

ALASKA LEGISLATURE COMMITTEE FILES 1900-1900 00/2  
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## ACCUSATION

**Price increases are excessive. Losses are not the problem.**

**CHARGE:** The insurance industry needed only a 12-15% increase in written premium in 1985 in order to achieve a 13-15% return on net worth in 1986. Given the magnitude of the premium increases in 1985, no additional price increases are needed in 1986.

**THE FACTS:** No reasonable set of assumptions could support the above statements. It is not plausible that a 12-15% premium increase in 1985 could produce such a high rate of return in 1986. This analysis cannot refute the specific assumptions or calculations underlying the critics' charges since no supporting data have been provided.

Based on an ISO analysis, if industry written premiums had increased only 12-15% in 1985, further increases in excess of 30% would be required in 1986 to achieve a 13% return on net worth. An overall premium increase of this magnitude would be far larger than any ever achieved by the insurance industry.

Given the estimated 20% premium growth that occurred in 1985, ISO forecasts there will be a smaller increase in 1986. Assuming a 17.5% increase for 1986, ISO projects that 1986 industry returns on net worth will rise. Under reasonable assumptions for loss growth, investment income, realized capital gains and taxes, the 1986 return on net worth will be only 8-9%, which is far below the typical returns for most other U.S. industries and below the median result for the Fortune 500 in each of the last 10 years.

The following facts support the ISO analysis and forecasts.

- (1) Recent insurance industry returns on net worth have been low—below 2% for 1984, with modest improvement, at best, in 1985. Roughly a 10-point increase in return on net worth would be required to reach the 13-15% range hypothesized for 1986.
- (2) Industry losses have continued to escalate rapidly, rising 15% in the first nine months of 1985. The full-year increase in losses will be at least as high.

The charge that no additional price increases are needed in 1986 is false. If the industry implements no increases in 1986, a return on net worth of only 5% could be expected—and 1987 returns would be even lower. The beginning of another downturn so soon after the longest and most severe downturn in the history of the industry would seriously threaten the industry's ability to make future claim payments.

**CHARGE:** Insurance premiums are increasing so dramatically today solely because of prior inadequate prices. Increasing losses are not the problem.

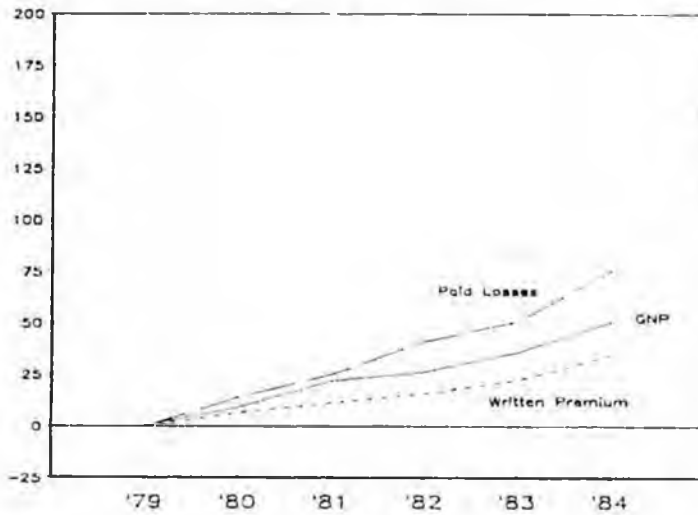
**THE FACTS:** This charge is incorrect. No one can deny that insurers reduced prices far below the level needed to cover the costs of policies written. However, in the past five years, growth in property/casualty losses has far exceeded the country's economic growth as measured by GNP.

During 1979-1984, GNP grew 50% while written premium increased only 34%, or 2.4 points per year *slower* than the average annual GNP growth rate. On the other hand, paid losses grew 76%, or 3.4 points per year *faster* than GNP. (See chart 14.)

