Automobile Leasing and the Vicarious Liability of Lessors

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Abstract

The Comment begins by discussing the New York Vehicle and Traffic Law Section 388, which makes lessors vicariously liable for their cars even when they are begin leased by others, and how this led many car companies in New York to stop offering leases in the 1920’s, the Comment will recommends that Section 388 be amended to exclude lessors from vicarious liability. The Comment then goes through the history of Section 388, explains what leasing is and why it is popular, looks at the recent impact of Section 388 which includes several companies have stopped leasing in New York, looks at current legislation for and against Section 388, examines the various theories of vicarious liability, such as enterprise liability, the control test, and externalities. The Comment concludes by saying that Section 388 should be repealed and lessors should not be vicariously liable for lessees because finance companies acting as insurers is inefficient and expensive, and actual insurance companies would be better and cheaper alternatives.

KEYWORDS: automobile, vicarious liability, lessors

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INTRODUCTION

In 2003, some of the largest automobile financing companies determined that they would no longer offer leasing in New York State. These companies ceased leasing because of a 1920s New York law that creates vicarious liability for car owners. The statute, New York Vehicle and Traffic Law section 388, has been interpreted to include long-term lessors as automobile owners because they hold title to the leased vehicles, even though the lessors do not possess the vehicles during the lease period.

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3. (McKinney 2004). Section 388 states in pertinent part:

   1. Every owner of a vehicle used or operated in this state shall be liable and responsible for death or injuries to person or property resulting from negligence in the use or operation of such vehicle, in the business of such owner or otherwise, by any person using or operating the same with the permission, express or implied, of such owner . . . .

   2. As used in this section, “owner” shall be as defined in section one hundred twenty-eight of this chapter and their liability under this section shall be joint and several.

4. See N.Y. VEH. & TRAF. LAW § 128 (McKinney 2004) (defining a lessee possessing an automobile for more than thirty days as an owner). This Comment does not address short-term leases—defined as leases that are for less than thirty days, for example, renting a car—and whether it is rational to hold car rental companies or other short-term lessors vicariously liable for their short-term lessees.

This Comment addresses whether holding such automobile lessors vicariously liable is justified. Part I discusses the relevant background of the statute, case law interpreting the language of the statute, and the effect of the interpretation. It also gives an overview of the different financing options available to automobile consumers and describes how New York auto purchases have been affected by section 388 in recent years. Part II analyzes how vicarious liability is justified in general, focusing specifically on employer and employee relationships. It further explores how vicarious liability can generally help to minimize the costs that a tortious actor can impose on society. It concludes with an overview of the ways that insurance companies structure their product to operate efficiently. Finally, Part III applies the justifications for vicarious liability in general to vicarious liability in automobile leasing specifically and addresses how vicarious liability forces lessors to perform the functions of insurers. The Comment concludes that applying section 388 to lessors is bad policy for three reasons: first, because it holds lessors liable for the actions of a party whom they neither benefit from nor control; second, vicarious lessor liability does not appropriately apportion the cost of an accident to the party that caused the accident; and third, vicarious liability is inefficient in this context because it requires financing companies to assume the role of insurers. Consequently, this Comment recommends that section 388 be amended to exclude lessors from vicarious liability.

I. THE HISTORY OF SECTION 388 AND ITS MODERN IMPLICATIONS

A. The Statutes

New York Vehicle and Traffic Law section 388 was enacted in 1924 to “ensure access by injured persons to a ‘financially responsible insured person against whom to recover for injuries.’”6 The major policy goal of section 388 was to compensate automobile accident victims.7

Section 388 makes all owners of a vehicle jointly and severally liable for the negligence of any driver to whom an owner gives permission to drive the vehicle.8 Section 388 refers to another section of the New York

8. See supra note 3.
Vehicle and Traffic Law, section 128, in its definition of “owner.” In section 128, an owner is defined as a person, other than a lien holder, who holds title to a vehicle. There can be multiple owners of a single car under this definition, including vehicle lessors. Even though lessors that argue they should be considered lien holders, and thus excluded from the statutory definition of owner, New York courts have concluded that lessors are owners because they are titleholders.

New York is one of fewer than a dozen states that hold an owner of a vehicle vicariously liable for a permissive user’s negligence. Further, it has become the only state to impose unlimited liability for lessee negligence on lessors. The other two states which had unlimited lessor liability, Connecticut and Rhode Island, have passed statutes capping lessor liability within the last few years because vehicle financing companies threatened to stop leasing in those states unless their liability was removed or limited.

B. What is Leasing and Why is it Popular?

Automobile leasing is a financing arrangement whereby a lessee, in exchange for monthly payments, obtains possession of an automobile for an agreed term. When a lease commences, a financing company (or
“lessor”) purchases a vehicle from a dealer and then the financing company leases the vehicle to the consumer (or “lessee”).18 The lessor retains the vehicle’s title and resells the vehicle at the end of the lease term when the vehicle is returned. Vehicles depreciate in value over time and, although there will probably be a significant residual value—the value of the vehicle after the lease ends—by the end of the lease term, most vehicles are worth far less than when they were new.19 To recoup this value, the lessor will set the lease price by determining how much the car will depreciate over the course of the lease term.20 As the titleholder, the lessor can treat the leased cars as depreciable assets and take tax deductions for the depreciation.21

