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Encouraging Insurers to Regulate: The Role (If Any) for Tort Law

Kyle D. Logue*

Insurance companies are financially responsible for a substantial portion of the losses associated with risky activities in the economy. The more insurers can lower the risks posed by their insureds, the more competitively they can price their policies, and the more customers they can attract. Thus, competition forces insurers to be private regulators of risk. To that end, insurers deploy a range of techniques to encourage their insureds to reduce the risks of their insured activities, from charging experience-rated premiums to discounting premium rates for insureds who make specific behavioral changes designed to reduce risk. Somewhat paradoxically, however, tort law discourages insurers from engaging in the direct regulation of their insureds' behavior. Under long-standing tort principles, if an insurer "undertakes" to provide serious risk-reduction services to its insured, the insurer can be found to have a duty of reasonable care in performing such services and, should that duty be breached, held liable for any harms caused to third parties. This application of tort principles to insurance companies could be contributing to the moral hazard problem often associated with insurance—the tendency of insurance to cause risk to increase rather than decrease. This Article explores this problem and analyzes a number of ways to encourage insurers to regulate—from insurer-specific Good Samaritan statutes (which we might call "carrots") to the creation of an affirmative duty on the part of insurers to regulate through the expansion of tort liability (which would definitely be a "stick"). What combination of carrots and sticks produces the optimal insurer incentives to regulate their insureds' behavior? That is the question this Article addresses.

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INTRODUCTION

It is well known that insurance companies are financial intermediaries that transfer and distribute risk. Specifically, insurers enter into contractual arrangements with risk-averse individuals and corporations in which liability for an agreed-upon set of hazards is shifted from the latter to the former. The insurers, who themselves are corporations owned by private shareholders, spread this risk across their policyholders through premiums that reflect each policyholder's risk. Thus, each policyholder pays a relatively small and certain premium to the pool in exchange for the pool absorbing the risks of large losses. The risk-transferring and risk-spreading functions compose the standard picture of insurance markets.

But insurers do more than this. Insurance companies also serve as active risk regulators.[1] In many of the same ways that government agencies monitor and place limits on the risky behaviors of individuals and businesses within their jurisdictions, insurance companies also monitor and place limits on the risky behavior of their insureds. Because insurance is a practical necessity for certain activities, if not a legal one, insurers for those activities function as gatekeepers, determining who gets to engage in the risky activity. Homeownership, for example, is not possible for most people without home-mortgage financing, which in turn is not available to anyone who does not first purchase homeowners insurance. Similarly, one cannot legally drive a car in most states without first purchasing the statutory minimum amount of liability insurance. It is also difficult, if not impossible, to be actively engaged in some professions—law, medicine, engineering, etc.—if one does not have professional-liability insurance coverage, purchased either individually or through one's employer.

1. *See generally* Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197 (2012).

In addition to regulating entry into much commercial activity, insurers also have more subtle regulatory tools. For example, auto insurers charge higher premiums for vehicles that pose a statistically greater chance of being involved in an accident, are more likely to cause harm to others if an accident occurs, or are more expensive to repair. Such risk-sensitive premiums create incentives at the margins for auto purchasers to take into account the risks associated with their vehicle choices. Likewise, when auto insurance companies adjust premiums based on the driving histories of individual drivers, the way in which drivers operate their vehicles, or the number of miles the insured drives, the insurer is, in effect, regulating driver behavior and forcing drivers to internalize the expected value of the accident costs associated with their driving choices. In this way, insurance premiums can be viewed as cost-internalizing Pigouvian taxes similar to taxes on carbon emissions, but here they are administered by private insurance companies rather than by a government agency.

An argument can be made that this is all beneficial. We should want insurers to act as risk regulators; private regulation is sometimes needed, whether because of externalities, cognitive biases, or some other market failure. Moreover, there are times when private regulation through insurance can be superior to government regulation. This happens when insurers are able to utilize their two primary institutional advantages over government regulators. First, private insurers have relatively cheap access to highly relevant risk-related information. Second, private insurers are motivated by profit to find clever and practical ways to reduce risks. These two factors explain why regulation by insurance is not only common, but why it is often desirable.

However, there is one type of regulation by insurers that is surprisingly uncommon. It is analogous to what might be called "direct regulation," "input regulation," or "command-and-control regulation" in the government regulation context.[2] For example, after the EPA inspects a coal-fired power plant, it might issue an order specifying steps that the plant's operator must take to reduce harmful airborne emissions; such an intervention is a quintessential example of direct regulation. Direct regulation is generally considered the policy instrument of choice only if the regulator has vast quantities of information regarding the risk being regulated. Because of their increased access to information regarding insured risks, insurers are uniquely suited to engage in private direct regulation. Insurers, for example, could inspect their insureds' activities and recommend specific steps that the insureds should take to reduce the risks that they pose to themselves and to others. Moreover, insurers could give those recommendations teeth by linking them to premium adjustments or by making them a condition of coverage.

Although insurers do engage in some direct regulation (as discussed in more detail below), they do surprisingly little of it given the potential benefits. One

2. SUSAN ROSE-ACKERMAN, RETHINKING THE PROGRESSIVE AGENDA: THE REFORM OF THE AMERICAN REGULATORY STATE 19, 155–56 (1992) (discussing incentive-based regimes vis-à-vis command-and-control and performance-based forms of regulation).

possible explanation for this restraint is surprising as well: insurers' incentive to engage in direct regulation of their insureds' risky behavior may be inhibited by concerns about direct tort liability. Under well-accepted common law principles of tort, if a party undertakes to render a service that is expected to reduce the risk of harm to a third party, the party providing the service has a duty to take reasonable care in engaging in this undertaking.[3] Some states have passed legislation to eliminate this duty as it applies to insurance companies or to categories of insurance companies, such as workers' compensation insurers.[4] Most states, however, have no such "insurer Good Samaritan laws," but have chosen to leave the common law cause of action in place; this is sometimes referred to as the tort of "negligent inspection."[5] What's more, in most of those states, liability for negligent inspection has in fact been applied to insurance companies. Therefore, existing tort doctrine in most states poses an actual risk to insurers who engage in direct regulation of their insureds: if they regulate but do so poorly, they may be held responsible for the consequences.

Whether exposing insurers to such tort liability is a good thing depends on tradeoffs that are familiar to the economic analyst of law. On the one hand, it can be argued that exposing insurers to negligent-inspection liability has at least two potentially negative effects: (1) insurers are discouraged from engaging in a socially-desirable form of risk regulation; and (2) insurers who do engage in such regulation find it necessary to raise their premiums to cover increases to their own direct tort liability, thereby pricing some insureds out of the market for coverage. If these two effects are large, perhaps more states should enact insurer Good Samaritan laws. On the other hand, applying the negligent inspection rule to insurers enhances efficient deterrence by providing insurers who undertake to provide safety inspections the incentive to do so with reasonable care; the market alone does not provide this incentive, for reasons discussed below. If this incentive is an effective deterrent to substandard inspection, perhaps the existing insurer Good Samaritan statutes should be repealed.

Of course, enactment or repeal of insurer Good Samaritan statutes are not the only two options—there are both more extreme and less extreme alternatives. For example, if it is the case that insurers are in the best position to prevent certain accidents from happening—if insurers are the "cheapest cost avoiders"—it is conceivable that courts or legislatures could create an affirmative duty to regulate on the part of insurers by providing specific safety recommendations or mandates when doing so would constitute reasonable care. Such a rule could be seen as a major expansion of traditional tort liability, which generally imposes no

3. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 42 (AM. LAW INST. 2011). The *Third Restatement* is a revision of the language from the *Second Restatement*. *See* RESTATEMENT (SECOND) OF TORTS § 324(a) (AM. LAW INST. 1965).

4. *See, e.g.*, Blackwell v. Citizens Ins. Co. of Am., 579 N.W.2d 889, 892 (Mich. 1998).

5. *See, e.g.*, CAL. INS. CODE § 11759 (West 2005); 745 ILL. COMP. STAT. ANN. 10/2-207 (West, Westlaw through P.A. 99-500 of the 2015 Reg. Sess.); *see also* N.C. GEN. STAT. ANN. § 160A-411 (West, Westlaw through 2015 Reg. Sess. of the Gen. Assembly).

affirmative "duty to rescue" others who are in danger, even when doing so would impose little risk to the rescuer.[6] Alternatively, a duty imposed on insurers to regulate could instead be seen as a hybrid of the existing exception to the no-duty-to-rescue rule—namely, the exception for situations in which the tort defendant has a "special relationship" with the victim.

This Article explores all of these possibilities. Part I provides a detailed discussion of why insurers might be viewed as effective private-sector regulators of the risks posed by their insureds. Part II surveys the existing doctrine dealing with negligent inspection liability, as applied both to trade associations and insurance companies—both examples of private risk regulators. Part III addresses the normative questions: How would insurers respond to various alternative tort rules with respect to direct regulation by insurers of their insureds, and what rule or combination of rules would create the optimal incentive structure? This Article builds on a number of literatures, including the previous work on trade association and insurer liability for negligent standard setting and negligent inspections,[7] as well as the literatures on vicarious liability, gatekeeper liability,[8] and the duty to rescue.[9]

I. INSURERS AS PRIVATE REGULATORS

Economic theories of regulation seek to identify the situations in which market failures create a need for government intervention in the economy, as well as what sort of interventions make the most sense; this could be command-and-control regulations, performance standards, cost-internalizing taxes, or some combination.[10] Whatever form of regulatory intervention is chosen, effective

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6. *See generally* Ernest J. Weinrib, *The Case for a Duty to Rescue*, 90 YALE L.J. 247, 247 (1980) ("No observer would have any difficulty outlining the current state of the law throughout the common-law world regarding the duty to rescue. Except when the person endangered and the potential rescuer are linked in a special relationship, there is no such duty.").

7. Two important articles on the liability of trade associations are Peter H. Schuck, *Tort Liability to Those Injured by Negligent Accreditation Decisions*, LAW & CONTEMP. PROBS., Autumn 1994, at 185; and Ralph G. Wellington & Vance G. Camisa, *The Trade Association and Product Safety Standards: Of Good Samaritans and Liability*, 35 WAYNE L. REV. 37 (1988). There have been a number of articles written on negligent inspection liability of insurers. *See, e.g.*, Victor P. Goldberg, *Tort Liability for Negligent Inspection by Insurers*, *in* 2 RESEARCH IN LAW AND ECONOMICS: A RESEARCH ANNUAL 65, 76 (Richard O. Zerbe, Jr., ed., 1980); John Dwight Ingram, *Liability of Insurers for Negligence in Inspection of Insured Premises*, 50 DRAKE L. REV. 623 (2002); Amy Schulman, *Recent Developments in Self-Insurance and Risk Management*, 31 TORT & INS. L.J. 479 (1996); Michael Braden, Comment, *An Insurer's Liability to Third Parties for Negligent Inspection*, 66 KY. L.J. 910 (1977); James F. Reddoch, Jr., Comment, *Insurer's Liability for Negligent Performance of Voluntary Safety Inspections*, 3 CUMB.-SAMFORD L. REV. 118 (1972).

8. *See, e.g.*, Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 57 (1986); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984).

9. *See, e.g.*, William H. Landes & Richard A. Posner, *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism*, 7 J. LEGAL STUD. 83 (1978); Saul Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of Affirmative Obligations*, 72 VA. L. REV. 879 (1986).

