CONNECTICUT INSURANCE LAW JOURNAL

VOLUME 11 2004-2005 NUMBER 1

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THE CASE AGAINST DOG BREED DISCRIMINATION BY HOMEOWNERS' INSURANCE COMPANIES

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INTRODUCTION

In the Spring of 2003, I moved from Virginia to Texas to begin work as a tenure-track faculty member at Texas Tech University School of Law. I brought my two dogs with me: Saffy (a 4-year-old mixed breed whose parents were a fluffy red Chow Chow and a big black Labrador Retriever) and Semona (a 2-year-old Rottweiler). Neither Semona nor Saffy has ever bitten anyone. Neither has shown any aggressive tendencies. Both are extremely playful and friendly animals.

After I placed a bid on a house in Lubbock, Texas, I began the search for homeowners' insurance—a process which I thought would be straightforward and easy. Much to my surprise, dozens of insurance companies denied my application outright. The reason? Semona is a Rottweiler and Saffy is half-Chow. Rottweilers and Chow Chows are on the "blacklist" of dog breeds. Some insurance companies believe they, along with Pit Bulls, Huskies, Doberman Pinchers, and other specified breeds, are more likely to bite humans and, in turn, cause liability claims to be brought against their owners. Even mixed breeds, like my half-Chow Saffy, are blacklisted. This practice is known by many dog owners as "breed discrimination."

Thankfully, the story ended happily for my dogs and me. After weeks of calling nearly every insurance agent in Lubbock, I was able to obtain insurance through the Texas Farm Bureau, an organization that advocates for farmers and farming issues.[1] Had it not been for the Farm Bureau, I would have found myself on the horns of a horrible dilemma: whether to buy a home or give up my dogs. Anyone who knows me can confirm that this dilemma would have been easy to resolve; I would have chosen my furry family members over home ownership.[2] Sadly, however, many

1. The Farm Bureau provides a number of services to its members, including insurance and banking. *See* Tex. Farm Bureau, *at* http://www.txfb.org (last visited July 7, 2004).

2. On the other hand, renting would not necessarily have been an easy task either. Many landlords prohibit certain breeds from living on their property or forbid dogs altogether. Obtaining renters' insurance would also have been difficult because of breed discrimination by insurance companies.

Americans are finding themselves in similar positions and are opting to give up their dogs to animal shelters.[3]

Breed discrimination by insurance companies is on the rise in the United States. Insurers are refusing to write homeowners' policies for people who own breeds that the insurance industry considers to be dangerous. Their decisions are based solely on the breed of the animal, not the individual characteristics of the particular dog. Dog bites are certainly a public health concern. However, the insurance industry's approach to the problem is based on faulty assumptions and improper use of dog bite statistics. The insurance industry has prejudged entire breeds of dogs as being "too risky," instead of taking a more reasonable dog-to-dog approach to risk assessment.

Major veterinary and breed registry organizations have strongly opposed breed discrimination in insurance. Authors of scientific studies on dog bites have even argued against the use of their data to support breed-based decision-making by insurers and legislatures. Dog owners across the country have spoken out about the horrible choice they have been forced to make between obtaining insurance and keeping their dogs.

There has existed a historic tension between risk classification and social policy. Classification and insurability decisions are usually "actuarially justified"—that is, the insurance company has identified a statistical correlation between a characteristic and increased risk. Actuarial justification is frequently cited by insurers as a reason to avoid social regulation. Insurers exist to make a profit for their shareholders. They do so by minimizing risk which, in turn, minimizes claims paid out.

Actuarial justification is only the first step in determining the social propriety of a proposed underwriting mechanism. Social utility of the risky conduct must also be considered. Statutes across the United States are replete with examples of legislatures overruling actuarially justified practices in favor of competing social policies. "Red-lining" is a classic example. Actuaries identified statistical correlations between living in certain neighborhoods and increased risk for claims against homeowners' policies. As a result, insurance companies began to refuse to write policies in these high-risk neighborhoods. The neighborhoods in question were often economically depressed and occupied by members of racial or ethnic minorities. Legislatures and courts stepped in to prohibit red-lining, despite the actuarial justification for the practice.[4]

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3. *See infra* Part IV.C. for a discussion of the effects of breed discrimination.

4. *See* 42 U.S.C. §§ 3601-31 (2003); MICH. COMP. LAWS § 37.2302 (2001); N.J. STAT. ANN. §§ 10:5-4, 10:5-9.1 (2002); *see also* NAACP v. Am. Family Mut. Ins. Co., 978

Breed discrimination is a different animal altogether. Even without considering the high social utility of pet ownership, insurers have been unable to demonstrate an actuarial justification for discriminating based on breed. As the multidisciplinary Task Force on Canine Aggression and Human-Canine Interactions concluded, "[d]og bite statistics are not really statistics, and they do not give an accurate picture of dogs that bite."[5] The popular notion that Pit Bulls and Rottweilers are inherently more likely to bite is simply not supported by the available statistics.

When the social utility of pets is added to the equation, breed discrimination becomes even more unreasonable. Dogs and other domesticated animals provide immeasurable joy and happiness to the families that own them. Even some components of the legal system itself have evolved to recognize pets as being more than mere chattel.[6] In addition, the failure to obtain homeowners' insurance is a death knell for homeownership—no insurance, no mortgage; no mortgage, no house.

My argument is quite simple: Decisions regarding the provision, rating, termination, or renewal of a homeowners' insurance policy should not be based on ownership or possession of a particular breed of dog unless there is evidence of dog-specific risk. Insurers would concededly be actuarially justified in charging higher premiums or declining coverage for people who own dogs that have unjustly bitten in the past. After all, the best predictor of future behavior is past behavior. Breed discrimination, as it currently stands, is not actuarially justified because scientists have not been able to accurately determine whether certain breeds are inherently more dangerous, or instead whether a breed's high population is making it *appear* that the breed is more dangerous.

The consequences of breed discrimination could not be greater. Homeowners' insurance is the gatekeeper to homeownership. Without homeowners' insurance, a buyer cannot get a mortgage. For most Americans, if a person cannot obtain a mortgage, he cannot buy a home.

In Part I of this article, I will give an overview of the problem: dog breed discrimination by insurers, as well as a related problem of breed-specific legislation by some states. In Part II, I will analyze the major scientific studies on dog bites, showing that no one has adequately proven

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F.2d 287, 297-98 (7th Cir. 1992) (Fair Housing Act is applicable to allegations of racially discriminatory red-lining).

5. American Veterinary Medical Association, Task Force on Canine Aggression and Human-Canine Interactions, *A Community Approach to Dog Bite Prevention*, 218 J. AM. VETERINARY MED. ASS'N 1732, 1733 (2001) [hereinafter *Task Force*].

6. *See* Richard Willing, *Under Law, Pets Are Becoming Almost Human*, USA TODAY, Sept. 13, 2000, at 1A.

that some breeds are more inherently dangerous than others. In Part III, I will show that breed discrimination and breed-specific legislation are opposed by most veterinary and animal groups. Part IV will demonstrate that insurers have been ignoring the unique and special role that pets play in millions of American homes. I draw upon not only the profoundly personal arguments advanced by myself and others, but also the way in which the law itself is evolving by recognizing pets as more than mere property. Part V shows how the insurance industry is a highly regulated industry which subjects itself to legislative control where, as here, the public is being harmed by underwriting decisions not driven by actuarial justification. I will also offer a number of alternatives to breed discrimination.

I. DOG BREED DISCRIMINATION

Breed discrimination in insurance is a recent phenomenon that was preceded by the enactment of "breed-specific legislation" ("BSL") by some state legislatures and municipalities. Both breed discrimination and BSL are a perceived response to highly publicized attacks by certain breeds, particularly Pit Bulls.

A. HIGHLY PUBLICIZED ATTACKS BY PIT BULLS

In the 1980s, there were a number of high-profile attacks on humans by Pit Bulls. These attacks led to a near-hysterical reaction by members of the communities that were affected by the attacks and by the legislators who represented them.

In March of 1984, Pit Bulls attacked Angie Hands, a 9-year-old girl in Tijeras, New Mexico.[7] The dogs bit her right leg to the bone, ripped flesh from her arms, and tore her ear in half.[8] The child survived but had to undergo years of reconstructive surgery.[9] She had been attacked by her uncle's four Pit Bulls in between her bus stop and her home.[10] The small community of Tijeras—located outside of Albuquerque—responded with an outright ban on Pit Bull ownership.[11] Dog owners challenged the law in

7. Fred Bayles, *Pit Bullterriers: Too Fierce to Live? Call for Ban Follow Maimings, Death*, THE RECORD, (N. N.J.), Dec. 30, 1985, at B16.

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

court, but the law was upheld as a constitutional exercise of the town's police power.[12]

The attack on Angie Hands followed a number of other Pit Bull attacks around the country. A 4-year-old girl was killed in Oregon City when she fell into a yard where a Pit Bull was chained.[13] Two Pit Bulls mutilated their owner in Edgemere, Maryland.[14] A recent, widely-publicized attack in San Francisco has also brought the issue of aggressive dogs to the forefront of public attention. In January 2001, Diana Whipple was mauled to death by two Presa Canario dogs. The dogs were owned by a pair of lawyers. Evidence at the owners' murder trials showed that the dogs had tried to attack other people and animals in the past. Both defendants were convicted and served prison time.[15] A subsequent civil lawsuit brought by Ms. Whipple's mother was settled out-of-court.[16]

B. THE REACTION OF SOME STATE LEGISLATURES: "BREED-SPECIFIC LEGISLATION"

Highly-publicized Pit Bull attacks in the 1980s led to "knee-jerk reactions" by many communities.[17] Attacks led to editorials, which led to public outrage, which led to swift and spontaneous legislative action that was based on neither good science nor good law. "Breed-specific legislation" ("BSL") began to emerge in the 1980s and early 1990s. These laws targeted specific breeds for regulation or, in some cases, outright bans. BSL is on the rise in the United States. States and municipalities across the country have considered—and in some cases, enacted—breed-specific legislation designed to protect the public against dog bites.[18] Commonly,

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12. Garcia v. Vill. of Tijeras, 767 P.2d 355, 362 (N.M. Ct. App. 1988).

13. Bayles, *supra* note 7, at B16.

14. *Id.*

15. Bob Egelko, *Appeal for Murder Rap in Dog-Maul Case / Attorney General Says Judge Had No Right to Let Knoller Off So Easy*, S.F. CHRON., Apr. 12, 2003, at A15.

16. Kenneth Phillips, *Diane Whipple Case*, *at* http://www.dogbitelaw.com/PAGES/Whipple.html (last visited Jan. 8, 2004).

17. Karyn Grey, Note, *Breed-Specific Legislation Revisited: Canine Racism or the Answer to Florida's Dog Control Problems?*, 27 NOVA L. REV. 415, 417 (2003) (describing a series of dog attacks in Florida); *See* Julie A. Thorne, Note, *If Spot Bites the Neighbor, Should Dick and Jane Go to Jail?*, 39 SYRACUSE L. REV. 1445, 1445 (1988) (asserting that media attention fueled public outrage against Pit Bulls); *See generally* Jeffrey J. Sacks et al., *Fatal Dog Attacks, 1989-1994*, 97 PEDIATRICS 891 (June 1996) [hereinafter *CDC 1989-1994*].

18. For a list of communities that have adopted or are considering BSL, *see* Jan Cooper, *Breed Specific Legislation*, *at* http://www.rott-n-chatter.com/rottweilers/laws/breedspecific.html (last visited June, 2004).

these statutes and ordinances have banned, or placed restrictions on, Pit Bulls, Rottweilers, Doberman Pinschers, Chow Chows, German Shepherds, and Shar-Peis.[19]

Ohio has aggressively targeted Pit Bulls for regulation. Ohio law declares any dog that "[b]elongs to a breed that is commonly known as a Pit Bull dog"[20] is automatically a "vicious dog."[21] "Vicious dogs" must be penned or tied up when on their owners' premises.[22] If off-premises, they must be tethered, caged, or muzzled.[23] Owners must obtain liability insurance to provide coverage in the event of a bite.[24]

BSL has also occurred at the local municipal level. Denver, Colorado, passed an outright ban on the ownership, possession, keeping, control, maintenance, harboring, transportation, or sale of Pit Bulls.[25] A "Pit Bull" is defined as an American Pit Bull Terrier, American Staffordshire Terrier, Staffordshire Bull Terrier, or any dog displaying the majority of physical traits of one of those breeds.[26] This ordinance is in addition to Denver's "dangerous dog" ordinance which regulates "[a]ny dog with a known propensity or disposition to attack unprovoked, to cause injury or to otherwise endanger the safety of humans or other domestic animals."[27] "Dangerous dogs" must be confined while at home and must be leashed and muzzled while traveling.[28]

Not all states have followed the BSL trend. Some legislatures have prohibited BSL enacted by municipalities. Florida enacted a statute that permits localities to regulate dogs "provided that no such regulation is specific to breed."[29] Some legislators have attempted, without success, to repeal this anti-BSL statute in response to several highly-publicized attacks.[30] Minnesota also has the following prohibition against BSL: "A

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19. *Id.*

20. OHIO REV. CODE ANN. § 955.11(a)(1)(B)(4)(a)(iii) (West 2004).

21. *Id.* § 955.11. For a general discussion of Ohio's regulation of Pit Bulls, see Paula Lynn Wilson, Note, *A.M. Sub. H.B. 352: An Overview—Dogs Under Control*, 13 U. DAYTON L. REV. 297 (1988).

22. OHIO REV. CODE ANN. § 955.22(C) (West 2004).

23. *Id.* § 955.22(D)(2).

24. *Id.* § 955.22(E).

25. DENVER, COLO., REV. MUN. CODE § 8-55(a) (2003). The ordinance provides several exceptions, including a grandfather clause, possession by animal shelters or humane societies, public exhibition, or transportation through the city. *Id.* § 8-55(c).

26. *Id.* § 8-55(b)(2). For an analysis of the problem of defining "Pit Bull," *see infra* notes 240-241 and accompanying text.

27. *Id.* § 8-52(a)(1).

28. *Id.* § 8-52(c)-(d).

29. FLA. STAT. ANN. § 767.14 (West 2003).

30. *See* Grey, *supra* note 17, at 418.

statutory or home rule charter city, or a county, may not adopt an ordinance regulating dangerous or potentially dangerous dogs based solely on the specific breed of the dog."[31]

Court challenges to BSL have been largely unsuccessful.[32] Opponents of BSL have brought lawsuits claiming the legislation is unconstitutional because it violates due process (substantive and procedural), the Takings Clause,[33] equal protection, and the vagueness doctrine.[34] Plaintiffs have challenged BSL on due process grounds by arguing that there was no "rational relationship" to a legitimate legislative goal or purpose.[35] Courts have ruled that BSL is a rational response to a perceived problem of dog bites by certain breeds.[36] They have also rejected plaintiffs' arguments that the statutes and ordinances do not provide dog owners with sufficient notice and an opportunity to be heard, which are the requirements for procedural due process.[37] The Tijeras ordinance, for example, provides that a Pit Bull may be destroyed by the village only after a hearing to determine whether the dog is, in fact, a Pit Bull.[38] Plaintiffs have also contended that BSL amounts to a taking without just compensation. Courts have rejected this argument, noting that personal property is subject to

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31. MINN. STAT. ANN. § 347.51(8) (West 2004).

32. *See generally* Russell G. Donaldson, Annotation, *Validity and Construction of Statute, Ordinance or Regulation Applying to Specific Dog Breeds, Such as "Pit Bulls" or "Bull Terriers,"* 80 A.L.R. 4TH 70 (2004). For discussion and background on challenges to BSL, see Thorne, *supra* note 17; Lynn Marmer, Comment, *The New Breed of Municipal Dog Control Laws: Are They Constitutional?,* 53 U. CIN. L. REV. 1067 (1984); Heather K. Pratt, Comment, *Canine Profiling: Does Breed-Specific Legislation Take a Bite Out of Canine Crime?*, 108 PA. ST. L. REV. 855 (2004).

Cases in which courts have upheld the constitutionality of BSL include: Vanater v. Vill. of South Point, 717 F. Supp. 1236 (S.D. Ohio 1989); Colo. Dog Fanciers, Inc. v. City and County of Denver, 820 P.2d 644 (Colo. 1991) (en banc); State v. Peters, 534 So. 2d 760 (Fla. Dist. Ct. App. 1988); Hearn v. City of Overland Park, 772 P.2d 758, 766 (Kan. 1989); Garcia v. Vill. of Tijeras, 767 P.2d 355 (N.M. Ct. App. 1988); State v. Anderson, 566 N.E.2d 1224 (Ohio 1991); State v. Robinson, 541 N.E.2d 1092 (Ohio Ct. App. 1989); Am. Dog Owners Ass'n v. City of Yakima, 777 P.2d 1046 (Wash. 1989) (en banc).

The Massachusetts Supreme Judicial Court, however, found a Pit Bull ban in Lynn, Massachusetts, to be unconstitutional. Am. Dog Owners Ass'n, Inc. v. City of Lynn, 533 N.E.2d 642, 646 (Mass. 1989).

33. U.S. CONST. amend. V.

34. Sallyanne K. Sullivan, *Banning the Pit Bull: Why Breed-Specific Legislation is Constitutional*, 13 U. DAYTON L. REV. 279, 280-93 (1988).

35. *See, e.g., Garcia*, 767 P.2d at 358. Since dog ownership is not a "fundamental right," BSL need only meet the "rational relationship" test to be constitutional. Sullivan, *supra* note 34, at 281.

36. *See, e.g., Garcia*, 767 P.2d at 358-62.

37. *See, e.g., id.* at 361.

38. *Id.*

regulation under the police power of a state.[39] Challenges based on vagueness have argued that identifying a dog's breed is difficult.[40] Most courts have found BSL to be sufficiently specific to enable a reasonable dog owner to determine if his or her dog is covered by the particular statute.[41] Plaintiffs have also alleged that BSL violates equal protection by singling out Pit Bulls but not other breeds.[42] Courts have noted that Pit Bull ownership is not a "suspect classification" and therefore BSL need only have some reasonable basis to be constitutional. Courts have concluded that sufficient evidence exists to support a finding that Pit Bulls can be regulated by legislatures and municipalities.[43]

One significant decision found BSL to be unconstitutional. In *American Dog Owners Assoc., Inc. v. City of Lynn*,[44] the Massachusetts Supreme Judicial Court upheld a trial court's finding that the City of Lynn's attempt to regulate Pit Bulls was unconstitutional.[45] The Court noted that it is particularly problematic to determine a dog's breed. The Court held, "[t]here is no scientific means, by blood, enzyme, or otherwise, to determine whether a dog belongs to a particular breed, regardless of whether 'breed' is used in a formal sense or not."[46] The Court upheld the trial court's finding that animal control officers had no real standards to identify Pit Bulls, in part because they had no training in breed identification.[47] The ordinance included a ban on mixed-breed dogs that contained "any mixture" of Pit Bull.[48] This provision was likewise found to be unconstitutional since it is scientifically "impossible to ascertain" whether a dog is part Pit Bull.[49] The ordinance was also unconstitutional because it tried to define "Pit Bull" as including any breed where "common understanding and usage" dictated that the dog was, in fact, a Pit Bull.[50]

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39. *See, e.g., id.* at 361-63.

40. *See, e.g.*, Hearn v. City of Overland Park, 772 P.2d 758, 762-65 (Kan. 1989).

41. *See, e.g., id.*

42. *See, e.g., id.* at 766.

43. *See, e.g., id.*

44. 533 N.E.2d 642 (Mass. 1989).

45. The ordinance prohibited the sale of Pit Bulls and required the registration of any Pit Bulls within city limits. *Id.* at 644. Transportation of Pit Bulls was permitted only if they were muzzled and leashed. Even then, they could only be transported to a veterinarian. *Id.*

46. *Id.* at 644. For further discussion of the problem of identifying dogs by breed, see *infra* Part II.E.

47. *American Dog Owners Assoc., Inc.*, 533 N.E.2d at 644.

48. *Id.* at 646.

49. *Id.*

50. *Id.*

The combination of these facts led the court to conclude that the statute was too vague to pass constitutional muster.[51]

C. THE REACTION OF INSURERS: "BREED DISCRIMINATION"

While some communities and states have responded to dog bites with breed-specific legislation designed to regulate or outlaw certain breeds, insurance companies have also reacted to the problem of dog bites in a breed-specific manner. Dubbed "breed discrimination" by dog owners, insurance companies have started making coverage and renewal decisions based on one's ownership of certain breeds of dog.

1. A Rise in Breed Discrimination

During 2003 and 2004, the media brought breed discrimination to light. The *CBS Evening News with Dan Rather* aired a story in June of 2003 that featured a family that had difficulty obtaining insurance because they owned a Dalmatian.[52] The report stated, "[a]nimal lovers have a term for what the insurance company did. They call it 'breed discrimination'—arbitrarily punishing all dogs of certain breeds because some are vicious."[53] In the months that followed, several newspaper stories discussed the prevalence of breed discrimination and documented the effects this practice has had on families.[54] These news reports replicate the experience I had in

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51. *Id.* The purpose of this article is not to address the constitutionality of BSL, but rather to focus on the insurance aspect of breed discrimination. For further discussion of BSL, *see* Linda S. Weiss, *Breed-Specific Legislation in the United States*, ANIMAL LEGAL AND HISTORICAL WEB CENTER (2001), *at* http://www.animallaw.info/articles/aruslweiss2001.htm (last visited June 8, 2004); Randall Lockwood, *Humane Concerns About Dangerous Dog Laws*, 13 U. DAYTON L. REV. 267 (1988); Grey, *supra* note 17; Ohio Valley Dog Owners, Inc., *OVDO is Opposed to Breed-Specific Bans*, *at* http://www.canismajor.com/orgs/ovdo/bslho.html (2003) [hereinafter *OVDO*]; Cindy Andrist, Note, *Is There (and Should There Be) Any "Bite" Left in Georgia's "First Bite" Rule?*, 34 GA. L. REV. 1343 (2000); Marmer, *supra* note 32, at 1067; Pratt, *supra* note 32, at 855; Sullivan, *supra* note 34, at 279; Diane Blackman, *Practicality of Breed Specific Legislation in Reducing or Eliminating Dog Attacks on Humans and Dogs*, *at* http://www.dog-play.com/pitbull.html (last updated July 14, 2003).

52. *Insurance Industry Discriminates Against Dogs*, *CBS News: Evening News with Dan Rather* (CBS television broadcast, June 3, 2003), *available at* 2003 WL 5212276.

53. *Id.*

54. *See, e.g.*, Jeff Bertolucci, *Man's Best Friend but Insurers' Foe; Their Assembly Bill Has Failed, But Dog Lovers Continue to Rail Against Breed Discrimination*, L.A. TIMES, June 6, 2004, at K1 (discussing failure of Bill AB 2399, prohibiting breed discrimination but allowing a higher premium and requiring a discount for canines that pass an obedience test); Vincent J. Schodolski, *"Bad" Dogs Put Costly Bite on Insurers, Homeowners*, CHI. TRIB.,

trying to get homeowners' insurance. Multiple insurers denied coverage because of the dogs I owned. I literally could not find a carrier in the Lubbock market willing to write a policy for me until I stumbled upon the Farm Bureau on the advice of one insurance broker who sympathized with my plight.

The practice of breed discrimination produces absurd results. Consider the case of Chris and Norm Craanen of San Antonio, Texas.[55] They own a 12-year-old dog named Bukarus. He is a Rottweiler, a breed often targeted for discrimination by insurance companies. Yet, Bukarus does not pose much of a threat: he is deaf, partially blind, and has arthritis.[56] Despite his bite-free history, his owners lost their homeowners' insurance.[57]

May 17, 2004, at 1; Jeff Bertolucci, *Is Nothing Private? Home Insurers Ask About Everything from Rover to Rolexes. And the Answers Matter.*, L.A. TIMES, May 9, 2004, at K1; Allan Woods, *Rottweilers, Pit Bulls New Insurance Liability*, NAT'L POST, Mar. 26, 2004, at A3; Michele Derus, *Dog Bites Giving Insurers Pause*, MILWAUKEE J. & SENTINEL, Feb. 29, 2004, at 1F; Gloria Campisi, *Beware of Dog When Seeking Insurance; Some Firms Have 'Bad Breed' Lists*, PHILA. DAILY NEWS, Oct. 7, 2003, at 14; Ryan Slight, *Liability Factor Can Hurt Homeowners*, SPRINGFIELD NEWS-LEADER, Sept. 28, 2003, at 6A; William Sweet, *Insurers in Doghouse With Some Pet Owners*, SPRINGFIELD UNION-NEWS, Aug. 19, 2003, at A01; Purva Patel, *A Bite to the Pocket, Home Insurers Often Charge Higher Premiums Because of Dogs*, SUN-SENTINEL (Ft. Lauderdale, Fla.), Aug. 12, 2003, at 1D; Charles Toutant, *Insurers Attempt to Leash Dog-Bite Claims: Small-Scale Nuisance Litigation Turning Into Big Business*, 29 CONN. L. TRIB. 8 (Aug. 11, 2003); Jim Spencer, *Homeowners Insurance Rules Not For the Dogs*, DAILY PRESS (Va.), Jan. 10, 2003 at C1.

Breed discrimination is not confined to American insurers, either. Reports have also come from Canada describing the practice there by Canadian insurance companies. *Calgary Man Denied Home Insurance Renewal Due to the Type of Dogs He Has*, CAN. PRESS, Mar. 25, 2004 available at 2004 WL 74118306; *Some Insurance Companies Won't Cover You if You Own Certain Dogs, CTV News – PM* (CTV television broadcast, Mar. 24, 2004), *available at* 2004 WL 60848476.

55. *See* Patrick McMahon, *Dog Owners' New Policy: Bite Back*, USA TODAY, MAY 20, 2003, at 03a.

56. *Id.*

57. *Id.* I wonder if breed discrimination is encouraging homeowners, who are in a situation like mine or the Craanen's, to engage in policy fraud by lying about their pet's breed or by hiding the dog altogether. In *Mutual Benefit Ins. Co. v. Lorence*, No. 02-1734, 2003 WL 1354845 (4th Cir. Mar. 20, 2003), homeowners lied on their insurance application about owning dogs. One of their dogs (a Pit Bull) subsequently attacked a mother and her son, resulting in a claim against the homeowners' insurance. The insurer brought suit against the owners, seeking a declaratory judgment that it was not required to defend the claim because of the misrepresentation. *Id.* at *596. The courts, however, declined to exercise jurisdiction and instead deferred to ongoing proceedings before the Maryland Insurance Administration. *Id.* at *597. The owners had filed a complaint with the MIA alleging that the insurance company's practice of breed discrimination is against Maryland law. *Id.* at *596-97.

Some of the most well-known insurers are engaging in breed discrimination.[58] Some insurers have outright bans on specific breeds,[59] while others take a more realistic and logical dog-by-dog approach. These decisions are predicated on insurers' assessment of relative risk.[60] The "usual suspects" for breed discrimination are Pit Bulls, Rottweilers, German Shepherds, Doberman Pinschers, Chow Chows, Wolf hybrids, and Presa Canarios.[61]

The Humane Society of the United States has documented an increase in the number of people being denied insurance because they own certain breeds of dog.[62] As a result, the Society has started collecting data through the Internet, in the hopes of eventually convincing the insurance industry that there are alternatives to the current practice and that it must stop.[63] To achieve their goal, the HSUS and the American Society for Prevention of Cruelty to Animals have created a joint grassroots campaign designed to educate the insurance industry.[64]

2. The Insurance Industry's Defense of Breed Discrimination

Homeowners' insurance protects a policyholder in the event of financial loss. Most policies include two provisions: property damage and liability. Property damage provisions protect the policyholder in the event of fire, lightning, wind, water or hail damage, theft, and vandalism. Liability provisions protect the policyholder in the event that a claim is made against a homeowner for negligence. Liability coverage typically pays for bodily injury, medical payments, and property damage that is

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58. Stephanie Davis, *ASPCA/HSUS Campaign Tackles Insurance Industry*, 34 DVM: THE NEWSPAPER MAG. OF VETERINARIAN MED., Nov. 2003, at 1 ("Some household name insurance companies either have canceled or refused to write homeowners' policies for individuals with certain dog breeds.").

59. *See* Brian Sodergren, *Insurance Companies Unfairly Target Specific Dog Breeds*, *at* http://www.hsus.org/ace/18624 (last visited June 11, 2004) (perceived increase in the number of claims, or risk, exists for people who own certain breeds of dogs).

60. *See infra* Part I.C.2. for the insurance industry's arguments in favor of breed discrimination.

61. Davis, *supra* note 58.

62. Sodergren, *supra* note 59.

63. Dog owners wishing to report incidents of breed discrimination to the HSUS can do so at the following website: http://files.hsus.org/web-files/PDF/insurance_incident_form.pdf (last visited July 5, 2004). *See* Sodergren, *supra* note 59.

64. Davis, *supra* note 58.

sustained because of the negligence of the property owner.[65] Absent breed discrimination, most homeowners' insurance policies would cover injuries due to dog bites on the premises between the amounts of $100,000 and $300,000.[66] In 1995, the average policyholder paid $418 in homeowners' insurance premiums.[67] By 2004, the average premium climbed to $608.[68]

"Insurance is a business."[69] Insurers must make profits in order to continue in existence.[70] Companies survive by minimizing risk, which reduces the likelihood of claims. Some companies have decided that certain breeds of dog are simply "too much of a risk" to insure.[71] An industry representative claims that the issue of dog bites "is a major concern for insurers."[72]

The industry defends its position, in part, on a series of studies from the Centers for Disease Control ("CDC"), which the industry claims as support for the proposition that certain breeds have a propensity to bite.[73] As I will demonstrate in Part II, however, the industry's reliance on the CDC studies is misplaced. Even the authors of the CDC studies have stated that breed discrimination is wrong and is not supported by scientific evidence.[74]

The industry has also pointed to the large amount of money that has been paid out in recent years for dog bite claims.[75] The Insurance Information Institute ("III"), a trade group of the insurance industry, stated that in 2002, $345.5 million was paid out in dog bite liability claims, up

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65. Insurance Information Institute, *Homeowners Insurance*, *at* http://www.iii.org/media/facts/statsbyissue/homeowners/ (last visited June 11, 2004) [hereinafter III, *Homeowners Insurance*].

66. Insurance Information Institute, *Dog Bite Liability*, *at* http://www.iii.org/media/hottopics/insurance/dogbite/ (visited June 11, 2004) [hereinafter III, *Dog Bite Liability*].

67. III, *Homeowners Insurance*, *supra* note 65.

68. III, *Dog Bite Liability*, *supra* note 66. The insurance industry points to rising construction costs and natural disasters, such as wind and hail, as principal causes for the rise in premiums. *Id.*

69. Davis, *supra* note 58, at 36 (quoting Alejandra Soto, spokesperson for the Insurance Information Institute, a trade group of the insurance industry).

70. Dan Hattaway, *Dogs and Insurance*, 210 J. AM. VETERINARY MED. ASS'N 1143 (Apr. 15, 1997).

71. Sodergren, *supra* note 59.

72. III, *Dog Bite Liability*, *supra* note 66.

73. Nationwide Insurance stated to *USA Today* that it relies on CDC data to support its breed-specific policies. McMahon, *supra* note 55, at 03a.

74. *Infra* Part II.

75. III, *Dog Bite Liability*, *supra* note 66.

from $250 million in 1995.[76] The group argues that dog bite lawsuits are on the rise and juries are awarding larger claims.[77] They claim, therefore, the need to curtail their risk.

The industry's cost statistics are misleading, however. The III states, "[d]og bites now account for almost one quarter of all homeowner's insurance *liability* claims costing $345.5 million."[78] Some perspective is in order. For every $100 in premiums, insurers spend $77 paying claims. Of that $77, the overwhelming majority ($72, or 93.5%) is spent on paying *property damage* claims. *Liability* claims only amount to $5, or 6.5%, of total claims.[79] Even then, dog bites only constitute a percentage of that figure. Put into perspective, the money paid out in dog bite claims is negligible when compared to the overall amount of money paid out for other types of claims. Damage due to lightning, fire, and mold all individually account for more claims payouts than all liability claims combined.[80]

The insurance industry has not been consistent in the reasons for its defense of breed discrimination. One report from III's website seems to defend breed-specific responses based on the aggregate claims paid[81] and stories of several high-profile and tragic bites.[82] However, in a statement to a newsletter of veterinary medicine, the III defended breed discrimination on the basis that certain breeds cause more damage when and if they do bite.[83] Ultimately, a spokesperson for the III conceded, "[t]he industry isn't

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76. *Id.* One insurance company, State Farm Fire and Casualty Co., reported that in 1995 they paid out $70 million on 11,000 claims. That year, they insured a total of five million dog-owning homes. *See* Hattaway, *supra* note 70, at 1144.

77. III, *Dog Bite Liability*, *supra* note 66.

78. *Id.* (emphasis added).

79. III, *Homeowners Insurance*, *supra* note 65.

80. *Id.* A plausible argument could be made that dog bites are a preventable risk, in a way that damage due to fire, mold, and theft are not. Property damage claims are the result of true accidents—unforeseeable acts for which insurers have little to no control over. Dog bites are one small way in which insurers can try to minimize risk.

In reality, big-ticket risks can be controlled. Insurers could decide, for example, not to insure a home unless it has smoke detectors. This would provide an incentive for people to install smoke detectors, which would, in turn, reduce the amount of fire-related claims. Insurers could also justify refusing to write policies for homes where there is a high risk of wind or hail damage. Any risk is controllable, but only to the extent that the insurance market can bear the loss of this business.

81. As shown, *supra*, while the industry's aggregate figures may sound "scary," they misstate the scope of the dog bite problem in the larger context of total claims paid.

82. III, *Dog Bite Liability*, *supra* note 66.

83. Davis, *supra* note 58, at 36 ("We just know that certain breeds, when they do attack, tend to cause a lot more damage when they do bite, not because they bite most often."); Randall Lockwood & Kate Rindy, *Are "Pit Bulls" Different? An Analysis of the Pit*

positioned to determine which dogs should be deemed vicious. . . . [W]e're certainly not dog experts or veterinarians."[84] This, however, has not stopped many insurers from engaging in breed discrimination.

3. Some Exceptions to the Rule?

It appears that not all insurers have followed the breed discrimination trend. *DVM* reported that Nationwide Insurance changed its breed discrimination policy in October 2003. While Nationwide will now insure all dog owners, it will specifically exclude dog bites from its liability coverage.[85]

State Farm's national representatives have repeatedly stated that the company does not practice breed discrimination.[86] However, when I searched for homeowners' insurance in 2003, a State Farm agent in Lubbock refused to even take my application because of the breeds I owned.

D. OTHER INSTANCES OF BREED DISCRIMINATION

There are other examples where a person's ownership of a particular breed of dog can have negative consequences. Families seeking to adopt children can face roadblocks if they own dogs that belong to certain breeds. In Massachusetts, the Adoption and Foster Care Unit of the Department of Social Services will not place children in homes with certain breeds of dog.[87] The state relied upon data provided by the insurance industry when it made its decision to discriminate based on breed.[88] Some airlines also

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Bull Terrier Controversy, 1 ANTHROZOÖS 2, 4 (1987) (damage caused by pit bulls is generally more severe due to the attack behavior of the breed).

84. Davis, *supra* note 58, at 36 (quoting Alejandra Soto, spokesperson for the III).

85. *Id.* at 38. This policy of exclusion is not without problems, as it leaves plaintiffs without a remedy if a dog bite does occur and subjects a homeowner to loss of the home and bankruptcy. Kenneth Phillips, *Breed Specific Laws, Regulations and Bans*, *available at* http://www.dogbitelaw.com/PAGES/breedlaws.html (updated July 21, 2003) (Phillips is a lawyer and expert on dog bite law). Litigation over exclusions can be costly and lengthy, and can lead to uncertainty in the marketplace.

86. *See* Davis, *supra* note 58, at 36 ("We don't discriminate or deny coverage based on breed of dog."); McMahon, *supra* note 55; Hattaway, *supra* note 70 (author works for State Farm).

87. Franco Ordonez, *Pet Peeve: A New State Regulation Prohibiting Owners of Some Dog Breeds From Adopting Draws Fire*, BOSTON GLOBE, Jan. 15, 2003, at B1.

88. *Id.*

practice breed discrimination by prohibiting some dogs from flying, even though they are stored in cargo and in a closed carrier.[89]

II. THE LACK OF SCIENTIFIC EVIDENCE TO SUPPORT BREED DISCRIMINATION

Numerous scientific studies have attempted to identify the number of annual dog bites, the dogs most likely to bite, the people most likely to be bitten, and the circumstances under which bites are most likely to occur. Such studies have not reached a uniform consensus and have left us with more questions than answers. Even the studies that have attempted to report on breeds' proclivity to bite have cautioned that their research is incomplete and should not be used to justify breed discrimination by legislatures or insurers.[90]

A. CDC STATISTICS

The U.S. Department of Health and Human Services, Centers for Disease Control and Prevention ("CDC"), commissioned a number of studies during the 1980s and 1990s to determine the scope and nature of the problem of dog bites in the United States.

1. Fatality Studies

Four separate studies attempted to chronicle the number of fatal dog bites during the periods of 1979-1988,[91] 1989-1994,[92] 1995-1996,[93] and 1997-1998.[94] The studies were specifically limited to fatal dog attacks because fatality statistics are easier to track.[95] Non-fatal bites were excluded from the studies, although other scientists have attempted to use

89. Phillips, *supra* note 85.

90. *Infra* Part III.

91. Jeffrey J. Sacks, et al., *Dog Bite-Related Fatalities From 1979 Through 1988*, 262 JAMA 1489 (1989) [hereinafter *CDC 1979-1988*].

92. *CDC 1989-1994*, *supra* note 17.

93. Centers for Disease Control, *Dog Bite Related Fatalities—United States, 1995-1996*, 46 MORBIDITY & MORTALITY WKLY REP. 463 (1997) [hereinafter *CDC 1995-1996*].

94. Jeffrey J. Sacks, et al., *Breeds of Dogs Involved in Fatal Human Attacks in the United States Between 1979 and 1998*, 217 JAMA 836 (2000) [hereinafter *CDC 1979-1998*].

95. *Id.* at 838.

emergency department reports and other sources to determine the number of non-fatal bites per year.[96]

The authors combed three sets of sources in an attempt to determine the number of fatal dog bites per year. First, they searched NEXIS for news reports of dog bite-related fatalities.[97] Second, they used the National Center for Health Statistics' ("NCHS") single-cause mortality tapes ("SCMTs") to identify deaths where the underlying cause was listed as a dog bite.[98] Finally, the authors supplemented these reports with information collected by the Humane Society of the United States ("HSUS") to help identify the breed of dog involved in each incident.[99] From these three sources, the authors tried to piece together the number of people who died each year in the United States from dog bites.

The authors concluded that dog bites caused approximately 7 deaths per year per 100 million people.[100] They discerned no identifiable trend that would indicate an increase in the incidence of fatal bites over the years of the studies.[101] During the first reporting period (1979-1988), approximately 70% of victims were under the age of 10.[102] Males, under the age of 29, were more likely than females to be victims.[103] These findings as to age and gender were consistent throughout the study periods.

Many of the fatal bites of children involved horrific attacks on the very young. A 3-week-old girl was killed in her crib by the family's Chow Chow.[104] A 2-year-old boy in South Dakota wandered into a neighbor's yard where he was attacked and killed by two German Shepherd-wolf

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96. *See infra* Parts II.A.2. and II.B.

97. *CDC 1979-1988*, *supra* note 91, at 1489.

98. *Id.* The NCHS uses reports from hospitals and other sources to classify deaths. There is a category of deaths just for dog bites: "E906.0." NATIONAL CENTER FOR HEALTH STATISTICS ET AL., INTERNATIONAL CLASSIFICATION OF DISEASES, 9TH REVISION, CLINICAL MODIFICATION (2003), *available at* http://ww.eicd.com.

99. *CDC 1979-1988*, *supra* note 91, at 1489. The HSUS reports are particularly detailed and are believed to be the most accurate in determining the true breed of a biting dog. *CDC 1989-1994*, *supra* note 17, at 891. HSUS staff reviewed police reports, animal control reports, statements by dog owners and victims, and photographs. *Id.*

100. *CDC 1979-1988*, *supra* note 91, at 1490; *CDC 1989-1994*, *supra* note 17, at 892.

101. *CDC 1979-1988*, *supra* note 91, at 1490.

102. *Id.* Between 1989 and 1994, that figure had dropped to 56.9%. *CDC 1989-1994*, *supra* note 17, at 892. From 1995 through 1996, that number climbed to 80%. *CDC 1995-1996*, *supra* note 93, at 463. From 1997 through 1998, the number settled at 70%. *CDC 1979-1998*, *supra* note 94, at 837.

Victims were often elderly, suggesting that, "The main victims of fatal dog bites were the very young and very old, those least able to protect themselves." *CDC 1979-1988*, *supra* note 91, at 1492.

103. *CDC 1979-1988*, *supra* note 91, at 1490.

104. *CDC 1995-1996*, *supra* note 93, at 463.

hybrids.[105] The elderly were also victims of several fatal attacks. In March, 1996, two Rottweilers killed an 86-year-old Tennessee woman. One month before the assault, the dogs had attacked and injured the same woman.[106]

In the twenty-year period of the CDC studies, the breed responsible for the most number of bites has changed.[107] From 1979-1980, Great Danes caused the most number of fatalities with three deaths for the time period. However, four breeds were tied with two deaths each: Pit Bulls, Rottweilers, Huskies, and Malamutes.[108] In 1981, Pit Bulls took over as the breed with the most number of fatal bites.[109] Pit Bulls remained in that position until 1993 when Rottweilers began causing approximately ten fatal bites per two-year reporting period.[110] The last available reporting period, 1997-1998, shows that Rottweilers caused ten fatal bites per two-year period, while Pit Bulls caused six, and Saint Bernards caused three.[111] During the 20-year study, 90 deaths were excluded because the breed was "unavailable."[112]

The authors of the CDC studies acknowledged that the methods they used in their studies had a number of limitations. NEXIS, they pointed out, was not designed for scientific research. News reports would only be flagged if their text contained certain keywords.[113] Further, reliance on NEXIS assumes that newspapers accurately reported the breed of dog involved in a particular attack.[114] SCMTs have a one-to-two year lag time, which means that some fatalities may have been missed.[115] The authors believed that, on average, their methods only uncovered approximately 74% of dog bite related fatalities.[116]

Even if one accepts the CDC statistics as definitive on the subject, they have a number of other limitations in answering the question of whether

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105. *Id.*

106. *Id.*

107. *CDC 1979-1998*, *supra* note 94, at 839. The Sacks/Sinclair study attempted to piece together the data on attacks by breed from the previous three studies as well as new data from 1997 and 1998. *Id.* at 837.

108. *CDC 1979-1988*, *supra* note 91.

109. *Id.*

110. *CDC 1979-1998*, *supra* note 94, at 837.

111. *Id.*

112. *Id.* This accounted for approximately 28% of the deaths during the study period. *Id.*

113. *CDC 1979-1988*, *supra* note 91, at 1492.

114. *Id.* at 1489. For further discussion of the problem of breed misidentification, see *infra* Part II.E.

115. *CDC 1979-1988*, *supra* note 91, at 1492.

116. *CDC 1979-1998*, *supra* note 94, at 838.

certain breeds are more dangerous than others. First, the studies were limited to fatal dog attacks.[117] Secondly, the breed of the dog could not be accurately determined in every case.[118] Finally, the number of fatal attacks per year is so low that it is problematic to statistically extrapolate conclusions from the data. For example, in the first two years of the study (1979-1980), Great Danes accounted for the most number of fatal bites (three).[119] Four breeds, however, followed closely behind with two fatal bites each (Pit Bull, German Shepherd, Husky, and Malamute).[120] It would be statistically questionable to conclude that Great Danes were inherently more dangerous than the other breeds, based on a net difference of only one fatality.

2. Non-Fatality Studies

The CDC fatality studies acknowledged that, while death rates for dog bites do not appear to have increased over time,[121] nonfatal bites were becoming more of a public health problem.[122] The CDC conducted a study on nonfatal dog bites in 2001.[123] The study used data from the National Electronic Injury Surveillance System-All Injury Program ("NEISS-AIP") to identify the number of nonfatal dog bites during the 2001 calendar year. NEISS-AIP collects data from initial visits to Emergency Departments ("EDs") across the country.[124] NEISS-AIP data is drawn from a nationally representative sample of NEISS hospitals.[125] The CDC analyzed every case where "dog bite" was listed as the external cause of injury.[126]

In total, NEISS-AIP data revealed that hospital EDs treated 6,106 patients for dog bite-related injuries during 2001.[127] Since the NEISS-AIP

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117. *Id.* (fatal attacks are easier to track than non-fatal bites because fatal attacks result in SCMT coding and are more likely to be reported by the news media).

118. *CDC 1979-1988*, *supra* note 91, at 1492.

119. *Id.* at 1491.

120. *Id.*

121. *See supra* note 101 and accompanying text.

122. *CDC 1989-1994*, *supra* note 17, at 894. They estimated that, in 1994, 1.8% of the population was bitten by a dog and 0.3% of the U.S. population sought some medical care for a dog bite. *Id.*

123. Centers for Disease Control, *Nonfatal Dog Bites-Related Injuries Treated in Hospital Emergency Departments—United States, 2001*, 52 MORBIDITY & MORTALITY WEEKLY REP. 605 (JULY 4, 2003) [hereinafter *CDC Nonfatal*].

124. *Id.* The NEISS-AIP is operated by the U.S. Consumer Product Safety Commission. *Id.*

125. *Id.*

126. *Id.* Deaths were excluded from the study. *Id.*

127. *Id.*

data did not include every hospital in the nation, the authors used this data to extrapolate to the general population.[128] They estimated that 368,245 people were treated for dog bite-related injuries in 2001.[129] The highest cohort of victims was children between the ages of five and nine.[130] Boys, under the age of 14, were more likely than girls to be seen in EDs for dog bite-related injuries.[131]

The NEISS-AIP data included narratives for many of the attacks. One case involved a 4-year-old who was bitten by a dog guarding her puppies.[132] Another involved a 3-year-old girl who was bitten when she tried to take away a dog's food.[133] A 34-year-old man was bitten while trying to break up a dogfight. Some victims were bitten by their own dogs. A 27-year-old woman was bitten by her dog after he had been hit by a car and became disoriented.[134] A 75-year-old woman was attacked while trying to prevent her dog from biting an EMT who was attempting to put the woman in an ambulance.[135]

The *Morbidity & Mortality* report describing the study does not document the number of attacks per breed. This is likely due to the fact that the ED reports did not specify the breed of dog. An attempt to determine the number of bites per breed would depend on victims accurately self-reporting the breed of the attacking dog.[136]

The study had a number of limitations. First, the authors excluded fatal dog bites. Second, the study only examined cases where the victim sought treatment in an ED. Victims may have gone to other health care providers, such as private physicians or urgent-care centers. Third, 26% of reports were missing an injury diagnosis. Many cases had limited data on the circumstances of the attack or the identity of the dog involved.[137] Thus, the CDC's estimates may be both over inclusive ("just cause" bites may have been included)[138] and under inclusive (insofar as victims may have sought treatment at other facilities).

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128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id. at 607.*
133. *Id.*
134. *Id.*
135. *Id.*
136. *See infra* Part II.D.1.
137. *CDC Nonfatal, supra* note 123.
138. *See infra* Part II.F. for a discussion of what I call "just cause" bites.

Another CDC study attempted to identify the incidence of dog bites in a particular locality: Denver, Colorado.[139] The authors examined reports from the Denver Municipal Animal Shelter in 1991.[140] There were a total of 991 bites during the study period.[141] However, only 178 were eligible for the study,[142] as the authors excluded several categories of bites: bites involving household members, attacks involving multiple dogs, attacks before 1991, dogs which had been owned for less than 6 months, cases in which the owner did not live in Denver County, attacks where the owner's phone number was not listed on the report, and cases in which the victim did not receive medical treatment.[143]

The study created a control group of dogs to try to determine whether certain characteristics (such as breed) made a dog more likely to bite.[144] Using a multivariate statistical analysis, the study concluded that biting dogs were more likely than control dogs to be German Shepherds or Chow Chows, male, intact (not neutered), and reside in a house with one or more children.[145] Denver had (and still has) a ban on Pit Bulls, so it is not surprising that no cases involved that breed.[146]

The authors acknowledged that their results had several problems. First, they were only able to speak to owners of approximately half of the biting dogs. They excluded cases in which the victim did not seek medical attention. In this respect, the authors believed that seeking medical attention was a "surrogate" for "real bites."[147] The authors did not verify the breeds of the dogs involved, but instead "identified predominant breed as whatever breed the owner considered the dog."[148] Because of the small number of bites per breed, the authors could not assess the statistical significance of breeds other than German Shepherd and Chow Chow.[149]

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139. Kenneth A. Gershman, Jeffrey J. Sacks, & John C. Wright, *Which Dogs Bite? A Case-Control Study of Risk Factors*, 93 PEDIATRICS 913 (1994). Two of the three authors (Gershman and Sacks) were with the CDC at the time. *Id.*

140. *Id.* at 913.

141. *Id.* at 914.

142. *Id.*

143. *Id.* at 913.

144. *Id.* To create a control group, the authors used the first five digits of a biting-dog owner's phone number and randomized the last two digits. They called numbers until an eligible control dog was found. *Id.*

145. *Id.* at 915.

146. *Id.* at 914; *see also supra* notes 25-28 and accompanying text.

147. Gershman, *supra* note 139, at 916.

148. *Id.* at 914.

149. *Id.* at 916.

Another CDC study attempted to determine the frequency of dog bites by conducting a random telephone survey of households.[150] The authors used the Injury Control and Risk Survey ("ICARIS"), a random digit dialing telephone survey.[151] They asked each adult respondent whether he (or his children) had been bitten by a dog in the previous twelve months and whether the victim had sought medical attention.[152] Out of 5,328 completed interviews, 94 adults and 92 children reported being bitten in the previous twelve months.[153] Of these, 12 adults and 26 children sought medical care.[154] From this data, the authors extrapolated that 1.8% of the American population (4,494,083 people) had been bitten in the previous twelve months, and 0.3% had sought medical attention.[155] This shows that non-fatal bites are a public health problem that "is five orders of magnitude greater" than fatal dog bites.[156] The study concluded that several factors had no statistical significance on the likelihood of being bitten: census region, urbanicity, race/ethnic group, and household income.[157] The study did not attempt to correlate between the number of bites and the breed of dog. The authors acknowledged that the study relied on the self-reporting of data, which was not validated, and that they received a poor response rate (only 56% of people responded to the survey).[158]

B. OTHER STUDIES

Other studies have attempted to document the total number of dog bites and the number of bites per breed.

A study of ED visits for dog bite injuries[159] confirmed many of the conclusions of the previously-discussed CDC study on ED visits.[160] The study noted that a lack of a national reporting system for dog bite injuries makes gathering and analyzing data on the subject difficult.[161] The authors,

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150. Jeffrey J. Sacks, Marcie-jo Kresnow, & Barbara Houston, *Dog bites: How Big a Problem?*, 2 INJURY Prevention 52 (1996) (two of the three scientists who conducted the survey were with the CDC at the time.).

151. *Id* at 52.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* at 53.

156. *Id.*

157. *Id.*

158. *Id.*

159. Harold B. Weiss, Deborah L. Friedman, & Jeffrey H. Coben, *Incidence of Dog Bite Injuries Treated in Emergency Departments*, 279 JAMA 51 (1998).

160. *CDC Nonfatal*, *supra* note 123.

161. Weiss, *supra* note 159, at 51.

in reviewing the literature on the subject, found that previous studies concluded that between 0.3% and 1.1% of all ED visits are due to dog bite-related injuries.[162] To determine the true percentage, they collected data from the National Hospital Ambulatory Medical Care Survey ("NHAMCS"), a random surveying instrument that is used to calculate the number of ED visits per year.[163] They estimated that between 1992 and 1994, 333,687 annual visits were made to EDs seeking medical treatment for dog bite related injuries.[164] This amounted to 0.4% of all ED visits nationwide.[165] Looking at the monetary cost of dog bites, they found that the average cost for a dog bite related ED visit was $274, resulting in an annual cost of $102.4 million.[166] The study, however, did not address the question of whether certain breeds are particularly more dangerous than others. This is partly due to the unavailability of data through NHAMCS. Moreover, the study most likely undercounted the number of non-fatal dog bites because victims may have sought treatment from places other than EDs.[167]

Other studies have attempted to examine the problem at a more localized level. A July 1991 study[168] found that dog bites were responsible for 0.3% of all ED visits at The Children's Hospital of Philadelphia.[169] Of those visits, 77% involved cases where the victim knew the biting dog.[170] The study found one statistically significant conclusion: more Pit Bull injuries were the result of unprovoked attacks as compared to such attacks by other breeds.[171] "Unfortunately, the absence of reliable dog breed-

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162. *Id.*

163. *Id.* at 52.

164. *Id.*

165. *Id.*

166. *Id.* at 53. The conclusions about the monetary impact of dog bites were confirmed by a CDC study in 1999. *See* Kyran P. Quinlan & Jeffrey J. Sacks, *Hospitalization for Dog Bite Injuries*, 281 JAMA 232 (1999). A sample of 904 hospitals in seventeen states found that 5,991 hospital discharges in 1994 were the result of dog bite injuries. *Id.* The average length of stay was 3.6 days, costing a total of $164.9 million in direct care per year. *Id.*

167. In this respect, it suffers from many of the same flaws as the CDC non-fatal bite study discussed *supra* in Part II.A.2.

168. Jeffrey R. Avner & M. Douglas Baker, *Dog Bites in Urban Children*, 88 PEDIATRICS 55 (1991).

169. *Id.* at 56.

170. *Id.* Consequently, the authors concluded that in such cases the patient's accuracy of breed identification should be high. *Id.* at 57. I disagree with this conclusion. Just because Little Johnnie knows Spot from the neighborhood does not necessarily mean that Johnnie knows with any certainty what breed Spot is.

171. *Id.* at 56.

specific population figures prevent[ed] the calculation of breed-specific injury rates."[172]

An October 1997 study tried to determine the number of dog bites in Alleghany County, Pennsylvania (Pittsburgh) by using the "capture-recapture" method of statistical analysis.[173] The authors found that 790 dog bites were reported to the Alleghany County Health Department in 1993.[174] Using the capture-recapture method, along with log-linear modeling, the study concluded that the number of unreported dog bites was 1,388 (with a 95% confidence interval of between 1,010 and 1,925).[175] The authors cautioned, however, that the self-reporting sources are problematic in that "whether or not a case is reported depends largely on the severity of the event and the attitude, knowledge, or education level of the victim."[176] Accordingly, the authors suggested that the actual Pittsburgh dog bite incidence rate must be higher than that found in the study.[177]

Another survey[178] in Pennsylvania polled children in order to determine an overall bite rate from the perspective of bite victims.[179] The survey, conducted in 1981, found that 46.1% of children reported that they have been bitten by a dog during their lifetime.[180] The study concluded that "being bitten by a dog is a rather common occurrence for children, especially those between the ages of seven and twelve years, and the event is greatly underestimated by official bite statistics."[181] Nevertheless, the authors did not attempt to catalog bites per breed.[182]

Unfortunately, not all scientists have used statistically sound methods to draw conclusions about the relative dangerousness of breeds. Two physicians, Lee E. Pinckney and Leslie A. Kennedy, from the Department of Radiology at the University of Texas Southwestern Medical School and

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172. *Id.* at 57.

173. Yue-Fang Chang, et al., *Dog Bite Incidence in the City of Pittsburgh: A Capture-Recapture Approach*, 87 AM. J. PUB. HEALTH 1703 (1997).

174. *Id.* at 1703.

175. *Id.* at 1703-04.

176. *Id.* at 1704.

177. *Id.*

178. Alan M. Beck & Barbara A. Jones, *Unreported Dog Bites in Children*, 100 PUB. HEALTH REP. 315 (1985).

179. The authors described previous studies as relying principally on official reports of bites. *Id.* at 316. This resulted in significant underreporting of bites. *Id.*

180. *Id.* at 317. The survey included children in preschool to twelfth grade. *Id.* at 316.

181. *Id.* at 319. The study went on to find that children's attitudes towards dogs were not affected by being bitten: "Children appear to accept being bitten by dogs much as they do other accidents such as falling off a bike. Being bitten had little influence on their liking for dogs." *Id.*

182. *See id.* at 317-20.

Children's Medical Center sent letters to the editors of 245 major newspapers requesting copies of all stories about dog bite-related fatalities.[183] The number of fatalities reported by the responding newspapers between March 1966 and June 1980 totaled seventy-four.[184] Of the seventy-four fatalities, sixteen were caused by German Shepherds, nine by Huskies, eight by Saint Bernards, six each by Bull Terriers and Great Danes, and five by Malamutes.[185] The remaining dog bite fatalities were caused by a variety of breeds, including ten attacks by mixed breeds and five attacks by dogs of unknown breeds.[186] In addition to acquiring bite fatality statistics from newspapers, the authors used American Kennel Club ("AKC") registration data to compare the relative number of fatalities per breed.[187]

The CDC authors criticized the Pinckney/Kennedy study as being "primarily anecdotal" rather than "systematic" in its approach.[188] Indeed, Pinckney and Kennedy conceded that their database was "incomplete" and "may not be entirely reliable."[189] Their data depended on newspaper reports, which may themselves be incomplete or inaccurate. Thus, the authors said their data required "cautious interpretation."[190] An example of such "cautious interpretation" is represented by the authors' observation that even though German Shepherds were involved in more fatalities than any other breed in the study, such large frequency could be reflective of the fact that German Shepherds had the highest AKC registration of any large breed.[191] Hence, the use of AKC data to draw comparisons between breeds is problematic,[192] as demonstrated by the high number of registrations for breeds such as German Shepherds, and low number of registrations for a popular breed, such as the Pit Bull.[193]

William Winkler's study[194] in 1977 has also been criticized for its lack of scientific method.[195] His "study" involved compiling news reports from

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183. Lee E. Pinckney & Leslie A. Kennedy, *Traumatic Deaths From Dog Attacks in the United States*, 69 PEDIATRICS 193 (1982). Only 48% of the newspapers responded. *Id.*

184. *Id.*

185. *Id.* at 194.

186. *Id.*

187. *Id.*

188. *CDC 1979-1988*, *supra* note 91, at 1489.

189. Pinckney & Kennedy, *supra* note 183, at 195.

190. *Id.*

191. *Id.*

192. *See infra* Part II.D.2.

193. *See* Pinckney & Kennedy, *supra* note 183, at 195.

194. William G. Winkler, *Human Deaths Induced by Dog Bites, United States, 1974-75*, 92 PUB. HEALTH REP. 425 (1977).

eleven dog bite-related fatalities from January 1974 through December 1975.[196] From this data, he made various conclusions about the breeds responsible, finding that, "not unexpectedly," German Shepherds were the breed most often responsible for fatal dog attacks.[197] Because St. Bernards were responsible for two deaths during this 24-month period, he concluded, "[t]his relatively uncommon breed may be a greater hazard than others."[198]

A common thread running through several studies is the attempt to extrapolate conclusions about breeds based on limited data. For example, an April 2000 epidemiological study in Philadelphia used reports from the Department of Health to conclude that between 1995 and 1997 there were approximately 5,390 bites.[199] The authors concluded that Pit Bulls, German Shepherds, and Rottweilers combined were responsible for 59% of bites each year.[200] The authors felt comfortable drawing this conclusion despite the fact that they could not determine the breed in 74% of cases.[201]

C. THE PROBLEM OF THE UNKNOWN ORIGIN OF AGGRESSIVENESS

Despite all of the research and studies on the subject, scientists and veterinarians cannot state with certainty or confidence why certain dogs are more aggressive than others.[202] It seems that a particular dog may be aggressive because of a variety of factors.[203] According to the American Veterinary Medical Association's multidisciplinary Task Force on Canine Aggression and Human-Canine Interactions, "a dog's tendency to bite depends on at least five interacting factors: heredity, early experience, later

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195. The CDC authors criticized the Winkler study as being "anecdotal" rather than "systemic." *CDC 1979-1988*, *supra* note 91, at 1489.

196. Winkler, *supra* note 194.

197. *Id.* at 428.

198. *Id.*

199. Jason W. Stull & Robert R. Hodge, *An Analysis of Reported Dog Bites: Reporting Issues and the Impact of Unowned Animals*, 62 J. ENVTL. HEALTH 17 (2000).

200. *Id.* at 19.

201. *Id.* The authors were truthful when they stated, "[f]or cases in which breed was given, Pit Bulls, German Shepherds, and Rottweilers combined were responsible for over 59% of bites each year." *Id.* Nevertheless, as a lawyer, I am concerned by scientists drawing this conclusion. Such statements can be taken out of context and used by the insurance industry and legislatures to justify breed discrimination and BSL when such actions are not supported by statistics.

202. Lockwood & Rindy, *supra* note 83, at 7 ("The genetics of canine aggression are still poorly understood . . . .").

203. *Id.*

socialization and training, health (medical and behavioral), and victim behavior."[204]

While breed (as an inherited characteristic) is one component of predicting a dog's dangerousness, it is not the only factor.[205] There is no way to scientifically determine whether a dog is likely to bite in the future, anymore than psychologists can predict whether certain people will commit crimes of violence. The exception to this rule is the axiom that the best predictor of future behavior is past behavior. For this reason, many veterinary and scientific groups support "dangerous dog laws" which target individual dogs that have demonstrated a propensity to bite or attack innocent victims.[206] The problem with BSL and breed discrimination is that legislatures and insurers have attempted to prophylactically determine which breeds are most likely to bite without any evidence of individual dangerousness.

D. THE PROBLEM OF NUMERATORS AND DENOMINATORS IN DOG BITE STATISTICS

To date, no scientific study has been able to resolve what I term to be the problem of "numerators and denominators." A person wishing to determine whether certain breeds are more likely to bite than others must first determine the number of bites per breed (the numerator) and then compare that number to the total number of dogs of that breed in the general population (the denominator). This can be expressed as a ratio:

$$Relative\ Dangerousness\ Ratio = \frac{Number\ of\ Bites\ by\ Breed}{Total\ Population\ of\ Breed}$$

This ratio ("RDR") allows for a comparison between breeds. The higher the RDR, the greater proclivity a particular breed has to bite. It allows for a comparison of "oranges to oranges" and "apples to apples." Otherwise, it is likely that highly popular breeds will appear to be more

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204. *Task Force*, *supra* note 5, at 1736, (citing J.C. Wright, *Canine Aggression Toward People: Bite Scenarios and Prevention*, 21 VETERINARY CLINIC N. AM. SMALL ANIMAL PRACTICE 299 (1999)).

205. Lockwood & Rindy, *supra* note 83, at 7 (discussing the factors that can lead a dog to be aggressive).

206. *See infra* Part V.D. for a discussion of dangerous dogs laws as an alternative to BSL and breed discrimination.

dangerous, when in fact the number of bites is reflective of the overall population of the particular breed.

A study which tried to extrapolate breed data from the previously-discussed CDC studies agreed that the proper method for determining a breed's dangerousness was the use of a comparative ratio:

> Ideally, breed-specific bite rates would be calculated to compare breed and quantify the relative dangerousness of each breed. For example, 10 fatal attacks by Breed X relative to a population of 10,000 X's (1/1,000) imply a greater risk than 100 attacks by Breed Y relative to a population of 1,000,000 Y's (0.1/1,000). Without consideration of the population sizes, Breed Y would be perceived to be the more dangerous breed on the basis of the number of fatalities.[207]

Using the RDR normalizes the effect of a breed's popularity, or lack thereof. Dogs of popular breeds are going to bite more often simply because there are more of them.[208] A January 1997 article warned that, as Dalmatians become more popular, people should expect to see more bites from that breed.[209] This is not to say that Dalmatians are inherently more dangerous than other breeds. Rather, an increase in their population should also result in a proportional increase in bites from that breed.[210] Similarly, the Pinckney/Kennedy study[211] cautioned that, despite the fact that German Shepherds accounted for the most number of deaths, their finding must be read in conjunction with the popularity of the breed, as evidenced by AKC registrations of the same time period.[212]

The problem of numerators and denominators is that it is difficult—if not impossible—to accurately determine the number of bites per breed and

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207. *CDC 1979-1998*, *supra* note 94, at 838. At the time of the study, Sacks and Gilchrist were with the CDC's National Center for Injury and Control, Division of Unintentional Injury Prevention, Sinclair and Lockwood were with the HSUS, and Golab was with the American Veterinary Medical Association. *Id.* at 836.

208. *Task Force*, *supra* note 5, at 1733.

209. *Dalmatian Popularity May Spur Increase in Bites, HSUS says*, DVM: THE NEWSMAGZINE OF VETERINARY MED., Jan. 1997, at 40.

