

THE IMPACT OF BAD FAITH LAWSUITS ON CONSUMERS IN FLORIDA AND NATIONWIDE

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EXECUTIVE SUMMARY

Under long-standing law in every state, insurance companies have a strong economic incentive to act in good faith when processing claims. When an individual believes an insurer has not acted in good faith, he or she has two remedies available, both of which are available in every state:

- The individual can file a complaint with the state's insurance commissioner. The commissioner can require remedial action to address the harm caused by its bad behavior, and it can also punish the insurer for its failure to act in good faith, thereby deterring bad behavior in the future.
- The claimant can sue the insurance company pursuant to contract law for breach of contract.

Some states go further and allow individuals to sue the insurer for acting in bad faith when processing claims. When an individual sues his or her own insurer for failing to act in good faith, the action is commonly known as a *first-party* bad faith lawsuit. When an individual is injured by another party and sues the other party's insurance company for failure to act in good faith, the action is commonly known as a *third-party* bad faith lawsuit.

When a state authorizes bad faith lawsuits, it changes the economic incentives for both individuals and insurance companies alike. It does so by significantly increasing the insurer's potential loss and the claimant's potential recovery, since a successful bad faith lawsuit can: (1) remove coverage limits under the policy; (2) expand the types of losses that are compensable (*e.g.*, pain and suffering); and (3) open the door to punitive damage awards. With more money at stake:

- Individuals have a greater economic incentive to pursue weak claims.
- There is a greater economic incentive for individuals to commit insurance fraud.
- Insurers have an economic *disincentive* to investigate instances of possible insurance fraud.

- Insurers have a greater economic incentive to enter into artificially inflated settlements.

The change in economic incentives occurs even if no bad faith lawsuit is filed. The threat of such a suit is often sufficient to encourage an insurer to settle a borderline or possibly fraudulent claim, rather than risk incurring the heavy costs that could result from a successful lawsuit. While such a threat may benefit some individuals – particularly those with fraudulent or weak claims – it is likely to impose a heavy cost on policyholders generally, since the costs resulting from the threat will be passed along to the consumer in the form of higher insurance premiums.

Four empirical analyses of bad faith lawsuits’ economic and behavioral effects conducted by prominent researchers have confirmed what bedrock economic principals predict:

- Hawken, Carroll, and Abrahamse (2001) in a report published by RAND found that when California’s Supreme Court temporarily allowed third-party bad faith lawsuits, the number of bodily injury claims rose sharply and the annual bodily injury insurance premiums increased between 32 and 53 percent.
- Browne, Pryor and Puelz (2004) found that settlement amounts were higher in states that allow first-party bad faith tort liability.
- Tennyson and Warfel (2009) found that tort liability for first-party bad faith reduces insurer’s incentive to monitor claim fraud, and increases the number of paid claims containing characteristics associated with fraud.
- Tennyson and Asmat (2009) found that claim payments are higher in states that permit first-party tort actions for insurer bad faith.

In addition, a study by the West Virginia Insurance Commissioner found that insurers in states permitting third-party bad faith lawsuits incur bodily injury claim costs that are about 25% higher than the average for non-third-party tort states.

At the request of U.S. Chamber of Commerce’s Institute for Legal Reform, we examined the impact of bad faith lawsuits on consumers and businesses in Florida – a state that makes it relatively easy for individuals to file bad faith lawsuits against insurance companies. We

obtained data on personal automobile insurance claims and claim costs from respected sources, and analyzed the data using an econometrics model. By holding other determinants of claim costs constant, we were able to isolate the impact of bad faith tort liability on these costs.

Our analysis focused on bad faith litigation's effects on personal automobile insurance costs because reliable nationwide data is only available for this line of business. Although the focus of our analysis is on personal automobile insurance premiums, we believe our results are indicative of how the threat of bad faith lawsuits affects the cost that consumers and businesses must pay for other types of insurance, such as homeowners and general liability.

Our econometrics model estimates the impact that allowing third-party bad faith private causes of action have on bodily injury liability pure premiums. We exploit variations in the timing of different states' adoption of bad faith regulations afforded by the gradual enactment and repeal of third-party bad faith reforms across states from 1976 through 2006. In addition to controlling for changes in various economic and demographic variables that are reasonably expected to influence pure premiums, we also include state- and time-fixed effects to control for time-invariant differences in settlement costs across states and state-invariant changes in costs across time.

Findings: Third-party bad faith litigation. After adjusting for other factors that can reasonably be expected to influence personal automobile bodily injury (BI) pure premiums, we find that allowing individuals to file third-party bad faith lawsuits increases the BI pure premium per insured vehicle in Florida by 30.2%. This implies a *minimum* increase in Florida BI liability insurance pure premiums of approximately \$33.30 per insured vehicle (2006).

To analyze the financial impact of first-party bad faith lawsuits, we compare Florida's average personal automobile uninsured motorist/underinsured motorist (UM/UIM) pure premium with the average for states without a defined first-party bad faith cause of action.

Findings: First-party bad faith litigation. After removing the effects of other economic and demographic variables that may influence premiums, we find that the average UM/UIM personal automobile pure premium in states with a first-party cause of action is \$25.45, or 80.8%, higher than the average in the five states without a defined first-party bad faith cause of action. In addition, we find that Florida's average personal automobile UM/UIM pure premium is \$59.26, or 188%, higher than the average for states without a defined first-party bad faith cause of action.

Our findings *underestimate* the effect of bad faith litigation on pure premiums because our data does not reflect claims settlement costs attributable to greater attorney involvement in the process. If allowance could be made for the higher claims settlement costs caused by lenient bad faith regimes, the adverse impact of these regimes on pure premiums would be greater than what our models yield.

Our models measure the impact of bad faith lawsuits on pure premiums – the average cost per insured vehicle incurred by insurance companies in settling claims. Initially – but only initially – these costs are paid by insurance companies. Most of the costs, however, are passed along to consumers and businesses, in the form of higher insurance premiums.

Some advocates for bad faith lawsuits contend that the costs attributable to the threat of bad faith lawsuits are not paid by consumers and businesses, and instead reduce insurance companies' excess profits. The available data does not support this contention. The National Association of Insurance Commissioners has found that property and casualty insurance companies' average return on net worth is less than half of the average for all industries in the United States. In fact, it appears that these companies earn a *negative* return for assuming the risks that are the essence of the insurance business.

For a state like Florida that permits both first-party and third-party bad faith lawsuits, the financial burden imposed on consumers and businesses is not necessarily equal to the sum of the first- and third-party effects. There may be unobservable state-specific factors that account for part of the difference in UI/UIM pure premiums between Florida and the five non-first-party

states. If no such factors exist, we estimate that by allowing bad faith lawsuits, Florida increases annual BI and UM/UIM premiums for insured consumers and businesses by \$92.56 per vehicle. For a two-car family with both types of coverage, the added burden amounts to nearly \$190 per year.

As premiums rise, the number of motorists who are unable to – or choose not to – purchase insurance also rises, placing an additional burden on other motorists, particularly those without UM/UIM coverage.

By increasing the potential rewards from filing non-meritorious claims, allowing bad faith lawsuits also increases the costs incurred by taxpayers to maintain state court systems.

In sum, when states make it easy to file and win bad faith lawsuits, they increase the cost of insuring consumers and businesses against property, casualty, and other losses. The rate-setting process and market forces, in turn, cause consumers and businesses, rather than insurance companies, to bear most – and in many states, all – of the costs attributable to bad faith litigation.

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I. INTRODUCTION

A. Overview

Not all insurance claims are meritorious. The validity of an individual insurance claim usually hinges on three key determinations: (a) who was at fault? (b) how much damage resulted from the covered event? and (c) is the loss covered by the insurance policy? Sometimes, these determinations are easy to make. Often, however, they are far from clear-cut, and require a complex and time-consuming investigation. In these latter cases, honest differences of opinion between the insurance company and the insured may arise. When these differences persist, the claimant may believe that he or she is not being treated fairly by the insurer.

Insurers have a legal obligation to treat claimants fairly. This obligation is often expressed as the insurer's duty to act in good faith when processing and settling claims. If a claimant believes the insurer has not fulfilled its obligations under the insurance policy or has failed to act in good faith, he or she has two alternative means for securing fair treatment. First, the claimant can file a complaint with the state's insurance commissioner. If the complaint is found to be valid, the commissioner can require the insurer to compensate for any losses and can punish the insurer for its bad behavior. Second, the claimant can sue the insurer under contract law for breach of contract.

Some states provide policyholders or third parties another avenue for seeking redress: they allow the claimant to sue the insurance company in a separate lawsuit for acting in bad faith. The threat of bad faith lawsuits alone may make it possible for the claimant to obtain a favorable settlement of his or her claim. If the threat is followed by an actual lawsuit, the claimant may receive an award that significantly exceeds the policy limits and actual damages suffered. Bad faith lawsuits, however, have other consequences that may impose significant costs on consumers and businesses in the form of higher insurance premiums.

This study analyzes the economic impact of bad faith lawsuits, with particular reference to Florida – a state that makes it relatively easy for individuals to sue insurance companies. It does so by (a) analyzing the impact of bad faith lawsuits on the economic incentives that influence the

behavior of claimants (and their attorneys) and insurance companies, (b) reviewing the findings from empirical studies of bad faith litigation conducted by scholars and published in scholarly journals, and (c) creating an econometric model that isolates the economic effect of bad faith litigation by holding other determinants of insurance premiums constant.

B. Organization of the Report

The remainder of this report consists of six parts:

- Part II provides background information on insurance claims and the insurer's obligation to act in good faith when it processes and settles these claims.
- Part III discusses the impact of bad faith regimes on the economic incentives confronting claimants, claimants' attorneys, and insurance companies.
- Part IV reviews the findings of recent empirical studies of bad faith litigation's impact on insurers and claimants.
- Part V presents the findings from our econometric analysis of first- and third-party bad faith litigation.
- Part VI considers how the increase in claims settlement costs attributable to bad faith litigation affects consumers and businesses.
- Part VII offers concluding comments on the impact of bad faith lawsuits on consumers, businesses, and taxpayers.

