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Insurance and the Law

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3.8.135 Insurance and the Law

Insurance may be uniquely tied up with the law. Social insurance and other public sector insurance arrangements are creatures of statute, governed through administrative law. (See Social Insurance, legal aspects.) Private sector insurance arrangements depend upon a well-functioning contract law and a regulated market. (See Contract, legal; Markets and the law.) Insurance thoroughly dominates the field of tort law, especially with respect to the liabilities of individuals and small business. (See Torts, in law) Moreover, because insurance institutions inevitably exert a regulatory force over their subjects, insurance must be understood as a complement to direct state regulation. Finally, some social theorists have argued that insurance has exerted a profound ideological force on law and regulation, as activities increasingly are governed through risk. (See Law and risk)

1. The Term Insurance

Identifying the core features of insurance is anything but a simple task. Indeed, Spencer Kimball, one of the leading insurance law scholars of the 20th century, once wrote: "There is no good definition of insurance, for any purpose." (Kimball 1992: xv). Kimball's admonition notwithstanding, it is useful to begin by thinking of insurance as a formal mechanism for sharing the costs of misfortune.

Contemporary insurance arrangements typically involve fixed premiums paid in advance

and guaranteed benefits in the event that a specified loss or event occurs, but these are not necessary elements of the insurance form. Insurance arrangements typically provide protection against risks that are fortuitous from the perspective of the insured, yet reasonably predictable in the aggregate by an insurer, and that are not so catastrophic that they would overwhelm the financial capacity of insurers (as would, for example, insurance against world-wide depression.) Ideas about what is and what is not insurable vary widely over time and place, so these descriptions should be taken as provisional.

Following the French social theorist Francois Ewald, it is helpful to distinguish among four aspects of insurance: *technologies, institutions, forms* and *visions*. (Ewald 1991). These categories usefully illustrate the conceptual variety of insurance activities and, correspondingly, some of the deficiencies in analytical definitions.

Insurance technology is the *how* of insurance. Examples include: the mortality tables and inspection procedures of ordinary life insurance; the incentive-based medical provider contracts and computerized claim processing procedures of managed health care companies; the payroll tax and administrative review procedures of social insurance programs; and the standard form insurance contracts used in almost all private insurance. Insurance in this sense of insurance *technology* refers to a set of procedures for dealing with risk. As a technology for managing risk, insurance extends far beyond what might ordinarily be understood as the insurance field. Life insurance companies were pioneers in epidemiology and public health, and fire insurance companies formed the first fire departments. More recently, health insurance companies have been behind many efforts to compare, test and measure the effectiveness of medical procedures.

Insurance *institutions* are the various kinds of organizations that provide insurance. Social insurance agencies (such as the German Arbeitsamt) and stock insurance companies (such as the Dutch -based ING Group) are two (very different) insurance institutions. Insurance *forms* are the various kinds of insurance provided by insurance institutions, as well as the variations in form among those kinds. Unemployment and property insurance are two different forms of insurance. Fire insurance and flood insurance are two different forms of property insurance.

Finally, insurance *visions* are ideas about and images of (or, alternatively, discursive practices regarding) insurance which animate the development of insurance technologies, institutions and forms. Three examples follow:

1. It was once commonly believed that life insurance was immoral, either because it interfered with divine providence, equated life and money, or represented a form of gambling. (Zelizer) This vision of insurance had important consequences for the development of insurance law and institutions in the west. It slowed the growth of life insurance, and it helped explain the intense preoccupation during the 19th century in the U.S. and France with establishing the morality of all kinds of insurance. Related ideas about risk and insurance more generally affect Islamic institutions today. (Vogel)