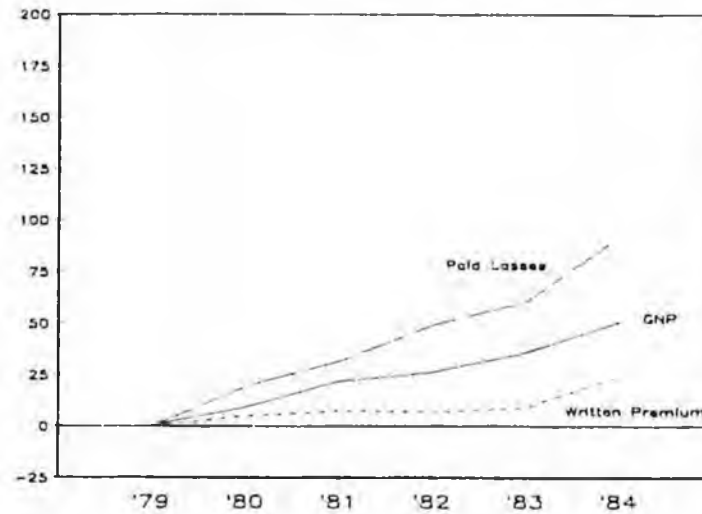
Moreover, the increase in losses was not uniform across all lines of insurance. Commercial lines paid losses grew 92% while personal lines

## LOSSES GREW FASTER THAN PREMIUMS, ESPECIALLY FOR COMMERCIAL LIABILITY LINES

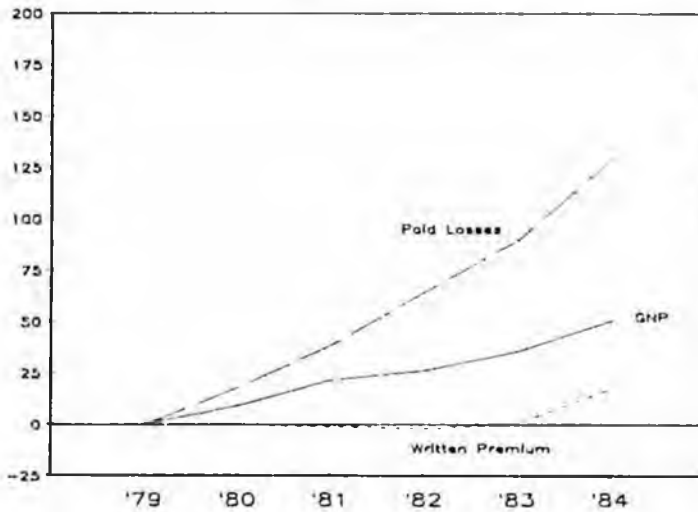
Since 1979, paid losses have grown at a faster rate than either GNP or premiums. The problem is more severe for commercial lines, especially the commercial liability lines.



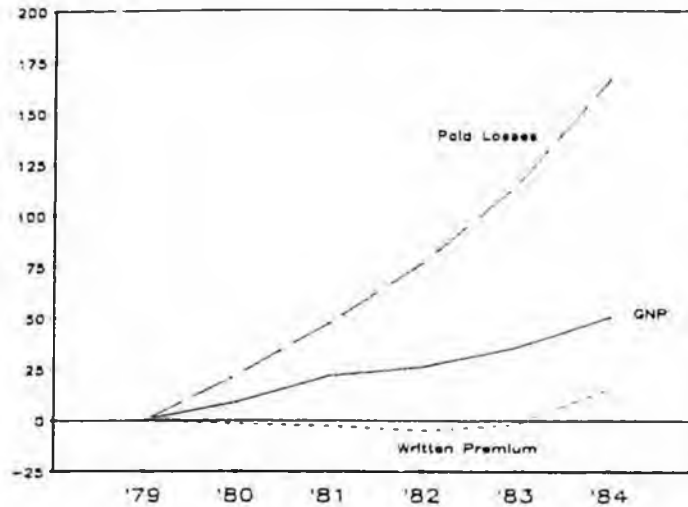
**14**  
Loss Growth and  
Premium Growth  
vs. GNP (%): All  
Lines



**15**  
Loss Growth and  
Premium Growth  
vs. GNP (%): Com-  
mercial Lines



**16**  
Loss Growth and  
Premium Growth  
vs. GNP (%): Com-  
mercial Liability



**17**  
Loss Growth and  
Premium Growth  
vs. GNP (%): Gen-  
eral Liability &  
Medical Malprac-  
tice Combined

paid losses increased 62%, and commercial liability paid losses increased 130% during the period—well over double the GNP growth rate. (See charts 15 and 16.)

