The Damaging Effect of Regulation of Insurance by the Courts

NAMIC®

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

The National Association of Mutual Insurance Companies (NAMIC) is a full-service national trade association with more than 1,300 member companies that underwrite 40 percent ($123 billion) of the property/casualty insurance premium written in the United States. NAMIC's membership includes five of the 10 largest property/casualty carriers, every size regional and national property/casualty insurer and hundreds of farm mutual insurance companies. NAMIC benefits member companies through government relations, public affairs, education, arbitration services, professional liability insurance and employee benefit programs.

Acknowledgements

The notion that people should be able to rely on the law is so fundamental that it should not have to be defended. Yet, tort litigation over the last decade has begun to erode this obvious truth. When a court steps outside its traditional role of resolving individual disputes, and places itself in the shoes of legislators or regulators, our ability to rely on the letter of the law is shaken. This is particularly true of the insurance industry because it is so heavily regulated. If we cannot presume that a practice authorized by a legislature or approved by a regulator is legal, then there are grave implications for the rule of law. However, the problem is not only legal. The ill effects of "regulation through litigation" can damage entire markets, affecting everyone - including consumers.

We have two objectives in publishing this paper:

1. To raise public awareness about the dangers of regulation through litigation, making it a vital part of the civil justice reform public policy debate, and
2. To pursue passage of the Fair Notice and Market Stability Model Act, so that insurers may once again rely on the law.

We must emphasize that the American civil justice system has worked remarkably well throughout our nation's history, and it must continue to ensure that injured people are properly compensated. Most courts understand and honor this principle. They play an indispensable role in administering justice and ensuring that people may rely on the laws as written. Our intent is to restore the balance that has served us so well for so long.

This paper was written by Peter Bisbecos, NAMIC's Director of Legal and Regulatory Affairs, with the expert assistance of Victor Schwartz and his staff at the law firm of Shook Hardy & Bacon. Peter's experience as a lawyer and litigator and his zeal for restoring equilibrium to the legal system made this paper a reality. Victor is a legal scholar, and one of the leading voices in the nation on civil justice reform. His contributions to this paper, and his guidance, have been invaluable.

Finally, this paper would not have been possible without the wisdom and guidance of NAMIC members. We owe much of our common sense approach to members who asked the fundamental questions that drew our attention to this problem. We owe special thanks to the NAMIC Civil Justice Reform Public Policy Group. This is a group of dedicated NAMIC members, already serving on other committees, who agreed to give their time to this effort. They reviewed the paper at various stages and provided thoughtful guidance that has made this a much better product than would otherwise have been the case.

Charles M. Chamness
Executive Vice President

Table of Contents

The Damaging Effect of Regulation of Insurance by the Courts

By

Peter A. Bisbecos

Victor E. Schwartz

Executive Summary

The central role of lawmakers, regulators, and the courts is to ensure that markets function freely, creating an environment where citizens may rely on the rules. When a court renders a decision that unexpectedly alters a law, it steps imperfectly into the shoes of a regulator and shatters the public confidence in the law's reliability. These decisions are imposed on people who were not parties to the litigation – without notice, public debate, or consideration of broader public policy implications. In some instances, state officials charged with enforcing the insurance laws are not even parties to the lawsuit that may overrule their regulatory determinations. Further, because courts must write decisions within the factual context presented by the parties, a decision's broader application may be unclear. Since courts are not allowed to cure the uncertainties caused by their decisions, the most likely consequence is more litigation. In short, because courts are inherently ill-equipped to regulate, their regulatory intervention creates a void, or an absence of law, for which there is currently no solution.

Insurance is particularly sensitive to such changes because it is founded on contractual agreements that are dependent on the regulatory structure of each state. Increasingly, insurers are being sued for legal conduct. If insurers can't rely on regulations, and can be held liable for legal conduct, laws and regulations become meaningless, markets are destabilized, and insurance availability will be damaged. In this unstable environment, a few major decisions can have a significant impact. Even though the vast majority of liability insurance claims are settled out of court, the verdicts on the relatively small number of disputed cases drive settlements. A huge verdict on a close case can drive up the costs of claims, and thus premiums, in a whole marketplace.

This is exactly what happened after the Illinois Supreme Court decided against State Farm's use of non-original equipment manufacturer (non-OEM)[1] parts in repairing damaged cars. The use of non-OEM parts is a common practice, and is even required in some states. It creates competition that has driven down the cost of auto repairs. After this stunning ruling, many insurance companies, not even parties to the litigation, discontinued the use of non-OEM parts because they no longer knew what risks they would face. A court decision made in one state had a national impact, created legal uncertainty, forced insurers to act defensively, and ultimately increased the cost of auto insurance.

A plaintiff's attorney, who recently won a $225 million asbestos judgment against U.S. Steel, inadvertently exposed the problem of courts being used as regulators. When asked why the jury awarded so much money, he said: "I think they were incensed and they wanted to send a message not just to U.S. Steel, ***but to every employer in the country*** [emphasis added] – that you cannot poison your workers."[2] Nobody condones the poisoning of workers, but it is not the place of a jury in Illinois to send a message to every employer in the United States of America. This over-reaching has an enormously destructive force.

Most judges render fair decisions based on the framework of existing law. A few excesses by some courts, however, have upset the balance of government authority and harmed insurers and insureds alike. In order to restore this historical balance, NAMIC is offering the "Fair Notice and Market Stability Model Act." This model legislation would cure the problems cited above without hindering access to the courts by people with legitimate claims. The Act would:

Eliminate uncertainty by requiring regulators to immediately issue new regulations when a regulation is stricken down by a court, or to issue an emergency regulation when a statute is stricken down and the legislature is not in session.

---

[1] *See* Avery v. State Farm Mut. Auto Ins. Co., No. 97-L-114, 1999 WL 955543 (Ill. Cir. Ct. Oct. 8, 1999) (addressing breach of contract claim); Avery v. State Farm Mut. Auto Ins. Co., No. 97-L-114, 1999 WL 1022134 (Ill. Cir. Ct. Oct. 8, 1999) (addressing claims for breach of consumer fraud statute); *see generally* Victor E. Schwartz & Leah Lorber, *State Farm v. Avery: State Court Regulation Through Litigation Has Gone Too Far*, 33 CONN. L. REV. 1215 (2001) (concluding that "[t]he Avery case clearly illustrates how well-meaning state judges and juries can go awry when they attempt to set nationwide public policy").

[2] See Tresa Baldas, *The Art of Harnessing a Jury's Anger*, THE NATIONAL LAW JOURNAL, April 21, 2003, 4/21/03 Nat'l L.J. B5, (Col. 1).

1. Provide insurers with defenses when their conduct was compliant with a statute, regulation, finding, order, or emergency regulation, or when the law is unclear due to a judgment.

2. Prohibit the use of a judgment in a different state if the laws conflict or the facts differ materially.

With this model act in place, courts will continue to provide relief to injured and aggrieved individuals without harming innocent bystanders.

Introduction

The United States Supreme Court recently decided the case *State Farm Mutual Automobile Insurance Co. v. Campbell*,[3] holding that a $145 million punitive damages award was so grossly out of proportion to the $1 million compensatory damage award that it violated State Farm's right to due process of law under the Fourth Amendment of the Federal Constitution.[4]

State Farm was assessed with this massive award after it declined to settle a third-party automobile liability lawsuit within the policy limits in light of a strong liability defense. Over the company's objections, the trial court improperly allowed plaintiffs' counsel to introduce evidence of numerous out-of-state, unrelated acts of alleged misconduct on the part of State Farm. Playing up this evidence in the closing argument, the plaintiff's attorney told the jurors that they were the only regulators of insurance – the *only* ones who could stop State Farm from engaging in similar misconduct in the future.

Counsel's argument about the jury's role was clearly false. Unfortunately, its use and success reflects a growing problem faced by insurers and policyholders: the emergence of trial lawyers, courts and juries as regulators. As one commentator wrote:

> *Once upon a time, in a land now far, far away, regulating corporate conduct was seen as the duty of elected representatives and their designees. No more. In the last two decades, trial lawyers have supplanted government regulators and labor unions as the bedevilers-in-chief of corporate America. And the heaviest cudgel the trial lawyer swings is the threat of huge punitives.*[5]

While the Campbell decision should reduce the threat posed by punitive damages, the role of courts in the insurance regulatory system remains a source of serious concern.

Why does the intrusion of trial lawyers into the realm of regulation continue to pose a problem? We all agree that wrongful acts should be punished appropriately. It is, however, a foundation of our system of justice and government that laws are made by legislatures; regulations are made by the executive branch; while the judicial branch is charged with interpreting and applying those

---

3 *See* State Farm Mutual Auto. Ins. Co. v. Campbell, 2003 WL 1791206 (US), 2001 WL 1246676 (Utah Oct. 19, 2001), *cert. granted*, 122 S. Ct. 2326 (2002). Decided April 7, 2003.

4 Campbell.

5 Douglas McCollam, *Damaging Justice*, WALL ST. J., Oct. 31, 2002, at A18.

laws and regulations in particular cases. Fairness requires that people and corporations be able to understand, and rely on, the established rules of law by which their conduct is measured. The Supreme Court addressed the notion that people should be able to rely on the law in Campbell: *"… the point of due process – of the law in general – is to allow citizens to order their behavior"*.[6] This statement speaks volumes about the fundamental need for a well-defined, orderly and reliable regulatory structure.