10. *E.g.*, STEPHEN BREYER, REGULATION AND ITS REFORM 15–35 (1982).

regulation requires that the regulator have enormous amounts of information about the behavior of the parties being regulated and the consequences of that behavior. After all, the regulator must identify the optimal standards of conduct and the appropriate penalties for breaching those standards, both of which are information-intensive inquiries. This is why economic theories of rule making focus on the comparative abilities of different regulatory institutions—courts as compared with agencies, for example—to gather and process risk-relevant information.[11]

Effective regulation also requires proper motivation: the regulator must have an incentive to produce and enforce regulations that maximize social welfare. Many, perhaps most, individuals who work for government agencies generally have such an incentive, but this is not always the case.[12] In fact, it is almost a cliché to point out that regulatory agencies often have incentives that do not align perfectly with the public interest.[13] For example, agency capture is a persistent problem, although its pervasion may be exaggerated. This is especially true in situations in which the regulated parties are relatively few in number, have relatively homogeneous interests, and are relatively well-off, while the beneficiaries of the regulation are the diffuse public.[14] In such situations, government agencies can have a tendency to regulate primarily in the interest of the parties they are regulating, which may well conflict with regulations that would maximize overall social welfare. Moreover, even without agency capture, agencies lack the motivation from market forces that drives private firms to efficient solutions.

Many commentators have noted that insurance companies can and do act as regulators of risk.[15] Building on this scholarship, Omri Ben-Shahar and I have

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11. *See, e.g.*, Louis Kaplow, *General Characteristics of Rules*, *in* 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 502, 510–11 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000); Steven Shavell, *A Model of the Optimal Use of Liability and Safety Regulation*, 15 RAND J. ECON. 271, 274 (1984); Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 J.L. & ECON. 255, 259–65 (1993).

12. *See, e.g.*, STEVEN P. CROLEY, REGULATION AND PUBLIC INTERESTS: THE POSSIBILITY OF GOOD REGULATORY GOVERNMENT 9 (2008).

13. *See, e.g.*, Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 339–41 (1974).

14. *See* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 4–5 (1971).

15. See KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 57 (1986) (coining the term "surrogate regulation" when describing the (then new) regulatory role being foisted on liability insurers to regulate toxic tort and environmental risks); DAVID A. MOSS, WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER 10 (2002); Tom Baker, *Bonded Import Safety Warranties*, *in* IMPORT SAFETY: REGULATORY GOVERNANCE IN THE GLOBAL ECONOMY 215, 216–22 (Cary Coglianese et al. eds., 2009) (arguing for reliance on insurers to police food safety); Jon D. Hanson & Kyle D. Logue, *First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 145–53 (1990) (arguing for shifting the regulatory function of product safety to products-liability insurers through adoption of strict products liability); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited*, 8 STAN. J.L. BUS. & FIN. 39, 48–60 (2002) (arguing for use of insurance to regulate accuracy of financial statements); Steven Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120, 120–22 (1982) (exploring the relationship between tort law and insurance and how insurance has potential to

argued that insurance companies, in some settings, have a comparative advantage over government regulators of risk, due to both information and motivation asymmetries.[16] The informational advantage that insurers have results from the nature of private insurance markets. Because insurers are providing risk-shifting and risk-distributing services to their insureds, they need to keep track of risk-relevant data to price their products efficiently. This information is gathered at the underwriting stage (when the insurer must decide whether to insure a particular party, and at what price) and at the claims stage (when the insurer decides whether and how much to pay out for each claim that is filed). Each insurer has its own data specific to its own pool of insureds, and the industry accumulates information through institutions called insurance "rating bureaus," or "rating agencies."[17]

This is the sort of information that a regulator would obviously find useful. Indeed, such information—about the risks presented by particular insureds, and about the effect on those risks of the insureds' choices and actions—is arguably essential to effective regulation. What's more, such information is costly to collect. Assuming insurers must collect the information in any event, it would be entirely duplicative and wasteful to have government regulators independently gather the very same information. This does not mean that the government should not also gather risk-related information. Rather, the point is simply that for those risks that have a competitive, individually underwritten insurance market, private insurers will aggregate risk-related information; it would not be cost-effective for the government to duplicate it.

Insurers also specifically invest resources to identify the best ways for insureds to reduce their losses. For example, a group of large property/casualty insurance companies have historically operated a research institute that tests and rates the crashworthiness of automobiles; these tests produce information that is, or can be, used by consumers in determining which cars to buy.[18] More recently, other insurers have begun a similar inquiry into risks of damage to property, especially damage from disasters.[19] In both of these cases, the information that is generated is shared with consumers generally and, in some cases, with policy makers. These types of safety research and development initiatives are not unique to insurance companies and are sometimes replicated by the government.

create optimal accident-prevention incentives). For a detailed proposal to privatize the regulation of medical care that raises many of the same arguments that have been raised in support of using private insurers as regulators of risk more generally, see Ronen Avraham, *Private Regulation*, 34 HARV. J.L. & PUB. POL'Y 543 (2011).

16. Ben-Shahar & Logue, *supra* note 1, at 228. This Part draws heavily from this Article.

17. *See, e.g.*, Kyle D. Logue, *Toward a Tax-Based Explanation of the Liability Insurance Crisis*, 82 VA. L. REV. 895, 903–05 (1996) (explaining rating bureaus or agencies).

18. *See, e.g.*, *Fatality Facts: General Statistics*, INS. INST. FOR HIGHWAY SAFETY-HIGHWAY LOSS DATA INST., http://www.iihs.org/iihs/topics/t/general-statistics/fatalityfacts/overview-of-fatality-facts [https://perma.cc/UV2L-V872] (last visited Feb. 14, 2016).

19. *See* INS. INST. FOR BUS. & HOME SAFETY, https://www.disastersafety.org [https://perma.cc/2XRG-6UMB] (last visited Feb. 14, 2016).

Nevertheless, they contribute to the overall stock of information that insurers have, which no other institution can claim.

Insurance companies also have a strong incentive to help their insureds reduce risks; this is an incentive that government agencies do not have, and that is mostly consistent with the public interest. Liability insurers, for example, are on the hook when their insureds negligently cause harm to others. Therefore, the insurer that fails to find the most cost-effective way to reduce the risks posed by its insureds, and thereby to reduce the premiums it charges, may find itself losing customers to its more innovative competitors who can offer cost savings. Even absent strong competition among insurers, an insurance company has an incentive to maximize its own profits by minimizing its costs, which means finding ways to reduce the expected payouts to insureds after collecting the premiums.

Besides their unique access to information and their competitive motivation, insurers also have access to a number of especially effective regulatory tools.[20] For example, insurance contract terms that impose some portion of every loss on insureds themselves, such as copayments and deductibles, can be understood as devices to align insureds' accident-prevention incentives with those of their insurers. Similarly, exclusions impose the entirety of certain types of losses on insureds; these are often losses from particular types of excluded causes, such as intentional wrongdoing. While the ex post effect of such exclusions can be draconian (i.e., total loss of coverage), the ex ante effect is to strongly incentivize insureds not to engage in certain types of behavior—such as intentionally causing the loss.[21]

One of the most powerful regulatory tools insurers wield is the insurance premium itself. Profit-maximizing insurers seek to charge premiums correlated to the expected costs of the individuals and firms they insure—that is, premiums which are differentiated based on the risks presented by each insured. Failure to charge risk-differentiated premiums can result in the loss of low-risk customers who will find paying the blanket premiums to be a bad deal. Such low-risk parties may shift to competing insurers who have priced their policies with more accuracy. Alternatively, depending on how risk-averse the parties are and how inaccurate the premiums are across the market, they may opt for being self-insured or uninsured. The departure of low-risk insureds from an insurance pool then leads to higher average costs for the remaining pool participants, which can

20. Other scholars have pointed this out. *See, e.g.*, Tom Baker & Thomas O. Farrish, *Liability Insurance & the Regulation of Firearms*, *in* SUING THE GUN INDUSTRY: A BATTLE AT THE CROSSROADS OF GUN CONTROL AND MASS TORTS 292 (Timothy D. Lytton ed., reprt. 2009) (identifying and categorizing the various methods of regulation used by insurers); Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance*, 5 REV. L. & ECON. 541 (2009); Haitao Yin et al., *Risk-Based Pricing and Risk-Reducing Effort: Does the Private Insurance Market Reduce Environmental Accidents?*, 54 J.L. & ECON. 325 (2011).

21. Most modern insurance policies contain some sort of exclusion for losses caused intentionally by the insured. *See, e.g.*, TOM BAKER & KYLE D. LOGUE, INSURANCE LAW AND POLICY: CASES AND MATERIALS 9 (3d ed. 2013).

then induce additional lower-cost insureds to leave the pool. And so on until, in the worst-case (though perhaps unlikely) scenario, the insurance pool "unravels" entirely.[22] To prevent all of this from happening, insurers attempt to charge premiums that are sensitive to the risks posed by particular insureds.[23] And when an insured's risks change over time, so must the insurer's premiums. Such premium adjustments are based on experience rating, which takes into account the losses of particular insureds during the previous contract period, and preloss risk-rating based on information about insureds that is gathered during the initial underwriting or renewal process.

The economic-efficiency benefit of risk-differentiated premiums has to do with cost internalization. That is, to the extent insurance premium differences reflect risk-related choices made by insureds—so that insureds can, by altering their behavior, reduce or increase their insurance premiums—those premiums operate as a sort of cost-internalizing Pigouvian tax, not unlike a pollution tax. Insureds, because of their obligations to pay the premiums, are forced to realize the full social costs of their decisions, which they might otherwise externalize.

Similar cost internalization can be achieved by insurers with deductibles and copayments. These are contractual provisions that leave insureds responsible for covering some portion of their insured losses. Economists have long known that such cost sharing can be efficient in insurance contracts, precisely because perfectly individualized and risk-adjusted insurance premiums are not possible, given the amount of information that would be required.[24] A deductible automatically forces the insured to internalize some of the costs of their activities, up to the amount of the deductible. Thus, an insurance contract that contains a deductible can induce an insured to take particular steps to reduce risks, even when the insurer is not able to monitor the insured's behavior. Deductibles work best for small but highly effective care level investments: for example, an insured can virtually eliminate a particular risk (and thus virtually eliminate the risk of having to pay the deductible) by making a minor investment in accident prevention.[25]

22. George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1577 (1987). There is a strong case to be made that this sort of "death spiral" unraveling is rare and unlikely. *See also* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223, 1225 (2004).

23. Note that this practice of risk-adjusted individualized premiums is consistent with the idea of risk shifting from insured to insured. That is, a risk-averse insured would rather pay an insurance premium that accurately reflects his or her particular risk than to bear the risk itself, assuming they can afford to pay the premium. That is what risk aversion means.

24. Economists have famously noted that deductibles can be used to induce insureds to voluntarily sort into high-risk and low-risk groups when expressly risk-differentiated premiums are not practical. Thus, under certain assumptions, low-risk insureds would agree to a contract that contains a deductible but relatively low premiums, while high-risk insureds would prefer no deductible with a higher premium. The seminal article showing this result is Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976).

25. *See, e.g.*, Ronen Avraham, *The Economics of Insurance Law—A Primer*, 19 CONN. INS. L.J. 29,

In addition to incentive-based regulation through the use of premiums, deductibles, and the like, insurers also engage in some forms of direct safety input regulation. This is similar to what the EPA does when it tells a power plant how specifically to alter its practices to reduce emissions, or what OSHA does when it inspects a workplace and identifies safety improvements that need to be made. Insurers, especially liability insurers—workers' compensation, products liability, and commercial property liability—are in a position to do this sort of inspection work reasonably well. As Victor Goldberg once put the point, "a tied sale of insurance cum inspection has very attractive properties. By tying inspection to insurance the parties in effect make the inspector's compensation contingent upon its success."[26]

This regulation by insurer inspection developed first with boiler and machinery first-party coverage (discussed further below), but insurer inspections now are used to some extent across several types of coverage. Most large property/casualty insurance companies have a division whose primary job is to educate insureds about how to reduce risks. These services have a number of different titles: "loss control,"[27] "loss prevention,"[28] "risk control,"[29] or even "risk engineering."[30]

I have just laid out the most optimistic version of the insurance-as-regulation story. The truth is more complex, of course, and considerably less rosy. While insurance companies have some comparative advantage as risk regulators in certain settings, they also have limitations. First, unlike a government agency, an insurance company cannot compel its insureds to act under the threat of force; insurers have only the threats of premium increases, coverage cancelations, or other contractual remedies at their disposal. Second, those contractual remedies are not universally used. Although some insurers adjust premiums based on their insureds' risky choices, others do not or do so only minimally because of high

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71 (2012) (explaining how deductibles can induce insureds to make low-cost, risk-reducing changes in behavior).