210. The CDC authors noted, "[c]onsidering American Kennel Club registration data for Rottweilers in parallel with fatality data for that breed indicates that as the breed has soared in popularity, so have Rottweiler-related deaths." *CDC 1979-1998*, *supra* note 94, at 838-39.

211. Pinckney, *supra* note 183.

212. *Id.* at 195.

the number of dogs in a particular breed. Without an accurate count for either the numerator or denominator, one runs the risk of stigmatizing an entire breed as "overly dangerous" based on the breed's *absolute* number of bites, instead of examining the breed's number of bites *relative to its overall population.*

1. The Numerator Problem

The principal problem in determining the total number of bites by a particular breed is that there is no national reporting system for dog bites.[213] The CDC studies[214] demonstrate that while fatal dog bites are easier to track than non-fatal bites, even the methodology used to uncover fatalities misses approximately 26% of cases.[215] Further, news accounts—on which the CDC relied, in part, to determine the number of fatal dog bites and the breeds involved—may be biased towards reporting attacks by certain breeds.[216]

The numerator may also be biased against dogs that cause more damage, while ignoring breeds that bite more often but do not cause victims to seek emergency treatment.[217] If a dog bite does not cause serious injury, it is not likely that the victim would seek medical treatment.[218] This then skews the results of studies that use emergency department visits to track the incidence of dog bites.[219] "The problem with self-reporting sources is that whether or not a case is reported depends largely on the severity of the event and the attitude, knowledge, or education level of the victim."[220] Studies which have used random sampling[221] are equally problematic because they, too, depend on accurate self-reporting of their sample groups. The low response rates of these studies also lead to questions about the accuracy of the results that are extrapolated to the general population.[222]

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213. Weiss, *supra* note 159, at 51.
214. *Supra* Part II.A.
215. *CDC 1979-1998*, *supra* note 94, at 838.
216. *Id.*
217. *Task Force*, *supra* note 5, at 1733.
218. *Id.*
219. *See supra* notes 137-138, and 167 and accompanying text.
220. Chang, *supra* note 173, at 1704.
221. *See supra* notes 150-158 and accompanying text.
222. *Id.*

2. The Denominator Problem

No one knows how many dogs are present in the United States at any one time. This should not be surprising, as even the Constitutionally mandated[223] decennial census of human beings is known to undercount people.[224]

Determining the true number, or even an accurate estimate, of dogs can be problematic. While many dogs are kept as household pets,[225] others are used as service animals or guard dogs; kept in animal shelters or animal stores; or simply allowed to wander the streets as strays. The dog population is constantly changing and moving, which makes obtaining an accurate count difficult and expensive.

Even if it was possible to determine how many dogs exist in the country at any one time, the problem then becomes how to determine how many of those dogs belong to each breed. Determining the breed of *one* dog is difficult enough.[226] To take a census of all dogs and identify their breeds would be an impossible task.

Some scientists have suggested using AKC or municipal registration data to determine the number of dogs in a particular breed in a particular community.[227] However, one study concluded that city registrations account for only 29.1% of all dogs.[228] Further, owners of breeds considered "dangerous" may be reluctant to register their animals.[229] This may be particularly true of dogs used for illicit purposes, such as those owned by drug dealers, dog fighters, and gang members.[230]

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223. U.S. CONST. art. I, § 2, cl. 3.

224. Dep't of Commerce v. United States House of Representatives, 525 U.S. 316, 322 (1999).

225. One study estimated that as of 1998 approximately 34.3 million of homes had dogs and that there were a total of 53.6 million dogs in the United States being kept as pets. *See* J. Karl Wise & Jih-Jing Yang, *Dog and Cat Ownership, 1991-1998*, 204:8 J. AM. VETERINARY MED. ASS'N 1166, 1166-67 (1994).

226. *Supra* Part II.E.

227. *See, e.g.*, Pinckney, *supra* note 183; Winkler, *supra* note 194. The Winkler and Pinckney/Kennedy studies were also criticized by Sacks *et al.* for taking a more anecdotal, rather than systematic, approach to determining the relative dangerousness of breeds. *See CDC 1979-1988*, *supra* note 91, at 1489.

228. John C. Wright, *Canine Aggression Toward People: Bite Scenarios and Prevention*, 21:2 VETERINARY CLINICS OF N. AM.: SMALL ANIMAL PRACTICE 299, 301 (1991).

229. *CDC 1979-1998*, *supra* note 94, at 839.

230. David Brand, *Time Bombs on Legs*, TIME, July 27, 1987, at 60. Call me cynical, but I cannot envision drug dealers or gang members registering their dogs with the local municipality or the AKC.

American Kennel Club ("AKC") registration data is also problematic because the AKC only registers pure-bred dogs[231] and depends on owners taking the initiative to register their dogs.[232] Mixed breeds, for which there are numerous combinations, are not eligible for registration.[233] Pit Bulls are often registered with organizations other than the AKC. If owners do register them, they register with the United Kennel Club or the American Dog Breeders Association.[234] If a breed is undercounted in the denominator of the ratio, it will make a breed appear more dangerous than it actually is.[235]

E. THE PROBLEM OF BREEDS

Breed is a human construct that is used to conveniently group dogs based on similar physical characteristics.[236] There is no scientific test to determine a dog's breed.[237] The only way to determine a dog's breed is to examine its heredity. This task is made possible but expensive and time-consuming,[238] if a dog is registered with the AKC.[239]

As examples of the problem of defining and identifying breed, consider the case of Huskies and Pit Bulls. "Husky" refers to a class of dogs, not any one particular breed. Siberian Huskies, Alaskan Malamutes, and Samoyeds are all considered to belong to the "Husky" family, yet they are all different breeds.[240] Similarly, there is no AKC-standard breed called

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231. American Kennel Club, *Register a Dog*, *available at* http://www.akc.org/registration/registeradog.cfm (last visited July 9, 2004).

232. While there were approximately 57 million dogs in the United States in 1990, only 12 million were registered with the AKC. Mark Derr, *The Politics of Dogs*, ATLANTIC MONTHLY, March, 1990, at 49, 50.

233. *See id.*

234. Lockwood & Rindy, *supra* note 83, at 3.

235. *Id.*

236. Derr, *supra* note 232, at 51.

237. *Id.* at 52 (discussing interview with Joe W. Templeton, professor of veterinary pathology and genetics at Texas A&M University, in which Professor Templeton stated that scientists cannot distinguish between breed by using genetic fingerprinting or examining chromosomes); Am. Dog Owners Ass'n, Inc. v. City of Lynn, 533 N.E.2d 642, 644 (Mass. 1989) ("After trial, the [trial] judge found that there is no scientific means, by blood, enzyme, or otherwise, to determine whether a dog belongs to a particular breed, regardless of whether 'breed' is used in a formal sense or not."). Professor Templeton described one study in which two American Staffordshire Terriers were compared with a Whippet. The profile of one of the terriers more closely matched the Whippet than the other terrier.

238. *CDC 1979-1998*, *supra* note 94, at 839.

239. However, only some dogs have their "AKC papers." *See supra* notes 231-233 and accompanying text.

240. Katharine Dokken, *Dog Bite Statistics: Bad Logic*, *at*

"Pit Bull." "Pit Bull" is a collective classification of the American Staffordshire Terrier, Staffordshire Pit Bull Terrier, and Bull Terrier.[241]

Scientists have not been able to determine if victims of dog bites can accurately report the breeds of dogs that attacked them. Many scientists, particularly the CDC authors, have stated that misidentification is a likely problem, especially under the stress of a dog attack.[242] Part of the problem may be that as a particular breed gets a reputation for dangerousness, some victims jump to the conclusion that they were bitten by a dog of that breed.[243]

Even under ordinary, low-stress conditions, many people have difficulty identifying a dog's breed. "For the average person anything with prick ears and blue eyes automatically becomes a 'husky' . . . Any smooth coated brown dog, medium sized, and muscular becomes a 'pit bull' . . . Any tall dog becomes a Great Dane, fuzzy or hairy and it's a Chow Chow. If it's black and tan and heavy it's a Rottweiler, etc."[244] One survey of bite reports found that medium-sized black and tan animals were likely to be recorded as German Shepherds. Stocky, short-haired dogs were listed as Pit Bulls. Media reports of Pit Bull attacks are often accompanied by pictures of Boxers or Pugs instead of American Staffordshire Terriers.[245] One entertaining website called "Find the Pit Bull" displays 21 pictures of pure-bred dogs and challenges the user to identify the Pit Bull amongst them.[246]

Even veterinarians and other experts have difficulty determining whether a particular dog belongs to a particular breed.[247] This was a central concern of the Massachusetts Supreme Judicial Court in *American Dog Owners Ass'n v. City of Lynn*.[248] The Court declared the city of Lynn's Pit Bull ordinance to be unconstitutional in part because the animal control

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http://www.thedogplace.com/library/articles156.htm (last visited June 1, 2004).

241. *OVDO*, *supra* note 51; *Am. Dog Owners Ass'n, Inc.*, 533 N.E.2d at 644.

242. Wright, *supra* note 228, at 301; *Task Force*, *supra* note 5, at 1733; Gershman, *supra* note 139, at 916.

243. *CDC 1979-1988*, *supra* note 91, at 1492.

244. Dokken, *supra* note 240.

245. Lockwood & Rindy, *supra* note 83, at 2.

246. *Find the Pitbull*, *at* http://www.pitbullsontheweb.com/petbull/findpit.html (last visited June 1, 2004) ("Breed misidentification is a scary thing in a time breed specific legislation is growing .... Pit [B]ull dogs are often blamed for dog attacks that may very well have been caused by another breed.").

247. *CDC 1979-1998*, *supra* note 94, at 838 ("even experts may disagree on the breed of a particular dog").

248. 533 N.E.2d 642 (Mass. 1989).

officers designated to enforce the ordinance used conflicting and subjective standards to determine and identify breed.[249]

The problem of mixed breed complicates the issue even further. In determining a relative dangerousness ratio, it is unclear how to count mixed breeds.[250] Should they be counted once per breed? Not at all? Create a new category for each possible combination of breeds? Aside from how to use the raw data on attacks by mixed breed, there is the additional problem of misidentification by lay people.[251] Victims sometimes inadvertently report mixed breed dogs as pure-breds[252] due to the heat of the moment and their lack of training in identifying subtle breed characteristics.

There is good reason to believe that the raw data being used to calculate relative dangerousness ratios is incomplete and inaccurate. If the data being inputted into the calculation is flawed, the results (claiming to show some breeds are more dangerous than others) are equally flawed.[253]

F. THE PROBLEM OF "JUST CAUSE" BITES

Even if an accurate count could be obtained of the number of bites per breed, there is the additional problem of how to handle "just cause" bites in the resulting statistics. If the purpose is to determine which breeds are *inherently* more dangerous, just by virtue of the breeds themselves, then the statistics should exclude bites that were justified by the dog. If a Rottweiler bites an intruder who is attacking the homeowner, we would expect the Rottweiler to be praised for defending its owner. This is not the type of bite that we should be trying to prevent. It is also not the type of bite that is likely to lead to an insurance claim. Similarly, if a dog is being physically tormented by a neighborhood child who is poking it in the eye, we would not deny that the dog has an inherent right to defend itself by growling, snarling, barking, or biting back.[254] These are "just cause" bites, bites in which the dog has a legitimate reason to defend itself or its owners.

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249. *Id.* at 644.

250. *CDC 1979-1998*, *supra* note 94, at 838 (stating that it is unclear how to count attacks by mixed breed dogs).

251. *Id.* at 839.

252. *Task Force*, *supra* note 5, at 1736.

253. Dokken, *supra* note 240 ("To go by statistics alone assumes that the majority of dog bites are reported and that the majority of breeds identified are correct.").

254. There is reason to believe that incidents of "just cause" bites are not uncommon. The CDC described a series of incidents where nonfatal dog bites that involved "just cause." Stated conversely, these are bites where the human "victim" is to blame. *CDC Nonfatal*, *supra* note 123.

It is possible that the statistics are being skewed because property owners who wish to purchase "guard dogs" may be self-selecting certain breeds based on the popular notions of relative dangerousness. Guard dogs are trained to protect property by scaring away would-be intruders and, if necessary, to bite an actual trespasser. Owners who desire to have guard dogs may rationalize the purchase of one breed over another based on the degree to which *they subjectively believe* that the dog will be "mean" or "scary." This creates a self-fulfilling prophecy. The "scarier" a breed is considered by a community, the more likely a dog of that breed will be purchased for protection, used for protection, and actually bite an intruder. This will skew the statistics in a way that purports to show that the particular breed is, in fact, inherently more dangerous.

Despite these concerns, it appears that the studies to date have not excluded this category of bites from their datasets.[255] This is a fatal flaw in the statistics, for it confuses the issue between *inherent* dangerousness (due to breed) and legitimate animal behavior.

G. THE PROBLEM OF BREED SWITCHING BY DOG FIGHTERS, GANG MEMBERS, DRUG DEALERS, AND OTHER BAD OWNERS

Assume for the moment that an accurate relative dangerousness ratio could be determined for each breed and that it could be scientifically determined that certain breeds are inherently more dangerous than others. What about the owners? Does this not excuse them from the responsibility to properly train and care for their pets?

The reality is that there is a wide spectrum of responsible pet ownership. For some people, occasionally providing food and water for a dog is considered sufficient. On the opposite end of the spectrum, some people spend thousands of dollars on luxuries such as pet spas, advanced dog agility classes, and elaborate beds. Somewhere in the middle of the spectrum are people who actively ensure that their pets have food, water, and shelter; get exercise; are well-trained; and receive adequate veterinary care.[256]

Unfortunately, a small percentage of pet owners breed and use their pets for illicit purposes. They intentionally seek out vicious dogs that will attack and maim humans and other animals.[257] Dog-fighting enthusiasts, gang members, and drug dealers will purposely select, breed, and train

255. Dokken, *supra* note 240.
256. *Task Force*, *supra* note 5, at 1742.
257. Brand, *supra* note 230.

dogs to be vicious. The purpose may be to intimidate rivals (in the case of gangs and drug dealers), to defend illegal drugs (in the case of drug dealers), or to make money (in the case of promoters of dog fights).[258] For some, having a vicious dog is simply a status symbol.[259] In order to make dogs into vicious weapons, they use "revolting and painful techniques to bring the animals to the verge of bloodlust."[260] Drug dealers in Philadelphia during the 1980s had Pit Bulls named "Murder, Hitler, and Scarface."[261] They wore collars that concealed crack, cocaine, and money.[262] In Chicago, gang members "brandish[ed] their fierce pit bulls just as they would a switchblade or a gun."[263]

Current statistics do not take into consideration the degree to which the source of a dog's aggressiveness is the torturous upbringing described above, as opposed to the dog's breed.[264] In those situations, the problem is clearly with the dog owner—not the dog itself or its breed. These problem owners are dangerous with any breed of dog.[265]

One solution would be for insurers to write policies that exclude injuries related to dog fighting. This would limit the claims paid out for these high-risk animals, yet it would leave potential plaintiffs without an adequate source of compensation. This result might be a socially acceptable solution because of the unclean hands of the "victims." If dog-fighting exclusions are incorporated into standard homeowners' insurance contracts, the language should be narrowly written to exclude only those bad faith actors who, as a matter of social policy, should not be rewarded or compensated for injuries attendant to an illegal activity. The key would be to write language that would still protect innocent passers-by.

One of the arguments against BSL is that once a breed becomes banned, problem owners will simply switch to another breed.[266] In the 1930s, Pit Bulls were far from considered a "vicious breed." In fact, a Pit Bull named "Pete" starred in the *Our Gang* films of the time.[267] Fifty years ago, the Doberman was considered the most vicious dog.[268] During the

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258. *Id.*
259. *See, e.g., id.*
260. *Id.*
261. *Id.*
262. *Id.*
263. Brand, *supra* note 230.
264. Lockwood & Rindy, *supra* note 83, at 3.
265. *Id.*
266. *OVDO*, *supra* note 51.
267. Brand, *supra* note 230, at 60.
268. *Id.*

1980s, the focus turned to Pit Bulls.[269] In short, today's public target may be tomorrow's favorite pet, and vice versa.

H. DO THE INSURANCE COMPANIES HAVE BETTER DATA?

It is quite possible that one or more insurance companies have their own proprietary data purporting to show that one breed or another is disproportionately responsible for bites. I am skeptical that their data would be any better than the CDC's. The problems associated with the CDC and non-CDC studies are inherent to the problem of trying to determine the number of bites per breed and the number of dogs per breed.

III. THE WIDESPREAD OPPOSITION TO BREED DISCRIMINATION

Breed discrimination by insurance companies and breed-specific legislation by state and local governments have attracted national attention and outrage by veterinarians, animal groups, and dog owners.

The American Veterinary Medical Association's Task Force on Canine Aggression concluded that BSL and other breed-specific actions are "inappropriate and ineffective."[270] The Task Force consisted of a diverse coalition of veterinarians, academics, physicians, insurers, representatives from animal rights advocates, CDC scientists, and lawyers.[271] The Task Force agreed that to properly determine the relative dangerousness of breeds, one must first determine the number of bites per breed and the total population of each breed. As noted above,[272] the accurate calculation of both numbers is an immense challenge.[273]

The Task Force rejected the notion that a dog's breed is the sole determinant of dangerousness. "[A] dog's tendency to bite depends on at least 5 interacting factors: heredity, early experience, later socialization and training, health (medical and behavioral), and victim behavior."[274] They also pointed to the problems of mixed breeds, misidentification of breeds, and shifting popularity of breeds.[275] The Task Force also expressed concern about making decisions based solely on breed, since there is a lack

269. *Id.*
270. *Task Force*, *supra* note 5, at 1736.
271. *Id.* at 1732.
272. *See supra* Part II.
273. *Task Force*, *supra* note 5, at 1736.
274. *Id.*
275. *Id.*

of scientific means to identify breed.[276] The Task Force recommended, instead, that local governments focus on individual dogs and dog owners.[277]

The very scientists who have authored studies trying to determine a link between breed and aggressiveness oppose breed discrimination and BSL. In many of the CDC studies, the scientists cautioned against using their incomplete data on attacks to make knee-jerk legislative or policy decisions based solely on breed.[278] They pointed to the lack of reliable data on bites per breed (the "numerator problem") and the absence of a reliable count of dogs per breed (the "denominator problem").[279]

Animal groups have also opposed BSL and breed discrimination. The American Kennel Club ("AKC") has taken a strong stance against breed discrimination by insurance companies:

> The American Kennel Club believes that insurance companies should determine coverage of a dog-owning household based on the dog's deeds, not the dog's breeds. If a dog is a well-behaved member of the household and the community, there is no reason to deny or cancel coverage. In fact, insurance companies should consider a dog an asset, a natural alarm system whose bark may deter intruders and prevent potential theft.[280]

The AKC also issued this statement concerning BSL:

> The American Kennel Club (AKC) strongly supports dangerous dog control. Dog control legislation must be reasonable, non-discriminatory and enforceable as detailed in the AKC Position Statement.

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276. *Id.*

277. *Id.* at 1733.

278. *CDC 1989-1994*, *supra* note 17, at 894 ("Although several breeds appear overrepresented in the population of animals involved in fatal attacks, this representation fluctuates over time. Thus, it may be unproductive to view this as a problem that is unique to any one breed."); *CDC 1995-1996, supra* note 93, ("Although some breeds were disproportionately represented in the fatal attacks described in this report, the representation of breeds changes over time. As a result, targeting a specific breed may be unproductive; a more effective approach may be to target chronically irresponsible dog owners."); *CDC Nonfatal, supra* note 94 (arguing for regulation of individual dogs over BSL).

279. *CDC Nonfatal, supra* note 123; Lockwood & Rindy, *supra* note 83, at 2 (describing BSL as "controversial" and attributing the problem to a lack of "good data" for the numerator and denominator).

280. American Kennel Club, *Canine Legislation Position Statements, available at* http://www.akc.org/love/dip/legislat/canleg.cfm (last visited July 2003).

> To provide communities with the most effective dangerous dog control possible, laws must not be breed specific. Instead of holding all dog owners accountable for their behavior, breed specific laws place restrictions only on the owners of certain breeds of dogs. If specific breeds are banned, owners of these breeds intent on using their dogs for malicious purposes, such as dog fighting or criminal activities, will simply change to another breed of dog and continue to jeopardize public safety.[281]

In response to a perceived rise in breed discrimination, the Humane Society of the United States ("HSUS") and the American Society for the Prevention of Cruelty to Animals ("ASPCA") developed a grassroots campaign to educate the insurance industry.[282] Both groups oppose breed discrimination.[283] Other groups that have spoken out against breed discrimination include the American Medical Veterinary Association, the American Dog Owners Association, the Westminster Kennel Club, and the American Humane Society.[284]

IV. INSURERS FAIL TO TAKE INTO ACCOUNT THE UNIQUE AND SPECIAL ROLE OF PETS IN OUR SOCIETY

For at least 12,000 years, the history of the domestic dog, *Canis familiaris*, has intertwined with that of human beings.[285] The law has generally treated dogs as mere property[286]—or worse, as non-property.[287] As the popularity of dogs as pets has grown, the law has responded in kind by recognizing the importance of dogs, cats, and other pets. The insurance industry, by practicing breed discrimination, has failed to appreciate the unique and special role of dogs to their owners and to society. This section is offered to provide some context for the implications of breed discrimination. This is a problem that has the potential for affecting a large

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281. American Kennel Club, *American Kennel Club Statement on Dangerous Dogs*, *at* http://www.akc.org/love/dip/legislat/dangerous.cfm (last visited June 8, 2004).

282. Davis, *supra* note 58, at 1.

283. *Id.*

284. Weiss, *supra* note 51; Lockwood, *supra* note 51, at 276.

285. Weiss, et al., *supra* note 159, at 51; *Task Force*, *supra* note 5, at 1733. In contrast, the domestic cat has been with us for only about 4,000 years. GINA SPADAFORI & PAUL D. PION, CATS FOR DUMMIES 14 (2d ed. 2000).

286. *See infra* Part IV.D.

287. *Id.*

segment of the population and for having damaging effects on the mental, physical, and emotional health of people.

A. THE GROWING POPULARITY OF PETS

1. Population

A study estimated that in 1998 there would be 53.6 million dogs in the United States, a 2.1% increase since 1991.[288] Approximately 34.3% of homes have one or more dogs.[289] Dog owners are thus a significant portion of the United States population. They are also a significant pool of customers (actual and potential) for insurers.

2. Spending

To understand the scope and power of the pet-owning population, consider the amount of money that is spent on pets each year. In 1998, Americans spent $11.1 billion on veterinary care alone, a 61% increase from 1991.[290] There are over 35 "pet vacation resorts" where dogs and cats can go to be pampered.[291] There are also over 650 pet cemeteries in the United States, indicating the extent to which owners will go to memorialize their pets.[292]

B. DOGS ARE MEMBERS OF THE AMERICAN FAMILY

Breed discrimination ignores the reality that most pet owners consider their pets to be members of their immediate family.[293] Indeed, this "coexistence has contributed substantially to humans' quality of life."[294] Dogs were initially domesticated to be work animals, assisting humans with farming, herding livestock, and providing security at night.[295] In time, dogs became "four-legged members of the family."[296] Some dogs provide

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288. Wise & Yang, *supra* note 225.
289. *Id.*
290. Willing, *supra* note 6.
291. *Id.*
292. *Id.*
293. *Task Force*, *supra* note 5, at 1739.
294. *Id.* at 1733.
295. *Id.* at 1739.
296. *Id.*

assistance to humans with disabilities.[297] Service dogs serve as a tangible resource for people, not just a source of companionship.[298]

Dogs can have positive effects on the health of their owners,[299] such as alleviating loneliness and depression, reducing high blood pressure, and addressing obesity.[300] On the other hand, these effects must be balanced against the negative health effects of dogs, such as bites and the transmission of zoonotic diseases.[301] When the positives are weighed against the negatives, at least one physician has concluded that dogs probably are beneficial to human health.[302] Some owners will forego their own health in order to care for their pets—a demonstration of how much pets mean to some owners. "Most physicians are familiar with at least one example of a person refusing hospitalization . . . because there was no one else in the home to care for their pet."[303]

The loss of a pet can have profound effects on an owner. A number of organizations provide bereavement support for people whose pets have died[304] and at least three greeting card companies make sympathy cards specifically for the loss of a pet.[305]

Breed discrimination forces pet owners to choose between their homes and their dogs. Forcing owners to make this choice represents a significant misunderstanding of the role of pets in our society. For some pet owners, giving up a pet is like losing a child, sibling, or spouse.

C. THE CONSEQUENCES OF BREED DISCRIMINATION

When a dog bites, it can have lasting consequences for both the dog and its owner's family. When an insurance company refuses to insure or renew a household based on a particular breed of dog, it too can have far-reaching consequences.

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297. Susan D. Semmel, Comment, *When Pigs Fly, They Go First Class: Service Animals in the Twenty-First Century*, 3 BARRY L. REV. 39 (2002).

298. *Id.* at 44.

299. *CDC 1995-1996*, *supra* note 93, at 466 ("Dogs provide many health and social benefits.").

300. David T. Allen, *Effects of Dogs on Human Health*, 210:8 J. AM. VETERINARY MED. ASS'N 1136, 1138 (1997).

301. *Id.*

302. *Id.*

303. *Task Force*, *supra* note 5, at 1740.

304. *See, e.g.*, *In Memory of Pets*, *at* http://www.in-memory-of-pets.com/ (last visited July 21, 2004); *Association for Pet Loss and Bereavement*, http://www.aplb.org/ (last visited July 21, 2004).

305. Willing, *supra* note 6.

Most people do not respond appropriately if their dog bites someone. Most punishment is too severe and too late to be of any value to the dog in preventing future occurrences.[306] The dog is usually isolated from the family and visitors. By limiting interaction with humans, the dog does not learn how to deal with people appropriately.[307] Isolation may also lead to inadequate medical care, which may in turn lead to serious health problems for the dog.[308]

Some owners abandon their dogs or euthanize them either out of frustration in not being able to correct aggressive behavior or because an insurance company tells them to do so in order to get homeowners' insurance.[309] When BSL goes into effect or insurance companies discriminate, it causes some owners to purposely assume a sheltered and low profile in the community to avoid being caught with an unauthorized pet.[310] Shelter drop-offs are common after BSL goes into effect or insurers begin to discriminate based on breed.[311] The Humane Society in Atchison, Kansas, reported a 40% increase in drop-offs of Rottweilers because of breed discrimination.[312] This is unfortunate because many shelters can only keep dogs a certain number of days before euthanizing them. Breed discrimination can have a chilling effect on ownership of certain breeds,[313] which means certain breeds are not likely to be adopted and will have to be euthanized.

Breed discrimination will likely have an effect on homeownership in states that permit this practice. Homeowners' insurance is the "gatekeeper" to homeownership. Without homeowners' insurance, a person cannot get a mortgage. Without a mortgage, most people cannot buy a house.[314] An insured who chooses to lie about a dog's breed or the existence of a dog altogether is committing policy fraud, running the risk of criminal prosecution[315] and the complete cancellation of his or her policy.[316]

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306. Wayne Hunthausen, *Effects of Aggressive Behavior on Canine Welfare*, J. AM. VETERINARY MED. ASS'N 1134, 1134 (1997).

307. *Id.*

308. *Id.* at 1135.

309. *Id.*

310. *Id.*

311. Sodergren, *supra* note 59; McMahon, *supra* note 17, at 03a.

312. Sodergren, *supra* note 59.

313. *Id.*

314. *See infra* Part V.C.

315. Robert R. Googins, *Fraud and the Incontestable Clause: A Modest Proposal for Change*, 2 CONN. INS. L.J. 51, 69 n.86 (1996).

316. 2 COUCH ON INS. § 31:10 (3d ed. 2004).

D. THE LAW IS BEGINNING TO RECOGNIZE PETS AS MORE THAN MERE PROPERTY

The problem of breed discrimination should be viewed in light of modern developments in animal law, which is beginning to recognize that animals are more than mere property. Until recently, the legal status of animals was governed by an 1897 Supreme Court case, *Sentell v. New Orleans & C. R. Co.*[317] The case involved a Newfoundland named Countess Lona who was killed by a railroad car.[318] Her owner brought suit against the railroad for negligence. The railroad defended by relying on a statute that prohibited an owner from recovering for more than the declared value on the animal's registration form.[319] An owner whose dog was not registered could not recover anything for the loss of or damage to the animal.[320] Countess Lona's owner brought suit, challenging the constitutionality of the law.[321]

The Supreme Court held that the statute was constitutional as a valid exercise of the state's police power.[322] The Court declared that dogs are a form of quasi-property that is "imperfect or qualified" in nature.[323] The Court relied on the common law rule that dogs could not constitute stolen property for purposes of larceny statutes.[324] The common law held that wild animals had no property value until killed or subdued.[325] Domesticated animals, such as horses, cattle, sheep, and other "work" animals, were considered "perfect and complete" property.[326] Dogs fell in a third category, that of "cats, monkeys, parrots, singing birds, and similar animals, kept for pleasure, curiosity, or caprice."[327] The Court saw no useful, social value for dogs, except for companionship, which the Court dismissed as unsatisfactory for the establishment of a property interest. Thus, the Court held that property interests in animals are on a continuum: wild animals (animals *ferae naturae*) on one end, domesticated animals (such as horses, cattle, and sheep) on the other end, and dogs somewhere in

317. Sentell v. New Orleans & C.R. Co., 166 U.S. 693 (1897).
318. *Id.*
319. *Id.*
320. *Id.*
321. *Id.* at 694.
322. *Id.* at 696.
323. *Id.* at 694.
324. *Id.* The Court noted, however, the dogs can be considered property for purposes of the tort of conversion. *Id.*
325. *Id.*
326. *Id.*
327. *Id.*

between.[328] To the *Sentell* Court, dogs hold "their lives at the will of the legislature, and properly falling within the police powers of the several states."[329] The Court concluded, "It is purely within the discretion of the legislature to say how far dogs shall be recognized as property, and under what restrictions they shall be permitted to roam the streets."[330]

The question of the legal status of dogs and other pets has recently been addressed by courts in the context of family disputes. *Bennett v. Bennett*[331] and *Arrington v. Arrington*[332] typify the majority rule with respect to the "custody" of pets upon their owners' divorce. In both cases, divorcing couples sought both custody and visitation of their dogs. In *Bennett*, the trial court awarded legal custody of the dog, Roddy, to the husband, with the wife receiving every-other-weekend and holiday visitation rights.[333] Subsequent squabbling between the parties led the Court to modify its order to have the parties swap custody of the dog every month.[334] The appellate court reversed the trial court's order and affirmed the *Sentell* doctrine: "While a dog may be considered by many to be a member of the family, under Florida law, animals are considered to be personal property."[335] The court found that the trial court lacked authority to order visitation rights in mere property.[336]

The court in *Arrington* reached a similar conclusion. *Arrington* involved a custody dispute over Bonnie Lou, "a very fortunate little dog with two humans to shower upon her attentions and genuine love frequently not received by human children from their divorced parents."[337] The trial court had awarded custody of Bonnie Lou to Mrs. Arrington. Mr. Arrington appealed, claiming he should have been appointed "managing conservator" (primary guardian) of Bonnie Lou.[338] The Court held that

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328. *Id.* at 694-95.

329. *Id.* The Court's distinction between full, incomplete, and no status is interesting, but ultimately irrelevant, as the Court held that even if dogs were considered complete property, they (like all forms of property) are subject to the police power of the state. *Id.*

330. *Id.* at 696

331. Bennett v. Bennett, 655 So. 2d 109 (Fla. Dist. Ct. App. 1995).

332. Arrington v. Arrington, 613 S.W.2d 565 (Tex. App. 1981).

333. *Bennett*, 655 So. 2d at 110.

334. *Id.*

335. *Id.*

336. *Id.*

337. *Arrington*, 613 S.W.2d at 569.

338. *Id.* In Texas family law, a "managing conservator has the right to establish the child's residence and has primary custody of the child. A possessory conservator typically has visitation rights under terms and conditions set by the court." *In re* V.L.K., 24 S.W.3d 338, 340 n.1 (Tex. 2000) (citations omitted); *see generally* TEX. FAM. CODE ANN. §§ 153.132, 153.371, 153.192 (2004).

managing conservatorships were designed for humans, not animals.[339] The Court held, "A dog, for all its admirable and unique qualities, is not a human being and is not treated in the law as such. . . . A dog is personal property, ownership of which is recognized under the law."[340]

There is an indication that the legal status of dogs and other pets may be beginning to change. In *Raymond v. Lachmann*, the court had to determine the custody of a cat named Merlin.[341] The defendant originally owned Merlin, but left him for 1½ years with a former roommate, the plaintiff.[342] During that time, the plaintiff renamed him "Lovey" and grew to be quite attached to him.[343] The trial and appellate courts both held that Lovey should remain in the custody of the plaintiff, who had taken care of him for a lengthy period of time. What is remarkable about this case is that the court used a "best interests of the cat" standard to decide the issue. The court discarded strict application of property law and in its place adopted a version of the "best interests of the child" standard from (human) family law. The court held:

> Cognizant of the cherished status accorded to pets in our society, the strong emotions engendered by disputes of this nature, and the limited ability of the courts to resolve them satisfactorily, on the record presented, we think it best for all concerned that, given his limited life expectancy, Lovey, who is now almost ten years old, remain where he has lived, prospered, loved and been loved for the past four years.[344]

Some courts have also recognized that pets are more than mere property in the context of tort awards. In *Corso v. Crawford Dog & Cat Hospital, Inc.*,[345] a New York City Civil Court judge awarded $700.00 in damages to the owner of a deceased poodle. The dog had been euthanized by the defendant, on instructions from the plaintiff.[346] "The plaintiff had arranged for an elaborate funeral, . . . including a headstone, an epitaph, and attendance by plaintiff's two sisters and a friend."[347] When the

339. *Arrington*, 613 S.W.2d at 569.
340. *Id.*
341. Raymond v. Lachmann, 264 A.D.2d 340 (N.Y. App. Div. 1999).
342. *Id.*
343. *Id.*
344. *Id.* at 341.
345. Corso v. Crawford Dog & Cat Hosp., Inc., 97 Misc.2d 530 (NY. Civ. Ct., Queens County 1979).
346. *Id.*
347. *Id.*

plaintiff opened the casket, however, she saw the body of a dead cat.[348] She brought suit, alleging that she had suffered emotional distress as a result of the incident.[349] The court held that the plaintiff was entitled to sue not just for the market value of the dog (for conversion of her property) but also for her mental anguish and suffering in seeing the cat instead of her dog. The Court stated:

> This court now overrules prior precedent and holds that a pet is not just a thing but occupies a special place somewhere in between a person and a piece of personal property. . . . A pet is not an inanimate thing that just receives affection it also returns it. . . . To say that [the poodle] is a piece of personal property and no more is a repudiation of our humanness. This I cannot accept.[350]

Dicta in other cases demonstrate that courts are beginning to rethink the concept that pets are mere property. In *Bueckner v. Hamel*,[351] the Texas Court of Appeals had to decide the amount of damages to be awarded the owner of then deceased dogs, a Dalmatian and an Australian Shepherd.[352] The defendant shot the dogs while they were chasing a deer.[353] The plaintiffs brought suit to recover damages for the loss of their property, which the trial court found "had special value to the Plaintiffs and were loved as pets by the Plaintiffs."[354] The majority concluded that, "Texas law recognizes a dog as personal property"[355]—a holding consistent with *Sentell*. The majority went on to hold that the plaintiffs could recover only for the loss of value of prospective puppies but only in the context of how much the animal itself would be worth as breeding stock.[356]

A concurring judge took a broader view of damages in the case. He said the award for damages should be based on "the intrinsic or special value of domestic animals as companions and beloved pets."[357] The market value was inadequate to compensate the plaintiffs for the full extent of their

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348. *Id.* at 530-31.
349. *Id.* at 531.
350. *Id.*
351. Bueckner v. Hamel, 886 S.W.2d 368, 370 (Tex. App. 1994).
352. *Id.* at 370.
353. *Id.*
354. *Id.*
355. *Id.*
356. *Id.* at 371.
357. *Id.* at 373 (Andell, J., concurring).

loss.[358] "It is common knowledge among pet owners that the death of a beloved dog or cat . . . can be a great loss."[359] He called for the acknowledgment of pets as a special form of property[360] based on the relationship between humans and their pets:

> Many people who love and admire dogs as family members do so because of the traits that dogs often embody. These represent some of the best of human traits, including loyalty, trust, courage, playfulness, and love. This cannot be said of inanimate property. At the same time, dogs typically lack the worst human traits, including avarice, apathy, pettiness, and hatred. . . . Losing a beloved pet is not the same as losing an inanimate object, however cherished it may be. Even an heirloom of great sentimental value, if lost, does not constitute a loss comparable to that of a living being. This distinction applies even though the deceased living being is a nonhuman.[361]

Juries have been following this trend. In cases where harm had been done to pets, juries have been awarding damages as high as $35,000. In contrast, the average award in the early 1990s was only a few hundred dollars.[362]

V. BREED DISCRIMINATION SHOULD BE ENDED THROUGH LEGISLATION OR ADMINISTRATIVE REGULATION

A central principle of insurance law is that insurance companies operate at the pleasure of the states.[363] "Indeed, the organization of an

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358. *Id.*

359. *Id.* at 376.

360. *Id.* at 377.

361. *Id.* at 377-78.

362. Willing, *supra* note 290.

363. Blue Cross & Blue Shield of Central New York, Inc. v. McCall, 674 N.E.2d 1124, 1126 (N.Y. 1996) [hereinafter *Blue Cross & Blue Shield*]. For further discussion of insurance as a "privilege" instead of a "right," see 43 AM. JUR. 2D *Insurance* § 23 (2004). "The organization of an insurance company and the conduct of the business of writing insurance is not a right but a privilege granted by the state, subject to the conditions imposed by it." *Id.* § 24.

Regulation of the insurance industry is primarily a power of states, not the federal government. 43 AM. JUR. 2D *Insurance* §§ 29, 30 (2004). The McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015, declared that regulation of insurers by the states was in the public interest. 43 AM. JUR. 2D *Insurance* § 30 (2004). McCarran-Ferguson creates a reverse

insurance company and the conduct of the business of writing insurance is not a right but a privilege granted by the State subject to the conditions imposed by it to promote the public welfare."[364] The power to regulate insurance is so strong that a state may take over the entire business of insurance if it decides it is in the public interest to do so.[365]

States have the power to regulate insurers as an exercise of their police power.[366] Although insurance law is governed in part by contract law,[367] it is also quasi-public in nature.[368] States have the power not just to regulate insurance contracts, but also to declare the terms and conditions of those contracts and to impose additional duties and obligations.[369] On the other hand, when a state does not regulate a particular practice of the insurance industry, companies are free to contract as they see fit.[370]

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preemption system where the power to regulate is vested in the states, not the federal government. *Id.* However, plans created under the Employee Retirement Income Security Act (ERISA), are still subject to joint federal-state regulation. John Hancock Mut. Life Ins. Co. v. Harris Trust & Sav. Bank, 510 U.S. 86 (1993) ("We are satisfied that Congress did not order the unqualified deferral to state law that Hancock both advocates and attributes to the federal lawmakers. Instead, we hold, ERISA leaves room for complementary or dual federal and state regulation, and calls for federal supremacy when the two regimes cannot be harmonized or accommodated.").

364. *Blue Cross & Blue Shield*, 674 N.E.2d at 1126.

365. 43 AM. JUR. 2D *Insurance* § 25 (2003).

366. Bekken v. Equitable Life Assurance. Soc'y., 293 N.W. 200, 211 (N.D. 1940); 43 AM. JUR. 2D *Insurance* §§ 24, 25 (2003).

367. *Bekken*, 293 N.W. at 209.

368. *Id.*at 210.

369. *Id.* at 211. ("It will be noted that the State, under its police power, in the interest of the general welfare, may regulate not only the business of insurance in a general way, but it may, also, regulate contracts of insurance, and in a large measure prescribe the terms and conditions of such contracts, and it may impose duties and obligations incident to the relation created by the contract or the negotiations for a contract different from those arising or existing under other contracts, and it may prohibit the parties from altering such duties or obligations."). In *Bekken*, the North Dakota Supreme Court had to decide whether a beneficiary of a life insurance policy could enforce the policy even though the insurance company had not acted promptly in writing the policy before the deceased died. The court held that the insurance company had breached its duty to act promptly on the deceased's application and ordered the company to pay the beneficiary. *Id* at 218.

One court has stated, "Such regulation, even down to 'the minutest particular in the interest of the public, has never been questioned." *Blue Cross & Blue Shield*, 674 N.E.2d at 1126 (quoting People v. Formosa, 30 N.E. 492 (N.Y. 1892)).

370. Greer v. Aetna Life Ins., 142 So. 393, 395 (Ala. 1932) ("The generally recognized rule is that 'in the absence of statutory prohibitions discriminations or rebating as to premiums is not illegal.'"). In *Greer*, the state complained that Aetna's policy of not charging higher premiums for mortgage insurance for older people (who pose a greater risk) in essence discriminated against the young. *Id.* at 394-95. Since state law did not prohibit

States regulate and legislate insurance on behalf of the public interest. Regulations counterbalance free market forces to protect the public at-large.[371] Some states prohibit unfair and deceptive trade practices.[372] Some administratively set rates.[373] In determining whether a rate is reasonable, states will look to see if the rate is based on "legitimate cost factors."[374] Some states require insurers to write policies for particular risks, even though the marketplace may have determined such insureds are poor risks or that they are simply uninsurable.[375]

In 1997, Professor Hellman evaluated the widespread practice of the time of insurers in denying health, life, and disability coverage to victims of domestic abuse.[376] She presented a compelling and detailed analysis of the philosophical and legal implications of this practice, ultimately concluding that state legislatures should intervene and prevent underwriting decisions based on a customer's history of domestic abuse.[377]

Professor Hellman's analysis started with the premise that insurers had been able to draw an actuarially justified conclusion that domestic abuse victims were, from a statistical standpoint, more likely than others to be victimized in the future and, thus, to result in claims against their insurers.[378] Domestic abuse victims were a higher risk—so high, the insurers concluded, that the insurance pool could not bear to have them as a risk, no matter how high the premium.[379] Breed discrimination is an entirely different problem altogether. There is a lack of statistically and

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discrimination based on age or life expectancy, the Alabama Supreme Court held that the insurance company did not do anything illegal. *Id.* at 395.

371. *Blue Cross & Blue Shield*, 674 N.E.2d at 1126 (stating that the conduct of insurance companies is subject to conditions imposed by the state to promote public welfare).

372. 44 C.J.S. *Insurance* § 45 (1993).

373. *Id.* § 66 ("The rates charged by insurance companies must not deviate from those established by state authority. Rates may not be unreasonable, excessive, inadequate, or discriminatory."). In states where rates are regulated, insurers bear the burden of proving the reasonableness of their rates. *Id.* § 69(b). Legislatures can prohibit discrimination against insureds of the same "class." *Id.* § 64. Some states provide a private cause of action to enable insureds to recover for unfair trade practices or violations of rate regulations. *Id.* § 45.

374. 43 AM. JUR. 2D *Insurance* § 43 (2003).

375. *Id.* § 25. Most states require insurers to contribute to an "assigned risk plan" which writes "high-risk" policies for drivers who cannot get insurance in the free market, often because of DWI convictions. *See, e.g.*, TEX. INS. CODE ANN. art. 21.81 (2004-2005).

376. Deborah S. Hellman, *Is Actuarially Fair Insurance Pricing Actually Fair?: A Case Study in Insuring Battered Women*, 32 HARV. C.R.-C.L. L. REV. 355 (1997).

377. *Id.* at 410.

378. *Id.* at 356, 377-78.

379. *See id.* at 358.

scientifically sound data to show that certain breeds are more dangerous than others. Even if such data existed, a plausible case could be made that the breed of a family's dog should not be used as a factor in underwriting.

A. INSURERS HAVE A DUTY TO MAKE UNDERWRITING DECISIONS BASED ON ACTUARIALLY JUSTIFIED FACTORS

In making underwriting decisions, insurers decide which of many risks to insure in order to protect their fiscal solvency and profitability.[380] When an underwriter decides not to insure a particular risk, the would-be insured is left to find insurance elsewhere. If no insurer will underwrite or accept the risk, the result may be a cost-shifting to society[381] or the loss of an economic opportunity to a consumer.[382]

The question then becomes which factors an insurer may consider in making its underwriting decisions. Insurance is a highly regulated industry. It does not operate in a regulatory vacuum, free to let the give-and-take of the marketplace decide who gets insurance, how much coverage they get, and how much it will cost them. There is social utility in making insurance available to the most number of people as possible.[383] Insurance allows people to buy homes, afford health care, and drive automobiles.[384] The high stakes and high social utility of insurance have historically justified strict government regulation of the industry.[385]

All states require underwriting decisions to be based on actuarially sound data.[386] In Maryland, for example,

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380. Deborah A. Stone, *The Rhetoric of Insurance Law: The Debate over AIDS Testing*, 15 LAW & SOC. INQUIRY 385, 388 (1990).

381. If a person cannot obtain health insurance, his or her health care costs shift to the public (through Medicare or Medicaid) or to hospitals who may be required to treat every patient regardless of the ability to pay. In the latter case, the costs are likewise shifted to the public because hospitals must increase costs for paying customers (and their insurers) in order to make up for their losses from their non-paying customers. *Id.* at 390.

382. In the case of breed discrimination, the latter results. If I had not been able to secure insurance with the Farm Bureau, I would have lost out on a significant economic opportunity—the ability to purchase a house. See *infra* Part V.B. for a discussion of insurance as gatekeeper to homeownership. In the alternative, I could have given up my dogs, which likewise would have been a significant loss of happiness and opportunity.

383. *See* Stone, *supra* note 380, at 386 (stating that insurance is the primary mode people provide for needs not affordable through a normal work income).

384. Brian J. Glenn, *The Shifting Rhetoric of Insurance Denial*, 34 LAW & SOC'Y REV. 779, 782 (2000).

385. LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 2:1 (3d ed. 1995).

386. Sonia M. Suter, *Disentangling Privacy From Property: Toward a Deeper Understanding of Genetic Privacy*, 72 GEO. WASH. L. REV. 737, 795 (2004) ("All states

> An insurer or insurance producer may not cancel or refuse to underwrite or renew a particular insurance risk or class of risk for a reason based wholly or partly on race, color, creed, sex, or blindness of an applicant or policyholder *or for any arbitrary, capricious, or unfairly discriminatory reason.*[387]

Maryland law also provides that underwriting must be accomplished "by the application of standards that are reasonably related to the insurer's economic and business purposes."[388]

Actuarially justified underwriting is not only the law, it is good business. By accurately separating out risks into "not insurable" and "insurable" (and, then, in turn, separating out insurable risks into various risk classifications), actuarially justified underwriting promotes efficiency and profit. Consumers are not allowed into the insurance pool when the likelihood of loss is so high that inclusion of their risks threatens the viability of the pool itself.[389] For those insureds allowed in the pool, actuarially justified underwriting promotes efficiency by assigning low premiums to low-risk insureds and high premiums to insureds more likely to have a claim.[390] This creates a market incentive for low-risk insureds to participate in the pool as opposed to engaging in adverse selection.[391] Accurate risk classification also maximizes profits for the insurer. By eliminating the highest-risk insureds from the pool, an insurer keeps

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require underwriting decisions to be actuarially, or rationally, based; they cannot be arbitrary. Insurers must engage in good-faith practices in deciding whether to underwrite, at what rate, and for what conditions."); 43 AM. JUR. 2D *Insurance* § 43 (2003) (underwriting and rate setting may take into account only legitimate cost factors). To some extent, this requirement is based on a prohibition of unfair trade practices, as enumerated in the model Unfair Trade Practices Act, developed by the National Association of Insurance Commissioners. *See* UNFAIR TRADE PRACTICES ACT (Nat'l Ass'n of Ins. Comm'rs 2001) [hereinafter UTPA]. The NAIC, a non-governmental organization of insurance regulators, drafted this model act to regulate unfair trade practices in the insurance industry. Most states have adopted UTPA in some form or another. *See* Stone, *supra* note 380, at 392; Richard J. Wirth, *My Customer's Keeper: The Search for a Universal Suitability Standard in the Sale of Life Insurance*, 24 W. NEW ENG. L. REV. 47, 79 (2002).

387. MD. CODE ANN. INS. § 27-501(a)(1) (2002) (emphasis added).

388. *Id.* § 27-501(a)(2).

389. Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 377 (2002/2003).

390. Otherwise insurers would run a risk of low-risk consumers being priced out of the market and only high-risk insureds remaining, a danger known as the "death spiral." *See* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223, 1224 (2004).

391. Baker, *supra* note 389, at 373.

premiums low for the low-risk insureds who remain. An insurer who does not maintain its "classification edge" faces the potential of having its low-risk insureds leave to join other companies who are able to charge lower premiums due to better risk classification decisions.[392] The insurer is stuck with its high-risk insureds as well as the high-risk insureds who migrate over from the insurer's competition.[393] This means that the insurer is not maximizing its profitability.

How much statistical correlation is required for a rating factor to be "actuarially fair"? How legitimate do "legitimate cost factors" have to be?[394] Certainly, perfect 1:1 correlation is not required.[395] Thus, I do not suggest that insurers must be able to demonstrate that every Chow Chow will have an unjust bite in its lifetime. Risk classification necessarily will involve some "false positives."[396] Otherwise, insurers would be very limited in the classifications they could use, there would be insufficient stratification of the rate pool, and the dangers of moral hazard[397] and adverse selection[398] would increase dramatically. On the other end of the spectrum is the insurers' position, that any correlation is sufficient.[399] This is not an economically viable position for an insurer, since low-risk insureds may be incorrectly classified as high-risk customers, and high-risk insureds might be priced out altogether.[400] For example, my ownership of a Rottweiler and a half-Chow put me in an irrationally high-risk classification—so high that every insurer except the Farm Bureau declined to provide coverage. The dozen or so insurers that I contacted in Lubbock who declined to provide coverage lost out on what would otherwise be a low-risk insured, simply because they adhered to a hypothesis (Rottweilers and Chow Chows are more dangerous than other dogs) that has not been scientifically proven. In my case, the insurer who used a more actuarially sound rate classification structure (the Farm Bureau) benefited by offering

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392. KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 67-68 (Yale University Press 1986).

393. Baker, *supra* note 389, at 377.

394. *See, e.g.*, 43 AM. JUR. 2D *Insurance* § 43 (2003).

395. Hellman, *supra* note 376, at 380.

396. *Id.* at 378.

397. Moral hazard is the change in incentives that can result because an individual is protected by an insurance contract. Baker, *supra* note 389, at 373. Insureds without a sufficient personal investment in a particular risk—through co-insurance, for example—may be more likely to engage in the risky conduct in a negligent manner.

398. Adverse selection is the tendency for low-risk insureds to drop out of insurance pools altogether, unless administrators provide financial incentives for them to remain in the pools. *Id.* at 375-76.

399. *See* Hellman, *supra* note 376, at 380.

400. *See id.* at 380-81.

a low-risk consumer a low-risk premium, thus gaining a market advantage over its competition.[401]

I do not believe there exists sufficient data for an insurer to even justify a weak correlation between breed and bite risk. Insurers should work to minimize the risk of false positives so as to "fine tune" its risk classifications to the greatest extent possible.[402] Risk classifications should be sufficiently refined so as not to be overbroad. Excluding all dogs would clearly be overbroad and would come with high social costs. Excluding some breeds is also unsound, based on my review of the scientific literature.[403] What I propose—and what the Task Force on Canine Aggression and Human-Canine Interactions proposed[404]—is the refinement of breed-specific actions by legislatures and insurers to control and regulate "dangerous dogs." Dangerous dogs are those that have demonstrated (on an individual, dog-by-dog basis) a propensity for violence. This would be actuarially fair because adequate evidence exists that a dog with a history of unjustified bites is likely to be dangerous in the future.

As demonstrated in Part II of this article, there is insufficient evidence to support the insurance industry's argument that certain breeds bite more often. In other words, the current risk classification (by breed) is too general and is generating too many false positives while at the same time having unnecessary social costs. A spokesperson for the III recently conceded, "[T]he industry isn't positioned to determine which dogs should be deemed vicious. ... [W]e're certainly not dog experts or

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401. *Id.*

402. *Id.* at 380 (noting that "statistical discrimination is justified when the social utility, including the cost to the insurer of employing a particular classification, could not be increased by further refinement of the classification," a view expressed by Steven Meitzen in *The Ethics of Statistical Discrimination*, 17 SOC. THEORY & PRAC. 23, 26 (1991)).

403. Frederick Schauer argues that BSL and breed discrimination are justified practices. FREDERICK F. SCHAUER, PROFILES, PROBABILITIES, AND STEREOTYPES 55-78 (2003). Schauer starts with the premise that there is a statistical correlation between pit bulls and unprovoked bites. *Id.* at 55 ("Looking at what evidence we have, it turns out that the generalizations underlying pit bull restrictions do indeed have the kind of empirical support that distinguishes them from purely spurious generalizations."). He then goes on to argue that BSL and breed discrimination, while both underinclusive and overbroad, are justifiable from the perspective of statistical correlation and the need to protect people from dangerous events. *Id.* at 59. As I have demonstrated, however, the correlation between breed and dangerousness is weak at best. *See supra* Part II. Schauer's citation for his proposition is several of the CDC studies that have been discussed in this article. SCHAUER, *supra*, at 59 n.7; *see supra* Part II. Yet, these very studies cautioned that their data was incomplete and that it would not be statistically sound to make generalizations about breeds. *See supra* Parts II & III.

404. *Task Force*, *supra* note 5, at 1737.

veterinarians."[405] Unless and until the industry can demonstrate that different breeds have different relative dangerousness ratios with some degree of accuracy, breed discrimination should be opposed by the general public, insurers themselves, and regulators.

B. EVEN IF INSURERS COULD ACTUARIALLY JUSTIFY BREED DISCRIMINATION, THERE ARE GOOD ARGUMENTS TO SUPPORT REGULATION IN THE PUBLIC INTEREST

The law is full of examples where "actuarially fair" factors have nevertheless been prohibited in underwriting because of overriding public interests. Statistical correlation between behavior and risk, therefore, is only the first step in a much bigger, public policy analysis. Drive-through deliveries,[406] preexisting medical conditions,[407] civil rights,[408] and witness

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405. Davis, *supra* note 58, at 36 (quoting Alejandra Soto, spokesperson for the III).

406. The practice of "drive-through deliveries" required doctors to discharge new mothers within hours after giving birth. Vicki Lawrence MacDougall, *Medical Gender Bias and Managed Care*, 27 OKLA. CITY U. L. REV. 781, 882, 892-94 (2002). States responded by passing laws requiring insurance companies to allow new mothers to stay in the hospital for a minimum period of time. Elizabeth C. Price, *The Evolution of Health Care Decision-Making: The Political Paradigm and Beyond*, 65 TENN. L. REV. 619, 626 (1998). Connecticut, for example, passed a law that required insurance companies to pay for forty-eight hours of inpatient care following vaginal deliveries and ninety-six hours following caesarian deliveries. CONN. GEN. STAT. ANN. §§ 38a-503c, 38a-530c (West 2004). Congress, using its power to regulate ERISA-based insurance policies, followed suit by passing the Newborns' and Mothers' Health Protection Act of 1996, which included the 48/96 hour rule that had been adopted by several states. Newborns' and Mothers' Health Protection Act of 1996, Pub. L. No. 104-204, 110 Stat. 2874, 2935 (codified at 29 U.S.C. §§ 1185(a)(1)(A)(i)-(ii)(2004)).

407. Customers with preexisting medical conditions represent a high-risk class of insureds. They are people likely to need additional care in the future. The market responded by charging higher rates for people with preexisting medical conditions or flat-out rejecting them for coverage. The result was that many people found themselves without insurance when they switched insurers. *See* Grey, *supra* note 17, at 421 (insurers are given wide-latitude to refuse to cover certain high-risk customers, absent state legislation or regulation to the contrary). Some states responded by passing legislation prohibiting insurers from refusing to provide coverage based on preexisting medical conditions. Connecticut requires health insurers to provide coverage for preexisting conditions if the person was previously covered by his or her preceding plan. CONN. GEN. STAT. ANN. §§ 38a-476 (West 2004).

408. Legislatures have acted to protect consumers from discrimination on the basis of race, color, national origin, gender, and other protected classes. Maryland, for example, has a relatively far-reaching statute prohibiting discrimination in underwriting based on race, color, creed, sex, blindness, or for any arbitrary or capricious reason. MD. CODE ANN., INS. § 27-501 (2004).

intimidation[409] are all examples of where otherwise actuarially justified practices were prohibited by state legislatures and courts due to overriding interests in equality, health, and fairness.

Part IV demonstrated the importance of dogs and other pets in society. Pets provide physical and emotional benefits to humans and are not mere property. Even if breed discrimination was actuarially justified, I think a plausible argument would exist that the practice should be regulated because of the public interest in protecting animal-human bonds.

There is an additional, and arguably more important, social value that is compromised by breed discrimination: homeownership. Most home buyers require homeowners' insurance in order to purchase a home. This

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States have enjoined insurers from charging higher automobile insurance rates to men even though actuarial statistics show that women are a lower risk. For example, in *Hartford Accident and Indem. Co. v. Ins. Comm'r*, 482 A.2d 542 (Pa. 1984), the Pennsylvania Supreme Court held that the practice of charging different rates based on gender violated the state's statute which prohibited "unfairly discriminatory" rates. *Id.* at 549. The court looked to the purposes of the act and insurance regulation in general: to promote the public welfare. *Id.* at 547. The court held, "[P]ublic policy considerations require more adequate justification for rating factors than simple statistical correlation with loss." *Id.* at 548 (quoting Nat'l Ass'n of Insur. Comm'rs, *Report of the Rates and Rating Procedures Task Force of the Automobile Insurance (D3) Subcommittee, November 1978* at 5-6 (footnotes omitted)).

A Michigan court declared unlawful the practice of refusing to write automobile insurance for adults under 21 unless they resided with parents. *Detroit Auto. Inter-Ins. Exch. v. Comm'r of Ins.*, 326 N.W.2d 444, 445 (Mich. Ct. App. 1982). The court found that this practice violated the state's unfair trade practices law, which permitted refusing to insure a group "only if the cost is unreasonable." *Id.* at 447. The court affirmed a central notion of insurance law that the free market is not the sole determinant of insurance rates. The court stated, "The mere fact that one group is more expensive to insure than another does not preclude fixing a reasonable rate." *Id.*

Plaintiffs have also relied on federal law for relief against discrimination in the provision of homeowners' insurance. In *Nat'l Fair Housing Alliance, Inc. v. Prudential Ins. Co. of Am.*, 208 F. Supp. 2d 46 (D.D.C. 2002), a U.S. district judge held that discrimination by a homeowners' insurance company on the basis of race, color, religion, sex, handicap, familial status, or national origin was made illegal by the Fair Housing Act and implementing regulations from HUD. *Id.* at 55-56.

409. At least one court has stated, as a matter of public policy, that insurers may not engage in witness intimidation. In *L'Orange v. Med. Protective Co.*, 394 F.2d 57 (6th Cir. 1968), an insurance company cancelled a dentist's malpractice policy after he testified against another dentist who was insured by the same company. *Id.* at 59. The court acknowledged that insurance policies are treated as voluntary contracts, but noted that they are also subject to public policy concerns. *Id.* In this diversity-of-citizenship case, the court looked to the law of Ohio and found that the defendant-insurer had violated Ohio's public policy against witness intimidation. The court noted the need for expert testimony, the existence of statutes against intimidating witness from testifying, and the potential chilling effect of the defendant's behavior, and awarded judgment to the dentist. *Id.* at 61-63.

requirement comes from mortgagors, who require some protection in the event their security (the home itself) is destroyed, damaged, or otherwise made unavailable for collection.[410] As the Seventh Circuit stated in *NAACP v. American Family Mutual Insurance Co.*,[411] "No insurance, no loan; no loan, no house; lack of insurance thus makes housing unavailable."[412] The issue in *American Family* was a practice known as "red-lining" where homeowners' insurance companies were charging higher rates, or declining to write insurance altogether, based on geographic location of insureds.[413] The boundaries ("redlines") which defined the no-insurance zones frequently fell along racial and socioeconomic lines, and the NAACP brought suit alleging that this practice was discriminatory and illegal. The Seventh Circuit held that red-lining violated the Fair Housing Act, a statute passed by Congress to prohibit discrimination in the housing market.[414]

It is quite possible that red-lining was actuarially justified; that is, it may have in fact cost insurance companies more to write policies in certain areas than others. This, however, did not end the inquiry for Congress or the Court of Appeals. The Seventh Circuit held that homeowners' insurance is a service that has the power to make homeownership available.[415] If a plaintiff can demonstrate that an application for homeowners' insurance was rejected or unfairly rated on the basis of race or another prohibited factor, the practice constitutes discrimination in housing.[416]

Homeownership is a worthwhile public interest. People who own their homes develop roots in a given community. A homeowner is less likely to leave than someone who is in a year-to-year or month-to-month lease. The homeowner, therefore, has a personal investment in the well-being of the community. Homeownership provides an incentive for civic involvement and community-wide improvement. For many families, homeownership is the way to accumulate wealth for the future.[417] Home equity can be

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410. Of course, if a person can purchase the house through cash on-hand, then securing a mortgage is unnecessary and obtaining homeowners' insurance is "optional." A prudent homebuyer would nevertheless purchase homeowners' insurance to protect his or her investment in the event of catastrophic loss.

411. 978 F.2d 287 (7th Cir. 1992).

412. *Id.* at 297.

413. *Id.* at 290.

414. *Id.* at 298.

415. *Id.* at 297-98.

416. *Id.* at 290-91.

417. David H. Harris, Jr., *Using the Law to Break Discriminatory Barriers to Fair Lending for Home Ownership*, 22 N.C. CENT. L.J. 101, 101 (1996).

borrowed against for emergencies, higher education, or retirement.[418] The family home is often the most significant component in an estate after a parent dies.[419]

Breed discrimination should, thus, be viewed in a larger social context. There is a high social cost when someone is denied homeowners' insurance: he is unable to buy a home.[420] The social harm in preventing the dream of homeownership must be weighed against the small risk of a dog bite claim. There are over 50 million dogs in the United States, yet only a few dogs have been responsible for biting people.

This is *not* a simple matter of deciding to throw away the family trampoline or forego the purchase of an in-ground pool. Pets are not mere property. To make people choose between the family pet and homeownership is unfair, unnecessary, and goes against an important social value: homeownership.

C. ARE THERE OTHER MEANS FOR INSURERS TO CONTROL RISK?

Let me assume for the moment that insurers could demonstrate with some degree of actuarial confidence that some breeds are more likely to bite than others. Could there be other ways of controlling this risk, short of outright denial of coverage?

1. Exclusions

When I was shopping for homeowners' insurance, one of the first questions I asked insurers was whether they would write a policy with an exclusion for dog bites. I did this because I was desperate—I needed insurance and I was willing to assume the risk that my dogs were not dangerous and were not likely to bite someone. Insurers still turned me away. They refused to write a policy with a dog bite exclusion in it.

There are several good reasons why exclusions may not be good public policy or wise business sense. Exclusions operate to the detriment of third parties, those would-be plaintiffs who are injured and need compensation for their loss. Exclusions would create pockets of plaintiffs who would, in effect, have no way to satisfy a judgment if they could prove liability. This is not an insignificant public policy, for the same reason that states require

418. *Id.*
419. *Id.*
420. Unless, of course, he is independently wealthy and does not need a mortgage.

certain professionals to have liability insurance[421] and drivers to carry minimum limits on their automobile policies,[422] to provide a source of recovery for third parties in the event of a legitimate claim. If we exclude dog bites or even those dog bites from breeds we can prove are the most dangerous, we would run the risk of creating a special class of plaintiffs who would have no source of recovery. Plaintiffs would have to turn to other sources in order to have their basic medical needs met.[423]

Exclusions are also bad for business because they make insurance less attractive to consumers. A person with cancer is a much higher risk than a healthy individual. If a health insurer began excluding coverage for cancer treatment, few employers or individual consumers would purchase that company's insurance. My decision to try to bargain my way into the insurance risk pool by excluding dog bites from coverage was, in reality, pretty stupid. In the rare event that I was found liable for one of my dogs biting someone, I would be solely responsible for the judgment against me. I would lose whatever equity I had in my house, my car, my savings, and I could have my wages garnished. In retrospect, an exclusion would not have been a good choice for me.