2. Because the primary benefit of insurance is a sense of security that for most people will never be tested by a catastrophic loss, the value of insurance rests, in an important sense, in the imagination. Recognizing the significance of imagination to insurance, courts in the United States place great emphasis on the reasonable expectation of the insured. In determining the nature of that expectation, courts invoke two distinct visions of insurance. The first mirrors the vision of insurance portrayed in insurance advertising: a promise to be there, conveyed by

narratives of family and the need to protect the individual against sudden misfortune. The second mirror the vision of insurance companies invoke when denying claims: a complicated amalgam of tough love and protecting the insurance fund, conveyed by narratives of institutional ethics and the need to protect ratepayers against fraud and abuse. In resolving insurance contract disputes, courts first decide which of these visions to employ. Who wins a dispute often depends as much on which vision the court adopts as on how the court applies that vision. (Baker 1994)

3. The Actuarial vision of insurance has had enormous influence over the development of insurance and insurance law. In the actuarial vision, the ideal type of insurance involves premiums paid in advance, guaranteed indemnity in the event of a covered loss, and risk-based premiums based on the best available information regarding the expected losses of the individual insured. (Abraham 1986) This vision of insurance helps explain the decline of fraternal insurance over the 19th and early 20th centuries, as actuarial expectations overcame the values of friendship, brotherly love and charity. It helps explain the decision to model unemployment insurance on private insurance, and the related effort to tightly link benefits to premiums. And it helps to explain the intensity of the popular belief that U.S. Social Security retirement benefits have been earned by the people who collect them, as well as the corresponding expert belief that Social Security is not really insurance (because the money to pay today = retirees comes from the contributions made by today = workers and not from the contributions of the retirees themselves). Indeed, the actuarial vision of insurance has been so successful that many well-informed people would deny that it is a vision at all and assert, instead, that it is *the* model of insurance. (Baker & Simon 2001)

2. Insurance as a Form of Regulation

Given the enormous size of insurance institutions relative to contemporary western economies, it is surprising that social scientists and historians have not paid more attention to insurance. Indeed, looking at the broad sweep of 20th century social policy, it is tempting to describe insurance as the sleeping giant of power.

In setting eligibility requirements and benefit levels for social insurance, the state obviously is engaged in the regulation of populations. Yet, private insurance can also be a crucial form of (delegated) state power. Rather than set their own criteria for access to economic freedoms like operating an automobile or a business, states often mandate that a person obtain some form of insurance. Examples include liability insurance for automobile owners, workers compensation insurance for employers, and (in the United States) surety bonds for companies engaged in business with the state. The state leaves it to the private market – typically property-casualty insurance companies – to set underwriting criteria that will determine access to these privileges and immunities (either by denying coverage altogether, or setting a prohibitively high price).

Motivated by controlling the losses they contracted to bear, insurance companies establish norms of conduct, which they enforce by contract terms and pricing and, ultimately, through the judicial system. Whether obtained as a result of compulsion or prudence, insurance is a form of regulation. Exclusions and conditions written into coverage for property, life, and health amount to a form of private legislation. Significantly, this legislation often acts inside the home or business, where the sovereignty of the King traditionally was expected to stop. (O’Malley 1991)

2.1. Insurance as Tort Regulation

The field of law most thoroughly dominated by insurance is tort law. In analyzing the relationship between insurance and tort law, it is helpful to distinguish between liability insurance and other forms of insurance, such as life, health or property insurance.

Liability insurance pays the costs of claims made against the insured person, and its regulatory effects on the tort field include the following:

- S Liability insurance has become a *de facto* element of tort liability, at least for ordinary individual or small business defendants (because it is so difficult to collect money damages from someone without insurance). This means that liability insurers (and statutory insurance regimes) decide, in effect, who is capable of being sued, for what wrongs, and for how much.
- S Tort claims are shaped to match the available liability insurance coverage. As a result, exceptions in the coverage provided by liability insurance policies become *de facto* carveouts to tort law.
- S Liability insurance policy limits are *de facto* caps on tort damages. Indeed, it is the low insurance limits that explain the persistent social science finding that people with serious injuries are under-compensated and people with minor injuries are overcompensated. (Sugarman 2001)
- S Liability insurance makes lawsuits against ordinary individuals into repeat player lawsuits on the defense side, making tort law *in-action* more focused on managing aggregate costs and less focused on the fault of individual defendants.
- S Insurance personnel transform complex tort rules into simple rules of thumb.

