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# Fair Plans: History, Holtzman and the Arson-for-Profit Hazard

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# FAIR PLANS: HISTORY, HOLTZMAN AND THE ARSON-FOR-PROFIT HAZARD

## I. Introduction

Fair Access to Insurance Requirements (FAIR) plans were implemented in twenty-six states, the District of Columbia, and Puerto Rico pursuant to the Urban Property Insurance Protection and Reinsurance Act of 1968[1] in an attempt to ameliorate urban deterioration by reducing unfair insurance practices. FAIR plans provide insurance to property owners denied insurance in the voluntary market. These plans operate as insurance pools whereby each insurance company participates in writing higher risk business according to the proportionate share of property insurance which the company voluntarily underwrites in the state.

Subsequent to the urban riots of the late sixties, it became apparent that urban areas could not grow and prosper without access to vital property insurance for businesspeople and homeowners. Recognizing the magnitude of the problem, the National Advisory Commission on Civil Disorders established a separate National Advisory Panel on Insurance in Riot-Affected Areas.[2] The panel aptly described the situation as an "insurance crisis"[3] requiring a joint solution by property owners, the insurance industry, and local, state, and federal governments. This Comment will outline the history of FAIR plans, their federally mandated guidelines, and the state's implementation of such requirements. The impact of the recent Holtzman amendment, enacted in 1978, will also be explored. Fi-

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1. Housing and Urban Development Act of 1968, 12 U.S.C. §§ 1749bbb-1749bbb-21 (1976), *as amended by* Pub. L. 95-557, 92 Stat. 2097 (1978).

2. The President's National Advisory Panel on Insurance in Riot-Affected Areas, Meeting the Insurance Crisis of Our Cities (1968) [hereinafter cited as Panel Report]. The Panel was chaired by Richard J. Hughes, then Governor of New Jersey, and is sometimes referred to as the Hughes Panel. The Vice Chairman was William W. Scranton, former Governor of Pennsylvania. Other members were Frank L. Farwell, President, Liberty Mutual Insurance Co., George S. Harris, President, Chicago Metropolitan Mutual Insurance Co.; A Addison Roberts, President, Reliance Insurance Co.; Walter E. Washington, Commissioner, District of Columbia and Former Chairman, N.Y.C. Housing Authority; Frank M. Wozencraft, Ass't Attorney General in Charge of Office of Legal Counsel, U.S. Dep't of Justice. *Id.* at v.

3. A survey of approximately 1,500 businesspeople and 1,500 homeowners in poverty areas in six major cities revealed that more than 40% of businesspeople, and almost 30% of homeowners had serious property insurance problems. *Id.* at 2. For complete results of the survey, see *id.* at 126-60.

nally, the relationship between FAIR plans and arson-for-profit will be examined.

## II. History of FAIR Plans

In the Report by the President's National Advisory Panel on Insurance in Riot-Affected Areas, *Meeting the Insurance Crisis of Our Cities,*[4] the panel emphasized the role of insurance in the revitalization of urban core areas.[5] The Panel Report concluded that the insurance crisis resulted from the unavailability and high cost of property insurance in the nation's inner cities.[6] The Panel Report brought attention to the issue of insurance unavailability,[7] but its examination was limited in breadth by the government's attempt to avert further social and political upheaval. This was accomplished by focusing on one aspect of the urban problem: irresponsible insurance industry activity.[8]

Although heightened public concern about under-insurance in inner cities followed the riots of 1967,[9] the underwriting practices which aggravated the problem were in operation for more than twenty years. The beginnings of the residual market[10] comprising

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4. PANEL REPORT, *supra* note 2. The hearings which preceded the *Panel Report* are reported as the HEARINGS BEFORE THE PRESIDENT'S NATIONAL ADVISORY PANEL ON INSURANCE IN RIOT-AFFECTED AREAS (1967).

5. PANEL REPORT, *supra* note 2, at 1. The report stated:

> Insurance is essential to revitalize our cities. It is a cornerstone of credit. Without insurance, banks and other financial institutions will not—and cannot—make loans. New housing cannot be constructed, and existing housing cannot be repaired. New businesses cannot be opened, and existing businesses cannot expand, or even survive. . . . Communities without insurance are communities without hope.

*Id.*

6. *Id.* at 2. For a statistical documentation of the Panel's conclusion, see *id.* at 115-60 (Appendix A).

7. The term "insurance unavailability" also refers to the cost of insurance. If property coverage is unaffordable, it becomes, for all practical purposes, "unavailable."

8. An analysis of the multifarious causes of urban deterioration is beyond the scope of this Comment. The conduct of the insurance industry is only one factor contributing to the decline of the inner cities. A plethora of other factors exist, including those attributable to the government. Two notable examples of post-World War II federal policies largely responsible for urban decay were extensive highway construction, and the Federal Housing Administration's cheap mortgaging arrangements. These policies accelerated the growth of surburban areas and the flight of the middle class from urban areas.

9. *See* statements of urban core residents, PANEL REPORT, *supra* note 2, at 115-26.

10. The residual market includes those properties that insurers have systematically refused to insure. This "market of last resort" is

> a byproduct of the intense competition over the past twenty years by insurance companies for a select market: those homeowners considered least exposed to hazard . . . .

those properties deemed uninsurable by the voluntary market can be traced to the emergence of package homeowner policies in the early 1940's.[11] The risk selectivity fundamental to the insurance business excluded risks which insurance underwriters considered undesirable. Urban properties deemed insurable were typically denied comprehensive coverage and limited to traditional lines of insurance.[12] The terms which describe the presumption of uninsurability without reference to the individual property: redlining,[13]

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> The wider separation between homes in suburban settings reduced the risk of fire spreading from adjacent properties. Additionally, improved wiring and construction safeguarded homes from fires and made the suburban home a preferred risk from the viewpoint of the insurance industry.

FEDERAL INSURANCE ADMINISTRATION, U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, INSURANCE CRISIS IN URBAN AMERICA 3-4 (1978) [hereinafter cited as INSURANCE CRISIS REPORT]. In an effort to attract this business, insurers offered comprehensive coverage at reduced rates. *Id.* at 4.

11. *Id.* at 4 n.4. The report noted that

> [t]he advent of the homeowner policy in the early 40's followed the liberalization of State laws that permitted insurance companies to branch out into diverse insurance fields. As a result of this liberalization and the social changes in the 50's and 60's, the marketing of the homeowners policy intensified in suburban areas.

*Id.*

12. Traditional lines of insurance are limited to fire and extended coverage excluding burglary, theft, and personal liability. Extended coverage includes windstorm, hail, explosion, riot, riot attending a strike, civil commotion, aircraft, vehicles, and smoke. PANEL REPORT, *supra* note 2, at 19.

13. Redlining has become the generic term for any arbitrary geographical discrimination practiced by insurance companies or institutions. The name reflects the former practice of insurance companies evidenced by the following underwriting manual:

> An underwriter should be aware of the following situations in his territory:
> 1. The blighted areas.
> 2. The redevelopment operations.
> 3. Peculiar weather conditions which might make for a concentration of windstorm or hail losses.
> 4. The economic makeup of the area.
> 5. The nature of the industries in the area . . . .
>
> A good way to keep this information available is by *the use of a red line* around the questionable areas on territorial maps centrally located in the Underwriting Division for ease of reference by all Underwriting personnel.

PANEL REPORT, *supra* note 2, at 29 (emphasis added by PANEL REPORT).

While insurance companies may no longer explicitly identify which areas are redlined, the same exclusion occurs through more surreptitious methods. Redlining has been described as "a kind of arbitrary, guilt-by-association indictment of entire neighborhoods or even cities that excludes many decent risks from access to a free insurance market." INSURANCE CRISIS REPORT, *supra* note 10, at 28. Numerous reports by the National Association of Insurance Commissioners (NAIC) and such states as Illinois, Michigan, and New York, consistently reaffirm the continuance of the practice. *Id.* at 30-38.

The Federal Insurance Administration (FIA) analyzed neighborhood data compiled by the black-out maps, knock-out (KO) areas, and zip code zoning, convey the insurance industry's admonition regarding properties within such designated areas—"don't write the business."[14] The location approach resulted in "dumping" marginal properties into the high risk market.[15] The anticipation of decay often brought about its fruition.[16]

The insurance industry acknowledged the restricted market situation by 1966 and urged agents, insurance companies, government, rating bureaus, and insurance commissioners to accept the responsibility of providing insurance for well-maintained properties regardless of location or value.[17] Flexible rating plans were developed in accordance with the insurance maxim that "everything is insurable at a price." Insurance was sometimes written through a substandard rating plan, applying surcharges for specific hazards. An alternative method was writing insurance through an excess rate (ER) plan,[18] which required written consent to be charged over manual rates. A second alternative was obtaining insurance through the surplus lines market.[19]

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New York Public Interest Research Group (NY PIRG) and found a strong correlation between FAIR plan writing and racial composition (nonwhite areas having the heaviest concentration of FAIR plan policies). A strong correlation was also found with FAIR plan writing in areas with many vacant buildings. A weak correlation was found between FAIR plan writing and the age of the building. *Id.* at 30-38.

14. PANEL REPORT, *supra* note 2, at 6.

15. INSURANCE CRISIS REPORT, *supra* note 10, at 18.

16. *Id.* at 27-28.

17. II 1966 NAT'L ASS'N INS. COMMISSIONERS PROCEEDINGS 522, *cited in* Works, *Whatever's FAIR—Adequacy, Equity, And the Underwriting Prerogatives in Property Insurance Markets*, 56 NEB. L. REV. 445, 485 n.88. The industry's call for responsible action was not predicated on altruistic concerns. Rather, it was a desperate, but unsuccessful attempt to avoid governmental interference.

18. Excess rating plans allow an underwriter to charge higher rates based on perceived hazardous conditions not included in standard rate schedules. These might include factors such as the building's location in a heavily congested area or an area otherwise especially exposed to the spread of fire or inadequate fire protection for highly valued buildings. This method permitted complete rate flexibility so long as written consent was obtained. PANEL REPORT, *supra* note 2, at 33-34.