Finally, general liability and medical professional liability paid losses have grown 167% over the five-year period—more than triple the GNP growth. (See chart 17.) From 1979 to 1984, paid loss growth averaged 22% a year—13 points more than the average annual GNP growth rate. (See chart 18.)

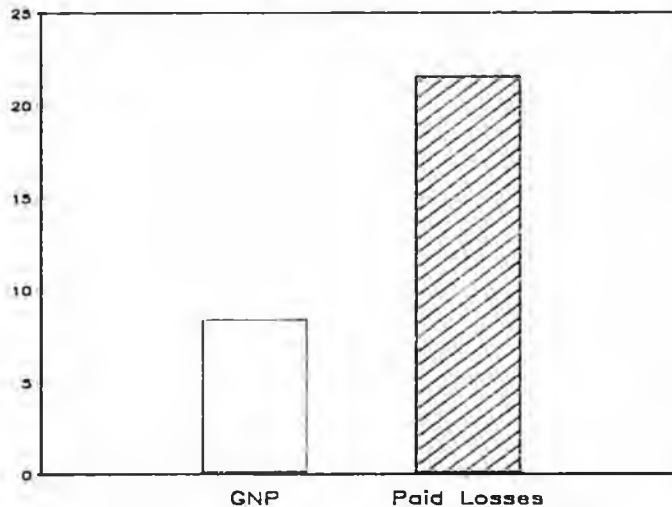
The Administrative Office of U.S. Courts reports that product liability suits filed in U.S. District Courts increased from 1,600 in 1974 to more than 13,500 in 1985—a growth rate of 22% per year. (See chart 19.) Very large awards are becoming much more common. Jury Verdict Research, Inc. reports that the number of million-dollar verdicts in the U.S. has increased each year, from 24 in 1974 to over 400 in 1984. (See chart 20.)

One aspect of the problem of increasing losses is the accompanying litigation costs. The Institute for Civil Justice studied asbestos litigation and found that a disproportionate share of the expenditures on these claims does not reach the victims. Specifically, only 37% of costs in asbestos litigation become net compensation to victims. (See chart 21.)

While current availability and affordability problems are certainly due in part to past price reductions, a major contributor to the problems has been the significant increase in losses. From 1979 to 1984, policyholders had the benefit of low insurance price levels that did not keep pace with losses. But as a result, the insurance industry experienced below-average returns on net worth relative to the Fortune 500 companies in every year since 1979.

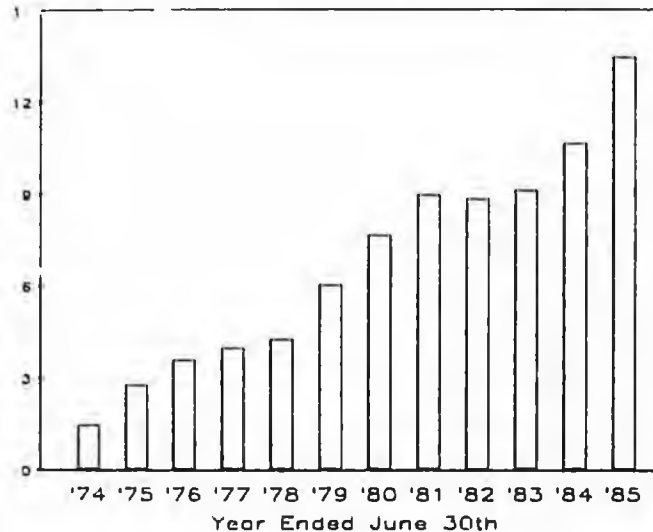
The large premium increases occurring now, particularly for the commercial liability lines, will not recoup past losses nor make up for recent substandard returns. Such increases are needed simply to bring insurance prices in line with the costs of policies written today.

