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EXIT RIGHTS AND INSURANCE REGULATION:
FROM FEDERALISM TO TAKINGS

Richard A. Epstein*

INTRODUCTION

Few themes are important enough to capture simultaneously the attention of both politicians and theorists. One theme that clearly qualifies for such dual attention is that of economic regulation, which for the purpose of this essay covers the question of when the state should regulate the terms and conditions under which goods and services are supplied in the marketplace. At one extreme, it is easy to conceive of (but hard to defend) a system that permits no freedom in the terms and conditions under which goods and services are offered; the entire system becomes a command-and-control economy run from the center. Few people today think that the government can calculate the forces of supply and demand (let alone some abstract social condition of need) in ways that make this ambitious enterprise plausible. It is hard enough for the regulator to guess an initial set of prices and conditions. It is virtually impossible for that same regulator to revise its initial guess if it is erroneous when made or rendered obsolete by changes in external conditions—changes that are a constant of social life even if their direction and magnitude is unpredictable.

The modern view of regulation therefore shrinks back from the vast task of organizing a modern economy, and instead seeks to target certain businesses and activities for special attention. The strongest possible candidate for rate regulation are those firms that have legal monopolies that bar entry of rivals and allow them to charge prices above the competitive level. Yet it would be a mistake to think that rate regulation is necessarily limited to these cases. Rate regulation might also make sense when a single firm has a situational or natural monopoly in a given market. In those cases, the burden of proof may fall heavily on the regulator. But in principle, if we were satisfied that the allocative gains from moving rates toward their competitive level exceeded the administrative costs (and other dislocations) of making that move, then we could support this shift, albeit with more diffidence than confidence. In this brief essay, however, I want to address a setting in which the case for introducing rate regulation is at its low ebb: insurance markets.

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The insurance industry is generally competitive. Yet it is also subject to extensive rate regulation in many states. In these circumstances it is hard to find any efficiency rationale for that regulation, so one must look elsewhere, if anywhere, to justify the exercise. On that issue, I am hard-pressed to see what that justification might be. The use of rate regulation holds the price of insurance down, increases the level of coverage that must be provided, or both. As with other goods and services, the mispricing of insurance can only have negative social consequences.\(^2\)

Insurance is not designed solely to cushion the blow of losses *ex post*, although that is surely one function it performs. Equally important is that insurance, when accurately priced, helps incorporate risk into the initial decisions regarding the deployment of physical and human resources. Keeping insurance rates too low for high risks induces individuals to engage in ventures whose private costs may be below their private gains, but whose social costs will exceed the associated social gains. State-mandated insurance against natural catastrophes, from earthquakes to hurricanes, systematically induces people to make location decisions, building decisions, and investment decisions that do not reflect the full cost of their activities. Simultaneously, it reduces the insurance industry’s capacity to supply insurance at market rates for those businesses whose risk can be covered at a prudent rate. In practice, these crude forms of rate regulation are often too broad based, and systematically ignore salient differences within the class of insured risks, so that similar premiums can be imposed, for example, for both new homes constructed on porous soil and those constructed on hard rock only a couple of hundred yards away.\(^3\) Insurance blinds people to the adverse consequences of what they do, and we all end up eating the losses.

I think that the case against rate regulation in competitive markets is sufficiently strong that for these purposes I do not wish to comment on it further. Instead I wish to turn my attention in another direction that better suits my talents as a constitutional lawyer. The question that I want to ask is what kind of constitutional theory could lead to the toleration of laws that have such negative social effects. That the current legal situation is so unsatisfactory did not arise by chance. Rather, it comes at the end of a long and convoluted process of legal evolution that rests on some key mistakes


\(^3\) A vivid demonstration of this was given at the Stanford Conference on Social Treatment of Catastrophic Risk in which the Priest paper was presented by Professor Haresh C. Shah who did a block by block breakdown of prime earthquake region from San Francisco down the peninsula. The local variations were extraordinary, but the study was not published, so I was told, because it contained proprietary information of great value. For a general discussion of this issue, see Weimin Dong, et al., *A Rational Approach to the Pricing of Catastrophic Insurance*, 12 J. Risk & Uncertainty 201 (1996).
in both the law of takings and the law of federalism. I think that it is useful to spend some time dealing with both strands of the argument. But before I deal with those issues, it is necessary to frame the argument by looking at the uses and limitations of government power. Thus, we must start with fundamentals.

**CONSTITUTIONAL BASICS**

The basic problem of constitutional theory has been how to construct a just political order sufficient to resist the dangers of self-interested behavior, both public and private. That problem would be easy to solve if all private individuals were virtuous and all government officials evil: anarchy would be the solution. Similarly, it would be easy if all private individuals were evil and all government officials virtuous: absolute dictatorship would be appropriate. But the true state of affairs is that some individuals are virtuous, and some not; some government officials are virtuous, and others not. Faced with this choice, the unending social challenge is to control, albeit only partially, both forms of abuse at the same time, without snuffing out the essential role for either private enterprise or government regulation. Stated otherwise, the central question is, how may a Constitution give a government enough power to prevent violence and provide for other needed government services without giving it so much power that it becomes a tyrant in its own right? The entire system of limited government is a fragile enterprise designed to steer an uncertain course between the extremes of too much and too little government. In dealing with a global issue of this complexity, it becomes quickly evident that no single device will suffice to set the right level of government power. Instead, a number of overlapping remedies, each with its own limits, are required.

