

THE ECONOMICS OF INSURANCE LAW

A REVIEW OF

DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY. By Kenneth S. Abraham.* New Haven, Connecticut: Yale University Press, 1986. Pp. 254. \$25.00.

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Until recently, insurance law was one of the backwaters of legal scholarship. Of course, a number of case books and texts have analyzed this area, but insurance law has not attracted the same degree of legal scholarship as areas such as antitrust, contracts, and torts. In *Distributing Risk*, Professor Kenneth Abraham of the University of Virginia School of Law attempts to remedy this inadequacy by applying an economic and policy analysis to this class of legal issues. Using this conceptual framework, Professor Abraham reviews the foundations of current insurance law and outlines needed reforms. The result is a book that will probably be widely cited in the insurance law literature.

In Chapter 2 of *Distributing Risk*, Professor Abraham outlines his two part conceptual approach. First, Abraham delineates the fundamental purposes of insurance law, such as economic efficiency and equitable distribution of risk. Economic inquiry into insurance law typically ends here. In addition, Abraham discusses a second area: the institutional context of insurance law, including the role of legislatures, administrative agencies, and the courts.

Abraham's discussion of the purposes of insurance law is the stronger of the two topics he covers. Abraham analyzes the economic underpinnings of insurance, the problems of moral hazard in which insured parties alter their actions after receiving insurance, the problems of adverse selection in which a specific insurance policy attracts disproportionately high risk insurance seekers, and the equitable distribution of risk. Although his economic analysis is generally sound, I would suggest that Abraham has read the Coase Theorem¹ once too often. The Coase Theorem is, of course, one of the most powerful tools of law and economics. In pollution contexts, for example, it asserts that victims of pollution will contract with polluters to eliminate pollution if doing so is efficient

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¹ See, Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

and if transaction costs are zero. Abraham ties many aspects of insurance and potential deficiencies in the insurance market to this theorem. In the insurance context, however, the Coase Theorem is minimally relevant since it sheds little light on the main problems of adverse selection and moral hazard. Abraham's attempt to apply the Coase Theorem by lumping such concerns under the general heading of transactions costs is strained. Abraham's analysis is generally thoughtful and correct, but his emphasis on the Coase Theorem is misplaced.

The subsequent discussion of fair risk distribution is illuminating and reading it would be profitable both to lawyers and to economists. In an insurance scheme based on traditional economics, an individual's insurance premiums will reflect the risks he creates for the insurance company. The result should be a range of insurance rates. For example, male teenage drivers and others with poor accident histories would pay extremely high rates. State laws limit distinctions insurance companies may draw in categorizing policyholders. For instance, race generally cannot be a distinguishing characteristic, and in some states neither can gender. As a result of these statutes which restrict insurance companies from categorizing individuals based on certain personal characteristics, insurance companies often infer personal characteristics from driving histories. Consequently, these distinctions are necessarily grounded more in politics than economics. Abraham does a superb job of reviewing the various theories of distribution that might be applied to analyze the appropriate allocation of risk-bearing by insurance in such instances.

The final section of the conceptual framework involves institutions. Abraham's discussion of institutional roles is weaker than his discussion of the purposes of insurance. However, he does provide a comprehensive perspective on legislators, insurance commissioners, and the courts.

In the remainder of *Distributing Risk*, Abraham applies his framework to several insurance law issues. The issue of greatest general interest is toxic torts in Chapter 3. Insurance for environmental hazards, such as asbestos and Agent Orange, is problematic, Abraham argues, at least in part because these mass toxic torts generate substantial damages. Also, the deterrence value of insurance is low in this context because of the great length of the latency period, the time between the toxic risk and the injury in fact. Abraham argues that as a result, injury awards for mass toxic tort victims do little to promote effective insurance incentives.

Abraham explores several mass toxic tort issues in detail. An issue of particular note is Abraham's treatment of the limitations that subrogation has in this context. He concludes this section by advocating a new role for the insurance industry in which mass toxic tort insurance need not be mandatory. He argues that requiring insurance companies to provide coverage in this context is ineffective. Abraham analyzes a hypothetical mandatory insurance scheme and concludes that it would require the insurance industry to "play an authoritative role—perhaps even an

authoritarian one—in making decisions about the way other businesses conduct their operations.”²

In the next three chapters Abraham discusses issues of traditional insurance policy coverage. Chapter 4 explores efficiency and fairness goals in the classification of risks. Chapter 5 questions why the law upholds insurance contracts based on the expectations of the insured. Finally, Chapter 6 outlines the problems of coordinating different types of insurance coverage.

Abraham devotes one chapter to a legal topic that is currently hotly debated: risk classification. Abraham suggests an analytic foundation for approaching risk classification, which ranges from specific proposals, such as the use of mileage as a risk gauge, to general insurance objectives, such as emphasizing risk reduction in a classification scheme. He also explores issues such as experience rating, which gives any reader a firm foundation in the basic principles underlying insurance.

Using this framework, Abraham then addresses policy issues, such as the fairness of using specific attributes in classifying individual risks. Classifications based on immutable characteristics, such as age, race, and sex, are particularly controversial. Abraham argues that although there is a correlation between these characteristics and risk, linking insurance to these characteristics does not promote risk-averse behavior. Thus, no deterrence results from these classifications. At stake is higher insurance industry costs. This is due in part to adverse selection, in which individuals with high risk characteristics purchase insurance in disproportionately large numbers. Legitimate social policy reasons exist to reject classifications based on certain personal characteristics. One example of this rejection is the subsidization of automobile insurance rates to high risk drivers. Abraham suggests that this subsidization, however, represents an attempt to aid victims of automobile accidents who otherwise would not obtain any relief.

Abraham explores these and other issues with originality and insight. Although *Distributing Risk* does not exhaust all insurance law issues, its scope is reasonably broad. It is also quite thorough in developing an intellectual foundation applicable to almost any insurance problem. This book should be required reading for all insurance lawyers. It should also be invaluable to economists and insurance industry officials. *Distributing Risk* is well written and should have a major impact on insurance law for many years. Yale University Press should give *Distributing Risk* more extensive commercial production and provide aggressive advertising. This would ensure the wide readership that *Distributing Risk* deserves.

² K. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 62.