

Shattering Some Myths on the Insurance Liability Crisis: A Comment on the Article by Clarke, Warren-Boulton, Smith, and Simon

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In their article, *Sources of the Crisis in Liability Insurance: An Economic Analysis*,¹ Richard Clarke, Frederick Warren-Boulton, David Smith, and Marilyn Simon (“the authors”) of the Justice Department’s Antitrust Division confirm the insurance industry’s view that the limited federal antitrust exemption accorded to the industry under the McCarran-Ferguson Act² did not contribute to the crisis in property-casualty insurance which occurred in 1985 and 1986. Indeed, their report dispels some of the myths that have been perpetuated by industry critics, who have attributed the blame for the liability crisis to (1) collusive activity by insurers, (2) price increases by inefficient and inept insurance companies damaged by their investment losses in the early 1980s, and (3) inadequate state insurance regulation.³ The authors substantiate the views of the Justice Department’s Tort Policy Working Group, which in two earlier analyses concluded that these factors were unlikely to have caused the crisis.⁴ The Working Group concluded that changing patterns in our civil justice system are the principal cause of the liability crisis.⁵

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1. Clarke, Warren-Boulton, Smith & Simon, *Sources of the Crisis in Liability Insurance: An Economic Analysis*, 5 YALE J. ON REG. 367 (1988).

2. Ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (1982 & Supp. III 1985)).

3. See, e.g., Angoff, *Insurance Against Competition: How the McCarran-Ferguson Act Raises Prices and Profits in the Property-Casualty Insurance Industry*, 5 YALE J. ON REG. 397 (1988); Olender, *The Great Insurance Fraud of the '80s*, NAT'L L.J., July 21, 1986, at 15; Goldberg, *Product Liability: Manufactured Crisis*, 51 CONSUMER REP. 544, 544-45 (1986).

4. U.S. DEP'T OF JUSTICE, TORT POLICY WORKING GROUP, REPORT OF TORT POLICY WORKING GROUP ON THE CAUSES, EXTENT AND POLICY IMPLICATIONS OF THE CURRENT CRISIS IN INSURANCE AVAILABILITY AND AFFORDABILITY (1986) [hereinafter TORT POLICY REPORT].

5. *Id.* at 32-59. Similarly, the New York Advisory Commission on Liability Insurance rejected allegations that price increases in some liability premiums were attributable to anticompetitive practices. REPORT OF THE GOVERNOR'S ADVISORY COMM'N ON LIAB. INS., INSURING OUR FUTURE 65 (1986) (State of N.Y.) [hereinafter CUOMO COMM'N]. The Commission maintained that there was “no evidence that would warrant an assertion that a conspiracy occurred, and that there are strong

While we support the authors' thesis that the erosion of fault as the standard of tort liability is the primary cause of the insurance crisis, we believe that we can further add to their discussion an understanding of how the McCarran-Ferguson Act operates. We intend to explain why the limited antitrust exemption is necessary and how the public benefits from its implementation. This Comment first explains the motives underlying passage of the McCarran-Ferguson Act, and then proceeds to examine its place in the insurance market. The Comment shows that, in the absence of the Act, rigorous standards of state involvement would require a much higher degree of state regulation and would impose inordinate costs on the consumer and the industry.

I. The McCarran-Ferguson Act and the Mechanics of the Insurance Market

Enacted in 1945, the McCarran-Ferguson Act has two major components. The first reserves authority for states to regulate and tax the insurance industry.⁶ The second exempts insurers from federal antitrust regulation to the extent that states already regulate insurance.⁷ Thus, insurers are protected from federal intervention under the Sherman Antitrust Act.⁸ State insurance commissioners played a prominent role in the debate which preceded the adoption of the McCarran-Ferguson Act.⁹ They were concerned that the Supreme Court decision in *United States v. South-Eastern Underwriters Association*,¹⁰ which defined insurance as interstate commerce, would deprive them of the right to regulate and tax insurers within their states. Insurance regulation had long been a state prerogative. While the commissioners were clearly interested in preserving their traditional authority, they also believed that the states, not the federal government, were the proper source of regulation.¹¹ Insurance rates are often predicated on the legal and demographic characteristics of individual states, and state regulators are therefore better equipped than the federal government to supervise the activities of insurers.

practical reasons to suggest that it did not." *Id.*

6. 15 U.S.C. § 1012 (1982).

