Financial Statements Insurance

In the aftermath of corporate-reporting fraud scandals and the conflicts of interest that auditors and other gatekeepers (e.g., underwriters and lawyers) were revealed to have, the Sarbanes-Oxley Act sought to regulate the role and the liability of gatekeepers. The Act addresses problems of auditors' and accountants' conflicts of interest through a set of regulations, penalties, allocation of authority to audit committees, and stricter standards relating to the involvement between auditors and clients. Much debate and critique has been leveled against the Act, the incentives it creates, and the growing involvement and supervision of the law in the governance of firms. The Act has been criticized for imposing costly burdens on the parties involved, for its thicket of bureaucratic mandates, and for its lack of empirical

141. As Baker explains in his proposal for warranty bonds, insurers "would demand that importers maintain detailed records of the sources of all of the ingredients and components of the goods being imported, facilitating the accountability process." *Id.* at 220. Baker also points out that the insurance industry is experienced in underwriting similar kinds of health and safety risks related to global food supply. Many existing importers voluntarily purchase liability insurance that covers product liability risk and product recall costs, as well as the costs of business interruption.

success.¹⁴² But the problem it addresses is important: if auditors are hired and paid for by management, their conflict of interest is endemic to the relationship. Meanwhile, investors who rely on the statements do not have the incentive to hire private auditors. Thus, the problem seems to require government regulation in the form of fiduciary duties, agency monitoring, ex post penalties, disclosures, and various other mandated procedures.

Can government regulation of auditors' conduct be outsourced to insurers? Joshua Ronen has proposed such an insurance scheme as a regulatory alternative.¹⁴³ Under Ronen's proposal, the law will not have to determine when a conflict of interest arises, and how to divide the blame between the auditors and the audited firms. Instead, the law will need to set clear rules of strict liability (for firms, not auditors) for misrepresentation, and it has to mandate that firms purchase liability insurance.

This insurance—which Ronen calls “Financial Statement Insurance”—would resemble any type of business liability insurance, like D&O insurance. Many such policies already exist and cover a variety of other forms of financial liability. Insurers selling such misrepresentation liability insurance would be the ones to hire external auditors to assess the risk of misrepresentation. And the insurers would vary the premiums, the policy limits, and other policy terms (e.g., deductibles) that are charged to each insured company, based on the risks presented by each company. Thus, the auditors would be working for the insurers, not for the audited firms.

Each firm's insurance coverage would be publicized in the same way that many other sellers publicize the warranty or limits of liability they offer. These publicized parameters would be visible to investors, provide information about the reliability of financial statements, and thus affect the price of the firm's securities. If the firm has to pay a high premium for its coverage, the market would infer that the insurer regards the firm as high risk. By contrast, if the firm has a high policy limit, or maintains a substantial deductible, this would be viewed by the market as a good signal of low risk to investors. (Of course, the presence of insurance for misrepresentation would make the risk signal less crucial, since the losses are insured.)

Importantly, it would be up to the insurers to audit the firm's statements and to hire reliable monitors who are not conflicted. It is the standard business of insurance to rely on experts in underwriting risks, and insurers have no clear interest in hiding or overstating potential risks. Because the risk would be assessed by outsiders, and because high-risk factors would become visible to the market through the price and limits of the insurance coverage, firms will have an incentive to improve the quality of their finan-

142. See *The Louis & Myrtle Conference on the Impact of Sarbanes-Oxley on Doing Business*, 105 MICH. L. REV. 1597 (2007).

143. Ronen, *supra* note 9, at 48–60; Alex Dontoh et al., *Financial Statement Insurance* (N.Y. Univ., NYU Working Paper No. 2451/27449, 2008), available at <http://ssrn.com/abstract=1280670>; see also Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 441–56 (2004); Lawrence A. Cunningham, *A Model Financial Statement Insurance Act*, 11 CONN. INS. L.J. 69 (2004).

cial statements. Insurance would eliminate the need for regulatory oversight of auditors' independence. It would also harness the reputation and claim-paying capabilities of the insurer to the benefit of investors, who will be able to assess the misrepresentation risk more accurately. It would therefore serve the objectives of securities laws quite well. Even the settlement of claims could be simplified. Rather than relying on courts to resolve securities fraud suits, insurers could investigate claims or prescribe a claim-resolution procedure in the policy.

CONCLUSION

The goal of this Article is to bridge two conflicting truths about insurance. The first is the moral hazard concept—that insurance can destroy incentives to minimize risk. The second is the risk management concept—that insurance can improve incentives to reduce risk. We started by noting that regulation of risk is not an obvious goal of the insurance industry, which thrives on the presence of irreducible risks. It is the pressure of competition, the demand from insureds, and the selfish incentive to contain costs once premiums have been paid that motivates insurers to seek risk mitigation.

Insurers regulate risk in various ways. From mandating specific investments in risk reduction, to offering premium discounts for favorable claims experience, to selling cost-containment expertise to policyholders and even designing safety technologies and codes, insurers perform many of the same regulatory functions that government regulators and courts perform. However, in many (though obviously not all) situations, private insurers, because of their inherent informational comparative advantage, should be expected to do the job of regulation better than public regulators and courts. Through private contracting, insurers monitor safety in ways that legal commands cannot.

There are many aspects to the insurance-as-regulation paradigm that were not explored in this Article. For example, the regulatory paradigm suggests that the choice of primary liability rules should ideally be affected by a determination of which type of insurer is better at regulating its insureds' behavior. Thus, while one party might be the least-cost avoider of a particular risk (and thus the *prima facie* target of an optimal liability rule), if that party is covered for this risk by a type of insurance ill suited to regulate incentives, shifting the liability to the other party whose behavior is more readily regulated by insurance could be superior. For example, if first-party insurers are the better regulators of a particular risk than liability insurers, then a no-liability rule could be desirable, even if injurers are the more efficient risk avoiders. Alternatively, if liability insurers are the better regulators, then a rule that shifts costs to injurers could produce the most efficient risk reduction, even in situations in which victims might be the cheapest-cost avoiders. Products liability might well fit this scenario.¹⁴⁴

144. See generally Hanson & Logue, *supra* note 9, at 145–53.

Another way in which the insurance-as-regulation paradigm affects the design of primary legal rules is in the rules directly applying to insurance. First, the law should at times mandate insurance coverage, in order to harness the regulatory capacity of insurers. We argued that mandatory environmental liability insurance was necessary to enticing the insurance industry to develop its regulatory skills, and that mandatory liability insurance could substitute for much of food safety regulation. Such mandatory insurance would be equivalent to making insurers the licensing agents for certain types of risky activities. Second, the law should monitor the integrity of insurers' decisions as regulators whenever competition does not provide sufficient discipline. For example, insurers' ex post underwriting could be a desirable regulatory tool, but could also quickly digress to an opportunistic and even fraudulent strategy that justifies stiff deterrence.

Indeed, regulation by insurance often walks a delicate path between a socially desirable, information-rich incentive mechanism and an opportunistic set of self-serving, rent-seeking tactics. Insurers can require specific forms of conduct from their clients in order to improve safety, but they can also do this as a pretense for unjustified denial of paid-for coverage. We don't know which pattern dominates. The insurance law literature is saturated with studies of insurance opportunism. This Article's goal is to illuminate the often underappreciated flip side of improved safety.