26. Goldberg, *supra* note 7, at 72.

27. *E.g.*, *Loss Control Services*, FARMERS INS., http://www.farmers.com/business/loss-control [https://perma.cc/EQ62-5DL8] (last visited Feb. 14, 2016); *Risk Engineering: The Hartford's Industrial Hygiene Laboratory*, HARTFORD, http://www.thehartford.com/loss-control [https://perma.cc/RU5K-7VXP] (last visited Feb. 14, 2016); *Smart Strategies that Help Manage Risk and Prevent Losses*, BERKSHIRE HATHAWAY, https://www.bhhc.com/workers-compensation/services/loss-control.aspx [https://perma.cc/M2SN-BZ9L] (last visited Feb. 14, 2016).

28. *E.g.*, *Loss Prevention Services*, AIG, http://www.aig.com/loss-prevention-services_3171_444286.html [https://perma.cc/CNB2-9KRY] (last visited Feb. 14, 2016); *Property 'All Risks' and Operating Losses*, AIG, http://www.aig.com.kw/business/products/property/multi-risk-and-operating-losses [https://perma.cc/8CFW-RFJP] (last visited Feb. 14, 2016).

29. *E.g.*, *Risk Control*, LIBERTY MUTUAL INS., http://www.libertymutualgroup.com/business-insurance/insurance-news/risk-management [https://perma.cc/9GZF-N4UQ] (last visited Feb. 14, 2016); *Risk Control*, TRAVELERS, https://www.travelers.com/business-insurance/risk-control/index.aspx [https://perma.cc/UV9F-ASKD] (last visited Feb. 14, 2016).

30. *E.g.*, *Risk Engineering*, ZURICH, http://www.zurichna.com/en/risk [https://perma.cc/SA55-7VNF] (last visited Feb. 14, 2016).

costs of information and transactions. Third, to the extent that insurance companies completely opt out of active involvement in the regulation of their insureds' activities, insurance can have a counterproductive effect on incentives. Insurance can, and sometimes does, undermine incentives to reduce risk. It is common knowledge that insurance can produce moral hazard, and any attempt to use insurance as a form of regulation must take the possibility of insurer inaction into account.[31] Fourth, with respect to liability insurance in particular, if the insured's activity poses a risk of harm to others that exceeds the value of the insured's assets (in which case the insured is said to be "judgment proof"), insurance cannot perform well as a regulatory mechanism unless it is accompanied with a coverage mandate. Fifth, and most obvious, the interests of insurance companies—even in reasonably competitive markets—can and sometimes do diverge from the interests of society generally. This is why insurance companies and insurance contracts are themselves regulated. For one example, bad-faith law is necessary to counteract insurers' financial incentive to behave opportunistically with respect to their insureds in situations when market forces alone are not likely to punish such opportunism.[32] Another example would be the problem of loss externalization by insurers through the use of annually renewed contracts.[33]

For all of these reasons, it obviously does not make sense to rely solely on insurers as regulators. For some risks, government regulation is the only option; for others, perhaps there is no regulatory solution. But for some subset of risks, insurers' incentives to minimize their insureds' losses can be a useful supplement to government regulation. Moreover, insurers will almost inevitably make use of such incentives, so long as privately sold, individually underwritten insurance contracts are permitted. That is, so long as there are risk-averse individuals and firms demanding insurance coverage and competitive insurance markets responding to that demand, insurers will have an incentive to reduce their

31. For the origins of the concept, see KENNETH J. ARROW, ESSAYS IN THE THEORY OF RISK-BEARING (Julius Margolis ed., 1971); and Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979). For its relevance to law, see KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY (1986); and Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

32. For a more in-depth discussion of the types of insurance regulation and their market failure rationale, see BAKER & LOGUE, *supra* note 21. In addition, to the extent liability law itself is vague or ambiguous, liability insurance companies and their representatives—as translators of that law for their insureds—will have a tendency to encourage their insureds to reduce their legal risk, not only by being more careful and thus reducing risk of harm to others (which enhances social welfare), but also by changing the way their behavior can be legally characterized and thus reducing liability risk without truly reducing risk of harm to others. *See, e.g.*, Shauhin Talesh, *A New Institutional Theory of Insurance*, 5 U.C. IRVINE L. REV. 617 (2015).

33. Insurance contracts usually last for only one year. As a result, any losses that the insured is likely to sustain in years after the policy has lapsed may be externalized, or ignored, by the current insurer. This effect is limited with occurrence-based liability insurance, which puts the insurer on the hook for any current or future claim arising out of "occurrences" that take place during the policy period. *See, e.g.*, *IOA Q&A*, IOA INS. SERVS., http://www.ioapro.com/?page=faq#Q3 [https://perma.cc/PX3X-4GBC] (last visited Feb. 14, 2016). But even there, the insurer will tend to externalize post policy occurrences.

insureds' risk levels, and thus will regulate subject to the qualifications listed above. The point of this section has been to summarize why this role of insurance should be accepted, and perhaps encouraged.

There is a possibility, however, that existing tort law is indeed discouraging insurers from regulating, even when we should want them to. In the process of researching another article, I interviewed a number of officials at large property/casualty insurance companies, and some of them stated that they are reluctant to get too involved in the safety-related decisions of their insureds because of the concern that their involvement will expose them to direct tort liability. This factual claim is impossible to verify without access to data that only the insurers have and that they generally are not willing to share with outsiders. The issue that can be explored, however, is the plausibility of the claim that tort law discourages insurers from regulating. This inquiry is taken up in the next Part.

II. CURRENT LAW: THE TORT OF NEGLIGENT INSPECTION

As it turns out, there is indeed a well-settled doctrine within American tort law that insurers who engage in the active regulation of their insureds' behavior—through inspection, instruction, standard setting, etc.—owe a duty of reasonable care not only to their insureds, but also to any other reliant third parties. To understand this rule, however, one must first understand the general no-duty-to-rescue rule, to which the negligent inspection rule is an exception. The no-duty-to-rescue rule is very simple to understand: there is no duty, generally, to rescue another who is in danger.[34] So, if you come across a person who is drowning and could easily be helped without causing any risk for yourself (maybe you only need to toss the person a life preserver or call 911), tort law says that you may simply let the person drown and do not need to lift a finger or dial for help.[35] To be sure, if you did not act, you would be a jerk, and at least one jurisdiction within the United States might fine you $100 for such egregious nonfeasance,[36] but you would not be a tortfeasor in the eyes of the U.S. common law.[37]

The no-duty-to-rescue rule has several well-known exceptions. First, if one party's actions put another party at risk of harm, the first party may have a tort-based obligation to provide assistance to the second, assuming the first party was aware, or should have been aware, of its role in creating the risk.[38] In addition,

34. *See, e.g.*, RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 37 (AM. LAW INST. 2012).

35. *E.g.*, Osterlind v. Hill, 160 N.E. 301 (Mass. 1928) (finding no tort liability where the defendant rented a canoe to a drunken man and then later ignored the man's calls for help as he was drowning).

36. Vermont's Duty to Aid the Endangered Act, VT. STAT. ANN. tit. 12, § 519(a) (West, Westlaw through 1st Sess. of 2015-2016 Gen. Assembly 2015).

37. The rule is different in a number of other countries. *See, e.g.*, Jay Silver, *The Duty to Rescue: A Reexamination and Proposal*, 26 WM. & MARY L. REV. 423, 434–35 (1985) (discussing Europe's adoption of the duty to rescue).

38. Jennifer L. Groninger, *No Duty to Rescue: Can Americans Really Leave a Victim Lying in the*

there are a number of "special relationships" that courts have recognized as creating an affirmative duty to take steps to prevent harm to others.[39] For example, courts have held that a common carrier owes something like a duty to rescue to its passengers, at least while they are in transit.[40] Landowners traditionally owe a similar duty to invitees and licensees on their property.[41] In addition, some courts have even found that special relationships between two parties (A and B) can create a duty in one (A) to prevent the other (B) from harming a third party (C).[42] In such cases, the duty is owed, in a sense, by A to C. An example of this involves hospitals: in most jurisdictions, hospitals have an obligation to take reasonable care to prevent their patients from harming others. Taking this exception a step further, in the famous *Tarasoff* decision, the California Supreme Court recognized an affirmative duty on the part of mental health professionals to, under certain circumstances, take reasonable care to prevent obviously dangerous patients from harming others.[43] Many other jurisdictions have since adopted this rule. Again, these special-relationship cases, to which we will return later in this Article, are important exceptions to the otherwise generally applicable no-duty-to-rescue rule.

The other (and final) exception to the no-duty-to-rescue rule takes us one step closer to the law imposing liability on insurers as regulators; this is the exception for voluntary undertakings. The quintessential example involves a failed rescue attempt. Specifically, if a person voluntarily renders aid to another who is at risk (the drowning stranger, for example), then the would-be rescuer has a tort duty to exercise reasonable care in attempting the rescue.[44] The rule makes some sense. After all, if one person attempts to make a rescue, other potential rescuers, after seeing the first rescuer, may refrain from volunteering, which could make the rescuee's situation even more perilous. As a result, it seems sensible that someone who is undertaking to rescue another should be encouraged by tort law to do a reasonably good job of it. I will have more to say about the wisdom of all of these rules later in this Article.

The negligent undertaking exception was eventually extended to include private regulation of risky activities, including private regulation by insurance companies of their insureds' activities. Under this rule, stated generically, if Party

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Street? What Is Left of the American Rule, and Will It Survive Unabated?, 26 PEPP. L. REV. 353, 355 (1999).

39. *Id.* at 359–63.

40. *See, e.g.*, Yu v. N.Y., New Haven & Hartford R.R., 144 A.2d 56 (Conn. 1958).

41. *See, e.g.*, Robert Addie & Sons (Collieries), Ltd. v. Dumbreck, [1929] A.C. 358 (H.L.) 370 (appeal taken from Scot.) (discussing duties of landlords to trespassers, invitees, and licensees).

42. Tarasoff v. Regents of the Univ. of Cal., 551 P.2d 334, 343 (Cal. 1976).

43. *Id.* at 343–44.

44. *See* Zelenko v. Gimbel Bros., 287 N.Y.S. 134 (N.Y. Sup. Ct. 1935) ("[I]f a defendant undertakes a task, even if under no duty to undertake it, the defendant must not omit to do what an ordinary man would do in performing the task."); RESTATEMENT (SECOND) OF TORTS § 323 (AM. LAW INST. 1965); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 56, at 378 (5th ed. 1984) ("If there is no duty to go to the assistance of a person in difficulty or peril, there is at least a duty to avoid any affirmative acts which make his situation worse.").

A undertakes, either for pay or voluntarily, to provide services for Party B, and such services are expected to reduce a risk faced by Party C, then A owes a tort duty to C to exercise reasonable care, provided that either B or C is relying on A.[45] This rule was tailor-made to manage private regulators.

