

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILE 8672
2123 SCOMM 79. HOUSE SPEC. COMM. ON OIL & GAS, 1991-1992

AS 46.03 is amended by adding a new section to read:

Sec. 46.03.825. OIL SPILL RESPONSE ACTION CONTRACTORS. (a)

A person who is a response action contractor with respect to a release or threatened release of oil is not liable for injuries, costs, damages, expenses or other liability that results from the release or threatened release, or from the response action contractor's acts or omissions in response to the release or threatened release, unless the person bringing a claim against the response action contractor proves by a preponderance of the evidence that:

(1) the response action contractor would have been liable for the release or threatened release under state or federal law even if that contractor had not carried out a response action with respect to the release or threatened release; or

(2) the response action contractor acted with gross negligence or intentional misconduct.

(b) The liability limitation of (a) of this section does not apply to an action for personal injury or death.

(c) As used in this section:

(1) "gross negligence" means criminal negligence as defined in AS 11.81.900(a)(4);

(2) "response action contractor" has the same meaning as in AS 46.03.823(g)(2); and

(3) "response action contractor" has the same meaning as in AS 46.03.823(g)(3).

6

SPRING 1990

Tort & Insurance Law Journal

In This Issue:

- Advice of Counsel in Insurance Bad Faith Litigation: A Substantive Framework for Pleading, Discovery and Proof
- Recovery of Natural Resource Damages under CERCLA
- Punitive Damages and the U.S. Constitution
- Federal Claims in Insurance Insolvencies
- The Recognition of Sureties' Rights under Government Contracts
- You Only Die Once—But Did You Intend It?: Psychiatric Assessment of Suicide Intent in Insurance Litigation
- Hazardous Waste Liability and the Surety
- Tipping the Cap without Tipping Its Hand: The Washington Supreme Court and Tort Reform



HAZARDOUS WASTE LIABILITY AND THE SURETY

William F. Ryan, Jr., and Robert M. Wright

I. INTRODUCTION

The purpose of this article is to discuss issues which should be of concern to the contract bond surety with regard to hazardous waste liabilities. It is not the authors' intention to tilt at windmills in forecasting potential claims against the surety. It is also not our intention to endorse the theories of claims discussed in this article which would impose liability on the surety far beyond its traditional role of ensuring that the project is completed and all bills are paid. The surety industry must anticipate, however, that the Department of Justice, as well as state and local authorities, and certainly plaintiffs' counsel, will argue the broadest possible interpretation of the hazardous waste statutes and common law liability theories in order to impose financial responsibility upon whomever is financially capable of paying for the costs associated with a hazardous waste release. Any person, including a contract bond surety or principal, who is in any way associated with the hazardous waste may find himself the target of such an effort. As will be seen below, a literal reading of the hazardous waste statutes can create unusual and unexpected potential claims against the surety.

State and federal hazardous waste laws present at least three separate problems for the contract bond surety. First, the most difficult problem faced by the surety is the question of bonding contractors bidding on hazardous waste cleanup projects in light of the unique risk to the surety undertaking such an obligation. Second, the surety faces the potential inadvertent risk associated with the discovery of hazardous

William F. Ryan, Jr., is a partner in the Baltimore and Washington, D.C., law firm of Whiteford, Taylor & Preston, where he specializes in litigation. He received his J.D. in 1979 from the University of Baltimore School of Law.

Robert M. Wright is a partner in the same firm, where he specializes in commercial litigation, including contract disputes. He received his L.L.B. from the University of Maryland School of Law in 1968.

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

SPRING 1990

Tort & Insurance Law Journal

In This Issue:

- Advice of Counsel in Insurance Bad Faith Litigation: A Substantive Framework for Pleading, Discovery and Proof
- Recovery of Natural Resource Damages under CERCLA
- Punitive Damages and the U.S. Constitution
- Federal Claims in Insurance Insolvencies
- The Recognition of Sureties' Rights under Government Contracts
- You Only Die Once—But Did You Intend It?: Psychiatric Assessment of Suicide Intent in Insurance Litigation
- Hazardous Waste Liability and the Surety
- Tipping the Cap without Tipping Its Hand: The Washington Supreme Court and Tort Reform



Editorial Statement

The *Tort & Insurance Law Journal* is published by the Section of Tort and Insurance Practice of the American Bar Association as a service to its members and for the benefit of lawyers and lay persons involved in the practice of tort law and insurance. As a publication of the Section, the Journal's interests mirror those of the Section which span thirty-three general substantive and procedural areas involved in or affecting the law of torts and insurance. These areas are listed in the Journal with the names of the present General Committee Chairpersons. Also, the Section has created Special Task Forces devoted to additional areas of concern such as AIDS, bankruptcy in tort litigation, Jonas Salk proposals project, legal education and long-term health care.

The *Tort & Insurance Law Journal*, known formerly as *The Forum*, adopted its new title commencing with the volume published for the 1985-86 Association year, to more appropriately reflect its commitment to the publication of articles which present scholarly analysis of and insight into issues affecting the broad scope of tort and insurance law and practice. The new title further reflects the standing of the Journal within the legal community as a focal point for the examination of timely legal issues confronting the judiciary, the tort and insurance bar, and the general insurance community. The Section actively seeks to serve as an umbrella for the varied and disparate special interest bars and organizations within the field of tort and insurance law. To that end, the *Tort & Insurance Law Journal* will continue to solicit and present the multiplicity of views that exist within our legal community. The Editorial Board trusts that each issue will be a significant contribution to practitioners and students.

HAZARDOUS WASTE LIABILITY AND THE SURETY

William F. Ryan, Jr., and Robert M. Wright

I. INTRODUCTION

The purpose of this article is to discuss issues which should be of concern to the contract bond surety with regard to hazardous waste liabilities. It is not the authors' intention to tilt at windmills in forecasting potential claims against the surety. It is also not our intention to endorse the theories of claims discussed in this article which would impose liability on the surety far beyond its traditional role of ensuring that the project is completed and all bills are paid. The surety industry must anticipate, however, that the Department of Justice, as well as state and local authorities, and certainly plaintiffs' counsel, will argue the broadest possible interpretation of the hazardous waste statutes and common law liability theories in order to impose financial responsibility upon whomever is financially capable of paying for the costs associated with a hazardous waste release. Any person, including a contract bond surety or principal, who is in any way associated with the hazardous waste may find himself the target of such an effort. As will be seen below, a literal reading of the hazardous waste statutes can create unusual and unexpected potential claims against the surety.

State and federal hazardous waste laws present at least three separate problems for the contract bond surety. First, the most difficult problem faced by the surety is the question of bonding contractors bidding on hazardous waste cleanup projects in light of the unique risk to the surety undertaking such an obligation. Second, the surety faces the potential inadvertent risk associated with the discovery of hazardous

William F. Ryan, Jr., is a partner in the Baltimore and Washington, D.C., law firm of Whiteford, Taylor & Preston, where he specializes in litigation. He received his J.D. in 1979 from the University of Baltimore School of Law.

Robert M. Wright is a partner in the same firm, where he specializes in commercial litigation, including contract disputes. He received his L.L.B. from the University of Maryland School of Law in 1968.

waste on a conventional construction project. Finally, the surety faces the potential inadvertent assumption of risk under the hazardous waste laws by acquiring property in connection with salvage.

While the legal framework for the cleanup of the nation's hazardous waste has been in place for approximately nine years, relatively few contracts for the cleanup of the major hazardous waste sites have actually been let. The complex nature of these sites has increased the time necessary to complete preliminary site investigations and feasibility studies and to select appropriate remedies. Most of the cleanup work that has been done to date has been of a relatively minor nature. As a result, the surety industry has not, until recently, been asked to make major bonding line commitments to hazardous waste cleanup contractors.

The major commercial sureties have begun to appreciate and understand the implications of issuing contract bonds for major hazardous waste cleanups. This past year, several owners on major projects have sought bonding, forcing sureties to focus upon their potential liabilities as well as the effect of these potential liabilities upon their contractor clients.

In addition, new concerns have surfaced regarding the availability of corporate surety bonds for hazardous waste cleanup projects as state and federal agencies grow increasingly concerned about the viability of the individual surety market. The Miller Act¹ and state "Little Miller Acts" require that bonds be posted for all cleanups contracted for by federal or state agencies. Up to this point, many of the minor cleanup projects have been bonded by individual sureties.² As government agencies have become increasingly concerned about the adequacies of individual sureties, particularly for major environmental cleanup projects, the issue of bonding capacity from commercial sureties has become increasingly important. In fact, it is likely that the surety industry will increasingly be asked for its views on the bondability of these projects and the steps which must be taken to assure the availability of bonding which will satisfy the Miller Act requirements.

The Superfund reauthorization in 1991 will undoubtedly be the forum for renewed discussion of the contractor liability/indemnification issue, among many others.³ The issue of the bondability of these projects will be a new topic to be discussed. For this reason alone, the surety industry should focus upon the problem and the potential market both for the sureties themselves and their clients.

1. 40 U.S.C. § 270a (1982).

2. Individual sureties have not been particularly satisfactory, and, as a result, new regulations have been proposed which will make it much more difficult to secure individual securities. See 53 Fed. Reg. 44,564 (Nov. 3, 1988).

3. The 1991 reauthorization process may dwarf the 1986 reauthorization in its scope and depth, and the controversy is now under way. EPA has come under increasing fire from the Office of Technology Assessment (OTA) regarding the adequacy of its cleanups and the contracting policies used to implement them. Contractor organizations continue to question the contractor liability/indemnification policy. Environmentalists are dissatisfied with the pace of the program.

It has been forecast that the potential market for hazardous waste cleanup work may approach \$100 billion over the next ten years, and estimates by organizations such as the Office of Technology Assessment (OTA) which exceed that number are gaining increasing credibility.⁴ This includes cleanups which are expected to be done by the federal government, by the states, and by private parties.

As surety companies examine their alternatives and decide whether to bond hazardous waste activities in this huge potential market, they must also be concerned about the effect of hazardous waste work being done by their clients on the entire bonding line for which the sureties are responsible. In other words, if a client is subjected to multimillion dollar liability on a hazardous waste project, it gives the surety little comfort that it did not bond that project if the contractor's financial distress causes default on millions of dollars of conventional construction work that the surety *has* bonded.

Many of the decision makers concerned with Superfund cleanup projects ask why there should be excessive concern by the surety industry over hazardous waste cleanup. Sureties have historically bonded very large projects where the potential for losses is huge. The factors that make this type of work unique and create concern to contract bond sureties are:

1. The inability to underwrite the project under normal underwriting standards due to:
 - The use of unproven technology;
 - The uncertain nature of the materials which may be encountered on site and which must be disposed of;
 - Stringent, and in some cases unrealistic, government standards which must be met under the contract as to what is "clean";
 - The potential of increasing liability exposure as the project progresses versus decreasing liability exposure on the conventional construction project; and
 - Long liability "tails" for hidden defects in the manner in which the work was done.
2. The potential for the application of strict liability to the contractor as to third-party claims.
3. Unavailable or inadequate pollution liability insurance and/or indemnity for the cleanup contractor.
4. The possible loss of the surety's traditional option to complete performance in the event of default.
5. The potential for "arranger" liability on the part of the surety.

All of these subjects are discussed in more detail on the following pages. In reviewing the general schemes of the hazardous waste laws, it is important to bear in mind that the contractor who is cleaning up someone else's mess is the party who is not only treating or disposing of the hazardous waste but who is also in control of the con-

4. OTA estimates \$500 billion over the next 50 years, excluding cleanup of Department of Energy sites. CONGRESS OF THE UNITED STATES, OFFICE OF TECHNOLOGY ASSESSMENT, *ASSESSING CONTRACTOR USE IN SUPERFUND* (January 1989).

struction site. In that role, the contractor is in control of the "facility" where the hazardous substance has been deposited. That factor, together with its "operations" on the site, in treating or disposing of hazardous waste, may make the contractor an "operator" of a hazardous waste "facility" under the language of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)⁵ and the Resource Conservation Recovery Act (RCRA).⁶ This is only the beginning of the problem. The balance of this article will explore the problem in more detail and, hopefully, suggest some useful solutions.

II. TECHNOLOGY

A number of technologies and combinations thereof are employed to effect cleanup at toxic waste sites. The technologies broadly fall into categories including removal and containment strategies, solidification/stabilization treatments and methods of destruction and detoxification, including incineration.⁷ Many remedies selected include complex combinations of these technologies, with the use of one procedure often dependent on the outcome of another.

While the technologies are still evolving, most are targeted at specific types of toxic wastes. Chemical fixation, stabilization and solidification treatments are often used to reduce mobility, particularly for toxic metals. Stabilization techniques essentially dilute or encapsulate hazardous material in a liquid which hardens; however, hazardous chemicals remain in the mass. Thermal destruction and chemical and biological treatment can irreversibly destroy or detoxify nearly all of some substances, although low temperature thermal treatments just volatilize some organic chemicals but do not destroy them. Some physical and chemical treatments separate organic and inorganic materials. Carbon adsorption, precipitation, soil washing, and solvent extraction allow the separation of the materials for placement in a landfill, sometimes calling for the separated materials to be further treated and destroyed. Another technology employed is *in situ* vitrification (ISV), which uses electrodes in the ground to pass electricity through the soil, melting it, vaporizing and at least partially destroying organic chemicals and leaving a chemically inert, stable, glass-crystalline mixture.

The Environmental Protection Agency (EPA) has been criticized for the selection of what OTA and others assert are impermanent technologies often selected because they are less costly, at least in the short term, over new and innovative technologies which may offer a more costly, but permanent remedy. OTA has stated its view that about 75 percent of cleanups are unlikely to work over the long term.⁸ One of the major problems facing cleanup contractors are the liabilities attendant to the development and testing of new technologies. In a 1987 Report to Congress, the United

5. 42 U.S.C. § 9601 (1982 & 1987 Supp.).

6. 42 U.S.C. § 6901 (1982 & 1987 Supp.).

7. For a recent general discussion of cleanup technologies, see CONGRESS OF THE UNITED STATES, OFFICE OF TECHNOLOGY ASSESSMENT, COMING CLEAN: SUPERFUND'S PROBLEMS CAN BE SOLVED 139-91, OTA-ITE-433 (Washington, D.C.: U.S. Government Printing Office, October 1989).

8. *Id.* at 3.

States General Accounting Office (GAO) stated that the experience of those firms which participated in EPA's Superfund Innovative Technology Evaluation Program "suggests that the lack of performance records for innovative technologies may create uncertainty about the long-term effectiveness of . . . new cleanup remedies." The GAO further found that "as technologies evolve and approach commercial application, the need for insurance may become more significant."⁹ In this connection, OTA has recently warned that "the rapid growth of the national cleanup effort, both in Superfund and many other cleanup programs, has meant that technical experience and expertise in the private sector has likely been spread very thin. . . . Currently, there are not enough appropriately trained and experienced engineers and scientists to implement a high quality and expanding national cleanup program."¹⁰ In fact, OTA's report points out that "[a]t the Iron Mountain Mines Superfund site in California, the responsible party has written EPA about actions by contractor personnel (under the direction of CH2M HILL, the REM contractor) *during cleanup* which are resulting in extensive migration of hazardous substances offsite."¹¹

The uncertainties of the available technologies are illustrated, to some extent, by the case of *USF&G v. United States*,¹² where the appellate court held that the discretionary function exception to the Federal Tort Claims Act barred USF&G (as a liability insurer) from recovering from the United States monies which USF&G paid to settle third-party property damage claims against a Superfund contractor insured by USF&G. At the direction of EPA's On-Site Coordinator, the contractor had sought to neutralize oleum, an extremely reactive sulfuric acid. The plan was to slowly drain the oleum into water so that the oleum would react in a controlled fashion. Unfortunately, the oleum apparently drained too quickly, causing a larger reaction than expected. The reaction formed a dense cloud of sulfur trioxide and sulfuric acid which migrated away from the site and caused respiratory injury to five persons. Thereafter, the drainage of oleum stopped when a valve through which it passed became clogged with sludge. To clear the valve, the contractor's employees inserted rods. Following the insertion of the rods, an explosion occurred and another cloud of sulfuric trioxide and sulfuric acid was released. Blown by winds, this cloud migrated

9. UNITED STATES GENERAL ACCOUNTING OFFICE, REPORT TO THE CONGRESS, HAZARDOUS WASTE, ISSUES SURROUNDING INSURANCE AVAILABILITY 32 (October 1987).

10. CONGRESS OF THE UNITED STATES, OFFICE OF TECHNOLOGY ASSESSMENT, ASSESSING CONTRACTOR USE IN SUPERFUND 4 (January 1989). OTA stated in this report that the constant shift of people from government to the private sector keeps the government work force inexperienced, which makes effective government oversight and management of contractor activities difficult if not impossible. As to the contractors, the report found that there was a high degree of mobility of the most experienced people as contractors competed to maintain their increased market share or business volume with the report concluding:

The result is a national cleanup work force which is expanding rapidly, which is in constant motion, with few people having institutional memories or loyalties, for whom information transfer and education through working with experienced people is minimal, with no substantial improvement in average level or experience, and where labor costs are increasing.

Id. at 191.

11. *Id.* at 29 (emphasis in original).

12. 638 F. Supp. 1068 (M.D. Pa. 1986), *rev'd*, 837 F.2d 116 (3d Cir. 1988).

into a nearby town, where it caused properly damage to over 500 motor vehicles, an airplane and several buildings. The point to be drawn from this illustration is that even the simplest of technologies carries large risks when applied to hazardous material remediation efforts.

III. GENERAL SCHEME OF THE HAZARDOUS WASTE LAWS

A. Federal Law

In 1980, Congress enacted the Comprehensive Environmental Response, Compensation, and Liability Act,¹³ which has become commonly known as either CERCLA or Superfund, in order to provide a mechanism to clean up hazardous waste sites. In essence, CERCLA subjects five categories of persons to strict, joint and several liability¹⁴ for the costs of responding to a "release or threatened release" of hazardous substances from a "facility,"¹⁵ as well as for damages to natural resources.

The persons subject to CERCLA liability are:

- The owner and operator of a vessel;
- The owner and operator of a facility;
- Anyone who at the time of disposal owned or operated any facility at which hazardous substances were disposed;
- Anyone who arranges for the transport, disposal or treatment of hazardous substances; and
- Any person who accepts hazardous substances for transport to a site selected by such person.¹⁶

The breadth of CERCLA's reach is demonstrated by the definitions which it gives to the following terms:

"Operator" is defined as "a person who is carrying out operational functions for the owner of the facility pursuant to an appropriate agreement."¹⁷

"Facility" is "any site or area where a hazardous substance has been deposited, stored, disposed of, or placed, or otherwise come to be located," and specifically includes any:

- building
- structure
- installation

13. 42 U.S.C. § 9601 (1982 & 1987 Supp.).