Governments at all levels exercise monopoly power over the use of force within their jurisdiction. If left unregulated, the government monopoly will extract too much wealth from the bulk of its citizens and provide them with too little by way of services in exchange. Unconstrained by constitutional limitations, political forces will allow political majorities (who will always find benevolent reasons to help their compatriots) to curtail the liberties and expropriate the wealth of political minorities. It is well recognized that the most vulnerable of political minorities include individuals or businesses located outside any given state but doing business within it, for these persons or groups are subject to state power on the one hand, but without rights to vote in its elections on the other.

What constitutional counterweights can be raised against the ravages of the self-interest of an electoral majority? Here, two broad classes of remedy may be adopted: direct rights of action against the sovereign for an
abuse of its powers, and exit rights, which permit individuals to flee from the exercise of that power. Identifying the scope and limits of those two protections is necessary to balance majority and minority interests.

The first questions we have to ask are what kinds of direct property protection could be supplied to firms in the insurance industry, and what kinds of arguments could lead to the exercise of government power over the firms within that industry. The history of this subject in American constitutionalism has been schizophrenic. One line of thought advocates the use of government power and holds that the government may regulate the rates of any industry that is "affected with the public interest." In its inception, this phrase is one that should not necessarily strike terror into the hearts of the defenders of free markets, for when used by Lord Hale in De Portibus Mari (Concerning the Gates of the Sea), it only included those industries where firms exercised monopoly power over their customers. That was most evidently the case when the firm received an exclusive franchise from the state, but it could also arise in some cases in which the overall circumstances prevented free entry by rivals. It is important to note that this is not an important consideration in a financial service business like insurance where capital is mobile on a global scale. But the key point here is that if the monopoly were created, then the state could seek to impose regulations that made it operate effectively.

The exact form of the optimal set of regulations is difficult to determine. In some cases it involves pledges of nondiscrimination among customers; in other circumstances it could require rate of return regulation; and in still others more modern developments, such as rate or price-caps. The latter were employed with moderate success to counteract the local monopoly position (here created by law) in the telecommunications indus-

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4 For an account, see RICHARD A. EPSTEIN, PRINCIPLES FOR A FREE SOCIETY, ch. 10 (1998).
5 See Alnutt v. Inglis, 104 Eng. Rep. 206 (K.B. 1810), where the key passage from Hale is quoted. It reads as follows:

A man for his own private advantage may in a port town set up a wharf or crane, and may take what rates he and his customers may agree for cranage, wharfage, &c; for he doth no more than is lawful for any man to do, viz. makes the most of his own, &c—

If the King or subject have a public wharf, unto which all persons that come to that port must come and unlade or lade their goods, as for the purpose, because they are the wharfs only licensed by the queen, according to the st. 1 Eliz. c. 11., or because there is no other wharf in that port, as it may fall out where a port is newly erected; in that case there cannot be taken arbitrary and excessive duties for cranage, wharfage, &c, neither can they be enhanced to an immoderate rate; but the duties must be reasonable and moderate, though settled by the king's licence or charter; for now the wharf and crane and other conveniences are affected with the public interest, and they cease to be jusri privati only. As if a man set out a street in a new building on his own land, it is now no longer bare private interest but it is affected with the public interest.

Id. at 208.
try as it operated under the 1982 Bell divestiture decree. The implicit cor-
relative of this early position was, however, that where industry rates were
competitive, no form of regulation could take place.

But each good doctrine seems, in constitutional law at least, to have
its evil twin. In this case, the rival definition of “affected with the public
interest,” received its constitutional debut in the United States in *Munn v.
Illinois.* In *Munn,* the Supreme Court seemed to say that an industry was
“affected with the public interest” so long as it was very large and its cus-

The dangers of that position are evident to any student of antitrust
law. The key question of what kind of advantage a firm may possess over
a consumer depends on the alternatives open to the customers, not on the
size of the firms that supply the services: A single, small firm is far more
dangerous to a consumer than a dozen large ones vying for its business.
Unfortunately, that point was missed by the Supreme Court in *German
Alliance Insurance Co. v. Lewis,* which held that a large insurance com-
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The overall constitutional picture was, however, a bit more cloudy
than this, for while the doctrine of “affected with the public interest” al-
lowed state governments to regulate insurance companies as though they
were public utilities, a parallel line of cases took the position that any
regulation in question had to guarantee to the regulated firm a “fair value”
on the assets subject to that regulation. Within the context of public utili-

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6 For an explanation, see *National Rural Telecom Ass'n v. FCC,* 988 F.2d 174, 177, 179 (D.C.
Cir. 1993).

7 94 U.S. 113 (1876). *Munn* incorporated Hale only to move beyond it. *Id.* at 128-32, 139.


law on this point, see Walton Hamilton, *Affectation with the Public Interest,* 39 YALE L.J. 1089 (1930).

