

RECEIVED
SUPREME COURT
STATE OF WASHINGTON

2000 SEP 22 P 12: 15

No. 80753-1

BY RONALD R. CARPENTER

**SUPREME COURT
OF THE STATE OF WASHINGTON** CLERK

AMERICAN BEST FOOD, INC., a Washington
corporation d/b/a CAFE ARIZONA; and MYUNG CHOL
SEO and HYUN HEUI SE-JEONG,

Respondents,

v.

ALEA LONDON, LTD., a foreign corporation,

Petitioner.

FILED
SUPREME COURT
STATE OF WASHINGTON
2000 SEP 30 P 4: 32
BY RONALD R. CARPENTER
CLERK

**AMICUS CURIAE BRIEF OF
PROFESSOR KAREN WEAVER
AND INTERESTED LONDON MARKET INSURERS**

Karen Southworth Weaver, WSBA #11979
SOHA & LANG, PS
701 - 5TH AVENUE, SUITE 2400
SEATTLE, WASHINGTON 98104
TELEPHONE: 206.624.1800
FACSIMILE: 206.624.3585

Individually and as Counsel for
Interested London Market Insurers

TABLE OF CONTENTS

	<u>Page</u>
I. IDENTITY AND INTEREST OF AMICI	1
II. ISSUES TO BE ADDRESSED	1
III. STATEMENT OF THE CASE.....	2
IV. ARGUMENT.....	2
A. Insurance Contracts Reflect a Necessary Balance Between Covered and Non-Covered Claims	2
B. Insurers Conduct Their Business Following Strict Guidelines.....	5
C. The Reasonableness of a Legal Decision Should Be Determined as a Matter of Law.....	11
D. This Case Affords This Court a Unique Opportunity to Provide Guidance	12
V. CONCLUSION.....	13

TABLE OF AUTHORITIES

	<u>Page</u>
Washington Cases	
<i>Am. Best Food, Inc. v. Alea London, Ltd.</i> , 138 Wn. App. 674, 158 P.3d 119 (2007)	2, 8, 10
<i>Ball v. Smith</i> , 87 Wn.2d 717, 556 P.2d 936 (1976)	11
<i>Constr. Indus. Training Council v. Washington State Apprenticeship</i> , 96 Wn. App. 59, 977 P.2d 655 (1999)	9
<i>Crunk v. State Farm Fire & Cas. Co.</i> , 38 Wn. App. 501, 686 P.2d 1132 (1984), <i>reversed</i> , 106 Wn.2d 23, 719 P.2d 1338 (1986).....	9, 10
<i>Felice v. St. Paul Fire & Marine Ins. Co.</i> , 42 Wn. App. 352, 711 P.2d 1066 (1985)	6, 7
<i>International Ultimate, Inc. v. St. Paul Fire & Marine Ins. Co.</i> , 122 Wn. App. 736, 87 P.3d 774 (2004)	7
<i>Kirk v. Mt. Airy Ins. Co.</i> , 134 Wn.2d 558, 951 P.2d 1124 (1998)	6
<i>Leingang v. Pierce County Medical Bureau, Inc.</i> , 131 Wn.2d 133, 930 P.2d 288 (1997)	6
<i>Olympic Steamship Co., Inc. v. Centennial Ins. Co.</i> , 117 Wn.2d 37, 811 P.2d 673 (1991)	6
<i>Overton v. Consol. Ins. Co.</i> , 145 Wn.2d 417, 38 P.3d 322 (2002)	6
<i>Queen City Farms, Inc. v. Central Nat. Ins. Co. of Omaha</i> , 126 Wn.2d 50, 882 P.2d 703 (1994)	9
<i>Smith v. Safeco Ins. Co.</i> , 150 Wn.2d 478, 78 P.3d 1274 (2003)	6, 11
<i>Standard Fire Ins. Co. v. Blakeslee</i> , 54 Wn. App. 1, 771 P.2d 1172 (1989)	5

<i>State v. Salavea</i> , 151 Wn.2d 133, 86 P.3d 125 (2004)	9
<i>State v. Thomas</i> , 150 Wn.2d 821, 83 P.3d 970 (2004)	11
<i>Tank v. State Farm Fire & Cas. Co.</i> , 105 Wn.2d 385, 715 P.2d 1133 (1986)	5
<i>Transcontinental Ins. Co. v. WPUDUS</i> , 111 Wn.2d 452, 760 P.2d 337 (1988)	6
<i>Woo v. Fireman's Fund Ins. Co.</i> , 161 Wn.2d 43, 164 P.3d 454 (2007)	5

