LEGAL MALPRACTICE INSURANCE AND LOSS PREVENTION: A COMPARATIVE ANALYSIS OF ECONOMIC INSTITUTIONS

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TABLE OF CONTENTS

INTRODUCTION .................................................................................................................. 306

I. A BRIEF HISTORY OF LEGAL MALPRACTICE INSURANCE ........................................ 307

II. THE ECONOMIC INSTITUTIONS OF LEGAL MALPRACTICE INSURANCE ......................... 310

A. WHAT IS LEGAL MALPRACTICE INSURANCE? ......................................................... 310

B. SELF-INSURANCE .......................................................................................................... 314

C. CLIENT CONTRACT INSURANCE .................................................................................. 319

D. MARKET INSURANCE .................................................................................................... 323

1. Methods of Risk Reduction ............................................................................................ 324

2. The Effect of an Increase in Risk on the Demand for Market Insurance ....................... 327

3. The Demand for Legal Malpractice Insurance and the Insurer's Transaction Cost Advantage ...................................................................................................................... 329

4. The Demand for Loss Prevention Services from Malpractice Insurers ......................... 332

   a. The Incentive Problem ............................................................................................... 332

   b. Information about Loss Prevention ......................................................................... 334

   c. Free Rider Problems ............................................................................................... 337

   d. The Nature of Precautions ..................................................................................... 338

   e. Monitoring by Insureds: Mutual Insurance Companies ........................................ 339

   f. The Problem of Solvency Risk ................................................................................. 341

5. The Bundling of Loss Prevention with Diversification .................................................. 342


III. CLIENTS AND LAWYERS AS ENTITIES ..................................................................... 346

   A. COMPLEX CLIENTS AS INSURERS ......................................................................... 346

   B. LAW FIRM INSURANCE ............................................................................................ 346

CONCLUSION ..................................................................................................................... 351

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INTRODUCTION

Legal malpractice is finally getting the recognition it deserves as an important institution for regulating lawyer behavior.¹ Legal malpractice insurance is not—yet.² Although scholars have begun to focus on the relationship between malpractice and legal ethics, the effect of malpractice insurance on this relationship has gone largely unexplored.³ And although legal and economic scholars have examined the theoretical underpinnings and practical uses and limitations of liability insurance generally,⁴ no one has yet tried to apply those insights to legal malpractice insurance.


2. Recent discussions of legal malpractice insurance include Andrew S. Hanen & Jett Hanna, Legal Malpractice Insurance: Exclusions, Selected Coverage and Consumer Issues, 33 S. TEX. L. REV. 75 (1992); Frederic L. Goldfein, Legal Malpractice Insurance, 61 TEMP. L. REV. 1285 (1988). Both of these articles were written by practitioners and approach the subject from that perspective. By contrast, Professor Wolfram includes only two pages on legal malpractice insurance in his treatise. See CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 5.6.8, 240-41 (1986).

3. The one significant exception is the recent exchange between Anthony Davis, a practitioner, and Professor Charles Silver. See Anthony E. Davis, Professional Liability Insurers as Regulators of Law Practice, 65 FORDHAM L. REV. 209 (1996); Charles Silver, Professional Liability Insurance as Insurance and as Lawyer Regulation: Response to Davis, 65 FORDHAM L. REV. 233 (1996).

This article attempts to remedy this deficiency and to spark debate over the current and proper role for legal malpractice insurance as an institution of lawyer regulation. My thesis is simple. Legal malpractice insurance, like other liability insurance, can further the deterrence goals of liability by improving the behavior of the insureds. This "loss prevention" function of legal malpractice insurance seems to be increasing in ways that the economics of insurance would predict. In fact, because of their comparative institutional advantages, legal malpractice insurers are increasingly serving as regulators of lawyer behavior and may be beginning to substitute for the firm and the bar in this role. Whether the trend is good or bad is a harder question, the answer to which depends, of course, on how effective this regulation is likely to be, what negative consequences it has, and what plausible alternatives are available.

I begin by offering some historical and institutional background. I then set forth an economic theory of legal malpractice insurance, comparing different insurance institutions. In particular, I try to articulate when market insurance is likely to be a relatively strong institution for shaping the behavior of insureds, and to argue that legal malpractice insurance fits this category. Initially, I make the simplifying assumptions that both lawyers and clients are, or can be treated as, individuals. Later, I relax the assumptions of individual clients and individual lawyers, and argue that the complexities introduced further support the argument that legal malpractice insurance may be a superior institution for regulating lawyer behavior.

I. A BRIEF HISTORY OF LEGAL MALPRACTICE INSURANCE

Although the first policy for lawyers' professional liability written through a United States company was issued in 1945, the history of legal malpractice insurance in this country is usually traced to the 1960s, when it first gained prominence.\(^5\) Legal malpractice insurance was offered by property and casualty insurers as an ancillary service to their main business.\(^6\) For our purposes, two other significant events relevant to the regulation of lawyers occurred in the 1960s. The first event was the California Supreme Court's decision in *Lucas v. Hamm*,\(^7\) which held that lawyers owed a duty of care to non-client beneficiaries of a will, though it rejected the claim on the ground

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that the lawyer did not breach this duty by botching the Rule Against Perpetuities because (try explaining this to a non-lawyer with a straight face) no lawyers understood the Rule. The second event was the ABA’s adoption of the Model Code of Professional Responsibility in 1969.

In the 1970s malpractice claims against lawyers increased substantially.8 In some jurisdictions, such as California, insurers started dropping out of the of the legal malpractice insurance market and focusing on more profitable and stable areas.9 In other jurisdictions, the availability of insurance increased.10 Two significant changes in insurance policies took place during this period: the adoption of “claims-made” policies that took insurers off the hook for claims arising long after the policy was issued; and “eroding policy limits,” which counted legal defense expenditures against the policy limits.11 By the end of the 1970s, premiums were increasing sharply.12 There were several other significant developments. On the insurance side, in 1978 Oregon adopted mandatory malpractice insurance for lawyers, and North Carolina and California formed the first “bar-related,” mutual (owned by the lawyers) insurance companies. The following year saw the arrival of the Attorneys’ Liability Assurance Society (ALAS), a non-bar-related mutual that limited membership to large (at the time, 40 or more lawyers) law firms outside of New York.

At the same time, the law governing lawyers was undergoing extensive change. In 1976, a state court held that a lawyer for a guardian owed a duty to the guardian’s ward as well as to the guardian and could be subject to liability for failing to protect the ward’s interests against the guardian’s wrongful behavior.13 In 1977, the ABA’s Kutak Commission was formed to consider revising the Model Code; its efforts led to the Model Rules of Professional Conduct in 1983. In 1978, a federal district judge decided National Student Marketing,14 which sent shock waves through the corporate bar with its holding that lawyers violated the securities laws by allowing a merger deal to close despite being in possession of information that suggested trouble (though the

8. See Goldfein, supra note 2, at 1286.
12. See Goldfein, supra note 2, at 1285.
court watered down this holding by refusing to issue an injunction against the lawyers. Those shock waves intensified two years later, when a federal court found Willkie, Farr & Gallagher liable for $34.8 million in a malpractice suit stemming from the alleged looting of IOS Ltd. and its offshore mutual fund, Fund of Funds, Ltd, by Robert Vesco.¹⁵

An additional phenomenon that was occurring during the 1970s is worth noting. The Supreme Court was paved the way for greater competition among lawyers by its 1975 decision in Goldfarb v. Virginia State Bar,¹⁶ applying the antitrust laws to lawyers for the first time, and its 1977 decision in Bates v. State Bar of Ariz.,¹⁷ striking down restrictions on lawyer advertising on First Amendment grounds. Whether these cases caused, ratified, or facilitated competition among lawyers, they led to a greater focus on competition and the effects—good and bad—that competition could have on the profession. One of these effects was the possibility of more malpractice.

In the 1980s the insurance crisis hit legal malpractice insurance, as it did other areas. Premiums increased between 400% and 1500%, coverage decreased, and availability declined.¹⁸ These premium increases were driven in part by lower interest rates and in part by an increase in the frequency and severity of malpractice claims being made against lawyers.¹⁹ Some of these claims were securities actions spurred on by National Student Marketing, liability for which insurance companies were unable to avoid completely because of their broad duty to defend. Other claims stemmed from the collapse of the real estate market, and a crackdown on tax shelters by the IRS and SEC.²⁰ According to one source: “Between 1982 and 1984, estimated losses nationwide, including adjustment expenses, roughly doubled. Between 1982 and 1986, no other area of professional liability insurance experienced anywhere near this rate of severe increase for a similar period.”²¹ Some insurers responded by dropping out of the market; others restricted coverage and limited the availability of excess insurance. Premiums remained high through the end of the decade, as claims frequency remained high.²² Lawyers again responded by forming more bar-related mutuals, in part spurred on by the

¹⁸. See Goldstein, supra note 2, at 1285.
¹⁹. See 1 SMITH & MALLEN, supra note 10, § 33.1, at 278.
²⁰. See Reid, supra note 5, at 3.
²². See id. at 40.
1986 Liability Risk Retention Act.\textsuperscript{23} Most notable among the new mutuals were the Association of Trial Lawyers Assurance (ATLA) for members of the trial lawyers' group that has the same acronym, and the Attorneys Liability Protection Society (ALPS), both of which started in 1988.

In the 1990s, the biggest developments so far have not been in malpractice insurance, where rates seem to have stabilized and mutuals continue to grow and thrive, but in the law of lawyering and the law of law firms. Cases arising out of the savings and loan crisis, including the famous Kaye, Scholer case, led to huge payouts by malpractice insurers. Currently, the ALI's Restatement of the Law Governing Lawyers is being debated and adopted. On the law firm side, the biggest development is the explosion of Limited Liability Company and Limited Liability Partnership statutes and their application to law firms.

Given this background, I aim in the remainder of the paper to try to understand how and why legal malpractice insurance has developed as it has. In particular, what are we to make of the development and persistence of groups like ALAS and other mutuals? What is the relationship between the evolution of insurance institutions and other developments in the law governing lawyers as well as the general competitive environment facing lawyers? The remaining sections explore these and related questions.

II. THE ECONOMIC INSTITUTIONS OF LEGAL MALPRACTICE INSURANCE

A. What Is Legal Malpractice Insurance?

Legal malpractice insurance is one of many economic institutions that regulate lawyer behavior. It does so indirectly and often incidentally. Like other third-party liability insurance, legal malpractice insurance regulates indirectly in the sense that legal liability—in this case, legal malpractice—provides the primary form of regulation. Legal liability sets the regulatory standard; liability insurance responds to that standard. Legal liability is of course not the only form of regulation. Ethics rules, for example, also serve to regulate lawyer behavior.\textsuperscript{24} But in this article, I take legal malpractice liability

\textsuperscript{23} The purpose of the act was to encourage the formation of Risk Retention Groups (RRGs), which are special purpose insurance companies wholly owned by the policyholders. The major advantage of RRG status is that "after meeting the regulatory requirements of the state in which it is chartered, an RRG can provide insurance to members in other states without first having to meet their individual licensing requirements." ABA, BAR-RELATED INSURANCE, supra note 9, at 7.

as the relevant regulatory mechanism. I also take the standard of legal malpractice as given, though recognizing how it has changed.

Liability insurance can either help or hinder the regulatory goals of the liability system, in addition to simply serving the interests of the insured.\textsuperscript{25} To understand the regulatory function of legal malpractice insurance, then, we must understand the goals of legal malpractice. Recognizing that other legitimate goals of legal malpractice exist, I want to focus in this paper on deterrence. The economic approach to tort liability posits the goal of minimizing the sum of the costs of reducing harmful behavior and the expected costs of the remaining harms.\textsuperscript{26} Expected costs are risks, because when the relevant actor makes decisions about whether to engage in conduct, these costs are uncertain. Liability insurance serves the deterrence goal of the liability system when it reduces the sum of the costs of prevention and expected harm below what would exist in the absence of insurance. Liability insurance disserves the deterrence goal of the liability system when it reduces costs to the insured merely at the expense of increasing costs to the victims of harm.

But what exactly is liability insurance? Although the answer may seem obvious, from an economic institutional perspective it is less clear. In particular, in this part I examine three general economic institutions that lawyers use to respond to the risk of malpractice liability, all of which can be understood as "insurance." In this section, I want to explain how I am using that term. I define liability insurance broadly as any institution whose purpose is to reduce for some person (the insured) any cost associated with liability risk to that person. We tend not to think of liability insurance as any institution designed to reduce costs associated with the risk of liability, and to think of liability insurance so broadly is perhaps confusing. But thinking of it more narrowly is also somewhat confusing, or at least confining. The narrow conception of liability insurance views insurance as "loss spreading" services offered by a commercial entity designed primarily to offer such services. Economists, however, have tried to get us to think of insurance more broadly than that to show how other institutions perform the same functions. But even

\textsuperscript{25} It is common to think of liability insurance as providing the link between ignorance of the law and deterrence. Even if a person doesn't know the rules of negligence, the deterrence theorist argues, his insurance company does, and will force him to conform his conduct to these rules. See, e.g., WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW II (1987) (arguing that one way tort law deters is "by forcing up liability insurance rates to the point where people are priced out of driving").

economists seem not to want to adopt the broadest definition. Nor do they seem to agree on how to delimit liability insurance.