19. The surplus lines carrier of insurance offers specialized coverage, i.e., coverage not readily available in an area or to a certain class of insureds, and is often not licensed to do business in the State where the risk(s) is located. As provided by State charters, the surplus lines carrier does business in a State by transferring its insurance liability in whole or in part through reinsurance to State licensed companies. The attenuated connection between surplus carrier, reinsurer and policyholder leaves the consumer most vulnerable to summary cancellations of his insurance or to default of legitimate claims.

INSURANCE CRISIS REPORT, *supra* note 10, at 3 n.2.

In addition to authorizing price-differentiated rating structures, various states responded with some form of Urban Area Plan.[20] These plans attempted to provide a means for distinguishing between insurable and uninsurable properties, usually through an inspection by the local rating bureau. Results of the inspection were sent to the insurance company designated by the insured. The insurer maintained discretion over acceptance, conditional acceptance or denial of the risk. Periodic reports were usually required to be sent to the state insurance department so that participation could be monitored.[21] An alternative course was exemplified by the "Watts Pool," organized in California after the riots of 1965. The pool was intended to provide last chance coverage to those responsible property owners denied insurance elsewhere. The participating companies shared an agreed percentage of premiums, expenses and losses.[22]

The major recommendation of the Panel Report was to expand the type of services provided by Urban Area Plans by instituting state-regulated Fair Access to Insurance Requirements (FAIR) plans.[23] As an incentive to insurance industry participation, the Report suggested formation of a National Insurance Development Corporation (NIDC) to provide federal riot reinsurance for companies paying reinsurance premiums in FAIR plan states.[24]

## III. Federal Legislation

The Congressional response to the insurance crisis of American inner cities is found in the Urban Property Insurance and Reinsurance Act of 1968,[25] the statute authorizing FAIR plans and the con-

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20. Before 1968, Urban Area Plans were implemented, formally or informally, in the following states: California, Delaware, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, New York, North Carolina, Ohio, Pennsylvania, and Wisconsin. PANEL REPORT, *supra* note 2, at 56.

21. *Id.*

22. *Id.* at 75-79.

23. *Id.* at 87.

24. *Id.* at 101.

25. *See* note 1 *supra*. Congress, in its Findings and Declaration of Purpose of the 1968 Act, determined that

> the capacity of the private property insurance industry to provide adequate insurance is threatened, and the continuity of such property insurance protection is essential to the extension of credit in these areas; and . . . the national interest demands urgent action by the Congress to assure that essential lines of property insurance, including lines providing protection against riot and civil commotion damage will be available to property owners at *reasonable cost* . . . .

comitant federal riot reinsurance. FAIR plans are administered under the insurance authority in each state or authorized by state law.[26] Only those insurers participating in the FAIR plan can receive the benefits of riot reinsurance. In the spirit of the "creative federalism"[27] of the sixties, and in recognition of insurance as primarily a state concern,[28] the federal guidelines were designed to be broad enough to allow for variations by cooperating states.[29] The 1968 Act

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> The purposes of this title are, therefore, to (1) encourage and assist the various State insurance authorities and the property insurance industry to develop and carry out statewide programs which will make necessary property insurance coverage against fire, crime, and other perils more readily available for residential, business, and other properties meeting reasonable underwriting standards; and (2) provide a Federal program of reinsurance against abnormally high property insurance losses resulting from riots and other civil commotion, placing appropriate financial responsibility on the States to share in such losses . . . .

S. 3497, 90th Cong., 2d Sess., *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 547, 648.

26. 12 U.S.C. § 1749bbb-3(b).

27. MESSAGE FROM PRESIDENT JOHNSON TO THE CONGRESS, H.R. DOC. No. 251, 90th Cong., 2d Sess., 114 CONG. REC. 3956, 3959 (1968).

28. Up until 1944, the Supreme Court had consistently held that "[i]ssuing a policy of insurance is not a transaction of commerce." Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183 (1869). The cases which reaffirmed this position all dealt with the validity of state statutes, *e.g.*, Hooper v. California, 155 U.S. 648 (1895); New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495 (1913), and not with any Act of Congress. In United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944), the Court held that an insurance company which conducts its business across state lines is not beyond the regulatory power of Congress under the Commerce Clause of the Constitution. *Id.* at 553.

After finding that a price-fixing conspiracy existed, the Court also held that Congress did not intend to exempt insurance from the broad scope of the Sherman Act. *Id.* at 560. The Court noted the exaggeration inherent in the argument that the Sherman Act would invalidate many state insurance laws, stating: "[n]o states authorize combinations of insurance companies to coerce, intimidate, and boycott competitors and consumers in the manner here alleged, and it cannot be that any companies have acquired a vested right to engage in such destructive business practices." *Id.* at 562. The McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (1976), reasserted the authority of the states to regulate and tax insurance companies if not contrary to the will of Congress. Seizing on the language of Justice Black in the majority opinion in South-Eastern Underwriters, the application of the Sherman Act to the insurance business was narrowed by the McCarran-Ferguson Act to cases of "boycott, coercion, or intimidation." 15 U.S.C. § 1013(b) (1976). The Court noted, however, that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act "shall be applicable to the business of insurance to the extent that such business is not regulated by State law." 15 U.S.C. § 1012(b) (1976).

29. 12 U.S.C. § 1749bbb-3(b). An overview of the functioning of FAIR plan operations will be helpful to illustrate the various approaches. Data from Puerto Rico were not available. FAIR plan associations can operate as one of three different types of carriers: seventeen are syndicates (the FAIR plan operates like an insurance company), seven are single servicing carriers (one insurance company performs the administrative functions), and three are multiple servicing carriers (several companies perform the administrative functions). Regardless of the type of plan organization, profits and losses are shared by all insurance companies

indicates that FAIR plans are "designed to make essential property insurance more readily available in, but not necessarily limited to, urban areas.[30]

There are ten minimum federally imposed criteria,[31] adopted almost entirely from the Panel Report,[32] which must be included in each state's FAIR plan. No risk is to be written at surcharged rates or denied essential property insurance unless an inspection reveals that the risk does not meet "reasonable underwriting standards at the applicable premium rate."[33] Essential property insurance is defined as:

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participating in the plan within the state. PROPERTY INSURANCE PLANS SERVICE OFFICE (PIPSO), NATIONAL COMMITTEE ON PROPERTY INSURANCE, PIPSO COMPENDIUM OF INDIVIDUAL STATE PROPERTY INSURANCE PLANS 6 (1979) [hereinafter cited as PIPSO REPORT]. Sixteen FAIR plans provide statewide coverage, eight cover only specific geographic areas. Two other plans have independent criteria for eligibility (*e.g.*, in Kentucky, eligibility is based on fire protection class ratings of one through eight; in California, the Insurance Commisioner designates eligible urban and brush areas). *Id.*

All plans provide minimum coverage which includes fire, extended coverage and malicious mischief. Four plans provide crime insurance (California, Michigan, New Jersey, and Wisconsin) and six plans include sprinkler leakage. Illinois, Rhode Island, Massachusetts, and Wisconsin provide a package homeowner policy. *Id.* The state legislatures redefined "basic or essential property insurance" to include this homeowner coverage. A federal amendment was proposed to accomplish the same result. *See* note 34 *infra.*

Twenty-one states exclude farm properties from FAIR plan coverage. Fifteen states exclude manufacturing concerns (with four allowing coverage on certain conditions relating to number of employees or insurable value). Seven states exclude mobile homes, except six cover the homes if they have permanent foundations. *Id.* at 7, 13.

30. 12 U.S.C. § 1749bbb-3(b). Although this Comment concentrates on the impact of FAIR plans in urban areas, many low value rural properties are insured by FAIR plans. Also, seven states have a similar program for sharing high risks from natural disasters through State Beach Plans. These states are Alabama, Florida, Louisiana, Mississippi, North Carolina, South Carolina, and Texas. PIPSO REPORT, *supra* note 29, at 17-25.

31. 12 U.S.C. §§ 1749bbb-3(b)(1) to -3(b)(10).

32. PANEL REPORT, *supra* note 2, at 87-113 (Recommended Program to Solve Urban Core Insurance Problems).

33. 12 U.S.C. § 1749bbb-3(b)(1). It is significant that such a crucial term to the proper functioning of FAIR plans as "reasonable underwriting standards" is not defined. For a comprehensive discussion of this and related issues, see Works, *Whatever's FAIR—Adequacy, Equity, And the Underwriting Prerogative in Property Insurance Markets*, 56 NEB. L. REV. 445.

It is possible to predict which properties will probably not meet "reasonable underwriting standards" on the basis of various state standards for "uninsurable property." All FAIR plans exclude properties which are vacant and open to trespass, properties in poor physical condition, including unrepaired fire damage, and properties which are used in violation of law or public policy. Twenty states disallow coverage on the basis of poor housekeeping, including overcrowding or storage of rubbish and flammable materials. Two states deny inclusion in the FAIR plan due to violations of building and safety codes. Three states (Illinois, Montana, and New York) make properties with delinquent taxes ineligible. PIPSO REPORT, *supra* note 29, at 7.

> insurance against direct loss to property as defined and limited in standard fire policies and extended coverage endorsement thereon, as approved by the State insurance authority, and insurance for such types, classes, and locations of property against the perils of vandalism, malicious mischief, burglary, or theft, as the Secretary by rule shall designate. Such insurance shall not include automobile insurance and shall not include insurance on such types of manufacturing risks as may be excluded by the State insurance authority.[34]

Under a FAIR plan, property owners have a right to an inspection and insurance if the property meets the usual standards for insurability. Either the property owner, his representative, the insurer, agent, broker, or other producer may request an inspection.[35] A tenant may obtain an inspection and insurance under the plan despite the building owner's absence.[36] The inspection report is sent to the insurer or an all-industry placement facility.[37]

The ultimate discretion is left to the insurer to determine whether the risk meets the "reasonable underwriting standards" criteria. This is a questionable policy, as is demonstrated by the original rationale for the FAIR plans. These urban properties were denied insurance on the voluntary market precisely because the risk seemed unreasonably high. The Panel Report determined that the classification of certain risks as unreasonably high, often was not predicated on any factor other than geographic location.[38] The only countervailing provision to this practice appears as a condition for obtaining riot reinsurance. A state or the property insurance industry in a state must comply with the FAIR plan requirements *and* agree "to make essential property insurance available without regard to environmental hazards."[39] Environmental hazard is defined as "any hazardous condition that might give rise to loss under an

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34. 12 U.S.C. § 1749bbb-2(a)(5). Congresswoman Holtzman introduced a bill to amend § 1203(a)(5) of the National Housing Act which did not pass. 124 CONG. REC. H2661 (daily ed. April 10, 1978). The bill would have added the following language to the definition of "essential property insurance": "Such insurances shall include forms of insurance which are by the Secretary, by rule, to be property insurance primarily (notwithstanding that they contain and element of liability or other casualty insurance), such as, but not limited to, homeowners insurance." *Id.*

35. 12 U.S.C. § 1749bbb-3(b)(2). The inspection request need not be in writing. *Id.*

36. *Id.* § 1749bbb-3(b)(3).