Consider first the example of trade associations as standard setters.[46] Trade associations are nonprofits organized to represent the interests of firms in a particular industry. One important function of a manufacturing trade association is to promulgate product design and safety standards, which are then followed by manufacturers within the association. A manufacturer's failure to follow the privately promulgated standard product safety standards can result in tort liability for the manufacturer; a failure to follow industry standards is considered relevant (though not dispositive) evidence of negligence or defective design. Therefore, standards enunciated by trade associations can be understood as a form of direct private regulation, similar to the direct regulation that insurers provide, as described above.[47]

As a result of the negligent undertaking rule described above, the promulgation of private standards of care can also subject the trade associations themselves to tort liability. For example, in *King v. National Spa & Pool Institute, Inc.*, an industry association set standards governing the type of diving board that can be safely used in with swimming pools of various depths and sizes.[48] The court held that because the trade association voluntarily undertook a duty to exercise due care in promulgating safety standards, it had a duty to do so with reasonable care.[49] There are many other such cases—trade associations from the chemical industry, the blasting cap industry, the window treatment industry, and the welding industry, among many others—that have been found to owe a duty of reasonable care to consumers when establishing industry standards of safety.[50] The same duty has been applied to hospital associations, associations of state school boards, and a wide range of other accreditation entities.[51] Finally, under the same theory, numerous tort suits have been brought (successfully) against the Underwriter's Laboratory, a safety research and certification organization. Underwriter's Laboratory provides safety standards and inspections on a wide range of products, from household electronics and their component parts (wiring,

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45. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43 (AM. LAW INST. 2012) (with special emphasis on subsection (c)). A similar rule can also be found in section 342(a) of the *Second Restatement*. RESTATEMENT (SECOND) OF TORTS § 342(a) (AM. LAW. INST. 1965).

46. The leading article on this topic is Wellington & Camisa, *supra* note 7.

47. *See generally* Avraham, *supra* note 15, at 595–96 (making a similar point in the healthcare context, arguing for, among other things, a private-regulatory compliance defense where doctors sued for malpractice are following privately promulgated evidence-based guidelines).

48. King v. Nat'l Spa & Pool Inst., Inc., 570 So. 2d 612, 613 (Ala. 1990).

49. *Id.* at 614.

50. *See generally* Wellington & Camisa, *supra* note 7.

51. Schuck, *supra* note 7, at 193.

circuitry, etc.) to fire extinguishers, smoke detectors, and other fire-protection technologies.[52]

Clearly, tort law has been applied to encourage private standard setters to take reasonable care and to hold them responsible for failing to do so in setting private regulatory standards. Tort law is also being applied in much the same way to insurance companies. In fact, my research assistants were able to find 171 reported negligent-inspection cases involving insurance companies, spread over 41 separate jurisdictions. Of those cases, 107 involved workers' compensation insurance, 33 involved some form of property insurance (often boiler-and-machinery or equipment repair insurance), and the remainder involved other types of insurance. The remainder of this Part summarizes these cases by type.

It is no surprise that the vast majority of cases involving negligent inspection by an insurer have to do with workers' compensation coverage for two reasons. First, anecdotal evidence suggests that workers' compensation insurers are among the most active direct regulators of their insureds' risky activities. Second, workers' compensation remedies are less generous than traditional tort remedies,[53] which means that the injured party in a workers' compensation setting is more likely to have sustained losses left uncompensated by insurance.

The workers' compensation negligent inspection cases share a similar and unsurprising fact pattern: a worker, or a group of workers, is injured or killed in a workplace accident as a result of an unsafe workplace condition.[54] In these cases, in addition to the standard workers' compensation claim brought against the employer, a lawsuit is brought by the injured victims against the workers' compensation insurer, alleging that the insurer had inspected the workplace prior to the accident; that, in effect, the insurer deemed it reasonably safe; and that the employer-insured and the employees relied on this certification.[55] In some of the

52. *See id.* at 187.

53. *See generally* JOHN C.P. GOLDBERG ET AL., TORT LAW: RESPONSIBILITIES AND REDRESS 260 (3d ed. 2012) (describing difference between workers' compensation benefits and remedies available under tort law).

54. *See, e.g.*, Love v. Flour Mills of Am., 647 F.2d 1058, 1059 (10th Cir. 1981) (grain elevator employees injured by explosion and fire); Adams v. Travelers Ins. Co., 494 So. 2d 401, 402 (Ala. 1986) (employee injured when roller on an inspecting machine snagged); Burns v. State Comp. Ins. Fund, 265 Cal. App. 2d 98, 99 (Cal. Ct. App. 1968) (employee seriously injured at a sawmill that was negligently inspected by state agencies); Mimms v. Travelers Ins. Co., 275 S.E.2d 825, 826 (Ga. Ct. App. 1981) (employee injured when he fell off a piece of scaffolding from which safety rails had been removed); Jadosh v. Goeringer, 275 A.2d 58, 59 (Pa. 1971) (employee's fingers crushed while operating a hydraulic ram of a lug cover press).

55. *See, e.g.*, Phillips v. Liberty Mut. Ins. Co., 813 F.2d 1173, 1174 (11th Cir. 1987) (employee injured by scaffolding on a construction site inspected by employer's insurance company); Bartolotta v. Liberty Mut. Ins. Co., 411 F.2d 115, 116–17 (2d Cir. 1969) (employees exposed to argon gas after insurance company inspected employer's factory and equipment); Van Biene v. ERA Helicopters, Inc., 779 P.2d 315, 316 (Alaska 1989) (employees killed in plane crash after insurance company negligently approved of working conditions allowing pilots to work longer than allowed by FAA regulations); Fireman's Fund Am. Ins. Co. v. Coleman, 394 So. 2d 334, 335 (Alaska 1980) (employees injured when sparks from tool caused an industrial fire after safety inspection undertaken by insurance company); Nelson v. Union Wire Rope Corp., 199 N.E.2d 769, 772 (Ill. 1964) (seven

cases there is evidence that the insurer had suggested safety enhancements that were in fact made, but in most of the cases, the evidence is unclear on this point; the facts reveal only that the insurer had not raised objections to the injuring condition of the workplace before the injury.[56]

The key issue in many of the cases is the question of reliance.[57] The insurer typically argues that the safety inspection was not made "for the benefit" of the employer-insured or for the benefit of the employees of the insured but rather was exclusively for the benefit of the insurer. Specifically, the insurer contends that it engaged in safety inspections solely to determine whether to offer the insurance and, if so, under what terms.[58] The relevance of this fact, as mentioned above, is that because the inspection was solely for the benefit of the insurer, no one else relied or should have relied on the inspection. Some courts have found this argument and the evidence in support of it to be persuasive.[59] Other courts, however, have found that if the insured or other third parties in fact relied on the insurer's safety inspections, the insurer owes a duty of reasonable care, regardless of whether the insurer was motivated primarily or even exclusively by minimizing its own risk under the policy.[60] In all cases, the issue of reliance is crucial.

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employees killed and twelve employees injured when construction platform fell six stories after negligently inspected by insurance company).

56. *See, e.g.*, Hill v. U.S. Fid. & Guar. Co., 428 F.2d 112, 115 (5th Cir. 1970) (insurance company recommended that hotel fix hazards, which hotel relied upon to rectify hazards); Patton v. Simone, 626 A.2d 844, 848 (Del. Super. Ct. 1992) (insurance carrier supplied company with list of recommended improvements, which company made, that did not include elevator in violation of building codes).

57. *See, e.g.*, *Phillips*, 813 F.2d at 1174–75 (whether or not employer relied on insurer's safety inspection is a jury question); *Hill*, 428 F.2d at 116 (insurance company created reliance by indicating they would carry out safety inspections); Kohr v. Johns-Manville Corp., 534 F. Supp. 256, 259 (E.D. Pa. 1982) (insurer can be held liable if inspections had been carried out negligently and then relied upon by employer); Ray v. Transamerica Ins. Co., 208 N.W.2d 610, 615–16 (Mich. Ct. App. 1973) (whether or not employee relied on insurer's safety inspections is a jury question); Derosia v. Liberty Mut. Ins. Co., 583 A.2d 881, 886 (Vt. 1990) (insurer liable where employee relied on them for expertise in safety matters and where inspections are undertaken for benefit of the insured).

58. *See, e.g.*, Manker v. Zurich Servs. Corp., 556 F. App'x 907, 907–08 (11th Cir. 2014) (argued inspection only for purposes of underwriting assessment); Heath v. B.J. Hughes, Inc., 431 So. 2d 68, 69 (La. Ct. App. 1983) (argued inspection done for fulfillment of insurance contract, not for benefit of employees); Jansen v. Fid. & Cas. Co. of N.Y., 589 N.E.2d 379, 380 (N.Y. 1992) (argued inspections carried out solely for underwriting process); Schultz v. Mills Mut. Ins. Grp., 474 N.W.2d 522, 526–27 (S.D. 1991) (argued inspections carried out solely for insurer's benefit).

59. *See, e.g.*, *Manker*, 556 F. App'x at 909 (holding insurance company not liable where it "did not undertake to render services to another which it should have recognized as necessary for the protection of a third person or his things"); *Heath*, 431 So. 2d at 69 (holding insurance company not liable where "policy language makes it clear that the inspections were made only in connection with the contract of insurance, and not for the benefit of plaintiff"); *Jansen*, 589 N.E.2d at 380 (holding insurance company not liable where "it is apparent that the safety inspections were undertaken solely for defendant's own underwriting purposes").

60. *See Kohr*, 534 F. Supp. at 259 ("The completeness and accuracy of the studies which [the company] received from [the inspector] and their degree of reliance thereon are all material issues of fact obstructing summary judgment."); *Nelson*, 199 N.E.2d at 776 (insurance company promoted safety inspections as benefitting company's clients, which "fully negates any concept that defendant's gratuitous inspections were solely for its own internal purposes").

In some of these workers' compensation cases, the insurer seeks expressly to avoid negligent inspection liability by referring to language in the policy that explicitly disclaims any duty to the insured or to third parties in connection with the insurer's inspections of the insured's property or premises.[61] This language, which is an obvious reference to the language found in both the Second and Third Restatements of Torts, as well as in the negligent undertaking cases, is routinely enforced by some courts, irrespective of whether the employer-insured did in fact act in reliance on the insurer's inspections.[62] Other courts have viewed such terms with more suspicion. Some have enforced such terms only if there was in fact no evidence of reliance by the employer or the third-party victim.[63] Others have refused to enforce them at all when third-party victims are involved.[64] A few have declared such terms void as against public policy.[65]

The second most common type of negligent inspection cases brought against insurers besides the workers' compensation insurance cases are disputes involving various types of property insurance, especially boiler and machinery coverage.[66] This also is unsurprising, as insurers who offer boiler and machinery coverage heavily advertise their loss control expertise, which enhances the case for

61. See Tomasich v. U.S. Fid. & Guar. Co., 470 So. 2d 191 (La. Ct. App. 1985) for the language from an old US F&G workers' compensation policy ("The Company and any rating authority having jurisdiction by law shall each be permitted but not obligated to inspect at any reasonable time the work places, operations, machinery and equipment covered by this policy. Neither the right to make inspections nor the making thereof nor any report thereon shall constitute an undertaking on behalf of or for the benefit of the Insured or others, to determine or warrant that such workplaces, operations, machinery or equipment are safe or healthful, or are in compliance with any law, rule or regulation.").

62. Louisiana is one example. *Id.*; *see also* Leroy v. Hartford Steam Boiler Inspection & Ins. Co., 695 F. Supp. 1120, 1127 (D. Kan. 1988) (court held insurance company not liable, following reasoning of *Smith* case below); Smith v. Allendale Mut. Ins. Co., 303 N.W.2d 702, 715 (Mich. 1981) (insurance policy disclaimed liability for inspections and court held "[t]he insurer was entirely justified in so limiting its liability"); Rosenhack v. State, 447 N.Y.S.2d 856 (N.Y. Ct. Cl. 1982) ("The facts clearly and unequivocally lead to the conclusion that this contract for insurance and in particular the provision dealing with inspection of the premises specifically exclude claimant.").

63. *See, e.g.*, Bussey v. Travelers Ins. Co., 643 F.2d 1075, 1076 (5th Cir. 1981) (affirming the insurance company was not liable because defendant "did not establish the requisite degree of reliance by himself or his employer on the insurer's inspection services"); Stacy v. Aetna Cas. & Sur. Co., 484 F.2d 289 (5th Cir. 1973) (upholding the policy language where there was no reliance by the insured or injured workman on the inspections made by the insurance company).

64. *See, e.g.*, Van Winkle v. Am. Steam-Boiler Ins. Co., 19 A. 472 (N.J. 1890); Sheridan v. Aetna Cas. & Sur. Co., 100 P.2d 1024 (Wash. 1940).