Consumers like leasing because less money is required upfront and monthly payments are lower in a lease than for the purchase of a vehicle on credit.22 Lease payments cover the value of the car over a set period of time, after which possession of the car reverts to the lessor, while a consumer under a credit purchase eventually has unencumbered ownership of the car.23 Thus, monthly payments on the lease will be based on the lower total cost of owning the vehicle for the lease term instead of on the total purchase price of the vehicle.24 Lower monthly payments give consumers a chance to drive a vehicle that they might find too expensive if they were purchasing the car on credit25 and are also advantageous to businesses that would prefer to rent.26

A key difference between loans and credit purchases under New York Vehicle and Traffic Law section 38827 is that under a lease, but not under a

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18. Id. at 587-88. In a typical vehicle lease, the original lessor is a car dealer who assigns the lease to a financing company. Rohner, supra note 16, at 652 n.21.
19. See Litwin, supra note 17, at 588-89; Rohner, supra note 16, at 650 n.11.
20. Rohner, supra note 18, at 650 n.11.
23. Id. at 650 n.11.
24. See id.
25. Id. One article cited a consumer who wanted to lease a Chevrolet Cavalier because she was “short on cash but long on desire.” Marc Santora, Carmakers Limit New York Leases, N.Y. TIMES, Apr. 24, 2004, at A1.
26. Telephone Interview with Charles Territo, supra note 21. The total cost of leasing may be more expensive than purchasing a vehicle on credit because, even though the monthly payments are lower, at the end of the term, a lessee does not possess an asset whereas in a credit purchase the owner does. Even if individual consumers are cognizant of this fact, some may prefer to have lower monthly payments throughout the term, instead of higher payments and an asset. See supra note 26 and accompanying text.
27. (McKinney 2004).
credit purchase, the financing company, not the lessee, has title to the vehicle. In a sale, the consumer is the titleholder and the lender’s rights and liabilities are limited to that of a creditor. Section 388 holds lessors liable, but not lenders, because lessors are title-holders.

Leasing has become a very popular form of auto ownership in New York, particularly in the New York City Metropolitan Area. Consumers benefit because the lower payments allow them to drive new cars every two to four years if they desire. Having the option to lease or to purchase also gives consumers more flexibility in deciding how they want to own an automobile.

C. Recent Impact of Section 388

The mounting costs associated with section 388 are attributable to rising amounts in jury awards and to, what seems to some, outrageous determinations of lessor liability. Lessors claim that vicarious liability under section 388 has cost them over $1 billion since 1997 in New York, and that between August 2001 to August 2002 there were over 215 vicarious liability suits against them, seeking a total of $1.6 billion. Even if the lessors were to prevail in many of these suits, litigation costs would still be substantial.

Last year, the finance arms of General Motors, Ford, and Honda stopped leasing in New York because of the increasing costs associated with liability under section 388. These lenders account for seventy-five percent of car leases in New York.

29. Id. at 650–51.
30. See Caher, Car Makers Step Up Lobbying, supra note 7. In 2002, roughly one quarter of all vehicles acquired in New York were obtained through leases. Id. In a study conducted by J. D. Power and Associates, national leasing was found to account for 14.7% of all new vehicle sales in June 2003, whereas in the New York City Metropolitan Area they accounted for 31.4% of sales. Garsten, supra note 1.
31. See Rohner, supra note 16, at 650.
35. Garsten, supra note 1; Rombel, supra note 2.
36. Rombel, supra note 2.
Financing Corp., the auto leasing arm of J.P. Morgan Chase and Co., and several smaller lenders have also discontinued offering leases in New York.\textsuperscript{37} Some of the companies that continue to lease cars have altered their lease terms by raising their fees several hundred dollars to account for their liability under section 388.\textsuperscript{38} Some that stopped leasing altogether began offering balloon payment options instead.\textsuperscript{39}

Balloon payment options are similar to leases in that a consumer takes possession of a vehicle for a set term while making monthly payments. Under this approach, however, at the end of the term the consumer has the option of either making a “balloon” payment and obtaining unencumbered ownership of the vehicle, or returning the vehicle (and title).\textsuperscript{40} The key difference is that during the term of the agreement, the consumer, not the finance company, is the titleholder, and thus the finance companies are not vicariously liable under section 388.\textsuperscript{41} The consumer makes payments as though he were owning the vehicle only for a set term and then, in consideration for not having to pay the cost of buying the car outright, returns it to the dealer.\textsuperscript{42}

Balloon payment plans, however, are more expensive than leases for two reasons. First, the monthly balloon payments are higher because consumers pay interest as though they had purchased the vehicle on credit.\textsuperscript{43} In a lease, the consumer only pays interest based on the total cost of the lease, not the entire purchase price of the car. Second, the consumer must pay sales tax as though he were purchasing the car in its entirety rather than for a set lease term.\textsuperscript{44} This is because the sales tax will be based