37. *Id.* § 1749bbb-4.

38. PANEL REPORT, *supra* note 2, at 5-6.

39. 12 U.S.C. § 1749bbb-9(a)(2).

insurance contract, but which is *beyond the control of the property owner.*"[40]

The insurer may agree to write insurance immediately,[41] on a contingent basis if specified improvements are made,[42] or refuse to write the insurance with specific reasons for such action.[43] The prospective insured is entitled to appeal the insurer's decision to the state insurance authority and must be informed of this right by the insurance agent.[44] Provisions are made for coding FAIR plan policies[45] for evaluation purposes and for statistical reports on acceptance, conditional acceptance and denials.[46] The statute also mandates reasonable notice requirements before cancellation or nonrenewal.[47] Finally, in order to reach those intended to benefit by the availability of FAIR plans, continuing public education programs are to be undertaken by insurers, agents, and brokers.[48]

Each FAIR plan must include an all-industry placement facility[49] which arranges inspections, distributes the risks equitably among insurers and seeks to provide insurance up to the full insurable value of the risk. Industry cooperation is specifically enlisted through a pledge by insurers to fully participate in carrying out the FAIR plan.[50] Federal control was enhanced by providing that the Secretary of Housing and Urban Development (HUD) may, after consultation with the Advisory Board,[51] modify plan criteria if such action

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40. *Id.* § 1749bbb-2(a)(4) (emphasis added).

41. *Id.* § 1749bbb-3(b)(5)(A)(i). The insurer may also write the insurance with surcharges (where authorized), but must inform the insured of improvements which could be made to reduce the charge to an unsurcharged premium rate. *Id.*

42. *Id.* § 1749bbb-3(b)(5)(A)(ii).

43. *Id.* § 1749bbb-3(b)(5)(B).

44. *Id.* § 1749bbb-3(b)(6). Appeals can concern the decision not to insure, cancellation, non-renewal, or premium rate assessment. Typically, the seeker of insurance must address any complaints to the FAIR plan itself before appealing to the state insurance authority, except that FIA requirements eliminate this intermediary stage when an insured appeals a five-day cancellation notice.

45. *Id.* § 1749bbb-3(b)(7).

46. *Id.* § 1749bbb-3(b)(8).

47. *Id.* § 1749bbb-3(b)(9).

48. *Id.* § 1749bbb-3(b)(10).

49. *Id.* § 1749bbb-4.

50. *Id.* § 1749bbb-5.

51. *Id.* § 1749bbb-1 establishes an Advisory Board of nineteen members, appointed by the Secretary of Housing and Urban Development (HUD). The Board, by statute, must include representatives of the insurance industry, the public, state and local governments, and the federal government. The Board's functions entail review of policies and general advisement to the Secretary as the Board sees fit. *Id.*

would improve the programs, or waive certain criteria if local circumstances justify this action.[52]

The Secretary of HUD is authorized to offer to any insurer or pool, subject to certain conditions,[53] reinsurance against property losses resulting from riots or civil disorders.[54] The basic reinsurance contract offers combined reinsurance only on standard lines of property insurance,[55] including fire and extended coverage, vandalism and malicious mischief, other allied lines of fire insurance, burglary and theft, and analogous risks covered by multiple peril policies.[56] Insurers may then separately purchase reinsurance on lines including inland marine, glass, boiler and machinery, ocean marine, aircraft, physical damage, and such other lines which the Secretary may designate by regulation.[57] The 1968 Act's provision for reinsurance coverage for losses from riots or civil disorders was designed to serve two purposes: (1) to reassure insurance companies fearful of insuring in inner-city areas due to the potential of disastrous losses from further urban disruptions, and (2) to operate as an incentive to participate in authorized FAIR plans, since only FAIR plan insurers

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52. *Id.* § 1749bbb-6.

53. *Id.* § 1749bbb-9.

54. *Id.* § 1749bbb-7(a)(1). The contract, at § XVII (8) provides these definitions:

> (8) "Loss resulting from riot" means:
> loss of or damage to property actually and immediately resulting from an overt and tumultuous disturbance of the public peace by three or more persons mutually assisting one another, or otherwise acting in concert, in the execution of a common purpose through the unlawful use of force and violence.
> "Loss resulting from civil disorder" means:
> (A) Loss of or damage to property actually and immediately resulting from any pattern of unlawful incidents taking place within close proximity both as to time and place and involving damage to property intentionally caused by persons apparently having the primary motivation of disturbing the public peace through civil disruption, civil disobedience, or civil protest; provided that at least two of such related incidents result in property damage in excess of $1,000 each; or
> (B) Loss of or damage to property actually and immediately resulting from any occurrence involving property damage in excess of $2,000 caused by persons whose unlawful conduct in so causing the occurrence manifests their primary purpose of disturbing the public peace through civil disruption, civil disobedience, or civil protest.

*See* Federal Insurance Administration, Reinsurance Claims Guidelines 1 (August 1977).

This definition basically follows the common law definition of riot. The disturbance must be clamorous and violent and must involve at least three persons. In addition, there must be evidence of concerted intent to cooperate among the perpetrators. There must be an unlawful use of force which results in property damage. *Id.*

55. 12 U.S.C. § 1749bbb-7(a)(2).

56. *Id.* § 1749bbb-2(a)(13)(A)-(E).

57. *Id.* § 1749bbb-2(a)(13)(F)-(K).

are eligible for federally subsidized reinsurance.[58]

The statute provides for a commitment by each state to reimburse the Department of Housing and Urban Development for certain reinsured losses in a given contract year up to five percent of the aggregate property insurance premiums earned in a state for reinsurance. This provision is activated only when the reinsured losses paid exceed the total of reinsurance premiums received and the excess of "(i) the total premiums earned by the Secretary for reinsurance in that State . . . over (ii) any amounts paid by the Secretary for reinsured losses that were incurred during such period."[59] In addition to the reserve funds of each state in the National Insurance Development Fund (NIDF) accumulated from reinsurance premiums which would be exhausted before state participation is required, there is an additional buffer provided by a floating nationwide reserve fund, which at present has approximately $28 million of unallocated funds.[60] The procedures by which each state obtains resources to pay their share of the losses when required, are determined individually by each state. No riot loss to date has triggered the provision calling for state involvement in riot losses.[61] Reinsurance is only available to insurers in a state with a FAIR plan which includes a provision making essential property insurance available without regard to environmental hazards. As previously noted,[62] this provision is designed to curtail redlining practices.

Two important amendments were passed in 1970.[63] The Housing and Urban Development Act of 1970 established an Office of Review

58. *Id.* §§ 1749bbb-7 to -10. Recently, due to the Holtzman amendment which requires that FAIR plan rates be equal to voluntary market rates as an additional condition for obtaining federal riot reinsurance, *see* text accompanying note 75 *infra*, the need for federal riot reinsurance has been questioned. Opponents to the amendment assert that reinsurance can be obtained in the private market at affordable rates. The rates are considered affordable, even if higher than the rates charged by the federal government, in view of the savings to the insurer by not lowering FAIR plan rates to voluntary market levels, as required by the Holtzman amendment. News from N.Y. State Senator John R. Dunne, Fire Insurance Under the "FAIR" Plan: The Federal Directive to Lower Fire Insurance Rates for "FAIR" Plan Policyholders: Should [New York] State Comply? at 4 (Jan. 22, 1979).

59. 12 U.S.C. § 1749bbb-9(a)(1).

60. News from Congresswoman Holtzman 2 (Jan. 29, 1979).

61. INSURANCE CRISIS REPORT, *supra* note 10, at 5.

62. 12 U.S.C. § 1749bbb-9(a)(2). *See* text accompanying note 40 *supra*.

63. Housing and Urban Development Act of 1970, 12 U.S.C. § 1749bbb-6a, -10a (1970). For a discussion of these amendments, see Comment, *The Central City Insurance Crisis: Experience Under the Urban Property Protection and Reinsurance Act of 1968*, 38 U. CHI. L. REV. 665 (1971).

and Compliance[64] under the Federal Insurance Administration (FIA), and agency under the Department of Housing and Urban Development (HUD), to insure that the purposes of the 1968 Act were being carried out, especially regarding the mandate to make essential property insurance "readily available."[65] The more substantive change was the creation of direct federal insurance against burglary and theft.[66] The Secretary of HUD was granted authority to ascertain whether crime insurance "is available at affordable rates."[67] To remedy the market's failure to provide this commodity through private or state action, the Secretary was empowered to offer crime insurance through the facilities of the federal government.[68]

## IV. The Holtzman Amendment

The Holtzman amendment, named after its sponsor, Congresswoman Elizabeth Holtzman, became law on October 31, 1978.[69] Section 1749bbb-3 was amended by adding the following new subsection at the end thereof:[70]

> (c) At least one-third of the voting members of every board of directors, board of governors, advisory committee, and other governing or advisory board or committee for each plan described in subsection (b) shall be individuals who are not employed by, or otherwise affiliated with, insurers, insurance agents, brokers, producers, or other entities of the insurance industry.

The provision requiring at least one-third of the voting members of the FAIR plan governing boards to be independent representatives of the public, unconnected with the insurance industry would, according to its sponsor, "help assure protection of consumers in the plan and neighborhoods served by it. Given the critical impact of board decisions on the future of many neighborhoods, it is unconscionable not to allow citizens to have a voice in policies which affect them so directly."[71] The FAIR plan states split three ways regarding

64. 12 U.S.C. § 1749bbb-6a.