The central role of lawmakers, regulators, and the courts is to ensure that markets function freely, creating an environment where citizens may rely on the rules. When a court renders a decision that unexpectedly alters a law, it steps imperfectly into the shoes of a regulator and shatters the public confidence in the law's reliability. These decisions are imposed on people who were not parties to the litigation – without notice, public debate, or consideration of broader public policy implications. In some instances, state officials charged with enforcing the insurance laws are not even parties to the lawsuit that may overrule their regulatory determinations. Further, because courts must write decisions within the factual context presented by the parties, a decision's broader application may be unclear. Since courts are not allowed to cure the uncertainties caused by their decisions, the most likely consequence is more litigation. In short, because courts are inherently ill-equipped to regulate, their regulatory intervention creates a void, or an absence of law, for which there is currently no solution.

When confidence in the law is destroyed, markets cannot function properly. When insurers have confidence in the system, they will take calculated risks so that products will reflect consumer needs and choices. But, when courts begin to act like regulators, insurers are forced to act conservatively, or worse – defensively. As one commentator noted:

> *A legal system needs multiple lines of defense against miscarriages of justice, and historically the jury has had few rivals as a way of protecting defendants from overweening official power. But like any other part of government, a jury can pose a danger to liberty when it begins wielding government power in an affirmative way, as when it extends legal liability into new areas or inflicts arbitrary damage awards. A*

[6] Campbell, page 6.

> *mechanism that works extremely well as a brake may lead to disaster when pressed into service as an accelerator.*[7]

Insurance is particularly sensitive to such changes because it is founded on contractual agreements dependent on the regulatory structure of each state. If insurers can't rely on regulations and can be held liable for legal conduct, laws and regulations become meaningless, markets are destabilized, and insurance availability will be damaged. Increasingly, insurers are being sued for conduct that is legal under the current regulatory structure. In this unstable environment, a few major decisions can have a significant impact. Even though the vast majority of liability insurance claims are settled out of court, it is the verdicts on the relatively small number of disputed cases that drive settlements. A huge verdict on a close case can drive up claims costs, and thus premiums, in a whole marketplace.

Most judges render fair decisions based on the framework of existing law. A few excesses by some courts, however, have upset the balance of government authority and harmed insurers and insureds alike. The resulting lack of confidence in the law impairs market function, forcing insurers to act defensively – resulting in unaffordability or even unavailability of insurance products. This is what happens when insurers cannot *order their behavior*.

The Role of Courts: Arbiters not Regulators

Courts, serving in their traditional role as impartial arbiters, are indispensable in maintaining strong insurance markets. Courts are designed, and well-equipped, to serve as impartial arbiters in legal disputes. While their structure makes them ideal for this role, it denies them the tools necessary to be good regulators. A brief discussion of their structure and functions as compared to regulators proves that courts and juries serve best as arbiters rather than regulators.

The Role of Regulators

The role of regulators is to make policy judgments that implement the expressed will of the legislature. In the insurance industry, regulators have particularly wide-ranging authority. For example, in Iowa, the commissioner of insurance has "general control, supervision, and direction

---

7 Walter K. Olson, *Courting Stupidity, Why Smart Lawyers Pick Dumb Jurors*, REASONONLINE, Jan. 2003, *available at* <http://www.reason.com/0301/fe.wo.courting.shtml>.

over all insurance business transacted in the state, and shall enforce all the laws of the state relating to such insurance."[8] The breadth of this directive is common among the states and the scope of state insurance laws is similarly broad. Insurance regulators are responsible for addressing a diverse assortment of public policy concerns, ranging from overseeing the solvency of insurers licensed in their states to protecting consumer interests. They are to act after having considered the best interests of society as a whole.

Regulators are chosen because they have "knowledge of the insurance industry."[9] Whether appointed or elected, regulators must have specialized expertise that will enable them to perform their critical responsibilities in a professional manner. Their expertise is increased through regular interactions with insurers, consumers and other interested parties.

Regulators must consider far-reaching and complex public policy issues related to insurance. They play an active role in gathering information before making public policy decisions. Regulators can obtain a wide variety of views on the issues from industry and consumers alike. For instance, in Illinois, the director of insurance is empowered *"to conduct such examinations, investigations and hearings in addition to those specifically provided for, as may be necessary and proper for the efficient administration of the insurance laws of this State."* [10] Regulators also can act when they find that a problem is developing – they are not required to wait until a formal proceeding is initiated.

In Texas, the approach to the issue of so-called "toxic mold" provides a good example of the breadth and flexibility of a regulator's decision-making authority. While there are mixed feelings about the outcome of the regulatory actions in Texas related to mold, the process employed by the insurance commissioner shows that regulators are best suited to address major issues of public policy. Unlike a court, the Texas Department of Insurance was not required to wait for the initiation of formal action to get involved with this issue. When Texas consumers began to face the prospect of an availability crisis in their homeowners insurance market, the Department of Insurance began to use its policymaking apparatus to restore the market's balance.

---

[8] IOWA CODE ANN. § 505.8, *see also* 18 DEL. CODE § 310.

[9] *See* IND. CODE § 27-1-1-2.

[10] 215 ILL. COMP. STAT. 5/401 (c)

The crisis was sparked in 2001, when Farmers Insurance Group was assessed $32 million in damages after a trial alleging that the company's delay in repairing a plumbing leak led to mold infestation at an Austin home.[11] During the trial, the company asked Texas Insurance Commissioner Jose Montemayor to eliminate mold damage coverage from all Texas homeowner policies, saying that its mold-related claims had skyrocketed in recent months.[12] Before making a decision, Commissioner Montemayor held four public hearings [13] – 600 to 700 people attended the first public hearing and 73 people testified. [14] He asked the five largest homeowners insurance carriers in Texas to report their mold-related losses to the state so the information could be analyzed in developing new rules on mold coverage.[15] He appointed an *Advisory Task Force for Mold-Related Claims* with 19 members to develop recommendations on how insurers should respond to claims for water and mold damage.[16]

Once the public debate is complete, regulators then make laws prospectively, which gives the public and the industry fair notice about significant changes. As a result of the state's analysis of mold claims, Commissioner Montemayor expanded the options for homeowners insurance in Texas by allowing State Farm, USAA, Allstate and Farmers to begin selling a basic homeowners policy that is sold in other states.[17] These decisions were intended to increase the availability of insurance and reduce premiums. With regard to State Farm, for example, premiums for a basic

---

11 *See* Laura Goldberg et al., *Year in Review 2001*, *Houston's Top Business Stories*, Houston Chron., Dec. 31, 2001, at 1. An appeals court subsequently reduced the award, throwing out the $17 million punitive damages award and suggesting that the $9 million attorney fee award be recalculated and likely reduced. *See* Michael Ha, *Texas court lowers record mold award*, NAT'L UNDERWRITER PROP. & CASUALTY-RISK & BEN. MGMT., Dec. 23, 2002, at 9.

12 *See* Goldberg, *supra* n. __.

13 Press Release, Tex. Dep't of Ins., *Montemayor Protects Consumer Choice, Availability of Mold Coverage* (Nov. 28, 2001), *available at* <http://www.tdi.state.tx.us/commish/mold.html>.

14 *See Mold Infestation Hearing Attracts Hundreds in Texas*, BEST'S REV., Aug. 1, 2001, at 16.

15 *Id*; Terence Stutz, *Texas' Second-Largest Property Insurer to Halt New Homeowners' Policy Sales*, KNIGHT-RIDDER TRIB. BUS. NEWS, July 31, 2001.

16 Press Release, Tex. Dep't of Ins., *Mold Task Force Members Appointed* (Jan. 11, 2002), *available at* <http://www.tdi.state.tx.us/commish/mold.html>. The activities of the task force led to something else that a court could never do: dissemination of information and instructions to the impacted industry. Commissioner Jose Montemayor sent a letter to all property and casualty insurers in Texas with a copy of a mold claims handling brochure developed by the task force. *See* Letter to P&C CEOs Re: Effectively Handling Water Damage and Mold Claims (Apr. 12, 2002) *available at* <http://www.tdi.state.tx.us/commish/mold.html>.

17 *See* Claudia Grisales, *USAA No-Mold Policy Gets Approval*, AUSTIN AM.-STATESMAN, May 23, 2002, at C1.

homeowners policy without mold coverage were expected to be as much as 41 percent lower than a policy with full mold coverage.[18]

The Role of Courts

Courts have a unique role that is independent from regulators. Courts were designed and intended to resolve specific cases and controversies between identifiable parties.[19] Their work may only begin when a plaintiff initiates judicial proceedings by filing a complaint and serving process. The complaint identifies specific issues explaining how the plaintiff was aggrieved and identifies the parties allegedly responsible for the injury. The defendant files an answer denying the allegations and, in some instances, raises allegations of its own. It is from this narrow basis that the court defines the issues in a lawsuit.