For example, one way to think of liability insurance is as a particular method of risk reduction, namely risk pooling or diversification.27 This definition ties the concept of insurance to risk aversion. Risk aversion is a cost of risk over and above the costs associated with the expected value of the risk. More precisely, risk aversion represents a willingness to pay more than the expected value of some risk (the probability of harm times the size of the loss) to avoid bearing that risk. The amount in excess of the expected value that a risk-bearer would be willing to pay is called the “risk premium.”28 Because of the diminishing marginal utility of wealth, the risk premium is thought to be higher the larger the percentage of total wealth the potential loss represents.

Risk pooling eliminates the costs of risk aversion to the insured by substituting the certain costs of pooling for the uncertain risks of harmful conduct and its attendant liability. Defining insurance in terms of risk pooling narrows the concept of insurance in two ways. First, risk pooling does not reduce other costs associated with the risk of liability, such as the costs of preventing harmful conduct (precautions) and the loss associated with the harmful conduct. Second, risk pooling is not the only means of reducing the costs associated with risk aversion. One could also reduce the costs of risk aversion by reducing the magnitude of losses associated with harmful conduct, or by increasing wealth.

For these reasons, economists have sometimes espoused broader definitions of liability insurance. Judge Posner in his treatise seems to define insurance as any effort, not just pooling, to reduce the costs associated with risk aversion as opposed to expected accident costs.29 Thus, he distinguishes “insurance” from “prevention” by the fact that prevention refers to an expenditure to reduce expected losses when the expenditure is less than or equal to the expected reduction in loss, whereas insurance means any reduction in risk costs beyond such expenditures on preventable losses. For example, if expected losses from an accident are $100, then any expenditure up to $100 to eliminate those expected losses is “prevention.” Any (rational) expenditure

27. See KENNETH S. ABRAHAM, DISTRIBUTING RISK 1 (1986).
29. See POSNER, supra note 26, at 103-04. It is somewhat ironic that Posner develops this notion of insurance in the context of discussing the impossibility doctrine in contract law. A good case can be made that this doctrine has nothing to do with providing insurance in the sense Posner describes. See, e.g., MICHAEL TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 130-36 (1993) (summarizing critiques of Posner’s theory); Victor P. Goldberg, Impossibility and Related Excuses, 144 J. INST. & THEORETICAL ECON. 144 (1988) (developing an explanation for excuse doctrines based on efficient mitigation).
above $100, however, is not "prevention" but rather "insurance" because the only purpose it serves is to reduce the costs associated with risk aversion. The reason for this somewhat strained definition is to emphasize the idea that if more than $100 is spent on prevention, there is, in some meaningful sense, "too much" prevention, a point I shall return to below.

Another definition that economists have used loosens the concept of insurance from the shackles of risk aversion, though it does not remove the shackles entirely. Professors Ehrlich and Becker, in their classic article, define insurance as any attempt to reduce the size of the loss associated with harmful conduct. They distinguish insurance from "protection," which they define as any attempt to reduce the likelihood of harm. Thus, in the above example, if the expected losses of $100 are the product of a $100,000 harm and a likelihood of .001, then any expenditure designed to reduce the $100,000 (as opposed to reducing the .001) is "insurance," whether such expenditure is more or less than the $100 expected harm, and whether or not it involves pooling. Although this definition is broader than the previous two, it still leaves insurance somewhat tied to risk aversion, because risk aversion, given its connection to the diminishing marginal utility of wealth, is more closely tied to loss reduction expenditures than to probability reduction expenditures, which even a risk neutral party might undertake.

The reason Ehrlich and Becker define insurance in the way they do is to emphasize that self-insurance, which they define as any attempt by an individual to reduce the size of his potential losses without resorting to the market, can be viewed as a substitute for insurance purchased on the market. This focus on self-insurance distinguishes the Ehrlich and Becker definition from another definition of insurance, used by Shavell and Arrow, which involves any shifting of risk from one party to another. The risk-shifting definition is useful because it leads one to recognize that many contracts, whether with insurance companies, the potential victims of harm, or with other loss reduction entities such as law firms, provide a form of insurance against the risks associated with legal liability. I will use the term "contract insurance"

31. See id. at 639-40.
32. See id. at 633. Others who do not share this focus look less favorably on the term. See, e.g., Schwartz, supra note 4, at 315 (characterizing self-insurance as an "odd euphemism for 'uninsured'")
33. See SHAVELL, supra note 26, at 192 (defining insurance as an arrangement in which "parties referred to as insureds pay premiums to an insurer in exchange for protection against possible future losses")
34. See KENNETH J. ARROW, ESSAYS IN THE THEORY OF RISK BEARING 137 (1970) (defining insurance as any institution designed to shift risks from one party to another).
to refer to any contract with a party other than an insurance company that serves to shift liability risks.

I have elaborated on these definitions of insurance to make several points. Definitions depend on the purposes to be served. If we want to engage in comparative institutional analysis, then it makes sense to define insurance more broadly than economists have so far done. Thus, I shall use legal malpractice insurance to refer, as suggested above, to any institution designed to reduce any of the costs associated with the risk of legal liability. That means that self-insurance, contract insurance, and market insurance are all possible forms of insurance. It also means that insurance is not necessarily tied to risk pooling, risk aversion, or size-of-loss reduction. In particular, insurance may involve loss prevention. And to return to the earlier notion of insurance as what insurance companies do, insurance companies do sometimes provide loss prevention services. In fact, sometimes this is the main thing insurance companies do. I will argue that it is an increasingly important thing that legal malpractice insurance companies do. But to preserve the common and regulatory notion of insurance companies, I will reserve the term "market insurance" for firms that provide at least risk pooling services and may also provide loss prevention services. Thus, a law firm is not an insurance company, but may provide insurance services.

With these preliminary matters out of the way, let us consider the possible institutions that provide insurance, broadly defined, against legal malpractice and its associated costs. In the tradition of economics, we will go from the simple to the complex. In this part, I make two simplifying assumptions: both clients and lawyers can be thought of as individuals. I make these assumptions to put aside for the moment agency problems with entity clients and law firms. I relax these assumptions in the next part.

B. Self-Insurance

Self-insurance is the simplest form of insurance. It is also an extremely common one among lawyers, especially among sole practitioners. To isolate

35. See, e.g., Group Life & Health Ins. Co. v. Royal Drug Co., 441 U.S. 917 (1979) (defining an insurance contract as one that involves "spreading and underwriting of a policyholder's risk," and distinguishing "risk underwriting" from "risk reduction").

36. See Ramos, Reforming Lawyers and Law Professors, supra note 1, at 2587 (suggesting that 40% of lawyers nationwide do not have liability insurance); see id. at 2613 (suggesting that available evidence suggests a disproportionate percentage of uninsured lawyers among solo practitioners); ABA Standing Comm. on Lawyers' Professional Liability, Legal Malpractice Claims in the 1990s 5 (1996) ("It has been estimated that 30 percent to 50 percent of practicing lawyers carry no malpractice coverage at all") [hereinafter Legal Malpractice Claims]; Geoffrey C. Hazard, Jr., Susan P. Koniak, & Roger C. Cramton, The Law and Ethics of Lawyerin 192 (2d ed. 1994). But see Ted Schneyer, Mandatory Malpractice
the incentives on lawyers created by self-insurance, let us assume for the moment that clients can neither take precautions nor buy market insurance to reduce the risks associated with legal malpractice.37

Lawyers have a variety of risk reduction measures at their disposal.38 First, lawyers can take steps ex ante to reduce the likelihood that malpractice liability will occur.39 These steps include precautions, such as an improved calendaring or conflicts-checking system. They also include reducing the activity level of various forms of practice, such as restricting areas of practice or screening for and refusing to service high-risk clients.40 Second, lawyers can take steps to reduce the size of any loss to them from malpractice liability that does occur. These steps include ex ante precautions, such as double-checking numerical calculations41 or improving one's system for handling and accounting for client funds.42 They also include ex post mitigation, such as refiling a claim barred by the statute of limitations in another jurisdiction, or ex post loss reduction.

Not all methods of risk reduction by lawyers are socially beneficial. Some forms of risk reduction by lawyers will increase risk to their clients. In particular, a lawyer could reduce his losses from malpractice liability by making himself more judgment proof, say by maintaining minimal assets or sheltering assets in a way that would make them more costly for a plaintiff to reach.43 If the client does not know of these expenditures and is not in a

_Insurance for Lawyers in Wisconsin and Elsewhere_, 1979 Wis. L. REV. 1019, 1030-31 (noting that 85% of Wisconsin lawyers in full-time practice, other than in government offices or legal departments of corporations, carried legal malpractice insurance).

37. These assumptions are realistic. Client contributory negligence can happen, but it is rare. See infra note 53. I will consider the possibility of client contributory negligence in the next section. First party insurance typically does not cover legal malpractice. See N. Scott Murphy, _It's Nothing Personal: The Public Costs of Limited Liability Law Partnerships_, 71 IND. L.J. 201, 232, n.192 (1995).

38. See generally Fortune & O’Roark, supra note 1.

39. In Ehrlich and Becker’s terms, this is “self-protection.” Ehrlich & Becker, supra note 30, at 634.

40. See Geoffrey C. Hazard, Jr., _How to Cut the Cost of Malpractice_, NAT’L L.J., Dec. 17, 1990, at 16 (suggesting that lawyers should not “take bad people as transaction clients” or “represent doctors in business deals”).

41. For a prominent recent case alleging that insufficient precautions of this type were taken, see Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 573 N.Y.S.2d 981 (N.Y. App. Div. 1991) (malpractice claim by creditor against its law firm as well as against lawyers for co-creditor and debtor, arising out of $92 million typographical error in loan refinancing document), aff’d in part, 80 N.Y.2d 377 (N.Y. 1992) (upholding grant of summary judgment in favor of debtor’s law firm on the ground that the law firm’s opinion letter did not contain any assurance of a specific dollar amount of security).

42. See Hazard, supra note 40, at 15. This precaution will obviously also tend to reduce the likelihood of malpractice.

43. See Ramos, _Reforming Lawyers and Law Professors_, supra note 1, at 2613.
superior position to reduce or bear risks, as we are assuming here, then these expenditures are socially wasteful. Similarly, a lawyer might reduce his malpractice liability risk by increasing his expenditures on defending any malpractice suit, say by hiring a crack malpractice defense lawyer to represent him. Whether these expenditures are socially desirable will depend on how they affect the incidence of errors by clients in bringing malpractice suits and by courts in imposing malpractice liability. Expenditures that do not increase accuracy are socially wasteful; expenditures that improve accuracy may be socially beneficial, but only if they reduce error costs more than the amount of the expenditures. Legal defense expenditures decrease the likelihood that the lawyer will be wrongfully convicted of malpractice, but they also increase the likelihood that the lawyer will be wrongfully exonerated of malpractice. Which of these effects predominates will depend on, among other things, the quality of lawyering that malpractice plaintiffs have available to them, and the quality of judges and juries.

Finally, self-insured lawyers may be able to diversify their risks, that is, to reduce their risk premium associated with risk aversion. Diversification reduces the risk to the lawyer, but leaves the risk to the client unchanged. Diversification may be difficult for sole practitioners, however. They can perhaps diversify by expanding their client base, but diversification requires that risks be uncorrelated, and because the risk of malpractice is generally lawyer-controlled rather than client-controlled, it is possible that the risk of malpractice could increase from having more clients. This could occur, for example, if the lawyer has less time to work on each client’s case and so is more likely to make an error than if he had fewer clients. Let us assume, therefore, that diversification is not a meaningful option for the self-insured, sole practitioner. We will return to diversification below when we consider market insurance and law partnerships.

A lawyer who bears the full cost of his legal malpractice as a result of liability will be led to minimize the sum of his risk reduction (precaution) costs, expected malpractice costs (represented by the probability of malpractice times the loss, or PL), and risk premium. What this means is that the rational lawyer

44. See Ehrlich & Becker, supra note 30, at 634 (noting that legal services are an example of an activity that can reduce both the probability and size of loss).

45. Both Type II errors, erroneous filings and findings of malpractice, and Type I errors, erroneous failures to file and find malpractice, will lead a lawyer to increase his efforts to reduce the size of his loss associated with malpractice. Type II errors do so because they increase the lawyer’s risk. Less obviously, perhaps, Type I errors lead the lawyer to increase expenditures on size-of-loss reduction because they increase the value of those expenditures relative to expenditures on prevention. See Danzon & Harrington, supra note 4; Schwartz, supra note 4, at 344-45.
will allocate risk reduction dollars among the different techniques—pay for insurance services—until the marginal cost of the last act of cost reduction equals the marginal benefit to him in terms of reduced costs. This result differs slightly, but significantly, from the result usually presented in the law and economics literature, which is that the tortfeasor will take precautions until the marginal benefit of those precautions in reduced expected liability equals the marginal cost of the precautions. The difference is that there may be some situations in which it will be desirable for the lawyer to spend $1 on risk reduction even if that $1 is greater than the marginal reduction in expected malpractice costs (PL). The reason for the difference is that the typical economic model, for reasons of analytical convenience as well as the model’s focus on the choice of liability rule rather than insurance institution, assumes the risk premium is 0 (the actors are risk neutral), or at least defines the social optimum with reference to that assumption. The justification for the assumption is either the lawyer or the client can diversify the risk at no cost, or equivalently, can purchase market insurance at an “actuarially fair” premium equal to the expected malpractice costs. The importance of this assumption will become clear when we begin to compare alternative insurance institutions.