65. *Id.*

66. *Id.* § 1749bbb-10a.

67. *Id.* § 1749bbb-10a(a). "Affordable rate" is defined as: "Such premium rate as the Secretary determines would permit the purchase of a specific type of insurance coverage by a reasonably prudent person in similar circumstances with due regard to the costs and benefits involved." *Id.* § 1749bbb-2(a)(1).

68. *Id.* § 1749bbb-10a(b).

69. Pub. L. 95-557, 92 Stat. 2097 (1978) (amending 12 U.S.C. § 1749bbb-3).

70. 92 Stat. at 2097-98.

71. 124 CONG. REC. H2660 (daily ed. April 10, 1978) (remarks of Rep. Holtzman).

compliance with the public membership provision. One-third of the states have adopted the required number of public representatives, one-third have not complied, and one-third have remained undecided.[72] In response to questions by the House Subcommittee on Housing and Community Development, the American Insurance Association (AIA) stated: "AIA would welcome representation on FAIR plan governing boards by responsible members of the public. . . . Those representatives have often made constructive contributions."[73] This enthusiastic support was tempered by another official statement which conditioned fulfillment of the proposal on the industry's retention of majority control.[74]

The Holtzman amendment also added the following provision to section 1749bbb-3(b):[75]

> (11) Notwithstanding any other provision of this section, on and after January 31, 1979, no risk within the plan shall be insured at rate higher than the rates set by the principal State-licensed rating organization for essential property insurance in the voluntary market, except that this provision shall not be deemed to prohibit the application to any such risk, on a nondiscriminatory basis, of condition charges for substandard physical conditions within the control of the applicant for insurance as set by the principal State-licensed rating organization for the voluntary market.

The bitter controversy over the Holtzman amendment focused

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72. It is expected that the states which have not yet adopted the minimum one-third public representative membership quota on the various boards and committees, will comply before the federal riot reinsurance contracts expire on September 30, 1979. FIA issues these contracts for one year terms. It should be noted that whereas riot reinsurance was terminated for companies obtaining reinsurance in states which had not complied with the rate equalization mandate, similar action was not taken cancelling reinsurance on the basis of noncompliance with the public representation mandate. The different consequences of noncompliance are attributable to the language of the amendment itself. The public representative section indicates no particular time limitation. It is expected that compliance will be necessary to obtain or renew reinsurance contracts for the next contract term period. However, the rate parity section specifically indicates that FAIR plans must alter their rating schedules, where necessary, by January 31, 1979. Failure to meet this deadline resulted in cancellation of riot reinsurance contracts. Interview with Property Insurance Plans Service Office (PIPSO) (May 10, 1979).

73. Testimony by the Honorable Elizabeth Holtzman before the New York State Insurance Department 8. (Jan. 8, 1979) [hereinafter cited as Holtzman Testimony].

74. George M. Mulligan, vice president and associate general counsel of the American Insurance Association noted: "The retention of majority control of the FAIR Plan's board of directors is also an important element of our committee considerations in order to assure that the FAIR Plan is operating in an efficient manner." American Insurance Association News 2 (Jan. 8, 1979).

75. 92 Stat. at 2097-98.

almost entirely on the equalized rating scheme. Opponents felt that the federal legislation was introduced by the New York Congresswoman solely to alter New York's self-rating system.[76] This assertion was rebutted by demonstrating that eleven jurisdictions had higher rates than the voluntary market[77] and the trend of FAIR plan rating had been decidedly towards imposing higher rates.[78]

Given the clear Congressional intent of the 1968 Act to make insurance available at a "reasonable cost,"[79] the amendment's sponsor believed the amendment should not have been necessary.[80] However, FAIR plans came into being in the aftermath of the rioting of the 1960's, as an emergency response to the inner city insurance crisis. Ten years later, the sense of urgency was gone. Public attention waned. Redlining practices proliferated,[81] resulting in

76. New York state law requires that the premiums the FAIR plan collects be sufficient to pay for the claims that it satisfies. This policy is referred to as "self-rating." N.Y. INS. LAW §§ 651-62 (McKinney Supp. 1978). Due to the presence of some legitimately higher risk properties covered by the plan, a greater ratio of claims are paid than in the normal market. Therefore, premium rates charged for FAIR plan policies range from 250 to 500 percent of private market rates for similar properties. News from Congresswoman Holtzman (Jan. 8, 1979). The sentiment that the amendment was designed to alter only New York's policy is expressed as follows: "We should not, because there is a problem in the State of New York, be passing a Federal law which in effect will dictate in an extremely rigid way how the other 49 States shall handle the rating of their insurance policies." 124 CONG. REC. H7123 (daily ed. July 21, 1978) (remarks of Rep. Brown).

77. The following eleven states had FAIR plan rates exceeding those in the voluntary market before the Holtzman amendment: Connecticut, Delaware, Iowa, Kansas, Kentucky, Minnesota, Missouri, New York, Oregon, Virginia, and Wisconsin. Illinois uses an "open rating law," so that FAIR plan rates cannot be compared to voluntary market rates. PIPSO REPORT, *supra* note 29, at 10, 16.

78. In 1975, only three states had higher FAIR plan rates than the private market. By 1979, the number had increased to eleven with rate disparities. Holtzman Testimony, *supra* note 73, at 1.

79. *See* note 25 *supra*.

80. Holtzman Testimony, *supra* note 73, at 2.

81. The FIA described the difficulties inherent in FAIR plans as follows:

> The keystone in the arch of deficiencies in the property residual market—indeed within the total property and liability market—is continuation of the absolute right of insurer underwriters to deny essential insurance to applicants without reason or for arbitrary and capricious reasons which are entirely subjective in nature and which may have much more to do with the insurers' competitive moods, modes, and postures than with the objectively determined loss-potential characteristics of the risks. So long as the exercise of untrammeled underwriting selection remains the right of insurers, the insurance regulator has little, if any, means of assisting the disadvantaged insurance consumer. Measures such as anti-discrimination statutes and regulations have been proved demonstrably inadequate to halt discrimination save in cases of the most blatant exercise of racial or ethnic discrimination . . . .

INSURANCE CRISIS REPORT, *supra* note 10, at 19.

"dumping"[82] marginal insurance risks into the residual FAIR plan market. The need for the Holtzman amendment became apparent. The amendment's provision for rate parity is one weapon to combat the effects of redlining by eliminating premium levels which are excessive for the sole reason that the property was denied insurance in the voluntary market.

The insurance industry was never enthusiastic about insuring inner city properties.[83] However, the industry responded to the fed-

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82. In British and Foreign Marine Insurance Co. v. Stewart, 30 N.Y.2d 53, 281 N.E.2d 149, 330 N.Y.S.2d 340 (1970), the New York Insurance Department tested the propriety of "dumping" risks previously written in the voluntary market into the newly created FAIR plans. The statutory provisions of the New York FAIR plan required mandatory participation in the residual market pool with insurance companies sharing profits and losses according to their share of business written in the state. The "Royal Globe Insurance Companies" (a single business enterprise of seven insurance companies) proceeded to substantially reduce their fire insurance liability in ghetto or riot-prone areas by cancelling or not renewing commercial insurance policies in these areas. The New York Insurance Department fined Royal Globe for racial discrimination based on its systematic cancellation of commerical line policies in predominantly black areas in violation of N.Y. INS. LAW § 40(10) (McKinney 1966) which provides in pertinent part that no insurance company "shall make any distinction or discrimination between persons because of race, color, creed or national origin, as to the premiums or rates charged for insurance policies or in any other manner whatever." *Id.*

The insurance company successfully appealed based on their contention that the actions were prompted by legitimate business judgment (to avoid over-commitment to riot-prone areas) rather than by racially discriminatory motives. The court held that geographic discrimination, irrespective of the racial composition of the geographic area, did not constitute racial discrimination. The court based its holding on a twofold rationale. First, the insurance companies continued to write "personal line" fire insurance in the designated areas, thus dispelling a discriminatory motive. Second, the effect of the cancellation by these insurance companies was to force the commercial property owners to seek insurance coverage from the state FAIR plan. The court noted that requiring certain owners of high risk properties to obtain insurance through the residual market mechanism was "precisely the reason that the pool was established." 30 N.Y.2d at 60, 281 N.E.2d at 152, 330 N.Y.S.2d at 344. The result was the vindication of the untrammeled discretion of insurance companies to commit risks to the residual market mechanisms, *i.e.*, FAIR plans.

83. *See* notes 10, 13 *supra*. However, the insurance industry has taken some steps to meet the special problems of serving the residual insurance market. The National Committee on Property Insurance (NCPI) is a non-profit advisory organization created in 1976. The Property Insurance Plans Service Office (PIPSO) coordinates activites and provides information and other services to the twenty-eight FAIR plans. PIPSO, once a division of the Insurance Services Office (ISO), is now a division of NCPI. The objectives of NCPI are to:

* Improve the public image of FAIR Plans—Now
* Represent the interests of property insurers in providing oversight review of residual market activities
* Provide management assistance and consulting expertise to the Plans and establish improved standards for their performance.

NATIONAL COMMITTEE ON PROPERTY INSURANCE, NEW PERSPECTIVES iii (Sept. 1, 1978).

eral government's proposals by participating in state authorized FAIR plans. Federal riot reinsurance was the primary inducement offered to the insurance companies in return for their cooperation.[84] Protection from insolvency due to nationwide rioting or major rioting in a more concentrated area, is essentially the "carrot" proffered by the federal governement.[85] The amendment provides that states which fail to restructure their FAIR plan rating schemes by January 31, 1979, if this is necessary to bring these states into compliance with the rate parity provision, will disqualify insurance companies from obtaining reinsurance on risks written in those states. The Holtzman amendment requires FAIR plan rates to be no higher than those of the state's major rating organization. This level is used as a general indicator of current competitive rates by the insurance companies. Actual rates are typically lower than this recommendation.[86]

The FIA's studies demonstrate that insurance companies have a consistently higher overall profit in FAIR plan states than in non-FAIR plan states.[87] While numerous other factors such as variable corporate tax treatment and the effect of urban populations on underwriting costs may affect these results, it is significant that FAIR plans have not prevented the industry from maintaining a high level of profits.[88] These considerations however, do not alleviate the perennial insurance residual market problem. Insurance is a profit-making industry, but also a social and economic necessity. The attempt to strike a balance between socially mandated rates and actuarially sound rates[89] is the threshold issue which is rarely addressed. The Holtzman amendment reflects the federal govern-

84. 12 U.S.C. §§ 1749bbb-7 to -10.