(Ross 1970)

The regulatory effects produced by other forms of insurance include the following:

- S Liability is commonly limited whenever a statutory insurance regime is established. This not only creates bar on certain types of tort claims, it also leads plaintiff to shape their claims to avoid the tort bar, thereby shaping the tort system.
- S People may be less likely to sue in tort when they have health, disability, or property insurance covering an injury (depressing the aggregate of tort damages).
- S In jurisdictions that deduct health or other insurance payments from tort damages, the existence of that insurance reduces tort damages.
- S Perhaps paradoxically, the existence of first party insurance can in some cases increase tort damages, by reducing the immediate financial need that might otherwise force the plaintiff to settle cheaply and quickly.

Insurance has also exerted an ideological effect on tort law. The existence of liability insurance helped make it possible to conceive of tort law as a *risks spreading system*. In deed, as a form of insurance rather than simply a mechanism for determining right and wrong in individual situations. (Cf., Ewald 1986) This conception of tort law has had a variety of consequences over the last 100 years. These include: the simplification of tort doctrine; the elimination of common law exceptions to tort; and the partial replacement of tort law by statutory insurance schemes in jurisdictions such as Quebec, Israel and New Zealand. (Sugarman 2001) More recently, the conception of tort law as insurance has lent intellectual force to political efforts in the U.S. and Britain to cap damages and eliminate *A coverage for pain and suffering,*

on the grounds that the benefits provided by the tort/insurance system should mimic the (lesser) benefits provided by first party insurance. (Clarke 1998)

2.2. Insurance and Governing Through Risk

The ideological effect of insurance on tort law illustrates a more general phenomenon, namely the role that insurance technologies, institutions, forms and visions have played in governing through risk. (Baker & Simon 2001). Insurance institutions pioneered the use of formal considerations of risk to direct organizational strategy and resources. Moreover, the actuarial techniques adopted by a wider range of institutions, from police departments to social service agencies and money management all depend upon thinking about the world in the probabilistic, demographic manner that insurance helped make possible. (Ewald 1986).

For most of the 20th century the dominant form of governing through risk was *spreading risk* as insurance institutions increasingly assumed financial responsibility for risks faced by individuals, families and organizations. More recently, both public and private insurance institutions may be placing a greater emphasis on individual responsibility *embracing risk*. The governmental rationalities inherent in spreading or embracing risk have significant consequences for law. Spreading risk leads to the simplification and expansion of tort law, more expansive interpretations of the statutes regulating social insurance and the contracts regulating private insurance, and, in general, more effort to round the hard corners of life. Embracing risk leads to reductions in social insurance benefits, deductibles and benefit caps in private insurance, and links between pension benefits and market performance.

3. Insurance Law

Traditionally, legal scholars have divided the field of insurance law into two parts: (1) the

law concerning the relationship between private insurance organizations and their insureds, which is considered a part of contract law; and (2) the law concerning the state regulation of private insurance organizations, which is considered a part of the law of regulated industries. (E.g., Clarke 1997, Cousy 1999, Jerry 1996, Schimikowski 1999). A broad view of insurance law *should* include the law relating to social insurance, but the division of topics in this Encyclopedia reflects the traditional view; thus, the law regarding social insurance is addressed in Social Insurance, legal aspects.

3.1. Insurance as a Species of Contract

Contemporary insurance institutions grew from two distinct roots: mutual benefit associations dating back to the medieval guilds (or earlier), and marine insurance arrangements dating back to 15th century Italian city-states (and possibly earlier, e.g., Greek bottomry loans). Early insurance law treatises report that courts treated both these forms of insurance within the framework of contract law, adjudicating the obligations of the company or society according to the promises made in the insurance contract.