Non-Washington Cases

<i>ACL Technologies, Inc. v. Northbrook Prop. And Cas. Ins. Co.</i> , 17 Cal. App. 4th 1773 (1993).....	9
<i>Bucci v. Essex Ins. Co.</i> , 393 F.3d 285 (1st Cir. 2005)	8, 9

Constitutional Provisions

Wash. Const. art. IV, § 16.....	11, 12
---------------------------------	--------

Statutes

RCW 48.30.015	6
---------------------	---

Regulations and Rules

ER 702	11
--------------	----

Other Authorities

C.A. Williams, G. Head, R. Horn, G.W. Glendenning,
PRINCIPLES OF RISK MANAGEMENT AND INSURANCE,
Vol. I (2d ed. 1981) 3

I. IDENTITY AND INTEREST OF AMICI

Amici are Professor Karen Weaver, an Insurance Law instructor at the University of Washington School of Law,¹ local insurance coverage lawyer, and expert, along with the Interested London Market Insurers (collectively "Amici").² Amici are familiar with the scope of the arguments presented by the parties, having reviewed all briefing and the underlying decision in this case. They file this brief as friends of the Court to provide a broader perspective for this Court to consider when deciding this matter.

II. ISSUES TO BE ADDRESSED

Amici urge this Court to provide a clear declaration of Washington law to affirm claim handling techniques that allow the insuring mechanism to operate in the best interest of the public. Specifically, Amici ask this Court to confirm that a coverage determination based upon a reasonable interpretation of Washington law cannot support a claim of bad faith. Amici further ask for confirmation that whether an interpretation of

¹ Professor Weaver's title is Part-Time Lecturer in Insurance Law, and she has held this position for sixteen years. During that time, she has been the University's only lecturer specific to Insurance Law. Positions taken in this brief, however, may not be attributed to the University of Washington as an institution.

² Additional details about Amici are set forth in detail in the Motion for Leave to File this Brief that is being filed simultaneously herewith.

Washington law is “reasonable” is a question of law to be decided by the court, and is not a question of fact for a jury.

III. STATEMENT OF THE CASE

For the purpose of this brief, Amici rely upon the statement of facts set forth in the underlying Court of Appeals decision. *See Am. Best Food, Inc. v. Alea London, Ltd.*, 138 Wn. App. 674, 158 P.3d 119 (2007).

IV. ARGUMENT

This Court has been asked to address whether an insurer’s determination of no coverage under Washington law is unreasonable as a matter of law due to the existence of non-Washington “authorities contrary to its position.” Consistent with the laudable purposes that underlie liability insurance and the practical need for bright line rules, Amici respectfully request that this Court hold as follows: 1) a coverage determination based upon Washington law is reasonable as a matter of law, notwithstanding commentary and holdings from foreign courts, and 2) where, as here, an insurer’s coverage determination is not unreasonable, frivolous, or unfounded, allegations of bad faith are appropriately dismissed by the court as a matter of law.

A. Insurance Contracts Reflect a Necessary Balance Between Covered and Non-Covered Claims.

The mechanism of insurance is critical to business operations in our society. It is an inherent and necessary feature of each insurance

contract that it cover certain risks and exclude others, with the price of coverage being a function of its scope. In selecting from available coverage, consumers of insurance make reasoned choices that balance their risk tolerance with cost. Ultimately, businesses and individuals contract with insurers to transfer some – but not all – of the risks they face in exchange for a market-set premium.³ Premiums paid by participants are “pooled” for purposes of establishing a common fund for use in responding to losses of the type insured against.⁴ Insurers, in turn, use these funds to respond to those losses that fall within the scope of the specific coverage selected by policyholders, as outlined in the insurance contracts. Conversely, they do not respond to those losses that fall outside of the parties’ insurance contracts. This distinction between covered and non-covered claims results in premiums that are affordable, while ensuring the ability of the “pool” to respond as agreed.

³ Businesses and individuals may opt in or out of certain available coverages based upon cost concerns and/or risk tolerance determinations. This is part of the decision-making process called “risk management.” *See generally*, C.A. Williams, G. Head, R. Horn, G.W. Glendenning, *PRINCIPLES OF RISK MANAGEMENT AND INSURANCE*, Vol. I (2d ed. 1981). *See* App. A, attached hereto. If the Court desires a copy of this resource, Amici will provide it.

⁴ C. Arthur Williams, et al., define the insurance mechanism as “a social device under which two or more (generally many more than two) entities make or promise to make contributions to a fund from which the insurer promises to make certain cash payments or render certain services to those contributors who suffer accidental losses.” C.A. Williams, et al., *supra* note 3, at 224 (included in App. A).