\begin{itemize}
\item \textsuperscript{37} Id.
\item \textsuperscript{38} See, e.g., Bill Platt, \textit{Leasing a Chrysler or Mercedes Will Cost More in Four States}, \textit{Wall St. J.}, Apr. 16, 2003, at D7 (noting that Chrysler and Mercedes planned to add a $1000 fee to all new leased vehicles in Connecticut, Kentucky, New York, and Rhode Island).
\item \textsuperscript{39} Rombel, \textit{supra} note 2.
\item \textsuperscript{41} \textit{See id}.
\item \textsuperscript{42} \textit{Cf. id}.
\item \textsuperscript{43} It is unclear why the interest rates for a balloon payment are based on the price of the car if it were purchased. It is possible that the finance companies base these rates on the total sale price because they want to ensure that a court sees substantive differences in a balloon payment and lease. If a court were to find them too similar, they may consider it a lease, in which case the financing company would remain liable under section 388. But the finance companies may be doing this without justification and could reduce it to the levels of a lease. Regardless of whether the finance companies could lower their rates, they have not. In the end, it hurts consumers because they are still paying more than they would have under a balloon payment than a lease. \textit{Cf. id.}
\item \textsuperscript{44} Boyer, \textit{supra} note 40.
\end{itemize}
on the entire retail cost of the car for a balloon payment, whereas for a lease, sales tax is only based on the total cost of the lease. Because of these increased costs, financing companies do not consider balloon payments to be competitively priced and they claim that they will not use balloon payments for much longer because consumers will choose to buy on credit instead.

D. Current Legislation and Lobbyists For and Against Section 388

Several trade organizations have spoken out against section 388, including, not surprisingly, the Alliance of Automobile Manufacturers, the National Vehicle Leasing Association, and the New York State Automobile Dealers Association. The New York State Bar Association has also criticized section 388. These critics allege that vicarious liability under section 388 is unfair because it holds them liable for the acts of people over whom they have no control. Opponents further claim that section 388 limits consumer choices, hurts auto sales, and is not needed to help injured


46. N.Y. TAX LAW § 1111(i) (McKinney 2004); Maria T. Jones, et al., 2000-2001 Survey of New York Law: State and Local Taxation, 52 SYRACUSE L. REV. 635, 656; see Boyer, supra note 40. In a lease, the lessor purchases the car from the dealer and is thus liable for sales tax based on the entire purchase price of the car. See supra note 45 and accompanying text. It is possible, but not necessarily true, that the lessor will pass some of this cost on to the consumer. In a balloon payment, the consumer purchases the car from the dealer, albeit for a limited term set by the consumer’s agreement with the financing company, and is responsible for sales tax based on the entire purchase price of the car. See supra note 45 and accompanying text. Thus, in a lease, the consumer must pay sales tax based on the lease price and the financing company may pass some of the costs of the sales tax it paid on to the consumer. But in a balloon payment, the consumer will definitely pay sales tax based on the cost of purchasing the entire car. This makes it possible that under a lease the lessee will pay more in sales taxes than what he pays in taxes for the lease itself because he may have the additional cost of reimbursing the lessor. But under a balloon payment, the consumer is guaranteed to pay the full sales tax. Furthermore, if the consumer does not make the balloon payment at the end of the term, he will transfer title to the financing company, and they will pay a sales tax—based on the balloon payment—because title is being transferred. The financing company could also pass along some of its costs to the consumer here, but will not necessarily do so.

47. See Boyer, supra note 40.


50. See Barbara Woller, State Bar Backs Lease Law Changers, J. NEWS, Apr. 12, 2003, at D.

51. Caher, Lobbyists Push for Last-Minute Tort Reform, supra note 59; Woller, supra note 50.
parties. They assert that the legislature’s fondness for section 388 arises from the fact that the law discourages leases, thereby increasing car sales and sales tax revenues, and increases tax revenues because unless the financing companies lease cars, they cannot take depreciation deductions on them.

Proponents of section 388 include the New York Public Interest Research Group, a consumer interest group, and the New York State Trial Lawyers Association. These groups contend that the law should remain intact because it compensates tort victims who would otherwise be inadequately compensated by financially irresponsible drivers. Although these proponents of the statute imply that such compensation in itself justifies section 388, they also assert that section 388 does not substantially hurt automobile sales. They contend that the auto industry wants the statute repealed only so financing companies can continue to claim tax deductions for depreciation on the leased vehicles.

A bill that would amend the law by excluding lessors from liability under section 388 passed in the New York State Senate, but has been frozen in committee in the State Assembly. State Assembly speaker Sheldon Silver opposes any changes to the law, citing his concern for accident victims and his belief that the law does not cause the automobile industry undue harm.

II. THEORIES OF VICARIOUS LIABILITY AND INSURANCE

A. Vicarious Liability

This section discusses whether, under a tort law regime that is

52. Caher, Lobbyists Push For Last-Minute Tort Reform, supra note 49.
53. The total amount of taxes the state collects are more for balloon payments and sales than they are for consumer leases because consumers, unlike lessors, cannot deduct depreciation expenses on their tax returns because only businesses can deduct for depreciable assets. N.Y. State Trial Lawyer’s Ass’n, Two Faces: The Auto Leasing Industry’s $1.1 Billion Tax Deduction for Cars It Says It Doesn’t Really Own, June 2003, available at http://www.nystla.org/nicecontent/documents/Vicarious%20Report.PDF. Lessors, who are liable for the sales tax in a lease are able to deduct for depreciation, so even though the sales tax will be technically the same for a lease, balloon payment, or sale, leases result in lower taxes after deductions. Id.
55. Baker, supra note 33; Caher, Car Makers Step Up Lobbying, supra note 8.
56. See Caher, Car Makers Step Up Lobbying, supra note 8.
57. See Baker, supra note 33; N.Y. State Trial Lawyer’s Ass’n, supra note 55.
58. See N.Y. A.B. 7453 (2005); Caher, Car Makers Step Up Lobbying, supra note 8.
59. Santora, supra note 25.
predominately negligence based, holding a party vicariously liable is justified. Vicarious liability, unlike negligence, may hold a party liable when it is not at fault.\textsuperscript{60} In general, liability under tort law in the United States is based on finding fault.\textsuperscript{61}