II. BACKGROUND

A. The Nature of Insurance Claims

Insurance claims can be easy or difficult to value. Some are relatively straightforward, such as property damage claims. For example, the cost to replace a cracked windshield is easy to determine, and fault generally is not an issue when an insured motorist files a claim to repair the damage.

Some claims, however, are highly complex and can be hard to value. Bodily injury claims, for example, may be difficult to substantiate. Other claims, such as mental anguish, are highly subjective. Honest disagreements can arise between claimants and insurance companies in valuing such claims.

Further complicating the claim settlement process is the fact that fault is not always easy to determine. It can be expensive and time-consuming for insurance companies to investigate claims, particularly when consumer fraud is suspected. Doubt as to fault can also lead to honest disagreements over claims between claimants and insurers.

Finally, the insurer must determine whether the loss is one that is covered by the insurance policy. This analysis may involve comparing a complex set of facts resulting from an in-depth investigation to an interpretation of policy language. This application of facts to the policy language can also lead to honest disagreement about whether the loss is covered (fully or partially) by the policy.

B. The Insurer's Obligation to Act in Good Faith

Insurance companies are regulated by state governments. Each state has an "Insurance Code" or statute that outlines specific procedural requirements governing insurance company operations. All states require insurance companies to deal with their policyholders in good faith, either through statute or by court-established laws. The good-faith requirement obligates the insurer: (1) to thoroughly investigate each claim; (2) to respond to each claim promptly; and (3) to pay or deny each claim within a reasonable period of time.

C. Methods for Resolving Disputes between Claimants and Insurers

Consumers have two effective means for enforcing their contractual right to fair treatment.

First, when an individual feels that the insurance company has not acted in good faith, he or she can file a complaint with the state insurance commissioner. The state insurance commissioner monitors insurance companies' compliance with these requirements, investigates complaints

against insurance companies, and requires remedial action and/or imposes fines when insurers are found to have mistreated policyholders.

All states have policies and procedures for investigating and acting on allegations of bad faith. When an insurer is found to have violated its obligation to act in good faith, the commissioner can (1) require the insurer to redress the harm and (2) punish the insurer for its bad behavior, thereby deterring such behavior in the future.

Second, policyholders can enforce their rights by suing their insurer for breach of contract. Courts in all states have held that an insurance policy is a contract that outlines the insurance company's obligations to the policyholder. If a policyholder believes that the insurer has failed to fulfill its obligations under the contract, the policyholder can sue the insurer for breach of contract and seek an award that compensates for the damages caused by the breach.

D. Bad Faith Lawsuits

Some, but not all, states also allow individuals to sue an insurer under tort¹ law for failure to act in good faith. These suits are commonly referred to as bad faith lawsuits.

There are two types of bad faith lawsuits that individuals may file: first-party and third-party. First-party bad faith claims arise when an individual brings a complaint against his or her own insurance company for not acting in good faith. Third-party bad faith claims arise when an individual who has been injured by another party brings a complaint against the responsible party's insurance company. A typical third-party complaint might arise as follows:

Driver A runs a stop sign and hits Driver B's car, injuring Driver B and damaging his car. Driver B files a claim against Driver A for damages to his car and for medical costs. If Driver B feels that Driver A's insurance company refuses to reach a prompt, fair, and equitable settlement of this initial claim, Driver B can sue Driver A's insurance company in a separate lawsuit for failure to act in good faith.

¹ According to the Merriam-Webster Online Dictionary, a tort "is a wrongful act other than a breach of contract for which relief may be obtained in the form of damages or an injunction."

Proponents of allowing individuals to sue insurance companies for acting in bad faith maintain that there is an imbalance of bargaining power between policyholders and insurance companies, since the insurers investigate claims and set the terms of the settlements. Only by allowing bad faith lawsuits, the proponents argue, will this imbalance be eliminated.

The premise underlying this argument, however, is not correct. In fact, as noted earlier, consumers have two effective means for eliminating the imbalance of bargaining power and enforcing their contractual right to fair treatment: (a) by seeking remedial action from the state insurance commissioner, and (b) by filing suit for breach of contract.

Thus, when a state authorizes individuals to sue insurance companies for acting in bad faith, it adds a third means for holding these companies accountable. The costs to consumers resulting from bad faith lawsuits, therefore, must be weighed against the incremental benefits, if any, that result from supplementing the remedies for bad faith action already available under the state's insurance code and contract law.

III. BAD FAITH LAWSUITS AND ECONOMIC INCENTIVES

When a state allows first- or third-party claimants to sue insurers under tort law for acting in bad faith, they greatly increase the claimant's potential recovery and the insurer's potential pay-out. Bad faith lawsuits increase the amount at stake in at least three ways:

- By rendering the policy or coverage limits moot, so that the insured may recover more than the amount of insurance for which he or she has paid and to which he or she is entitled;
- By expanding the types of losses for which compensation may be sought (*e.g.*, pain and suffering); and
- By allowing an award of punitive damages well in excess of policy limits.

By increasing the amount at stake, the threat of bad faith litigation significantly alters the economic incentives facing insurers, claimants, and attorneys. Specifically, laws or court decisions that allow individuals to file bad faith lawsuits:

- ***Increase an individual's incentive to pursue weak claims.*** Empirical research has demonstrated that the decision to file or not to file a lawsuit is based on a comparison of the expected costs of, and expected recoveries from, the suit.² Bad faith lawsuits provide claimants the potential to recover much larger total awards. As a result, claimants in states that allow bad faith lawsuits have a greater incentive to pursue weak or marginal claims – claims that they otherwise would have abandoned or settled.
- ***Increase incentives for insurance fraud.*** The same incentive that encourages claimants to pursue weak cases – the large potential payoff – also increases the incentives to engage in insurance fraud.
- ***Reduce the likelihood that an insurer will investigate instances of possible insurance fraud.*** By significantly increasing the insurer's financial exposure, the threat of a bad faith lawsuit will tend to deter insurers from taking the time necessary to conduct investigations that may uncover fraud and reduce the financial burden that all policyholders must carry.

It is the *threat* of a bad faith lawsuit that changes the individual's and insurance company's economic incentives. The financial risks associated with such litigation encourage insurers to reduce their exposure by settling borderline and possibly fraudulent claims. Claimants' attorneys, equally aware of insurers' desires to minimize the risk of a bad faith lawsuit, will threaten to file such a suit as a matter of course, since there is no downside to filing a bad faith lawsuit. This threat gives claimants leverage to demand settlements that exceed justified damages.

The change in the insurers' economic incentive to contest possibly fraudulent claims resulting from the threat of a bad faith lawsuit is demonstrated in the following hypothetical example. Consistent with the findings of empirical research, we assume that an insurer will decide to investigate a potentially fraudulent claim only if the expected costs of contesting the claim are

² See e.g., Patricia M. Danzon and Lee A. Lillard, Settlement out of Court: the Disposition of Medical Malpractice Claims, *Journal of Legal Studies*, vol. XII (June 1983): p. 356.

less than the expected costs of settlement. The expected costs of contesting the claim depend on three primary variables:

- The estimated payout if the claim is deemed (by either the insurer or a jury) to be valid.
- The probability that the claim will be deemed to be valid.
- The cost of investigating the claim and, if necessary, defending the insurer's decision to reject the claim at trial.

Assume an individual with a \$300,000 bodily injury policy files a \$500,000 insurance claim that has characteristics often associated with insurance fraud.³ Assume also that the insurance adjuster's experience with similar claims indicates that the claimant's likelihood of prevailing in a lawsuit is 20%. Given these two assumptions, the expected cost of contesting the potentially fraudulent claim when bad faith lawsuits are not permitted is \$90,000 – 20% times \$300,000, plus investigation costs assumed to be \$30,000. This means that the expected benefit from contesting the claim is \$210,000 (the \$300,000 cost of settling the claim without investigation minus \$90,000). (See Table 1.)

Now consider how the threat of a bad faith lawsuit alters the expected benefit from contesting a potentially fraudulent claim. Assume that a successful suit would (a) remove the \$300,000 policy limit, and (b) expose the insurer to a \$1.5 million extra contractual damages (*e.g.*, punitive damages) award.⁴ Given these assumptions, the expected cost of contesting the claim is \$530,000 – 20% (the estimated likelihood that the plaintiff will prevail at trial) times \$2 million (\$500,000 claim plus \$1.5 million punitive damages) plus \$130,000 for investigation costs and attorney fees. This amount is \$230,000 more than the cost of simply settling the suspicious claim at the \$300,000 policy limit. (See Table 1.)

³ For a discussion of these characteristics, see Sharon Tennyson and William J. Warfel, "The Law and Economics of First-Party Insurance Bad Faith Liability," *Connecticut Insurance Law Journal*, Vol. 16, 2009.

⁴ Not all bad faith lawsuits raise the threat of punitive damages.

Table 1 Assumptions		
Bodily injury claim		\$500,000
Policy limit		\$300,000
Probability that an investigation will uncover and prove fraud		80%
Insurer's cost to investigate claim		\$30,000
Punitive damage exposure in a bad-faith lawsuit		\$1,500,000
Attorney fee exposure in a bad-faith lawsuit		\$100,000
Bad-faith lawsuits...	NOT Permitted	ARE Permitted
Insurer's expected payout if no investigation is conducted	\$300,000	\$300,000
Expected payout after investigation	\$90,000	\$530,000
Expected net benefit from investigation	\$210,000	(\$230,000)

In other words, when bad faith lawsuits are allowed, it may not be in an insurance company's economic interest to investigate claims that it believes are fraudulent. Since consumers and businesses ultimately pay (through their insurance premiums) for payouts on fraudulent or non-meritorious claims, the disincentive to contest such claims when an insurer is exposed to the threat of a bad faith lawsuit imposes a cost on them as well.

IV. RESULTS FROM SCHOLARLY STUDIES OF BAD FAITH LAWSUITS

Four empirical analyses of bad faith lawsuits' economic and behavioral impact have been published in scholarly journals. In addition, empirical evidence has been presented on the expected impact that recent changes in state bad faith regimes will have on consumers and businesses. In this part, we summarize these findings.