10 For modern validation of such rate regulation, see *State Farm Mutual Automobile Insurance Co. v.

11 See Smyth v. Ames, 169 U.S. 466, 532, 544-46 (1898) (discussing the original formulation),
individuals to invest in the jurisdiction in the first place. This point gains especially great power in public utility cases because the firm's threat to exit is not credible once the entry has been made. The interconnection between exit rights and takings is thus apparent from the outset. Regulated firms in the public utility business must incur heavy sunk costs before their operations can begin. Once those costs are incurred, the firm will not leave, even if allowed to do so, so long as the rates received from the state are high enough to cover its variable costs. To leave means to lose the fixed costs (which were not transferable to any one else); to stay and take the low rates means that some portion of those fixed costs can be recouped. Once a firm commits to the jurisdiction, therefore, the exit threat is not credible. The only way to prevent confiscation is to guarantee rates that allow a reasonable return on the original invested capital.

The precise measures of compensation are beyond the scope of this particular essay because insurance differs from the public utility business on the one critical dimension of market structure. There are no monopoly profits that have to be controlled, so there is no warrant at all to adopt a position that allows regulation, given the risks of confiscation (and the economic distortions that it creates) that manifest themselves once the (only possible) raison d'être of rate regulation is no longer satisfied. In these circumstances, it takes very little, I think, to show that the forms of regulation involved here are necessarily unconstitutional because they cannot guarantee the regulated industry anything approaching a competitive rate of return on its assets.

A NECESSARY TAKING

The theoretical argument hearkens back to the fundamental difference between rate of return regulation in a competitive market relative to a monopolized market. One can see how natural monopoly regulation may (not must) yield a social improvement. It is impossible, however, to duplicate that arrangement with a competitive market.

Here, the argument is best made with simple algebra. Assume that \( \pi > 0 \) equals the competitive rate of return, which is below the monopoly rate of return. The rate of return before and after regulation is defined in terms of the relationship between revenues (R) and costs (C). For a competitive market, that ratio looks as follows:

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11 All this is not to say that insurance should be a completely unregulated industry. With insurance, consumers pay first and collect later. A system of regulation that insures that the firm leaves assets available to cover claims when it goes out of business is perfectly legitimate, and has never to my knowledge been contested in the exit rights litigation of which I am aware.

12 See Epstein, supra note 1, at 274-77.
\[ \pi = \frac{(R-C)}{C} \]  

(1)

With regulation in this market, the revenues decrease by some quantity and the costs increase. Hence the new rate of return equals

\[ \pi^* = \frac{(R^*-C^*)}{C^*} \]  

(2)

It is easy to deduce that \( \pi^* < \pi \). Since \( R^* < R \), and \( C^* > C \), it follows that the double whammy, \( R^* - C^* \), gives a smaller numerator for \( \pi^* \) than for \( \pi \). Likewise, since \( C^* > C \), we have a larger numerator, and hence a much smaller rate of return.

To give a numerical example, assume that in this market a competitive rate of return is 18 percent on capital, and that such a rate is obtained when revenues are $1,180 and costs are $1,000. If regulation decreases revenues to $1,100 and increases costs to $1,050, then the rate of return drops to \( \frac{(1,100 - 1,050)}{1,050} \), which amounts to $50/$1,050, or under 5 percent. It does not take much to move the revenue levels way down, even into negative territory. But the theoretical result does not depend in any way on the choice of numbers. So long as the above assumptions hold true (that is, so long as \( R > R^* \) and \( C < C^* \)) then the formula holds and there can be no system of rate regulation that meets the just compensation formula. A court need not therefore compile a large factual record to determine the magnitude of the taking, except in the extremely unlikely event that the state wants to pay a lump-sum to the firm to cushion it against the shortfalls brought on by regulation. In the above example, rate regulation would have to provide for an 18 percent return on the increased base of $1,050 to avoid a taking. There is $50 in the till, and a need for $189, so that approximately $139 has to be offered as annual subvention; and that number will have to increase as the administrative costs rise and as the revenue stream is reduced. Absent such compensation, mere articulation of the formula shows that all rate of return regulation is confiscatory in dealing with competitive industries, and should be struck down forthwith.

The same type of arguments could apply in principle to natural monopoly arrangements, but these yield a window of possible social improvement. Thus, suppose that a monopolist could garner with unregulated prices a 35 percent rate of return on the same $1,000. Now a system of regulation that added $50 to total cost (as above), and brought the revenues down from $1350 to $1250 could meet the rate of return standard; i.e. a $200 profit on a base of $1050 yields a return of 19 percent. In this monopoly situation, therefore, we have to show some caution about the entire process. The rate hearings are typically necessary so long as the firm remains in business within the state. But can it leave? That question in turn brings us back to the issue of federalism and exit rights, as a kind of a
backstop protection for property rights generally.

EXIT RIGHTS

We now take a quick detour from property rights to federalism. One strong practical justification for a federal system is that it promotes competition among states. When individuals and businesses are mobile, and have the option to locate elsewhere, they have a credible threat against government aggrandizement: They can leave. Governments are therefore set in competition with each other to attract business and citizens, and (like economic competition in markets) this competition between sovereigns has long been recognized as one silent but effective restraint on the abuse of government power.