Simply stated, some liability exposures are covered and some are not. While insurers must be held to their bargain when a given risk has been transferred, they must also be allowed to decline to respond to risks that were not transferred. To require otherwise would either result in insufficient funds to pay covered losses, or would require premiums to be higher than required by the risks defined in the insurance contract. Either of these results would damage the premium-paying public.

In an effort to provide policyholders with all the benefits they did purchase – without penalizing the pool by paying for losses for which no premiums were contributed – insurers analyze each loss to determine if it falls within the coverage purchased. For insurers doing business in Washington, this means, first and foremost, close consideration of the wording of the insurance contract at issue. In certain situations, this may also include the consideration of applicable state statutes and published decisions from this Court and the Court of Appeals that shed light on how Washington state has construed material contractual terms in the past. As each set of “loss facts” is by definition unique, even “black letter” pronouncements of law on a given point are rarely an exact match to differing factual scenarios. Insurers are thus not infrequently called upon to derive guiding principles from Washington law in the conduct of their business.

This claim consideration process can and very often does result in a determination of coverage. Conversely, unambiguous policy language can and sometimes does result in a determination that the insurer has no obligation to respond to a given claim. *See, e.g., Woo v. Fireman's Fund Ins. Co.*, 161 Wn.2d 43, 62, 164 P.3d 454 (2007) (where there was no case law directly on point, concluding that the insurer "had no duty to defend under Woo's employment practices liability provision because [the] complaint clearly did not allege actions that met the definition of wrongful discharge under the policy."); *Standard Fire Ins. Co. v. Blakeslee*, 54 Wn. App. 1, 4, 771 P.2d 1172 (1989) (concluding that the insurer had no duty to defend against sexual assault allegations that are not part of the practice of dentistry, despite the absence of Washington precedent precisely on point). This process, whereby insurers assess and then meet their obligations based upon an existing contractual and legal framework, is an essential feature of insurance.

B. Insurers Conduct Their Business Following Strict Guidelines.

In assessing their contractual and legal obligations, insurers must, of course, "deal fairly with an insured, giving equal consideration in all matters to the insured's interests." *Tank v. State Farm Fire & Cas. Co.*, 105 Wn.2d 385-86, 388, 715 P.2d 1133 (1986). Insurers must not make a coverage determination that is "unreasonable, frivolous, or unfounded."

Smith, 150 Wn.2d at 485 (quoting *Overton v. Consol. Ins. Co.*, 145 Wn.2d 417, 433, 38 P.3d 322 (2002)). If an insurer violates these fundamental, “black letter” rules, Washington law imposes punitive penalties, including coverage by estoppel, the imposition of unlimited treble damages under RCW 48.30.015(1),⁵ and *Olympic Steamship* fees. See *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 561, 951 P.2d 1124 (1998); *Olympic Steamship Co., Inc. v. Centennial Ins. Co.*, 117 Wn.2d 37, 811 P.2d 673 (1991).

Despite the requirement that they always make careful and reasonable coverage assessments, insurers do have a recognized right to be wrong without being in bad faith. *Transcontinental Ins. Co. v. WPUDUS*, 111 Wn.2d 452, 471, 760 P.2d 337 (1988) (“A denial of coverage based on a reasonable interpretation of the policy is not bad faith, ... and even if incorrect, does not violate the Consumer Protection Act if the insurer’s conduct was reasonable.”). “Acts performed in good faith under an arguable interpretation of existing law do not constitute unfair conduct violative of the consumer protection law.” *Leingang v. Pierce County Medical Bureau, Inc.*, 131 Wn.2d 133, 155, 930 P.2d 288 (1997); see *Felice v. St. Paul Fire & Marine Ins. Co.*, 42 Wn. App. 352, 361, 711 P.2d

⁵ As RCW 48.30.015 did not become effective until after this lawsuit was filed, it does not apply to this case. The penalties set forth in that statute may nonetheless be imposed in other cases.

1066 (1985) (“Denial of coverage due to a debatable question of coverage ... is not bad faith.”).

When an insurer makes a coverage determination that is not unreasonable, frivolous, or unfounded, then the insurer is not in bad faith. This remains true even if the insurer’s decision is later deemed to be incorrect. *See, e.g., International Ultimate, Inc. v. St. Paul Fire & Marine Ins. Co.*, 122 Wn. App. 736, 756 87 P.3d 774 (2004) (“[A]n insured must show more than an incorrect denial of coverage. The insured must also establish that the insurer acted ‘without reasonable justification’ in denying coverage. The test is not whether the insurer’s interpretation is correct, but whether the insurer’s conduct was reasonable.”) (citations omitted). The reasonableness of the insurer’s substantive legal decision on coverage is inherently a question of law for the court, not a question of fact for a jury of lay persons.