85. The *Panel Report* recommended providing riot reinsurance as a backup for insurance companies in the event of large riot losses to encourage the industry to provide essential property insurance for inner cities. PANEL REPORT, *supra* note 2, at 9.

86. INSURANCE CRISIS REPORT, *supra* note 10, at 26.

87. *Id.*

88. Congresswoman Holtzman also noted that compliance with the Holtzman amendment will not bankrupt the insurance industry.

> In fact, since the risk will simply be spread more broadly statewide, it is unlikely that the industry will suffer any financial dislocation whatsoever. In any event, given the fact that *Business Week* reported that the property-casualty insurers posted a record 21% return on net worth in 1977 (its previous high was 12% in 1972), I am certain the industry can survive the Holtzman Amendment.

Holtzman Testimony, *supra* note 73, at 4-5.

89. See discussion of underwriting profits, combined loss and expense ratio, investment profit, and rate of return in PANEL REPORT, *supra* note 2, at 40-48.

ment's commitment to the public policy of making property insurance available in urban core areas. Its implementation curtails the practice of price differentiation based on whether insurance is obtained in the voluntary market or the state authorized FAIR plan. The most important effect is the reduction of the disparate treatment that resulted from classification as a FAIR plan property.[90]

However, other practices remain which impose harsher treatment on FAIR plan properties. For instance, although both FAIR plan and voluntary market properties are subject to condition surcharges, these are only a practical reality for FAIR plan properties. Because of the expense constraints on insurers, private market properties are rarely inspected,[91] making assessment of condition charges extremely unlikely. Alternatively, inspection is almost universal in the residual market, allowing surcharges to be levied at the individual inspector's discretion. A further distinction exists in the more liberal policy terms which accompany comprehensive package policies in the voluntary market. FAIR plans generally provide only the minimum coverage, thereby eliminating the benefits of cost-efficient package policies.[92] It is also rare for FAIR plan insureds to receive the same customer services as private market policyholders,[93] e.g., premium payment plans and available agents.

From 1969 to the end of end of 1977, FAIR plans have had nationwide operating losses of $16,787,000.[94] These losses are absorbed by

90. INSURANCE CRISIS REPORT, *supra* note 10, at 26.

91. The National Association of Independent Insurers (NAII) estimates that a thorough inspection of a dwelling costs between $25 and $50. Due to the political, social, and competitive pressures on insurers to keep prices down, the companies assert that they must carefully allocate the inspections which can be afforded. NATIONAL ASS'N OF INDEPENDENT INSURERS, ARSON-FOR-PROFIT AND THE INSURANCE INDUSTRY: VICTIM OR VILLAIN? 2 (1978).

92. *Id.* at 20-21.

93. Holtzman Testimony, *supra* note 73, at 8.

94. FEDERAL INSURANCE ADMINISTRATION, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, FAIR PLAN OPERATING POSITIONS (Aug. 1978). The following figures provide statistical operational data concerning the operations of FAIR plans from 1969 to 1977:

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|---|---|
| Written premiums: | $1,322,690,000. |
| Investment income: | 38,757,000. |
| Total Operating Income: | $1,361,447,000. |
| Losses paid: | $1,037,698,000. |
| Inspection expense: | 29,460,000. |
| Commissions to agents: | 136,597,000. |
| All other operating expenses: | 174,479,000. |
| Total Operating Expenses: | $1,378,234,000. |

the industry and passed on to insurance consumers. The Holtzman amendment denies reinsurance benefits to companies seeking to reinsure risks in a state which provides that FAIR plan insureds must subsidize their own losses, either completely or up to a certain percentage. States which have failed to equalize FAIR plan rates with voluntary market rates, excluding reasonable surcharges for objectively determined and individualized hazardous conditions, no longer qualify for federal riot reinsurance.[95]

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|---|---|
| Operating Expenses: | $1,378,234,000. |
| Operating Income: | - 1,361,447,000. |
| Total Operating Results: | -$ 16,787,000. |

It should be noted that it was not expected that FAIR plans would operate at a profit. The residual market mechanism was intended to provide a means for equitably sharing the risks of providing essential property insurance to urban core properties and low value rural properties.

The most recent data compiled by the Property Insurance Plans Service Office (PIPSO) for the first nine months of 1978 reveal a net operating loss of $25.4 million, representing a 55% decline in losses from the comparable 1977 experience. The statutory underwriting losses were $32.9 million for this period. The reduced overall loss figure is reached by offsetting the statutory underwriting loss by investment income of $7.5 million earned during the same nine months. News from the National Committee on Property Insurance (NCPI) prepared by Insurance Information Institute (April 4, 1979).

95. Conditioning the retention of federal riot reinsurance benefits on compliance with the Holtzman amendment proved an inadequate incentive for those opponents who asserted that federal riot reinsurance was a "bad buy." News from N.Y. State Senator Dunne 3 (Mar. 18, 1979). The National Association of Insurance Commissioners (NAIC) completed a study which opponents refer to in support of their contention that federal reinsurance is not necessary. The report found that since its inception in 1968, close to $84 million in premiums were collected, while less than $14 million in claims were paid out. It was also suggested that if a large riot occurred today, the federal government would pay only 3 to 5 percent of the losses. Statement of Senator John R. Dunne on Recent Proposals Concerning Fire Insurance and the New York FAIR Plan 11 (Feb. 27, 1979). The Federal Insurance Administration (FIA) responded to the NAIC study by demonstrating alternative situations in which the federal government would pay greater percentages of major riot losses. The complex scheme of the riot reinsurance program involves twenty-three layers of sharing of losses between the reinsured company, the state, the National Insurance Development Fund (NIDF), and if necessary, the U.S. Treasury. The ultimate purpose which the reinsurance policy serves is to protect insurance companies from insolvency due to catastrophic riot losses. The contract provisions and the levels of sharing losses operate to insure that a particular company will not be destroyed due to the excessive losses attending major rioting, according to FIA officials.

Opponents also assert that reinsurance is available in the voluntary market at slightly higher rates. Others refute this point, arguing that participation in the reinsurance program has always been voluntary, and yet insurance companies continually purchased reinsurance from the federal government, apparently because it was the best buy. News from Congresswomen Holtzman 2 (Jan. 29, 1979). The assertion that riot reinsurance is readily available in the private market was undermined by a recent suit brought in the U.S. District Court for the District of Columbia. Several insurance companies whose reinsurance contracts

Seventeen of the twenty-eight FAIR plan states operated their residual insurance pools without charging automatically higher premiums on policies written through the FAIR plan.[96] The Holtzman amendment did not affect the financial operations of these plans. Six of the eleven states which required adjustment of their FAIR plan rating structure in order to comply with the amendment made the necessary changes.[97] On February 3, 1979, letters were sent to the FAIR plan authorities in the five remaining non-complying states: Iowa, Minnesota, Missouri, New York, and Virginia, cancelling their entitlement to riot reinsurance for failure to revise their automatically imposed FAIR plan premium surcharges.[98]

Advocates of the recent statutory change point out the fairness of spreading risks over the entire market rather than only the residual market. The Urban Coalition and the New York Public Interest Research Group (NY PIRG) estimated that "75% of FAIR plan policyholders whose sole risk-increasing characteristic is geographic

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were cancelled following the failure of certain states to comply with the Holtzman amendment's rate equalization provision brought an action for reinstatement of their policies until the end of the contract term. The complaint alleged that such coverage could not be obtained elsewhere. United States Fire Ins. Co. v. United States Dep't of Housing and Urban Development, No. 79-1290 (D.D.C., filed May 11, 1979).

The federal government now offers riot reinsurance at a cost of approximately $.02 per $100 of direct premiums earned. These rates are substantially lower than the rates in force when the legislation was first passed in 1968. At that time, the cost was $1.25 per $100 of direct premiums earned. The difference is attributed to the growth of the reserves accumulated over the past eleven years. For private companies to offer the same type of coverage, it would be necessary to first build up a reserve. It is estimated that the cost of private reinsurance would be as much as sixty times higher than federal riot reinsurance until the reserve was in force for several years.

Finally, federal riot reinsurance cannot be cancelled unless the reinsured violates the federal conditions set out in 12 U.S.C. § 1749bbb-9, which basically provides that the company must participate in a state authorized FAIR plan which is in compliance with all federal directives. It is unlikely that private reinsurers will put themselves in a position of total exposure. Currently, reinsurers avoid this by providing that policies will be cancellable at the reinsurer's option on short notice. In addition, the private reinsurance market has indicated that FAIR plan business would not be reinsured at all. Under the federal riot reinsurance, the insurance companies, not the FAIR plans, are the purchasers of reinsurance. According to the federal provisions, the insurance companies can reinsure all policies with the federal riot reinsurance which is offered. Panel Discussion, Association of the Bar of the City of New York, Is the "FAIR PLAN" Fair? (remarks by Congresswoman Holtzman) (May 17, 1979) [hereinafter cited as Panel Discussion].

96. PIPSO REPORT, *supra* note 29, at 10.

97. Interview with Property Insurance Plans Service Office (PIPSO)(May 10, 1979).

98. *Id.*

location are being forced to subsidize the genuinely riskier 25 per cent."[99] The FIA anticipates a 1.5 to 2% increase in voluntary market premiums in New York[100] and a negligible increase in the ten other states with higher FAIR plan than private market rates,[101]

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99. News from N.Y. State Senator Dunne, Fire Insurance Under the "FAIR" Plan: The Federal Directive to Lower Fire Insurance Rates For "FAIR" Plan Policyholders: Should [New York] State Comply? 4 (Jan. 22, 1979).