A. Empirical Research Studies

1. Hawken, Carroll and Abrahamse

Hawken, Carroll and Abrahamse (2001) performed a study for the RAND Corporation that examined the effects of allowing third-party bad faith tort liability claims in California during the 1979-1988 period. This period is commonly referred to as the Royal Globe era.⁵

⁵ Third-party lawsuits were first authorized by the California Supreme Court when it decided *Royal Globe Insurance Company v. Superior Court*, 592 P.2d 329 (Cal. 1979).

The Hawken *et al.* study models the factors that might influence the amount of compensation paid on bodily injury (BI) claims, and explores the extent to which claims brought in the shadow of the Royal Globe doctrine obtained greater compensation than they would have otherwise (referred to as the “shadow effect”). In addition, it models attorney involvement in BI claims, in order to identify the extent to which access to Royal Globe actions influence attorney representation and, consequently, BI compensation and costs (referred to as the “representation effect”).

The study focuses on bodily injury claims “to avoid the possibility that changes in the compensation and costs of coverages not subject to the shadow effect of Royal Globe actions affect our estimates.”⁶ Data on closed claims was gathered for BI claims during the Royal Globe era and after Royal Globe was reversed. The authors used an econometrics model to control for various factors such as claim and claimant characteristics.⁷

The model finds that Royal Globe increased BI compensation payments by 32 to 53 percent (the average of the low and high estimates). Since BI premiums accounted for 54 percent of total liability premiums, the higher payments translate into an increase of 17 to 29 percent in total liability premiums. Since liability premiums account for about 65 percent of total auto insurance premiums, a 17 to 29 percent increase in liability premiums represents an 11 to 19 percent increase in total premiums.⁸

The study also found that the frequency of BI claims was higher in California when third-party bad faith tort liability claims were allowed, and this frequency declined when the Royal Globe ruling was overturned.⁹

⁶ Angela Hawken, Stephen J. Carroll, and Allan F. Abrahamse, “The Effects of Third-Party, Bad Faith Doctrine on Automobile Insurance Costs and Compensation,” RAND Institute for Civil Justice, 2001, p. 7. Bodily injury is defined as “a third-party auto insurance coverage of the insured’s obligation to someone he or she injures, up to the policy limits.” (See also, Hawken, et al., footnote 12).

⁷ *Ibid.* pp. 29-30.

⁸ *Ibid.* p. xviii.

⁹ *Ibid.* p. 49.

2. Browne, Pryor and Puelz

Browne, Pryor and Puelz (2004) provide the first analysis of first-party insurance bad faith lawsuits' effect on automobile insurance payments.¹⁰ Using IRC data on first-party injury claims (*i.e.*, uninsured motorist and underinsured motorist claims) settled in 38 states in 1992,¹¹ the authors performed a multiple regression analysis to determine whether claim settlement amounts are larger in states that permit private actions for insurer bad faith, after controlling for a wide array of claim characteristics and for other features of the states' legal and claim environments.¹² Their results indicate that higher overall settlement amounts are paid in states that recognize first-party bad faith liability. The higher overall settlement amounts are a result of higher payments for both economic and noneconomic damages.¹³

3. Tennyson and Warfel

Tennyson and Warfel (2009) analyzed the relationship between a state's first-party bad faith regime and the settlement of automobile insurance claims involving uninsured motorists. They examined two aspects of insurance claims that may be affected by bad faith liability: the characteristics of claims (specifically, the accident, injury, and medical treatments), and the claim settlement behavior of insurers (specifically, the claim investigation).¹⁴ IRC data on first-party injury claims closed in 1997 for 48 states plus the District of Columbia was used.¹⁵ Their results indicate that tort liability for first-party bad faith reduces insurers' incentives to monitor claim fraud, leading to less intensive use of investigative techniques. They also found that more paid claims contained characteristics that are often associated with fraud.¹⁶

¹⁰ Mark J. Browne, Ellen S. Pryor, and Bob Puelz, "The Effect of Bad faith Laws on First-Party Insurance Claims Decisions," *Journal of Legal Studies*, Vol. 33, June 2004, p. 357.

¹¹ *Ibid.* pp. 367-369.

¹² *Ibid.* pp. 369-376.

¹³ *Ibid.* p. 386.

¹⁴ Sharon Tennyson and William J. Warfel, "The Law and Economics of First-Party Insurance Bad Faith Liability," *Connecticut Insurance Law Journal*, Vol. 16, 2009, p. 225.

¹⁵ *Ibid.* pp. 226 and 228.

¹⁶ *Ibid.* p. 240.

4. Tennyson and Asmat

Tennyson and Asmat (2009) examined how claim settlement amounts evolve over time in relation to changes in a state's legal regime for insurer first-party bad faith. Using IRC data on first-party automobile injury claims (*i.e.*, uninsured motorists claims) settled in 1977, 1987, and 1997, the authors used multiple regression analysis controlling for claim characteristics such as demographic characteristics of the claimant, the nature and severity of the injury, injury treatment, geographic location, and attorney representation, and whether a state has enacted legislation to limit punitive damages awards in first-party bad faith damage awards in tort cases.¹⁷ The results indicate that claim payments are higher in states that permit tort actions for insurer first-party bad faith. Additional analysis shows the probability that a claim is settled for less than the amount of economic losses claimed is also lower in states that permit bad faith actions under tort.¹⁸

B. Recent Changes in State Bad Faith Regimes

1. Washington

The State of Washington passed the Insurance Fair Conduct Act, effective December 6, 2007. This statute “provides legal remedies for policyholders, including the ability to seek punitive damages in court if their claims are unreasonably denied by their insurance companies or their insurance company violates particular regulations governing unfair claims settlement practices.”¹⁹ The law applies only to first-party bad faith litigation. It does not apply to claims under health insurance policies, but does apply to claims under other kinds of policies, including policies that include medical costs as part of that coverage.²⁰ According to the Property Casualty

¹⁷ Sharon Tennyson and Daniel P. Asmat, “Bargaining in the Shadow of the Law: An Empirical Study of Automobile Insurance Settlements,” Working Paper, December 10, 2009, pp. 8-9.

¹⁸ *Ibid.* p. 21.

¹⁹ Washington State, Office of the Insurance Commissioner website, “Insurance Fair Conduct Act” (<http://www.insurance.wa.gov/consumers/insurancefairconduct/index.shtml>).

²⁰ Washington State, Office of the Insurance Commissioner website, “Insurance Fair Conduct Act, Commonly asked questions and answers” (http://www.insurance.wa.gov/consumers/insurancefairconduct/questions_and_answers.shtml).

Insurers Association of America, during the 14 months following enactment of the first-party bad faith law, over 1,000 notices of intent to file lawsuits were filed pursuant to the new law, indicating that the cost of settling insurance claims will increase significantly.²¹

Before the law was enacted, Milliman Inc. conducted a study on the likely impact of a similar bill – Engrossed Substitute Senate Bill (“ESSB”) 5726 – on insurance rates. Milliman concluded that the bill would²²:

- Increase the number of first-party bad faith claims filed.
- Result in first-party claims settling for higher amounts.
- Change insurer claim settlement practices in ways that could potentially lead to increase in loss adjustment expenses.
- Likely increase claim frequency, as insurers settle some marginal claims that would have been denied under the prior law, in order to avoid the risk of litigation.

The Milliman study estimated that if the legislation was passed, it would increase premiums in Washington by about 7 percent, thereby increasing costs to consumers and businesses in Washington by more than \$650 million per year.²³

2. West Virginia

On April 29, 2005, West Virginia passed Senate Bill 418 that repealed private third-party causes of action under the West Virginia Unfair Trade Practices Act (“UTPA”).²⁴ At the time, West Virginia was one of only six states that allowed private cause of action by third-parties. The bill,

²¹ “PCI Analysis: The Impact of Enacting ‘Bad Faith’ Legislation on Michigan’s Insured Consumers,” prepared by Property Casualty Insurers Association of America, July 16, 2009 ([http://www.pciaa.net/legtrack/web/naiipublications.nsf/lookupwebcontent/c6896daa8392062c862575fd0066517/\\$File/MichiganBadFaith072109-Final3.pdf](http://www.pciaa.net/legtrack/web/naiipublications.nsf/lookupwebcontent/c6896daa8392062c862575fd0066517/$File/MichiganBadFaith072109-Final3.pdf)).

²² “The Impact of Engrossed Substitute Senate Bill 5726 on Insurance Rates,” Prepared by Milliman Inc, for Consumers Against Higher Insurance Rates, September 20, 2007, pp. 7-8.

²³ *Ibid.* p. 21.

“... shifts complaints by third parties under the UTPA from the court system to the Office of the Insurance Commissioner. It increases the penalties the Insurance Commissioner may impose on companies for violations of the UTPA, and permits the Commissioner to award economic damages and up to \$10,000 in non-economic damages to third parties from a trust fund established by increased examination fees on companies and from appropriations from the State's general revenue. The legislation also broadens the powers of the Consumer Advocate and empowers the Consumer Advocate, appointed by the Governor rather than the Insurance Commissioner, to represent UTPA complainants before the Commissioner.”²⁵

In February 2005, before the bill was passed, the Office of the Insurance Commissioner conducted a study in order to “report on the legal and economic consequences of West Virginia’s third party cause of action and the resulting effects on insurance rates and availability.”²⁶ Based on the Hawken, Carroll and Abrahamse (2001) study and a study by Hamm (1999), the Commissioner estimated that insurers in third-party states incur about 25 percent higher bodily injury claim costs when compared to non-third-party states. Applying the 25 percent to West Virginia’s personal lines of liability coverage, the study concluded that third-party bad faith costs the state about \$166.7 million per year.²⁷

V. CASE STUDY: IMPACT ON BAD FAITH LAWSUITS ON FLORIDA CONSUMERS & BUSINESSES

²⁴ News Release, “Governor Signs Civil Justice and Insurance Reform Legislation,” dated April 29, 2005 (<http://www.wvgov.org/sec.aspx?id=32&articleid=1214>).