2. Insure But Place Families with Certain Breeds in Higher Risk Classifications

Another option would be for insurers to write policies for families with "dangerous" breeds but charge them higher premiums. Risk classification is an accepted practice in the insurance industry.[424] By separating and grouping people of similar risks, insurers keep rates low for the desirable, low-risk insureds, and insure adequate resources in the event that high-risk insureds cause a claim.[425] I would have the same objection to high-risk classification for owners of certain breeds as I would for outright refusals to insure, that is, the lack of actuarial justification for the practice of breed discrimination. Classifying certain dog owners in a higher category is

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421. Kansas physicians are required to carry malpractice insurance. KAN. STAT. ANN. §§ 40-3402 (200); State *ex rel.* Schneider v. Liggett, 557 P.2d 221 (Kan. 1978) (upholding Kansas' mandatory, state-run malpractice insurance program). Oregon requires attorneys to carry malpractice insurance. OR. REV. STAT. § 9.080(2)(a) (2003).

422. *See, e.g.*, N.Y. INS. LAW § 5303 (McKinney 2003) (New York's assigned risk plan).

423. Hospitals, Medicare and Medicaid, and health insurers would thus bear the cost for treatment. *See* Stone, *supra* note 380, at 394 (making a similar argument regarding human diseases).

424. *See id.* at 392.

425. Baker, *supra* note 389, at 376-78.

unfair because it places those insureds in an artificially higher rate bracket. This is economically inefficient, although perhaps more profitable for the insurer.

Where I think risk classification could work is if insurers could demonstrate—to the veterinary and CDC communities with a sufficient degree of scientific certainty—that certain breeds, when they do bite, cause more damage. It is hypothesized, for example, that the jaw structure of Pit Bulls causes them to inflict more injury than other breeds.[426] This would still be breed discrimination[427] but, in my view, an acceptable form of risk classification ... *provided there is a scientific/veterinary basis for the conclusion.* To date, the studies in this area have focused on determining the *number* of bites per breed, not the amount of *damage per bite.*

I believe insurers would also be actuarially justified in classifying homeowners based on whether or not they own a dog, period. One does not need to be an actuary to state that a dog owner is more likely than a non-owner to have a bite claim against them. Insurers could simply classify all dog owners at a higher rate level because they are more likely to have claims against them. Let's be clear: This is not what is going on right now. The current practice of breed discrimination is to differentiate between breeds, even though there is no statistical evidence to prove that certain breeds are more dangerous than others. This creates an artificial risk classification that charges owners of certain breeds more than others.

If all dog owners were classified at a higher rate than non-dog owners, I think there would be a great public outcry. Then the social value of dogs as pets—and as security alarms on four paws—would come to the forefront of the debate.

3. Allow the Marketplace to Correct Itself

If, as I conclude, there is no reliable data to support breed discrimination, then there is a market of consumers (owners of Rottweilers, Pit Bulls, etc.) being overcharged or not served altogether. This creates an economic inefficiency. An insurer with good business judgment would seek to corner this underserved market by writing policies with low-risk premiums.

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426. *See* Lockwood & Rindy, *supra* note 83.

427. In this respect, the use of the term "discrimination" is a bit of a misnomer. All forms of risk classification are acts of discrimination in a literal sense. *See* Hellman, *supra* note 376, at 378 ("Because all insurer classifications are 'discrimination,' understood non-pejoratively, one must ask why use of this classification is 'plain, old fashioned,' 'profoundly unjust[,] and wrong[ful]' discrimination.").

There are a number of reasons why the market is not correcting itself. The number and identity of people being affected by breed discrimination is unknown. Without this data, it would be difficult for an insurer to market itself to those consumers. Also at work is the fact that insurers try to market themselves to the lowest risk consumers. Although these consumers pay lower premiums, they are responsible for fewer claims. Every insurer tries to maximize its number of low-risk insureds while maximizing the number of high-risk insureds who are serviced by its competitors.[428] The insurance industry as a whole appears to be caught up in this breed discrimination hysteria. Individual companies may fear that the assumptions behind breed discrimination are in fact true and therefore see little incentive to market themselves to people they view as high-risk. For these reasons, it is unlikely that the marketplace will correct itself to end breed discrimination.

D. OTHER SOLUTIONS EXIST TO REDUCE THE NUMBER AND SEVERITY OF DOG BITES

Preventing law-abiding homeowners from obtaining insurance is not the answer to the problem of dog bites. Better and more effective alternatives exist.[429]

1. Collect Better Data

An initial first step would be to improve surveillance and reporting of dog bites. Until accurate numbers for the numerator and denominator in the relative dangerousness ratio can be ascertained, insurers and governments will be without realistic data on which to make meaningful decisions. The need for more accurate data collection has been championed by the very scientists who have tried to calculate the scope of the dog-biting problem.[430] In addition, studies should be commissioned to

428. Baker, *supra* note 389, at 377.

429. These are alternatives which could be collaborative endeavors between animal groups, governments, and insurers. At least one insurer, State Farm, has publicly stated its willingness to find proactive solutions to the problem of dog bites. *See* Hattaway, *supra* note 70.

430. *See, e.g.*, Sacks, et al., *supra* note 150, at 53; *CDC 1979-1998*, *supra* note 94, at 840; Winkler, *supra* note 194, at 425.

determine if certain breeds, when they do bite, cause more physical injury or damage.[431]

2. Enforce Existing Laws Against Dog Fighting and Dogs-at-Large

There are existing laws that, if enforced more vigorously, could reduce the number of dog bites. Dog fighting is a cause for why some dogs are vicious. This underground industry brings some dogs "to the verge of bloodlust."[432] By shutting down criminal organizations of illegitimate breeders, promoters, and owners, local governments could take a first step towards reducing bites by dogs that have been purposely bred to be dangerous.[433] The American Kennel Club and other groups support the use of existing laws to break up dog fighting rings.[434]

Many attacks appear to be caused by strays or dogs that have been permitted to run off-leash.[435] The enforcement of existing laws against "dogs at-large" could reduce the number of bites.[436] While these laws exist in many places, they are not adequately enforced.

Owners are sometimes to blame for socializing a dog to be dangerous or for permitting it to get into situations where it can cause injury. Dog fighting, leash, and at-large laws address the root of the problem, which is irresponsible dog ownership. A dog is just as good as his owner trains him to be. One problem dog can be seized and destroyed. One problem owner, however, can continually breed, adopt, or purchase dog after dog. Replacing one dog for another, or one breed for another, will not help to reduce the overall problem of owner irresponsibility.[437] Existing laws can and should be used to address their behavior.

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431. Some scientists have suggested that some breeds are more dangerous because, when they do bite, their jaw structure and other physical characteristics cause them to inflict more pain and physical injury. *See* Lockwood & Rindy, *supra* note 83, at 36.

432. Brand, *supra* note 230, at 60.

433. Sacks et al., *supra* note 150, at 53 (supporting enforcement of existing laws to regulate dangerous dogs and dog fighting); *CDC 1979-1998*, *supra* note 94, at 840 (urging lawmakers to focus on problem owners, not dogs or breeds); *CDC 1989-1994*, *supra* note 17, at 894 (same).

434. American Kennel Club, *American Kennel Club Statement on Dangerous Dogs*, *at* http://www.akc.org/love/dip/legislat/dangerous.cfm (last visited Nov. 6, 2004).

435. *CDC 1979-1998*, *supra* note 94, at 840.

436. *See CDC 1989-1994*, *supra* note 17, at 894; *CDC 1979-1998*, *supra* note 94, at 840.

437. *CDC 1979-1998*, *supra* note 94, at 840 ("[P]roblem behaviors (of dogs and owners) have preceded attacks in a great many cases and should be sufficient evidence for preemptive action.").

3. Regulate Problem Dogs with Existing "Dangerous Dog" Laws

Some dogs, as a result of socialization (or lack thereof), bad temperament, or genetics, demonstrate that they are dangerous. They have a history of bites or attacks against people or other animals.[438] By regulating these individual dogs, municipalities can focus their efforts on the specific dogs likely to cause injuries in the future.[439] Instead of targeting an entire breed, governments can address the handful of dogs that are really the problem.

There are existing laws which permit local governments to regulate, or in some cases seize and destroy, dogs which have demonstrated a propensity to bite without just cause. Michigan enacted a statute to permit local governments to seize "dangerous animals" and have them tattooed, insured, fenced, sterilized, destroyed, "or any other action appropriate to protect the public."[440] The statute provides due process protections to the owner—requiring a hearing by a judge and a finding of dangerousness before a disposition is ordered.[441] A dangerous animal is one who, without just cause,[442] bites or attacks a person, or a dog that bites or attacks and causes serious injury or death to another dog while the other dog is on the property or under the control of its owner.[443] Oklahoma has a similar statute that allows for heightened regulation of animals declared dangerous by their conduct,[444] but prohibits local governments from enacting breed-specific legislation.[445]

"Most of the approximately 55 million dogs in the United States never bite or kill humans."[446] Dangerous dog laws are narrowly tailored to address the real problem, which is the small percentage of the overall dog population that is responsible for bites, injuries, and deaths.[447] Dangerous

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438. I would exclude from this category "just cause" bites, discussed *supra* at Part II.F.

439. *CDC 1979-1998*, *supra* note 94, at 840.

440. MICH. COMP. LAWS §§ 287.321, 287.322 (2004).

441. *Id.* § 287.322.

442. *Id.* § 287.321(a). The law provides a number of exceptions to the definition of dangerous. An animal is not dangerous if: (1) the "victim" was a trespasser or provoked or tormented the dog; or (2) the animal was protecting a person or livestock.

443. *Id.* § 287.321.

444. OKLA. STAT. tit. 4, §§ 44, 47 (2004).

445. *Id.* § 46(b).

446. *CDC 1995-1996*, *supra* note 93, at 466.

447. *See CDC 1989-1994*, *supra* note 17, at 894-95 ("[I]t is important to recognize that most of the 52 million dogs in this country never bite or kill anyone.").

dog laws exist in many states. Insurers could work with local governments to fund additional animal control officers or work with owners of dangerous dogs to help take steps to prevent future dangerous acts.[448]

4. Educate the Public, Particularly Children, About Animal Behavior

Insurers and local governments could partner together to educate the public about proper ways of socializing and approaching dogs. Proper training is essential for a family with a new dog.[449] Public education about the importance of neutering can reduce the incidence of dog bites[450] because a disproportionate number of bites are caused by intact dogs.[451]

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448. Frederick Schauer argues that a system of individualized determination of dangerousness—that myself and others propose—is unsound. SCHAUER, *supra* note 403, at 69-72. He states that such a system comes at a high social cost, since the State responds only after a dangerous dog attacks. He cites several examples, including the speed limit on highways, to show that BSL and breed discrimination are simply forms of acceptable, forward-looking regulation. While some drivers might be better than others, the State has set a maximum speed limit regardless of driver ability. This is a forward-looking or prophylactic attempt to prevent accidents, death, and injury before they happen. He also points to the regulation of doctors and lawyers as an example of how society legitimately controls behavior in advance in order to prevent dangerous occurrences from happening in the first place. Schauer's analysis, however, fails to recognize that dogs are different. Speed limits come at a small social cost-drivers who can drive safely at faster speed limits are forced to get to their destinations later than they would have had the speed limits not existed. This is a small social cost that comes with a more significant, larger societal benefit (saving many lives). *See* Philip Shuchman, *It Isn't That the Tort Lawyers Are So Right, It's Just That the Tort Reformers Are So Wrong*, 49 RUTGERS L. REV. 485, 523 (1997) (20% increase in highway fatalities after states given permission by the federal government to raise speed limits to 65). Similarly, an unlicensed or untrained person practicing law or medicine has an almost 100% certainty of causing damage to clients or patients. The social cost of *not* regulating those practices would be significantly high. Although the dog population is around 50 million, *see supra* notes 288-89 and accompanying text, only a handful of those dogs will bite a person. Fatalities for dog bites have hovered around 7 per 100 million people per year. *See supra* Part II.A.1. Yet, the social cost of having forward-looking regulations-such as BSL and breed discrimination-comes at a very high cost to families who own dogs, particularly those that are seeking to purchase a home. *See supra* Part IV. Further, individualized, dangerous dog prosecutions do have a prophylactic effect. Like tort law, dangerous dog laws indirectly encourage owners to take reasonable steps to prevent injuries. In this respect, dangerous dog laws can serve as a deterrence against negligent or intentional misdeeds.

449. *See* Benjamin L. Hart & Lynette A. Hart, *Selecting, Raising, and Caring for Dogs to Avoid Problem Aggression*, 210 J. AM. VETERINARY MED. ASS'N 1129, 1131 (1997).

450. *Id.* (neutering can reduce aggression).

451. *See* Gershman, et al., *supra* note 139, at 914 (finding a statistically significant relationship between number of bites and intact dogs).

New owners should also be educated about the steps in picking the right dog for a household.[452] "[T]here is no all-around best breed."[453] Certain breeds will be more compatible with certain types of families.[454]

Children must also be educated about dealing with dogs safely.[455] At least one study has demonstrated the effectiveness of public education as a way to improve children's behavior around and towards dogs.[456] The study, conducted in Australia, examined the reactions of children, ages 7-8, to a dog that was tied up in their playground.[457] Half of the study group received a 30-minute classroom lesson 7-10 days before on how to safely approach and treat dogs.[458] Researchers observed the reactions of the children to the dog.[459] The group that received the classroom instruction displayed greater precautionary behavior than the control group. While

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452. Hart & Hart, *supra* note 449, at 1130.

453. *Id.*

454. *Id.* An aggressive dog, for example, might do well with an assertive family.

455. This conclusion has been supported by several scientists. *CDC 1989-1994*, *supra* note 17, at 894 (calling for education of bite victims and children); Sacks, et al., *supra* note 150, at 53 (education programs needed on dog behavior); *CDC 1979-1998*, *supra* note 94, at 840 (education needed for children); Gershman, *supra* note 139, at 916 (suggesting education programs for children as a method to reduce bites and other attacks); *CDC 1995-1996*, *supra* note 93, at 466 (discussing public education as a strategy towards reducing bites); *Task Force*, *supra* note 5, at 1739 (education is key); Hunthausen, *supra* note 306, at 1135 (public education a necessary component of bite prevention). Education is also supported by the AKC. American Kennel Club, *American Kennel Club Statement on Dangerous Dogs*, *available at* http://www.akc.org/love/dip/legislat/dangerous.cfm (last visited June 8, 2004). Other groups support heightened efforts to teach responsible dog ownership and dog safety. *OVDO*, *supra* note 51. Education is also supported by the insurance industry. Hattaway, *supra* note 70, at 1144 ("I believe that of the insurance industry has a role in promoting responsible pet ownership, including education, to help reduce this national problem."); III, *Dog Bite Liability*, *supra* note 66 (recommending that homeowners educate their children not to approach a sleeping or eating dog).

456. Simon Chapman, et al., *Preventing Dog Bites in Children: Randomised Controlled Trial of an Educational Intervention*, 320 BRIT. MED. J 1512-3 (2000). Children are more likely than adults to be the victims of dog bites. *CDC 1979-1988*, *supra* note 91, at 1490 (70% of fatal dog bites were children under 10-years-old); Sacks & Kresnow, *supra* note 150, at 52-53 (children account for approximately half of all people who seek medical attention for dog bites); *CDC 1979-1998*, *supra* note 94, at 836 (most victims of fatal dog bites are children); *CDC 1995-1996*, *supra* note 93, at 463 (80% of fatality victims were children); *CDC Non-Fatal*, *supra* note 123 (children between 5- and 9-years-old are most likely to be victims of nonfatal dog bites).

Some have speculated that children are more likely to be victims than adults because of their small stature and inability to defend themselves. *See CDC 1979-1988*, *supra* note 91, at 1492 (young and old are most at risk to be victims of fatal dog attacks).

457. *Id.* at 1512.

458. *Id.*

459. *See id.*

79% of the control group hastily patted the dog and tried to excite it, only 9% of the group that received instruction did so.[460]

CONCLUSION

While dog bites are serious events for those who are bitten, the dog bite problem is not the public health crisis that the insurance industry has made it out to be. Some perspective is in order. The number of fatalities due to dog bites is very low when compared to the number of people who die from heart disease, cancer, accidents, suicide, and diabetes. Likewise, nonfatal bites are responsible for a small number of injuries when compared to other accidental, unintentional injuries. Falls (11.5 million), motor vehicle accidents (4.3 million), drugs (3.3 million), sports (2.0 million), insect bites (1.7 million), bicycle accidents (1.4 million), poisoning (.7 million), and knives (.6 million) all individually outrank dog bites (.5 million) as public health problems.[461] Similarly, claims paid out by homeowners' companies for dog bites are miniscule when compared to payouts for property damage. Damage due to fire, water, wind, and theft represent much larger problems for homeowners' insurance companies.

One way to eliminate the entire problem of dog bites would be to outlaw all dogs.[462] Without dogs, there would be no dog bites, and no dog bite-related insurance claims.[463] While this would result in an elimination

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460. *Id.* at 1513.

461. Daniel M. Sosin, et al., *Causes of Nonfatal Injuries in the United States, 1986*, 24:6 ACCIDENT ANALYSIS & PREVENTION 685, 686 (1992).

462. Bonnie V. Beaver, *Human-Canine Interactions: A Summary of Perspectives*, 210:8 J. AM. VETERINARY MED. ASS'N 1148, 1148 (1997).

463. That would, I suppose, lead more people to get cats as pets. However, there is evidence to suggest that cat bites are more dangerous than dog bites because of the high rate of infection associated with them. *See* Los Angeles County Animal Care & Control, *Cat Bites*, *at* http://animalcontrol.co.la.ca.us/html/pages/poetownerinfo/Catbite.htm (last visited June 9, 2004) (one million cat bites are reported each year in the United States; cat bites can be especially dangerous for children, the elderly, or those with suppressed immune systems); Cynthia B. Whitney, *Ouch! – More Than You Ever Wanted To Know About Cat Bites*, *at* http://www.thecatsite.com/cat_snips/snips.php?a=bites (visited June 8, 2004) (reporting that 80% of cat bites get infected and that one out of 170 people will be bitten by cats each year); NBC11.com, *Cat Bites Can Be Deadly: Woman Hospitalized After Bite, at* http://www.nbc11.com/print/2191468/detail.html?use=print (updated May 9, 2003) (describing the ordeal of a woman who had a "brush with death" after being bitten by her cat; she required hospitalization for a week); Sound Medicine, *Dog versus cat bites*, *at* http://www.soundmedicine.iu.edu/archive/2002/quiz/animalBites.html (updated July 27, 2002) (50% of cat bites are infectious, compared to 20% of dog bites; cat teeth can penetrate more deeply and transmit bacteria easier). In spite of this data, however, the insurance industry has not tried to outlaw cats as pets. Why not?

of the perceived financial burden to insurers, it would not be "practical, realistic, or desirable" to the average layman, scientist, or dog owner.[464] Unless we as a society are willing to disregard the social and health benefits of dogs as pets, then we must be willing to accept a certain number of bites. While "[t]he dog bite problem as a whole is not preventable, it is controllable."[465] Better alternatives to breed discrimination exist, such as education and enforcement of existing dangerous dog laws.

With over 34% of households owning at least one dog as a pet, dogs have become valued four-legged members of our society. To the families that love them, pets are not mere chattel. Refusing to write homeowners insurance policies, therefore, should be a narrowly curtailed remedy, limited to those families who own dogs that have proven to be dangerous to life or property. The insurance industry has chosen to paint with a very broad brush. Breed discrimination is an overreaction, an attempt to solve a small problem by prejudging all dogs of certain breeds as likely to be dangerous in the future.

When insurers develop underwriting standards and decide which risks to insure, they have a responsibility to the public interest. Insurers do not contract with consumers in a vacuum. A long history of state regulation of the industry serves as a backdrop for this issue. Underwriting decisions should be the product of reason, not speculation. In other words, if insurers are going to engage in breed discrimination, they better have hard science to back up their practice.

The science behind dog bites is inconclusive at best. Most of the scientists authoring studies on dog bites have acknowledged that their data is incomplete and should not be used to enact breed-specific legislation or to deny insurance to families with certain dogs. No study has accurately or completely determined the number of bites per breed, nor the number of dogs per breed. Without these numbers, it is impossible to compare breeds on the basis of dangerousness. Insurers who are making judgments about certain breeds are doing so without adequate scientific evidence. This is the Achilles' heal of breed discrimination; by acting without adequate evidence, the insurance industry has left itself open to regulation by the states.

State regulation is necessary to correct this injustice in the marketplace. Insureds are being shut out of entire markets because of the near-hysteria that has gripped the insurance industry. This is not a new phenomenon for the industry. In the past, insurers have cut benefits and denied applications

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464. Beaver, *supra* note 461, at 1148.

465. *Id.*

for insurance based on fiscal cost-benefit analyses that have had collateral social and health consequences. It was more costly to keep new mothers in the hospital for 48 hours. Our society came to the recognition, however, that discharging new mothers and their newborns within 6 hours of delivery was against public policy. Legislatures stepped in to correct the injustice in the marketplace, knowing full well that it would cost the industry more money. The same should be done here.

To the insurance industry, breed discrimination reflects a belief that denying coverage to families with certain breeds of dogs will save them money. Insurers have not produced scientific proof that dogs of certain breeds bite more often or cause more damage. The evidence simply does not exist because of the problems of data collection that I have highlighted here. The irony is that insurers who are practicing breed discrimination are turning away good customers who pay premiums. Legislative action to correct this practice will benefit both families with dogs and the shareholders of insurance companies.

Legislative action in this area is both appropriate and necessary. What happened to me is happening across the country to thousands of other families. To some insurers, dogs are mere property—like an old can of paint that can be left behind when a family moves. The truth is that dogs are members of the American family and deserve to be treated as such. When families are forced to make the choice between owning a home and having a dog, some have no choice at all; they must give up their beloved pet to an animal shelter. There are documented increases in "shelter drop-offs" due to breed discrimination. These animals cannot be housed indefinitely, so many have to be euthanized.

The social cost to families is too much to ride on incomplete statistics and hunches by insurance executives. Legislative action is necessary. Luckily, many state legislators have become aware of this problem and have taken steps to end breed discrimination. Pennsylvania enacted a statute prohibiting breed discrimination, which states the following:

> No liability policy or surety bond issued pursuant to this act or any other act may prohibit coverage from any specific breed of dog.[466]

New York is considering legislation that would outlaw breed discrimination as well. Bill 6761 would prohibit insurers from refusing to issue or renew, canceling, or charging or imposing an increased premium

466. 3 PA. CONS. STAT. ANN. § 459-507-A(d) (West 2004).

or rate for owning a dog of a specific breed.[467] A New Hampshire bill would prohibit non-renewal or cancellation of a policy "based solely on the insured owning a certain breed of dog."[468] Other states should follow suit and enact legislation or administrative regulations to prohibit the practice of breed discrimination.

467. A.B. 6761, 2003-2004 Sess. (N.Y. 2003).
468. H.B. 174, 2003 Sess. (N.H. 2003).

A MODEL FINANCIAL STATEMENT INSURANCE ACT

Lawrence A. Cunningham[*]

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INTRODUCTION

The accounting function in contemporary public-company corporate governance uses third-party auditor attestation with accompanying auditor liability exposure. Weaknesses in this voucher mechanism appeared in the late 1990s. Reforms tinkered with the model by strengthening auditing-profession oversight using the Public Company Accounting Oversight Board (PCAOB),[1] enhancing auditor independence in particular audit engagements,[2] and reducing capture risk by vesting engagement oversight in board audit committees.[3]

Other proffered reform proposals likewise tinkered with the existing model, including mechanisms adjusting auditor liability exposure.[4] A bolder innovation would replace the traditional auditor-engagement and liability model with financial statement insurance ("FSI").[5] In a separate Article, I evaluate the merits of this concept, concluding that its potential efficacy warrants further consideration.[6] In this Article, I elaborate on the details necessary to implement FSI in the form of federal legislation dubbed the Model Financial Statement Insurance Act ("Model FSI Act").[7]

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745 (codified as amended at 15 U.S.C. §§ 7201, 7211 (2002)).

2. *Id.* § 201 (restricting the scope of non-audit services auditors may perform for audit clients). *See also* S.E.C. Reg. S-X, 17 C.F.R. § 210.2-01(c)(4)(i)-(ix) (2004) (also restricting the scope of non-audit services); Sarbanes-Oxley Act § 203 (requiring audit firms to rotate lead audit partners on audit engagements every five years).

3. Sarbanes-Oxley Act § 301.

4. *E.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 349-50 (2004) (proposing semi-strict liability for auditors with damages set at a multiple of audit engagement revenue); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540-46 (2001) (proposing strict liability for auditors with damages set at a portion of total losses).

5. A somewhat bold innovation is the new requirement to provide formal audits of internal control over financial reporting. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), RELEASE ACCOMPANYING AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (March 9, 2004). However, this remains a concept tied to traditional auditing practice. *See* Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 HASTINGS L.J. 1451 (2004).

6. Lawrence A. Cunningham, Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability, 52 UCLA L. REV. 413, 474-75 (2004). The FSI proposal that was evaluated originated in Joshua Ronen, Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited, 8 STAN. J.L. BUS. & FIN. 39, 48-49 (2002).

7. *See* MODEL FINANCIAL STATEMENT INSURANCE ACT §§ 1-20 (Lawrence A. Cunningham, Proposed Draft 2004) *infra* pp. 84-104 [hereinafter MODEL FSI ACT]. The

FSI would be an optional alternative to traditional financial statement auditing ("FSA"), with public companies required to use one of the two. Under FSI, a company buys insurance covering a given set of financial statements, paying a premium, and an insurer engages an auditor to assess risk and establish coverage. When losses occur due to materially misstated financials, the insurer pays the issuer's covered security holders up to the amount of policy coverage. The Model FSI Act requires disclosure of premium and coverage to provide public information concerning financial statement reliability and disclosure of material policy terms, and imposes certain mandatory terms and minimum FSI insurer qualifications.

By making auditors employees of FSI insurers, FSI neutralizes risks of auditor capture and conflict besetting traditional FSA. It diminishes regulatory concern about and needs for auditor independence and oversight. Insurers decide questions concerning auditor independence, including other services auditors could provide to insured audit clients, and how frequently audit firms or lead partners should be rotated through audit cycles to minimize capture risks. At the same time, FSI insurers are required to be independent of issuers whose financial statements they insure, and they need to meet other regulatory supervision and financial (claims-paying) capacity requirements.

To be effective, FSI must differ from existing insurance policies used in corporate governance such as directors and officers' ("D & O") insurance and related entity-level policies. Key differences include that FSI policies must be occurrence-based (not claims-made) and must be primary insurance (not excess insurance or otherwise limited by other-insurance clauses).[8] Illustrative implementation differences include interpreting insurance law's fortuity requirement (concerning the insurability of intentional acts) and evaluating traditional insurance law problems such as application fraud and other insurer defenses.[9] Other differences relate to the determination and meaning of insurance premiums paid and coverage bought (for example, as to requirements for self-

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term "Model" is used to describe the FSI Act because while it contemplates application to the existing United States securities law framework, it could be attractive for application to other systems, ranging from the European Union and other such blocs to those of individual countries, whether boasting emerging or developed capital markets.

8. *See* MODEL FSI ACT § 7(a)(1)-(2) *infra* pp. 90-91 (presenting draft language); *see also infra* text accompanying notes 24-26 (providing analysis of such provisions).

9. *See* MODEL FSI ACT § 16 *infra* pp. 101-02 (presenting draft language); *see also infra* text accompanying notes 45-49 (providing analysis of such provisions).

insurance through deductibles and retentions) and the claims-settlement process.[10]

The Model FSI Act harnesses traditional insurance practice and state insurance law in the service of federal securities regulation. Three tools facilitate achieving the requisite marriage between state insurance law and insurance markets on the one hand and federal securities regulation on the other: contract, disclosure and some judicial/regulatory adaptation. For each, a federal regulatory overlay achieved principally through the Model FSI Act is designed to create a streamlined process by which FSI policies are originated, qualified, become effective, and are enforced in the interest of investors.

Part I of this Article discusses the key concepts of FSI, beginning with the originating and underwriting processes, identifying and explaining the need for various mandatory policy terms, discussing common tailor-able terms and related required disclosure and addressing issues of judicial administration. Part II draws upon these concepts and, using the architecture of the U.S. Trust Indenture Act of 1939 ("TIA"),[11] presents a draft Model FSI Act implementing these and related provisions.

Brief commentary on the Model FSI Act draft follows. It notes how the Model FSI Act's provisions concerning qualifications of FSI insurers and Securities and Exchange Commission ("SEC") power to reject applications on this basis is intended, in part, to address federal securities regulation objectives that may otherwise go unmet given that state insurance law governs insurer solvency and insurer regulation generally. A stronger federal role may be necessary and could be met by additional separate federal legislation concerning reinsurance and insurer-solvency mechanisms to support this insurance line.

I. ANALYSIS

The Model FSI Act begins by reciting perceived public policy advantages of the FSI alternative, including reducing systemic burdens posed by auditor conflict and capture risk. It contains the mechanisms necessary for a policy to be authorized, qualified with the SEC and become effective. The Model FSI Act follows the pattern of the Trust Indenture

10. *See* MODEL FSI ACT § 5(a)(2)(A)-(C) *infra* pp. 87-88 (presenting draft language); *see also infra* text accompanying notes 39-40 (providing analysis of such provisions).

11. 15 U.S.C. §§ 77aaa-77bbbb (2000) (specifying a variety of provisions required to appear in a bond indenture for public debt securities in order for the agreement to qualify under federal securities laws).

Act of 1939 by deeming all FSI policies to include a series of provisions designed to achieve federal securities law objectives FSI implicates.[12] The Model FSI Act also specifies minimum requirements FSI insurers must meet, requires certain disclosure, and contemplates particular judicial administrative engagement to advance its objectives. Each of these aspects is discussed in this Part, before presenting in the following Part the draft text of the Model FSI Act implementing this discussion.

A. AUTHORIZATION, QUALIFICATION, EFFECTIVENESS

For a company to use FSI as an alternative to FSA, the Model FSI Act requires audit committee approval, qualification of the proposed policy with the SEC and a favorable security holder vote. Each requirement is designed to assure that the FSI policy will provide at least as much protection to investors and capital markets as they are provided by traditional FSA, accompanied by auditor liability exposure.

A company wishing to buy FSI requests proposals from independent insurance carriers, stating maximum coverage sought and contemplated premium (as well as lesser coverage amounts and associated premiums). Coverage amounts are linked to a company's equity market capitalization and principal debt outstanding while premiums are a function of financial statement reliability.

Issuers procure FSI proposals before a company's annual proxy statement is circulated (for a company reporting on a calendar basis, this will be during November or December of the year before the year coverage will apply; call this Year-*X-1*). During this period, the FSI insurer engages an auditor to perform a preliminary review of the company, its internal-control and external-competitive environment, and other relevant factors. On the basis of this investigation, FSI carriers furnish proposals, specifying coverage, premium and other policy terms.

The issuer's audit committee decides whether to select one of the proposals. If it does, the company discloses related material information in its proxy statement circulated during the year coverage is contemplated (call this Year-*X*). This sets the stage for federal qualification of the FSI policy and a security holder vote on whether to opt for it.

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12. The Model FSI Act set forth in Part II of this Article follows the Trust Indenture Act in architecture, including the order of its sections. From scratch, the Model FSI Act could be ordered in slightly different ways for greater coherence; the TIA pattern is followed to facilitate comparison by securities law experts who are familiar with the TIA.

1. *SEC Qualification* — The Model FSI Act contemplates permitting issuers opting for the FSI alternative to apply for qualification of a proposed FSI policy in connection with the filing with the SEC of its proxy statement.[13] Application review follows the pattern charted in the Trust Indenture Act of 1939 for public bond indentures: the Model FSI Act deems all qualifying FSI policies to include a variety of mandatory provisions and prescribes minimum qualifications for the FSI insurer.[14] For example, under the Model FSI Act the SEC is empowered to issue stop orders if it determines that an FSI insurer is not qualified, either because of inadequate regulatory supervision, insufficient financial capacity, or lack of independence from the issuer.[15] Absent a stop order, the FSI application is deemed qualified and the proposing issuer may proceed to seek security holder approval at the meeting for which its proxy statement is circulated.[16]

2. *Security Holder Approval* — Proposed adoption of FSI is put to a security holder vote.[17] Investors of issuers not opting for FSI would effectively opt for FSA; those opting for FSI would be relieved of federal securities law obligations to have financial statements audited under the traditional FSA framework (and the Model FSI Act so amends related federal securities laws).[18] The Model FSI Act also provides enabling mechanisms to deal with multiple classes of stock and voting by non-equity security holders, by contemplating using corporate charters or debt instruments to specify whether particular creditors or other claimants are entitled to vote on such matters.[19]

3. *Effects of Security Holder Approval* — The chief regulatory effect of security holder FSI approval is to relieve the issuer of obligations to provide FSA in the traditional manner. Instead, FSI contemplates that the FSI insurer would engage an auditor to perform this function and provide requisite opinions. The chief legal effect is to limit investor recoveries against auditors or issuers for financial misstatements to the FSI policy and

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13. MODEL FSI ACT § 4(a) *infra* p. 86.

14. MODEL FSI ACT § 7 *infra* pp. 90-91.

15. MODEL FSI ACT § 5(c) *infra* pp. 88-89; MODEL FSI ACT § 6(b) *infra* pp. 89-90 (stop order after initial qualification); MODEL FSI ACT § 8 *infra* pp. 91-94 (eligibility and disqualification of FSI insurer).

16. *See* MODEL FSI ACT §§ 4(b), 6(a) *infra* pp. 86, 89. Given the innovative character of FSI, it may be desirable to implement it gradually, initially limiting availability to issuers meeting certain size or other requirements. *See* Cunningham, *supra* note 6. The Model FSI Act could give the SEC power to screen applications for meeting such requirements as well.

17. MODEL FSI ACT § 4(c) infra p. 86.

18. MODEL FSI ACT § 4(a) *infra* p. 86 (operative amending language); *see also* MODEL FSI ACT § 4(c) *infra* pp. 19-20 (cross-reference to such operative amending language).

19. MODEL FSI ACT § 4(c) *infra* p. 86.

its specified coverage amount. The Model FSI Act thus eliminates damages payable by auditors and issuers for financial statements covered by an FSI policy (though not of other parties, such as directors, officers, attorneys or underwriters).[20]

4. *Security Holder Alternatives* — In connection with the security holder vote on an FSI proposal, proxy statement disclosure and balloting offer three choices: (1) accepting the maximum offered coverage, paying related premium; (2) accepting lower levels management recommends; or (3) taking no insurance. For companies opting to take no insurance, traditional FSA procedures and related liability rules remain in place for that year. For companies opting for one of the FSI alternatives, the next step is for the FSI insurer to engage an auditor to conduct a full audit of the company's Year-*X* financial statements.

5. *The Audit Condition* — For companies opting into FSI coverage, the audit plan is developed, for the fiscal year in which the related security-holder vote is held and for which coverage is contemplated (that is, Year-*X*). The audit plan is designed by the auditor, subject to FSI insurer oversight, and the audit for Year-*X* conducted and concluded in the early months of the following year (call this Year-*X+1*). The audit plan and other auditing procedures are governed by generally accepted auditing standards in effect from time to time.

The FSI policy must contain a condition making it effective only if the auditor gives an unqualified financial statement audit opinion.[21] Otherwise, the policy does not become effective and the issuer remains subject to the FSA regime and all related liability rules. An unqualified audit report, issued in Year-*X+1*, must include a paragraph disclosing coverage associated with the Year-*X* financial statements and related premium. The Model FSI Act directs the SEC to direct the Public Company Accounting Oversight Board to amend generally accepted auditing standards to achieve this result.[22] FSI thus replaces auditor and issuer liability arising from material financial misstatements for Year-*X*, approved by investor vote in that year, and taking effect in Year-*X+1*.

6. *Coverage Amounts* — Markets can be relied upon substantially to set relevant FSI coverage amounts for particular issuers. However, federal securities laws may need to specify metrics establishing bands of minimum and maximum coverage. These would vary principally with each issuer's equity market capitalization, adjusted for the principal amount of its

20. MODEL FSI ACT § 4(c) *infra* p. 86; *see also* MODEL FSI ACT § 20(a) *infra* p. 104 (no effect on existing law except as expressly provided).

21. MODEL FSI ACT § 4(d) *infra* p. 87.

22. MODEL FSI ACT § 4(d)(2) *infra* p. 87.

outstanding public debt. The Model FSI Act authorizes and directs the SEC to establish by rule and regulation the appropriate coverage parameters based upon its study and evaluation.[23]

B. DEEMED TERMS

Apart from these mechanics concerning authorization, qualification and effectiveness of FSI policies, all FSI policies would necessarily contain a variety of provisions to make FSI a suitable alternative to FSA. While other policy terms could be tailored as particular issuers and FSI insurers prefer, the Model FSI Act establishes the mandatory minimum by deeming all qualifying FSI policies to contain the following provisions.

1. *Occurrences, Not Claims Made* — All FSI policies must be occurrence-based policies. FSI insures a particular year's financial statements, with coverage extending to discoveries made in future periods. In insurance parlance, this means FSI is retroactive coverage, to be provided on an "occurrence" basis. There invariably will be a time lag between the event causing damages (a material financial misstatement) and their manifestation (revelation with value-destroying effects on securities). As retroactive coverage, FSI covers a particular year's financial statements, and extends coverage for numerous subsequent years. The Model FSI Act contemplates defining the coverage period in parallel with analogous statutes of limitation and repose.[24]

2. *Primary, Not Excess* — FSI would play a central role in financial reporting and securities trading, including by providing a signaling function reflected in the premium-coverage mix various companies are offered.[25] This means FSI policies must be the primary insurance source, not subordinated to coverage under other overlapping policies and not exposed to disputation concerning which of multiple overlapping policies apply. To achieve this, FSI would be designated as primary, not excess, and contain no other-insurance clauses. The Model FSI Act therefore provides that FSI

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23. MODEL FSI ACT § 4(e) *infra* p. 87.

24. *See* MODEL FSI ACT § 7(a)(1) *infra* p. 90.

25. FSI's key information-generation is the premium-coverage mix, which meets conditions of a signaling equilibrium. *See* Ronen, *supra* note 6, at 54. While premium amount varies with coverage level, for a given coverage level, premiums vary inversely with quality (positively with assessed risk). Optimality is reinforced by higher-quality risk assessment and audit. Likewise, for a given premium, coverage varies positively with quality (negatively with assessed risk). *See* Ronen, *supra* note 6, at 48-55.

policies are deemed to contain a provision specifying primary coverage and to omit any other-insurance clauses.[26]

3. *Claims* — In traditional insurance law and practice, processes to determine, measure and pay recoveries for losses follow a rigid pattern: the insured must notify the insurer of a claim; the insurer investigates; the insurer becomes liable only when the insured is held liable; the insurer typically defends the claim; and settlements are reached or the case goes to trial. The Model FSI Act contemplates a more streamlined approach.[27] The FSI policy reflects joint selection by the FSI insurer and the issuer of a fiduciary organization to assess claims, notify the insurer of claims, and represent investor interests. When losses are claimed and notice provided, the FSI insurer and fiduciary organization mutually select an independent expert to determine the claim's validity and amount. The expert reports results to the FSI insurer, which then provides funds to the fiduciary organization to compensate investor losses.

4. *Notice* — Most insurance policies impose strict notice requirements, making compliance with specified procedures a condition to an insurer's obligation to pay proceeds. Typical requirements include notice given *by the insured* promptly after an occurrence that might create covered liability. For FSI, effective notice can arise from numerous sources, including the insurer's own auditor or management, as well as independent investigations by the SEC or securities lawyers. Because such notice would provide the FSI insurer with a basis and opportunity to investigate, the Model FSI Act provides that FSI policies are deemed to include more liberal notice provisions than those that apply to other types of insurance.[28]

5. *No-Action Clauses* — Insurance policies commonly contain no-action clauses restricting rights of third-party loss victims to recover directly from the insurer, requiring them instead to obtain judgments against the insured. This route would diminish the utility of FSI as a device to protect investors from issuer misconduct, manifested in its materially misstated financial statements that trigger FSI loss payouts. To avoid this result, the Model FSI Act deems FSI policies to permit direct actions against FSI insurers by investors or their fiduciary representative.[29]

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26. MODEL FSI ACT § 7(a)(2) *infra* p. 91. The Model FSI Act also requires related disclosure. *See* MODEL FSI ACT § 5(a)(2)(D) *infra* p. 88.

27. *See* MODEL FSI ACT § 7(a)(3) *infra* p. 91; *see also* MODEL FSI ACT § 12(c) *infra* p. 98.

28. *See* MODEL FSI ACT § 7(a)(4) *infra* p. 91; *see also* MODEL FSI ACT § 12(d) *infra* p. 98.

29. MODEL FSI ACT § 7(a)(5) *infra* p. 91. To make FSI attractive to the insurance industry, these provisions may need to be relaxed.

6. *Issuer Bankruptcy* — FSI policies must include provisions making the insured's bankruptcy or insolvency irrelevant to the insurer's obligations. Otherwise, without a judgment against the insured, investors have no way to sue the insurer. The Bankruptcy Code stays claims against debtors,[30] preventing investors from obtaining a judgment that would trigger liability under the policy. The Model FSI Act expresses its public policy preference for making issuer bankruptcy irrelevant by deeming FSI policies to contain related provisions.[31] These furnish a public-policy and contractual basis for bankruptcy courts to lift the automatic stay and allow judgments (providing that any judgment is not executed against the debtor's assets but only against the insurer).[32]

7. *Loss Payees* — For FSI, companies are the insured and policies name as loss payees those investors holding the company's securities during the reporting period for a set of covered financial statements. The Model FSI Act addresses apportionment issues among investors in issuers with complex capital structures by mirroring relevant voting rules determining FSI approval.[33] FSI policies are deemed to include such apportionment provisions.[34]

8. *Good Faith to Investors* — In third-party insurance, insurers are obliged to exhibit good faith towards the insured and may be subject to tort liability to insureds when acting in bad faith. For FSI, good faith requirements are necessary – not so much for the insureds – but for the loss payees (the investors). Enlisting insurers so directly in the auditing function under FSI requires imposing on them the public watchdog and investor protection functions associated with traditional financial statement auditing. Accordingly, the Model FSI Act deems to be part of FSI policies

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30. 11 U.S.C. § 362 (2000).

31. *See* MODEL FSI ACT § 7(a)(6) *infra* p. 91.

32. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 655-58 (3d ed. 2002).

33. A related issue concerns competing claims to treat FSI as an asset of the insured. When losses occur, payees may face competition from other parties for claims on that asset. While an FSI policy's contract rights may accrue only to the insured and investors as loss payees, third parties may assert rights to the policy's value. Most state laws limit this maneuver under so-called state exemption statutes that put insurance policies outside the reach of an insured's creditors. These laws may be of limited utility for FSI policies naming as loss payees both shareholders and debt-holders, however, leaving unresolved a competition between them and with other creditors. Insurers and issuers may therefore find it desirable to identify intended loss payees, rank priorities and provide mechanisms substantially as comprehensive as relevant bankruptcy rules addressing the relation between an insured and loss payees on the one hand and the insured's non-covered creditors on the other. Directive legislation may also be useful, although the Model FSI Act that follows does not attempt to delineate these matters.

34. *See* MODEL FSI ACT § 7(a)(7) *infra* p. 91.

provisions imposing on FSI insurers the duty of good faith towards investors, not issuers.[35]

C. TAILORING AND DISCLOSURE

FSI aspires to maximal standardization to provide as much informational content to the premium-coverage mix as possible, while allowing for tailoring, consistent with the Model FSI Act, to maximize premium-risk accuracy (and requiring disclosure of material policy-tailoring).[36] Disclosure upon FSI policy authorization, qualification and effectiveness is made in the issuer's proxy statement;[37] periodic disclosure is made in its other periodic reports containing covered financial statements.[38]

1. *Premium-Coverage Mix* — FSI's key information-generation is the premium-coverage mix, creating a signaling equilibrium as to the reliability of an issuer's financial statements. The premium-coverage is an integrated expression of risk, but numerous other FSI policy terms can be used to adjust risk in ways that alter the premium-coverage mix. Some standardization will be desirable to promote FSI's efficacy (and as the previous section discussed, the Model FSI Act deems certain provisions to be standard). The Model FSI Act requires material tailored terms to be disclosed.[39]

2. *Self-Insurance* — Provisions that can be tailored and accompanying disclosure required include self-insurance as through deductibles, retentions and co-insurance on the insured. These are designed to address *moral hazard*, disincentives to take precautionary measures when resulting

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35. MODEL FSI ACT § 7(a)(8) *infra* p. 91; MODEL FSI ACT § 12(e) *infra* p. 98. Public disclosure may be necessary or appropriate to explain the meaning of such provisions and remaining potential conflicts. The SEC can prepare requisite disclosure. *See also* MODEL FSI ACT § 5(b) *infra* p. 88 (following the Trust Indenture Act approach of directing the SEC to prepare requisite supplementary disclosure).

36. *See* MODEL FSI ACT § 20(b) *infra* p. 104.

37. MODEL FSI ACT § 5(b) *infra* p. 88.

38. MODEL FSI ACT § 5(a) *infra* pp. 87-88.

39. *See* MODEL FSI ACT § 5(a)(2)(A) *infra* p. 87. As to potential liability for disclosure deficiencies, *see infra* note 56. Materiality in this context can be treated in a functionally equivalent manner to its general treatment under federal securities laws (matters reasonable investors would consider important in making investment decisions), with due regard for its particular contextual relation to effects on an FSI policy's premium-coverage mix. The Model FSI Act provided below does not provide a special definition of the materiality concept, leaving this to judicial interpretation and application on a case-by-case basis.

losses are paid by others. The Model FSI Act does not impose substantive limits on these terms, but requires related disclosure.[40]

3. *Insurer Duties* — Some insurance lines, including traditional D & O policies used in corporate governance, do not impose on insurers duties to defend, but duties to indemnify only. Most public companies possess requisite resources and expertise to mount effective defenses without the need for the insurer's resources. As a result, demand for FSI would probably be for indemnity-only policies. Federal securities law should be indifferent to this choice, permitting either. The Model FSI Act, however, requires disclosure to explain the effects of the defend-versus-indemnity-only policy term on the premium-coverage mix.[41]

4. *Post-Policy Discoveries* — A key issue in making FSI efficacious concerns FSI insurer and auditor incentives to disclose accounting irregularities discovered in periods after an FSI policy becomes effective. An FSI audit for a given year, Year-X_1, for example, creates incentives to discover, correct and/or disclose all irregularities, but Year-X_2 may bring opposite pressure to conceal irregularities the auditor failed to discover during Year-X_1. To address this disclosure disincentive, the Model FSI Act requires FSI insurers to disclose any post-policy issuance discoveries triggering possible coverage under the FSI policy.[42] Failure results in penalties against the FSI insurer measured as a multiple of the loss payouts the FSI insurer otherwise faced under the FSI policy.[43]

D. ADMINISTRATION

The Model FSI Act is an ambitious innovation addressing numerous potentially complex issues. Most of these can be handled directly through its provisions, supplemented by particular FSI policy terms and requisite disclosure. In addition, however, certain provisions can only be addressed in the process of administering FSI policies under the Model FSI Act. These provisions require judicial engagement, which is given direction in the Model FSI Act.[44]

1. *Fortuity* — Traditional insurance law prohibits insuring losses arising other than through fortuity, thus excluding coverage for losses due

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40. MODEL FSI ACT § 5(a)(2)(B) *infra* p. 88.
41. MODEL FSI ACT § 5(a)(2)(C) *infra* p. 88.
42. *See* MODEL FSI ACT § 10(b) *infra* p. 95.
43. *See* MODEL FSI ACT § 19(b) *infra* p. 104.
44. The Model FSI Act also vests the federal judiciary with power to review SEC orders and jurisdiction over litigation arising out of its provisions. *See* MODEL FSI ACT §§ 16(a)-(b) *infra* pp. 101-02.

to intentional acts. The Model FSI Act contemplates applying judicial strategies to balance insurance law's fortuity requirement with FSI's public policy goals to permit coverage for a broad range of financial misstatement causes, including intentional acts.[45] These strategies interpret the fortuity requirement to vary depending on the viewpoint adopted. For liability policies, the viewpoint could be that of either the insured or a third party.[46] Injury to a third party is seen as fortuitous since, to it, injury is not certain. From the viewpoint of the insured, however, injury would not be fortuitous.[47] The former approach is justified since FSI makes insurers central participants as monitors of auditors. By hypothesis, FSI insurers would set FSI premiums in anticipation of this approach to the fortuity requirement.

2. *Application Fraud* — The Model FSI Act calls for limiting the circumstances under which FSI insurers may refuse coverage on grounds of application fraud, an otherwise commonly available insurer defense. FSI applications are required, but the information contained is used to make an initial determination of whether to investigate a proposed policy risk. No policy will issue until after the insurer's auditor completes a full financial statement audit and issues an unqualified opinion on financial statements. This audit condition gives insurers access to information and enhances risk-assessment capabilities, negating the credibility of any subsequent insurer claim of reliance on managerial assertions. While even an audit provides imperfect information, to assure FSI's efficacy, the Model FSI Act directs that judicial construction of FSI policies and disputes to limit the traditional scope of the application fraud defense.[48]

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45. *See* MODEL FSI ACT § 16(c)(1) *infra* p. 102. For fuller discussion of these strategies, as applied to FSI, and defending rationales, *see* Cunningham, *supra* note 6.

46. See Jeffrey W. Stempel, Recent Case Developments: Construing the Fortuity Requirement in Coverage for "Accident," Third Circuit Borrows Approach of "Expected or Intended" Exclusion and Applies "Standpoint of the Insured" Analysis to Find Coverage, 4 CONN. INS. L.J. 855 (1998) (discussing Nationwide Mutual Fire Ins. Co. v. Pipher, 140 F.3d 222 (3d Cir. 1998) (applying Pennsylvania law) where the court adopted approach of analyzing fortuity requirement and related policy provision excluding intentional or expected acts using insured's standpoint and finding coverage).

47. JERRY, *supra* note 32, at 452.

48. MODEL FSI ACT § 16(c)(2) *infra* p. 102. A misrepresented application means the insured was assigned to a lower risk tier than was appropriate, effectively seeking more coverage for a smaller premium than otherwise available. Rejecting or diluting the misrepresentation defense forces lower-risk insureds to fund the costs of covering higher-risk insureds. The trade-off, therefore, is between protecting the insurer's risk-classification model and extending coverage to those not meeting it. For FSI, the balance tips in favor of limiting the application fraud defense. Given the insurer's full opportunity to investigate, risk classifications should be precisely tailored to that investigation. Extending coverage to

3. *Other FSI Insurer Defenses* — Under third party (liability) insurance policies, the insurer's duty to pay proceeds is subject to the insured meeting various conditions, over which loss payees lack control. Insurers may be discharged from obligation when the insured makes misrepresentations, fails to give proper notice, cooperate with the insurer, and commits other failures. For FSI, the insured's conduct likely will be central to the claims process. This is the case even when a fiduciary organization is designated in the FSI policy as an investor representative. To minimize adverse effects of this risk, the Model FSI Act directs strict judicial construction of insurer defenses to protect investors.[49] FSI insurers would again likely set policy premiums in anticipation of this approach.

E. OTHER TIA-TYPE TERMS

Additional provisions of the Model FSI Act direct the coordination of its overall framework. These likewise follow the pattern of the Trust Indenture Act of 1939.

1. *Information Flows* — In addition to public disclosures, the Model FSI Act requires issuers to furnish various types of information to FSI insurers.[50] Key information includes the loss payee list, meaning the list of security holders entitled to share in any proceeds paid under a policy covering a given set of financial statements.[51] Issuers are obliged to furnish such lists to FSI insurers and the latter are required to maintain custody thereof for use in the event of payout. The FSI insurer is required to provide reports to investors whenever developments occur affecting its qualifications to serve as FSI insurer, and whenever it discovers, or should have discovered, accounting irregularities at an issuer covered by an FSI policy it issued.[52]

2. *SEC Role* — The SEC is given administrative authority in the Model FSI Act. In the origination and qualification process, its chief role is to review the FSI insurer's qualifications, and is empowered to refuse recognition of FSI policies backed by FSI insurers lacking regulatory supervision, financial capability or independence vis-à-vis issuers.[53] It is

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protect harmed investors should not impair the insurer's risk-classification methodology nor increase costs for other investors.

49. *See* MODEL FSI ACT § 16(c)(3) *infra* p. 102.

50. *See* MODEL FSI ACT § 11 *infra* pp. 96-97.

51. *See* MODEL FSI ACT § 9 *infra* pp. 94-95.

52. MODEL FSI ACT § 10 *infra* pp. 95-96 (also requiring the FSI insurer to provide copies to stock exchanges where covered securities are listed).

53. *See* MODEL FSI ACT § 6(e) *infra* p. 90.

not, however, required to conduct any particular investigation beyond such matters. Further, the Model FSI Act deems provisions to be included in FSI policies, relieving the SEC of any duty or need to examine particular policies.[54] More generally, the SEC is given power to issue related rules and regulations to administer the Model FSI Act and achieve its public policy objectives.[55]

3. *Liability Matters* — Of key concern are the liability exposures that could be generated by the disclosure and other provisions of the Model FSI Act. In general, these are restricted. Following the pattern of the U.S. Trust Indenture Act of 1939, disclosure concerning policy terms and FSI insurer qualifications do not expose the issuer or FSI insurer to liability for misrepresentations.[56] On the other hand, multiple damages are imposed on FSI insurers who fail to disclose accounting irregularities discovered after an FSI policy is issued.[57] Furthermore, general prohibitions against misleading statements or omissions concerning operation of the Model FSI Act apply, exposing guilty parties to both SEC and private actions.

II. TEXT

To recapitulate the prior discussion of how to make FSI efficacious as a matter of securities regulation: audit committees of issuers decide whether to opt for FSI as an alternative to FSA and file proxy statement materials with the SEC subject to its stop order and to security holders for an approval vote. The SEC can issue a stop order preventing qualification of policies for which the FSI insurer is not qualified. All mandatory terms specified in the Model FSI Act are deemed to be part of the FSI policy, including terms as to occurrence-based policies, primary coverage, notice

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54. *See* MODEL FSI ACT § 13 *infra* pp. 98-99.

55. MODEL FSI ACT §§ 14-15 *infra* pp. 99-101.

56. MODEL FSI ACT §§ 5(a), 5(d), 6(d) *infra* pp. 87-90; *compare* MODEL FSI ACT §§ 5(a), 5(d), 6(d) *with* Trust Indenture Act §§ 77eee, 77iii. The Trust Indenture Act excludes from liability under the federal securities laws material misstatements or omissions in disclosure concerning the indenture terms. *See* Trust Indenture Act § 77eee(d). The theory, in part, is this information abstracts from publicly disclosed contracts. A similar approach can be taken in the Model FSI Act to the extent that FSI policies are publicly disclosed. On the other hand, to the extent that those terms change significantly in ways affecting the premium-coverage mix and its interpretation, liability threats may be desirable. More likely warranting exact replication are the no-liability provisions relating to information concerning the FSI insurer. As drafted, the Model FSI Act follows the Trust Indenture Act approach.

57. *See* MODEL FSI ACT § 10(b) *infra* p. 95 (FSI insurer duty to disclose discovered accounting irregularities); *see also* MODEL FSI ACT § 19(b) *infra* p. 104 (imposing on FSI insurer penalties for violating this provision).

effectiveness, good faith duties to investors and other matters. Other policy terms are subject to disclosure, and various information and administrative provisions are included. The following draft text of the Model FSI Act implements these provisions, using the template of the U.S. Trust Indenture Act of 1939 governing public debt instruments and their trustees.[58]

A. A MODEL FINANCIAL STATEMENT INSURANCE ACT

§ 1. Short Title.[59]

This subchapter may be cited as the "Model FSI Act," and is so referred to herein.

§ 2. Advantages of Legislation.[60]

(a) *Positive Effects on the Public.* Upon the basis of investigation, it is hereby declared that the national public interest and the interest of investors in public securities, offered to the public or traded on public securities exchanges, can be positively affected: (1) when issuers, with audit committee and security holder approval, procure insurance to provide compensation to investors when the issuer's financial statements, accompanied by an unqualified opinion of a registered public accounting firm, do not comply with applicable accounting and disclosure requirements under the federal securities laws; (2) when the insurer is appropriately qualified as to regulatory supervision, independence and financial capacity; and (3) financial statement insurance policies contain certain provisions relating to various terms necessary in the public interest and for the protection of investors.

(b) *Declaration of Policy.* Providing financial statement insurance can benefit the capital markets, investors, and the general public; and it is hereby declared to be the policy of this Model FSI Act, in accordance with which policy all provisions of this Model FSI Act shall be interpreted, to meet the goals and aspirations enumerated in this section.

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58. This text is a model in the sense that a number of provisions likely would be modified for efficacy, harmonization or politics.

59. This section is equivalent to 15 U.S.C. § 77aaa (2000).

60. This section is equivalent to 15 U.S.C. § 77bbb.

§ 3. Definitions.[61]

Terms defined in section 2 of the Securities Act of 1933,[62] and not otherwise defined in this section shall have the meaning assigned to such term in such section 2. When used in this Model FSI Act, unless the context otherwise requires:

"application" or "application for qualification" means the application provided for in § 5 of this Model FSI Act, and includes any amendment thereto and any report, document, or memorandum accompanying such application or incorporated therein by reference.

"Commission" means the Securities and Exchange Commission.

"FSI" means financial statement insurance.

"FSI insurer" means each insurance company under the FSI policy to be qualified, and each successor insurer.

"FSI policy" means any policy of insurance issued with respect to the financial statements of an issuer.

"FSI policy to be qualified" means (x) the FSI policy under which there has been or is to be issued a set of financial statements in respect of which a particular annual report, registration statement or other filing has been made requiring a set of financial statements; or (y) the FSI policy in respect of which a particular application has been filed.

"institutional insurer" has the meaning specified in § 8 of this Model FSI Act.

"insured financial statement" means any financial statement covered or to be covered by an FSI policy to be qualified.

"insured," when used with respect to any such insured financial statement, means the issuer.

"State" means any State of the United States.

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61. This section is equivalent to 15 U.S.C. § 77ccc.
62. 15 U.S.C. § 77b.

§ 4. Financial Statements Permitted to be Insured.[63]

(a) *Authorization.* (1) Section 13 of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(a)(2), is hereby amended to provide that, in lieu of the requirement that an issuer's financial statements be audited by a registered public accounting firm,[64] that the financial statements be accompanied by a qualified and effective FSI policy as provided in this Model FSI Act. (2) To the same extent specified in the preceding clause (1), Section 7 of the Securities Act of 1933, 15 U.S.C. § 77aa, is hereby amended with respect to financial statements of issuers subject to the provisions of Section 14 of the Securities Exchange Act of 1934.

(b) *Qualification.* In order for an FSI policy to be eligible for qualification, the following procedures must be followed:

(1) the application must be approved by the issuer's audit committee, duly constituted in accordance with the Sarbanes-Oxley Act of 2002;

(2) the application must be disclosed in the issuer's proxy statement filed with the Commission and circulated to security holders in accordance with § 5 of this Model FSI Act; and

(3) the Commission must not have issued any stop order in accordance with §§ 5 or 6 of this Model FSI Act.

(c) *Effectiveness.* The FSI policy must be approved by the issuer's security holders in accordance with applicable voting requirements under the laws of the issuer's jurisdiction of organization and its by-laws, charter documents, and relevant contracts and other agreements addressing security holder voting. Such approval of a qualified FSI policy (1) relieves the issuer of the obligations referred to in subsection (a) of this section and (2) entitles the security holders to the benefits of the FSI policy as contemplated therein and in this Model FSI Act, and relieves the issuer and the FSI insurer's agents, including registered public accounting firms, from liability for material misstatements in covered financial statements.

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63. This section has no parallel in the Trust Indenture Act.

64. This section uses the language "registered public accounting firm," adopted under the Sarbanes-Oxley Act, whereas the original 1934 Act uses different equivalent language then prevalent to denominate such firms. *See* 15 U.S.C. § 78m(a)(2).

(d) *Audit Condition.* (1) Notwithstanding any other provision of this Model FSI Act, no FSI policy shall become effective absent the issuance by a registered public accounting firm engaged by the FSI insurer for an issuer's financial statements of an unqualified audit opinion letter as to their fair presentation and compliance with generally accepted accounting principles. Such an opinion letter shall be included as a component part of the issuer's financial statements filed with the Commission. (2) The Commission shall direct the Public Company Accounting Oversight Board to adopt as generally accepted auditing standards provision for an unqualified audit opinion letter accompanying financial statements covered by a qualified and effective FSI policy to include a paragraph disclosing coverage and associated premium.

(e) *Coverage Amount.* The Commission shall determine, based upon necessary and appropriate study, relevant maximum and minimum coverage amounts for FSI applicable to classes of issuers based in part upon relevant aggregate equity market capitalization and principal amount of debt outstanding.

§ 5. Information Required; Filing.[65]

(a) *Information Required in Periodic Reports.* Subject to the provisions of § 4 of this Model FSI Act, a filing containing financial statements covered or to be covered by an FSI policy shall include the following information and documents:[66]

(1) such information and documents as the Commission may by rules and regulations prescribe in order to enable the Commission to determine whether any person designated to act as FSI insurer under the FSI policy covering such financial statements is eligible to act as such under § 8 of this Model FSI Act; and

(2) an analysis of any provisions of such FSI policy with respect to:

(A) the premium and coverage associated with such FSI policy;

65. This section is equivalent to 15 U.S.C. § 77eee.

66. *Compare with* 15 U.S.C. § 77g.

(B) the nature and amount of any self-insurance provisions, including relating to deductibles, co-insurance, retentions and other such matters;

(C) the nature and scope of the FSI insurer's duties with respect to defending claims or providing indemnification for claims and the effect thereof on the FSI policy's premium and coverage terms;

(D) any overlapping insurance policies and the significance thereof, the meaning of the concept of primary insurance and the relation of any other excess or other potentially applicable insurance policies.

Any information and documents required by paragraph (1) of this subsection with respect to the person designated to act as FSI insurer shall be contained in a separate part of such filing, which part shall be signed by such person. Such part of the filing shall be deemed to be a document filed pursuant to this Model FSI Act.[67]

(b) *Information Required in Proxy Statement.* A proxy statement proposing a security holder vote concerning any FSI policy shall include, to the extent the Commission may prescribe by rules and regulations as necessary and appropriate in the public interest or for the protection of investors, as though such inclusion were required by § 14 of the Securities Exchange Act of 1934, a written statement containing the analysis of any FSI policy provisions with respect to the matters specified in paragraph (2) of subsection (a) of this section, together with a supplementary analysis, prepared by the Commission, of such provisions and of the effect thereof, if, in the opinion of the Commission, the inclusion of such supplementary analysis is necessary or appropriate in the public interest or for the protection of investors, and the Commission so declares by order after notice and, if demanded by the issuer, opportunity for hearing thereon. Such order shall be entered prior to the security holder vote, except that if opportunity for hearing thereon is demanded by the issuer such order shall be entered within a reasonable time after such opportunity for hearing.

(c) *Refusal of Filing.* The Commission shall issue an order prior to the related annual meeting refusing to permit a security holder vote on an FSI

67. *Compare with* 15 U.S.C. §§ 77k, 77l, 77q, 77x.

application, if it finds that any person designated as FSI insurer under such FSI policy is not eligible to act as such under § 8 of this Model FSI Act; but no such order shall be issued except after notice and opportunity for hearing. If and when the Commission deems that the objections on which such order was based have been met, the Commission shall enter an order rescinding such refusal order, and the security holder vote may proceed.

(d) *Applicability of Other Statutory Provisions*. The provisions of §§ 11, 12, 17, and 24 of the Securities Act of 1933,[68] and §§ 10 and 14 of the Securities Exchange Act of 1934 and the provisions of §§ 17 and 19 of this Model FSI Act, shall not apply to statements in or omissions from any analysis required under the provisions of this section.

(e) *Integration of Procedure with Securities Act and Other Acts*.[69] The Commission, by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, shall (1) authorize the filing of any information or documents required to be filed with the Commission under this Model FSI Act, or under the Securities Act of 1933,[70] the Securities Exchange Act of 1934,[71] or other applicable statutes, by incorporating by reference any information or documents on file with the Commission under this Model FSI Act or under any such Act and (2) provide for the consolidation of applications, reports, and proceedings under this Model FSI Act with registration statements, proxy statements, applications, reports, and proceedings under the Securities Act of 1933 and the Securities Exchange Act of 1934.

§ 6. Effective Time of Qualification.[72]

(a) *Effective Time of Application for Qualification of FSI Policy*. The FSI policy covering a set of financial statements shall be deemed to have been qualified under this Model FSI Act when an application for the qualification of such FSI policy becomes effective pursuant to § 4(b) of this Model FSI Act.