It is a mark of a dictatorial society that it has so little confidence in the justice of its internal institutions that it cannot and will not grant its citizens the free right to emigrate. Either they must stay against their will or abandon their property when they leave the state. The Berlin Wall was built in 1961 in order to defeat the exit rights of ordinary East German citizens, and every other totalitarian state takes the same hostile attitude toward the out-migration of capital or labor. By contrast, free states need not impose such restrictions on exit rights because they create an attractive enough environment to support both personal liberty and economic prosperity.

With respect to regulation of insurance rates, what was true of East Germany, or South Africa, or Soviet Russia, is now true of Massachusetts, New Jersey, and Florida. A state's unwillingness to let companies exit at will is a sign that it knows that its own business climate is so inhospitable that firms are unwilling voluntarily to remain. A simple test of that question is this: How many firms have come forward to fill the void of those firms who have left? In the insurance business, the answer is typically none.

This short account of federalism stresses the indirect protection that it gives to property rights. This protection becomes highly important if the property rights arguments outlined above fall on the deaf judicial and political ears from those who believe that talk about subcompetitive rates of return is simply a bluff by firms that always want more than they receive. In order to answer the skeptic's contention, it is again important to distinguish between competitive and monopolistic industries.

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14 See, e.g., Charles M. Tiebout, A Theory of Local Expenditures, 64 J. POL. ECON. 416 (1956) (making the point about competition between local governments, which also can extend to competition between states).
Start with monopoly industries, such as public utilities and common carriers. Should firms in such industries be allowed, in the face of hostile rate regulation, simply to flee the jurisdiction? One possible position is that withdrawal should never be allowed so long as the monopoly is maintained in the marketplace. But the monopolist that has little demand for its services may still find itself in a position where its revenues cannot cover its costs. Ideally we would like to see the monopolist leave any market in which that takes place, for almost by definition competitive firms, with lower revenues, could not survive in that environment either. So any per se rule that requires the firm to remain in business, come hell or high water, unless it receives the state's blessing to go, seems harsh indeed.

But by the same token it is tricky to find a suitable alternative. Part of the answer depends the shape of the market from which the common carrier wishes to withdraw. Start with the simplest case, where the carrier seeks to liquidate its position in an entire service area. One possible objection to this maneuver is that the carrier is simply seeking to extort a higher rate of return, even though it is already making the competitive rate of return. The argument is that the firm is only entitled to a competitive rate. But, of course, that presupposes that the state is confident of the soundness of its rate structure. Note that sound rate regulation has to contend with two forms of error simultaneously. It must control the extraction risk by which the firm seeks to gain monopoly rates for its services. Yet it also must avoid the confiscation risk where the regulated firm cannot cover its entire costs. The tension between these two risks is manifest, for under a skewed system of rate regulation, the only way we can avoid the extraction risk is to magnify the confiscation risk. The issue then is whether we think that the extraction risk by the firm is so large that it justifies eliminating the check on the confiscation risk provided by the exit right.

The basic telecommunications law, for example, takes the position that all service withdrawals must be shown not to be contrary to the public interest. The precise content of this public interest test is unclear, but its direction is inescapable. Firms that are affected with the public interest are not given the same privilege as firms in competitive industries to exit the market at will. Rather, they must show cause why they should be allowed to leave. The question is the extent to which regulating exit is a responsible approach to the monopoly problem. One possible response to this position is to say that this burden on the regulated firm is misplaced. Another possibility is to follow the common law rule, by allowing the common carrier to withdraw, but only after it gives notice, so that some new competitors

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15 See 47 U.S.C. § 214 (a) (1994) ("No carrier shall discontinue, reduce, or impair service to a community, or part of a community, unless and until there shall first have been obtained from the Commission a certificate that neither the present nor future public convenience and necessity will be adversely affected thereby . . . ").
could buy the franchise or negotiate some substitute deal which avoids the disruption of customer service.\textsuperscript{16} That approach assumes that there can be substitution of one common carrier for another, even if it is inefficient to have two common carriers. But even here it has to be asked whether the withdrawing firm must sell its capital stock to the new entrant, and if so, who if anyone sets the price for that sale. It is not an easy set of choices.

The case gets a bit clearer when the issue is partial withdrawal, either by line of service or by territory. In this context a large part of the answer depends on the level of cross-subsidy that is required under the scheme, consistent with the overall rate of return. Partial withdrawal opens the way to more firm opportunism than complete withdrawal, for now the firm has an incentive to dump its poorly performing lines or territories while keeping the profitable ones. If the subsidy to the weak portion of the market is required in the name of public policy, then so long as the bottom line over all is satisfactory, these forms of partial withdrawals have to be rejected.\textsuperscript{17}

The carryover to insurance companies that have assigned-risk business—the insurance industry equivalent of universal service—should be clear. A firm cannot avoid the assigned-risk portion of its business and keep the remainder of its markets in which state regulation entitles it to some supra-competitive rate of return.\textsuperscript{18}

The analysis changes, however, if the firm wishes to withdraw its services from a target population in the absence of any cross-subsidies. If the rates are too low here, then the firm cannot recoup its losses through its other businesses, and chances are it will be able to attack the overall rate level, even if it cannot leave any of its markets. It therefore follows that total withdrawal is in the social interest since (now that subsidy is denied) the cost of service exceeds the value of the service within the industry in question. But, of course, the extraction risk still remains. All in all, however, the risk of utility misbehavior seems to be greater in the partial withdrawal scenario than it does in the total withdrawal scenario. Thus, in this last context, the conditions for withdrawal are often somewhat more stringent, and public approval, subject to judicial review, may also be required.

