I will be presenting the attached manuscript this week. That ms, I hope, does not need a summary description in a cover memo. What I would like to do In this memo is briefly describe the three prior articles that report the results of my research with Rick Swedloff on lawyers’ professional liability and insurance so that you can get a sense of the larger project.

Our first article, Regulation by Liability Insurance: From Auto to Lawyers Professional Liability, 60 UCLA L. REV. 1412 (2013) surveyed the prior research on liability insurance as regulation and compared the tools used in different lines of liability insurance. The following table summarizes our findings:

<table>
<thead>
<tr>
<th></th>
<th>Shareholder</th>
<th>Auto</th>
<th>Guns</th>
<th>Medical Malpractice</th>
<th>Lawyers Professional</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overlap of liability and insurance</strong></td>
<td>Substantial, except for the biggest claims</td>
<td>Practically complete</td>
<td>Very limited</td>
<td>Substantial; some underinsurance</td>
<td>Substantial; small firms may go bare</td>
</tr>
<tr>
<td><strong>Risk-based pricing</strong></td>
<td>Individualized; some experiments with formulas</td>
<td>Big data</td>
<td>None, except for gun-related organizations</td>
<td>Scheduled for small; otherwise individualized</td>
<td>Varies from per capita to formulas to individualized</td>
</tr>
<tr>
<td><strong>Loss prevention underwriting</strong></td>
<td>Some</td>
<td>None</td>
<td>Only for gun-related organizations</td>
<td>None for small; some for large</td>
<td>Varies from limited to extensive</td>
</tr>
<tr>
<td><strong>Contracts address moral hazard?</strong></td>
<td>Yes</td>
<td>Minimal (family member)</td>
<td>Yes: deregulation by exclusion</td>
<td>Yes, but more for large organizations</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Insurer control over claims management</strong></td>
<td>Shared</td>
<td>Complete</td>
<td>Complete for accidents; none for intentional</td>
<td>Complete for small; shared for large</td>
<td>Varies</td>
</tr>
<tr>
<td><strong>Loss prevention services</strong></td>
<td>Minimal</td>
<td>Limited</td>
<td>None</td>
<td>Varies from none to some</td>
<td>Varies from limited to extensive</td>
</tr>
<tr>
<td><strong>Research and education</strong></td>
<td>Minimal</td>
<td>Extensive</td>
<td>None</td>
<td>Some; maybe increasing</td>
<td>Substantial</td>
</tr>
<tr>
<td><strong>Engagement with public regulation</strong></td>
<td>Minimal</td>
<td>Extensive</td>
<td>None</td>
<td>Some; but largely to limit liability</td>
<td>Unknown</td>
</tr>
</tbody>
</table>
Our second article, Liability Insurer Data as a Window on Lawyer’s Professional Liability, -- Irvine L. Rev. (forthcoming) compiled and analyzed publicly available lawyers liability insurance claims data to report, among other findings:

the frequency of lawyers’ liability claims, the distribution and cost of claims by type of practice, the disposition of claims, and lawyers liability insurance premiums from the early 1980s to 2013. Notable findings include remarkable stability over thirty years in the distribution of claims by area of practice among both small and large firms, a large percentage of claims (64-70%) involving de minimis expense (less than $1000) in the small firm market, and in the large firm market a declining rate of “real claims” per 1000 lawyers, a declining rate of real average gross loss per claim, and stable real premiums per lawyer since the early 1990s.

While these findings were interesting (to our minds at least), we cautioned that they may not be generalizable because the data were biased and flawed in a number of ways. Better data are unlikely to be available anytime soon. Thus, understanding more about lawyers’ liability and insurance will require qualitative research.

Our third article, Insurers as Bumblebees in the Garden of Law Firm Norms, is still in working paper form, not yet posted on SSRN. The current draft of the abstract follows:

This article describes the mechanisms by which carriers influence law firm behavior. Rather than viewing insurers as generating and enforcing risk management and loss prevention rules, the article describes a symbiotic system where insurers act, as one industry insider stated, “as the bumblebee that cross pollinates” best practices and industry norms among large law firms. Legal malpractice insurers and brokers, through extensive contact with law firms and legal malpractice claims, gather law firm risk management best practices. They then disseminate those norms to law firms that are hungry for the information. This relationship helps insurers mitigate moral hazard and helps law firms that desperately want to avoid claims regardless of financial exposure. This article contributes to the extant literature in several ways. First, it identifies and describes a new institutional actor that plays a previously unreported role in disseminating norms of law firm governance. Second, by studying a market where there is a demand for loss-prevention services bundled with risk transfer, this article offers a marketing explanation for that bundling that goes beyond the simple moral hazard explanation relied on in the prior literature. This, in turn, helps shift the traditional conversation of insurance as governance to better describe the agency of the policyholder in the relationship. Lastly, this article contributes to the conceptual model of tort as deterrence by offering an explanation of how the non-diversifiable consequences of liability can lead to a demand for loss prevention services bundled with risk transfer.
The Organization of Lawyers’ Liability Insurance Companies: Mutual and Stock
Tom Baker and Rick Swedloff

One striking feature of the medium to large law firm lawyers’ professional liability (LPL) insurance market is the prevalence of specialized, lawyer-owned mutual insurance organizations. The largest insurer in the LPL market is a well-known lawyers’ mutual insurer – Attorneys Liability Assurance Society (ALAS). In addition, a substantial number of New York City and California-based law firms have long had their own separate mutual insurers.¹

Even more notably, these mutual insurers all have stable, complementary relationships with large, general-purpose property and casualty (re)insurance companies. These complementary relationships are notable because, in the corporate law and insurance literatures, mutual insurers are understood to compete with “stock” insurance companies (corporations with shareholders organized according to the traditional American model), not to cooperate with them. Moreover, because stock insurers have access to all of the forms of capital available on the financial markets, they should – absent a market failure – be better able to spread risk than mutual insurers, which have access to more limited capital market instruments (because of the requirement that mutuals be owned by their members). The puzzle for the corporate law and insurance literature is why mutuals are so prevalent in the insurance market, given that they face this disadvantage (e.g., Hansmann 1985 & 1996, Ligon & Thistle 2005 & 2008, Mayers & Smith 1988, MacMinn & Ren 2011). Better access to capital should allow stock insurers to out-compete mutuals, unless, of course, there are market failures that provide a countervailing competitive advantage to mutual insurers.

In this article we draw upon our qualitative research into the medium to large law firm LPL market to explain the role of mutual insurers in that market and to begin to reframe the scholarly understanding of the relationship between organizational forms in the commercial liability insurance market more generally. Our title signals the core insight behind this reframing. Borrowing from the title of Henry Hansmann’s important 1985 article, “The Organization of

¹ We take a functional approach to what constitutes a “mutual” insurer, not an insurance regulatory approach, with the result that, for us, member-owned captive insurance companies, member-operated risk retention groups, and even member-operated risk purchasing groups all qualify as mutual insurers, subject to differences that we will highlight as appropriate.
Insurance Companies: Mutual versus Stock,” we change his “versus” into an “and” – so that that we have “mutual and stock,” rather than “mutual versus stock.” This difference signals the complementary, and perhaps even symbiotic relationships that we encountered in the LPL insurance market. While there is spirited competition in that market and some ebb and flow in the relative market shares of the different kinds of organizations, our research shows that the different organizational forms play complementary roles. For example, the mutual insurers all purchase reinsurance from commercial insurers, and most of them also arrange their members’ purchase of commercial LPL insurance for higher-level excess layers of protection.

Our qualitative observations largely are consistent with Hansmann’s explanations of the reasons for mutual insurance in the property and liability insurance market: mutual insurers have a comparative advantage in addressing certain market failures that are endemic to insurance markets (Hansmann 1985 & 1996). Consistent with his analysis, many of our respondents report that lawyer mutuals are better than stock insurance companies at grouping together comparatively less risky law firms (managing adverse selection) and encouraging loss prevention (managing moral hazard).²

We improve on Hansmann’s analysis by explaining how mutual liability insurance organizations manage a long-term liability insurance contracting problem that was not well understood at the time Hansmann conducted his research. This problem derives from insureds’ vulnerability to classification risk (the risk of becoming more risky) and continuity risk (the risk of gaps in coverage from changes in contracts or insurers) in the claims-made form of insurance that became dominant in the LPL market during the late 1970s (Works 1999) and to the periodic reductions in insurance supply that occur during the hard market phase of the underwriting cycle (Harrington 2004). The ability of the mutual LPL insurers to protect law firms from classification and continuity risk and from loss of capacity during hard markets provides substantial benefits to their members.

Hansmann certainly understood the ability of mutual insurers to solve long-term contracting problems. Indeed, this was one of his primary explanations for mutual life insurance. Moreover, it was his explanation of how mutual life insurers solved the long-term contracting problem that crystalized for us the economic reasons behind our respondents’ emphasis on

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² As we discuss in part II, some of the brokers and commercial insurance underwriters disagree, raising an interesting question about the ability of brokers to provide a quasi-mutual experience for large law firms that buy purely commercial insurance.
“stability” as one of the most important reasons that law firms joined mutual LPL insurance organizations. Accordingly, we think of our analysis as a friendly amendment to Hansmann’s, based on more focused institutional research and benefiting from thirty more years of research into the liability insurance market.

The Article proceeds as follows. In part one we introduce the three forms of mutual insurance presently operating in the medium to large firm lawyers’ professional liability market (which we will refer to simply as the “LPL market,” with the understanding that, unless we indicate to the contrary, we are not making any claims about insurance for firms smaller than about 35 lawyers). We then describe the relationships between these mutual insurers and commercial insurers, highlighting their complementary roles. In part two we report what we learned from our qualitative research about the benefits of belonging to a mutual LPL insurance organization. In part three we integrate our qualitative findings into the scholarly account of mutual insurance. In concluding, we explore the degree to which our findings and analysis may be generalizable to the broader commercial liability insurance market.

The evidentiary base for our research comes from four sources: a series of over 50 semi-structured interviews with participants in the medium to large law firm LPL market; participant observation in law firm and insurance settings; the insurance and legal trade literature; and the legal and general business press. Our interviews were confidential. When we quote our respondents we identify them only by number and, where appropriate, by title. We identify details of the operation of specific organizations only as necessary and, with regard to information that we understand to be sensitive, only if we were able to obtain that information from public sources or from respondents who were not closely connected to that organization.