14. CERCLA provides that its standard of liability is that which is imposed under Section 311 of the Federal Water Pollution Control Act (FWPCA), 33 U.S.C. § 1321 (1982, 1987 Supp.). See 42 U.S.C. § 9601 (32) (1987 Supp.). Cases interpreting § 311 of FWPCA hold that strict liability applies. See, e.g., *Burgess v. M/V Tamano*, 564 F.2d 964 (1st Cir. 1977), cert. denied, 435 U.S. 941 (1978). Accordingly, the courts have held that CERCLA imposes strict liability. See, e.g., *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985).

15. 45 U.S.C. § 9607 (1982 & 1987 Supp.).

16. *Id.*

17. 1980 U.S. CODE CONG. & ADMIN. NEWS 6119, 6182. See also *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 578 (D. Md. 1986), citing this definition as supporting the view that liability exists on the part of the owner of the property and also on the part of the operator if the operator is a different person than the owner.

- equipment
- pipe or pipeline (including any pipe into a sewer or publicly owned treatment works)
- well
- pit
- pond
- lagoon
- impoundment
- ditch
- landfill
- storage container
- motor vehicle
- rolling stock
- aircraft¹⁸

"Hazardous substance" is defined as those substances that are listed as hazardous under the Resource Conservation & Recovery Act of 1976,¹⁹ the Federal Water Pollution Control Act,²⁰ the Clean Air Act,²¹ and other materials specified by EPA. These substances exceed a thousand. Hazardous substances do *not* include petroleum, crude oil and natural gas.²²

"Release" is "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping or disposing into the environment."²³

If one falls within one of the categories subject to CERCLA liability, there are only three potential defenses: (1) act of God; (2) act of war; and (3) where the release is caused by the act or omission of a third party and (a) the third party does not have a direct or indirect contractual relationship with the defendant and (b) the defendant establishes that (i) he exercised due care with respect to the substance concerned and (ii) he took precautions against foreseeable acts and omissions of the third party.²⁴ In an attempt to respond to the potential liability concerns of Superfund cleanup contractors, Congress exempted such contractors from strict liability under federal law and also provided EPA with discretionary authority to indemnify the contractors for releases arising out of negligent response action activities when it amended CERCLA with the passage of the Superfund Amendments and Reauthorization Act of 1986 (SARA).²⁵

18. 42 U.S.C. § 9601(9) (1987 Supp.).

19. 42 U.S.C. § 6901 (1982 & 1987 Supp.).

20. 33 U.S.C. § 1251 (1982 & 1987 Supp.).

21. 42 U.S.C. § 7401 (1982 & 1987 Supp.).

22. 42 U.S.C. § 9601(14) (1987 Supp.).

23. 42 U.S.C. § 9601(22) (1987 Supp.).

24. 42 U.S.C. § 9607(b) (1982 & 1987 Supp.).

25. Pub. L. No. 99-499, 100 Stat. 1613 (1986).

1. Negligence Standard under SARA

Response Action Contractors²⁶ shall not be liable under CERCLA or under any other federal law for any liability which results from a release or threatened release of a hazardous substance unless the release is caused by conduct of the Response Action Contractor which is negligent, grossly negligent or which constitutes intentional misconduct.²⁷

By its terms, the section 9619 standard applies only to federal law. With regard to actions brought under state law, it does not preclude the courts from applying state statutory or common law standards, which may in some cases be strict liability.

B. State Law

In addition to statutory liabilities for additional cleanup costs, the hazardous waste cleanup contractor faces potential application of strict liability for third party claims under the common law doctrine of ultrahazardous or abnormally dangerous activities. While strict liability has generally not been applied to engineering and construction work, and while the traditional premises for the imposition of strict liability do not apply to hazardous material cleanup work,²⁸ there is no certainty that remedial contractors and engineers will not be swept into the chain of strict liability that may be applied under the common law to those persons who created the particular haz-

26. "Response action contractor" is defined as:

(A) Any (i) person who enters into a response action contract with respect to (A) any release or threatened release of a hazardous substance or pollutant or contaminant from a facility and is carrying out such contract; and (ii) person, public or nonprofit private entity, conducting a field demonstration pursuant to Section 11021(b) of this title; and (iii) recipients of grants (including sub-grantees) under Section 126 for the training and education of workers who are or may be engaged in activities related to hazardous waste removal, containment, or emergency response under this chapter; and (B) any person who is retained or hired by a person described in subparagraph (A) to provide any services relating to a response action. 42 U.S.C. § 9619(e)(2) (1987 Supp.).

A "response action contract" is defined as a written contract or agreement entered into by a Response Action Contractor with the President, any federal agency, a state or political subdivision or any potentially responsible party (private party) carrying out an agreement to provide any remedial action for removal under CERCLA of a hazardous substance or to provide any evaluation, planning, engineering, surveying and mapping, design, construction, equipment, or any ancillary services thereto for a facility. 42 U.S.C. § 9616(e)(1) (1987 Supp.).

27. 42 U.S.C. § 9619(a) (1987 Supp.).

28. The premise of strict liability is to impose liability upon those persons who "introduced into the community an abnormal risk of a serious character." PROSSER AND KEATON, THE LAW OF TORTS § 78 (5th ed. 1984). The Restatement of Torts sets forth six factors to be considered in determining if an activity is abnormally dangerous before strict liability principles will be applied: (1) the existence of a high degree of risk or harm to the person, land or chattels of others; (2) the likelihood that the harm that results will be great; (3) inability to eliminate the risk by the exercise of reasonable care; (4) the extent to which the activity is not a matter of common usage; (5) the inappropriateness of the activity to the place where it is carried on; and (6) the extent to which the value to the community is outweighed by its dangerous attributes. Application of the fifth and sixth factors demonstrate that strict liability should not be applied to Superfund cleanup activity. See RESTATEMENT (SECOND) OF TORTS § 520 (1965). Under state law, however, each court would make a determination of whether strict liability should be applied to the activities of remedial contractors by analyzing these factors on a case-by-case basis. Given the general trend toward expanding theories of liability, the remedial contractors' potential liability is unpredictable.

ard that is the subject of the cleanup activity." Moreover, careful analysis of the statutory law of each state is necessary in order to evaluate the potential for statutory imposition of strict liability for additional costs resulting from a further release during the contractor's work. For example, New Hampshire's mini-Superfund law specifically provides that:

any person who . . . (c) by contract, agreement or otherwise arranged for disposal or treatment . . . of hazardous waste . . . shall be strictly liable for all costs incurred by the State in responding to a release or threatened release.¹⁰

Additionally, some states have "Good Samaritan" statutes which afford protection for civil liabilities to persons who engage in hazardous waste remedial work, but provide that the protection does not apply to those who work for compensation." Texas, on the other hand, specifically provides that a Response Action Contractor cannot be liable for additional cleanup costs which result from its cleanup activities unless the costs were caused by gross negligence or willful misconduct." Attached as Appendix A to this article is an outline as of April 19, 1989, of all of the state mini-Superfund laws which affect contractor cleanup activity."

In addition to strict liability in tort, state common law has also imposed liability without fault under the common law doctrines of nuisance and trespass against owners of properties containing hazardous waste." Trespass liability may exist in some jurisdictions." As far as nuisance liability is concerned, in general a private nuisance is an unreasonable interference with the plaintiff's use and enjoyment of its land. A nuisance cause of action can arise from air and noise pollution as well as surface and

29. See, e.g., *State v. Ventron Corp.*, 94 N.J. 473, 493, 468 A.2d 150 (1983) ("mercury and other toxic wastes are 'abnormally dangerous,' and the disposal of them, past or present, is an abnormally dangerous activity"). But see *Forrest v. Imperial Serv., Inc.*, 712 P.2d 488 (Colo. App. 1985), *rev'd on other grounds*, 741 P.2d 1251 (Colo. 1987) (court rejected application of strict liability on basis of ultra-hazardous activity to landfill disposal of hazardous substance which resulted in personal injury).

30. N.H. REV. STAT. ANN. § 147-B:10 (1987).

31. See, e.g., ALA. CODE § 6-5-332.1 (1988 Supp.); COLO. REV. STAT. § 29-22-109 (1986); CONN. GEN. STAT. ANN. § 22a-452 (1989 Supp.); FLA. STAT. ANN. § 768-128 (West 1986); IDAHO CODE § 39-4421 (1985); KY. REV. STAT. ANN. § 411.460 (Baldwin 1988); ME. REV. STAT. ANN. tit. 38, § 1403(2) (1988 Supp.); MISS. CODE ANN. § 17-17-29 (1988 Supp.); S.C. CODE ANN. § 44-56-320, 330 (Law. Co-op. 1976 & 1988 Supp.).

32. TEX. REV. CIV. STAT. ANN. art. 4477-7, § 13(g)(9) (Vernon 1989 Supp.); compare § 8(i)(2).

33. The outline is based upon an update of a "Summary Matrix of State Law Information to Response Action Contractors," which is included in HAZARDOUS WASTE ACTION COALITION (HWAC), STATE LAWS RELATED TO RESPONSE ACTION CONTRACTORS (1988). HWAC is a coalition of the American Consulting Engineers Council. The authors of this paper are grateful for HWAC's permission to allow use of its format. Copies of the HWAC publication may be obtained from James W. Garvin, Editor, Donohue & Associates, Inc., 111 North Canal Street, Suite 305, Chicago, Illinois 60606.

34. *New York v. Shore Realty Corp.*, 759 F.2d 1032 (2d Cir. 1985); *State v. Ventron Corp.*, 94 N.J. 273, 468 A.2d 150 (1983).

35. *Martin v. Reynolds Metals Co.*, 221 Or. 86, 342 P.2d 790 (1959), *cert. denied*, 362 U.S. 918 (1960) (air pollution).

subsurface contamination.³⁶ Public nuisance actions are brought by a governmental authority on the public's behalf and damages generally are the governmental authority's cleanup costs and the costs of an injunction or abatement order.³⁷ Of course, a straight negligence action can also be brought. It is interesting to note that damages that have been claimed in hazardous waste actions include emotional distress because of concern about exposure to toxic waste, damages for the financial burden of medical surveillance, and damages for interference with the quality of life.³⁸

While hazardous waste may be obnoxious, it creates fertile ground for an injured party's counsel to plow.

IV. CONTRACTOR INDEMNIFICATION

A. *Indemnification under Federal Law*

The EPA has discretionary authority to provide *limited* indemnification to Response Action Contractors against liability for negligence arising out of the contractor's performance in carrying out response activities.³⁹

Indemnification is authorized for Response Action Contractors who are working under a written agreement with EPA, other federal agencies, a state or political subdivision which has entered into a contract or cooperative agreement with the federal government, or any potentially responsible party carrying out a cleanup agreement under CERCLA. It is critical to note from the surety standpoint that indemnification is provided only for a:

*release of any hazardous substance or pollutant or contaminant if such release arises out of response action activities. (Emphasis added.)*⁴⁰

This means there is no indemnification for expenses which might be incurred in connection with a threatened release to prevent the "release" from taking place or to minimize a "release." Such expenses may be totally unanticipated by the Response Action Contractor in its bid or, alternatively, be far beyond any contingencies provided for by the Response Action Contractor in its estimate.

The indemnification provisions were the product of extensive lobbying by the contractor community during the 1985-86 Superfund reauthorization process. The provision finally adopted in the statute does not closely resemble either the legislative proposals of the contractor organizations or the legislation initially passed by either chamber. Rather, the provisions were the product of hurried conference committee negotiations following passage of the respective bills, which negotiations categorized

36. See, e.g., *Soap Corp. v. Reynolds*, 178 F.2d 503 (5th Cir. 1949) (odors from soap factory created nuisance); *Signal Mountain Portland Cement Co. v. Brown*, 141 F.2d 471 (6th Cir. 1944) (dust from cement plant); *Cook Indus., Inc. v. Caulson*, 334 F. Supp. 809 (N.D. Miss. 1971) (drainage of surface waters blocked); *Bostick v. Smoot Sand & Gravel*, 154 F. Supp. 744 (D. Md. 1957), *rev'd on other grounds*, 260 F.2d 534 (4th Cir. 1958) (dredging sand and gravel); *Iverson v. Vint*, 243 Iowa 953, 54 N.W.2d 494 (1952) (pollution of well water).

37. *State v. Charpentier*, 489 A.2d 594 (N.H. 1985); *State v. Schenectady Chem., Inc.*, 103 A.D.2d 33, 479 N.Y.S.2d 1010 (1984); *Wood v. Picillo*, 443 A.2d 1244 (R.I. 1982).

38. *Ayers v. Township of Jackson*, 202 N.J. Super. 106, 493 A.2d 1314 (1985).

39. 42 U.S.C. § 9619(c) (1987 Supp.).

40. *Id.*

the contractor liability issue as controversial and difficult to resolve, but relatively low in importance. In fact, although contractors expressed their liability concerns before three House panels considering the Superfund legislation, they had only a brief audience before the Senate Environment and Public Works Committee, which only became aware of the contractor liability problem rather late in its consideration of the reauthorization.

Contractors originally sought language in House legislation which would limit their liability to a gross negligence standard and establish a preemptive federal standard of liability for cleanup contractors. The House eventually adopted a preemptive standard of liability for contractor actions other than negligence and an indemnification program with certain limitations. Senate conferees would not accept a preemptive federal standard of liability, but agreed to an indemnification program. Compromise with the House on this issue during the final hours of conference committee action resulted in the final language of section 9619, which failed to meet the liability concerns of most in the contractor community, and specifically failed to preempt state law.

Much of the contractor liability dialogue during this process included discussion of the lack of insurance availability. Surety bonding was mentioned, but was not a central concern of prospective Superfund contractors. Commercial sureties were essentially left out of the debate.

1. Prerequisites for Indemnification

Indemnification can be provided only if the government determines that each of the following requirements is met:

- the liability covered by the indemnification exceeds or is not covered by insurance available, at a fair and reasonable price, to the Response Action Contractor at the time it enters into the response action contract;
- adequate insurance to cover such liability is not generally available at the time the response action contract is entered into;
- the Response Action Contractor has made diligent efforts to obtain insurance coverage to cover such liability; and
- in the case of a contract covering more than one facility, the Response Action Contractor agrees to continue to make diligent efforts to obtain insurance each time it begins work under the contract at a new facility.⁴¹

2. Limitations on Indemnification

All indemnification agreements "shall include deductibles and shall place limits on the indemnification to be made available."⁴²

3. Payment of Indemnification Claims

Indemnification payments are to be made from the Hazardous Substance Superfund (Fund). If sufficient monies are unavailable from the Fund, or if the Fund is repealed,

41. 42 U.S.C. § 9619(c)(4) (1987 Supp.).

42. 42 U.S.C. § 9619(c)(5)(B) (1987 Supp.).

the statute provides authorization to appropriate such monies as may be necessary to make such payments. Authorization for future appropriations does not necessarily mean, however, that a future Congress will appropriate such monies.

4. Indemnification Agreements on Private Projects with Potentially Responsible Parties

Limitations exist on Response Action Contractor indemnification agreements when the response action contract is with a private potentially responsible party.⁴³ First, a determination is made as to the extent to which the potentially responsible party is able to indemnify the Response Action Contractor and indemnity is offered under section 9619 only if the private party's indemnification is inadequate to cover the reasonable potential liability of the Response Action Contractor.⁴⁴ Additionally, the claims procedure is radically different. The claim is paid only *after* the Response Action Contractor has exhausted all possible remedies for indemnification against *all* potentially responsible parties participating in the cleanup of the facility.⁴⁵ Also, the Response Action Contractor must pay all of its deductible before there can be any recovery of any amount from either the potentially responsible party or under the indemnification agreement.

5. EPA's Interim Guidelines for Indemnification

EPA is required to promulgate regulations for carrying out the indemnification authorization and, prior to promulgation of the regulations, to develop guidelines to carry out this authority.⁴⁶ On October 6, 1987, EPA released its "Interim Guidance on Indemnification of Superfund Response Action Contractors Under Section 119 of SARA,"⁴⁷ which are still in effect.

The Interim Guidance contains general policy guidelines, procedural guidelines for EPA's contracting officers and model indemnification agreements for use by EPA for various classes of contractors. Significantly, the model agreements provide that (1) they will be modified by mutual agreement of the parties after EPA's promulgation of final guidelines; (2) they apply only to liability for negligence and, therefore, apparently do not indemnify against any strict liability which may apply under state law;⁴⁸ (3) they apply only to liability which results from a release and, therefore, not to a "threatened" release; and (4) they "apply only to liability not compensated by insurance or otherwise."

43. 42 U.S.C. § 9619(c)(5) (1987 Supp.).

44. 42 U.S.C. § 9619(c)(5)(C)(i) (1987 Supp.).

45. 42 U.S.C. § 9619(c)(5)(C)(ii) (1987 Supp.).

46. 42 U.S.C. § 9619(xc)(7) (1987 Supp.).

47. OSWER Directive 9835.5.

48. In fact, the Model State Cooperative Agreement for contractors who contract with a state or political subdivision expressly states that "the Contractor shall not be indemnified for liability arising under strict tort liability, or any other basis of liability other than negligence."

6. EPA's Proposed Final Guidelines for Indemnification

On October 31, 1989, EPA's proposed Final Guidelines were published with a request for public comment.⁴⁹ While the EPA expresses confidence that it is not necessary to provide indemnification in order to attract qualified Response Action Contractors, it has expressed concern in its comments to the proposed Final Guidelines that if indemnity is not provided, sureties may be unwilling to write performance bonds where adequate insurance protection is not available.⁵⁰ The proposed Final Guidelines are more restrictive than the Interim Guidelines as to the scope and availability of indemnity. The general characteristics of the guidelines are as follows:

- EPA's indemnity will indemnify the contractor only against "third party liability." If the contractor is working under a contract with the EPA or other federal agency or a state or political subdivision, the guidelines suggest that the indemnity does not protect the contractor from actions brought by the EPA or the state or political subdivision or any other entity which is a party to the contract. Therefore, consequential losses to an agency resulting from a release as well as indemnity or contribution actions brought against the contractor as a result of third party claims are not subject to indemnity under the guidelines. This appears to be contrary to 42 U.S.C. § 9619(a)(1) which states that the Response Action Contractor shall not be liable under federal law to "any person" including claims for indemnification or contribution. The statute contains no reference to limiting its protection to claims by "third parties."

- The indemnity amount is limited to \$50,000,000. A contractor may request in its bid or proposal any amount of indemnification coverage not to exceed \$50,000,000. Under cost reimbursement contracts, the deductible depends upon the indemnity limit chosen. The deductible ranges from \$10,000 for \$1,000,000 in indemnity to \$3,500,000 for \$50,000,000 in indemnity. Under firm fixed price (sealed bid) contracts, the Response Action Contractor may request any amount of indemnification up to \$50,000,000 and any deductible amount with a minimum deductible of \$10,000 subject to a "price schedule" penalty described below. It is not clear how EPA arrived at a \$50,000,000 indemnification limit. Depending upon the circumstances of a particular project, that limit may be seriously inadequate.

