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Regulation and Litigation

COMPLEMENTS OR SUBSTITUTES?

ERIC HELLAND AND JONATHAN KLICK

Michael Avery, Mark Covington, Sam DeFrank, Carly Vickers, and Todd Shadle were all involved in separate relatively minor traffic accidents in the early 1990s. Each of their accidents required minimal repairs to their vehicles. Their insurer, State Farm, had a policy of repairing damaged cars with parts that were not made by the original equipment manufacturer (OEM). The use of non-OEM parts would have reduced each individual's bill between \$45 and \$155. Avery and Shadle opted for OEM parts and paid the cost difference themselves. The others had their vehicles repaired using non-OEM parts.

In 1997 these five drivers, along with almost all other State Farm customers who had non-OEM parts installed on their vehicles or who paid the difference between OEM and non-OEM parts, were included in a class of about 4.5 million people.¹ The plaintiff class alleged that State Farm's policy of using non-OEM parts was a breach of contract because the insurer promised to restore their cars to their pre-loss conditions. They further alleged that State Farm had committed fraud by violating Illinois consumer protection statutes. The alleged violation resulted, according to the plaintiffs, from the inferiority of non-OEM parts. The alleged damages to each individual plaintiff in the case were so small that the action would not have been brought without the class action procedural mechanism. The ques-

tion at issue was whether non-OEM parts were really inferior to OEM parts.

In this class action, State Farm faced litigation on behalf of anyone in 48 states² who had had his or her car repaired with non-OEM parts. The aggregated damage judgment in the initial cases was \$1.2 billion, a sum representing a third of State Farm's net income in 2007. Faced with the possibility of such large damages, most defendants would have settled and discontinued the use of non-OEM parts. State Farm did the latter, but it did not settle. The judgment against State Farm was overturned, but not before the case had altered company policy toward non-OEM parts.³ While the State Farm case is atypical in its size, the cumulative effects of several class actions against a company can have a similar effect on a firm's practices.

This change in policy would not be surprising if virtually every state had not previously regulated the issue of whether insurers could use non-OEM parts. Non-OEM parts were allowed in Illinois if their use was disclosed on the consumer's estimates, the parts were of like kind and quality, the manufacturer was identified on the part, and a warranty was provided. Illinois already had regulations designed to balance the competing goals of lower costs versus higher quality repairs. In effect, the litigation created a parallel system of regulation.

On one level, operating a system of state regulation and a parallel system of regulation through the courts is redundant and potentially contradictory. Further, the system generates its own administrative costs. In the 27 cases in the RAND Insurance Class Action database that reported attorneys' fees, the average fee award constituted 29 percent of the gross common fund.⁴ The median award was 30 percent, and the largest award was 41 percent.⁵ This is slightly higher than the Eisenberg and Miller estimate of 22 percent,⁶ but it is consistent with some other findings in the literature. Further, this does not include defense costs or the cost of administering the case by the courts.

Despite the cost, the operation of potentially redundant and expensive regulatory systems might perhaps be justified on two grounds:

1. Administrative regulation and class actions can both be used in the process of controlling behavior with states alternating in their use

depending on which one can be operated more cheaply on the margin. That is, the two systems serve as substitutes in the regulatory production function in the same way that manufacturers use both labor and capital in producing goods but, on the margin, more labor implies less capital and vice versa;

2. Class actions allow consumers to influence regulatory policy when administrative regulators are captured by industry.

The first hypothesis is that regulation by an administrative office and regulation by the courts using class actions are simply substitutes. The choice is not either administrative regulation or class actions: administrative regulation represents the minimum standard that courts can go beyond if the agency in question has not protected consumers at the relevant legal standard. Regulation represents a minimal level of deterrence that does not require litigation, but if that level is insufficient, then litigation will provide an additional backstop.

To take a prominent example, the Securities and Exchange Commission (SEC) has long argued that private securities litigation is a substitute for SEC fines. This division of labor supposedly frees up enforcement resources and allows the SEC to target firms that private attorneys would not.