The final part of the economic analysis of self-insurance asks how lawyers respond to exogenous changes in risk, or what economists call comparative statics. Institutional economists and traditional economists tend to use this analysis in different ways. Institutionalists try to understand why various institutions have developed historically; traditional economists try to examine how some proposed policy change might affect behavior. Prediction about the future is always riskier than explanation of the past, but the latter can often usefully inform the former. As noted in the introduction, the historical picture of legal malpractice is a story of increasing risk over the last thirty years. Let us consider how that increased risk has probably affected self-insurance. An increase in risk can be caused by an increase in the probability of malpractice liability or an increase in the size of the losses associated with malpractice, as well as by an increase in the risk premium of lawyers or clients. The source of this increased risk can be a change in the legal, economic, or social environment, or more likely a combination of all three.

46. See Shavell, *supra* note 26, at 206-07; Landes & Posner, *supra* note 25, at 57 (assuming that actors are risk neutral because their focus is on the efficiency of tort rules, but noting that such an assumption would be inadequate if the analysis focused on “an institution patently designed to reduce risk, such as insurance”).

47. See Shavell, *supra* note 26, at 192, n.10.
For example, one plausible explanation of increased risk of malpractice liability is increased competition among lawyers. Although increased competition could reduce malpractice by making lawyers more responsive to their clients' needs, there are other possibilities. One is that if clients cannot distinguish careful lawyering from bad lawyering, competition might lead lawyers to become more neglectful of their clients because lawyers choose to spend more time "competing" for new clients and less time servicing existing clients, or more time engaging in competitive activity that clients can identify, but may not be related to quality, such as price competition or advertising.

In economists' terms, the opportunity costs of risk prevention techniques (namely, the time spent on them) have increased. One would predict increased competition to increase the probability of malpractice liability arising from, for example, calendaring problems. The increased liability would in turn lead lawyers over time to adjust their behavior by substituting other, now relatively cheaper, methods of risk reduction. Perhaps lawyers would be led to hire a law office administrator, which seemed extravagant before the change in circumstances. Perhaps lawyers would reduce certain types of particularly risky lawyering activities. Perhaps lawyers would spend more on reducing the size of malpractice liability losses, by sheltering more of their assets, thereby shifting some of the new risk onto his clients. The point is that we would expect lawyers to increase their cost reduction efforts in some direction, and these new efforts might or might not benefit the client, and might or might not be socially desirable.

The same analysis applies if the source of the increased risk is a change in the liability regime and the nature of the increased risk is an increase in the size of malpractice losses. For example, courts have become more willing to allow punitive damages and damages for emotional distress in legal malpractice cases. These changes not only increase expected malpractice liability, but to the extent they put a greater percentage of the lawyer's wealth at risk, they increase the lawyer's risk premium as well. The lawyer will again be led to undertake new risk reduction techniques, such as improving client communications or reducing the number of clients he takes on.


49. A second possibility is that for sophisticated clients, competition will lead lawyers to engage in more activity likely to impose harm on third parties. I discuss the problem of malpractice arising out of third-party harm below. See infra pp. 322-23.

50. See Ramos, Dirty Little Secret, supra note 1, at 1691. Treble damages are also typically available under state consumer protection laws, which have been applied to lawyers in some states. Id. at 1687.
This last example is important because it implicates the assumption of the now-traditional economic model discussed earlier. If the change in legal regime increases the lawyer's risk premium, that is, makes him more risk averse, and the lawyer takes extra precautions to reduce that increased risk, is this a bad thing? The traditional law and economics answer is yes, if the additional expenditure on the new precautions exceeds the additional expected malpractice cost (PL) savings. The increased expenditure on precautions is now "excessive." But that analysis depends on the assumption that there is available an alternative insurance institution that can bear the new risk at lower cost, for example, market insurance available at an actuarially fair premium. If, however, there is no such alternative institution, then the extra precautions are excessive only with respect to a nonexistent ideal. One could of course argue that there is an available institution that imposes lower costs, namely the prior liability rules. That is possible, but it depends again on the assumption that perfect insurance was available to clients to eliminate the residual risks they bore under the prior rules. Absent such an institution, evaluating whether the change in legal rule was a good one requires analyzing difficult questions of whether clients or lawyers have lower risk premiums, that is, an evaluation of relative risk aversion. But this brings us to the reason for the rule change. Courts do not just change the liability rules willy nilly. Judges do not just wake up one morning and decide after breakfast, to use an overworked metaphor, that it might be nice to adopt punitive damages today. They respond to some perceived need, some perceived inadequacy in the current regime. That does not mean they always respond correctly, but it does mean that it is foolish to ignore the perceived need and what is driving it. In any case, I want to focus here on institutional responses to liability changes, not the reverse.

C. Client Contract Insurance

The existence of a contractual relationship between a lawyer and the client victim of malpractice affects the lawyer's choice of risk reduction methods. At the very least, clients bear the costs of lawyers' risk reduction choices in the fees the clients wind up paying, in the costs to them of enforcing their malpractice rights, and in the failure of the legal system to compensate them fully for their malpractice losses. I want to focus here, however, on the voluntary transfer of malpractice risks from the lawyer to the client.

Contracting parties can use ordinary contracts to provide insurance to each other by transferring risks to the party better able to reduce those risks, the least

51. See Shavell, supra note 26, at 209; Danzon & Harrington, supra note 4, at 29.
cost insurer. 52 But in lawyer-client contracts, the ethics rules severely limit the ability of lawyers to shift malpractice risks to their clients. 53 Do these restrictions make sense? If clients are better able to reduce certain malpractice liability risks, then lawyers and clients would be better off if lawyers could shift these risks to the client in return for lower fees. Are clients ever least cost insurers with respect to their lawyer’s malpractice liability?

Let us consider the various risk reduction methods. As for reducing the probability of malpractice liability, if this liability is sensibly applied with some kind of contributory negligence defense, 54 then usually there is little the client can reasonably do that would warrant a contractual shifting of malpractice risks. One possibility that the ethics rules permit is a lawyer’s limiting the scope of his representation to areas within his expertise. 55 For example, a lawyer might say to a client, “I am not an expert in tax matters. Before you consummate this transaction, I urge you to consult with a tax attorney.” This could be viewed as effectively shifting the risk of the lawyer’s “malpractice” (inexpertness in necessary tax advice) to the client, who must now hire a second lawyer. In addition, a client might be willing to waive malpractice liability with its attendant costs if the client’s long-term relationship with his lawyer gives the client alternative responses to lawyer malpractice, or if the client is sufficiently knowledgeable about the lawyer’s quality that he believes


53. See Model Rules of Professional Conduct Rule 1.8(h) (“A lawyer shall not make an agreement prospectively limiting the lawyer’s liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement”) [hereinafter Model Rules]; Model Code of Professional Responsibility DR 6-102(A) (1980) (“A lawyer shall not attempt to exonerate himself from or limit his liability to his client for personal malpractice.”); Leonard E. Gross, Contractual Limitations on Attorney Malpractice Liability: An Economic Approach, 75 Ky. L.J. 793, 830-31 (1987). The ethics rules do allow clients to consent to certain conflicts, see Model Rules, supra, Rule 1.7 and Rule 1.9, or to consent to disclosure of confidential information, see Model Rules, supra, Rule 1.6, but whether consent given ex ante waives malpractice liability is questionable. See, e.g., In re Boone, 83 F. Supp. 944, 957 (N.D. Cal. 1987); Westinghouse Elec. Corp. v. Gulf Oil Corp., 588 F.2d 1195 (7th Cir. 1978); Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195 (2d Cir. 1978).

54. See, e.g., Leubsdorf, supra note 1, at 138-39. An example of contributory negligence would be if a client fails to supply his lawyer with necessary information, or supplies his lawyer with misleading information.

55. See Model Rules, supra note 53, Rule 1.2(c). The lawyer’s ability to limit the scope of the representation is bounded by the lawyer’s obligation to provide competent representation under Model Rule 1.1. See id., Rule 1.2, cmt. 5 (noting that “the client may not be asked to agree to representation so limited in scope as to violate Rule 1.1”).
that likelihood of the lawyer’s committing malpractice is extremely small.\textsuperscript{56} As for reducing the size of the loss, the client might for example maintain sufficiently good relations with its suppliers, customers, creditors, and employees that it could easily smooth over any malpractice that his lawyer committed. Finally, as for diversification, if clients have a continual need for legal services, they might be able to diversify by hiring multiple lawyers,\textsuperscript{57} or perhaps by maintaining a portfolio of transactions with uncorrelated risks.

But even if clients might seem to be superior insurers, the restrictions against the shifting of malpractice risk may be justified on the basis of transaction cost problems that would often make contract insurance undesirable if such risk shifting were allowed.\textsuperscript{58} Transaction costs is a tricky term, but I will use it here in the institutional economics sense of “costs that are most likely to differ under alternative institutional arrangements.”\textsuperscript{59} For now, we can use the concept to compare self-insurance to contract insurance.

It will be useful to separate two types of transaction costs: those arising from the behavior of the parties, and those associated with economies of scale and scope. The first type of transaction cost arises out of the fact that in a client-lawyer relationship, as in any principal-agent relationship but in particular in contracts involving professionals and their clients, the parties have asymmetric information about the agent’s riskiness and ability to engage in risk reduction. As a result, “there can really be no contract which insures against the agent’s failure to do his business properly.”\textsuperscript{60} Asymmetric information causes the twin problems of moral hazard and adverse selection. Although these terms come from commercial insurance, economists have recognized their applicability to contract insurance as well.\textsuperscript{61} Moral hazard means that a lawyer who transfers malpractice risk to his client contractually will have an incentive after signing the contract not to engage in reasonable risk reduction, that is, to act opportunistically by increasing risk to the client-insurer. Clients will find it difficult to monitor and control this behavior. Like other

\textsuperscript{56} See Gross, supra note 53, at 830-31.

\textsuperscript{57} To see how hiring multiple law firms could of course increase the likelihood of malpractice, as Charles Keating’s Lincoln Savings & Loan experience might suggest, see In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424 (D. Ariz. 1992), though it also might have increased the likelihood of malpractice recovery for Lincoln and its successors-in-interest.


\textsuperscript{61} See, e.g., Oliver E. Williamson, The Economic Institutions of Capitalism 47 (1985).
contractually insured agents, an insured lawyer might pursue a higher risk strategy than his client would prefer, might favor other clients’ or his own pecuniary interests to the detriment of this client, or might increase enforcement costs to the client ex post in the event of malpractice.\(^{62}\) Adverse selection means that lawyers more prone to malpractice will not candidly disclose their true risk to their clients, and so would be more likely to “purchase” contract insurance if they could. Clients will find it difficult to do sufficient “underwriting” to separate out the good lawyers from the bad. Adverse selection relates, for example, to the lawyer insolvency problem discussed in the last section. Because lawyers who are judgment proof will not reveal this fact to their clients, and lawyers who are not judgment proof may have a hard time convincing clients of that fact, the low risk lawyers may not be able to obtain contract insurance from clients at a price commensurate with their riskiness.

Aside from moral hazard and adverse selection, other transaction costs not so easily controlled by lawyers would hinder their ability to obtain contract insurance from clients were it permissible. Insurance contracts are contingent claims contracts. Drafting such contracts is costly—in particular it might necessitate an additional lawyer to represent the client in negotiating with the first lawyer—and may not be worthwhile, especially if the “claims” are too infrequent, or the losses are too small to be worth contracting over. A related point is that lawyers and clients both may have insufficient information about the relevant risks to be able to determine a “price” (fee reduction) for the insurance or client risk reduction measures.

The concept of transaction costs can help us compare the institutions of insurance on which I have so far focused, self-insurance and contract insurance. Recall our posited historical fact, that the risks associated with malpractice liability have been increasing. Would we expect these increased risks to lead to more contract insurance if it were allowed? That depends on what the sources of the increased risks are. To go back to our prior hypothesis about increased competition among lawyers leading to more client neglect, it seems unlikely that this source of increased malpractice risk would lead to more contract insurance. We might expect just the reverse. Increased competition among lawyers could lead clients to be more suspicious of lawyer requests for malpractice waivers and in a better bargaining position to reject such requests.

\(^{62}\) See David Mayers & Clifford W. Smith, Jr., On the Corporate Demand for Insurance, 55 J. BUS. 281, 287-88 (1982). It should be obvious that these concerns motivate numerous ethics rules. See, e.g., MODEL RULES, supra note 53, Rules 1.2(a), 1.7, 1.8, 1.9.
Increased competition among lawyers has led, however, to an increase in an important class of malpractice against which we might expect clients to be willing to provide more contract insurance to lawyers. I refer to the extraordinary rise in malpractice claims by “non-clients” or “ambiguous clients.”

Lawyer competition has contributed to this type of malpractice by encouraging lawyers to seek out more marginal clients and engage in more marginal activity on behalf of clients to keep them satisfied. Suppose, to take a common example, that the lawyer makes a misrepresentation during a course of a transaction and a party to the transaction, not the lawyer’s express client, relies on that misrepresentation. Courts have become more receptive to such suits. The “client” may be perfectly happy to “waive” malpractice rights against the lawyer because the client may be benefited, not harmed, by the lawyer’s actions. Thus, although clients might want contract insurance in these cases, contract insurance is not socially desirable. Contract insurance in these cases may increase moral hazard by allowing lawyers and their clients to increase risks to third parties.