Taken together, the alternatives are not too happy. If a state denies the exit right, the law invites expropriation for which constitutional protections

\textsuperscript{16} See, e.g., H.W. Chaplin, Limitations upon the Right of Withdrawal from Public Employment, \textit{16 Harv. L. Rev.} 555, 555 (1903) ("[O]ne cannot abruptly, and without reasonable opportunity to the public to change their own affairs accordingly, so terminate his relations with the public . . . nor [can a] common carrier suddenly leave his occupation and abandon his passengers or freight by the roadside . . . .")

\textsuperscript{17} See \textit{FPC v. Hope Natural Gas Co.}, 320 U.S. 591 (1944).

\textsuperscript{18} For a discussion of the assigned-risk apparatus, see Richard A. Epstein, \textit{A Clash of Two Cultures: Will the Tort System Survive Automobile Insurance Reform?}, \textit{25 Valparaiso L. Rev.} 173 (1991). Thus suppose the state imposes a surcharge on regular rates to cover the assigned-risk pool. Clearly the regulated firm cannot keep the revenues from the tax without covering the unwanted business.
are likely to be insufficient. Yet if a state allows the exit right, then the law creates the risk of extraction by bluffing of the regulated firm. Moreover, mixed positions that vary the burden of proof between total and partial withdrawals merely complicate the analysis without improving the clarity of outcomes. The real world often places such difficulties in our path.

The analysis is, however, far easier with a competitive market such as that which prevails in the insurance industry. To be sure, the exit right cannot just allow a firm to get up and go if it still has unperformed obligations on its current contracts. But that issue has never been disputed. Firms that seek the exit right are always willing to discharge obligations under existing contracts, without having to force local citizens to chase the insurance carrier back to its home base.

So once past obligations are accounted for, the hard question is why any firm could be charged with bluffing when we know that rate regulation necessarily pushes its rate of return below the competitive level. The decision of the firm to leave, especially when it is willing to leave in all lines of business, is conclusive evidence that the rate of return offered within the state is not sufficient to cover its costs. I have no doubt that the exit right is not strictly required when the Constitution supplies strong property rights protection against confiscation; that system has the benefit of allowing the firm to stay in the local market. Therefore, no one should think that exit rights are a first best option. To use a comparison with contract law, exit rights protect a reliance interest (a return to the status quo ante) even if they do not protect an expectation interest (the profit from competing within the state).

That said, the exit option becomes very important in those circumstances in which property rights protection is stunted at the constitutional level. If the firm is not in a position to stay, then at least it should be in a position to leave because, as with other totalitarian regimes, thwarting its exercise of exit rights offers powerful evidence that something is deeply amiss with local regulation. Granted, that exit right is of limited use in public utilities where the initial sunk costs are high. But it has far greater value in insurance markets with relatively few sunk costs. To be sure, there are contracts and leases that have to be canceled, old advertising campaigns that have to be curtailed, existing claims that have to be honored and processed, and so on. Yet these costs are sufficiently small that they make it possible for an insurance carrier to leave and cut its losses, rather than to fight for the just rate of return.

Stated otherwise, when variable costs are high relative to fixed costs, fleeing becomes the preferred option to fighting. Regulated firms will only exercise the right of a complete and orderly withdrawal where there is no prospect of getting a reasonable rate of return on invested capital. The mere fact that exit is not costless gives further evidence (if such is needed)
of the uncompensated losses suffered by any firm that wants to forsake the jurisdiction. That firm will only suffer that loss if it thinks that it will lose more if it stays than if it goes. The exit will take place, therefore, only when just compensation is not received for remaining in business. Thus, the firm's decision should be given conclusive weight as a far more efficient way to discipline state regulatory excesses than laborious ratemaking proceedings with their dubious projections as to costs and benefits.

What is good for the firm and for the system may of course be bad for the state which hopes to bleed captive firms dry as long as they are able. To be sure, most states will be reluctant to impose exit restrictions because deep down they know that exit restrictions operate in the long run as entry restrictions that keep the state from developing competitive markets. Who would take a job that he could not quit? Who would go into business when there is no right to withdraw? But in some cases, the threat of future losses will not be sufficient to deter the state from blocking exit as well. The state might, like New Jersey or Massachusetts, have a long history of punitive rate regulation such that no new businesses have entered the state in recent years. In such states, putting restrictions on the exit right does little to deter new entrants; there are no new entrants to deter. So at that point the state that cannot attract new business will do better by its citizens (and worse by the nation) if it can keep firms from leaving the state, which is just what happened in New Jersey and Massachusetts.19 It was no coincidence that the price for leaving these states was equal to the anticipated losses that the carriers would have suffered by having to remain in the states, given their obligation to participate in assigned risk pools and state guarantee funds. You could leave only if you were prepared to be as bad off in going as you were in staying.