7. *Id.* § 1012(b).

8. Ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1-7 (1982 & Supp. III 1985)).

9. For a discussion of the legislative history of the McCarran-Ferguson Act, see *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 217-24 (1979).

10. 322 U.S. 533 (1944).

11. See Kimball & Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH L. REV. 545, 566-67 (1958) (McCarran-Ferguson Act embodies federal policy that regulation of insurance industry be conducted by states).

The exemption from federal antitrust laws, controversial when it was enacted in 1945, continues to provoke debate. There is a common misperception that the exemption is complete. In fact, the McCarran-Ferguson Act exempts insurance companies from antitrust litigation only if: (1) the activity at issue constitutes the business of insurance, (2) the activity is regulated by state law, and (3) the activity does not amount to boycott, coercion, or intimidation.¹² The essential question raised both then and now is why the insurance industry warrants a unique exemption from national antitrust laws. To answer this question, one must understand the unique characteristics of the insurance market.

Unlike the provider of almost any other good or service, the insurer does not know at the time the insurance contract is entered into the total costs that will ultimately be incurred. In contrast, an automobile manufacturer, for example, knows the production and sales costs at the time a car is sold and is thus able to calculate with a reasonable degree of certainty the costs that must be recovered from the final sale price of the car in order to break even or make a profit. Even providers of financial services, such as equity underwriters, who also work with a nonfungible risk, are nonetheless capable of ascertaining the net worth of the company and can determine, albeit with less certainty than manufacturers, the price they must obtain for their product in order to recover its costs and make a profit. Moreover, an equity underwriter's risk is smaller than that of an insurance underwriter since losses, should they occur, become apparent at the time the issue is first made available in a public offering. By contrast, in return for a premium, an insurer must promise the insured indemnification for any injury covered by the insurance contract. Therefore, in order for insurers to determine an appropriate price for their product, they must rely on statistical projections. The accuracy and adequacy of these projections are important not only to the insurer but also to insurance regulators who need such information to determine whether the price charged by the insurer is illegally inadequate, excessive, or discriminatory.¹³

12. 15 U.S.C. § 1012(b) (1982); see Anderson, *Insurance and Antitrust Law: The McCarran-Ferguson Act and Beyond*, 25 WM. & MARY L. REV. 81, 89-107 (1983) (discussing legislative history and judicial construction of these three requirements).

13. Most state insurance codes begin with a section stating the purpose of the regulation. A typical statute reads as follows:

The purpose of this chapter is to promote the public welfare by regulating insurance rates to the end that they shall not be excessive, inadequate, or unfairly discriminatory, and to authorize and regulate cooperative action among insurers in rate-making and in other matters within the scope of this chapter. Nothing in this chapter is intended:

- (1) To prohibit or discourage reasonable competition; or
- (2) Prohibit or encourage except to the extent necessary to accomplish the aforementioned purpose, uniformity in insurance rates, rating systems, rating plans or practices.

As is generally the case with statistical analyses, the larger and more representative the sample, the greater the probability that predictions based on it will be acceptably accurate. A broader range of actuarial data provides a more accurate assessment of the losses and expenses associated with a particular insurance line. With few exceptions, no single insurer has sufficient statistical evidence to calculate an actuarially sound rate and must therefore pool its data with other insurers.¹⁴ Thus most of today's data are collected by advisory organizations and transmitted to insurers in various forms, including advisory rates. Statistical reporting agencies, such as the Insurance Services Office (ISO), aggregate loss data and loss adjustment expenses and provide trending information to insurers as well as to insurance regulators.¹⁵ Insurers participating with the ISO may then choose to deviate from the advisory rates according to their individual marketing strategies after assessing how their particular business and expenses compare with industry averages.¹⁶ Such pooling of information is valuable to insurers, regulators, and ultimately, consumers.