In this case, the insurer made a reasonable coverage determination.⁶ It assessed its obligations by considering and then relying upon the unambiguous language in the involved insurance contract, the clear allegations made against its insured as set forth in the complaint, and

⁶ The trial court found, and the Court of Appeals affirmed, that the procedures used by the insurer met standards of good faith. The question here is whether the legal determination made by the insurer was reasonable and not frivolous or unfounded. This is a question of law for the court, not a question of fact for the jury.

the best available indicators of Washington law. On this basis, the insurer reasonably concluded that there was no coverage.

Notwithstanding the longstanding principles set forth above, the Court of Appeals stated as follows: “The fact that [the insurer] incorrectly determined that it had no duty to defend is evidence of bad faith.” *Am. Best Food*, 138 Wn. App. at 691. In other words, despite the fact that multiple Washington courts have provided clear pronouncements on the issues presented,⁷ the Court of Appeals criticized the insurer for declining to follow case law from other jurisdictions. This was error. Where Washington courts have passed on an issue, Washington citizens and businesses must be able to rely upon those pronouncements without concern for what other jurisdictions may have concluded.

Indeed, the danger of relying on cases from other jurisdictions, as opposed to relying on Washington precedent, is clearly illustrated in this case. For example, the Court of Appeals relied upon the First Circuit’s interpretation of Maine law in *Bucci v. Essex Ins. Co.*, 393 F.3d 285, 290-91 (1st Cir. 2005), even though the “but for” test that has been adopted in Washington was rejected in Maine. *See Am. Best Food*, 138 Wn. App. at 687. It is notable that the First Circuit indicated that it

⁷ *See* Supp. Br. of Petitioner Alea, at 4-12 (discussing Washington courts’ pronouncements on the phrase “arising out of”).

would have reached a different result if Maine law followed the “but for” test. *Bucci*, 393 F.3d at 290-91.

Moreover, although non-Washington law that is consistent with Washington law might ultimately be considered persuasive by a Washington court, Washington courts are not compelled to adopt foreign law. *See, e.g., State v. Salavea*, 151 Wn.2d 133, 144 n.9, 86 P.3d 125 (2004) (rejecting other states’ interpretations of statutes similar to a Washington statute); *Constr. Indus. Training Council v. Washington State Apprenticeship*, 96 Wn. App. 59, 67, 977 P.2d 655 (1999) (“[W]e are not compelled to adopt a federal procedure which is at odds with the usual and customary practice in Washington”).⁸ Furthermore, this Court has expressly rejected a determination by the Court of Appeals that “[a]n ambiguity exists when there is a difference of opinion among courts of different jurisdictions with respect to the construction of terms in insurance policies.” *Crunk v. State Farm Fire & Cas. Co.*, 38 Wn. App.

⁸ Just one of many possible examples of Washington courts reaching conclusions that differ from non-Washington courts involves an insurance contract. *Compare ACL Technologies, Inc. v. Northbrook Prop. and Cas. Ins. Co.*, 17 Cal. App. 4th 1773, 1787 (1993) (concluding that “‘sudden and accidental’ unambiguously does not include gradual pollution”), with *Queen City Farms, Inc. v. Central Nat. Ins. Co. of Omaha*, 126 Wn.2d 50, 82, 882 P.2d 703 (1994) (concluding that the term “sudden” is ambiguous and that the policy’s coverage “clearly contemplates gradual events”). Note that *ACL Technologies* was decided before the Washington Supreme Court decision in *Queen City Farms*. Thus, had the insurer relied on California case law, even though the decision was on all fours with the presented loss, the resulting coverage decision would have been incorrect under Washington law.

501, 508, 686 P.2d 1132 (1984), *reversed*, 106 Wn.2d 23, 719 P.2d 1338 (1986).

Thus, the Court of Appeals' statement that "[t]he fact that [the insurer] incorrectly determined that it had no duty to defend is evidence of bad faith," standing alone, is incorrect and should be disapproved. *See Am. Best Food*, 138 Wn. App. at 691. While text following this sentence appears to qualify it, future advocates will use this sentence to suggest that the mere fact that a decision was ultimately incorrect constitutes bad faith. This is not the law, nor should it be.

Moreover, if the Court of Appeals' reasoning is taken to its logical conclusion, insurers would be obligated to deplete the premium pool by paying losses regardless of whether they fell within the purchased coverages. This will not benefit policyholders. Some insurers will have no alternative other than to reduce volume and increase pricing for Washington risks. Others may cease issuing policies in this state altogether. The result will be higher premiums and less risk transfer capacity, severely undermining the very purpose of liability insurance, *i.e.*, to cover the losses that are described in the policies purchased. These consequences will damage the public.