1. Mutual Insurance Organizations in the LPL Market

For law firms in the United States that have more than 35 lawyers, there are three alternatives to purchasing a primary insurance policy directly from commercial insurers (i.e. stock insurers and Lloyd’s of London syndicates): (1) a relatively large, national mutual insurance

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3 The large, general-purpose mutual property casualty companies such as Liberty Mutual and State Farm do not provide LPL insurance. Separate treatment of the stock insurance companies and the Lloyd’s syndicates awaits future work. Historically, Lloyd’s syndicates were owned by their managers, who obtained the necessary capital from individuals who were completely passive, as distinguished from stock insurance companies, which were owned by the individuals who provided the capital – i.e. the shareholders. Today, we suspect that institutional investors own
company that is the largest insurer of such law firms in the U.S.; (2) three smaller and more geographically focused mutual insurance arrangements; and (3) a risk purchasing group for mid-sized law firms. Not all law firms have these mutual insurer options, and not all law firms that have these options use them, but altogether these organizations provide insurance for over 80,000 lawyers, including about half of the AmLaw 100 and 200, and a sizeable number of smaller, high-quality boutique and regional law firms. Drawing on the most recent lawyer demographics, this number accounts for at least one third of all of the lawyers working in firms larger than 21 lawyers.4

A. The Big Mutual: ALAS

ALAS is short for the Attorneys’ Liability Assurance Society, the largest, best-known, and most public mutual insurer in the LPL market. ALAS was formed by 31 large U.S. law firms in 1979, during a relatively quiet period in the LPL insurance market between the two most significant crises in the U.S. liability insurance market (Baker 2005 & 2013). Donald Breakstone, a former ALAS general counsel and former partner in a large Chicago law firm who helped to create ALAS, described the origins of ALAS and the central goals and beliefs of ALAS members as follows:

ALAS' core purpose for existing, and the need that brought its member firms together in 1979, was to provide stable and high quality professional liability coverage to its large law firm members. What drew the initial 31 member law firms together were several commonly held goals and beliefs, namely that:

- Commercial insurers providing professional liability coverage to large law firms were unstable and inconsistent providers - insurers could and did enter and leave that market at will, making it difficult, if not impossible, for large law firms to count on the continual availability of needed coverage;
- Large law firms were not rated by commercial insurers as an independent risk class - instead large law firms were lumped together with individual lawyers, small law firms, individual accountants, small accounting firms,

most of the shares in the stock insurance companies and also supply most of the capital to Lloyds, indirectly through their ownership of the shares of the companies that directly provide capital to Lloyds. Lloyd’s became predominantly corporate in the years following the Reconstruction and Renewal process of the early 1990s.

4 The ABA reports that there were 1.3 million licensed lawyers in 2015, an uncertain number of which are actually in practice. (ABA 2015) Of those in practice in 2005 (the most recent year for which we have the following breakdowns), 75% were in private practice. Thus, 975,000 is an upper bound of the lawyers in private practice. Of the lawyers in private practice 16% (156,000) work in firms of 100 lawyers or more, and 10% (97,500) work in firms of 21-100 lawyers. (American Bar Foundation 2012)
and the then Big 8 accounting firms in assessing risks and establishing "proper" premium; and

• Large law firms, bound together in their own mutual facility, were in a much better position than commercial insurers to understand and meet the professional liability needs of their own profession through a broad policy form, fair claims management, and a state of the art loss prevention program.

(Breakstone 2005).

Originally organized in Bermuda in 1979 as a mutual insurance company, ALAS reorganized in 2013 as a Vermont domiciled captive insurance company that is owned by its members (ALAS 2014 at 9). For present purposes, the ALAS captive is properly regarded for economic purposes as a mutual insurer, recognizing that its status as a Vermont captive, rather than an ordinary mutual insurance company, means that it is subject to less stringent financial regulation and reporting requirements than a company like State Farm Mutual Automobile Insurance Company or Liberty Mutual Insurance. For our purposes the differences between an ALAS kind of captive and a traditional mutual are regulatory rather than economic. In each case the members are both policyholders and owners, and there are no shareholders or other outside investors with an ownership interest. As a practical matter, the regulatory difference means that ALAS is even more of a true mutual organization, as the lower regulatory scrutiny requires greater self-regulation by members. ALAS is rated by public rating agencies (currently Best’s and Fitch), and it releases its annual reports to the public, both of which distinguish it from the small lawyer mutuals discussed next.

As of January 1, 2015, ALAS had grown to 220 member firms, with 58,178 practicing attorneys (ALAS 2015). Most of the growth in the number of firms occurred when “the commercial market abandoned large law firms in the mid-1980s” liability insurance crisis (Risk Retention Reporter 1997). This crisis was the most extreme event in the U.S. liability insurance market since industry wide data have been collected (Baker 2013). In the “non-statutory” lines of liability insurance (i.e. other than auto and workers compensation) aggregate premiums more than

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5 The concept of a “captive” insurer began as a mechanism for large corporations to adapt the insurance form to what is functionally a self-insurance program, with minimal regulatory oversight. There then developed multi-member captives, which, for present purposes, can be understood as lightly regulated, non-transparent mutual insurance companies. Typically, captive insurance companies are not required to make their financial statements or other information publicly available. ALAS makes public far more information about its finances and operations than it is legally obligated to do.
doubled over a two year period in which the supply of insurance shrunk significantly, indicating that insurance prices for a given amount of coverage increased by much more (Baker 2013).\(^6\)

ALAS members are closely involved with ALAS. As a condition of membership, ALAS has always required member firms to have a partner in charge of loss prevention (ALAS 2002 at 20). These partners are the backbone of the ALAS committee structure, which oversee core functions such as claims, member services (including underwriting), loss prevention, investments and reinsurance. ALAS also has a significant permanent staff, the senior members of which have traditionally been drawn from member law firms.

ALAS describes its membership philosophy as one of “preferred risk underwriting” (ALAS 2015). Membership is limited to high quality firms of at least 35 lawyers (many significantly larger) with an acceptable “management structure, claims history, and approach to loss prevention” (ALAS 2015 at 22). At least in the jurisdictions with which we are familiar, the law firms that are ALAS members do tend to have an elite reputation. ALAS members include 77 of the AmLaw 200, 28 of the AmLaw 100 (listings of the 200/100 most profitable U.S. law firms), and 6 of the 22 firms with more than 1000 lawyers, with a conspicuous under-representation of California and New York City law firms that is the result of underwriting decisions made in the early years of ALAS’ existence (Baker & Swedloff 2015).

Some of the distinguishing features of the ALAS approach to LPL insurance include the following:

- ALAS engages in “unitary pricing,” meaning that all member firms are charged the same per lawyer price for a given combination of “self-insured retention” (similar to a deductible) and limit of coverage. Because of differences in firm size, retentions and limits, however, member firms pay different total premiums.
- While ALAS prices in the early years tended to be lower than those prevailing in the commercial market (most notably during the hard market conditions of the mid-1980s), ALAS announced in the early 1990s that it would not to try to beat commercial market prices in absolute terms but rather to offer more consistent pricing over time (Risk Retention Reporter 1997). In the mid to late 1990s

\(^6\) The publicly available information about insurance premiums is taken from financial reports that provide only the aggregate premiums collected, not the prices charged for that insurance.
ALAS pricing for large law firms was considerably higher than the commercial market (Breakstone 2005).

- ALAS has a significant full time staff (100 employees as of 2008), with a large percentage of lawyers involved in claims management, loss prevention, underwriting, and general management (Risk Retention Reporter 2008).
- ALAS has an active loss prevention program traditionally run by former partners from member firms.
- ALAS has the right to approve members’ selection of claims counsel, and it participates actively in the management of claims.
- As owners, ALAS member firms have rights to ALAS’ capital, which as of December 31, 2014 amounted to about $580 million (about $10,000 per insured lawyer) (ALAS 2015 at 3). Member firms have the right to return of capital when they leave ALAS, but the payments are “subject to certain forfeitures” and are made over a period of five years (ALAS 2015 at 74).
- ALAS members tend to remain members. As an illustration, ALAS reports that when non-member firms merge with member firms the resulting merged firm almost always remains an ALAS member.7

B. The Small Mutuals: BAR, MPC, and AIM

To a significant degree, the three small mutual LPL insurance organizations owe their existence to underwriting decisions made by ALAS in the early years. At inception ALAS members elected to exclude New York City firms and to discourage the participation of California firms, among other ways by charging California firms higher premiums (ALAS 2001). A senior LPL broker explained to us that this ALAS policy was the result of an underwriting policy of ALAS’s most important reinsurer. This meant that firms in New York City and California had to create their own mutual insurance arrangements: a group of large Wall Street

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7 The current count of member firms is down from a high of 374 firms in 1991, largely as a result of the consolidation of the legal market during that period, rather than the loss of members to the commercial market. ALAS reports that most of the reduction in member firms is attributable to mergers, and that, on the whole, mergers have resulted in an increase in the number of lawyers that ALAS insures. The current count of lawyers is down from a high point of 63,420 in 2008, largely as a result of attrition at member firms following the financial crisis of 2008 (ALAS 2010).
firms formed BAR; the large San Francisco firms formed MPC; and a group of Los Angeles and other California firms formed AIM.

As a group, these three small mutual insurers are even more protective of their organizational details and practices than ALAS. They do not release annual reports and, as a rule, neither the organizations nor their members make public statements about their operations. All of the sensitive information we report here about each of the three comes from public sources or from individuals who are well-informed about the operation of the mutual in question but who are not members or managers of that mutual, though we have attempted to verify the accuracy of this information through interviews of people who are closely involved with each mutual.

B.1. BAR

Bar Assurance and Reinsurance Limited, is a Bermuda Based captive insurance company organized in 1979 by 21 New York City firms. Today BAR has just under 20 member firms, all still based in New York City, with about 12,000 practicing lawyers. BAR differs from ALAS in a variety of ways in addition to its size and geographic concentration.

First, BAR does not have its own staff. Like the other small mutuals, BAR is managed by a major insurance brokerage firm, in this case Aon, with the assistance of committees primarily composed of partners from member firms. Aon manages BAR and arranges for all of the LPL insurance of BAR firms, not just the layers with BAR participation. Aon’s large presence in the LPL market is attributable to Aon’s acquisition of the Minet brokerage, which was originally based in Montreal, where it served as the North American point of contact for the London Market’s extensive U.S. professional liability insurance customer base.