The second justification for operating a dual system is the possibility of regulatory capture. Economists, starting with Stigler,⁷ have argued that regulators are likely to be captured by the industry they regulate. The source of this capture is a collective action problem. The cost to an industry resulting from regulation is concentrated, while the benefits to consumers from the regulation are diffuse. For example, in the case of price regulation, no consumer has an incentive to lobby the regulator to control prices, as the individual gains are too small to warrant the effort of lobbying. Regulated industries, in contrast, have incentives to lobby for more generous rate increases.

Some observers argue that since courts are less likely to be captured by industry than a regulatory agency with a single jurisdiction, class actions can represent a check on the ability of industry to determine regulatory policy. The point extends beyond regulated prices. In the case of breast implants, Hersch argues that the initial motivation of the consumer class

actions was a perception that regulation was lax because the Food and Drug Administration (FDA) was unwilling to actively monitor medical devices.⁸ In cases such as lawsuits against handgun manufacturers, the argument goes even one step further. The political process, according to proponents, is deadlocked and unable to produce meaningful safety regulation. The courts offer an avenue for a “more rational” standard for consumer protection.

In this article, we examine the substitution hypothesis.⁹ Insurance regulation in the United States is largely in the hands of the states. Although regulatory agencies are similar in many respects, it is not an overstatement to say that the U.S. has 51 separate regulatory regimes for insurance. State regulation generally focuses on two areas: solvency regulation and market regulation. Solvency regulation, which requires insurers to maintain adequate reserves and guaranty funds and meet financial disclosure requirements, is relatively homogenous across states. But market regulation, which regulates insurance products, practices, and prices, varies dramatically. We use this variation to evaluate the link between insurance regulation and class action litigation.

We test whether regulation and litigation are substitutes on the margin. Specifically, if regulation has some deterrent value, the probability that a company commits a wrongful act is a function of the level of regulation. This implies that more active regulators should be associated with less harm in their jurisdictions. Once a harm or perceived harm occurs, the case enters the civil justice system if the plaintiff’s attorney expects that the case is likely to be successful and financially viable.¹⁰

We use data from the National Association of Insurance Commissioners concerning the regulatory environment in each state.¹¹ We link these data to a unique dataset, the RAND Insurance Class Action database. The data on class actions contain information on class actions against firms in the insurance industry for 748 distinct cases that were open at least once during the period of 1992 to 2002. Because the data are reasonably comprehensive for the companies responding to the survey, we are able to link the frequency of class action litigation to the states’ insurance regulation data.

We examine multiple facets of the regulation litigation tradeoff. First, we examine whether a regulator’s interest in a particular cause of action

reduces the likelihood that class actions covering this cause of action will be filed in the regulator's home state.

Second, we examine several measures of regulatory stringency in the state to determine whether there is a substitution effect between regulatory action and litigation. For example, we use state regulatory budgets as a proxy for regulatory stringency, a factor that varies enormously from state to state, examining the relationship between levels of stringency and the incidence of class actions.

Third, we examine whether class actions are less frequent if regulators had previously issued an administrative decision on a particular issue, or if there are no existing state laws on the particular issue. In a system where regulation and litigation are substitutes, if regulators are silent, then the private attorneys are more likely to step in. Using OEM parts cases, we examine whether states that have not issued rulings on the use of non-OEM parts have more OEM class actions. Since the issue is unsettled, the theory goes, class actions fill the regulatory void.

Understanding the relationship between litigation and regulation, especially as it relates to the insurance industry, takes on special importance given the current financial crisis. The uproar over the government's \$170 billion commitment to bail out American International Group (AIG), along with similar (though less dramatic) problems among other insurers, may be a harbinger of sweeping changes in how we regulate the insurance industry in the U.S.

The next section discusses the nature of insurance regulations and provides some background on class action litigation necessary to motivate our empirical investigation. We then discuss the data and examine the evidence for a substitution between administrative regulation and class actions.

The Substitution Thesis

There are several theoretical reasons why we might observe a tradeoff between regulation and class actions. The seminal Shavell model of the relationship between regulation and litigation provides a useful starting point.¹² Shavell's model provides conditions for the efficient use of both

regulation and litigation in a system geared toward incentivizing individuals to take the socially optimal level of care.