Vicarious liability provides an exception to this general rule in that it imposes liability upon one party for a wrong committed by another.\textsuperscript{62} It is most commonly associated with employer-employee relationships.\textsuperscript{63} Because vicarious liability imposes liability on a party who is not at fault, it must be justified by reasons distinct from those supporting negligence liability.\textsuperscript{64}

The discussion below describes the rationale supporting vicarious liability.\textsuperscript{65} There are several theories justifying vicarious liability, but the predominate theory, enterprise liability, holds that an enterprise should be liable for the costs associated with its business. Of lesser importance, but related to the justification by enterprise liability, is when the party being held vicariously liable has the ability to control the negligent party. Vicarious liability may also be justified when it forces the defendant to internalize costs it would otherwise impose on society.

One of the benefits of vicarious liability is that it may increase the chances that a plaintiff can recover for his loss because he can sue more—and wealthier—defendants.\textsuperscript{66} This alone, however, is not sufficient justification for the doctrine.\textsuperscript{67} If it were, vicarious liability would

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\begin{enumerate}
\item See, e.g., Hammontree v. Jenner, 97 Cal. Rptr. 739, 742 (Ct. App. 1971) (refusing to hold drivers strictly liable for their actions). Justice McKenna wrote “the very foundation of right—of the essence of liberty as it is of morals—[is] to be free from liability if one is free from fault.” Arizona Copper Co. v. Hammer, 250 U.S. 400, 436 (1919) (McKenna, J., dissenting); see also Oliver Wendell Holmes, Jr., The Common Law 94-95 (1881).

\item See, e.g., Ira S. Bushey & Sons, Inc. v. United States, 398 F.2d 167, 171-72 (2d Cir. 1968) (citations omitted).


\item See, e.g., Sykes, Boundaries of Vicarious Liability, supra note 64.


\item See Sykes, Boundaries of Vicarious Liability, supra note 64, at 584.

\item See, e.g., Ira S. Bushey & Sons, Inc. v. United States, 398 F.2d 167, 171-72 (2d Cir. 1968) (citations omitted).
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dominate the tort system instead of being the bounded anomaly that it is.

1. Enterprise Liability

An employer is justifiably held vicariously liable if an employee, while acting for the employer’s benefit, negligently causes harm. This is because the employer’s enterprise should bear the costs associated with running its business. These costs include social harms that the enterprise causes, including the costs of an employee’s negligence. Thus, if an employee acts negligently in performing activities for the benefit of the enterprise, both the employee and the enterprise should be held jointly and severally liable for the tort: the employee because he caused harm by acting negligently and the enterprise because it benefits from the employee’s actions.

Without vicarious liability, victims of insolvent employees would be unable to recover, thus allowing the enterprise to impose large costs on society through the actions of their employees. With vicarious liability,

68. See generally Gregory C. Keating, The Idea of Fairness in the Law of Enterprise Liability, 95 Mich. L. Rev. 1266 (1997). The Restatement (Second) of Agency section 219(1) states that with regard to agency law, vicarious liability is only used when a principal and agent are in a master-servant relationship, also known as an employer-employee relationship. Restatement (Second) of Agency § 219(1) (1958) (“A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.”). If the agent is an independent contractor then, barring the doctrine of negligent entrustment, the principal is not held vicariously liable. Id. § 2 (distinguishing masters, servants, and independent contractors); id. § 220 (defining servant). Although the principal still benefits from the agent’s activities, whether an agent is a servant or independent contractor, the benefits are distinguishable. One scholar distinguished them, writing that “the servant is ‘an integral part of his master’s establishment,’ whereas the non-servant ‘aids in the business enterprise but is not a part of it.’” Dalley, supra note 64, at 541 (citation omitted). Thus, a principal should be liable for a servant’s negligence because the servant is part of the business, but a principal should not be liable for the torts of an independent contractor, even though the independent contractor confers a benefit on the principal, because the independent contractor is not a part of the business. This distinction is one of several between servants and independent contractors in the Restatement (Second) of Agency. Restatement (Second) of Agency § 220. Other distinctions are discussed infra Part II.A.2.

69. Keating, supra note 68, at 1269.

70. See id. at 1293.

71. See Sykes, Boundaries of Vicarious Liability, supra note 62, at 564-66. The Restatement (Second) of Agency § 219(2) imposes vicarious liability on employers only for employee torts committed in the “scope of employment.” When an employee acts outside the scope of business, he is not acting in the interest of advancing the enterprise and so it would be unfair to impose damages on the employer. See id. § 219 cmt. e; Sykes, Boundaries of Vicarious Liability, supra note 62, at 583-85.

that if employers were not vicariously liable, they would be able to unjustly impose some of the costs of their business on society in the numerous cases where the employee cannot fully compensate the victim. If employees were not vicariously liable, they might avoid hiring solvent employees because a solvent employee with bargaining power is more likely to require his employer to indemnify him for his negligence. So, employers may decide to hire only insolvent employees so the enterprise can avoid some of the costs of its activities. See Sykes, Boundaries of Vicarious Liability, supra note 62, at 569.

