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## THE ECONOMICS OF THE INSURANCE ANTITRUST SUITS: TOWARD AN EXCLUSIONARY THEORY

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## I. INTRODUCTION

On March 22, 1988, the Attorneys General of eight states filed antitrust actions in state and federal courts<sup>1</sup> alleging that major insurance and reinsurance companies colluded to boycott specific types of insurance coverage<sup>2</sup> in violation of section 1 of the Sherman Act.<sup>3</sup> The suits suggest that this collusion was responsible for the unprecedented increase in premiums and concomitant erosion of coverage that has come to be known as "the insurance crisis."<sup>4</sup> The lawsuits have provoked fierce denials by insurance industry participants, including assertions that the suits, which came in an election year, were politically motivated.<sup>5</sup> The litigation is certain to involve some of the country's highest-paid law firms in a protracted struggle that, by all estimates, will cost many millions of dollars.<sup>6</sup>

The allegations of collusion, however, are directly at odds with one prominent explanation of the insurance crisis. In a recent article, Professor George Priest specifically rejects the view that "the insurance crisis has been caused by explicit price-fixing by commercial casualty insurers."<sup>7</sup> Instead, he offers an

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1. Alabama, California, Massachusetts, Minnesota, New York, West Virginia, and Wisconsin brought suit in the United States District Court for the Northern District of California. In addition, Texas filed a related complaint in a Texas state court. New York Attorney General's Office, *Fact Sheet on the Multi-State Prosecution of Antitrust Violations in the Insurance Industry*, March 22, 1988, at 1 (unpublished manuscript on file with authors) [hereinafter *Fact Sheet*]. In June, 10 more states—Alaska, Colorado, Connecticut, Maryland, Michigan, Montana, New Jersey, Pennsylvania, Ohio, and Washington—filed "largely identical" actions in the same court. Shalowitz & Bradford, *Antitrust Litigation Mounts: 10 New States Sue Insurers*, BUS. INS., June 20, 1988, at 1, col. 1.

2. *Fact Sheet*, *supra* note 1, at 1.

3. See 15 U.S.C. § 1 (1982).

4. See, e.g., *Sorry, Your Policy is Canceled*, TIME, Mar. 24, 1986, at 18; Brody, *When Products Turn Into Liabilities*, FORTUNE, Mar. 3, 1986, at 20.

5. "Several observers said there was a definite political motivation behind the suits, noting that some of the attorneys general are seeking office this year." Greenwald, *Lawsuits Rock Industry*, BUS. INS., Mar. 28, 1988, at 37, col. 1; see also *An Outrageous Waste*, BUS. INS., Apr. 4, 1988, at 8, col. 2 ("Perhaps the suits are merely designed as a publicity stunt for politically ambitious attorneys general.").

6. Shalowitz, *Industry's Defense to Be Costly*, BUS. INS., Apr. 11, 1988, at 47.

7. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1527 (1987) (citations omitted). Interviewed after the filing, Professor Priest commented:

alternative theory that explains the breakdown in insurance markets by the judicial expansion of liability that caused markets for certain types of insurance coverage to unravel.<sup>8</sup>

The insurance industry's first public response might be interpreted as a demurrer—even taken as true, the allegations do not describe illegal behavior.<sup>9</sup> Important facts in the case have not yet emerged or are in dispute. Nevertheless, we seek to evaluate the credibility of various explanations of the defendants' behavior before society devotes the immense resources necessary to litigate an antitrust suit of this proportion. Using the lens of economic theory, we examine whether the states' case is plausible taking the facts set forth in the complaints as true. This Article will therefore analyze, under a demurrer standard, whether a coherent economic theory underlies the plaintiffs' Sherman Act claims.

In the first section, we set out the alleged facts and describe the states' theory of the case. The second section not only criticizes the economic plausibility of the collusive explanation, but also finds Priest's competitive explanation to be at odds with the alleged facts. The final section argues that an exclusionary explanation may provide the best factual fit, although discovery is warranted.

## II. THE STATES' THEORY OF THE CASE

### A. *Eliminating Types of Insurance Coverage*

The Attorneys General allege that four of the country's largest insurance companies<sup>10</sup>—together with major domestic and international reinsurers<sup>11</sup> and the industry's trade organiza-

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"If this case were to go to the Supreme Court, it would probably dismiss it. The Supreme Court has been hostile to such wide-reaching investigations of industries without a clear understanding of the issues involved." Greenwald, *supra* note 5, at 37, col. 1.

8. Priest, *supra* note 7, at 1534-35. An alternative noncollusive theory suggests that the dramatic increase in premiums was caused by escalating predictions of future legal liability. Epstein, *Shooting the Insurance Messenger*, Chicago Tribune, May 30, 1986, § 1, at 25, col. 1.

9. *An Outrageous Waste*, *supra* note 5.

10. These companies were Hartford, Allstate, CIGNA, and Aetna.

11. Reinsurance companies offer insurance for the insurance companies who are the issuers of primary insurance policies. Domestic reinsurers included, among others, General Reinsurance Corporation and North American Reinsurance Corporation; foreign reinsurers included a number of Lloyd's of London syndicates. Complaint, *New York v. Hartford Fire Ins. Co.*, 88 Civ. 0983WWS (N.D. Cal. filed March 22, 1988) [hereinafter Complaint]. The seven state suits filed in the Northern District of California have been

tion<sup>12</sup>—conspired to eliminate three types of insurance coverage from commercial general liability (CGL) policies.<sup>13</sup> As described below, CGL policies are written under an industry-wide standard form promulgated by the Insurance Services Office (ISO). The standard form explains the terms and conditions under which insurance is offered.

According to the complaints, the conspirators sought to exclude coverage for pollution damages and certain lawyers' fees from CGL policies, and to reduce the time period covered by the ISO CGL forms. Specifically:

- (1) The traditional CGL coverage for sudden or accidental pollution was eliminated under the revised 1986 ISO CGL forms;<sup>14</sup>
- (2) Revised CGL forms end the historical obligation of the insurer to pay the full legal costs of defending a claim and substitute a defense cost cap, under which the insured's legal defense costs are counted as part of the stated policy limits;<sup>15</sup>
- (3) New CGL forms are written on a claims-made rather than an occurrence basis. Under a claims-made policy, policyholders are covered for all claims made while the policy is in effect. By contrast, an occurrence policy provides coverage for claims whenever they are made, as long as they are based on incidents that occurred while the policy was in effect. (See Figure at Appendix). For example, under an old occurrence policy covering the year 1956, insureds were protected against claims made by workers who were exposed to asbestos during that year, even if the claims were not filed until 1986. The move to a claims-made form therefore eliminated the insured's coverage for prospective claims made after the expiration of a current policy, the so-called long tail risk.<sup>16</sup>

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consolidated before Judge William W. Schwarzer under docket number 88 Civ. 1688WWS. The complaints are virtually identical.

12. The Insurance Services Office, Inc. is a nonprofit trade organization for approximately 1,400 primary property/casualty insurance companies operating in the United States.

13. Complaint, *supra* note 11, at 4-5. Most businesses, municipalities, and nonprofit organizations have traditionally purchased CGL insurance to cover third-party casualty damage claims. CGL insurance does not include coverage for damage to the property of an insured. *Id.* at 5.

14. *Id.* at 6.

15. *Id.* In other words, lawyers' fees were deducted from total coverage under the new CGL forms. Under the old forms, a \$2 million policy would pay for \$2 million in damage awards as well as any legal fees incurred in defending against a claim.