## 18 LOSS GROWTH OUTPACES ECONOMIC GROWTH



**General Liability & Medical Malpractice Losses vs. GNP—1979-84 (Annual % Change)**  
For the past five years, the average rate of growth in general liability and medical malpractice paid losses was 22% vs. a 9% GNP growth rate, a 13-point annual gap.

## 19 LITIGATION EXPLOSION



**Product Liability Lawsuits (Thousands)** Since 1974, the number of product liability lawsuits filed in U.S. District Courts has increased more than eight-fold. Source: Administrative Office of U.S. Courts.

**CHARGE:** The 1985 written premium increase of 71% for general liability insurance was excessive. If insurers had not slashed liability rates a few years ago, they would have earned handsome profits.

**THE FACTS:** The 1985 premium increase was not excessive. Even after that increase, current general liability premium levels are still inadequate when compared with current general liability losses.

The 1984 general liability written premium of \$6.5 billion was no greater than the 1978 written premium. But from 1978 to 1984, losses and loss adjustment expenses incurred increased 74%, from \$4.3 billion to \$7.5 billion. (See chart 22.) Even after including the estimated 1985 increase, written premium has grown at an annual rate of only 8% since 1978, while losses have grown at an annual rate of 14%.

A.M. Best Company estimates the 1985 combined ratio<sup>3</sup> for general liability at 144. At that level, even with a reasonable estimate of anticipated investment income, the general liability lines will lose money. With an estimated annual 8½% interest rate, historical payout patterns for general liability and the A.M. Best combined ratio estimate for 1985, insurers lost 7¢ on every dollar of general

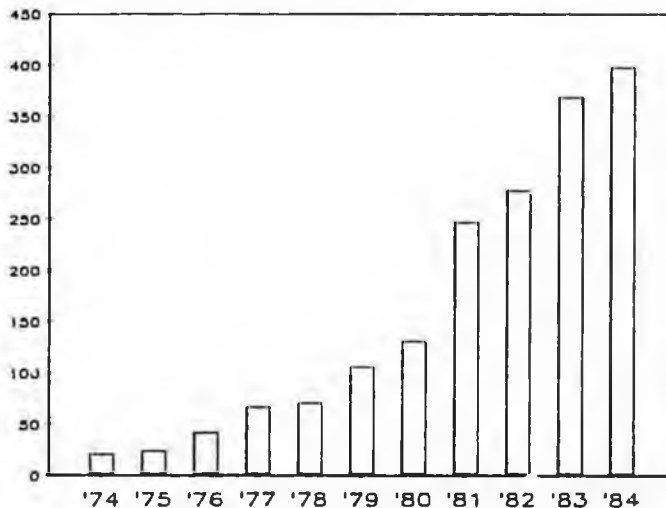
liability premium written in 1985. Obviously, the 1985 increase was not sufficient.

One critic has charged that "general liability rates of return on net worth" would have averaged 30% per year from 1976 to 1983, if insurers had not cut premiums. This hypothetical rate of return is flawed by unrealistic assumptions.

- For all lines combined, it assumes that the ratio of earned premium to net worth is 2:1. The actual average for 1976 through 1983 was 1.6:1.
- Further, it assumes that the hypothetical 2:1 earned premium to net worth ratio is

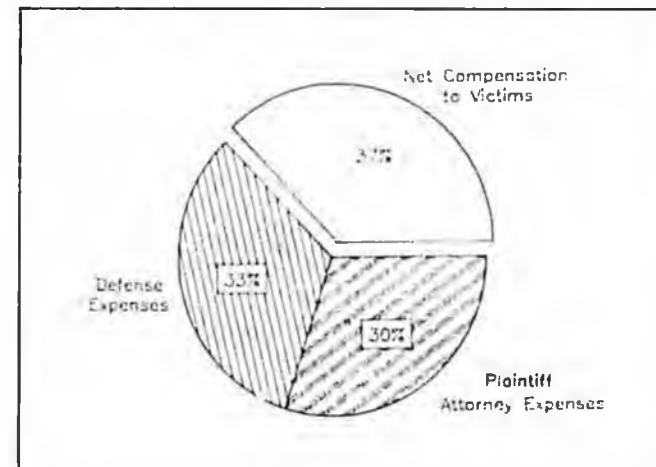
<sup>3</sup>Combined ratio = incurred losses and loss adjustment expenses divided by net earned premium plus other underwriting expenses divided by net written premium plus dividends to policyholders divided by net earned premium.