II. Public Benefits of the Antitrust Exemption

Real benefits flow from this aggregation of actuarial data by the insurance industry. Not only does this aggregation assist in the regulation of insurers for solvency, but it also promotes competition within the industry.¹⁷ Small companies, which would otherwise lack the means to deter-

This chapter shall be liberally interpreted to carry into effect the provisions of this section.
ALA. CODE § 27-13-1 (1975).

14. See INSURANCE SERVS. OFFICE, INC., INSURANCE SERVICES OFFICE IN A COMPETITIVE MARKETPLACE: ISO'S ROLE WITHIN THE PROPERTY/CASUALTY INSURANCE INDUSTRY 7-8 (1987).

15. *Id.*

16. In testimony before the House Energy and Commerce Committee, industry critic Robert Hunter alleged that the ISO advisory rates reflected the average cost of the least efficient insurers. Were this true, almost every company could price its product below the advisory rate and still make a substantial profit. Yet according to data compiled by A.M. Best, the annual rate of return as a percentage of net worth for the industry has consistently been lower for insurance companies than for Fortune 500 companies. See *Insurance Industry Financial Condition: Hearings Before the Subcomm. on Commerce, Consumer Protection, and Competitiveness of the House Comm. on Energy and Commerce*, 100th Cong., 1st Sess. 52-54 (1987) (testimony of J. Robert Hunter, Pres., Nat'l Ins. Consumer Org.); see also INSURANCE SERVS. OFFICE, INC., INSURER PROFITABILITY—THE FACTS 8, table A (1986).

17. In 1942, the top eight insurance groups held a 27% market share in the property-casualty insurance business. In 1986, the top eight groups commanded a market share of 25.2%. This decrease occurred when market concentration for most major industries was increasing. A.M. BEST CO., BEST'S AGGREGATES & AVERAGES: PROPERTY-CASUALTY, 102, 252 (1987) (1986 figure calculated by dividing total property-casualty premiums less accident and health (\$57.6 billion) by net premium (\$176.5 billion)); R. HENSLEY, COMPETITION, REGULATION, AND THE PUBLIC INTEREST IN NON-LIFE INSURANCE 29, table 3 (1962); see also R.A. Winter, *The Liability Crisis and the Dynamics of Competitive Insurance Markets*, 5 YALE J. ON REG. 455 (1988).

mine an actuarially sound rate, are given access to the same information available to larger companies.

The limited antitrust exemption not only allows insurers to receive enough information to make actuarially sound rates, but also permits them to develop standardized policy forms which are likely to stabilize the cost of purchasing insurance policies. These standardized forms enable insurance customers and regulators to make meaningful price and coverage comparisons among insurers.¹⁸ If each insurer were to issue its own forms, even the most sophisticated consumer would find it impossible to make meaningful comparisons of the prices and services offered by different companies. Such data would also be of little use for rulemaking and regulatory monitoring.

Instances will also arise in which insurers who have jointly developed forms and data will nevertheless find it impossible to serve a market because no single insurer has the capacity to underwrite the risk. The anti-trust exemption resolves this problem by allowing insurers to pool their resources to provide liability coverage where it might not otherwise be made available. An example of such a pool is the American Nuclear Insurers,¹⁹ a cooperative organization comprising some 800 companies which insures nuclear power plants. The extraordinary costs of any possible nuclear accident make the risk too large for any one insurer to cover. Accordingly, a large number of companies must be assembled to underwrite the risk. Pools of smaller companies may also be established to allow them to compete with larger insurers.