Judges and juries are not well-equipped to resolve wide-ranging, complex public policy issues as they do not get a broad view of a public policy problem. Their background and knowledge are limited to arguments from opposing counsel who seek to advance purely private interests. This information is carefully tailored so that it is relevant to a narrow series of facts and supports the position of the presenting party. For a variety of reasons, not all relevant evidence regarding an individual case is presented to the jury.[20] Moreover, it's unlikely that judges and jurors will have the substantive expertise with the insurance market, the industry or its practices that is essential to making strong public policy decisions.[21]

Unlike legislators and regulators, judges and juries "make law" retroactively. When judges substantially change legal principles or create new ones in the course of a lawsuit, they apply to

---

18 Press Release, Tex. Dep't of Ins., *Montemayor Expands Options for Homeowners* (Mar. 8, 2002)*, available at* <http://www.tdi.state.tx.us/commish/mold.html>.

19 *See* U.S. CONST., art III., § 2, cl.1.

20 *See, e.g.*, FED. R. EVID. 403 ("Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by consideration of undue delay, waste of time, or needless presentation of cumulative evidence.").

21 Whether elected or appointed, "the principal qualifications for judges are a competent mastery of the law, good moral character, intelligence, impartiality, emotional stability, courtesy, decisiveness, and administrative ability, plus a high level of education and expertise." *See* Mark A. Behrens & Cary Silverman, *The Case for Adopting Appointive Judicial Selection Systems for State Court Judges*, 11 CORNELL J. L. & PUB. POL'Y 273, 277 (2002) (internal quotations omitted). Jurors, by definition, are supposed to be representative of a "fair cross section" of the community, *see* 28 U.S.C. § 1861, and those with special expertise in the insurance industry may actually be excused from service.

the parties even though the parties may have had no reason to anticipate a change and could not shape their behavior to accommodate them. Similarly, juries that impose multimillion-dollar damages awards as a way to “change” corporate behavior also regulate that behavior in hindsight. In short, the practice that some have called “regulation through litigation” creates both notice and fairness problems.

What is an Insurance Market, and Why is this Important?

Because of the consequences that regulation plays out in insurance markets, it is necessary to understand what insurance markets are and how they function. Insurance markets exist in every state and the District of Columbia and are governed by laws and regulations unique to each jurisdiction. The purpose of an insurance market is to provide a systematic and reliable mechanism within which insurers and policyholders can do business.

The key players in an insurance market are insurance companies, consumers, regulators, lawmakers, and the courts. Insurance companies provide financial protection to consumers for a defined risk. They accomplish this by assessing the nature of the risk and the potential for a claim. Regulators and lawmakers create and oversee the legal structure in which these transactions occur. As suggested above, courts should settle individual disputes by enforcing the laws as written.

Structure and Desirable Qualities

Markets that support (or at least don’t interfere with) competitive pricing consistently provide the best insurance environment – consumers enjoy moderate to low rates, and have a large numbers of insurers from which to choose. Interference with competitive pressure may come in the form of legislation, regulation or court decisions. While this paper’s focus is on the damage that occurs when courts act like regulators, it would be out of context without a general discussion of the impact that regulations have on markets.

Ideally, laws and regulations should focus on:

1. Protecting and sustaining competitive markets.
2. Monitoring the solvency and conduct of insurers licensed in that market.

3. Providing stability so that insurers and consumers may rely on the law.

Protecting and Sustaining Competitive Markets

Insurance in a competitive market is very much like a mirror; the premium charged for a risk reflects its cost and nature. As policyholders take measures to reduce risk, their premiums are reduced as well. Where competition is encouraged by law, it:

> *… creates strong incentives for insurers to forecast costs accurately and to price and underwrite each policyholder so as to avoid adverse selection. Thus, competition produces highly refined underwriting and classification systems. Prices vary across insurers in relation to the stringency of classification and underwriting standards. The pressure for increased accuracy is relentless. Insurers that predict claim costs better than their competitors prosper. Insurers that respond slowly end up insuring a disproportionate volume of business at inadequate rates; they lose money and either take corrective action or disappear.*[22]

When a market lacks these qualities, companies cannot afford to act like competitors because they must take defensive measures. Writing about the homeowners insurance market crisis in Texas, which soon may be subject to strict regulation, former Illinois insurance director Nathaniel Shapo said: *"[f]earing insolvency, the national carriers are carefully selling insurance in Texas through single-state subsidiaries, protecting their national surplus from a dangerous and unpredictable market and preparing their withdrawal from Texas."*[23]

Illinois and South Carolina have created reliable markets that protect competition. Consider the results:

> *As a result of reform legislation enacted in 1997, South Carolina has now experienced notable success with modernizing its rating laws. During the first half of the 1990s, an average of 59 insurers did business in the state while other southeastern states averaged 197 insurers. After the 1997 reforms, South Carolinians benefited from the choices provided by almost twice as many insurers and by a dramatic drop in the size of the residual market.*[24]

---

22 Scott Harrington, *Repairing Insurance Markets*, REGULATION (Summer 2002).

23 SHOPPING FOR A SOLUTION, EFFECTIVE CONSUMER PROTECTION THROUGH COMPETITIVE REGULATION OF INSURANCE RATES, (2003) Nathaniel S. Shapo, The Texas Public Policy Foundation, www.TexasPolicy.com

24 MARTIN F. GRACE, ROBERT W. KLEIN & RICHARD D. PHILLIPS, AUTO INSURANCE REFORM: SALVATION IN SOUTH CAROLINA (2001), *available at* http://rmictr.gsu.edu/Papers/SC_Auto_Salvation_4-15-01.pdf ; *see also* Scott Harrington, *Repairing Insurance Markets*, REGULATION (Summer 2002) (discussing the success of the South Carolina reform).

Illinois has not required approval of auto insurance rates since 1969, so insurers are able to compete. This has created a stable and reliable market with impressive results. Premiums remain stable with Illinois ranking in the middle of all states in average personal expenditures. In 1999, Illinois ranked 30th in the nation in the cost of auto insurance.[25] Residual markets are small because insurance is affordable and available.[26] Consequently, Illinois attracts the largest share of private passenger auto and homeowner insurers in the nation.[27]

The Illinois and South Carolina competitive markets prove that regulatory structures, which encourage competition, provide a reliable environment so that insurers may *order their behavior*, and create the most desirable insurance markets for consumers.

Monitoring the Solvency and Practices of Insurers Licensed in that Market

Appropriate regulation prohibits bad acts and oversees solvency, but does not interfere with competitive pressure. It is not necessary for regulations to control the product creation and pricing practices of insurers since *"… consumers today are able to effectively shop for price,* [and the] *government's scarce resources should be budgeted on areas like solvency, market conduct, and forms, where consumers cannot protect themselves without active state oversight."*[28] In fact, the former Insurance Commissioner of Illinois, Nathanial Shapo, refers to solvency regulation, or the verification that insurers have the financial resources necessary to pay claims, as "the ultimate consumer protection."[29] By ensuring that insurers can pay for their promises, solvency regulation supports competitive markets without interfering with competitive pressures.

Another excellent example of regulation that protects consumers and supports the function of the market is embodied in a proposal currently working its way through the National Association of

---

25 National Association of Insurance Commissioners, 1999 Average Auto Insurance Premium Comparison by State.

26 *Id*.

27 For a discussion of Illinois' competitive rating environment, *see* Phillip R. O'Connor & Eugene P. Esposito, *Modernizing Insurance Regulation: Tacking to the Winds of Change*, Apr. 26, 2001.

28 SHOPPING FOR A SOLUTION, EFFECTIVE CONSUMER PROTECTION THROUGH COMPETITIVE REGULATION OF INSURANCE RATES, (2003) Nathaniel S. Shapo, The Texas Public Policy Foundation, www.TexasPolicy.com

29 Id.

Insurance Commissioners (NAIC) Market Regulation and Consumer Affairs (D) Committee.[30] This regulatory process, developed cooperatively by regulators and industry representatives, would improve the manner in which most state insurance regulators conduct examinations of insurance companies. The standard approach today is that a regulator chooses an insurer, either randomly or on a rotation basis, and conducts an in-depth review of the insurer's operations. This examination occurs even if all parties agree that the insurer has been a model citizen. In many instances, it occurs despite limited regulatory resources and inappropriate behavior by other insurers. The proposal under consideration by the NAIC would enable regulators to focus on a company based on its conduct, improving a state regulator's ability to protect consumers. If adopted, conduct-focused regulation would reinforce strong markets by accomplishing a valid regulatory function without interfering with competitive rating practices.

Providing Stability so that Insurers and Consumers Can Rely on the Law

Insurers must be able to rely on the written law. Absent such stability, they cannot predict the consequences of their actions, and a free market cannot exist. Unfortunately, in some jurisdictions, the civil justice "system" is reducing this needed predictability through retroactive lawmaking. The consequence is that insurers are having second thoughts about doing business in these jurisdictions.

A Harris Poll of senior attorneys at major corporations found that 78 percent of respondents report that the litigation environment in a state could affect important business decisions at their company such as where to locate or do business.[31] This survey is particularly relevant because executive-level corporate counsel are primarily responsible for their client's perceptions of a state's litigation environment. Delaware, which received the best rating in the Harris Poll, posts this survey on the Internet. Its decision to do so is evidence of the state's recognition that markets are sensitive to these perceptions.