I do not mean to suggest by the above discussion that the transaction cost problems associated with contract insurance would always make contract insurance undesirable. Some clients might well have sufficient information about lawyer quality to mitigate the adverse selection problem, or might well be able to control their lawyers’ behavior sufficiently to mitigate the moral hazard problem, and might have no interest in using their lawyers to shift risks inefficiently to third parties. But the question is whether there are enough of these clients to justify abandoning the restrictions on contract insurance or whether these clients can be sufficiently categorized that an exception can be crafted for them. One might, for example, try to craft more permissive rules for “sophisticated” or “corporate” or “repeat player” clients. But as I will argue in Section III, there would be additional problems with creating such an exception because of the problems associated with complex clients.

D. Market Insurance

Having set the stage, we are now ready to consider the main subject of our inquiry, market insurance against legal malpractice. A lawyer may purchase insurance services from a commercial provider either because the lawyer unilaterally decides that such insurance is desirable, because the client insists on such insurance as part of the contract, or because the law requires it. In

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63. See Leubsdorf, supra note 1, at 126-35.
65. Currently only Oregon requires all of its lawyers to purchase malpractice insurance. See OR. REV. STAT. § 9.08(2)(a) (1997). Several states that have adopted statutes recognizing
this section, I examine the advantages of market insurance over self-insurance and contract insurance that have contributed to the demand for market insurance against legal malpractice. More specifically, I explore when lawyers will demand and market insurers will supply loss prevention services. I also consider the question of when market insurance is likely to be socially desirable.

1. Methods of Risk Reduction

Legal malpractice insurers make use of all the methods of risk reduction I have discussed so far. The primary method is, of course, diversification, which is generally thought to be the main advantage market insurance offers over self-insurance and contract insurance. Diversification is made possible by economies of scale and gains from specialization leading to superior information about risk. To provide diversification, the market insurer must be able to amass a sufficient pool of similar, but sufficiently uncorrelated, risks and to compute the expected losses associated with that pool. Thus, the insurer needs a broad customer base and accurate information. The cost of attracting lawyers and acquiring information about their riskiness must be sufficiently low and the risk to lawyers sufficiently great that market insurance is an attractive option to lawyers compared to alternative insurance institutions. Legal malpractice insurance developed later than other liability insurance, and has been a less stable market, in large part because these requirements have not always been met. For example, some malpractice risks may be correlated; this would occur if a custom or culture developed among lawyers that a court later deemed to be malpractice.

After diversification, the risk reduction method most used by legal malpractice insurers, as well as by other liability insurers, is ex post loss reduction. In insurance jargon, this method goes under the names of claims management and claims repair. Claims management largely refers to the legal defense services provided by the insurer. All legal malpractice insurance policies impose a duty to defend against malpractice claims. It may not be obvious why this is so, especially when one considers the other insurance institutions we have already looked at. A self-insured lawyer would of course

Registered Limited Liability Partnerships require LLPs to maintain liability insurance. See infra note 148.

66. "While the law of large numbers, which is the basis for rate making, can assure fairly accurate rates in life insurance, those large numbers are not available to insurers of lawyers' professional liability. Also, commercial insurers have not kept reliable statistics on their professional liability writings." J O A N N F E L I X, A L A W Y E R'S G U I D E T O L E G A L M A L P R A C T I C E I N S U R A N C E 4 9 (1982).

have to provide a defense for himself. A lawyer who was permitted to shift
malpractice risk to his client contractually could not, because of the conflict of
interest problems, impose on the client a duty to defend the client’s own
malpractice suit, but could in theory contract to have the client reimburse the
lawyer for his legal defense expenses, at least if the suit were unsuccessful. By
contrast, the duty to defend in most market insurance contracts can be
explained on transaction cost grounds. By defending numerous claims, the
commercial insurer gains an informational advantage over insureds, and is able
to enjoy the contracting advantage of a long-term relationship with legal
defense firms, as well as the expertise to monitor lawyer performance. But
these advantages seem far smaller for lawyer-insureds, many of whom would
be well aware of good lawyers to represent them and would be able to monitor
any lawyer chosen by the insurance company fairly closely. Thus, although
most legal malpractice policies allow the insurance company the right to
choose defense counsel, in practice, most legal malpractice insurers probably
allow substantial input from their insureds.

Insurers do, of course, need to worry about the moral hazard problem of
an insured insisting on an exorbitantly priced legal defense. Lawyers have a
keen interest in protecting their reputations, and so would often insist on the
best defense possible. As a result, most legal malpractice insurance policies
now have “eroding policy limits,” that is, they include legal defense costs in the
limits of the policy. Eroding policy limits put the burden on the insured
lawyers to monitor their defense counsel by eliminating the incentive of the
insurer to monitor legal defense costs for claims at or above the policy limits,
as many claims are. They also encourage early settlement by malpractice
plaintiffs who are reluctant to seek more than the policy limits in damages, and

68. See Posner, supra note 26, at 436. A less optimistic interpretation is that insurers are
able to exploit the ignorance of their insureds to provide low-budget, low-quality legal defense
services. This problem may be less prevalent in legal malpractice insurance than in other
insurance because of lawyers’ greater ability to monitor quality.
69. Professor Schwartz suggests that liability insurance “eliminates the burden that a
defendant would otherwise bear in attempting to review or monitor the performance of the
lawyer he would need to hire if he were uninsured.” Schwartz, supra note 4, at 336.
70. See Long & Levit, supra note 21, at 9.
71. A few current legal malpractice policies expressly allow the insured lawyer to choose
his defense counsel, subject to insurer approval, for example, the policy of the Association of
Trial Lawyers Assurance, a mutual insurer formed by members of the American Trial Lawyers
Association. Other policies say the insured’s recommendations will be considered and a few
say there must be mutual agreement.
72. See Long & Levit, supra note 21, at 4.
73. See Ramos, Reforming Lawyers and Law Professors, supra note 1, at 2605 (arguing
that claims handling is almost an afterthought and that insurers allow defense counsel to run
up costs).
therefore would, absent an early settlement, see their recovery erode with the policy limits.

In addition to claims management, legal malpractice insurers also try to reduce losses ex post through claims repair, which is essentially a form of mitigation that occurs before a claim is filed.\textsuperscript{74} Unlike claims management provisions, however, claims repair provisions in legal malpractice policies do not seem to raise any issues unique to legal malpractice insurance. Notification requirements, such as the requirement to notify the carrier as soon as he or she becomes aware of an act or omission that could be the basis of a suit, may facilitate mitigation.\textsuperscript{75} In addition, some carriers maintain a consultation “hotline” for insured lawyers who need help resolving a problem.\textsuperscript{76} Other carriers “specifically provide that reporting a potential claim will not affect the insured’s future risk assessment with the carrier,” or offer discounts on deductibles for early notice.\textsuperscript{77} These provisions and services suggest that mitigation may be a more realistic possibility in many cases than one might think.

Finally, many legal malpractice insurers take steps to try to reduce the probability of legal malpractice loss ex ante.\textsuperscript{78} Insurers refer to these steps as loss prevention. Types of loss prevention range from general educational services, such as newsletters, seminars, and speeches,\textsuperscript{79} to more individually

\textsuperscript{74} See Long & Levit, supra note 21, at 12; Ramos, Reforming Lawyers and Law Professors, supra note 1, at 2607 (noting that the Oregon State Bar Professional Liability Fund sometimes achieves mitigation); Marsha L. Morrow & Martin T. Lee, How and When to Submit a Claim Under a Professional Liability Policy, 3 Legal Malpractice Rep. 7, 13 (1990) (“the insurance carrier may be able to assist in averting a claim and/or mitigating damages”).

\textsuperscript{75} Goldfein, supra note 2, at 1289. Such a provision is currently used by The American International Specialty Lines Insurance Company. See Long & Levit, supra note 21, at 149.

An example of how such early notification could lead to mitigation would be a lawyer who mistakenly thought he missed a statute of limitations deadline, when in fact he had not. See Malpractice Insurers Help Regulate Lawyers Conduct, 13 ABA/BNA Lawyers’ Manual on Professional Conduct 163 (June 11, 1997) (remarks of Sally Field, president the legal professional liability division of Great American Insurance Companies, at a panel discussion of the ABA National Conference on Professional Responsibility).

\textsuperscript{76} See Morrow & Lee, supra note 74, at 13; Long & Levit, supra note 21, at 35. The hotline could also be used as an ex ante loss prevention technique.

\textsuperscript{77} See Morrow & Lee, supra note 74, at 13.

\textsuperscript{78} Of the 50 legal malpractice insurance carriers listed by Long & Levit in their survey, 32 reported having some kind of loss prevention program, 11 reported having no such program, and 7 did not respond. Of the 32 reporting the existence of a loss prevention program, 20 listed either on-site review or audits as part of the available package. See Long & Levit, supra note 21, at 159-69.

\textsuperscript{79} A recent example is a talk by Mary Scott of CNA Insurance at the ABA’s annual meeting in San Francisco in the summer of 1997. She appeared on a panel program entitled “Hazards of the Job: How to Recognize Legal Malpractice Pitfalls and Purchase Insurance to
tailed consulting services, such as firm audits. These services may be provided by in-house insurance personnel, such as a “loss prevention counsel,” or by outside lawyers retained by the insurance company. The services include identifying and seeking to reform “troubled” lawyers or firms, as well as risky practices. As with claims management services, why a legal malpractice insurer would provide loss prevention services to lawyers is something of a puzzle. Legal malpractice insurance protects lawyers against risks for which they are, in theory, expert at avoiding. Loss prevention often involves essentially legal advice. This makes legal malpractice insurance akin to fire insurance purchased by fire safety equipment manufacturers (such as First Alert), whom we might not expect to seek loss prevention services from their insurers. In fact, though, lawyers are not as expert in legal malpractice as many think they are; in particular, they tend not to fully appreciate the extent to which they owe duties to people other than their clients.

Finally, it is important to note that not all “loss prevention” to the insurance company results in loss prevention to society. In particular, the insurance company will engage in underwriting (assessing the risk of a potential insured) before deciding whether to take on a new insured and will reject an applicant it deems too risky. Similarly, the company could fail to renew an existing insured with a bad enough track record. If these lawyers go on simply to commit malpractice elsewhere, then the insurance company has not reduced social loss. I will return to loss prevention below, to try to give a fuller explanation of when a legal malpractice insurer might offer these services. Before doing that, however, I want to examine more closely the demand for market insurance as opposed to self-insurance and contract insurance.

2. The Effect of an Increase in Risk on the Demand for Market Insurance

As a first cut, let us return to the question of how an increase in liability risk, that is expected liability costs plus the risk premium, affects the demand for market insurance. This section identifies three effects that such a change could have. The following three sections try to explore which effects we might expect to dominate.

Cover Them.” For a summary of her remarks, see ABA/BNA LAWYERS’ MANUAL ON PROFESSIONAL CONDUCT, Aug. 20, 1997, at 253-54.

81. See LONG & LEVIT, supra note 21, at 12.
The first effect of an increase in risk is the substitution effect. The substitution effect is the typical explanation for the law of demand: as the price of a good or service increases, people buy less of that good or service because they substitute other goods and services that are now relatively cheaper. In the insurance context, an increase in expected malpractice liability risk (PL) will increase the price of malpractice insurance (i.e., premiums), which must be at least sufficient to cover the extra payouts, and therefore will tend to decrease the amount of malpractice insurance purchased. Insureds who previously bought market insurance will now be diverted to substitute activities, such as self-insurance.

The second effect of an increase in risk is the income effect. For most goods and services, the income effect reinforces the substitution effect and the law of demand: as the price of a good or service increases, real disposable income declines, and so does demand for most goods and services, including the one whose price increased. In the insurance context, however, the income effect works in the opposite direction from the substitution effect. If the increase in risk is due to the fact that the magnitude of malpractice losses is increasing, then the potential losses are a larger proportion of wealth. That means the risk premium is likely to increase, which will increase the demand for diversification services and hence the demand for market insurance. This increase in demand could offset the decrease in demand from the substitution effect.

But—and this is the key point for our purposes—there is yet a third effect, which results from the fact that, as we have defined it (hence the importance of the definition), insurance is not only diversification. The third effect is that

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83. If the likelihood of loss (P) increases, premiums will also likely rise because of the added administrative costs necessary to handle the additional claims. Thus, the risks insurers are most likely to insure are low probability, high loss events.

84. See Pottier & Witt, supra note 4, at 1686, n.31. The “price” of self-insurance does not vary with the probability of loss, as the price of market insurance does, because the actions a self-insured individual could take to reduce risk do not cost more simply because the probability of harm increases. By the same token, if the likelihood of harm decreases, a self-insured person does not face a lower “price.” The fact that the price of market insurance declines with the likelihood of loss is one reason that people tend to buy market insurance for low probability events. See Ehrlich & Becker, supra note 30, at 628, 637.

85. See Ehrlich & Becker, supra note 30, at 629.

86. Arguably, this is exactly what happened during the liability insurance crisis of the 1980s. See Pottier & Witt, supra note 4, at 1686. Declining interest rates (meaning lower returns on insurance company investments) and adjusted expectations about future claims costs shifted the supply curve market insurance in, while the increased risk aversion created by the higher potential losses shifted the market insurance demand curve out. The result was extremely high premium increases. Whether the quantity of market insurance demanded declined would depend on the size of the demand shift relative to the supply shift. See id.
the higher risk premium could lead the insured to demand more risk reduction in addition to, or instead of, diversification services. This effect could either increase or decrease the demand for market insurance, depending on whether market insurers or other insurance institutions could provide risk reduction services more cheaply.\textsuperscript{87} Thus, the effects of an increase in liability risk on the demand for market insurance are highly ambiguous.