(b) *Stop Orders After Effective Time of Qualification*. After qualification has become effective as to the FSI policy covering a set of

68. 15 U.S.C. §§ 77k, 77l, 77q, 77x.
69. This subsection is equivalent to 15 U.S.C. § 77hhh.
70. *See* 15 U.S.C. §§ 77a-77aa.
71. 15 U.S.C. §§ 78a-78mm.
72. This section is equivalent to 15 U.S.C. § 77iii.

financial statements, no stop order shall be issued pursuant to section 77h(d) of this title, suspending the effectiveness of the application for qualification of such FSI policy, except on one or more of the grounds specified therein, or the failure of the issuer to disclose publicly the information as specified in § 5 of this Model FSI Act.

(c) *Effect of Subsequent Rule or Regulation on Qualification.* The making, amendment, or rescission of a rule, regulation, or order under the provisions of this Model FSI Act shall not affect the qualification, form, or interpretation of any FSI policy as to which qualification became effective prior to the making, amendment, or rescission of such rule, regulation, or order.

(d) *Liability of FSI Insurer under Qualified FSI Policy.* No FSI insurer under an FSI policy which has been qualified under this Model FSI Act shall be subject to any liability because of any failure of such FSI policy to comply with any of the provisions of this Model FSI Act, or any rule, regulation, or order hereunder, except to the extent that all terms deemed by this Model FSI Act to be part of the FSI policy shall be binding on the FSI insurer.

(e) *Commission Investigation.* Nothing in this Model FSI Act shall be construed as empowering the Commission to conduct an investigation or other proceeding for the purpose of determining whether the provisions of an FSI policy, which has been qualified under this Model FSI Act, are being complied with, or to enforce such provisions.

§ 7. FSI Policy Terms.[73]

(a) *Deemed Terms.* The FSI policy to be qualified shall automatically be deemed to provide as follows:

(1) the FSI policy is an occurrence-based policy, not a claims-made policy, with a limitations-on-actions period extending for a term equivalent to the related period of limitations or repose otherwise applicable under the Securities Act of 1933, the Securities Exchange Act of 1934, or other relevant statute;

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73. This section has no precise equivalent in the Trust Indenture Act, but draws its architecture from provisions contained in 15 U.S.C. §§ 77jjj-77qqq; *see also* 15 U.S.C. § 77rrr.

(2) the FSI policy is primary coverage, not excess coverage, and does not contain any other-insurance clauses;

(3) provision governing the making of claims as set forth in § 12(c) of this Model FSI Act;

(4) provision governing the effectiveness of notice as set forth in § 12(d) of this Model FSI Act;

(5) if any provision of the FSI policy to be qualified limits, qualifies, or conflicts with the duties imposed by operation of subsection (c) of this section, the imposed duties shall control;

(6) an issuer's bankruptcy shall have no effect on the FSI insurer's obligations under the FSI policy;

(7) the category of loss payees under the FSI policy shall be those security holders entitled to vote on an FSI policy approval under § 4(c) of this Model FSI Act and particular loss payees shall be those appearing in the records of the issuer furnished to the FSI insurer in accordance with § 9 of this Model FSI Act;

(8) provision governing insurer good faith as set forth in § 12(e) of this Model FSI Act; and

(9) other terms set forth in this Model FSI Act.

(b) *Additional Terms.* The FSI policy to be qualified shall automatically be deemed to contain such other terms as the Commission from time to time adopts by rules and regulations as necessary and appropriate in the public interest or for the protection of investors.

§ 8. Eligibility and Disqualification of FSI Insurer.[74]

(a) *Authority and Supervision.* There shall at all times be at least one FSI insurer under every FSI policy qualified or to be qualified pursuant to this Model FSI Act, which shall at all times be organized and doing business under the laws of the United States or of any State or Territory or

74. This section is equivalent to 15 U.S.C. § 77jjj.

of the District of Columbia or otherwise permitted to act as FSI insurer by the Commission (referred to in this Model FSI Act as the institutional insurer), which (1) is authorized under such laws to underwrite insurance, and (2) is subject to supervision or examination by Federal, State, Territorial, or District of Columbia authority.

(b) *Non-US FSI Insurers.* The Commission may, pursuant to such rules and regulations as it may prescribe, or by order on application, permit a corporation or other person organized and doing business under the laws of a foreign government to act as FSI insurer under an FSI policy qualified or to be qualified pursuant to this Model FSI Act, if such person (1) is authorized under such laws to underwrite insurance, and (2) is subject to supervision or examination by authority of such foreign government or a political subdivision thereof substantially equivalent to supervision or examination applicable to United States institutional insurers. In prescribing such rules and regulations or making such order, the Commission shall consider whether under such laws, a United States institutional insurer is eligible to act as insurer under any equivalent or analogous insurance relating to financial statements prepared and/or securities sold within the jurisdiction of such foreign government.

(c) *Financial Capacity.* The institutional insurer shall have at all times a combined capital and surplus of a specified minimum amount, which shall not be less than $150,000.[75] If such institutional insurer publishes reports of condition at least annually, pursuant to law or to the requirements of said supervising or examining authority, the FSI policy may provide that, for the purposes of this paragraph, the combined capital and surplus of such insurer shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published. The Commission shall establish such additional or supplemental requirements concerning FSI insurer claims-paying capacities by rules and regulations as necessary and appropriate in the public interest or for the protection of investors.

(d) *Multiple FSI Insurers.* If the FSI policy to be qualified requires or permits the designation of one or more co-insurers or re-insurers in addition to the institutional insurer, the rights, powers, duties, and obligations conferred or imposed upon the insurers or any of them shall be conferred or imposed upon and exercised or performed by such institutional insurer, or

75. 15 U.S.C. § 77jjj sets the minimum combined capital and surplus figure at $150,000, which should be adjusted upward substantially for FSI.

such institutional insurer and such co-insurers or re-insurers jointly, except to the extent that under any law of any jurisdiction in which any particular act or acts are to be performed, such institutional insurer shall be incompetent or unqualified to perform such act or acts, in which event such rights, powers, duties, and obligations shall be exercised and performed by such co-insurers or re-insurers.

(e) *Issuer Independence.* No issuer or person directly or indirectly controlling, controlled by, or under common control with such issuer, shall serve as FSI insurer with respect to its financial statements.

(f) *FSI Insurer Independence.* No FSI insurer or person directly or indirectly controlling, controlled by, or under common control with it, shall serve as insurer with respect to the financial statements of any issuer in which:

(1) the insurer shall be or shall become a creditor of the issuer (except as a result of an issuer's obligations to pay premiums and related FSI insurance costs or expenses) or be the beneficial owner of any of its equity securities (excluding certain derivative financial instruments created and used solely for the purpose of providing functional reinsurance with respect to the FSI insurer's obligations under an FSI policy);

(2) such insurer or any of its directors or executive officers is a securities underwriter for an issuer upon its securities;

(3) such insurer directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with a securities underwriter for an issuer upon its securities;

(4) such insurer or any of its directors or executive officers is a director, officer, partner, employee, appointee, or representative of an issuer upon any securities, or of an underwriter (other than the insurer itself) for such an issuer who is currently engaged in the business of securities underwriting, except that:

(A) one individual may be a director and/or an executive officer of the insurer and a director and/or an executive

officer of such issuer, but may not be at the same time an executive officer of both the insurer and of such issuer;

(B) if and so long as the number of directors of the insurer in office is more than nine, one additional individual may be a director and/or an executive officer of the insurer and a director of such issuer; and

(C) such insurer may be designated by any such issuer or by any securities underwriter for any such issuer, to act in the capacity of transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent, or depositary, or in any other similar capacity, or, subject to the provisions of paragraph (a) of this subsection, to act as insurer, whether under an FSI policy or otherwise.

(g) 10% or more of the voting securities of such insurer is beneficially owned either by an issuer or by any director, partner or executive officer thereof, or 20% or more of such voting securities is beneficially owned, collectively by any two or more of such persons; or 10% or more of the voting securities of such insurer is beneficially owned either by a securities underwriter for any such issuer or by any director, partner, or executive officer thereof, or is beneficially owned, collectively, by any two or more such persons.

§ 9. Loss Payee Lists.[76]

(a) *Periodic Filing of Information by Issuer with FSI Insurer.* Each issuer covered by an FSI policy shall furnish or cause to be furnished to the related institutional insurer at stated intervals of not more than six months, and at such other times as such insurer may request in writing, all information in the possession or control of such issuer, or of any of its paying agents, as to the names and addresses of its security holders, and requiring such FSI insurer to preserve, in as current a form as is reasonably practicable, all such information so furnished or received.

(b) *Access of Information to Security Holders.* The FSI insurer shall have no obligation to provide such information to any security holder.

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76. This section is equivalent to 15 U.S.C. § 77lll.

(c) *Disclosure of Information Deemed Not to Violate Any Law.* The disclosure of any such information as to the names and addresses of security holders in accordance with the provisions of this Model FSI Act, regardless of the source from which such information was derived, shall not be deemed to be a violation of any existing law, or of any law hereafter enacted which does not specifically refer to this section.

§ 10. Reports by FSI Insurer.[77]

(a) *Eligibility and Qualification Reports to Security Holders.* The FSI insurer shall transmit to the insured's security holders as hereinafter provided, at stated intervals of not more than 12 months, a brief report with respect to any of the following events, which may have occurred within the previous 12 months (but if no such event has occurred within such period no report need be transmitted):

(1) any change to its eligibility and its qualifications under § 8 of this Model FSI Act;

(2) the creation of or any material change to a relationship specified in paragraph § 8 of this Model FSI Act; or

(3) the character and amount of any advances made by it, as FSI insurer, which remain unpaid on the date of such report, and for the reimbursement of which it claims or may claim a lien or charge against the issuer, if such advances so remaining unpaid aggregate more than one-half of 1% of the issuer's average market capitalization during the preceding 12 months.

(b) *Discovery Reports to Security Holders.* The FSI insurer shall promptly transmit to the insured's security holders a reasonably detailed report with respect to any event or circumstance that would have the effect of either (1) changing materially the terms on which any future FSI policy would be issued, including material changes in the premium or coverage of any future FSI policy and (2) any knowledge it obtains, from whatever source, indicating financial statement irregularities with respect to financial statements covered by an existing FSI policy it has underwritten.

77. This section is equivalent to 15 U.S.C. § 77mmm.

(c) *Parties.* Reports pursuant to this section shall be transmitted by mail: (1) to all registered holders of issuer securities, as the names and addresses of such holders appear upon the registration books of the issuer; (2) to such holders of issuer securities as have, within the two years preceding such transmission, filed their names and addresses with the FSI insurer for that purpose; and (3) to all holders of issuer securities whose names and addresses have been furnished to or received by the FSI insurer pursuant to § 9 of this Model FSI Act.

(d) *Filing of Report with Securities Exchanges and Commission.* A copy of each such report shall, at the time of such transmission to security holders, be filed with each securities exchange upon which the issuer's securities are listed, and also with the Commission.

§ 11. Reports by Issuer.[78]

(a) *Periodic Reports.* Each person who, as set forth in the proxy statement or application, is or is to be an issuer of securities covered by an applicable FSI policy shall:

(1) file with the FSI insurer copies of the annual reports and of the information, documents, and other reports (or copies of such portions of any of the foregoing as the Commission may by rules and regulations prescribe) which such issuer is required to file with the Commission pursuant to section 78m or 78o(d) of this title; or, if the issuer is not required to file information, documents, or reports pursuant to either of such sections, then to file with the FSI insurer and the Commission, in accordance with rules and regulations prescribed by the Commission, such of the supplementary and periodic information, documents, and reports which may be required pursuant to section 78m of this title, in respect of a security listed and registered on a national securities exchange as may be prescribed in such rules and regulations;

(2) file with the FSI insurer and the Commission, in accordance with rules and regulations prescribed by the Commission, such additional information, documents, and reports with respect to compliance by such issuer with any conditions and covenants

78. This section is equivalent to 15 U.S.C. § 77nnn.

provided for in the FSI policy, as may be required by such rules and regulations; and

(3) transmit to the holders of the issuer's securities, in the manner and to the extent provided in subsection (c) of § 10 of this Model FSI Act, such summaries of any information, documents, and reports required to be filed by such issuer pursuant to the provisions of paragraph (1) or (2) of this subsection as may be required by rules and regulations prescribed by the Commission.

The rules and regulations prescribed under this subsection shall be such as are necessary or appropriate in the public interest or for the protection of investors, having due regard to the types of FSI policies, and the nature of the business of the class of issuers affected thereby, and the amount of issuer securities outstanding and market capitalization, and, in the case of any such rules and regulations prescribed after the FSI policies to which they apply have been qualified under this Model FSI Act, the additional expense, if any, of complying with such rules and regulations. Such rules and regulations may be prescribed either before or after the qualification of any such FSI policy.

(b) *Optional Reports.* Nothing in this section shall be construed either as requiring the inclusion in the FSI policy to be qualified of provisions that the issuer shall furnish to the FSI insurer any other information or as preventing the inclusion of such provisions in such FSI policy, if the parties so agree.

§ 12. Duties and Responsibilities of FSI Insurers.[79]

The FSI policy to be qualified shall automatically be deemed to provide as follows.

(a) *Duty to Investigate.* The FSI insurer shall conduct such investigations of the financial statements of an issuer, including using and relying upon public accounting firms, as it deems necessary and appropriate to evaluate risk, establish policy premium and coverage levels and otherwise perform its obligations under such FSI policy.

79. This section is equivalent to 15 U.S.C. § 77ooo.

(b) *Duty to Examine.* The FSI insurer shall be responsible for ascertaining the reliability and truth of the statements and the correctness of the financial statement assertions covered by the FSI policy, including examining the evidence furnished to it pursuant to § 11 of this Model FSI Act.

(c) *Claims.* The FSI insurer shall promptly process claims under an FSI policy. The FSI insurer and issuer shall jointly specify in the FSI policy an independent fiduciary organization to assess claims, notify the insurer of claims, and represent security holder interests. When losses are claimed, and notice provided, the FSI insurer and fiduciary organization shall mutually select an independent expert to determine the claim's validity and amount. The FSI policy shall provide that the expert reports its results to the FSI insurer and fiduciary organization, and that the FSI insurers promptly provide funds to the fiduciary organization and the latter will distribute these to security holders to compensate losses.

(d) *Notice.* Notice of claims shall be deemed effective when the FSI insurer becomes aware, or reasonably should have become aware, of their existence.

(e) *Duty of Good Faith.* The FSI insurer shall exercise good faith to and for the benefit of the issuer's security holders in all matters arising under the FSI policy and shall exercise such rights and powers vested in it by the FSI policy and this Model FSI Act and related rules and regulations hereunder, and to use the same degree of care and skill in their exercise, as prudent persons would exercise or use under the circumstances in the conduct of their own affairs.

(f) *Responsibility of the FSI Insurer.* The FSI policy to be qualified shall not contain any provisions relieving the FSI insurer from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct.

§ 13. Effect of Prescribed FSI Policy Provisions.[80]

(a) *Imposed Duties to Control.* If any provision of the FSI policy to be qualified limits, qualifies, or conflicts with the duties imposed by operation of subsection (c) of this section, the imposed duties shall control.

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80. This section is equivalent to 15 U.S.C. § 77rrr.

(b) *Additional Provisions.* The FSI policy to be qualified may contain, in addition to provisions specifically authorized under this Model FSI Act to be included therein, any other provisions the inclusion of which is not in contravention of any provision of this Model FSI Act.

(c) *Provisions Governing Qualified FSI Policies.* The provisions of sections 7-12 of this Model FSI Act that impose duties on any person (including provisions automatically deemed included in an FSI policy) are a part of and govern every qualified FSI policy, whether or not physically contained therein, and shall be deemed to govern each FSI policy qualified under this Model FSI Act.

§ 14. Rules, Regulations, Orders.[81]

(a) *Authority of Commission; Rules.* The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary or appropriate in the public interest or for the protection of investors to carry out the provisions of this Model FSI Act, including rules and regulations defining accounting, technical, and trade terms used in this Model FSI Act. Among other things, the Commission shall have authority for purposes of this Model FSI Act, to prescribe the form or forms in which information required in any statement, application, report, or other document filed with the Commission shall be set forth. For the purpose of its rules or regulations the Commission may classify persons, securities, FSI policies, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, FSI policies or matters.

(b) *Rules and Regulations Effective Upon Publication.* Subject to the provisions of chapter 15 of title 44 and regulations prescribed under the authority thereof,[82] the rules and regulations of the Commission under this Model FSI Act shall be effective upon publication in the manner which the Commission shall prescribe, or upon such later date as may be provided in such rules and regulations.

(c) *Limited Exemption from Liability.* No provision of this Model FSI Act imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission,

81. This section is equivalent to 15 U.S.C. § 77sss.

82. These refer to various administrative procedures.

notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

§ 15. Special Commission Powers.[83]

(a) *Investigatory Powers.* For the purpose of any investigation or any other proceeding which, in the opinion of the Commission, is necessary and proper for the enforcement of this Model FSI Act, any member of the Commission, or any officer thereof designated by it, is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such books, papers, correspondence, memoranda, contracts, agreements, or other records may be required from any place in the United States or in any Territory at any designated place of investigation or hearing. In addition, the Commission shall have the powers with respect to investigations and hearings, and with respect to the enforcement of, and offenses and violations under, this Model FSI Act and rules and regulations and orders prescribed under the authority thereof, provided in sections 77t and 77v(b), (c) of this title.

(b) *Availability of Reports.* The Treasury Department, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Reserve Banks, and other authorities within the United States having jurisdiction or regulatory authority are authorized, under such conditions as they may prescribe, to make available to the Commission such reports, records, or other information as they may have available with respect to insurers or prospective insurers under FSI policies qualified or to be qualified under this Model FSI Act, and to make through their examiners or other employees for the use of the Commission, examinations of such insurers or prospective insurers. Every such insurer or prospective insurer shall, as a condition precedent to qualification of such FSI policy, consent that reports of examinations by Federal, State, Territorial, or District authorities may be furnished by such authorities to the Commission upon request therefor.

83. This section is equivalent to 15 U.S.C. § 77uuu.

(c) *Restrictions*. Notwithstanding any provision of this Model FSI Act, no report, record, or other information made available to the Commission under this subsection, no report of an examination made under this subsection for the use of the Commission, no report of an examination made of any insurer or prospective insurer by any Federal, State, Territorial, or District authority having jurisdiction to examine or supervise such insurer, no report made by any such insurer or prospective insurer to any such authority, and no correspondence between any such authority and any such insurer or prospective insurer, shall be divulged or made known or available by the Commission or any member, officer, agent, or employee thereof, to any person other than a member, officer, agent, or employee of the Commission; *provided, however*, that the Commission may make available to the Attorney General of the United States, in confidence, any information obtained from such records, reports of examination, other reports, or correspondence, and deemed necessary by the Commission, or requested by the Attorney General, for the purpose of enabling the performance of the Attorney General's duties under this Model FSI Act.

(d) *Investigation of Prospective FSI Insurers*. Any investigation of a prospective FSI insurer, or any proceeding or requirement for the purpose of obtaining information regarding a prospective FSI insurer, under any provision of this Model FSI Act, shall be limited: (1) to determining whether such prospective FSI insurer is qualified to act as FSI insurer under the provisions of § 8 of this Model FSI Act; (2) to requiring the inclusion in the proxy statement or application of information with respect to the eligibility of such prospective FSI insurer under § 8 of this Model FSI Act; and (3) to requiring the inclusion in the proxy statement or application of the most recent published report of condition of such prospective insurer, as described in § 8 of this Model FSI Act.

§ 16. Judicial Review.[84]

(a) *Orders*. Orders of the Commission under this Model FSI Act (including orders pursuant to the provisions of § 5 of this Model FSI Act) shall be subject to review in the same manner, upon the same conditions, and to the same extent, as provided in § 9 of the Securities Act of 1933,[85] with respect to orders of the Commission under such Act.

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84. Subsections (a) and (b) of this section are equivalent to 15 U.S.C. § 77vvv. Subsection (c) has no equivalent in the Trust Indenture Act.

85. 15 U.S.C. § 77i.

(b) *Jurisdiction.* Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability or duty created by this Model FSI Act, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 22(a) of the Securities Act of 1933.[86]

(c) *Construction.* For purposes of achieving the overall public policy expressed in this Model FSI Act, judicial construction of the terms hereof and of particular FSI policies shall (1) treat as fortuitous losses arising when these would be fortuitous from the perspective of the security holders for whose benefit FSI policies are adopted, (2) treat information provided by issuers to FSI insurers and their representatives, including registered public accounting firms, as providing a basis and opportunity for investigation and verification thereof by the FSI insurer and its representatives and (3) treat the conduct of the issuer and its agents in dealing with the FSI insurer as undertaken without regard to its effect on the FSI insurer's obligations under this Model FSI Act and the FSI policy.

§ 17. Liability for Misleading Statements.[87]

(a) *Liability.* Any person who shall make or cause to be made any statement in any application, report, or document filed with the Commission pursuant to any provisions of this Model FSI Act, or any rule, regulation, or order thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or who shall omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall be liable to any person (not knowing that such statement was false or misleading or of such omission) who, in reliance upon such statement or omission, shall have purchased or sold a security covered by an FSI policy to which such application, report, or document relates, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading or of such omission. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an

86. 15 U.S.C. § 77v(a). This provision could be drafted for particular linkage between relevant filings accompanied by FSI policies and securities law sections requiring the related filing.

87. This is equivalent to 15 U.S.C. § 77www.

undertaking for the payment of the costs of such suit and assess reasonable costs, including reasonable attorneys' fees, against either party litigant, having due regard to the merits and good faith of the suit or defense. No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.[88]

(b) *Remedies*. The rights and remedies provided by this Model FSI Act shall be in addition to any and all other rights and remedies that may exist under the Securities Act of 1933,[89] or the Securities Exchange Act of 1934,[90] or otherwise at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this Model FSI Act shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of such person's actual damages on account of the act complained of.

§ 18. Unlawful Representations.[91]

It shall be unlawful for any person in offering, selling, or issuing any security to represent or imply in any manner whatsoever that any action or failure to act by the Commission in the administration of this Model FSI Act means that the Commission has in any way passed upon the merits of, or given approval to, any FSI insurer, FSI policy or security, or any transaction or transactions therein, or that any such action or failure to act with regard to any statement or report filed with or examined by the Commission pursuant to this Model FSI Act or any rule, regulation, or order thereunder, has the effect of a finding by the Commission that such statement or report is true and accurate on its face or that it is not false or misleading.

§ 19. Penalties.[92]

(a) *General*. Any person who willfully violates any provision of this Model FSI Act or any rule, regulation, or order thereunder, or any person

88. The statute of limitations in 15 U.S.C. § 77www provides for one year. The Model FSI Act could adjust this as appropriate.

89. 15 U.S.C. §§ 77a-77mm.

90. 15 U.S.C. §§ 78a-78kk.

91. This is equivalent to 15 U.S.C. § 77xxx.

92. This is equivalent to 15 U.S.C. § 77yyy.

who willfully, in any application, report, or document filed or required to be filed under the provisions of this Model FSI Act or any rule, regulation, or order thereunder, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.[93]

(b) *Discovery Reports.* Any FSI insurer, including persons acting on its behalf, who willfully violates the provisions of § 10(b) of this Model FSI Act requiring discovery reports to security holders, shall upon conviction be fined amounts which, in aggregate, total three times the amount of losses otherwise payable under the related FSI policy.

§ 20. Miscellaneous.

(a) *Effect on Existing Law.*[94] Except as otherwise expressly provided, nothing in this Model FSI Act shall affect: (1) the jurisdiction of the Commission under the Securities Act of 1933,[95] or the Securities Exchange Act of 1934,[96] over any person, security, or contract, or (2) the rights, obligations, duties, or liabilities of any person under such acts; nor shall anything in this Model FSI Act affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person or security, insofar as such jurisdiction does not conflict with any provision of this Model FSI Act or any rule, regulation, or order thereunder.

(b) *Contrary Stipulations Void.*[97] Any condition, stipulation, or provision binding any person to waive compliance with any provision of this Model FSI Act or with any rule, regulation, or order thereunder shall be void.

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93. As to the amounts and sentences, 15 U.S.C. § 77yyy provides for $10,000 and five years. The Model FSI Act could adjust these as appropriate, particularly in light of enhanced penalties imposed under the Sarbanes-Oxley Act concerning matters within the competence of FSI that are outside the Trust Indenture Act.

94. This subpart is equivalent to 15 U.S.C. § 77zzz.

95. 15 U.S.C. §§ 77a-77aa.

96. 15 U.S.C. §§ 78a-78kk.

97. This subpart is equivalent to 15 U.S.C. § 77aaaa.

(c) *Separation of Provisions.*[98] If any provision of this Model FSI Act or the application of such provision to any person or circumstance shall be held invalid, the remainder of the Model FSI Act and the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby.

The foregoing provisions of the Model FSI Act are substantially comprehensive.[99] As with most federal securities legislation, the Act vests substantial administrative power in the SEC. The SEC's plenary power would likewise be available to enable it to adopt rules and regulations from time to time necessary or appropriate in the public interest and for the protection of investors to advance the purposes of FSI as a matter of policy. In addition to these technical federal provisions governing FSI, a federal supervisory role with respect to related insurance markets may be necessary, as discussed briefly next.

B. CONCLUDING COMMENTARY CONCERNING REINSURANCE AND INSOLVENCY

FSI as an alternative to FSA would depend critically and ultimately upon justifiable confidence in the solvency of the insurance industry, and of particular carriers underwriting FSI policies. Insurer solvency is a central concern of all insurance law, with state law generally providing the mechanisms to promote it. But since FSI would form a central part of the federalized enterprise of securities regulation, additional coordination efforts might be necessary.

The Model FSI Act uses a minimalist approach, authorizing the SEC to issue stop orders against applications for FSI to be issued by FSI insurers lacking requisite qualifications as to both regulatory supervision and financial capacity. It authorizes the SEC to adopt additional or supplemental rules and regulations to meet related public policy objectives.

This minimalist approach reflects federal traditions of deference to state insurance law. Federal entrée in insurance regulation attempts to

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98. This subpart is equivalent to 15 U.S.C. § 77bbbb.

99. Additional issues not addressed in the foregoing that may usefully be addressed in an actual statute include transition rules, experimental-period rules (such as limiting availability to qualified issuers measured by seasoning or size) and sunset provisions pending results of any experimental period.

narrow any preemption of related state insurance law.[100] State insurance law, in turn, defers to markets for efficient and fair insurance products, pricing and operation, with regulatory intervention requiring a specific justification. The most common justification relevant to FSI concerns risks of excessive competition among insurers yielding low premiums, leading to loss-payouts exceeding aggregate premium volume, and producing industry insolvencies.

The SEC's authority to adopt additional FSI insurer qualifications equips it to monitor for such issues as they arise. The SEC could apply similar attention to tools the FSI industry likely would use to manage solvency risks in markets, such as financial derivative instruments that can hedge and distribute risks of FSI loss[101] (and which the Model FSI Act specifically contemplates allowing FSI insurers to use).[102]

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100. This role is usually reserved for providing reinsurance mechanisms or programs to stimulate insurance coverage for extraordinary matters of national public policy. Leading examples include insurance covering nuclear reactors, reinsurance for damages to urban property damaged by riot or civil disorder, promoting political risk insurance covering private business investment in developing countries, funding of a national flood insurance program, and terrorism insurance.

101. Ronen, *supra* note 6, at 54. For example, insurers would buy tailored put options on insured-company securities with durations matching the FSI policy period. Puts would be exercisable when securities prices fall due to financial misstatements, spreading risk. *Id.* (puts become exercisable "upon a stock price decline of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements").

102. *See* MODEL FSI ACT § 4 *supra* pp. 86-87.

DYNAMIC FEDERALISM: COMPETITION, COOPERATION AND SECURITIES ENFORCEMENT

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INTRODUCTION

The central role of the federal-state relationship in our democracy is receiving renewed attention. In part, the increased attention to this issue forms part of an effort by constitutional scholars to explain and critique the Supreme Court's "new federalism." This discussion focuses on determining what constitutional limits, if any, exist on Congress's power and whether it is appropriate for the courts to define and enforce such limits.[1] Although the question is typically framed as one of constitutional interpretation, the debate inevitably evokes reverence for the social benefits said to flow from federalism as well as admonitions regarding potential social costs.

At the same time as constitutional scholars struggle to discern the limits of Congressional authority, the recent corporate scandals and Congress's swift reaction have prompted corporate scholars to re-assess the implications of federalism for corporate and securities law policy. For years corporate scholars have debated whether the laws governing a corporation's internal affairs (the relationship among stockholders, directors and officers) were a proper province for federal regulation. Two diametrically opposed camps vigorously debated whether the current federal system has led to a "race to the top" or a "race to the bottom" in corporate law.[2]

Recent corporate scholarship has discarded the stark "either/or" perspective that characterizes the "race" debate. Scholars have begun to examine more closely the ways in which federal securities law and state corporate laws influence each other and interact to form a complex body of regulation for corporate officers and directors.[3] For example, both Mark Roe and I have argued that the federal securities laws impose significant

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1. *See generally* Todd E. Pettys, *Competing for the People's Affection*, 56 VAND. L. REV. 329 (2003); Edward L. Rubin & Malcolm Feely, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903 (1994); Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485 (1994).

2. For the seminal articles setting forth the opposing viewpoints, *see* Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (race to the top); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (race to the bottom).

3. *See, e.g.*, Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Robert J. Thompson & Hillary A. Sale, *Securities Law as Corporate Governance, Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003); Robert J. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961 (2003).

constraints on the Delaware legislature and its courts and therefore influence the development of corporate law at the state level.[4] Professors Robert Thompson and Hillary Sale similarly argue that civil litigation under the federal securities laws plays a larger role than state law in monitoring the conduct of officers and directors in the performance of their fiduciary duty of care.[5]

Although their theories differ, these recent contributions all emphasize the central role of federal securities law (and stock exchange listing standards) in the legal framework that creates U.S. corporate governance rules and standards. This recognition of the multi-layered dimension of corporate regulation complicates the debate about how to best allocate authority among state and federal regulators, extending the debate beyond the familiar "race to the top" or "race to the bottom" dialectic.

This essay forms part of an effort to promote a broader discussion about the role of federalism in corporate regulation. It emphasizes the importance of competition between federal and state authorities in the process of developing regulation in the corporate and securities arenas. Rather than seeking to establish that one level of government is inherently superior to the other in these matters, I argue that the interaction among the regulators, filtered through the prism of public opinion, can help to achieve an appropriate allocation of regulatory authority. I also argue that any allocation of authority must remain fluid so that it may shift from time to time to reflect the public's revised assessments of the dominant regulator's performance.

This essay builds on an argument I have presented elsewhere: that the concept of vertical (federal-state) competition in corporate law should replace, or at least supplement, the outmoded horizontal (state-state) model that currently dominates legal scholarship.[6] I have argued that the limited federal preemption imposed by the Sarbanes-Oxley Act of 2002[7] is a necessary component to the dynamic of vertical regulatory competition that helps ensure that state corporate law reflects national concerns, and protects the interests of groups other than corporate managers who dominate the state policy-making process.[8] I also argue against complete preemption of

4. Roe, *supra* note 3, at 591-93; Jones, *supra* note 3, at 635.

5. Thompson & Sale, *supra* note 3, at 904.

6. Jones, *supra* note 3, at 634-37.

7. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 28 U.S.C.).

8. Jones, *supra* note 3, at 638-41.

state corporate law because state-level regulation may provide some advantages over federal regulation.[9]

In this Essay, I move beyond the corporate law arena to apply the vertical competition model to the question of how best to allocate authority for securities enforcement between federal and state regulators.[10] A review of recent regulatory responses at the state and federal level to widespread market abuses shows how vertical competition functions to improve the performance of regulators at both levels of government and increase the public's satisfaction with their representatives. The rising profile of state officials as securities regulators and calls from certain quarters to curtail states' enforcement powers thus presents a paradigm through which to explore the effects of vertical competition on regulatory policies and practices. Although regulatory competition may sometimes spur more vigorous enforcement action, the political process also works to constrain excessive regulatory zeal and commands diverse regulators to work together to protect the public interest. Lessons from recent scandals show that efforts to limit states' enforcement powers are misguided. We should instead preserve a wide berth for state action in this field, particularly in light of public perception of regulatory stagnation at the national level.

Part I of this Essay reviews the historical division of power between the federal government and the states in securities regulation and describes the preemption offensive of the 1990s, which stripped the states of much of their regulatory authority. Part II describes the recent ascension of state regulators as enforcers of securities laws. Part III analyzes the effects of vertical regulatory competition and concludes that many benefits derive from the states' direct challenge to the Securities and Exchange Commission's position as the nation's premiere securities enforcement agency. Part IV considers objections to continuing regulatory duality and shows why they are misguided.

I. THE FEDERAL-STATE RELATIONSHIP IN PERSPECTIVE

Securities regulation has long been a key component to corporate governance in the United States. For decades, the securities laws' disclosure requirements, civil and criminal liability under Exchange Act Rule 10b-5, and the stock exchange listing standards have played a leading role in regulating the conduct of corporate officers and directors and

9. *Id.* at 643.

10. Unlike the corporate law regime, which is governed largely by state law, the federal government, acting principally through the SEC, dominates the regulatory system governing securities transactions in the United States.

protecting shareholder rights. In fact, some believe that the federal securities regime has begun to overshadow traditional corporate law in defining standards of conduct for officers and directors.[11]

This acknowledgement of the securities laws' central role in corporate governance suggests that understanding the federal-state balance in securities regulation is at least as important as prescribing the proper relationship in traditional corporate law. Unfortunately, however, the task of defining the federal-state relationship in policing securities fraud has received far less academic attention than the problem of resolving the similar division of authority over corporate internal affairs.[12] The lack of extensive discussion of the states role as securities regulators hampers our understanding of federalism issues in corporate law.

A. THE HISTORIC BALANCE OF FEDERAL AND STATE POWER

Defining the proper limits on the states' power in securities enforcement has emerged as a policy issue because of the states' central role in the investigation of two major securities scandals in recent years. States took the lead in addressing the Wall Street analyst conflicts and the mutual fund trading abuses, prompting renewed debate over whether a uniform system of securities regulation is preferable to the current dual system. To fully understand the implications of the debate, it is important to review the historical context in which the dual system of securities regulation system developed, its recent demise, and its more recent resurgence.

Historically, states led the way in providing legislation to protect investors from exploitation by unscrupulous securities promoters. Until the adoption of the Securities Act of 1933 (the "Securities Act")[13] states were the only regulators of securities transactions. Kansas adopted the first blue sky statute in 1911.[14] Other states quickly followed suit, so that by the time the Congress adopted the Securities Act, every state except Nevada had a

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11. *See* Thompson & Sale, *supra* note 3, at 861-62.

12. A spate of articles about the role of state securities regulation were published from 1995 through 2000 in reaction to Congress's 1990 reforms. *See* sources cited *infra* notes 33-43. However, these articles do not extensively discuss the allocation of power for public securities enforcement.

13. 15 U.S.C. §§77a-aa (2000).

14. State securities laws are popularly known as "blue sky" laws, reportedly because they were aimed at unscrupulous stock promoters who "would sell building lots in the blue sky." *See* LOUIS LOSS & JOEL SELIGMAN, 1 SECURITIES REGULATION 36 (3d ed. 1998).

securities law.[15] Despite their prevalence, state securities laws were largely ineffective in eradicating fraud.[16] The failure of state regulation and the abuses that preceded the Great Depression set the stage for the adoption of the federal securities laws.[17]

When Congress enacted the first securities statutes, it opted for a uniform system of national regulation, which would supplement the states' securities laws already on the books.[18] With the adoption of the Securities Exchange Act of 1934 (the "Exchange Act"), Congress also vested considerable authority in self-regulatory organizations ("SROs"), such as the New York Stock Exchange ("NYSE"), and the National Association of Securities Dealers ("NASD"), subject to SEC oversight.[19]

The dual regulatory structure created by Congress was deliberate, and recognized that the states' experience and expertise in the field would be necessary to provide remedies beyond those that the new statutes created.[20] This dual system has been criticized as being duplicative, inefficient and overly burdensome, as it required companies to deal with the inconvenience of complying with federal securities laws in addition to the laws of every state in which they offered securities.[21] Beginning in the 1990s this dual regulatory regime was subject to a full-scale legislative assault.[22]

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15. *Id.* at 40. Today all 50 states have a securities statute. *Id.* at 41.

16. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 20 (4th ed. 2002).

17. *Id.*

18. The Securities Act and the Exchange Act both contain savings clauses, preserving the continued viability of state securities statutes. *See* Securities Act § 16(a), 15 U.S.C. § 77r(c); Exchange Act § 28(a), 15 U.S.C. § 78bb(a) (2000).

19. *See* Exchange Act § 6, 15 U.S.C. § 78(c)(a)(26); Exchange Act § 15A, 15 U.SC §78(f). The SROs police the activities of their members to prohibit manipulative and abusive practices and also maintain disclosure requirements and financial and conduct standards for companies that list securities for trading in the markets they control. *See* Thompson, *supra* note 3, at 970.

20. Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 515-24 (1984); *see also* Manning Gilbert Warren III, *Reflections on Dual Regulations of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U. L.Q. 497, 504 (2000).

21. *See* H.R. CONF. REP. NO. 104-864, at 25 (1996).

22. *See, e.g.*, Rutherford B. Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH U. L.Q. 407, 411-13 (2000).

B. THE PREEMPTION OFFENSIVE

Criticism of state blue sky laws first led to efforts to coordinate federal and state exemptions.[23] The objective was to ensure that if a securities offering satisfied the exemption requirements of one state, it would also satisfy similar exemption provisions adopted by all other states and the SEC. Ultimately these coordination efforts failed, as true uniformity was never achieved.[24] Business interests then successfully lobbied Congress to adopt the National Securities Market Improvement Act of 1996 ("NSMIA"),[25] which prohibits states from enforcing their registration requirements for offerings of listed securities and most private placements.[26] NSMIA represented the first in a series of attacks on state regulatory power in securities regulation.

Congress preempted state power again in 1998. This time preemption advocates argued that securities lawsuits filed in California were undermining the strict procedural rules mandated by the Private Securities Litigation Reform Act (the "PSLRA").[27] They therefore lobbied for federal preemption of securities fraud actions brought in state court.[28] Congress abided when it adopted the Securities Litigation Uniform Standards Act

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23. *See* Small Business Investment Incentive Act of 1980 § 505, Pub. L. No. 96-477, 94 Stat. 2275, 2292-93 (adding Section 19(c) to the Securities Act); Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 507-08 (2003).

24. *See* Campbell, *supra* note 22, at 419-20.

25. National Securities Market Improvement Act, Pub. L. No. 104-290, 11 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

26. Securities Act of 1933 § 18(a), 15 U.S.C. § 77(r) (2000). NSMIA prohibits states from enforcing registration or qualification requirements for any "covered security." NSMIA's definition of "covered security" includes any securities listed, or to be listed, on a national stock exchange or the NASDAQ National Market.

27. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.). Among other reforms, the PSLRA created new lead plaintiff provisions for securities class actions, imposed heightened pleading standards for securities fraud claims, codified the "bespeaks caution" doctrine to immunize companies from liability for false projections, and imposed a mandatory stay on discovery pending a defendant's motion to dismiss. *See* DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT 395-402 (2003). Some commentators have challenged the empirical basis for the SLUSA proponents' claims that state law suits were undermining the PSLRA. *See* Manning Gilbert Warren III, *Federalism and Investor Protection, Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169, 178 (1997) [hereinafter Warren, *Federalism*].

28. David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 2 (1998); Michael A. Perino, *Fraud and Federalism: Preempting State Private Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 273-89 (1998).

("SLUSA"), which preempts most securities class actions based on state law.[29]

The prospect of federal preemption of the state securities laws appealed to business interests only because of a complementary trend that had developed in the federal courts and in Congress. This retrenchment trend became evident in the 1970s and has been marked by a series of Supreme Court decisions that have narrowed the remedies available to investors under the federal securities laws.[30] Business interests also made headway when Congress adopted the PSLRA, which codified many of these defendant-friendly doctrines.[31] Ironically, conservative politicians, the purported champions of states' rights, advocated preemptive legislation that severely restricts state powers. Despite the clear ideological consistency of this position, the political, economic and market environment of the 1990's presented a window of opportunity apparently too enticing for the conservatives in power to resist.[32]

II. THE RISE OF THE STATES

A. THE STATES' LATENT POWER

The preemption offensive of the 1990s focused on limiting state authority over securities registration and private litigation of fraud claims. These initiatives left intact state power to publicly enforce their securities

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29. 29 Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as 15 U.S.C. § 77(p)(c), 78(b) (2000)). SLUSA prohibits the litigation of any "covered class action based upon the statutory or common law of any State" for fraud in connection with the purchase or sale of a covered security. The act defines "covered class action" as a law suit seeking damages on behalf of fifty or more plaintiffs. A "covered security" is defined as a security that is listed or authorized for listing on a national stock exchange and any other security of the same issuer of equal or higher seniority. Securities Act § 16(b); Exchange Act § 28(f). *See also* Levine & Pritchard, *supra* note 28, at 2.

30. *See* Levine & Pritchard, *supra* note 28, at 5. The "retrenchment" cases include Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (establishing a purchaser-seller requirement for standing in an Rule 10b-5 case); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (ruling that scienter is a required element of a Rule 10b-5 claim); Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (finding no Rule 10b-5 liability for "constructive fraud" in the absence of false statements); Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (establishing a federal statute of limitations for Rule 10b-5 actions); Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (eliminating aiding and abetting liability under Rule 10b-5); Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (limiting liability under Securities Act § 12(a)(2) to statements made in connection with a public offering).

31. *See* Perino, *supra* note 28.

32. *See generally* Warren, *Federalism*, *supra* note 27.

fraud statutes.[33] At the time, preserving the states' enforcement powers was uncontroversial because state and federal regulators had informally divided the world in a manner that suited business interests. State regulators focused their enforcement efforts on pursuing small-time fraud (boiler rooms, Ponzi schemes and the like) and left the SEC to pursue cases of national importance.[34] In the aftermath of the bubble-burst, in which millions of individual investors lost their savings, this informal equilibrium faltered. Disturbed by the notion that ordinary investors were being misled by self-serving analyst recommendations, New York Attorney General Eliot Spitzer began to investigate industry practices that the SEC had long tolerated.[35]

The states' newly aggressive posture provoked an outcry from business groups and prompted efforts to expand federal preemption to preclude states from enforcing their securities laws.[36] A number of public officials lent their voices to this cause. Supporters included SEC chairman William Donaldson,[37] SEC enforcement chief Stephen Cutler,[38] Congressmen

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33. Securities Act § 18(c)(1), 15 U.S.C. § 77r(c) (2000); *see also* Warren, *Federalism, supra* note 27, at 176.

34. *See* Perino, *supra* note 28, at 279 (describing state regulators as local "cops on the beat" with a traditional "consumer protection" role).

35. John Cassidy, *The Investigation; How Eliot Spitzer Humbled Wall Street*, NEW YORKER, Apr. 7, 2003, at 54; *see also* ARTHUR LEVITT, TAKE ON THE STREET 74-81 (2002) (describing the SEC's inability to satisfactorily address analyst conflicts).

36. *See, e.g.*, Press Release, Securities Industry Association, SIA Welcomes NY AG's Support for National Standards for Capital Markets (June 26, 2002), *available at* http://www.sia.com/press/2002_press_releases/html/pr_nyag.html (last visited Nov. 6, 2004); *see also* Kathleen Day, *Brokerage Settlement Leaves Much Unresolved: SEC acknowledges Need for New, Specific Rules*, WASH. POST, Apr. 30, 2003, at E1 (indicating that Wall Street firms are lobbying Congress to demonstrate that federal securities laws clearly preempt state laws); Gretchen Morgenson, *State Regulators Win Some, Lose Some*, N.Y. TIMES, Feb. 29, 2004, § 3, at 8.

37. At his confirmation hearings before the Senate, Chairman Donaldson stated, "I think that one of the great strengths of our market system is that it is a national market system and has not been Balkanized." *Nomination of William H. Donaldson, of New York, to be a Member of the U.S. Securities and Exchange Commission: Hearing Before the Comm. On Banking, Hous., and Urban Affairs*, 108th Cong., 1st Sess. 25 (2003). In September 2003, Donaldson again warned Congress that "state law enforcement officials are jumping on securities cases for political gain and may compromise federal investigations in the process." Judith Burns, *Mutual Funds Under Fire: SEC Warns of Uncoordinated Inquiries*, WALL ST. J., Sept. 10, 2003, at C14.

38. In remarks at a Washington University Law School conference, Cutler argued that state enforcement power can be a problem "because Congress clearly intended . . . that the federal government, not the states, establish the rules and policies governing the securities markets, and that it do so on a national, rather than piecemeal, basis." Stephen M. Cutler,

Michael Oxley[39] and Richard Baker. Congressman Baker, in his capacity as Chair of the House Subcommittee on Capital Markets, led a legislative attempt to preempt state power. He inserted a provision in pending securities reform legislation that would have prevented state regulators from enforcing state requirements against brokers and dealers that differed from rules established by the SEC or the SROs.[40] The Baker provision was ultimately withdrawn after sustained negative commentary from defenders of the states' enforcement efforts.[41]

Some of the academic commentary addressing the states' enforcement role endorses the notion that unchecked state authority in securities regulation could harm the economy.[42] Again, ironically, the very attributes of decentralization (diversity, experimentation, competition, etc.) that defenders of corporate federalism celebrate, are decried by those who advocate for a single central authority to regulate the national securities markets.[43]

Remarks at the F. Hodge O'Neal Corporate and Securities Law Symposium (Feb. 21, 2003), *in* 81 WASH. U. L.Q. 545, 552-53.

39. In a letter to the editor of the New York Times, Congressman Oxley asserted that "[s]etting policy for our national capital markets is properly the duty and responsibility of the Securities and Exchange Commission and the self-regulatory organizations." Michael G. Oxley, Letter to the Editor, *Who Should Police the Financial Markets?*, N.Y. TIMES, June 9, 2003, § 3, at 11.

40. *See* H.R. 2179, 108th Cong. § 8(b) (2003).

41. *"Anti-Spitzer" Provision to be Removed from Bill*, CHI. TRIB., Feb. 25, 2004, at C3.

42. *See* Karmel, *supra* note 23, at 546 (reasoning that "[s]ince the problems are national, and in some respects international in scope, an effective national regulator seems more appropriate than piecemeal state regulation." She also suggests that "[c]ontinued state regulation might prove costly and may lead to conflicting regulations; if so, the benefits to investors will be problematic"); *see also* Steve A. Radom, Note, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295 (2003) (arguing that preemption may be necessary to prevent a "Balkanized" system of securities regulation).

43. *See, e.g.*, Perino, *supra* note 28, at 278 (noting that "[n]one of the traditional justifications for allocating authority to the states applies to the regulation of private causes of action against issuers whose securities trade on national securities markets.") [*see also* Stephen Bainbridge, *Can you be a Competitive Federalist and Still Want Spitzer to Shut the #@!% Up?*, Sept. 15, 2003, *at* http://www.professorbainbridge.com/2003/09/can_you_be_a_co.html (last visited Nov. 6, 2004) ("What then are we to make of Elliot [sic] Spitzer's hyperactive enforcement regime? Must we conclude that Spitzer has raced to the top? NO! A thousand times no! Competitive federalism only works when the entity being regulated has an exit option.")].

B. RECENT SCANDALS

After a string of high-profile investigations, New York and other states have usurped the SEC's traditional role as the principal overseer of the national securities markets. The states have repeatedly outmaneuvered the SEC in exposing pervasive conflicts that seem to have infected the financial services industry. The states adopted an agenda that extended beyond the exposure and punishment of fraud. They also sought to implement policy reforms to address the conflicts and abuses exposed by their investigations. To this end, Spitzer and other state officials imposed settlement conditions that require target companies to reform their business practices.[44] For example, Spitzer brokered a controversial settlement with mutual fund group Alliance Capital, which included a condition that Alliance reduce its management fees by 20%. The Alliance settlement precipitated a vigorous debate between state and federal regulators about the appropriateness of government intervention in setting fees for the industry.[45]

By initiating the analyst conflict and mutual fund trading investigations, the states departed from their traditional role of policing petty fraud and invaded the terrain preserved for national regulatory bodies. Under SEC practices, more than 90% of the SEC's enforcement actions are resolved through settlement.[46] In a typical settlement, the target would simply agree not to repeat the alleged violations and perhaps pay a small fine, without either admitting or denying liability.[47]

State authorities, with their aggressive investigations, disrupted the status quo, thereby disabling defendants' ability to settle charges painlessly. The state-led investigations also cast unwelcome light on the abuse of the public trust by blue chip companies, inflicting serious reputational harm on some of the country's most prestigious financial institutions. With their reputations and goodwill at stake, the regulated companies began to embrace the very reforms they had previously thwarted.

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44. This objective has been pejoratively described as "regulation by prosecution." Karmel, *supra* note 23, at 520. *See generally* ROBERTA KARMEL, REGULATION BY PROSECUTION (1982).

45. *See* Mara Der Hovanesian & Paula Dwyer, *Where Will Eliot Spitzer Strike Next?*, BUS. WK., Mar. 8, 2004, at 66. (discussing Spitzer's settlement with Alliance). Monica Langley, *The Enforcer: As His Ambitions Expand Spitzer Draws More Controversy*, WALL ST. J., Dec. 11, 2003, at A1 (quoting SEC officials as charging that "Spitzer is acting more like a policy czar than a prosecutor.").

46. NAGY, ET AL., *supra* note 27, at 651.

47. *Id.*; JAMES D. COX ET AL., SECURITIES REGULATION 772 (4th ed. 2004).

1. Analyst Conflicts

Eliot Spitzer first entered the national spotlight with his investigation of analyst conflicts on Wall Street. His investigation, conducted under the Martin Act,[48] began in 2001 with a probe into Merrill Lynch's analyst recommendations. It was this investigation that uncovered the now-infamous e-mails that revealed that Merrill Lynch's analysts (including star analyst Henry Blodget) did not always believe the advice they gave investors.[49] These e-mails confirmed what many observers suspected: the analysts' recommendations were hopelessly tainted with concerns of maintaining investment banking relationships with the firms they covered.[50]

Merrill Lynch initially resisted Spitzer's settlement offers.[51] Frustrated by Merrill Lynch's intransigence, Spitzer launched a public phase of his investigation into the firm's practices.[52] In a press release, he described the case as "a shocking betrayal of trust by one of Wall Street's most trusted names," and vowed that "[t]he case must be a catalyst for reform throughout the entire industry."[53] The attorney general's press release included excerpts from the most damaging Merrill Lynch e-mails. The public release of the incriminating e-mails unleashed a torrent of negative media coverage. In response to this intense scrutiny, Merrill Lynch acceded to Spitzer's demands and agreed to pay $100 million in penalties. Merrill Lynch also agreed to a set of fundamental reforms that would separate its research and investment banking functions.[54]

The Merrill Lynch settlement was only the opening volley in Spitzer's investigation of Wall Street. His office joined forces with the SEC, the NYSE, the NASD and other state regulators. These disparate agencies

48. N.Y. GEN. BUS. LAW § 352 (McKinney 1996). For a more extensive account of Spitzer's analyst investigation, *see* Cassidy, *supra* note 35.

49. *See* Cassidy, *supra* note 35.

50. Charles Gasparino, *Merrill Lynch Will Negotiate with Spitzer*, WALL ST. J., Apr. 15, 2002, at C1.

51. The firm hired former Mayor Rudolph Giuliani to intervene on its behalf. *See* Charles Gasparino, *Merrill Enlists Giuliani in Bid to Battle Spitzer*, WALL ST. J., Apr. 24, 2002, at C1. Giuliani pleaded that Merrill Lynch had been a good corporate citizen that had returned to its headquarters near "ground zero" after the September 11 terrorist attacks. *Id.*

52. N.Y. GEN. BUS. LAW § 354 (McKinney 1996). Section 354 of the Martin Act permits the Attorney General to launch a public investigation of fraudulent practices related to securities transactions.

53. Press Release, Office of New York Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased By Undisclosed Conflicts Of Interest, *available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (last visited Nov. 6, 2004).

54. *See* Cassidy, *supra* note 35, at 53.

worked together to conduct a comprehensive investigation of analyst fraud at other Wall Street firms. These agencies paired up into teams, each of which investigated one or two of the leading firms.[55] This expanded investigation revealed similar conflicts at other firms and eventually led to the $1.4 billion "global settlement" among ten Wall Street firms, the SEC, the SROs and all fifty states.[56]

Despite public fascination with the rancor and resentment that bubbled between the SEC and Spitzer during the Wall Street investigations, the achievement of the global settlement required extensive cooperation, coordination and collaboration among state, federal and self-regulatory agencies. By dividing up responsibilities, the regulators were able to marshal resources effectively. By collaborating in structuring a settlement, they were able to bring the investigations to closure, and eliminate the cloud that hung over the industry.[57]

2. Mutual Funds

Less than six months after finalizing the "global settlement," Spitzer again stunned the investment community when he announced a $40 million settlement with hedge fund Canary Capital Partners ("Canary").[58] Canary was charged with late trading and market timing in a number of mutual funds.[59] Spitzer played a key role in bringing the mutual fund trading

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55. For example, Credit Suisse First Boston was investigated by both the NASD and the Commonwealth of Massachusetts. *Id.*

56. *See* Gretchen Morgenson & Patrick McGeehan, *Wall Street Firms are Ready to Pay $1 Billion in Fines*, N.Y. TIMES, Dec. 20, 2002, at A1.

57. Charles Gasparino & Michael Schroeder, *Pitt and Spitzer Butted Heads to Overhaul Wall Street Research*, WALL ST. J., Oct. 31, 2002, at A1.

58. Randall Smith & Tom Lauricella, *Spitzer Alleges Mutual Funds Allowed Fraudulent Trading*, WALL ST. J., Sept. 4, 2003, at A1.

59. "Late trading" refers to illegal transactions in mutual fund shares that are executed after the 4:00 p.m. close of the securities markets, when funds typically price their shares. "Market timing" refers to practices of certain fund investors who make frequent trades in mutual fund shares to exploit temporary disparities between the share value of a fund and the values of the underlying assets in the fund's portfolio. Although market timing is not *per se* illegal, most funds discourage such trading because it increases their costs and lowers returns for their long-term investors. The prospectus disclosures of these funds frequently recite policies prohibiting or discouraging market timing. The failure to enforce the disclosed policies could render such disclosure false and misleading, thereby violating Rule 10b-5, and other federal and state securities provisions. *See generally Strategic Planning, Resource Allocation and Crisis Management – Is the SEC Ready?: Hearing Before the Subcomm. on Gov't Efficiency and Fin. Mgmt., Comm. on Gov't Reform*, 108th Cong., 2d Sess. 71-72 (2004) [hereinafter *Hillman Testimony*] (prepared statement of Richard J. Hillman, Director, Fin. Mkts. and Cmty. Inv., U.S. Gen. Accounting Office).

abuses to light. Yet the actions of another state regulator, who has received far less attention, are equally enlightening.

Massachusetts Secretary of State William Galvin outflanked the SEC when he opened an investigation into market timing at Putnam Investments, the nation's fifth largest mutual fund complex. This case is particularly instructive because Galvin followed up on a lead from a whistleblower who was reportedly ignored by the SEC.[60] According to press reports, a Putnam employee and his lawyer met with representatives of SEC's Boston office to report alleged market-timing in Putnam funds by members of certain labor unions. When the SEC failed to act, the whistleblower brought his complaints to Secretary of State Galvin's office. Galvin immediately opened an investigation, which ultimately exposed significant market-timing violations at Putnam.[61] Senior Putnam employees, including portfolio managers, had repeatedly engaged in market-timing transactions.[62] More troubling were revelations that Putnam executives knew about the improper trading but never disciplined the managers involved. They also failed to report the employee misconduct to the funds' trustees.[63]

In the wake of the scandal, Putnam CEO Larry Lasser was forced to resign, along with more than a dozen other employees.[64] For Putnam, the market impact of these revelations was especially severe. Investors withdrew more than $50 billion from Putnam funds, and the stock of parent company Marsh & McLennan dropped 14%.

Following state investigations, the SEC opened its own investigation into the abuses revealed by the New York and Massachusetts regulators.[65] The agency also embarked on a comprehensive regulatory initiative to address the abuses uncovered.[66] The SEC reached a partial settlement with

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60. Jeffrey Krasner & Andrew Caffrey, *SEC Missed a Chance in its Probe of Putnam*, BOSTON GLOBE, Nov. 16, 2003, at A1.

61. Steve Bailey, *Downtown: Asleep at the Switch*, BOSTON GLOBE, Oct. 24, 2003, at D1.

62. Andrew Caffrey, *State, SEC Hit Putnam, 2 Managers Personal Profit Tied to Excessive Rapid Trading*, BOSTON GLOBE, Oct. 29, 2003, at A1.

63. Steve Bailey & Andrew Caffrey, *Putnam Chief Lasser Agrees to Resign: Officials of Parent Firm Meet in Boston*, BOSTON GLOBE, Nov. 3, 2003, at A1.

64. Andrew Caffrey & Jeffrey Krasner, *Putnam Fires 9 for Improper Trades; A Coordinated Market-Timing Effort also Revealed*, BOSTON GLOBE, Dec. 17, 2003, at C1.

65. Judith Burns, *SEC Chief Pledges Action on Funds*, WALL ST. J., Nov. 10, 2003, at C19.

66. *See, e.g.*, Press Release, U.S. Securities and Exchange Commission, SEC Approves NYSE Governance Structure Changes; Proposes Mutual Fund Disclosure Rules; Solicits Comment on Fund Transaction Cost Issues (Dec. 17, 2003) (*available at*

Putnam in November 2003. This agreement provoked pointed criticism from both Spitzer and Galvin, who complained that the SEC had "gone around them to cut a quick deal with Putnam."[67] Donaldson responded in kind: in testimony before Congress he called his critics "misguided and misinformed."[68] Concerned senators urged Donaldson to make peace with state regulators, and Donaldson promised to try to work with his state counterparts.[69]

Ultimately, Massachusetts and the SEC did coordinate their efforts. In April 2004, the state and the SEC announced a final settlement with Putnam. Putnam agreed to pay $110 million in disgorgement and penalties, and Massachusetts won a rare admission of guilt in its agreement with Putnam.[70]

III. THE BENEFITS FROM VERTICAL COMPETITION

A. THE CONCEPT

The concept of competition between the state and federal governments was part of the Framers' vision of the federalist system.[71] The Framers anticipated that a dual system would allow the public to "giv[e] most of

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http://sec.gov/news/press/2003-173.htm); Compliance Programs of Investment Companies and Investment Advisers, 17 C.F.R. §§ 270, 275 (2003), *available at* http://sec.gov/rules/final/ia-2204.htm (last modified Dec. 17, 2003); Amendments to Rules Governing Prices of Mutual Fund Shares, 17 C.F.R. § 270 (2003), *available at* http://www.sec.gov/rules/proposed/ic-26288.htm (last modified Dec. 11, 2003); Investment Company Governance, 17 C.F.R. § 270 (2004), *available at* http://www.sec.gov/rules/proposed/ic-26323.htm (last modified Jan. 16, 2004).

67. Brooke A. Masters, *States, SEC Split Again in Attack on Investment Abuses: Spitzer Critical of Settlement With Putnam*, WASH. POST, Nov. 15, 2003, at E1; Andrew Caffrey & Jeffrey Krasner, *Settlement, New Trouble for Putnam; Galvin Rips Deal with the SEC, Vows More Charges*, BOSTON GLOBE, Nov. 14, 2003, at A1.

68. William H. Donaldson, *Investors First*, WALL ST. J., Nov. 18, 2003, at A20. *See also* Andrew Caffrey, *SEC Chief Calls Critics 'Misguided'*, BOSTON GLOBE, Nov. 19, 2003, at D1; Deborah Solomon, *SEC Chairman Defends Decision to Quickly Settle Putnam Charges*, WALL ST. J., Nov. 18, 2003, at D9.

69. Senator Christopher Dodd warned Donaldson, "We can't have you and Spitzer and the guy from Massachusetts screaming at each other in a public forum every day." Caffrey, *supra* note 69. This type of sparring and bickering can be an unfortunate by-product of regulatory competition. Yet, because such bickering plays poorly with the public it is likely to detract from each regulator's standing. Conversely, competing regulators can boost their public esteem when they are seen as cooperating to effectively address market abuses.

70. Beth Healy, *Putnam Agrees to $110 Million Settlement; Trading Penalty is 10 Times More than Investor Restitution*, BOSTON GLOBE, Apr. 9, 2004, at D1.

71. *See* Pettys, *supra* note 1, at 338-45 (discussing THE FEDERALIST PAPERS).

their confidence where they may discover it to be most due."[72] Thus, the framers envisioned that state and federal governments would compete to persuade the public as to which was better suited to regulate in a particular field.[73] As James Madison stated in Federalist No. 46: "[i]f . . . the people should in [the] future become more partial to the federal than to the State governments, the change can only result from such manifest and irresistible proofs of a better administration as will overcome all their antecedent propensities."[74]

In this view, vertical competition is fueled by the rival regulators' desire to preserve or expand their regulatory domain by competing for the public's confidence in their competence as regulators. Such competition gives voters a primary role in achieving a desirable balance between federal and state power. If the public becomes dissatisfied with a federal regulator's performance in a substantive area, citizens can appeal to state regulators to address their concerns. Conversely, if the public loses confidence in a state-based regime, voters can pressure Congress to adopt laws that either supplement or supplant state regulation.[75]

Certainly, our democracy functions in a more complex manner than this abbreviated analysis admits. The legislative and administrative processes are prone to corruption, manipulation and domination by moneyed interests at both the state and federal levels. Such reality undermines any idealistic hope that the public's will ultimately determines the rules that govern society.

Yet, even when we acknowledge the pitfalls of our democracy, a dual system of regulation should help to alleviate these risks. A dual system provides two related safeguards. First, the existence of multiple layers of government makes regulatory capture a more arduous task for interest groups. To influence the regulatory process at the federal level and in fifty states, interest groups would have to expend significant resources and energy.

Second, in the event of capture at one level of government, the dual system provides an alternate venue through which citizens can seek to effect regulatory reform. If a dominant regulator is controlled by interest groups, effecting popular reforms through that regulator would be difficult. If citizens can instead mobilize an "uncaptured" regulator (whose officials remain unconstrained by prior commitments to the regulated industries), reform becomes a more achievable prospect. In short, regulatory dualism

72. *Id.* at 341 (quoting THE FEDERALIST NO. 46 (James Madison)).
73. *Id.* at 333.
74. THE FEDERALIST No. 46 (James Madison).
75. *See* Jones, *supra* note 3, at 635.

facilitates a more functional democracy because the existence of an alternative venue for reform (even when dormant) helps to forestall and counteract corruption.

B. VERTICAL COMPETITION AND SECURITIES ENFORCEMENT

The success of the state-led securities fraud investigations and the SEC's response shows how competition from a previously inactive sector of government can spur the dominant regulator into more effective action. A comparison of Spitzer's track record to that of the SEC in addressing analyst fraud demonstrates the importance of this dynamic relationship. Former SEC chairman Arthur Levitt and his successor Harvey Pitt sought unsuccessfully for years to prod the brokerage firms, the SROs and the media to address the spiraling analyst conflicts.[76] In contrast to the national regulators' complaisance, Spitzer acted decisively. His aggressive approach forced the powerful investment banks to the bargaining table and led to significant monetary penalties and business reforms from the industry.[77]

The Merrill Lynch and Putnam investigations are just two of many fraud investigations initiated by states, and ultimately resolved through cooperation with the SEC.[78] Popular accounts of the intermittent sniping between the SEC and state regulators tend to classify the dispute as a clash of personalities fueled mainly by political ambition.[79] By stepping back

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76. *See* LEVITT, *supra* note 35, at 67-80 (detailing Levitt's efforts to convince the NASD and the media to address analyst conflicts of interests); Charles Gasparino, *New York Attorney General Turns Up Heat on Wall Street*, WALL ST. J., Apr. 10, 2002, at C1.

77. Some say the penalties amount to no more than a drop in the bucket. *See, e.g.*, Lucian Bebchuk, *Settling for Less*, N.Y. TIMES, Dec. 27, 2002, at A21.

78. *See, e.g., In re* Massachusetts Fin. Servs. Co., Investment Advisers Act Release No. 2224 (Mar. 31, 2004), *available at* http://sec.gov/litigation/admin/ia-2224.htm (regarding cease-and-desist proceedings); *In re* Alliance Capital Mgmt., L.P., Investment Advisers Act Release No. 2205 (Dec. 18 2003), *available at* http://sec.gov/litigation/admin/ia-2205.htm (regarding cease-and-desist proceedings); *In re* Banc of America Sec., L.L.C, Securities Exchange Act Release No. 49386 (Mar. 10, 2004), *available at* http://www.sec.gov/litigation/admin/34-49386.htm (imposing remedial sanctions and cease-and-desist order); Pilgrim Baxter & Assocs., Ltd., Investment Advisers Act Release No. 2251 (June 21, 2004), *available at* http://www.sec.gov/litigation/admin/ia-2251.htm (imposing sanctions and cease-and-desist order).