49. EPA, Superfund Response Action Contractor Indemnification, 54 Fed. Reg. 46,012 (proposed Oct. 31, 1989).

50. *Id.* at p. 46,016. In September, 1989, the GAO issued its report entitled *Superfund: Contractors Are Being Too Liberally Indemnified by the Government*, (GAO/RCED-89-160, Sept. 26, 1989), expressing the view that EPA blanket indemnification with no set limit under the Interim Guidelines resulted in excessive and unnecessary indemnification of Response Action Contractors. Their report suggests that indemnification be made an element of competition in the contract award process. The GAO recommended placing a dollar limit on indemnification and incentives making it competitively unattractive to obtain more indemnification than is needed. This is the scheme followed by the proposed Final Guidelines.

quate. A study commissioned by EPA's Indemnification Task Force done by Tillinghast, Nelson & Warren, Inc., recommended limits of \$200,000,000.

- For firm fixed price (sealed bid) contracts, the Invitation for Bid will include a "price schedule" for indemnification, with prices depending on the size of the indemnification limit requested and size of deductible amount requested. The "price schedule" for indemnification which is to be the source of the dollar amount added to a firm fixed price bid is not yet published. It is unclear what EPA's basis will be for establishing the "price schedule." EPA will add the amount from the "price schedule" to the bidder's requested price. In selecting the lowest bidder, the EPA will evaluate the "net bid" constituting the bid plus the value of any requested indemnification. A request for indemnification, therefore, becomes a penalty to the bidding contractor. A contractor who finds it necessary to request indemnity could find that it is unable to compete against those who do not. Contractors who may not request indemnity are not necessarily limited to those who are small or thinly capitalized. This group may also include those contractors who already have very large existing hazardous waste exposures by reason of the operation of a number of disposal sites. It is certainly possible the EPA's penalty scheme will have significant impact on the bidding process. From the surety's perspective, the indemnification scheme requires that the underwriter carefully examine its contractor's indemnification arrangement. It cannot be assumed that a contractor seeking a bond has requested and received indemnification.

- The period of indemnification is the period of performance of the contract plus any time within ten years after the contract term. For multisite contracts, the coverage term with respect to an individual site is the ten year period following the RAC's completion of work at the site. In this connection, however, there is no statutory time limit on the RAC's potential liability for future releases. Many Statutes of Repose at the state level may not apply to Superfund cleanups since they may be construed to apply only to traditional improvements to real property (buildings or other structures), and not to the elimination or removal of hazardous waste.

- The guidelines state that EPA will not indemnify subcontractors directly. With written consent of EPA, prime contractors can include subcontractors in their indemnification agreements, but EPA will enter into only one indemnification agreement per contract, with the agreement covering only the prime contractor. The effect of this is to require the prime contractor to share its indemnity with its subcontractors. Since there is no adjustment to the prime contractor's deductible, the contractor remains exposed for the subcontractor's negligence to the extent of the prime's deductible. If the prime contractor has a high deductible, this may well create a situation where a prime will give indemnity to a subcontractor

51. Letter from Tillinghast, Nelson & Warren, Inc., to Robert J. Mason, Environmental Protection Specialist, EPA CERCLA Enforcement Division, dated Aug. 7, 1987. Tillinghast, Nelson & Warren, Inc., is a consulting and actuarial firm. Their study mentions that at one time architects and engineers could purchase up to \$50,000,000 in umbrella coverage, with this limit now being decreased as a result of the more restrictive insurance market. If this was the basis for EPA's proposed \$50,000,000 liability limit, it is not necessarily relevant to hazardous waste disposal operations by remedial action contractors.

with a significantly smaller deductible than that of the prime contractor. An example would be a \$2,000,000 indemnity to a subcontractor with a \$200,000 deductible. If the prime's deductible is \$3,000,000, this arrangement requires the prime to fully indemnify the subcontractor out of its own pocket. It is important to the surety underwriter to appreciate that the prime contractor cannot necessarily reduce its exposure by the use of subcontractors unless the contractor is able to find subcontractors who are financially responsible and willing to perform the work without indemnity from the prime. To the extent that the surety is approached by subcontractors for bonding on hazardous waste projects, it is important for the underwriter to appreciate that EPA indemnity is not available except through the prime contractor and that the prime contractor may be unwilling to share its indemnity with its subcontractors.

- The indemnity applies only to negligence, and does not apply if the Response Action Contractor is found both strictly liable and negligent and the cause of action is not divisible. The Guidance also provides EPA with the right to direct or control the defense of any claim or action against a Response Action Contractor. This provision makes it impossible to know whether the indemnity will provide any protection whatsoever. Whether the cause of action is or is not divisible is dependent upon circumstances of a particular case and the law of the particular jurisdiction. Obviously these provisions put EPA in a conflict of interest, since it is in EPA's interest to have a Response Action Contractor found liable on a strict liability theory.

- The indemnity limit is a contract aggregate limit, while any deductible is a per occurrence deductible. Occurrence is not a defined term under the guidelines and could be construed to be a separate deductible for every claim which might arise from a single event. Additionally, if the surety is requested to bond a single contract covering multiple sites, the underwriter should note that the contractor could incur very significant liability for multiple claims within its deductible.

- The Response Action Contractor must notify EPA of any claim or action that may involve indemnification within 20 days of the date when the Response Action Contractor "knew or should have known of the claim or event." While the guidelines do not say so specifically, presumably if the 20 day notice is not given, EPA will deny liability under the indemnification agreement. Because the 20 day notice period is triggered by an "event," the Response Action Contractor must guess correctly as to what "event" may ultimately (and possibly many years later) give rise to a claim. This provision may also create a fact issue in every case as to when the Response Action Contractor "should have known" of the claim or event. The surety's underwriter should take particular note of this provision in its assessment as to whether the indemnity has any real value.

- the EPA will not reimburse the RAC for the cost of insurance to cover any deductible. All available insurance must be applied to the payment of the claim, and, additionally, the deductible must be exhausted before the indemnity is paid.

- To qualify for indemnity, all of the requirements of Section 119 must be satisfied regarding efforts to secure third party insurance coverage.

- The guidelines state that EPA will not indemnify Response Action Contractors under contract to Potentially Responsible Parties (PRPs). EPA may agree to indemnify Response Action Contractors working under state cooperative agreements but it is in EPA's discretion as opposed to an entitlement.
- EPA indemnity applies only to work "directly related to site cleanup."
- At any time the EPA may cancel its indemnification of a RAC due to a material misrepresentation or a "failure on the part of the RAC to provide necessary information." The term "necessary information" is undefined and therefore totally unclear in this context.
- The EPA reserves the right to add additional terms and conditions to the indemnification agreement "as it deems necessary" consistent with Section 119 of the statute. Does this mean EPA can further restrict limits or scope of indemnification after the agreement is issued since that would be consistent with Section 119? Perhaps not, at least as to fixed price contracts, since another section of the guidelines states that indemnification terms and conditions cannot be modified once included in a fixed price contract.

The EPA is soliciting comments from the industry on its proposed guidelines. Hopefully, some of the provisions which are of concern to the surety industry will be either eliminated or modified so as to make the indemnity reliable and worthy of consideration by the underwriter. As matters now stand, the surety's underwriter may be forced to disregard the indemnity as a positive factor in the underwriting decision.

B. *Indemnification under State Law*

A number of states have anti-indemnification statutes which void indemnification agreements for liability which arises out of certain design and construction contracts.⁵² Because nothing in section 9619 preempts the application of state anti-indemnity statutes, specific attention must be paid to state law when one analyzes the effect of an indemnity agreement.

Additionally, with regard to indemnification by state or local governments, some states have constitutional provisions or statutes similar to the Federal Anti-Deficiency Act,⁵³ which may make an indemnity obtained from a governmental entity unenforceable.⁵⁴

Ten states have passed legislation specifically authorizing governmental indemnification of Response Action Contractors. They are: California, Connecticut, Florida, Illinois, Louisiana, Massachusetts, New Jersey, Oregon, Texas and Washington.⁵⁵ Because most of the authorizations contain distinctions from one another, each stat-

52. See, e.g., MD. CTS. & JUD. PROC. CODE ANN. § 5-305 (1984).

53. The federal indemnification authority is excepted from the Anti-Deficiency Act. 42 U.S.C. § 9619(c)(3) (1987 Supp.).

54. See, e.g., IDAHO CONST. art. VIII, §§ 1-2 (governmental liabilities in excess of \$2 million must be authorized by law which provides for method of repayment; KY. REV. STAT. ANN. §§ 157-58 (Baldwin 1988).

55. See Appendix A.

ute must be analyzed separately to determine the terms and conditions upon which indemnity is authorized. Texas, for example, forbids state indemnification of a contractor unless the federal government agrees to indemnify the state.⁵⁶

V. AVAILABILITY OF INSURANCE

Throughout the 1986 Superfund reauthorization process which culminated in the enactment of SARA, EPA officials agreed with contractor testimony that adequate insurance coverage at a reasonable price was not available to them and was unlikely to be available in the near future. In fact, the lack of such insurance coverage was the underlying justification for the establishment of a federal negligence standard and an indemnification program for Superfund cleanup contractors.

In response to concerns about the lack of insurance in the hazardous waste market in general, the GAO prepared a report dated October, 1987, which outlined the state of insurance availability in the hazardous waste field. The report concluded that "Only one insurance organization is actively marketing pollution insurance. A few hundred companies are insured under its policies. The maximum annual coverage that can be purchased is \$12.5 million. Several other insurance organizations provide limited-coverage pollution risk insurance."⁵⁷

On the more specific subject of pollution liability insurance for Response Action Contractors, EPA itself concluded that only two U.S. property and casualty insurers, as of April, 1988, were offering specialized pollution liability insurance programs to Response Action Contractors active in the Superfund program.⁵⁸ In addition, EPA has identified a captive insurance company, DEMETER, formed by the Hazardous Waste Action Coalition (HWAC) of the American Consulting Engineers Council (ACEC), as an alternative providing professional and general liability coverage on a claims-made basis to qualified members with a hazardous waste practice. The coverage includes pollution claims otherwise excluded from a member's professional liability or comprehensive general liability policy.

The coverage offered by the two insurance companies was in the form of claims-made policies,⁵⁹ each carrying maximum limits of \$1 million per occurrence and \$2 to \$5 million annual aggregate, respectively. Each carried a minimum premium of \$25,000, one with a \$25,000 self-insured retention and the other with a \$50,000 self-insured retention.

56. TEX. REV. CIV. STAT. ANN. art. 4477-7, § 13 (Vernon 1989 Supp.).

57. UNITED STATES GENERAL ACCOUNTING OFFICE, HAZARDOUS WASTE, ISSUES SURROUNDING INSURANCE AVAILABILITY 3 (October 1987).

58. In its April 25, 1988, issue, NATIONAL UNDERWRITER reported that Reliance, through underwriting manager Environmental Compliance Service, offers a claims-made contractor pollution liability policy for Superfund sites on a job-by-job basis. According to an article in the March 21, 1988, issue of BUSINESS INSURANCE, Reliance's limits at that time were \$1 million per claim and a \$2 million aggregate. The article also reports that "Reliance charges a minimum premium of \$20,000 for a \$1 million policy with a \$25,000 self-insured retention."

59. The "claims-made" policy generally provides coverage only for claims which are presented to the insurer during the effective dates of the policy.

Contractors point out that the coverage available is very low coverage, with restrictive terms and at high premiums. While the language of section 9619(c)(4) requires Response Action Contractors to make diligent and continuing efforts to obtain adequate insurance at a fair and reasonable price, there is no definition of what is "fair and reasonable" or "adequate."

EPA has expressed optimism regarding the future availability of insurance coverage for Response Action Contractors and envisions a phasing out of contractor indemnification as that insurance increasingly becomes available. It is unclear whether claims-made insurance will be considered by EPA to be adequate to address the potential long-term risks which concern Response Action Contractors. Response Action Contractors are legitimately concerned that they may be found liable for hazardous waste releases precipitated by some event occurring during the actual cleanup, but not discovered until years after completion of their contract. Claims-made insurance currently available will not, in their judgment, address that long-term risk.

VI. POTENTIAL CLAIMS AGAINST CONTRACT BONDS FOR HAZARDOUS WASTE LIABILITY

To date, there are no reported cases where either a governmental entity or private party has attempted to assert hazardous waste liability against a surety issuing a contract performance bond. This, of course, does not mean that the day will not come. The contract performance bond is, after all, the "insurance of last resort when all else fails." In a general sense, the surety's liability is coextensive with that of its principal, with any damages recoverable against the principal being recoverable from the surety. Like all general statements, this is subject to exceptions depending upon the circumstances. The potential claims which might be made against the contract bond surety are discussed below.

A. *General Liability Principles*

From the preceding discussion, it is obvious that the contract bond surety which is bonding a Response Action Contractor, whether on public or private contracts, has significant exposure for a "release" of a hazardous substance. This risk is recognizable by the surety when it is making the decision whether or not to underwrite the performance bond. More subtle is the potential risk to the surety on a conventional contract where the surety is not on notice that hazardous waste liability might be accepted by its contractor. In this connection, the bonded contractor might uncover unanticipated hazardous waste at the project site and agree by change order to participate in a cleanup or transport of the material. This would expose the contractor and the surety to strict liability under federal law.⁶⁰ All that would be happening in this scenario is the issuance of a change order, which may well be within the scope of the base contract. The issuance of such a change order would normally not discharge the

60. Under these circumstances the contractor would not be a "Response Action Contractor" because the contract would not be a "Response Action Contract" as defined by 42 U.S.C. § 9619.

surety, even without its consent, if either the contract or the bond documents permit the issuance of change orders without notice to the surety.⁶¹ Any dealing with the substance, once discovered, can constitute "arranging," "transport," "disposal" or "treatment" under CERCLA, and can subject the contractor to strict liability under federal and state law. It is even conceivable that such a contractor could be considered to be an "operator" of a "facility" under RCRA when hazardous waste is uncovered on a conventional construction site in control of the contractor, subjecting the contractor to the permitting requirements of RCRA and the surety to claims if the requirements of the permit are breached.

B. *Strict Liability and Negligence*

In our view, the contract bond surety would not be responsible for liability based on strict liability. Performance bonds, whether given under the Miller Act or privately, are conditioned upon the contractor performing and fulfilling all of the undertakings in its contract. A recovery in strict liability would not be based upon a breach of the contract or failure to perform any of its terms and conditions, whether categorized as a breach of contract or negligent failure to perform the contract. Most courts view the surety bond as being interpreted under traditional rules of contract interpretation, viewing the bond as a simple contract which should be interpreted in accordance with the intention of the parties.⁶² In this connection, it has even been held in a recent case that a surety is not liable where a contractor was found liable based upon negligence on the theory that a surety bond is conditioned only on breach of contract.⁶³ Unfortunately, this case could easily have been decided against the surety. Negligence, in addition to creating a cause of action in tort, also creates an action for breach of contract where there is a contractual duty to use reasonable care.⁶⁴

C. *Punitive Damages*

There are relatively few cases dealing with a contract bond surety's liability for punitive damages. In general, the state of the law today is that the contract bond surety is not liable for punitive damages if the surety is not an active participant in the act giving rise to the punitive damage liability.⁶⁵ A punitive damage claim against the surety is not likely to arise except in the context of indemnity claims by the obligee as a result of a third party tort claim.⁶⁶ Punitive damages under CERCLA are awarded for failure to properly provide removal or remedial action upon an order of the government. While such a claim is not likely, a claimant against the contract bond surety could theorize that, if the surety was notified of the governmental order and refused to ensure that its principal acted, then it was therefore a participant in the act justifying punitive damages. The surety's response would be that if the order was based

61. See generally 17 AM. JUR. 2D, *Contractors Bonds* § 26 (1964); AIA Form A311 (Performance Bond) (waiving notice of any "alteration" or "extension of time made by owner").

62. *Republic Ins. v. Board of County Comm'rs*, 68 Md. App. 428, 511 A.2d 1136 (1986).

63. *Chesapeake & Potomac Tel. Co. v. Sisson & Ryan, Inc.*, 234 Va. 492, 362 S.E.2d 723 (1987).

64. *Koppers Co., Inc. v. Inland Steel Co.*, 498 N.E.2d 1247 (Ind. 1986).

65. *Aiken County v. BSP Div. of Envirotech*, 657 F. Supp. 1339 (D.S.C. 1986).

66. See *infra* notes 66-67 and accompanying text.

upon the strict liability theory of CERCLA, and was under circumstances where the contractor receiving the contract could be entitled to extra compensation from the owner, which the owner refused to acknowledge, the contractor would not be in breach of its contract with the owner unless it had assumed hazardous waste liability by contract. Regardless of arguments that might be made that the surety is an "actor" in such a scenario by failing to ensure compliance, it remains very doubtful that the government, for policy reasons, would pursue the contract bond surety for punitive damages.

D. *Consequential Losses*

As a general rule, consequential damages to the owner are recoverable against the surety if such damages are recoverable against the principal under the bonded contract. Significant consequential losses exist in the hazardous waste context which are not encountered with conventional contracts. Consequential losses which might be recovered under CERCLA are the costs of removal where remedial action is incurred by the U.S. or a state consistent with the National Contingency Plan⁶⁷ or such costs incurred by any other third party consistent with the National Contingency Plan. In addition, damages for injury to natural resources and costs of any health assessment or health effect study are provided for. To the extent that the contractor is required by contract to store or dispose of the hazardous waste on site, RCRA⁶⁸ may categorize the contractor as an operator of a treatment or disposal facility where an RCRA permit is required.⁶⁹ That statute requires that the operator (contractor) take corrective action for all releases of hazardous waste or constituents from any treatment or disposal facility. If the contractor fails to perform its work under the contract and/or violates the permit by the release of any hazardous waste, a claim might be made against the contract bond surety to the extent of its bond penalty for any *on- or off-site corrective action* which may be required. This is not a normal risk undertaken by a surety in a performance bond. A surety is not normally required to go off the project site and do work on another person's property. This may be the case in a situation where the contractor under its permit is required to take corrective action if there is a release that requires cleanup on another's property.

E. *Third Party Tort Claims*

As to the liability of the surety to third parties other than the obligee under the performance bond, to date the case law has been consistent that where the performance bond contains a third party beneficiary clause prohibiting claims of third party beneficiaries other than the obligee, this language will be upheld as a valid contractual limit on liability. Such language reads as follows:

67. The National Contingency Plan is the general plan for removal of all hazardous substances from the environment under CERCLA. See 42 U.S.C. § 9605 (1987 Supp.).

68. 42 U.S.C. § 6901 (1982 & 1987 Supp.).

69. In this regard, EPA cannot indemnify owners or operators of facilities regulated under RCRA. 42 U.S.C. § 9619(5)(D) (1987 Supp.).

No right of action shall accrue on this bond to or for the use of any person or corporation other than the Owner named herein or the heirs, executors, administrators or successors of Owner.

Under this provision, no direct claim can be made on the performance bond by anyone other than the obligee.⁷⁰ Obviously, if the obligee is subject to CERCLA damage claims or third party tort claims, the obligee may make an indemnity claim against the contract bond surety under the indemnity clause appearing in the general contract which is incorporated into the performance bond by reference. For example, an adjacent landowner may sue the owner for a "release" caused by the operations of the bonded contractor. The owner may then file an indemnity claim against the surety for the recovery of these damages claiming they were proximately caused by the contractor's breach of contract. The claim could be based on cleanup costs or personal injuries sustained. In the circumstance where there is no casualty insurance covering the bonded contractor, the owner has every incentive to make such an indemnity claim against the performance bond.