3. The Demand for Legal Malpractice Insurance and the Insurer’s Transaction Cost Advantage

Given the ambiguity of the effects of increased risk on the demand for market insurance, I turn in this section to a transaction cost comparison to try to sort out which effects might predominate. In general, lawyers will purchase legal malpractice insurance when they cannot get equivalent benefits at lower cost from alternative insurance institutions. As I said above, insurance companies have obvious transaction cost advantages associated with diversification. But what about the behavioral transaction costs?

Under the standard law and economics analysis of insurance, market insurance creates a moral hazard problem. Unless the insurance company can perfectly observe the behavior of its insureds and adjust its premiums based on these observations, then insureds will engage in too much inefficient behavior.\textsuperscript{88} In our context, malpractice insurance will give lawyers too much incentive to commit malpractice. The institutional economics approach is different. Whereas under the traditional approach moral hazard makes market insurance costly, under the institutional approach moral hazard may make market insurance \textit{necessary}.\textsuperscript{89} The key point is that the moral hazard problem exists no matter what insurance institution governs behavior. If a lawyer seeks contract insurance, he is still subject to a moral hazard problem. Even if the lawyer self-insures, he may still be subject to a moral hazard problem stemming from the temptation to engage in activities that do not reduce the social cost of malpractice, such as making himself more judgment proof. Thus,

\begin{footnotesize}
\textsuperscript{87} See, e.g., Schwartz, \textit{supra} note 4, at 341-42. (arguing that strict liability will not necessarily increase the demand for liability insurance because substitutes such as self-insurance might be more attractive if insurer cannot effectively monitor insureds).

\textsuperscript{88} The insurance contract may also create a moral hazard problem for the insurer, which may be able to both disguise its insolvency risk, \textit{cf.} Skogh, \textit{supra} note 58, at 727-28 (noting that insurer must solve the “credibility problem” of proving its solvency), and exaggerate the insured’s malpractice risk, \textit{see} Harris Schlesinger & Emilio Venezian, \textit{Insurance Markets with Loss-Prevention Activity: Profits, Market Structure, and Consumer Welfare}, 17 RAND J. ECON. 227, 228 n.2 (1986), to sell more insurance.

\textsuperscript{89} See Skogh, \textit{supra} note 58, at 729 (arguing that “in the pool-of-risks theory, moral hazard is treated as a complication. In the transaction-cost theory, moral hazard is the \textit{raison d’etre} for insurance.”).
\end{footnotesize}
market insurance might reduce moral hazard rather than increase it. As a result, the absence of perfect monitoring by a market insurer does by itself not tell us whether market insurance is an inefficient institution.

The difference between the approaches is the relevant baseline. Under the traditional approach, the baseline is perfection; under the institutional approach, the baseline is the next best available institution. Thus, the relevant moral hazard question in the institutional approach is not which institution is the perfect monitor of lawyer behavior, but rather which institution is the best monitor. If the market insurer is the best monitor, then lawyers will buy market insurance; if the market insurer is an inferior monitor, then market insurance will not be available at acceptable prices to lawyers and will not be demanded.90

Although the institutional economics theory of insurance developed to explain why corporations, whose shareholders can often diversify risk, buy insurance, the theory has broader application. When legal malpractice insurers are better monitors of lawyer performance—and hence moral hazard—than other insurance institutions, lawyers will buy more malpractice insurance. The reduction in moral hazard will lead insurers to reduce premiums and expand coverage. It will also lead clients to insist that their lawyers purchase malpractice insurance, or buy it at higher levels, as a bonding device to guarantee lawyer performance.

A similar argument applies to adverse selection. The traditional adverse selection argument is that if an insured has better information about his riskiness than an insurer, too many poor risks will end up buying insurance and at the extreme the insurance will not be available. Again, adverse selection is viewed as a cost of market insurance. But under the institutional approach,

90. See Ehrlich & Becker, supra note 30, at 642 (arguing that if the moral hazard problem cannot be surmounted either no market insurance will be offered or no self-protection will occur). Professor Schwartz puts this point nicely:

In our society, there is a tendency for people to assume that for liability insurance to be unavailable signifies some breakdown in the overall functioning of the tort system. But such an assumption may well be misguided. The unavailability of insurance—far from revealing that the system is malfunctioning—may verify that it is functioning very effectively as a deterrence regime: that it is targeting for liability precisely those forms of conduct that are so readily controllable by defendants as to render unacceptable to insurers the moral-hazard prospect of insurance policies.

Schwartz, supra note 4, at 343 (footnotes omitted).

The converse of Schwartz's proposition may not be true, however. That is, the availability of insurance does not necessarily mean that the system is targeting the wrong types of conduct, because insurers may be better monitors.
market insurance may reduce the adverse selection problems of alternative insurance institutions. Recall that because clients may be poor underwriters of the riskiness of their lawyers, they would be reluctant to offer contract insurance to their lawyers, even if it were allowed by the ethics rules. But if malpractice insurers are better underwriters than clients, clients have another reason to insist that their lawyers buy malpractice insurance: the lawyers’ ability to procure malpractice insurance will provide a signal of lawyer quality. As for self-insurance, the ability of lawyers to make themselves judgment proof may mean that too many high risk lawyers will choose this insurance institution. Thus, the institutional perspective leads to the complete opposite of the traditional adverse selection story: the good risks will buy market insurance. On the other hand, if the client is better at judging lawyer quality than the market insurer, the client would view the lawyer’s purchase of market insurance as a signal of poor quality; the traditional adverse selection story would then apply.

This last example suggests that the transaction cost story is not yet complete. The fact that malpractice insurers might be better monitors of lawyer moral hazard or adverse selection does not mean that they are. Thus, we cannot necessarily infer from the fact that lawyers purchase malpractice insurance that malpractice insurers have transaction cost advantages over other insurance institutions in controlling moral hazard and adverse selection. Unlike the case with corporate insurance, where diversification is not available as an explanation, diversification might explain a fair amount of the motivation for lawyers purchasing market insurance against legal malpractice. Thus, clients might want their lawyers to buy market insurance, fully cognizant of the moral hazard problems created, because they are sufficiently risk averse that they are willing to trade off increased diversification benefits for increased malpractice costs. The short answer to this objection is that legal malpractice insurers have increased their loss prevention services over the last twenty years. Just as diversification cannot fully explain corporate insurance, it cannot explain the rise in loss prevention services offered by legal malpractice insurers. But not all legal malpractice insurers offer loss prevention services, and it is possible that these services are largely public relations and window-dressing. I therefore need to examine more closely under what circumstances lawyers might demand, and insurers might offer, these services from malpractice insurers.

91. The signaling function would, of course, be significantly curtailed if insurance were mandatory.
4. The Demand for Loss Prevention Services from Malpractice Insurers

The economic theory I have been developing suggests that malpractice insurers will provide loss prevention services if they can do it more cheaply than other institutions. Some academics are optimistic about insurers providing loss prevention services,92 others are skeptical. In this section I will consider several factors that help determine whether a malpractice insurer will offer loss prevention services.

a. The Incentive Problem

The first hurdle that an insurer offering loss prevention services must overcome is the incentive problem, or what might be termed—the paradox of loss prevention. The argument is as follows. If the insurer adjusts premiums based on riskiness, then the insured has an incentive to engage in loss prevention to enjoy lower premiums, but the insurer has no incentive to provide it, because “any reduction in its eventual payouts is offset by a reduction in its premium income.”93 On the other hand, if the insurer does not adjust premiums based on riskiness, the insurer has an incentive to offer loss prevention, but the insured gets no benefit from following the advice.94 The first of these propositions is theoretically unsound; the second is factually inaccurate.

Take the first proposition, that if the insurer offers what Professor Schwartz calls “perfectly responsive insurance,” the market insurer will not want to offer loss prevention. Presumably a market insurer who offered loss prevention services would include the cost of providing them in the premium, including a competitive return on investments in providing those services.95 Other institutions that provide loss prevention services, such as lawyers, seem

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92. See Shavell, supra note 26, at 199 (“When parties can influence risks, insurers often supply advice about risk reduction and include in policies a great variety of features that serve to induce insured parties to lower risk.”).
94. See Schwartz, supra note 4, at 357; Hansmann, supra note 93, at 148. It should be noted that neither Professor Schwartz nor Professor Hansmann accept the paradox fully; both argue there are situations in which it would make sense for the insurer to offer loss prevention services.
95. In fact, some legal malpractice insurers charge insureds separately for loss prevention services. See Long & Levit, supra note 21, at 60-170 (chart of insurers and coverages).
to be able to make a profit doing so.\textsuperscript{96} Moreover, the fact that loss prevention services could reduce the premium paid by insureds who used those services does not necessarily mean that total premium income to the insurer would decrease. If an insurer can charge lower premiums to its insureds because they follow the insurer's loss prevention techniques and so are better risks, the insurer might very well increase the demand for its services, as insureds substitute more market insurance for other insurance institutions.\textsuperscript{97} And if the demand for these services is elastic, the total revenue for the insurer will increase.

The second proposition, that "flat" insurance premiums will give an incentive to the insurer to offer, but not to the insured to adopt, loss prevention measures, is based on the unrealistic assumption that perfectly flat insurance exists,\textsuperscript{98} or more precisely that lawyer insureds bear no residual risk of malpractice liability. Even if a market insurer charged perfectly flat premiums, lawyers would bear risk associated with reputational harm, the threat of nonrenewal by the insurer, and the possibility of professional discipline or court sanctions. Moreover, legal malpractice insurers employ a variety of restrictions that have the effect, if not the purpose, of maintaining some risk on lawyers, and thereby encouraging loss prevention by lawyers. Legal malpractice insurers impose deductibles,\textsuperscript{99} caps on payments,\textsuperscript{100} and exclusions

\textsuperscript{96} Professor Schwartz may have something like this in mind when he asserts that competition among insurers might force insurers to offer loss prevention services. \textit{See} Schwartz, \textit{supra} note 4, at 357, n.186.

\textsuperscript{97} It is true that what we referred to above as the "income effect" could theoretically reduce the demand for insurance. As an insured's riskiness and therefore premium paid decline, and his effective income increases, his risk premium might also decline, so he might buy less insurance. But even if this effect were significant, it could be outweighed by the fact that one's demand for loss prevention services (as distinct from diversification services) might increase as riskiness declines and income goes up. The point is that if insurers are offering loss prevention services, they probably believe that the "income effect" is small.

\textsuperscript{98} Professor Schwartz makes this point. \textit{See} Schwartz, \textit{supra} note 4, at 357, n.186. But he thinks that liability insurance premiums tend to be more flat than responsive.

\textsuperscript{99} According to the survey by Long & Levit, minimum deductibles range from $0/claim to $100,000/claim with $1000/claim being the most common minimum. Maximum deductibles range from $25,000/claim to $500,000/claim. \textit{See} O'Malley, \textit{supra} note 80, at 117. The loss prevention counsel of ALAS, describes the purpose of deductibles as "reducing the company's defense costs on frivolous claims and non-frivolous nickel and dime claims, and reducing the company's internal claims handling expenses on such claims." \textit{Id.}

This statement tends to contradict Professor Schwartz's assertion that deductibles are less useful for liability insurance than for first party insurance because deductibles do not serve to eliminate many claims. \textit{See} Schwartz, \textit{supra} note 4, at 316-17, n.18. Schwartz also asserts that deductibles in liability insurance would tend to impose processing costs on an insured who is not in a good position to process claims. \textit{See id.} But this assertion seems less true for lawyers than for other insureds. Finally, Schwartz argues that "if the plaintiff's total loss exceeds the
from coverage for certain activities they view as too risky. Finally, and most significant, legal malpractice insurers are more and more taking into account the riskiness of individual insureds in setting premiums.

b. Information about Loss Prevention

The resolution of the loss prevention paradox does not of course, guarantee that the market insurer will offer loss prevention services. A second factor is whether the market insurer has better information about loss prevention than

deductible, the deductible serves to divide the claim between insurer and insured, leading to a costly problem of coordination.” id. That is true, but coordination problems exist whenever the insured has an independent interest in the suit, for example to preserve reputation or avoid being subject to professional discipline. And insurers have ways to minimize the coordination problems. For example, most legal malpractice policies require an insured’s consent to settle, but the insured must often bear any extra defense costs if he rejects a settlement acceptable to the insurer and the insured’s client. See Long & Levit, supra note 21, § 10.2.23. This provision serves as a kind of ex post deductible. Coordination problems may better explain why legal malpractice insurers tend not to use co-insurance. See Schwartz, supra note 4, at 316 n.17. Legal liability is often more difficult to measure than, say, health care expenses.

100. The Long & Levit survey shows caps ranging from $100,000/claim and $300,000/policy period (with the exception of one insurer that insures only sole practitioners in practice four years or less) to $20,000,000 per claim and per policy period. ALAS, which did not fully participate in the survey, nevertheless reported that its policy limits are significantly higher: $75,000,000/claim and $125,000,000/policy period. See Long & Levit, supra note 21, at 46. Liability caps essentially make lawyers self-insurers of any malpractice liability over the cap, unless the lawyers buy excess insurance. See Schwartz, supra note 4, at 316. Caps are less likely to encourage self-insurance to the extent that malpractice plaintiffs are reluctant to seek greater damages than the caps. See Ramos, Reforming Lawyers and Law Professors, supra note 1, at 2602; Syverud, supra note 4, at 1635, n.19.