16. The tail refers to the length of time during which claims may be made after a given injury. *Id.* Priest notes that tails of varying lengths—ranging from five years to sixty days—are now being offered. Priest, *supra* note 7, at 1575-76. Long tail risks are

(4) The movement to the claims-made form by itself would not have eliminated insurers' liability for past injuries if the claims for these injuries were made while a current policy was in effect. That is, a claims-made policy for 1986 would still cover claims arising out of an injury that occurred in 1956, as long as the claims were filed during 1986. (See Figure at Appendix). To eliminate their responsibility for these past risks, however, insurance companies changed the CGL forms to include a retroactive provision. This provision ended insurance companies' liability for injuries that occurred before a certain date, typically the start of the policy term.<sup>17</sup>

The various modifications of the CGL forms can be viewed as manifestations of a single phenomenon. The old CGL forms offered the insureds coverage for a bundle of risks. The new forms unbundled three different types of insurance while simultaneously eliminating all coverage for certain risks. The new CGL forms left each of these risks—pollution coverage, coverage for high legal fees, and long tail claims—completely uncovered.

### *B. Mechanisms Used to Change the CGL Forms*

Insurance industry supporters admit that the companies met, . . . talked, and . . . agreed that they wanted to write commercial general liability insurance on a claims-made form and that coverage for pollution damage should not be written as part and parcel of the CGL form. They decided these changes were necessary for . . . them . . . to conduct business on sound financial footing.<sup>18</sup>

But the Attorneys General argue that the major insurers and reinsurers went further, using "boycotts, threats, intimidation and other coercive conduct"<sup>19</sup> in their efforts to get the changes in coverage adopted. According to the Attorneys General,<sup>20</sup> the boycott and other coercive conduct constitute per se

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particularly important in the case of latent injuries such as exposure to asbestos, when the lag between initial exposure and onset of symptoms (and hence, of claims) is measured in decades. Felstiner & Siegelman, *Neoclassical Difficulties: Tort Deterrence for Latent Injuries* (forthcoming in *LAW & POLICY* (1989)). The claims-made form gives insurers the option to limit their liability for future claims by refusing to renew the policies of insureds who exhibit an unexpected increase in claims.

17. *Fact Sheet*, *supra* note 1, at 3.

18. *An Outrageous Waste*, *supra* note 5, at 8.

19. *Complaint*, *supra* note 11, at 3.

20. *Fact Sheet*, *supra* note 1, at 10.

violations of the Sherman Act<sup>21</sup> and related state antitrust laws. Specifically, the complaints allege that the reinsurers, in conspiracy with the large insurance companies, threatened to stop underwriting CGL insurance unless the new forms were adopted. The alleged boycott centered on the control of two inputs essential to the provision of CGL insurance—pooled information (statistical support) and access to reinsurance markets. The complaints allege that the conspirators threatened to withhold supply of one essential input—reinsurance—in an attempt to control the provision of the other essential input—ISO forms supported by pooled information.<sup>22</sup>

### 1. Statistical Support

Insurance policies require statistical support—actuarial data—on the claims record for a given type of policy. In order to know the appropriate premium to charge on a particular type of policy, the issuing firm must have a good estimate of the probability that insureds will make claims for damages against that policy and of the likely amount of such claims. The ISO promulgates standard form policies so that the claims information of its more than 1,400 members will be comparable, and thus can meaningfully be pooled. The law of large numbers<sup>23</sup> implies that the estimates derived from the pooled claims of all insurance companies will give a more accurate picture of the expected value of claims under a policy than will the experience of any company taken by itself.<sup>24</sup>

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21. See 15 U.S.C. § 1 (1982). The McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (1982 & Supp. 1985), grants a limited exemption to the insurance industry from antitrust laws:

Congress provided in § 2(b) [of the Act] that the antitrust laws “shall be applicable” unless the activities of insurance companies are the business of insurance and regulated by state law. Moreover, under § 3(b) the Sherman Act was made applicable in any event to acts of boycott, coercion, or intimidation.

*Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 221 (1979). Because it is unclear what degree of state regulation is necessary to trigger the Act, companies in states that have deregulated insurance premiums might not be exempt from the Act. *But see Ohio AFL-CIO v. Insurance Rating Bd.*, 451 F.2d 1178, 1184 (6th Cir. 1971), *cert. denied*, 409 U.S. 917 (1972) (a potential for state supervision is sufficient to establish the exemption).

22. Complaint, *supra* note 11, at 3.

23. The law of large numbers dictates that as the sample size becomes large, a sample mean will tend to converge to the actual mean of the population from which the sample is drawn. R. HOGG & E. TANIS, *PROBABILITY AND STATISTICAL INFERENCE* 153-54 (1977).

24. Complaint, *supra* note 11, at 23, argues that for all but the largest insurers, it is impossible to operate profitably without using the ISO database; according to the

A further cost savings from the use of ISO forms arises from the regulatory context. In most states, regulatory authorities must approve insurance forms: companies wishing to use nonstandard forms must secure regulatory approval from multiple jurisdictions rather than relying on the ISO to do so for them. This extra effort makes it considerably more expensive for any single company to use non-ISO forms.<sup>25</sup>

The complaint alleges that two of the defendant companies—Hartford and Aetna—pressured the ISO to end its statistical support for the occurrence form and to endorse only the claims-made form, which the ISO had been considering in 1984. The plaintiffs contend that the defendants objected not only to the ISO's proposal to continue supporting the old occurrence form, but also to certain provisions of the claims-made form (specifically, the inclusion of pollution coverage, absence of defense cost cap, and lack of retroactive provision).<sup>26</sup> The attempt to force the ISO to adopt only a claims-made form was a failure. On December 15, 1983, the ISO Board of Directors decided to support *both* the old occurrence form *and* a claims-made form that did not contain the retroactive date, defense cost cap, or pollution exclusion provisions.

After the defendants failed to achieve their aims through the ISO, they allegedly sought to use control of the second major essential input to force the abandonment of the old form and its replacement by the form they favored.

## 2. Access to Reinsurance Markets

The second crucial input in the provision of an insurance policy is reinsurance. Even with standardized policy forms and industry-wide actuarial information, insurance companies need to maintain a portfolio of diversified risks.<sup>27</sup> Thus, if a firm writes a ten million dollar CGL policy but already has a large

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complaint, two large CGL insurers attempted to develop and support their own forms in 1984 but found it unprofitable to do so. *See also* R. POSNER & F. EASTERBROOK, ANTITRUST 1045 (1981) ("The casualty and life insurance business can operate efficiently only if each firm has substantial information about the likelihood of injury, death, and so on in specific classes of cases. The data are most useful if aggregated across the experience of many insurers.").

25. Telephone conversation with New York Assistant Attorney General George Sampson (April 27, 1988).

26. Complaint, *supra* note 11, at 27.

27. *See* R. POSNER & F. EASTERBROOK, *supra* note 24, at 1045 ("[S]ome policies call for large payments, so large that it is prudent for a firm to 'reinsure' them.").

volume of other CGL policies outstanding, then it may choose to sell off some of the ten million dollar risk by purchasing insurance from a reinsurer against claims made on the policy.