65. Deines v. Vermeer Mfg. Co., 752 F. Supp. 989, 997 (D. Kan. 1990).

66. *See, e.g.*, Manker v. Zurich Servs. Corp., 556 F. App'x 907 (11th Cir. 2014); Howell v. Hartford Steam Boiler Inspection & Ins. Co., 991 F.2d 795 (6th Cir. 1993); Hartford Steam Boiler Inspection & Ins. Co. v. Pabst Brewing Co., 201 F. 617 (7th Cir. 1912); Indus. Risk Insurers v. New Orleans Pub. Serv., Inc., 666 F. Supp. 874 (E.D. La. 1987); Mueller v. Daum & Dewey, Inc., 636 F. Supp. 192 (E.D.N.C. 1986); Blalock v. Syracuse Stamping Co., 584 F. Supp. 454 (E.D. Pa. 1984); Phila. Mfrs. Mut. Ins. Co. v. Gulf Forge Co., 555 F. Supp. 519 (S.D. Tex. 1982); A.O. Smith Corp. v. Viking Corp., 79 F.R.D. 91 (E.D. Wis. 1978); Hassan v. Hartford Ins. Grp., 373 F. Supp. 1385 (D. Del. 1974); Huggins v. Standard Fire Ins. Co., 304 S.E.2d 397 (Ga. Ct. App. 1983); Cleveland v. Am. Motorists Ins. Co., 295 S.E.2d 190 (Ga. Ct. App. 1982).

reliance.[67] Boiler and machinery coverage is usually sold by insurers who specialize in such risks and in special policies separate from and in addition to general property insurance policies.[68] The coverage is typically first-party only and insures not only damage to the machinery itself but also any resulting business interruption or other lost income.[69] The triggering event is the "breakdown" of the machine itself and not some external force such as fire, wind, or water, which would be covered under the standard property policy.[70] Indeed, what has traditionally been called boiler and machinery insurance is now commonly called "equipment breakdown insurance."[71] Damages are typically limited to the cost of repairing or replacing the broken equipment along with associated lost income to the business, similar to business interruption coverage.[72]

The fact pattern in a standard boiler/machine case is straightforward: a boiler or other large machine on the insured's business premises explodes and injures one or more individuals, possibly a tenant or some other customer. The injured individuals then bring suit against the insurer that issued the policy covering the malfunctioning equipment. The claim itself typically tracks the language of the sections of the Restatement dealing with negligent undertakings—the main issues again being the nature of the service provided by the insurer, and whether that service was for the benefit of the insurer or the victims.[73] Insurers lose as many of these cases as they win.

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67. *See, e.g.*, *Boiler & Machinery*, TRAVELERS, https://www.travelers.com/business-insurance/specialized-industries/boiler-machinery/risk-control.aspx [https://perma.cc/5TNX-NA58] (last visited Feb. 14, 2016) (discussing the "entire team of national board-commissioned engineers dedicated exclusively to servicing equipment breakdown business").

68. *Id.*

69. *See, e.g.*, TRAVELERS, ENERGY MAX 21 (2015), https://www.travelers.com/business-insurance/specialized-industries/boiler-machinery/docs/CP6943EMAX21.pdf [http://perma.cc/H4JX-SKSR]; ZURICH, BM-4-E, BOILER AND MACHINERY INSURANCE EXPLAINED (2009), http://www.zurichcanada.com/internet/can/SiteCollectionDocuments/Equipment-Breakdown/Risk-topic2-BoilerandMachinery-insurance-Equipment-break-down.pdf [https: //perma.cc/CM6A-ARHJ].

70. *See Equipment Breakdown Insurance*, TRAVELERS, https://www.travelers.com/business-insurance/specialized-industries/boiler-machinery/index.aspx [https://perma.cc/NJ5V-KG7F] (last visited Feb. 14, 2016).

71. *See, e.g.*, *Coverage Basics*, MUNICH RE, https://www.munichre.com/HSB/products/agents-and-brokers/equipment-breakdown-coverage/coverage-basics/index.html [https://perma.cc/36XY-8UHS] (last visited Feb. 14, 2016); *Equipment Breakdown Insurance*, NATIONWIDE, http://www.nationwide.com/business-equipment-insurance-protection.jsp [https://perma.cc/SY6R-GY6P] (last visited Feb. 14, 2016).

72. *See, e.g.*, *Equipment Breakdown*, W. RES. GRP., http://www.wrg-ins.com/Commercial/EquipmentBreakdown.aspx [https://perma.cc/CA29-XJ6Q] (last visited Feb. 14, 2016).

73. *See, e.g.*, Howell v. Hartford Steam Boiler Inspection & Ins. Co., 991 F.2d 795 (6th Cir. 1993); Hartford Steam Boiler Inspection & Ins. Co. v. Pabst Brewing Co., 201 F. 617 (7th Cir. 1912); Riverbay Corp. v. Allendale Mut. Ins. Co., No. 83 CIV 8271 (MJL), 1988 WL 52783 (S.D.N.Y. May 18, 1988); Phila. Mfrs. Mut. Ins. Co. v. Gulf Forge Co., 555 F. Supp. 519 (S.D. Tex. 1982); Cleveland v. Am. Motorists Ins. Co., 295 S.E.2d 190 (Ga. Ct. App. 1982); Hartford Steam Boiler Inspection & Ins. Co. v. White, 775 N.E.2d 1128 (Ind. Ct. App. 2002); Logestan v. Hartford Steam Boiler Inspection & Ins. Co., 626 N.E.2d 829 (Ind. Ct. App. 1993); Van Winkle v. Am. Steam-Boiler Ins. Co., 19 A. 472 (N.J. 1890); Seay v. Travelers Indemnity Co., 730 S.W.2d 774 (Tex. Ct. App. 1987). In

Some types of insurance have given rise to very few, if any, negligent inspection lawsuits against insurers, presumably because such insurers are engaging in relatively little direct regulation—or perhaps because the sort of direct regulation that is being done produces relatively small likelihood of a negligence claim. For example, there are few cases involving homeowners insurance, and the cases that have been reported involve claims adjusting rather than preloss inspections; in any event, these have almost uniformly favored insurers (on reliance grounds).[74] There are essentially no auto-insurance cases.[75] Neither of these is a surprise, under current insurance schemes. Homeowners insurers do not inspect homes and provide certifications of safety, in the way that workers' compensation or boiler and machinery insurers do. Rather, the type of direct regulation that homeowners insurers provide tends to be very general and uncontroversial—the sort of clearly reasonable safety suggestions that, as noted above, are supported by actuarial evidence and may be tied to premium discounts, but that is not likely to create a cause of action. The same goes for auto insurers; discounting premiums for safe driving or for reducing the number of miles driven is not a safety inspection or a certification that the activity of driving is now safe. Whether there might be more tort cases brought against homeowners and auto insurers if the duty were expanded is a different question.

Unlike auto and homeowners insurers, it is somewhat surprising that there are not more negligent inspection suits brought against products-liability insurers. In fact, I was able to find only one. In *Deines v. Vemeer Manufacturing, Co.*,[76] the insured was a manufacturer of mechanical hay balers—a machine that cuts hay and then rolls the hay into large bales. The case arose out of a products-liability suit brought against the manufacturer and the insurer by an individual whose arm got caught in the baler's compression rollers and, as a result, had to be amputated.[77] The plaintiff alleged that his injury was caused by the unreasonably dangerous and defective nature of the design of the intake area of the baler, the operating manual, and the safety stickers on the side of the baler.[78]

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some cases, the courts have implied that the issue turns on the interpretation of a statute. For example, in Cassell v. Babcock & Wilcox Co., 588 N.Y.S.2d 459, 460 (N.Y. App. Div. 1992), the court suggested that, if the insurer's boiler inspection was conducted to satisfy a state labor law requirement, then it would have been for the benefit of the worker victims, rather than for the insurer's benefit. As it turned out, however, there was insufficient evidence in the case to determine the precise purpose of the insurer's inspection.

74. *See, e.g.*, GuideOne Mut. Ins. Co. v. Hunter, 650 S.E.2d 424 (Ga. Ct. App. 2007); Hamill v. Pawtucket Mut. Ins. Co., 892 A.2d 226 (Vt. 2005).

75. The one exception that I could find was Ayers v. Allstate Ins. Co., 878 N.Y.S.2d 190 (N.Y. App. Div. 2009) (holding that there is an issue of fact as to whether truck driver's economic losses were caused by his auto insurer's negligent inspection of his car).

76. Deines v. Vermeer Mfg. Co., 752 F. Supp. 989 (D. Kan. 1990).

77. *Id.* at 992.

78. *Id.*

During the relevant period, the insured manufacturer had purchased product liability coverage from a large property/casualty insurance company.[79] Part of the arrangement under the policy was that the insurer would inspect all of the equipment used by the manufacturer insured to make the balers. The insurer also reviewed the design of the baler itself, as well as the warning labels and operating manuals that the manufacturer sent with the balers to the purchasers. After these inspections were completed, the insurer made suggestions for how the insured manufacturer might enhance the safety of the baler. When making these inspections, the insurer utilized their loss prevention experts, who applied safety standards that had been adopted by various standard-setting industry groups—including the American National Standards Institute, the Occupational Safety and Health Administration, and the American Society of Agricultural Engineers. In addition to being a condition of coverage, the inspections were a selling point: part of the reason the manufacturer-insured purchased products coverage with this particular insurer was to gain access to the insurer's advertised loss control service, including the on-site safety inspections. Indeed, the insured manufacturer did not employ any safety engineers of its own, nor did it conduct any independent safety inspections because it was relying on the services provided by the insurer.

The court, when evaluating the plaintiff's tort claim against the insurer, applied each of the three prongs of the negligent undertaking rule from the Restatement discussed above.[80] The court held, first, that there was no evidence that the insurer's inspection increased the risk beyond that which would have existed in the absence of the inspections.[81] Hence, there was, as a matter of law, no liability under prong (a). However, the court then held that the insurer *had* in fact undertaken a duty owed to the plaintiff by the insured manufacturer—that is, the duty of designing reasonably safe products and the duty to warn of the risk of the product—and that the insured manufacturer had relied on the insurer's inspections being reasonable.[82] Thus, potential liability was found under prongs (b) and (c).

The court rejected the insurer's argument that the state's product-liability statute, which limited liability in various ways, applied to the case; the court concluded that the statute was not intended to eliminate negligent-inspection liability.[83] In addition, the court held that the provision in the insurance policy that purported to eliminate any duty of reasonable care to third parties (including any duty that might arise out of the safety inspections) was void as against public policy.[84]

79. *Id.*
80. *Id.* at 993–97.
81. *Id.* at 995.
82. *Id.* at 995–97.
83. *Id.* at 998.
84. *Id.* at 997.

The *Dienes*-type situation likely happens with some frequency: liability insurers specialize in products-liability coverage, employing products-liability law experts as well as experts in product design, manufacturing, and labeling, and provide product-specific recommendations to relatively small manufacturing companies who do not have the resources to maintain such expertise in house. Indeed, for the same reasons that workers' compensation and boiler/machinery insurers often provide rigorous safety inspections, one would expect that product liability insurers do the same. There are product liability insurers who do provide some such services, as evidenced by their web advertising[85] and by anecdotal evidence from my own interviews with insurers. And yet, there are far fewer reported negligent inspection cases involving product-liability insurance than there are involving workers' compensation or boiler/machinery-liability insurance.