Second, BAR does not provide its member firms a complete layer of either primary or excess insurance. Instead, BAR participates as a minority interest in “quota share” primary and excess layers of insurance, with the majority interest provided by commercial insurers – either

8 The National Law Journal reported in 1992 that the following firms were members: (1) Cadwalader, Wickersham & Taft; (2) Chadbourne & Parke; (3) Cleary, Gottlieb, Steen & Hamilton; (4) Cravath, Swaine & Moore; (5) Davis Polk & Wardwell; (6) Debevoise & Plimpton; (7) Dewey Ballantine; (8) Donovan Leisure Newton & Irvine; (9) Fried, Frank, Harris, Shriver & Jacobson; (10) Kaye, Scholer, Fierman, Hays & Handler; (11) Lord Day & Lord, Barrett Smith; (12) Milbank, Tweed, Hadley &McCloy; (13) Mudge Rose Guthrie Alexander & Ferdon; (14) Paul, Weiss, Rifkind, Wharton & Garrison; (15) Proskauer Rose Goetz & Mendelsohn; (16) Rogers & Wells; (17) Shearman & Sterling; (18) Simpson Thacher & Bartlett; (19) Sullivan & Cromwell; (20) White & Case; and (21) Winthrop, Stimson, Putnam & Roberts (Adams 1992).
stock companies or Lloyd’s syndicates. In a quota share insurance arrangement, a group of insurers each takes a share of the risk in a layer of insurance, similar to the way that a Lloyd’s syndicate operates. BAR acts as one of those insurers in at least the primary and first layer excess layer of coverage purchased by member firms. For example, the New York Law Journal reported in 1993 that BAR was responsible for 10% of the $20 million primary insurance lawyer, 7.5% of the first layer excess insurance policy of $20 million and 15% of a second layer excess insurance policy with an unspecified limit (Adams 1993). Over time BAR has substantially increased the share of the risk that it takes on behalf of its members, while always taking a minority position in any specific layer.

Third, the “lead insurer” for each layer of insurance is a commercial insurer, not BAR (Adams 1994). The lead insurer sets the price for that layer, with the result that BAR firms as a group pay a market price for all of their insurance. This arrangement means that BAR members do not have access to the extensive confidential information that other members submit as part of the renewal process – a confidentiality-preserving arrangement that distinguishes BAR from the other two small mutual LPL insurers.

Fourth, the BAR insurance program consists of three-year LPL insurance policies, typically rolled over each year (meaning that members get new three-year policies each year), providing protection to BAR members against short-term price increases. BAR has the option in any particular year not to roll over the policy into a new three-year policy with a new price, but rather to keep the same policy at the same price for one or two more years. This means that BAR always has the option to continue with the same insurance at the same price for two more years. One respondent told us an instructive story about a meeting with BAR members and Hank Greenberg, former head of AIG, at a time when Greenberg wanted to substantially increase premiums. Apparently no one told Greenberg that the BAR had a three-year policy, so his attempted bullying was ineffective: the BAR firms responded, first, by exercising the option to keep the AIG coverage in place at the then current price and, second, by replacing AIG in the BAR program.

Fifth, the prices each firm pays for their primary and first layer excess policies are based on a per lawyer unitary rate, with debits or credits that reflect unusually poor or unusually good

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9 The New York Law Journal reported that BAR switched the lead primary position from one Lloyd’s syndicate to another in 1993 because the former syndicate refused to continue to offer three-year policies (Adams 1994).
claims experience. For higher-level excess policies, firms pay an individualized, risk-rated price, with BAR functioning as a purchasing group that seeks to ensure consistent access to the high levels of insurance needed by firms with a Wall Street corporate transaction practice or a high stakes, bet-the-company litigation practice: limits of $500 million or even more.

Finally, the BAR policies authorize member firms to pick their own defense counsel for any liability claim, without the need for approval from BAR or any of the insurers that participate in the BAR program. Reportedly, BAR insurers do not second-guess defense strategy or expenditures. Firms cannot settle their claims without the consent of their insurers, but the BAR claims committee – the members of whom are sworn to secrecy (consistent with BAR’s emphasis on preserving confidentiality) – play an active role in that process, reportedly to the general satisfaction of BAR members and the insurers on the risk.

In other ways, BAR is similar to ALAS. BAR member firms have significant paid in capital. BAR member firms are an elite group, arguably even more elite on average than ALAS members. BAR emphasizes loss prevention, though not through as formal a program as ALAS. Finally, BAR members appear to be as loyal, or perhaps even more loyal than ALAS members. While 4 of the original 21 member firms have dissolved and two other member firms merged with firms that have different LPL insurance traditions, the rest remain BAR members – a full 36 years after formation.10

B.2. MPC

Originally known as the “Managing Partners Council,” MPC began in the early 1980s as a “mass-purchasing vehicle under which [the firms] self-insure the first $100,000 of potential liability. The next $500,000 of liability risk is shared. After that, member firms collectively buy insurance.” (Galante 1985) Today, MPC is a Vermont captive insurance company that provides a $10 million primary insurance policy and an excess policy that is supported by commercial reinsurance, and arranges for the purchase of substantial amounts of excess insurance for a small group of law firms predominantly based in San Francisco. MPC is managed by the insurance brokerage giant, Marsh, with the very active participation of lawyers from the member firms.

10 Of the original 21, the four that dissolved are Dewey, Donovan, Lord Day, and Mudge Rose; the two that merged with firms known to obtain their insurance in other ways are Rogers & Wells (merged with the UK firm Clifford Chance) and Winthrop Stimson (merged with Pillsbury, which remains a member of MPC, as indicated by the report on the firm’s website that the General Counsel is on the board of directors of MPC). We understand that at least one firm has joined since the list was published in 1992.
MPC provides primary insurance and arranges for excess policies “written by many other insurers” with limits of at least $150 million per claim and $300 million aggregate (Dorsey & Whitney). According to the website of its current chairman, MPC presently is “owned by 9 national and international law firms [and] provides professional liability insurance coverage for more than 7,000 attorneys practicing in the United States and in many foreign jurisdictions.” While the center of gravity remains San Francisco, MPC members include at least two large firms that are based elsewhere.\(^{11}\)

MPC’s primary layer of insurance is actually a commercial insurance policy, issued by Lexington Insurance Company, a member in the AIG insurance group with a very high credit rating. Because MPC provides 100% reinsurance for that Lexington policy, all of the risk transfer is provided by MPC, provided that MPC remains solvent. In this kind of “fronting” insurance arrangement (which is a relatively common approach for large scale commercial enterprise), the law firms get the benefits of mutual insurance and a high credit rating, without the mutual needing to go through the effort required to get its own credit rating. BAR’s use of a lead commercial insurer provides a similar benefit to BAR members. (ALAS, by contrast, has gone through the effort to obtain a credit rating.) In addition, the fronting insurance arrangement provides MPC members a measure of protection in the event that MPC becomes insolvent. ALAS and BAR members do not have that protection.

MPC operates in a fashion that combines elements of the ALAS and BAR approaches, with an annual member auditing process that is more extensive than either.\(^{12}\) Like both ALAS and BAR, MPC member firms have paid in capital with some restrictions on return of that capital.

\(^{11}\) Dorsey & Whitney, which is based in Minneapolis, has publicly identified that it is a member of MPC. We infer that ReedSmith, which is based in Pittsburgh, is a member from the fact that the firm website indicates that the COO is a member of the MPC finance committee and a senior lawyer who is of counsel is President and Chairman of MPC.

\(^{12}\) A broker who is not associated with MPC described the process to us as follows:

  It’s pretty intrusive. They have sit-down meetings with people and they can walk through the hallways, apparently, and pick somebody out of thin air and start interviewing them, asking them if they’ve read the manual, do they understand whatever issues they’re dealing with at the time. (10)

A commercial insurance executive provided a similar account:

  I will tell you that if you talk to the MPC people—and you probably can—they’ve had unbelievably good results, at least they had when I was looking at them—even though some of their firms like [] have seen some tough days, they would argue that it was all about peer review. It was all about their ability to ask questions that no firm was gonna answer an insurance underwriter about. Now I would argue you can ask those questions if there’s ten of you and you’re all going to the Olympic Club together. (16)

ALAS also has extensive member audits, but on a less frequent basis.
in the event of withdrawal. Like ALAS, MPC provides a full primary layer of insurance to its members (through the Lexington fronting insurance arrangement) and sets the price for that insurance using its own judgment. Like BAR, MPC uses modified unitary pricing with a standard per lawyer premium with adjustments based on claims experience. According to a competitor of MPC, MPC risk rates members with poor claims history in two ways: charging a higher per lawyer premium for at least the primary $10 million policy and requiring the firm to carry a higher self-insured retention.

MPC appears to be more involved in the claims management process than BAR, but less so than ALAS. Thus, among the large law firm mutual insurers, the claims handling autonomy spectrum ranges from a low among ALAS members to a high among BAR members, with MPC in the middle. MPC also appears to fall between BAR and ALAS in terms of formal loss prevention activities. With that said, an attorney in one MPC member firm who claimed to be knowledgeable about ALAS loss prevention efforts, asserted that MPC’s loss prevention efforts were more cutting edge and better tailored to the firms in MPC. For our purposes the truth of this assertion is less important than the value that it suggests MPC places on loss prevention. Because of the smaller size and greater homogeneity of the firms in MPC as compared to ALAS, it makes sense that MPC could develop more tailored loss prevention programs. Of course, smaller size and greater homogeneity don’t guarantee that a mutual will develop more tailored approaches to loss prevention than ALAS, as suggested by reports that BAR plays a less central role than MPC or ALAS in the loss prevention activities of its members.