The Attorneys General allege that the defendant insurance companies organized a boycott by major domestic and international reinsurers of the 1984 ISO claims-made form.<sup>28</sup> Believing that they would not be able to reinsure policies written under the 1984 form, other insurance companies agreed to modify the form along the lines favored by the defendant companies.<sup>29</sup> In September 1984, the ISO's Executive Committee voted to accept many of the defendants' proposed modifications.<sup>30</sup> The ISO did not agree to eliminate the old occurrence form, however, and the Attorneys General allege that the defendants then tried to organize a boycott by reinsurers of the old occurrence form.<sup>31</sup>

Whether this attempt was successful is a matter of some dispute. The ISO did withdraw its support for the old occurrence form on July 1, 1987.<sup>32</sup> The Attorneys General claim that "[w]ithout such support, ISO members could not continue to use the 1973 occurrence form . . . . Although many insurance consumers preferred the 1973 [occurrence] forms, the availability of this type of coverage has been severely restricted."<sup>33</sup> However, *Business Insurance*, a trade publication, claims in a lead editorial and in several articles that the 1973 occurrence form has continued to be "the most widely used CGL form,"<sup>34</sup> and that "most CGL risks are still written on occurrence forms."<sup>35</sup>

In sum, the complaints maintain that the defendants repeatedly attempted to boycott the old occurrence forms and withhold reinsurance of policies using these forms. Richard Posner has advocated, however, that boycotts "are properly attacked under the antitrust laws when, and only when, they are employed to enforce a practice that is objectionable on the basis of substantive antitrust policy."<sup>36</sup> For Posner, boycotts can be

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28. Complaint, *supra* note 11, at 27-31.

29. *Id.* at 34. The new forms excluded pollution coverage and contained a retroactive date provision. The defense-within-limits provision was not part of the new form, although the ISO Executive Committee allegedly agreed to consider inclusion of such a provision at a later date. *Id.*

30. *Id.*

31. *Id.* at 34-39.

32. *Id.* at 38.

33. *Id.* at 39.

34. *An Outrageous Waste*, *supra* note 5, at 8.

35. Greenwald, *supra* note 5, at 37.

36. R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 210 (1976).

used to further both pro-competitive and anti-competitive ends, so that economically rational antitrust analysis should proscribe only boycotts that seek to restrain trade.<sup>37</sup> This Article will now examine competing explanations for the defendants' alleged actions in an attempt to determine their economic motivations. Our goal is to determine, taking the plaintiffs' allegations as true, whether the boycott was designed to restrain trade.

### III. DO THE ALLEGATIONS STATE A CAUSE OF ACTION?

#### A. *The States' Theory of Collusion*

The complaints are unusual documents in two respects. First, they allege underlying facts with great specificity. Instead of generally asserting that defendants entered into a conspiracy "on or about a certain date," the complaints detail specific meetings and events.<sup>38</sup> But combined with this wealth of factual detail is an analytic poverty of motive or purpose. Complaints often include only general allegations of motive. However, these complaints are unusual because the plaintiffs' theory of the case completely fails to elaborate why the defendants undertook the alleged conspiracy. In short, the plaintiffs fail to explain how the conspiracy could have increased the conspirators' profits.

While profitability has not been an element of Sherman Act cases, courts, especially since *Matsushita Electric Industrial Co.*

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37. Posner elaborates:

A boycott is simply a method of self-help enforcement. It can be used by firms to enforce a cartel, in which event it is bad because cartels are bad; but it can equally well be used, and often is, by firms or individuals to enforce a code of truthful advertising, to minimize credit risk, or to express opposition to communism, or racial discrimination, or the use of nonunion labor.

*Id.* at 207. Under this theory, the McCarran-Ferguson Act's exemption for all acts except "boycott, coercion or intimidation" is especially misguided. See R. POSNER & F. EASTERBROOK, *supra* note 24, at 1044 ("If price fixing is lawful under the McCarran-Ferguson Act when done explicitly, why not allow it when achieved by a boycott?").

The Act may, however, be a rational way of fostering information pooling while discouraging welfare-reducing collusion. Because the ability to punish breaches of collusive agreements is a prerequisite to successful collusion, see Ayres, *How Cartels Punish: A Structural Theory of Self-Enforcing Collusion*, 87 COLUM. L. REV. 295 (1987), prohibiting boycott as a method of punishment may undercut the insurance industry's ability to punish. If the incentives to deviate from pro-competitive information pooling are smaller than the incentives to deviate from anti-competitive price collusion, then the Act may instrumentally further Posner's goal of disaggregating efficient and inefficient behavior.

38. For example, the complaint alleges that the defendants conspired at "a dinner at the Garrick Club, a private men's club [in London] . . . on July 4, 1984," Complaint, *supra* note 11, at 30, and another dinner on "the evening of September 19, 1984 . . . at The Board Room Club, a private club in New York City." *Id.* at 33.

*v. Zenith Radio Corp.*,<sup>39</sup> have been extremely skeptical of alleged conspiracies that are found to be irrational—that is, unprofitable. In *Matsushita*, the Supreme Court reversed a denial of summary judgment against plaintiffs who had alleged that Japanese electronics manufacturers conspired to sell television components below cost. Although there was evidence indicating that the firms engaged in predatory pricing, the Court stressed economic theory, suggesting that such pricing is rarely profitable.<sup>40</sup> Therefore, the decision signalled that summary judgment would be appropriate when plaintiffs lacked an economically coherent motive to conspire:

[T]he absence of any plausible motive to engage in the conduct charged is highly relevant to whether [summary judgment should be granted]. Lack of motive bears on the range of permissible conclusions that might be drawn from ambiguous evidence: if petitioners had no rational economic motive to conspire, and if their conduct is consistent with other, equally plausible explanations, the conduct does not give rise to an inference of conspiracy.<sup>41</sup>

An unfriendly reading of the case might suggest that absence of motive can even trump direct evidence of predation.<sup>42</sup> Accordingly, post-*Matsushita* antitrust plaintiffs are well-advised to link allegations of conspiracy to a profitable motive.

On its face, the Attorneys General's theory lacks a plausible explanation for why the defendants would have entered into the cartel. As described above, the attempted changes in the ISO forms may represent an effort to unbundle and eliminate completely the sale of three distinct types of insurance coverage. Although cartels will generally try to restrict output,<sup>43</sup> reducing output to zero would only succeed in eliminating *all* cartel profits for those types of coverage.<sup>44</sup> Under standard cartel theory, colluding firms want to reduce, but not eliminate, output, so that

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39. 475 U.S. 574 (1986).

40. *Id.* at 589 (“[T]here is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful.”).

41. *Id.* at 596-97.

42. *See id.* at 594 n.19 (“expert opinion evidence of below-cost pricing has little probative value in comparison with the economic factors . . . that suggest that such conduct is irrational”); *see also id.* at 606 (White, J., dissenting).

43. *See, e.g.,* Ibrahim, *Oil Prices Stabilize on Hopes for a Production Agreement*, N.Y. Times, May 4, 1988, at D2, col. 1 (OPEC continues to attempt to curtail oil production).

44. Formally, cartels will never want to reduce output beyond the point at which marginal revenue exceeds marginal cost. R. POSNER, *supra* note 36, at 243.

they can sell the remaining goods at a higher price.<sup>45</sup> The alleged conduct seems to be an irrational way to organize a cartel.

In addition, eliminating long tail, pollution, and legal fees coverage should not have increased the profitability of or the demand for the remaining types of CGL coverage because the components of the standard CGL bundle do not seem to be demand substitutes for each other.<sup>46</sup> Cartels have incentives to fulfill consumers' desires efficiently, but to do so at an inflated price.<sup>47</sup> Making the "stripped down" CGL coverage less desirable should therefore reduce the potential profits from collusion.