Shavell posits that liability and regulation serve as substitutes on the margin. All other things equal, as the regulatory standard (or enforcement level in the real-world setting where not all violations are discovered by the regulator)¹³ is raised, there is less need for liability in generating socially optimal behavior. In fact, in the limit, if the regulatory standard is set above the social value of the harm avoided, we will have too much care taken, in which case any additional care induced by liability will be pure social waste. Further, as a positive matter, the higher the regulatory standard, the less harm that will occur, leaving a smaller domain for litigation, all other things being equal.

In Shavell's model, regulation is most useful where harm across parties is similar, whereas litigation is most useful where there is a high degree of variability across parties. In class actions, where by definition the harms are similar across parties, the case for regulation is strongest and that for litigation is weakest, on the Shavell model.

The Data

To investigate the relationship between litigation and regulation, we use a unique data source covering the experience of insurance companies with class action litigation. The dataset contains information on class actions against firms in the insurance industry derived from 988 case-level surveys from 130 insurance companies, describing 748 distinct cases that were open at least once during the period of 1992 to 2002. The information was gathered through a survey that concentrated on larger insurance companies in the property-casualty, life, and health markets. The complete dataset contains information on cases filed between 1984 and 2002.

The survey asked the responding companies to describe, for each such case in which they were a named defendant, the courts of filing and disposition, the names of other defendants in the case, whether there were also similar cases filed earlier or in other jurisdictions, the lines of insurance involved, the key allegations of the plaintiffs, key statutes involved, whether

the issue of regulatory jurisdiction was raised by any of the parties, the description of the actual or putative class, the geographical scope of the actual or putative class, the outcome of any certification process, the manner in which the case was resolved, and the details of any settlement or trial verdict for the plaintiffs. Table 3.6 contains the distribution of cases by insurance line. The vast majority of cases in the data concern automobile insurance.

Examining data for the 12 companies that were able to provide complete information about their experience with class actions between 1992 and 2002, we find a strong upward trend in the amount of class action litigation involving these insurers. While the actual numbers of cases remains small throughout the period, 14 cases in 1994 rising to 68 in 2002, the percentage increase is dramatic. This represents growth by a factor of five throughout the period.

Focusing on a subset of these cases, the growth in cases alleging harm to nationwide or multi-state classes of plaintiffs grew at an even more dramatic rate in this period. At the beginning of the period, there were only two such cases (one nationwide and one multi-state) in 1992 up to highs of

Table 3.6 Lines of Insurance Involved in the Case

<i>Lines</i>	<i>Percentage of All Cases</i>
Automobile	67.5
Homeowners	12.8
Life	7.1
Workers' Compensation	6.3
Health	2.4
Multiple Lines	1.2
Annuities	1.2
Earthquake	1.2
Mobile Home	0.9

Source: Nicholas Pace, Stephen J. Carroll, Ingo Vogelsang, and Laura Zakaras, *Insurance Class Actions in the United States* (2007).

19 multi-state and 16 nationwide classes in 1999, a percentage increase of more than 1,600 percent.

Unless underlying behavior or social damages worsened during this period, the substitution model suggests that we should have seen an offsetting reduction in regulation during this period. This is not the case. Although litigation appears to have become a more important force in the regulatory setting, there is no evidence of a dramatic decrease in regulation. In fact, as measured by budget resources and staffing levels, regulatory action increased during this time period.

Two important caveats are required. Respondents are more likely to have reported newer cases. A number of responding insurers indicated that older class actions litigated near the start of our study period were not tracked in a way that would allow them to be as identifiable. For this reason the growth may be less dramatic than it appears. The second limitation is that we do not generally know the size of the class. A simple explanation of the growth of class actions may well be that earlier cases represented more individuals than later cases, such that the overall impact of class actions litigation during this period is unchanged.

The cases also concern a number of different allegations. About half of the cases involved claims related to health care providers as assignees of medical benefits in automobile policies (either as part of personal injury protection plans in “no-fault” states or as first party medical payments coverage in “add-on” states), various property coverage claims, claims by policyholders or beneficiaries under automobile uninsured/underinsured motorist coverage, diminished value claims related to first-party automobile coverage, and various workers’ compensation issues. Diminished value allegations were the most frequently cited in our data.