²⁵ PIIAWV2005 Legislative Update, West Virginia Legislature Makes History with Sweeping Tort Reform Bills, Independent Insurance Agents of West Virginia (http://www.iiaba.net/WV/04_GovernmentAffairs/04_InsuranceLegislation/WV20050907112328?ContentPreference=WV&ActiveState=WV&ContentLevel1=GOVAFF&ContentLevel2=GAINSLEG&ContentLevel3=&ActiveTab=STATE&StartRow=0).

²⁶ “Third Party Causes of Action: Effects on West Virginia Insurance Markets,” Provided by the Offices of the Insurance Commissioner, February 2005, p. 3.

²⁷ *Ibid.* p. 41.

In this part of the report, we present our findings from an analysis of insurance data designed to determine the impact of third- and first-party bad faith lawsuits on insurance costs in Florida. We obtained data on personal automobile insurance claims and claim costs from respected sources, and analyzed the data using an econometrics model that isolates the impact of bad faith tort liability on claim costs. We focus on bad faith litigation's effect on personal automobile insurance costs because reliable nationwide data is only available for this line of insurance. Although the focus of our analysis is on personal automobile insurance premiums, we believe our results are indicative of how the threat of bad faith lawsuits affects the cost of other insurance lines, since this threat has the same impact on claimant and insurer incentives and behavior regardless of what peril is being insured.

A. Economic Impact of Third-Party Bad Faith Lawsuits

In this section, we review Florida's insurance costs before and during the years in which it allowed third-party bad faith litigation. We compare the per-vehicle claims costs in Florida before and after it affirmed a third-party right to sue for bad faith, with per-vehicle claims costs in states that did not allow such suits. We then present an econometric model that isolates the effect of third-party bad faith litigation on claim costs by adjusting for other factors that influence these costs.

Third-party bad faith lawsuits arise when an injured party accuses another party's insurer of failing to act in good faith when settling claims brought against an individual or business it insures. Bodily injury ("BI") liability and property damage ("PD") liability coverages are most susceptible to third-party claims. Because BI claims are much more difficult to value and have a much higher potential total damage award (due to the possibility for permanent injury and pain and suffering), we focus our analysis on BI claims.

The measure of claim costs we use in our analysis is the BI pure premium. The pure premium is defined as the average annual cost of settling BI claims per insured vehicle.²⁸ The pure premium captures changes in the total number of claims filed in a state and the average claim

²⁸ The term pure premium is used interchangeably with per-vehicle loss cost in this paper.

size, but it does not reflect changes in claim processing costs due to attorney involvement.²⁹ Since allowing third-party litigation is likely to increase claims processing costs, our results underestimate the impact of third-party bad faith laws on claim costs. Moreover, the pure premium does not reflect the insurance company's expenses, insurance premium taxes imposed by states, allowances for contingencies and the insurance company's return on capital. Thus, the increase in the dollar cost of insurance resulting from state laws and court decisions that allow bad faith lawsuits exceeds the increase in the pure premium.

We were able to obtain 31 years of BI liability pure premium data from the Insurance Research Council and the Fast Track monitoring system. Fast Track collects data from approximately 50 large insurance companies representing about 70 percent of U.S. personal automobile premium volume. Both Fast Track and IRC data have been used in numerous scholarly studies, such as Hawken, Carroll and Abrahamse (2001). During this 31 year period (1976 – 2006), the seven states listed in Table 2 allowed a broad right to third-party bad faith litigation for at least part of the time. (Two of these states have repealed this right.³⁰) These seven states serve as our third-party bad faith “treatment group”, while the other 43 states plus Washington D.C. that did not allow broad third-party bad faith rights serve as the “control” group.

²⁹ “Pure premiums” usually reflect the total amount of losses incurred per year, including loss adjustment expenses. (See, *e.g.*, Dictionary of Insurance Terms at www.allbusiness.com). The IRC data used in our analysis does not include loss adjustment expenses as part of pure premiums.

³⁰ Several other states have established narrow rights for third-party bad faith recovery. For example, New Hampshire allows private action only after an investigation by the state's insurance commissioner has found an insurer violation. Other states, like Oregon and New Jersey, allow limited recovery of damages under contract law. The state of Georgia allows third-party bad faith claims for property damage but not bodily injury. The volume and size of claims in these states is unlikely to resemble those in Florida or other states which define a broad right to third-party recovery.

Table 2

States Permitting Third-Party Bad Faith Lawsuits During 1976-2006

State	Period
California	1979-1988
Florida	1995-Present
Kentucky	1988-Present
Massachusetts	1983-Present
Montana	1983-Present
New Mexico	2004-Present
West Virginia	1981-2005

1. Bodily Injury Insurance Costs in Florida

Figure 1 provides a preliminary look at trends in personal automobile BI liability pure premiums around the time Florida authorized third-party bad faith lawsuits. The solid black line reflects Florida’s personal automobile BI liability pure premiums, while the dotted black line reflects the average personal automobile BI liability pure premiums in the 43 states and Washington D.C. that did not have a broad right to third-party recover at any time during this period. Both of these numbers have been adjusted for inflation based on 2006 dollars.

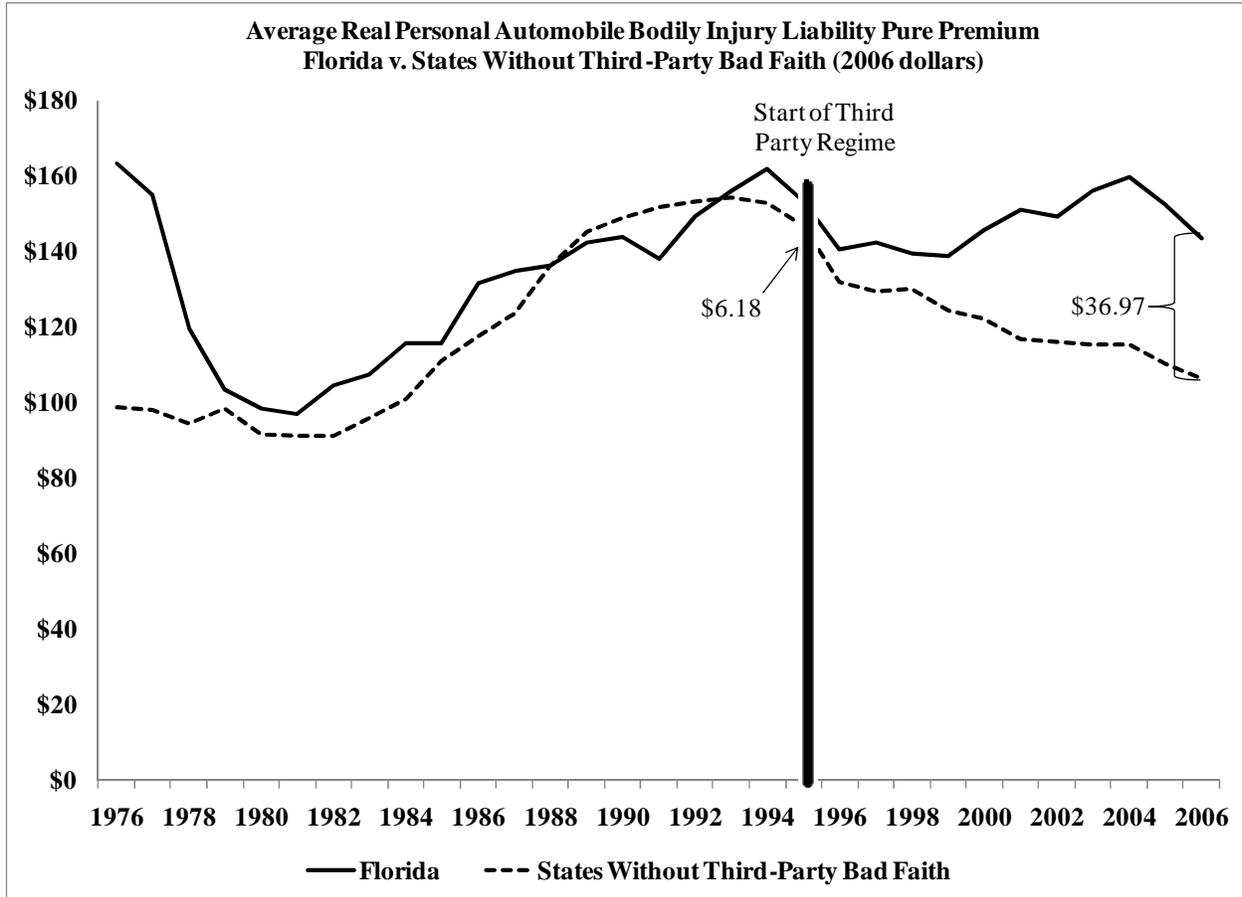
As the figure shows, prior to establishing a third-party bad faith regime in 1995³¹, personal automobile BI pure premiums in Florida closely followed the trend of premiums in the control states. On the eve of the third-party law’s enactment, the average personal automobile BI pure premium was \$6.18 (4%) higher in Florida than in the control states. The difference increased steadily after the right to file third-party bad faith lawsuits was granted, until 2003 – at which point premiums in Florida stabilized at a level roughly 35 percent above those in the control states. The gradual ramp-up of the differential is not surprising. It takes time for individual behavior to adjust to a new litigation regime, and there is a lag between an accident and claim settlement. One should note that, while the trend in the control states should reflect any

³¹ Florida Statute 624.155 provides that “any person may bring civil action against an insurer when such person is damaged.” In 1995, the Florida Supreme Court interpreted this statute to include both first and third-party suits in *Auto Owners Insurance Company v. Bonita Conquest*, which was the first case that affirmed the third-party right.

economic, legal or demographic changes that impact all states simultaneously, it does not account for changes in factors, if any, that only affected Florida.

Figure 1

Preliminary Look: Trends in Personal Automobile BI Pure Premiums



2. Quantitative Model

In order to estimate the true economic and financial impact on consumers of allowing third-party bad faith lawsuits in Florida, we need to control for other factors that may affect pure premiums within individual states. A set of statistical techniques known as econometric analysis allows us to isolate the influence of a single factor (in this case, the ability to file third-party bad faith lawsuits) by controlling for other sources of variation in outcomes. We constructed an empirical model of personal automobile BI liability pure premiums as a function of third-party bad faith

policy in addition to a variety of economic and demographic variables likely to influence insurance costs.