The corporate perceptions reported by Harris are further borne out in a study by the American Tort Reform Association (ATRA), a bipartisan coalition of more than 300 businesses,

---

30 This proposed process is currently in the pilot phase.

31 U.S. Chamber of Commerce, STATE LIABILITY SYSTEMS RANKING STUDY, FINAL REPORT, 8 (Jan. 11, 2002), *available at* http://courts.state.de.us/superior/docs/liabilities_survey.pdf.

corporations, municipalities, associations and professional firms that support civil justice reform. In a paper highlighting judicial excesses, ATRA reports that a member survey identified the most plaintiff-friendly jurisdictions in the country.[32] These jurisdictions are aptly named "judicial hellholes," because they are places where defendants believe that rules of law are not applied in a fair and evenhanded manner.[33] Four of the six states identified as having locations that are judicial hellholes, Mississippi, Louisiana, Texas and California, are also listed in the Harris Poll as four of the six worst litigation climates in the country for business.

These deep corporate concerns are translating into corporate action. AIG President and Chairman Maurice Greenberg recently addressed the need for politicians from states with the most egregious legal systems to embrace tort reforms. He asked, "Why should we invest in their states or buy their municipal bonds? They're not going to get re-elected if their state has an absence of investors in their state. … We have to be pragmatic about how we're going to get tort reform."[34] Companies like AIG are considering this kind of action because out-of-control legal systems have damaged the markets, making business increasingly difficult. If this were a mere irritation, corporations might just "talk tough." The fact that they are acting proves that they are deeply troubled by activist courts.

Another consequence of an inability to rely on the law is an increasing uncertainty about the future costs of damages. One estimate of the costs imposed by the U.S. court system was $205 billion in 2001, a 14.3 percent increase over the previous year.[35] In the last fifty years in the U.S., "tort costs have increased 100-fold," while "overall economic growth, as measured by gross domestic product (GDP), has grown by a factor of 34 and the population has grown by a factor of less than two."[36] The statistics for 2002 are not encouraging:

> *Comparing this year's [2002] top 50 verdicts with last year's, jurors awarded punitives in the same number of cases, 22. But this year they awarded 10 times the amount: $32 billion compared with $3.2 billion. It's true that most of the 2002 amount came in one*

---

32 In this instance jurisdictions are counties, not states.

33 American Tort Reform Association, BRINGING JUSTICE TO JUDICIAL HELLHOLES (2002), *available at* http://www.atra.org/reports/hellholes/report.pdf

34 Lee McDonald, *Greenberg: It's Not Easy Being AIG*, BESTWEEK, Feb. 17, 2003.

35 TILLINGHAST-TOWERS PERRIN. U.S. TORT COSTS: 2002 UPDATE, TRENDS AND FINDINGS ON THE COSTS OF THE U.S. TORT SYSTEMS (2002).

36 *Id*.

huge case, but so did most of the 2001 amount. Eliminate the biggest cases each year and the more recent punitives are 20 times the previous year's.[37]

While the Campbell decisions should curb the growth of punitive damages, it does not address other contributing factors, including compensatory damages and the cost of defending new theories of liability.

The growing size of damage awards is not the only problem faced by insurers. The types of lawsuits brought are expanding as well. In an article discussing the coming legal storm threatening sport utility vehicle (SUV) manufacturers, one author states:

"But why now? Is there something about the law or the facts that suddenly makes the legal case against SUVs compelling? The answer is that these suits have less to do with the law and the facts than with the social climate."[38]

The new fast food lawsuits are another example. A plaintiff filed a lawsuit in New York naming McDonald's, Burger King, Wendy's, and Kentucky Fried Chicken as defendants on the theory that these companies sold high fat, addictive foods.[39] He told a reporter:

"I trace it all [my health problems] back to the high fat, grease and salt, all back to McDonald's, Wendy's, Burger King – there was no fast food I didn't eat, and I ate it more often than not because I was single, it was quick and I'm not a very good cook. . . . It was a necessity, and I think it was killing me, my doctor said it was killing me and I don't want to die."[40]

His lawyer soon followed up by filing a punitive class action with three obese teenagers as lead plaintiffs.[41] While the teenagers' original suit was dismissed,[42] they subsequently filed a new complaint, alleging that McDonald's deceptively markets its food and has made children fat.[43] Fast foods are legal, and it is common knowledge that some of them are high in fat. These suits challenge the notion that people are responsible for their own conduct. The resulting uncertainty

---

37 *See* David Hechter, *Huge Jury Awards in 2002*, NAT'L L.J., Feb. 19, 2003, *available at* <http://www.law.com/jsp/article.jsp?id=1043457951689>.

38 *See* Daniel Akst, *The Lawyers Are Lurking Over S.U.V.'s*, N.Y. TIMES, Feb. 14, 2003.

39 *See* Michael Y. Park, *Ailing Man Sues Fast-Food Firms*, Foxnews.com, July 24, 2002, *available at* <http://www.foxnews.com/story/0,2933,58652,00.html>.

40 *Ailing Man Sues Fast Food Firms*, *available at*<http://www.foxnews.com/story/0,2933,58652,00.html>.

41 *See* Ellen Sorokin, McDonald's marketing cited for teens' obesity, WASH. TIMES, Sept. 10, 2002, *available at* < http://www.washtimes.com/national/20020910-75514038.htm>.

42 *See Pelman v. McDonald's Corp.*, 02 Civ. 7821 (RMS) (S.D.N.Y. Jan. 22, 2003).

43 *See McDonald's Blasts New Obesity Lawsuit*, Feb. 21, 2003, ABCnews.com, <http://abcnews.go.com/wire/Business/reuters20030220_709.html>.

makes it difficult for insurers to predict the risk, and therefore the right price, of providing liability coverage.

Given such lawsuits, how can an insurer calculate a risk in today's climate? Insurers are left wondering whether yesterday's $200 damage might cost $4,000 today, and whether today's legal conduct might lead to tomorrow's big stakes lawsuit. These uncertainties have combined to leave the insurance market suffering from increasing instability. If this trend continues unchecked, insurers will be increasingly unable to assess the cost of a risk. The resulting uncertainty will lead to more expensive insurance rates. In this tailspin scenario, consumers are the ultimate losers.

What Has Happened?

Most state courts respect the role of insurance regulators and give them the opportunity to fulfill their responsibilities. In some instances, though, some courts have taken on the role of regulators. In so doing, they have increased the cost of insurance. Here are some examples.

Requiring Use of Original Equipment Manufacturer Parts

Avery v. State Farm,[44] an Illinois case regarding the use of aftermarket automobile parts in lieu of original equipment manufacturer (OEM) parts, exemplifies the growing trend of courts usurping the role of regulators. *Avery* aptly illustrates how plaintiffs' lawyers persuaded a court to limit the use of generic parts and confine the non-safety related automobile replacement market to equipment made by the automobile's original equipment manufacturer – after Congress, state legislators and state regulators refused to impose such a limitation.

The use of generic auto parts in repairs has a hard-fought history. During the 1970s, OEMs were the sole source of crash parts; they set the prices, and the price of these non-competitive crash parts rose at a rate sharply steeper than the price of competitive parts. Once insurers and

---

[44] *See* Avery v. State Farm Mut. Auto Ins. Co., No. 97-L-114, 1999 WL 955543 (Ill. Cir. Ct. Oct. 8, 1999) (addressing breach of contract claim); Avery v. State Farm Mut. Auto Ins. Co., No. 97-L-114, 1999 WL 1022134 (Ill. Cir. Ct. Oct. 8, 1999) (addressing claims for breach of consumer fraud statute); *see generally* Victor E. Schwartz & Leah Lorber, *State Farm v. Avery: State Court Regulation Through Litigation Has Gone Too Far*, 33 CONN. L. REV. 1215 (2001) (concluding that "[t]he Avery case clearly illustrates how well-meaning state judges and juries can go awry when they attempt to set nationwide public policy").

consumers sought alternatives to the high cost of fixing damaged cars using only parts supplied by the automakers, the aftermarket parts industry surged. On average, generic parts were 60 percent cheaper than those made by the automakers.[45] As a result of competition from after-market suppliers, prices of many OEM parts decreased substantially, while prices in non-competitive markets continued to increase.[46]

OEMs aggressively sought to respond to the threat to their monopoly. After failing to obtain help in Congress, they turned to the states. Despite a continuous battle throughout the 1980s and 1990s, not one state legislature prohibited the use of non-OEM parts. In 1999, the auto industry targeted 23 states for a range of restrictive legislation and was unsuccessful in all of them.[47] As a result, by either statute or regulation, the majority of states expressly permit insurers to specify non-OEM parts. In fact, to promote competition and keep prices down, some states actually require that insurers use non-OEM parts.

With federal and state legislators and regulators refusing to act, plaintiffs' lawyers sought to wage their generic parts battle in the courts. Prior to *Avery*, no court had prohibited the use of non-OEM parts. Courts in other jurisdictions that were asked to consider whether to certify a nationwide class on this issue "got it right" and declined to do so.[48] But the *Avery* court arbitrarily applied Illinois law and granted *ex parte* certification of a national class of 4.7 million State Farm policyholders in 48 states and the District of Columbia on the same day the complaint was filed. In certifying a nationwide class, the court failed to account for the variations in state laws regarding the use of OEM parts. By imposing a $1.2 billion judgment (including $600 million in punitive damages) on State Farm for using generic auto parts, the judge and jury effectively set a new nationwide standard for the insurance industry to meet when repairing automobiles.