Whether or not such a claim would be recognized against a performance bond surety is a matter of debate, with the absence of casualty insurance being an important factor.⁷¹ In a conventional construction contract where hazardous waste is encountered inadvertently under circumstances where it was not suspected, a surety might defend against the indemnity claim by contending that the damages did not naturally arise from a breach of the contract since the handling or disposing of hazardous waste was not within the contemplation of the parties at the time the contractor entered into its contract. Additionally, there may be significant differences in the surety's exposure depending on whether the principal is working as a Response Action Contractor for a private owner or whether it is working under contract to a federal or a state agency. In the latter case, either the federal agency or the state agency may be immune to third party tort actions by reason of governmental immunity.

F. Warranty Claims

Warranty claim liability for hazardous waste is a matter of serious concern, particularly to a surety considering bonding a cleanup contractor. The majority of cases hold that the contract bond surety is responsible for latent defects arising long after the final acceptance and final payment of the contract funds in circumstances where the contractor remains responsible under its contract.⁷² These circumstances are as follows:

70. *Rush Presbyterian v. Safeco Ins. Co.*, 825 F.2d 1204 (7th Cir. 1987); *Board of Educ. v. Ackerland & Assoc.*, 165 Ill. App. 3d 562, 519 N.E.2d 95 (1988).

71. Franklin, *Problems of the Performance Bond Surety with Casualty Insurance Exposures*, 16 FORUM 567 (1981); Fields, *Claims Against Surety For Personal Injury and Property Damage*, 31 INSURANCE COUNSEL JOURNAL 658 (1964).

72. E.g., *President of Georgetown College v. Madden*, 505 F. Supp. 557 (D. Md. 1980); Warin, *The Surety's Liability for Latent Defects* (ABA Fidelity and Surety Committee, January, 1985).

- Where there is a breach of contract by the contractor. The breach may be failing to build in accordance with applicable plans and specifications or failing to design adequately where the contract is "design-build."
- Where the owner is unaware of the defect at the time of final acceptance.
- Where the defect was not apparent upon reasonable inspection.
- Where the claim is otherwise made within the applicable period of limitations.

Where the contract involves the cleanup and disposal of hazardous waste, there is obviously a long "tail" on when the surety's principal could be sued by reason of a "release" of hazardous waste arising from the performance of a cleanup contract. As a practical matter, the "tail" could be virtually never-ending absent the applicability of a Statute of Repose. The risk is far less with a standard construction contract not involving hazardous waste cleanup.

G. Indemnification of Response Action Contractors—Can the Surety Count on It?

We have already commented upon the problems raised by EPA's proposed Final Guidelines. In addition, there are certain characteristics of the underlying CERCLA statute⁷³ providing for "indemnification" of Response Action Contractors which need to be understood. Indemnity is not automatic. It must be granted within the terms of the Response Action Contract. The indemnification agreement is provided only where it is determined that insurance is not available to the Response Action Contractor at a fair and reasonable price.⁷⁴ If the indemnity is given in connection with a *private party cleanup*, a claim may not be paid unless the contractor has exhausted all administrative, judicial and common law claims for indemnification against all potentially responsible parties participating in the cleanup of the facility.⁷⁵ Also, the contractor must pay any deductible established under the indemnification agreement.⁷⁶ For the contract bond surety considering whether to underwrite a private party contract, it must realize that it may well be financing a very long and protracted series of legal proceedings to exhaust administrative, judicial and common law claims before any reimbursement under the indemnity provisions of the cleanup contract is paid. Additionally, the contract bond surety should also realize that for other reasons the indemnity is to a large extent illusory. The indemnification provision indemnifies the contractor only against the contractor's negligence and not against gross negligence or intentional misconduct. In this day and age, when injury occurs, negligence is almost always found among one or more of the acting parties. The concept of an accident without fault is virtually unknown in modern tort law. Therefore, the indemnity provision is illusory since it indemnifies only for pure negligence and not for "gross negligence." What is more than likely to happen is that actions which would otherwise be characterized as merely "negligent" will now rise to the level of "gross negligence." It is the view of some industry representa-

73. 42 U.S.C. § 9619 (1982 & 1987 Supp.).

74. 42 U.S.C. § 9619(c)(4) (1987 Supp.).

75. 42 U.S.C. § 9619(c)(5)(C)(ii) (1987 Supp.).

76. 42 U.S.C. § 9619(c)(5)(B) (1987 Supp.).

tives involved with the lobbying of this statute that, in reality, the indemnity provisions have only eliminated strict liability, with the cleanup contractor still exposed for negligent conduct garbed in the concept of "gross negligence." The situation could become extremely uncomfortable and risky for a contract bond surety attempting to enforce the contractor's indemnity against a government agency which contends that the contractor's conduct was "grossly negligent" under the circumstances.

H. The Contract Bond Surety's Potential Liability after Default of the Bonded Contractor

Difficult as it may seem for the contract bond surety to face the problem of deciding whether to bond a hazardous waste cleanup contractor, consider the difficulties when the surety is faced with complexing such a contract after the default of its principal. Whether the surety elects to finance its principal to completion or to relet the contract to others, someone at some point will make the argument that the surety takes on all of the contractor's hazardous waste liability, thereby exposing the surety beyond the amount of its bond penalty. Ridiculous as it may seem, the surety itself may be viewed as the "operator" of a hazardous waste "facility," "disposing" of or "treating" hazardous wastes, in connection with its election to complete the contract.⁷⁷ The argument may also be made that the surety arranging for the completion of the contract has become an "arranger"⁷⁸ which is arranging for the disposal of hazardous substances and which therefore has CERCLA liability. Either of these findings exposes the surety to CERCLA liability beyond the amount of its bond penalty and subjects the surety to the risk of third party liability.

Obviously, the most dangerous situation is where the surety enters into a contract with another contractor to complete. In many cases, the surety may be unable to find a contractor willing to take on the project, much less a contractor who is bonded. Additionally, the default may well have occurred because the available technology could not meet the requirements of the contract. In these cases the surety will have little choice except to tender its bond penalty. If a completing contractor is available, the less dangerous course would seem to be to attempt to arrange for the completing contractor to enter into a contract directly with the owner, with the surety agreeing with the owner to finance progress payments in excess of the contract balances to the extent of the bond penalty. Presumably, this would not subject the surety to hazardous waste liability since it would not be actively completing the contract in a direct relationship to the owner.

What about financing the contractor? This activity raises the specter of the surety being subjected to derivative hazardous waste liability under circumstances akin to "domination" or as an "arranger." In *United States v. Mirabile*,⁷⁹ the court ruled that

77. The Miller Act does not necessarily immunize the Surety from state law liability for its conduct relating to the performance of obligations arising out of Miller Act bonds. See *K-W Indus. v. National Sur. Corp.*, 855 F.2d 640 (9th Cir. 1988).

78. 42 U.S.C. § 9607(a) (1982 & 1987 Supp.).

79. 15 Env't. L. Rep. (Env't. L. Inst.) 20994 (E.D. Pa. 1985).

a bank which was a secured creditor of a company operating a hazardous waste site was not liable for response cost under CERCLA by reason of the bank's action in monitoring a cash collateral account, ensuring that receivables went to the proper account, and establishing a reporting system between the company and the bank. The court did hold, however, that a bank might be liable under CERCLA if it exercised control over the day to day operations of the hazardous waste facility and that control might be evidenced by frequent visits to the site by an auditor and other bank personnel, insisting on certain manufacturing changes, reassigning personnel, and day to day supervision of the debtor's employees by an employee of the bank. However, cases in other contexts have held the surety not to have exercised such control over its principal as to justify holding the surety derivatively liable to other parties.⁸⁰

At this juncture, there is no reason to believe that the ordinary activities which a surety undertakes in financing its contractor would subject it to any greater risk of derivative liability under the hazardous waste laws than in the ordinary "domination" case. There are two possible exceptions to this proposition. The first circumstance is where the surety is an "actor" under circumstances demonstrating that the surety, through the monitoring of its consultants, or otherwise, had reason to know that the contractor was negligent in its operations and was risking a "release." The second circumstance is if the courts find that the completing surety can be deemed an "arranger."⁸¹ Arranger liability under CERCLA applies to anyone who arranges for the transport, disposal or treatment of hazardous substances. There is no sound reason for viewing a performance bond surety as an "arranger." Judicial policy should not create results that discourage bonding companies from bonding projects which are necessary and in the public interest. Imposing "arranger" liability upon the surety would do just that.

As a practical matter, the risk to the completing surety of incurring hazardous waste liabilities in excess of its bond penalty may be such that the surety may be forced to post its bond penalty in all cases rather than inject itself into the completion process. All sureties must be absolutely sure that their bond forms do not require them to engage a completing contractor, but allow the surety simply to indemnify the owner for its completion costs beyond the contract balance without subjecting the surety to the risk that it has breached the bonding obligation.

VII. HAZARDOUS WASTE LAWS AND THEIR EFFECT UPON THE SURETY'S SALVAGE OPTIONS

One area which is frequently overlooked by sureties and their counsel is the exposure to the surety when it executes on real estate under collateral agreements or upon judgments against its principal and indemnitors. The surety should not take title to real estate until it is satisfied that no hazardous waste has been deposited on the property. In this connection, the surety is in the same situation as is a foreclosing bank. If

80. *Ser James E. McFadden, Inc. v. Baltimore Contractors*, 609 F. Supp. 1102 (E.D. Pa. 1985); *Irwin & Leighton, Inc. v. W.R. Anderson Co.*, 532 A.2d 983 (Del. Ch. 1987).

81. 42 U.S.C. § 9607(a) (1982 & 1987 Supp.).

there is any reason to suspect that hazardous waste has been deposited, the surety should consider an environmental investigation by consulting engineers before taking title to the real estate. The danger in not doing so is illustrated by *United States v. Maryland Bank & Trust Company*,⁸² where the United States sued a bank that had foreclosed on a hazardous waste site following the default of the debtor. The United States sued the bank because the bank had held title for a year and was the owner of the property which was the subject of an EPA cleanup costing in excess of \$500,000. The court granted summary judgment in favor of the United States and against the bank as to liability. The court reserved judgment as to whether the bank could prove the third party defense.⁸³ The third party defense is available if one can show that the release or threat of release is caused solely by a third party other than an employee or agent of the defendant or one whose act or omission occurs in connection with a contractual relationship existing directly or indirectly with the defendant. This assumes that the defendant exercised due care with respect to the hazardous substance concerned, taking into consideration the characteristics of such hazardous substance, in light of all relevant facts and circumstances, and that the defendant can also establish that he took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions. From a very strict reading of the statute, it is unclear whether this defense is available to the surety if the bonding relationship (contractual relationship) has existed during the period when the act or omission causing the release took place, particularly where the deposit of the hazardous substance was in some fashion connected with the principal's business operation.

VIII. CONCLUSION AND RECOMMENDATIONS

To date, there are a few instances of legitimate commercial sureties which have bonded hazardous waste remediation contracts. It is not clear whether these sureties have made a decision to participate in this market or whether they simply have not focused on the risks which might be encountered. It is also the authors' understanding that the reinsurance market has not yet refused to accept hazardous waste surety bond obligations. To the extent that sureties are uneasy about entering this market, the surety industry should become active in attempting to secure legislative relief to reduce the risk, both to itself and to its contractors. Areas of potential legislative relief are:

- Limiting the surety's liability to the cost of completing performance of the original contractual undertaking of the contractor, i.e., completion of "the work," thereby eliminating the risk for consequential damages and release the cleanup liability as well as indirect third party tort liability.
- Establishing a liability limit for Response Action Contractors and their sureties or, alternatively, more reasonable indemnity provisions.

82. 632 F. Supp. 573 (D. Md. 1986).

83. 42 U.S.C. § 9601(35)(A) (1987 Supp.).

- Reducing the required amount of the performance bond penalty on Miller Act and Little Miller Act jobs. This can be done by regulation under the Miller Act and under those state Little Miller Acts where the contracting officer has discretion as to the amount of the performance and payment bonds.
- Preemption of state law as to the liability of Response Action Contractors and their sureties.
- Clarification of RCRA permit requirements so its liabilities do not apply to Response Action Contractors and their sureties.
- Clarification that a surety is not to be deemed an "arranger" or "operator" of a "facility" in connection with any of its activities as a surety on a Response Action Contract.

All of the above deal only with limiting the surety's risk in bonding a Response Action Contract with a federal or state agency where the surety is not free to condition the terms of its bond. It does not cover a conventional construction contract where the contractor, by change order or otherwise, gets involved in cleaning up a hazardous waste. In private party cleanups, to the extent that private parties solicit bonding, the problems are not as severe because some of the limitations on potential liability can be secured by adjustments in the terms and conditions of the bond and the principal's construction contract. Additionally, where the private party is substantial, the Response Action Contractor may secure an effective indemnity provision in the contract that substantially reduces its liability risk and consequently that of its surety. However, potential liability of the contractor under CERCLA cannot be eliminated.

Insofar as those unusual cases where the surety and its contractor may risk liability under a conventional construction contract, the sureties should instruct their clients to place appropriate provisions in their contracts excepting all forms of hazardous waste work from the scope of the contract and from the operation of the changed conditions clause. The owner should be prohibited from directing the contractor, by change order or otherwise, to transport, dispose of, or to treat any form of hazardous substance.

The surety's underwriting process consists of an examination of the individual contractor, its experience and competence in light of the project in question and its probability of success on that project, combined with the effect of the project on its overall work program. This type of underwriting analysis is almost impossible in connection with a major hazardous waste cleanup contract. Any such analysis leads to the inevitable conclusion, under present law, that a substantial cleanup contract is very likely to be an unacceptable bonding risk to the surety. If Congress and the involved agencies expect the surety industry to participate in the cleanup of the nation's waste, they should be willing to limit both the sureties' risk and the Response Action Contractors' risk as suggested. Neither of these parties created the mess that they are being asked to clean up. For that reason, there is no justification for exposing them to responsibility for that risk under the guise of a Response Action Contract.

APPENDIX
SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Alabama	Pollution Control Grant Fund (§ 22-22A-16)	No. 22-22-9(m) includes wrongful acts, omis- sions and negligence.	No.	No.	Yes.
5/89	Alaska	No.	Yes, but RAC must have control over haz- ardous substances. (46.03.822)	No.	Yes, but does not apply to RACs (45.45.900)	Anti-deficiency statute is limited to mortgage has no application RACs. (34.20.100)
5/89	Arizona	Water Quality As- surance Revolving Fund (49-282)	No.	No.	Yes, for sole negligence in certain AE and con- struction contracts (34-226)	Yes. Section 34-154 precludes public sector indemnities unless funds are appropriated.
5/89	Arkansas	Remedial Action Trust Fund (8-7-508)	No. 8-7-420 holds RAC's to a negligence stan- dard.	No. 8-7-512 requires RAC's to indem- nify states.	No.	No. DPCE contracts with consultants and contrac- tors have received full state indemnification.

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	California	Haz. Sub. Acct. (CA H&S Code, Ch. 68 § 25300- 395)	Yes, if RAC is respon- sible for release (CA H&S Code, 25363) and if RAC causes or contributes to the dis- charge. (Proposition 65)	Yes, State can in- demnify RACs for up to \$25 million (CA H&S Code 25364.6(d)(s), ex- pires 1-1-92)	Yes. Indemnification of sole negligence unen- forceable in design and construction contracts (CA Civil Code 2782(a))	No. Anti-deficiency statute applies by its terms to RACs.
5/89	Colorado	Hazardous Sub- stance Response Fund (Colgo. RS 25-16-104.6)	None.	None. Public en- tity can seek reim- bursement for those responsible for a "hazardous substance inci- dent."	None.	No.
5/89	Connecticut	Emergency Spill & Relief Fund (229-451)	Yes, if RAC causes pollution and contami- nation	Yes, for any per- son etc. who con- tains, removes or mitigates hazard- ous waste (22a- 452)	Yes, for sole negligence in certain construction contexts (52-572k)	No.

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Delaware	Hazardous Waste Management Act, § 6316, allows Department of Conservation to receive funds in carrying out Act.	Yes, if RAC treated or disposed of wastes (7DE Code 6301-6309)	No.	Yes, for negligence of all parties in all phases of design and construction projects (6 DE Code 2704)	Yes, sovereign immunity statutes exempt the state from liability (10 DE Code 4001, <i>et seq.</i>)
5/89	District of Columbia	None.	No.	No.	No.	No.
5/89	Florida	Hazardous Waste Management Trust Fund (403.725)	Yes, if RAC arranged for disposal or treatment (Fla. Stat. Ann. 403.727)	Yes, for state and local contractors (376.319)	Yes, For acts or omissions in certain construction contexts unless indemnification capped or consideration given.	No.
5/89	Georgia	Hazardous Waste Trust Fund (12-8-68)	Yes, if RAC contributes to the release (12-8-81)	No.	Yes, for sole negligence in certain construction contexts (13-8-2)	No.
5/89	Hawaii	None, but Director has authority, with approval of the Governor, to receive money from the Federal and State government	No, however, Director was authorized in 1988 to bring state into compliance with federal law	No.	Yes, for sole negligence in certain construction contexts) (431-453)	No.

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

	<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
	5/89	Idaho	Hazardous Waste Training, Emergency and Monitoring Account. (39-4417)	No, liability would only be incurred for law violations (39-4401, <i>et seq.</i>)	No.	Yes, for sole negligence in certain construction contexts (29-114)	Yes, Constitution restricts debts or liabilities unless specifically authorized (Art. 8, SSH2)
692	5/89	Illinois	Hazardous Waste Fund (1022.2)	Yes, for persons who operate a facility used for treatment or storage, or who contract for same (111-1/2, <i>et seq.</i>)	Yes, for RACs working for state, with a \$2 million cap per occurrence. (HB 3207: 111-1/2)	Yes, for own negligence in certain construction contexts and (Ch. 29-s61) for transport of hazardous waste (1022.2(g))	Yes, for negligence
	5/89	Indiana	Hazardous Substance Response Trust Fund	Yes, potentially under 13-7-12-2- and 13-7-13-1	No.	Yes, for sole negligence in certain construction contexts (26-2-5-1) but no if liability insurance unavailable (26-2-5-2)	Yes.

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Iowa	Hazardous Waste Remedial Fund (455B.423)	Yes, if RAC has control over hazardous substance (455B.392), but no (negligence standard) if transport hazardous waste	No.	No.	Yes, no state indemnification if paid to do the work
5/89	Kansas	Environmental Response Fund (65-3454a)	No, liability only for gross negligence or reckless, wanton or intentional misconduct (65-3472)	No.	No.	No.
5/89	Kentucky	Hazardous Waste Assessment and Management Fund (224.876)	Yes, if RAC has possession or control over discharge or caused the discharge (224.877)	No.	Maybe. Kentucky Constitution §§ 50-177 arguably bars indemnification.	Yes.
5/89	Louisiana	Hazardous Waste Protection Fund (30:2198) and Hazardous Waste Site Cleanup Fund (30:2205)	No. Statutory negligence standard (9:2800.3(a))	Yes, holds harmless state contractors from property damage and personal injuries caused by negligence (30:1149-1)	Yes, applicable to owners of facility or any person liable for discharge or disposal (30:2278)	No.