Some states, perhaps concerned that negligent inspection suits might result in higher premiums or withdrawal of coverage (or perhaps concerned that such suits will reduce insurer profits), have enacted statutes limiting such claims. Twenty U.S. states have enacted statutes that appear to be designed to limit negligent inspection suits generally, or to limit such suits against insurers in particular, or so the insurers argue.[86] Some state courts have also sought to impose limits by interpretation of existing statutes. For example, courts in a few jurisdictions have applied the workers' compensation statutes themselves (the statutes that create the workers' compensation regime in a state) to provide tort immunity for workers' compensation insurers.[87] Most courts, however, have not so held.[88] Regardless, the existing state statutes explicitly protecting insurers from

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85. *See, e.g.*, CHARTIS, PRODUCT LIABILITY LOSS CONTROL SERVICES (2010), http://www.aig.com/ncglobalweb/internet/US/en/files/Commercial%20Risk%20-%20Product%20Liability%20Loss%20Control%20Services%20-%201%20pgr_tcm295-276525.pdf [https://perma.cc/PCZ6-PDKX]; *Products Liability Services*, CHUBB GRP. OF INS. COS., http://www.chubb.com/businesses/cci/chubb2492.html [https://perma.cc/F7EJ-XDXW] (last visited Feb. 14, 2016).

86. *See, e.g.*, ALA. CODE § 25-5-53 (LexisNexis 2007); ALASKA STAT. ANN. § 23.30.055 (West 2007); ARIZ. REV. STAT. ANN. § 23-485 (2012); CAL. INS. CODE § 11759 (West 2005); COLO. REV. STAT. ANN. § 8-41-104 (2011); DEL. CODE ANN. tit. 19, § 2304 (West 2006 & Supp. 2014); FLA. STAT. ANN. § 440.11 (West 2009); GA. CODE ANN. § 34-9-11 (2008); IND. CODE ANN. §§ 22-3-2-6, 34-30-17-2 (LexisNexis 1997); IOWA CODE ANN. §§ 85.20, 88.6, 517.5 (West 2009); ME. REV. STAT. ANN. tit. 14, § 167 (2003); MD. CODE ANN., LAB. & EMPL. § 9-509 (Lexis Nexis 2008); MICH. COMP. LAWS ANN. § 418.131 (LexisNexis 2006); MICH. COMP. LAWS ANN. § 500.2925b (LexisNexis 2010); N.Y. WORKERS' COMP. LAW § 11 (McKinney 2013); 27 R.I. GEN. LAWS ANN. §§ 27-7-2, 27-8-15 (2008); 28 R.I. GEN. LAWS ANN. § 28-36-7 (2003); TENN. CODE ANN. § 50-6-108 (1999); TEX. LAB. CODE ANN. § 408.001 (West 2006); VT. STAT. ANN. tit. 21, §§ 622, 624(h) (2009); WIS. STAT. ANN. § 895.475 (West 2006).

87. Kifer v. Liberty Mut. Ins. Co., 777 F.2d 1325 (8th Cir. 1985); Johnson v. Am. Mut. Liab. Ins. Co., 559 F.2d 382 (5th Cir. 1977); Horne v. Sec. Mut. Cas. Co., 265 F. Supp. 379 (E.D. Ark. 1967); Barrette v. Travelers Ins. Co., 246 A.2d 102 (Conn. Super. Ct. 1968); Jadosh v. Goeringer, 275 A.2d 58 (Pa. 1971).

88. *See, e.g.*, Bryant v. Old Republic Ins. Co., 431 F.2d 1385 (6th Cir. 1970); Mays v. Liberty Mut. Ins. Co., 323 F.2d 174 (3d Cir. 1963); Stacy v. Aetna Cas. & Sur. Co., 334 F. Supp. 1216 (N.D. Miss. 1971); Beasley v. MacDonald Eng'g Co., 249 So. 2d 844 (Ala. 1971); Newton v. Liberty Mut. Ins. Co., 252 S.E.2d 199 (Ga. Ct. App. 1979).

negligent inspection liability have been enforced. These statutes can be seen as a type of insurer-specific "Good Samaritan" law.

III. EVALUATING ALTERNATIVE TORT RULES FOR INSURERS AS PRIVATE REGULATORS

A. The Full Coverage Scenario: When Disclaimers Should Be Enforced

This Part examines the regulatory or incentive effects of the existing doctrine of negligent inspection as well as the effects of several alternatives to current law, as applied to both insurers and their insureds. To provide a baseline for the analysis, observe that if the insurer in question (the one doing the regulating) provides full coverage for the underlying liability, the optimal tort rule is probably the absence of any tort liability. In such a situation, which I will call the "full coverage scenario," the insurer is contractually on the hook for the full amount of any such losses that arise. In other words, there are either no limits on the policy, or there are limits high enough to cover any conceivable losses. In that scenario, at least in theory, there would be no regulatory benefit in providing injured victims with a tort cause of action against the insurer. The incentive of liability imposed by the insurance contract itself should be sufficient to motivate the insurer to take all reasonable steps to help its insureds reduce risks through inspections and/or standard setting.[89] Thus, the optimal rule in a full-coverage scenario, from the perspective of the effect on incentives, would be one of no liability on insurers for negligent inspection. Not coincidentally, a rule of no liability would also be desirable from the perspective of providing fair compensation, since the injured party, by assumption, is entitled to full compensation from the insurer. For these reasons, in a full-coverage scenario, if the insurance policy contains a term disclaiming or waiving any tort duties by the insurer to the insured, a strong argument can be made that such a term should be enforced by the courts.

The only cases in which tort law has any potential role are those in which the coverage limit of the policy issued by the regulating insurer is significantly less than the damages that can be recovered through a direct tort suit against the insurer for negligent inspection/regulation. This divergence between insurance coverage and the potential negligent inspection remedy can happen in two general situations. First, there can be divergence when the insurance coverage in question does not cover the full losses that occur. This shortcoming can happen with first-party insurance coverage (e.g., boiler and machinery policies that do not cover personal injuries) or with liability insurance coverage (e.g., products-liability policies that have low policy limits). Second, in the case of liability insurance in particular, there can be divergence between the insurance coverage and the potential negligent inspection remedy when the underlying liability regime (the

89. One qualification to this conclusion is that insurance contracts tend to be written on an annual basis. Therefore, the contractual cost internalization would be limited to the risks of a single policy year.

regime creating the liability for which insurance is purchased) has substantially limited remedies. The primary example of this type of divergence involves workplace injuries where the workers' compensation regime provides a substantially smaller potential recovery than a tort suit would. The remainder of this Part addresses both types of divergence situations.

B. Divergence Type I: Less-than-Full Insurance and Judgment Proof Insureds

The less-than-full insurance coverage situation provides the strongest case for imposing a tort-based duty on insurers. In the absence of such a tort duty, the insurer, in deciding how to regulate its insured (e.g., how rigorous to make its inspection; how detailed and comprehensive to make its safety recommendations; how insistent it should be about compliance with those recommendations), may be inclined to ignore any potential costs to third-party victims that would exceed the amount of coverage agreed to in the insurance contract. Those additional costs, which are beyond the coverage provided by the insurer, are simply not the insurer's contractual responsibility. As a result, there is an externality of sorts, or at least a potential externality, as the insurer externalizes those beyond-coverage costs to the insured.

To visualize this situation, consider an example in which a property insurer provides first-party equipment breakdown coverage for an insured's boiler (for repair and replacement costs to the boiler in the event it breaks down), but no liability insurance coverage should the boiler explode. And for whatever reason, the insured either has no separate policy providing liability coverage for such events, or has liability coverage that expressly excludes harm resulting from exploding boilers. Assume also that there is a substantial difference between the optimal boiler inspection for the purpose of avoiding breakdown of the boiler and the optimal inspection for the purpose of avoiding injury to persons. The externality concern is that, absent a legal rule forcing the insurer to take into account the uninsured liability risk of the insured, the insurer will have an incentive to do only the property risk inspection and not the personal injury risk inspection when, in fact, both types of inspections were appropriate. And the failure to conduct the personal injury risk inspection may, in fact, lead to injuries to third parties, for which there is no insurance. Similarly, imagine a product manufacturer purchases a products-liability insurance policy with very low policy limits. In that case, the liability insurer might have an incentive to perform only a cursory inspection, or none at all, given its relatively limited stake in the insured manufacturer's risk of liability; such an inadequate or nonexistent inspection could precipitate a design flaw that results in numerous injuries or deaths. In both of these situations, the insurer is externalizing the uncovered losses to the insured—the party that purchased the boiler policy or the products-liability policy.

A potential response to this conclusion is to suggest that there is, in fact, no externality. That is, so long as the losses are borne by the insurer or the insured, those parties—who are already in a contractual relationship with each other—can negotiate to the efficient, Coasean outcome. If it makes sense for the boiler insurer to do a personal-injury-type inspection of the boiler (as seems likely), then the insured can pay a somewhat higher premium to the insurer in return for that service. The same principle applies in the products-liability example: even if the products-liability insurer is contracted for less-than-full coverage, if the insurer is in a better position (in terms of information) to provide a product-risk assessment than the insured itself is, the insured can contract for such services; this is desirable if the insured is potentially liable for any product-related injuries arising out of the use of its products. Moreover, the insureds, in both examples, will have an incentive to contract for such services. As a result, market forces—together with the underlying tort duty of the insureds—internalize any potential externality.

The externality in these cases returns, however, when the insured party is judgment proof. A potential tort defendant is judgment proof when its assets, including its liability insurance coverage, are insufficient to pay for the harm that can be caused by its activities.[90] When a party is judgment proof, tort law—ex post sanctions, generally—has limited usefulness as a regulatory tool, because the misbehaving party cannot be forced to pay an amount that exceeds the value of its assets. This is why it has been argued that government agency-based ex ante regulation is preferable when parties engaging in activities that pose risk to third parties are judgment proof.[91] Still, there are reasons to prefer ex post sanctions and tort law, in particular, over ex ante government regulation. For example, ex post sanctions require significantly less information on the part of the regulator or court.[92] To the extent such arguments in favor of ex post sanctions are persuasive, tort law has found ways to work around the judgment proof problem.

The doctrine of vicarious liability is one example. Vicarious liability holds one party liable for the torts of another under circumstances in which the first party either (a) is the cheapest cost avoider or, more importantly, (b) is *one* of the cheapest cost avoiders *and* has sufficient assets to be motivated by the threat of sanction.[93] The classic example is an employer's liability for torts employees commit within the scope of their employment. The justification is two-fold: (1) employers may be in the best position to prevent certain types of employee torts (in part because of information available only to the employer, and in part because the employer may control access to certain risky instrumentalities—such as heavy machinery—that are available to employees), and (2) the employer, unlike the employee, is not judgment proof.[94]

Similar cheapest-cost-avoider–defendant-insolvency arguments have been deployed to justify a specialized form of vicarious liability known as "gatekeeper

90. *See* Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 45 (1986).

91. *See, e.g.*, Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357 (1984).

92. *See id.* at 359.

93. *See* Sykes, *supra* note 8.

94. *Id.*

liability."[95] With gatekeeper liability, the party held vicariously liable is, obviously, the keeper of the gate—the party whose approval or certification is required by the party whose actions directly caused the harm. Maybe the best-known examples of gatekeeper liability arise in the context of corporate financial malfeasance. In such cases, by the time the harm is discovered, the parties who have been harmed (usually the parties who invested in the corporation without knowledge of the shenanigans) cannot recover for their losses from the defendant. Similarly, ex post sanctions against the offending corporation are ineffective, as the company has gone into bankruptcy. The Enron scandal is perhaps the most vivid example of this phenomenon, but the observation is more general: a regime of regulation that seeks only to punish the offending corporation after the fact may not be enough.

For this reason, an argument can be made that the optimal regulator strategy in the context of corporate financial misbehavior includes, in addition to ex ante government regulation (e.g., SEC oversight), the extension of ex post liability beyond the corporation itself to the corporation's lawyers, accountants, lenders, and underwriters. These gatekeepers are all, in a sense, private regulators with access to the relevant information regarding the corporation whose behavior needs to be regulated. Their stamps of approval are either legally or practically required for the regulated corporation to engage in the particular transactions that pose substantial risk to third parties (often unsophisticated investors).[96] Imposing a tort duty on these private regulators will encourage them to take reasonable care in determining whether to certify the books of such regulated corporations; that is the regulatory effect of gatekeeper liability.