Finally, in certain instances state insurance commissioners themselves require insurers to provide coverage jointly. For example, in many states it is compulsory to obtain automobile coverage.²⁰ States have established assigned risk plans to minimize the risk that selective underwriting will prevent drivers from obtaining compulsory insurance because of poor driving records.²¹ These plans run contrary to antitrust concepts because they specifically set out the coverage, premium, commission, and form of the policy.²² A similar residual market mechanism exists for property insurance in inner cities. Known as Fair Access to Insurance Requirements plans (FAIR), they require insurers to provide coverage at prices and

18. INSURANCE SERVS. OFFICE, INC., *supra* note 16, at 7.

19. *Hearings on S. 843 Before the Subcomm. on Nuclear Regulation of the Senate Comm. on Environment and Public Works*, 100th Cong., 1st Sess. (1987) (statement of Joseph Marrone, Gen. Counsel & Sr. Vice Pres. of Am. Nuclear Insurers) (official report forthcoming).

20. See, e.g., MASS. GEN. L. ANN., ch. 175, § 113A (West 1987) (requiring insurance of all vehicles). For a discussion of the Massachusetts experience, see Giffin & Hillman, *Automobile Insurance Reform Law: Highlights of Chapter 266 of the Acts of 1976*, 61 MASS. L.Q. 211 (1977).

21. MASS. GEN. L. ANN. ch. 175, § 113H (West 1987).

22. *Id.*

terms set by the state government as a precondition for doing business in the state.²³ Absent the protection of the McCarran-Ferguson Act, these residual market mechanisms could be held subject to antitrust scrutiny as per se violations of the Sherman Antitrust Act since they constitute a concerted effort to fix prices.²⁴

III. The State Action Doctrine

While the authors do not dispute that the unusual characteristics of the insurance industry make it more necessary for participants in the market to engage in joint activities than for participants in other industries, they suggest that the state action doctrine would immunize such cooperation from antitrust objections even if the McCarran-Ferguson Act were repealed.²⁵ In fact, however, without the exemption created by the McCarran-Ferguson Act, it is quite likely that insurers would be forced to cease sharing data. The state action doctrine, a judicially created exemption from federal antitrust law, emerged in *Parker v. Brown*,²⁶ which held that the Sherman Act²⁷ was not intended to apply to combinations created by actions of a state government.²⁸ A two part test was developed by the Court in *California Retail Liquor Dealers Association v. Midcal Aluminum, Inc.*²⁹ to determine the applicability of the state action doctrine in a particular case. First, a state must clearly articulate its intent to displace competition in a particular field with a regulatory structure.³⁰ Second, under the so-called "active supervision" test, the state policy displacing competition must be enforced actively by the state itself.³¹

It is doubtful whether information-sharing practices could qualify

23. See Urban Property Protection and Reinsurance Act of 1968, Pub. L. No. 90-448, 82 Stat. 476 (1968) (codified as amended at 12 U.S.C. §§ 1701(s), 1709, 1735(d), 1749bbb (1)-(21) (1982 & Supp. III 1985)). The Act states that one of its purposes is to "encourage and assist the various State insurance authorities and the property insurance industry to develop and carry out statewide programs which will make necessary property insurance coverage against fire, crime, and other perils more readily available for residential, business, and other properties meeting reasonable underwriting standards." 82 Stat. 476, 556 (1968).

24. See *North Little Rock Transp. Co. v. Casual Reciprocal Exch.*, 85 F. Supp. 961, 964 (D. Ark. 1949) (absent contrary regulation, Sherman Act would control price fixing activities by insurance association), *aff'd*, 181 F.2d 174 (8th Cir. 1950)

25. See *Clarke, Warren-Boulton, Smith & Simon*, *supra* note 1, at 378-80; see also R.A. Winter, *supra* note 17.

26. 317 U.S. 341 (1943).

27. 15 U.S.C. § 1 (1982).