C. **The Reasonableness of a Legal Decision Should Be Determined as a Matter of Law.**

As this Court confirmed in *Smith v. Safeco Ins. Co.*, 150 Wn.2d 478, 486, 78 P.3d 1274 (2003), an insurer is entitled to summary judgment if reasonable minds could not differ that its denial of coverage was based upon reasonable grounds. There are circumstances where this determination can and should be made as a matter of law. This case presents just such a circumstance.

It is well established that “questions of fact are to be determined by a jury, and that all matters of law are to be determined and declared by the court.” *Ball v. Smith*, 87 Wn.2d 717, 723, 556 P.2d 936 (1976); *see* Wash. Const. art. IV, § 16 (“Judges shall not charge juries with respect to matters of fact, nor comment thereon, but shall declare the law.”). Examples of decisions that are appropriately made by a jury include assessments of credibility and evidence in order to decide facts in issue. *See, e.g., State v. Thomas*, 150 Wn.2d 821, 874, 83 P.3d 970 (2004). When a fact must be determined by a jury and the evidence is not readily understandable by the average juror, it is appropriate for courts to allow expert testimony. ER 702 (allowing expert testimony if “scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue”) (emphasis added).

At issue in this case is an insurer's legal determination that the policy provides no coverage under Washington law. The reasonableness of such a determination does not turn on the credibility of witnesses, nor does it depend upon questions of fact. Rather, it turns purely on interpretation of law. Interpretation of the law is the province of the court. *See*, Wash. Const. art. IV, § 16 ("Judges ... shall declare the law.") Indeed, trial courts frequently reject proffered expert testimony of lawyers discussing and describing Washington law regarding coverage and bad faith because the law is the province of the court. This case offers the opportunity for this Court to clarify that, where the claimed bad faith is the insurer's interpretation of the law, reasonableness of that interpretation is the province of the court, not of the jury.⁹

D. This Case Affords This Court a Unique Opportunity to Provide Guidance.

This Court should reaffirm that insurers that reasonably rely on Washington law in making their coverage determinations are acting in good faith and will not be punished even if a Washington court later disagrees with their ultimate determinations. Such a holding is consistent

⁹ This is not to suggest that all allegations of bad faith are questions of law. Many bad faith allegations do involve questions of fact, such as what investigation was performed, whether such investigation was reasonable under the circumstances, etc. Rather, this rule applies when facts are undisputed and the dispute relates solely to the insurer's application of law to undisputed facts, as is the case here.

with longstanding Washington law discussed herein. It also serves to promote the availability of insurance at a reasonable price. By making clear that it is entirely appropriate for insurers to assess the landscape of insurance law in Washington and render good faith determinations of coverage, this Court will be supporting the parties' mutual intent to transfer risks under agreed parameters. This is beneficial to policyholders and insurers alike.

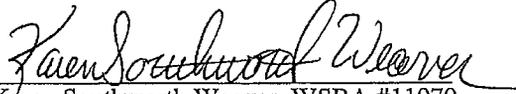
For all of the reasons set forth herein, Amici urge this Court to conclude that a coverage determination based upon a reasonable interpretation of existing Washington law is reasonable as a matter of law, notwithstanding the commentary and holdings of foreign courts. The Court should also hold that where, as here, an insurer's coverage decision was not unreasonable, frivolous, or unfounded, all allegations of bad faith are appropriately dismissed as a matter of law.

V. CONCLUSION

Amici respectfully request that this Court confirm that a coverage determination made based upon a reasonable interpretation of Washington law is reasonable as a matter of law and cannot, in itself, support a claim of bad faith, and that when the issue is reasonableness of a legal interpretation, that is a question of law for the Court and not a question of fact for the jury.

RESPECTFULLY SUBMITTED this 22nd day of September,
2008.

SOHA & LANG, PS



Karen Southworth Weaver, WSBA #11979

SOHA & LANG, PS

701 - 5th Avenue, Suite 2400

Seattle, Washington 98104

Telephone: 206.624.1800

Individually and as Counsel for
Interested London Market Insurers

**FILED AS
ATTACHMENT TO EMAIL**

RECEIVED
SUPREME COURT
STATE OF WASHINGTON

2008 SEP 22 P 12:15

DECLARATION OF SERVICE

BY RONALD R. CARPENTER

Angela Murray states as follows:

I am a citizen of the United States of America and a resident of the State of Washington, I am over the age of 21 years, I am not a party to this action, and I am competent to be a witness herein.