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Maine	No, uses Federal Superfund Program (38 § 1366)	Yes. RAC can be considered a "responsible party." (38 § 1361, <i>et seq.</i>)	No. RACs may have to indemnify state (38 § 1367)	No.	No.
5/89	Maryland	Cont. Haz. Subs (Md. Health Env. Code Ann. Tit. 7:201, <i>et seq.</i>)	No.	No.	Yes, for sole negligence in certain construction contexts (S-305)	No.
5/89	Massachusetts	No State funding mechanism	No, but applies with respect to releases or threatened releases of hazardous materials (21 E. § 16(9); otherwise may be strictly liable under 21 E. § 5.	Yes, with \$2 million cap and certain restrictions. (21 E. § 17)	Yes, voids agreements by subcontractors to indemnify others for injuries not caused by subcontractor (Ch. 149 S29C)	No.
5/89	Michigan	Environmental Response Fund (299.609)	No.	No.	Yes, for sole negligence in certain construction contexts (691.991)	No.

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Minnesota	Environmental Response, Compensation and Compliance Fund (§ 115 B.20)	No, as long as RAC is working under State or Federal Acts (115 B.05)	No.	Yes, cannot transfer liability to another person (115 B.10)	No.
5/89	Mississippi	Hazardous Waste Facility Siting Fund (§ 115 B.20)	Yes, if it helps create necessity for cleanup (17-17-29(4))	No.	Yes, for own negligence in certain construction contexts (31-5-41)	No.
5/89	Missouri	Hazardous Waste Fund (260.391)	Yes, if RAC has control over hazardous substance (260.530), but liability capped at \$3 million per occurrence (260.552)	No, but RACs right to indemnification is preserved against other liable parties. (260.552: 1-(1))	No, 260.552:1-(1) recognizes right of a RAC to seek indemnification	No.
5/89	Montana	Environmental Quality Protection Fund (75-10-704)	No. Action taken to contain or remove a release is not an admission of liability for the discharge. (75-10-60, <i>et seq.</i>)	No.	Yes, for fraud or negligent violation of the law (28-2-702)	No.
5/89	Nebraska	None	No, but negligence standard for those who cause discharges.	No.	Yes, for own negligence in certain construction contexts (25-21, 187)	Yes. The State constitution provides for immunity from suits. (Art. III, S 18)

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Nevada	Contingency Fund for Hazardous Ma- terials (459.735)	Yes, if RAC was re- sponsible for spill or controlled the waste (459.750)	No, but RAC may have to reimburse state (459.760)	Yes, for workers' com- pensation but Courts have broadly construed the statutes to apply to contracts (616.265)	Yes, unless liability funded (353.255 and 353.260)
5/89	New Hampshire	Hazardous Waste Cleanup Fund (147-B:3)	Yes, if RAC arranged for disposal or treat- ment (147-B:10)	No.	Yes, for negligence for architects, engineers and surveyors (338-A:1)	No.
5/89	New Jersey	New Jersey Spill Compensation Fund (58:10-23.11i)	No, negligence stan- dard for RAC, but work must be in ac- cordance with proce- dure established pursu- ant to state and federal laws. (58:10-23.11g(1))	Yes, 58:10- 23.11(f). Expires 1/1/90.	Yes, for sole negligence in certain construction contexts, and for AEs surveyors (2A:40A-1,2)	No, anti-deficiency stat- ute

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	New Mexico	Hazardous Waste Emergency Fund (74-4-8)	No.	No.	Yes, for negligence, acts or omissions in certain construction contexts unless certain actions excluded (56-7-1)	Yes. New Mexico has a sovereign immunity statute.
5/89	New York	Hazardous Waste Remedial Fund (NY Env. Cons. Law 27-0916)	No, negligence standard is applied (NY Env. Cons. Law 27-1321(3))	No.	Yes, for negligence in certain construction AE and surveying contexts (Gen. Ob. Laws 5-322.1, 5-323, 5-324)	Contracts cannot be let for amounts exceeding the appropriation (State Fin. Law 136)
5/89	North Carolina	Hazardous Waste Fund and Hazardous Waste Site Remedial Fund (130 A-298 <i>et seq.</i>)	Yes, if RAC has control of hazardous waste discharge (143-215.93)	No, but RAC may reimburse state for role in inactive hazardous waste site. (130A-310-7)	Yes, for negligence in certain construction contexts (22B-1)	Yes.
5/89	North Dakota	None.	No.	No.	Yes, for fraud or negligent violations of the law (9-08-02)	Yes, Article 1, § 21
5/89	Ohio	Hazardous Waste Clean-up Fund (3734.28)	Yes, if RAC transports or disposes of wastes. (3734.15, 16)	No. RAC may have to indemnify state. (3734.22)	Yes, for negligence in certain construction contexts (2305:31)	No.

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Oklahoma	None	Yes, for releases to waters of state (Title 82, 926.1); for disposal of controlled industrial waste (Title 63, 1-2001)	No, but indemnification specifically authorized for lawful activities (Title 15, 421, 422, but see also Title 15, 212, 212.1)	No.	No.
5/89	Oregon	Hazardous Substance Remedial Action Fund (466.590)	Yes, for the release of hazardous material under RAC control (466.640)	No.	Yes, for negligence in design and sole negligence in inspection in certain construction contexts (30.140)	Yes.
5/89	Pennsylvania	None	Clean Streams Act imposes strict liability on polluters. (691.316)	No.	Yes, for architect, engineer or surveyors' work or directions to others (Title 68 § 491)	No.

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
	Pennsylvania (continued)	Solid Waste Management Act imposes strict liability on violators. (6018.401 + 503) No, RACs must meet conditions set forth in Hazardous Sites Clean-up Act, § 702(c)				
5/89	Rhode Island	Environmental Response Fund (23-19.1-23)	No. Absolute liability only for unauthorized transportation, storage or disposal (23-19.1-22)	No.	Yes, for negligence in certain construction contexts (6-34-1)	Yes, state liable in tort actions subject to period of limitations and monetary limitations (9-31-1)
5/89	South Carolina	Hazardous Waste Contingency Fund (44-56-160)	Yes, for unpermitted water discharges (48-1-90) and for transporting or disposing of hazardous waste without reporting to Agency. (44-56-130, 140)	No.	Yes, for sole negligence in certain construction contexts (32-2-10)	Yes.

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	South Dakota	Regulated Sub- stance Response Fund (34A-12-3)	No.	No, but RAC may have to reimburse state (34A-12-6)	Yes, for sole negligence in certain construction contexts (56-3-18); for architects' or engineers' work or direction to others (56-3-16, 17)	Yes, specific legislative approval required
700 5/89	Tennessee	Hazardous Waste Remedial Action Fund	No, but transporters of hazardous substances at inactive sites are strictly liable (68-46-202)	No.	Yes, for sole negligence in certain construction contexts (62-6-123)	Yes.
5/89	Texas	Solid Waste Disposal Act (4477-7)	No. RAC not liable pursuant to Water Code, 26.303 (Water Code, 26.308 (f)); but strict liability if RAC handles, transports, processes or disposes of solid waste in context other than water pollu- tion. (4477-7 Section 8(a)(2))	Yes, but only if the federal government agrees to indem- nify the state (Wa- ter Code, 26.308(e))	Yes, for defects in archi- tects' or engineers' work or AE negligence in cer- tain construction con- texts. (Art. 249d)	Anti-deficiency statute specifies procedures for pledging state credit (4351)

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Utah	Solid and Hazardous Waste Act (26-14-1, <i>et seq.</i>)	Yes, if RAC contributed to the release. (26-14-19 (4))	No.	Yes, for sole negligence in certain construction contexts (13-8-1)	Yes.
5/89	Vermont	Solid Waste Management Assistance Fund (Tit. 10, 6618)	Yes, if RAC arranged for disposal of treatment (Tit. 10, 6605)	No.	No.	No.
5/89	Virginia	Virginia Waste Management Act (10.1-0402)	No.	No.	Yes. Voids agreements by contractors to indemnify other for sole negligence (11-4.1)	Waiver of sovereign immunity (8.01.192)
5/89	Washington	Hazardous Waste Regulation (70.105B.010)	No.	Yes, (70.105 B.100 (3))	Yes, for negligence in certain construction contexts (4.24.115)	No.
5/89	West Virginia	Hazardous Waste Emergency Response Fund (20-56-1)	No.	No.	Yes, for sole negligence in certain construction contexts (55-8-14)	No.

SUMMARY TABLE OF STATE LAW
INFORMATION RELEVANT TO
RESPONSE CONTRACTORS (RACs)—continued

<i>Last Update</i>	<i>State</i>	<i>Mini S. Fund Law</i>	<i>Strict Liability for RAC's by Statute</i>	<i>Indemnity Statutes for RAC's</i>	<i>Anti-Indemnity Statutes</i>	<i>Restrictions on Public Sector Indemnities</i>
5/89	Wisconsin	Wisconsin Solid Waste, Hazardous Waste and Refuse (144.43, et seq.)	No.	No.	Yes, voids agreements that limit tort liability but does not void agree- ments which make one party the insurer for damages (895.49)	No.
5/89	Wyoming	None.	No.	No.	No.	No.

7

R-3391-ICJ

Costs and Compensation Paid in Tort Litigation

James S. Kakalik, Nicholas M. Pace

1986

RAND

**THE
INSTITUTE FOR
CIVIL JUSTICE**

-2138

sation-to-cost ratios
es many important
loes not attempt to
ually on tort litiga-
benefits delivered—
address the issue of
er systems for com-
But by providing a
ost, how much does
for those who seek
ectiveness.

I. Shubert

ute for Civil Justice

Executive Summary

COSTS AND COMPENSATION PAID IN TORT LITIGATION

Scope of This Study

Many people are concerned over the amount of society's resources being expended on civil liability litigation. But as with many long-standing issues, neither critics nor defenders of the tort system have had much solid evidence to support their views. Instead, anecdotes abound and misinformation is plentiful. The facts are hard to gather because most litigation costs and compensation payments are private expenditures, and are not reported publicly.

We undertook this study to provide empirical evidence on the following issues:

- What was the total expenditure nationwide for tort litigation¹ that was terminated in state and federal courts of general jurisdiction in 1985?
- How much of the total was spent for the various costs of the tort litigation system: plaintiffs' and defendants' legal fees and other litigation expenses, the value of litigants' time spent on their lawsuits, the value of time spent by insurance personnel, and the costs of operating the courts?
- How much of the total consisted of net compensation to plaintiffs?
- How do litigation costs and compensation paid differ for torts involving motor vehicles and all other torts?
- How fast is the tort system growing?

¹Cases involving civil wrong or injury, other than breach of contract, for which the court may provide damages, e.g., cases involving personal injury, death, or property damage.

We do not pass judgment on whether the costs of tort litigation and the compensation paid are too high or too low, nor do we make any policy recommendations for reforming the civil justice system. Indeed, we draw no conclusions on whether the system should undergo reform. Making such conclusions or recommendations would necessitate additional research on the costs of alternative reforms and on the benefits of the current court system and alternative systems.

This study focuses on lawsuits filed in federal district courts and in state trial courts of general jurisdiction—which account for about 92 percent of all compensation paid in tort litigation—because the most reliable data derive from those cases. The study excludes: (1) all expenditures for insured and self-insured claims that did not involve lawsuits, and (2) all expenditures for small claims and for tort litigation in courts of limited jurisdiction.

The study presents a range for the total bill for our current tort litigation system. We made two estimates. We used available published and unpublished information from the insurance industry, data from surveys of lawsuits and claims, and information on the number of lawsuits terminated in 1985. We made our first estimate from the top down, starting with the insurance industry's aggregate data on direct losses and expenses paid in 1985, adding self-insurance, and then deleting payments for claims that were not lawsuits. We made our second estimate from the bottom up, starting with data from surveys of individual tort lawsuits, appropriately projecting the numbers to 1985, and then multiplying by the number of tort lawsuits terminated in 1985 to make a national estimate.

OUR NATION'S BILL: TOTAL COSTS AND COMPENSATION PAID IN TORT LITIGATION

We estimate that the total expenditure nationwide for tort litigation terminated in state and federal courts of general jurisdiction in 1985 was between \$29 billion and \$36 billion. These expenditures for the approximately 866,000 tort lawsuits terminated annually in state and federal courts of general jurisdiction² include compensation paid to plaintiffs, legal fees and related expenses for both plaintiffs and defendants, insurance company claims-processing costs for claims in suit,

²Approximately 866,000 tort lawsuits were terminated in state and federal courts of general jurisdiction in 1985: 827,000 in state courts and 39,000 in federal courts. Tort litigation related to motor vehicles constituted just over half of the total case terminations. Tort cases filed in 1985 were slightly higher: 869,000 in state and 42,000 in federal courts.

of tort litigation and nor do we make any justice system. Indeed, could undergo reform. could necessitate additions and on the benefits.

district courts and in account for about 92 percent—because the most widely excludes: (1) all cases that did not involve torts and for tort litigation.

Our current tort litigation data is based on the available published industry data from 1980 on the number of lawsuits, estimate from the top 100 courts, and then delete. We made our second survey of 100 courts in 1985, and terminated in 1985 to

D TION

wide for tort litigation jurisdiction in 1985 expenditures for the annually in state and compensation paid to plaintiffs and defendants for claims in suit,

state and federal courts of 100 in federal courts. Tort of the total case terminated 100 in state and 42,000 in

the value of litigants' time spent, and the costs of operating the court system for these cases.

Since our \$29 billion and \$36 billion estimates are based on information of varying accuracy from several sources, neither can be taken as exact. However, although they were made using very different methods and using different sources for much of their data, they are similar enough to give us confidence that they are reasonably accurate.

We believe the true figure lies between our two estimates. The \$29 billion estimate, based primarily on insurance industry data, is probably somewhat low because it includes data from the major lines of insurance that pay for liability litigation (the auto liability, medical malpractice, general liability, and multiperil insurance lines) but excludes the relatively small liability expenditures buried in other lines of insurance (such as the marine and boiler and machinery lines). The \$36 billion estimate, based primarily on lawsuit survey data, is probably somewhat high because the survey response rate in the Civil Litigation Research Project was somewhat higher for lawsuits with higher amounts of litigation activity (and presumably higher costs).³ Lacking sufficient data to adjust our estimates to account for these factors, we therefore present a range of estimates.

TOTAL COSTS OF TORT LITIGATION

Of the \$29 to \$36 billion, an estimated \$16 to \$19 billion was spent for the various costs of the tort litigation system, not including the net compensation paid to plaintiffs.

The breakdown of the total costs for defendants, plaintiffs, and the courts is as follows:

Defendants' Costs of Litigation

Defendants' total costs were an estimated \$8 billion to \$10 billion: \$4.7 to \$5.7 billion for legal fees and related expenses, \$0.8 billion for insurance company costs of processing claims in suit, and about \$2.5 to \$3.5 billion representing the value of defendants' nonlawyer time and other expenses. (See Table S.1.)

³See David M. Trubek et al., *Civil Litigation Research Project Final Report: Vol. 1, Studying the Civil Litigation Process: The CLRP Experience*, University of Wisconsin Law School, Madison, March 1983, p. 1-120. Court records showed that the median case in the sample had 11 legal "events," while there were 13 legal events for the median case with a completed lawyer interview.

Table S.1

DEFENDANTS' COSTS OF TORT LITIGATION TERMINATED
IN STATE AND FEDERAL COURTS OF GENERAL
JURISDICTION IN 1985
(In \$ billion)

Type of Cost	Estimate 1, Primarily Based on Insurance Industry Data	Estimate 2, Primarily Based on Lawsuit Survey Data
Defendants' legal fees and expenses	4.7	5.7
Claims-processing cost for lawsuits	0.8	0.8
Value of defendants' time and other expenses	2.5	3.5
Total	8.0	10.0

The average⁴ tort lawsuit closed in 1985 resulted in an estimated \$5,400 to \$6,600 in defendants' legal fees and related expenses.

Plaintiffs' Costs of Litigation

Out of the total compensation that plaintiffs received, they paid \$6 billion to \$8 billion in legal fees and expenses, and the value of plaintiffs' time spent on the litigation was about \$1 billion. (See Table S.2.)

The average tort lawsuit concluded in 1985 resulted in an estimated \$7,300 to \$8,800 in plaintiffs' legal fees and expenses, which was approximately 30 to 31 percent of total compensation paid to plaintiffs.

Court Expenditures

Court expenditures are defined as those by any level of government (federal, state, or local) for processing tort cases in the court system. The total court expenditure nationwide, net of court fees paid by tort litigants, was an estimated \$0.5 billion.

⁴Throughout this report, the term "average" is defined as the arithmetic mean, and zero values always are included in the calculation. The average should not be interpreted as the typical value or as the median, which is the value below and above which there are an equal number of data values.

TERMINATED
GENERAL

Estimate 2,
Primarily Based
on Lawsuit
Survey Data

5.7

0.8

3.5

10.0

ed in an estimated
d expenses.

ceived, they paid \$6
l the value of plain-
on. (See Table S.2.)
ltd in an estimated
xpenses, which was
on paid to plaintiffs.

level of government
in the court system.
rt fees paid by tort

he arithmetic mean, and
should not be interpreted
and above which there are

Table S.2

PLAINTIFFS' COSTS OF TORT LITIGATION TERMINATED
IN STATE AND FEDERAL COURTS OF GENERAL
JURISDICTION IN 1985
(In \$ billion)

Type of Cost	Estimate 1, Primarily Based on Insurance Industry Data	Estimate 2, Primarily Based on Lawsuit Survey Data
Plaintiffs' legal fees and expenses	6.3	7.6
Value of plaintiffs' time and other expenses	0.7	1.1
Total	7.0	8.7

COMPENSATION PAID IN COMPARISON WITH TOTAL
COSTS OF TORT LITIGATION

Of the \$29 to \$36 billion total national expenditure in 1985, plaintiffs received \$21 to \$25 billion in total compensation, or about \$14 to \$16 billion in net compensation, after deducting all their litigation costs. (See Table S.3.)

The average total compensation paid per lawsuit concluded in 1985 in a court of general jurisdiction was in the range of \$24,000 to \$29,000. This average includes all tried, settled, and dismissed lawsuits.

Table S.3

COMPENSATION PAID IN COMPARISON WITH TOTAL COSTS OF
TORT LITIGATION TERMINATED IN STATE AND FEDERAL
COURTS OF GENERAL JURISDICTION IN 1985
(In \$ billion)

Type of Expenditure	Plaintiffs	Defendants	Courts	Total
Total compensation	20.7-25.1	20.7-25.1	NA	NA
Total costs of litigation	7.0-8.7	8.0-10.0	0.5	15.5-19.2
Net compensation	13.7-16.4	NA	NA	13.7-16.4
Total expenditure	NA	28.7-35.1	0.5	29.2-35.6

NOTES: The first number in the range is the RAND estimate primarily based on insurance industry data, and the second number is the RAND estimate primarily based on lawsuit survey data.