73. See Sykes, Boundaries of Vicarious Liability, supra note 62, at 569.
74. See id.
76. See Sykes, Boundaries of Vicarious Liability, supra note 62, at 582.
77. See RESTATEMENT (SECOND) OF AGENCY § 220.
78. Sykes, Economics of Vicarious Liability, supra note 72, at 1261-71. Control is viewed by some commentators as mostly illusory. See Dalley, supra note 64, at 536. To the extent control can be found, the employer may be held directly liable for the employee’s negligence without vicarious liability. Id. Thus, they argue, vicarious liability must be justified on another basis. Id. These arguments hold some weight, however, and, as stated, the Restatement (Second) of Agency and case law have used the right to control as a test in determining whether to hold a party vicariously liable. See, e.g., RESTATEMENT (SECOND) OF AGENCY §§ 219-20 (1958).
not be held vicariously liable.\textsuperscript{79}

Although an employer’s ability to control his employees is limited—for example automobile accidents may occur as the result of simple carelessness that the employer may be unable to prevent—the right to control is still important to vicarious liability.\textsuperscript{80} An employee act under the direction of his employer, and, although he may have some discretion in how he performs his work, he must ultimately perform his job in a manner that is acceptable to his employer.\textsuperscript{81} The employer, however, has no right to tell an independent contractor how to perform his job, even though the independent contractor is acting for the benefit of the principal.\textsuperscript{82} Thus, it seems inequitable to hold the employer liable for injuries caused by the independent contractor over whom the employer has no control.\textsuperscript{83}

The right to control the tortfeasor is essential if vicarious liability is to be imposed on an employer because without that right, an employer has no ability to demand that their employees take precautions against negligence.\textsuperscript{84} If an employer does not properly exercise this control, it is

\textsuperscript{79} See \textit{Gregory}, supra note 77, at 1358 n.214.

\textsuperscript{80} See \textit{generally} Sykes, \textit{Economics of Vicarious Liability}, supra note 72, at 1268-71. As one court stated, “It is not the actual interference or exercise of the control by the employer, but the existence of the right or authority to interfere or control, which renders one a servant rather than an independent contractor.” \textit{E.g.}, Wallis v. Sec. of Kan. Dep’t of Human Res., 689 P.2d 787, 792 (Kan. 1984). In a later case, the same court elaborated further:

An independent contractor is defined as one who, in exercising an independent employment, contracts to do certain work according to his own methods, without being subject to the control of his employer, except as to the results or product of his own work. The primary test used by the courts in determining whether the employer-employee relationship exists is whether the employer has the right of control and supervision over the work of the alleged employee, and the right to direct the manner in which the work is to be performed, as well as the result which is to be accomplished. It is not the actual interference or exercise of control by the employer, but the existence of the right or authority to interfere or control, which renders one a servant rather than an independent contractor.


\textsuperscript{81} \textit{Wallis}, 689 P.2d at 792. “The primary test used by courts in determining whether the employer-employee relationship exists is whether the employer has...the right to direct the manner in which the work is to be performed, as well as the result which is to be accomplished.” \textit{Id}.

\textsuperscript{82} See \textit{Gregory}, supra note 75, at 114.

\textsuperscript{83} See id.

\textsuperscript{84} An employer may be able to demand that an independent contractor take safety precautions. But since independent contractors, unlike employees, often run their own businesses as separate entities from their employers, they are probably in a better position than employers to decide what precautions to take. Furthermore, they are more likely to take necessary precautions because their businesses will be more likely than an employee to pay the full costs of damages. \textit{Cf. supra} note 80 (describing the role of the independent contractor).
reasonable that he should be held liable for the employee’s negligence because the employer has failed to take necessary precautions.85

3. Externalities

Economists’ concept of externalities provides another justification for imposing vicarious liability on employers. An externality arises when a party receives a benefit without fully paying for it.86 For example, a polluting factory that produces widgets benefits from the sale of the widgets. If the residents of a town near the factory are damaged by the pollution, but the factory is not required to pay the residents for the pollution damage, the factory has created an externality equal to the pollution damage. Economists believe it is efficient, and thus beneficial, to require entities such as this factory to internalize such externalities by requiring them to pay for these injuries instead of imposing these costs on society.87 In the polluting factory example, this could be accomplished if nuisance law either granted an injunction against the factory or required the factory to pay damages to the town residents.88

If employers were not liable for injuries caused by their employees’ torts committed within the scope of their employment, an externality would be created whenever the employee could not fully pay for the damages. In such cases, the employer would be receiving the benefits of the employee’s work, but imposing part of the costs of the work on the public—the uncompensated injuries caused by the employee’s tort. When this occurs, the enterprise unfairly profits because it is imposing some of its costs on the victim.89

On the other hand, if the employer is held vicariously liable for the employee’s negligence, then the employer will be forced to internalize the

85. Theoretically, if the employer demands that his employee take reasonable precautions and the employee complies, the employee that caused an accident will not be held negligent because he will not have violated the standard of care. If the employee is not negligent, then the employer cannot be held vicariously liable. See Father Belle Cmty. Ctr. v. N.Y. Div. of Hum. Rts. ex rel. King, 221 A.D.2d 44, 52 (N.Y. App. Div. 1996) (“Both State and Federal cases require, as a predicate for imposing liability, that there be some basis for imputing the employee’s conduct to the employer; neither imposes liability on the employer based solely on the employment relationship.”) (citations omitted).
87. See id. at 45.
88. See id. at 310.
89. See id. at 44-45. When an externality is created, economists believe that the externality generator’s production is inflated. See id. at 45. This is so because the externality generator will produce more output than would be profitable if he were paying for all the costs associated with production himself. See id. If the producer internalized his costs, he would either have to decrease production or receive less profit.
costs that his business imposes on society. By internalizing these costs, the enterprise’s profits will rightly reflect the enterprise’s total cost of production, avoiding inefficiently inflating production at the expense of society.90

B. Insurer’s Ability to Assess an Insured’s Propensity for Risk

The availability of insurance is important in tort law and relevant to vicarious liability.91 This section discusses some common insurance concepts while Part III addresses how insurance applies to vicarious liability.