**FLORIDA WIND INSURANCE**

A similar pattern of argument took place in Florida, which after the horrible losses from Hurricane Andrew imposed extensive restrictions on the ability of insurance companies to cease writing "wind insurance" within the state.20 Florida's legislative program had three key components. First, it called for the mandatory renewals of current business under Emergency Rule No. 4-ER93-18 and Chapter 93-401 of the Laws of Florida.21


21 In relevant part, the section provided:
Second, Florida also passed a “Phaseout Statute,” which restricts the number of homeowner policies that the insurer can cancel or nonrenew in order to reduce its overall hurricane exposure. That statute exempts from the prohibition any cancellation or nonrenewal of these homeowner policies for “any lawful reason unrelated to the risk of loss from hurricane exposure.” As might be expected, state administrative regulations have construed this escape hatch narrowly. Finally, the Florida laws called for mandatory participation in the Hurricane Catastrophe Fund. The political economy behind these two provisions is easy to see. The local residents within the state wanted to rebuild their homes, but desired cheap insurance against a risk that was all too apparent.

The evident conclusion is that the Florida legislation flies in the face of competitive efficiency and is counterproductive to any sound system of rate regulation for the reasons noted earlier. That result can be understood by an examination of the purposes that the state puts forward to justify commandeering the resources of insurance companies for political purposes. The immediate impasse in the insurance industry began after August 1992, when Hurricane Andrew, a dry, fast-moving storm, caused over $30 billion in damages in the state of Florida, half of which was covered by existing policies. In response to that disaster, the insurance companies announced widespread cancellations of existing policies in accordance with their contract rights, higher rates for new policies, and more restrictive coverage.

The state claimed that these business responses created “chaos” in the relevant markets and that there is a strong public purpose for the noncancellation provisions and the creation of the catastrophic funds. Yet its analysis of the problem is incomplete and superficial. The first point is that Hurricane Andrew was not just a “sunk cost,” an event, once completed, that should be forgotten. As the state noted, one consequence of the Hurricane was that “world reinsurance capacity has significantly contracted.” In principle, that contraction in capacity should lead to a reduction of

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1993 Fla. Laws ch. 93-401. This provision expired on November 14, 1993. See id.

23 Id. ch. 627.7013 (2)(b).
24 Proposed Rules 4-141.020 (9)(a) and 4-141.021(3)(a)(3) provide that the term “unrelated” should be interpreted in a “liberal, wide-reaching” manner, such that any exemptions from the statute must be shown to be “completely unrelated, directly or indirectly, to the reduction of risk of loss from hurricane exposure.” Butler, supra note 20, at 770 n.30 (citing 20 Fla. Admin. Weekly 531 (Feb. 4, 1994)).
25 See FLA. STAT. ch. 215.555.
26 Id. ch. 215.555 (1)(b).
the amount of insurance that can be written, so that all things equal, an increase in price, such as that demanded by the insurance companies in Florida, is the appropriate response in a well-functioning competitive market. Higher cost of a good—insurance—results and should result in smaller quantities of it being sold. The clear intent of the Florida statute is to try to immunize the citizens of Florida from the consequences of this world-wide contraction. Yet the plan, if executed, will exacerbate the predicament of citizens in other states who, if the statute is upheld, will find that their ability to buy insurance is diminished. Apart from the interests of its own citizens, Florida has offered no justification for the negative consequences that its action will have on other homeowners outside of Florida. These individuals had no opportunity to vote on the adoption of the nonrenewable policy, or the creation of the Hurricane Catastrophic pool which, as one might expect, shall "operate exclusively for the purpose of protecting and advancing the state's interest in maintaining insurance capacity in this state." 27

There is also pressure on the cost side. The State of Florida noted "[n]o change has occurred in the risk characteristics of Florida policy holders. The risk of another major hurricane striking a heavily populated area of Florida is not greater now than in all the years in which premiums were charged and no hurricanes occurred." 28 The statement is again false in several particulars. First, why assume that the probability of a serious hurricane in the future was unaffected by Hurricane Andrew? The rapid concurrence of Andrew and Hugo could rationally lead insurance companies (and the state of Florida) to conclude that some natural or human factor has newly altered that probability distribution, or that prior estimates of severe hurricane frequency were inaccurate. Indeed, if the probability of a serious harm did not change, then why would other insurance companies not rush to fill the void left by the departure of established firms? Second, it is undoubtedly true that the economic severity of any hurricane has risen as Florida's population density has increased, and continues to increase. Increases in population density could increase the expected loss to an insurer with large market share. Third, the evidence from Andrew proved that the expected loss, given that a hurricane does occur, could easily be greater than anticipated.