To tell a persuasive collusionary story, the Attorneys General must explain how a change to the new CGL forms would have increased the defendants' ability to collude. But neither the complaints nor the accompanying fact sheet<sup>48</sup> provides such an explanation. The plaintiffs have vaguely alleged that the defendants sought to "sell the stripped down [CGL forms] at a deluxe price,"<sup>49</sup> but they did not indicate why the defendants could not have more profitably sold the CGL policy at a super-deluxe price;<sup>50</sup> or alternatively, why competition would not reduce the stripped down CGL price to the competitive level.<sup>51</sup> In either case, plaintiffs need to explain how the conspiracy would increase the defendants' ability to collude over price. If they could collude after the forms were changed, why could they not collude beforehand? If they could not collude on the old forms,

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45. See Priest, *supra* note 7, at 1528.

46. For example, it is difficult to see how pollution insurance can substitute for other types of CGL insurance. By definition, two goods are complements if an increase in the price of one leads to a decrease in the quantity demanded of the other. Note that even if the components of the CGL coverage were substitutes, eliminating some of them would not necessarily increase the overall profit compared with what would have been earned when all components were sold simultaneously.

47. For example, it would be hard to see how agreeing to sell cars without radios could increase the profitability of an automobile cartel. See Steiner, *Program Patterns and Preferences, and the Workability of Competition in Radio Broadcasting*, 66 Q.J. ECON. 194 (1952) (monopolists provide more diverse programming than competitors clustering around the median taste).

48. See *supra* note 1 and accompanying text.

49. *Fact Sheet, supra* note 1, at 4.

50. As indicated above, colluding over a desirable product should be more profitable than colluding over an inferior quality product.

51. Plaintiffs might argue that although defendants could not induce state insurance commissions to raise the price of the old policies above competitive levels, they could keep the state commissions from lowering the current premiums when the new, lower-quality coverage was introduced. The magnitude of this regulatory effect is questionable, however, as many states no longer set CGL premium rates.

why would changing the forms increase their ability to do so now?<sup>52</sup>

### B. *Priest's Theory of Competitive Unraveling*

Not only does the alleged behavior appear inconsistent with traditional cartel behavior, but it also seems equally inconsistent with traditional notions of competitive behavior: competition would not lead to concerted efforts to eliminate the supply of products at any price. Indeed, this unwillingness to provide certain types of insurance at any price was central to the insurance crisis.

Professor George Priest has provided an important response to this criticism.<sup>53</sup> His theory explains the elimination of certain types of insurance without recourse to concerted anticompetitive behavior by insurance companies. Priest ties his theory not to the regulated structure of the industry, but to the informational aspects of risk pooling that are uniquely central to the provision of insurance.<sup>54</sup>

In a competitive insurance market, premiums will be tied to the average expected liability of the insureds. To the extent that insurers are not able to differentiate among people with high- and low-liability risks, the premium charged will be too high for low-risk insureds and too low for high-risk insureds, so that the low-risk insureds will effectively cross-subsidize the high-risk

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52. See *infra* notes 66-96 and accompanying text for our suggestions of two possible mechanisms by which the changes in forms might have facilitated collusion.

53. See generally Priest, *supra* note 7.

54. Priest's article is the first to analyze comprehensively the relationship between the judicial expansion of tort liability and the insurance crisis. It suggests that the expansion of tort liability has amounted to mandated provision of third-party insurance by sellers of products and services. In many cases, Priest argues, the judicial tying of the sale of insurance to the sale of the underlying product or service has resulted in unwanted insurance by inefficient providers. (For example, Priest notes that tort law increasingly provides insurance coverage for nonpecuniary losses, even though "no first-party insurance market provides [such] coverage." *Id.* at 1553.) Although the analysis that follows takes issue with Priest's unqualified rejection of anticompetitive theories of the crisis, we do not question these important insights of his work.

Other analyses of the tort crisis have also been forthcoming. See, e.g., *Symposium*, 48 OHIO ST. L.J. 317 (1987), especially Abraham, *Making Sense of the Liability Insurance Crisis*, 48 OHIO ST. L.J. 399 (1987); *Tort Reform Symposium*, 24 SAN DIEGO L. REV. 795 (1987), especially Trebilcock, *The Social Insurance-Deterrence Dilemma of Modern North American Tort Law: A Canadian Perspective on the Liability Insurance Crisis*, 24 SAN DIEGO L. REV. 929 (1987); *Perspective on the Insurance Crisis: Symposium*, 5 YALE J. ON REG. 367 (1988), especially Winter, *The Liability Crisis and the Dynamics of Competitive Insurance Markets*, 5 YALE J. ON REG. 455 (1988); see also P. HUBER, *LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES* (1988).

consumers. If the risk pool becomes too diverse, low-risk consumers may drop out of the pool, choosing instead to self-insure rather than pay the cross-subsidy.

Priest suggests that changes in the liability system increased the heterogeneity of consumer risks, to the point that insurance for these types of risk began to unravel:

The unraveling process would consist of the lowest-risk members of the pool dropping out, which, in turn, would necessitate premium increases. The premium increases would be followed by a new set of lowest-risk members dropping out; then, further increases in premiums; and so on, in successive episodes of withdrawals and premium rises.<sup>55</sup>

For Priest, the insurance crisis originated in changes in the legal system that caused insurance markets to unravel; and the attempts of the insurance companies to change the forms were attempts to stop or mitigate this unraveling.

Priest argues that the insurers moved to exclude the three types of coverage as “a method to narrow insurance risk pools in the face of the increasing legal risk generated by modern tort law.”<sup>56</sup>

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55. Priest, *supra* note 7, at 1576. Priest does not fully explain why this unraveling should be complete. When low-risk insureds drop out of the pool, the variance of the remaining risk pool is reduced (albeit with a higher mean risk). At some point, after successive waves of low-risk insureds have exited the pool, the remaining risk pool should be homogeneous enough to support a stable (higher) premium.

At various points in the article, Priest begins to offer explanations for why the unraveling may be complete. For example, complete unraveling should occur if there is significant moral hazard accompanying the adverse selection of Priest's theory, whereby the high risk insureds would take actions to become even riskier as the unraveling proceeded. *Id.* at 1583 n.244. Alternatively, if the high-risk insureds left in the pool after the adverse selection are too small a group for the law of large numbers significantly to diversify risk, then unraveling might be complete.

Priest analogously argues that changes in the liability system that decrease independence of risk can undermine the diversification benefits of the large numbers. *Id.* at 1563. As risks become more interdependent, insurers are effectively insuring just one big risk.

Finally, Priest suggests that for events that are virtually certain, the comparative advantage of insurance companies over self-insurance falls. *Id.* at 1582-83. At the extreme, purchasing insurance against an event that will occur with probability 1.0 requires a premium equal to the expected value of the loss. Rather than purchasing such a policy, an insured could simply set aside the amount of the loss in a savings account. Thus, Priest argues that the contraction of risk pools leaves only insureds with high probabilities of loss in the market. However, it is precisely such insureds who can self-insure relatively cheaply compared to the costs of purchasing insurance. When these insureds choose to cover themselves by setting aside their own reserves against losses, market deterioration might be complete.

56. *Id.* at 1576.