Insurance functions by pooling together large numbers of insureds based on the risk exposures of the insured.92 Insurers rely on the fact that if they pool large numbers together, a certain percentage of those insured will have claims while the others will not.93 Of course, all the insureds pay in premiums, so the insurer collects premiums from all its insured and pays only a few.

Insurance is more efficient when the insurer is able to segregate its customers into narrow risk pools related to their propensity for risk.94 To effectively assess risk, insurers must research their customers carefully so that the customers are assessed the correct premiums and deductibles for their insurance policies. The higher the risk exposure for any given insured, the higher his premium should be because there is a greater chance that a loss will occur or that loss will be larger. Because the insurer charges insureds in the same pool the same rates, the pools must be narrow to correctly charge customers.

One problem that arises when insurers are not able to segregate customers into risk pools is called “adverse selection.”95 Adverse selection arises when high-risk insureds enter a low-risk pool.96 Statistically, these

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90. See Sykes, Economics of Vicarious Liability, supra note 72, at 1251. When an enterprise does not fully internalize its production costs, it does not account for those costs when calculating how much it should produce. Thus, the enterprise could produce more than is efficient because it imposes some of its production costs on society.


93. Id.

94. Id. (“It is crucial to the insurance enterprise to segregate uncorrelated risks, as much as possible, into separate, narrowly-defined risk pools . . . .”).

95. Id.

96. See id. at 1540-41 (explaining that the presence of high-risk persons in a risk pool
high-risk individuals will be paid more than their low-risk counterparts, but will only pay low-risk premiums. If adverse selection is prevalent, premiums charged to all members of the pool will rise to reflect the additional risk. As a result, low-risk insureds will either drop out of the pool because the costs of obtaining insurance are too high, or they will remain in the pool, paying high premiums that would not be required but for the presence of the high-risk individuals.

Insurers use a variety of methods to narrowly define their risk pools. For example, insurers can charge different rates for different classes of drivers so that those with a statistically higher risk of accidents are placed in a pool that is charged higher premiums. Insurers can also assess risk by inspecting safety measures and charging higher rates to those who have more risk. Additionally, they can base their rates on the value of whatever is being insured. By distinguishing between different risks, insurers can operate most efficiently and provide coverage at a fair price to a broad range of people.

III. SECTION 388 SHOULD BE REPEALED

The remaining portion of this Comment discusses how the principles discussed in Part II should be applied to determine whether imposing vicarious liability on automobile lessors is desirable. It concludes that it is not desirable and recommends amending section 388 of the New York Vehicle and Traffic Law to exclude vehicle lessors from vicarious liability.

Section 388 has hurt consumers in New York. Some lessors that still offer leases in New York charge more for auto leases than in other states because of the need to pay for losses imposed under section 388. Because of the higher rates, consumers' choices of how to finance vehicle purchases are limited and some consumers are deterred from obtaining new vehicles as often as they would if leasing were still offered by all financing companies. An alternative to leasing, balloon payments, also harms

increases the range of risk, causing persons with a low risk level to pay disproportionately high rates.

97. See id. at 1541.
98. Id.
99. See id. at 1545 (listing driver age, property value, and the existence or absence of smoke alarms as some of the factors considered in determining risk pools).
100. (McKinney 2004).
102. See supra text accompanying note 38.
103. See supra Part I.C and text accompanying note 52.
potential lessees because they pay higher monthly payments on vehicle purchases than they do under a traditional lease.\textsuperscript{104} Furthermore, because financing companies think balloon payments are too high in price to compete with credit sales, they have threatened to discontinue balloon payments plans from New York.\textsuperscript{105} Thus whatever relief this option offered to consumers by giving them an option similar to a lease may soon disappear.

Section 388 also presumably has negative collateral effects on both the environment and public safety. By raising the price of leased cars, section 388 deters some consumers from acquiring new cars as often as they would if traditional leasing were an option. Technological advances making newer cars cleaner for the environment and safer for drivers and passengers are thus available to fewer people.\textsuperscript{106} Furthermore, regardless of technological advances, newer cars run more efficiently than older ones because all of their parts are newer and in good working order.\textsuperscript{107} Barriers to leasing like section 388 thus have a negative effect on both the environment and public safety.

It is clear that section 388 has harmed both finance companies and consumers. Thus it should only remain law if there is sufficient justification for the imposition of vicarious liability.\textsuperscript{108} Whether this justification exists is discussed below.

\section*{A. Why Justifications for Vicarious Liability in General Do Not Justify Vicarious Lessor Liability}

Vicarious liability is only imposed in one kind of auto sale arrangement

\textsuperscript{104} See supra text accompanying notes 39-47.