Thus, the state speaks out of both sides of its mouth. On the one hand, it says that imperative public necessity requires that insurance companies be kept in their place: after all

as a result of the massive number and amount of claims arising from Hurricane Andrew,

27 Id. ch. 215.555 (1)(f) (emphasis added).
and the fear of future claims from some future hurricane, insurers have expanded their attempts to reduce their exposure to hurricanes by initiating campaigns to cancel and/or non-renew current policy holders totally in the aggregate approximately 500,000 policyholders.29

So now we know that the prospect of huge uninsured losses is what drives the plan. But not to worry: Even though the exposure of Florida property is great and rising, the exposure of the insurance companies commandeered to underwrite that coverage against them does not increase. There is a form of legal alchemy at work here: Great losses to Florida property owners can be fully insured by imposing only small losses on insurers, as if the money paid on insurance claims could be larger than the money paid out in insurance claims.

Given that the insurance product that is sold is more expensive per unit of coverage and there is less capacity to write it, the only rational response is a contraction of the insurance market. No doubt this contraction would have led to a reduction in the amount of reconstruction and repair of damaged properties in Florida. But far from that being a sign of social disaster, it constitutes the proper social response. What Florida has done is to create massive subsidies for the construction of housing and businesses that are exposed to hurricane risks. It wished to have investors from out of state and insureds from out of state fund its own form of folly. A legal regime in which exit rights are protected defeats this form of legislative egotism and thus advances broader social interests. The new information that is acquired from Hurricane Andrew should influence these investment decisions. The reality will set in all the quicker if insurance companies are allowed to charge market rates for their goods and services. Competition is the best way to organize markets in both good times and bad.

There is yet another way to see the national peril that lurks in the adoption of the Florida plan. At every point, the state of Florida trumpets the need to have greater insurance capacity. But at no point does it put its own money at risk. Unlike most states, Florida has no income tax. It once sought to impose its sales tax so broadly as to effectively tax citizens of other states to support its own excesses. Here, if the state wishes to increase insurance capacity, it can tax its own citizens to raise the money. Once the state makes it clear that firms can exit, then new firms will enter to increase the capacity, but at rates that reflect the full economic risk. But the state chose to do no such thing. It did not put a dime of its own revenue into solving its own imperative disasters. Rather, it has taken the property of others to do this. The just compensation remedy mires insurance companies in hopeless risks and delays. It forces them to remain in business at a loss while lawyers fight over the proper computations. The exit right

29 Id. (quoting Emergency Rule ER93-20 (1993)).
brings market forces to bear on the problem, and should be respected.

This last conclusion is especially true from the nature of the proposed exit. As noted earlier, partial exits could be regarded as strategic or opportunistic, at least in monopoly industries. But in Florida's case, it was clear that the regulated firms were prepared to throw in all their licenses, for profitable and non-profitable lines of business. Their judgment was that the risk from wind exposure dwarfed everything else, and the fact that the state refused that offer showed that both sides had common ground on the *ex ante* judgments.

**CONSTITUTIONAL PROTECTION FOR EXIT RIGHTS**

What I find so ironic is that the constitutional protection of property rights seems to provide no protection for the exit right at all. The point is ironic because even those people who are, in the context of land use regulation, uneasy about allowing developers to make strong challenges to local zoning or land use ordinances, often do so (in apparent indifference to the position of the owner of nonmobile land) because the exit right protects developers from being caught in the state's web.

There is within the academic literature no serious dispute that an exit right is indispensable to counteract the totalitarian tendencies inhering in all governments at all levels. Instead, the debate has revolved around the question of whether the exit right is sufficient under all circumstances to protect individuals against expropriation by the state. One school of opinion, led by Professor Vicki Been, holds that it is.30 Professor Been places such high confidence in the power of an untrammeled exit right that she thinks that individuals and firms do not need any additional protection against state intervention. Professor Been thus concludes, for example, that the risks of exactions in the land use markets (e.g. special taxes for schools or roads) can be effectively blunted by developers who are astute enough to play off one local government against another. Similarly, in her view, the Supreme Court's decision in *Nollan v. California Coastal Commission*,31 was incorrect in holding (in an exaction context) that the state was required to pay just compensation when it conditioned its building permit (which it was entitled to withhold) on the surrender by the land owner of a lateral easement across his premises.32 In essence, she believed that weak judicial protections of private property were sufficient because exit rights offer powerful protections against government misconduct, and

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32 As one might expect, my view of Nollan is the opposite of Professor Been's. See Richard A. Epstein, Bargaining with the State 184-91 (1993).
do so without administrative hassle and costly judicial oversight.

The need for some exit right seems basic to our constitutional structure of federalism. But does it have a textual home? Ironically, it might under the takings clause. One way to look at the situation is to note that any taking must be for public purpose. Yet what is taken here? It is simply money from captive insurance companies who are forced to contribute to the catastrophic insurance funds while remaining in business in a state which they desire to leave. The takings and due process clauses require that there be some substantial relationship between the end sought by a government program and the means employed to achieve it. Here, there is no fit between ends and means. Any goal that the state wishes to impose could be achieved by opening up the state to competition, and to footing some portion of the insurance bill to the extent that it thinks, for whatever reason, that the rates demanded in the marketplace are too high. It is possible to use general revenues to subsidize any particular class; and there is no need whatsoever to impose the whole burden on the insurance companies that are in that line of business. The disproportionate impact of the tax therefore renders it violative of the due process clause.