NA = not applicable.

To deliver this \$14 to \$16 billion in net compensation, the tort litigation system expended \$16 to \$19 billion in transaction costs. These costs included \$11 to \$13 billion in combined defendants' and plaintiffs' legal fees and expenses, \$0.5 billion in court expenditures, and an additional \$4 to \$5 billion in the value of the time spent by litigants and their employees.

In sum, of all the money paid in compensation and legal fees and related expenses of tort litigation, the injured plaintiff receives approximately 56 percent in net compensation. The litigation system consumes the rest. If we add the value of the time spent by the litigants to the costs, the injured parties' net compensation sinks to 46 percent of the total expenditures.⁵ All the components of expenditures are shown graphically in Fig. S.1.

COMPARISON OF AUTO TORT AND OTHER TORT LITIGATION EXPENDITURES

How do litigation costs and compensation differ between torts involving motor vehicles and all other torts? Auto torts accounted for about half of all tort filings in courts of general jurisdiction in 1985, and also about half of the total compensation paid. (See Table S.4.)

The legal fees and expenses paid by plaintiffs as a percent of total compensation were essentially the same for auto tort (31 percent) and other tort cases (30 percent). However, defendants' costs of litigation differ significantly. For auto tort cases, which are usually relatively straightforward, defense legal fees and expenses were an estimated 16 percent of total compensation. For other (nonauto) tort cases, which are often more complex, defense legal fees and expenses were much higher—28 percent of total compensation paid.

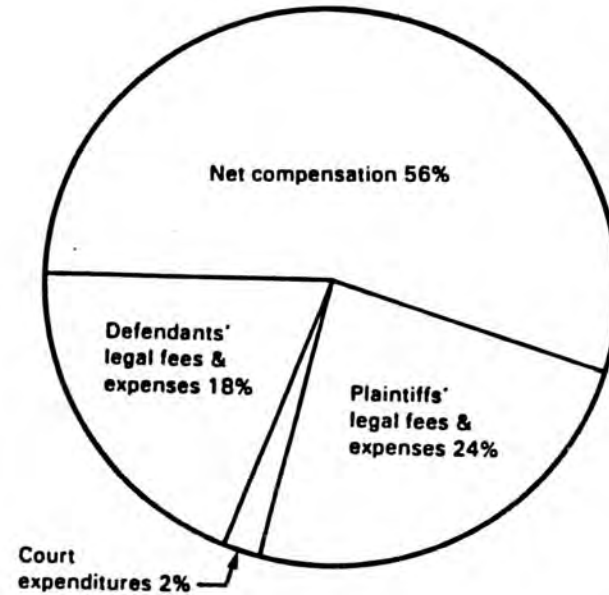
The plaintiffs' net compensation as a percentage of the total expenditures was 52 percent for auto torts and 43 percent for all other torts. This difference primarily reflects the relatively higher defendants' litigation costs for nonauto torts. All the components of auto and other tort litigation expenditures are shown graphically in Fig. S.2.

⁵Our two estimation techniques yielded similar results. The most important number, the plaintiffs' net compensation as a percentage of the total expenditures, was 47 percent using one method and 46 percent using the other.

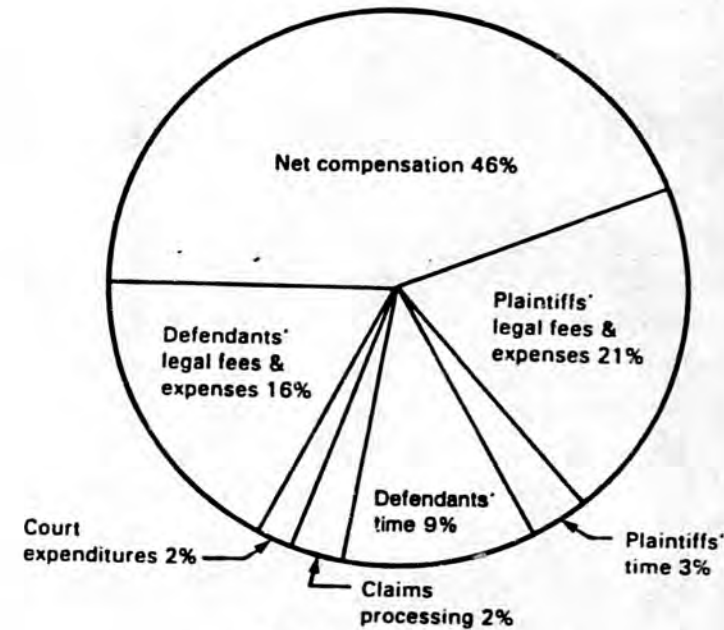
isation, the tort litigation costs. These defendants' and plaintiffs' expenditures, and an amount spent by litigants and legal fees and plaintiff receives approximately the same amount by the litigants sinks to 46 percent of expenditures are

R TORT

iffer between torts, torts accounted for jurisdiction in 1985, (See Table S.4.) is a percent of total tort (31 percent) and s' costs of litigation re usually relatively ere an estimated 16 o) tort cases, which xpenses were much of the total expenditure for all other torts. her defendants' litigants of auto and other Fig. S.2. most important number, inditure, was 47 percent



Percentages of total expenditures excluding value of litigants' time and claims processing



Percentages of total expenditures including value of litigants' time and claims processing

NOTE: Totals may not sum to 100 due to rounding.

Fig. S.1—Costs and compensation paid for the average tort lawsuit terminated in 1985 (average gross compensation paid = \$24,000 to \$29,000)

CORRECTION

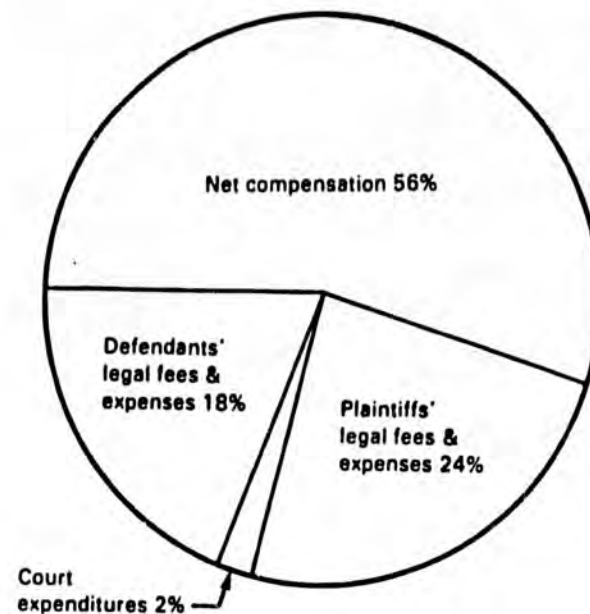
**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

action, the tort litigation costs. These defendants' and plaintiffs' expenditures, and amount spent by litigants and legal fees and plaintiff receives approximately the litigation system content by the litigants sinks to 46 percent of expenditures are

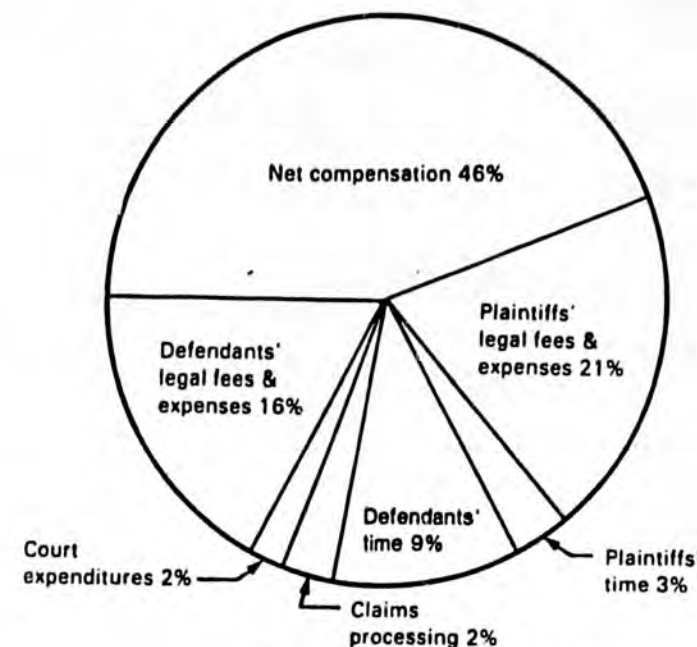
R TORT

iffer between torts, torts accounted for jurisdiction in 1985, (See Table S.4.) is a percent of total tort (31 percent) and s' costs of litigation re usually relatively ere an estimated 16 o) tort cases, which xpenses were much of the total expenditure for all other torts. her defendants' litigants of auto and other Fig. S.2.

most important number, expenditures, was 47 percent



Percentages of total expenditures
excluding value of litigants'
time and claims processing



Percentages of total expenditures
including value of litigants'
time and claims processing

NOTE: Totals may not sum to 100 due to rounding.

Fig. S.1—Costs and compensation paid for the average tort lawsuit terminated in 1985 (average gross compensation paid = \$24,000 to \$29,000)

Table S.4

AUTO AND OTHER TORTS: COSTS OF LITIGATION AND
COMPENSATION PAID IN STATE AND FEDERAL
COURTS OF GENERAL JURISDICTION IN 1985
(In \$ billion)

Type of Expenditure	All Torts	Auto Torts	Other Torts
Costs to plaintiffs	7.8	3.3	4.5
Costs to defendants	9.0	2.8	6.2
Court expenditures	0.5	0.2	0.3
Total costs of litigation	17.3	6.3	11.0
Net compensation paid	15.1	6.9	8.2
Total expenditures	32.4	13.2	19.2

NOTE: Dollars shown are the average of Estimates 1 and 2.

GROWTH OF THE TORT SYSTEM

Although the main focus of our study has been analysis of litigation costs and compensation paid on cases terminated in 1985, in the course of our research we also compiled some data on the rate of growth in the tort system.

That growth rate depends on what part of the system you are considering. In terms of tort lawsuits filed, we estimate that the annual growth rate has averaged 3.9 percent since 1981—about 3.0 percent per capita.

The growth rate in the expenditures for the tort system has been higher. Although we do not have precise data on that rate for tort lawsuits, we can get a reasonable idea of that rate by looking at the growth rate in amounts paid per claim by insurers over the last five years. The following figures include both claims involving lawsuits and claims for which no lawsuit had been filed.⁶

The average annual growth rate in average compensation paid per liability claim over the past five years has been about 12 percent for auto claims and 17 percent for other tort claims—considerably higher than the 7 percent average growth in the Consumer Price Index during the same years. The average growth rate in insured defendants' average legal fees and expenses paid per liability claim over the past five years has been about 6 percent for auto and 15 percent for other tort claims. Thus, other nonauto tort expenditures per claim are growing faster than auto tort expenditures per claim.

⁶Of all insured liability compensation paid in 1985, we estimated 50 percent was paid for claims involving lawsuits.

IGATION AND
FEDERAL
IN 1985

ts	Other Torts
	4.5
	6.2
	0.3
1.3	11.0
1.9	8.2
1.2	19.2

imates 1 and 2.

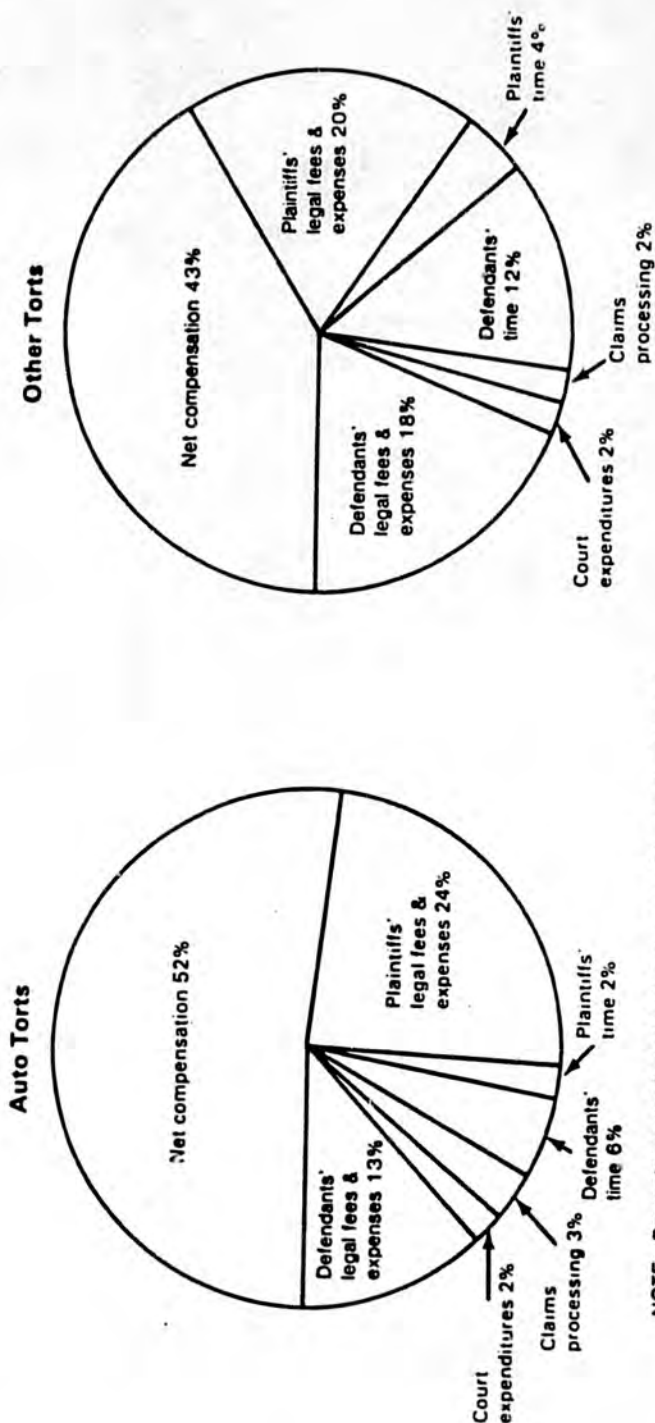
n analysis of litigation
l in 1985, in the course
the rate of growth in

e system you are con-
imate that the annual
—about 3.0 percent per

tort system has been
on that rate for tort
rate by looking at the
rers over the last five
involving lawsuits and

ompensation paid per
about 12 percent for
s—considerably higher
ner Price Index during
ured defendants' aver-
aim over the past five
percent for other tort
per claim are growing

timated 50 percent was paid



NOTE: Percentages are based on the average of two estimates, and may not sum to 100 due to rounding.

Fig. S.2—Costs and compensation paid for the average auto and other tort lawsuit terminated in 1985

Because compensation payments and litigation expenditures are growing, the expenditures on cases filed in 1985 will be higher than they were on cases terminated in 1985.

SUMMARY

Plaintiffs with tort lawsuits terminated in 1985 in state and federal courts of general jurisdiction received approximately half of the \$29 to \$36 billion spent. The costs of litigation consumed the other half.

Table 4.2

**TOTAL VALUE OF PLAINTIFFS' TIME AND EXPENSES
OTHER THAN LEGAL FEES AND EXPENSES IN TORT
LITIGATION IN THE UNITED STATES IN 1985**
(In \$ billion)

Type of Tort Litigation	Estimate 1, Based on Insurance Industry Compensation Data and Low Percent	Estimate 2, Based on Lawsuit Survey Compensation Data and High Percent
Auto torts ^a	0.10	0.29
Other torts ^a	0.58	0.81
Total	0.68	1.10

^aNumbers have been proportionally reduced so they correctly sum to total.

**NATIONAL ESTIMATE OF TORT PLAINTIFFS'
TOTAL COSTS**

Plaintiffs' total costs of tort litigation in courts of general jurisdiction in the United States in 1985 were an estimated \$7.0 to \$8.7 billion, of which an estimated \$6.3 to \$7.6 billion was for legal fees and expenses, and \$0.7 to \$1.1 billion was the value of plaintiffs' time and other expenses. Details for auto and other tort cases are shown in Table 4.3.

Table 4.3

**TOTAL PLAINTIFFS' COSTS OF TORT LITIGATION
IN THE UNITED STATES IN 1985**
(In \$ billion)

Type of Tort Litigation	Estimate 1, Based on Insurance Industry Compensation Data			Estimate 2, Based on Lawsuit Survey Data		
	Legal Fees and Expenses	All Other Costs ^a	Total Costs	Legal Fees and Expenses	All Other Costs ^a	Total Costs
Auto torts	2.5	0.1	2.6	3.8	0.3	4.1
Other torts	3.8	0.6	4.4	3.8	0.8	4.6
Total	6.3	0.7	7.0	7.6	1.1	8.7

^aAll other costs include the value of plaintiffs' time and expenses other than legal fees and expenses.

Auto Tort Defendants' Legal Fees and Expenses Per Lawsuit.

How much was paid in defense legal fees and expenses on the average auto tort lawsuit terminated in 1985? The University of Wisconsin survey data show an estimated \$3,169 paid per auto tort lawsuit by all defendants combined in 1978.⁵ Updating this to 1985 using a 6.3 percent growth rate yields \$4,900 per lawsuit. (See App. D for derivation of this growth rate.)

Auto Tort Defendants' Legal Fees and Expenses Nationwide.

Approximately 461,000 auto tort cases were terminated in courts of general jurisdiction nationwide in 1985 (see Sec. II). Multiplying that number of lawsuits by the \$4,900 average defense legal costs paid per auto tort lawsuit yields an estimate of \$2.26 billion in 1985.

DEFENDANTS' LEGAL FEES AND EXPENSES IN OTHER TORT LITIGATION

We will make two estimates of the amount paid in defendants' legal fees and expenses for other (nonauto) tort litigation that terminated in 1985 in courts of general jurisdiction. Starting with aggregate insurance industry data, we will work down to a \$3.68 billion estimate for other tort litigation nationwide. Starting with lawsuit data, we will work up to an estimate of \$3.44 billion using data on the number of other tort lawsuits nationwide.

Defense legal fees and expenses as a percent of compensation paid calculated primarily using insurance industry data (estimate 1) are 29 percent, and calculated primarily using lawsuit survey data (estimate 2) are 27 percent.

Estimate 1: Other Tort Defendants' Legal Fees and Expenses Based on Insurance Data

The steps we took to make our estimate based on insurance industry data are outlined in Fig. 5.3 and are discussed below.