\textsuperscript{105} See supra text accompanying note 47.

\textsuperscript{106} See supra text accompanying notes 52-53 and 103 (explaining that section 388 limits consumer choices for financing, and as a result consumers obtain new cars less frequently than if leasing were still an option).

\textsuperscript{107} For example, as engine parts in a car wear down, the engine becomes less efficient and uses more gasoline and oil per mile.

\textsuperscript{108} See supra note 64 and accompanying text. Before discussing the merits of New York Vehicle and Traffic Law section 388, it should be noted that proponents of the statute often argue that the statute should apply to automobile lessors because leasing permits lessors to claim depreciation on leased vehicles for tax purposes and that by imposing liability, section 388 deprives lessors of this improper tax avoidance. (McKinney 2004). This, however, is irrelevant in considering whether section 388 is good public policy. If lessors are improperly avoiding tax liability by claiming depreciation on their leased vehicles, they are doing so because the tax law allows for it. If it is bad policy, the tax law should be changed. Therefore, tax avoidance by lessors is an insufficient justification for imposing vicarious liability under section 388.
There is no reason offered as to why liability on financing companies is proper in that situation but not others. Regardless of whether a vehicle is purchased in cash, financed over time, paid for by balloon payments, or funded through a traditional lease, all of the parties are in substantially similar positions. The dealer is selling a car, the bank is making a loan, the driver possesses and uses the vehicle, and, if there is an accident, the victim is injured. Regardless of the type of transaction, the bank and dealer have deep pockets that would benefit the injured plaintiff if the driver is insolvent. But, only under a lease does a plaintiff have access to these deep pockets. As discussed above, vicarious liability is justified in employment relationships. The same reasoning, however, is inapplicable to a leasing situation, leaving no justification for why vicarious liability should be applied to lessors.

Vicarious liability in employment relationships is justified in part because the loss occurs in the course of the employer’s business. An enterprise should be held liable for the costs directly associated with its business. Losses arising from the negligence of a lessee, however, are not directly associated with a financing company’s business. A finance company’s business purpose is to make a profit by leasing cars. It does not profit from the lessee’s use of the car. Indeed, the less the lessee uses the car, the higher the value of the car returned to the lessor, and the greater the lessor’s profit. Thus, the leasing situation differs from an employer-employee situation in a way that goes to the heart of the reason for imposing vicarious liability. Because financing companies do not directly benefit from lessees’ use of the car, they should not be held liable for their lessee’s negligence.

Similarly, lessors have no power to control the conduct of their lessees, so vicarious liability cannot be justified on those grounds. Control, an important factor for imposing vicarious liability in the employment context, does not exist in the lease situation. There is generally no

109. See supra Part I.A.
110. See supra Part I.A.
111. See supra Part II.A.
112. See supra Part II.A.1.
113. See supra Part II.A.1
114. This is demonstrated by two examples. In the first scenario, A leases a vehicle to X and X subsequently injures P while driving to the post office. In the second, A hires X to drive A’s truck. While driving the truck to deliver goods for A, X injures P. A directly benefits from X’s driving in the second example, but not the first.
115. See supra Part II.A.2.
116. See supra Part II.A.2
vicarious liability in an independent contractor relationship, even though the independent contractor is performing a service for the employer. The lessor is even more removed from the lessee than is the employer from the independent contractor. Thus, the two lynchpins often used to justify vicarious liability for employers— injury in the course of the employer’s business and control by the employer—do not exist in leasing.

Furthermore, financing companies do not pose an externality problem. Unlike an enterprise that benefits from an activity that causes social costs, a financing company neither causes accidents nor benefits from them. As stated, the accidents caused by lessee negligence are not directly related to a lessor’s business. Since the financing company does not generate an externality to internalize, section 388 merely transfers the lessee’s liability to his lessor. A negligent lessee imposes an externality on his victim: in gaining a benefit through driving, the lessee causes harm to the victim. When the lessee does not compensate the victim, he creates an externality. But, lessor vicarious liability does not internalize this externality, it merely ensures that the cost will be imposed on someone other than the victim. The only way the cost could be internalized would be if the lessee himself paid for the injury. Shifting the loss to another party does not internalize the cost.

Lessors do not profit from lessee actions, nor do they have a right to control them. Further, forcing them to pay for harm caused by lessees does not internalize the cost. None of the reasons for imposing vicarious liability on employers applies to leasing. Section 388 holds automobile lessors liable for a third-person’s fault, even though the rationale supporting similar vicarious liability rules does not apply. Thus, the only justification for section 388 is compensating victims. This, however, is insufficient to hold lessors’ liable. Making a person pay for another’s injury simply because he can afford to do so violates basic notions of fairness and cannot be used as sole justification for tort law.

117. See supra text accompanying notes 76-79.
118. See supra text accompanying notes 82.
119. See supra Part II.A.1.
120. See supra Part II.A.2.
121. See supra Part II.A.3.
122. N.Y. VEH. & TRAF. LAW § 388 (McKinney 2004).
123. See supra Part II.A (outlining the justifications for vicarious liability).
124. See supra notes 66-67 and accompanying text.
B. Why Finance Companies Acting as Insurers is Inefficient and Expensive

Section 388 forces financing companies to act as insurers, but using section 388 to compensate tort victims is inefficient from an insurance perspective for several reasons. First, liability insurance companies are in a better position to assess risk than financing companies: assessing such risks is insurance companies’ specialty, while financing companies are in the business of financing automobile purchases. It is inefficient for the law to force financing companies to hire insurance experts and thus raise financing costs. Insurers should handle the insuring business, and financers should handle the financing business.