28. *Parker* held that a marketing program imposed by the state of California that restricted output of raisins did not violate the Sherman Act. "There is no suggestion of a purpose to restrain state action in the [Sherman] Act's legislative history." 317 U.S. at 351.

29. 445 U.S. 97 (1980).

30. See also *New Motor Vehicle Bd. v. Orrin W. Fox Co.*, 439 U.S. 96, 109 (1978) (following *Midcal*).

31. *Id.* at 105.

under the two pronged state action test. It is difficult to find a state intent to displace competition. The primary purpose of most state insurance codes is not to displace competition but to enhance it by preventing abuses and protecting the public.³² For example, the purpose of the New York Code is "to promote the public welfare by regulating insurance rates, . . . to promote price competition among insurers, to provide rates that are responsive to competitive market conditions, to improve the availability and reliability of insurance and to authorize and regulate cooperative action among insurers."³³ Since its provisions explicitly authorize industry cooperation in a competitive context, such cooperation might not qualify under the state action doctrine.³⁴

The second component of the state action doctrine, the active supervision test, raises even greater legal doubt. In the insurance marketplace, many states employ forms of regulation that, although they regulate rates extensively, do not completely suppress insurers' flexibility to set rates and do not require that the state approve every filing. This type of regulation may not be sufficient to invoke the state action exemption.³⁵ Insurers remain concerned that they would be subject to protracted litigation in almost every state which maintains some type of competitive rating system.³⁶

A recent FTC administrative decision involving six title insurance companies illustrates this point.³⁷ The FTC judge agreed that title insurance was not covered by the McCarran-Ferguson Act and engaged in a state-by-state examination of regulatory activities. Within weeks after the deci-

32. See *supra* note 13.

33. N.Y. INS. LAW § 2301 (McKinney 1985).

34. When the primary insurer of nurse midwives went bankrupt, the American College of Nurse-Midwives lost its blanket malpractice insurance coverage in mid-1985. When no single insurance company was willing to provide coverage, nurse midwives faced the possibility of having to terminate their operations. In the summer of 1986, however, several large insurance companies decided to form a consortium in order to provide insurance coverage to nurse midwives. This decision illustrates a form of voluntary joint agreements. American College of Nurse-Midwives, Nurse-Midwives Obtain Liability Insurance From Insurance Consortium, Press Release & Fact Sheet (July 22, 1986).

35. Insurers conducting business in states with open competition systems are allowed to file rates which are different from those recommended by the statistical reporting agency. Companies may file their rates and use them unless specifically disallowed by the state insurance commissioner. See, e.g., GA. CODE ANN. § 33-9-9 (1987).

36. Many states use an open competition system, in which a company may select any rate it wishes. Some states require that rates be approved by the state insurance department prior to use. Other states allow companies to use any rates that have been filed with the state insurance department although the insurance company may later require that the rates be amended. In 1986, New York State adopted a hybrid approach with its flex rating system. The insurance department establishes ranges within which rates may vary from the rates which the company has filed. See CUOMO COMM'N, *supra* note 5, 93-98 (1986).

37. See *In the Matter of Ticor Title Insurance Co.*, Federal Trade Commission Docket No. 9190, initial decision at 159 (Dec. 22, 1986) (WESTLAW, FABR-FTC file).

sion, class action suits were filed across the country alleging inadequate state regulation of this activity.³⁸

The pall of legal uncertainty would cause many insurers to withdraw from participation in insurance pools that encourage competition.³⁹ It would also call into legal question voluntary activities such as Marketing Assistance Plans (MAPs) which are designed to help small businesses and others find insurance in the private marketplace when they experience difficulty finding it on their own. Many state regulators have urged the industry to adopt such plans as an alternative to state run plans because they are superior and far less intrusive on private competition than joint underwriting associations. Were the McCarran-Ferguson Act to be repealed, these plans could face a legal challenge as an allegedly illegal agreement to allocate customers. Insurance companies, which make little if any profit from these activities, would certainly not want to participate knowing that they would risk spending the next several years involved in expensive antitrust litigation. State insurance commissioners would find themselves frustrated in carrying out their statutory obligation to ensure that their citizens have adequate access to insurance coverage.⁴⁰