Like BAR, MPC does not have any full time employees, relying, instead, on its broker/manager Marsh and on committees composed of lawyers from member firms. Because MPC does its own underwriting, however, this means that lawyers from member firms engage in detailed review of the policies and procedures of other firms. A broker (not involved in MPC) reported that MPC members consider the ability to look into the other member firms as a plus: “I wouldn’t want to be in a group where I didn’t know what the other guy, the other members were like. It’s like joining a club and you realize, my god, it turns out not to be the golf club, it’s the Hell’s Angels.” We expect, but were not able to confirm, that MPC relies on Marsh or other consultants to review detailed financial records of member firms, preserving the confidentiality of that competition-relevant information.
B.3. AIM

Attorneys Insurance Mutual Risk Retention Group (AIM) is a Hawaii-domiciled risk retention group that is the successor to a Barbados-based group captive formed in 1985 (during the second and most extreme liability insurance crisis) by a group of 21 California-based law firms with about 1500 lawyers. Most of the firms shared a common broker and had been insured by the same insurance company (Shand Morahan), which left the California market at that time. While that group included Manatt Phelps and Wilson Soncini, AIM members today tend to be smaller firms than the members of MPC or BAR. Consistent with that pattern, the only two firms that ever left MPC in favor of AIM are mid-sized firms.

Today, AIM has 13 law firm members with a total of 2500 lawyers. In organizational structure AIM is closer to MPC than BAR. Although AIM has a contract with Aon to provide administrative services, AIM members play a larger role in managing AIM than BAR members play in managing BAR. AIM committees set prices, adjust claims (with the assistance of a full time outside counsel), conduct audits, prepare and update their loss prevention manual, and decide whether to admit new members. AIM’s annual member audits are much less intrusive than MPC’s, but that difference may reflect the significantly smaller size of AIM member firms, more than a difference in management philosophy. In contrast to BAR, there is “total transparency” on underwriting and claims among AIM board members; the only aspect of underwriting information that is kept confidential from member firms is the individual firms’ financial information, which is reviewed by AIM’s brokers.

Like MPC, AIM premiums are quasi-unitary, using a formula that penalizes members with poor claims history in an amount that is less than fully risk-rated. In addition, firms with poor claims experience have to carry a larger deductible. Interestingly, prices for higher-level excess policies are unitary. Like MPC, AIM members get all of their insurance through AIM, with excess insurance provided by commercial insurers. MPC retains significantly more risk than AIM. AIM offers its members a $9 million primary insurance policy, but supports that policy by buying reinsurance in the commercial insurance market. Thus, as compared to MPC, AIM’s risk transfer arrangements are more like a group purchasing service than a mutual insurer.
C. The Risk Purchasing Group: PilotLegis

PilotLegis is the trade name of a risk-purchasing group chartered in California as the “Professional Insurance Liability Organization, Inc.” and headquartered in Minneapolis. Unlike the other groups, PilotLegis does not assume any risk, though it reportedly has an organizational structure in place that would allow it to assume risk if it were unable to obtain adequate insurance in the commercial market.\(^\text{13}\)

PilotLegis has 40 member firms, all of which are mid-sized law firms (20-200 lawyers), with a total of 1600 lawyers, with about half practicing in California. Aon manages PilotLegis. Aon supplies all of the professional staff and, with the exception of the board of directors, Aon employees are members on each of the active committees: risk management, claims, marketing, membership and standards, and strategic planning. Aon plays a larger role in setting the agenda for PilotLegis than the broker/manager in any of the small mutuals, but law firm members are actively involved in creating and maintaining the culture. Membership has grown largely through referrals, and there is an expectation among at least some of the firms that membership in PilotLegis can lead to business relationships among the firms that extend beyond PilotLegis.

The PilotLegis website contains the following statement from its chairman (Jeffrey Sharp, managing partner of a Chicago-based intellectual property firm) about the group’s history and approach:

PilotLegis was formed in 1991 to generate purchasing power for midsized firms that were willing to embrace risk management procedures in order to obtain the best possible coverage at the best possible rates. PilotLegis members have never wavered from these goals, and the group is thriving. Our claims experience is excellent, our risk management efforts are innovative, and our coverage, policy terms and security are extremely strong, all of which contribute to a program that works well for our members and our underwriters.

Through group purchasing power, our members enjoy preferential treatment in the LPL marketplace, more predictable pricing, and a stable source of insurance. Member firms also learn from each other in a myriad of ways, including the sharing of risk management and practice management procedures, a cornerstone of the program.

PilotLegis member firms pay individual risk-rated premiums with an expectation that premiums will go up and down through the underwriting cycle at a rate that is smoother than

\(^{13}\) Risk Retention Reporter (1999).
would be possible for the firms on their own. The PilotLegis website describes the group’s pricing approach as follows:

PilotLegis was not designed to “beat the market,” but rather, offers stability through both multiyear and annual policies at competitive, intelligent terms. Where PilotLegis is different is in our approach to risk management. We have a passion for helping law firms identify and reduce their risk, leading to fewer claims, better service for claims when they do arise, and stronger long-term relationships with underwriters. In this way, PilotLegis offers law firms a superior value. For law firm managers, the savings are generated through lower operating costs and reduced risk. Members understand that PilotLegis is not just an insurance product, but also a better way of doing business.

The claims committee participates actively in the management of claims, for example by approving the appointment of defense counsel and remaining involved in the settlement of claims.

The table below presents some of the characteristics of these five LPL mutuals in summary form.

<table>
<thead>
<tr>
<th></th>
<th>ALAS</th>
<th>BAR</th>
<th>MPC</th>
<th>AIM</th>
<th>PilotLegis</th>
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<td>&lt;10</td>
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<td>Quasi-unitary</td>
<td>Quasi-unitary</td>
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</tr>
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<td>commercial market</td>
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<td>none</td>
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</table>
D. PLUG – The Professional Liability Underwriting Group

The final LPL mutual is the Professional Liability Underwriting Group, which issued insurance policies from mid 1980s through 1991. PLUG was a captive insurer organized for a group of about 15 large law firms during the insurance crisis to plug a gap in a tower of insurance (Adams 1992).14 The choice of the name – PLUG – was intentional. The broker for the law firms involved – Minet, which is now owned by Aon – was unable to obtain coverage for the law firms in the commercial market for what was at the time a relatively high level excess layer of insurance. With Minet’s help, the law firms created a captive that provided the missing layer of insurance, with the expectation that the captive would be used only as long as that layer could not be placed in the commercial market. As of 1992, the firms were able to obtain the coverage on acceptable terms in the commercial market, so PLUG stopped issuing new policies to its members (Adams 1992). Because PLUG was a short-term solution to a capacity limit in the commercial market, it did not have the kinds of committees, collective loss prevention efforts, or other features of the other mutual insurers described in this section.

E. Relationships between the LPL Mutuals and the Commercial Market

All of these mutual insurance arrangements have significant commercial insurance aspects. At one end of the continuum there is PLUG: a short-term, broker-driven mutual component in an otherwise purely commercial LPL program. At the other end is ALAS: a large LPL mutual with a sizeable staff that uses the reinsurance capacity of the commercial insurance market and whose larger members buy high level excess insurance on the commercial market on their own, without assistance from ALAS. The other mutual insurers occupy intermediate positions on this continuum:

- PilotLegis is a risk purchasing group, so all of its members are entirely insured by the commercial insurance that PilotLegis and Aon arrange for them. Nevertheless, because PilotLegis has committees, audits, and an expectation of permanence, the LPL arrangements of PilotLegis members are more mutual in

14 The New York Law Journal reported in 1992 that the members of PLUG were: Bingham, Dana & Gould; Breed, Abbott & Morgan; Cahill Gordon & Reindel; Dechert Price & Rhoads; Eckert Seamans Cherin & Mellott; Hale and Dorr; Irell & Manella; Kelley Drye & Warren; Latham & Watkins; McGuire, Woods, Battle & Boothe; Piper & Marbury; Skadden, Arps, Slate, Meagher & Flom; Thelen, Marrin, Johnson & Bridges; and Weil, Gotshal & Manges (Adams 1992).
nature than those of the firms in PLUG. While PilotLegis doesn’t presently assume risk, it claims to be ready to do so.

- AIM differs from PilotLegis in being less broker-driven and, of course, it already bears risk, so AIM is a step further along the mutual continuum. Nevertheless, at least in terms of risk transfer, it functions primarily as a buying service for commercial insurance.\(^\text{15}\)

- BAR takes on much greater risk than AIM, but it relies on commercial insurers to take the lead in underwriting and pricing. In addition, BAR members obtain all of their higher-level excess insurance from the commercial market.

- MPC has a more arms-length relation with its brokers than BAR or AIM, and its members have a more active involvement in pricing than BAR, but MPC’s substantial layer of primary “insurance” is actually reinsurance that backs a primary insurance policy provided by a commercial insurance company. While that commercial insurer hopes never to have to pay its own money, it would have to do so if MPC were to become insolvent. Like BAR, MPC functions as a buying service for higher-level commercial excess insurance.

What all this means is that, at least in the LPL market, mutual and commercial insurance are complements. Except for those ALAS member firms that only buy the lowest levels of coverage (which are not reinsured), the members of all of these mutual insurers are shifting a substantial share of their LPL risks into the commercial liability insurance market. And even those ALAS members who buy the lowest levels of coverage, for which ALAS doesn’t purchase reinsurance, depend on the participation of larger firms that would be less likely to stay in ALAS if there were no higher, reinsurance-facilitated levels of coverage. Thus, for firms with the option to join a lawyers’ mutual insurance organization, the choice is not between mutual and commercial insurance, but rather between a mutual/commercial hybrid and commercial insurance.

Indeed, one way of thinking about mutual LPL insurance is not as an alternative to the commercial insurance market, but rather as a mechanism for managing law firms’ access to that market. The mutuals facilitate a risk management and transfer approach in which (1) the partners of individual firms share the lowest, most likely to be accessed layer of exposure through the

\(^{15}\) An informed observer estimated that 95% of the risk transfer for AIM members is through the commercial market.
firms’ self-insured retentions, (2) the member firms share the next exposure layer through the insurance issued by the mutual, and, (3) beyond that, the firms shift their risks to the commercial insurance market.