100. INSURANCE CRISIS REPORT, *supra* note 10, at 26. The New York State Assembly passed a bill which would bring New York's FAIR plan rates into compliance with the Holtzman amendment requiring parity between FAIR plan rates and rates in the voluntary market. The bill was A. 1421-B, introduced by Assemblyman Nicolosi, and supported by both Governor Carey and New York Insurance Superintendent Albert B. Lewis. Insurance Advocate, Feb. 3, 1979, at 5, 23-24, 31.

The New York State Senate did not pass any of the proposed bills which would have brought the state into compliance with the Congressional mandate. Rather, a bill introduced by Senate Majority Leader Warren M. Anderson and Senate Insurance Committee Chairman John R. Dunne (S. 1200-A) was passed on March 26, 1979. The bill provides that owners of one to eight unit owner-occupied dwellings and small businesses (those with net gross income of $300,000 or less) would be charged no more than 30% above private market rates for policies written through the FAIR plan. News from N.Y. Senator Dunne (March 18, 1979). No relief is provided for those property owners obtaining insurance through the FAIR plan who do not fit within these classifications.

New York is at present the only major urban state which has not complied with the Holtzman amendment. By not complying, New York has lost a state credit of $15 million in reserve funds accumulated to offset any reimbursement to the National Insurance Development Fund (NIDF) which might be required. This amount will be distributed among the reserves of those states remaining eligible for participation in the riot reinsurance program. New York has also lost access to an additional $28 million nationwide reserve similarly designed to offset any necessary state reimbursement to the NIDF. Finally, the effect of noncompliance will be that the FAIR plan rates will remain significantly higher than voluntary market rates and the voluntary market rates will also be increased to absorb the extra cost of purchasing riot reinsurance. News from Congresswoman Holtzman 2-3 (Jan. 29, 1979).

It is noteworthy that although the New York Property Insurance Underwriting Association (FAIR plan) has experienced statutory underwriting losses of $66 million since its inception in 1968, the plan produced an $8 million underwriting gain in 1978. The statutory underwriting loss figure reduced by investment income of $19 million, resulted in an operating loss, before further adjustment, of $47 million. This figure was further reduced by $35 million in assessments against member companies to offset the unprofitable years, yielding a net loss of $12 million. News from New York Property Insurance Underwriting Association, prepared by Insurance Information Institute (Jan. 19, 1979). Considering that the creation of the FAIR plans reduced the insurance industry's private market exposure to properties perceived to be high risks, one might have expected that the rates in the voluntary market would have been commensurately reduced. This did not occur. It could be argued that this benefit which accrued to the industry would offset any additional burden of complying with the Holtzman amendment. Panel Discussion, *supra* note 95.

101. The anticipated increase in these states is $.25 per year for the average private market policyholder. This increase would be sufficient to equalize the FAIR plan rates with the voluntary market rates. 124 CONG. REC. H7128 (daily ed. July 21, 1978) (remarks of Rep. Holtzman).

with no adjustment in the majority of states.[102] This increase would offset the net operating deficiencies resulting from the reduced premiums.

Some view the rate parity mandate as inordinate federal intervention in a state concern.[103] The major argument is that the federal government is usurping the state's legislative and regulatory rate-making prerogatives in the insurance field.[104] Those who support this view are not persuaded by the assertion that the Holtzman amendment does not set rates, but merely standards to which the states must comply to remain eligible for riot reinsurance. Others emphasize the federal government's responsibility to taxpayers on the basis of (1) the FIA's borrowing power of up to $250 million in the event that premiums received and the resources of the National Insurance Development (NIDF) are insufficient to cover catastrophic riot losses,[105] and (2) the obligation of the federal government to see that the $500 billion[106] of federal riot reinsurance is distributed equitably.[107] Such reinsurance protection for insurance companies and the states is percieved as justification for the federal intervention necessary to impose reasonable conditions on FAIR plans. The Holtzman amendment reaffirms the original purpose of Fair Access to Insurance Requirements (FAIR) plans: to insure the availability and affordability of property insurance as a necessary tool in the revitalization of American cities.[108]

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102. INSURANCE CRISIS REPORT, *supra* note 10, at 25. The actual experience of rate parity has increased voluntary rates in three states as follows: 1.0% in Massachusetts, 0.8% in New Jersey, and 0.2% in Pennsylvania. In New York, an increase of $3 to $4 per policy is expected to reduce FAIR plan rates by 60% per year or $160 per year for average dwellings. Holtzman Testimony, *supra* note 73, at 4.

103. "The amendment is clearly, purely, and simply Federal intervention in a State matter." 124 CONG. REC. H7125 (daily ed. July 21, 1978) (remarks of Rep. Wylie). Those who assert that this is an unwarranted federal intervention in a state matter discount the role the federal government has taken from the beginning, *e.g.*, organizing the initial investigatory panel (The President's National Advisory Panel on Insurance in Riot-Affected Areas), enacting the federal legislation authorizing FAIR plans (Urban Property Protection and Reinsurance Act of 1968), which provided certain administrative and reporting procedures in addition to minimum guidelines relating to insurance availability. The federal government's role is to offer riot reinsurance to insurance companies that participate in FAIR plans operating in accordance with federal standards and to review operations with regard to the effectiveness of FAIR plans in making essential property insurance readily available.

104. 124 CONG. REC. H7124 (daily ed. July 21, 1978) (remarks of Rep. Brown).

105. 12 U.S.C. § 1735d(b).

106. 124 CONG. REC. H1593 (daily ed. Jan. 28, 1978) (Schedule 9, Insurance Commitments, as of Sept. 30, 1977).

107. 124 CONG. REC. H7127 (daily ed. July 21, 1978) (remarks of Rep. Lundine).

108. *See* note 25 *supra*.

## V. FAIR Plans and Arson-for-Profit

In assessing the problem of arson-for-profit in FAIR plans, it is important to recognize that by so defining the investigation, a correlation is attempted which addresses subdivisions of both the crime and the target. Arson related insurance fraud, commonly known as arson-for-profit, is only one of various categories of arson.[109] Likewise, FAIR plans represent only a small segment of the insurance industry.

The Commerce Department's study, *Arson: America's Malignant Crime,*[110] recommended a plan of action to combat the national arson problem. The report indicated that the crime of arson "recognizes neither political nor geographic boundaries."[111] The report identified nine major areas requiring attention.[112] These include defining the responsibilities of those agencies concerned with the arson situation, conducting research to aid in arson investigation and prevention, developing specialized training programs, improving data collection and reporting systems, and developing a uniform terminology for an effective interdisciplinary attack on the arson problem.[113]

While numerous recommendations were specifically directed to the insurance industry, the FAIR plans were not singled out as requiring different or greater measures to reduce insurance-related arson. Training programs were suggested for all insurance adjusters and other claims personnel.[114] The report also encouraged reexamination of all insurance underwriting practices which impact on arson, particularly the problem of overinsurance.[115] Further, the

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109. The National Fire Protection Association identifies at least eight categories of arson. *See* General Accounting Office, Comptroller General of the United States, Arson-For-Profit: More Could Be Done To Reduce It 5 (1978) [hereinafter cited as GAO Report]. The categories identified were: fraud fires to collect insurance (arson-for-profit), political fires, pyromaniac fires, crime cover-up fires, spite fires, vanity fires (to allow the arsonist to appear as a hero in taking countermeasures), "psycho fires" set for no rational motive, and vandalism fires set for thrills. *Id.* at 5-6.

110. U.S. Dep't of Commerce, National Fire Prevention and Control Administration (NFPCA), National Academy for Fire Prevention and Control, Arson: America's Malignant Crime (Sept. 1976) [hereinafter cited as Malignant Crime].

111. *Id.* at v.

112. *Id.* at 8.

113. *Id.* The other "needs areas" identified were: reclassifying arson in national reporting systems as a major offense, educating the public about the consequences of arson, promulgating effective laws and regulations, and identifying sources of funding to combat arson. *Id.*

114. *Id.* at 17.

115. *Id.* at 21.

study stressed the need to avoid potential arson risks through inspections of property and collection of other relevant data before issuing a policy.[116] In this regard, the report noted that the attempts being made by FAIR plans to prevent arson should be recognized and encouraged.[117] Analysis of this arson report supports the conclusion that arson is a national problem, and that arson-for-profit is an insurance problem not endemic to FAIR plans. Therefore, the solution necessarily transcends the FAIR plans and requires the coordinated efforts of government and industry.

A recent report by the Comptroller General of the United States (GAO Report) examined the extent to which FAIR plans provide an incentive for insureds to commit arson-for-profit.[118] The conclusion stated: "FAIR Plan and insurance industry officials *believe* that arson-for-profit is a serious problem in the FAIR Plans *as well as* in the private insurance market."[119] The significance of the arson problem in the FAIR plans could not be more authoritatively established because of the unavailability of specific data.[120] The report was based on consideration of only nine out of the twenty-eight FAIR plans.[121] Statistics on arson-for-profit involved only three states.[122] The report's attempt to demonstrate a causal relationship

116. *Id.*

117. *Id.* at 22.

118. Letter from the Comptroller General of the U.S. to Senator Charles H. Percy 1 (May 31, 1978), *reprinted in* GAO REPORT, *supra* note 109 [hereinafter cited as Letter from the Comptroller General].

119. GAO REPORT, *supra* note 109, at 25 (emphasis added).

120. *Id.* at 10. However, according to statistics compiled from data filed with the FIA by the FAIR plans, "about 1,000,000 American families and businesses are insured through FAIR Plans, and less than five percent of these have had claims of any nature, much less arson-for-profit. In any given year, 95 percent of policyholders in the various FAIR Plans have no losses." Letter from Patricia Roberts, then Secretary of HUD, to Senator Abraham A. Ribicoff, Chairman, Committee on Governmental Affairs 1 (Aug. 29, 1978).