---

45 *See Mandating A Car Parts Monopoly*, CHI. TRIB., Oct. 10, 1999, at H16.

46 *See* John C. Bratton & Stephen M. Avila, *After Market Crash Parts: An Analysis of State Regulations*, J. OF INS. REG. 150, 169 & table 8 (showing historical OEM and non-OEM parts prices for several makes of automobiles).

47 *See, e.g.*, Letter to Alabama State Senator Bobby Denton, Banking and Insurance Committee, May 11, 1999, from the Coalition for Auto Repair Equality (opposing HB 186/SB 403).

48 *See, e.g.*, Moorhead v. State Farm Mut. Auto. Ins. Co., Civ. No. 95- AR-0668-S (N.D. Ala. Sept. 12, 1996) (refusing to certify class); Rios v. Allstate Ins. Co., No. 94 CH 11396 (Cir. Ct. Cook County, Ill. Jan. 27, 1998) (refusing to certify class); Murray v. State Farm Mut. Auto. Ins. Co., No. 96-2585-MI (W.D. Tenn. Aug. 19, 1997) (denial of class certification).

The *Avery* decision was poor public policy resulting from the tunnel vision of the legal process. It had an immediate and detrimental effect on the auto insurance industry as well as consumers. Insurers, such as State Farm, Nationwide, Travelers, and MetLife, uncertain of the rules in the insurance markets outside Illinois, stopped authorizing the use of generic auto parts.[49] The decision created a virtual monopoly for OEM parts manufacturers and, not coincidently, the cost of OEM parts made by Detroit automobile manufacturers has already increased as much as 293 percent.[50] John Claybrook, president of the nonprofit consumer protection group *Public Citizen*, observed, "[t]his ruling, if not overturned, will severely harm automobile owners throughout the country. Repairing a car after a crash will become prohibitively expensive, and insurance rates will skyrocket."[51] Unfortunately, the Illinois Court of Appeals upheld the circuit court's decision.[52]

Punishing Conduct Beyond the State Line

The United States Supreme Court recently ruled that the Utah Supreme Court engaged in overreaching conduct when it sought to punish State Farm for a "national scheme" against policyholders, as alleged in *State Farm Mutual Automobile Insurance Co. v. Campbell*.[53] *Campbell* involved State Farm's alleged failure to settle, within policy limits, third-party claims against its insured that arose out of an automobile accident. A jury awarded $145 million in punitive damages to punish a "national scheme" against State Farm policyholders.[54] Much of the evidence offered to support this claim involved acts that took place in other states that were unrelated and dissimilar to the conduct at issue in the case. The Utah Supreme Court upheld the punitive damages award, despite the controlling authority of the United States Supreme Court's ruling barring the use of evidence of extraterritorial conduct to calculate punitive damages

49 Schwartz & Lorber, *supra* note __, at 1217.
50 See *Canadian Findings on Aftermarket Part Prices Confirm Alliance of American Insurers' Fears About Lack of Competition,* COLLISION REPAIR INDUS. INSIGHT, Nov. 13, 2000, *available at <http://www.collision-insight.com/news/20001113-aai.htm>*.
51 Press Release, Public Citizen, *Consumer Groups Ask Illinois Supreme Court to Expedite Automobile Crash Parts Case* (Feb. 9, 2000), *available at* <http://www.citizen.org/pressroom/release.cfm?ID=470>.
52 *See* Avery v. State Farm Mut. Auto Ins. Co., 746 N.E.2d 1242 (Ill. App. Ct. 2001) (affirming the circuit court's decisions in all respects except in regard to disgorgement damages).
53 *See* State Farm Mut. Auto. Ins. Co. v. Campbell, No. 981564, 2001 WL 1246676 (Utah Oct 19, 2001), *cert. granted*, 122 S.Ct. 2326 (U.S. Jun 3, 2002) (No. 01-1289).
54 2001 WL 1246676 at *3.

awards.[55] Even if there were truth to the nationwide conduct alleged by the plaintiff, this would be conduct for regulators to address – at least on a broader scale.

This decision clarifies and strengthens *BMV v. Gore*[56], in which the court first held that punitive damages could be so excessive as to violate a defendant's rights to due process under the federal constitution. Consequently, *Campbell* offers defendants hope that some excesses in awarding punitive damages have finally been put to rest. There are numerous bases for this optimism, the first of which is that the court found "this case neither close nor difficult."[57] Further, it held that a court could not punish legal conduct in another state.[58] It is also worthy of note that during oral arguments, Justice Breyer observed that allowing a randomly picked jury of 12 people to look at the entire scope and history of plaintiff's business practices and punish them for what could be a minor infraction was very troubling for him, particularly where there is little guidance on how to make that decision.[59] Finally, while declining to establish a "bright line" test limiting punitive damage awards, the court held "… that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, … will satisfy due process."[60]

Given the opportunity to alter or weaken the doctrine established in *Gore*, the U.S. Supreme Court instead chose to strengthen and clarify this critically important principle of due process of law. Unfortunately, *Campbell* does not apply generally to courts acting as regulators. Therefore, while a critical issue has been addressed, regulated businesses, like insurance companies, must continue to hope that their legal actions are not subsequently the basis of punishment as the result of a court's retroactive alteration of a statute or regulation.

Expanding Uninsured/Underinsured Motorist Coverage

Another example of a court inserting itself into the regulatory field is the Ohio Supreme Court's track record of rewriting and expanding Uninsured Underinsured Motorist (UM/UIM) coverage. UM/UIM coverage provides bodily injury coverage to an insured driver or passenger as a result

---

55 *See BMW of North America v. Gore*, 517 U.S. 559 (1996).
56 517 U.S. 559, 116 S.Ct. 1589 134 L.E. 2d 809 (1996).
57 *Campbell* page 7.
58 *Campbell* page 9.
59 *See* Transcript of Oral Argument, State Farm Mut. Auto. Ins. Co. v. Campbell, 2002 WL 31808900, **23-24 (U.S. Dec. 11, 2002).
60 *Campbell*, page 11.

of an accident caused by the owner or operator of an uninsured or underinsured vehicle. In a series of rulings over the past decade, the Ohio Supreme Court has required UM/UIM payments in situations never contemplated by the parties.[61]

For example, in 1993, the court ruled that a policyholder could collect UM/UIM coverage even if the at-fault driver carried insurance equal or greater than the victim's coverage if the court-approved damages exceeded the driver's coverage.[62] Out of concern for a predicted $250 million in increase premiums for Ohio consumers as a result of the decision, the state legislature intervened and clarified coverage limits.[63]

In 1994, the Ohio Supreme Court ruled in *Martin v. Midwestern Group Insurance Company* that a claimant could collect under the UM/UIM coverage of his automobile insurance policy even though he was injured while riding a motorcycle on which he had no insurance.[64] Prior to that case, insurers calculated rates for UM/UIM coverage by determining the loss exposure based on the number of vehicles listed by the insured. In *Martin*, however, the court found that an insurer could not limit UM/UIM coverage to listed automobiles, but had to cover any car driven by an insured consumer, even if he or she had not insured the vehicle involved in the accident. Again, three years later, the legislature intervened to correct the court's intrusion into the policymaking process. It amended the law to explicitly permit insurance companies to deny coverage when an

---

[61] Other state high courts have also intruded in the regulation of automobile insurance coverage. One of the most egregious examples of overreaching is Mitchell v. Broadnax, 537 S.E.2d 882 (W. Va. 2000). In this case, the Supreme Court of Appeals of West Virginia required an insurer to demonstrate that there was a specific premium reduction for exclusions incorporated into insurance policies even though historically neither the state legislature nor the insurance commissioner imposed such an obligation. The decision caused great concern that insurers operating in West Virginia would be exposed to unexpected risks which were not anticipated when policy forms were drafted and approved, and that consumers would pay for the lack of predictability through higher insurance premiums. For these reasons, the West Virginia Legislature amended its insurance code to "correct a misinterpretation and misapplication of the law in Mitchell v. Broadnax." *See* H.B. 4670, 2002 Reg. Sess. (W. Va. 2002) (codified at W.VA. CODE §33-6-30). The new law provided that there is no basis for a policyholder to sue insurers for refunds when insurance forms have been approved by the Insurance Commissioner. *See id.*

[62] *See* Savoie v. Grange Mut. Ins. Co., 620 N.E.2d 809 (Ohio 1993) (ruling that insureds could enlarge UM/UIM coverage by (1) stacking policies issued to separate household, (2) collecting multiple "per person" limit of liability when one person was injured, and (3) collecting such amounts in excess of (rather than set off by) other insurance recoveries).

[63] *See* S.B. 20, 120th Gen. Assem. (Ohio 1994); James Bradshaw, *Insurance Ruling May Raise Prices*, COLUMBUS DISPATCH, Oct. 6, 1994, at 1A.

[64] *See* Martin v. Midwestern Group Ins. Co., 639 N.E.2d 438 (Ohio 1994).

injured party is occupying a motor vehicle owned by a named insured, if the motor vehicle is not itself insured under the policy.[65] Nevertheless, lawsuits to expand UM/UIM coverage continued.