Second, insurance policies are more flexible than leases and can respond when additional information, such as a poor driving record, becomes known. An insurer can and will raise a lessee’s premium and per incident deduction in response to poor driving. Car leases, however, do not allow rate changes based on a lessee’s risk history. Although it is theoretically possible to structure a lease so that the lease payments will vary depending on the lessee’s driving record, such a structure would involve tremendous transaction costs. For example, this type of structure would require leases to include payment schedules with payments that fluctuate depending on the lessee’s level of risk. Such complex calculations would require lessors to hire insurance experts. The lessor would also have to determine risk by monitoring the lessee’s accident rate. Such functions would duplicate a monitoring system that insurance companies already have in place.

Further, the financing companies would need to hire additional staff to complete the requisite paperwork whenever a lessee changed risk pools. It seems likely that it would be cheaper for the lessor to charge all lessees the same rate without trying to incorporate a lessee’s changing risk or adverse selection into the leasing agreement. A separate insurance policy specifically focusing on risk is a better option.

Third, unlike the lessor, the insurance company might have knowledge of changes in a lessee’s propensity for risk because the lessee must notify the insurer if he wants to make a claim against his insurance policy, for example, if he is involved in an accident. The insurer will learn the facts of the accident and how much it cost, and may then compile a record of the lessee’s driving history to determine whether the lessee has become more risky. Under section 388, however, a lessor would only learn of an accident if the lessor was sued because the lessee will not report an accident or other parts of his driving record just to alert the lessor that he
should be charged a higher premium. Even if the lessor required the lessee to report such information, if the insurer is already compiling it, it would be inefficient for the lessor to do so as well.

Lastly, insurance companies are in a better position to insure because they can better narrow insurance risk pools. As stated, insurance cannot be efficient unless the insured are segregated into pools based on the risk they pose. Insurers are able to do this for drivers based in part on the insured’s driving record. Because the insurer has better access to this record than a lessor, the insurer will be in a better position to place the lessee in the appropriate risk pool. If a lessor is held vicariously liable, however, it will either self-insure or obtain liability insurance for a lessee’s torts. The lessor’s policy will have to cover all of the lessor’s lessees, and because the lessor will be unable to distinguish between high-risk and low-risk lessees after the lease has commenced, it will result in an adverse selection problem. Thus, the lessor’s policy will charge the lessor a premium based on the average risk of its lessees. This cost will be passed onto lessees when they lease their vehicles, thus causing low-risk lessees to pay a higher premium than they would if they bought their own insurance, and high-risk lessees to pay a lower premium. This is an inefficient result because some low-risk potential lessees will decide that this added expense is too high and they will not lease. When several low-risk consumers choose not to lease, the proportion of high-risk consumers in the pool increases, as does the cost of the lessor’s premium per lessee. Leasing thus becomes more expensive and increasingly unattractive to low-risk drivers. By making leasing—which low-risk drivers might prefer absent adverse selection—economically unattractive, section 388 is most

125. A lessor could also learn of an accident at the end of the lease term if the car itself is damaged. At this stage, however, the lease term has expired and the lessor’s propensity for risk is irrelevant.

126. See supra text accompanying notes 92 and 94.

127. See supra text accompanying note 94.

128. See supra text accompanying notes 94-97. The lessor may be able to distinguish between high-risk and low-risk lessees at the beginning of the lease based on objective features of the lessee, such as age or gender, but will be unable to do so for subjective details without demanding a driving record. After the lease commences, the lessor has no way of learning subjective details of the lessee’s risk without heavy transaction costs, such as demanding periodic driving records or monitoring the lessee. Once again, insurance companies already collect this information so if the lessors did so as well it would be inefficiently duplicative.

129. See supra text accompanying notes 96-97.

130. See supra text accompanying note 98.

131. See supra text accompanying notes 97-98.

132. See supra text accompanying notes 97-98.

133. N.Y. VEH. & TRAF. LAW § 388 (McKinney 2004).
unfair to good drivers. Furthermore, it under-deters high-risk drivers because they will be paying lower prices than their risk level dictates. This problem would not occur if the lessor did not have to insure himself for vicarious liability under section 388.

Section 388 forces financing companies to assume the role of an insurance company. But, as shown, insurance companies are clearly better than financing companies at assessing risk and varying their rates according to risk. Furthermore, since insurance companies already provide similar services, if financing companies provide them too, their services would be duplicative. Making financing companies provide insurance is inefficient when there is a party—in this case an insurance company—better suited to do so.

CONCLUSION

Holding lessors vicariously liable under section 388 is unjustified and inefficient. Section 388 provides compensation for victims who may otherwise go uncompensated, but that objective alone is not sufficient to warrant holding a defendant liable. Vicarious liability in leasing is unjustifiable: Lessors do not profit from lessees’ actions and do not control lessees, nor does holding lessors liable internalize the harm the lessee causes. Furthermore, section 388 forces lessors to inefficiently act as insurers of their lessees when actual insurance companies would be better, cheaper alternatives. Section 388 results in higher costs to lessors, leading to higher costs for consumers and fewer buying options. Section 388 should be amended so that automobile lessors are exempt from vicarious liability.