121. GAO REPORT, *supra* note 109, at 1.

122. *Id.* at 10-11. Although the presentation of these limited statistics is meant to demonstrate a relationship between arson-for-profit and FAIR plans, the statistics provided refer generally to arson, or to individual estimates of the broad category of arson, or to the even more inclusive classification of arson or suspicious fires. The report noted that in Illinois, the Metropolitan Chicago Loss Bureau found that 33% (685) of FAIR plan claims paid in 1977, totalling $7.7 million, were incendiary, *i.e., arson and arson-for profit.* In Massachusetts, one FAIR plan official *estimated* that 40% of the *arson* in the state was FAIR plan related although the plan writes only 15% of the insurance in Massachusetts. In Pennsylvania, records of *arson or suspicious fire losses* in the FAIR plan, mostly occurring in 1976 and 1977, showed losses of $1.8 million. *Id.* The dearth of arson-for-profit statistics is attributed to both the difficulty in developing them and inadequate fire, police, and FAIR plan investigations. *Id.* at 10.

between FAIR plans and arson fraud fails, because throughout the study the problem appeared to be equally prevalent in the private insurance field.[123] It is also noteworthy that in preparing the report, none of the state insurance departments, which have direct supervisory authority over FAIR plans, were contacted.[124] The FIA was also not formally consulted prior to the release of the report.[125]

Two basic criticisms of FAIR plan operations were pinpointed as arson fraud incentives: overinsurance and under-selectivity.[126] These will be examined separately. The report stated that overinsurance of FAIR plan properties created an incentive to arson-for-profit.[127] Overinsurance could occur in two ways: initial overvaluation of the property resulting from granting insurance requests without attempting to assess the actual or market value,[128] or subsequent overvaluation of the property due to external factors after the policy is written which make the property worth less, *i.e.*, the declining neighborhood syndrome.[129]

The GAO Report examined the effects of overinsurance, focusing on consideration of the method of valuation used in paying fire loss claims. Generally, depreciation is taken into account and will result in less than full payment on a claim. Beyond this, what occurs varies with each jurisdiction. Many FAIR plan states value proper-

123. *Id.* at 5-6, 13.

124. *Id.* at 27-29.

125. Letter from the Comptroller General, *supra* note 118, at 5. The FIA responded to the General Accounting Office's report, *Arson-For-Profit: More Could Be Done To Reduce It* (*see* note 108 *supra*), by noting that despite its broad title, the report only examined arson-for-profit in the FAIR plans, and could lead a reader to erroneously conclude that arson-for-profit occurs primarily in these plans rather than in the general insurance market. Letter from Patricia Roberts Harris to Senator Ribicoff (Aug. 29, 1978).

126. GAO REPORT, *supra* note 109, at 12-24.

127. *Id.* at 12.

128. *Id.* at 13.

129. *Id.* at 17. There is a certain difficulty inherent in the charge that overinsurance results from the general decline of a neighborhood. The 1968 Act specifically prohibited the consideration of "environmental hazards" in deciding whether to grant insurance. "Environmental hazard" is defined as "any hazardous condition that might give rise to loss under an insurance contract, but which is beyond the control of the property owner. . . ." 12 U.S.C. § 1749bbb-2(a)(4). To consider these same factors in reaching the conclusion that a property is overinsured does not fit within the intent of the legislation. However, although ideally the insured's property should be valued without reference to other properties, the "market value" formula is inextricably connected to neighborhood. Therefore, the insured's recovery will necessarily be affected by external factors beyond his control which may preclude him from receiving proceeds sufficient to rebuild. This often results in abandonment and perpetuation of the cycle of urban decay.

ties according to the "actual cash value" at the time of loss, which is often determined by the "replacement cost less depreciation" test.[130] The avowed problem with this formulation is that because many FAIR plan properties are in economically declining neighborhoods, the "actual cash value" award can be much greater than the fair market value, creating an incentive to commit arson.

A number of states alleviated the valuation discrepancy by utilizing the "broad evidence" rule to determine "actual cash value."[131] Assessment of property value by this method requires reference to various criteria, including market, rental, and economic value, to supplement the "replacement cost less depreciation" formula.[132] The GAO Report indicated that "[p]roperty owners in these States . . . are not likely to be overcompensated for fire losses."[133] Courts which adhere to the "broad evidence" rule may give greater weight to the "replacement cost less depreciation" feature when the insured indicates a willingness to rebuild the destroyed property. The flexibility of the "broad evidence" rule is more likely to allow the court to take the insured's intent into consideration in this regard. These considerations support the conclusion that the "broad evi-

130. GAO REPORT, *supra* note 109, at 16.

131. *Id.*

132. *Id.* McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 159 N.E. 902 (1928), was the first case to employ the "broad evidence" rule.

133. Letter from the Comptroller General, *supra* note 118, at 4. It is interesting to note that the indictment of overinsurance based on the initial overvaluation of property was directed at the same states the GAO REPORT praised for discouraging overpayment by using the "broad evidence" rule. The overinsurance charge is based on the practice of failing to assess property value at the time the policy is written. Since the "actual cash value" method authorizes payment based on the value at the time of *loss*, these states argue that initial valuation is costly and unnecessary double work. However, the failure to inspect the insured's premises, leading to overvaluation, is more likely to create an incentive to commit arson, since the insured is unlikely to be aware of judicial remedies which protect insurance companies from excessive claims of loss. For the insurance industry, the "broad evidence" rule is a more attractive, if less successful, method for deterrence, because of higher commissions for brokers and higher premiums for insurers. Several states (*e.g.*, Massachusetts, Maryland, Pennsylvania, and Rhode Island) have found initial valuation helpful in preventing overinsurance. GAO REPORT, *supra* note 109, at 14-15.

The GAO REPORT recommended that all FAIR plans be required by federal regulation to establish property value at the time of underwriting. The FIA disagreed, asserting that such decisions should be left to the individual states, particularly when there is disagreement over the most equitable method of property valuation in paying loss claims. Furthermore, according to the Secretary of HUD, "a sweeping requirement could be used to limit adequate coverage to deserving risks. The same measure which serves as a disincentive to arson profiteers can also prevent homeowners from being able to rebuild their homes after a fire." Letter from Patricia Roberts Harris to Senator Ribicoff 2 (Aug. 29, 1978).

dence" rule offers a more satisfactory approach to the difficult process of valuation than other more rigid tests.[134]

The "actual cash value" formula reflects the theory that the insured should be put in substantially the same position as before the loss, thus indemnifying the insured. Fair indemnification is achieved by denying the insured overcompensation which would provide an incentive to arson fraud. Fair compensation is often considered to require that the insured receive a sufficient recovery to make reconstruction a feasible alternative.[135] This policy has the positive ramification of encouraging community development, while discouraging abandonment of properties and neighborhoods.

The FIA and NAIC are currently formulating a new policy form which would limit cash payments after a loss to "market value"[136] (a disincentive to arson-for-profit), unless a building is reconstructed at the same or nearby location. The policy would then allow payment for the replacement of the structure up to a previously agreed dollar amount (a disincentive to abandonment of the destroyed building).[137] The policy of awarding compensation based upon whether the insured will rebuild is commendable. However, a provision in the insurance contract which fixes the amount to be paid to the insured who rebuilds may create the same problems evident in "valued policy" contracts.[138] This difficulty could be lessened by providing for periodic review and modification of the contract terms according to an agreed method specified in the contract. In the case of an owner's decision not to rebuild, there are proposals which would allocate a portion of the claim recovery for demolition costs where such action is warranted.[139] This would

134. More stringent tests include the "replacement cost less depreciation" formula and the "valued policy" method.

135. The "replacement cost less depreciation" formula reflects this policy.

136. For a discussion of "market value," see Comment, *Arson Fraud: Criminal Prosecution and Insurance Law*, 7 FORDHAM URB. L.J. 541, 571 (1979).

137. Statement by Gloria M. Jimenez, Federal Insurance Administrator, before the Senate Permanent Subcommittee on Investigations 5 (Sept. 14, 1978) [hereinafter cited as FIA Statement].

138. *See* text accompanying notes 141-143 *infra*.

139. Statement by Gloria M. Jimenez, Federal Insurance Administrator, Government Affairs Conference sponsored by the American Insurance Association 5 (Mar. 22, 1979). Ms. Jimenez stated:

> The insurance policy could . . . provide for the application of some portion of the forfeited insurance proceeds to defray the cost to the city of demolition of the building and removal of debris. The Pennsylvania legislature is currently considering a bill which would accomplish this by creating a lien in favor of the city upon insurance

reduce the negative effect on neighborhoods caused by the presence of abandoned structures,[140] and is therefore a practice which should be encouraged.

Twenty states require insurers to pay the face amount of the policy on total property losses.[141] This "valued policy" method may reduce the tendency of insurers to overinsure,[142] but it also serves to fix the value of the property when numerous intervening factors could lead to its devaluation. The result in this situation is the alleged overinsurance despite compliance with the GAO Report's suggestion to value the property when the policy is written.[143] The "valued policy" laws have the advantages of providing certainty and discouraging litigation. Moreover, this policy most likely comports with the insured's understanding of the insurance agreement regarding the amount of recovery in the event of a loss. However, the inflexibility of the valuation procedures can provide as much of an incentive to arson fraud as the lure of replacement cost proceeds. Thus, despite certain positive features, the "valued policy" method should be rejected in favor of the "broad evidence" rule.

The GAO Report found that FAIR plans could operate more efficiently if given more authority to deny or limit insurance to high risk properties.[144] According to the report, FAIR plan officials expressed the need for more flexibility in underwriting prerogatives.[145] The FIA asserts that FAIR plan underwriters can make judgments regarding which properties to insure according to the statutory and regulatory standards which clearly grant this discretion.[146] Insurance must only

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> proceeds for such purposes. While all legislative solutions to this question may not be equally acceptable, it would seem to be a worthwhile concept to work toward.

*Id.*

140. For an in-depth study of the process of abandonment, see WOMEN'S CITY CLUB OF NEW YORK, INC., WITH LOVE AND AFFECTION, A STUDY OF BUILDING ABANDONMENT (1977).

141. GAO REPORT, *supra* note 109, at 16-17.

142. *Id.* at 17. However, a factor contrary to this tendency is the incentive for insurance agents and brokers to encourage property owners to purchase more insurance than may be necessary because their fees will thereby be commensurately increased. *Id.* at 15-16.

143. *Id.* at 26. *See* note 129 *supra.*

144. *Id.* at 17. One insurance company official expressed the view that since "the original purpose of FAIR plans was to provide insurance in those instances where the insurance industry would not 'solely because of where the property is located' . . . FAIR Plans . . . should be granted all of the perogatives [sic] of the industry except location." *Id.* at 20. The FIA's position is that the FAIR plans are able to use their discretion and are not required to insure risks that do not meet "reasonable underwriting criteria." *Id.* at 24. Since the inception of FAIR plans, over 227,000 out of approximately 2.9 million applications have been denied for various reasons. FIA Statement, *supra* note 137, at 5-6.