101. See Davis, supra note 3, at 202-20; but see Silver, supra note 3, at 234. The most significant exclusion that has developed among legal malpractice insurers is for liability arising out of a lawyer’s serving as a director or officer of a client. See Robert E. O’Malley, Preventing Legal Malpractice in Large Law Firms, 20 Toledo L. Rev. 325, 332 (1989). ALAS has gone even further and excluded all malpractice claims by lawyers who hold an executive position in a publicly-held client, which effectively prohibits lawyers from holding such positions. Id. at 333-34.

102. See Long & Levit, supra note 21, at 39 (“Experience rating . . . is a standard underwriting practice.”). The Reliance National Insurance Company and the Meadowbrook Insurance Company (Michigan Lawyers Mutual Insurance Company) offer premium credits for participating in loss control seminars, and the Clarendon National Insurance Company offers premium credits for using their loss control consultant. See id. In addition, a recent survey by a publisher of legal software identified 14 insurance carriers, including the National Casualty Company and Attorneys Liability Protection Society, that commonly offer premium reductions of about 5% to firms using docketing software, with one carrier, Commercial Bankruptcy Lawyers Purchasing Group, granting 25% reductions. See Gary Blane Crouse, Profession Watch 12 Of Couns., Mar. 1, 1993, at 19. Professor Schwartz’s contrary assertion that “professional malpractice insurance . . . make[s] no effort to reflect the individual’s accident potential,” Schwartz, supra note 4, at 319, may be limited to medical malpractice, if true at all.
lawyers do. Although it might seem that lawyers should have better information than their malpractice insurers about how to avoid malpractice, in fact this is not necessarily true. As Professor Abraham argues:

[1]n its capacity as a risk pooler the insurer may acquire useful information more efficiently than individual insureds. Insurance prices or risk classifications can provide information about the riskiness of an insured’s activities that the insured himself would have ignored or figured inaccurately. The insured may then be able to make more efficient decisions concerning the optimal combinations of risk, insurance, and loss prevention to adopt in conducting his or her activities. Further, since the insurer pools a large number of similar risks, it will sometimes be better equipped than any individual insured—because of its superior access to loss experience statistics or greater ability to finance research into loss prevention methods—to discover more efficient courses of conduct than those its insureds currently follow. When this is so, and the insurer is able to have its suggestions for changes in behavior implemented, efficiency is enhanced.⁹³

The relevant legal regime may also affect who is better able to acquire loss prevention information. The more liability is based on custom, as negligence usually—but not always¹⁰⁴—is, the more likely the insured will have superior

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⁹³. See Abraham, supra note 27, at 16. See also Arrow, supra note 60, at 74 (“In an organization of any complexity, an individual or small group simply cannot be aware of all that is relevant. Even if formal provision is made for the acquisition of information, as in the massive provision of statistical services in the modern advanced state, no small group of individuals can assimilate the data needed.”). Although Professor Shavell contends that insureds should be willing simply to pay insurers to develop information about risk, see Shavell, supra note 26 at 197, in fact insureds may not cooperate fully in the insurer’s efforts to acquire this information. The more the insured believes that the information he supplies will disadvantage him, the less likely he will be to supply it.

¹⁰⁴. See Gleason v. Title Guar. Co., 300 F.2d 813 (5th Cir. 1962) (relying on Judge Hand’s decision in In re Eastern Transp. Co. v. Northern Barge Corp., 60 F.2d 737 (2d Cir. 1932), to rule that relying on telephone conversations with a title company, which was the customary practice, rather than checking titles, was malpractice); but see Gleason v. Title Guar. Co., 317 F.2d 56, 60 (5th Cir. 1963) (on petition for rehearing, noting that the court “had no quarrel with the law” that the lawyer’s duty to the client “must be measured by community standards,” but finding that there was “no evidence whatsoever that the community condoned” the lawyer’s failure to tell the client he was relying entirely on the title company’s representation and the inherent risks of that action).
information. But when custom is rejected as a standard of liability, as in a strict liability system, the insurer may be in a better position to acquire information about cost-effective loss prevention techniques. Liability not based on custom may be becoming more common in legal malpractice cases, as many involve duties to nonclients, conflicts of interest, or other breaches of fiduciary duties. Market insurers may also have an informational advantage when liability rules are simply changing or new cases are rapidly accumulating.

Finally, apart from economies of scale and changes in legal regime, there may simply be psychological reasons associated with cognitive dissonance that may make it difficult for a lawyer to process and assimilate, rather than

105. Even under a custom based standard, the insured may not have superior information. In fact, Professor Leubsdorf has recently advocated a non-custom-based malpractice standard precisely because lawyers often lack sufficient information about what the custom is. He argues:

Whatever its merits in medical malpractice cases, a professional practice test simply will not work for legal malpractice except in a few areas where procedures are standardized as in real estate closings. Otherwise, we have no information about how most lawyers deal with most of the problems that arise in malpractice cases. A lawyer called as an expert witness will know of the practice in his or her firm and possibly also that of a few other firms. He or she cannot possibly know how most of the thousands of lawyers who practice in a typical jurisdiction handle a problem. Even were such knowledge available, it is unclear whose practice would set the standard.

Leubsdorf, supra note 1, at 110-11. Interestingly, Professor Leubsdorf does not consider the possibility of malpractice insurers serving as expert witnesses in malpractice cases, see id. at 120-23 (arguing for replacing much of the role of malpractice experts with more detailed court instructions and treating lawyers’ duties as issues of law), though that would not solve all of his concerns and might pose too many conflict of interest problems to be feasible.

106. Interestingly, two areas of law in which insurers have long offered loss prevention services, title insurance and workers compensation, see Schlesinger & Venezian, supra note 88, at 228, are strict liability systems. In a strict liability system, courts have less opportunity to collect and publicize in opinions information about loss prevention. Thus, insurers are likely to have much better information about loss prevention than insureds under such a regime.

107. See, e.g., Legal Malpractice Claims, supra note 36, at 21-22 (noting anecdotal evidence from insurers of an increase in claims involving conflicts of interest, breaches of fiduciary duty, and non-client third parties).

108. Professor Hyman in his comments seems to suggest that uncertainty and change could lead to less loss prevention because its value would be uncertain. See David A. Hyman, Professional Responsibility, Legal Malpractice, and the Eternal Triangle: Will Lawyers or Insurers Call the Shots?, 4 CONN. INS. L.J. 353 (1997). That would be true if the changes were truly random and the value of precautions varied greatly from one type of malpractice to another. I am not convinced that either is true.
discount and discard, information that suggests he should change his established method of practice.\(^{109}\)

c. Free Rider Problems

Even if the market insurer has better information about loss prevention, free rider problems may discourage the insurer from providing this information to its insureds. These problems come in two forms. First, because of the public good nature of general loss prevention information—that is, the inability to exclude others from using the information and the ability of numerous people to consume the information at no additional cost—competitor insurance companies have an incentive to let some other insurance company offer the loss prevention information. They can then benefit from the lower risk of their insureds without having incurred the investment in loss prevention information.\(^{110}\) Second, the insurer may provide loss prevention information specific to a particular insured, who may then turn around and switch (or threaten to switch) to an insurer willing to offer a lower premium because of his now lower risk profile.

It is important not to exaggerate the extent of free rider problems in the context of legal malpractice insurance, however. As for general information, many lawyers make a good living providing loss prevention advice that is to a large extent publicly available. The reason is that the information is costly to collect, organize, and digest in a useful way. Moreover, although insurance companies often do not broadly circulate their loss prevention materials, legal malpractice insurers may find it worthwhile to publicize loss prevention information, rather than hoard it, to encourage other institutions, such as law schools, law firms, or bar associations to do the loss prevention work in the future.\(^{111}\)

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\(^{109}\) See Arrow, supra note 60, at 75 ("The efficiency loss due to informational overload is increased by the tendency . . . to filter information in accordance with one's preconceptions.").

\(^{110}\) See Schlesinger & Venezian, supra note 88, at 234; Hansmann, supra note 93, at 147.

\(^{111}\) ALAS, for example, makes available a fair amount of general loss prevention information. An example is the charts found in most Professional Responsibility supplements noting state variations in the ethics rules on client fraud and imputed disqualification. Moreover, Robert O'Malley, ALAS's chief loss prevention counsel, has written several publicly available articles on loss prevention. See O'Malley, supra note 80; O'Malley, supra note 101. A more ambiguous example is the fact that the St. Paul Fire and Marine Insurance Company, one of the largest legal malpractice insurers in the country, published the Legal Malpractice Review from 1977 until 1984. The insurer's explanation for stopping publication was:

Much has changed since [the Review was started] over six years ago. The legal community has become much more aware of legal malpractice
As for specific information, insureds may have sunk their own specific investments in their relationship with the insurance company that provided them the loss prevention services. The original insurance company might, for example, have succeeded in subtly modifying a law firm’s culture in a way that is not easy to communicate to a new insurance company. Moreover, insurance companies view frequent carrier changes by insureds quite suspiciously because of the possible malign explanations.112 Finally, as long as the first insurance company charged (through a higher premium) for the loss prevention services, it gets some benefit even if the insured jumps ship.

**d. The Nature of Precautions**

Information is not all there is to loss prevention. Loss prevention involves taking precautions. The nature of these precautions will also influence whether insurance companies are better situated than alternative institutions to provide loss prevention services. In particular, loss prevention may be less useful when malpractice is caused by inattention rather than a failure to invest in some durable precautionary device or structure.113 It will be easier for the insurer to monitor durable precautions than attentiveness.114 This distinction may explain why loss prevention is not an important part of homeowner and car insurance,115 which cover many accidents caused by momentary inattentiveness. Although some legal malpractice certainly results from exposure and the adverse professional liability climate; new publications have appeared addressing the subject of legal malpractice; and a large number of lawyer associations across the country have formed task forces or added standing committees to research and keep abreast of issues and trends relating to professional liability.

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**LEGAL MALPRACTICE REV.,** Winter 1984, at 1. Putting aside the delicious irony of this explanation coming in the midst of the largest liability insurance crisis in history, one might surmise that St. Paul was tired of having others free ride and anxious to free ride itself. The journal might also have simply been a form of advertising, see Schlesinger & Venezian, supra note 88, at 228, whose useful life had expired.

112. See LONG & LEVIT, supra note 21, at 29 (“The importance of continuity in the insured-insurer relationship should not be underestimated. . . . Underwriters may construe frequent changes in insurers as opportunistic, or potential evidence of instability.”).


114. See SHAVELL, supra note 26, at 197. That does not mean, of course, that loss prevention could not be used at all to reduce the incidents of malpractice associated with momentary inattentiveness. Momentary inattentiveness could be caused, or at least exacerbated, by excess hours worked or some drug or mental health problem. Loss prevention could be used to mitigate some of these “root causes” of inattentiveness.

115. See Schwartz, supra note 4, at 357.
momentary inattentiveness, such as a calculation error made in the last-minute rush before a transactional deadline,\textsuperscript{116} or a missed objection opportunity in the heat of trial, much malpractice can be prevented by some durable precaution.\textsuperscript{117} Examples include improved systems for checking conflicts, calendaring, preserving confidentiality, staffing, maintaining accurate billing records, and evaluating client riskiness. Standardized procedures in all these areas could make even malpractice due to inattentiveness less likely.

Loss prevention may also be difficult when malpractice results from poorly exercised discretion in a particular situation, both because it will be difficult to put in place a corrective mechanism that solves the problem and because it will be difficult to monitor such behavior.\textsuperscript{118} But difficult does not necessarily mean impossible. Ex ante, practice manuals could provide guidance, at the time of decision, an ethics hotline could backstop discretionary judgments or random audits could regulate others, and ex post, a review and critique of prior decisions could improve future performance. Obviously, not all malpractice will be prevented using these techniques, and not all such techniques are cost-justified. But the question is whether market insurance, as compared to other institutions, could lead to the adoption of more techniques that reduce the risk of malpractice by more than their cost.\textsuperscript{119}

e. Monitoring by Insureds: Mutual Insurance Companies

As the above examples of durable precautions demonstrate, loss prevention often involves establishing better procedures for evaluating malpractice risks.

\textsuperscript{116} See, e.g., Prudential Ins. Co. v. Dewey, Ballantine, Bushby, Palmer & Wood, 573 N.Y.S.2d 981 (N.Y. App. Div. 1991) ($93 million typographical error in loan document). Professor Hyman views this case as an example of how much little marginal benefit loss prevention might provide, because it shows that even heavily lawyered transactions can result in mistakes. See Hyman, supra note 108, at 368. Another lesson that could be drawn, however, is that too many lawyers were relying on their assumption that others would be checking rather than checking themselves.

\textsuperscript{117} According to one insurer in a recent survey, “most of its claims could have been avoided through (1) a clear retainer agreement with the client, (2) a clear understanding with the client concerning the scope of services to be provided, and (3) better and more complete communication with the client during the representation.” See e.g. Legal Malpractice Claims, supra note 36, at 23. Routinized procedures could help in all three areas.

\textsuperscript{118} See Kevin Lang & Peter-John Gordon, Partnerships as Insurance Devices: Theory and Evidence, 26 RAND J. ECON. 614, 615 (1995) (“Creative and/or intellectual pursuits are more difficult to monitor than mechanical, repetitive tasks.”).