Self-Reported Regulatory Interest and Litigation

To draw any inference about the substitution thesis, we had to confirm that our regulators and class actions were operating in the same domains. That is, we had to ensure that the regulators saw the issues being litigated as falling within their purview. If they do, the substitution thesis would predict

lower levels of litigation. However, that seems not to have happened. A survey of state regulators reports that the incidence of class action litigation is unrelated to the regulators' self-reported assertions of interest in the matter.

To determine the relationship between regulator interest and class actions, the RAND Institute for Civil Justice conducted a survey in 2005 of staff members of state departments of insurance.¹⁴ Seventeen states completed the survey. The survey asked the regulators to rank the 260 key allegations made by the plaintiffs in our cases according to their relationship with the traditional activities of the regulator.

The substitution thesis would predict that class actions alleging a particular cause of action should be more frequent when surveyed regulators respond that the cause of action is outside their regulatory mandate. For example, most regulators responded to the survey saying that "vanishing premium" cases were within their regulatory mandate.¹⁵ Given the level of interest in the harm generated by vanishing premiums, we would expect them to be rare in the data. In fact, however, our analysis shows that class action frequency has no relationship to regulatory interest. In sum, regulators and class actions appear to be concerned with similar issues.

Regulatory Resources

The substitution thesis might not hold if state regulators lack the resources to take action in cases that concern them. To test this, we selected three measures of regulatory stringency: the regulatory budget per insurance firm, the number of market conduct exams per insurance firm regulated by the state, and the number of market conduct examiners per insurance firm regulated by the state.

Our data on regulatory activity come from insurance regulators, as seen in the National Association of Insurance Commissioners (NAIC) "Insurance Department Resources Report." According to the NAIC website, this "provides an in-depth look at the resources of the 55 insurance departments." Ideally, we would like information on regulatory activity specific to the line or allegation, but the data provided by the NAIC are not this specific.

Figure 5 shows the relationship between budgets and the number of class actions filed in the state. The insurance regulator's budget is the

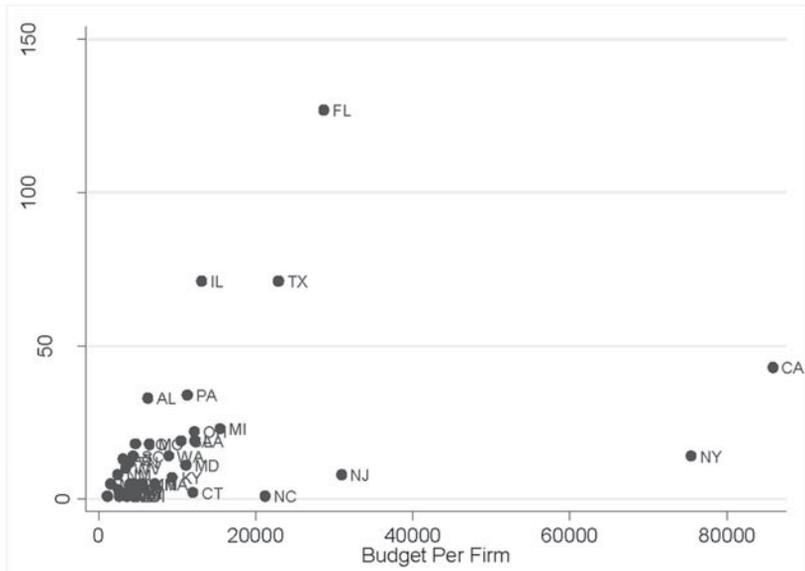


Figure 5. Number of cases and budget per firm

broadest measure of the resources devoted to insurance regulation in the state. As in the case of the survey data, a substitution between regulation and class actions would predict that class actions are more frequent when budgets are tighter. The results suggest that the relationship between regulatory stringency and class actions is either flat or weakly positive. When states provide more resources to regulators we see more, not fewer, class actions.

One concern is that the states' budgets might mask important differences in the scope of a state agency's regulatory activity. Our other measures of regulatory stringency are more specific. Market conduct exams are broad investigations into the business practices of insurers in the state. For example, according to the Maryland Insurance Commissioner, its Compliance Unit reviews insurance company operations to determine how the company operates in the market place. The examiners' review includes, but is not limited to, sales practices, advertising materials, underwriting practices, and claims handling practices. Examinations often help alert companies to problems and serve as a form of consumer protection. The

resulting examination report presents a detailed analysis of a company's general business practice.