Insurance ALAE Paid. Recall that, based on discussions with various insurance industry executives, we understand that the overwhelming majority of tort litigation compensation (and hence ALAE) is paid through the auto liability, medical malpractice, general

⁵Estimate is based on data from App. A, Tables A.21, A.39, and A.45. Using data from the University of Wisconsin survey from 1978, we estimate that defendants' average legal fee and expenses were \$3,126 (26 percent of \$12,024 compensation) in state court and \$5,961 (13 percent of \$45,854 compensation) in federal court. Averaging these weighted by the number of auto tort lawsuits terminated in state and federal court in 1985 yields \$3,169.

d expenses for
ts of general
data

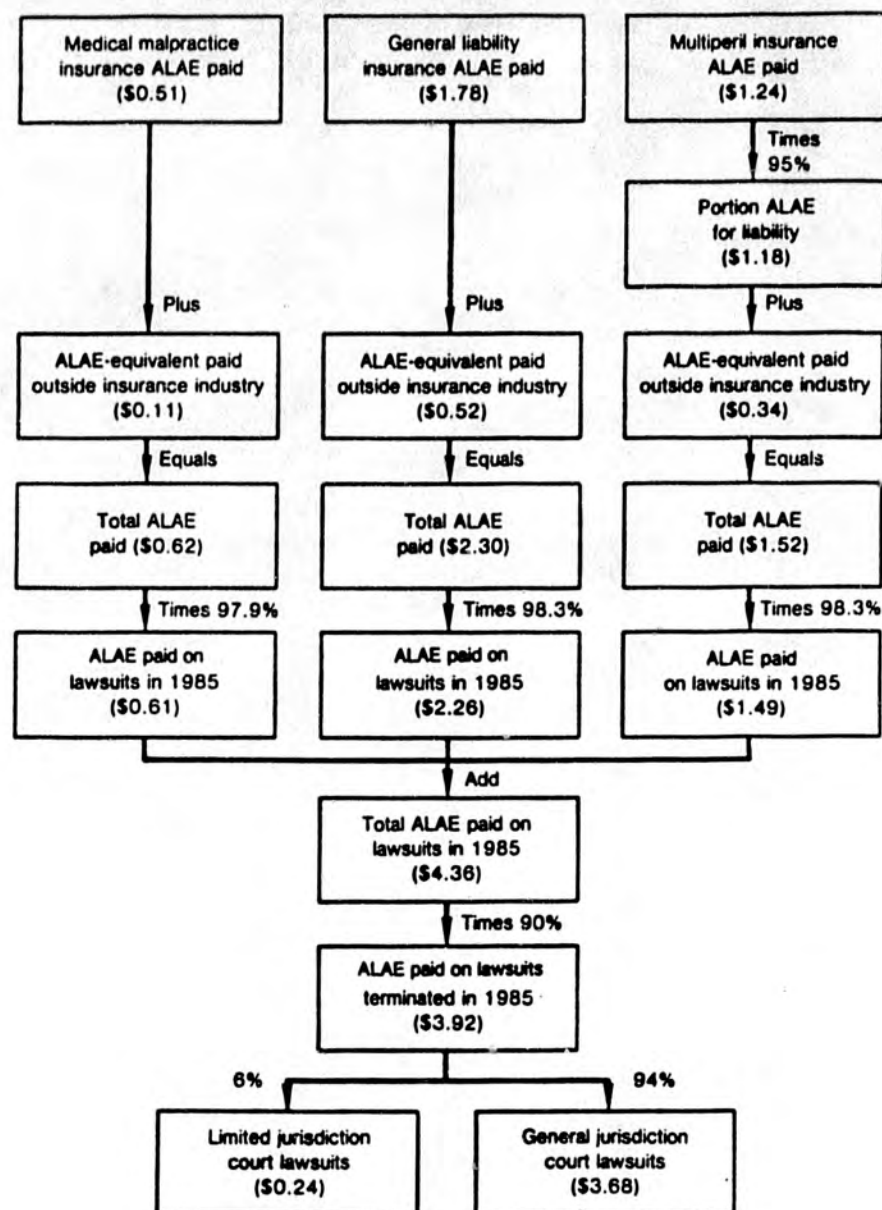


Fig. 5.3—Estimation of defendants' legal fees and expenses for other (nonauto) tort litigation terminated in 1985, based on insurance data (in \$ billion)

liability, commercial multiperil, and homeowners multiperil lines of insurance. We have already reviewed the auto data. Here we will review medical malpractice, general liability, and multiperil insurance data. In making our total estimate of tort litigation defendants' costs, we have not undertaken the difficult task of ferreting out the relatively small amounts of tort litigation costs that may be buried in other lines of insurance.

A total of \$511 million in direct ALAE was paid in 1985 for all medical malpractice claims with and without lawsuits.⁶

For the general liability line of insurance, an estimated \$1.78 billion was paid in 1985 in direct ALAE for all claims with and without lawsuits.⁷

For the multiperil lines of insurance, an estimated \$1.24 billion was paid in direct ALAE in 1985.⁸ Because these multiperil policies are not exclusively written for paying tort claims, we must estimate the percentage of ALAE that is used for that purpose. Discussions with Insurance Services Office (ISO) personnel indicated that precise data do not exist for multiperil insurance, but that as in other lines of insurance, nearly all ALAE is for legal fees and expenses, and nearly all multiperil litigation is over liability instead of fire, theft, or some other peril. We assume that approximately 95 percent of all multiperil insurance ALAE is for liability; we assume the remaining 5 percent is predominantly for miscellaneous nonlitigation ALAE for the fire, theft, and other nonliability components of the multiperil insurance. Thus, of the \$1.24 billion in direct ALAE paid in 1985, an estimated \$1.18 billion was for liability.

Other Tort Defendants' Legal Fees and Expenses Paid Outside the Insurance Industry. For medical malpractice, A. M. Best Company's and ISO's insurance statistics provide information on costs of the commercial insurers and many of the physician-owned insurers but do not report complete data regarding Joint Underwriting Associations, Patient Compensation Funds, Catastrophe Funds, and the self-insured hospitals, government agencies, and physicians that make up the balance of liability compensation sources. We must turn to other sources for those data.

Using A. M. Best's figures as a starting point, Milliman and Robertson, Inc., estimated the total medical malpractice insurance premiums

⁶See App. D, Table D.11, and associated text.

⁷See Table D.13 and associated text.

⁸See Table D.15 and associated text.

Multiperil insurance
ALAE paid
(\$1.24)

Times
95%

Portion ALAE
for liability
(\$1.18)

Plus

AE-equivalent paid
by insurance industry
(\$0.34)

Equals

Total ALAE
paid (\$1.52)

Times 98.3%

ALAE paid
in lawsuits in 1985
(\$1.49)

Legal expenses
in 1985,

(including "self-insured") in the United States for 1984.⁹ Their total is 22 percent larger than the amount reported by A. M. Best Company sources. Accordingly, the reported insurance industry medical malpractice data must be increased to obtain a national total. Using the ratio of 1.22 to 1 described above, and assuming that direct paid ALAE rises proportionally with direct premiums for all types of medical malpractice insurance, the nationwide direct ALAE paid for medical malpractice claims was an estimated \$623 million in 1985.

Our estimated total of \$2.96 billion in defendants' ALAE paid by insurers through general liability and multiperil policies also needs to be increased to account for "ALAE-equivalent" costs paid by the captive-insured, self-insured, uninsured, and government defendants. Again, we can use the results of the Conning and Company survey of the real extent of the property and casualty commercial market.¹⁰ We estimated in Sec. III that the total nonauto liability compensation paid (including self-insurance, captive insurers, and so forth) was 29 percent larger than the compensation paid by traditional insurance companies. We assume that, like compensation, the total legal fees and expenses paid for nonauto tort litigation are 29 percent larger than ALAE reported by traditional insurers. Multiplying 29 percent by the \$2.96 billion in general and multiperil insured ALAE yields an estimated \$0.86 billion in "self-insured" defendants' "ALAE-equivalent" costs paid in 1985.

Other Tort Defendants' Legal Fees and Expenses Paid for Litigation Terminated in 1985. Adding the total ALAE paid in 1985 for medical malpractice, general liability, and multiperil liability gives a total of \$4.44 billion. Next, we must estimate the portion of that total spent for other tort litigation, excluding expenditures for claims settled without a lawsuit.

For medical malpractice, the 1974 closed-claim survey conducted by the Insurance Services Office reported the allocated expenses of defending a claim (see Table 5.1). Note that the average defendants' costs were 29.6 percent of the average compensation paid, and that lawyer fees were 87.2 percent of the total costs.¹¹ The study found that

⁹Milliman and Robertson, Inc., *Actuarial Analysis of American Medical Association Tort Reform Proposals*, New York, September 1985.

¹⁰Conning and Company, *The Changing Property and Casualty Commercial Lines Markets*. Hartford, Connecticut, December 1980, p. 46. Conning and Company included the following in "other" liability: general liability, medical malpractice, and 40 percent of commercial multiperil insurance.

¹¹Defendants' costs in medical malpractice cases, unlike those for auto liability, constitute a comparatively substantial percentage of total compensation. Defendants in medical malpractice litigation have far more control over negotiations than do their counterparts in auto tort cases, and there is an increased tendency to withhold consent

Table 5.1

DATA ON DEFENDANTS IN MEDICAL MALPRACTICE CLAIMS

Claim Disposition ^a	Average Compensation (\$1974)	Average ALAE (\$1974)	Average ALAE as Percent of Average Award	Lawyer Fees as Percent of ALAE
Verdict	9,715	6,231	64.1	87.5
Settled	10,156	2,604	25.6	87.1
Not in suit	1,892	95	5.0	74.8
All claims in suit ^b	10,108	2,995	29.6	87.2

SOURCE: Insurance Services Office, *Report of the All-Industry Committee Special Malpractice Review: 1974 Closed Claim Survey: Technical Analysis of Survey Results*, American Insurance Association, New York, 1976, Tables 11.2a and 11.4a, pp. 59-61.

^aUntrended data including zero compensation claims.

^bWeighted average using 595 claims tried to verdict and 4,927 claims in suit that did not reach verdict.

97.9 percent of all ALAE paid was for claims in suit; only 2.1 percent was for claims without an associated lawsuit.¹²

The portion of the \$623 million in medical malpractice ALAE that is for claims with lawsuits is estimated by using the 97.9 percentage from the ISO closed-claim survey described above. Accordingly, lawsuit-related defendants' legal fees and expenses were estimated to be \$610 million in 1985.

For general liability insurance, we estimate the fraction of ALAE spent on lawsuits using the same method we used for compensation in Sec. III. That is, we assume that all claims paid with an ALAE greater than \$1,000 involved a lawsuit and that one-half of all the claims paid with an ALAE of \$1 to \$1,000 also were lawsuits. (See Table D.14 and associated text.) An estimated 98.3 percent of the general liability claim ALAE paid in 1984 was for lawsuits. Given that \$2.30 billion was paid in direct ALAE (and the ALAE-equivalent for self-insured defendants) in 1985, we estimate that \$2.26 billion of that amount was associated with lawsuits.

from potential settlement agreements that might adversely affect a physician's or surgeon's professional reputation. As a result, cases go further toward trial and incur greater defense costs.

¹²Calculated from data in Table 5.1 plus the fact that the ISO study collected data on 3,647 claims not in suit (p. D-33).

For the liability portion of multiperil insurance, we assume the percentage of ALAE that went for lawsuits was the same as it was for the general liability line of insurance (98.3 percent). (See App. D for a discussion of this assumption.) This yields an estimated \$1.49 billion in ALAE paid on lawsuits in 1985 in the multiperil lines of insurance and the ALAE-equivalent costs of self-insurance.

Adding the amounts for medical malpractice, general liability, and the liability portion of multiperil insurance yields a total of \$4.36 billion in ALAE paid on lawsuits in 1985.

We must adjust the insurance data on ALAE paid in calendar year 1985 to obtain an estimate for other tort cases terminated in 1985; the logic for the adjustment is the same as that which we used for auto tort cases earlier in this section. Since other tort case terminations are 95 percent of filings, we will adjust ALAE downward by 5 percent to account for the growth in the number of other tort cases (see Sec. II). Then we will adjust ALAE downward to account for the growth in expenditures, using a 15 percent annual growth rate (see App. D), and the assumption that the ALAE expenditures occur an average of six months before case termination. An annual rate of 15 percent for six months is 7.5 percent, less six months inflation of 2.2 percent (to correct to constant value dollars) yields an adjustment of 5.3 percent. Combining the 5 percent and 5.3 percent adjustments, we estimate that ALAE for other tort cases terminated was 90 percent of ALAE paid in 1985. Thus, we estimate that \$3.92 billion was paid in ALAE for other tort lawsuits terminated in 1985.

Other Tort Defendants' Legal Fees and Expenses Paid on Litigation Terminated in 1985 in Courts of General Jurisdiction. How much of that \$3.92 billion was paid for other tort lawsuits in state and federal courts of general jurisdiction? In Sec. III we estimated that 94 percent of all litigation compensation paid is paid on suits in courts of general jurisdiction. Assuming that the same ratio holds for legal fees and expenses, we estimate that \$3.68 billion is spent in defense legal fees and expenses on other (nonauto) tort lawsuits in courts of general jurisdiction.

Estimate 2: Other Tort Defendants' Legal Fees and Expenses Based on Lawsuit Survey Data

The steps we took to make this estimate are outlined in Fig. 5.4.

Other Tort Defendants' Legal Fees and Expenses Per Lawsuit. How much was paid in defense legal fees and expenses on the average other tort lawsuit terminated in 1985? The University of

assume the per-
as it was for the
App. D for a dis-
\$1.49 billion in
of insurance and

all liability, and
of \$4.36 bil-

in calendar year
ed in 1985; the
used for auto tort
minations are 95
5 percent to
s (see Sec. II).
or the growth in
App. D), and
average of six
5 percent for six
2.2 percent (to
of 5.3 percent.
We estimate that
of ALAE paid in
LAE for other

enses Paid on
eral Jurisdic-
r tort lawsuits
In Sec. III we
n paid is paid on
the same ratio
3.68 billion is
: (nonauto) tort

and Expenses

d in Fig. 5.4.

Expenses Per
d expenses on
the University of

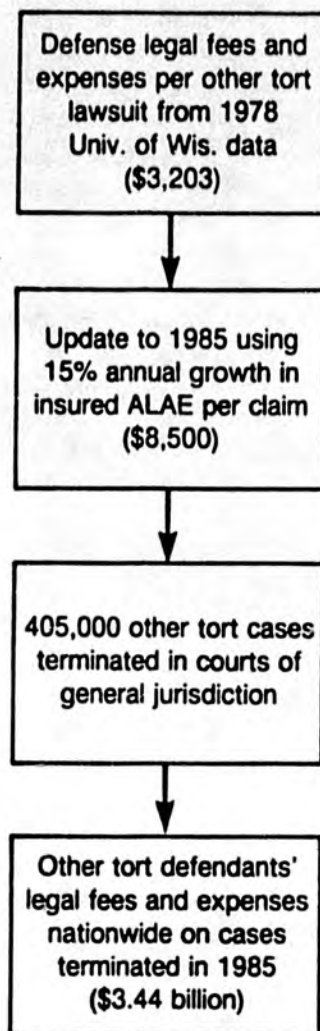


Fig. 5.4—Estimation of defendants' legal fees and expenses for other (nonauto) tort litigation terminated in courts of general jurisdiction in 1985, based on lawsuit survey data

Wisconsin survey data show an estimated \$3,203 paid per other tort lawsuit terminated in 1978.¹³

In recent years, medical malpractice ALAE per claim has grown 15.7 percent annually, while total general liability ALAE has grown at a 15.5 percent rate and multiperil ALAE has grown at a 14.9 percent rate. (See App. D, Tables D.12, D.13, D.15, and associated text.) Based on the available data, we estimate the growth rate in defense litigation costs for all other tort cases combined to be approximately 15 percent. Updating the 1978 data to 1985 using the 15 percent estimated annual growth rate in the average defense legal fees and expenses paid per other tort claim yields \$8,500 per lawsuit.

Other Tort Defendants' Legal Fees and Expenses Nationwide. Approximately 405,000 other tort cases were terminated in courts of general jurisdiction nationwide in 1985 (see Sec. II). Multiplying that number of lawsuits by the average defense legal costs paid per other tort lawsuit yields an estimate of \$3.44 billion in 1985.

NATIONAL ESTIMATE OF ALL TORT DEFENDANTS' LEGAL FEES AND EXPENSES

Combining the results for auto and other tort litigation terminated in state and federal courts of general jurisdiction yields a total of \$4.7 billion to \$5.7 billion nationwide in 1985. We again were gratified that our two estimation methods (working down from aggregate insurance industry data and working up from individual lawsuit survey data) yielded similar results (see Table 5.2).

The average growth rate in defendants' legal costs paid per claim over the past five years has been about 6 percent for auto and 15 percent for other tort claims. The average tort lawsuit concluded in 1985 resulted in an estimated \$5,400 to \$6,600 in defendant's legal fees and expenses.

CLAIMS-PROCESSING COSTS

In addition to defendants' legal fees and related expenses that constitute about 98 percent of what insurance companies call "allocated

¹³Estimate is based on data from App. A, Tables A.21, A.39, and A.45. Using overall data from the University of Wisconsin survey from 1978, we estimate that defendants' average legal fees and expenses were \$2,809 (37 percent of \$7,593 compensation) in state courts and \$7,791 (18 percent of \$43,288 compensation) in federal courts. Averaging these weighted by the number of other tort lawsuits terminated in state and federal courts in 1985 yields \$3,203.

Table 5.2

TOTAL DEFENDANTS' LEGAL FEES AND
EXPENSES PAID IN TORT LITIGATION
TERMINATED IN COURTS OF GENERAL
JURISDICTION IN 1985
(In \$ billion)

Type of Tort Litigation	Estimate 1, Based on Insurance Industry Data	Estimate 2, Based on Lawsuit Survey Data
Auto torts	1.05	2.26
Other torts	3.68	3.44
Total	4.73	5.70

loss adjustment expenses" (ALAE) for liability claims, the insurers also have "unallocated loss adjustment expenses" (ULAE). As discussed earlier in this section, the unallocated expenses are insurance company salaries, expenses, and overhead of processing claims (and suits) that are not allocated by the insurer to any specific claim.

When someone is injured or suffers property damage and files a claim for liability compensation, the insurer's claims department personnel will process the claim, ask for information about the incident and the injury or damage, and attempt to settle the claim; the associated costs are "unallocated" costs. If unsuccessful in arriving at a mutually acceptable settlement with the claimant whereupon a suit is filed, or if the initial claim is accompanied by a lawsuit, then legal counsel will spend time on the claim (and the associated costs will be recorded as "allocated" costs). However, the insurers' claims-processing personnel will continue to assist with the lawsuit; they still will handle paperwork and accounting matters, monitor and assist the lawyer, and follow settlement negotiations, since the insurer must approve any settlement negotiated by the lawyer. Thus, claims-processing costs (ULAE) are incurred both before and after filing a suit.

The ULAE are reported by insurers for all claims and lawsuits combined for each line of insurance. The total ULAE paid in 1985 were \$2.00 billion for auto liability, \$0.12 billion for medical malpractice,

\$0.31 billion for general liability, and \$0.35 billion for the liability portion of multiple-peril insurance policies. (See App. D, Table D.16.) Thus, the total ULAE in 1985 for all liability claims and suits was an estimated \$2.78 billion, of which \$2.00 billion was for auto liability claims and suits.