Even this framing may overstate the separation between commercial and mutual LPL insurance and obscure the degree to which the availability of mutual insurance affects the behavior of commercial insurance companies. AIG’s Hank Greenberg may have overplayed his hand with BAR once – because no one told him about the three-year policy – but he didn’t make that mistake again. Moreover, the presence of the mutual insurance option – not just the existing insurers but also the knowledge that Aon or Marsh or a well-connected specialty broker could help another group of law firms create a new PLUG or AIM or PilotLegis – cannot help but act as a check on commercial insurers, even in their dealings with law firms that exclusively buy commercial insurance.\(^{16}\)

II. The Benefits of Belonging to an LPL Mutual

As the preceding discussion makes clear, there are meaningful differences in the mutual insurance arrangements in the LPL market: in pricing, in the intrusiveness and frequency of the audits of law firms and who does them, in loss prevention, and in claims management. Nevertheless, among all of our respondents who are involved in these organizations, and even some who are not, there was remarkable uniformity about the benefits of belonging to an LPL mutual: stability in LPL insurance relationships; a high quality claims experience; a commitment to loss prevention; insurance premiums that are based upon members’ long-term LPL risk, shielded from the extremes of the liability insurance underwriting cycle; and the solidarity that comes from being part of a larger group of quality law firms. In a story about ALAS, the Risk Retention Reporter summed the benefits as follows: “stable rates, good claims service, proactive loss prevention, and pride in participating with other prestigious firms.”\(^{17}\)

\(^{16}\) Creating a new MPC or BAR would be more difficult because of the amount of capital that those three insurers have accumulated. Creating a new ALAS would have that problem, plus the challenge of creating such a significant organizational structure.

\(^{17}\) See Risk Retention Reporter (2008):

Despite competition for new clients, existing clients are overwhelmingly loyal. Last year, ALAS had a 99% retention rate, following 100% the previous two years. The participating law firms, most of which are large, average about $1 million in retentions per claim before ALAS kicks in. All believe in the mission of ALAS - stable rates, good claims service, proactive loss prevention, and pride in participating with other prestigious firms.
A. Stability in LPL Insurance Relationships

If there is a single dominant theme about the benefits of belonging to an LPL mutual insurer, it is stability. A general counsel who was involved in the founding of one of the mutuals put it this way:

By grouping together we could, and acting as a buyer group we would have greater market power than each firm does individually. The animating principal behind [mutual] is very much one of creating a stable insurance environment for all of its members. I think we all accept that we may be paying a little bit of a premium over what at least those of us that have better claims records could get in the open market for the benefit of having that stability. (32)

In the same vein, another law firm general counsel said:

I’ve never made a close study of the commercial premiums that we would pay versus what we’re paying with [mutual], because I think … it’s the wrong question to ask. … The question to ask is: Will this carrier be there when the crunch comes? (24)

As another law firm general counsel explained, “there are plenty of terrific commercial insurers out there,” but “they have varying degrees to which they are committed to the professional liability market,” and “you don’t want is to be hooked up in a substantial way with an insurer that decides it doesn’t want to write this kind of insurance anymore or having nothing to do with your particular firm.” (34). A long time LPL insurance broker concurred:

I mean, the market’s been so soft for so long, I mean, any law firm could pick up the phone, probably save ten percent just by making one phone call. It’s kind of just the way the market is. No, they’re—the idea with [mutual] and the other groups is they’re pitching stability and sort of pricing continuity and your ability to buy the coverage so you’re not going to find yourself whipsawed in a market that, where—as you used the example of the PLUG group, where you got capacity one day and the next day it’s gone. (10)

Part of that stability includes long-term relationships between the mutuals and the commercial market:

I mean, we really are kind of functioning with using our markets like reinsurers. It’s that sophisticated a relationship. Whereas commercial insurers, direct insurers, if you’re dealing with a one-on-one firm relationship, it tends to be much less stable. That’s what creates issues in the market, because the competitiveness of the market has to respond to that lack of loyalty, which is there, generally speaking. (5)
Stable, long-term relationships with insurers are especially important when buying the claims-made forms of liability insurance used in most of the LPL (and other professional liability) markets. Claims-made liability insurance provides coverage only for claims that are first made during the policy period, and, with limited exceptions, claims-made insurance does not cover any claims that are made in the future, even if the allegedly wrongful conduct occurred during the policy period. By contrast, “occurrence” coverage, which was common in professional liability insurance before the mid-1970s (and remains the prevailing form of coverage in the personal and much of the commercial general liability markets), provides coverage based on when a law firm provided the professional services that are the basis for the claim.

Liability insurance coverage is a highly technical subject, with important nuances, and it is easy to overstate the differences between claims-made and occurrence coverage. Nevertheless, there are several meaningful differences between the two forms of coverage that affect the ability of law firms to shift their liability risks:

- Claims-made insurance is priced closer in time to the filing of any claim that is covered by the policy, with the result that firms bear more classification risk (the risk of becoming more risky);
- Because claims-made insurance covers the claims of today based on the mistakes of the past, insurers are especially concerned about adverse selection (e.g. a law firm buying more insurance or switching to another insurer after becoming aware of a problem); and, relatedly,
- The structure of claims-made insurance exposes law firms to “continuity risk,” which is the risk of significant gaps in coverage following the annual renewal of an LPL program, especially if one or more of the insurers in the program is replaced.\(^{19}\)

By facilitating long-term, stable LPL insurance relationships, mutual insurers address each of these issues. The mutuals address classification risk through unitary or quasi-unitary

\(^{18}\) Claims-made policies typically permit policyholders to lock in a limited amount of coverage for future claims (1) by filing a “notice of circumstances” that could lead to a claim or, (2) for an additional payment, to obtain coverage for claims that are first made during an “extended reporting period.” These nuances reduce but do not eliminate the differences between claims made and occurrence coverage described in the main text.

\(^{19}\) Continuity risk is related to adverse selection because insurers created the features of claims-made insurance contracts that lead to continuity risk because of concerns about adverse selection. For an extensive discussion of claims-made insurance, see Works 1999.
pricing, which allow the members of the mutual to share more of the classification risk than does the purely risk-based pricing of the commercial market. Unitary and quasi-unitary pricing are only sustainable when the members of an insurance pool credibly commit to remain in the pool even if they are required to pay more for their insurance than they could pay elsewhere.\(^20\)

The mutuals address adverse selection at two distinct moments in the insurance relationship. At the outset of the relationship, they are well-equipped to assess whether a firm is a good fit for the mutual. On a going forward basis, the mutuals’ ability to retain members protects the pool from the adverse selection that would result if the good risks were to migrate out of the pool leaving the bad risks behind.

The mutuals address continuity risk by keeping the same primary insurance contract in place for a very long time, and by making sure that the excess policies that their members purchase are true “following form” policies – meaning that the excess policies have exactly the same terms and conditions as the primary policy. Notably, the one large law firm mutual that doesn’t provide its own primary layer of insurance – BAR – buys three year policies and takes a significant share of the risk under those policies as a way to obtain favorable, consistent policy terms.

B. A High Quality Claims Experience

After stability, respondents reported that the next most important benefit of belonging to an LPL mutual is a high quality claims experience. In the words of one law firm general counsel, “[T]he intangible is the claims control. …. Who’s your lawyer, and how much are they gonna screw around with your lawyer?” (35) Although there are significant differences in the claims handling approaches of the mutuals – with ALAS said to exercise the most centralized control over claims – all of our respondents who are members of or work with the mutuals stressed the quality of the claims experience.

With regard to the small mutuals, our respondents emphasized the degree to which the mutuals allow law firms to control their own claims. Indeed, when asked whether the firm would consider switching to ALAS, members of the small mutuals often mentioned the claims handling

\(^{20}\) The extent of the commitment to ALAS, for example, can be seen in the report from a senior executive at a leading commercial insurer who said that “squeaky clean firms” – i.e. “a firm [with] 10 years of loss experience and never had a claim over the retention” – that bought insurance in the commercial market in 2014 were “probably paying about 30, 35 points off the ALAS rate” (18).
autonomy afforded by the small mutuals as something they greatly preferred to the more active claims management of ALAS.

In contrast, ALAS members stressed the quality of ALAS claims handling. ALAS touts its active claims management as part of its value proposition and, thus focuses more on the quality of its claims management than the autonomy of its members in that process (Breakstone 2005, Risk Retention Report 2008). For ALAS, claims management is a partnership, as one law firm general counsel reported:

When a claim comes in, they are the best in terms of, first of all they are there, and you don’t get a reservation-of-rights letter at the first shot across the bow,\(^{21}\) and it is a clear, cooperative partnering arrangement, where that’s not so in the commercial market, I am convinced. I’m sure the commercial market has good and no-so-good arrangements, but as a founding member, it’s a mutual, so we own a piece of the rock. (24)

To be fair, none of the mutual members that we talked to had any personal experience with another mutual, and most of them had no experience in a purely commercial program, either. What we take from this is that the firms that belong to LPL mutuals have largely been happy with their claims experience, and, when seeking to explain why, they emphasize the features of their mutual that they perceive as being different from the most salient alternative. For the members of the small mutuals, ALAS is the salient alternative. Because ALAS is more centralized and controlling in relation to claims, the members of the small mutuals identify the more decentralized, less controlling approach of their current mutual as a preferred, distinguishing feature.

For ALAS members, in contrast, the salient alternative is buying purely commercial,\(^ {22}\) and, because commercial insurers regularly issue reservation of rights letters, sometimes deny claims based on technical requirements (typically related to continuity risk),\(^ {23}\) and sometimes even get sued for bad faith, ALAS members stress the lawyers-protecting-lawyers, find-the-covered-claim approach of ALAS as a preferred, distinguishing feature. A general counsel of an ALAS member put it this way:

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\(^{21}\) A reservation of rights letter is a letter that insurers need to provide to their insureds in order to preserve the right to refuse to pay a claim in the future (ALI 2015).

\(^{22}\) Most ALAS members are not eligible for BAR; they don’t think of MPC and AIM as alternatives; and we did not interview the smaller ALAS members that might be candidates for PilotLegis.