We include measures of possible insurance cost determinants, such as per capita income, unemployment rates, medical treatment costs, access to the legal sector, traffic density, traffic fatalities, the percent of drivers who are young (18 to 24) or old (over 65), and no-fault regulation. We also control for factors (*i.e.*, state fixed effects) that cannot be observed, in order to account for differences in loss costs across states.³² Finally, we control for time trends, to account for unobservable factors that may affect pure premiums in every state simultaneously. Our list of controls was developed based on a review of similar studies of automobile insurance premiums, and includes those variables commonly thought to be most significant in influencing premiums. Specific details regarding the third-party bad faith econometrics model can be found in **Appendix A**.

3. Results

After adjusting for other factors that can reasonably be expected to influence personal automobile BI pure premiums, we find that allowing individuals to file third-party bad faith lawsuits against insurance companies is associated with a 30.2% increase in the median personal automobile BI pure premium per insured vehicle. This implies that the average personal automobile BI pure premium per insured vehicle in Florida would have been at least \$33.30 lower in 2006 if Florida law had not authorized third-party bad faith lawsuits.³³ As discussed earlier in this report, the adverse impact of third-party bad faith lawsuits on Florida personal automobile insurance premiums is even greater, since the IRC data on pure premiums does not include loss adjustment costs, such as claims handling costs, nor does it reflect insurance premium taxes and other costs that affect premiums.

³² One or more states may have consistently high or low pure premiums due to factors that we can't observe. To ensure that such factors do not bias the results of our analysis, we include synthetic variables (called "dummy variables") in our model to capture these effects and ensure that they do not affect the estimates of bad-faith regimes on premiums.

³³ The average personal automobile BI pure premiums in the state of Florida in 2006 were \$143.48. We estimate that but-for the third-party bad faith regime, insurance premiums would have been \$110.18.

Although the lack of relevant data prevents us from conducting an empirical analysis of third-party bad faith's effects on the cost of other liability insurance lines, bad faith lawsuits' effect on the premiums charged for these types of coverages is likely to be similar. Regardless of the type of coverage under which a claim is filed, the threat of bad faith lawsuits significantly increases the claimant's potential recovery and the insurer's potential costs. By increasing the amount at stake, the threat makes it more likely that:

- Individuals will file weak claims with insurance companies.
- Individuals will commit insurance fraud.
- Insurance companies will settle dubious or possibly fraudulent claims.

The higher costs that result when insurers settle dubious or fraudulent claims ultimately is passed on to Florida consumers and businesses in the form of higher insurance premiums.³⁴

B. Economic Impact of First-Party Bad Faith Lawsuits

First-party bad faith lawsuits arise when an injured party accuses his or her own insurer of failing to settle a claim in a fair and just manner. Changes in first-party bad faith standards are likely to affect claims filed against the insured's uninsured/underinsured motorist ("UM/UIM") coverage and, in no-fault states, claims filed against personal injury protection ("PIP") policies. We focus on UM/UIM coverage in the first-party bad faith analysis, since UM/UIM coverage has been consistently available in most states while PIP coverage is only sold in states with no-fault regulatory schemes.

1. Underinsured/Uninsured Motorist Insurance Costs in Florida

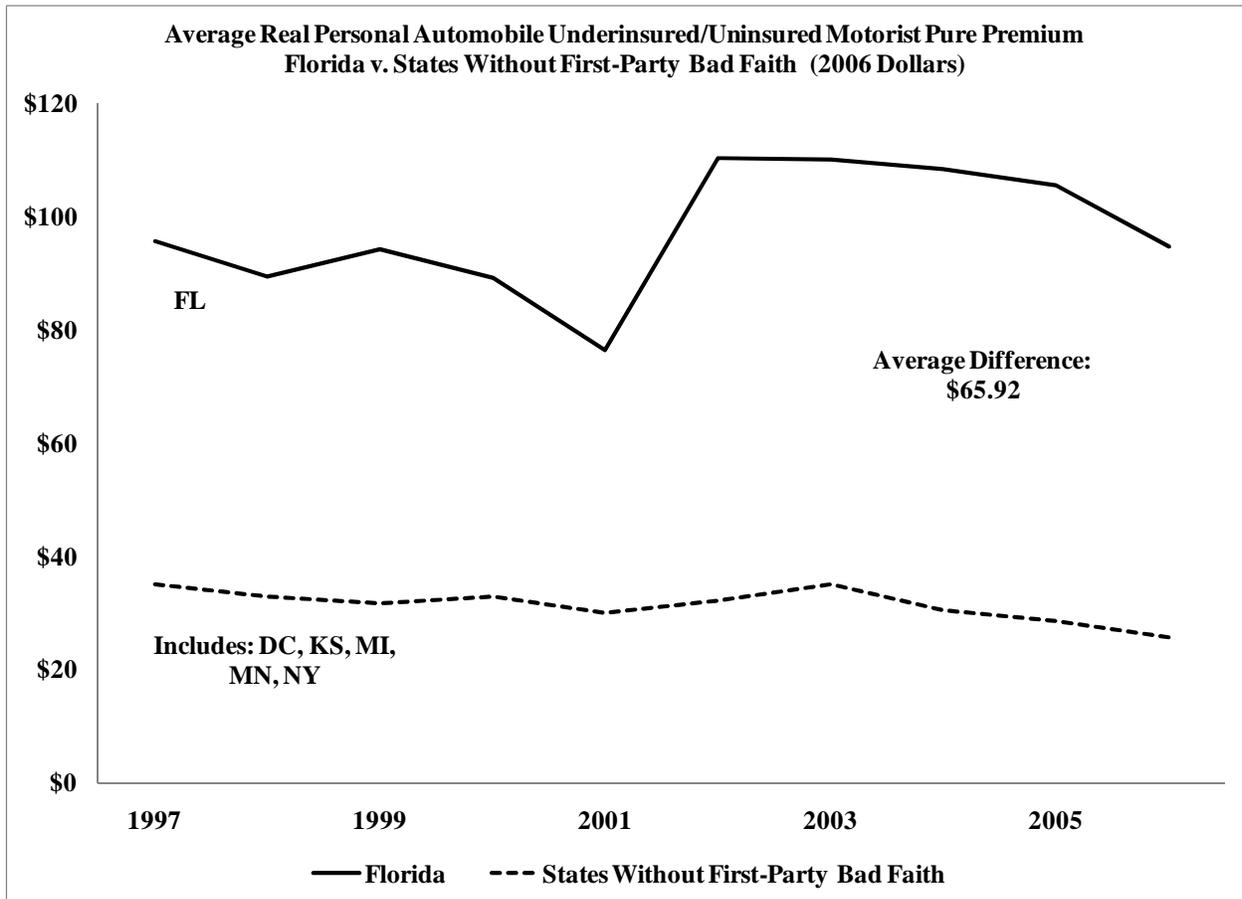
Figure 2, below, provides a preliminary look at trends in UM/UIM pure premiums during the time Florida authorized first-party bad faith lawsuits. The black line reflects Florida's average

³⁴ While Section 627.0651 of the Florida Statutes bars insurance companies from including awards and settlements resulting from statutory or common-law bad faith actions in their rate base, this prohibition does not apply to settlements offered to reduce the risk of such actions.

personal automobile UM/UIM pure premiums, while the dotted black line reflects the average personal automobile UM/UIM pure premiums in the five states that did not have a defined first-party bad faith private cause of action between 1997 and 2006. Both of these numbers have been adjusted for inflation based on 2006 dollars.

Figure 2

Preliminary Look: Trends in Personal Automobile UM/UIM Pure Premiums



As the figure shows, the average difference in pure premiums between Florida and the five control states is \$65.92. This difference makes no allowance for other factors that might affect pure premiums.

2. Quantitative Model

Isolating the impact of first-party bad faith litigation on insurance costs is complicated by the fact that there is significant variation across states in the rules governing first-party bad faith lawsuits. For example, Tennyson and Warfel (2009) classify first-party bad faith regimes into five main categories.³⁵

- Tort Action: Intentional Tort
- Tort Action: Negligence Standard
- Contract Law Actions
- Statutory Actions
- No Private Actions Allowed Other Than Breach of Contract

Moreover, even states with the same type of first-party bad faith standard (*e.g.*, Statutory Actions) can exhibit significant differences in the types and magnitudes of damages that claimants can be awarded. This variation means that relatively few states have first-party bad faith regimes that are the same as Florida's.

The analysis of first-party bad faith effects is further complicated by the limited window for which the relevant data is available. We were able to obtain data on personal automobile UM/UIM pure premiums only from 1997 to 2006. This data was published by the National Association of Insurance Commissioners. Data for four states – Maryland, North Carolina, South Carolina and Texas – was not available. Furthermore, relatively few states changed first-party bad faith status within this window, and only five states did not have a defined first-party bad faith private cause of action.³⁶ For these reasons, the model used to measure the impact of

³⁵ Sharon Tennyson and William J. Warfel, "The Law and Economics of First-Party Insurance Bad Faith Liability," *Connecticut Insurance Law Journal*, Vol. 16, 2009.

³⁶ *Ibid.*; and Gen Re Research, "Bad Faith Laws for Property/Casualty Claims, A review of the law on first- and third-party bad faith liability in all 50 states," Prepared by Gen Re and Edwards Angell Palmer & Dodge LLP, as of January 1, 2008.

third-party bad faith lawsuits will not yield reliable results if applied to first-party bad faith regimes, and it is necessary to use an alternative model.

In our analyses, we determine average personal automobile UM/UIM pure premiums in Florida. We then compare Florida's average personal automobile UM/UIM pure premium with the average personal automobile UM/UIM pure premiums in states without a defined first-party bad faith cause of action: Kansas, Michigan, Minnesota, New York and Washington D.C.³⁷

Before making the comparison, we removed the effects of other economic and demographic variables that may affect pure premiums. The same key control variables used in our third-party model were used in this model, as well as the same controls for time trends. (We do not have sufficient data to control for persistent differences in premiums across states.) Specific details regarding the first-party econometrics model can be found in **Appendix B**.