Although some level of investigation is regularly conducted by state regulators, there is wide variation in the frequency of these inspections. The New Jersey Department of Banking and Insurance explains that inspections may be based on an increase in complaint volume, an increase in the frequency of complaints on a particular issue, the findings of a prior exam, a change in the company's market presence, or the length of time since the last exam.

The frequency with which a firm can expect to have its business practices reviewed in the state as well as the number of inspectors the state retains to conduct these exams are useful proxies for regulatory resources.

In Figures 6 and 7, we present a plot of these measures of regulatory stringency against the number of class actions filed in the state. A few states, such as New York, stand out in the frequency with which they inspect the firms under their jurisdiction, while several other states, such as Florida, stand out for the frequency with which class actions are filed in their borders. Overall, we find no evidence for the hypothesis that class actions will be more common in states with relatively weak regulatory environments.

One concern may be that we miss interesting variation by treating all states equally. That is, perhaps substitution emerges if we weight states by their population since an effect in California might be masked by non-effects in states where very few people live anyway, limiting their practical importance in drawing general conclusions. If we scale the number of class actions filed by the population of the state under the assumption that class actions may be more likely in states with larger population, the pictures change slightly, but the broad interpretation remains the same. There is no evidence of a substitution effect between insurance class actions and the stringency of regulation.

One possible reason for this divergence is that class actions can be filed in places other than where the harm originated. A case in New York, for example, might actually cover harms in other states but is filed in New York because an insurer is headquartered there or for other idiosyncratic reasons. Examining the number of cases filed on behalf of residents of a state regardless of where the case was filed generates the same qualitative