Each of these coverage exclusions represents an effort to narrow risk pools and make them attractive to low-risk members. . . . The exclusion from municipality policies of claims relating to pollution narrows the risk pool to those cities whose managers have never authorized, regulated, or otherwise monitored hazardous waste sites or waste disposal. . . . Similarly, the adoption of a claims-made policy narrows the risk pool by excluding coverage of the long tails of liability exposure that are increasingly common in chemical, pharmaceutical, and hazardous waste industries.<sup>57</sup>

The potential power of Priest's theory is that it provides a competitive explanation for two crucial aspects of the insurance crisis:

- (1) insurance premiums have increased more rapidly than damage awards; and
- (2) there has been a dramatic move toward self-insurance.

If true, Priest's competitive unraveling theory provides a truly benign—indeed benevolent—motive for the insurers' actions: by choosing new forms that reduced the variance of the risk pool, the insurers could have protected all insureds from unraveling insurance markets and prevented grossly inequitable cross-subsidization.

Moreover, Priest's theory suggests that the insurance companies' actions were not concerted. Such a suggestion is especially important after *Matsushita* because "[t]o survive a motion for summary judgment or for a directed verdict, a plaintiff seeking damages for a violation of § 1 [of the Sherman Act] must present evidence 'that tends to exclude the possibility' that the alleged conspirators acted independently."<sup>58</sup> Priest's theory provides the possibility of independent action. Given that CGL insurance needed to be written on standard forms for actuarial reasons, each insurance company had an independent reason to lobby for a change to more efficient forms. Simply because the actions were parallel does not mean they were necessarily concerted.<sup>59</sup>

Priest's scenario of competitive unraveling, however, rests

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57. *Id.* at 1574-75.

58. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588 (1986) (quoting *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 764 (1984)).

59. Central to the concept of concerted action is the element of consideration—"I will reduce output, if you agree to as well." Competitive markets, alternatively, are awash with parallel, independent acts—witnessed, *inter alia*, by competitors' choice of an identical (competitive) price. See VI P. AREEDA, *ANTITRUST LAW* (1986).

crucially on the dual assumptions that insurance companies cannot differentiate between low- and high-risk insureds, but that the insureds themselves can. If either assumption fails, the unraveling would not take place. If insurers could differentiate between high- and low-risk insureds, they could eliminate the cross-subsidization by charging different premiums to consumers with different risks.<sup>60</sup> If the insureds themselves could not differentiate their risks under a new legal rule, they would be in no better position than the insurance companies to assess whether they are subsidizing others in the risk pool or being subsidized. For example, Priest claims that “[t]he adoption of claims-made policies and retro-date provisions are responses, in part, to the substantial disagreement and continuing uncertainty among United States jurisdictions with respect to whether a provider’s liability dates from the occurrence of the injury or its manifestation.”<sup>61</sup> However, with regard to this legal uncertainty, it is hard to see how individual insureds would be in a better position to know whether they are high- or low-risk members of the insurance pool than the companies that offer them insurance.

While it is certainly an empirical question, the class of (a) new, legally created (b) heterogeneous risks that (c) insurance companies cannot differentiate but that (d) insureds can, seems too small to explain all the recent behavior of insurance markets. Thus, although Priest’s theory is internally coherent, its reliance on asymmetric information seems to exclude some of the most important aspects of the insurance crisis.<sup>62</sup>

### C. *Alternative Collusive Explanations*

Even if Priest is correct that the changes in the CGL forms reduced buyer heterogeneity, this could also explain why the change of forms increased the industry’s ability to collude.

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60. Priest’s own observation that long tails of liability exposure “are increasingly common in chemical, pharmaceutical, and hazardous waste industries,” provides a ready example of how insurers might disaggregate heterogeneous risk pools. Priest, *supra* note 7, at 1575.

61. *Id.*

62. Priest suggests that the growth of self-insurance groups, and the convergence of premiums to aggregate coverage among firms that purchase insurance, provides empirical support for his hypothesis of asymmetric information. *Id.* at 1575-76. But the increase in self-insurance could simply be the product of rationing. When insureds get closed out of the market for pollution coverage, it is a natural response that they might start providing it themselves.

Structural theories of collusion posit that the ability of firms to collude successfully depends on the characteristics of the environment in which they operate.<sup>63</sup> As George Stigler noted,<sup>64</sup> homogeneity among buyers is a structural condition favorable to collusion. The more buyers resemble each other, the easier it is for a cartel to reach agreement and detect price shading by an individual firm.<sup>65</sup> Thus, increased homogeneity among consumers enhances the ability to collude.

If, as Priest suggests, the ISO changes made the industry's output more homogeneous, the new forms would have enhanced the ability to collude. According to Priest, changes in tort doctrine increased the heterogeneity of the risk pool to which a given type of insurance policy was sold. Other things being equal, this increased heterogeneity would have made collusion more difficult.<sup>66</sup> Seen in this light, the unbundling of the CGL forms might be reasonable as a response to the greater diversity among insurance risks, but for collusive, rather than Priest's competitive, reasons. Priest's own insight might be turned on its head to provide the needed mechanism, outlined above,<sup>67</sup> for explaining how unbundling insurance coverage could have *increased* the industry's ability to collude.

A second possible collusive explanation for defendants' conduct derives from the fact that claims-made policies with retroactive provisions make it more difficult for insureds to switch insurers. Under an occurrence form policy covering a given year, an insured is covered for all events that occur during that year, regardless of when the claim for insurance is actually made. If the insured switches companies in the interval between the initial incident and the filing of a claim, the old insurance policy still covers that claim.

Under a claims-made form with a retroactive provision, the insured is covered only if both the underlying event and the

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63. See Ayres, *supra* note 37, at 295; Weiss, *The Structure-Conduct-Performance Paradigm and Antitrust*, 127 U. PA. L. REV. 1104 (1979).

64. Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44 (1964).

65. "When no two orders are ever exactly alike or when there is leeway for deviations from the . . . product specifications in hundreds of particulars, . . . coordination on joint profit-maximizing strategies becomes extremely difficult to maintain." F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 201 (2d ed. 1980).

66. If all insureds are identical, one need look only at the price of a standard policy to determine if it represented chiseling on a cartel agreement. However, when insureds become very diverse, a given customer may be offered a low price because the firm is anxious to make another sale or because the insured is actually a low risk.

67. See *supra* note 52 and accompanying text.

claim occur during the policy period. However, the form is generally written so that when a policy is renewed, the retroactive date remains set at the start of the original policy, rather than starting over again at the renewal date.<sup>68</sup> This tends to discourage switching because when an insured switches, he loses coverage for certain long tail risks that would have been covered had he renewed the original policy. The creation of switching costs is a particularly effective way of facilitating market division because by their very nature, such costs insulate a firm's demand from price reductions by its rivals.<sup>69</sup>

Without a more detailed set of facts, an evaluation of whether buyer heterogeneity or switching costs are of sufficient magnitude to explain the defendants' alleged conduct is impossible. We suggest below the kind of information that would be necessary to assess the importance of these effects.

In sum, both the states' collusion theory and Priest's competitive unraveling theory fail to explain important phenomena. The states' explanation does not demonstrate why a cartel would seek to eliminate form coverage for long tail, pollution, and legal fee risks (although a collusive desire to raise switching costs might explain the long tail exclusion). Priest's unraveling theory provides a competitive explanation for coverage exclusion but at the price of highly restrictive assumptions. The next section examines further failing of the collusion and competition theories and explores an exclusionary explanation of defendants' behavior.