## 20 NUMBER OF HUGE VERDICTS INCREASING



**Million-Dollar Verdicts** From 1974 to 1984, the number of million-dollar verdicts rose dramatically. Source: Jury Verdict Research, Inc., Solon, Ohio.

## 21 VICTIMS RECEIVE ONLY 37% OF ASBESTOS CLAIMS EXPENDITURES



**Average Expenditures per Tried Asbestos Claim (%)**  
The Institute for Civil Justice has found that only 37% of asbestos claims expenditures become net compensation to victims.

the same for general liability as for all lines combined. In a line like general liability, claims remain outstanding for long periods of time while legal standards change; a prudent insurer would therefore require more net worth to support each dollar of general liability premium than for most other lines.

- In rewriting history, the critics assume that, had premiums been greater, all the additional premium revenue would have been profit. This assumption ignores the fact that, at a minimum, commissions and premium taxes would be paid and income taxes would rise (or credits decrease).

Thus, the conclusion that the "general liability return on net worth" would have been 30% is inaccurate.

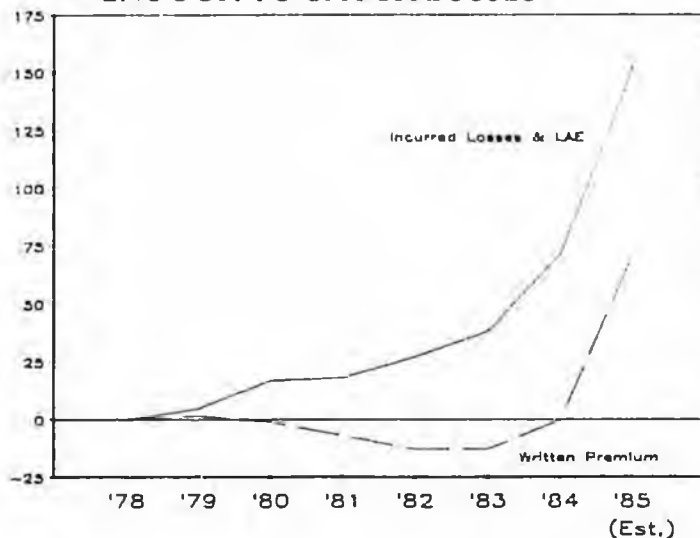
**CHARGE:** Since, for medical malpractice, the industry's paid losses are less than their investment income, this line can be treated on a "pay as you go" basis.

**THE FACTS:** This charge has two flaws. First, the figures are inaccurate and incomplete; the industry's paid losses alone for medical malpractice are substantially greater than investment income, even without consideration of paid loss adjustment expenses. Second, even if the figures were accurate and complete, the charge is

irrelevant. It is inappropriate to consider only actual payments without recognizing future liabilities for injuries that have already occurred but for which the related claims are not yet settled. For long-tail lines like medical malpractice, these claims take many years to settle.

For 1984, A.M. Best reported \$970 million in medical malpractice paid losses and \$440 million in paid loss adjustment expenses (monies expended in the investigation and settlement of claims), for a total of \$1.4 billion.

## 22 1985 GENERAL LIABILITY PREMIUM GROWTH NOT ENOUGH TO CATCH LOSSES



**General Liability Premium Growth vs. Loss Growth (%)** 1985's large premium growth for general liability was not enough to bring premiums in line with 1985 general liability losses and loss adjustment expenses. And, since 1978, the rate of growth in losses is nearly double that of premiums.

This compares with only \$750 million of net investment gain. (See chart 23.) In addition, underwriting expenses and policyholder dividends of \$300 million were paid in 1984.