The argument takes a somewhat different form when the case is argued under either the Takings Clause or the Contracts Clause, both of which bind the states. Here, the text allows property to be taken so long as it is for a public use, broadly conceived. But once again, just compensation must be offered. Just compensation is that rate of return sufficient to attract and keep capital in the business. It is below the actual rate of return that a firm could garner when it has monopoly power. It is equal to the rate of return that the firm can garner when the firm is in a competitive industry. Therefore, the firm exits only when it cannot sustain that which it is entitled to, and that which the state refuses to allow it: a just rate of return taking into account the hazards of the business.

To see why this is so, consider a case where the state wishes to take a dollar from an ordinary individual, and offers it only $0.60 in exchange. Here, the state could be enjoined from the taking because it refuses to pay the needed $0.40. Or it could be said that the taking is allowed (if pointless) so long as an extra $0.40 is paid in compensation. Either way, the state that takes a dollar has to pay a dollar.

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33 See, e.g., Dolan v. City of Tigard, 512 U.S. 374, 386 (1994) (requiring an "essential nexus" between the "legitimate state interest" and the means used to implement the state's program).
34 U.S. CONST. amend. V ("[N]or shall private property be taken for public use without just-compensation.").
35 Id. art. I, § 10 ("No state shall . . . pass any . . . Law impairing the Obligation of Contracts . . . .").
36 Indeed, the Supreme Court has interpreted "public use" so broadly as to have effectively erased the phrase from the Fifth Amendment. See, e.g., Hawaii Housing Auth. v. Midkiff, 467 U.S. 229, 240 (1984) (holding that "[t]he "public use" requirement is . . . coterminous with the scope of a sovereign's police powers."). See also, Epstein, supra note 1, at 161-82.
Now suppose that the state takes $1.00 (or land worth $1.00) and offers the individual in exchange a lottery ticket, which pays $2.00 thirty percent of the time and nothing the rest of the time. The expected value of that ticket is $0.60 (thirty percent of $2.00). Yet no one would insist that the lottery ticket is just compensation for the money taken, given that the individual is down $0.40 when the bargain is completed. And the result would not change even if, after the fact, the individual won the lottery, because it is the expected value of the property given that determines compensation; the 70 percent chance of coming out empty-handed cannot be ignored.

What now is the remedy? One possibility is to say that the state, when it forces the individual to take the lottery ticket, must also pay him $0.40 so that the sum of the ticket plus the cash is equal to one dollar. Yet that is an economic mistake. There is no reason to think that the lottery ticket is worth exactly $0.60 to its holder. Thus the common psychological phenomenon of risk aversion often means that individuals will attach a negative value to uncertainty, such that the 30 percent chance of $2.00 is worth considerably less than its expected value. By some accounts, risk aversion cuts out as much as 30 percent of the expected value of the lottery ticket, so that it may be worth only $0.42. In reply it may be said that the ticket could be worth more than $0.60 to some persons who are risk preferrers, and thrive on uncertainty. But these cases are of little concern here because those individuals will buy the lottery ticket voluntarily, even if the absence of state compulsion.

At this point, the proper approach to the just compensation problem takes into account both classes of individuals. Here it is no justification to pay some persons too much while paying other individuals too little. Some individuated compensation is needed to make sure that every person receives just compensation for the dollar that has been surrendered. Rather than speculate which persons have received just compensation and which persons have not, the proper solution is to eliminate the forced sale altogether and to allow the useful transactions to go forward voluntarily. The difficulty of determining compensation, and the tendency of states to rig the rules in its own favor, means that there is no justification for taking money from individuals, as the catastrophic insurance funds surely attempt to do. Nor is there any justification for forcing individuals or firms to assume complex burdens that are difficult to value in exchange for cash that may be insufficient to cover those obligations. Where the valuation problems of the compensation remedy are acute; that is, where there is some major chance of state abuse or where the assets that the state wishes to acquire are not unique (e.g. critical land for a fort), there is no reason to run the risk that just compensation will not be paid. In those cases where the compensation offered by Florida (i.e. the rates it will allow to be
charged) are adequate, other companies will enter this market, so there is no danger of overcompensation. But in those cases where no one else will enter, then it is clear that the state has muddied the water by making it impossible for a court to evaluate one side of the cash for cash exchange. With the catastrophic fund, it is impossible to give a clear value to the return promised by the fund, but they have to be worth less than the proverbial lottery ticket because no one will enter the transaction voluntarily. With the renewal statute, it is likewise difficult to value the costs imposed by the policy, but they have to be less than the premiums for otherwise who would leave. So the likelihood of undercompensation is manifest, if difficult to quantify. The solution should be that followed in the lottery case: Do not force the state to make up the difference that is hard to calculate. Instead, stop the transaction in its tracks on the ground that if the state had wanted to make up the difference it would have found a clearer way to do so. And once the exit right is recognized, then the state can reduce its ambitions or support the insurance industry from general revenues.

Over and over, it has been said that the purpose of the just compensation clause is to make sure that expenditures for the public benefit are paid for by the public at large. Only by allowing the exit right can that be done. And that remedy is appropriate because it is evident that Florida wants to resort to coercion only because it is not willing to compensate insurance companies for the added risks they are required to run.