#### IV. TOWARD AN EXCLUSIONARY EXPLANATION OF DEFENDANTS' BEHAVIOR

Concerted anticompetitive behavior may be broadly categorized as either collusionary or exclusionary: collusive behavior involves cooperation among competitors, usually to raise prices above the competitive level; exclusionary behavior involves attempts to exclude competitors from a market (as an antecedent to collusion among the remaining firms).<sup>70</sup> Rather than an

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68. *Fact Sheet*, *supra* note 1, at 4.

69. Klemperer has shown that "[t]he resulting (noncooperative) equilibrium [in a market with switching costs] may be the same as the collusive solution in an otherwise identical market with no switching costs." Klemperer, *Markets with Consumer Switching Costs*, 102 Q.J. ECON. 375, 377 (1987) (emphasis in original). Switching costs also facilitate strictly collusive behavior, by making "chiseling" unprofitable. *Id.* at 386-87, 387 n.19.

70. R. POSNER, *supra* note 36, at 218.

attempt to organize collusion among firms in the insurance industry, we suggest that the defendants' behavior may have been an effort to exclude smaller rivals from the CGL market. An exclusionary theory of the defendants' actions is appealing because it, unlike the collusive or competitive explanations, provides a rationale for (1) the resistance of consumers, smaller insurance companies, and the ISO to using the new claims-made forms; and (2) the defendants' attempts to remove the old occurrence form even as an alternative for their rivals.

#### A. *Explaining Rivals' Resistance*

Competitive or collusionary theories of the attempt to eliminate the old occurrence form have difficulties in explaining a series of anomalous facts. If the occurrence form (with the pollution and legal fee coverage) was unprofitable, why should a boycott have been necessary to get the industry to abandon it? If the old form was a guaranteed money loser, why were many firms seemingly so wedded to it; why was there resistance to switching to the new form; and why does the occurrence form (without pollution coverage) still dominate the CGL market?<sup>71</sup>

The apparent failure of the claims-made form to replace the occurrence form runs counter to both the Priest and the collusionary theories of the insurance crisis. Priest argues that "[t]he adoption of claims-made policies is a way to salvage some form of insurance availability"<sup>72</sup> by "narrow[ing] risk pools and mak[ing] them attractive to low-risk members."<sup>73</sup> If Priest is correct, low-risk insureds should have preferred claims-made to occurrence forms because the former offer narrower risk pools with less cross-subsidization. Even high-risk insureds should have preferred the claims-made forms to a complete unraveling of the market, which would leave them with no possibility of obtaining insurance. Moreover, if the claims-made form was, as Priest asserts, a superior instrument for providing insurance to at least some elements of a deteriorating risk pool, it is hard to

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71. Greenwald, *supra* note 5, at 36, 37, cites industry observers who point out that the claims-made form has not been widely accepted. *An Outrageous Waste*, *supra* note 5, at 8, notes: "As everyone knows, the claims-made CGL form has been a flop. Indeed, even the revised occurrence form is a flop. The most widely used CGL form is still the 1973 occurrence form, albeit with an exclusion for all pollution damages."

72. Priest, *supra* note 7, at 1575.

73. *Id.* at 1574.

explain why many smaller insurance companies and the ISO resisted the introduction of such policies.

The defendants' attempts to eliminate ISO support even as an alternative to the newly promulgated claims-made form creates an even larger tension with competitive explanations. Priest's theory attempts to explain why individual insurance companies would favor the claims-made form, but it offers no explanation for the defendants' alleged interest in prohibiting their rivals from using the old occurrence forms. Indeed, Priest's theory seems to suggest that defendants should have applauded their rivals' unprofitable preference to insure unraveling risks.

Consumer resistance to the claims-made form also appears inconsistent with the collusion theories, however. The claims-made form's lack of acceptance indicates consumer dissatisfaction with the coverage exclusions. As argued earlier,<sup>74</sup> it is hardly plausible that insurance companies would have colluded to sell to insureds products they did not want. Moreover, the collusive theories cannot readily explain the resistance on the part of smaller insurance companies or the ISO to the claims-made form.<sup>75</sup>

These anomalous facts do suggest a third possibility, however. Perhaps the defendants' objective was not to induce rivals to collude with them in charging higher prices, but to exclude rivals from the market by choosing forms with which the defendants had a competitive advantage. The large and growing literature on "raising rivals' costs"<sup>76</sup> has persuasively demonstrated that such a strategy can, in theory, be effective. Activities that raise rivals' production costs and make production unprofitable can drive rivals from a market. If the switch to new

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74. See *supra* notes 47-50 and accompanying text.

75. Moreover, in light of the *Matsushita* decision, the apparent failure of the collusive agreement (if there ever was such a thing) suggests that plaintiffs would be ill advised to argue a collusive motive for defendants' conduct. "The alleged conspiracy's failure to achieve its ends in the two decades of its asserted operation is strong evidence that the conspiracy does not in fact exist." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 592 (1986).

76. See Ayres, *supra* note 37, at 308-09; Krattenmaker & Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986); Krattenmaker & Salop, *Competition and Cooperation in the Market for Exclusionary Rights*, 76 AM. ECON. REV. 109 (1986) (Papers & Proceedings); Salop & Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983) (Papers and Proceedings); see also Ordovery & Saloner, *Predation, Monopolization, and Antitrust*, in HANDBOOK OF INDUSTRIAL ORGANIZATION (R. Schmalensee & R. Willig eds.) (forthcoming 1989).

forms was in some way disadvantageous to the small firms but advantageous to the large ones that organized the boycott, then the defendants' lobbying to eliminate ISO support of old forms can be viewed as an exclusionary attempt to raise the costs of their rivals.<sup>77</sup> The resistance to the new forms by the industry as a whole, as well as by consumers, would be a predictable response to such exclusion.

How, then, might such a "raising rivals' cost" strategy work? We offer two possibilities. First, any change in the forms that increases fixed costs will leave smaller firms disadvantaged vis-à-vis larger ones. The move to the new claims-made forms and the exclusion of what had been standard coverage (for example, coverage of pollution) may have entailed certain fixed startup costs. For example, new computer programs have to be written to monitor claims under the new policies and new actuarial analyses must be done to determine pricing for the new forms. Most of these costs are constant regardless of the volume of insurance issued; the cost to rewrite a computer program capable of tracking 100 policies is the same as the cost to rewrite a program capable of tracking 10,000 policies. But since larger companies can spread these fixed costs over a larger number of policies, they gain a cost advantage over smaller rivals.<sup>78</sup>

A second means by which the claims-made forms might give an advantage to larger firms arises from the nature of the retroactive provision. As discussed earlier,<sup>79</sup> the use of claims-made policies with retroactive provisions could make it more difficult for insureds to switch insurers. Realizing that under the claims-made policies they will be tied to individual insurance companies, insureds may choose the larger insurance providers who have more secure and longer standing claims reputations.

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77. Although Salop and others have conceived of the "raising rivals' cost" strategy solely as an exclusionary device, see Salop & Scheffman, *supra* note 76, "[t]he ability to raise the costs of other firms can [also] be used as a collusive practice . . . . [I]f a cartel member breached the collusive agreement, the cartel could credibly punish by raising the breaching firm's cost." Ayres, *supra* note 37, at 308. The collusive theory of the reinsurance boycott provides an example of raising rivals' costs as a punishment. Under the states' collusion theory, failure to abide by the claims-made conspiracy would result in higher costs of reinsurance. In contrast, under the present exclusionary theory, forcing rivals to use the claims-made forms increased their costs and thus drove them from the market.