At least by the mid 19th century, courts in Europe and elsewhere recognized that insurance contracts differed significantly from what was traditionally understood as the ideal type of contract (a voluntary agreement, with terms that were negotiated between two parties with equal bargaining power). Because of the gatekeeper role of insurance institutions, insurance can hardly be said to be voluntary in many instances. Insurance companies almost universally employ standard form contracts with terms that are not subject to negotiation. And, in all but a very few cases, the parties do not have equal bargaining power. Typically, the insurance company is a much larger economic entity; competing insurance companies rarely offer

significantly different terms (except sometimes price); and the insurance company has information about the meaning and value of the contract that the applicant for insurance does not.

For these reasons, courts classed insurance contracts within the general category of *contracts of adhesion* and developed somewhat more protective rules regarding their interpretation of insurance contracts. (Baker 1994). Indeed, insurance contracts have long been regarded as the paradigmatic contract of adhesion and, to the extent that the adjudication of insured disputes has developed the law regarding contracts of adhesion, this might be regarded as another effect of insurance law. (See Contract, legal.)

Recently, the federal legislature and judicial system in the United States has acted to shift an increasingly large portion of the health insurance market away from a private contract regime to a not-yet-stable amalgamation of contract, trust and administrative law. As private health insurance markets grow in Europe and elsewhere, there are likely to be similar efforts to create a paternalistic, yet market-oriented, legal regime governing the relationship between insurance companies and their members.

3.2. Insurance as a Regulated Industry

Contemporary insurance regulation dates to the 19th century, when a rash of insurance insolvencies in the U.S. and Europe led to the establishment of state regulatory authorities. States limited the kinds of investments insurance organizations were permitted to make, and mandated the employment of actuaries to calculate rates and reserves, the filing of reports with state agencies, and minimum capital reserves.

In economic terms, the justifications for these and more recent forms of insurance

regulation are *information problems* and the *positive externalities* of insurance. Insurance consumers are often poorly equipped to evaluate the soundness of insurance companies, to compare insurance contracts, or to evaluate the degree to which insurance companies live up to their promises. These information problems justify solvency, contract, and market conduct regulation. The *positive externalities* of insurance are the benefits that insurance provides to people other than the direct beneficiaries of insurance. Examples include the public health benefits of health insurance and the victim compensation benefits of liability insurance. These positive externalities justify regulation directed at expanding access to insurance.

Solvency remains the primary focus of insurance regulation worldwide. Regulatory tools have expanded to include risk-based capital requirements; electronic auditing of accounts; and a wide variety of limits on the ways that companies can invest the funds held in reserve to pay claims. Not surprisingly, these tools have been used for other than their express purpose. Insurance can be a tremendous engine of capital accumulation, and investment regulations can be used to steer capital into preferred fields. For example, French insurance companies are required to invest some of their funds in French real estate, with the interesting result that French insurance companies have become a major force in the French wine industry. On a larger scale, prohibitions on foreign investment in insurance in countries such as India, China, Brazil, and Argentina were long justified as a way to steer capital to indigenous insurance institutions (typically government-owned or authorized monopolies), which would invest the capital locally. Recently, the International Monetary Fund and the World Bank, along with the globalization of the economy, have been significant forces in opening up capital markets -- including insurance -- to foreign investment. (See Globalization)

Understanding insurance as an institution for storing and accumulating capital, it is no surprise to learn that insurance firms compete with banking and securities firms. Yet, banking, insurance and securities have traditionally been subject to different regulatory regimes. The contemporary convergence of the insurance, banking and securities industries in the financial services marketplace places great strain on the existing regulatory institutions, as they struggle with each other and the firms they regulate, both to achieve regulatory ends and maintain regulatory authority. (Jackson 1999). Convergence and the related trend toward globalization will likely be the primary economic forces driving the evolution of insurance regulation in the foreseeable future. This evolution will address such fundamental issues as whether and to what extent there will be democratic control over capital and the proper level of governmental control (local, federal or international) over regulatory decisions.

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