\(^{23}\) See, e.g., New York Court of Appeals 2009.
I know all the ALAS claims attorneys. I’ve known them for years. They worked our claims, I worked with them when I represented other ALAS firms. I’ve seen them as outside counsel and inside counsel. They’re highly professional, very intelligent and they also are very supportive; … they handle claims in a very good way. I just am aware of enough contrast in the commercial market that, to us at least, the way ALAS handles claims is extremely important. That relationship is worth it to us. (28)

Another general counsel in an ALAS member firm described for us what he called the “horror story” of the Philadelphia law firm Pepper Hamilton, which had a coverage dispute with its commercial insurers about whether a claim should have been filed in a prior year (an example of what we described earlier as “continuity risk”). He contrasted that experience with firms in ALAS:

There’s not the risk of coverage denial. There’s not the risk of being caught between years. … It’s not the case with ALAS that when you give them a claim that they’re looking at the claim with a reason to turn it down. They’re in it for the long term. (27)

Criticizing commercial insurers’ claims practices is one topic on which the members of ALAS and the small mutuals agree. The general counsel of one member of a small mutual reported:

[Mutual] is self-administered, meaning that there are no employees with this company. The firms loan people to do the various functions and so your claims are administered by lawyers from other firms that you know. They are very supportive and helpful. I mean it’s not—not to trash another company too much, but it’s not like you have to call National Union24 and say, “Help me settle this case.” If you’re calling on one of your colleagues in another firm that you’ve been working with for the last 25 years—and so it’s a very interactive approach to claims handling.

While it is not possible for our qualitative research to prove or disprove these accounts, the money-for-promise nature of insurance can create an incentive for opportunistic behavior at the point of claim. Insurance law and regulation attempt to reduce that opportunism, and insurance marketing is directed at alleviating policyholder concerns (Baker 1992). The fact that mutuals are owned by their members may reduce the opportunism incentive, because there are no shareholders whose interests are in conflict with the policyholders. A general counsel in another ALAS member firm expressed that point as follows:

24 National Union is the name of a prominent commercial insurance company in the AIG group of companies.
Q. Do you think you pay a premium for the services that you get?

R: Well, premium is a—that’s kind of a loaded term. In the scheme of things, I don’t think it’s terribly significant, because I think it benefits us on the other end in terms of avoiding claims, and reducing claims, and the size of claims, and the impact of claims.

I think there is—one of the arguments that commercial carriers make—we get solicited a fair amount—is, “If you come with us, you’re going to pay X dollars a lawyer, and that’s Y dollars less than what you’re paying at ALAS.” Well, that may be, but that doesn’t take into account the question as to whether or not this carrier is going to be there when a claim comes in. It doesn’t take into account the loss-prevention services. ... Do we pay for the loss-prevention services? Sure. *We pay for it, but we’re not paying for Chubb’s—we’re not paying out anything to Chubb stockholders.*

Two corollaries to his point are the following. First, because of the long-term stability of their membership and their law firms’ demonstrated willingness to pay a higher price for what is understood to be a higher quality relationship, mutuals have less concern that the higher costs associated with high quality claims handling will drive members away. Second, as discussed further below, the relative homogeneity of the pool may make law firm members less concerned that certain members may “milk” the high-quality claims experience.

**C. High Quality Loss Prevention Services**

The mutual insurers, especially ALAS, have a reputation for providing high quality loss prevention services:

We’re very satisfied with ALAS and I think it does a terrific job not only with respect to clients but with respect with loss prevention programs and so forth. (30)

They’re the best in loss prevention support and assistance. … Not only their publications, they have seven or eight loss-prevention counsel who are all former partners in ALAS firms and are very experienced in the area. … [Y]ou just call up, and you get an ALAS—sophisticated ALAS person who will work through a problem with you; and if he or she doesn’t know the answer, they’ll caucus and get back to you. (24)

Why do we stay with ALAS? It’s a couple of things. One is that they have outstanding loss prevention resources. I mean better than any other carrier or any other source we can imagine. They provide a lot of educational and a lot of backstopping, a lot of counseling, a lot of support for prevention activities. If I get a really thorny conflict question that I’m having difficulty with I can call any
one of a number of people up there and get a really, really thoughtful answer. That’s nice. (28)

The small mutuals do not have the same internal loss prevention staff, but the three that are managed by Aon – AIM, BAR, PilotLegis – have access to Aon’s loss prevention unit, which Aon created to compete with ALAS. In addition, the small mutuals hold loss prevention meetings and share loss prevention information, and the annual member-run audits of other member firms provide opportunities for feedback on loss prevention practices, except for BAR. Whether the loss prevention information gained is as cutting edge or as closely tailored to the needs of the members as some of the members of the small mutuals claim is less important to us than the fact that actively participating in the mutual builds structured attention to loss prevention into the busy professional lives of the law firm partners charged with carrying out the firms’ obligations to the mutual. As the general counsel of one law firm explained,

\[R:\] … Let me go a different way. If you ask the question, ”What does a board of directors do for a corporation to management?” …. There's a lot of different kinds of things you can say. One of the things that happens is management has to show up on a periodic basis and just explain why it's doing what it's doing. … I have come to believe that having, if you're management, having to come and just sit down and explain why you're doing what you're doing makes you better at what you do, in a pretty big way.

What's the analogy here? I can only go to two meetings a year. I listen to some stuff probably that I wouldn't hear otherwise. I think a little bit more about it. My firm wants me to write a one-page summary to report to the board. Just that attention focuses people to do a little better than they might otherwise. It doesn't actually take a great idea. That's sort of my point.

\[Q:\] Got it. Yep. And if you weren't part of a group, there wouldn't be that built-in process.

\[R:\] Correct…. That feels real to me. … I'm the general counsel to firm, of our firm. What are my responsibilities? How to get people to do a good job on stuff. I have a couple different places I can go to get ideas. That's my point. (35)

Law firms that buy strictly commercial report a different approach to loss prevention by their insurers, with less insight and fewer structured opportunities for firm lawyers to focus on risk management:

Occasionally they make suggestions, although we are pretty far ahead of the curve, at least that’s our perception, and that’s reinforced by the carriers. It’s
fairly rare that we have a carrier pushing us to take a risk management step that we don’t. It’s more that they like to hear it and know what we’re doing, so that they can calibrate how much capacity they wanna allocate to us, and what rates they feel like they need to justify that, I guess, the risk that we present. (33)

[Y]ou know about ALAS right, the co-op group? We’ve never been an ALAS firm. I have the impression just anecdotally that ALAS is much more hands on about stuff that its insureds do. I think they’ve expressed a view about whether you should have a mandatory arbitration provision in your engagement letter. Those are subjects that I’ve just never seen come up in some years I’ve been dealing with the insurers. (31)

From an economic perspective, it makes sense that the mutuals invest more in loss prevention than the commercials, for at least two reasons. First, because of the long-term relationship between the mutuals and their members, the mutuals can expect to earn a greater return from a given investment in loss prevention. (Cf., Kunreuther) A commercial insurer that spends a lot of money on loss prevention raises its costs. Absent some way to lock in a long-term relationship with the law firms that benefit from this investment, that commercial insurer may simply be improving the loss ratio of the law firm’s next insurer – an insurer that may have a more competitive price because the insurer doesn’t spend money on loss prevention. Second, to the extent that loss prevention provides benefits to firms that are not reflected in lower claims costs, the owners of the commercial insurer derive no benefit. Because the law firms own the mutual, by contrast, they do receive these non-claim-related benefits (Hansmann 1996).

D. Stable Pricing Based on Real, Long-Term Risk

The stable pricing theme is a corollary to the stability theme discussed earlier. There are three analytically distinct challenges to pricing stability in the LPL market: changes in the risk level of individual firms (classification risk), changes in the risk level of law firms generally (industry-wide risk), and changes in general insurance market conditions (underwriting cycle risk).

As discussed earlier, the LPL mutuals differ in the degree to which they protect their firms from classification risk. At one end of the continuum, ALAS charges unitary premiums, which provides the greatest protection from classification risk (subject of course to a law firm being asked to leave ALAS). At the other end of the continuum, PilotLegis firms pay individualized, risk-based premiums from commercial insurers. BAR, MPC, and AIM occupy intermediate positions, charging quasi-unitary prices that allow for adjustments based on unusually good or bad claims experience.
Our sense is that the LPL mutuals do not attempt to protect firms from changes in industry-wide risk, except as part of an overall effort to smooth year-to-year changes in premiums. Indeed, paying prices that are based on law firm risks – as opposed to accounting firm risks or other professional liability insurance risks – was an explicit goal of the mutuals at their formation.

The primary focus of smoothing year-to-year changes in premiums is underwriting cycle risk: protecting members from the sharp premium spikes that occur in a hard market. ALAS, MPC, AIM and BAR protected their members in the liability insurance crisis in the mid 1980s, and they moderated the impact of the “hard market” of the early 2000’s. The mutuals expect their commercial partners to be patient in making pricing changes, but there is a recognition that this patience means that, in the event of a reduction in losses, premium decreases will also come slowly:

[R]emember, in the [small mutual] context, I am looking to have a viable commercial insurer forever. I’m not looking to hit the insurer for a big loss. Then they up my premium, and I say, “Sayonara, it was nice to know you,” and I give my business to somebody else. I am looking for them to make a reasonable level of profit. We can argue over reasonable, but a reasonable level of profit over a sustained period, hopefully with minimum losses, so that everyone in their shop is usefully employed and happy, and that I am not subject to the vagaries of folks that can hurt me in knowing that I’ve got cover by taking unreasonable positions that I’m not covered at all. (34)

PilotLegis was organized too late to address the mid 1980’s liability insurance crisis, but they are similarly focused on protecting members from underwriting cycle risk: "In times when premiums are low, we are not going to be paying the lowest, but in hard times, we will not be paying the highest." 25

E. Solidarity

Solidarity is not a word that is typically associated with liability insurance. Nor is it one that any of our respondents used. Nevertheless, it is an apt label for the commonly expressed

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25 Risk Retention Reporter (1999): "When Pilot formed," says Hepper, "the members wanted to control how they purchased insurance." She notes that the founders of PilotLegis sought to establish predictability and stability in professional liability insurance irrespective of market conditions and formulated an agreement with its underwriters that the group's premiums would experience controlled changes thereby avoiding the severe price swings of the open market. Hepper says that, "In times when premiums are low, we are not going to be paying the lowest, but in hard times, we will not be paying the highest."
sentiment that each of the LPL mutuals is a group of similar law firms that are comfortable linking their fates together:

You probably have a conception of your peer group. Your either Penn Law peer group, or in-your-field peer group. We probably have a view of that, that cuts across quality, the competence, and there is a kind of a view that there's a slight—we're still a little old-fashioned where culture actually matters. It's thought to be a good thing that when you have a partners' meeting, everyone actually can sit around the same table. … There is this sense in which a little pride of culture matters. The profession has actually been experiencing a decline in professionalism and becoming more and more like accounting firms. That's a bad thing. It's bad for the quality of life. It's bad for the quality of representation. It's bad for risk. It's terrible for associates. I would say there's a certain way in which there's a high degree of homogeneity on that, as expressed (35)