78. Much depends, of course, on the magnitude of these additional fixed costs caused by the move to the new forms. Without more discovery, economists could tell either side a convincing story.

79. See *supra* notes 68-69 and accompanying text.

Thus, forcing smaller insurance companies to write only claims-made policies might put the smaller firms at a competitive disadvantage.<sup>80</sup>

Without more factual support, both mechanisms for raising rivals' costs are speculative. A satisfying theory of the defendants' behavior, however, must not only explain why the defendants wanted to use the new claims-made form, but also (1) why they wanted to force their rivals to use the forms and (2) why the rivals, the ISO, and the insureds resisted the use of the forms. Although the precise mechanism of how the new forms disadvantaged smaller insurance companies is, at this point, conjectural, an exclusionary theory can explain these otherwise perplexing phenomena.<sup>81</sup>

*B. Eliminating the Old Occurrence Form: A Non-Exclusionary Explanation?*

The previous section suggested that the defendants' interest in forcing the new claims-made form on their rivals was an attempt to exclude by putting their rivals at a competitive disadvantage. A nonexclusionary interpretation of this behavior, however, might be found in an analysis of information pooling. As discussed above,<sup>82</sup> using standard forms to pool actuarial information significantly reduces the costs of providing insurance. For smaller firms, such pooled information may even be an essential input. By pooling the comparable claims data of standard policies, insurers can develop a more accurate picture of the claims that are likely to be made under a given type of policy. Thus, it may be welfare enhancing to have a single insurance form rather than to allow companies to offer a number of different forms.<sup>83</sup>

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80. Raising the insured's switching cost is formally a demand impairing action. See Ordover & Saloner, *supra* note 76, at 42 (placing a rival at a competitive disadvantage "can be accomplished by raising the rival's costs or by impairing its ability to generate demand for its product").

81. An exclusionary theory is also supported by anecdotal evidence that a smaller insurance company decided to stop selling CGL insurance after the incidents at issue in the case. Telephone conversation with G. Sampson, *supra* note 25.

82. See *supra* notes 22-24 and accompanying text.

83. This point has been recognized implicitly in the congressional exemption of the insurance industry from antitrust laws in the McCarran-Ferguson Act; it has also been recognized explicitly by a leading group of insurance purchasers, the Risk and Insurance Management Society, Inc. (RIMS). In a response to the Attorneys General's complaints, RIMS noted,

As risk managers and consumers [of insurance] we are acutely aware that

However, companies might not independently and voluntarily choose to use a single form. When any single company decides to use an additional form, some of the social costs of that decision (the decrease in informational accuracy for claims against the first form) accrue to other firms; but the firm itself captures the benefits of the decision (presumably, sales to marginal consumers). Hence, collective decisions to use a single form might be necessary.<sup>84</sup>

Collective decisions to pool information have been affirmed in other contexts. In 1918, Justice Brandeis upheld a rule of the Chicago Board of Trade that prohibited after-hours trading at other than the closing price on the exchange.<sup>85</sup> The Supreme Court's opinion has been justified on the ground that the after-hours rule prevented traders from "free riding"<sup>86</sup> on the exchange's information: "The people who traded after hours, *i.e.*, off the Board of Trade, may have been free riders using the information generated by the transactions on Board to decide at what price to sell after hours, without compensating the (other) members of the Board for the information."<sup>87</sup> The after-hours rule both stopped members from free riding on the exchange's price information and forced members to share or pool the information of all trades by letting it be consolidated with the other transactions into a single market price.

The defendants may claim that the insurance context is analogous: just as every decision to buy or sell a bushel of wheat conveys some information to those not party to the transaction, each claim filed against a given type of insurance policy reveals something to the industry as a whole about the nature of the risk being insured. Under this interpretation, the effort to persuade the industry to use a single form was meant not to exclude the smaller firms, but instead to pool information efficiently.

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common coverage policy forms provide benchmarks that enable insurance buyers and regulators to compare coverage among insurers.

... A wide variety of forms would produce more litigation, more conflicting judicial interpretations and lead to more confusion in the marketplace.

Statement of the Risk and Insurance Management Society, Inc., *quoted in Antitrust Suit Litigation Puts Focus on State Regulations*, BUS. INS., Apr. 25, 1988, at 1.

84. See R. POSNER & F. EASTERBROOK, *supra* note 24, at 1045 ("Information pools ... involve extensive cooperation among insurance firms.").

85. Board of Trade v. United States, 246 U.S. 231 (1918).

86. Free riding has been defined: "When people use a valuable good without paying for it, economists call them 'free riders . . .'" R. POSNER & F. EASTERBROOK, *supra* note 24, at 177.

87. *Id.*

This analogy, however, is flawed. Although the after-hours traders could be accused of free riding on the exchange's price information, it is difficult to see how the small insurance companies' refusal to change to the claims-made form gives them free rides on the claims-made information pool. Instead, the after-hours rule and defendants' attempts to eliminate the occurrence form are analogous only in that both force the pooling of information.

Although the prevention of free riding is laudable, it is much less tenable to argue that small insurers have an obligation to produce information for the defendants. Even if using a single form is more efficient than multiple forms, there is no reason why the defendants should have a right to impose their form on unwilling rivals. To make the *Chicago Board of Trade* analogy compelling, the defendants at a minimum would need to explain why their rivals resisted the new forms, and why, given this difference of opinion, society should favor the claims-made form.<sup>88</sup>

Moreover, it is at least possible that claims-made insurers could "translate" occurrence form data into claims-made data, so that the industry's experience with the old occurrence form would not need to be abandoned in setting policies under the new form. As the Figure in the Appendix demonstrates, insurers might be able to estimate what their exposure under the old occurrence forms would have been had they used claims-made forms. They could accomplish this estimation by eliminating the long tail risks to recreate the claims-made data. If such data translation or "reverse engineering" were possible—by eliminating long tail claims (or similarly, by censoring pollution or legal fees claims) from the database—then even under *Chicago Board of Trade*, the defendants would have had little reason to force their rivals to use new claims-made forms.<sup>89</sup>

## V. CONCLUSION

We have examined three theories that seek to explain the

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88. Information pooling can explain the necessity of a concerted agreement (and its enforcement), but cannot, without a theory of buyer or seller heterogeneity, explain the rivals' resistance to entering the agreement. By way of contrast, the externality of the prisoners' dilemma can only be cured by an enforceable agreement, but the prisoners in the game would never be reluctant to enter such an agreement. See G. OWEN, *GAME THEORY* 129 (1983); Ayres, *supra* note 37, at 298.

89. Note, however, that the claims-made data cannot be translated into occurrence data. Because claims-made data sets will not reveal information about long tail or other excluded risks, occurrence insurers would face an asymmetric data disadvantage.

defendants' alleged action. The states' theory that the defendants sought to collude is the least plausible because it fails to explain how the complete elimination of certain types of insurance coverage could be profitable (with the possible caveat that the higher switching costs of the new forms could facilitate collusion).

Priest's theory of the insurance crisis corrects this failure by arguing that competitive unraveling made certain risks uninsurable. However, competitive unraveling depends crucially on the assumption that insurers cannot differentiate between high- and low-risk consumers but that the consumers themselves can. Moreover, Priest's theory fails to explain why the defendants' rivals, the ISO, and the consumers themselves resisted the defendants' proposed forms.