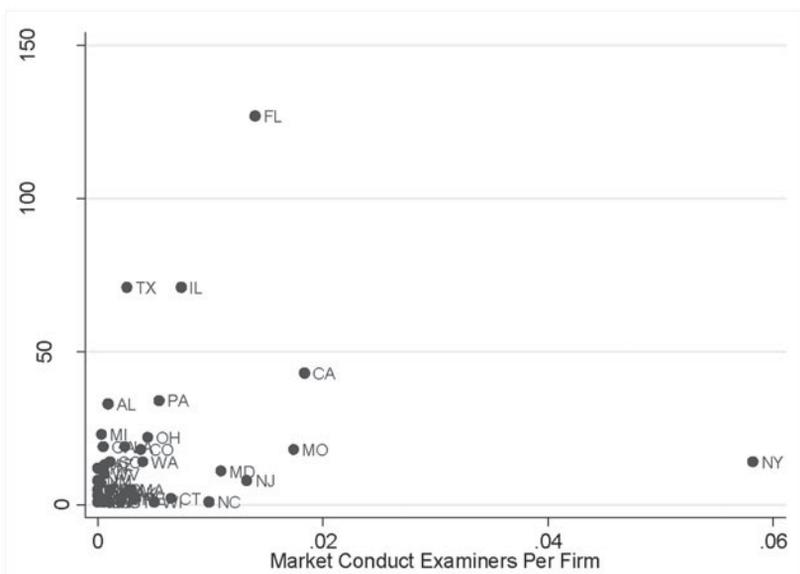


Figure 6. Number of cases and market conduct examiners per firm

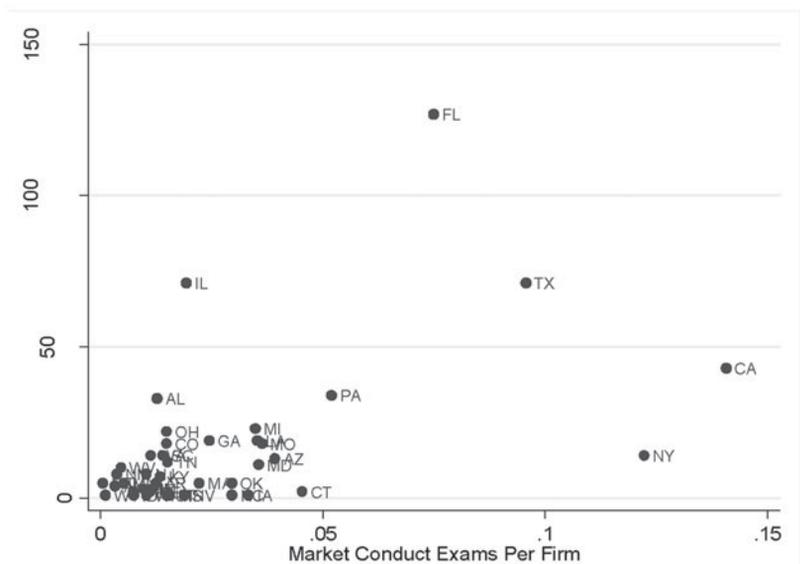


Figure 7. Number of cases and market conduct exams per firm

results for all of our indicators of regulatory stringency. Again, states that devote more resources to enforcement appear to also be more likely to feature their citizens as class members.

Graphical representations of data have the potential to obscure underlying relationships, especially if there are idiosyncratic differences across states. This “unobserved heterogeneity” makes it difficult to sort out the causal relationship between regulation and litigation. For example, if a given state demands a higher level of consumer protection, it may exhibit both more regulation and litigation, even if on the margin the state substitutes between the two mechanisms.

To address this worry, in a 2007 article in the *Journal of Tort Law*, we examined these relationships in a regression framework. By using this methodology, we could control for some of the other differences across states that may confound isolating the relationship between litigation and regulation. Specifically, we included constant state fixed effects to account for baseline differences in the level of consumer protection demanded by state residents. These baseline differences may arise due to wealth and income effects or from other sources of differential preferences.

Wealth and income effects may be particularly important in this context as consumer protection may be a normal good and high-income states are likely to provide more funding for their regulators. Thus, even with a high degree of regulation, residents of richer states may be more apt to litigate because they expect more protection. Failure to account for this effect would lead an analyst to examine the average relationship between regulation and litigation, as is done in the graphs above, when the theoretical hypothesis concerns the marginal relationship. The regression framework allows us to net out any constant preference-induced differences in the relationship between regulation and litigation, focusing attention on what happens to litigation when a given state changes its regulatory activities.¹⁶

The regression framework also allows us to account for national litigation trends that occur independently of any regulatory changes. For example, if federal procedural rules make it more difficult to bring a class action, we would expect the number of class actions to decline everywhere to some extent. It is important to net out these effects by including year

effects in the regression equation. The regression methodology also allows us to account for differences in other attributes of the litigation to ensure that a simple count of cases is meaningful. For example, if the number of cases declines but there is a shift toward allegations that generally generate larger judgments and settlements, we would not want to count that as a decline in litigation activity. By controlling for differences in case attributes, we can mitigate the importance of these kinds of issues.

The regression results we present in the 2007 article are very consistent with the graphical results presented above. We do not find a statistically significant negative relationship between the likelihood an insurer faces a class action in a given state litigation and the regulation metrics we examine. In fact, any statistically significant relationships we find are positive relationships. For example, we find that when the number of market conduct exams per insurer increases by 10 percent, the likelihood an insurer will face a class action in that state goes up by about 2 percent. This result is statistically significant at the 10 percent level. If we instead focus on the number of market examiners per insurer in the state, when that metric rises by 10 percent, the likelihood of an insurer facing a class action in that state increases by almost 8 percent. This effect is statistically significant at the 1 percent level.

When we examine the likelihood of facing a class action filed on behalf of state residents in another jurisdiction, we find less evidence of a positive relationship between litigation and regulation. The coefficients generally still suggest a positive relationship, but they are much smaller in magnitude, leading to a lack of statistical significance. However, we still find zero evidence of substitution on the margin.

These regression results provide confidence that the graphical analysis presented above is not obscuring some true substitutability between litigation and regulation on the margin. If anything, the more systematic examination of the data through regression techniques is suggestive of complementarity, not substitutability. In further research, it would be interesting to examine whether this complementarity is driven by litigants filing in the wake of some regulatory discovery, regulators piggy-backing on the discoveries of litigants, or some combination of these.

The Evidence from Non-OEM Parts Litigation

To get a more precise view of how litigation and regulation interact, we examine the controversy surrounding the use of OEM parts in accident repairs. While our aggregate data does not support the substitution thesis, it may be that a more narrow focus might reveal that litigation results from gaps in rules.