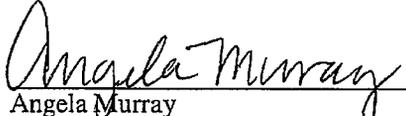
On this 22nd day of September, 2008, I caused to be filed via electronic filing with the Supreme Court of the State of Washington, the foregoing AMICUS CURIAE BRIEF OF PROFESSOR KAREN WEAVER AND INTERESTED LONDON MARKET INSURERS. I also served copies of said document on the following parties as indicated below:

<i>Counsel for Petitioner:</i> J.C. Ditzler Melissa O'Loughlin White Molly Siebert Eckman Cozen O'Connor 1201 Third Avenue, Suite 5200 Seattle, WA 98101	<input type="checkbox"/> Via Legal Messenger <input type="checkbox"/> Via Facsimile <input checked="" type="checkbox"/> Via Email by permission <input type="checkbox"/> Via U.S. Mail
<i>Counsel for Petitioner:</i> Philip A. Talmadge Talmadge/Fitzpatrick PLLC 18010 Southcenter Parkway Tukwila, WA 98188-4630	<input type="checkbox"/> Via Legal Messenger <input type="checkbox"/> Via Facsimile <input checked="" type="checkbox"/> Via Email by permission <input type="checkbox"/> Via U.S. Mail

<p><i>Counsel for Respondents:</i> Scott B. Easter Paul J. Miller Montgomery Purdue Blankinship & Austin PLLC 701 Fifth Avenue, Suite 5500 Seattle, WA 98104 Fax: (206) 625-9534</p>	<p><input checked="" type="checkbox"/> Via Legal Messenger <input type="checkbox"/> Via Facsimile <input type="checkbox"/> Via Email <input type="checkbox"/> Via U.S. Mail</p>
<p><i>Counsel for Respondents:</i> Shane Moloney Short Cressman & Burgess PLLC 999 Third Avenue, Suite 3000 Seattle, WA 98104 Fax: (206) 340-8856</p>	<p><input checked="" type="checkbox"/> Via Legal Messenger <input type="checkbox"/> Via Facsimile <input type="checkbox"/> Via Email <input type="checkbox"/> Via U.S. Mail</p>

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Executed at Seattle, Washington, this 22nd day of September, 2008.


Angela Murray
Legal Secretary to Karen Southworth Weaver

**FILED AS
ATTACHMENT TO EMAIL**

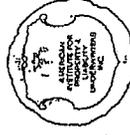
Principles
of
Risk Management
and
Insurance
Volume I

C. ARTHUR WILLIAMS, JR., Ph.D.
*Minnesota Insurance Industry
Professor of Economics and Insurance
University of Minnesota*

GEORGE L. HEAD, Ph.D., CPCU, CLU
*Director—Risk Management/Loss Control Education
American Institute for Property and Liability Underwriters*

RONALD C. HORN, Ph.D., CPCU, CLU
*Professor of Insurance and Professional Studies
Baylor University*

G. WILLIAM GLENDENNING, Ph.D., CPCU
*Professor of Insurance and Risk
Temple University*



Second Edition • 1981

AMERICAN INSTITUTE FOR
PROPERTY AND LIABILITY UNDERWRITERS
Providence and Sugartown Roads, Malvern, Pennsylvania 19355

Appendix A

Table of Contents

Chapter 1—Loss Exposures and Risk Management 1

Introduction

Loss Exposures ~ *Elements of a Loss Exposure; Pure and Speculative Loss Exposures; "Risk" and Its Synonyms*

Why Manage Loss Exposures? ~ *Cost of Losses That Actually Occur; Cost of Losses That Might Occur*

Risk Management ~ *Types of Loss Exposure Handled; Objectives of Risk Management*

The Risk Management Process ~ *Identification and Analysis of Loss Exposures; Selecting the Techniques; Determining Specific Objectives; The Selection Process; Implementing the Selected Techniques; Monitoring the Risk Management Program*

The Risk Management Function ~ *The Risk Management Function in a Large Business; The Risk Management Function in a Small or Medium-Sized Business; The Risk Management Function in a Family*

Contributions of Risk Management ~ *Risk Management Contributions to a Business; Risk Management Contributions to a Family; Risk Management Contributions to Society*

Impact of Risk Management Upon Insurers and Their Representatives

Chapter 2—Controlling Loss Exposures 53

Introduction

Avoidance—*Examples of Avoidance; Advantages; Limitations; When Desirable; Implementing; Monitoring*

Loss Control—*Comparison with Avoidance*

Two Theories on Accident Causes and Effects—*Heinrich's Domino Theory; Haddon's Energy Release Theory; The Two Theories Compared*

Classification of Loss Control Measures—*By Objective; Loss Prevention or Loss Reduction; By Approach; Engineering or Human Behavior; By Time of Application*

Organization for Loss Control—*Loss Control Specialists; Loss Control Policy Statement*