79. *See, e.g.*, Brooke A. Masters, *States, SEC Split Again in Attack on Investment Abuses; Spitzer Critical of Settlement with Putnam*, WASH. POST, Nov. 13, 2003, at E1; Deborah Solomon, *Its Spitzer vs. SEC on Mutual Funds' Fees*, WALL ST. J., Dec. 19, 2003, at C1 ("[A] philosophical debate over regulators' role in setting mutual fund fees escalated into a showdown yesterday with the Securities and Exchange Commission and New York

and disregarding any personality conflicts, one sees important implications lurking in this dramatic shift in the power from Washington to New York and Boston. These cases, taken together, demonstrate the important benefits that can flow from invigorated competition between state and federal regulators.

1. Defense Against Regulatory Capture

Maintaining multiple levels of regulation provides an antidote to regulatory capture.[80] Arthur Levitt has described the SEC of the 1990s as an agency hobbled by fiscal starvation at the hands of Congress.[81] Levitt reports that members of Congress repeatedly pressured his agency to relent in its initiatives, threatening to cut the SEC's budget if Levitt ignored their demands. According to Levitt, accounting firms and their lobbyists exerted considerable influence over the Congressional representatives responsible for SEC oversight.[82] He describes an oversight structure in which his agency was kept in a stranglehold by representatives in the thrall of the industry they were charged with regulating. Levitt's description of a captured SEC is reinforced by accounts of Harvey Pitt's performance as SEC chair. Pitt, a former accounting industry lawyer, notoriously promised accountants to run a "kinder, gentler" agency; a pledge that exposed him to charges of being improperly aligned with the industry. These accounts of industry capture of the SEC underscore the importance of protecting the states' role as an alternate jurisdiction, which can counteract the pernicious effects of regulatory capture.

2. Maximization of Government Resources

A second benefit to maintaining multiple enforcement centers is that such a structure facilitates the maximization of scarce government resources. When multiple agencies with distinct funding sources exercise

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Attorney General Eliot Spitzer sniping at each other over their respective settlements with Alliance Capital Management Holding, L.P..").

80. Under capture theories of regulation, interest groups and policymakers enter into jointly maximizing relationships. Under this theory smaller interest groups with a lot at stake can organize to influence government policy. *See* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1885-86 (1995); Jonathan Macey & Geoffrey Miller, *Toward and Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 498-99 (1987).

81. LEVITT, *supra* note 35, at 123, 132.

82. *Id.* at 10-13, 131-39, 287-307. A recent GAO study has also documented the chronic under-funding of the SEC. *See Hillman Testimony*, *supra* note 59, at 65.

overlapping authority, the costs of complex investigations can be shared.[83] The "global settlement" of the analyst investigation demonstrates the benefits of this strategy. After the Merrill Lynch settlement, the myriad securities regulators adopted a "divide and conquer" strategy. Investigators divided into teams, each of which investigated one or two of the firms implicated in the scandal.[84] Similarly, New Hampshire and Massachusetts joined forces to investigate mutual fund abuses at six fund companies located in Boston.[85] In each of these cases, it would have been overly burdensome for a single regulator to complete an investigation of so many firms within the same time frame.

3. Improvement In The Public's Satisfaction With Their Government

Finally, regulatory competition can improve public satisfaction with *both* levels of government.[86] As Spitzer took action to confront industry corruption, his political fortunes rose.[87] The political failure of Congressman Baker's efforts to limit states' enforcement authority reinforces the notion that the public approves of the states' performance. Press commentary on the Spitzer phenomenon also reflects general

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83. Mark D. Hunter, *SEC/DOJ Parallel Proceedings: Contemplating the Propriety of Recent Judicial Trends*, 68 MO. L. REV. 149, 177 (2003).

84. *See supra* text at note 55; Cassidy, *supra* note 35.

85. Andrew Gaffrey & Jeffrey Krasner, *Mass., N.H. Probe States Seek Records of Managers' Trades at 6 Hub Fund Firms*, BOSTON GLOBE, Nov. 19, 2003 at D1.

86. As SEC enforcement chief Stephen Cutler has acknowledged, "[A] visible and aggressive state enforcement machine may motivate *federal regulators*, like me, to respond more quickly to potential securities related misconduct. Of course, if we in the federal government want to be the dominant securities enforcement authority, we must be vigilant in protecting the investing public." *See* Cutler, *supra* note 38, at 551.

87. Spitzer is one of New York State's most popular public figures. A 2003 Quinnipiac University poll reported that Spitzer had the highest job approval rating of any New York state official. Quinnipiac University, *Pataki Approval Inches Up, But Spitzer's is Better*, *available at* http://www.quinnipiac.edu/x8347.xml (Oct. 2, 2003). As he continued his investigations, Spitzer's job approval ratings improved while his disapproval ratings fell. Siena New York Poll, *The Siena New York Poll for May: Approval Ratings: New York State Officials*, *available at* http://www.siena.edu/sri/results/2004/040616StateOfficials.htm (June 16, 2004).

approval of his actions.[88] Spitzer has won accolades from such unlikely sources as the Wall Street Journal, Fortune, and Business Week.[89]

Having an alternate regulator also gives investors a place to turn if one regulator ignores their concerns. This benefit is starkly illustrated by the Putnam case, where the SEC reportedly ignored the Putnam whistleblower.[90] The Canary Capital whistleblower also chose to contact Spitzer's office rather than the SEC, demonstrating that the public has come to appreciate Spitzer's reputation for responsiveness.[91] The SEC's embarrassment at Spitzer's hands caused the agency to revise its intake procedures so that its staff can better respond to tips and complaints from the public.

IV. OBJECTIONS TO REGULATORY DUALITY

A. THE RATIONALE FOR PUBLIC ENFORCEMENT

Before evaluating arguments against maintaining regulatory competition in securities enforcement, we must first consider the characteristics of an ideal regulatory regime. A primary objective of any securities regime must be to maintain justifiable public confidence in the integrity of the securities markets by ensuring the flow of reliable information to investors. To accomplish this goal, a securities regime must provide investors adequate remedies for fraud and deter wrongdoing by promising public enforcement efforts to detect and punish fraud. Such a regime can be maintained more readily when multiple agencies with differing strengths, resources and enforcement tools work together to exploit their regulatory power. Because the SEC lacks adequate resources to effectively police the national securities market, supplemental

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88. *E.g.*, Steve Bailey, *Asleep at the Switch*, BOSTON GLOBE, Oct. 24, 2003, at D1 (commenting that "'Where was the SEC?' is becoming part of the lexicon."); Steven Syre, *Piling on the SEC*, BOSTON GLOBE, Nov. 18, 2003, at E1.

89. Time magazine named Spitzer "Crusader of the Year" for 2002. *See* Adi Ignatius, *Crusader of the Year/Eliot Spitzer*, TIME, Dec. 20, 2002, at 64. *See also Revenge of the Investor Class*, WALL ST. J., Oct 23, 2003, at A20 (editorial praising Spitzer's investigation of mutual fund trading abuses); *Eliot Spitzer, Once Again*, BUS. WK., Sept. 15, 2003, at 120 (editorial praising Spitzer).

90. *See supra* text accompanying notes 61-62.

91. *See* Henny Sender & Gregory Zuckerman, *Behind the Mutual Fund Probe: Three Informants Opened Up*, WALL ST. J., Dec. 9, 2003, at A1 (stating, "Ms. Harrington [the Canary Capital whistleblower] decided to talk. She says she didn't go to the Securities and Exchange Commission because she wasn't confident the agency would follow up on her allegations. She says she trusted Mr. Spitzer's team, which had just finished its big investigation of Wall Street research analysts[.]").

enforcement is essential to achieve an appropriate level of deterrence.[92] Judicial and legislative reforms of the 1980s and 1990s limited the deterrent effect of private securities litigation, making the emergence of new regulatory forces, whether from states or from a wave of more restrictive federal regulation (i.e., Sarbanes-Oxley), seemingly inevitable.[93]

B. PERCEIVED PROBLEMS WITH THE DUAL SYSTEM

1. Balkanization

Those who criticize the dual regulatory system for securities enforcement often warn of the ominous dangers of "balkanization."[94] They argue that allowing states to continue their independent enforcement efforts will result in a confusing patchwork of conduct standards throughout the nation.[95] Although the term "balkanization" has become a favored catch phrase for the state critics, a close examination of the law of securities fraud reveals that critics exaggerate when they complain of an unjustified need to comply with fifty or more conduct standards. The problem of "balkanization," if it exists, relates mainly to enforcement policies and practices, and is not caused by contradictory or conflicting legal standards.

Contrary to the assertions of preemption advocates, similar standards for fraud *do* exist across all securities regimes, state and federal. There is an inexorable connection between Rule 10b-5, the principal federal anti-fraud provision, and state common law of fraud and deceit. The judicially distilled elements of a Rule 10b-5 action track the elements of a common

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92. *See Hillman Testimony*, *supra* note 60, at 65; *see also* Mark Maremont & Deborah Solomon, *Missed Chances: Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1 (exploring the reasons for the SEC's recent failures in securities enforcement).

93. *See supra* text accompanying notes 23-43.

94. For example, Congressman Oxley warned, "[W]hat we are witnessing is nothing less than a regulatory coup that would usurp the proper role of the SEC and the self-regulatory organizations. This could result in a disastrous balkanization of oversight . . . ." Oxley, *supra* note 39; *see also* Culter, *supra* note 38, at 550 (arguing "[o]ur mutual goal should be to avoid re-balkanizing . . . the securities markets, and effectively, undoing the work Congress has done."); Michael S. Greve, *Free Eliot Spitzer!*, 12 FEDERALIST OUTLOOK, AEI ONLINE, *at* www.aei.org/include/pub_print.asp?pubID=13928 (May 1, 2002) ("The strongest argument *for* federal intervention is that it constitutes the only alternative to regulatory balkanization.").

95. Congressman Baker accused Spitzer of "a failed attempt to usurp federal rulemaking and oversight" that would "cause confusion in the markets." Ben White, *Lawmaker Vows to Thwart Spitzer*, WASH. POST, May 24, 2002, at E01.

law action for fraud.[96] In a bid for uniformity, the civil liability provisions of most blue-sky statutes also mirror federal statutory standards.[97] Overall then, securities industry participants are guided by uniform legal principles that prohibit them from making false statements or misleading investors. It is of course true that the elements of proof for fraud are not identical under federal law and the state statutory and common law. Nonetheless, careful reflection reveals that state and federal governments speak with one voice in establishing a conduct standard for securities issuers and their representatives. The states' emergence in the securities enforcement arena has not changed the prevailing legal standard. It has only altered the prior reality that federal and state authorities rarely imposed serious penalties against major firms for securities fraud.[98]

Although there is a fairly uniform standard of conduct under all securities laws, jurisdictions vary widely in the resources they devote to policing securities fraud.[99] There are also important variations among jurisdictions in available enforcement tools and the range of remedies for misconduct. These variations mean that the risks of detection and punishment for fraud can vary dramatically from one jurisdiction to the next.

New York's Martin Act, for example, is singular in granting the Attorney General broad investigatory powers and in limiting the rights afforded to subjects of an investigation.[100] In addition, an action for fraud under the Martin Act does not require the Attorney General to establish the

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96. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

97. Forty states have adopted either the 1956 Uniform Securities Act or the Revised Uniform Securities Act of 1985. The anti-fraud provisions of both versions of the Uniform Securities Act (and new Uniform Securities Act of 2002) are substantially the same as Rule 10b-5. LOSS & SELIGMAN, *supra* note 14, at 42.

98. Before its conviction for obstruction of justice in connection with Enron's collapse, Arthur Andersen had been the subject of a number of major SEC enforcement actions for falsely certifying its clients' financial statements. Andersen settled the SEC's investigation of the $1.7 billion fraud at Waste Management by paying a modest fine and agreeing to an injunction against future violations. Andersen was later implicated in four of the major accounting frauds of 2002, including Qwest, Global Crossing, Enron and WorldCom. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 926 (2003).

99. LOSS & SELIGMAN, *supra* note 14, at 147-50, nn.336-37.

100. N.Y. GEN. BUS. LAW §§ 352-354 (McKinney 1996). Under the Martin Act, a subject of an Attorney General's investigation must comply with the Attorney General's subpoena, and the failure to comply constitutes prima facie evidence of fraudulent conduct. In addition, a subject of an investigation has no right to have an attorney present during questioning (although Spitzer has allowed attorney presence). LOSS & SELIGMAN, *supra* note 14, at 75-82; *see also* Cassidy, *supra* note 35.

defendant's intent to defraud.[101] These differences (and, of course, the willingness to exploit them) likely explain the contrasting outcomes of state and federal regulatory efforts.[102] The fact that the SEC joined Spitzer and Galvin in the analyst and mutual fund investigations supports the proposition that the conduct targeted by the states also breaches the federal securities laws.

Few of Spitzer's critics have argued publicly that the disgraced securities analysts and market timers complied fully with federal securities laws, or that their legal problems can be traced to conflicting state and federal conduct standards. Instead they seem to advance a defense based on the industry's "detrimental reliance" on regulatory inaction by positing that federal regulators' prior tolerance of alleged misconduct makes it unscrupulous for state regulators to enforce *their* anti-fraud provisions.

Rather than explicitly advance this untenable argument, critics instead launch *ad hominem* attacks against Spitzer as they warn about the crippling of the system of capital formation caused by requiring companies to comply with fifty different legal standards.[103] These critics seem to ignore the reality that unchecked fraud, once revealed, does more to cripple capital formation than does a vigorous system of enforcement.[104]

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101. *See* People v. Federated Radio Corp., 154 N.E. 655 (N.Y. 1926). In contrast, the U.S. Supreme Court has ruled that scienter is an essential element for a securities fraud claim under Rule 10b-5. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

102. See *supra* notes 33-43 and accompanying text.

103. *See* Oxley, *supra* note 39; Ben White, *Lawmaker Vows to Thwart Spitzer; La. Congressman Decries State Move*, WASH. POST, May 24, 2002, at E1 (quoting Congressman Richard Baker); Bainbridge, *supra* note 43.

104. *See* Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 713 (1996). Stout argues that:

> When securities scholars get together, they often find they agree on very little. But there is one thing they do agree on: fraud is very, very bad for securities markets. In lay terms, fraud is bad for securities markets because it erodes investor confidence. This occurs because fraud makes it difficult for investors to detect differences in the quality of the securities they buy. Companies issuing bad securities--poorly run firms that throw away money and do a poor job for their investors--can sell their securities at about the same price as well-managed firms, because fraud makes it impossible for investors to easily distinguish between high-quality and low-quality firms.

Id.

2. Unfairness of Parallel Proceedings

Critics also argue that it is unreasonable for companies to have to answer to multiple regulators investigating the same conduct.[105] This argument fails to withstand scrutiny. Complexities associated with parallel enforcement investigations[106] extend beyond the context of securities fraud, and are inevitable in our federal system of government. State and federal enforcement authority frequently overlaps in areas ranging from crime and drug enforcement to the environment and workplace safety.[107] In all of these areas, state and federal regulators have found ways to cooperate to fulfill their public duties.[108] The SEC, in particular, has extensive experience in inter-agency cooperation because it coordinates many of its investigations with the Department of Justice.

Although targets are understandably opposed to parallel investigations, the regulators have demonstrated their ability to coordinate action, despite occasional rivalries and differing policy perspectives. Targets do suffer a tactical disadvantage when multiple investigations co-exist.[109] The corresponding advantage to government regulators enhances their ability to protect the public interest.

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105. *See* Oxley, *supra* note 39 (describing the need to "cut a separate deal with 50 state regulators").

106. Abbe David Lowell & Kathryn C. Arnold, *Corporate Crime After 2000: A New Law Enforcement Challenge or Déjà Vu?*, 40 AM. CRIM. L. REV. 219, 233 (2003) ("Parallel proceedings are simultaneous or successive investigations, prosecutions, or other actions brought against a person, a corporation, or some other entity by federal and state governmental departments or agencies, or by a governmental entity and a private party.").

107. For discussions about, and proposed solutions to, the challenges of concurrent enforcement in various fields, see generally John C. Dernbach, *Pennsylvania's Implementation of the Surface Mining Control and Reclamation Act: An Assessment of How "Cooperative Federalism" Can Make State Regulatory Programs More Effective*, 19 U. MICH. J.L. REFORM 903 (1986) (discussing environmental law); Susan Bartlett Foote, *Administrative Preemption: An Experiment in Regulatory Federalism*, 70 VA. L. REV. 1429 (1984) (discussing health and safety regulation); Jamie S. Gorelick & Harry Litman, *Prosecutorial Discretion and the Federalization Debate*, 46 HASTINGS L.J. 967 (1995) (discussing criminal law enforcement).

108. Gorelick & Litman, *supra* note 109, at 976-78.

109. *See* Lowell & Arnold, *supra* note 108, at 234 ("Parallel proceedings change everything about the planning and strategy of a case. Whether to allow a client to testify in a civil deposition or before a congressional committee, for example, is a much different question when there is a grand jury just waiting to review a copy of that testimony.").

CONCLUSION

State regulators emerged as significant securities enforcement agents only because of the prolonged failure of the SEC and the SROs to competently confront systemic problems affecting the financial services industry. The SEC's inaction created a vacuum that state regulators moved to fill. The states' actions, in turn, have prompted the SEC to squarely address the chronic abuses exposed by the states through a combination of regulatory and enforcement efforts. This pattern of actions and reactions by state and federal regulators illustrates how vertical regulatory competition can lead to more effective government regulation. Efforts to limit states' enforcement power are not only misguided, they are also contrary to the framers' vision of our democracy.

THE DISLOYALTY OF STOCK AND STOCK OPTION COMPENSATION

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INTRODUCTION

Stock options have grown over the last decade to take up an increasing percentage of the rising compensation of top management.[1] The popularity of options is best understood as arising from deceptive accounting. Current accounting standards allow management to avoid mentioning the cost of its compensation in its earnings statements. But for the opportunity to understate compensation cost, stock and stock option compensation are terrible ideas that will harm the equity investors' interests.

- Stock options give managers an incentive to impose too much risk on shareholders and to accumulate too much of the corporation's earnings. Shareholders who allow their managers significant options may find that they have given their managers a motive to undertake suicidal risks from which the managers are immune.
- Stock and stock options carry an unnecessarily high discount rate in the time-value of money calculations. Better management of the discount rate would lower the corporation's real cost of compensation or increase the recipient's present-value benefit from the cost or both.
- Stock compensation can give employees capital gains, but compensation is almost always more tax efficient if employee capital gains are avoided. The tax harm to a corporation by loss of its compensation deductions in using capital-gains compensation almost always exceeds the tax benefit to the managers. Employee capital gain usually means the managers have not counted the corporation's harm.

Given the harm that stock options can do to investor interests, management's use of stock options and stock compensation are a sign that managers are being disloyal to investors, especially when management chooses not to record the cost of the options in its income statements given to investors.

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1. *See, e.g.*, Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 848 (2002) (discussing an increase in executive compensation in the 1990s driven predominantly by growth of options from 27% of compensation to 51% of compensation); Kenneth J. Klassen, *Options for Compensation*, CA MAGAZINE, Aug. 2000, at 41 *available at* http://www.camagazine.com/index.cfm/ci_id/6970/la_id/1/camagazine/1/print/true.htm (last visited Nov. 1, 2004) (citing studies that American CEOs on average received stock options worth $1.21 million).

The insurance industry is an important institutional investor in corporate stock. Life insurance companies held $1.5 trillion dollars of corporate equities at the end of 2002 and purchased $144 billion of stock during that year.[2] Corporate equities typically represent between a quarter and a third of the gross assets of life and health insurance companies.[3] In its role as a heavy investor in corporate equities, the insurance industry needs to understand that stock options, especially those not reported as a compensation expense, are a badge of disloyalty. Managers who use stock option compensation can be presumed to be unfriendly to investor interests.

Moreover, because the insurance industry is such an important institutional investor in corporate equities, it has a special role in insuring that financial reports give investors the information they need. The process of setting financial accounting standards has been overly influenced by management interests on this issue. Management likes to treat its payroll as having no cost and it especially likes having its own compensation reported as if it were free. Off-budget and out-of-mind means that managers can pull away more money from their shareholders with little chance of being noticed. Equity investors, each with very little at stake, do not seem to have been able to organize well enough to guarantee earnings reports that are loyal to their needs. However, the insurance industry's stake, on the investor side, is large enough for the industry to take an interest in fair accounting.

This article first explains the accounting war over how to account for stock option compensation. It then explains the economic drawbacks of stock and stock option compensation that make the use of stock-based compensation such a sign of disloyalty.

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2. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2003, at 755 (123rd ed. 2003) (data from Federal Reserve Board, National Income and Product Accounts). Other insurance companies held $208 billion of corporate equities at the end of 2002 and purchased $12 billion during 2002. *Id.*

3. *Id.* at 764 (data from American Council on Life Insurers) (corporate equities represented $909 billion/$3269 billion or 27.8% of life and health insurance company assets in 2001, $997 billion/$3182 billion or 31.3% of assets in 2000, 32.2% of assets in 2000, and 26.8% of assets in 1998).

I. THE ACCOUNTING WAR

A. NO-INITIAL BARGAIN OPTIONS ARE REPORTED AS IF FREE

Accounting for compensatory stock options is the subject of a political firestorm. Under current accounting standards, stock options can now be reported in earnings statements as if they were free. The Financial Accounting Standards Board has proposed to end the free option privilege. The U.S House of Representatives, but so far not the Senate, has voted to block the change.

In 1972, before the Black-Scholes option-pricing formula had given some precision to the valuation of options, and before accessible option markets were very meaningful, the American accounting profession adopted a simple-minded rule of thumb for valuing compensatory stock options.[4] Under the accounting rules, the only reported cost of an option to acquire an employer's own stock is the initial bargain, measured at the time the option is granted. If the option is set up to have no difference between the exercise price the option holder has to pay to get the stock and the market value of that stock at the time the option is granted, then the option may be treated in the public reports of earnings as if the option were free.

Zero-costing for an option with no initial bargain is not a good faith attempt to measure the value or cost of the option. If it were certain that no change in value would occur, an option with no initial bargain would be worthless. An option to buy a bank account (but not the interim interest) in a year for its current value is not worth anything because bank accounts do not rise or drop in value. As volatility in the price of the underlying stock increases, however, the value of the option increases, even in absence of any *initial* bargain. The holder of an option with no initial bargain can capture all of the subsequent gains from the appreciation of the underlying stock without having supplied the capital that contributed to that appreciation. Simultaneously, the holder has insurance-like protection on the loss side, because if the stock value drops below exercise price, the option holder can avoid the loss simply by failing to exercise. Holding an

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4. ACCOUNTING FOR STOCK BASED COMPENSATION, Accounting for Stock Issued to Employees No. 25 (Accounting Principles Bd. 1972). The Accounting Principles Board was the pre-1973 predecessor of the Financial Accounting Standards Board, which now sets U.S. accounting standards. The classic article on option valuation is Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973). *See also* RICHARD BREALEY & STEWART MYERS, PRINCIPLES OF CORPORATE FINANCE 606-08, 632-33 (6th ed. 2000).

option is much like getting to bet on the horse race after the race has been run.

For high-risk stocks, a holder of a no-initial-bargain option holds essentially all of the value of the stock. If there were a stock called Cold-Fusion Corporation, for example, which had a one in a million shot of becoming very valuable, the holder of a no-initial-bargain option would be able to grab the value in the rare case that the high value comes to fruition. The value of a no-initial-bargain option would be short of the value of owning the Cold Fusion stock outright by only one-millionth of the current value.[5]

Options that are exercised, moreover, require that the corporate employer issue stock to satisfy the option, and stock is not free to other shareholders. An executive given stock has been given some fraction of the future cash that the corporation will distribute with respect to its stock. Other shareholders have lost that cash. There is no enforceable legal obligation to pay dividends nor to redeem shares, but all new shareholders have a powerful remedy, which younger siblings and toddlers in Day Care have learned to use, namely to shout, "Share!" A corporation cannot distribute money to old or other shareholders without including the new shareholder proportionately. Anything that a new shareholder gets has to be lost by the old. If a new CEO gets 5% of the stock by exercise of an option, the CEO has taken 5% of all future cash on the stock away from the other shareholders. The CEO may or may not be worth it, but it is certain that the 5% of all future cash for as long as the stock is outstanding, is a cost of whatever the CEO can bring in. The CEO is not free.

Stock is nothing but a proxy for the future cash that the corporation must pay out on the stock. Stock has value only because the market is assessing the discounted present value of the future cash that will be paid out. Without the expectation of cash distributions, as dividends or in redemption, stock is not worth the paper it is printed on. The market does not *pay* the compensation. The market just appraises what cash the employer corporation will pay in the future with a heavy dose of skepticism.

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5. Assume a share of Cold Fusion is worth $10 because that represents a one in a million chance of having a share with a worth of $10 million, even when discounted back to the present. Executive X is given an option to buy a Cold Fusion share for $10 at any time over the next 10 years by which time the doubts about success will be resolved one way or the other. In 999,999 times out of a million, both the stock and option are worthless. Still X has a one in million chance of making $10 million less the $10 exercise ($10,000,000 - $10)/ 1,000,00 = $9.99999), which is less than the $10 current fair market value of the stock only by a millionth of $10, or one-ten thousandths of a penny.

The discount rate at which the market evaluates the future cash is ruthless to the issuer: a lot of future cash supports only a little current value. The discount rate, moreover, is not deductible. Debt is one competing alternative to pay future cash and debt is far cheaper to the issuer. Over the last 75 years, the stock market has discounted future cash that it expects to be paid by the issuer, after inflation adjustments, at a discount rate of 7.6%. The corporation must, therefore, bear an average cost of 7.6% per year on stock, after inflation, in the nature of interest or rental cost of capital for deferring payment.[6] For corporate debt, the discount rate, called interest, starts lower and is made cheaper by the corporate deduction. On average over the same 75-year period, corporate bonds have had an after-tax, after-inflation cost of between 0.7% cost per year and *negative* 0.3% cost per year.[7] Debt is almost zero interest, and stock bears very high real interest.

Cash payments on compensatory stock are enforced, primarily, by the rule that all shareholders share in distributions pro rata, but there are also some backup threats. If the value of the corporation's stock drops substantially below the value of its assets, that invites a hostile takeover by some outside pirate who will fire management and acquire the company's assets.[8] To protect their jobs, managers need to keep the price of stock up by continuing to convince the market that there is sufficient cash yet to come that will support the present value of the stock at the brutal discount rate by which the market values stock.

If stocks really were free, then the stewards of the corporation would have no obligation to keep watch over stock or stock options. Management has stewardship responsibility only for economic resources that have some cost or value. Treating the options as free is to teach management to waste

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6. IBBOTSON ASSOCIATES, *Stocks, Bonds, Bills, and Inflation*, SBI 2003 YEARBOOK 22 (2003) (reporting large corporate stocks discount rate at 10.7%, inflation at 3.1%).

7. *Id.* (reporting corporate bonds at 5.8% over 75 years). The U.S. corporate tax rate has varied from 13.5% to 52% during the 75-year history, and from World War II through 1993 it was at or above 40%. JOSEPH A. PECHMAN, FEDERAL TAX POLICY 290 (3d ed. 1977). The after-tax cost of corporate bonds to the corporation paying 35% tax is interest less tax savings, then minus inflation or *5.8%(1-35%) - 3.1% = 0.7%.* With corporate tax at 52%, as it was from the Korean War through 1964, the after-tax cost of 5.8% interest is –0.3 of 1%. In inflation adjusted terms, the negative cost means that the debtor makes money, by owing money. *See also* discussion of the comparative cost of debt and stock *infra* text accompanying notes 41-46.

8. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965) (arguing that takeover market is a discipline of inefficient managers); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 567 (1984) (arguing that outsiders will try to take over the company if there is a 20% premium available if management changes hands).

them. Top management seems to be acting as if the accounting value assigned to no-initial-bargain options were correct, such that they can issue themselves mega-options. It is not mysterious that management would take anything not nailed down. It is mysterious that shareholders seem to be letting them get away with it.[9]

Treating stock options as free also generates non-reflective income statements because economic resources the company needs to give out are stripped out of the public income statements. Assume a company gets executives to work for it only because it gives out stock options worth $200 million. Assume that the executives together are able to generate only $50 million in revenue. When income is reported, the value of the stock issued pursuant to a no-initial-bargain option is not mentioned. Instead of reporting a $150 million loss measured considering the resources it used up, the corporation gets to report $50 million profit. The $50 million profit will not be replicated when other non-stock resources must be used in otherwise identical years and situations. The $150 million loss is the more accurate sample and will be replicated.

For creditors, additional stock and stock options really are free. Since creditors get paid before shareholders, creditors are not hurt by additional stock and they are indifferent to it. Creditors would indeed prefer that the company replace cash expenses of any kind with payments in stock, because cash paid out reduces the collateral securing their debt holdings, but stock does not. Creditors should be worrying about income statements using the zero-costing rule for options as not providing them with a fair indicia of the profits the firm can make in the future or the trouble that the debtor may be in. However, the creditors have not been active in asking the standards board to treat stock options as a cost.

B. POLITICS PREVENTS FAIR ACCOUNTING

1. The Fate of the 1993 Initiative

Accounting has had a great deal of difficulty correcting itself on the zero-costing of stock options. In 1993, the Financial Accounting Standards Board ("FASB") published an Exposure Draft of a proposal that would have ended the zero-cost rule and replaced it with a rule that would have required something closer to the true value of the option, which would be

9. *See, e.g.*, Murphy, *supra* note 1, at 848 (showing that the increase in executive compensation in 1990's was driven predominantly by growth of options from 27% of compensation to 51% of compensation).

treated as a corporate expenditure when the option was granted.[10] The zero-cost rule, however, had by that time created a powerful constituency of managers who liked their compensation to be considered not worth metering, and the managers and their allies defeated the proposed reform with a firestorm of razzle-dazzle, none of it with any accounting merit.[11] Investors, shareholders and the country at large would be benefited by more accurate descriptions, but they could not get organized into an effective constituency and nobody important helped the Board. The Statement that finally came out in 1995 allowed a firm to continue to use the no-cost rule for no-initial-bargain options, provided, however, that the firm disclosed in its footnotes the costs computed from value of the options at the time they were granted.[12]

There are some who think that footnote disclosure is sufficient.[13] Zero-costing may be deceptive, but smart investors are not misled, the argument

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10. ACCOUNTING FOR STOCK-BASED COMPENSATION, Proposed Statement of Financial Accounting Standards No. 127-C (Financial Accounting Standards Bd. 1993); *see also* Calvin H. Johnson, *Stealing the Company with Free Stock Options: The Furor Over Accounting Standards—Part II,* 65 TAX NOTES 479 (1994) (arguing that the standard understated value of the stock and that accruing the bargain on the stock as the bargain rises would be better accounting).

11. *See, e.g.*, Senator Joseph I. Lieberman, *...But They Do Create Good Jobs; Stock Options are Necessary Growth Tools for Start-Up Firms*, L. A. TIMES, April 8, 1994, at B7; *see also Employee Stock Options: Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous. and Urban Affairs*, 103d Cong. 88 (1993) (statement of Lisa Conte, Chairman and CEO of Shaman Pharmaceuticals, Inc.) (testifying she could not get the healing pharmaceuticals from rain forest shamans without stock options). The apparent argument of both Senator Lieberman and Conte is that zero-costing might well be a lie and fraud on investors, but one can get jobs and pharmaceuticals from the rain forest only by such fraud. If the necessary fraud argument is not the argument, I cannot follow the causal connection that is being claimed, much less evaluate it. *See* Calvin H. Johnson, *Stealing the Company with Free Stock Options: The Furor Over Accounting Standards—Part I,* 65 TAX NOTES 355 (1994) (recounting and dismissing some arguments in favor of treating stock options as cost-free).

12. ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995). In December 2002, the Board required more clarity in the heretofore opaque disclosures in the footnotes, requiring, for instance, tables instead of prose paragraphs. ACCOUNTING FOR STOCK-BASED COMPENSATION—TRANSITION AND DISCLOSURE, Statement of Financial Accounting Standards No. 148 (Financial Accounting Standards Bd. 2002).

13. *See* J. Carter Beese Jr., *A Rule That Stunts Growth*, WALL ST. J., Feb. 8, 1994, at A18 (reporting that Big Six accounting firms, Council of Institutional Investors, and Business Roundtable favor disclosure rather than reporting costs in body of financial statements); *see also* Samuel A. Derieux, *Stock Compensation Revisited*, 177 J. ACCT. 39, 39 (1994) (arguing that full disclosure will serve as well as reporting). In Johnson, *supra* note 11, at 358-60, that argument is rejected.

goes, because they can digest the information about cost given in footnotes. The Financial Accounting Standards Board stated in 1995 that, in principle, disclosure in the footnotes was no substitute for including costs in the financial statements themselves, but the Board stated that it had met with such a firestorm of opposition to its exposure draft proposal to end zero-costing that it had decided to "bring closure to the divisive debate" by requiring only that option cost be disclosed in footnotes.[14] The Board recommended, but did not mandate, that option cost be included in the calculation of reported income.[15]

Even if smart investors were able to see through the subterfuge, however, that does not justify accounting as deceptive as zero-costing is. Accountants should not be trying to fool the market or trying to raise the barriers that a smart market might or might not overcome. Indeed the difficulty of correcting the silliness is pretty good evidence that someone thinks that the fraud is succeeding. If footnote disclosure were sufficient, there would be no opposition to putting stock option cost into financial statements, since all the effects of including costs in financial statements would already have happened. As Federal Reserve System Chairman Alan Greenspan has said:

> There is a legitimate question as to whether markets see through the current nonexpensing of options. If they do, moving to an explicit recognition of option expense in reported earnings will be a nonevent. The format of reports to shareholders will change somewhat, but little more will be involved. Making an estimate option expense requires no significant additional burden to the company.
>
> If, however, markets do not fully see through the failure to expense real factor inputs, market values are distorted and real capital resources are being diverted from their most efficient employment. This *would* be an issue of national concern.
>
> Clearly then the greater risk is to leave the current accounting treatment in place . . . . If, however, expensing

14. ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123, § 62 (Financial Accounting Standards Bd. 1995).

15. *Id.* at §§ 61-62 (requiring disclosure of compensatory options in footnotes, but not in income statements that include the costs).

> does affect market values, a continuation of current accounting practice could be costly to capital efficiency.[16]

The firestorm of politics in 1993 and again currently is superb evidence that the major players think that expensing of options within the income statements makes a difference. There would be no political campaign unless managers and their representatives thought they were establishing something by keeping the costs of their compensation out of the income statement.

2. The Still-Open 2004 Initiative

On March 31, 2004, the FASB released an exposure draft of a proposed new standard which would require the corporate employer to recognize the estimated value of stock options at the time the option was granted to the employee.[17] Under the new proposal, the estimate of value would take into account the price of the underlying stock and the volatility of the stock that contributes to the option's value.[18] Once the value was estimated at grant, however, the cost of the option would not be measured again by reason of subsequent changes in stock price or expected volatility.[19] If it is not possible to measure the fair value of the option when granted, the proposed standard would require the company to measure the bargain or "intrinsic value" of the option at the end of each period and to measure the final cost of the option when it is settled or satisfied.[20] Nonpublic entities can choose this "intrinsic value" valuation method; however, valuation of the option when granted is the preferred method and if the nonpublic employer chooses to value the option when granted, the standards will not upset that choice.[21]

In response to the new FASB stock-based compensation proposal, Congress quickly held a flurry of popular hearings on bills to block the

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16. Alan Greenspan, Remarks at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia (May 3, 2002), *quoted in* ROBERT HERZ, FIN. ACCT. STANDARDS BD., SUBMISSION TO U.S. SENATE ROUNDTABLE, PRESERVING PARTNERSHIP CAPITALISM THROUGH STOCK OPTIONS FOR AMERICA'S WORKFORCE 25 (2003), *available at* http://www.fasb.org/testimony/05-08-03_full_text.pdf.

17. *See* SHARE BASED PAYMENT, Proposed Statement of Financial Accounting Standards No. 1102-100 (Financial Accounting Standards Bd., Exposure Draft 2004) [hereinafter Exposure Draft].

18. *Id.* app. A, §§ 17, 19, at 18-20.

19. *Id.* app. A, § 19, at 20.

20. *Id.* app. A, § 22, at 21.

21. *Id.* app. A, §§ 20-20A, at 20-21.

proposal from going into effect. The Senate Committee on Government Affairs, Subcommittee on Financial Management chaired by Senator Fitzgerald (Rep., Ill.), held hearings on April 20, 2004.[22] The House Committee on Financial Services, Subcommittee on Capital Markets, chaired by Michael Oxley (Rep., Oh.) held hearings on April 20, 2004. [23] The Senate Committee on Small Business, chaired by Senator Michael B. Enzi (Rep., Wyoming), held hearings on April 28, 2004.[24] The Commerce, Trade, and Consumer Protection Subcommittee of the House Committee on Energy and Commerce held hearings on July 8, 2004[25]

The U.S. House of Representatives has responded to management demands by passing legislation that would mandate that stock option compensation could continue to be treated as cost free. On July 20, 2004, the House passed a bill that would prohibit mandatory expensing of options for small businesses and for all but the four top executives of large businesses. Even expensing allowable under the bill would be allowed only after studies of the supposed harm that accurate accounting would do to the economy.[26] Under the bill passed by the house, stock options would continue to be treated as free money.

The outcome in the Senate, as of the publication date, is not certain. Senator Richard Shelby (Republican, Alabama), the Chairman of the Senate Banking, Housing and Urban Affairs Committee and Senator Fitzgerald (Republican, Illinois), the chairman of the Senate Subcommittee on Financial Management, have announced opposition to measures to stop expensing of stock option or to impede the FASB.[27] The battle has joined

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22. *See Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board: Hearing Before the Subcomm. on Fin. Mgmt., the Budget, and Int'l Sec. of the S. Comm. on Governmental Affairs,* 108th Cong. (2004), *available at* http://www.senate.gov/~gov_affairs/index.cfm?Fuseaction=Hearings.Detail&HearingID=170.

23. *See The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the House Comm. on Fin. Servs.,* 108th Cong. (2004), (statement of Michael G. Oxley, Chairman , Fin. Servs. Comm.) *available at* http://www.savestockoptions.org/pdf/oxley.pdf.

24. *See Impact of Stock Option Expensing on Small Businesses: Hearing before Subcomm. on Small Bus. and Entrepreneurship,* 108th Cong. (2004), *available at* http://enzi.senate.gov/fasbme.htm.

25. *See FASB Proposals on Stock Option Expensing: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Prot. of the House Comm. on Energy and Commerce,* 108th Cong. (2004).

26. Stock Option Accounting Reform Act, H.R. 3574, 108th Cong. (2004).

27. Senator Richard C. Shelby, *Accounting Reform,* http://shelby.senate.gov/legislation/accounting_reform.cfm; Press Release, Senator Peter G.

on the new proposals and the outcome is in doubt. Maybe this time it will be different.

C. HOW TO FIX IT: ACCRUING THE BARGAIN

The Accounting profession *should* measure the employer corporation's accrued cost of an option at the end of every year as the bargain the employee can get from the option arises and is finally achieved upon exercise. Fluctuations in the price of the underlying stock would be reflected every year in the bargain that the employee gets and in the cost that the corporation bears. This method is called "intrinsic method" in the new FASB proposals, but the terminology is unnecessarily confusing. "Intrinsic method" in the current rules, Statement 123, and in the APB Opinion No. 25 that preceded it, referred to the zero costing method, that is, the view that the bargain was measured but once at grant and if there was no bargain at grant, there never was a cost. The new "intrinsic cost" method is not zero costing, but a much superior method. To avoid confusion here, this section refers to the method measuring the cost annually by looking at the bargain as the "accruing the bargain" method. Accrual of the bargain as it arises is better accounting than the valuation of the option at grant. The Exposure Draft of the proposed changes limits the use of the "accruing the bargain" method, what it calls the "intrinsic method," inappropriately. The *new* "intrinsic method" is required if the option value truly cannot be estimated at grant, but it is assumed that failure to estimate will occur only when measurement is "virtually impossible."[28] Nonpublic entities may elect to use the new intrinsic method, but if they elect to value the option but once at grant, that choice will not be upset. Thus except for a small range where accruing the bargain is mandated or allowed, the overwhelmingly general rule under the Exposure Draft is that the cost of the option must be assessed at the time it is granted, and not again thereafter.

The accounting board is shooting itself in the foot by insisting that the value of the option must be measured when the option is issued. The value of a newly issued option depends upon how volatile the underlying stock is. An option on asset that cannot fluctuate in value is indeed not worth anything more than the initial bargain. Black-Scholes option pricing or

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Fitzgerald, Sen. Fitzgerald Vows to Block Any 11th Hour Attempt by Congress to Reverse Crucial Stock Option Expensing Reform (July 28, 2004), http://fitzgerald.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=428&Month=7&Year=2004&ShowOthers=True.

28. Exposure Draft, *supra* note 17, at app. A, §§ 21,22 at 21.

indeed any alternative valuation requires a track record to generate volatility measures. New companies, closely held companies and thin markets do not generate enough information about volatility to make up-front valuations work. For a broad range of new and smaller corporations, it is possible to estimate stock prices at the end of each year, especially since errors can be corrected by a new estimate the next year, and yet there is not enough of a reasonably accurate track record to give volatility measures sufficiently accurate to have any confidence in the one-time-only Black-Scholes valuation. Accruing the bargain as it arises does not require a volatility measure and thus would avoid a major source of trouble in valuing options for nonpublic companies.

Valuation of a compensatory option at grant is usually too early. Even when there is some record of volatility for the stock, value at grant relies on the law of averages. Some options will indeed prove to be free to the issuing company because they expire out of the money. Some will be very expensive. Investors need cost figures that distinguish between expensive or free according to how the story comes out. You can drown in a lake that is only 6 inches deep on average. If you cannot swim, you need to know not the average depth, but the outcome of whether this part of the lake is a muddy half-inch part or the 40-foot deep part. Even if the average sets a fair expectation for the cost value of the option at grant and even if it represents the price an outsider would pay for the option, investors generally need to know the company's costs according to how the costs come out once the big contingency—value of the stock at exercise – has been resolved. Unvested options, moreover, can be exercised by the employee only if he or she stays with the company for long enough for the option rights to vest. New, untested companies have a turn over rate that is large and also unknowable. Mr. Kevin A. Hassett of the American Enterprise Institute has argued that reporting option value at grant of the option is just like reporting next year's best selling novel as profit today.[29] A good crystal ball or at least speculation is required. The future is very hard to predict, philosopher Yogi has said, because it has not happened yet.

A one-time only valuation of the option, moreover, means that valuation can be too easily defeated by craft. There is a cottage industry of estate planners who have learned over the history of the federal estate tax how to get property undervalued when it has to pass through one date of valuation. Estate planning techniques for undervaluation can be transferred

29. *The FASB Stock Options Proposal: Its Effects on the U.S. Economy and Jobs, Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises*, 108th Cong. 97 (2004), (testimony of Kevin A. Hassett, American Enterprise Institute) *available at available at* http://financialservices.house.gov/media/pdf/108.80.pdf.

to undervaluation of stock options too easily if there is just one chance to value the option. Management is too intensely self-interested in the reporting of its own compensation to give unbiased estimates of value. It is not just that option value is too hard for some managers to understand, which is true, but also that managers will be trying to misjudge value to understate the cost of their own compensation because if compensation costs can be understated, then management can tease more compensation out of their company, off-budget and out of sight. If executives can get their compensation measured at ten cents on the dollar on the income statement, they can get more compensation for the cost the company is willing to devote to them. In esoteric areas where valuation is not transparent to investors, managers will hire experts to help them understate value. They will design option packages that exploit tiny cracks in valuation into gaping chasms, so that their compensation will appear less costly. Enron and World Com have also taught us that auditors, regrettably, cannot be counted on to be adverse to management without bright-line cook-book rules. Management estimates of value, even if audited, need to be "trued up" every year to the real bargain, and they need to be trued up to the final actual cost when the option is exercised. Reliable accounting needs to "true up" an option value to the bargain that is in fact achieved on exercise, just to make sure. To provide accurate interim information, a reliable accounting system needs to accrue the bargain annually at the end of each accounting period during the option's duration.

The difficulty of the valuing options at grant is also being used to continue the even greater error of zero-costing for compensation options:

> [The expensing proposal] involves applying an esoteric mathematical operation to an executive's stock options at the moment they're granted (i.e. before anyone knows whether they will be worth anything), for the sole purpose of whipping up a dubiously meaningful dollar figure that can be deducted from earnings as the "cost" of the options.[30]

The criticism should not lead to a conclusion, as the author of the passage used it, that zero-costing of options should continue, but criticism of valuation at grant is meritorious. The Black-Scholes approach is attempting to determine whether this is a high cost or a low cost option by

30. Holman W. Jenkins, Jr., *Much Ado About Stock Options—The Epilogue,* WALL ST. J., April 23, 2003, at A23.

looking to the law of averages and valuation at grant is debiting an unripe unaccrued contingency too early to get it right. Accruing the bargain as it arises does not require a volatility measure and thus would avoid a major source of confusing "esoteric mathematics" that sophisticated opponents of fair accounting are using to beat FASB once again.

If the ultimate payment will be in cash rather than stock, the accounting profession correctly accrues the added obligation every year. Stock appreciation rights ("SAR"), for instance, match a stock option by giving the executive any increase in value of the stock (but not the loss) over some period, but SAR plans end by paying the executive in cash. Phantom-stock plans also pay cash and track stock price, but phantom stock plans track losses as well as gains because the employee starts with a share-like unit that will decline in value when the underlying stock does. For cash-payout plans such as SARs and phantom-stock, accounting standards require that the employer must accrue the obligation as it arises even though it is not yet paid. The accrued obligation is measured by the stock price the cash award traces. An increase in the stock price increases the employer's obligation and so increases its reported expense. If the stock subsequently drops in value, the decrease will reduce the employer's cost under the plan and some of the previously accrued expense will be reversed into income. The final payment on the plan in cash is like paying a payable and it creates no newly booked expenditure, except to the extent that the payout has not been accrued previously.[31]

The distinction the accountants make between payout in stock and payout in cash is unprincipled. For example, accounting treats straight stock compensation, that is, a payment in stock without any prior option, as an expenditure equal to the equivalent cash.[32] Stock and its cash equivalent are equivalents, we can say tautologically. Fair market value of the stock means the cash equivalent of the stock. The corporation has the same economic burden whether the compensation is to be satisfied in stock or cash. Indeed, we could imagine a single plan could be satisfied either in cash or in stock, perhaps at the option of either the employer or of the employee without that making any difference in the economics of the

31. *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, *supra* note 14 § 25; *see also* ACCOUNTING FOR STOCK APPRECIATION RIGHTS AND OTHER VARIABLE STOCK OPTION OR AWARD PLANS, Financial Accounting Standards Board Interpretation No. 28 (Financial Accounting Standards Bd. 1978).

32. ACCOUNTING FOR STOCK-BASED COMPENSATION, *supra* note 14 §§ 16, 18. The rule is maintained by proposed Exposure Draft, *supra* note 17, app. A, § 25A.

plan.[33] Yet in the end, FASB makes a distinction between cash and stock and does not accrue the existing bargain if the payout is scheduled to be in stock.[34]

The accrued bargain approach also usually matches the accounting cost to the right year automatically. Under a stock option, management makes money by causing the stock to rise during a year. If management causes a big rise in the stock price, that will mean a big compensation cost. If the stock price drops, that reduces or erases cost. The initial valuation approach, by contrast, requires some kind of arbitrary allocation of the big up-front found value across a number of years in which services are provided. Thus for example, if an option vests over 10 years of service, a 10-year option is treated as costing $1/10^{th}$ of the total value for each year over which the option is earned out, whether the management causes a big rise in price or loss in stock price during the year. The accrued bargain approach tells outside investors more about the economics of how the executive earned his or her stock than does amortizing the initial big value of the option over the life of the option.

II. THE ECONOMIC AWFULNESS OF STOCK AND STOCK OPTIONS

Except for the accounting camouflage available with stock options, stock options and stock compensation would probably disappear for at least the following reasons. Options give management an incentive to take too much risk. Stock and stock options are also inefficient compensation because of their high discount rate. Employees, moreover, undervalue stock and stock options because they under diversified. Employee capital gain, available on stock, is usually something to be avoided.

A. SUICIDAL RISK: THE CONFLICT BETWEEN SHAREHOLDERS AND OPTION HOLDERS

A corporation that has given its top management stock options has given its management a private incentive to go into risks that are suicidal for the company as a whole. A holder of an option does not share in down side risk on the underlying stock. If the stock loses any value, the holder of the option will just fail to exercise and will thus avoid the loss. Thus, risks

33. *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, *supra* note 14 § 39 (requiring a plan to be treated as a cash plan if the employee has the option of choosing cash or stock payment or if there is a pattern in which the corporation pays in cash).

34. *Id.*

of loss that would properly scare the flesh off someone who owned the stock are a matter of indifference to the option holder.

Assume, for example, that Company B has $1 billion assets and no debt and is offered a high-risk scheme for what to do with all its assets. The scheme has a 5% change of being worth $10 billion, and 95% chance of failing in full. Rationally, Company B should say no to the scheme because the expected value is not high enough. The expected-value tree looks as follows:

Expected-value Tree for the Scheme			
	Likelihood	x Payout =	Expected-value
Success leg	5%	$10 billion	$1/2 billion.
Loss leg	95%	0	0
Sum value	100%		$1/2 billion

The straight odds say that this scheme is like investing a billion dollars to make half a billion. It is plausible that the straight odds do not even fully capture the awfulness of this scheme in terms of human damage. In 95% of the cases, any one who invested his or her nest egg in Company B will lose it and all employees and many suppliers will need to find other jobs.

Suppose, however, that Company B gave its CEO an option to buy 1% of its stock at current price, and that the CEO has the authority to decide whether to take such schemes. In his or her own interest, the CEO will take Company B into the scheme. If the scheme is a success, the CEO's 1% of the stock will be worth $10 billion times 1% or $100 million. The exercise price at 1% of the current value, or $1 billion, is $10 million. The scheme and the option together have given the CEO a chance to make $90 million! The downside risk is uninteresting to the CEO, since option holders do not exercise their option in worthless companies and so do not participate in their losses.

The expected value of the CEO's option is positive if Company B undertakes the scheme:

Expected-value tree for an option			
	Likelihood	x Payout =	Expected-value
Success leg	5%	$100 mil.- $10 mil. = $90 mil.	$4.5 mil.
Loss leg	95%	0	0
Sum value	100%		$4.5 mil.

It looks like Company B has given its CEO a very tempting incentive to kill the company in 95% of the cases.[35] There is empirical evidence that management stock options in fact increase the risks that management imposes on their company.[36]

There may well be offsetting factors that modulate the incentive for suicidal risk and keep it under tolerable control. It is possible the CEO of Company B will not take the scheme on these facts because his job is worth more than $4.5 million to him. CEOs tend to be more risk averse than properly diversified shareholders. This is because the CEO tends to have his whole livelihood and expertise tied to the company he works for, whereas diversified shareholders can take some losses on any one stock position without breaking stride. Thus, it might take a more valuable option—perhaps one with a 98% chance of failure—before the CEO will go for the suicidal risk. Some have argued that stock options are part of a well-modulated compensation scheme, in which executive conservatism is offset by options that make them risk seekers because they are under diversified.[37] In a world where CEOs and top management are the company, however, the usual situation is that there is nobody who will engineer risk or options who also has the motive to adjust the risk properly. The option that set up the incentive for the suicide was reported to the shareholders monitoring the manager as being cost free.

Shareholders need an absolute prophylactic rule to protect themselves: do not give CEOs positive value from doing dreadful things to shareholders. From that rule a second one follows: do not make anyone an option holder who is deciding what level of risk a company should

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35. The hypothetical in the text bears some passing resemblance to Corning Glass, which went from $20 a share in a mature industry to $113 and then down to $1.45 as a fiber optics maker, but I have not tried to determine the degree to which management stock options contributed to the shift to high risk. *See* http://www.shareholder.com/corning/stocklookup.cfm (stock prices from June 25, 1999, Sept. 1, 2000 and Oct. 14, 2002, respectively) (last visited Nov. 6, 2004).

36. *See, e.g.*, Jouahn Nam et al., *The Effect of Managerial Incentives to Bear Risk on Corporate Capital Structure and R&D Investment*, 38 FIN. REV. 77 (2003) (showing that management stock options incentives for more risk yield increased leverage and R&D investment); *cf.* Richard DeFusco et al., *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 J. FIN. 617 (1990) (finding that management stock options increase risk, resulting in a decrease of bond value but an increase in stock value).

37. *See, e.g.*, M. P. Narayanan, *Form of Compensation and Managerial Decision Horizon*, 31 J. FIN. & QUANTITATIVE ANALYSIS 467 (1996); M. Andrew Fields & Phyllis Y. Keys, *The Emergence of Corporate Governance from Wall St. to Main St.: Outside Directors, Board Diversity, Earnings Management, and Managerial Incentives to Bear Risk*, FIN. REV. 1 (2003) (reviewing the literature with an emphasis on cases in which decreasing management risk aversion *improves* decisions about firm investments).

undertake, as option holders will not share in the pain from shareholder losses. Only managers who share in the shareholders' losses will seek to avoid them.

An option holder's indifference to loss is not duplicated if management is given stock of the same value, rather than options. If stock granted to the executive goes down in value, the executive, as owner, is hurt. Yet stock compensation is not a panacea that will guarantee that management will be loyal to shareholders, even if management stock ownership is substantial. A manager with a 1% stock interest in the employer corporation, for instance, would still want excessive compensation, even if 1% of the excess is clawed back by losses on stock that he or she owns. Managers can sell short or buy put options or derivatives that will protect them from loss for a period of time. Managers also learn about bad news before the general public does, and they can usually sell their stock early enough to avoid the consequences of impending doom, even doom that they themselves caused. Still, option holders are by nature indifferent to losses during the option period, whereas actual shareholders are not. Overall, even if stock compensation does not alone guarantee management loyalty to shareholders, stock compensation is superior to stock option compensation because of the option holder's immunity from risk of loss.

B. MANAGING THE TERRIBLE DISCOUNT RATE

1. The High Cost of Stock

It is likely that both stock and stock option compensation would be rare without the accounting camouflage available on no-initial bargain options, because of the high discount rate on stock. Stock options, if successful, require the employer to issue stock, and stock is the most expensive way to pay future cash.[38] Stock has value because of the future cash that will be paid out on the stock. The fair market value of stock is nothing but the discounted present value of the cash that the market expects in the future. Stock gives a premium return, not adequately explained by risk, and what is premium for the investor is extraordinary cost to the issuing corporate employer.[39] The high discount rate means that the corporation must pay out a large amount of cash to support a quite modest present value.

38. Calvin H. Johnson, *Stock Compensation: The Most Expensive Way to Pay Future Cash*, 52 SMU L. REV. 423, 424 (1999), *reprinted in* 85 TAX NOTES 351 (1999).

39. *See, e.g.*, Jeremy J. Siegel & Richard H. Thaler, *Anomalies: The Equity Premium Puzzle*, 11 J. ECON. PERSP. 191 (1997) (collecting the research showing a high (and not fully explainable) premium paid on stock).

Alternatively stated, the discount imposed by the market, and even more so by executives, means that the present value of the cash to be paid out on stock is very low. Debt, by contrast, is very cheap. The underlying discount rate on fixed obligation is much lower than for stock and the discount rate on debt, called interest, which is usually deductible for tax.

Assume with a simplified model that an employer, Company B, gives Executive X a share of its stock that Company B will redeem in cash at its value in *n* years in the future when the share has reached a value of $1000.[40] Assume that the stock is now worth $100. Next assume, just for simplification, that the Company B gives no dividends on its stock between the present and time *n*. The stock is worth $100 now because that represents the discounted present value of the $1000 cash at *n*, at the discount rate R the market uses to value Company B stock. The following equations are illustrative:

Equation (1): $\$100 = \$1000/(1+R)^n$

Equation (1) is just another form of the statement that the stock will grow in value at rate R over period *n*.

Equation (1A): $\$100*(1+R)^n = \$1000$
Multiplying both sides of (1) by $(1+R)^n$

Growth rate R also represents an interest-like annual rent that Company B would have to pay to the market for giving it equity capital. If Company B sold its stock at the present value point, it would get only $100 from the proceeds of sale and the $1000 it pays out represents the company's cost of convincing the equity market to buy its stock initially for $100.

Over the last 75 years, the average growth rate on stock of large American corporations has been 10.76%.[41] If we use that typical growth rate as the rate on Company B's stock, then *n* will be a period of 22.5 years, because:

Equation (2): $100*(1+10.76\%)^{22.5} = 1000$, thus,
$\$100 = \$1000/(1+10.76\%)^{22.5}$
net present value of stock.

40. If Company B does not redeem the share at that time, it is of no advantage to the corporation. The market assesses the stock as worth $1000 because that is the discounted present value of the cash the share is expected to yield under its legal right to share in all distributions after point *n*.

41. Ibbotson Associates, *supra* note 6, at 22.

By contrast, Executive X would get more present value out of the $1000 that Company B will pay in 22.5 years if the discount rate were lower. The same 75-year sample used for stock shows the interest rate on large corporation bonds is 5.8%.[42] Assume, on the basis of that sample, that the market will accept 5.8% annual return for payments with respect to Company B's corporate bonds (even while demanding 10.76% annual return for future cash with respect to stock). If we assume that interest is reinvested in Company B bonds or is not paid so that interest compounds, then that rate can be used as the discount rate for the $1000 for the full 22.5 years. The present value is then almost three times better than $100 at $281:

Equation (3): $\$281 = \$1000/(1+5.8\%)^{22.5}$
which the net present value of the debt form.

Assume reasonably that the secondary market will use the same discount rates – typically 5.8% for debt and 10.76% for stock. Thus, Executive X could sell the bonds' $1000 immediately for $281, whereas X could sell the stock representing the same future cost to Company B for only $100. Debt gave Executive X more value Company B's $1000 payment, just because debt had a lower discount rate.

It is possible to describe the same phenomenon by keeping the executive's present value constant between the debt and the stock while allowing the corporation's ultimately cash outlay to vary. Company B can give $100 dollar value to Executive X by paying $1000 in 22.5 years. But, at a discount rate of 5.8% compounded, Company B can give $100 of transferable debt to Executive X by paying out only $344.57 in 22.5 years, because:

Equation (4): $\$100*(1+5.8\%)^{22.5} = \$344.57$

When the discount rate goes down, either Executive X will get more present value ($281 versus $100) or Company B will have a lower cost ($344.57 versus $1000), or possibly some of both will occur. That is how the discount rate drop has to work.

It is possible to drive the discount rate on debt to executives even lower. Corporate bonds, as unsecured debt, carry some risk. Securing the debt with corporate assets means that the debt will be paid ahead of other creditors and so the risk is lower. With a lower risk the interest rate should

42. *Id.*

drop. If we assume, for example, that the interest rate is only 5%, then the set $1000 future payment has a present value of $333.

Executives will value future payments like the $1000 using their own discount rate, drawn from the best after-tax return rate that is available to them. Executives' own discount rate will commonly make the bond present value go even higher. Corporate debt is not usually the source of the best after-tax return for high tax bracket taxpayers like Executive X because the interest from debt is taxed at high rates annually. Tax exempt or tax advantaged investments usually are better investments after tax. There is a drop on the yield on tax advantaged investments (which is sometimes called the implicit tax) to reflect tax advantages, but historically the drop has not been as large a burden as the burden of paying tax in high brackets.[43] Assume that Executive X gets 4.5% from tax exempt bonds when comparable low risk taxable bonds are paying 5%, and that Company B transfers a tax-exempt zero-coupon $1000 bond maturing in 22.5 years. The bond will have a present value or principal amount of $371 because that represents the discounted present value of $1000:

$$\text{Equation (5): } \$371 = \$1000/(1+4.5\%)^{22.5}$$

Equation (5) also describes the present value to Executive X of a reliable payment of deferred compensation of $1000, payable in 22.5 years. If Company B reliably promises to pay Executive X $1000 at *n* years, Executive X, who gets 4.5% return from his best alternative investments, will value the $1000 as equal to $371 present value.

The present value of Company B's $1000 cash payment at Executive X's 4.5% discount rate is not quite four times higher than the present value of Company B's $1000 cash payment at the 10.76% discount rate for stock. Quite plausibly by using stock instead of the best alternative plan, Company B will take away almost three-quarters of Executive X's value from the $1000 payment, reducing the present value of X's compensation down from $371 to $100.

The problem of a high discount rate can be viewed from the other side as a problem of high cost to Company B as well as low present value for Executive X. To give $100 of present value now, the corporation must pay $1000 in 22.5 years. Debt is much cheaper to the company and debt is deductible. At a 35% tax rate, the 5.8% interest has a cost of only 3.8%

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43. *See* Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 23 (2003) (showing data that the drop in interest rate reflecting the tax exemption is below 10%).

after tax. To give Executive X $100 now with debt requires payment in 22.5 years of only $230. Yet if Company B can secure the debt and drop the interest rate down 5% before tax and 3.25% after tax, then Company B can give Executive X the present value at the cost of only $205, instead of $1000. The switch from debt compensation to the alternative stock compensation increased Company B's ultimate cost by five times for the same current benefit to Executive X.

Corporate cost also commonly needs to be separated from executive benefit just because executives sell the compensation instrument long before the corporation needs to redeem it. Stock is usually a very long term instrument. Corporate debt has a fixed term, but it is usually replaced at the end of its term, so that if you view the debt and its replacements as a common pool or chain, debt too will last indefinitely. Executive X will commonly sell a very long term instrument before it is redeemed just to get some use out of it during X's life. The obligation of Company B, however, will continue for what may be many years after Executive X sells to get cash value. If we assume both stock and debt will be redeemed after 75 years, which is the full length of the Ibbotson Associates sample, then corporate debt will be redeemed at cost of $100*(1.038)^{75}$, which equals $1,605, whereas stock of $100 will be redeemed for $100* $(1.1076)^{75}$ or $213,000.[44] The cost of the stock at $213,000 is 133 times more expensive in real cash than the debt at $1,600.[45] Ironically, the stock could be considered free when issued under zero-costing of options, but debt is never free when issued under accounting standards and it was the "free" stock that turned out to be 133 times more expensive than the debt.

For the more successful company, stock is even more expensive. Debt has the tendency to become cheaper as the success of the corporate employer improves because the corporation becomes a better credit risk and gets lower interest rates. Stock, however, is a compensation plan with the payment contingent on the success of the company. The better the company does, the more expensive its stock becomes. If we assume a company with a 12% growth rate, appropriate for smaller, riskier

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44. *See* Ibbotson Associates, *supra* note 6, at 22.

45. According to the Ibbotson Associates figures, inflation over the 75-year period of its sample has been 3.1% per year. Ibbotson Associates, *supra* note 6, at 22. Over 75 years, a dollar is worth only $1/(1+3.1%)75 or 1/9.9 or roughly 1/10th. In inflation adjusted dollars, the stock requires payment of $21,300 per $100 present value and the debt requires payment of $160 per $100 present value. The ratio is still 133 times greater for stock. To get the real meaning of future dollars, there should always be an inflation adjustment. Still, as long as debt and stock are compared by ratio at the same time, the inflation adjustment does not make any difference to the analysis.

companies, then the corporation's cost for $100 stock will be $100* $(1.12)^{75}$ or $491,300 cash for each $100 of stock, which is over 300 times more expensive than the debt. An executive who issued a modest stock bonus of $1 million, for instance, will ultimately command that the corporation pay $4.97 billion in cash.[46]

2. Avoidable Costs

Stock has a high discount rate and low value per dollar devoted to the executive for many reasons, yet these factors are easily avoidable within compensation plans. Individual stocks are highly volatile investments and the market hates volatility. The market also discounts the value of accumulated earnings by reason of distrust of management, but distrust of management is not a necessary element when it is management that is getting paid.

a. Volatility

A rational investor is risk averse, because losses hurt asymmetrically more than gains help. Everyone satisfies his or her own most desperate needs first before lesser priorities. Losses, therefore, cut into more desperately needed funds. Gains add less crucial funds. Losses tend to cut into muscle, then bone, while gains tend just to add fat. Stock, even a portfolio of stocks, is highly volatile, risking substantial losses. The premium discount rates that the stock market demands from the issuing corporation are to compensate for the volatility. If the future cash flows that support current value may or may not appear, the market will discount those future values at a brutal discount rate.[47] The premium discount rate on publicly traded stocks is evidence that investing shareholders do not like volatility. Discount rates on investments that owners like are low; businesses such as interesting boutiques and restaurants, for instance, often give low or negative monetary return rates.