We adjusted this number upward to account for the equivalent claims-processing costs spent by "self-insured" people (using the same method and references we used earlier in this section for ALAE). The total rises to \$3.26 billion, of which \$2.26 billion was for auto liability claims and suits.

No industry-wide data are collected on how much of the total was for claims that were in suit, but we were able to locate one very detailed study by a large insurer.¹⁴ That study indicated that the average auto claim in suit required 1.62 times as much effort by claims-processing personnel as the average auto claim not in suit. The average other (nonauto) injury claim in suit required 2.15 times as much effort by claims-processing personnel as the average other injury claim not in suit. In light of our understanding of the claims process, this seems reasonable.

Using the above ratios plus the fraction of claims in suit¹⁵ yields an estimate that the ULAE for claims in suit totaled \$0.88 billion in 1985, of which \$0.44 billion was for auto liability claims in suit. Now we adjust these ULAE dollars spent in 1985 to ULAE dollars spent on lawsuits terminated in 1985, using the same method we used to adjust ALAE.¹⁶ The resulting estimate is that ULAE for lawsuits that terminated in 1985 were \$0.81 billion, of which \$0.41 billion was for auto torts.

Assuming that, like compensation, 92 percent of all ULAE for claims in suit goes for claims in suit in courts of general jurisdiction, we estimate that \$0.75 billion in ULAE was spent for claims in suit in general jurisdiction courts, of which \$0.37 billion was for auto liability.

The average claims-processing cost (ULAE) per tort lawsuit terminated in 1985 was \$866. Claims process costs (ULAE) amount to 4 percent of compensation paid in suit.

¹⁴These data were collected in a "time and motion" study of how much time claims personnel spent on various required tasks for various types of claims. One of the factors this large insurer considered was whether the claim was in suit. Cost figures developed included salary, fringe benefits, overhead, and miscellaneous claims-processing expenses. The data are unpublished, and the insurer has requested anonymity.

¹⁵Based on data presented previously, approximately 13 percent of all auto claims and 27 percent of all general liability claims are in suit.

¹⁶The auto tort numbers were reduced 6 percent and the other tort numbers were reduced 10 percent.

8

ISO Insurance Issues Series

Legal Defense: A Large and Growing Insurance Cost



Insurance Services Office, Inc.

Executive Summary

Why do people and businesses buy liability insurance? If the policyholder, through negligence or fault, causes injury to others or damages the property of others, the policyholder faces financial loss. Liability insurance provides financial protection against such a loss. In addition, most standard liability policies also provide for unlimited legal defense of the policyholder (until policy limits are exhausted by payments to those with injuries or damaged property) if a lawsuit results from an accident.

To shed some light on the legal defense cost component of liability insurance, Insurance Services Office, Inc. (ISO) examined insurer data—both financial and statistical. This study's findings can be divided into two areas: (1) an analysis of the casualty lines of insurance that quantifies the magnitude of legal defense costs; and (2) an analysis of the variability of general liability legal defense costs. The general liability analysis expands on some issues raised in the 1986 ISO study, *The Rising Costs of General Liability Legal Defense*.

The specific findings relating to the magnitude of legal defense costs are:

- For calendar year 1988, legal defense costs for the casualty lines of insurance amounted to \$12 billion, while insured losses for the same lines were \$95 billion.
- On an accident year basis, legal defense costs increased from 9.6% of losses for 1978 to 13.9% of losses for 1988—a 45% rise in the ratio of legal defense costs to indemnity costs—for all casualty lines of insurance combined.
- While legal defense costs affect all casualty lines of insurance, they are a proportionately larger cost for the longer-tailed general liability and medical malpractice lines.
- Indicated deficiencies in total loss adjustment expense reserves, which far exceed the estimated shortfalls in loss reserves, suggest that the true cost of insurance legal defense may be greater than insurers' current estimates of incurred legal defense costs.

The specific findings relating to legal defense costs for general liability are:

- Over the past 40 years, the ratio of legal defense costs to indemnity costs has tripled, indicating significantly more growth in defense costs than in indemnity costs.
- For all claims, the ratio of legal defense costs to indemnity costs increased the longer it took to settle claims.
- Claims closed without payment generated one-third of total legal defense costs. For most general liability claims, insurers incurred indemnity costs but paid zero legal defense costs.
- For claims where insurers paid both indemnity costs and legal defense costs, the ratio of legal defense costs to indemnity costs decreased as the size of the loss increased.

Background

Under most standard liability contracts, an insurer commits itself to unlimited legal defense of any covered claim until a settlement is reached, a judgment is entered, or the policy limits are exhausted by claim payments—regardless of the cost of providing that defense. The insurer is responsible for the defense of *any* suit by a third party against an insured, if the third party is claiming monetary damages that might be covered by the insurance. In the case of multiple claimants whose claims fall under the same limit on an insured's policy, the insurer must defend all the claims until settlements with, or judgments for, one or more of the claimants exhaust the policy limit. Only then may the insurer stop defending the remaining cases.

This study explores costs associated with providing legal defense for the casualty lines of insurance, which appear on Schedule P of insurers' Annual Statements:

- workers' compensation
- auto liability (personal auto and commercial auto)
- multi-peril (farmowners multiple peril, homeowners multiple peril, commercial multiple peril, ocean marine, aircraft, and boiler and machinery)
- general liability
- medical malpractice

Insurers are required to submit information about their business for several purposes in several forms. No one source provides adequate information with which to study insurance legal defense costs. Consequently, for this study, Insurance Services Office, Inc. (ISO), used information from several sources:

- insurer financial statements compiled and published by A.M. Best Company
- statistical data regularly reported to ISO
- special ISO calls for insurer expense data

These data were gathered and summarized on different bases—accident year, calendar year, and policy year. (See the Appendix for a more complete description of data sources and data organization.)

Loss Adjustment Expenses

Insurers incur two types of expenses when settling claims:

- Unallocated loss adjustment expenses (ULAE) include claim settlement functions ranging from claim reporting, processing, and investigation to issuing a check in settlement of a claim. These expenses are generally viewed as overhead claim settlement expenses. ULAE is not attributable to a particular case or claim.
- Allocated loss adjustment expenses (ALAE) are the direct costs attributed to settling specific claims. For liability insurance, the primary components of ALAE are the costs of attorneys and expert witnesses—legal defense costs, the focus of this study.

Legal Defense Costs in 1988

In calendar year 1988, the property/casualty insurance industry's legal defense costs for the casualty lines of insurance amounted to about \$12 billion, compared with \$95 billion for incurred losses. ULAE added \$7 billion. (See Figure 1.) That is, for every dollar spent on indemnity for liability insurance, another 13 cents went to legal defense costs. But defense costs differed by line of insurance.

Figure 1

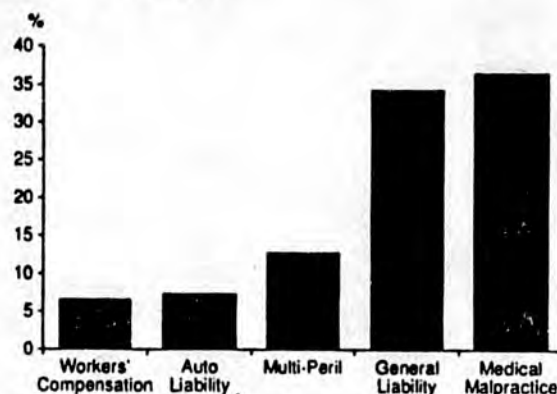
Legal Defense Costs, Overhead Claim Settlement Costs, and Indemnity Costs Liability Lines-1988



In 1988, legal defense costs amounted to \$12 billion, overhead claim expenses were \$7 billion, and incurred losses totaled \$95 billion.

Figure 2

Legal Defense Costs as a Percentage Of Incurred Losses Calendar Year 1988



Legal defense costs vary for the casualty lines of insurance, but are particularly significant in the longer-tailed lines of general liability and medical malpractice.

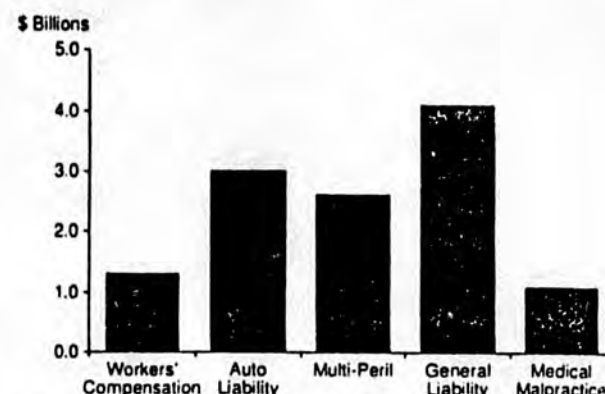
Workers' compensation settlements are usually determined by statute. In calendar year 1988, legal defense costs amounted to \$1.3 billion, or 6.6% of indemnity costs.

For auto liability, legal defense costs amounted to 7.4% of indemnity costs in calendar year 1988. Because auto liability indemnity costs are so large, legal defense costs represented an expenditure of \$3.0 billion, more than for any other line of insurance except general liability.

Multi-peril includes both property and liability coverages. While liability claims covered under multi-peril insurance often involve litigation, property claims by policyholders themselves involve investi-

Figure 3

Legal Defense Costs by Line of Business Calendar Year 1988



gation and settlement expenses but usually do not require litigation. Multi-peril legal defense costs were 12.9% of indemnity costs in calendar year 1988, or \$2.6 billion.

General liability legal defense costs in calendar year 1988 amounted to \$4.1 billion, or 34.3% of indemnity costs. Legal defense costs for medical malpractice totaled \$1.1 billion, or 36.6% of indemnity costs, in calendar year 1988. (See Figures 2 and 3.)

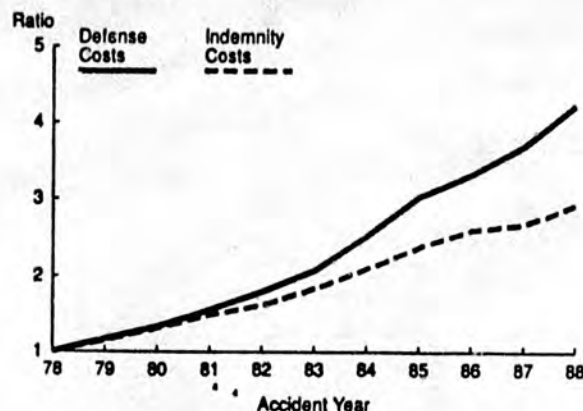
Legal Defense Costs Have Grown More than Indemnity Costs

Calendar year figures are a mixture of new and old costs. In practice, dollars earmarked or set aside for the payment of each claim already reported to the insurance company, but not yet settled, may be revised on a regular basis. Meanwhile, other new claims are continually reported to the insurer. Some liability claims can take more than a decade to settle, while many others settle in as little as one or two years. Accident year information—grouping together claims from accidents in a particular year—more accurately matches claim adjustment expenses with indemnity costs.

For all casualty lines of insurance combined, ultimate incurred legal defense costs rose an average of 16% per year from \$2.8 billion to \$11.8 billion—a 320% increase—from accident year 1978 to accident year 1988. During that same period, indemnity costs (losses) grew an average of 11% per year from \$28.9 billion to \$84.9 billion—a 190% rise. (See Figure 4.) Put in terms of the ratio of ALAE to indemnity, legal defense costs for the casualty lines of insurance increased from 9.6% of losses in accident year 1978 to 13.9% of losses in accident year 1988. (See Figure 5.)

Figure 4

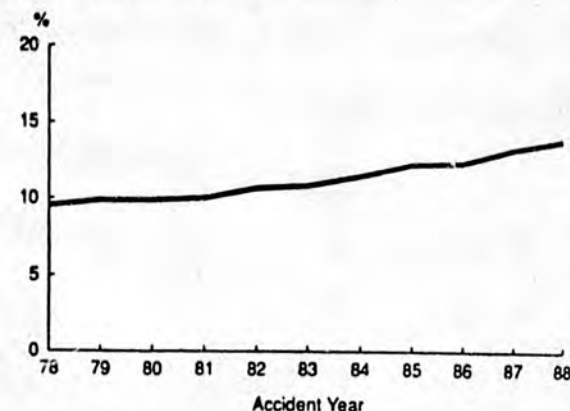
Rise of Legal Defense Costs and Indemnity Costs, 1978-1988
Schedule P Lines



Legal defense costs for accidents occurring in 1988 were 320% greater than legal defense costs for accidents in 1978. Indemnity costs rose 190% over the same period.

Figure 5

Ratio of Legal Defense Costs to Indemnity Costs, 1978-1988
Schedule P Lines



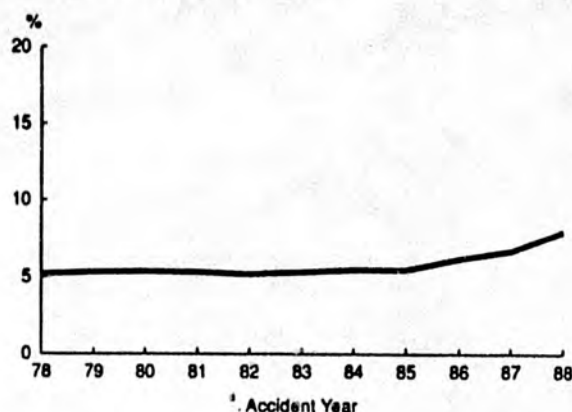
Legal defense costs for accidents occurring in 1988 were 13.9% of indemnity costs for all casualty lines of insurance—45% greater than the 9.6% legal defense cost ratio for accident year 1978.

The legal defense cost ratio for workers' compensation remained almost constant at 5% to 6% of indemnity costs from accident year 1978 to accident year 1985. The latest three accident years (1986-1988) saw a rise in these costs, and analysis of the financial data indicates that accident year 1988 will have a legal defense cost ratio of 8.0% when all payments have been made. (See Figure 6.)

The legal defense cost component of auto liability insurance was relatively stable during this 11-year period, increasing from 6.9% of indemnity costs in accident year 1978 to 8.0% in accident year 1988. (See Figure 7.) But that one percentage point translates to \$400 million of additional legal defense costs for accident year 1988.

Figure 6

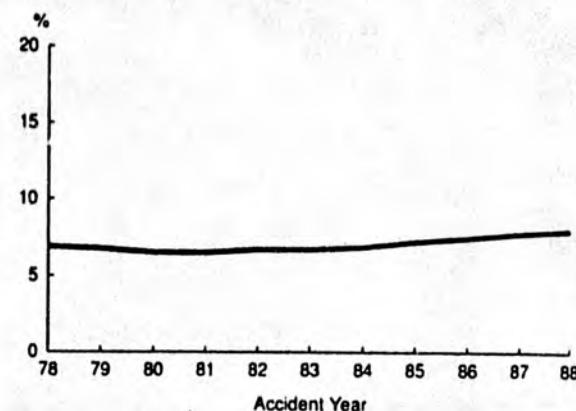
Ratio of Legal Defense Costs to Indemnity Costs, 1978-1988
Workers' Compensation



Legal defense cost ratios for workers' compensation accidents have risen significantly since accident year 1985.

Figure 7

Ratio of Legal Defense Costs to Indemnity Costs, 1978-1988
Auto Liability



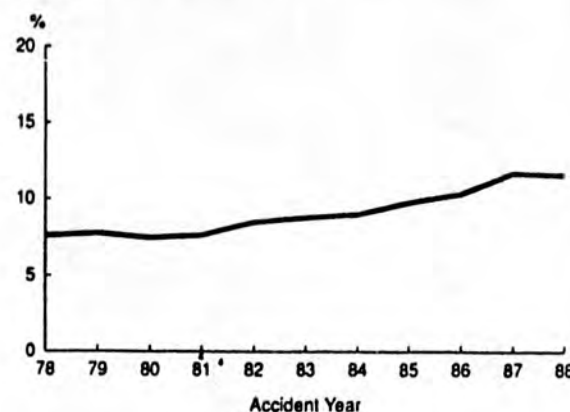
Legal defense cost ratios were relatively stable for auto liability from accident year 1978 through accident year 1988.

The ratio of legal defense costs to indemnity costs for multi-peril increased from 7.6% for accident year 1978 to 11.6% in accident year 1988. (See Figure 8.) This rise was significant for two reasons: (1) the legal defense cost ratio increase of more than 50% means that legal defense costs grew much faster than losses; and (2) multi-peril includes a large amount of property losses for which the legal defense cost component was very small. That is, the "ballast" of the property losses masked a significant jump in the legal defense cost component of the multi-peril liability coverage.

In accident year 1978, the ratio of legal defense costs to indemnity costs for general liability was 31.0%, and 24.3% for medical malpractice. For accident year 1978, legal defense costs amounted to approximately \$800 million for general liability and approximately \$250 million for medical malpractice. For accident year 1988, the general liability legal defense cost ratio is projected to exceed 40%, with ultimate legal defense costs of more than \$3.7 billion. (See Figure 9.) The medical malpractice legal defense cost ratio will also exceed 40%, with ultimate legal defense costs exceeding \$1.5 billion. (See Figure 10.)

Figure 8

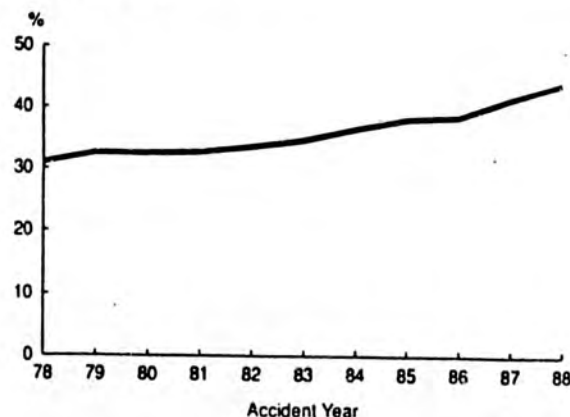
Ratio of Legal Defense Costs to Indemnity Costs, 1978-1988
Multi-Peril



Legal defense costs for multi-peril grew faster than indemnity costs.

Figure 9

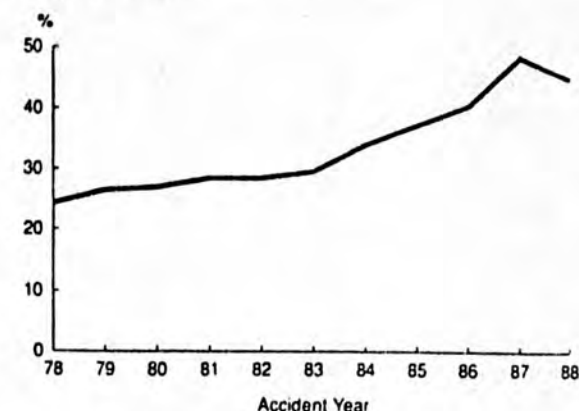
Ratio of Legal Defense Costs to Indemnity Costs, 1978-1988
General Liability



General liability legal defense costs have risen steadily.

Figure 10

Ratio of Legal Defense Costs to Indemnity Costs, 1978-1988
Medical Malpractice



Legal defense cost ratios for medical malpractice accidents have risen dramatically since 1983.