\textsuperscript{119} Professor Hyman suggests that it is “unlikely that more than a handful of such procedures can be instituted, because of the attendant cost and controversy.” See Hyman, supra note 108, at 363. His empirical intuitions about the cost-effectiveness of various loss prevention techniques—that is, how much current malpractice is economically “preventable”—may be different than mine.
One way to mitigate many of the problems already discussed is to have insureds monitor each other. That is essentially what mutual insurance companies, which are owned by their policyholders, do. In fact, many, though not all, legal malpractice insurers that offer loss prevention services are mutuals. Mutuals trade off the costs of reduced diversification against the benefits of improved loss prevention.\footnote{See Hansmann, supra note 93, at 149-50.} Mutuals can reduce moral hazard and adverse selection problems, and enhance compliance with loss prevention measures by having their members monitor each other.\footnote{See id. at 148} For example, Robert O’Malley, chief loss prevention counsel for ALAS, the largest mutual legal malpractice insurer, recommends that “[w]hen possible, seminars should be held at the [insurance] company’s Annual Meeting.”\footnote{O’Malley, supra note 80, at 119.} The reason is obvious. It would be hard to think of a more effective informal enforcement mechanism than having representatives from an insurer’s member law firms present to discuss the claims from the prior year. Having a legal autopsy done on one of your malpractice cases by top lawyers in your field who have a financial stake in your future behavior is probably a very sobering experience.\footnote{For a fascinating discussion of the goings-on at one such annual meeting of ALAS in Bermuda, see Rita Henley Jensen, Malpractice Rates May Level Off: ALAS Confab Looked at Future Costs, Past Law Firm Mistakes, Nat’l L.J., July 19, 1993, at 1. Jensen reports that “the most well-attended seminars, to the surprise of some ALAS officials, were the ‘Monday morning quarterbacking-confessionals’ of six firms hit recently by sizable malpractice verdicts or settlements, and a workshop on conflicts.” She describes these sessions further: Some ALAS law firms that are involved in litigation must each year face their toughest audience available: their colleagues who help pick up the tab. For each case, a presenter summarized the facts and the legal arguments, and noted what lessons might be learned from both. This year the crowd seemed to pay little heed to the arguments made on behalf of two firms caught in highly publicized and controversial malpractice cases. Many who had sat through the presentations said later they thought the firms had made serious mistakes, despite the opinions of the panelists. Id. Finally, she quotes one law firm partner-participant, who noted that “it is this very absorption in the day-to-day problems of attorneys that makes this gathering so much more enjoyable than other professional meetings because colleagues here are not networking or marketing, but genuinely searching for guidance in an increasingly complex legal landscape.” Id.}
deter free rider problems, and would improve information by fostering the sharing of relevant experiences among insured members.

f. The Problem of Solvency Risk

Not all roads lead to loss prevention. There is a class of lawyers who have a strong incentive to resist loss prevention by insurers. These are lawyers who would face a severe risk of insolvency in the absence of insurance. We have already seen that the moral hazard problem is strong in the absence of insurance for such lawyers. The problem is that insurance for these lawyers might exacerbate, rather than alleviate, the moral hazard problem.\textsuperscript{124} The insurance company could address this problem by screening for insolvency risk, but that does not seem to be a risk they consider in the underwriting process. Although malpractice insurers do consider claims history, a judgment proof lawyer may escape detection on this radar even though he committed many acts of malpractice if he incurred few claims precisely because of insolvency, or if he was able to hide the claims made against him because he settled them quietly with no insurance company involvement.\textsuperscript{125} Clients might also address this problem by insisting not only that the lawyer get insurance, but that he get insurance that requires claim prevention. That seems to demand a fairly high degree of monitoring and sophistication by the client, however. Thus, we should not be surprised if insolvent lawyers purchase a disproportionate amount of malpractice insurance that does not offer loss prevention services. If the insolvency problem is serious enough, and if the other factors discussed in this section suggest that loss prevention by insurers would be effective, then legislatively mandated legal malpractice insurance that includes a mandatory loss prevention component and an opt-out provision for those who can demonstrate sufficient asset reserves may be the best solution.\textsuperscript{126}

\textsuperscript{124} See Shavell, supra note 26, at 241-42.

\textsuperscript{125} According to Long & Levit:

A recurring question is whether to report a claim that will not exceed the attorney's deductible or self-insured retention. Such claims fall within most policy definitions of the term "claim." As a practical matter, however, there is little downside to omitting reference to such claims, although a carrier could conceivably argue that such claims would have alerted it to an undesirable risk.

\textsuperscript{126} See Shavell, supra note 26, at 242. Oregon, the only state in the country that makes legal malpractice insurance mandatory, has a bar-sponsored insurance company that does in fact engage in significant loss prevention activity.
5. The Bundling of Loss Prevention with Diversification

So far, I have established that lawyers might demand both diversification services and loss prevention services from market insurers. I have not yet explained, however, why the same institution needs to do both. In particular, lawyers could keep an outside law firm on retainer for long-term and emergency advice. To date, however, this option is rarely exercised. Nor do malpractice insurers tend to sell their loss prevention services separately from their diversification services.

Explanations of bundling seem to fall into three general categories. One is that bundling facilitates price discrimination and profit maximization by a monopolist insurer. This theory does not seem to fit the known facts about legal malpractice insurance. For example, it does not seem to explain the rise of legal malpractice mutuals, which seem to have increased competition while offering more loss prevention services.

A second explanation of bundling is based on economies of scope: “transaction costs are reduced if the insured relies on that insurer for its safety information rather than arranging a contract with an outside consultant, for the insured already stands in a contractual relationship with its liability insurer.”

A long-term contractual relationship between insurer and insured could facilitate monitoring necessary for loss prevention, for example. One institution is generally cheaper than two, and perhaps more than two since the outside ethics counsel would presumably also have to get malpractice insurance. But that explanation can be only partial, because hiring outside ethics counsel might also lead to economies of scope, and because insurers could bundle other services that they do not. A variation on this theme is that the market insurer may have advantages in the ability to coordinate information from and disseminate information to its insureds. Lawyers owe their clients duties of confidentiality and loyalty that go beyond any such duties of insurers;

127. See Schlesinger & Venezian, supra note 88, at 233-34. The basic idea is that a monopolist insurer wants its insureds to be as risk averse as possible, so it can extract the maximum risk premium from them. It can achieve this goal by manipulating the likelihood of loss. In some circumstances, lowering the probability of loss (loss prevention) can actually increase the risk premium (such as when the probability starts out close to 1). Thus, the monopolist insurer will engage in loss prevention to decrease risk, hence increase risk premiums and therefore monopoly profits. The monopolist will engage in loss prevention even if it cannot prevent insureds from free riding by not buying the insurance, but will do better if it can bundle the insurance and risk prevention and prevent free riding.

128. See Hansmann, supra note 93, at 146-47.

129. Schwartz, supra note 4, at 556; see also ARROW, supra note 60, at 68-69 (discussing value of centralized decisionmaking in terms of saving information costs).
in fact, a lawyer seeking to play loss prevention counsel for numerous other lawyers could run up against conflict of interest problems before reaching the scale and scope efficiencies of insurers, though this problem might be mitigated somewhat by waivers. Insurers (especially mutuals), by contrast, can justify using the information as part of a coordinated effort designed to benefit all of their insureds.

A third reason bundling of diversification and loss prevention may make sense is that the insurance company’s size and clout make it better able than an outside law firm to exercise the authority necessary to make loss prevention effective. A purveyor of loss prevention services must be able to say no to his client, which requires some degree of independence from the client. A consultant too dependent on his client’s business will be susceptible to bribery, or co-opting by the client. Moreover, authority is enhanced when the parties subject to it are convinced that everyone else is obeying it. An insurance company may be better able to convince its insureds of cooperation by other insureds than an outside lawyer would be able to convince his lawyer-clients. Finally, loss prevention services by an insurance company come with a stronger guarantee than loss prevention services by lawyers. The insurance company bonds its appraisal by agreeing to indemnify the insured for losses that occur; lawyers guarantee only nonnegligent appraisals. And competition among insurers keeps them from overprescribing or

130. See, e.g., Maritrans G.P. Inc. v. Pepper, Hamilton & Scheetz, 602 A.2d 1277 (Pa. 1992) (finding that law firm violated common law fiduciary duties by representing competing companies where there was a danger that confidential information acquired in one representation could be used in others). It is important to note that the Maritrans case was one discussed by ALAS members at its 1993 annual meeting and one thought correctly decided by many present.

131. Mayers & Smith, in their pathbreaking article on corporate insurance, explained the problem as follows:

[T]here are incentives to bribe the consultant to allow the firm to engage in actions which would result in wealth transfers. Therefore prior to entering these contracts it is in the firm’s interest to choose an agent who is expensive to bribe because the reservation prices of the claimholders will reflect the probability of enforcement. Bribing an insurance firm is expensive; a large fraction of an insurance company’s revenues is related to the sale of long-term financial contracts. These revenues will be reduced if the insurance company is discovered accepting bribes; further, the costs of accepting a bribe must be discounted over an infinite horizon.

Mayers & Smith, supra note 62, at 288-89.

132. See Arrow, supra note 60, at 71-73.
133. See Mayers & Smith, supra note 62, at 288-89.
underprescribing loss prevention. None of these considerations, of course, means that lawyers will or should never use other lawyers to advise them on matters relating to malpractice; rather it simply suggests why the insurance company may have an advantage in providing bundled services.

6. Is More Liability Insurance Good?

The preceding discussion can help inform the recent debate that has occurred over whether liability insurance is socially desirable. Although economists generally argue that if parties voluntarily contract for something, the thing contracted for is efficient, they recognize an exception if the contract imposes external costs on third parties. The argument against liability insurance is essentially that liability insurance imposes such costs on victims, in our case malpractice victims. Under what might be termed the diversification externality, insureds might inefficiently substitute more diversification for less expected loss reduction (the classic moral hazard problem). This makes insurers and insureds better off at the expense of victims, with the result that there will be too much liability insurance.

But as I have discussed, several features of the insurance market tend to mitigate the diversification externality. First, market insurers will not offer insurance if the moral hazard problem (the absence of loss reduction activity) is too severe; the price of market insurance will be so high that insureds will turn to substitutes, as they did during the liability insurance crisis. Second, when tort victims are in contractual relationships with tortfeasors, as clients are with their lawyers, the potential for the lawyer and insurer to combine to impose “external” costs on the client is reduced, at least for sophisticated, repeat clients. Third, clients might rationally decide that having their lawyers buy malpractice insurance is better than extra deterrence; thus, the diversification externality story seems especially implausible when clients demand malpractice insurance. The reason clients might be willing to trade off insurance for loss prevention is that to the extent that the tort system undercompensates them, by for example denying attorneys’ fees or damages for emotional harm, clients face a higher risk premium than they would if the tort system fully “insured” them. There may be some cases in which $1 spent

134. See id.
135. See Schwartz, supra note 4, at 350; Syverud, supra note 4, at 1629. Schwartz argues that the efficiency of liability insurance is unclear and probably varies from market to market, but concludes that liability insurance is probably efficient. See Schwartz, supra note 4, at 358. Syverud argues that an inefficient amount of liability insurance is being purchased. See Syverud, supra note 4, at 1639.
136. Shavell makes just this argument in trying to justify the social desirability of liability insurance. See SHAVELL, supra note 26, at 212.
137. See Schwartz, supra note 4, at 349.
on diversification may yield greater social benefit, by reducing the client's risk premium, than $1 spent on prevention, despite the fact that expected malpractice losses will be somewhat greater. This argument forms the basis for the support of no-fault insurance regimes; that is, there may be times when efforts to improve compensation may be more cost-effective than efforts to reduce expected losses. Fourth, and most important for our purposes, to the extent that the insurer provides loss prevention services, the diversification externality argument is weaker. The strongest case for the diversification externality is where otherwise judgment proof lawyers are able to obtain the insurance and neither the insurer nor the client is a good monitor of lawyer behavior.

A variant on the externality argument is that liability insurance leads to more lawsuits.\textsuperscript{138} Although this is undoubtedly true, it is also true of any procedural reform that reduces the cost of bringing a suit. Yet no one argues that all such reforms are bad. The question is whether the extra lawsuits are more likely to be meritorious ones that would not be brought without liability insurance,\textsuperscript{139} or frivolous ones that would not be brought without liability insurance (essentially client moral hazard).\textsuperscript{140} This in turn depends on how effective insurers and lawyers are at deterring or resolving malpractice suits that lack merit. For example, as I discussed above, eroding policy limits tend to discourage plaintiffs from bringing malpractice suits whose value stems from threatening lengthy litigation, because if plaintiffs will not pursue damages beyond the policy limits, then lengthy litigation reduces their recovery. The extent of the externality problem might also depend on how effective courts are at policing the risk that insurance might lead insurers and insureds to collude to prevent meritorious claims from being brought.\textsuperscript{141}

\textsuperscript{138} See Syverud, supra note 4, at 1629.

\textsuperscript{139} For a suggestion that malpractice insurance might make more viable meritorious small claims that might not be brought in the absence of insurance, see Wilkins, supra note 24, at 831 n.132. The small claims Professor Wilkins has in mind would, of course, have to be claims that exceed the deductible.

\textsuperscript{140} According to one commentator, "the pervasiveness of insurance has led clients to mistakenly believe that lawyers do not pay when they lose malpractice suits. They think that because the attorney's insurance pays the claim, the attorney will be unscathed both financially and in reputation." Susan Korevaes Robin, Note, Attorney Malpractice and Preventive Lawyering: Are Attorneys Safer in Large Firms? 40 U. MIAMI L. REV. 1101, 1105 (1986). As a result, some advise lawyers not to reveal to clients that they carry malpractice insurance, id. at 1107 n.10, despite the questionable ethical validity of such advice, see MODEL RULES, supra note 53, Rule 1.4.