According to the United States Government Accountability Office (GAO), 40 states have enacted some form of legislation governing the use of OEM parts.¹⁷ Of these states, 36 require companies to identify if aftermarket parts are used in the repair. A warranty is required by 27 states, and 23 states require a manufacturer's ID for tracking purposes on any non-OEM parts. Although the use of OEM parts is regulated, every state insurance commission and consumer product safety commission in the U.S. allowed it, and two states, Massachusetts and Hawaii, required it.

There have been many studies of the safety of non-OEM parts, much of it at the behest of regulators. Generally, such studies report that non-OEM parts differ only cosmetically from OEM parts and create little or no safety risk. Whether or not one agrees with the regulators' decisions on OEM parts, it is hard to argue that the issue had not been evaluated and that regulators and legislators had not reached a consensus favoring the regulated use of non-OEM parts.

The fact that 40 states regulated the use of non-OEM parts provides a basis for an evaluation of class actions as a substitute for regulation. If the 10 states that did not have rules or disallowed certain practices had more class actions, this would support the substitution thesis. When regulation is vague or nonexistent, private attorneys would then fill the void. However, this is not what we observe. Remarkably, all of the states with above average litigation filings in the RAND Class Action dataset had previously issued regulations on non-OEM parts.

The results are similar when we break down the filing rates by specific regulation. The regulations we examined include requirements about: (1) disclosure, (2) consent, (3) a duty to identify whether non-OEM parts will be used (4) or whether the aftermarket part is of like quality, (5) warranties, (6) disclosure as to warranties, (7) a ban on requiring non-OEM

parts, and (8) disclosure of the non-OEM manufacturer. We also examined the case in which no regulations existed.

We find that the number of class actions filed in a state is either indistinguishable in states that regulated certain practices or that class actions are more common in states that had explicit regulations. For four of the regulations, these differences are statistically significant: (1) states that required disclosure had almost one additional OEM parts case relative to those that did not require disclosure; (2) states that required estimates to identify non-OEM parts had an average of .93 more class actions during the sample period; (3) states requiring a warranty on non-OEM parts also had an average of one additional class action over those states that did not require warranties; and (4) states that had no regulation in place had .8 fewer cases than those with some regulation of non-OEM parts during the sample period. The existence of prior regulations on the allegation under litigation has essentially no negative effect on the filing rate of class actions. This is inconsistent with the substitution thesis.

The same conclusion arises if we adjust for population. There is no statistically significant difference in states with and without a particular regulation, or any regulation. The implication of this is that more populous states are both more likely to be the filing location of a class action lawsuit covering OEM parts, and that these states are also more likely to have issued rulings on the use of non-OEM parts.

However, we did find evidence consistent with the substitution thesis when we examined cases filed on behalf of individuals not residing in the state of filing (e.g., a case filed in Illinois that includes class members who are residents of Missouri). The majority of states with an above average number of suits on behalf of residents outside the filing state are states that had not issued a ruling on non-OEM parts. States without regulation of OEM parts are more likely to have cases brought on behalf of their residents, but these cases are more likely to be decided in other states.

Although the facts of these cases are complex and remain controversial, the important feature of the cases for our purposes is the plaintiffs' allegation that non-OEM parts were in fact unsafe and that insurance companies breached their contracts with policy holders by using non-OEM parts. Specifically, the effect of the *Avery* case mentioned above, at least until it was

overturned, was to cause a number of insurance companies to switch to OEM parts even though regulators in many of those states had specifically permitted non-OEM parts.¹⁸

Conclusion

We find that class action filing location is not determined by a lack of interest on the part of local regulators. Nor are filings more likely in states with fewer regulatory enforcement resources. We do find, however, that class actions are more frequently brought on behalf of residents of states whose regulatory authority has not issued rules in a particular area, but these cases are filed in states that are more likely to have regulations in place. Thus, in all but one of our tests, we find no evidence to support the substitution thesis. Moreover, the one instance where we do find evidence of the thesis has the unusual feature that cases are brought on behalf of those who live in states with ambiguous regulations in states that have regulations specifically allowing the conduct.