In 1999, the Ohio Supreme Court again expanded coverage. This time, the court ruled that insurance policies purchased by a business on its fleet of automobiles cover its employees and their families when driving their personal cars on vacation or on any personal trip.[66] Thus, an off-duty employee killed in his wife's personal automobile was entitled to UM/UIM coverage.

Several additional Ohio Supreme Court decisions in 1999 and 2000 expanded UM/UIM coverage.[67] In what may be the most costly of those decisions, the court set specific requirements for an insured to deny UM/UIM coverage – a clearly regulatory function.[68] In *Linko v. Indemnity Ins. Co*., the court found that the rejection of an offer of UM/UIM coverage was invalid because the offer was not "meaningful," in that it did not include each of three requirements:

1. A brief description of the coverage
2. The premium for that coverage
3. An express statement of the coverage limits[69]

The court then found that all three of these requirements had to be met within the "four corners" of the policy.[70] This new requirement may invalidate existing rejection forms. Prior to *Linko*, it was not common practice within the industry to use a rejection form containing each of the elements specified by the court. Instead, insurers could use collateral documents or a presentation by an agent to provide an offer of UM/UIM coverage. The court's decision may also nullify rejections that are not included as part of the insurance policy. Insurers depend on documents in the file and the coverage limits listed on the declaration page as evidence of the

---

65 *See* H.B. 261, 122nd Gen. Assem. (Ohio 1997) (codified at OHIO REV. CODE § 3937.18).

66 *See* Scott-Pontzer v. Liberty Mutual Fire Ins. Co., 710 N.E.2d 1116 (Ohio 1999); *see also* Ezawa v. Yashuda Fire & Marine Ins. Co., 715 N.E.2d 1142 (Ohio 1999) (extending Scott-Pontzer to the children of an employee), Schumacher v. Kreiner, 725 N.E.2d 1138 (Ohio 2000) (extending Scott-Pontzer to contractors of the employer).

67 *See* Selander v. Erie Ins. Group, 709 N.E.2d 1161 (Ohio 1999) (holding that hired/non-owned automobiles were subject to UM/UIM coverage); Moore v. State Auto. Mut. Ins. Co., 723 N.E.2d 97 (Ohio 2000) (ruling that an insured not involved in an accident could still collect UM/UIM for the wrongful death of her son, who was not an insured under the policy); *see also* S.B. 267 (halting recovery permitted under *Moore*).

68 *See* Linko v. Indemnity Ins. Co., 739 N.E.2d 338 (Ohio 2000).

69 *See id*. at 342.

70 *See id.* at 342-43.

selection or rejection of UM/UIM coverage. Even a complying offer or rejection form may not be effective if it is not included as part of the policy.

The ever-increasing scope of coverage led the *Columbus Dispatch* to chastise the court and urge legislation to reverse the trend:

> *The insurance companies that do business in this state have been suffering losses on claims against insurance that no one purchased. The money has to come from somewhere, a fact apparently lost on the court's bench-warmers who have directed these payments. That somewhere is from the pockets of those who buy insurance today and tomorrow and well beyond that.*[71]

Several pending UM/UIM cases may further impact the price that people must pay for automobile insurance and the extent of their coverage in Ohio.[72] The latest series of cases caused former Ohio Insurance Commissioner Covington such concern that he said:

> *If the trial lawyers are successful, these cases will affect the rates charged to consumers by all Ohio insurance companies. An adverse decision could also affect the authority of the Department to regulate insurance rates and destabilize the outstanding market all Ohioans enjoy. We have seen this in other states and we don't want it to happen in Ohio. It is simply not good for consumers.*[73]

Ultimately, the impact of this series of decisions has been to create extraordinary uncertainty in the Ohio auto insurance market, at least with regard to UM/UIM coverage. The increased

---

71 Editorial & Comment, *Liability Unlimited?*, COLUMBUS DISPATCH, June 3, 2001, at 2D.

72 Press Release, Ohio Dep't of Ins., *Insurance Department to Intervene in UM/IUM Lawsuits; Department Acts to Protect Consumers from $400 Million Hit* (Nov. 14, 2001), *available at* <http://www.ohioinsurance.gov/Newsroom/scripts/Release.asp?ReleaseID=729> (citing four class action lawsuits: *McDonald v. Westfield Nat'l Ins. Co*. in Wood County, *Baughman v. State Farm* in Summit County, *Lazarus v. Ohio Casualty* in Cuyahoga County, and *Mager v. Erie* in Erie County); *see also* Press Release, Ohio Dep't of Ins., ,*Insurance Department Weighs in on Premium Payment Lawsuit; Director Acts to Preserve State Regulatory Authority* (June 11, 2002) (citing intervention in same cases as well as the filing of two amicus briefs in the Ohio Supreme Court in *Lemm v. Hartford*); *see also* Baughman v. State Farm Mutual Auto. Ins. Co., 727 N.E.2d 1265 (Ohio 2000) (ruling that trial court had not abused its discretion in certifying a class action against the insurer for failing to notify policyholders that they needed to list only one vehicle in the household to receive UM/UIM coverage for all residents of the household); Lazarus v. Ohio Casualty Group, 761 N.E.2d 649 (Ohio App. 2001) (finding that the Superintendent of Insurance did not have exclusive jurisdiction over the subject of a similar class action and that the trial court had subject matter jurisdiction to hear the case); Lemm v. Hartford, No. 01AP-251, 2001 WL 1167585 (Ohio App. Oct. 4, 2001), *review granted*, 757 N.E.2d 773 (Ohio 2001) (requiring homeowners insurance to provide UM/UIM coverage when the injured party is a homeowner's residence employee and the injury occurred in the scope of employment, and certifying a conflict between the appellate circuits on this issue to the Ohio Supreme Court).

73 Press Release, Ohio Dep't of Ins., *Insurance Department to Intervene in UM/IUM Lawsuits; Department Acts to Protect Consumers from $400 Million Hit* (Nov. 14, 2001), *available at* <www.ohioinsurance.gov/Newsroom/scripts/ Release.asp?ReleaseID=729>.

premiums that have resulted are necessary because insurers are currently unable to predict how their contracts will be read in the future.

Requiring Overtime Pay for Insurance Adjusters

The tendency to punish companies for legal conduct is not limited to insurance law. Another lightning strike occurred in California when Farmer's Insurance Exchange was hit with a $90 million judgment for not giving their adjusters overtime pay.[74] The company classified adjusters as "exempt" employees, which means, among other things, that they were not eligible for overtime pay.[75] The problem with this judgment was that in classifying adjusters as exempt, Farmer's relied on a well-established practice followed by most other states and recognized by the United States Department of Labor. With numerous other insurers in California facing similar lawsuits, there is grave concern about the impact on the cost of insurance.[76] Moreover, the decision could change the nature of the jobs of insurance adjusters from one in which they set their own hours to a 9-to-5 operation.[77] This court-driven change, which is inconsistent with well-established law, could make the claims settlement process more costly and inconvenient for policyholders. Yet, despite its wide-ranging impact, there has been no public policy debate. Rather, those advocating this change are doing so through the courts, which may grant access to litigants only.

Requiring Coverage of "Toxic Mold" Claims

Yet another recent example of the pitfalls of courts and juries entering the regulatory process is seen with the filing of "toxic mold" claims. Toxic mold claims were unheard of as late as 1999 and blossomed only after lawsuits and media coverage.[78] Most insurance companies never

---

74 *See* Jahna Berry, *Claims Adjusters Win Big in Case Against Farmers*, NAT'L L.J., July 23, 2001, at A18; *Farmers Hit with $90 Million Judgment in Overtime Lawsuit*, BEST'S INS. NEWS, July 11, 2001, *available at* 2001 WL 24723990.

75 *See* Bell v. Farmers Ins. Exchange, 105 Cal. Rptr.2d 59, 61 (Cal. App. 2001), *cert. denied*, 534 U.S. 1041 (2001).

76 *See* Roberto Cericeros, *Adjuster OT Could Raise Premiums: Insurers*, BUS. INS. July 20, 2001, at 4, available at 2001 WL 5101871.

77 Berry, *supra*.

78 Farmer's received only twelve mold claims in Texas in 1999 compared with over 12,000 mold claims in 2001. Mold claims with Allstate increased from forty in the first quarter of 2001 to 1,000 one year later. Nationwide, mold claims rose from about $200 million in 2000 to an estimated $2.5 billion in 2002. *See* Dean Calbreath, *The 'New Asbestos': Increasingly Expensive Mold Infestation Claims are Wreaking Havoc with Homeowners and Insurance Companies*, SAN DIEGO UNION-TRIB., Feb. 16, 2003, at H1.

covered slow-growing mold, which is often a result of homeowner neglect. On the other hand, many companies covered mold if it was related to a covered event, such as a bursting pipe. The question in such lawsuits is whether mold is always covered or never covered. Still a hotly disputed topic, toxic mold claims are distinguished from ordinary mold claims by plaintiffs' lawyers using the science that toxic mold is an "infestation that causes illnesses." People with asthma, allergies, or other respiratory conditions may be particularly susceptible to illness from mold, "which has coexisted with humans as long as they have lived in houses."[79] As one State Farm representative pointed out, "There is no national or even state level about what is a safe level for mold exposure. . . . A spot on your wall, is that safe or not safe?"[80] Nevertheless, judges and juries have recently decided that insurance companies must cover such claims.