3. Results

After controlling for other determinants of UM/UIM pure premiums, we find that the average personal automobile UM/UIM pure premium in all states with a first-party cause of action is \$25.45 – 80.8 percent – higher than the average personal automobile UM/UIM premium in the five states without a defined first-party bad faith cause of action. Florida's average personal automobile UM/UIM pure premium is \$59.26 – 188 percent – higher than the average for these five states. It is possible that some of this difference may be due to persistent unobservable differences across states. It is also possible that these unobservable differences cause the difference to be understated in our analysis.

VI. WHO PAYS THE PURE PREMIUM?

In our analysis, we estimate the impact of bad faith litigation on the pure premium – the average annual cost of settling BI claims per insured vehicle. This part discusses how the increase in the pure premium attributable to bad faith lawsuits affects consumers and businesses.

³⁷ Washington D.C. appears to have not defined a private cause of action for first-party during this period, but has not explicitly ruled it out.

A. Increases in the Pure Premium and the Rates Consumers Pay

To the extent increases in the pure premium result from awards or settlements that are designated as attributable to bad faith claims, the added costs in some states may not be passed along to consumers in the form of higher insurance premiums. Florida law, for example, prohibits insurers from including these costs in the rate base.³⁸

Most of the claims affected by the threat of a bad faith lawsuit, however, are not subject to this prohibition, either because no lawsuit is filed or because no portion of the settlement is designated as compensation for failure to act in good faith. It is the threat of such a lawsuit that causes the insurer to settle non-meritorious and fraudulent claims that otherwise would be denied. The costs of these settlements will be considered in the rate-setting process, and consumers and businesses will be forced to pay higher insurance premiums as a result.

It is also likely that a portion of the pure premium increases resulting from awards or settlements that are designated as attributable to bad faith lawsuits will be borne by consumers as well, in the form of higher insurance premiums. This will occur when the awards or settlements deplete an insurer's reserves to the point where the insurance commissioner deems them to be inadequate and requires the insurer to increase the rates it charges consumers. It will also occur if the awards and settlements prevent the insurer from earning a reasonable rate of return on the insurance it writes, causing the insurer to withdraw from the market, thereby causing the market to be less competitive.

B. Insurance Companies Face Strong Market Competition

Some proponents of bad faith litigation have claimed that the cost of bad faith awards and settlements will be borne by the insurance industry, because firms in the industry earn excessive profits. We find no reliable evidence to support this argument, and in fact it is contrary to widely accepted assumptions about how highly competitive markets operate.

³⁸ For example, Florida Statutes 627.0651.

Economic principles hold that in competitive markets, prices must be high enough to enable firms to cover their costs and earn a competitive rate of return. If market conditions temporarily allow firms to earn returns exceeding their costs (including the cost of capital), new firms will enter the market or existing firms will expand and drive down prices, thereby eliminating any excess profits. Similarly, if competition pushes prices below the point where firms are able to earn a reasonable return on their capital, some firms will leave the market, causing prices to rise. Thus, the competitive process tends to force prices to the level where firms are able to cover their costs and earn a competitive return, but not an excessive return.

Insurance companies are not exempt from the competitive forces that keep prices and profits in check elsewhere in the economy. To the contrary, the evidence indicates that competition within the insurance industry is vigorous. As the GAO found, “competition among insurers can put downward pressure on premiums rates, even to the point at which the rates may, in hindsight, become inadequate to keep an insurer solvent.”³⁹

Insurance premiums ultimately are determined by the insurers’ cost of providing insurance (including the cost of capital). Therefore, most, if not all, of the increases in costs that result from laws allowing bad faith lawsuits ultimately are reflected in the insurance premiums paid by consumers and businesses.

C. Insurance Companies’ Return on Net Worth

One way to determine if insurers are earning supra-competitive profits is to examine the companies’ return on equity. The NAIC publishes annually the “NAIC Report on Profitability By Line By State” that contains various measures of profitability for the property and casualty insurance market, including a measure of “return on net worth”. The data utilized in the report is obtained from annual statements and exhibits filed with the NAIC by 2,846 property and casualty insurers representing about 95 percent of the premiums written in the U.S.⁴⁰ According

³⁹ United States General Accounting Office Report to Congressional Requesters, June 2003, Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates. GAO-03-702, p. 40.

⁴⁰ NAIC, Report on Profitability By Line By State in 2008, p. 1.

to the NAIC, property and casualty insurance companies in the U.S. are not earning excess profits.

“A chart has been included comparing the return on net worth in the property/casualty insurance industry with the return on net worth in other industries. The results for other industries have been obtained from figures published in *Fortune* magazines for the years 1996 through 2008. Over the period of 1996 to 2008, the property/casualty insurance industry had an average return on net worth of 5.4 percent, compared to an estimated 12.0 percent for all industries based on results reported by *Fortune*.”⁴¹

As stated in the NAIC report, during the 1996 to 2008 period, the average return on net worth⁴² for property and casualty insurance companies in the U.S. was 5.4 percent. By comparison, the return for other industries during the same period was more than twice as much, at 12.0 percent (which according to NAIC represents the “simple average of *Fortune*’s Industrial and Service sectors”).⁴³

Furthermore, the rate of return on one-year U.S. Treasury notes during this same period was 3.78 percent.⁴⁴ The yield on U.S. Treasury debt instruments is frequently used by economists as a measure of the risk-free time value of money. Since property and casualty insurers are in the business of bearing risk, we would expect them to earn a significantly higher return than the return earned on risk-free Treasury notes. Yet, the risk premium earned by these firms is only

⁴¹ NAIC, Report on Profitability By Line By State in 2008, p. 2.

⁴² The “return on net worth” is a ratio of net profits earned by a company to stockholder’s equity. In other words, it is the ratio that indicates the return on stockholder’s total equity. According to the NAIC, “the return on net worth in Column 12 is calculated to help regulators and other evaluate the profits earned in a particular market in relation to the net worth committed in that market. The return is equal to profit after taxes divided by allocated capital and surplus adjusted to place it on a GAAP basis. In this calculation, capital and surplus is allocated to each line/state on the same basis used for the total investment gain allocation. GAAP-adjusted net worth in the report is equal to statutory capital and surplus plus premium deficiency reserves (excess statutory reserves in years prior to 2001), unauthorized reinsurance, nonadmitted assets, prepaid expense and salvage/subrogation. For years prior to 2001, an adjustment was made to reflect deferred taxes. Beginning with 2001, deferred taxes are reported and shown as a component of surplus or as a non-admitted asset.” (See, NAIC, Report on Profitability By Line By State in 2008, p. 5)

⁴³ NAIC, Report on Profitability By Line By State in 2008, p. 36.

⁴⁴ Federal Reserve Statistical Release, H.15, Selected Interest Rates, U.S. Government Securities, Treasury Constant Maturities, Nominal, 1-Year, Annual (<http://www.federalreserve.gov/releases/h15/data.htm>).

1.62 percent -- a surprisingly small premium, given the risks (including political risks) that these companies are required to bear.

Thus, insurance providers are not only failing to earn excess profits; in an economic sense they may not be earning any profits at all (*i.e.*, negative risk-adjusted returns).

D. The Impact of Bad Faith-Related Costs on Consumers and Businesses

In sum, the rate-setting process and market forces cause consumers and businesses, rather than insurance companies, to bear most – and in many states, all – of the costs attributable to bad faith litigation. As a result, when states make it easier for individuals to sue insurance companies for bad faith, they impose higher costs on individuals, households, and businesses, in the form of higher insurance premiums.

VII. CONCLUSION

By allowing third-party bad faith lawsuits, a state increases personal automobile BI loss costs, on average, by more than 30.2% per insured vehicle. In states that allow first-party bad faith lawsuits, personal automobile UM/UIM loss costs, on average, are 80.8% higher than in states that do not have a defined first-party bad faith cause of action.

When adjusted for the effect of economic, demographic and other variables, Florida's average personal automobile UM/UIM insurance pure premiums exceed the average for states that do not have a defined first-party bad faith cause of action by 188%.

Our models measure the impact of bad faith lawsuits on pure premiums – the average cost per insured vehicle incurred by insurance companies in settling claims (not including loss adjustment expenses). These costs – plus a mark- up for premium taxes, insurance company expenses, and the cost of capital – are ultimately passed along to insured motorists, in the form of higher insurance premiums.

For Florida motorists, we estimate that allowing third-party bad faith lawsuits adds more than \$33.30 to their personal automobile insurance premium (2006). We also estimate that allowing first-party lawsuits in Florida may add another \$59.26 to their insurance bill if they have UI/UIM

coverage.⁴⁵ Thus, Florida's bad faith legal regime may add nearly \$190 per year to the amount an average Florida family with two cars must pay for automobile insurance coverage.

As premiums rise in Florida and other states, the number of motorists who are unable to – or choose not to – purchase insurance rises, placing an additional financial burden on other motorists, particularly those without UM/UIM coverage.

Finally, by increasing the potential rewards from filing non-meritorious claims, allowing bad faith lawsuits also increases the costs incurred by taxpayers to maintain state court systems. The increase results from an increase in the number of lawsuits filed against insurance companies.

⁴⁵ This amount could be higher or lower if state-specific factors that we are unable to observe affect UI/UIM loss costs in the states that we analyzed.

APPENDIX A – THIRD-PARTY BAD FAITH ECONOMETRIC ANALYSIS

This model evaluates the impact that allowing a third-party bad faith private cause of action has on BI liability pure premiums. We exploit variations in the timing of states' adoption of bad faith regulations afforded by the gradual enactment and repeal of third-party bad faith reforms across states from 1976 through 2006. Specifically, we use information on the year each state changed its third-party bad faith policy and examine the impact these changes had on average personal automobile BI pure premiums in that state. We control for changes in various economic and demographic variables that might be expected to influence filing rates and pure premiums. We also include state- and time-fixed effects to control for time-invariant differences in settlement costs across states and state-invariant changes in costs across time. This approach helps to address omitted variable concerns arising in cross sectional and pooled cross sectional models.