Executives suffer from volatility even more than the market as a whole because their stake tends to be too heavily concentrated in one firm. A single stock is much more volatile than a diversified portfolio.[48]

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46. Given inflation, the $4.97 billion is roughly *only* 1/2 a billion in uninflated dollars. *See supra* note 45.

47. *See* BREALEY & MYERS, *supra* note 4, at 158-60 (discussion of short-term stock volatility).

48. *See id.* at 153, 165-69, 178-79.

Executives tend to be especially under-diversified.[49] Executives shape their skills over time to fit the needs of the firm that they are working for and they cannot transfer their skills to another firm without significant loss. Given the heavy dependence of executives' future salaries upon the corporate employer, it magnifies the executives' risk to put significant investments from past salaries in the corporate employer as well. Executives should not put all their eggs – both investments and future salary – into one basket.

The market, by contrast, appears to assume that shareholders have diversified portfolios. The market return will be a premium only for returns unique to the firm and will not cover the pain that can be avoided by diversification. [50] Thus, single-stock positions hurt executives more than the market premium for risk will cover. For this reason, it would be unsound to advise an executive to invest in the stock of his or her own employer.

Consistently, undiversified executives rationally undervalue the options given to them by their company. Because executives are not diversified, as Black Scholes implies they should be, executives should rationally view options as worth only a fraction of the Black Scholes value of the options. [51] Executives, in fact, routinely complain that Black Scholes over-values their options.[52] Given that executives are so routinely under-diversified and that they so undervalue risky options, options are wasted on executives.

Most of the volatility on stock serves no incentive purpose. It appears that approximately 80% of volatility on a share of stock arises from industry-wide or stock-market-wide factors over which the employee has no control.[53] Thus, even if this executive could claim responsibility for all

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49. *See* Henry T. C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 318-22 (1990) (emphasizing undiversifiable human capital).

50. *Id.* at 291-94. *See also* William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425, 441-42 (1964) (market price for stock adjusts to only undiversifiable risk); Robert H. Litzenberger, *Equilibrium in the Equity Market Under Uncertainty*, 24 J. FIN. 663, 665 (1969).

51. Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 7, 8, 11 (2002) (see especially, figure 2.1, computing value of option to executive finding value to executives is far below Black-Scholes especially as to deep in the money options which represent significant fraction of executive wealth).

52. *Id* at 7.

53. *See* Jeffrey Kerr & Richard A. Bettis, *Boards of Directors, Top Management Compensation and Shareholder Returns*, 30 ACAD. MGMT. J. 645, 659 (1987). *See also* James J. Angel & Douglas M. McCabe, *Market-Adjusted Options for Executive Compensation* (January 31, 1997), *at*

of the value changes in the corporate employer, 80% of the change in stock price would still be random with respect to merit of the executive. This makes stock like a lottery ticket: the lazy can get lucky while the virtuous suffer losses. The loss side of volatility that the executives cannot control is especially painful. Executives have mortgage and tuition payments to make and a reasonably high standard of living that they do not want to lose. Bringing unnecessary and random volatility into the calm employment relationship is like bringing toxic waste into your living room.

b. Market Paranoia

The high discount rates on corporate stock also arise because the market is deeply suspicious of what management will do with undistributed earnings. The market does not receive very good information from corporations about their capital projects. In the absence of reliable information, the market presumes that every investment project the corporation will make will be a lemon, as some surely are.[54] The market also assumes that managers are going to waste undistributed earnings on self-indulgent projects or steal the earnings as excess compensation. The market has a strong sense of "a bird in the hand is worth two in the bush," and values dividends as cash in hand by enough that dividends actually improve share value. This is true even when taking into consideration the fact that dividends reduce corporate assets and that there is an immediate shareholder tax on dividends.[55] Stock has a high discount rate in part

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3052 (last visited Nov. 6, 2004) (finding that 41% of variance of individual firm stock is explained by variance of stock market as a whole, but not attempting to identify or filter out industry wide variance).

54. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 495 (1970) (arguing that markets are destroyed when buyers have inaccurate information because they underbid for assets based on the assumption that the asset is as bad as possible); Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371, 371-72 (1977) (arguing that information asymmetry will drive down the price of stock and prevent a corporation from using stock to fund projects with positive value); Paul K. Chaney & Craig M. Lewis, *Earnings Management and Firm Valuation Under Asymmetric Information*, 1 J. CORP. FIN. 319, 333-34 (1995) (applying the "lemons" argument to share valuation under bad accounting information); R. Glenn Hubbard, *Capital Market Imperfections and Investment*, 36 J. ECON. LITERATURE 193, 193-95 (1998) (arguing that shareholder-level investors with imperfect information about investments impose discounts that corporate-level managers do not need).

55. *See* Eugene F. Fama & Kenneth R. French, *Taxes, Finance Decisions, and Firm Value*, 53 J. FIN. 819, 840 (1998) (showing that the positive value dividends serve by giving

because the market does not trust the corporate managers in advance. The corporation pays a high cash return to investors because that high cost is needed to overcome the distrust.

The discount arising from market distrust of management has no place in the compensation relationship between the CEO and the artificial entity the CEO manages. Top managers *are* the insiders that the market distrusts. The CEO cannot distrust the CEO. It would be over compensating the CEO to allow him to recover the high return resulting from the market distrust of the CEO. It would be comparable to paying out on a fire insurance claim to an individual that has not suffered any fire loss.

Both the toxic volatility and the market distrust of insiders can be filtered out of a compensation plan, however. A company may still use the appraisals of value by the stock market to measure the executive's reward, but only if the employer gives up on the possibility of zero-cost accounting.

3. Filtered Phantom Stock

If zero-cost accounting for compensation were not available or were not an issue, it would be relatively easy to filter out much of the random pain from stock volatility without losing any of the true incentive value of stock. Filtering out toxic volatility and market paranoia would drop the discount rate to the benefit of the executive, the corporation, or both.

Executive X, for example, might be given units of an industry-indexed phantom stock deferred compensation plan. An initial unit might be worth $100 and could be redeemed for cash from the employer at the end of 10 years. The index that determines the average growth would be constructed from a portfolio of stocks of other corporations in the same industry, weighted for the size of the corporations. If Company B's stock grows at a rate higher than the average for the company's industry, the redemption price of the unit will grow above $100. If Company B's stock performs exactly at the industry average, the unit will remain constant at $100. If the employer stock performs at less than the industry average, the executive would receive less than $100. If Corporation B's stock performance is relatively better than its industry's competitors, the executive could potentially get a significant augmentation by subtracting out the industry average, even if the industry as a whole faces a decrease in stock price. [56]

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reliable information completely masks the tax effect, so that there is no hint of dividends reducing value).

56. There have been a number of suggestions to filter out market-wide volatility. *See* Rick Antle & Abbie Smith, *An Empirical Investigation of the Relative Performance of Corporate Executives*, 24 J. ACCT. RES. 1, 32-35 (1986) (arguing that taking systematic risk

Using the stock market, with an industry index subtracted, is a better idea than a profit-sharing plan. Profit-sharing plans almost always depend upon "profits" as defined by Generally Accepted Accounting Practices ("GAAP"). In high theory, GAAP accounting should be giving potential investors information that is as good as management can get internally about capital investment projects. In fact, however, GAAP is an archaic system at its core, with many evidences of inflexible age.[57] GAAP rarely gets either their description of corporate investment in intangibles or depreciation right. Conversely, the stock market value, with random volatility filtered out, depends on assessments generated by well-funded buyers and sellers who are trying to figure out value to serve greedy self-interest. By and large, the greed-motivated stock market assessments will do a better job of measuring value than GAAP "profits."

The corporate employer should readily substitute $100 units of such a deferred compensation plan for $100 of immediate cash compensation or for fixed amounts to be paid in the future worth $100. Fixed compensation has the very considerable draw back of paying the executive for showing up, but not necessarily for improving owner value. As Jensen and Murphy have argued, if a corporation pays their corporate managers like fixed salaried bureaucrats, the corporation should not expect the managers to act like value-maximizing entrepreneurs.[58] From the corporate point of view,

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out of stock volatility reduces risk to executives without reducing incentives). There have also been a number of suggestions to filter out market-wide risk on options by indexing the exercise price. *See* James Angel & Douglas McCabe, "Market Adjusted Options for Executive Compensation," *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3052 (last visited Jan. 31, 1997); Aigbe Akhigbe, Jeff Madura & Alan Tucker, *Market-Controlled Stock Options: A New Approach to Executive Compensation,* 9 J. APPLIED CORP. FIN. 93, 96 (1996); Mark Ubelhart, *Business Strategy, Performance Measurement and Compensation,* MIDLAND CORP. FIN. J., Winter 1985, at 67, 74. *See generally* Alfred Rappaport, *New Thinking on How to Link Executive Pay with Performance,* HARV. BUS. REV., Mar.-Apr. 1999, at 91 (hedges his endorsement of strict indexing, however, so as to ensure that even under-average management gets some extra pay out); Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance,* 3 STAN. J. L. BUS. & FIN. 31 (1997); *see also* Lucian A. Bebchuk, et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation,* 69 U. CHI. L. REV. 751, 796-801 (2002). The proposals to index option exercise price for market risk do not do anything about the loss-stripping aspects of options that give management the incentive to go into suicidal risk, and hence are not endorsed here.

57. Calvin Johnson, *GAAP Tax*, 83 TAX NOTES 425, 429 (1999), for instance, is critical about the quality of GAAP theory and information. *See also* BREALEY & MYERS, *supra* note 4, at 339-40, for another discussion of GAAP distortions.

58. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives – It's Not How Much You Pay, But How,* 68 HARV. BUS. REV. 138, 138 (1990).

an executive replaces his or her cash compensation entirely with $100 units making an acceptable substitution.

Rational executives, however, should have trouble substituting $100 in current cash for $100 of filtered phantom stock, even with compound interest that matches alternative investments. Filtered stock involves risk. There is an optimism bias to self assessment: most people who drive automobiles consider themselves to be above-average drivers,[59] and most executives will believe themselves to be above-average on business consequences that they can control. Executive control and optimism bias will help maintain the present value of a filtered phantom stock unit near to $100. Undoubtedly, executive behavior on valuation should be tested empirically: the basic rental or interest addition on a $100 unit should be set so that executives will choose to take a substantial percentage of their compensation, perhaps half, in filtered phantom stock.

Filtered phantom stock cannot be reported as cost free on financial statements. Even the no-initial-bargain stock options that are reported as free must have a fixed exercise price that cannot be adjusted for an industry or market wide index. Accordingly, for a filtered plan, the amount promised according to facts as of the end of the year is a booked cost. The ultimate payment is just a payment of a previously arising liability and is not a cost except to the extent that there is a change in the amount paid to the executive that was not previously booked. The availability of zero-costing for terrible incentive systems, like stock options, gets in the way of rational design of an incentive system for executives.

Filtered phantom stock will never give the employee any capital gain, but as explained next, employee capital gain is almost always a bad idea.

C. AVOID CAPITAL GAIN

Stock-based compensation plans are sometimes adopted because they give employees favorably-taxed capital gain. Employee capital gain, however, is almost always worse tax planning than is deferred compensation, which delays the taxation of capital. Even when there is no capital, plans that give up employee capital gain usually lose the employer deduction for compensation and the employer deduction is almost always more valuable than capital gain.

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59. JAMES R. BETTMAN ET AL., *Cognitive Considerations in Presenting Risk Information, in* LEARNING ABOUT RISK: CONSUMER AND WORKER RESPONSES TO HAZARD INFORMATION 15, 17 (1987).

1. Delay Tax to Avoid Capital Gain

Capital gain is taxed at a lower rate than ordinary compensation.[60] It is not uncommon for tax planners to try to get capital gain to their favored insider executives so as to get them the benefit of lower tax rates. One way this is accomplished is by transferring stock immediately before the company goes public or right before some large appreciation in the stock is anticipated. Capital gain rates are typically 20 percentage points lower than tax rates on ordinary income compensation.[61]

Creating employee capital gain in such circumstances is short-sighted tax planning. The parties would be better off deferring the stock transfer until *after* the large appreciation has occurred when the executive needs the cash. Deferred compensation is superior to capital gains. The deferral gives a tax benefit that is usually as good as or better than paying zero rates on capital gains. The equivalence of deferred compensation and zero capital gains is a branch of what is sometimes called the Cary Brown Thesis.[62] The deferred compensation plan is the more tax efficient choice by the amount of the capital gain tax.

Assume, for example, corporate employer Company B, whose stock goes up from $100 to $1000 a share over some period of time. We can describe the appreciation in terms of growth or appreciation of the stock at annual rate R over period *n* under the compound growth formula so that $100* $(1+R)^n = \$1000$. With a very high R, *n* can be very short, perhaps two years, but there is no need to specify what period *n* or rate R is. Let us compare two plans for the $100-to-$1000 appreciation by which Company B can pay Executive X. One plan gives X the $100 immediately so that the pending appreciation to $1000 will qualify as capital gain. The other is a deferred cash compensation, giving Executive X $1000 only at the terminal point (year *n*).

The comparison is clearest if we assume a phantom stock deferred compensation plan that matches the appreciation of the stock. Under the

60. I.R.C. § 1(h)(1)(C), (West 2004) (gives a general 15% maximum tax on individual capital gain).

61. I.R.C. § 1(i)(2) (West 2004) (gives a maximum tax rate of 35%).

62. See, e.g., E. CARRY BROWN, BUSINESS-INCOME TAXATION AND INVESTMENT INCENTIVES IN INCOME EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948); Dep't of the Treasury, Blueprints for Basic Tax Reform 123-24 (1977); Stanley S. Surrey, *The Tax Reform Act of 1969—Tax Deferral and Tax Shelters*, 12 B.C. INTL'L & COMP. L. REV. 307 (1971).

phantom stock plan, X gets cash when X wants it, here $1000, at the terminal point. Executive X's tax will decrease the amount that he can keep. Tax at X's rate t_x will reduce the compensation to an after tax fraction of $(1-t_x)$.

Equation (6): $\$1000^* (1-t_x)$

With a maximum tax rate of 35%, the executive, under (5), gets to keep $650.

Assume, for comparison, that Company B gives Executive X non-deferred compensation but transfers the stock itself to executive X before the ten-time appreciation. Tax has the same effect on the starting $100 as it has on the ending $1000 so that the compensation to X at the starting point is $\$100^* (1-t_x)$ after tax. If we assume reasonably that X sells the stock immediately at no gain or loss to pay his or her tax, then the executive will have $65 worth of stock after tax. The ten-times appreciation of the stock will give the executive $650 *before tax* at the terminal point:

Equation (6A): $\$100^* (1-t_x) (1+R)^n = \$100^* (1-t_x) * 10 = \$1000^* (1-t_x)$.

With tax at 35%, expression (6A) becomes $650.

Note that equation (6A) is the same as equation (5). The executive has the same after-tax position with deferred compensation after the ten-times appreciation, as X would have (before tax) if given the stock before the appreciation.

Equation (6A), however, fails to reflect the capital gain tax that Executive X must pay on stock at sale. The appreciation, to the extent of nine-times original value, is capital gain. Algebraically, X's after tax position is:

Equation (7): $\$1000^* (1-t_x) - cg^* [\$100^* (1-t_x) * (1+R)^n - \$100^* (1-t_x)]$,

where cg is capital gain tax rate. The expression within the bracket in equation (7) is a not-so-elegant expression of the fact that capital gain tax is imposed only on appreciation over basis so that the original basis must be subtracted out.

The capital gain tax in equation (7) at the rate of 15% drops Executive X's compensation by $15\% * 9 * \$100^* (1-t_x)$ or $15\%* 9 * \$65$ or $15\% * \$585$ or $87.75. The Executive with capital gain thus ends up with $650-

$87.75 tax or $562.25. Expression (7) is below the phantom stock deferred compensation by exactly the amount of the capital gain tax.

Comparison of expression (6) and expression (7) yields the conclusion that stock given to the employee should be given only when the employee wants cash. Give the stock early and the appreciation will be subject to capital gain tax. Yet, capital gain tax can be avoided by mere deferral of the taxable compensation.

Capital gain tax is not imposed until the executive sells the stock. If the executive does not need the cash, then the sale can be delayed, and the deferral in tax by delaying the sale reduces the real burden of the tax to lower than the nominal 15%. Delaying any burden drops the present value cost of the burden. Of course, deferred compensation can also be delayed, in parallel, to give cash only when the employee needs it. Moreover, even if the executive succeeds in deferring capital gain tax indefinitely and dropping the capital gain rate to almost zero, he or she will just succeed in getting back almost to expression (6A) and (5), that is, the position achieved by mere deferral. Capital gain tax becomes zero if the executive dies because heirs get a step up in basis.[63] Deferred compensation, described in expression (5), however, will allow the executive to have the benefit of a zero capital gain rate with the considerable advantage that X does not need to die.

The most important limitation to the Cary Brown thesis and to the equivalence of expressions (5) and (6A) is the assumption that the amount invested and hence, the amount of appreciation is sensitive to the executive tax on early transfers. Sometimes for stock options there is no tax initially, and sometimes the parties will succeed in undervaluing stock transferred early that the early tax will be paid by borrowing or from other funds and not by reduction of the amount of the stock or the amount of the appreciation. Still, as explained in the following section, all capital gain plans entail loss of the employer deduction, and the employer deduction is almost always more valuable than the incremental advantage of capital gain.

2. Take the Employer Deduction Instead of Capital Gain

Employee capital gain is also usually bad tax planning because the employer gets no tax deduction for amounts qualifying as capital gain to the employee. The employer deduction is almost always more valuable than the advantage of getting capital gain rates.

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63. I.R.C. § 1014(a)(1) (West 2004).

It is fairly common for a corporation to plan to give employees capital gain while avoiding the upfront tax on capital. Expression (5)(deferred compensation) was more valuable than expression (6a)(stock taxed immediately) because the employee lost capital in expression (6) immediately and hence, lost some of the ten-times appreciation, but that premise, immediate tax on capital, can sometimes be avoided.[64]

All employee capital gain planning, whatever its stripe, shares the common detrimental principle that the employer gets no deduction for the amount of the employee capital gain. Deferred compensation can give the same economic benefit, even mimicking stock appreciation, while preserving the valuable employer deduction. Almost always the employer deduction is worth more than the value of transferring the compensation from ordinary income to capital gain. Capital gain at 15% is typically 20% below the maximum tax on employment income (35%) but that 20% spread is less than the 35% tax lost by losing the employer deduction. When employer and employee talk to each other and realize that they are in the same economic pool, they should always conclude that the employer deduction needs to be preserved even with the sacrifice of employee capital gain.

Assume for example that Company B gives Executive X an option to purchase its stock for $100 at a time when the stock is worth $100. Because there is no initial bargain the option may be reported on financial statements as having no cost, and the option qualifies. Assume the executive exercises the option, holds on to the stock for two years, and sells the stock for $1000. The executive will have capital gain in the amount of $1000 minus the $100 cost or $900:

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64. I.R.C. § 421(a)(1)-(3) (West 2004) (providing that the employee will have no income from a qualified stock option, the employer will have no deduction, and the employee's basis shall be just the price paid). Qualification for employee capital gain from incentive stock options is subject to a number of restrictions. I.R.C. § 422 (West 2004). The option cannot last for more than 10 years. *Id.* There must be no initial bargain between value and exercise price when the option is granted. *Id.* The option cannot be saleable by the employee. *Id.* The employee must hold onto the stock acquired by exercise of the option for a least a year after the option is exercised and for at least two years after the option is granted. *Id.* Options vesting per year may acquire no more than $100,000 worth of stock. *Id.*

A program called "employee stock purchase plans" also constitutes an opportunity to give employees capital gain. I.R.C. § 423(b) (West 2004). Under employee stock purchase plans, there can be an initial bargain of up to 15% but the option price must be adjusted so that the bargain by exercise of the option never exceeds 15% of fair market value. Employee stock purchase plans must be given to full time employees, employed for more than 2 years, pro rata to salary, and they cannot be offered to shareholders who already own 5%. *Id.*

(7) ($1000-$100) – cg* ($1000-$100).
With capital gain rate of 15%, expression (7) become $765

Now assume, as an alternative, that Company B gives executive X stock-appreciation-rights (SARs) deferred compensation. Under the SARs plan, X will be able to call on cash that will match the amount of appreciation on a fixed number of shares of stock when he needs the cash. Tentatively, with same facts as that for expression (7), X will get $900 pre-tax.

The cash payment will, however, be deductible to the employer. The deduction will serve as a reimbursement, in that the tax saved by deducting the compensation will save tax the employer would have paid absent the deduction. At the terminal point when the SARs are paid out, there exists some increased compensation amount A, such that $A - t_c*A = \$900$, where t_c is the employer's tax rate. Since $A- t_c*A = \$900$, so $A*(1-t_c) = \$900$ and $A = \$900/ (1-t_c)$. An employer willing to pay $900 to executive X at the terminal point in absence of tax should be willing to pay $\$900/(1-t_c)$ to X with the help from its deduction, because that is the same after-tax burden, once the deduction is considered.

The payment of $\$900/(1-t_c)$ will be subject to the executive's ordinary income rates (35%) rather than to just capital gain rates (15%). Algebraically, the executive can keep A*(1-x). Considering both the augmentation of the SARs payout by the employer deduction and the shrinkage due to executive tax, the final after tax position of the executive will be

(8) $\$900* (1-t_x)/ (1-t_c)$

With both t_c and t_x at 35%, expression (8) turns out to equal $900, that is, the deduction and executive tax offset each other completely. Expression (8) is more than Expression (7) by exactly the 15% capital gain imposed in Expression (7).

Expression (7) describing a plan to give the employee capital gain gives the employee significantly less for the employee–after-tax than expression (8) describing a plan to give the employee ordinary income because expression (8) preserves the employer deduction. Expression (7) and (8) described stock options and the matching SARs, but the lesson that employee capital gain is a bad idea generalizes for other plans or schemes

to give employee's capital gain. Plans that give the employer a deduction for compensation should be used instead.[65]

The most serious limitation on the inferiority of employee capital gain is not economic, but relates to the availability of accounting camouflage. The deferred compensation of expression (8) had the drawback (for the executive) or the virtue (for outside investors, for the shareholders monitoring executive pay, and for the health of the economy as a whole) of not being eligible for zero-costing of the CEO's pay under current financial reporting. Expression (8) assumes that the corporate employer will increase compensation to reflect its deduction because it can augment or gross up the compensation at the same after tax burden if the deduction is available. Employee capital gain in expression (7), however, is not a charge to earnings and if the corporate employer is massaging earnings reports, as happens, then it cannot use deferred compensation. An employee who suggests that the compensation should shift from capital gain plan to one with a corporate deduction might well find that the move means not a raise to reflect the corporate deduction, but a cut to reflect the new charge to earnings.

There is considerable amount of employee capital gain planning that goes on, even though it is bad tax planning, because the costs to the corporation are disregarded. Executives, for example, commonly get low value stock, pumped out before a public offering, so as to qualify for capital gain on the appreciation. If the planning is done looking to both executive and corporation as a common interest, or if the compensation is grossed up by $1/(1-t_c)$ to reflect the corporate deduction, then the parties would go for the corporate deduction and not the employee capital gain. But management in charge does not consider the corporate deduction because any cost borne by the public or by the corporation is other people's money. Capital gain plans often adopted leave money on the table, or at

65. Gain from incentive stock plans over price paid for the stock is taxable to the employee as capital gain, even if the exercise is after death. I.R.C. § 421(c) (West 2004). Sometimes, however, the employee's capital gain will be forgiven upon death of the employee by reason of the general step up in basis at death. I.R.C. § 1014(a)(1) (West 2004). For example, if the employer succeeds in getting undervalued property to the employee, the gain will not be a growth of upfront taxed capital and the capital gain tax will become a zero rate tax upon death of the executive. After employee's death expression (7) will be $900 and the expression (8) will be greater or less than $900 depending upon whether t_x or t_c is greater. If employee capital gain were limited to its rational scope of appreciation realized post death on property significantly undervalued when transferred, then employee capital gain would have only a trivial niche. For employees who have a tax rate t_x lower than the corporate employer's tax rate t_c, employee capital gain planning would be bad planning even for amounts realized post death.

least make money for the taxing government, simply because management in charge has no loyalty to the corporation they manage.

CONCLUSION

Current accounting standards allow a company to report a stock option with no initial bargain between exercise price and stock value as if the option were cost free. Zero-costing of such options is not a good faith appraisal of either cost or value, but corporate managers favor the rule because they can get more pay if they can report their pay as free to their employer. With management so strongly in favor of the rule, zero-costing has survived and become more important over time.

Except for the access they give to deceptive accounting, stock options are a terrible way to compensate. Managers with significant options have an incentive to take the company into suicidal risks because option holders do not participate in the shareholders' losses. Both stock and stock options, moreover, are terrible compensation vehicles because stock entails risks over which management has no control and which management does not like. The high discount rate that arises in reaction to risk and outsider distrust of management will mean that the corporation will have to pay out too much future cash for present value given, or that the executive will get too little present value for cash ultimately paid, or both. Filtering out both the risk and distrust, by using a base line of an industry average, would improve the efficiency of compensation without undercutting the appropriate incentive, but any filtering must be done within a plan in which the accounting does not allow the compensation to be reported as cost free.

Stock compensation is also commonly thought advantageous because it gives employees access to low-tax capital gains. In general, however, deferred compensation is almost always better than employee capital gains because capital gain plans require the employee to pay immediate tax on capital and deferred compensation does not. Even when there is no underlying capital to defer, the employer deduction lost in employee capital gain plans is almost always more valuable than the incremental advantage of employee capital gain.

TOXIC MOLD IN TEXAS: WILL RECENT INSURANCE REFORMS CLEAN IT UP FOR GOOD?

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I. INTRODUCTION

"Mold is a ubiquitous substance that predated our arrival on the planet and will likely survive us as well."[1] From moldy bread and cheese to mildew on shower stalls, we see mold all around us. Other than as a household nuisance, it had never posed much of a problem or concern. Recently, however, mold has become a multi-billion dollar concern as claims of major property damage and serious illnesses are blamed on "toxic" mold. The public's heightened awareness of mold and the great cost to remove it has become a major concern for the construction, real estate, and insurance industries.

A. WHAT IS MOLD AND WHEN IS IT TOXIC?

There are over 100,000 different kinds of mold.[2] More than 1,000 strains of indoor molds have been found in U.S. homes.[3] Mold requires three conditions to grow: a suitable temperature, appropriate food source, and adequate moisture.[4] Mold grows within the temperature range of 40 to

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1. *Mold: A Growing Problem: Hearing Before the Subcomms. on Hous. and Cmty. Opportunity and Oversight and Investigation for the House Comm. on Fin. Servs*, 107th Cong., 2d Sess. 1 (2002) (statement of Gerald M. Howard, Executive Vice President, National Association of Home Builders), *available at* http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=156 (last visited Nov. 18 2004).

2. INS. INFORMATION INSTITUTE, *Mold and the Insurance Industry*, *available at* http://www.iii.org/media/hottopics/ insurance/mold2 (last visited Nov. 18, 2004).

3. *State of the Science on Molds and Human Health: Hearing Before the Subcomms. on Oversight and Investigations and Hous. and Cmty. Opportunity for the House Comm. on Fin. Servs.*, 107th Cong., 2d Sess. 2 (2002) [hereinafter *CDC Statement*] (prepared statement of Stephen C. Redd, MD, Chief, Air Pollution and Respiratory Health Branch of National Center for Environmental Health, Centers for Disease Control & Prevention) *available at* http://www.cdc.gov/nceh/airpollution/mold/default.htm (last visited Nov. 18, 2004).

4. Walter G. Wright, Jr. & Stephanie M. Irby, *The Transactional Challenges Posed by Mold: Risk Management and Allocation Issues*, 56 ARK. L. REV. 295, 314 (2003).

100 degrees Fahrenheit, so buildings regulated for our comfort clearly provide adequate temperatures for mold growth.[5] Building materials provide an appropriate food source, so all that is necessary to start a mold colony is the addition of water, which often occurs from leaky pipes or roofs, or as the result of flooding or high humidity.[6] Mold growth occurs extremely rapidly – often within 24 to 48 hours at exponential rates.[7] Most forms of mold are harmless and most people will not have an adverse reaction to them.[8] However, certain individuals are more likely to have allergic reactions to molds, especially people with compromised immune systems.[9]

Certain strains are considered "toxic" and the most prominent types include *aspergillus*, *penicillium,* and *stacybotrys*, which are also known as "black mold."[10] These forms of mold release mycotoxins, which have been blamed on causing various health risks[11] ranging from minor congestion, sore throats, and skin problems to serious aliments such as pneumonia, asthma, migraines, memory loss, and pulmonary hemorrhaging.[12] The validity and scientific accuracy of these claims is very much in dispute.[13] Although the scientific community accepts that people who have been exposed to extreme quantities of mold, such as grain farmers or lumbermen have suffered adverse health consequences, it is unclear whether mere inhalation of these substances would have the same adverse effect.[14]

A recent study conducted by the Institute of Medicine for the Centers for Disease Control and Prevention[15] addressed this issue. The study

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5. *Id.* at 315.

6. *Id.* at 316-17. *See also* Stephen J. Henning & Daniel A. Berman, *Mold Contamination: Liability and Coverage Issues: Essential Information You Need to Know for Successfully Handling and Resolving Any Claim Involving Toxic Mold*, 8 HASTINGS W.-NW. J. ENVTL. L. & POL'Y 73, 74 (2001).

7. Henning & Berman, *supra* note 6, at 74.

8. Thelma Jarman-Felstiner, *Mold is Gold: But, Will it be the Next Asbestos?*, 30 PEPP. L. REV. 529, 532 (2003).

9. *CDC Statement, supra* note 3, at 4.

10. Henning, *supra* note 6, at 81-82.

11. *See, e.g.*, Barbara Bowers, *Mixing – and Separating – Mold and Myth: Experts says it's hard to find scientific facts to support claims of some mold-related health hazards*, BEST'S REV., Feb. 1, 2003, at 45.

12. *See, e.g.*, Jarman-Felstiner, *supra* note 8, at 533.

13. *See* Wright & Irby, *supra* note 4, at 319.

14. Bowers, *supra* note 11.

15. Press Release, The National Academies, Indoor Mold, Building Dampness Linked to Respiratory Problems and Require Better Prevention, Evidence Does Not Support Links to Wider Array of Illnesses (May 25, 2004), *available at* http://www4.nationalacademies.org/news.nsf/isbn/0309091934?OpenDocument (last visited Nov. 6, 2004) [hereinafter *Mold Health Study*].

concluded that mold and damp conditions are associated with certain respiratory problems of asthmatics who are sensitive to mold, as well as coughing, wheezing, and upper respiratory tract symptoms in otherwise healthy people.[16] However, there was not sufficient evidence to meet the strict scientific standards to prove a clear causal relationship.[17]

The evidence also suggested a link between damp conditions and shortness of breath and lower respiratory illness in otherwise healthy children.[18] Additionally, visible mold can cause lower respiratory illness in children.[19] But in both these conclusions, the evidence was not as strong as evidence supporting the study's other observations.[20]

The committee's attempt to analyze some of the more attenuated health ailments blamed on mold, such as skin rashes, fatigue, neuropsychiatric disorders, and cancer, resulted in the discovery that very few studies have examined these connections.[21] Even though the scant evidence that is available does not support an association, the committee refused to rule out such a linkage, precisely because of the paucity of well-conducted studies and reliable data.[22] Ultimately, the study concluded what many others in the industry have been saying for years: more research must be done on this topic.[23]

The commission's inability to reach a clear conclusion was interpreted in conflicting ways by the media. As one banking journal noted, two major newspapers had conflicting headlines on the day after the report was released.[24] The *New York Times* proclaimed "Panel Finds Mold in Buildings Is No Threat to Most People,"[25] while the *Wall Street Journal* warned "Indoor Mold Linked to Problems Such as Asthma and Coughing."[26]

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16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *See id.*
21. *Id. See also* Jeff Nesmith, *Report: Mold Is Not Only Villain; Not Enough Data Exist to Link Home Mold to Array of Ills Study Says*, AUSTIN-AM. STATESMAN, May 26, 2004, at A1.
22. *Mold Health Study, supra* note 15.
23. *Id.*
24. Charles L. Perry, Jr., *Collateral Damage*, MORTGAGE BANKING, July 1, 2004, at 70.
25. Anahad O'Connor, *Panel Finds Mold in Buildings Is No Threat to Most People*, N.Y. TIMES, May 26, 2004, at A5.
26. Sarah Schaefer Munoz, *Indoor Mold Linked to Problems Such as Asthma and Coughing*, WALL ST. J., May 26, 2004, at D3.

One of the reasons mold is so difficult to analyze is that individual susceptibilities to mold vary widely.[27] Two people could live in the same mold-infested house and one might not be affected by it at all, while the other could suffer serious health consequences. Because of this disparity between individuals, it is very difficult to study the seriousness of the problem and to develop standards for "safe" levels of exposure to mold for people in general.[28] Recently, some states, including California[29] and Texas,[30] passed laws giving state agencies authority to create appropriate remediation standards for mold and to investigate the potential health consequences of mold, but specific exposure standards for mold have not yet been reached.[31]

B. MUSHROOMING MOLD CLAIMS

Why is there suddenly such an increase in the amount of mold? Two factors have been blamed (or credited, depending on your viewpoint) for heightened mold awareness and the proliferation of claims. First, some argue that the energy crisis encouraged airtight construction, which allows mold to proliferate when moisture does penetrate the construction.[32] Also, newer building materials such as drywall instead of plaster are more conducive to mold growth.[33] Similarly, HVAC (heating, ventilating, and air conditioning) systems have been blamed for spreading mold throughout buildings quickly and efficiently, so that minor mold damage, which might have been previously contained, now contaminates entire buildings.[34]

Second, many blame the media and Internet for frightening the public with dramatic stories about "toxic mold." In the fall of 2000, toxic mold entered the national spotlight after extensive media coverage of the Ballard

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27. Kyle B. Dotson, *A Few More Facts About Mold*, CLAIMS MAG., July 2003, at 32.

28. Henning & Berman, *supra* note 6, at 84-85. *See also* Wright & Irby, *supra* note 4, at 323.

29. *See* Preston W. Brooks, *More on Spores: Toxic Mold in Buildings*, J. PROP. MGMT., July 1, 2003, at 45.

30. *See* H.R. 329, 78th Leg., Sess. Ch. 205, number/designation of session (Tex. 2003).

31. Rodd Zolkos, *Exposure Standards Needed for Mold Liability Cover*, BUS. INS., Oct. 13, 2003, at 11.

32. Wright & Irby, *supra* note 4, at 309-10.

33. Andy Miller, *Sick Buildings/A Special Report: Bad Air Breeds Ailments in Homes, Schools, Offices*, ATLANTA J.-CONST., July 20, 2003, at A1.

34. Wright & Irby, *supra* note 4, at 309-10.

case.[35] This Texas woman's story about mold and the impact it had on her family cropped up all over the national media from *48 Hours*[36] to the *New York Times,*[37] sparking national interest in mold litigation and panic in the insurance industry. Other high profile plaintiffs such as Erin Brockovich and Ed McMahon, who sued over mold in their homes, have also kept mold in the media spotlight.[38] In addition to coverage of horrific health claims and the dramatic stories of people burning down their mold infested homes, astronomical jury verdicts also sparked interest in many potential plaintiffs.

Regardless of the reason for recent interest in mold, it has certainly become an important issue. There are currently over 10,000 active mold lawsuits, and in 2002 insurers paid out over $3 billion for mold-related claims, more than double the $1.4 billion they paid out in 2001.[39]

This Comment focuses on the issue of mold coverage under homeowner's policies in Texas. The Texas insurance industry has been at the forefront of the issue of mold coverage because of the broad water damage coverage under the traditional Texas homeowner's policy,[40] and because of national attention that has been focused on Texas since the Ballard case. Section Two discusses typical patterns of mold litigation, claims against the insurance industry, and Texas's unique homeowner's policy. Section Three discusses attempts that have been made to remedy the current mold crisis in Texas. Section Four analyzes whether Texas's new policies will be successful. Section Five concludes.

II. MOLD LITIGATION: TORT AND INSURANCE ISSUES

There are currently over 10,000 active mold lawsuits.[41] Private homeowners, tenants, local governments, and injured third parties have brought lawsuits regarding mold. As could be expected with such a large number of suits, causes of action and defendants vary dramatically. In general, claims can be divided into two categories: claims for physical property damage and claims for personal injury. These damages often

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35. The case was actually filed using the name of Ms. Ballard's husband, Ron Allison, but the case is almost universally referred to as the Ballard case, even within the *Allison* opinion. *See Allison v. Fire Ins. Exchange*, 98 S.W.3d 227, 233 n.1 (Tex. App. 2002).

36. *48 Hours: Invisible Killers* (CBS television broadcast, Sept. 28, 2000).

37. Lisa Belkin, *Haunted by Mold*, N.Y. TIMES, Aug. 12, 2001, at 28.

38. Jeff Ostrowski, *State Farm Can Charge Extra for Mold Policy*, PALM BEACH POST, Sept. 5, 2003, at A1.

39. Motko Rich, *Nightmares on Mold Street*, N.Y. TIMES, Dec. 11, 2003, at F1.

40 *See* discussion *infra* Part. II.C and *infra* note 124.

41. *Id.*

overlap and in many cases, even if scientific evidence regarding health effects is inadmissible, damages for property damage are still substantial.[42]

A. COMMON TARGETS OF MOLD LITIGATION

Mold litigation is often brought against those in the construction, real estate, and property management industries. Common causes of action in mold litigation include breach of contract or warranty of habitability, negligence, and misrepresentation.

1. Construction

Many mold problems stem from construction defects, such as leaky pipes, faulty construction, or inadequate ventilation. As a result, anyone involved with the structure of a building becomes a potential defendant, including original builders, subsequent repairers, and mold remediators. The Insurance Information Institute estimates that approximately twenty percent of the 10,000 pending mold suits involve construction defects.[43]

In one of the earlier prominent mold cases, occupants of prefabricated homes brought actions against their home manufacturer's insurers and an inspection service, alleging negligence and strict liability claims.[44] The occupants alleged that their homes retained excessive moisture within the exterior walls, which promoted mold, mildew, fungus, spores, and other toxins, which were a continuing health risk and adversely affected the value of the units.[45] Specifically, the occupants alleged that the excessive moisture resulted from "the defective design of the walls and roofs, inappropriately selected building materials and faulty construction practices."[46]

In another well-known case, Martin County sued the Centex-Rooney construction company, which had managed construction of the County's courthouse.[47] After construction was completed, numerous problems were

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42. *See* Elizabeth Amon, *Shunning Mold: For Many Insurers, Best Defense Against Growing Volume of Toxic Mold Is to Stop Issuing Policies in Key Areas,* BROWNARD DAILY BUS. REV., Oct. 30, 2002, at A7.

43. Gary S. Mogel, *Mold Is Weak Contender for Commercial Lines Crisis Crown,* NAT'L UNDERWRITER: PROP. & CASUALTY/RISK & BENEFITS MGMT. ED., Feb. 17, 2003, at 10.

44. Leverence v. U.S. Fid. & Guar., 462 N.W. 2d 218, 219 (Wisc. Ct. App. 1990).

45. *Id.* at 222.

46. *Id.*

47. Centex-Rooney Constr. Co., Inc. v. Martin County, Fla, 706 So. 2d 20, 23 (Fla. Dist. Ct. App. 1997).

discovered including wall and window leaks, mold growth, and excessive humidity.[48] In addition, investigators found problems with the HVAC systems.[49] After building occupants and visitors complained of health problems and indoor air testing was completed, the building was evacuated, so extensive mold remediation tasks could be conducted.[50] During the remediation, experts discovered extensive structural and electrical defects.[51]

The County asserted a claim against the construction company for breach of contract by failing to properly supervise the construction, resulting in poor workmanship and extensive damage.[52] The jury returned a verdict of $11,550,000 in damages, which was reduced to $8,800,000 by the trial judge and affirmed by the appellate court.[53] In addition to demonstrating that contractors are often held responsible in tort actions for faulty construction, the *Centex-Rooney* appellate decision was significant because it established that at least one Florida appellate court was willing to accept expert testimony regarding toxic mold's detrimental health effects.[54]

2. Real Estate

New homeowners who discover mold often bring suit against realtors and even previous owners for failing to disclose the condition of the property or for faulty workmanship.

For example, in *Bynum v. Prudential,*[55] the previous owners had remodeled two bathrooms in 1999.[56] In early 2000, the owners' employer hired Prudential to assist in selling the home and relocating the owners to a new city.[57] The Bynums purchased the home in May 2000 and discovered leaks, faulty construction, and the resulting mold growth in November

48. *Id.* at 23.
49. *Id.* at 24.
50. *Id.*
51. *Id.* at 24-25.
52. *Id.* at 25.
53. *Centex-Rooney*, 706 So. 2d at 25.
54. D. Chris Harkins, *Comment: The Writing Is on the Wall . . . and Inside It: The Recent Explosion of Toxic Mold Litigation and the Insurance Industry Response*, 33 TEX. TECH L. REV. 1101, 1107-08 (2002).
55. Bynum v. Prudential Residential Servs., Ltd. P'ship, 129 S.W.3d 781 (Tex. App. 2004).
56. *Id.* at 786.
57. *Id.*

2000.[58] As a result, the Bynums brought suit against the previous owners and Prudential, asserting claims including breach of contract, breach of express and implied warranties, violation of deed restrictions, negligence, negligent misrepresentation, and strict products liability.[59] The appellate court affirmed the lower court's decision granting summary judgment for Prudential.[60] Although the plaintiffs were unsuccessful, the *Bynum* case demonstrates a typical strategy of bringing suit against realtors and previous owners for construction defects resulting in mold damage.

3. Building Owners

Cases have been brought against building owners in various contexts including apartments and commercial buildings.[61] Claims against apartment owners are often brought as a breach of the implied warranty of habitability.[62] Depending on the situation, suits are often brought as class actions as well.[63]

In one case, 495 New York apartment residents sued the owners of their apartment building claiming that they were injured by mold.[64] The plaintiffs sought $9 billion in damages and reached a confidential settlement with the owners.[65]

In another example of a suit against building owners, a Louisiana woman brought an action against numerous parties, including her employer, the owner of the building where she worked, and a contractor who had made repairs to the building.[66] During the renovation of the plaintiff's office building roof, rainwater from a heavy rainstorm leaked, causing damage to the interior, soaking the ceiling tiles, carpet, and walls.[67] As a result, mold and mildew grew on some of the water-soaked surfaces.[68] The plaintiff claimed that she had suffered personal injuries from exposure

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58. *Id.* at 787.
59. *Id.* at 785.
60. *Id.* at 785-86.
61. Henning & Berman, *supra* note 6, at 73-77.
62. *Id.* at 75.
63. *Id.* at 76.
64. Davis v. Henry Phipps Plaza S., No. 116331/98 (N.Y. Sup. Ct.) (referenced in *Confidential Settlement Reached in New York Apartment Case,* 1-12 MEALEY'S LITIG. REP.: MOLD 3 (2001)).
65. *Id.*
66. State Farm Fire & Cas. Co. v. M.L.T. Constr. Co., 849 So. 2d 762, 765 (La. Ct. App. 2003).
67. *Id.*
68. *Id.* at 766.

to hazardous substances at work, including the mold that resulted after the office flooding.[69] The plaintiff dismissed claims against the building owner and employer, choosing instead to pursue the claims against the roofing contractor and its insurer.[70] Nevertheless, the case exposes the potential liability of building owners to any tenant's employee who is susceptible to mold.

4. Homeowner Associations

Homeowner associations are often common targets of mold litigation because they are responsible for maintaining the building premises. In fact, due to the increased litigation against condominium associations, many insurers of those organizations are adding exclusions for any sort of mold claim.[71]

For example, a plaintiff sued a condominium association for personal injuries allegedly caused by the defendant's negligence in failing to maintain and repair the plumbing in the plaintiff's condominium, causing the premises to become mold-infested.[72] As a result, the plaintiff claimed that she suffered asthma and a fungal infection, which developed into immune dysregulation.[73] Although the plaintiff's claims were barred by the statute of limitations, the case represents a good example of the potential liability of homeowner associations, and the importance of proper maintenance and timely repairs of plumbing or water problems.

B. TRADITIONAL MOLD INSURANCE CLAIMS

Insurance protects many individuals and businesses from some of the above-described claims through personal or commercial liability policies. Comprehensive general liability (CGL) policies protect policyholders from claims made against them by third parties for property damage and bodily injury.[74] These policies have provided mold coverage in some cases but now most insurers have added mold exclusion clauses. There has been

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69. *Id.* at 765-67.

70. *Id.* at 767.

71. David Mack, *Mold Trouble: A Fungus Among Us*, CHI. SUN-TIMES, June 14, 2002, at 10.

72. Miller v. Lakeside Vill. Condo. Ass'n, Inc., 2 Cal. Rptr. 2d 796, 797-98 (Cal. Ct. App. 1991).

73. *Id.* at 798-99.

74. Marilynn R. Greenberg & Alexa Richman-La Londe, *Growing Mold, Growing Litigation*, N.J. L.J., July 14, 2003.

much written about the applicability of those policies to mold suits,[75] but that is not the focus of this Comment. Instead, I focus on what relief an individual can seek under his homeowners' policy for mold damage.

1. Covered Mold Damage Under Traditional Homeowners Policies

Most homeowners' policies are all-risk policies, covering physical loss to the insured's premises, subject to numerous exceptions and exclusions. These exclusions generally include loss from wear and tear, latent defects, and mechanical breakdown.[76] Furthermore, policies generally have exceptions for "repeated or continuous seepage or leakage" and for inadequate or defective design, workmanship, or materials used in construction.[77] These exceptions prevent coverage for the sorts of problems that often lead to mold damage. For example, repeated leakage of pipes could lead to mold, but under a typical policy that leakage (and the resulting mold) would not be covered. Additionally, most policies have explicitly excluded coverage for losses caused by "smog, rust, or other corrosion, mold, wet or dry rot."[78]

Despite all these exclusions, mold damage will be covered if it is proximately caused by a "covered loss." Many cases make this distinction between damage *caused* by mold, and mold damage that in and of itself is damage caused by a covered event.[79] For example, although mold is excluded by most policies, if mold damage develops after a burst pipe or fire, both of which are covered, then the mold loss would be covered also.

Liristis v. American Family,[80] provides an example of a typically *covered* mold claim. In *Liristis*, the plaintiffs had a fire in their home resulting in fire and water damage (from the water used to extinguish the fire).[81] The insurer paid for a contractor to make repairs for that damage.[82]

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75. *See, e.g.*, Leverence v. U.S. Fid. & Guar., 462 N.W.2d 218, 221-22 (Wis. Ct. App. 1990).

76. Vincent P. Cook & Peter W. Schoonmaker, *Homeowner Policies Rarely Cover Losses Due to Mold*, CHI. DAILY L. BULL., Jan. 15, 2002, at 5.

77. *Id.*

78. Michael K. McCracken, *Mold Decision Wasn't Really About Mold*, NAT'L UNDERWRITER: PROP. & CASUALTY/RISK & BENEFITS MGMT. ED., Oct. 14, 2002, at 24 (includes language from the 1994 HO-3 Homeowners Policy). *See also* Cook & Schoonmaker, *supra* note 76, at 5.

79. *See* discussion *infra* Sec. II.C.1.a.

80. Liristis v. Am. Family Mut. Ins. Co., 61 P.3d 22 (Ariz. Ct. App. 2002).

81. *Id.* at 23.

82. *Id.*

Within several months of moving back into the home, the plaintiffs suffered allergic reactions, respiratory problems, and other unexplained illnesses.[83] In addition, after the repairs from the fire, the roof leaked each time it rained.[84] The plaintiffs notified their insurer, which had a contractor repair the roof; however, the roof continued to leak, soaking the walls, ceiling, carpet, and property inside the home, so the plaintiffs filed an additional claim for water damage.[85] The plaintiffs hired an expert to conduct environmental testing of their home, and he found *Stachybotrys* mold.[86] The insurer's expert also reached this conclusion.[87] The plaintiffs filed a claim for contamination caused by mold, but it was denied based on the policy's mold exclusion.[88] The plaintiffs sued alleging breach of contract, bad faith, and unfair insurance trade practices.[89]

The plaintiffs argued that the mold damage was caused by water used to extinguish the fire and was therefore covered as damage from the fire.[90] Both parties and the court recognized that depending on the circumstances, mold could either be a loss itself or a cause of loss.[91] In this case, the fire caused the mold damage and the fire was covered under the policy. In other cases, however, losses caused by mold may be excluded.[92] Therefore, if the plaintiffs could prove that the mold was caused by the fire, then the cost of removing it would be covered under the fire protection of the policy.[93] If, however, the mold had not been caused by the fire, then it would be properly excluded as an uncovered cause of loss under the mold exclusion clause.

This case reflects the standard analysis regarding mold and homeowners policies: mold is only covered if the mold damage was caused by a covered loss. Water damage from a fire is clearly covered, so if the plaintiff can prove that the fire's water damage caused the mold, the mold damage is also covered. If, however, mold growth occurred independently from the water and fire damage, then any damage caused by the mold is not covered.

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83. *Id.*
84. *Id.*
85. *Id.* at 23-24.
86. *Liristis*, 61 P.3d at 24.
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *See Liristis*, 61 P.3d at 25.
93. *Id.* at 26.

2. Bad Faith Claims and Ballard

Much of the mold litigation against insurance companies has focused on claims of bad faith. Common law and statutory standards for breach of good faith vary by jurisdiction, but in general they have similar elements.[94] "An insurer breaches its duty of good faith and fair dealing by denying or delaying payment of a claim when 'the insurer's liability has become reasonably clear.'"[95] The focus is not on "whether the claim was valid, but on the reasonableness of the insurer's conduct in handling the claim."[96] Reasonableness is determined by using the objective standard of whether a reasonable insurer under similar circumstances would have delayed or denied payment of the claim.[97]

By its nature, mold proliferates exponentially over a period of time, so the earlier water or mold claims are handled, the less damage will ultimately result to the property. Lawsuits for bad faith claims for poorly handled water and mold losses have led to large verdicts, but many courts have begun limiting punitive damages, so many of those verdicts have been substantially reduced. The most prominent bad faith case involving mold is the Ballard case out of Texas.

Melinda Ballard lived with her husband, Ron Allison, and their baby in an 11,000 square foot mansion in Dripping Springs, Texas.[98] In early 1998, they had a toilet leak repaired, causing water damage to carpeting and sub-flooring.[99] That damage was also repaired but the problems with the leak continued.[100] After the hardwood floors began buckling and warping, Ms. Ballard filed a claim with her insurer in December 1998.[101] After much correspondence, the insurer paid a total of $100,000 but refused to pay more, claiming that some of the damage was not covered under the policy.[102] Meanwhile, the entire family became ill. The baby developed asthma.[103] Ron developed unexplainable cognitive symptoms such as

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94. *See* 44A AM. JUR. 2D *Insurance* § 1738 (2003).

95. Allison v. Fire Exch. Ins., 98 S.W.3d 227, 248 (Tex. App. 2002) (standard under Texas law); *see also* AM. JUR. 2D, *supra* note 94.

96. *Allison,* 98 S.W.3d at 248. *See also* AM. JUR. 2D, *supra* note 94.

97. *Allison,* 98 S.W.3d at 248. *See also* AM. JUR. 2D, *supra* note 94.

98. Belkin, *supra* note 37.

99. *Allison*, 98 S.W.3d at 234.

100. *Id.*

101. *Id.* at 235.

102. *Id.*; Belkin, *supra* note 37, at 31-32.

103. Belkin, *supra* note 37, at 32.

memory loss and confusion.[104] Melinda suffered bloody coughs and dizzy spells.[105]

In April 1999, during the midst of this chaos, Ms. Ballard found herself on a flight sitting next to a mold remediation specialist, and he suggested that mold might be the source of her family's problems.[106] He encouraged her to test the home.[107] Mold testing showed numerous airborne molds, including *Stachybotrys*.[108] The family left the home immediately, leaving everything they had behind.[109]

In May 1999, they brought a lawsuit against the insurance company.[110] The trial court excluded the personal injury claims on the basis that Ballard's expert witnesses did not have reliable evidence linking mold exposure and adverse health consequences.[111] Nevertheless, the jury awarded over $32 million to the plaintiffs.[112]

Both sides appealed. The appellate court held that there was sufficient evidence to support the jury's finding that the insurer breached its duty of good faith and fair dealing and that the breach caused damage to Ballard.[113] As an example of the breach, the court cited an eighteen-month appraisal process, which allowed mold to spread, causing irreparable damage to the home.[114] The plaintiff also presented evidence of a pattern of delaying and denying claims by requiring further inspections and misrepresentations regarding why additional time was necessary to handle the claims.[115]

The court found inadequate evidence to support the jury's finding of unconscionability, fraud, or knowing violation of the duty of good faith.[116] Accordingly, the court dismissed the punitive damages and mental anguish damages.[117] As a result, the damages were reduced to $4 million.[118] Although the decision was appealed to the state supreme court, before a

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104. *Id.*
105. *Id.*
106. *Id.*; *Allison*, 98 S.W.3d at 236.
107. Belkin, *supra* note 37, at 32.
108. *Id.*
109. *Id.*
110. *Allison*, 98 S.W.3d at 236.
111. *Id.* at 237.
112. Belkin, *supra* note 37, at 62.
113. *Allison*, 98 S.W.3d at 248.
114. *Id.* at 249.
115. *Id.* at 249-50.
116. *Id.* at 264-65.
117. *Id.* at 258.
118. *Id.* at 264.

decision could be reached, Ballard reached a confidential settlement with Farmers Insurance.[119]

Although the Ballard case is often credited with sparking national concern in the insurance industry about mold, the case was decided primarily as a bad faith case.[120] The central issues were those regarding the proper handling of claims, rather than whether the water or mold damage would have been covered.[121] The case demonstrates how clearer communication between homeowners and their insurers and better mold prevention efforts could thwart millions of dollars of damage. It also served as a signal to plaintiff lawyers and insurers that even if health risks of mold cannot be proved, large verdicts can still be found by sympathetic juries.[122]

C. TEXAS HO-B POLICY AND MOLD EXCLUSIONS

In 2001, ninety-six percent of Texas homeowners held HO-B insurance policies, which provided unlimited coverage for water damage and any ensuing mold or fungi losses, not related to flooding.[123] Unlike most other policies nationwide, the HO-B policy did not limit coverage to only "sudden and accidental" events, such as burst pipes. It provided coverage for chronic problems, such as leaky pipes or foundation seepage.[124]

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119. R.J. Lehmann, *Farmers Settles* [sic] *Texas Mold Case with Ballard,* BEST'S INS. NEWS, Mar. 30, 2004, *available at* LEXIS, BestWire Database.

120. McCracken, *supra* note 78.

121. *See id.*

122. Harkins, *supra* note 54, at 1115.

123. Jane Elliott, *Home Insurance Cuts Questioned*, HOUSTON CHRON., Nov. 13, 2001, at 1. *See also* TEX. DEP'T OF INS., Order No. 01-1105 (2001), *available at* http://www.tdi.state.tx.us/commish/multi/co-01-1105.html (last visited Nov. 6, 2004) [hereinafter *TDI Nov. Rep.*].

124. Language from the 1991 Texas Standard Homeowner's Policy – Form B is reproduced in Appendix A of *Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738, 746 (Tex. 1998). The policy insures all risks of physical loss to the dwelling unless the loss is excluded in Section 1 Exclusions. *Id.* Notably, the policy does not contain a provision barring coverage for "continuous or repeated seepage or leakage of water or steam over a period of time, weeks, months or years, from within a plumbing, drainage, heating, air conditioning system or automatic fire protective sprinkler system, or from within a household appliance" as does a typical homeowners policy. *See, e.g.*, TOM BAKER, INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS 349 (2003) (provides example of a California homeowner's insurance policy).

1. Split Interpretation of the Texas HO-B Policy Exclusions

a. *Fiess*

In *Fiess v. State Farm*,[125] the Fiesses brought suit against State Farm for extensive mold damage to their home after it flooded during Tropical Storm Allison in 2001.[126] The Fiesses made a claim with State Farm under their flood policy, which was distinct from their homeowners policy, for damages during the flood. Under the flood policy, State Farm paid for repairs to the home and for the replacement of lost personal property.[127]

One week after the flood, the Fiesses were removing sheetrock and discovered black mold growing throughout the house.[128] After having the mold tested, the Fiesses learned that it contained among other strains, *Stachybotrys*.[129] There was a dispute as to which portion of the mold stemmed from Allison and which portion had existed before the storm. The Fiesses' expert testified that 70% of the mold occurred before Allison.[130]

The Fiesses filed a claim with State Farm for mold contamination.[131] Ultimately, State Farm paid the Fiesses $34,425 for non-covered mold remediation for portions of the home where there was evidence of pre-flood leaks, but the Fiesses argued that State Farm failed to fully compensate them for damage attributable to pre-flood leaks.[132] They brought suit asserting claims of violations of state fair trade law, breach of contract, fraud, and intentional misrepresentation.[133]

In order to determine if there had been a breach of contract, the court examined the exclusion provisions of the HO-B policy. Section 1 Exclusions, subsection f provides:

f. We [State Farm] do not cover loss caused by:

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125. Fiess v. State Farm Lloyds, No. H-02-1912, 2003 U.S. Dist. LEXIS 10962, at *1 (S.D. Tex. June 3, 2003), (Docket No. 03-20778).

126. *Fiess*, 2003 U.S. Dist. LEXIS 10962, at *1-*2.

127. *Id.* at *2.

128. *Id.* at *3.

129. *Id.*

130. *Id.* at *4.

131. *Id.* at *5.

132. *Fiess*, 2003 U.S. Dist. LEXIS 10962, at *1.

133. *Id.*

> (1) Wear and tear, deterioration or loss caused by any quality in property that causes it to damage or destroy itself.
> (2) Rust, rot, mold or other fungi.
> (3) Dampness of atmosphere, extremes of temperature.
> (4) Contamination.
> (5) Rats, mice, termites, moths or other insects.
>
> We do cover ensuing loss caused by collapse of building or any part of the building, water damage or breakage of glass which is part of the building if the loss would otherwise be covered by the policy.[134]

Under this provision, loss caused by mold is explicitly excluded.

The court noted that unless an exception to this exclusion applied, the policy would not cover the Fiesses' loss.[135] Accordingly, the court considered whether mold damage fell within the "ensuing loss caused by . . . water damage" exception to the exclusion.[136] The court reasoned that "[f]or coverage to be restored via the ensuing loss clause, an otherwise covered loss must result or ensue from the excluded loss."[137] It noted that an "'ensuing loss caused by . . . water damage' refers to water damage which is the result of, rather than the cause of one of the types of damage enumerated in exclusion . . . ."[138]

Applying this reasoning to this case, the question becomes whether the water damage was the result of mold.[139] The court suggested that the plaintiffs' argument that the mold damage should be covered under the ensuing loss provision "reverses the causation required by that exception."[140] Clearly, neither party would argue that the water damage was caused by the mold; rather, it is obvious that the mold was caused by the water damage. Therefore, the court determined that the mold damage was excluded under the ensuing loss provision of the policy.[141] The court

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134. *Id.* at *18-*19.
135. *Id.* at *19.
136. *Id.* at *23.
137. *Id.* at *24.
138. Fiess v. State Farm Lloyds, H-02-1912, 2003 U.S. Dist. LEXIS 10962, at *24 (S.D. Tex. June 3, 2003).
139. *Id.* at *24.
140. *Id.* at *26.
141. *Id.* at *25.

quoted the Fifth Circuit, expressing concern that if it followed the plaintiffs' interpretation of the ensuing loss provision, "a clause intended to narrow the exclusions for 'rust, rot, mould [sic] or other fungi' and 'dampness of atmosphere' [it] would very nearly destroy them."[142]

The court's analysis of the ensuing loss provision is consistent with the interpretation of similar provisions by other jurisdictions.[143] But its analysis does not seem to be consistent with a line of Texas cases interpreting ensuing loss clauses,[144] including the Fifth Circuit *Yates* case,[145] which was cited and relied upon in rendering its decision. These cases use an analysis similar to an efficient proximate cause approach to determine whether covered water damage caused the mold, but they do so by interpreting the ensuing loss coverage to bring mold damage within the policy's coverage.

In *Yates*, the plaintiff claimed that rot caused by inadequate ventilation of a crawl space should be covered under the policy.[146] The policy had an exclusion for rot and mold, similar to the language in the *Fiess* policy, and it had an ensuing loss provision for water damage.[147] The *Yates* plaintiff tried to argue that since the damage was caused by condensation of moist air into water, it should be covered.[148] The Fifth Circuit noted that if such a

142. *Id.* at *26-*27 (quoting Aetna Cas. & Sur. Co. v. Yates, 344 F. 2d 939, 941 (5th Cir. 1965)).

143. Generally, all risk policies cover all physical losses to a covered property, subject to certain exclusions, such as faulty materials, wear and tear, and fungus or rot. *See, e.g.*, BAKER, *supra* note 124, at 366-67. In order to prevent certain clauses from eliminating coverage that would be traditionally covered, ensuing loss clauses developed. *Id.* A typical ensuing loss clause refers to a specific set of exclusions and states that any ensuing loss not excluded would be covered. For example, if a fire were to break out from frayed wires (wear and tear), a homeowner would still be covered by her insurance policy because even though the cost of repairing worn wires would not have been covered by the policy, the fire damage would be an ensuing loss that was not excluded and would therefore be covered. *Id.* at 367. This analysis is consistent with the *Fiess* reasoning that simply because there is an "ensuing loss" clause for water damage, does not mean that mold, which is expressly excluded would suddenly become a covered event. However, not all courts have interpreted the Texas policy in this manner.

144. *See, e.g.*, Home Ins. Co. v. McClain, No. 05-97-01479, 2000 Tex. Ct. App. LEXIS 969, at *9-*12. (Tex. Ct. App. Feb. 10, 2000) (noting that the Court of Appeals has recognized fact patterns where ensuing losses from water damage would be covered, including instances of mold and fungi damage).

145. *Fiess*, 2003 U.S. Dist. LEXIS 10962, at *26-*27.

146. *Yates*, 344 F.2d at 940.

147. *Id.* at 940-41.

148. *Id.* at 941.

reading of the clause were allowed, it would essentially do away with the rot exclusion altogether.[149]

The Fifth Circuit suggested, however, that "a likely case for application of the clause would be if water used in extinguishing a fire or coming from a burst pipe flooded the house and in turn caused rust or rot; loss from rust or rot so caused would be a loss ensuing on water damage."[150]

Based on that reasoning, loss from mold would also appear to be considered an ensuing loss. For surely in the case of a burst pipe, the covered event would be the water damage from the burst pipe and the ensuing loss would be any mold or rust that resulted. Similarly, since leaks are covered under the Fiesses' policy, it would seem that the resulting mold damage from those leaks should also be covered as an ensuing loss. Therefore, it appears that the district court correctly relied on *Yates*, but that it did not follow *Yates's* understanding of causation.[151]

The *Fiess* appeal is currently pending before the Fifth Circuit.[152]

b. *Flores*

One month after the Southern District of Texas decided the *Fiess* case, it issued a contrary decision regarding the same issue of whether mold damage resulting from a covered loss is covered under the HO-B policy. In November 2001, the Floreses became concerned about wetness and mold in their home.[153] Upon the advice of their attorney, they hired contractors to investigate the problem. On November 1, 2001, the investigators discovered several leaks and mold growth in the hall and master bathrooms, an air conditioning unit, and the kitchen sink.[154] Consequently, the Floreses filed an insurance claim with Allstate under their Texas HO-B Policy on November 5, 2001. The plaintiffs did not seek coverage for the actual leaks, but only for the ensuing mold damage.[155]

Allstate argued that the plaintiffs had failed to promptly report the leaks, which occurred over many months, and suggested that had they been

149. *Id.*

150. *Id.*

151. *See* Flores v. Allstate Tex. Lloyd's Co., 278 F. Supp. 2d 810 (S.D. Tex. 2003).

152. *See* Randy J. Maniloff, *Mold and First Party Coverage: The Growth of Proximate Cause-Examining Mold Coverage Decision Since 1851*, 18 MEALEY'S LITIG. REP. INS. 9 (2004).

153. *Id.* at 812.

154. *Id.*

155. *Id.* at 813.

reported and repaired, the ensuing mold damage would never have occurred.