Court involvement in the toxic mold dispute culminated in 2001 with a $32 million jury verdict against Farmers Insurance Group in Travis County, Texas, which included $6.2 million in actual damages – $12 million in punitive damages, $5 million for mental anguish, and $8.9 million for lawyers' fees.[81] Melinda Ballard brought the lawsuit after her Austin, Texas, home was extensively damaged by toxic mold. The claim accused Farmers Insurance Group of committing fraud and acting in bad faith in its handling of her claim, alleging that the company knew that plumbing leaks created toxic mold that made her family sick and forced them to leave their home.

As a result of the huge jury verdict, Farmers Insurance Group announced that it would not renew its 700,000 homeowners policies in Texas. State Farm, the largest homeowners insurer in the country, stopped issuing policies in at least 20 states.[82] Companies that continued to offer homeowners insurance substantially increased premiums to cover mold claims. Texas homeowners experienced a 560 percent increase in their premiums between the first quarter of 2001 and the fourth quarter of 2002. Homeowners in other states hot on mold litigation such as

---

79 Dean Calbreath, The 'New Asbestos': Increasingly Expensive Mold Infestation Claims are Wreaking Havoc with Homeowners and Insurance Companies, San Diego Union-Tribune, Feb. 16, 2003, at H1; see also Cristina Merrill, Spreading Mold Lawsuits Threaten NY Infection: Residential Claims Triple to 4th-Highest, Crain's N.Y. Bus., Feb. 17, 2003, 22 ("The mold showing up here is not new, of course; lawyers joke that God created mold when he created water.").

80 See Elizabeth Amon, As Toxic Mold Suits Grow, Insurers Go: Insurers Wary Over Hot Litigation Area, Nat'l L. J., Oct. 21, 2002, at A1.

81 See Allison v. Fire Ins. Exchange, No. 03-01-00717-CV, 2002 WL 31833440 (Tex. App. Dec. 19, 2002).

82 See Elizabeth Amon, For Many Insurers, Best Defense Against Growing Volume of Toxic Mold Cases is to Stop Issuing Policies in Key Areas, Miami Daily Bus. Rev., Oct. 30, 2002, at 7.

California and Florida also experienced substantial increases in premiums.[83] In many states, insurance companies had to plead to their state legislatures to eliminate mold coverage in their policies, even when an event covered by the policy led to mold, so that they could remain in business.[84]

Although a Texas appellate court substantially chopped the award to $4 million plus interest and lawyers' fees, the effect of the increasing cost of mold claims on the availability and affordability of homeowners insurance is irreversible. Mold claims, once primarily limited to California, Florida, and Texas, are spreading to other states where they had not been seen – such as North Carolina and New Hampshire, and are expected to expand in other states, including Alabama, Georgia and Mississippi.[85] In New York, now host to the fourth highest number of mold claims in the country, homeowners insurance is predicted to increase by 25 percent.[86] Nationally, homeowners insurance has increased by an average of 20 percent since 2000 and many customers are denied coverage for fear that they might file a mold claim.[87]

The superiority of the regulatory process in making public policy determinations is immediately obvious when comparing the consequences of the Texas court decisions, and the Texas Insurance Commissioner's decisions. While there are mixed feelings about the outcome of the regulatory process, Texas Commissioner Montemayor has taken actions that have convinced insurers to not leave, and to continue selling homeowners insurance in Texas. Conversely, the Ballard case ignited a firestorm of copycat lawsuits that have threatened the homeowners insurance market in Texas and elsewhere.

Permitting Extraordinary Medical Malpractice Verdicts

The current situation facing doctors and hospitals is another example of how the lack of predictability in the insurance market, driven by litigation, can have devastating effects on the

---

83 *See* John Wasik, *Take Cover Over Rise in Insurance Costs*, FIN. TIMES, Dec. 4, 2002, at P26.

84 *See* Elizabeth Amon, *As Toxic Mold Suits Grow, Insurers Go: Insurers Wary Over Hot Litigation Area*, NAT'L L. J., Oct. 21, 2002, at A1.

85 *See Middle-Market Insurers Could be Hit Hard by Mold*, BEST'S INS. NEWS, Jan. 23, 2003, *available at* 2003 WL 4279526.

86 *See* Jennifer Gould, *Apt. Mold Becomes a Soar Point*, N.Y POST, Feb. 17, 2003, at 5; Cristina Merrill, *Spreading Mold Lawsuits Threaten NY Infection: Residential Claims Triple to 4th-Highest*, CRAIN'S N.Y. BUS., Feb. 17, 2003, 22.

87 Dean Calbreath, *The 'New Asbestos': Increasingly Expensive Mold Infestation Claims are Wreaking Havoc with Homeowners and Insurance Companies*, SAN DIEGO UNION-TRIB., Feb. 16, 2003, at H1.

public. Over the last 30 years, medical malpractice liability claims, once rare, have become commonplace. The frequency and severity of medical malpractice verdicts has steadily increased. As the Physicians Insurers Association of America (PIAA) recognized in recent testimony before Congress, *"[t]he insurance system was able to accommodate even this inexcusable volume of litigation as long as the size of the few valid claims was predictable."*[88] The problem became untenable with the explosion of unpredictable, individual claims. A few recent examples include a $268 million verdict in Texas, multiple verdicts of more than $50 million in Philadelphia, and four claims totaling more than $98 million in Arkansas.[89] According to the PIAA, the percentage of individual claims costing more than $1 million increased nearly four-fold between 1991 and 2001.[90] Meanwhile, the average indemnity payment increased by more than 60 percent over the past five years.[91] An OB-GYN (gynecologist), who recently relocated to Belfast, Maine, after twelve years of practice in Las Vegas, Nevada, said, *"Liability isn't about fault or bad practice anymore. It's about hitting a jackpot."*[92] Because of such extraordinary and increasingly frequent claims, insurance premiums have skyrocketed.

As a result of the unpredictability in medical malpractice litigation and the resulting rise of insurance premiums, some physicians have stopped practicing medicine, abandoned high-risk parts of their practices, or moved their practices to states where the liability rules are more certain. Many in the public have lost access to healthcare. For example, *USA Today* reported that the medical liability crisis forced the maternity ward in Bisbee, Ariz., to close its doors. Expectant mothers must drive more than a half-hour to the nearest town to deliver.[93] In Ohio, a general surgeon was scheduled to close her practice on June 30, the day before the price she paid

88 Statement of the Physicians Insurers Assn. of Am. Before the Subcomm. on Health, Comm. on Energy and Commerce, U.S. House of Rep., Regarding "Harming Patient Access to Care: Implications of Excessive Litigation, July 17, 2002, at 6; *see also* Statement of the Physicians Insurers Assn. of Am. Before a Joint Hearing of the U.S. Senate Judiciary Comm. and the Health, Education, Labor and Pensions Comm. Regarding "Patient Access Crisis: The Role of Medical Litigation," Feb. 11, 2003, at 14 (noting that "[t]he primary driver of the deterioration in the medical liability insurance industry performance has been paid claim severity, or the average cost of a paid claim").

89 *See* Statement of the Physicians Insurers Assn. of Am. Before the Subcomm. on Health, Comm. on Energy and Commerce, U.S. House of Rep., Regarding "Harming Patient Access to Care: Implications of Excessive Litigation," July 17, 2002, at 6.

90 *See id.*

91 *See id*. at 7.

92 *See* Testimony of the American College of Obstetricians and Gynecologists to the Senate Judiciary Comm. and Senate Health, Education, Labor, and Pension Comm., Feb. 11, 2003, at 2 (presented by Dr. Shelby L. Wilbourn).

93 *See* Steve Freiss, *Malpractice Gets Costlier; Insurance Rate Hikes Put Doctors in a Bind*, USA TODAY, Apr. 9, 2002, at D7.

for medical liability insurance would have jumped 80 percent to about $45,000 per year.[94] Had the doctor chosen to stay in medicine, she would have needed to clock 1,000 visits – half a year's work – just to cover the cost of insurance.[95] The Executive Director of the Nevada State Medical Association estimates that about 147 Las Vegas doctors have either left the state to practice elsewhere, announced that they are closing, or retired early. Many more are considering leaving.[96] A Texas orthopedic surgeon decided to abandon spinal surgeries and reduce his emergency room calls as an attempt to cut the cost of his malpractice insurance premium. His premium still rose by 63 percent.[97]

It does not have to be this way. Some states protected and restored predictability in the medical liability insurance market through passage of legislation. California, which took action in response to an insurance crisis in the 1970s, provides a prime example. In 1975, California enacted the Medical Injury Reform Act (MICRA), a comprehensive legislative package that limits non-economic (pain and suffering) damages to $250,000, allows for the introduction into evidence of "collateral source" payments received by the plaintiff, permits the periodic payment of judgments in excess of $50,000, allows patients and physicians to contract for binding arbitration, and limits the contingency fees of plaintiffs' lawyers to a sliding scale.[98] This legislation allowed California to avoid most of the unpredictability and rise of insurance premiums experienced by other states that were hit by high jury verdicts over the past 25 years. For instance, while insurance premiums have increased by 167 percent in California since 1976, premiums increased by 505 percent in the rest of the nation.[99]

Hopefully, the medical malpractice insurance crisis is not a sign of things to come for other industries. However, it does convey clear lessons. First, a liability system without real limits may ultimately drive insurers and businesses from a market. Second, the courts, bounded by reasonable limitations, perform a critically important service. In the case of medical malpractice,

---

94 See Roger Mezger, Insurance Costs Force Doctors to Quit, The Plain Dealer, Feb. 18, 2002, at A1.
95 See id.
96 See Joelle Babula, The Medical Malpractice Insurance Crisis: Operation Special Session, Las Vegas Review-Journal., July 28, 2002, available at <http://www.reviewjournal.com/lvrj_home/2002/Jul-28-Sun-2002/news/19271188.html>.
97 See Patricia V. Rivera, Malpractice Rates Take Feverish Leap; Texas Doctors Hit Hard By Increases, Which Insurers Say Are Needed, Dallas Morning News, Jan. 20, 2002, at 1A.
98 See Cal. Civ. Code §§ 3333 et seq.
99 National Association of Insurance Commissioners, Profitability Studies.