I mean one of the reasons that these firms are comfortable with each other is we’re all comfortable that each of us values our reputations. Putting aside claims experiences, etc., we’re all comfortable that each of the members of the group believes in risk management, simply in terms of preserving their reputations as firms that don’t do the sorts of things that expose them to malpractice claims. (19)

[W]e created the captive because of our desire to be able to control our own at least primary layers of insurance, control the terms and conditions of our policies and see that all the members of the group lived up to the kind of risk management that we all believe in. That’s exactly why we did it. You could say the captive—which has its own officers and directors—pushes things to us, but we own it and we direct it to do so. (26)

ALAS only does legal malpractice for a certain kind of practice, a corporate practice, not a money-center practice, a practice of good quality firms in cities like Philadelphia, Cincinnati, but not cities like New York, Chicago, L.A., San Francisco, although that’s changing. …. Their expertise is right for what we do. … [It’s notable there is] a very high percentage of the firms who are members, who are represented at the annual meeting. … They’re all like you are. …. People who work at ALAS in both claims and loss prevention are also people from our background, people who came out of corporate law firms. (27)

ALAS, as you probably know, but if you don’t, I can give you all this information about it—that’s really kind of a band of brothers type approach. They would do a lot of peer review and those sorts of things. (16)

F. Contrary reports

Perhaps not surprisingly, respondents who work in the commercial market report that the difference between buying purely commercial and participating in the mutual/commercial hybrids
is less significant than the members of the mutuals report. Commercial brokers report that they work to provide the same long-term relationships and stability for their purely commercial customers and those customers are not really worried about the commercial LPL insurers abandoning the market. Noting that 30 years have passed since the liability insurance crisis, one broker reported that law firms’ concern about commercial insurers lack of long term commitment to the LPL market “has dissipated”:

Most of those people who were involved in that [crisis] don’t even believe there’s a possibility that they could be left without insurance, so the continuance of the relationship of insurance slides down the agenda, I think, from the managing partner to other partners. It is no longer one of the vital relationships that the managing partner thinks he has to preserve, as he becomes managing partner, because it’s been a stable relationship, ever since. … I think, the likelihood that that complete disappearance will occur again is extremely remote. Anyway, it hasn’t happened. These guys were in high school, when that happened. (7)

Another broker emphasized that long term relationships with insurers were not unique to law firm mutuals:

The bottom line is we like keeping the same carriers on a firm’s program for a long period of time, so long as the pricing is right, because there’s stability there that’s good for everybody. Broker 1

The large LPL broker, Aon, has its own loss prevention experts, who, like the ALAS loss prevention experts, are also former partners in law firms. For law firms working with other brokers, there are independent loss prevention experts. As a result, some question whether greater attention to loss prevention by the mutuals makes any difference:

To be frank with you, I think there are clearly the nuts and bolts of risk management that all firms have to have done and do properly. They have to have conflicts of interest systems in place. They’ve got to have good diary and calendar systems. They have to have some type of peer review where they’re watching what their partners do. They have to have somebody look over tax opinion letters. They need to have some sort of system in place to make certain that their partners don’t have substance abuse problems and that the checks are being countersigned. When you get to a firm of a certain size, they have all that down. They know what they’re doing. I always find it interesting that the outfit that has the greatest loss prevention and risk management out there, that people just tout constantly, is ALAS. That’s what they’re known for in the industry is how good their risk management and loss prevention is. Interestingly, their loss

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26 The head of Aon’s loss prevention group is a former partner in an ALAS member firm.
history is no different or no better than, no worse, than the commercial market. … It doesn’t do anything. (18)

Finally, brokers and commercial underwriters emphasize the fact that the unitary and quasi-unitary pricing of the mutual insurers works to the advantage of members with poor claims histories and to the disadvantage of the “squeaky clean” firms:

There is a figure, which is a per-lawyer charge. The big problem there is: that’s great if you’re not a very good law firm. If you have lots of losses, that’s great, isn’t it? Basically, the good guys are subsidizing you. Conversely, if you’re an extremely professionally run and you’re as clean as a whistle, you’re helping to pay the losses of other firms for which you receive nothing. There are arguments, and ALAS will make them quite strongly, where they’ll say, “There’s no such thing as an entirely clean law firm. Therefore, the mutuality is more important, this idea of being a strong group. It gives us purchasing power. It allows us to remain stable through all markets.” The truth of the matter is, mutuals are better for bad insureds. If you’re clean as a whistle, you’re better off out there in the market. (48)

Of course, as this last statement reflects, the advocates of the purely commercial approach are trying to have their cake and eat it, too, reporting that they are able to provide the stability and loss prevention benefits of the mutuals, but at the lower cost that reflects the risk of the “squeaky clean” members of the mutual organizations.27 That may be the case for those squeaky clean members, and as long as there is no liability insurance crisis. Law firms with more difficult claims histories, however, will not receive that preferred pricing. Moreover, LPL insurance policies get re-priced every year, renewal is not guaranteed, and the premium increases and market share shake-up during the early 2000 hard market suggest that there remains a real risk that commercial insurers could leave the market (Hechler 2002). Moreover, the long term contracting problem is real, and, as we discuss in the next section, mutuals appear to have a comparative advantage in solving that problem. Nevertheless, a close, long-term relationship with a broker might provide similar benefits to a large law firm as membership in a mutual, perhaps even at a lower cost, especially when that cost is understood to include the time that firm lawyers devote to the mutual.

For law firms that buy strictly commercial there are no boards or committees, no member surplus accounts, and certainly no unitary or quasi-unitary pricing, but there are long term relationships and the expectation – even if sometimes honored in the breach – that, for law firms

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27 See note xx, supra (reporting that “squeaky clean” firms can save 30-35% by leaving ALAS and buying purely commercial).
above a certain size, LPL should primarily function to spread risk across time and not in the long run across law firms. One law firm general counsel put it to us this way:

I was always perfectly content to leave the insurance to the insurance people and to leave the law to the law people, and I always felt that—I mean, Minet was looking out after our interests, and later Minet was purchased by Aon, so now it’s Aon. We’re still customers of Aon. We’ve been basically represented by the same entity since 1976 when Minet first got us as a client. I just don’t see the point of spending a lot of time and energy. I’m glad that ALAS exists because the insurance market is very oligarchic, and there’s really just Aon and Marsh, and there really isn’t anybody else. I think it’s healthy to have more competitors in that market, … Joining ALAS meant a kind of commitment of time and energy that I think a lot of people just didn’t feel like making. (21)

Whether the brokers would be able to provide this same comfort in a market without ALAS, MPC, BAR, AIM or PilotLegis is an open question. The presence of these options gives brokers negotiating leverage on the part of the law firms that they represent.

In contrast to other commercial insurance arrangement with which we are familiar from research and practice, there appears to be greater agreement among buyers and sellers about the importance of long term relationships and about the principle that a good long term relationship means that insurers will make a reasonable profit at the individual law firm level, at least for large firms. The concept that our respondents used to explain how this principle works in practice is “payback,” which refers to paying above market premiums after a loss, so that, "In the long run your premiums are 120 percent of your claims." (50) Significantly, commercial insurance underwriters report that they enforce this principle by refraining from undercutting the premium of an insurer receiving payback. A senior executive at a commercial insurer explained this to us as follows:

Now, I’m also not going to come in and just bid against a firm that needs to get what we call payback. If you’re on the losing end on a firm and they need to start to pay back because you’ve lost money on them, I think most responsible markets would turn and say, “Yeah, that’s part of the deal.” You can’t hit somebody up with a big loss and then say, “I want a rate reduction cuz we’re gonna change things.” Even if you’re changing things, there has to be some

28 Note that the payback norm does not mean or require that individual excess insurers will have a good underwriting ratio at the individual firm level. The number of very large claims is simply too small for that to occur. The most that a high level excess insurer can expect is to earn a reasonable profit on its entire book over time.

50: “[Legendary broker] was very good on this. He would always say, ‘In the long run your premiums are 120 percent of your claims.’”) An actuary put it this way: “This ties back into the size of the account. If it was a truly large firm, I might expect it to be profitable on its own.” (39)
consistency. There has to be some loyalty to the market cuz, otherwise, I know that when I get banged around, my guys are just gonna walk away, so I’m not there to just do that. (Executive 3)

Q: Can I just ask a follow up question about that? When you were saying that the large firms aren’t a traditional insurance transaction—in other words, for them, they’re big enough that it’s more that they’re managing their cash flow than that they’re actually—

R: Yeah, I think that’s a good description. It was more kind of a—oh, what’s it called. You know you’d price it at year-end and look back and say, “Losses exceed what we—the expected loss or not,” and it was kind of a, “Let’s split the difference with your carrier.” As opposed to a premium up front, it was more of a retro price contract. (11)

Part of what makes this claim credible is that the commercial LPL insurance market is significantly smaller than the D&O insurance market, which, as prior research reports, is able to enforce norms that require collective effort to maintain (Baker & Griffith 2012). There are not that many large law firms. There are fewer than ten commercial insurers at any time that are willing and able to take a “lead” position in a large law firm LPL insurance program. One insurance broker – Aon – services a large percentage of the large law firm LPL market, putting it in a good position to enforce this norm. A law firm that needs $100 million or more coverage from insurers that will not provide more than $10 million each cannot afford to alienate very many insurers. And the people responsible for purchasing insurance in large law firms are partners in those firms (typically litigation partners), with the IQ and the paranoia needed to appreciate how changing insurers exposes their law firms to continuity risk. Taken together, all these factors provide support for the existence and force of the payback norm and, thus, the brokers’ and commercial underwriters’ assertion that large law firms don’t have to belong to a mutual to have stable insurance relationships, at least as long as the presence of the mutuals provides a credible alternative for a significant share of the law firms buying purely commercial.

III. Integrating Field Reports with Theory

The puzzle of mutual insurance in economic theory is easily stated: Because stock insurers are able to access all of the forms of capital available on the capital markets, they should – absent a market failure – be better able to spread risk than mutual insurers, which have access to more limited capital market instruments because of the requirement that mutuals must be owned by their members. The “puzzle” is why mutuals are so prevalent in many parts of the insurance market, given that they face this disadvantage. Better access to capital should allow stock
insurers to out-compete mutuals, unless there are market failures that provide a countervailing competitive advantage to mutual insurers.