All of these arguments concerning vicarious liability generally, and gatekeeper liability in particular, can be applied to insurers as private regulators of risk. In a sense, insurers' negligent inspection liability can be thought of as a specialized version of vicarious liability. Empowering injured third parties to bring tort actions against an insurance company that failed to take reasonable care when doing a workplace inspection or product safety evaluation could have the same sort of beneficial incentives that respondeat superior has in the employment context: insurers could be induced to take steps to prevent accidents that their insured does not have sufficient incentive to prevent. Imposing a tort duty on insurers could induce them to account for costs that might otherwise be passed onto society as a result of the combination of inadequate coverage and a judgment-proof insured.

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95. Kraakman, *supra* note 8, at 53, 57 (justifying gatekeeper liability in part because of impossibility of imposing fines on "individuals or corporations more than the value of their net assets").

96. *Id.*; *see also* Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17 (2003); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2004).

Moreover, insurers sometimes do act as gatekeepers, at least to some extent.[97] Home mortgage lending and auto insurance were mentioned as examples in the introduction, but there are others. Businesses cannot legally operate without workers' compensation insurance coverage, which is mandatory in every state (unless the business falls within certain statutory exceptions). Similarly, most businesses would find it practically impossible to function without other forms of property or casualty insurance. Many product manufacturers, for example, may find getting a loan to be very expensive, or even impossible, unless they can provide proof of adequate products-liability coverage. Likewise, businesses that are heavily dependent on some piece of property—a building or a large, complex piece of machinery—may have difficulty getting credit at reasonable rates without proof of insurance against the possibility of breakdown. In such cases when insurers function as gatekeepers, negligent inspection liability can be especially effective as means of internalizing costs often externalized as a result of judgment-proof insureds.

C. Activity Level Effects

When vicarious liability induces an employer to increase monitoring and regulating employees' risky activities, or gatekeeper liability incentivizes a financial auditor to increase scrutiny of a corporation's books, these actions can be understood as the "care-level effects" of such rules.[98] There are also "activity-level effects."[99] For example, when an employer is made subject to tort liability for the conduct of its employees, the employer's costs are increased in much the same way that its costs would be increased if a new excise tax were imposed. As a result, the employer may end up hiring fewer workers, paying lower wages, or perhaps replacing some of its workers with contract labor in hopes of avoiding liability. Similarly with gatekeeper liability, if corporate auditors, attorneys, and underwriters are made liable for the financial fraud of the corporations to whom they provide advice and whose integrity they certify, they (the gatekeepers) will raise their prices, or cut back on the number of corporations they are prepared to certify, or both. Precisely how the costs will be divided between the employers and employees, or between the gatekeepers and gate-kept, depends on the relative elasticities of supply and demand in the relevant markets. But in any event, if the additional costs imposed by vicarious liability are real costs that would otherwise

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97. Others have emphasized the role of insurers as potential gatekeepers, especially in the context of corporate governance and financial disclosure. *See, e.g.*, Avraham, *supra* note 25, at 39; Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413 (2004). In all of these proposals, however, the idea has been to make insurers only contractually liable through financial insurance policies. So far as I know, no one has argued in favor of imposing tort liability on insurers who fail to take reasonable care in monitoring their insureds.

98. Steve Shavell was the first to clearly draw the distinction between care level and activity level effects. *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 21 (1987).

99. *Id.*

be externalized due to judgment-proof employees or agents generally, these activity-level effects should tend toward efficiency.

The same sorts of beneficial activity-level effects could arise when insurers act as regulators or gatekeepers. Making the insurers subject to a potential tort suit for negligent inspection—just as exposing an accounting firm to the risk of liability for failure to take reasonable care in performing an audit—is akin to an excise tax on insurers and can lead them to substantially increase their premiums, in some cases beyond a point that businesses are willing to pay. The threat of negligent inspection suits will force the insurer to raise the price of its coverage to account for potential payouts far in excess of the stated policy limits. These negligent inspection surtaxes are most likely to occur when the risks posed by the insured's business activities far outstrip the value of the company's assets (for example, hotels with significant risk of fire; workplaces where employees are systematically exposed to dangerous conditions; or product manufacturers whose products could harm large numbers of consumers). In these situations, if insurance is effectively performing a gatekeeping function, some of these companies will be put out of business. That is, if they cannot persuade an insurer to provide them with coverage at a premium they can afford—and that the profits from their business can sustain—they will effectively be priced out of the market. That result would be efficient, at least in theory.

D. Insurer Withdrawal from Regulation and the Relative Merit of Carrots and Sticks

A potential difficulty with using tort law to encourage insurers to regulate reasonably, especially under the current rule, is the possibility that, facing the prospect of such liability, insurers will regulate in a way that is designed to avoid liability or, worse, will stop regulating altogether. As to the first possibility, recall that under current law, insurers can be held liable in tort for negligent inspection only if the insured or some third party relies on those inspections being done reasonably; if there is no reliance, there is no cause of action.[100] In practical terms, this means that insurers will (and often do) insert language into their policies or promotional materials stating that any inspections or audits or other regulatory services are provided solely for the benefit of the insurer and are not to be relied upon by the insured or anyone else. Such statements amount to disclaimers of liability, which courts sometimes enforce, but sometimes do not.

The problem with this outcome, of course, is that if insurance is to provide a useful regulatory function, there must be reliance. When insurers are better evaluators of an insured's risky activities than the insured itself is, the insured's reliance on the insurer's recommendations is the most desirable outcome. That is the point: for the insured to have the most information about its risky activities.

100. Subsection (c) of Section 43 of the *Restatement* limits negligent inspection liability to situations in which "the person to whom the services are rendered, the third party, or another relies on the actor's exercising reasonable care in the undertaking." RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43(c) (AM. LAW INST. 2012).

Thus, permitting insurers to avoid liability by proving the absence of reliance would discourage insurers from engaging in potentially beneficial private regulation—the type that is relied upon by the regulated party.

The more extreme response of insurers to the threat of negligent inspection suits is for them to stop inspecting and to stop engaging in direct regulation entirely.[101] Again, under current law, insurers can be held liable in tort for negligent inspection only if they "undertake" to provide inspection services.[102] Thus, by simply refraining from any sort of safety inspections, or declining to provide any "loss control" risk-reduction counseling to their insureds, insurers can essentially eliminate their liability in tort for negligent inspection. It is this sort of withdrawal from regulation in extreme response to the threat of such liability that, according to anecdotal evidence, some insurers have been doing.

One potential policy response to both types of insurer avoidance in their role as direct private regulator—their tendency to discourage reliance on their recommendations or to refrain from regulating at all—would be for more states to adopt what I have called insurer Good Samaritan statutes: laws that immunize insurance companies from lawsuits. By eliminating this negligent-undertaking liability, such laws create a legal environment in which insurers would have the freedom to engage in aggressive direct regulation of their insureds' behavior, if it is called for, without fear of tort liability far in excess of their policy limits.[103] These statutes are obviously analogous to the better-known Good Samaritan statutes in many states that protect certain individuals (usually limited to off-duty trained personnel, such as doctors and nurses) who voluntarily undertake to rescue those in imminent peril.[104] Good Samaritan statutes generally, and insurer Good Samaritan statutes in particular, are a type of "carrot" approach to encouraging rescue. They provide a positive reward to rescuers—a subsidy of sorts.[105]

The limitation of this particular carrot approach is, again, the problem of less-than-full coverage. That is, with the threat of liability removed, it is true that

101. Indeed, this is the primary reason Professor Goldberg gives for his opposition to negligent inspection suits against insurers. *See* Goldberg, *supra* note 7, at 76.

102. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43(c) (AM. LAW INST. 2012).

103. The statute in Maine, for example, reads as follows: "[T]he furnishing of, or failure to furnish, insurance inspection services related to, in connection with or incidental to the issuance or renewal of a policy of property or casualty insurance shall not subject the insurer, its agents, employees or service contractors to liability for damages from injury, death or loss occurring as a result of any act or omission by any person in the course of such services." ME. REV. STAT. ANN. tit. 14, § 167 (1982). Another example is from California, where the state insurance law places strict limits on negligent inspection lawsuits. Section 11759 of the California Insurance Code states that "licensed rating organizations and their officers and employees shall not be liable for injury or death or other damage caused or alleged to have been caused by their failure to inspect, or negligent or incomplete inspection of, an employer's location, plant or operation for classification or rating purposes." CAL. INS. CODE § 11759 (West 2014).

104. GOLDBERG ET AL., *supra* note 53, at 83–88.

105. Levmore, *supra* note 9, at 881 (coining the use of "carrot" and "stick" labels in this context).

insurers would no longer have an incentive to refrain from regulating their insureds or an incentive to discourage reliance on their recommendations—which lead to the same result. Rather, insurers would have an unambiguous financial incentive to regulate, but their incentive would again be capped by the limits of the insured's coverage, the amount that the insurer has at stake if the insured suffers a loss. For this reason, whether the adoption of an insurer Good Samaritan statute would have, on balance, beneficial incentive effects on insurer behavior would depend on a comparison of (a) the efficiency gains realized from those insurers who are induced by the statutory protection to engage in some useful regulation of their insureds with (b) the efficiency loss from those insurers who would have regulated in any event but who now, with the threat of liability removed, will regulate less effectively on account of the divergence between policy limits and amounts at risk of loss. This is the externality problem discussed above.

How these two factors balance out in the real world presents the quintessential difficult empirical question. My own intuition is that, all things considered, factor (a) is probably larger than factor (b), which means the adoption of insurer Good Samaritan statutes would be a sensible recommendation. However, if we consider tweaking the standard insurer Good Samaritan statute, we might achieve an even better outcome, in terms of the overall effect on incentives. Consider the possibility of adding a wrinkle to those statutes: make the insurer's freedom from tort liability contingent on a finding by a court (presumably upon a motion by an insured to dismiss a negligent inspection claim brought against it) that the amount of insurance involved in the case was adequate to cover the risk posed by the insured. Such a contingency would give insurers an incentive to make sure that insureds are purchasing adequate coverage, which would push the market closer to the full coverage situation described above, where tort law would not be necessary to encourage optimal direct regulation by insurers. This solution would of course present additional complexities, perhaps the most difficult being how to define "adequate" coverage. But that question could be left to the courts (in individual negligent inspection cases, or perhaps through declaratory judgment actions), to the insurance regulators (who could promulgate standards of adequate insurance), or to state legislatures.

A critic at this point might have the following complaint: "If higher insurance policy limits are the ultimate goal of this reform proposal, why not simply propose that state legislatures impose insurance mandates in areas where they have not yet done so, and increase the limits in areas where current mandates are too low? Once those are adopted, we would be close to a full coverage scenario, and the need to impose an affirmative tort duty on insurers to regulate would be eliminated." There is something to be said for this argument. Many scholars have suggested mandatory liability insurance as a response to the judgment proof problem, generally.[106] Likewise, broader use of insurance

106. *See, e.g.*, Peter-J. Jost, *Limited Liability and the Requirement to Purchase Insurance*, 16 INT'L

mandates, as well as stronger existing mandates, could be a solution to this version of the judgment proof problem as well. However, expanding legislative insurance mandates is likely to be politically unpopular; on the other hand, the sort of statute envisioned in this Article is less intrusive than an actual insurance mandate. Insurers could still opt not to provide full coverage and simply risk the possibility of a negligent inspection suit. Moreover, at least in those states that do not currently have any insurer Good Samaritan statute, the modified form that I am suggesting could be seen as a compromise—a middle position between a no-liability-limiting statute (the status quo) and a new liability-limiting statute that encourages, but does not actually mandate, higher policy limits. The proposal provides a more attractive carrot than the status quo but a less extreme stick than an expanded mandate.