Four Steps in Loss Control—*Loss and Hazard Identification and Analysis; Selection of Loss Control Measures; Implementation of Loss Control Measures; Monitoring Loss Control Measures*

Combination—*How Separation Improves Predictability; How Combination Improves Predictability*

Noninsurance Transfers—*Control-Type Noninsurance Transfers*

Chapter 3—Financing Loss Exposures..... 97

Introduction

Financing-Type Noninsurance Transfers—*Illustrations of Financing-Type Noninsurance Transfers; Advantages and Disadvantages of Noninsurance Transfers; Criteria for Noninsurance Transfers; Aggressive and Defensive Noninsurance Transfers; Implementation; Monitoring*

Insurance—*Insurance Defined as a Concept; Insurance Defined as a Mechanism; Benefits Provided by the Insurance Technique; Costs Imposed by the Insurance Technique; Implementation; Monitoring*

Retention—*Basic Characteristics; Types of Retention; Conditions Requiring or Favoring Use of Retention; Possible Advantages and Disadvantages of Retention; Tax Implications; Implementation; Monitoring; Retention Combined with Insurance; The Future*

Cash Flow Insurance Plans

Chapter 4—Measuring Loss Exposures 155

Introduction

What Should Be Measured and Why—*Measurements Needed; Why Needed*

The Prouty Approach—*Likelihood of a Loss; Severity of a Loss; Expected Dollar Loss*

Probability—*How Determined; Interpreting Probability; Assembling Experience to Determine Probability*

Some Elementary Laws of Probability and Their Application—*First Law of Probability—Compound or Joint Outcomes; Second Law of Probability—Mutually Exclusive Events; Applying the Laws of Probability; Probabilities Using Temporal Interpretation*

Probability Distributions—*Definition; Information That Can Be Obtained from Probability Distributions*

Illustration—*Number of Shipments Damaged Per Month; Total Dollar Losses Per Month*

Relationship of Probability Distribution Information to the Prouty Measures

Conclusion

Chapter 5—Measuring Loss Exposures, Continued 195

Introduction

How Probability Distributions Can Be Used to Select the Most Appropriate Risk Management Techniques—*Illustration—Evaluation of Alternatives; Which Technique Is Best?*

How to Construct a Probability Distribution—*Past Experience; Theoretical Probability Distributions*

How Large Is Large?—*The Law of Large Numbers; How Likely? How Close? Number Required to Satisfy Criteria*

A Concluding Note

Chapter 6—Insurance and Society 223

Introduction

“What Is Insurance” Revisited—*Definition in This Text; Some Other Conceptual Definitions; Legal Definitions*

What Exposures Are Commercially Insurable?—*Factors to Be Considered in Appraising Commercial Insurability; Institutional Constraints; Publicly Insurable Exposures; Evaluation of Certain Exposures*

Types of Private Insurer—*Legal Form of Organization; Domicile; Admission Status; Types of Insurance Written; Types of Customers Served; Marketing System; Pricing System*

Benefits to Society—*Payment for Loss; Reduction of Uncertainty; Loss Control; Long-Term Investments*

Costs to Society—*Resources; Moral Hazards; Morale Hazards*

Social Problems of Insurance—*Availability and Affordability—Common Rate Approach; Individual Rating; Class Rating; Government Subsidies; Illustrations*

Size, Growth, Composition, and Economic Significance—*Premiums; Assets; Employment*

Chapter 7—Insurance and the Government..... 279

Introduction

Why Regulate Insurance?—*Insurance—Public Interest Business; Current Public Attitudes Toward Insurance Regulation*

Goals of Insurance Regulation—*Internal Goals; External Goals; Choosing Among These Goals; A General Goal*

Regulatory Jurisdiction—*Historical Development; Legislative, Administrative, and Judicial Controls*

Contract Regulation—*Legislative Control; Administrative Control; Judicial Control*

Formation and Licensing of Insurers—*Domestic Insurers; Foreign and Alien Insurers; Acceptable Nonadmitted Insurers*

Licensing of Agents and Brokers

Government Insurers—*Reasons for Establishing Government Insurers; Private Insurer Involvement*

Three Important Property and Liability Insurance Programs—*FAIR Plans and Riot Reinsurance; National Flood Insurance; Federal Crime Insurance*

Conclusion

Index..... 335

CHAPTER 6

Insurance and Society

INTRODUCTION

The first five chapters of this text have examined principles of risk management. Chapters 6 through 15 are devoted to principles of insurance. While insurance has been analyzed as one type of loss financing technique used by risk managers, the remainder of this text focuses almost exclusively on insurance as a business and on a business framework for insurance coverage analysis. Chapters 6 and 7 examine insurance primarily from the viewpoint of society, rather than from the viewpoint of the risk manager.