Of course, as insurance economics has long held, and as insurance professionals have understood for even longer, insurance markets are prone to market failure, most notoriously because of the twin information problems of adverse selection and moral hazard (Arrow 1963, Akerlof 1970; for historical review see Baker 1995 & 2003). The prevalence of mutual organizations in insurance markets suggests that they do have some advantages in addressing these problems, and, as we will describe, mutual liability insurers have a comparative advantage in addressing a long term contracting problem that accompanies the claims-made form of liability insurance that has become the prevailing form of professional liability insurance in the U.S.

As we have already alluded, the most coherent analysis of the mutual insurance puzzle remains that of Henry Hansmann, first set out in 1985 in “The Organization of Insurance Companies: Mutual versus Stock” and then updated in a chapter in The Ownership of Enterprise (1996). Hansmann’s explanation begins with mutual life insurance. He identifies the following “three related factors” that lead to a long-term contracting problem that creates “an incentive for adoption of the mutual form” in life insurance:

(1) the difficulty of writing an adequate long-term contract between the insurance company and the policyholder in the face of substantial uncertainty; (2) asymmetry of information between policyholders and insurance companies regarding important aspects of the company’s performance; and (3) the need to lock policyholders into a company in order to avoid problems of adverse selection.

(Hansmann 1985) Although Hansmann identifies these as factors that provide a comparative advantage in life insurance, and not in property and liability insurance, our qualitative research reveals that liability insurance can face long-term contracting problems as well, as illustrated by our respondents’ concern with stability.

While the details of the long-term insurance contracting problem are different for lawyers liability insurance than life insurance, in both contexts policyholders need to have contracts in place over periods for which it is not possible to adequately anticipate all the things that could

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30 “Moral hazard” is … (Heimer). “Adverse selection” is … (Siegelman).
As Hansmann pointed out, the fact that the policyholders own the mutual gives a mutual a comparative advantage in addressing that problem. Because the policyholders own the insurer there is less concern that the insurer will behave opportunistically vis-à-vis the policyholders.

In addition, our research suggests that policyholders who are owners are easier to lock into the necessary long-term relationship, even without access to the kinds of contract mechanisms that are available in life insurance (such as whole life contracts and level term premium life insurance): through capital contribution requirements and limits on withdrawal, through a socialization process (e.g., committees and audits and help lines) that build participation in the mutual into the professional lives of the decision makers in the law firms, through reliance on loss prevention and risk management services outsourced to the mutuals, and through contracting and claims practices that protect firms from classification and continuity risk. Lock-in allows insurers to adjust prices over time to bring long-term losses and premiums into alignment despite unanticipated changes in industry-wide or underwriting cycle risks.

Hansmann also addressed the incentives for adoption of the mutual form in the property and liability context. He explained these incentives as the result of the advantages of the mutual form in addressing several other kinds of contracting problems, including: adverse selection, the externalities associated with loss prevention efforts, and avoiding moral hazard. Our qualitative research also provides evidence consistent with these advantages.

**Adverse selection.** Hansmann theorized that firms that are part of an industry would be better at assessing the risk of other members of that industry than an insurer would be. He identified this, historically, as a function of limited data regarding claims and methods of estimating future losses (1996 at 278-79). Although limited data seems less plausible as an explanation for the late 20th century growth of mutual LPL insurers, he generalized the underlying

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32 Hansmann identified two other factors for which we do not find support: avoiding rate regulation and bearing industry-wide risks. Rate regulation is no longer a significant factor for commercial liability insurance risks, and any advantage that mutual insurers have over commercial insurers in bearing industry-wide risks grows out of their advantage in locking their members into long-term contracts. If there are identifiable, industry-wide increases or decreases in liability losses, commercial insurers could also pass those increases or decreases on to their customers, just like the mutuals, except to the extent that commercial insurers face a disadvantage in maintaining long term contractual relationships.
economic dynamic in terms that do apply: “the cost of information about the riskiness of individual insureds [is] lower to firms within the industry than to those outside of it.” (Id.)

Especially in the small mutuals, the participating law firms know a great deal about each other outside of the membership and underwriting process, and they are better positioned than an insurance underwriter to use that process to uncover weaknesses that pose unusual liability risks. The notorious selectivity of AIM and ALAS (which appear to be more actively interested in new members than BAR or MPC) provides some support for this theory. A partner in a small group mutual member firm described their comparative advantage as follows:

If I were a senior executive of a big company in Europe, insurance company, was looking, somehow could look at everything about the US market and say, “How do I judge which firms are good risks, which firms are not good risks?” It just so happens because of our group, we know how to make those judgments quite well, because we’re dealing with people in our group that we’ve known for decades and we’ve all helped each other deal, or create first-rate risk management programs and claims handling programs and policy form. … But I don’t know how Swiss Re goes to New York and looks at—I’ll just pick a name, cause they don’t exist anymore—Dewey. I don’t know how they do it. I’ll never have to worry about it, cause we’re just ahead of the curve. That’s what we think. Our programs are—it’s not to say there aren’t good programs everywhere. There are. I mean, there’s lots of good law firms with great programs. The ALAS firms have many programs, but I think we’re just a little more nimble due to our small size, and we’re very, very interested in the subject. Always have been. That’s why we did it this way, so we—I think we stayed with the cutting edge of what’s going on in law firm risk, as well as just good practices. Not just avoiding risk, but good practices that promote the highest ethical behaviors and identifying issues as they come along. (26)

An executive in a commercial insurance company also observed that the small mutuals have an advantage over commercial insurers in underwriting:

I will tell you that if you talk to the MPC people—and you probably can—they’ve had unbelievably good results, at least they had when I was looking at them—even though some of their firms like [] have seen some tough days, they would argue that it was all about peer review. It was all about their ability to ask questions that no firm was gonna answer an insurance underwriter about. Now I would argue you can ask those questions if there’s ten of you and you’re all going to the Olympic Club together. (16)

A related selection advantage of the mutuals follows from the time and energy that some of the mutuals demand of their members, especially in relation to loss prevention and claims review. Firms with a greater willingness to engage in these time consuming loss prevention activities may
be more likely to join the mutuals and more likely to stay in the mutuals.\textsuperscript{33} Recall the candid explanation of one of the general counsels about why he had not recommended that his firm join ALAS: “Joining ALAS meant a kind of commitment of time and energy that I think a lot of people just didn’t feel like making.”

\textit{Externalities of loss prevention.} Hansmann noted that there are three aspects of what he called “inspection and safety research” that make it difficult for stock insurers to capture a large enough share of the return to justify investing in those activities. First, the payoff from the investment typically is longer term than the contract. If the insurer makes the investment the policyholder can behave opportunistically by subsequently leaving for a cheaper insurer. Second, because the insurer has to return a proportion of the loss savings to the policyholder in the form of reduced premiums, the insurer earns less than the full return on the investment even if the policyholder remains a long-term customer. Third, the “public good” character of loss prevention research leads to further underinvestment in these activities relative to their benefits. To these three aspects, we add a fourth, suggested by our respondents: some loss prevention activities benefit law firms in ways that go beyond a reduction in LPL losses:

\begin{verbatim}
R: Well, it's also—I'm the general counsel to firm, of our firm. What are my responsibilities? How to get people to do a good job on stuff. I have a couple different places I can go to get ideas. That's my point. Does that make sense?

Q: Yeah, yeah. Absolutely. And how to get people to do a good job is a bigger question than risk management from the perspective of dealing with your lawyer's professional liability insurance.

R: Exactly. Big time. (35)
\end{verbatim}

Because mutuals are owned by their members, mutual insurance arrangements can capture a larger share of the benefits of loss prevention, whether those benefits come in the form of a reduction in loss expenses or otherwise. Of course, mutuals still suffer from the public good problem. Thus, it makes sense that ALAS – the largest mutual – has the most active and public loss prevention program: by insuring more lawyers it captures more of the total benefits of its loss prevention R&D investment.

\textit{Avoiding moral hazard.} We doubt that LPL insurance leads law firms to be less careful to avoid making mistakes or to avoid taking on risky clients, and none of our respondents

\textsuperscript{33} An economist would call this propitious selection on moral hazard.
provided any indication that this was the case. (Swedloff & Baker 2015) If anything, the emphasis that LPL insurers place on assessing law firms’ commitment to loss prevention suggests to us that, to the extent that lawyers think about LPL insurance at all, those thoughts encourage greater care, not less. Thus, the potential difference between stock and mutual insurers lies not in their ability to prevent lawyers from slacking off because of insurance but rather in their ability to encourage lawyers to do more. In that regard, as reflected in the discussion of loss prevention in the preceding section, our respondents suggested that the mutuals do have an advantage. In addition to those already mentioned, the mutuals’ claims review process can foster positive peer pressure:

[I]n a group there’s more likely to be peer pressure to do a better job and have fewer claims. I’ve seen it in real—these guys do not want to sit in a meeting and have their claim information up on the board. There’s an incentive for them to go back to their firms and—I know a couple of firms that have taken all the information back to their partnership meetings and kind of laid it out there and said, “I don’t want to be the poster child at the next board meeting. We got to do it better the next time.” That sort of thing. (10)

Comparing the respondents’ reports with theory. As described in detail in the preceding section, our respondents reported the following benefits to belonging to a mutual insurer: stability in LPL insurance relationships, a high quality claims experience, high quality loss prevention services, stable pricing based on long term risk, and solidarity. These reports match reasonably well with economic theory.

First, stability in relationships and stable pricing are the desired result of addressing the long term contracting problem. Second, the perception that key aspects of the relationship are high quality can be understood as both cause and effect of addressing that contracting problem. Third, the sense of solidarity can be understood as both cause and effect of mutual insurers’ advantage in addressing adverse selection. Fourth, loss prevention and claims handling both implicate moral hazard – ex ante moral hazard in the case of loss prevention and ex post moral hazard in the case of claims handling. Finally, as already noted, the emphasis on loss prevention is consistent with the theoretical prediction that mutuals would be better at loss prevention because policyholder ownership allows for internalization of more of the benefits from loss prevention.

IV. Conclusion:
Can the LPL Insurance Experienced be Generalized?
[under construction]

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