The attraction of our exclusionary theory is that it can account for both the defendants' efforts to eliminate certain types of coverage and the rivals' and consumers' resistance. Our exclusionary motive is plausible, however, only if the larger firms had the ability to raise the costs of their rivals.<sup>90</sup> This ability in turn depends on the extent to which the new forms were somehow differentially more costly for smaller firms than for larger insurance companies. The defendants' efforts to impose the new forms on the industry might have put their rivals at a competitive disadvantage if the smaller insurance firms were made thereby to absorb fixed startup costs or if the new forms more effectively tied insureds to individual insurers for longer periods. Perhaps the large firms lacked the ability to raise their rivals' costs in this precise manner, but the ability of the exclusion theory to account for coverage elimination and rivals' resistance warrants further attention.<sup>91</sup>

As the foregoing analysis indicates, these alternative theories capture different aspects of a complex reality.<sup>92</sup> Our choice

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90. Moreover, to be profitable the exclusionary strategy must also work to raise prospective rivals' costs as an entry barrier to deter potential competition.

91. We do not mean to suggest that these explanations must be taken as mutually exclusive. It could well be, for example, that as markets were unraveling, insurance companies saw an increased opportunity to collude and took advantage of it, much as cigarette companies seized on the Great Depression of the 1930s to cartelize their industry. See *American Tobacco Co. v. United States*, 328 U.S. 781 (1946).

92. Ralph Winter has recently published an insightful alternative explanation of the insurance crisis. Winter, *The Liability Crisis and the Dynamics of Competitive Insurance Markets*, 5 YALE J. ON REG. 455 (1988). Winter's approach parallels both that of Priest and of this Article, in that Winter tests the competing explanations of the crisis against certain stylized facts. Specifically, Winter proposes a sophisticated cyclical model of the

among the competing explanations must ultimately turn on “goodness of fit”—which theory best explains the phenomena of interest.<sup>93</sup> The process of discovery will challenge the collusive, competitive, and exclusionary theories to explain a larger and more detailed set of facts, further distinguishing the theories. This Article has suggested that explaining the defendants’ desire to force claims-made forms on their rivals and the rivals’ and consumers’ resistance are central issues for further investigation.<sup>94</sup> While the states’ explanation of the case lacks plausibility, their allegations can support a coherent theory of attempted exclusion. Moreover, the exclusionary theory is more persuasive than currently articulated competitive alternatives. Under these circumstances, the plaintiffs’ (possibly amended) complaint should withstand an initial motion to dismiss.

In the end, residual ambiguities and unexplained behavior will likely remain. In this void, the court’s initial presumption may become determinative.<sup>95</sup> Much will turn on whether society starts with a presumption that antitrust law should prohibit behavior inconsistent with competition or permit behavior inconsistent with collusion or exclusion. Although Chicago school theorists have advocated strong initial presumptions of competition,<sup>96</sup> courts might pause before construing boycotts of unclear purpose in defendants’ favor—especially when defendants attempt to dictate the products that their rivals can sell.

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insurance market as a competitive explanation of defendants’ behavior and the ensuing crisis. Like Priest’s theory, however, Winter’s model cannot explain the defendants’ rivals’ resistance to the proposed ISO changes. Moreover, he does not address whether the cyclical effects of his theory could have enhanced defendants’ exclusionary or collusionary opportunities.

93. Richard Schmalensee has noted that the rich proliferation of models in industrial organization and antitrust analysis means that scholars and policymakers cannot simply plunk down “the” model and expect it to grind out a correct understanding of real-world behavior for them. Schmalensee, *On the Use of Economic Models in Antitrust: The Realemon Case*, 127 U. PA. L. REV. 994 (1979).

94. For example, exploring the changes in insurance premiums and insurers’ costs under the various forms may help validate or reject specific theories. Attention should also be paid to the insurers’ interest in participating in the boycott. For example, if the small insurers’ default risks were particularly significant for long tail risks, reinsurers who would be held jointly and severally liable might have incentives to reduce the systemic risk of default by prohibiting certain types of coverage.

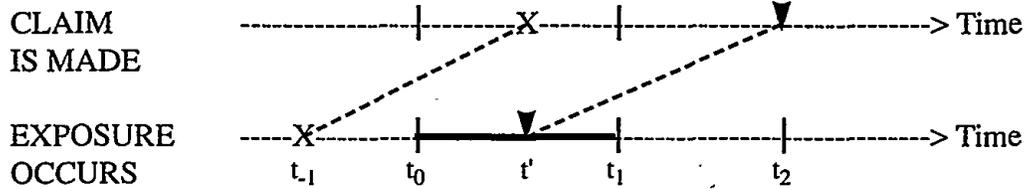
95. Characterization may also play an important role. Under traditional doctrine, much can turn on the success of advocates to characterize the events as per se (rather than rule of reason) violations. R. POSNER, *supra* note 36, at 135.

96. See Posner, *The Efficiency and the Efficacy of Title VII*, 136 U. PA. L. REV. 513 (1987).

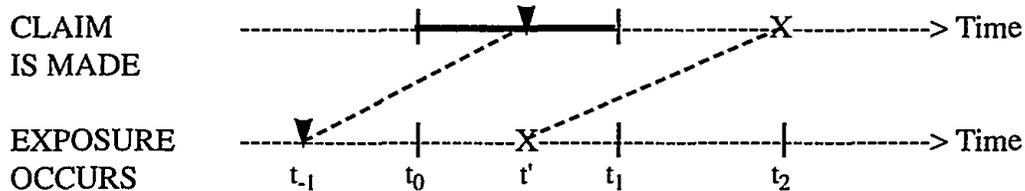
## APPENDIX

## COVERAGE UNDER 3 INSURANCE POLICIES

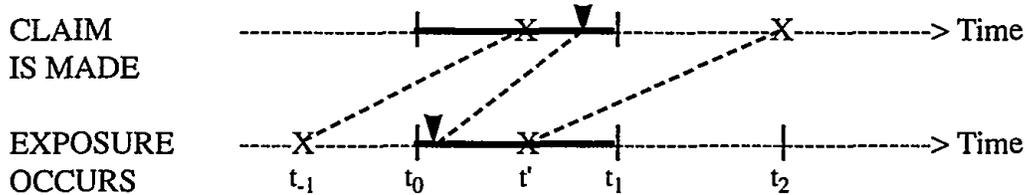
## (1) Old Occurrence Form



## (2) Claims Made Form, No Retroactive Date



## (3) New Claims Made Form, with Retroactive Date



## KEY:

- = Period covered by policy
- ▼ = A claim covered by policy
- X = A claim *not* covered by policy

We take the hypothetical case of insurance for damages resulting from a worker's exposure to asbestos. Under an occurrence policy in effect from time  $t_0$  to  $t_1$ , the employer will be covered if the exposure occurs at time  $t'$  even if the claim is not filed until  $t_2$ . Claims based on exposure at time  $t_{-1}$  (or  $t_2$ ) will not be covered even if the claim is made at time  $t'$ , while the policy is in effect.

A claims-made policy in effect from time  $t_0$  to  $t_1$  will cover all claims made during that interval. Thus, a claim based on an

exposure to asbestos at time  $t_{-1}$  and filed at time  $t'$  will be covered. A claim filed at time  $t_2$  will not be covered, even if it is based on exposure that occurred at time  $t'$ .

A claims-made policy with a retroactive date set at the start of the policy period covers only those situations in which *both* the exposure and the claim occur during the period from  $t_0$  to  $t_1$ . If either the exposure or the claim falls outside of this interval, the policy will not provide coverage.