Chapter 6 starts with an attempt to define insurance. Deciding which loss exposures are insurable occupies another important portion of this chapter. The many different types of insurer that operate in the United States are classified and discussed. The analysis in this chapter also examines the benefits and costs of insurance, from the viewpoint of society. Attention will be given to various social problems for which insurance has been advanced as a partial solution and what insurance can and cannot contribute to the solution of those problems. The concluding section of Chapter 6 outlines the size and economic significance of the insurance business.

"WHAT IS INSURANCE" REVISITED

Definition in This Text

Unfortunately, perhaps, there is no universally accepted definition of "insurance." Many definitions have been proposed by the American

Risk and Insurance Association, the courts, Congress, state legislatures, state insurance commissioners, and a variety of authors. However, no one definition has come close to universal acceptance. Strengths and flaws can be found in all definitions of the term.

This section reexamines the definitions of insurance offered earlier in this text and discusses other definitions.

Chapter 3 presented two definitions of insurance:

- (1) From the viewpoint of a risk manager, insurance was defined as *a technique that makes it possible to transfer the financial consequences of potential accidental losses from the insured entity, family, or individual to an insurer.*
- (2) As a mechanism, insurance was defined as *a social device under which two or more (generally many more than two) entities make or promise to make contributions to a fund from which the insurer promises to make certain cash payments or render certain services to those contributors who suffer accidental losses.* Insurance was said to differ from most noninsurance transfers in that:
 - The insurer pools or combines many loss exposures,
 - The insureds contribute to a fund out of which cash payments or services are provided, and
 - The insurance contract deals solely with the transfer.

The first definition of insurance as a transfer technique is widely accepted. However, many disagree with the above characteristics attributed to insurance as a mechanism or social device.

Some Other Conceptual Definitions

Various definitions of insurance are found in risk management and insurance literature. The following analysis of some of these other definitions should improve the reader's understanding of the nature of insurance.

Pfeffer According to Pfeffer, "Insurance is a device for the reduction of uncertainty of one party, called the insured, through the transfer of particular risks to another party, called the insurer, who offers a restoration, at least in part, of economic losses suffered by the insured."¹ In his opinion, this definition contains the minimum necessary and sufficient conditions for the existence of the device. On the other hand, for the business or institution of insurance to be safe, equitable, or both, Pfeffer observes that certain additional elements are required. He agrees that ideally the insurer would be able to rely on the law of large numbers in setting rates and, through insuring a large

number of exposure units, to reduce fluctuations in the annual loss experience. However, he observes that no line of insurance fulfills all of the conditions that must be present for the law of large numbers to apply perfectly. (This point will be demonstrated in more detail later in this chapter.) Hence, though these conditions may be desirable, they are not essential to the concept or practice of insurance. To the extent that these conditions are not satisfied, however, the financial capacity of the insurer to bear the unexpected becomes a more important consideration.

Pfeffer constructed his "generic" definition following an extensive analysis of definitions used by the courts, historians, economists, government "insurance" organizations, and insurance authors. A generic definition defines a word by naming the class of which it is a member ("insurance is a *device*") and identifying the traits that distinguish that word from other members of the same class. Pfeffer's analysis of other definitions suggested that they were not generic definitions. Most, especially the legal definitions, were ostensive-type definitions that indicated examples of the class to which the word applied but did not provide a basis for identifying all the examples to which the word applied. In other words, such definitions provide some illustrations of what the word means, though many other illustrations may exist. Other definitions, he observed, require more of insurance than is necessary to differentiate it from other members of the same class. To illustrate, he argues that:

- (1) Insurance need not *eliminate* uncertainty, as is claimed in some definitions; it *reduces the degree* of uncertainty of the insured. Some uncertainty remains concerning whether the contract will cover the loss and whether the insurer will remain solvent.
- (2) The law of large numbers need not apply. The insurer may rely on some principle such as specialized experience and judgment or financial power to feel less uncertain about the consequences of the potential losses.
- (3) The event need not be accidental. What is required is that the insured hazard (to use Pfeffer's term) cause uncertainty on the part of the insured. In an extreme case, the event may already have occurred, unknown to either the insured or the insurer.

To develop his definition, Pfeffer started with a broad set of terms which he then narrowed in a search for a generic definition. He noted that (1) out of a large number of terms *associated with uncertainty* (for example, anticipation, avoidance, bet, expectation, guarantee, hedge, insurance, prediction, risk, risk reduction, risk transfer [which to Pfeffer meant the transfer of the exposure itself to someone else], and speculation), (2) only a subset are *uncertainty-reducing devices*