The plaintiffs' policy covers all physical loss to the dwelling (Coverage A) and certain personal property contained within the dwelling (Coverage B). Both A and B coverage are subject to certain limitations. Coverage of the dwelling (Coverage A) is limited by "Section 1 Exclusions":

> 1 . . . f. We do not cover loss caused by:
> (2) rust, rot, mold, or other fungi . . .
>
> We do cover ensuing loss caused by collapse of building or any part of the building, water damage or breaking of glass which is part of the building if the loss would otherwise be covered under this policy.[156]

The policy did not exclude plumbing and air conditioning leaks and overflows, so the court presumed that they would be covered under Part A of the policy.[157]

The *Flores* court acknowledged its disagreement with the *Fiess* court and recognized that its decision reflected the Fifth Circuit *Yates* case and analysis by the Texas Supreme Court in *Balandran v. Safeco Insurance Co. of America*.[158] The *Flores* court construed the mold exclusion as "precluding coverage for mold occurring naturally or resulting from a non-covered event, but not for mold 'ensuing' from a covered water damage event."[159] This conclusion directly rejects the decision in *Fiess*, where the court determined that the same policy language would not cover mold damage, even if it occurred as a result of a covered water damage.[160] In other words, mold naturally arising from a damp basement or occurring from a non-covered flood would not be covered, but mold ensuing from covered water damage from a leaky pipe would be covered.

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156. *Id.* at 814 (quoting homeowners policy, which has the same language as the policy in the *Fiess* case).

157. *Id.* at 814.

158. Flores v. Allstate Tex. Lloyd's Co., 278 F. Supp. 2d 810, 814 (S.D. Tex. 2003). Balandran v. Safeco Ins. Co., 972 S.W.2d 738, 742 (Tex. 1998) (holding that foundation settling exclusion in 1991 Texas Standard Homeowner's Policy – Form B does not apply to loss caused by accidental discharge, leakage, or overflow of water or steam from within a plumbing or air conditioning system or household appliance.) The Texas Supreme Court expressly did not address whether the "ensuing loss" provision created an exception to the exclusion in the circumstances, because it did not need to reach that question. *Id.* at 740.

159. *Id.* at 814 n.3.

160. *Id.*

Next, the *Flores* court considered Coverage B, which insures against physical loss to personal property "caused by a peril listed below, unless the loss is excluded in Section I Exclusions."[161] The perils that are covered include:

> 9. Accidental Discharge, Leakage or Overflow of Water or Steam from within a plumbing, heating or air conditioning system or household appliance.
>
> A loss resulting from this peril includes the cost of tearing out and replacing any part of the building necessary to repair or replace the system or appliance. But this does not include loss to the system or appliance from which the water or steam escaped.
>
> Exclusions 1.a. through 1.h. under Section 1 Exclusions do not apply to loss caused by this peril.[162]

The peril of "accidental discharge, leakage or overflow of water or steam" is not subject to the mold exclusion, because the mold exclusion was numbered 1.f. in the "Section 1 Exclusions," and the policy explicitly states that exclusions 1.a through 1.f do not apply to this peril.[163] The court reasoned, "[b]ecause mold is not excluded from personal property coverage, it may well be considered *included* as 'a loss resulting from this [No. 9] peril.'"[164] Therefore, the court held that the plaintiffs' HO-B policy "covered mold damage to the dwelling or personal property that ensues from an otherwise covered water damage event under the policy."[165] This reasoning is much more consistent with other Texas decisions than the *Fiess* analysis was.[166]

c. *Hood*

The Southern District of Texas affirmed the reasoning of *Flores* in *Hood*, by noting that mold is not covered when resulting from a non-

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161. *Id.* at 814.

162. *Id.* at 814-15.

163. *Id.* at 815.

164. Flores v. Allstate Tex. Lloyd's Co., 278 F. Supp. 2d 810, 815 (S.D. Tex. 2003) (emphasis in the original).

165. *Id.*

166. *See, e.g.*, Home Ins. Co. v. McClain, No. 05-97-01479, 2000 Tex. Ct. App. LEXIS 969, at *9-*12. (Tex. Ct. App. Feb. 10, 2000).

covered problem as described in *Flores*.[167] The court recognized the *Fiess* decision's reasoning that no matter how mold is caused, it would be excluded,[168] and although that stringent standard could have been used in *Hood*, it was not necessary and the court chose not to go down that road.

Hood included a basic homeowner problem. The plaintiff's roof had deteriorated creating extensive leaks, which caused mold.[169] Since the policy excluded deterioration, the court found the mold to be properly excluded. It rejected the plaintiffs' argument that the roof caused leaks, causing water damage.[170]

Mold almost always develops from water *problems*, but those are not always water *damage*.[171] The court described traditional covered water damage, such as that resulting from a severe storm or a burst pipe.[172] The court did note that even if water damage caused mold, in most cases the mold should not be covered, based on the policy's exclusion.[173] Since the mold resulted from deterioration, which was not covered under the policy, the mold claim was not covered.[174]

2. Prompt Notice Requirement

Insurers often defend denial of coverage on the basis of the insured failing to promptly report the claim to the insurance company. However, mold poses a challenge, because it is often not discovered until its growth reaches a point where it starts to cause serious problems, therefore a common issue of litigation involves the timeframe within which a claim must be initiated for it to be covered.

a. Legal Standard for Prompt Notice

The district court interpreted the Texas HO-B policy's requirements for prompt notice in *Flores v. Allstate*. In that case, Allstate argued that coverage was barred because the plaintiffs failed to notify the insurance company regarding the water damage, violating their policy.[175] The policy

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167. Hood v. State Farm Lloyds, No. CIV.A.H-03-2621, 2004 WL 1490377, at *1 (S. D. Tex. May 17, 2004).
168. *Id.* at *2.
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.*
175. *Flores*, 278 F. Supp. 2d 810, 812 (S. D. Tex. 2003).

included specific provisions assigning duties regarding notice and repairs for the policyholder. The policy states:

> In case of a loss to covered property insured against you, you must:
> (1) give prompt written notice to us of the facts relating to the claim. . .
> (3) (a) protect the property from further damage.
> (b) make reasonable and necessary repairs to the property.[176]

Despite this policy language, under Texas law, "a party cannot be said to sustain actual property damage until such damage becomes manifest."[177] The court noted that there cannot be a duty to notify "until damage is apparent."[178] In this case, the plaintiffs made a claim for mold damage, not the initial water event, so they argued that the mold did not become apparent until discovered by remediation experts during a home inspection.[179] To resolve this dispute, the court relied on a Fifth Circuit decision that distinguished between "apparent" and "discovered."[180] The Fifth Circuit emphasized the difference between failing to discover an obvious defect based on "sheer indolence" as opposed placing a "heavy burden" on the homeowner to inspect his property for latent defects.[181] Under Texas law, "[t]he date of occurrence is when the damage is capable of being easily perceived, recognized, and understood."[182]

Applying this analysis to a typical mold case, the *Flores* court noted that an insured can satisfy the notice requirement by giving prompt notice of a claim for mold damage when it becomes manifest or apparent.[183] Usually, whether notice is considered reasonably prompt will be an issue of fact for the jury.[184] But if the facts are undisputed and the notice is delayed and not excused, a mold claim may be considered unreasonable as a matter of law.[185] The court provided a concrete illustration of this analysis:

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176. *Id.* at 815.
177. *Id.*
178. *Id.* at 816.
179. *Id.*
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. Flores v. Allstate Tex. Lloyd's Co., 278 F. Supp. 2d 810, 816 (S.D. Tex. 2003).
185. *Id.* at 816-17.

> [A] homeowner cannot sit back and watch mold grow in his home, or observe an obvious mold-instigating event – such as the flooding of a room in which the baseboards and walls are saturated for several days, or a continuous leak that saturates a surface – and not notify his insurers. But not every water event will cause mold to ensue. Consequently, an insured is not expected to notify his insurance company each time the toilet overflows or the sink drips, where the insured takes prompt remedial action appropriate to the circumstances.[186]

The *Flores* court's analysis seems straightforward and practical in light of the difficulties involved with "discovering" mold damage, but it also creates some uncertainty by leaving the issue of whether notice is reasonably prompt within the province of the jury. I would think that most jurors would probably be sympathetic to an insured who failed to report small leaks to his insurer, but they would also be capable of distinguishing more serious problems that should have been reported promptly.

The court's language is also helpful in putting owner responsibility in perspective. Clearly, owners who sit back and essentially watch mold grow as they ignore serious water damage should be subject to stringent time requirements. As the court noted, in cases where facts are undisputed and the insured inexcusably delayed reporting damage, a mold claim may be considered unreasonable as a matter of law. At the same time, given the media-hype over mold dangers, overly cautious homeowners should not be required to call their insurers about every small water event, especially if it has been remedied. If such a heightened reporting requirement were required, the insurers would likely be bombarded with numerous unnecessary and frivolous claims or reports.

b. Applying the Legal Standard to the Flores Claims

The *Flores* court analyzed each of the eight claims and only granted summary judgment for Allstate on one claim.[187] In *Flores*, most of the claims involved mold which resulted from what the plaintiffs thought were occasional spills or leaks, which the Floreses thought they had properly repaired or cleaned up.[188] The court did not grant summary judgment for

186. *Id.* at 816.
187. *Id.* at 820.
188. *See id.* at 817-20.

the insurers for those claims,[189] which seems very reasonable. As I have discussed, although it is important to keep an insurer informed, one can hardly be expected to report damage if the homeowner thinks that the problem has been fixed. It also seems reasonable for a homeowner to believe that brown stains near a spill or leak are simply water stains or damage, not the beginning of a toxic mold infestation.[190]

In the one claim where the plaintiffs thought there was water damage but never found the source, the court appropriately granted summary judgment because in such a case, the plaintiffs did have notice that something was causing the mold, yet ignored the problem rather than taking steps to remedy it.[191]

3. Impact of HO-B Policy on Texas Litigation

Although certain exclusions under the Texas HO-B policy existed and prompt notice provided some threshold for filing a mold claim, in general, the policies were fairly broad in coverage, especially when compared with other national policies that did not cover the same sorts of water damage claims. The generosity of coverage contributed to the chaos that erupted in the Texas insurance industry.

III. INSURANCE INDUSTRY'S APPROACH TO HALT THE GROWING CLAIMS

Insurers report that they have had difficult accurately underwriting mold claims, because claims of mold-related losses have been growing so rapidly.[192] In addition to having difficulty anticipating the cost of a claim, it is also difficult to determine how much must be done to clean up or prevent mold. There are no clear federal or state standards establishing "safe" levels of human exposure to mold, so even if an insurer attempted to solve a problem, it could still find itself in court for inadequately remedying the problem.[193] Another element of uncertainty is the lack of scientific understanding of how mold affects human health. Clearly, with

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189. *See id* at 820.

190. *See id.* at 818.

191. *Id.* at 819-20.

192. David Dybdahl et al., *Under Coverage*, J. PROP. MGMT., May 1, 2003, at 36-37.

193. There has been recent legislation setting remediation standards and establishing commissions to study mold, but no clear standards have been established to determine safe levels of exposure. *See* Zolkos, *supra* note 31. *See also Mold Health Study*, *supra* note 15 (indicating need for further studies).

mold in the spotlight, more research will be done, but in the meantime, it is difficult for insurers to anticipate the claims.

A. EXCLUDING MOLD

As mold concerns spread across the country, insurers attempted to clarify their policies regarding mold and issued many mold exclusions and endorsements. Each state has its own procedure for handling such exclusions. "File and use" states simply allow insurers to initiate exclusions as long as they do not violate state regulations or public policy. If such violations are found, then the insurance department will step in. In contrast, "prior approval" states require that the state insurance commissioner approve the exclusions before they are submitted to policyholders. The general approach of many insurers has been to exclude or minimize mold coverage in their policies or to stop providing certain lines of coverage altogether. By 2004, at least 44 states allowed exclusions for mold and some other water related events.[194]

B. ISO LIMITATION

Over 35 states have approved the Insurance Services Office's (ISO's) mold limitation for homeowners coverage.[195] This limitation excludes coverage for loss caused by mold, unless the damage results from a covered peril, such as accidental discharge or overflow of water.[196] The coverage provides $10,000 first-party coverage and $50,000 third-party coverage, on an aggregate basis.[197] In addition to covering physical damage, the policy also covers remediation in connection with mold.[198] The ISO reported that it created these exclusions to create flexibility for insurers to cap potentially high claims and allow competitive pricing in the market. By allowing

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194. *See* Terri Cullen, *Fiscally Fit – Insurers Won't Cover Mold in Homes, at* http://www.wsj.com (May 17, 2004).

195. *35 States Adopt Mold Limitations,* THE NAT'L UNDERWRITER CO., Feb. 2003, at 12; Kevin B. Thompson, *ISO Clarifies Mold Coverage*, NAT'L UNDERWRITER PROP. & CAS./RISK & BENEFITS MGMT ED., May 19, 2003, at 40, 42 (Letter to the editor by Senior Vice President of ISO) [hereinafter "Thompson letter"].

196. *35 States Adopt Mold Limitations, supra* note 195.

197. *See* Kevin B. Thompson, *Mold Delineated: Insurance Services Office Has Introduced Policy Language on Mold to Help Insurers Limit Exposure But Retain Underwriting Flexibility*, 103 BEST'S REV. 51 (2003). The policy provides full mold coverage when damage results from fire or lightning. *Id.*

198. *See id.*

flexibility for underwriting for individual policyholders, the industry would be able to accommodate coverage for most mold claims.[199]

C. TEXAS MOLD: PAST AND PRESENT

1. Background of Texas Mold Crisis

As news of the Ballard case and toxic mold spread, insurers became bombarded with mold claims.[200] The insurance industry stated that if it were to maintain the same level of mold coverage, it would have to increase homeowners' policy rates by forty to sixty percent on *all* Texas homeowners, even if they never made a claim.[201]

In response to the dramatic increase in mold claims, Texas insurers took drastic measures to limit their exposure. In the summer of 2001, several large insurers stopped issuing the HO-B policy to new homeowners entirely.[202] Others would not write any sort of new policy for homeowners who had previously had water claims.[203] These decisions caused serious ramifications for the real estate market, [204] as people could not find policies to cover their homes, thereby preventing buyers from obtaining mortgages and canceling closings.

2. Battling Rising Mold Claims with Insurance Reform

It was clear to consumers and insurers that reforms were necessary for Texas insurance, but naturally, both groups had competing goals. The Texas Department of Insurance (TDI) studied the problem of mold and insurance by conducting information hearings and analyzing statistics on mold losses obtained through a statewide data call.

In September 2001, Insurance Commissioner Montemayor released a preliminary staff recommendation that mold coverage should be limited to $5,000 but additional coverage could be purchased through "buy back"

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199. *See* Thompson letter, *supra* note 195.

200. *See* Melinda Wood Allen, *Texas Lassoes Mold Industry*, THE NAT'L UNDERWRITER CO., Aug. 2003, at 14.

201. Press Release, Tex. Dep't Ins., Commissioner Montemayor Statement to Consumers & Consumer Groups, *at* www.tdi.state.tx.us/commish/news/moldconsumer.html (Sept. 18, 2001).

202. *Mold Concerns Prompt Insurers to Limit Homeowners Coverage in Texas*, BESTWIRE, Aug. 22, 2001, at 1, 1.

203. David Kaplan, *Allstate Limits Policies for Homes,* THE HOUSTON CHRON., Aug. 23, 2001, at 1, 1.

204. *See id.* at 2.

endorsements.[205] Neither consumers nor insurers were pleased with this decision. Consumer groups wanted higher limits, because they believed the average cost of a mold claim to be about $17,000.[206] State Farm, the largest insurer in Texas, announced it would no longer write new property policies in the state.[207] Farmers, the second-largest insurer in the state, stopped renewing 600,000 HO-B policies, offering to sell only its HO-A policy, which did not coverage any sort of water damage.[208]

After the negative response by both consumers and insurers, the TDI revised its proposal and issued its final order on November 28, 2001.[209] This order purported to focus on "back to basics," providing coverage for the removal of mold related to covered water damage, such as leaks or sudden overflows (even if they were concealed), which was similar to the original HO-B policy.[210] But the proposal eliminated coverage for expensive remediation procedures.[211] In contrast with the September recommendation, the new proposal did not provide a specific limit on damages, allowing insurers and consumers to determine how much coverage they thought was appropriate.[212] Under the new proposal, policyholders would still have the option to buy back 25%, 50%, or 100% of their original coverage, so those individuals who wanted full mold coverage could obtain it, but at higher premiums.[213]

As with the earlier proposal, both sides were still unsatisfied.[214] The insurers, who had sought to eliminate mold coverage entirely, saw the proposal as "too little, too late."[215] Also disappointed were consumers, who already paid the highest homeowners insurance rates in the country,

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205. Press Release, Tex. Dep't Ins., Montemayor Gets Mold Recommendation, Urges Calm Consideration, *available at* www.tdi.state.tx.us/commish/news/moldconsumer.html (Sept. 18, 2001).

206. Terrence Stutz, *Changes Sought in Mold Plan; Consumer Groups Want Coverage Tripled to $15,000,* THE DALLAS MORNING NEWS, Oct. 16, 2001, at 19A.

207. *State Farm Drops New Homeowners Coverage in Texas,* BESTWIRE, Sept. 19, 2001, at 1, 1.

208. *Farmers Stops Renewals on 600,000 Texas Homeowners Policies,* BESTWIRE, Nov. 12, 2001, at 1, 1.

209. *TDI Nov. Rep. supra* note 123.

210. Press Release, Tex. Dep't Ins., Montemayor Protects Consumer Choice, Availability of Mold Coverage, *available at* www.tdi.state.tx.us/commish/news/moldconsumer.html (Nov. 28, 2001).

211. *Id.*

212. *Id.*

213. *Id. See also supra* Sec. II.

214. Harkins, *supra* note 54, at 1130.

215. Terrence Stutz, *Order Restricts Mold Coverage*, THE DALLAS MORNING NEWS, Nov. 29, 2001.

and now, if they wanted full mold coverage, they would have to pay even higher rates.[216]

The Commissioner directed insurance companies to make appropriate revisions to their policies by January 1, 2003 but allowed them to start implementing changes as early as January 1, 2002.[217]

3. Application of the New Order

In March 2002, the TDI issued an order granting State Farm permission to sell its "national" policy in Texas.[218] The policy contained limited mold coverage, similar to what TDI had suggested in its November proposal. The coverage, however, differed from the traditional Texas HO-B policy, because the State Farm policy would only cover damage from "sudden or accidental" events, not from slow leaks or seepage.[219] The order also approved thirty-six endorsements, which either added or excluded coverage. For example, consumers could purchase a water damage endorsement or fungus endorsement, providing various levels of coverage.[220] However, some of these endorsements would only be offered during the renewal period, and if policyholders declined them at that time, they would not be eligible for them at a later date.[221] Consumers would also have the option of buying remediation coverage in different amounts.[222] In approving the State Farm order, TDI noted that the insurer would need to file any rate changes with the Department, so that it could monitor the rates of the new policies for a period of two years.[223]

State Farm suggested that switching from the old HO-B policy to its "national" policy would reduce the premium for an average homeowner from $1481 to $867.[224] If the homeowner elected to have additional water and mold coverage (similar to that of the HO-B plan), the premium would only drop to $1348.[225]

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216. *Id.* at 1.

217. *TDI Nov. Rep., supra* note 123, at 65.

218. Press Release, Tex. Dep't Ins., *Montemayor Expands Options for Homeowners, available at* www.tdi.state.tx.us/commish/news/moldconsumer.html (Mar. 8, 2002).

219. *Id.*

220. Tex. Dep't of Ins., Commissioner Order No. 02-0208 (2002) [hereinafter State Farm Order], *at* http://www.tdi.state.tx.us/commish/rules/statefarm.html (last visited Nov. 18, 2004).

221. *Id.*

222. *Id.*

223. *Id.*

224. Montemayor Expands Options for Homeowners *supra* note 218.

225. *Id.*

Similar national policies have also been allowed for use in Texas. In May 2002, Commissioner Montemayor approved USAA's national policy,[226] and in October, he approved Nationwide's national policy.[227] Both policies had similar language to the State Farm national policy and provided buy back endorsements for losses that were no longer covered, such as for water and mold damage.

4. Texas Legislation

The next wave of confrontation between the industry and the TDI erupted in the summer of 2003 when the state passed new legislation. House Bill 329 prohibited insurers from holding previous mold claims against property owners if the problem had since been fixed.[228] It also set out standards for mold remediation licensing and gave authority to the Texas Board of Health to regulate the mold remediation industry.[229] This development was significant for the insurance industry because many of the high costs surrounding mold damages were blamed on unregulated and untrained remediators.

Senate Bill 127 amended the Texas Insurance Code to include licensing requirements for public insurance adjusters and addressed some of the basic problems with the industry's handling of mold and water damage claims by restricting the use of claims history for water damage claims and requiring claims to be handled with certain time frames.

Pursuant to Senate Bill 127 and House Bill 329, the TDI adopted § 21.1007 of the Texas Administrative Code, which placed restrictions on insurers from using previous water or mold damage claims as a basis of underwriting.[230]

Both the legislature and TDI had determined that it was unfair to make underwriting decisions based on previous mold damage or claims that had been properly remediated and such action should be prohibited.[231] This belief was further supported by the fact that many of the new insurance policies in Texas no longer even provided coverage for the type of water

226. News Release, Tex. Dep't Ins., Montemayor Further Expands Homeowners' Options, *at* https://wwwapps.tdi.state.tx.us/inter/asproot/commish/news/clips2002.asp?id=48 (May 22, 2002).

227. Tex. Dep't of Ins., Order No. 02-1067 (2002) [hereinafter Nationwide Order], *at* http://www.tdi.state.tx.us/commish/orders/co-02-1067.html (last visited Nov. 18, 2004).

228. H.R. 329, 78th Leg., Sess. 205 (Tex. 2003).

229. *Id.*

230. 28 TEX. ADMIN. CODE § 21.1007 (2004).

231. 28 TEX. ADMIN. CODE § 21.1007 (2004) (introduction).

and mold damage that they used to cover.[232] So, even if a particular house or person was more likely to have a mold claim based on his history of water problems, the damage would no longer be covered by homeowners insurance, and therefore, it should not be considered in the underwriting process.[233] Additionally, such a practice would be based on excluding a broad class of homes and applicants, rather than underwriting based on a home's unique characteristics.[234] The TDI acknowledged that previous water and mold claims might suggest the need for further underwriting investigation, but it refused to allow those factors to be the sole basis of declining coverage.[235]

The stated purpose of the new regulation is to protect individuals who had previously filed mold, water damage, or appliance-related claims under residential policies from being "unfairly stigmatized" in obtaining residential property insurance.[236]

To protect policyholders who had previously had mold or water damage, the rule provides that if the property had been remediated in accordance with the Texas Health Board's regulations, then the insurer would not be permitted to use the mold or water damage claim as an underwriting guideline.[237]

Also consequential for the insurance industry, the Texas Legislature passed Senate Bill 14, which regulates insurers under a prior approval system.[238] Under this system, rates must be approved by the TDI within thirty days.[239] If it has not been approved or disproved within thirty days, it is deemed approved.[240] The bill also addresses many other insurance concerns, but it also tries to make the process more transparent by requiring more public disclosure, including the insurers' methodologies behind their rates.[241]

5. Results of Rate Reductions

In August 2003, Commissioner Montemayor ordered twenty-nine insurance companies to reduce their rates by amounts ranging from 4 to 24

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232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.*
236. 28 TEX. ADMIN. CODE § 21.0077(a) (2004).
237. *Id.* § 21.007(e).
238. S.B. 14, 78th Leg. Reg. Sess. (Tex. 2003) (bill analysis).
239. *Id.*
240. *Id.*
241. *Id.*

percent,[242] totaling $510 million.[243] Twelve insurers fought those reductions including State Farm and Farmers, who collectively sell 43 percent of the policies in Texas.[244] The TDI had ordered State Farm to reduce its rate by 12 percent and Farmers by 17.5 percent.[245] They are still in the process of appealing the order.[246] State Farm contends that the rate process is flawed and denied the company due process protections.[247] The others who fought the reductions have since reached agreements with the TDI.[248] For example, Allstate, which controlled 17 percent of the Texas market was ordered to cut its rates 18.2 percent. It settled with the TDI, agreeing to an immediate reduction by 8.7 percent and consented to having the TDI review its rates in August 2004 and possibly credit policyholders another 8.7 percent.[249]

Despite all of these efforts at reducing rates, the success of these initiatives remains hotly disputed. By May 2004, many consumers complained that they had not seen a significant difference in their rates.[250] A Texas consumer group argues that Texas still has the nation's highest insurance rates.[251] Texas homeowners paid an average of $1,200 per year, compared with the national average of $569.[252]

The TDI counters that the reform efforts have been successful. The loss ratio for top homeowners insurance companies, which reflects losses on claims as a percentage of total premiums, decreased from 108 percent in 2002 and 118 percent in 2001 to 58 percent for the year 2003.[253] The percentages would have been somewhat higher if the new rate reductions

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242. Analisa Nazareno, *Rates Keep Rising,* SAN ANTONIO EXPRESS-NEWS, July 3, 2004, at H4.

243. *Insurers Seeing Relief in Texas: What About Policyholders?*, AUSTIN-AM. STATESMAN, May 27, 2004, at A12.

244. Nazareno, *supra* note 242; Janet Elliott, *Few Homeowners See Breaks on Insurance,* HOUSTON CHRON., Oct. 20, 2003, at A1.

245. Nazareno, *supra* note 242.

246. Terrance Stutz, *Home Insurance Rates Rise; Consumer Groups Seek Changes; Companies Say Reforms Are Working*, DALLAS MORNING NEWS, Dec. 11, 2003, at A3.

247. Nazareno, *supra* note 242.

248. Nazareno, *supra* note 242.

249. Elliott, *supra* note 244.

250. *Insurers Seeing Relief in Texas, supra* note 243.

251. *New State Insurance Laws Not Working, Groups Says,* HOUSTON CHRON., Mar. 17, 2004, at 23.

252. *Id.*

253. TEX. DEP'T INS., NEW DATA SHOWS IMPROVEMENT IN HOMEOWNERS INSURANCE MARKET, Mar. 15, 2004 *at* https://wwwapps.tdi.state.tx.us/inter/asproot/commish/news/searchdb.asp.

had been factored in.[254] Nevertheless, the TDI believes that stability has returned to the Texas market after the mold crisis.[255]

Since the Department has allowed policies excluding mold, the number of mold-related complaints filed with the Department has dropped dramatically from 1,055 complaints in 2002, to 541 in 2003, a drop of 49 percent.[256]

In contrast with the frozen insurance market during the height of the mold panic, Allstate has been eager for more business within Texas.[257] Beginning in May 2003, Allstate had been writing about 2,500 new policies a week and developed a new marketing campaign taking advantage of State Farm and Farmers' battle with ordered rate cuts.[258]

IV. WILL THE REFORMS WORK?

There is a basic tension between the need for the insurance industry to be profitable and cover its losses and for public policy concerns about making insurance affordable for homeowners and providing some sort of coverage for mold catastrophes when they occur. In addition, if mold is not covered, the ramifications reach much farther than individual homeowners and insurers. Homeowners and their insurers will seek to place responsibility for the mold and its cleanup with others, causing secondary results in real estate and construction markets.

A. TRANSACTIONAL COSTS

Not only does mold cause property damage and potential health risks, it could also prevent real estate or construction deals out of fear of future liability.[259] In real estate transactions, fear of mold could impose numerous transactional costs. If buyers suspect potential mold problems based on previous water damage or environmental testing, they will likely demand express warranties addressing mold or conditions that might facilitate mold growth.[260] Also, potential mold problems would likely reduce the price that the seller is able to obtain for the property. Furthermore, even if the buyer

254. *Id.*
255. *Id.*
256. *Insurers Seeing Relief, supra* note 243.
257. Purva Patel, *Allstate Hungry as Home Insurance Crisis Eases,* HOUSTON CHRON., Mar. 20, 2004, at 1.
258. *Id.*.
259. *See* Wright & Irby, *supra* note 4, at 344-48.
260. *Id.* at 349.

is willing to assume the risk of future mold problems, he may have difficulty satisfying a lender with adequate insurance coverage for potential mold problems.

For example, one Texas couple had been searching to buy a home for over a year and once they finally found a home they wanted to purchase, they could not find an insurer to issue a homeowners policy.[261] The seller had recently repaired a sewer line, so the various homeowners' insurers did not want to insure the home out of fear of mold claims.[262] Finally, about ten days before closing on the home, Nationwide conducted a home inspection and issued a policy.[263] None of the other insurers were even willing to come inspect the home.[264] The couple reported that the search for homeowners insurance was the most stressful part of the entire home-buying experience.[265] This story shows the complicated aspect of homeowners insurance and how it can affect secondary markets and possibly prevent basic real estate and mortgage transactions.

Problems also exist for contractors. Because insurers have been tightening mold exclusions on homeowners' policies, many mold plaintiffs are pursuing contractors. In insuring newly constructed buildings, most insurance policies exclude mold unless it results from covered losses. This exclusion turns contractors into likely defendants in mold litigation, placing strong incentives with them to use appropriate building materials and to take extra precautions to prevent moisture problems during the construction process.[266] In this respect, the lack of coverage in homeowners' policies could be viewed as appropriately aligning incentives for contractors and homeowners to remain vigilant about preventing mold. Unfortunately, most individuals have difficulty conforming present behavior to prevent distant liability in the future. Although these developments seem promising from both a construction liability standpoint, and because they will prevent the creation of future mold claims against homeowners insurers, they also seem somewhat unrealistic.

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261. Mary Sit-Duvall, *The Mold Toll; Claims Boost Insurance Rates, Fraud*, HOUS. CHRON., June 30, 2002, at A1.

262. *Id.*

263. *Id.*

264. *Id.*

265. *Id.*

266. *See* Thomas J. Acchione, Alfred B. Alessi, Jr., & Roger E. Riedley, *Don't Be Left Exposed to Mold: Cover Your Construction Risks*, CLAIMS MAG., Oct. 2003, at 59.

B. EDUCATION AND THE ESTABLISHMENT OF "SAFE" STANDARDS

An important step to reducing the number of mold claims is educating consumers and gaining a better scientific understanding of the relationship between mold exposure and health. Texas has implemented some of these measures by educating the public through publications regarding safe handling of water claims to prevent mold damage, as well as through the media.[267] A recent government study notes that information is already known by the industry about controlling indoor dampness, but more must be done to disseminate that information to contractors, maintenance staff, architects, and property managers.[268] Additionally, states should review building codes and regulations and revise them as necessary to combat moisture problems.[269]

In addition, recent Texas legislation delegated authority to the Board of Health to set appropriate mold remediation standards.[270] Although this is an important first step, it is critical that these guidelines are carried through. California passed similar legislation in 2001,[271] and New York City set fungal indoor air standards in early 1993,[272] yet there are still no specific exposure standards for mold.[273]

It is clearly important to have remediation standards, but it is also important to conduct more studies about mold itself and its effect on humans.[274] Once more is understood about the potential health impact, it will be easier to determine mold risks and the need to insure against them. Although mold will probably always be a pathogen of destruction, dealing with an inconvenient slimy substance would be much more favorable than dealing with a toxic one.

C. WILL THE NEW TEXAS POLICIES SUCCEED?

The allowance of "national" policies that only cover sudden and accidental water events was a critical decision by Texan insurers. The

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267. *See, e.g.*, Tex. Dep't of Ins., Effectively Handling Water Damage and Mold Claims, *available at* www.tdi.state.tx.us/consumer/moldpub.html (April 2002).

268. *Mold Health Study, supra* note 15.

269. *Id.*

270. *See supra* Sec. III.B.4.

271. CAL. HEALTH & SAFETY CODE §§ 26100-26204 (2004).

272. N.Y. City Dep't of Health & Mental Hygiene, Guidelines on Assessment and Remediation of Fungi in Indoor Env'ts, *available at* www.ci.nyc.ny.us/html/doh/html/epi/moldrpt1.html (Jan. 2002).

273. *See* Zolkos, *supra* note 31.

274. *See supra* Sec. I.A.

expansive coverage of the original HO-B policy was partially responsible for the current mold and insurance crisis in Texas. Although the previous coverage was generous, all homeowners paid dearly for it as their rates dramatically increased after the onslaught of mold claims resulting from continuous water damage.

In theory the modified HO-B policy and the national policies now being used in Texas are not very different from those used in the rest of the country and should leave Texas insurers with similar risks as those faced by national insurers. The national policies only covered mold resulting from limited "covered events," and the coverage dollar amounts are quite limited as well. Under these new policies, significant mold coverage will only be available to homeowners who are willing to pay additional premiums for expanded coverage through water damage and fungus endorsements. It is unclear how many homeowners will be willing to pay for that expensive coverage, especially since most Texas homeowners (even with some of the rate reduction) face higher rates than a few years ago, yet receive less coverage. Since remediation of a mold-infested home can be extremely costly, those without substantial coverage are at risk of a dramatic loss in the value of their homes. This risk is troubling from a policy viewpoint, especially because a home is generally a family's most valuable asset.[275]

Reports indicate that Texas, which has only eight percent of the United States population, suffered over 75 percent of all mold claims.[276] Perhaps insurers are simply being responsible by converting their Texas policies to those that are used nationwide, in an attempt to reduce the number of mold claims filed under homeowners insurance. It is clear that if the TDI had not allowed limited coverage for mold, more insurers would probably have left the state, and a lack of homeowners' insurers would certainly have been a crisis. As it was, Texas homeowners faced limited options for coverage during the mold crisis.

A better approach might be to take more proactive efforts aimed at the future, such as providing incentives for mold resistant construction, new detection methods, and mold resistant building products. Similarly, examples of incentives could be bonuses for facility managers who meet specified goals for reducing and preventing water problems, or fines for failing to correct problems by a specified deadline.[277] Many contractors

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275. Sylvia Pena-Alfaro, *Comment: The Toxic Mold Terrifying Texas: Mold's Hold on the Insurance Industry*, 34 ST. MARY'S L.J. 541, 577 (2003).

276. Sit-Duvall, *supra* note 261.

277. *Mold Health Study*, *supra* note 15.

have begun using such products to prevent future claims against them for negligent construction.[278]

This approach is somewhat unrealistic, because many of the claims facing insurers originated in older houses. Additionally, until we better understand the true health risks and reasons it will be difficult for homeowners and contractors to make this cost-benefit analysis. At the same time, however, this idea is consistent with the national insurance plans that focus more on sudden and accidental events, shifting the burden to the owners for proactively preventing maintenance problems.

V. CONCLUSION

"Sunlight is said to be the best disinfectant."[279] Although Justice Brandeis's words are generally reserved for the discussions regarding public disclosure, they are equally appropriate here. More than mere sunlight is required to solve the toxic mold problem. Although many predict that the mold hysteria will die down as both the scientific community and general public learn more about mold, it seems that just as mold has always existed, it will continue to plague homeowners into the future. Every homeowner is a potential victim of mold whether as a nuisance or something more, so even though some of the "hysteria" will die down, regardless of whether mold is excluded by insurers or removed from the media airways, mold damage will be around for a while.

The current solution reached in Texas pleases neither insurers nor homeowners. Mold claims will likely continue within a state that has received so much media attention and suffers from a humid climate, ripe for mold growth. Homeowners who elect to pay additional premiums will receive additional coverage, but they will still not have as complete coverage as they once had. Those individuals who choose not to buy the mold riders, or are not eligible for them, face the possibility of disaster if they do indeed develop a toxic mold outbreak. Insurers would prefer to exclude it entirely. Perhaps the lack of satisfaction on both sides reflects an appropriate compromise.

278. Rich, *supra* note 39.

279. LOUIS DEMBITZ BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (National Home Library Foundation 1933).

PRO-RATING DEFENSE COSTS TO AN INSURED FOR PERIODS OF UNINSURANCE; WHAT HAPPENED TO THE DUTY TO DEFEND?: *SECURITY INSURANCE CO. OF HARTFORD V. LUMBERMENS MUTUAL CASUALTY CO.*

Elizabeth Festa[*]

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INTRODUCTION

A debate continues in this country regarding the proper allocation of defense costs in cases involving long latency loss claims implicating multiple successive insurers where coverage is interrupted by periods of uninsurance. More specifically, the question debated is whether it is appropriate to allocate defense costs to the insured with respect to the periods of uninsurance, and if so, how? The Connecticut Supreme Court recently had the opportunity to decide precisely this question, as one of first impression, in *Security Insurance Company of Hartford v. Lumbermens Mutual Casualty Co.* (*Lumbermens*).[1] In a unanimous decision, the Court held that where coverage is interrupted by periods of uninsurance defense costs are to be pro-rated by time-on-risk to the insured with respect to the periods of uninsurance."[2]

As was the case in *Lumbermens*, this issue usually arises in the context of toxic tort claims, where exposure to a toxin results in injuries of a progressive and cumulative nature. One of the most common examples is asbestos exposure. Asbestos, a mineral compound of high strength and flexibility, is capable of withstanding high temperatures. As a result, it has many commercial uses.[3] Unfortunately, small asbestos particles often become airborne.[4] Once inhaled the asbestos particles are deposited in the lungs.[5] The presence of these particles in the lungs can cause a number of

1. Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107 (Conn. 2003) (hereinafter cited as *Lumbermens II*). There is no Connecticut appellate case deciding this issue. A number of Connecticut superior courts have addressed the issue of allocation among multiple insurers. *See* Met. Life Ins. Co. v. Aetna Cas. & Sur. Co., No. 115305, 1999 Conn. Super. LEXIS 1000, (Conn. Super. Ct. Apr. 16, 1999, Koletsky, J.); Reichhold Chem., Inc. v. Hartford Accident & Indem. Co., No. 085884, 1998 Conn. Super. LEXIS 3222 (Conn. Super. Ct. Oct. 1, 1998); Reichhold Chem., Inc. v. Hartford Accident & Ind. *Co.*, No. 085884, 1999 Conn. Super. LEXIS 2066 (Conn. Super. Ct. Feb. 11, 1999). The Second Circuit has not addressed the issue directly. *See* Dicola v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n. 158 F.3d 65, 85 n.12. (2d Cir. 1998); Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp., 73 F.3d 1178 (2d Cir. 1995).

2. *Lumbermens II*, 826 A.2d at 127.

3. Asbestos use has been particularly widespread in the construction industry, especially in products such as home insulation, cement, paint, and tile. 15 ATTORNEY'S TEXTBOOK OF MEDICINE ¶ 205C.10 (Roscoe N. Gray & Louise J. Gordy eds., 3d ed. 2003); 13 ATTORNEY'S TEXTBOOK OF MEDICINE ¶ 134A.30 (Roscoe N. Gray & Louise J. Gordy eds., 3d ed. 2003) (products containing asbestos and sources of exposure).

4. Such as when asbestos is mined, processed, or used in construction. Ins. Co. of N. Am. v. Forty-Eight Insulations, Inc., 633 F.2d 1212, 1214 (6th Cir. 1980).

5. It is impossible to cough out or expel asbestos particles from lung tissue. Thus once inhaled they remain in the lungs permanently. Porter v. Am. Optical Corp., 641 F.2d 1128, 1133 (5th Cir. 1981).

pulmonary diseases, including but not limited to asbestosis,[6] mesothelioma,[7] and broncheogenic carcinoma (lung cancer).[8] These diseases result from cumulative body reactions to the inhaled particles. While continuous or heavy exposure may accelerate the progression, these diseases develop slowly, requiring anywhere between ten to forty years to fully manifest.

Litigation involving asbestos typically arises when an individual previously employed in an industry using asbestos-laden products or materials contracts an asbestos-related disease and commences litigation against the manufacturer of the asbestos-laden product for failing to warn that asbestos was an inherently dangerous product[9] or his employer for bodily injuries resulting from the inhalation of asbestos while on the job, or both.

The manufactures and/or employers sued typically have insurance policies protecting them from liability, these polices are by and large occurrence based comprehensive general liability policies. The standard form language used in most comprehensive general liability insurance policies provides:

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6. Asbestosis is a process by which the human body reacts to the presence of asbestos particles in the lungs. The particles cause inflammation until fibrosis, the laying down of scar tissue surrounding the asbestos particles, occurs. Eventually, as asbestos particles collect in the lungs, the scar tissue replaces the healthy lung tissue, causing shortness of breath and other breathing difficulties. Asbestosis is a condition in and of itself, but it can also hasten the onset of other illnesses such as emphysema, bronchitis, and pneumonia. Asbestosis typically does not manifest until twenty to forty years following initial exposure, and it rarely occurs in less then ten years. *See Porter*, 641 F.2d at 1133; 13 ATTORNEYS' TEXTBOOK OF MEDICINE , *supra* note 3, ¶ 134A.34(1) (describing asbestosis).

7. Mesothelioma is cancer of the mesothelial cells. The mesothelial cells are those that line the chest wall and surrounding the organs of the chest cavity. Mesothelioma does not usually manifest until at least twenty years following excessive inhalation of asbestos. Although easily discoverable and diagnosable shortly after manifestation, there is currently no satisfactory treatment for mesothelioma. Within several years of the initial development of the tumor, the victim almost always dies. *Forty-Eight Insulations Inc.*, 633 F.2d at 1214 n.1. *See also* 13 ATTORNEYS' TEXTBOOK OF MEDICINE, *supra* note 3, ¶ 134A.34(2) (describing mesothelioma).

8. The exact correlation between lung cancer and asbestos has not been established. It appears, however, that inhalation of asbestos accelerates the development of lung cancer in persons who smoke. *Forty-Eight Insulations, Inc.*, 633 F.2d at 1214 n.1. "[I]t is accepted that the synergistic effects of cigarette smoking and asbestos exposure increase the risk of lung cancer by a factor of 50, and the smoking of a more than one pack of cigarettes a day by a factor of 87." 13 ATTORNEYS' TEXTBOOK OF MEDICINE, *supra* note 3, ¶ 134A.32(3).

9. *Forty-Eight Insulations Inc.*, 633 F.2d at 1214-15.

> The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence,[10] and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, . . .[11]

These polices, however, were drafted with the expectation that they would be applied to the ordinary situation, such as a car accident, where both the accident and resulting harm take place almost simultaneously. Under such circumstances it is easy to ascertain when an injury occurred and, therefore, if the policy is triggered.[12] Applying such a policy to a cumulative and progressive disease like asbestosis, where it is virtually impossible to assign injury to a specific date, is much more difficult.

Further complicating the situation is that comprehensive general liability policies are generally issued for only one year at a time. Therefore, given the latent nature of asbestos-related diseases, the employer and/or manufacturer will most likely have purchased a number of occurrence based comprehensive general liability policies, from several different insurance companies, during the period of time between initial exposure and manifestation. As a result, when a claim for an asbestos-related injury is made, any one of a number of insurance policies are potentially triggered, depending on the date of the injury.

Much controversy and division has surrounded the determination of when an asbestos-injury occurs and therefore which of the several insurance policies are triggered. The courts have yet to reach a unanimous answer to this question, adopting instead four different trigger theories; manifestation, exposure, injury-in-fact, and the multiple, continuous or successive trigger.[13] Regardless of which trigger theory a court adopts, a

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10. "Occurrence" is defined by the standard form policy as an accident including continuous or repeated exposure to conditions. Marcy Louise Kahn, *Looking for "Bodily Injury:" What Triggers Coverage Under a Standard Comprehensive General Liability Policy?*, 19 FORUM 532, 534 (1984).

11. *Id.* at 532.

12. *See* Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp., 73 F.3d 1178, 1186 (2d Cir. 1995).

13. 2 JEFFREY W. STEMPEL, LAW OF INSURANCE CONTRACT DISPUTES, § 14.09(b) (2004). Under the manifestation theory an injury occurs when it manifests itself or becomes reasonably capable of diagnosis. Under the exposure theory a policy is triggered when the

difficult question remains—how defense costs are to be allocated among the multiple insurers whose policies have been triggered? This question is even more difficult when there is a period or periods of uninsurance.

This Note will examine accuracy the Connecticut Supreme Court's decision to pro-rate defense costs to the inured with respect to the period of uninsurance. Part I provides an in-depth discussion of the *Lumbermens* opinion. Part II describes the framework in which *Lumbermens* was decided, including a brief discussion of rules of insurance contract interpretation in Connecticut, the language and purpose of occurrence based comprehensive general liability insurance, and the methods of allocation adopted by the various courts prior to the *Lumbermens* decision. Part III discusses the accuracy of the Court's reliance on *Insurance Co. of North America v. Forty-Eight Insulations, Inc.*[14] and *Owens-Illinois., Inc. v. United Insurance Co.*.[15] Finally, Part IV discusses the circular reasoning utilized by the Court in rejecting the appellant's arguments.

I. *SECURITY INSURANCE CO. OF HARTFORD v. LUMBERMENS MUTUAL CASUALTY CO.*

A. FACTUAL SYNOPSIS

ACMAT Corporation is engaged in the construction and renovation business and at various times used a fireproofing spray containing asbestos.[16] On May 1, 1996 over one hundred claimants commenced litigation against ACMAT for bodily injuries allegedly resulting from the inhalation of asbestos (hereinafter "Bridgeport Litigation").[17] ACMAT is potentially liable for the period March 16, 1951 through May 1, 1996.[18]

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claimant is exposed to the alleged cause of the disease regardless of when the injury became manifest or capable of diagnosis. Under the injury-in-fact or actual injury theory the occurrence giving rise to the third-party claim happens at the time when the body's defenses have been 'overwhelmed' so that significant injury is inevitable. Under the multiple, continuous, or successive trigger theory an occurrence has happened whenever the claimant is exposed to the cause of the injury, was injured in fact, or the injury becomes manifest. *Id.*

14. 633 F.2d 1212 (6th Cir. 1980).

15. 650 A.2d 974 (N.J. 1994).

16. ACMAT is a Connecticut corporation originally founded March 16, 1951, under the name Acoustical Materials Corporation. *Lumbermens II*, 826 A.2d at 110 n.2. On December 10, 1969, Acoustical Materials Corporation changed its name by amending its certificate of incorporation to ACMAT Corporation. *Id.* No change to the corporate structure took place. *Id.*

17. In re Bridgeport Asbestos Litig., No. 332364, 1998 WL 376024 (Conn. Super. Ct. June 24, 1998) [hereinafter Bridgeport Litigation]. ACMAT is only one of multiple defendants in this litigation. *Lumbermens II*, 826 A.2d at 110 n.3. "The model complaint

During the approximately forty-five year period for which ACMAT is potentially liable to the Bridgeport Litigation plaintiffs, ACMAT purchased occurrence based general liability policies from a number of different insurance companies.[19]

- March 16, 1951 - April 22, 1959: ACMAT purchased asbestos related insurance coverage, but does not know who the insurers were and has either lost or destroyed the policies. ACMAT did not demand that any insurance company provide it with a defense or pay defense costs with regard to this period.
- April 22, 1961 - January 1, 1964: ACMAT alleged Liberty Mutual Insurance Company (Liberty) provided ACMAT with asbestos related coverage. But ACMAT either lost or destroyed the policies. Liberty denied issuing these policies.
- January 1, 1964 - January 1, 1968 ACMAT alleged Greater New York Insurance Company (Greater New York) provided ACMAT with asbestos related coverage. But ACMAT has either lost or destroyed the policies. Greater New York denies issuing these policies.
- January 1, 1968 - January 1, 1972, ACMAT was insured by Travelers Insurance Company (Travelers).

[in the Bridgeport Litigation] alleges that the defendants (including ACMAT) were engaged in the business of buying, selling and installing asbestos products and asbestos materials. The model complaint further alleges that the plaintiffs, while working for their employers at various job sites, came into contact with asbestos materials and products. Specifically, the model complaint alleges that at all relevant times that the plaintiffs were working, they were 'forced to come in contact with and breathe, inhale and ingest airborne fibers and particles emitted by said [asbestos] products and materials as they were sawed, cut, mixed, installed, removed or otherwise used' by the plaintiffs. The complaint alleges that as a result of this contact with the asbestos the plaintiff's suffered permanent injuries, diseases, and death." *Id* at 110, n. 4. The claimants did not allege the precise dates of their injury. *Id.* at 110-111.

18. *See Lumbermens II,* 826 A.2d at 111; Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., No. 475565, 2001 Conn. Super. LEXIS 1387, at *6-7 (Conn. Super. Ct. May 9, 2001) (hereinafter *Lumbermens I*).

19. Asbestos-related injury insurance coverage was available to ACMAT from March 16, 1951 through April 1, 1985. ACMAT has been insured by "claims-made" as opposed to "occurrence" based comprehensive general liability policies since April 1, 1985. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *6. These policies specifically exclude coverage for claims related to asbestos and were the only comprehensive liability insurance available after April 1, 1985. *Id.* at *23 n.7. "Claims-made" policies are triggered by the assertion of a claim against the insured during the policy period. Evans v. Medical Inter-Ins. Exchange, 856 A.2d 609, 611-12 n.1 (D.C. 2004). "Occurrence" based polices are triggered by "bodily injury" resulting from an "occurrence" that takes place during the policy period. Only the "bodily injury," not the occurrence, needs to take place during the policy period to trigger coverage. *Lumbermens II,* 826 A.2d at 111 n.5.

- January 1, 1972 - January 1, 1976, ACMAT was insured by Security Insurance Company of Hartford (Security).
- January 1, 1976 - January 1, 1979, ACMAT was insured by Liberty
- January 1, 1979 - April 15, 1981, ACMAT was insured by Lumbermens Mutual Casualty Company (Lumbermens).
- April 15, 1981 - April 15, 1985, ACMAT was insured by Cigna Corporations (Cigna).[20]

ACMAT tendered the defense to each insured, demanding a defense or in the alternative a pro-rata share of the defense costs. Travelers, Liberty, Cigna, and Security agreed to participate in the defense of ACMAT pursuant to their obligations under the occurrence based comprehensive general liability policies they issued to ACMAT. Liberty and Greater New York refused ACMAT's demand with respect to the lost/missing policy periods.[21]

B. PROCEDURAL HISTORY

On August 26, 1996, Security filed a two-count complaint against ACMAT and Lumbermens. The first count sought a declaration that ACMAT and/or Lumbermens was responsible for an equitable portion of the defense costs attributable to the two year period Lumbermens provided coverage to ACMAT. The second count sought a declaration that ACMAT was responsible for an equitable portion of its defense costs attributable to the period after April 1, 1985 when ACMAT's insurance policies excluded asbestos coverage.[22]

In a decision dated July 12, 1999 the trial court (Graham, J.) granted Security's second renewed motion for summary judgment against ACMAT on the first count and denied Security's motion as to the second count. In ruling for Security, the trial court found that ACMAT was legally obligated to assume an equitable share of the defense costs by virtue of its having released Lumbermens from the latter's obligation to defend.[23] In ruling against Security, the trial court found that ACMAT was not responsible for

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20. *Lumbermens II*, 826 A.2d at 111.

21. *Id.* at 111-12.

22. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *2.

23. *Id.* at *2-4. ACMAT had executed a buy-back agreement whereby it agreed to release Lumbermens from all obligations under its insurance policy. Because of this agreement, the court (Graham, J.) had previously granted Lumbermens' motion for summary judgment as to count one. *See* Sec. Ins. Co of Hartford v. Lumbermens Mut. Cas. Co., No. 475564, 1998 Conn. Super. LEXIS 1327, at *4-5 (Conn. Super. Ct. May 8, 1998).

defense costs proportionate to the period of time after 1985 when asbestos exposure coverage was not available.[24]

On November 30, 1999 Security filed an Amended Complaint, which added a third count against ACMAT as the remaining defendant. The third count sought a declaration that "ACMAT is obligated to assume an equitable share of the cost of its defense because of the period of time from 1951 through 1967, during which time ACMAT lost or destroyed its insurance policies and for which no insurer has provided coverage."[25]

On January 9, 2001, the third count was tried via oral argument based on a stipulation of facts and the trial court (Graham, J.) issued a written decision on May 9, 2001.[26] The trial court first determined that the Bridgeport Litigation involved a "continuous trigger situation such that all asbestos related injury policies issued during the extended exposure period have been triggered for coverage and all companies that issued such policies are responsible for defense costs related to the [Bridgeport Litigation]."[27] Then basing its decision on Second Circuit precedent and equitable considerations, the trial court held ACMAT was liable "for the share of defense costs proportionate to the years for which the relevant insurance policies have been lost or destroyed."[28] Accordingly, the trial court ordered ACMAT, as the insured to contribute, 50.18%, of all past, present, and future defense costs based on its liability under counts one and three.[29]

ACMAT appealed to the Connecticut Appellate Court.[30] The Connecticut Supreme Court thereafter transferred the case to itself.[31]

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24. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *4; *see also* Sec. Ins. Co of Hartford v. Lumbermens Mut. Cas. Co., No. 475564, 1999 Conn. Super. LEXIS 1902 (Conn. Super. Ct. July 12, 1999). Security withdrew this count before trial. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *4.

25. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *4.

26. Brief for Appellant at 2, Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., No. 475565, 2001 Conn. Super. LEXIS 1387 (Conn. Super. Ct. May 9, 2001).

27. *Lumbermens I*, 2001 Conn. Super LEXIS 1387, at * 9.

28. *Id.* at *22.

29. *Id.* at *25. Of the 50.18%, a portion, 6.73%, corresponds to ACMAT's equitable contribution with respect to the buyback period, for which the trial court had previously held ACMAT responsible. *Id.* at *24-25. *See* Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., No. CV 960475565S, 1999 Conn. Super. LEXIS 1902 (Conn. Super. Ct. July 12, 1999).

30. ACMAT appealed the trial court's grant of summary judgment in favor of Security with respect to count one, as well as the trial court's judgment in favor of Security as to count three. This Note will not discuss the Supreme Court's decision with respect to count one.

C. THE CONNECTICUT SUPREME COURT DECISION

On appeal ACMAT claimed that "the trial court improperly rendered judgment in favor of Security as to count three, pertaining to the lost policy period, because it failed to apply the joint and several method of allocating defense costs."[32] In support ACMAT argued the pro-rata method was inappropriate because it "(1) improperly treats the duty to defend in the same manner as the more narrow duty to indemnify; (2) improperly recognizes a claim for equitable contribution by an insurer against its insured; and (3) improperly recognizes a claim for reimbursement of defense costs by an insurer against its insured."[33] In the alternative, ACMAT argued that even if the Court were to adopt the pro-rata method in general, it should not do so in this case because the insured did not choose to forgo insurance.[34]

Thus the issue specifically before the Supreme Court was: To what extent, if any, is ACMAT liable for the defense costs incurred in defending the Bridgeport Litigation?[35]

The only policy on record before the Court was the Lumbermens policy issued in 1980.[36] In relevant part the policy provided that Lumbermens

> will pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages because of . . . bodily injury . . . to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury ... even if any of the allegations of the suit are groundless, false, or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient, but the Company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the Company's liability

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31. Pursuant to CONN. GEN. STAT. § 51-199(c) (2003) and Conn. Practice Book § 65-1 (2004).

32. *Lumbermens II,* 826 A.2d at 115.

33. *Id. See also* Brief for Appellant, Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107 (Conn. 2003).

34. *Lumbermens II,* 826 A.2d at 115.

35. *Id.* at 110.

36. *Id.* at 112 n.8.

> has been exhausted by payment of judgments or settlements."[37]

"Bodily injury" is defined by the policy as "bodily injury, sickness or disease sustained by any person which occurs during the policy period, including death at any time resulting therefrom . . . ."[38] "Occurrence" is defined as "an accident, including continuous or repeated exposure to conditions which results in bodily injury...neither expected nor intended from the standpoint of the insured . . . ."[39]

On July 22, 2003 the Supreme Court, in an opinion by Chief Justice Sullivan, held "the trial court properly applied the pro rata method of apportioning defense cost to the lost policy period."[40] The Court further concluded that the trial court properly recognized a cause of action for equitable contribution and reimbursement by an insurer against its insured." Accordingly, the Court ordered ACMAT to contribute 50.18% of all past, present, and future defense costs.[41]

The Court explicitly relied on the analysis of the Sixth Circuit in *Insurance Co. of North America v. Forty-Eight Insulations, Inc.* and the Supreme Court of New Jersey in *Owens- Illinois, Inc.* v. *United Insurance Co.* in affirming the trial court's allocation of defense costs to ACMAT on a pro-rata basis:[42]

> [A]pplying the pro-rata method allocation does not violate the reasonable expectations of the parties to the insurance contracts. Neither the insurers nor the insured could reasonably have expected that the insurers would be liable for losses occurring in periods outside of their respective policy coverage period. Additionally, we do not agree . . .

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37. *Id.* at 112 n.8 (emphasis added). The trial court found the other policies triggered in the Bridgeport litigation afforded "substantially similar" coverage. *Id.*

38. *Id.* at 112 n.8.

39. *Id.* The policy also contained an "Other Insurance" clause and a contribution provision. *Id.*

40. *Id.* at 115. The court specifically did not decide the method of allocation between insurers where the claim does not involve uninsured periods. *Id.* at 127 n.18. The court also affirmed the trial court's decision with respect to the buyback period and reversed the trial court's order of contribution and reimbursement to nonparty insurers. *Id.* at 115, 127-28. Neither of these holdings is relevant to the topic of this Note and will therefore not be discussed.

41. *Id.* at 128.

42. *Id.* at 121. ("We are persuaded by the reasoning of the courts in *Forty-Eight Insulations, Inc.*, and *Owens-Illinois, Inc.*, and, accordingly, adopt the pro rata approach to the allocation of defense costs . . . .").

> that the insurance contract language was not so ambiguous as to how to allocate defense costs in long latency loss claims that it will bear the interpretation that the insurers should be liable for injuries that do not occur during the policy period . . . .[43]

Having adopted the pro-rata method, the Court rejected each of ACMAT's claims in turn. First, in rejecting ACMAT's claim that pro-rata allocation improperly treats the duty to defend like the narrower duty to indemnify, the Court relying on the rational set forth in *Forty-Eight Insulations*, found that:

> [I]n long latency loss claims that implicate multiple insurance policies, there is a reasonable means of prorating the costs of defense, i.e., time on the risk . . . . [B]ecause the duty to defend arises solely under contract and because the insurance companies have not contracted to defend the insured for periods outside of the policy period, requiring the insured to pay its fair share of the defense costs in a long latency loss suit that implicates multiple insurance policies does not treat the broad duty to defend as the more narrow duty to indemnify.[44]

Second, in rejecting ACMAT's claim that the pro-rata approach is improper because there is no cause of action for equitable contribution by an insurer against its insured, the Court found that those courts adopting the pro-rata method recognize the cause of action and that its applicability "necessarily follows from the rationale underlying the pro rata method of allocation, i.e., that the duty to defend does not extend to periods of self insurance."[45] Thus, contribution may be had where the pro-rata method is properly applied.[46]

Likewise, in rejecting ACMAT's claim that the pro-rata approach is improper because there is no cause of action for reimbursement by an insurer against its insured, the Court concluded "where the pro rata method of allocating defense costs applies, it is proper for the trial court to order the insured to reimburse its insurer for defense costs for periods of self-

43. *Id.* at 121.
44. *Id.* at 123.
45. *Id.* at 124.
46. *Id.*

insurance."[47] In reaching that conclusion, the Court first adopted the California Supreme Court's holding in *Buss v. Superior Court*[48] that "as to claims that are not even potentially covered . . . the insurer may indeed seek reimbursement for defense costs."[49] The Court then reasoned that "consistent with the pro rata method of allocation, we have concluded that time on risk is a reasonable means of prorating defense costs for periods of self-insurance. Those costs allocable to periods of self-insurance are not even potentially covered by the insurer's policies."[50]

Finally, the Court rejected ACMAT's claim that even if the Court were to adopt generally the pro-rata method of allocating defense costs, it should not do so in the present case because ACMAT did not chose to forgo insurance but merely lost or otherwise destroyed the policies of the identified insurers. The Court concluded that this "is a distinction without a difference,"[51] and that the pro-rata method is equitable because Security never contracted to pay for defense costs arising outside of its policy period and that ACMAT, in effect, chose to forgo insurance.[52]

The accuracy of the Court's reliance on *Owens-Illinois. Inc. v. United Insurance Company* and *Insurance Company of North America v. Forty-Eight Insulations, Inc.* in adopting the pro-rata method of allocation and the circular reasoning utilized by the Court in rejecting ACMAT's arguments on appeal are discussed below in Parts III and IV, respectively.

II. FRAMEWORK

To fully understand the Court's decision in *Lumbermens,* it is necessary to have clear understanding of three basic concepts: (a) the canons of insurance contract interpretation in Connecticut, (b) the language and purpose of the occurrence based comprehensive general liability policy, (c) the methods of allocating defense costs adopted by the courts prior to the *Lumbermens* decision.

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47. *Id.*

48. 939 P.2d 766 (Cal. 1997).

49. *Lumbermens II*, 826 A.2d at 125.

50. *Id.*

51. *Id.* at 126 (relying on *Forty-Eight Insulations, Inc.*, in which the court treated the insured, who had lost or otherwise destroyed its policies, as self-insured, and United States Fidelity & Guaranty Co. v. Treadwell Corp., 58 F. Supp. 2d 77, 83 n.4 (S.D.N.Y. 1999), in which the court concluded there was no distinction between an insured that cannot identify its claimed insurers and an insurer that has chosen to forgo insurance).

52. *Lumbermens II*, 826 A.2d at 126.

A. CANONS OF INSURANCE CONTRACT CONSTRUCTION

The language of an insurance policy is interpreted much like that of any other written contract. In Connecticut, the principles governing construction of an insurance contract are well defined.

> The [i]nterpretation of an insurance policy, . . . involves a determination of the intent of the parties as expressed by the language of the policy . . . . The determinative question is the intent of the parties, that is, what coverage the . . . [insured] expected to receive and what the [insurer] was to provide, as disclosed by the provisions of the policy . . . . It is axiomatic that the contract of insurance be viewed in its entirety, and the intent of the parties for entering it derived from the four corners of the policy . . . . The policy words must be accorded their natural and ordinary meaning . . . .[53]

That is, if the policy language is clear and unambiguous the intention of the parties is to be derived from the plain meaning of the policy language, only if the policy language is ambiguous may extrinsic evidence be introduced to support a particular interpretation.[54] An insurance policy is ambiguous when it is reasonably susceptible to more than one reading.[55] Where language is ambiguous, the ambiguity is to be resolved (a) by examining the parties' intentions, (b) determining the reasonable expectations of the insured when he entered into the contract, and (c) against the insurer under the rule of *contra proferentem* as the drafter of the language.[56]

B. OCCURRENCE BASED COMPREHENSIVE GENERAL LIABILITY INSURANCE

Liability insurance is a relatively recent development recognized by most scholars as beginning with general accident and specific risk liability policies sold to manufacturers and merchants of the late nineteenth

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53. Bd. of Educ. v. St. Paul Fire & Marine Ins. Co., 801 A.2d 752, 755-56 (Conn. 2002) (quoting Cmty. Action for Greater Middlesex County, Inc. v. Am. Alliance Ins. Co., 757 A.2d 1074, 1081 (Conn. 2000)) (emphasis added).

54. Met. Life Ins. Co. v. Aetna Cas. & Sur. Co., 765 A.2d 891, 896-97 (Conn. 2001).

55. *Id.* at 897.

56. *See id.* at 896-97; *see also Cmty. Action for Greater Middlesex County, Inc.*, 757 A.2d at 1074, 1081.

century.[57] Coverage expanded to automobile liability policies in the late nineteenth and early twentieth centuries, in the form of coverage for damages resulting from accidents.[58] Liability insurance as a form of commercial insurance protection developed in the 1920s and 1930s and during the late 1930's to early 1940's coverage was expanded to include a "duty to defend."[59] As insurers began offering coverage packages rather than separate policies for separate categories of risk, the "comprehensive" general liability policy or CGL emerged.[60] The CGL continued to be written in "accident" form until 1966, at which time the "accident" concept was replaced by the "occurrence" concept in most CGL policies.[61] An "occurrence" is commonly defined as "an accident, including continuous or repeated exposure to conditions, which results, [during the policy period] in bodily injury or property damage neither expected nor intended from the standpoint of the insured."[62] Thus, the coverage of the standard CGL policy was explicitly expanded to include injuries or damages, such as those with long latency periods, which might not be characterized as having been derived from an "accident" under the earlier formulation.[63]

A "standard form" CGL policy has been in use since the early 1940s. Its uniform language was prepared and periodically revised by the National Bureau of Casualty Underwriters and the Mutual Insurance Rating Board

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57. STEMPEL, *supra* note 13, § 14.01.

58. The term "accident" was not defined but was often interpreted by the courts to mean a single sudden event. *See e.g.,* Leggett v. Home Indem. Co., 461 F.2d 257 (10th Cir. 1972) (toxic fumes escaping over a five year period not an "accident"); Tennessee Corp. v. Hartford Accident & Indem. Co., 326 F. Supp. 520 (N.D. Ga. 1971) (where the continuous discharge of pollutants did not constitute an "accident").