Our base specification is:

$$\ln(BI_{st}) = \beta_0 + \beta_1 * BadFaith_{st} + \sum_{i=2}^n \beta_i * X_{ist} + \sigma_s + \tau_t + \varepsilon_{st}$$

Where:

- $\ln(BI_{st})$ is the natural log of real personal automobile BI pure premiums in state s in year t
- $BadFaith_{st}$ is a dummy variable equal to 1 if state s allowed third-party bad faith lawsuits in year t
- X_{ist} is a matrix of control variables discussed below
- σ_s is a set of state-fixed effects
- τ_t is a set of time-fixed effects
- ε_{st} is an error term for state s in year t

A. Dependent Variable

Our model focuses on changes in the personal automobile BI pure premiums in response to changes in third-party bad faith regimes. Third-party bad faith claims may be brought against

both BI liability and PD liability policies. However, since BI claims are more difficult to value and have a much higher potential total damage award (due to the possibility for permanent injury and pain and suffering), economic theory would suggest that allowing a third-party bad faith litigation would have a much larger impact on BI liability settlement costs.

A “pure premium” is the average annual cost of settling BI claims per insured vehicle. According to standard economic theory⁴⁶, an increase in the cost of settling insurance claims is usually passed on to consumers in the form of higher premiums. To the extent that pure premiums do not reflect increases in insurance companies’ costs of investigating and defending against bad faith claims, dollar changes in pure premiums will underestimate the dollar impact of allowing third-party bad faith actions on total insurance company costs, and thus on the increase in premiums paid by consumers. Therefore, using pure premiums avoids the complications of controlling for changes in company overhead expenses, desired returns on capital and premium taxes, which all affect paid premiums.

Data on personal automobile BI pure premiums from 1976 to 2006 is obtained from the Fast Track Monitoring system and also reported by the Insurance Research Council (“IRC”). Fast Track collects data from about 50 large insurance companies representing about 70% of U.S. personal auto premium volume. Fast Track and IRC data have been used in numerous scholarly studies including Hawken et al. (2001) and Regan et al, (2009).

B. Primary Explanatory Variable: Bad Faith

Our primary variable of interest is whether or not a state permitted third-party bad faith causes of action. In our empirical model *Bad Faith* is an indicator variable equal to 1 if state *s* allowed third-party bad faith actions in year *t*. States that allow third-party bad faith claims are considered ‘treatment’ states and are compared to ‘control’ states without a bad faith cause of action. The presence of a third-party bad faith regime was determined based on a survey of each

⁴⁶ See, e.g., David Cummins and Sharon Tennyson, “Controlling Automobile Insurance Costs,” *The Journal of Economic Perspectives*, Vol. 6, No. 2 (Spring, 1992), pp. 95-115.

state's statutory and case law, and analyses produced by GenRe Research and the Property Casualty Insurers of Association of America (PCIAA).

For the purposes of our analysis, a state was considered to allow third-party bad faith actions if plaintiffs had broad rights to recovery. As discussed in the body of this document, seven states were found to meet this criterion. Other states with narrow rights for third-party bad faith recovery are excluded from the treatment group. For example, New Hampshire allows private action only after an investigation by the state's insurance commissioner has found an insurer violation. Oregon and New Jersey allow limited recovery of damages under contract law. Georgia allows third-party bad faith claims for property damage but not bodily injury. The volume and size of claims in these states is unlikely to resemble those in Florida or other states which define a broad right to third-party recovery.

C. Control Variables

It is important to control for other factors that may affect pure premiums. Previous studies have explained variations in insurance costs as a function of such factors as accident rates, hospital costs, per capita income, traffic density, access to legal representation, and the fraction of drivers who are young or old. We draw upon published work in developing the appropriate set of controls.⁴⁷ In the following paragraphs, we describe the logic behind including each of these control variables. It should be noted that our model does not reflect every conceivable factor that could influence pure premiums. When deciding what variables to include in any econometric model, one must balance concerns about omitting relevant variables with the loss of precision and statistical significance that comes with including too many variables. We believe our analysis reflects the effect of the primary variables identified by researchers as influencing loss costs.

⁴⁷ See, e.g., David J. Cummins and Mary A. Weiss, "The Effects of No Fault on Automobile Insurance Loss Costs," *The Geneva Papers on Risk and Insurance*, January 16, 1991, pp. 20-38; Henry Grabowski, W. Kip Viscusi, and William N. Evans, "Price and Availability Tradeoffs of Automobile Insurance Regulation," *Journal of Risk and Insurance*, June 1989, pp. 275-299; and Laureen Regan, Sharon Tennyson, and Mary Weiss, "The Relationship Between Auto Insurance Rate Regulation and Insured Loss Costs: An Empirical Analysis," *Journal of Insurance Regulation*, 2009.

- **Per Capita Personal Income:** Average per capita income in a state is reasonably expected to impact the cost of settling BI claims. Bodily injury claims include compensation for lost income and will, *ceteris paribus*, be higher in areas with higher income levels. At the same time, the marginal benefit of pursuing a BI claim is lower for those who already earn a high income. We obtained statewide average annual personal per capita income from the Bureau of Economic Analysis - Regional Economic Accounts summary tables.⁴⁸
- **Unemployment:** As unemployment increases, average traffic levels during commute hours and total time spent commuting to work likely decrease. This may decrease accident frequency. High unemployment rates may also decrease the average economic damages caused by each accident. At the same time, high unemployment may increase the incentive to file or inflate the total amount of damages claimed. We obtained annual unemployment rates by state from the Bureau of Labor Statistics - Local Area Unemployment Statistics program.⁴⁹
- **Fraction of Population Employed in the Legal Services Sector:** Numerous studies have shown that attorney involvement in auto claims is associated with higher gross settlement values.⁵⁰ (Note: higher gross settlement values do not imply that the amount realized by claimants net of attorney fees is higher.) We control for access to legal services by including a variable equal to the fraction of a state's population employed in the legal services sector. Data for the years 1976 to 2000 was obtained from the Bureau of Economic Analysis - Regional Economic Accounts employment by industry tables. This data series was discontinued when U.S. reporting agencies switched from the SIC to

⁴⁸ U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts (<http://www.bea.gov/regional/spi/default.cfm?selTable=summary>).

⁴⁹ U.S. Department of Labor, Bureau of Labor Statistics, Local Area Unemployment Statistics (<http://www.bls.gov/lau/>).

⁵⁰ These studies include, among others, Angela Hawken, Stephen J. Carroll, and Allan F. Abrahamse, "The Effects of Third-Party, Bad Faith Doctrine on Automobile Insurance Costs and Compensation," RAND Institute for Civil Justice, 2001; and Mark J. Browne, Ellen S. Pryor, and Bob Puelz, "The Effect of Bad faith Laws on First-Party Insurance Claims Decisions," *Journal of Legal Studies*, Vol. 33, June 2004, p. 357.

the NAICS reporting system. Data for legal services employment under the NAICS reporting scheme was obtained for the years 2000 to 2006 from the U.S. Census Bureau – County Business Patterns department.⁵¹ The NAICS scheme uses a slightly different definition of the legal sector – resulting in employment measures that are approximately 75% of those reported under the SIC system. We use data reported under both schemes in the year 2000 to create a state-level correction factor and then inflate the NAIC 2001 through 2007 values. Both series are divided by annual state population estimates produced by the Census Bureau and reported in the Bureau of Economic Analysis summary tables.

- **Medical Costs:** Incurred medical expenses are a major component of BI liability claims. A higher average cost of medical care in a state will cause its BI settlement costs to be higher. We obtain data on the total amount spent on personal healthcare in each state from the U.S. Department of Health and Human Services.⁵² We convert these numbers to a per capita level of spending by dividing them by the population in each state. This dataset has two limitations. First, aggregate costs are calculated according to the physical location of the healthcare provider. To the extent that people seek treatment outside their state of residence, medical costs will be misattributed although we do not expect this factor to greatly influence the relative magnitude of this variable. The second limitation of this dataset is that it only tracks expenditures from 1980 through 2004. Since no alternative source contains medical expenditures at a state level, we use our current data to extrapolate backwards to 1976 and forward to 2006. Specifically, we calculate the growth rate of expenses from 1980 to 1981 for each state, and assume medical expenses grew at the same rate from 1976 to 1979. We use this growth rate and medical expenses

⁵¹ U.S. Department of Commerce, Bureau of Economic Analysis, Regional Economic Accounts (<http://www.bea.gov/regional/spi/default.cfm?selTable=SA25&selSeries=SIC>) for years 1976 to 2000. For 2000 to 2006, from U.S. Census Bureau, County Business Patterns (<http://censtats.census.gov/cgi-bin/cbpnaic/cbpcomp.p1>).

⁵² U.S. Department of Health & Human Services, Centers for Medicare & Medicaid Services (https://www.cms.gov/NationalHealthExpendData/05a_NationalHealthAccountsStateHealthAccountsProvider.asp#TopOfPage).

for 1980 to back out values for 1976 to 1979. We also find the growth rate between 2003 and 2004 and apply it to 2004 values to calculate medical expenses for 2005 and 2006.

- **Fraction of the Population between 18 and 24 and over 64:** Demographic shifts in age may influence average settlement costs in a number of ways. First, young and inexperienced drivers are known to have significantly higher accident rates than the average driver. At the same time, many of these accidents may be relatively minor or involve a single vehicle. Age may also affect the average cost of a BI claim. Younger drivers may recover from accidents more quickly, but will suffer lost income for a longer period of time if a permanent disability results. To control for demographic shifts, we include a variable equal to the fraction of each state's population that is between the age of 18 and 24 and the fraction of the population over 64. Data for 1976 through 1999 come from the National Bureau of Economic Research data page and are derived from Census Bureau estimates.⁵³ Data from 2000 through 2006 were obtained directly from the Census Bureau - Population Estimate Department.⁵⁴
- **Traffic Density:** The type and frequency of accidents are likely to differ between urban and rural areas, and are also likely to increase as traffic density increases. To control for differences in the location and concentration of traffic, we include a variable equal to the percent of miles driven in urban areas of the state divided by the total miles in each state-year. This data was obtained from the Federal Highway Administration.⁵⁵
- **Motor-Vehicle Fatalities per Million Miles Traveled:** A number of factors may influence the number and severity of accidents within a state. For example, a particularly icy winter or ongoing road maintenance may increase both the number and severity of accidents. We control for unobserved changes in road conditions by including a variable

⁵³ National Bureau of Economic Research, U.S. Census Bureau, U.S. Intercensal Population by State, Age, and Sex 1970-1999 (<http://www.nber.org/data/>).