\textsuperscript{141} For example, in Passanante v. Yormark, 350 A.2d 497 (N.J. Super. Ct. App. Div. 1975), the court held that fraudulent conduct by an insured in secreting prior misconduct that is covered by the policy does not act as a bar to coverage under the fraud exclusion. To hold
III. CLIENTS AND LAWYERS AS ENTITIES

So far, I have considered three institutions that can provide insurance services to lawyers: self-insurance, client contract insurance, and market insurance. But in comparing the relative strengths and weaknesses of these insurance institutions, I have assumed that clients and lawyers are both monads. This part relaxes that assumption and explores some of the complications arising from client and lawyer entities. Interestingly, it turns out that these complications often strengthen the conclusions of the last part, namely that market insurance that offers loss prevention services may often be the best insurance institution.

A. Complex Clients as Insurers

When lawyers’ clients are entities rather than individuals, one might think that market malpractice insurance should be less important. Entity clients are often “sophisticated” and so might be thought to be sufficiently able to take care of their own interests that they could provide contract insurance to their lawyers. In fact, however, market insurance that offers loss prevention may be more necessary rather than less necessary for these types of clients.

The problem is that entity clients have agency problems within themselves. As a result, the “client” faces the risk that he may have not one unfaithful agent—the lawyer, but two—the lawyer and management. To the extent that the lawyer is likely to side with the managing agent, even when that agent’s action is not in the client’s best interest, the client might be quite interested in having the lawyer monitored by an active insurer and quite reluctant to have the managing agent offer contract insurance to the lawyer.

This is not to say that client monitoring will be completely ineffective. When there is no conflict between the managing agent’s interests and the client’s interests, monitoring of the lawyer will probably be very effective, as the increased use of in-house counsel for this purpose shows. But this fact may also provide a further reason to think market insurance is likely to be effective, namely that the diversification externality discussed above will be less likely to occur with these clients.

B. Law Firm Insurance

An important insurance institution remains, namely the law firm. Traditionally, law firms have been organized as partnerships. Partners in general partnerships are subject to vicarious liability for torts and breaches of fiduciary obligation committed by fellow partners, as well as associate

otherwise would invite collusion between the insurance company and the insured to cover up potential negligence.
1997] LEGAL MALPRACTICE INSURANCE AND LOSS PREVENTION 347

lawyers.142 The combination of vicarious liability and the general failure to seek indemnity from the lawyer who commits malpractice means that the firm provides the equivalent of a malpractice insurance policy to its lawyers.143

Partnerships engage in all of the risk reduction methods that market insurers do, including diversification.144 Although market insurers may provide more diversification, large law partnerships are close to, if not greater than, the size of some mutual malpractice insurers. Partnerships also engage in extensive underwriting and monitoring of their lawyers to minimize adverse selection and moral hazard problems. They have elaborate screening methods for hiring. They put their associate lawyers on lengthy and highly scrutinized “partnership tracks” before allowing admission to partnership. And they are more frequently creating “ethics committees” to supervise and ameliorate difficulties that arise in day-to-day practice.145 In fact, a strong argument could be made that partnerships are better situated than market insurers to perform these tasks.146 Partners have more continual contact with lawyers in their firm than an insurer with even an extensive loss prevention program probably has. Partners may also have better information about the strengths and weaknesses of the lawyers in the firm. Thus, one could make a plausible argument that at least large partnerships are superior insurers.

But if partnerships are superior insurers, then one might reasonably ask why they purchase as much market insurance as they do, and why they often favor malpractice insurance that offers loss prevention services. Law firms seem to be getting less enthusiastic about providing partnership malpractice insurance. The latest evidence of this fact is the current rush to pass Limited Liability Company (LLC) and Limited Liability Partnership (LLP) legislation.

142. The partnership is liable to non-partners for “any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners,” UPA § 13, RUPA § 305(a), as well as for the “misapplication” of money or property received from a third person, UNIF. PARTNERSHIP ACT § 14, REV. UNIF. PARTNERSHIP ACT § 305(b). All partners are jointly and severally liable for these partnership obligations. UPA § 15; RUPA § 306(a).

143. See Lang & Gordon, supra note 118, at 615.

144. In fact, partnerships provide diversification against business risks associated with human capital investments, which is broader than the diversification service commercial malpractice insurers provide. See Lang & Gordon, supra note 118, at 614.


146. Note that if the firm is a better monitor than the insurance company, the traditional arguments about adverse selection and moral hazard apply. For example, if the law firm is a superior underwriter, then clients might view the fact that such a firm bought malpractice insurance as a signal of low quality. See Robert Puelz, Comment, The Effectiveness of Debt Insurance as a Valid Signal of Bond Quality, 59 J. RISK & INS. 499 (1992).
and allow law firms to take advantage of these new organizational forms.\textsuperscript{147} In general, vicarious liability of LLCs and LLPs for the torts of members or partners is limited to the assets of the firm and does not reach the assets of the individual members or partners. But individual members or partners are subject to personal liability for torts they commit, and for the torts of others over whom they had supervisory responsibility, or torts of which they have notice. Several LLC and LLP statutes require firms wishing to take advantage of these entities to maintain a minimum amount of liability insurance.\textsuperscript{148} These statutes certainly encourage the substitution of market insurance for partnership insurance. Because active monitoring of one’s colleagues exposes a member of an LLC or LLP to personal liability, such monitoring may well be discouraged, though how significant this effect will be remains to be seen.\textsuperscript{149}

But these statutes may simply represent a legislative approval of a trend that was already taking place. One of the most striking features of the last two decades of lawyer regulation is the decline of the partnership as a regulatory institution. As law partnerships have approached mutual insurance companies in size, they have distanced themselves in spirit. Why?

Superior diversification of market insurers is probably part of the answer, because the costs of some types of monitoring have increased.\textsuperscript{150} But it seems unlikely that the rise of mutuals such as ALAS can be fully explained by their superior diversification abilities compared to commercial insurers such as CNA or imperfections in the commercial insurance market. That leaves superior loss

\textsuperscript{147} Robert R. Keating & George W. Coleman, \textit{Practice of Law by Limited Liability Partnerships and Limited Liability Companies}, in \textit{The Professional Lawyer} (1995). According to Keating & Coleman, 21 state statutes currently allow professionals to organize as LLCs, and regulatory bodies in 8 states and the District of Columbia have explicitly allowed lawyers to organize as LLCs. Fifteen states and the District of Columbia have adopted LLP legislation; only D.C. has expressly allowed lawyers to form LLPs, but Keating & Coleman contend that specific regulatory authority for lawyers to form LLPs may not be required, because unlike LLCs, LLPs are general partnerships. \textit{See id.}


\textsuperscript{149} For a recent example of how monitoring activity can expose lawyers in limited liability entities to personal liability, \textit{see} Sanders, Brain, Coll & Worley, P.A. v. McKay Oil Corp., 943 P.2d 104 (N.M. 1997) (holding that individual members of an incorporated law firm who voted to terminate the representation of a client in an allegedly negligent manner may be held personally liable).

\textsuperscript{150} For example, some firms have grown rapidly and opened satellite offices, making it harder to keep track of one’s colleagues. \textit{See, e.g., Legal Malpractice Claims}, supra note 36, at 24. Others have downsized rapidly, leaving themselves potentially understaffed or unable to supervise associates or other employees properly. \textit{See id.} at 23.
prevention services. But why, given the partnership’s apparent advantages in this area, should we ever expect market insurers ever to do better?

The theory developed above suggests several possible reasons. First, the character of law partnerships has changed, largely as a result of increased competition, in ways that may increase agency costs within the firm. A particularly important example of how large firms have changed is the fact that the locus of power in partnerships seems to have shifted away from centralized control to individual autonomy.\textsuperscript{151} If central authority declines generally, that will increase the ability of individual lawyers to pursue their own agendas at the expense of the firm’s welfare, and thereby hinder the firm’s ability to monitor malpractice.\textsuperscript{152} If the managing partner cannot control the rainmaker’s salary, he probably cannot control the rainmaker’s behavior either.\textsuperscript{153} A mutual insurer may be able to exert leverage over firms that the firm’s management cannot on its own.\textsuperscript{154}


\textsuperscript{152} Law partners are thus becoming more like corporate managers in the sense that conflicts of interest between them and the “owners” (other partners) may be increasing. And “firms whose managers have greater discretion over the choice of hazard-reducing projects will be more likely to purchase insurance.” Mayers & Smith, supra note 62, at 286.

Professor Hyman in his comments on this article argues that lawyer resistance to loss prevention “strongly suggests that lawyers believe they are better at assessing risk than insurers are—or are willing to pay substantial malpractice premiums to maintain their preferred pattern of practice.” David A. Hyman, supra note 108, at 360-61. But what may be good for individual lawyers may not be good for the firm as a whole, especially when the swashbucklers can impose some of the costs of their actions on others in the firm while reaping a greater percentage of the benefits. Thus, to the extent that law firms resist loss prevention, that may be the manifestation of an agency problem within the firm rather than a true reflection of the preferences of a majority of the partners. This certainly seems to be the view of Anthony Davis, whom Professor Hyman repeatedly cites. Davis views the weak central management of law firms as a “disease,” Davis, supra note 151, at 679, for which the cure is in part providing the firm’s management with “sufficient authority to control the practice of each member of the firm without exception and regardless of seniority.” Id. at 683 (emphasis added).

\textsuperscript{153} In their recent empirical study of law partnership salaries, Lang & Gordon, supra note 118, find that in larger partnerships, partners keep a smaller share of the profits, which they conclude is more consistent with the partnership performing an insurance function than with the increased autonomy story commonly believed. The idea is that larger partnerships are better insurers, so risk averse lawyers will join large partnerships and pay for the insurance in smaller profit shares. They recognize, however, that their results are consistent with the autonomy story to the extent that partners seek power rather than salary. Another possibility is that partners get extra remuneration in ways that do not show up in salary data, such as business deals from clients. See generally id.

\textsuperscript{154} For example, Bob O’Malley of ALAS reports that it is a very common experience to hear lawyers say of some proposed policy, “I can’t sell this to my firm, but if you tell us we have to do it, we’ll do it.” Interview with Robert E. O’Malley, Vice Chairman of the Board and
Another feature of the changing character of law partnerships is increased mobility of lawyers between firms. The more mobile lawyers are, the harder they are to control because they can threaten to leave and take their clients with them. Insurers like ALAS may effectively reduce the mobility of lawyers by making it more likely that lawyers will face similar constraints on their behavior at their new firm, which may also be insured by ALAS or a similar market insurer.

Relatedly, the combination of competition for clients and increased third party liability may make it necessary for the partnership to have some “outside authority” to refer to as a way of maintaining independence from their clients. Third party liability means that malpractice is not only failing to do what your client wants when you should, but also doing what your client wants when you should not. A lawyer may not be able, however, to “just say no” to his client’s desires, especially when the client can threaten to go elsewhere. But if the lawyer can rely on the authority of his malpractice insurer, he might be able to convince the client not to do something risky or wrong. Not only might the client be convinced that something more than an “ethics problem” might be going on, but the client also might realize that other lawyers (at least those insured by the same carrier) would not be able to act any differently. Thus may malpractice insurance bind lawyers to a code of conduct more effectively than does a partnership.

Finally, the law governing lawyers has undergone tremendous change over the last several decades. Not only have two sets of ethical rules been promulgated by the ABA, with numerous state variations, but the expansion of third party liability, fiduciary obligation, disqualification motions, and Rule 11, to name a few, have turned professional responsibility from a quaint sideline to a business necessity. Market insurers may be better able to collect information about these changes and the best responses to them. More important, to the extent that partnership culture has to change to adapt to what lawyers perceive—whether rightly or wrongly—as new legal circumstances, it may be difficult to effect such change from within the partnership.155 That is how management consultants make their money.

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155. According to Professor Arrow:

> It may really be true that social agreements ultimately serve as obstacles to the achievement of desired values, even the values desired by all or by many. The problem is that agreements are typically harder to change than individual decisions. When you have committed not only yourself but many others to an enterprise, the difficulty of changing becomes considerable. If it is done on a conscious level, we have all the formalities
CONCLUSION

I have sought in this paper to describe and explain an institutional response to an increase in liability. In particular, I have tried to argue that the current regulatory climate governing lawyering has spawned active market insurance that provides loss prevention services. More broadly, I have tried to show that legal malpractice insurance is an area worthy of further study. For example, this paper merely touches on questions of how legal malpractice insurance fits into the larger regulatory scheme, which includes professional discipline and court sanctions. In future research, I may try to address such questions as how legal malpractice insurance and professional ethics rules affect each other. For now, I will simply close with the somewhat whimsical thought that if we have not yet, we may soon reach the point where if a famous Supreme Court justice were to ask a famous French author what the most effective check on lawyer misconduct is, the response might very well be, “ALAS, Hugo.”

involved in persuading others to change their minds. What may be hardest of all to change are unconscious agreements, agreements whose very purpose is lost to our minds. Some commitments are to purposes which involve much sacrifice and very great depth of involvement. A commitment to a war or a revolution or to religion is typically one that is very hard to reverse, even if conditions have changed from the time when the thing started. Even if experience has shown the unexpectedly undesirable consequences of a commitment, the past may continue to rule the present.

ARROW, supra note 60, at 28.