59. STEMPEL, *supra* note 13, § 14.01.

60. *Id.* The modern CGL is the "commercial general liability policy." It is the successor of the "comprehensive general liability insurance policy" and both are commonly referred to by the acronym "CGL." *Id.* The purpose of the name change was to avoid the implication that CGLs covered everything. *Id. See also* 20 ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE LAW & PRACTICE 2D § 129.1 (2003).

61. STEMPEL, *supra* note 13, § 14.01.

62. *Id. See also* Michael Dore, *Insurance Coverage for Toxic Tort Claims: Solving the Self-Insurance Allocation Dilemma,* 28 TORT & INS. L.J. 823 (1993); Kahn, *supra* note 10. The 1966 form used the term "injurious exposure," but it was replaced with the phrase "continued or repeated exposure," with the intention of broadening coverage further. D. DEY & S. Ray, ANNOTATED COMPREHENSIVE GEN. LIAB. INS. POLICY 3 (1984) (1973 Form).

63. *See* Am. Home Prods. Corp. v. Liberty Mut. Ins. Co., 565 F. Supp. 1485, 1489 (S.D.N.Y. 1983); *Indep. Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 654 F. Supp. 1334, 1351 n.6 (D.D.C. 1986). *See also* Davis J. Howard, *"Continuous Trigger" Liability: Application to Toxic Waste Cases and Impact on the Number of "Occurrences,"* 22 TORT & INS. L.J. 624, 625 n.2 (1987); Dore, *supra* note 62.

(since 1972 the Insurance Services Office or ISO).[64] Today, the standard coverage grant language is as follows:

> The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, . . .[65]

"Occurrences," the event(s) causing the bodily injury, are clearly distinguished, from the resulting injury.[66] Thus the standard CGL is triggered if "bodily injury" takes place within the policy period, but it is not necessary for the "occurrence" or event causing the injury to take place during the policy period in order to trigger coverage.[67] Consequently, even if the event that caused the injury took place prior to the policy period, the injury will be covered if it occurs during the policy period. For this reason, CGLs are frequently described as providing "unlimited prospective coverage."[68]

The CGL embodies two major coverage components. In exchange for receiving a premium the insurer is required (1) to defend lawsuits against the insured, and (2) to indemnify the insured for any damages legally imposed against the insured in that lawsuit, to the extent those damages are covered by the policy.[69] Although these two obligations are often discussed simultaneously it is well established that they are independent and distinct.

The duty to indemnify derives from the following policy language: "the company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence."

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64. Dore, *supra* note 62; Kahn, *supra* note 10.

65. Kahn, *supra* note 10; SUSAN J. MILLER & PHILIP LEFEBVRE, 1 MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 421 (4th ed. 1997).

66. Typically "bodily injury" is defined as "bodily injury, sickness or disease sustained by any person, which occurs during the policy period, including death at any time resulting therefrom." STEMPEL, *supra* note 13, § 14.01. *See also* Dore, *supra* note 62; Kahn, *supra* note 10.

67. Owens-Illinois, Inc. v. United Ins. Co., 650 A.2d 974, 982 (N.J. 1994).

68. STEMPEL, *supra* note 13, § 14.02.

69. HOLMES, *supra* note 60.

Thus the duty to indemnify arises only upon the establishment of a legal obligation to pay damages.[70]

The duty to defend, on the other hand, derives from the following policy language: "the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent . . . " and is triggered by the allegations of the underlying claim. The general rule in Connecticut is that "if an allegation of a complaint falls even 'possibly' within coverage" of the insurance policy, the insurer must defend the insured.[71] This rule follows from the well settled tenant that:

> An insurer's duty to defend, being much broader in scope and application than its duty to indemnify, is determined by reference to the allegations contained in the [underlying] complaint . . . . The obligation of the insurer to defend does not depend on whether the injured party will successfully maintain a cause of action against the insured but on whether he has, in his complaint, stated facts which bring the injury within the coverage. If the latter situation prevails, the policy requires the insurer to defend, irrespective of the insured's ultimate liability . . . . It necessarily follows that the insurers duty to defend is measured by the allegations of the complaint. Hence, if the complaint sets forth a cause of action within the coverage of the policy, the insurer must defend.[72]

The duty to defend is to be measured only by comparing the language of the policy to the allegations of the complaint, without consultation of any facts beyond those two documents.[73] In determining whether a

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70. *See* Schilberg Integrated Metals Corp. v. Cont. Cas. Co., 819 A.2d 773, 783 (Conn. 2003) ("the liability insurer's duty to indemnify depends upon the facts established at trial and the theory under which judgment is actually rendered in the case."); *see generally* HOLMES, *supra* note 60.

71. *Schilberg Integrated Metals Corp.*, 819 A.2d at 783.

72. Board of Educ. v. St. Paul Fire & Marine Ins. Co., 801 A.2d 752, 754-55 (2002) (quoting Cmty. Action for Greater Middlesex County, Inc. v. Am. Alliance Ins. Co., 757 A.2d 1074 (Conn. 2000)).

73. Nationwide Mut. Ins. Co. v. Mortensen, 222 F. Supp. 2d 173, 181 (D. Conn. 2002) ("The existence of a duty to defend is determined on the basis of what is found within the four corners of the complaint; it is not affected by facts disclosed by independent investigation, including those that undermine or contradict the injured party's claim."); QSP,

particular claim is within the policy coverage, courts resolve all doubts in favor of the insured.[74]

If, however, the complaint alleges a liability that the policy does not cover, the insurer is not required to defend.[75] But where the complaint alleges multiple causes of action, some of which are covered by the policy and some of which are not, an insurer generally cannot divide the duty to defend. Once an insurer has a duty to defend an insured for one claim, the insurer must defend all claims brought at the same time, even if some of the claims are beyond the scope of the insured's coverage.[76]

C. METHODS OF ALLOCATION

Suits brought under CGL policies generally involve injuries and occurrences that happened simultaneously or in close temporal proximity. Under such circumstances it is easy to determine when the alleged injury happened and therefore which policy was triggered. However, in cases involving diseases, such as asbestosis, with long-latency periods, the occurrence that caused the injury (inhalation for example) takes place long before the ultimate injury (asbestosis, lung cancer, etc.) manifests itself. Inhalation, disease progression, and manifestation take place over long periods of time and across numerous policy periods. Thus different insurers are likely to be on risk during different points in the development of such an injury. The standard CGL policy language does not explicitly resolve questions of allocation where the successive policies on risk are triggered.[77]

Inc. v. Aetna Cas. & Sur. Co., 773 A.2d 906, 914 (2001) ("A liability insurer has a duty to defend its insured in a pending lawsuit if the pleadings allege a covered occurrence, even though facts outside the four corners of those pleadings indicate that the claim may be meritless or not covered.").

74. 22 ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE 2D § 136.1 (2003).

75. *See Schilberg Integrated Metals Corp.*, 819 A.2d at 783.

76. Clinton v. Aetna Life & Sur. Co., 594 A.2d 1046, 1049 (Conn. Super. Ct. 1991) ("when a complaint alleges several causes of action or theories of recovery against the insured, one of which is within the coverage of the policy, a duty on the part of the insurer to defend arises"); *see* HOLMES, *supra* note 74, at § 136.2(D).

77. Most CGL polices have "other insurance" clauses dictating allocation between two or more policies which insure the same risk. However, such clauses refer only to concurrent, not successive, policies. For a description of the three general types of "other insurance" clauses – excess, pro-rata and escape – see *Owens – Illinois, Inc.*, 650 A.2d at 991 (internal citations and quotation marks omitted).

While the majority of courts permit allocation of defense costs between insurers, they have yet to adopt a uniform manner of allocation.[78] Two general approaches have emerged, the pro-rata and joint-and-several methods of allocation. With regard to the insured's potential obligations, "[u]nder the pro-rata method, the insured is liable for costs attributable to losses occurring during periods when it was uninsured, while under the joint and several method, all costs are allocated among insurers . . . . Using either method, allocation will exist among the insurance companies on risk . . . . The real difference between the [methods] is in their treatment of periods of self insurance."[79]

1. Joint-And-Several Method of Allocation[80]

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78. *But see* Sloan Constr. Co. v. Central Nat'l Ins. Co., 236 S.E.2d 818, 820 (S.C. 1977) ("[Any form of allocation is inappropriate] where two companies insured the identical risk and both policies provide for furnishing the insured with a defense, neither company, absent a contractual relationship can require contribution from the other for the expenses of the defense where one denies liability and refuses to defend. The duty to defend is personal to both insurers; neither is entitled to divide the duty.").

79. *Lumbermens II*, 826 A.2d (2003) at 701-02 (quoting *Owens-Illinois, Inc.*, 650 A.2d at 990).

80. The leading case applying the joint-and-several method is Keene Corp. v. Insurance Co. of North America, 667 F.2d 1034 (D.C. Cir. 1981). Prior to the *Keene Corp.* decision, the predominant case applying the joint and several method of allocation was Gruol Constr. Co. v. Insurance Co. of North America, 524 P.2d 427 (Wash. Ct. App. 1974) (continuous property damage—insurance coverage for damage to building caused by dry rot as a result of defective backfilling during construction). *See also* Emons Indus., Inc., *v.* Liberty Mut. Fire Ins. Co., 481 F. Supp. 1022 (S.D.N.Y. 1979) (duty to defend diethylstelbesterol (DES) liability cases); Transamerica Ins. Co. v. Bellafonte Ins. Co., 490 F. Supp. 935 (E.D. Pa. 1980) (drugs causing birth defects).

Keene and *Lumbermens* are factually similar. Plaintiff corporation, Keene, manufactured thermal insulation products containing asbestos from 1948-1972. *Keene Corp.*, 667 F.2d at 1038. Keene was named co-defendant in over 6,000 lawsuits for injuries resulting from exposure to its products. *Id.* From 1961 through 1981 (time of litigation) Keene was issued virtually identical CGL policies from a number of insurance companies. *Id.* at 1038-39. Keene tendered its defense to each of these insurance companies, which either accepted partial responsibility or denied responsibility all together. *Id.* at 1039. Keene filed for declaratory judgment and damages. *Id.* After adopting the "triple trigger" or "continuous trigger" approach, the D.C. Circuit held that: (1) once coverage is triggered under a given policy, the insurer is fully liable (subject only to its policy limits and "other insurance" clauses) to the policyholder for both indemnification and defense costs, without pro-ration to the policyholder, even if part of the injury may have occurred at time when the policyholder was self-insured, and (2) insurance companies whose policies are triggered may seek contribution from each other, under the "other insurance" clauses of their policies, but not from the policyholder. *Id.* at 1047, 1050.

The court reasoned that: (a) because the "all sums" language of the policies means that each policy purchased by Keene provides it with the right to be free of liability for asbestos

The basic premise of the joint-and-several method of allocation is that, given the broad "all sums" language of the policies, each policy triggered may be obliged to satisfy claims until the limits of the policy are exhausted.[81] This method of allocation allows the policyholder to choose among its CGL policies and collect indemnification from a single insurer subject only to the policy's limits. That is not to say the insurance company chosen by the policyholder is burdened with the entire liability and other insurers are let off the hook, the burden is merely placed on the defending insurance company to pursue contribution claims against the policyholder's other insurers.[82] For example, if exposure and the resulting injury occurred over a period of thirty years, and each of ten different insurers covered the policyholder for three years, the insured could select one of the insurers to defend the suit. Thereafter the insurer selected could pursue contribution and reimbursement from the other nine insurers.

Policyholders normally prefer this method of allocation for two reasons. "First, it virtually guarantees them full recovery because they can collect from a few solvent insurers and allow the insurers to determine how they will spread those costs equitably among themselves. Second, by allowing full recovery from one insurer, [this rule] also minimizes the policyholder's transactions costs (time and expense of negotiating and/or litigating with insurers). Thus [this rule] shifts transaction costs to the

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related disease, allocating a pro-rata share of the liability to Keene for prior periods for which it was uninsured would thereby undermine the expected function of the CGL policies purchased and violate the reasonable expectations of the contracting parties; (b) since the language of the policies includes a built-in trigger of coverage, it is a fiction to say Keene also had a "self-insurance" policy that is triggered for periods in which no other policy was purchased; and (c) in keeping with its holding that each insurer is fully liable to Keene for indemnification, an insurer must defend Keene, so long as the complaint indicates Keene may be liable for injury and the facts alleged in the complaint indicate that its policy covers the alleged injury. *Id.* at 1047-50. The policyholder may choose which insured will defend it and the insurer chosen to defend the policyholder may share the costs of the defense with other insurers under the doctrine of contribution or as dictated by the "other insurance" clauses. *Id.* at 1050 n. 37.

81. STEMPEL, *supra* note 13, § 14.10. The name "joint-and-several" is somewhat of a misnomer. It is not "joint-and-several" liability such as that in the context of tort law, where a tortfeasor who is found ten percent negligent is required to pay one hundred percent of a judgment if the other liable defendants turn out to be insolvent. In this context an insured is never required to pay more than its policy limits, i.e. its contractual stake. *Id.*

82. DAVID W. STEUBER ET AL., PRACTICING LAW INST., EMERGING ISSUES IN ENVIRONMENTAL INSURANCE COVERAGE LITIGATION, IN FIFTH ANNUAL LITIGATION MANAGEMENT SUPERCOURSE (PLI Litig. & Admin. Practice Course Handbook Series No. 496, 1994) WL, PLI/Lit 331, 360.

insurers, who must pursue contribution actions to spread the costs among all insurers."[83]

The joint-and-several method has been adopted by a number of courts including; the Third Circuit,[84] the District of Columbia,[85] the District of New Jersey,[86] the Supreme Courts of Pennsylvania[87] and Washington,[88] and the California Court of Appeals.[89]

2. Pro-Rata Method of Allocation[90]

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83. Christopher R. Hermann et al., *The Unanswered Question of Environmental Insurance Allocation in Oregon Law.*, 39 Willamette L. Rev. 1131, 1138 (2003).

84. New Castle Co. v. Hartford Acc. & Indem., 933 F.2d 1162 (3d Cir. 1991) (applying Delaware law); ACANDS, Inc. v. Aetna Cas. & Sur. Co., 764 F.2d 968 (3d Cir. 1985) (applying Pennsylvania law).

85. *Keene*, 667 F.2d 1034; Eli Lilly & Co. v. Home Ins. Co., 653 F. Supp. 1 (D.D.C. 1984).

86. Lac D'Amiante du Quebec, Lte. v. Am. Home Assur. Co., 613 F. Supp. 1549 (D.N.J. 1985).

87. J.H. France Refractories Co. v. Allstate Ins. Co., 626 A.2d 502 (Pa. 1993).

88. Am. Nat'l Fire Ins. Co. v. B & L Trucking, 951 P.2d 250 (Wash. 1998).

89. Armstrong World Indus. Inc., v. Aetna Cas. & Sur. Co., 52 Cal. Rptr. 2d 690 (Cal. Ct. App. 1996).

90. The seminal case applying the pro-rata method is *Forty-Eight Insulations, Inc.* 633 F.2d 1212 (6th Cir. 1980). Forty-Eight Insulations, Inc. manufactured various products containing asbestos from 1923 until 1970. Forty-Eight was named as a defendant in thousands of asbestos suits. From 1955 to 1977 Forty-Eight purchased twelve different CGL policies issued by five different companies. *Id.* at 1226 n.28. Forty-Eight believed it had insurance coverage prior to 1955 but was unable to prove coverage. One of the insurers, Insurance Company of North America, filed a diversity action, seeking a declaration as to which carrier was liable. *Id.* at 1214-16.

The district court adopted a version of the exposure theory of liability and pro-rated liability among all the insurance companies that were on risk while the injured victim was inhaling the asbestos. The district court treated Forty-Eight Insulations as self-insured for those years it did not have insurance and therefore responsible for a pro-rata share of the cost of indemnification and the cost of defending the underlying suits. Forty-Eight Insulations appealed only the part of the district court's decision pro-rating the cost of defending the lawsuits. *Id.* at 1224.

The Sixth Circuit adopted a slightly different version of the exposure theory, finding that the date of the occurrence is the date on which the injury-producing agent first contacts the body (i.e., when the asbestos fibers contacted the lungs), and that additional exposures were to be considered as arising out of one occurrence. The court adopted this particular trigger theory in order to maximize coverage. *Id.* at 1221-22. Forty-Eight was effectively uninsured after 1976 and any other theory would have put the date of occurrence after 1976. After adopting the exposure theory, the Court held that the duty to defend is based in contract, and each insurer contracted to pay only those costs attributable to bodily injury during its policy period. The Court reasoned that an insurer must bear the entire cost of defense only when there is no reasonable means of pro-rating the costs of defense between covered and not-covered items, and that having adopted the exposure theory, such means

The basic premise of the pro-rata method of allocation is the insured contracts to pay the entire cost of defending a claim which has arisen within the policy period but has not contracted to pay defense costs for occurrences which took place outside the policy period, thus where the distinction can be made the insured must pay for the defense of a non-covered risk.[91] Under this method of allocation, defense costs are divided proportionally among the different insurance companies and the insured (for periods of self-insurance).[92]

Insurers usually prefer this method to the joint-and-several method for three significant reasons. First, the pro-rata method often reduces the insurer's overall liability. If an insurer's pro-rated share exceeds its policy limits, the policyholder is left to bear the remainder. Second, the policyholder is assigned liability for any periods for which it lacked insurance.[93] Third, the transaction costs are borne by the policyholder rather than the insurer, for the policyholder must recover separately from each insurer.[94]

There are two general types of allocation under the pro-rata method, allocation by time-on-risk and allocation by percentage of coverage.

Under the time-on-risk rule, each insurance company's share of liability equals the percentage of time that it covered the risk.[95] Thus, if exposure and the resulting injury occurred over a period of 30 years, and each of ten different insurers covered the policyholder for three years, then each insurer must pay ten percent of the liability.[96] One problem with the time-on-risk method of allocation is that while

> [T]ime on the risk is a factor in assessing the degree of risk, it is not the only factor and has only a superficial

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were available. Accordingly, the Court found that indemnification and defense costs for each underlying asbestos claim should be pro-rated among all years in which the claimant breathed asbestos fibers. For those years which the Forty Eight Insulations, Inc. did not have insurance, it was considered "self-insured" and thus responsible for the pro-rata share of indemnification and defense costs during that period. *Id.* at 1224-5.

91. *Forty-Eight Insulations, Inc.* 633 F.2d at 1224-25.

92. *See* STEMPEL, *supra* note 13, § 14.10.

93. *See generally Owens-Illinois, Inc.*, 650 A.2d 974; *Stownewall Ins. Co.*, 73 F.3d 1178.

94. *See* STEMPEL, *supra* note 13, § 14.10.

95. *Forty-Eight Insulations, Inc.*, 633 F.2d 1212.

96. Owens-Illinois, Inc. v. United Ins. Co., 650 A.2d 974 (N.J. 1994); *See* Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp., 73 F.3d 1178, 1202 (2d Cir. 1995) (an insurer's liability is determined by "multiplying the judgment or settlement by a fraction that has as its denominators the entire number of years of the claimant's injury, and as its numerator the number of years within the period when the policy was in effect.").

> connection to the actual risks assumed and losses incurred. In addition, temporal proration may be inequitable among insurers because of changes in insurance products, premiums charged, and the mix of claims. For example, under a temporal proration formula, long-ago insurers who may have charged bargain basement coverage rates prior to the surfacing of any reason for concern may owe as much or more than latter-day insurers who charged higher premiums and had greater reason to expect the claims at issue.[97]

Nevertheless, this method of allocation has been adopted by a number of courts.[98]

Under the percentage of coverage rule, an insured's liability depends on the percentage of total coverage that it issued.[99] For example, if two insurers covered a policyholder during a two-year period, each for one year, and the first insurer contracted for $10 million of coverage, and the second for $20 million, the total coverage is $30 million. The first insurer would be held liable for one-third of all liability and the second for two-thirds. The rationale behind this method of allocation is that "policy limits bear a relationship to the risk assumed, premium charged, and profit made by the insurer. Consequently, where a loss occurs over several policy periods or involves several layers of coverage, policy limits proration imposes responsibility on the insurers in proportion to the risks assumed and the premiums earned."[100] One problem with this rule, however, is that it may unfairly advantage insurers on risk for the early years of a multi-year loss. "The later carriers may be forced to pay more simply because of inflation or policyholders' increased sensitivity to risk,"[101] or based on the

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97. STEMPEL, *supra* note 13, § 14.10.

98. *See, e.g.*, Lincoln Elec. Co. v. St. Paul Fire & Marine Ins. Co., 210 F. 3d 672 (6th Cir. 2000) (applying Ohio law); Ducre v. Executive Officers of Halter Marine Ins., 752 F.2d 976 (5th Cir. 1985); *Porter v. Am. Optical Corp.*, 641 F.2d 1128 (5th Cir. 1981); Uniroyal, Inc. v. Home Ins. Co., 707 F.Supp. 1368, 1391 (E.D.N.Y. 1988); N. States Power Co. v. Fid. & Cas. Co. of N.Y., 523 N.W.2d 657 (Minn. 1994); Ins. Co. v. Asbestos Claims Management Co., 73 F.3d 1178 (2d Cir. 1995); Gulf Chemical & Metallurigal Corp. v. Assoc. Metals & Mineral Corp., 1 F.3d 365, 372 (5th Cir. 1993); Fireman's Fund Ins. Co., v. Ex-Cell-O Corp., 685 F. Supp. 621, 626 (E.D. Mich 1987).

99. STEMPEL, *supra* note 13, § 14.10.

100. *Id.*

101. *Id.*

fact that they collected much higher premiums. Nevertheless, this method of allocation has also been endorsed by a number of courts.[102]

III. *OWENS-ILLINOIS, INC. v. UNITED INSURANCE CO. & INSURANCE CO. OF NORTH AMERICA v. FORTY-EIGHT INSURLATIONS, INC.*

In adopting the pro-rata method, the Connecticut Supreme Court explicitly relied on the reasoning of the Sixth Circuit in *Insurance Co. of North America v. Forty-Eight Insulations, Inc.* and the Supreme Court of New Jersey in *Owens-Illinois, Inc.*, v. *United Insurance Co.* Specifically, the Court stated, "[w]e are persuaded by the reasoning of the courts in *Forty-Eight Insulations, Inc.*, and *Owens-Illinois, Inc.*, and, accordingly, adopt the pro rata approach to the allocation of defense costs in long latency loss claims that implicate multiple insurance policies." [103] Upon examination, the Court's substantial reliance on these two cases may not be warranted.

A. *INSURANCE CO. OF NORTH AMERICA v. FORTY-EIGHT INSULATIONS, INC.*[104]

In *Forty-Eight Insulations, Inc.*, the Sixth Circuit pro-rated liability among all the insurance companies on risk during the injured party's exposure to asbestos. With respect to the years of exposure for which Forty-Eight Insulations, Inc. could not prove coverage, the Court treated Forty-Eight Insulations, Inc. as self-insured and responsible for a pro-rata share of the costs of defending the underlying suit. In doing so the Court reasoned:

> An insurer must bear the entire cost of defense when there is no reasonable means of prorating the costs of defense between the covered and the not-covered items. Thus, in the typical situation suit will be brought as the result of a single accident, but only some of the damages sought will be covered under the insurance policy. In such cases, apportioning defense costs between the insured claim and

102. *See, e.g.*, Armstrong World Indus. v. Aetna Cas. & Sur. Co., 52 Cal. Rptr. 2d 690, 707 (Cal. Ct. App. 1996); *Owens-Illinois, Inc.*, 650 A.2d 974.

103. *Lumbermens II*, 826 A.2d at 710.

104. 633 F.2d 1212 (6th Cir. 1980). *See supra* note 90 for a factual summary of this case.

> the uninsured claim is very difficult. As a result, courts impose the full cost of defense on the insurer.
>
> These considerations do not apply where defense costs can be readily apportioned. The duty to defend arises solely under contract. An insurer contracts to pay the entire cost of defending a claim which has arisen within the policy period. The insurer has not contracted to pay defense costs for occurrences which took place outside the policy period. Where the distinction can be readily made, the insured must pay its fair share for the defense of the non-covered risk.
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> In this case Forty-Eight's own exposure theory, substantially adopted by the district court, establishes that a reasonable means of proration is available. Forty-Eight has urged that indemnity costs can be allocated by the number of years that a worker inhaled asbestos fibers. By embracing the exposure theory, we have agreed. There is no reason why this same theory should not apply to defense costs...were we to adopt Forty-Eight's position on defense costs a manufacturer which had insurance coverage for only one year out of 20 would be entitled to a complete defense of all asbestos actions the same as a manufacturer which had coverage for 20 years out of 20.[105]

The Connecticut Supreme Court adopted the reasoning of the Sixth Circuit in its entirety. The propriety of the Court's decision is far from clear.

First, it is clear from the language quoted above, that the Sixth Circuit found that exposure theory, as adopted, provided a reasonable means of pro-rating defense costs.[106] Therefore, the Sixth Circuit's decision to pro-rate defense cost between the insurers and the insured (for periods of self-insurance) is inextricably tied to its adoption of the exposure trigger. The Connecticut Supreme Court relied on the language quoted above in adopting the pro-rata method of allocating defense costs, but did not, however, adopt the exposure theory. Rather the Court adopted instead the

105. *Id.* at 1224-25 (internal quotation marks and citations omitted) (emphasis added).

106. Under the exposure theory adopted by the court, initial exposure to asbestos fibers in any given year triggers coverage; any additional exposure to asbestos fibers is treated as arising out of the same occurrence. *See id.* at 1225.

continuous trigger theory.[107] Thus, the Court's reliance on the Sixth Circuit's rationale appears to be without merit.[108]

A clue to the Court's logic, however, might be found in its description of the trial court's adoption of the continuous trigger method and its second reference to the language quoted above. In describing the trial court's adoption of the continuous trigger the Court stated, "the Bridgeport asbestos litigation involved a 'continuous trigger situation' such that all asbestos related injury policies issued during the extended exposure period have been triggered for coverage . . . .'"[109] By such description the "continuous trigger" merely results in an extended exposure period.

In rejecting ACMAT's claim that the pro-rata method improperly treats the duty to defend like the narrower duty to indemnify, the Court relied for a second time on the language quoted above. In this instance however, the Court explained "in long latency loss claims that implicate multiple insurance policies, there is a reasonable means of prorating the costs of defense, i.e., time on the risk."[110] Although the Sixth Circuit did not use the term "time on the risk," functionally, however, that is how it allocated defense costs.[111] Accordingly, the Court's reliance on the rationale of *Forty-Eight Insulations. Inc.* may not be faulty, but merely cryptic.

Second, the Connecticut Supreme Court defends the pro-rating of defense costs by surmising that apportionment of defense costs pursuant to the joint-and-several method would provide the insured with a windfall. In doing so the Court relies on the Sixth Circuit's statement that "were we to adopt [the insured's position] on defense costs [an insured] which had

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107. Under the continuous trigger theory adopted by the Connecticut Supreme Court "an occurrence has happened whenever the claimant was exposed to the cause of injury, was injured in fact, or the injury became manifest." *Lumbermens II*, 826 A.2d at 114 n.12. Any and all of these events trigger the applicable insurance policy in force at the time of the event. *Id.*

108. As noted by the New Jersey Supreme Court, "[t]he choice of trigger theory is related to the method a court will choose to allocate damages between insurers." *Owens-Illinois, Inc.*, 650 A.2d at 985 (citation and internal quotations omitted).

109. *Lumbermens II*, 826 A.2d at 113-14 (emphasis added).

110. *Id.* at 123.

111. *Forty-Eight Insulations, Inc.*, 633 F.2d at 1225; Insurance Co. of N. America v. Forty-Eight Insulations, Inc., 451 F. Supp. 1230, 1244 (E.D. Mich. 1978) ("The cumulative and indivisible nature of the injuries makes it impossible to determine when any given portion of such injuries occurred. Consequently, the resulting judgment [and defense costs] relates to the entire period of exposure and must be apportioned by the length of each insurer's coverage...Since a portion of the injury is allocated to the period for which Forty-Eight is considered self-insured, it must be treated as an insurer, and a portion of the defense costs must be allocated to that period.")

insurance coverage for only one year out of 20 would be entitled to a complete defense of all asbestos actions the same as an [insured] which had coverage for 20 years out of 20."[112] This statement, however, distorts the coverage provided by the joint-and-several method. As noted by the Court of Appeals for the District of Columbia in *Keene Corp. v. Insurance Co. of North America*, "[a]s a matter of probability, the more years of coverage that an insured has purchased, the smaller will be the number of injuries for which it will be liable. An insured will not be covered for an injury if it has insurance neither when the plaintiff's disease was developing nor when the disease manifested itself."[113] Therefore, as a practical matter an insured with insurance coverage for only one year out of twenty will not receive the same coverage as an insured with insurance coverage for twenty years out of twenty.

B. *OWENS-ILLINOIS, INC. v. UNITED INSURANCE COMPANY*[114]

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112. *Lumbermens II*, 826 A.2d at 120.

113. *Keene Corp.*, 667 F.2d at 1049.

114. 650 A.2d 974 (N.J. 1994). O-I is the manufacturer of Kaylo, a thermal insulation product containing around 15% asbestos. O-I manufactured and distributed Kaylo from 1948-1958. Between the 1948 and 1963 O-I was self-insured, it maintained no insurance to cover product liability, but rather chose to bear the risk itself. From 1963-1977, O-I was insured by Aetna Casualty & Surety Co. (Aetna) under excess indemnity (umbrella) insurance policies. In 1975 Owens Insurance Limited (OIL) was established to provide reinsurance and loss prevention services to O-I. In 1977, OIL provided casualty insurance, including product-liability coverage to O-I. United Insurance Company (United) provided primary coverage under a CGL. OIL issued the excess umbrella policy and reinsurance with various companies, including United. In 1978 O-I notified Aetna, of asbestos-related claims involving Kaylo. Aetna denied coverage, maintaining manifestation of the disease triggered coverage, and the policy in effect at the time of manifestation should respond, not Aetna. In 1980 O–I notified the other insurance companies, which declined coverage, maintaining exposure to the product, which predated their policies, triggered coverage. O-I sought declaratory judgment from the Chancery Division that Aetna and OIL, the two lead carriers were obligated to provide coverage for O-I's asbestos-related claims. *Id.* at 976-77. The pertinent language of both the United and OIL policies closely resembled that of the standard CGL policy. *Id.* at 979.

The trial court adopted the continuous trigger method and held all insurers whose policies were triggered were jointly-and-severally liable to the extent of their policy limits. The appellate court affirmed, adopting the continuous trigger theory, concluding that insurers' liability was joint-and-several, and that allocation of damages on a pro-rated basis was not feasible in light of the indivisible nature of the injury and damages sustained. *Id.* at 978. The New Jersey Supreme Court adopted the continuous trigger theory, but reversed as to the joint-and-several allocation. The New Jersey Supreme Court adopted a version of the pro-rata method and held that defense costs should be allocated by policy limits multiplied by time on risk. *Id.* at 995. The Court held that the insured was to share in the allocation where periods of uninsurance reflected a decision by the insured to forgo coverage. *Id.*

In *Owens-Illinois, Inc.* the New Jersey Supreme Court pro-rated defense costs to the insured with respect to those periods for which the insured chose to forgo coverage.[115] In holding the insured responsible for a pro-rata share of the costs of defending the underlying suit, the New Jersey Supreme Court was candid in stating that it was unable to find the answer to allocation in the language of the policies.[116] The Court based its holding instead on the mode of allocation which would encourage the acquisition of adequate insurance coverage and which would best reflect the reasonable expectations of the parties. The Court's determination with respect each of these factors was dependant on the period of uninsurance reflecting a conscious decision on the part of the insured to forgo available coverage.[117] As a result, the reasoning of *Owens-Illinois, Inc.* is inapplicable to the circumstances of *Lumbermens*.

First, in choosing a method of allocation, the New Jersey Supreme Court chose the pro-rata method because it would encourage the purchase of adequate insurance coverage. In doing so the Court reasoned:

> The theory of insurance is that of transferring risks. Insurance companies accept risks from manufacturers and either retain the risks or spread the risk through reinsurance. Because insurance companies can spread costs throughout an industry and thus achieve cost efficiency, the law should, at a minimum, not provide disincentives to parties to acquire insurance when available to cover their risks. Spreading the risks is conceptually more efficient.
>
> Almost all such insurance controversies are retrospective, and to reflect now on what might have been done if the parties had contemplated today's problem is almost fatuous. Our job, however, is not just to solve today's problems but to create incentives that will tend to minimize their recurrence . . . . Future actors would know that if they do not transfer to insurance companies the risk of their activities that cause continuous and progressive injury, they may bear that untransfered risk.[118]

115. *Id.* at 995.
116. *Id.* at 990.
117. *Id.* at 977, 995.
118. *Id.* at 992 (emphasis added).

The Connecticut Supreme Court adopted this reasoning in its entirety. Applying such reasoning to the circumstances in *Lumbermens,* however, makes little sense. ACMAT purchased adequate insurance coverage from two identified carriers. It transferred the risk to the insurance companies. Fifty-years later, it merely could not produce the policies. This is not surprising given that "few companies keep records more than 15 or 20 years, if that long."[119]

The *Lumbermens* decision may encourage parties to maintain records of the policies they purchase, but creating such an incentive is hardly necessary. The burden of proof in insurance coverage disputes ordinarily rests with the insured. If the insured cannot produce its policies or proof of coverage it will not receive indemnification.[120] That alone is a sufficient impetus for the parties to keep track of their policies. Moreover, if the Connecticut Supreme Court intended to create such an incentive there is no evidence of it in the language of the *Lumbermens* decision.

Second, in choosing a method of allocation, the New Jersey Supreme Court adopted the pro-rata method because it reflected the reasonable expectations of the parties involved, as measured by the risks transferred and retained during the years of exposure. The Court sought to avoid providing a windfall to the insured, whose lack of adequate coverage reflected a conscious assumption of the risk.

> A fair method of allocation appears to be one that is related to both time on the risk and the degree of risk assumed. When periods of no insurance reflect a decision by an actor to assume or retain a risk, as opposed to periods when coverage for a risk is not available, to expect the risk-bearer to share in the allocation is reasonable. Estimating the degree of risk assumed is difficult but not impossible.[121]

It is clear from this language that the holding of *Owens-Illinois, Inc.* is limited to circumstances in which periods of uninsurance represent a decision by the insured to go bare, i.e. "to assume or retain a risk." So limited, the holding of *Owens-Illinois, Inc.,* does not apply to the

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119. *Forty-Eight Insulations, Inc.*, 633 F.2d at 1225.

120. *See also* Northeast Utils. v. Century Indem. Co., No. X03CV 990495495S, 1999 Conn. Super LEXIS 1660, at *7 (Conn. Super. Ct. June 21, 1999) ("Under Connecticut law, [the insured] has the initial burden of proving the existence and terms of unavailable agreements.").

121. *Owens-Illinois, Inc.*, 650 A.2d at 995 (emphasis added).

circumstances in *Lumbermens*. ACMAT purchased an unbroken chain of insurance coverage. The periods of uninsurance in *Lumbermens* do not reflect a conscious decision on the part of the insured to forgo available coverage, but rather a period for which the policies, purchased and paid for, have been either lost or destroyed.[122]

IV. ACMAT'S ARGUMENTS ON APPEAL

As noted above in Part I, ACMAT made four claims on appeal each of which the Court summarily rejected. In rejecting each of ACMAT's arguments the Court relied on its prior adoption of the pro-rata method and the underlying rationale. Because, however, ACMAT's first three claims attack the adoption of the pro-rata method itself the reasoning employed by the Court is circular and begs the question.

ACMAT's claims were as follows:

1) The pro-rata method is inappropriate because it improperly treats the duty to defend like the narrower duty to indemnify.
2) The pro-rata method is inappropriate because it improperly recognizes a claim for equitable contribution by an insurer against its insured.
3) The pro-rata method is inappropriate because it improperly recognizes a claim for reimbursement of defense costs by an insurer against its insured.
4) Even if the Court adopts the pro-rata method, it should not do so in this case because the insured did not choose to forgo insurance. [123]

The circular nature of the Court's reasoning is most apparent in its rejection of ACMAT's third claim of error. Under the third claim,

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122. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *18 ("[T]he present issue as to the third count concerns a period of time in which asbestos exposure insurance coverage was available was purchased by ACMAT and ACMAT never released the insurance companies from their obligations.").

123. *Lumbermens II*, 826 A.2d at 115; *see also* Brief for Appellant, Sec. Ins. Co. of Hartford v. Lumbermens Mut. Cas. Co., 826 A.2d 107 (Conn. 2003). The Court's rejection of ACMAT's fourth claim is more incomplete than circular. Under the fourth claim, ACMAT argued that an insured who can identify its claimed insurers is distinguishable from an insured who chose to forgo purchasing insurance, and that while it may be proper to apply the pro-rata approach to the latter it is not proper to apply it to the former. The Court rejected ACMAT's argument finding that "this is a distinction without a difference" and that ACMAT "in effect, chose to forgo insurance," and therefore the pro-rata method was equitable. *Lumbermens II*, 826 A.2d at 126. The Court, however, never adequately explained (a) why it is a "distinction without a difference" or (b) exactly how ACMAT who purchased insurance and paid premiums "in effect, chose to forgo insurance."

ACMAT argued that there is no cause of action for reimbursement of defense costs by an insurer against its insured, the pro-rata method permits reimbursement and therefore the adoption of the pro-rata method is improper. In rejecting this argument the Court explicitly relied on its previous adoption of the pro-rata method, stating "[w]e conclude that, where the pro-rata method of allocating defense costs applies, it is proper for the trial court to order the insured to reimburse its insurer for defense costs for periods of self-insurance."[124] More specifically, the Court adopted the California Supreme Court's holding in *Buss v. Superior Court,*[125] that "[a]s to the claims that are at least potentially covered, the insurer may not seek reimbursement for defense costs . . . [a]s to the claims that are not even potentially covered, however, the insurer may indeed seek reimbursement for defense costs," and then found that the costs of defense pro-rated by time on risk are not even potentially covered by the insurer's policies.[126]

The Court's rejection of ACMAT's second claim is equally as circular. Under the second claim, ACMAT argued there is no cause of action for equitable contribution of defense costs by an insurer against its insured; the pro-rata method permits equitable contribution by an insured to the insurer and therefore the adoption of the pro-rata method is improper. In rejecting this argument, the Court held that where the pro-rata method of allocation

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124. *Lumbermens II*, 826 A.2d at 124.

125. 939 P.2d 766, 775-76 (Cal. 1997).

126. *Lumbermens II,* 826 A.2d at 125-26. The Court's reliance on *Buss* is problematic for a number of other reasons. First, the California Supreme Court in *Buss* reaffirmed its holding that in a mixed action (an action in which some of the claims are at least potentially covered and the others are not) the insurer has a duty to defend the action in its entirety, stating, "[t]o defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely." *Buss,* 939 P.2d at 775. Second, the California Supreme Court holding differentiates between covered and uncovered "claims." In *Lumbermens,* the Connecticut Supreme Court differentiated between covered and uncovered "portions" of a single claim of bodily injury. 826 A.2d at 110-19. Finally, and most significantly, the California Supreme Court limited its holding as follows: "An insurer may obtain reimbursement *only* for defense costs that can be allocated *solely* to the claims that are not even potentially covered. To do that, it must carry the burden of proof as to these costs by a preponderance of the evidence. And to do *that* . . . it must accomplish a task that, 'if ever feasible,' may be 'extremely difficult.'" *Buss*, 939 P.2d at 781 (emphasis in original). Therefore, even if time on risk is a legitimate means of distinguishing between covered and uncovered portions of a single claim of bodily injury, under *Buss,* the insurer would have to prove by a preponderance of evidence that the funds sought were expended solely in defense of the specific uncovered portion of the injury. Given the indivisible nature of the bodily injury in question doing so is virtually impossible and time on the risk does not even address the question.

is properly applied, contribution from the insured may be had.[127] The Court acknowledged that the general rule in Connecticut is that "all insurers providing primary coverage to an insured are duty bound to defend the insured and will be required to contribute their pro rata share of the cost of defense."[128] The Court failed, however, to explain why that rule should be expanded to include the insured. Rather it merely pointed out that those courts adopting the pro-rata method permit contribution by the insured and that "the doctrine of equitable contribution necessarily follows from the rationale underlying the pro rata method of allocation . . . ."[129]

The Courts response to ACMAT's first claim is also circular though less explicitly so. ACMAT's first argument is that the very words of the policy the insurer's obligation to defend is very broad—broader than its obligation to indemnify. In effect it is so broad that it arises even where one count of the complaint is within policy coverage and other counts are not. Therefore the insured should not be liable for any costs of the defense, even if part of the underlying lawsuit concerned periods of time when the insured was uninsured, so long as any insurance company had a duty to defend. In rejecting ACMAT's this argument the Court concluded:

> [I]n long latency loss claims that implicate multiple insurance policies, there is a reasonable means of prorating the costs of defense, i.e., time on the risk . . . . [B]ecause the duty to defend arises solely under contract and because the insurance companies have not contracted to defend the insured for periods outside of the policy period, requiring the insured to pay its fair share of the defense costs in a long latency loss suit that implicates multiple insurance policies does not treat the broad duty to defend as the more narrow duty to indemnify.[130]

Thus the Court rested its rejection of ACMAT's claim upon the same foundation upon which it rested its adoption of the pro-rata method: (a) that an insurer must bear the entire cost of defense only when there is no reasonable means of pro-rating the costs of defense between covered and uncovered items, and (b) that time on the risk is a reasonable means of differentiating between those claims, which "possibly" fall within the coverage of the policy, and those that do not.

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127. *Lumbermens II,* 826 A.2d at 124.
128. *Id.* at 123.
129. *Id.* at 124.
130. *Id.* at 123.

CONCLUSION

Should a portion of the defense costs in long-latency liability claims implicating multiple successive insurers be allocated to the insured when coverage is interrupted by periods of uninsurance? In 2003, the Connecticut Supreme Court answered this question in the affirmative, thereby settling, at least for the state of Connecticut, a frequently debated issue.

The decision, however, left many other questions unanswered. Three of the most significant are as follows:

- Given that the Supreme Court specifically limited its holding to those circumstances where coverage is interrupted by periods of uninsurance, how are costs to be allocated where coverage is uninterrupted?[131] Logic directs that the Court would adopt the pro-rata method in the uninterrupted situation as well. It remains unclear, however, whether the Court would retain the time-on-risk approach or embrace the policy limits approach adopted in *Owens-Illinois, Inc.*
- Ordinarily as a corollary to the insurer relieving the insured of its obligation to seek counsel and put on a defense, the insured surrenders to the insurer complete control over the conduct of the defense.[132] Where, however, the insured is held responsible for a majority or even a substantial portion of the costs of defending the underlying suit, does the insurer still retain control of the defense? And if the answer is no, may the insured conduct its defense in a manner contrary to the interests of the insurer?
- Do all forms of "self-insurance" receive identical treatment with respect to allocation of defense costs? "Self-insurance" arises out of various contexts, including but not limited to, the insured assuming the risk, the unavailability of the relevant insurance, the insolvency of the triggered insurer, or the insured having lost or destroyed the relevant policies. The Connecticut Supreme Court found that an insured who lost/destroyed its policies should be treated identically to an insured that assumed the risk, but never explained why.[133] On

131. *Lumbermens II*, 826 A.2d at 127 n.18 ("[w]e do not decide in this case how costs should be allocated if there is uninterrupted coverage").

132. *See generally* HOLMES, *supra* note 60, at § 136.1.

133. The Court acknowledges there is a distinction, but concludes it is immaterial and that ACMAT "in effect chose to forgo insurance." *Lumbermens II*, 826 A.2d at 718-19. In

> the other hand, the trial court found, that the insured was not responsible for a pro-rata share of the defense costs for the period after 1985 when asbestos coverage was no longer available.[134]

Moreover, the court's substantial and problematic reliance on *Insurance Co. of North America v. Forty-Eight Insulations, Inc.*, and *Owens-Illinois, Inc. v. United Insurance Co.* and in adopting the pro-rata method of allocation and its circular reasoning in rejecting ACMAT's arguments on appeal, calls into question the soundness of the decision.

And yet, despite its shortcomings, the holding articulated in *Lumbermens* is now Connecticut law and precedent. It will be cited and relied upon in future cases dealing with a variation of the facts present in *Lumbermens*, as well as, in circumstances that have not yet arisen nor were envisioned by the Connecticut Supreme Court.

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doing so the court relies on *Forty-Eight Insulations, Inc.*, 633 F.2d at 1215 n.4, and U.S. Fidelity & Guaranty Co. v. Treadwell Corp., 58 F. Supp. 2d 77, 83 n.4 (S.D.N.Y. 1999). Neither court explains why the distinction is immaterial.

134. *Lumbermens I*, 2001 Conn. Super. LEXIS 1387, at *4. Security withdrew this count before trial. *Id.* at *4. Therefore, this issue was not before the Supreme Court on appeal.

FROM THE JOURNALS: INSURANCE LAW ABSTRACTS

Edited by Matthew Fitzsimmons[*]

TERRORISM

Jeffrey Manns, Note, *Insuring Against Terror?*, 112 YALE L.J. 2509 (2003).

This Note analyzes the Terrorism Risk Insurance Act (the "Act"), signed by President George W. Bush in November of 2002. Manns states that the Act was passed to purportedly protect consumers by ensuring the availability and affordability of terrorism insurance. The Act does so by mandating that all property and casualty insurance providers must offer terrorism insurance. Additionally, the Act, as a reinsurance measure (as opposed to a direct insurance program), creates a "backstop" instead of acting as a bailout for insurers. Manns identifies four main features of the Act, summarily: (1) a ninety percent reinsurance coverage above insurer deductibles (with deductibles increasing each of the three years in which the Act governs); (2) mandatory and discretionary recoupment of federal compensation (mandating/allowing the Secretary of the Treasury to recoup statutorily defined amounts of federal compensation under certain circumstances); (3) mandatory offering of terrorism insurance (which consequently negates all terrorism exclusions); and (4) a requirement that insurance companies separately tabulate and disclose the premium for terrorism insurance and the amount of federal compensation.

Manns next discusses the potential flaws in the Act, of which he identifies four. The first is the always present problem of moral hazards. With respect to terrorism insurance, Manns describes the problem of moral hazard as one where both the insurer and the insured take greater risks. The second possible shortcoming identified by Manns is adverse selection. Manns explicates this concern by pointing to the Act's requirement that insurers offer terrorism insurance and asserting that this may eliminate private insurers' ability to guard against adverse selection via case-by-case assessments and proxies of geography and type of asset. The third possible

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* Candidate for Juris Doctor, University of Connecticut School of Law, 2005; Bachelor of Arts, University of Hartford, 2002. I would like to dedicate this work to my grandfather Marco C. Smith, III, who passed away during the preparation of the abstracts – I am going to miss you, Harry.

shortcoming that Manns recognizes is the Act's creation of a system where both the federal and state governments are involved in regulation of terrorism insurance. The degree to which state and federal goals will be the same is, in Manns's view, uncertain and potentially dangerous. Regarding the fourth and final potential flaw in the Act, Manns discusses politics and "ex post moral hazard." Manns describes this problem as the politicians' extension of ex post relief to the un- or underinsured. Manns believes that the fact that uninsured flood victims annually receive federal subsidies creates a moral hazard that the Act may not cure; that is, people may not buy terrorism insurance in the hope (and possibly with the expectation) that they will still receive federal monies.

Though Manns describes the relative weaknesses of the Act, he maintains that the Act does indeed have its strengths. Manns contends that the very fact that the Act is a reinsurance program with indirect subsidies reflects the federal government's innovation in the face of traditionally flawed direct subsidized insurance programs. Moreover, the Act allows private insurers to retain control of pricing insurance, thus minimizing the federal government's direct role in the insurance market (while still shifting significant risks to the government). Additionally, Manns identifies a significant strength in the Act's use of deductibles and co-payments. Manns asserts that the Act, through such a method, helps to minimize moral hazards by providing insurers with incentives to monitor the insured's precautionary measures.

Manns ultimately concludes that the Act is a viable attempt to address the economic challenges presented by terrorism. Manns maintains that, though the Act was, in his view, motivated more by overwhelming rent-seeking pressures than by economic analysis, the Act stands as a model of innovation that incorporates significant economic safeguards in order to, among others, limit rent-seeking and minimize moral hazards. Manns contends that the Act was not passed to address an actual market failure, but the reinsurance program the Act creates goes far to avoid potential problems with regard to terrorism.

Desmond Keith Derrington, *Occurrences: The World Trade Center Insurance Question*, 13 IND. INT'L & COMP. L. REV. 831 (2003).

This Article, written by former Australia Supreme Court Justice Derrington, examines the terrorist attack on the World Trade Center on September 11, 2001. Derrington suggests that a major question left unanswered in the wake of the attack is whether, under the terms of the insurance policy, there was one "occurrence" or two. The significance of

the distinction lies in the insurance policy itself, which limits recovery to $3.546 billion for "any one occurrence," but allows an unlimited amount in the aggregate. Thus, Derrington puts forth, if the attack was determined to be one occurrence, the policy limit would be insufficient to cover the loss of either building individually, let alone the loss of both buildings. Construction of the ambiguous term "occurrence" would most likely proceed along separate paths when performed in the United States, as opposed to in Australia or England. Derrington attributes the different approaches to the construction of an ambiguous term to the greater regularity with which courts in the U.S. resort to the *contra proferentem* rule. Contrarily, in Australia and England, Derrington asserts, *contra proferentem* is regarded as a rule of last resort. Derrington argues that the United States also differs form England and Australia in its concern about the reasonable expectation of the insured.

Derrington discusses various cases from the United States, England, and Australia and examines their usefulness with respect to resolving the question of whether the World Trade Center attack was in fact "one occurrence." Derrington ultimately concludes that, if the World Trade Center litigation were held in England or Australia, the insured would more likely than not receive a favorable construction of the policy. Derrington explains that in light of the principles articulated in the cases he examines, Australia and England would take note of the entire context in which the term was used and the relevant factors with regard to the collapse of the towers, most likely deciding that there was one "occurrence."

HEALTH INSURANCE

Carol S. Weissert, *Promise and Perils of State-Based Road to Universal Health Insurance in the U.S.*, 7 HEALTH CARE L. & POL'Y 42 (2003).

This Article examines both the advantages and the pitfalls of pursuing universal health insurance via state action. Weissert puts forth five reasons why states are more likely than the federal government to establish universal health policy for the uninsured: (1) states are better able to lead the way in the health care area because their administrative and policy systems allow the states to work in ways the federal government cannot; (2) states have traditionally been innovators in that many programs to improve health care delivery have originated in the states (with states often borrowing ideas from similar states); (3) states, through direct democracy mechanisms such as popular voter referendums, are more likely to achieve

the broad-based consensus that health care reform should reflect; (4) states are more homogeneous than the nation as a whole and, as a result, state decisions reflect the interests of state citizens in a much different way than federal decisions; and (5) in the absence of a national policy, states almost have to create health care policy by default.

Weissert next points to five "major constraints" that can act to obstruct state leadership in the health policy arena. First, Weissert asserts that states, by their nature, have limited resources and the scope of the states' policy decisions are necessarily limited by their borders. Second, Weissert identifies the existence of one important federal encumbrance: the Employee Retirement Income Security Act of 1974 (which, Weissert states, hinders state efforts to provide comprehensive access to health care through its federal preemption clause). Third, Weissert cites the fact that a new Congress convenes in Washington, D.C. every two years, which allows laws passed by the former Congress to be repealed by a subsequent Congress (thus leading to instability and uncertainty). Fourth, Weissert maintains that the federal government is simply unable to obtain a national consensus on what the national health care policy ought to be (though Weissert points out that this can be a problem in state government as well). Finally, the existence of legislative term limits in seventeen states lead legislators in those states to pursue short-term, self-beneficial solutions and neglect long-term solutions because the legislator's time to make an impression is limited.

Weissert then discusses how state-based comprehensive health insurance programs would look, if realized. Weissert suggests that state-based programs would reflect the incremental change that is common in state policies, which lead to larger, systemic changes over time. Additionally, Weissert argues, there is evidence that there is more local involvement in the states than there has been in the past, which leads to policy decisions that reflect the preferences of citizens of each state. However, Weissert points out, this leads to inequities among the states because citizens of one state will necessarily be treated differently than citizens of another state.

Weissert also presents evidence relating to the 2002 state elections. For instance, Weissert illustrates that the gubernatorial races in the year 2002 show that health access was a major issue in many races (with 76 percent of all candidates describing health policy as a major issue). Additionally, Weissert describes how the candidates of the different political parties viewed the issue of health care. Weissert also examines state-sponsored messages that elected governors delivered in 2003 (with nearly half of those messages mentioning access to health care). From this

and other information, Weissert concludes that American citizens prefer a casually governed health care system and disfavor centralized government. Additionally, Weissert's systematic analysis of the 2002 gubernatorial candidates' health care proposals portrays a state of affairs in which the state is politically important.

Weissert ultimately suggests that, given both the positive and negative aspects of state-initiated universal health care, the best approach is possibly having the state and federal government working in tandem. The federal government, Weissert states, may establish the framework and offer incentives for states to act. Weissert also suggests that, perhaps, the state and federal governments can work as partners. In sum, Weissert reminds that the debate over health access has been present for decades and the road to universal health care will most likely resemble the incremental, state-innovation reform that is currently visible. However, Weissert concludes, state-based universal health access is highly unlikely.

Susan Adler Channick, *Come the Revolution: Are We Finally Ready for Universal Health Insurance?*, 39 CAL. W. L. REV. 303 (2003).

This Article examines the current state of health care in the United States. Channick discusses the health insurance industry in the United States and describes how it was once a community rating system, where the entire community was rated as a whole and participants were all charged approximately the same premium, with no regard to individual health status and risk. The system has since moved from community rating to experience rating, meaning that health plans rate on the basis of risk experience. The move to experience rating, Channick states, was occasioned by the rise of a competitive marketplace in health insurance. All of this, Channick argues, has caused employers to either eliminate health care plans or shift the cost of the health insurance to the employee. As a result, Channick concludes, the health insurance companies and the wealthiest citizens are the ones who benefit, because companies make more money and the wealthy are still able to afford the more expensive coverage. Conversely, individuals who cannot afford the insurance suffer when an insurance market becomes competitive.

Channick also discusses the current conditions in the United States in terms of health insurance availability and affordability, concluding that the traditional catalysts for more comprehensive health insurance coverage exist today just as they did during the late 1980's and 1990's. Channick then discusses some proposed plans to move to universal healthcare coverage in the United States. Though Channick believes that each plan

has its benefits, each also shares one common problem: Americans are very unlikely to make the necessary long-term commitment to a universal health insurance regime. Channick suggests that Americans are too individualistic and do not possess the commitment to community that a universal health insurance system necessitates. Additionally, Channick notes that Americans' familiarity and comfort with the idea of a free market make the transition to universal health insurance very unlikely.

LIFE INSURANCE

Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Like Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449 (2003).

This Article examines the benefits to both policyholders and incumbent insurers of an active secondary market for life insurance policies. The authors begin by analyzing the benefits that secondary markets have in the home mortgage and catastrophic risk insurance industries and analogize the life insurance industry. The authors state that the home mortgage and catastrophic risk insurance industries share similar features with life insurance, allowing them to compare and draw provident conclusions about the benefits of the creation of a secondary market for life insurance.

The Article then examines the necessity of a secondary market for life insurance, arguing that without it, "impaired" policies are surrendered at an inefficiently low level. The authors state that a life insurance policy is "impaired" when the state of health of the policyholder is such that the policyholder's life expectancy has decreased to a greater degree than contemplated in the original policy (thus, the policyholder has built up equity in the policy). Without an active secondary market for life insurance, the authors contend, an impaired policy is most likely to be bought back only by the incumbent insurer, which means that the surrender value is below market value because of the incumbent insurer's monopsony power. The authors also assert that competition in the primary market does little to help the value of an impaired policy, meaning that the appreciation in value of the policy is not realized by the impaired policyholder. Since there is no incentive to adequately compensate impaired policyholders if insurers in the primary market retain their monopsony power, the authors argue that the monopsony power of the insurers can only be broken by entry of firms into the secondary market.

The authors then examine the benefits of a secondary market for life insurance policies with respect to both policyholders and incumbent insurers. The authors state that entry into the secondary market has

generated an increase in the liquidity of life insurance policies and, drawing on the earlier comparison to home mortgages and catastrophic risk insurance, they assert that this parallels the increase in the liquidity of the underlying assets in those markets (note that the authors view the underlying asset in the home mortgage industry as the stream of payments made by the homeowner and not the loan itself). As illustrated by the pro-competitive and pro-consumer results of the emergent secondary market, the authors conclude that a robust secondary market will benefit both consumers and insurers. Finally, the authors argue that lawmakers should encourage participation in the secondary market because, as more sophisticated and larger investors enter the secondary market, there will be a certain degree of self-policing which overreaching regulations may encumber.

INSURANCE REGULATION

James M Cain, *Financial Institution Insurance Activities--Time for a GLB Act Upgrade?*, 58 BUS. LAW. 1339 (2003).

This Article looks at the Gramm-Leach-Bliley Act of 1999 ("GLB Act") and considers the GLB Act's intended reforms of, among others, clearer lines of regulatory authority and consistent regulation of insurance activity by financial institutions. Cain poses the question of whether the uncertainties of the GLB Act's promised reforms will be cured (or aided) by the courts, or whether wholesale changes need to be made and the GLB Act abandoned altogether.

Cain discusses, *inter alia*, one case from the Fourth Circuit that is illustrative of the GLB Act's complexities and, in Cain's view, "glitches." In *Cline v. Hawk*, 2002 WL 31557392 (4th Cir. Nov. 19, 2002) (an unpublished opinion), the Fourth Circuit confronted two questions which Cain notes. The first issue was whether the Office of the Comptroller of the Currency ("OCC") has the authority to issue opinions regarding a GLB Act provision concerning federal preemption of state laws. The Fourth Circuit answered in the affirmative, concluding that the OCC has implied authority to issue such opinions by virtue of the GLB Act being an extension of § 92 of the National Bank Act, which gives the OCC such authority.

The second issue the court addressed concerned the level of deference with which a reviewing court reviews the OCC's interpretation of the GLB Act. The court ultimately concluded that *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), applied, setting the applicable standard of deference under

the GLB Act such that the OCC's interpretation would be entitled to deference if it had the "power to persuade." The court held that the OCC opinion was persuasive in that it was cogent and logically reasoned.

Cain notes that the Fourth Circuit's opinion was not only unpublished, but split as well. By different reasoning, one concurring judge agreed that federal law preempted the state law at issue in the case. There was also a dissent, which argued that there was no case or controversy for Article III purposes because the OCC opinion was advisory. Cain here uses the case to illustrate the problematic nature of the preemption provision in the GLB Act.

Cain also discusses recent OCC activities that, given the Fourth Circuit's analysis, may indeed preempt conflicting state law. Cain states that the OCC has declared that debt cancellation contracts and debt suspension agreements are banking and not insurance. If the GLB Act preemption provisions function as the Fourth Circuit held, they would trump the interpretations of states such as New York, which determined that such contracts and agreements are insurance and not banking. The Fourth Circuit's opinion, according to Cain, may thus prove to be quite significant.

INSURANCE GENERALLY

Hazel Glenn Beh, *Reassessing the Sophisticated Insured Exception*, 39 TORT TRIAL & INS. PRAC. L. J. 85 (2003).

This Article examines the sophisticated insurer exception to the traditional contra-insurer rules of construction with regard to insurance contracts. Beh states that, typically, insurance contracts are construed against the insurer. This policy of construction, though divergent from concepts of normal contract law, promotes important social policy goals. Beh relates that this policy of contra-insurer contract construction has been justified by, among other things, the adhesive quality of the insurance contract, the relative bargaining power of the parties, the parties' asymmetrical access to information, and the quasi-public nature of insurance generally. Beh posits that although the contra-insurer rules of construction function to advance societal goals, there are indeed circumstances where the unique factual circumstances of the case, with regard to the context and the parties, must be taken into account. It is in this situation that Beh suggests the sophisticated insured exception should apply.

Beh traces the exception to early cases where the sophisticated insured exception was applied in situations where the court noted the insured's wealth, knowledge, bargaining power, and/or representation by a broker or attorney. Thus viewed, Beh contends that the courts interpreted ambiguous terms in insurance contracts in light of the relative economic and bargaining strength of the contracting parties. This, according to Beh, betrays the object of the exception.

However, Beh notes that over time the courts have come to examine many different factual considerations in determining whether to employ the exception. Beh attributes the construction of this more functional approach to Professor Jeffrey Stempel. In a significant work, *Reassessing the "Sophisticated" Policyholder Defense in Insurance Coverage Litigation*, 42 DRAKE L. REV. 807 (1993), Professor Stempel suggested certain factual considerations that would help guide courts in their application of the sophisticated insured exception. Beh credits Professor Stempel with the important suggestion that, to advance the goals of the exception, courts ought to focus on these factual considerations and not on the relative economic positions of the parties.

Beh cites to cases applying the exception in a variety of contexts, arguing that regardless of the context in which it arises, the sophisticated insured exception is only proper where the disagreement is not over standardized language. Beh suggests that there should be a factual inquiry (a sort of caveat to Professor Stempel's approach) to determine whether the provision or language is standardized. Since all of the justifications for interpreting the contract against the insurer (inequality, desirability of predictability, etc.) are present and should not be eschewed because of any inequality between the parties, Beh believes that the sophisticated insured exception has no place in a dispute over standardized language or provisions. Thus, Beh suggests a more narrow approach than that offered by Professor Stempel. Beh adds that a determination of whether the provision in dispute is a standard provision is a principled caveat to Stempel's approach and one that ensures that courts confronted with disputes over standardized provisions will not wrongly apply the exception.

Finally, Beh asserts that the sophistication of the insured should only be considered when the dispute is factual. Beh maintains that rules created by courts and statutes should not be altered merely because the insured has significant wealth or because the insured is a commercial entity. To do so, Beh argues, would threaten the positive goals of predictability, equality, and uniformity that the rules seek to advance. Beh discusses how treating insureds differently based solely on their "sophistication" undermines the public policies behind the rules. However, the insured's sophistication is

rightly considered where the dispute is factual and the threat to consistency and certainty is not present (as when equal parties negotiate and draft a non-standardized provision jointly). In that situation, Beh submits, consideration of the insured's sophistication aids the court in interpretation but does not have any resounding implications beyond the case at bar. Beh concludes by stating that when the language is standardized—no matter which side offered it and no matter how much negotiation took place—the courts should continue to interpret the insurance contracts as they would generally. The selection of standard language, Beh states, is the selection by the parties of standard interpretation consistent with other cases. Individualizing the interpretation of standard provisions is, in Beh's view, undesirable. But individualizing non-standard, bargained-for provisions is desirable and therefore, Beh suggests, Professor Stempel's functional approach should be narrowed accordingly.

Giuseppe Dari Mattiacci & Francesco Parisi, *The Cost of Delegated Control: Vicarious Liability, Secondary Liability and Mandatory Insurance*, 23 INT'L REV. L. & ECON. 453 (2003).

This Article addresses an aspect of delegated control which, the authors suggest, has not garnered the amount of attention that law and economics literature has devoted to other issues. In this article, the authors examine the various regimes of secondary and vicarious liability and address the existence and possible effects of monitoring costs on those regimes. The authors consider vicarious liability, secondary liability, and mandatory insurance as mechanisms to overcome. Viewed through those lenses, the authors compare alternative legal instruments' structure and incentive properties.

The authors begin, quite logically, by discussing the choice of liability rules under delegated control. The authors put forth that, under a personal liability regime, optimal precaution is reached by minimizing the total cost of accidents (balancing the benefit of precaution with its marginal cost). However, under vicarious liability and secondary liability, the authors contend, the agent's precaution cost includes the monitoring costs of the principal (which are similar to insurance contracts, where the insurer is also vicariously liable for the insured). Thus, to reduce the total expected accident loss under vicarious liability, one must increase the marginal cost, which now reflects the sum of the precaution cost and the principal's monitoring cost. As a result, the authors determine that monitoring costs, and by extension delegated control, increase the overall cost of accident precaution. The authors view this situation as one in which society chooses

a delegated control system and the overall increase in the accident cost represents the price society pays for that choice.

The authors state that precaution is not free, and that it is unlikely to be inexpensive, so the legal system's shift of liability onto a second party with an incentive to monitor the injurer (or agent) and minimize risk raises the marginal cost of precaution. This lowers the socially optimal level of care because under delegated control precaution is attained at a higher marginal cost. However, the authors notice that the due level of care under a negligence rule does not reflect this lower, socially optimal level of care. The additional cost of delegated control, according to the authors, is paid by both the principal and the agent, and it is seen in monitoring costs and higher precaution costs. The authors assert that this result is inefficient in terms of precaution but serves as an incentive to lower monitoring costs. The authors concede that questions of the desirability of efficient precaution or efficient monitoring lie beyond the scope of their empirical analysis.