California's MICRA has proven that businesses, insurance and courts can coexist. In the case of the property/casualty insurance industry, deference to the regulatory structure is absolutely a necessary limit.

One Solution: The Fair Notice and Market Stability Model Act

It is possible to have a healthy competitive market and a strong judiciary functioning as an arbiter of disputes? California has proven that it is with the unquestionable success of MICRA. This balance may be achieved in regulated industries, like insurance, through legislation that reasserts the traditional roles that have served this country so well. To accomplish this, we endorse passage of the *Fair Notice and Market Stability Model Act*.

The Fair Notice and Market Stability Model Act

Legislative Findings

1. The law must be predictable so that people may order their behavior. This fundamental concept is a cornerstone of any democratic society.
2. When people cannot rely on the written law, they cannot plan and conduct their daily activities with the assurance that their legal conduct will not subsequently be the source of punishment. This state of disorder destroys an individual's ability to enter into contracts and a market's ability to structure and regulate business conduct in an orderly, reliable, and fair manner.
3. The legislative, executive, and judicial branches of government have well-defined roles that are critically important to ensuring that the law remains predictable and reliable.
4. When courts step outside their assigned role, laws are changed without notice, without consideration of the consequences of the change, and without the opportunity for the appropriate parties to defend their positions or the law. This makes the law unreliable and unpredictable.
5. Requiring courts to operate within their traditional role as an arbiter of disputes will not limit an aggrieved party's access to the courts, or their ability to obtain judgments that redress their grievances or compensate them for their injuries.

Definitions

1. *Aggrieved party*: Any person or business that has a contractual relationship with a regulated party, and believes that the regulated party has violated a statute, regulation, order or finding detrimental to the aggrieved party.
2. *Appropriate government authority*: The official or agency of government having the responsibility of interpreting or enforcing laws, or regulating parties under state law. For purposes of representing the state in litigation, but not in promulgating regulations, it may also include the State Attorney General or Chief Legal Officer.
3. *Judgment*: A final order by a court of competent jurisdiction. (If the state has a definition of judgment, consider citing it.)
4. *Litigation*: For purposes of this Act, litigation means a lawsuit brought in a court of competent jurisdiction, in which individual disputes are resolved, or the legality, constitutionality, or application of a statute, regulation, order or finding is in question.
5. *Regulated Party*: Any person, corporation, or other business entity licensed and regulated by an appropriate government authority of this state.

Permissible Scope of a Judgment

1. A judgment against a regulated party may only extend to the regulated party's conduct as defined in the litigation.
2. Judgments may not affect a statute, regulation, finding, or order, unless the validity of that statute, regulation, finding or order was raised as part of the litigation.
3. The appropriate government entity may, at its discretion, intervene as a party in litigation to defend a statute, regulation, finding or order.
4. The judgment of a court in another state may only extend to a regulated party in this state if the party attempting to apply the judgment shows that:

a. Application of the foreign judgment would not be inconsistent with, or nullify, a statute, regulation, finding or order in this state that governs the conduct being challenged, and

b. The facts of the foreign judgment do not differ materially from the facts being alleged in the cause in question, and

c. Compliance with the foreign judgment will not require a regulated party to violate a domestic statute, regulation, finding or order.
(Note: this is intended to prevent a party from challenging one state's valid legislative or regulatory determinations without joining the state. This provision is not intended to prevent a foreign party from directly challenging a state's law, nor would it nullify any state laws allowing for the enforcement of foreign judgments.)

d. The court may not consider conduct of a regulated party outside of this state except as it may be relevant in proving the regulated party's intent in the conduct alleged in litigation.
(Note: This may not be appropriate in states where the rules of evidence are established by the courts.)

Remedies

1. If the validity of a statute, regulation, order or finding is an issue in the litigation, a court may consider and rule on whether the statute, regulation, finding, or order is unconstitutional or invalid.
2. An aggrieved party, who is not engaged in litigation of a grievance, may pursue a remedy of the grievance through an administrative procedure with the appropriate government authority. The appropriate government authority's ruling shall be final, but may be appealed to a court of competent jurisdiction. If, before a final ruling, any party to an administrative action under this section enters into litigation on the matter being heard by the appropriate government entity, the administrative proceeding shall terminate immediately.
(Note: in some states, the legislature may also have to enact enabling legislation before an appropriate government authority may create and employ this administrative process.)

3. If, after an administrative hearing, the appropriate government authority finds in favor of the aggrieved party, the appropriate government entity may:
   a. Order the regulated party to amend its conduct so that it complies with the statute, regulation, order or finding.
   b. Order the regulated party to pay actual damages.
   c. Order attorneys fees for the prevailing party.

Regulatory Authority and Duties

1. If a court of final jurisdiction has ruled that a statute, regulation, order or finding is invalid or unconstitutional, the appropriate government authority shall take the following actions:
   a. For regulations, orders, or findings, the appropriate government authority shall immediately amend the regulation, finding, or order to comply with the judgment.
   b. For statutes, if the legislature is out of session or concludes without addressing the court's ruling, the appropriate government authority shall immediately promulgate an emergency regulation which identifies problems created by the court's ruling, and provides regulated parties with a prescribed method of conduct until the issues set out in the emergency regulation are resolved by the legislature. The emergency regulation shall remain in effect until the legislature addresses and resolves the issues set out in the emergency regulation.
      (Note: a regulator could not issue emergency guidelines if the statute in question was nullified on constitutional grounds. Further, if the judgment finds that the statute, finding, regulation or order, is unconstitutional in a particular application, amended or emergency regulations will not be necessary, in that the state law remains valid.)

Defenses

If a court properly determines that a statute, regulation, finding, or order is illegal:

1. It shall be a defense that a regulated party relied on the law, regulation, finding or order.
2. It shall be an absolute defense for conduct occurring between the time that a statute, regulation, finding, or order is found invalid, and the promulgation of a corrective or

emergency regulation, or the enactment of a corrective statute, that the regulated altered its conduct to comply with the court's ruling.

3. It shall be a defense that a regulated party relied upon and complied with an emergency regulation.

This Act will achieve and sustain a healthy judiciary while ensuring market stability by: requiring that public policy decisions be made in open public proceedings with considerations of a broad range of concerns and interests, limiting the impact of individual disputes to those named individuals, providing a mechanism for defining appropriate conduct when a court overturns a statute or regulation, clarifying that a state court judgment has no force or effect in other states, and providing a defense from damages for legal conduct.

Conclusion

While the court system has historically played a crucial role in sustaining competitive markets by ensuring that the law is reliable and predictable, in recent years some courts have expanded their roles by taking on the attributes of a regulator. A comment by a plaintiff's attorney who recently won a $225 million asbestos judgment against U.S. Steel reflects this growing instability. When asked why the jury awarded so much money, he said: "I think they were incensed and they wanted to send a message not just to U.S. Steel, ***but to every employer in the country*** [emphasis added] – that you cannot poison your workers."[100] Nobody condones the poisoning of workers, but it is not the place of an Illinois jury to send a message to every employer in the United States of America.

The question of who regulates insurance markets is important to our society. Court rulings and jury awards should not attain the status of broad public policy determinations. Because courts are intended to function as fair and impartial arbiters of individual disputes, they are poorly equipped to make value-based judgments that carry regulatory consequences. This is particularly true when there is an expert regulator in place who is charged with consumer protection responsibilities. Currently, the court system, which has served its purpose well for centuries, is

[100] See Tresa Baldas, *The Art of Harnessing a Jury's Anger*, THE NATIONAL LAW JOURNAL, April 21, 2003, 4/21/03 Nat'l L.J. B5, (Col. 1).

out of control. This has reduced predictability for insurers in that they cannot rely on regulations and laws, nor can they accurately assess a risk.

Regulators, as those charged with balancing the interests of all consumers, the solvency of insurers and the health of the entire system, are particularly well situated to make industry-wide policy determinations. Achieving a balance where the courts address individual disputes and regulators make broader public policy determinations is ideal. Failure to achieve and maintain this balance will have both an immediate and prolonged detrimental impact on the insurance market, ultimately harming insurers and consumers.