145. GAO REPORT, *supra* note 109, at 17.

146. 12 U.S.C. § 1749bbb-3; 24 C.F.R. § 1905.3, 1905.7 (1978).

be written on properties meeting "reasonable underwriting standards," excluding consideration of environmental hazards. The FIA also notes that all requests for altering FAIR plan underwriting requirements, approved by state insurance authorities, were likewise approved by the FIA.[147] It appears that there is some confusion concerning taking the initiative for implementing changes.[148] The confusion is dispelled by reference to the federal guidelines for FAIR plans, which demonstrate the intent to allow states to adopt regulations to meet their own needs.[149]

Three major problems cited by the FAIR plan officials[150] contacted during the GAO study were (1) the inability to consider the "moral hazard"[151] factor (2) the requirement to provide immediate coverage through a binder provision before inspection[152] (3) the necessity for giving thirty days notice before cancellation of an insurance policy.[153] The FIA takes the position that provisions exist to remedy these problems. For instance, the "moral hazard" factor can be taken into consideration in declining to insure a risk. FIA regulations permit denial of insurance based on "specific characteristics of ownership, condition, occupancy, or maintenance that are violative of law or public policy."[154] The FIA also does not require immediate coverage, but allows up to twenty calendar days to delay coverage pending inspection.[155] Finally, the FIA has recommended five-day cancellation notices as HUD policy for several years. At present, three states have adopted this policy.[156] Information concerning

147. Federal Insurance Administration, Dep't of HUD, Memorandum: Specific GAO Points Warranting Clarification 7 (1978).

148. ILLINOIS LEGISLATIVE INVESTIGATING COMMISION, ARSONS: A REPORT TO THE ILLINOIS GENERAL ASSEMBLY 41 (May 1978) [hereinafter cited as ARSONS].

149. The 1968 Act states that FAIR plans "must be approved by, and administered under the supervision of the State insurance authority. . . . Such plans may vary in detail from State to State because of local conditions . . . ." 12 U.S.C. § 1749bbb-3(b). The federal government is responsible for periodic review of each plan "in order to assure that such plan is effectively making essential property insurance readily available . . . ." *Id.* § 1749bbb-6a.

150. GAO REPORT, *supra* note 109, at 17.

151. "Moral hazard" is the term used to refer to the risk element based on the character, attitude, and purpose of the insured. Factors considered in assessing this risk could include information regarding the person's or company's financial condition, tax arrearages, building code violations, and the insured's past fire history. *Id.* at 20.

152. 24 C.F.R. § 1905.6 (1978).

153. *Id.* § 1905.9 (1978).

154. *Id.* § 1905.7(c)(3) (1978).

155. *Id.* § 1905.6(b)(1) (1978).

156. Letter from Patricia Roberts Harris to Senator Ribicoff 4 (Aug. 22, 1978).

waiver of this provision was distributed to all FAIR plans in 1974 through PIPSO, the national trade organization for FAIR plans. These facts undermine the position that federal regulations impede state efforts to implement effective and innovative operational policies.

Various groups advocate the effectiveness of increasing controls on the selection and screening process to eliminate arson-for-profit risks in the FAIR plan.[157] However, since there is no substantiation at present that more arson-for-profit occurs in the FAIR plan than the voluntary market,[158] there is no rational basis to pursue overzealous underwriting screening in one market and not the other. The Property Loss Insurance Register[159] provides a system where relevant arson prevention information can be easily compiled and readily ascertained. Four basic computer searches coordinate data revealing the following information: the loss history of an individual or corporate insured, the loss history at a particular location, undisclosed duplicative insurance, and combinations of individuals involved in losses, regardless of their identification as owner or mortgagee.[160] This information is a valuable tool for insurance companies

157. *See* MALIGNANT CRIME, *supra* note 110, at 21; ARSONS, *supra* note 148, at 37; GAO REPORT, *supra* note 109, at 17; News from New York Property Insurance Underwriting Association, prepared by Insurance Information Institute (Jan. 19, 1979).

158. INSURANCE CRISIS REPORT, *supra* note 10, at 40. The available evidence indicates that arson-for-profit is an increasing problem of national proportions. This is demonstrated by the fact that in both Texas and Florida, where there are no FAIR plans, there is an increasingly high incidence of arson, including arson-for-profit. *Id.* at 39. The only grand jury to consider the allegation that arson-for-profit and FAIR plans can be linked in a cause and effect relationship found the charge to be without merit. The Missouri Grand Jury noted:

> We have been led to believe that pressures from Washington force insurers writing coverage under the FAIR Plan to accept many risks contrary to their best judgment. Our understanding is directly contrary to this. Nowhere did we find that the Federal directives or guidelines required insurers to assume questionable, let alone ridiculous, risks.

INSURANCE CRISIS REPORT, *supra* note 10, at 39.

159. The Property Insurance Loss Register presently has 418 companies as subscribers, representing about 90% of premium dollars in the nation. The system was designed to comply with the Fair Credit Reporting Act, 15 U.S.C. §§ 1681-81t(1976). Privacy laws and free access to loss potential information for insurers serve important, yet conflicting, social policies. At least twenty-five states have acted to give insurance companies immunity against civil actions for damages based on sharing information with fire, police, and other public sector officials. These include Arizona, California, Connecticut, Florida, Georgia, Illinois, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Nebraska, New York, North Carolina, North Dakota, Ohio, Rhode Island, Texas, Utah, Virginia, West Virginia, and Wisconsin. Interview with Property Insurance Loss Register Office (May 22, 1979).

160. *Id.*

in their voluntary, as well as their residual market underwriting activity. Despite nationwide interest in reducing arson, underwriting techniques which operate to deny essential property insurance to deserving property owners in the FAIR plans cannot be tolerated.[161]

In addition to underwriting screening, emphasis should be placed on rigorous post-claim review[162] as an effective deterrent. Insurers argue that opposing societal demands dictate conflicting messages.[163] Insurance companies are urged to withhold payment on suspicious claims, but are pressured to pay legitimate claims once proof of loss is established. Distinguishing between valid and fraudulent claims is not an easy task. Proving the distinction is even more difficult. The insurance industry is regulated by government and competitive market forces. At present, there is little incentive to pursue costly litigation with no guarantee of success. The possibility of punitive damage suits and the one percent nationwide conviction rate for arson are further deterrents.[164]

A coordinated arson offensive must work to limit the safety, ease, and profitability of committing arson. Defining arson-for-profit as a problem particularly prevalent and essentially confined to FAIR plans is counterproductive for the insurance industry and will

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161. Efforts to reduce arson-for-profit should confine the preventive measures to attacking owner-involved arson fraud. It is improper to formulate policies on the assumption that all arson is first-party arson, *i.e.*, arson by the property owner motivated by the intention to collect insurance proceeds. In a great many cases, the property owner is the innocent victim of third-party arson, *i.e.*, arson committed for revenge or a variety of other reasons. *See* note 109 *supra*.

162. MALIGNANT CRIME, *supra* note 110, at 9-13, 17; ARSONS, *supra* note 148, at 36. The FIA also strongly supports this policy. Ms. Jimenez advocated the effectiveness of deterrence through diligent law enforcement post-crime efforts:

> More must be done by every involved sector of society to increase the risk of committing arson. Experienced arson investigators stress that arson-for-profit is largely a white-collar crime, and studies have shown that the threat of prosecution is a serious deterrent to such crime. The challenge, therefore, is to strengthen the chain which leads from arson detection to prosecution and conviction. One of the weakest links in this chain at present, according to investigators, is the myth that arson cannot be proven. Efforts should be made to dispel this myth.

Statement by Gloria M. Jimenez, Federal Insurance Administrator, Government Affairs Conference sponsored by the American Insurance Association 8 (Mar. 22, 1979).

163. NATIONAL ASS'N OF INDEPENDENT INSURERS, ARSON-FOR-PROFIT AND THE INSURANCE INDUSTRY: VILLAIN OR VICTIM? (1978).

164. *Id.* at 2-3.

impede national efforts directed at reducing the incidence of the crime of arson.[165]

## VI. Conclusion

Fair Access to Insurance Requirements (FAIR) plans were authorized by federal legislation to provide essentail commercial and habitational property insurance to those unable to obtain it in the voluntary market. FAIR plans have been effective. A prospective insured cannot be denied insurance for arbitrary or capricious reasons. Although the decision to insure property through the voluntary or residual market remains the prerogative of insurance underwriters, the Holtzman amendment has reduced the disparate consequences resulting from assignment of insureds to FAIR plans.

A decade after the inception of FAIR plans, Congress passed the Holtzman amendment, reaffirming the original intent of the Urban Property and Reinsurance Act of 1968 to make property insurance available at affordable rates. Premiums charged for FAIR plan insurance must be no higher than those charged in the voluntary market, and members of the public, independent of the insurance industry, must comprise one-third of all governing and advisory FAIR plan committees. Those states not in compliance with the Holtzman amendment forfeited their access to federal riot reinsurance. Arguments against adopting a rate-equalization provision are often based on the assertion that riot reinsurance is available in the private market. This rationale does not address the issue of the unfairness of operating a FAIR plan without providing access to insurance requirements at affordable rates.

It is possible that the charge that FAIR plans provide incentives to arson-for-profit were publicized to obstruct adoption of the Holtzman amendment rate parity mandate. Examination of available data provides no basis for the allegation that FAIR plans promote a higher incidence of arson-for-profit. Since arson-for-profit is primarily a white collar crime, attacks aimed solely at the insurance residual market mechanism are misdirected. Anti-arson fraud efforts and FAIR plans can comfortably co-exist. When urban revitalization efforts have significantly reduced the effects of the "insurance crisis," the residual insurance market will be integrated

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165. For an overview of the problems related to arson fraud, see Comment, *Arson Fraud: Criminal Prosecution and Insurance Law*, 7 FORDHAM URB. L.J. 541 (1979).

into the voluntary market. At such time, the FAIR plans will have achieved their original objective.

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