⁵⁴ U.S. Census Bureau, Population Estimate Department, State Single Year of Age and Sex Population Estimates: April 1, 2000 to July 1, 2009 (<http://www.census.gov/popest/datasets.html>).

⁵⁵ U.S. Department of Transportation, Federal Highway Administration (<http://www.fhwa.dot.gov/policyinformation/statistics/hm60.cfm>).

equal to the number of traffic fatalities per million miles driven. Traffic fatalities from 1976 through 1985 were obtained from the Federal Highway Administration reports.⁵⁶ Data from 1986 through 1993 were derived from figures reported by the U.S. Census Bureau.⁵⁷ Data from 1994 through 2006 are from the National Highway Traffic Safety Administration.⁵⁸ Vehicle miles traveled during this entire period were obtained from the Federal Highway Administration.⁵⁹

- **Percent of Population with a Bachelor's Degree:** Drivers who have obtained a higher education may be more aware of legal and contractual rights when filing insurance claims and may be more adept at negotiating higher settlements. Education also may influence driving behavior or claim filing propensity. To control for shifts in average levels of education, we include a variable equal to the percent of each state's population over the age of 25 that has obtained a bachelors degree or higher. Unfortunately, this information is reported infrequently at the state level. As such we use data on education rates for 1970, 1980, 1990, 2000, and 2008 as reported by the Census Bureau and assume a linear transition between points.⁶⁰
- **No Fault Laws:** Regulations other than first- and third-party bad faith regimes may influence average settlement costs. Many states implemented no-fault reforms which allow injured accident victims to seek compensation from their own insurance company regardless of who was at fault in the accident. These reforms typically restricted the right to sue other drivers and restricted the recovery of non-economic damages. No fault laws may decrease claim frequency, since some claims are recovered from one's own insurer,

⁵⁶ U.S. Department of Transportation, Federal Highway Administration, (<http://www.fhwa.dot.gov/policy/ohpi/hss/hsspubsarc.cfm>).

⁵⁷ U.S. Census Bureau (http://www.allcountries.org/uscensus/1036_motor_vehicle_deaths_by_state.html).

⁵⁸ National Highway Traffic Safety Administration (<http://www-fars.nhtsa.dot.gov/States/StatesFatalitiesFatalityRates.aspx>).

⁵⁹ U.S. Department of Transportation, Federal Highway Administration (<http://www.fhwa.dot.gov/policyinformation/statistics/>).

⁶⁰ Decennial census numbers are from *Census 2000 PHC-T-41. A Half-Century of Learning: Historical Statistics on Educational Attainment in the United States, 1940 to 2000*. Values for 2008 are based on current population survey statistics and were reported in the 2006-2008 American Community Survey 3-Year Estimates data set.

but increase damages when a claim is actually filed (since it exceeds personal injury coverage under the no fault policy).⁶¹

- **State Fixed Effects:** Certain states may have consistently high or low pure premiums due to factors we can't observe. To control for this possibility we include a full set of state fixed effects. State fixed effects take the form of an individual dummy variable for each state and capture time-invariant differences in average pure premiums in each state.
- **Year Fixed Effects:** There may be unobservable factors (*e.g.*, federal 55 MPH limit) that affect pure premiums in every state simultaneously. To control for this possibility we include a full set of year fixed effects. Year fixed effects take the form of an individual dummy variable for each year and capture factors that affect premiums in all states at once.

D. Econometric Results

We perform a fixed-effect regression on a panel dataset containing all 50 states plus the District of Columbia for the years 1976 through 2006. We cluster standard errors at the state level and correct for heteroskedasticity. The table below displays the results from the model described in this appendix. Since we use a semi-logarithmic model (*i.e.*, our dependent variable is the natural log of pure premiums while our explanatory variables are in levels), the coefficient on the bad faith variable can be interpreted as: enacting a broad right to file third-party bad faith lawsuits is associated with a 30.2% increase in average pure premiums paid in that state, holding all other variables constant.⁶² This value is statistically significant at the 99% confidence level.

⁶¹ James M. Henderson, Paul Heaton, and Stephen J. Carroll, "The U.S. Experience with No-Fault Automobile Insurance, A Retrospective," RAND Institute for Civil Justice, 2010, p. 41, Figure 3.1.

⁶² Calculated as $30.2 = (e^{.264} - 1) * 100$. See, R. Thornton and J. Innes, "Interpreting Semi logarithmic Regression Coefficients in Labor Research," *Journal of Labor Research*, 1989.

Table 1
Effect of Third-Party Bad Faith Regime on BI Pure Premiums

	<u>ln(BI Pure Premium)</u>
Third Party Bad-Faith Regime	0.264***
	-0.066
No-Fault Regime	-0.147*
	-0.062
Per Capita Income ('000s)	0.008
	-0.011
Unemployment Rate	-0.003
	-0.011
% Population w/ Bachelors or Higher	-0.062**
	-0.018
Traffic Fatalities Per Million Miles Driven	-3.959
	-2.65
% Traffic in Urban Areas	0.005
	-0.003
Legal Sector Size	-0.008
	-0.034
% Population 18 to 24	0.029
	-0.016
% Population Over 65	-0.043
	-0.027
Medical Cost Index	0.137*
	-0.052
State Fixed Effects	Yes
Year Fixed Effects	Yes
R-squared	0.657
States	51
Observations	1575

Robust standard errors clustered at the state level in parenthesis.

* p<0.05, ** p<0.01, *** p<0.001

APPENDIX B – FIRST-PARTY BAD FAITH ECONOMETRIC ANALYSIS

A. Difference Between First-Party and Third-Party Estimation

As discussed in the main body of this report, several factors complicate the analysis of the first-party bad faith litigation. A lack of variation in the first-party bad faith regime *within* each state prevents the use of a fixed-effect model. Further, the large amount of variation in the structure of first-party laws *among* states makes it difficult to select states which have bad faith regimes that are economically comparable to that of Florida.

Given these limitations it is difficult to present a quantitative analysis of first-party bad faith regimes that is as nuanced as that used to assess the impact of third-party bad faith litigation. As an alternative, we estimate the differences between the average personal automobile UI/UIM pure premiums paid in Florida (and all first-party states) and average personal automobile UI/UIM pure premiums paid in the five states without a first-party bad faith cause of action. We are able to control for the observable economic and demographic factors discussed in **Appendix A** and for unobserved factors that affect all states simultaneously. Unfortunately, we are not able to distinguish between the effects of allowing first-party bad faith suits and the effects of other unobservable factors, if any, which cause persistent and material differences in premiums across states.

B. Difference Between First-Party and Non First-Party States

To estimate the difference between personal automobile UI/UIM pure premiums in the 45 states that allow some form of first-party bad faith action, we perform an ordinary least-squares regression on of UI/UIM premiums using the base specification:

$$UIUIM_{st} = \beta_0 + \beta_1 * BadFaith_{st} + \sum_{i=2}^n \beta_i * X_{ist} + \tau_t + \varepsilon_{st}$$

Where:

- $UIUIM_{st}$ is the average real personal automobile uninsured/underinsured motorist pure premiums in state s in year t
- $BadFaith_{st}$ is a dummy variable equal to 1 if state s allowed third-party bad faith in year t
- X_{ist} is a matrix of control variables discussed below
- τ_t is a set of time-fixed effects
- ε_{st} is an error term for state s in year t

Data on personal automobile UM/UIM pure premiums from 1997 to 2006 were obtained from the National Association of Insurance Commissioners. Personal automobile UM/UIM pure premiums include money paid to both property damage and bodily injury claims and include policies sold on both a voluntary and involuntary basis. Data for four states (MD, NC, SC and TX) were not available during this period and these states were excluded from the analysis. We control for the same demographic and economic factors that were included in the third-party bad faith analysis.

We find that, after controlling for observable economic and demographic factors that may affect pure premiums, states that allow a first-party private cause of action have personal automobile UM/UIM pure premiums that are \$25.45 (or 80.8%) higher than those in the five states that do not allow such actions.

C. Difference Between Florida and Non First-Party States

To estimate the difference between personal automobile UI/UIM pure premiums in Florida and in the five states which do not allow first-party bad faith actions, we employ a two-step procedure which first controls for observable demographic and economic factors and then calculates the unexplained difference between Florida and the control states. Using a two-step procedure allows us to use data from *all* states to determine the affects of each demographic and economic factor on personal automobile UM/UIM pure premiums instead of only using data

from Florida and the five states that do not allow first-party bad faith claims. This allows us to more precisely control for these observable factors.

Our first step is to regress personal automobile UM/UIIM premiums on the economic and demographic variables discussed in **Appendix A** and on individual time-fixed effects, but not on the first-party bad faith variable. Stated alternatively, we estimate the following function:

$$UIUIM_{st} = \beta_0 + \sum_{i=1}^n \beta_i * X_{ist} + \tau_t + \varepsilon_{st}$$

We use the results of this equation to estimate the ‘residual’ or unexplained variation in personal automobile UM/UIIM pure premiums that cannot be explained by observable factors. These residuals are calculated as the actual pure premium observed in state s in year t minus the pure premium we would expect this state to have given the economic and demographic factors we can observe.

$$UIUIMresidual_{st} = UIUIM_{st} - UI\hat{U}IMpredicted_{st}$$

Finally, we restrict the dataset to Florida and the five control states and perform an ordinary least squares regression of these residuals on a dummy variable equal to one for the state of Florida and zero otherwise.

$$UIUIMresidual_{st} = \beta_0 + \beta_1 * Florida + \varepsilon_{st}$$

The resulting coefficient tells us that after controlling for other observable factors that affect premiums, Florida’s personal automobile UI/UIIM pure premiums are, on average, \$59.26 higher than those in states that do not have a first-party bad faith private cause of action.