The alternative and considerably more radical policy response to insurers' reluctance to regulate or withdrawal from regulation would be to eschew the (modified) carrot of (contingent) freedom from tort liability for the unambiguous stick: an affirmative duty to regulate. The idea would be to penalize those insurers who fail to regulate when they ought to by imposing an affirmative tort duty on them to engage in direct regulation of their insureds' behavior when doing so is reasonable. Such a duty to regulate would clearly be a departure from current law. Moreover, it would arguably be inconsistent with the approach the law has taken to affirmative obligations in other contexts. The most obvious example is the general no-duty-to-rescue rule mentioned in the Introduction; the arguments that have been made in defense of that rule would similarly apply here. For example, William Landes and Richard Posner have pointed out that adopting an affirmative duty to rescue would encourage potential rescuers to avoid situations in which they might be called on to rescue.[107] Picture off-duty doctors, nurses, and EMT workers avoiding swimming pools and public beaches.[108]

What is the analog in the insurance context? Insurance companies refusing to offer insurance coverage to certain insureds for fear of being held liable in tort for failing to regulate every time there is a loss claim? That is one realistic possibility—some insurers may well decline to cover certain insureds or categories of insureds, based on their inability to mitigate certain risks. Other insurers, however, may continue to insure, but would start to engage in active regulation to minimize their insureds' risks. Insurers would almost certainly respond by increasing the prices of their coverage to include the risk of a duty-to-regulate lawsuit. Perhaps even more likely, insurers might both raise their prices and insist on higher policy limits; if they are going to be taking on the risk of being held liable for amounts beyond their existing policy limits (under an affirmative duty to regulate), they might as well raise their policy limits and their prices. This change

REV. L. & ECON. 259 (1996); Shavell, *supra* note 91.

107. Landes & Posner, *supra* note 9.

108. *Id.*

would again move the market towards the full coverage scenario, where the negligent inspection tort suit would be rendered irrelevant.

Note also that imposing an affirmative obligation on insurers to regulate would not be totally without precedent. Recall the various "special relationship" exceptions to the general no-duty-to-rescue rule mentioned above. The idea of imposing this obligation on insurers would be to treat the insurer-insured relationship as being more akin to the business-premises-owner–business-guest relationship, the employer-employee relationship, or even the teacher-student relationship.[109] A primary reason for these special relationship exceptions is that they provide a way to draw administrable lines in deciding who is potentially liable under this affirmative duty to rescue. That is, while it would be quite burdensome on the affected parties, as well as on the judicial system, to have an unrestricted affirmative duty to rescue, a rule that applies only to parties in certain enunciated categories of relationships is narrower, less burdensome generally, and easier for courts to apply. Imposing an affirmative duty on insurers to provide regulatory advice to their insureds when it is reasonable to do so could be seen as another example of a special relationship.

But let's not kid ourselves. Imposing a new affirmative tort duty on insurers to engage in reasonable inspections when it is reasonable to do so would be highly controversial. What's more, if it worked, it would produce a result not entirely different from the modified (adequate-policy-limit-contingent) version of the insurer Good Samaritan statute that I suggested above. Both reforms would tend to push up the amount of coverage offered by insurers, thus helping to align the inspection-regulation incentives of insurers with those of society. The latter reform, however, would have two big advantages over the former. First, it would be less of a departure from current law and, as a political matter, less of an apparent imposition of costs on insurers, for the reasons described above. Second, it would require less regulation by courts in the business of insurance than the simple duty to regulate does. That is, if the insurer-modified Good Samaritan statute works as planned, there would rarely be a need for courts to hear negligent inspection cases against insurers, assuming insurers write policies with adequate coverage, since the insurers would be immune. By contrast, under the affirmative-duty-to-regulate approach, courts would continually be called on to second-guess insurers' regulatory judgments, both whether to regulate and how; this is a task for which courts are not necessarily well-suited.[110] This limitation of the courts is of course not unique to tort suits against insurance companies for what amounts to negligent risk regulation. To the contrary, all negligence-based tort causes of

109. GOLDBERG ET AL., *supra* note 53, at 83–88.

110. This is, of course, not a critique unique to tort suits against insurance companies for what amounts to negligent risk regulation. To the contrary, a negligent-based tort cause of action that involves complex and technical issues of engineering and science present difficulties for courts. (Risk-utility analysis in product design defect cases is similarly difficult for courts.) The point is that the critique would be less applicable to the insurer Good Samaritan statute alternative.

action that involve complex and technical issues of engineering and science present difficulties for courts: for example, risk-utility analysis in product design defect cases. The point is that the difficulty would be less problematic in the insurer Good Samaritan statute alternative.

E. Divergence Type II: The Workers' Compensation Example

I noted above that negligent inspection liability against insurers only makes sense, even potentially, as a regulatory tool in situations in which the insurer provides less than full coverage. That is, there must be a divergence, a gap between the insurance coverage actually provided and the potential negligent inspection remedy. Until now, I have been discussing situations in which the gap arises because the insured purchases less than full coverage for the losses its activity might cause, whether for market reasons or for reasons having to do with being judgment proof. There is another source of coverage gap which applies primarily to workers' compensation insurance but could likewise apply to any situation where the underlying liability regime (the regime creating the liability for which insurance is purchased) provides remedies for injured victims that are substantially less than those available through a tort claim.

Consider the workers' compensation example. When a worker is injured on the job, she does not have a traditional tort claim against her employer, even if she can prove that her employer's negligence caused her injury. As a result of state workers' compensation statutes, many of which were enacted in the early part of the twentieth century, a worker's remedies are limited to partial recovery for medical expenses, lost income, and vocational rehabilitation cost; all of these may be subject to a cumulative cap.[111] Note, then, that under a typical workers' compensation regime today, neither pain-and-suffering damages nor punitive damages may be recovered by the injured worker.[112] Contrast that outcome with the traditional tort remedies available in nonworkplace settings: those remedies include unlimited recovery for compensatory damages, including pecuniary (medical expenses, lost income, and the like) as well as nonpecuniary damages (pain and suffering) and, potentially, punitive damages.[113]

Given this divergence, a proponent of tort liability as a regulatory tool might initially argue that the negligent inspection suit provides an especially useful regulatory tool for improving workplace safety. Since workers' compensation remedies do not account for some of the real costs associated with workplace injuries (yes, pain and suffering is a real cost), the threat of workers' compensation damages does not give employers sufficient incentive to maintain workplace safety. Imposing tort liability on workers' compensation insurers when they fail to

111. PRICE V. FISHBACK & SHAWN EVERETT KANTOR, A PRELUDE TO THE WELFARE STATE: THE ORIGINS OF WORKERS' COMPENSATION (2000).

112. PETER M. LENCSIS, WORKERS COMPENSATION: A REFERENCE AND GUIDE (1998).

113. *Id.*

do a reasonably effective workplace inspection, which results in an injury to a worker, serves a useful cost-internalizing function.

Critics of tort law as a mode of regulation would have a number of familiar responses to this line of argument. Jury awards in tort cases, especially pain-and-suffering damage awards, are inaccurate and wildly inconsistent, or so they would say. Critics would also point out that people do not generally purchase first-party insurance coverage for purely non-economic losses. Why is that fact relevant? If true, it would mean that when tort law forces insurers to raise their premiums to cover the possibility that they might be held liable through a negligent inspection lawsuit for the pain-and-suffering damages of some unfortunate person, the law will be making insureds pay for a type of insurance that they do not want. Finally, these critics would likely note that the main point of workers' compensation laws was to eliminate the inconsistencies and excesses of tort liability (including pain-and-suffering damages) in exchange for the elimination of several defenses that employers had at in common tort cases, such as the fellow servant rule. To permit injured third parties to recover pain-and-suffering damages from insurers for breach of the duty to provide reasonable inspections, when the same injured parties cannot sue the insured employer directly for the same damages, undermines the political and pragmatic compromise represented by the workers' compensation law reforms.[114]

The problem with the argument is that it gives greater scope to the workers' compensation compromise than may be warranted. Although workers' compensation laws were intended to limit remedies that employees have against their employers for workplace injuries, they were not intended to limit employees' remedies against everyone. For example, if an employee is injured in the workplace by a product, perhaps some large piece of equipment, that employee can bring a products-liability claim or a negligence claim against the equipment's manufacturer in addition to their workers' compensation claim. And the damages available in the products-liability case, of course, are likely to include pain-and-suffering damages. What's more, this side-by-side coexistence—of the traditional tort remedies against product manufacturers and the more limited remedies against the employer—is not considered problematic, at least as a legal matter. Product manufacturers were clearly not a part of the bargain that produced the workers' compensation regime, and they are not protected by workers' compensation statutes.[115] Likewise, workers' compensation insurers were not part of that grand bargain. That is, at the time the workers' compensation statutes were originally enacted, there is no evidence that they intended to limit independent tort remedies against workers' compensation insurers who fail to take reasonable care when providing services to the insureds, although the lawmakers did contemplate

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114. *See generally* FISHBACK & KANTOR, *supra* note 111 (discussing political compromise reached between unions and employers).

115. *See* Jonathan M. Weisgall, *Product Liability in the Workplace: The Effect of Workers' Compensation on the Rights and Liabilities of Third Parties*, 1977 WIS. L. REV. 1035, 1036 (1977).

that workers' compensation liability insurers would provide workers' compensation policies to employers to cover the damages that employers would be required to pay. Frankly, lawmakers were probably not thinking about that particular issue. As a result, it is no surprise that most, though not all, courts that have addressed the question have held that workers' compensation statutes themselves, the ones that created the workers' compensation regimes, do not immunize workers' compensation insurers from negligent inspection liability.[116]

Whether negligent inspection suits should be available against workers' compensation insurers, then, turns not on factors specific to workers' compensation coverage, but rather on the issues discussed above in connection with other types of insurance: the extent to which the presence of such suits is likely to discourage insurers from inspecting at all, and whether that effect would be greater or less than the effect of the rule on the quality of the inspections. Unlike with other types of insurance where the crux of the problem was insufficient coverage and the solution was to find a way to encourage insurers to offer full coverage, in workers' compensation, the amount of liability and the amount of insurance coverage are both determined by statute and regulation. Therefore, the only way to increase the coverage, and thereby to eliminate the need and motivation for the negligent inspection suits, would be to reform workers' compensation regimes generally to provide greater damages, including pain-and-suffering damages. Or, we take the reverse approach and reform tort law to be more like workers' compensation. Either approach would likely eliminate the need for what amounts to vicarious liability suits against insurers.

CONCLUSION

Insurers have access to information that puts them in the ideal position to be effective private regulators of their insureds' risky activities, and they have exceptionally effective regulatory tools at their disposal. Nothing motivates someone to change their behavior like a financial reward, perhaps in the form of a premium discount. And when insurers control access to certain domains of the economy—either because of legal or practical requirements—the ability to withhold coverage can induce insureds to follow the insurer's recommendations for reducing potential losses. Moreover, because insurers are bonded to the interests of their insureds, as a result of their contractual obligation to pay the insureds' claims, insurers are motivated by their own bottom line to find ways to minimize their insureds' losses. For all these reasons, if tort law (particularly, negligent inspection lawsuits by insureds and third parties against insurers) is

116. *Compare* Beasley v. MacDonald Eng'g Co., 249 So. 2d 844 (Ala. 1971) (holding that the state's workers' compensation law, which prohibits lawsuits against employers, did not apply to negligent inspection suits against workers' compensation insurers, even though the term "employer" was defined in certain situations to include insurers), *with* McHargue v. Stokes Div. of Pennwalt Corp., 649 F. Supp. 1388 (D. Colo. 1986) (holding that the Colorado workers' compensation statute immunizes workers' compensation insurers from liability for negligent inspection).

discouraging insurers from engaging in some types of direct regulation of their insureds' behavior, perhaps some insurers would respond to additional encouragement. This Article has argued that a modified carrot approach to providing such encouragement, where insurers are given immunity from tort liability if they provide adequate coverage limits, might be superior to a more radical stick approach, in the form of an affirmative duty to regulate.