Finding little support for the standard law-and-economics explanation for the dual regulatory and litigation system, we are left seeking other models of the relationship between regulation and litigation. Elsewhere, we present evidence that litigation does not generally serve to undo regulatory capture. Thus the two primary economic justifications for dual regulatory and litigation systems appear to be inconsistent with the data. Although it is possible that economic theorists have simply missed a strong justification for the dual system during the 30 years since this topic first garnered interest in the law-and-economics literature, efficiency concerns seem to support calls for regulatory preemption of litigation.¹⁹

Notes

1. *Avery v. State Farm Mut. Auto. Ins. Co.*, WL 955543 and WL 1022134 (Ill. Cir., 1999). See State Farm Media Backgrounder for estimate of class size available at http://www.statefarm.com/about/media/backgrounder/avery_sf.asp (last accessed on March 12, 2009).

2. Residents from Arkansas and Tennessee were not included.

3. The class was certified on July 1997 in Williamson County, Ill. On October 4, 1999, a jury awarded \$456 million to the plaintiffs for breach of contract. This award was followed four days later by an additional award of \$730 million for consumer fraud made by Judge John Speroni. The award included \$600 million in punitive damages. On April 5, 2001, the Appellate Court reduced the verdict by \$130 million but let stand \$1.05 billion of the award. In 2005, the Illinois Supreme Court overturned the judgment against State Farm. The Court unanimously ruled that class should not have been certified because it was too broad and that the plaintiffs failed to demonstrate either a breach of contract or consumer fraud.

4. More information on this database is available at <http://www.rand.org/pubs/monographs/MG587-1.html>.

5. Nicholas Pace, Stephen J. Carroll, Ingo Vogelsang, and Laura Zakaras, *Insurance Class Actions in the United States* (2007).

6. See T. Eisenberg and G. Miller, *Attorney Fees in Class Action Settlements: An Empirical Study*, 1J. Emp. Legal Stud. 27, 51–52 (2004).

7. George Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. Mgmt. Sci. 3 (1971).

8. Hersch, *Breast Implants: Regulation, Litigation and Science*. *Regulation through Litigation*, AEI-Brookings Joint Center for Regulatory Studies, Washington, D.C. (2002).

9. We examine the regulatory capture hypothesis, as well as some other ad hoc rationales, in Helland and Klick, *To Regulate, Litigate, or Both*, available at SSRN: <http://ssrn.com/abstract=1375522>.

10. We examine the relationship between harm generation while controlling for the likelihood of litigation in Helland and Klick, *The Tradeoffs between Regulation and Litigation: Evidence from Insurance Class Actions*, 1J. Tort. L. Article 2 (2006).

11. These data are published in the NAIC's Insurance Department Research Report. The most recent report is available at http://www.naic.org/store_pub_naic_state.htm#dept_resources.

12. Shavell, *A Model of the Optimal Use of Liability and Safety Regulation*, 15 Rand J. Econ. 271 (1984); Shavell, *Liability for Harm versus Regulation of Safety*, 13J. Legal Stud. 357 (1984).

13. Although the Shavell model does not distinguish between the standard and its enforcement (i.e., Shavell assumes that any standard can be enforced perfectly), in the real world, standards are not self-enforcing. This implies that, for any given standard, the care achieved will be a function of enforcement. For simplicity, we will assume that regulators adopt optimal enforcement levels.

14. See Pace, *supra* note 5.

15. Vanishing premium cases are generated by an insurer's claim that premiums will vanish over time, without a lifetime of payments, where premiums failed to disappear because the financial assumptions were unrealistic.

16. Heterogeneity in preferences can work through a number of different channels in addition to the income and wealth one discussed above. Other issues could

involve differential risk aversion leading to a higher desired consumer protection level.

17. Motor Vehicle Safety: NHTSA's Ability to Detect and Recall Defective Replacement Crash Parts Is Limited, GAO-01-215 (2001).

18. This point is made in Schwartz and Lorber, *State Farm v. Avery: State Court Regulation through Litigation Has Gone Too Far*, 33 Conn. L. Rev. 1215 (2001).

19. While there are many arguments offered in favor of preemption by practitioners, economics scholarship has also offered support for this position. See, e.g., Schwartzstein and Shleifer, *Litigation and Regulation* (2009), working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344505.