These and other joint activities would be subject to a "rule of reason" analysis that would be reviewed by the courts on a case-by-case basis. These cases tend to be highly specialized, involving the use of expert witnesses, and are consequently very expensive to litigate. Insurers, even those convinced that they will prevail in antitrust proceedings, would probably avoid such potential litigation because of the high legal costs.⁴¹

38. By the end of January 1985, 12 class action suits were filed throughout the United States alleging that title insurance companies were violating antitrust laws. These cases were consolidated in *In re Real Estate Title & Settlement, Services Antitrust Litigation Multi-District Litigation Docket No. 633* (filed Mar. 27, 1985, E.D.Pa.). The District Court approved the settlement on June 10, 1986. The Court of Appeals affirmed on March 3, 1987, 815 F.2d 695 (3d Cir. 1987).

39. Many insurers pool their resources to provide coverage where no one company would underwrite the risk. The profits derived from such a limited participation are likely to be small. If insurers were to face the prospect of protracted and expensive antitrust litigation, they might decide not to commit their resources to underwriting a risk which promises only marginal profits.

40. See, e.g., CAL. INS. CODE § 11890 (West 1988) (obliging state insurance commissioner to ensure adequate access to insurance coverage).

41. In *United States v. United States Gypsum Co.*, 438 U.S. 422, 440-41 (1978), Chief Justice Burger wrote:

With certain exceptions for conduct regarded as per se illegal because of unquestionably anticompetitive effects . . . the behavior proscribed by the [Sherman] Act is often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct. Indeed, the type of conduct charged to the incident in this case—the exchange of price information among competitors—is illustrative in this regard. The imposition of criminal liability on a corporate official, or for that matter on a corporation directly, for engaging in such conduct which only after the fact is determined to violate the statute because of anticompetitive effects, without inquiring into the intent with which it was undertaken, holds out the distinct possibility of overdeterrence; salutary and pro-competitive conduct lying close to the borderline of impermissible conduct might be shunned by businessmen who chose to be excessively cautious in the face of uncertainty regarding possible exposure to criminal punishment for even a

In these conditions, many insurers might decline to participate with others in jointly underwriting catastrophic risks, hazardous activities, and liability coverage. Repealing the McCarran-Ferguson Act, therefore, would tend to restrict rather than increase the availability of coverage for those classes of policyholders that have the most difficulty obtaining it.

Conclusion

Competition has flourished in the insurance industry since the McCarran-Ferguson Act was passed forty-five years ago. While it must be acknowledged that in selective lines of business coverage may be difficult to obtain, this problem has arisen not because of a lack of competition, but because sweeping changes in our tort system have made the activity nearly uninsurable.⁴²

Proponents of the repeal of the McCarran-Ferguson Act have failed to realize that the state action doctrine would not allow the continuation of the joint activities which actually promote competition within the insurance industry. The McCarran-Ferguson Act allows regulators to choose whatever form of regulation they find most satisfactory. Its elimination would send a message to state regulators that if they wished to retain full jurisdiction over the insurance industry, they must revise their laws in such a way as to adopt the most restrictive, anticompetitive form of regulation possible. Years of legal uncertainty would certainly ensue, the public interest would undoubtedly be injured, and small insurance companies, lacking access to necessary data, would be forced to withdraw from the marketplace.

Clarke, Warren-Boulton, Smith, and Simon have written a thoughtful, valuable contribution to this symposium. While their analysis of the state action doctrine is somewhat abbreviated, they have added considerably to our understanding of the real reasons for the liability crisis.

good-faith error of judgment.

42. See TORT POLICY REPORT, *supra* note 4 at 30-52.