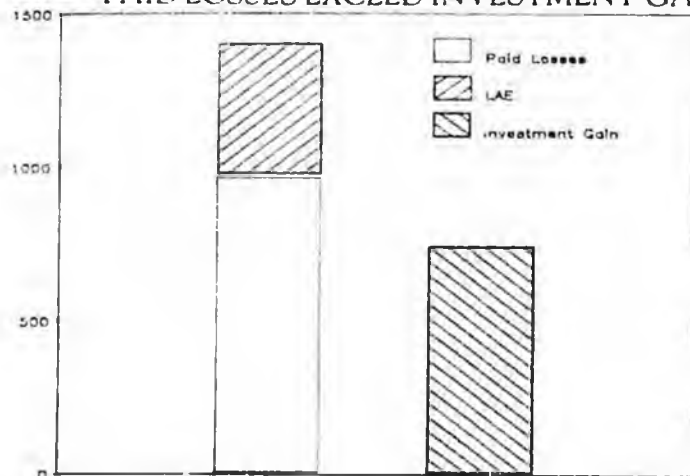
Even if 1984 paid losses had been less than investment income, comparing the two is naive. An analogy can be made to a pension plan with the vast majority of participants in their 30's and 40's. For many years, premiums paid into the plan will far exceed benefits paid out, but it

is quite obvious that the liability for future benefit payments is growing each year and must be funded.

Similarly, medical malpractice claims often take years to emerge and additional years to be litigated. Claims paid out the first year are miniscule, and even after several years, only a small percent of ultimate losses are paid out. For 1976, the year for which the most complete and mature data is available, only 1% of total estimated losses were paid in the first year, only 11% in the first three years and only 72% even after nine years. (See chart 24.) The percentages

are similar for other years examined. To conclude anything about the profitability of this line on the basis of paid losses is like saying that the Social Security system is properly funded simply because more money was collected this year than was paid out this year.

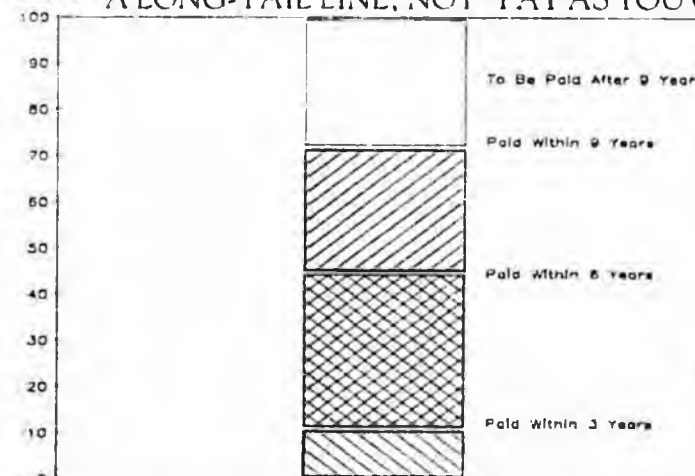
## 23 CRITICS' CHARGES FALSE: MEDICAL MALPRACTICE PAID LOSSES EXCEED INVESTMENT GAIN



### Medical Malpractice Insurers' Paid Loss & Loss Adjustment Expense vs. Investment Gain (\$ Millions)

For 1984, investment gain for medical malpractice insurance is significantly lower than loss and loss adjustment expenses paid. Critics falsely contended the opposite.

## 24 MEDICAL MALPRACTICE INSURANCE: A LONG-TAIL LINE, NOT "PAY AS YOU GO"



### 1976 Medical Malpractice Claims: Percent of Ultimate Losses Paid

After nine years, only 72% of 1976 medical malpractice losses were paid. Claims often take years to emerge and additional years to litigate.

## ACCUSATION

**Insurers are making substantial profits and paying no taxes. There's nothing fundamentally wrong with industry profitability. This is just a typical cyclical downturn.**

**CHARGE:** The stock index of property/casualty insurers rose by 50% during 1985, almost double the rise of the general stock market. This is hardly indicative of a troubled industry.

**THE FACTS:** The fact that property/casualty stock prices, as measured by the A.M. Best Company's property/casualty stock index, outperformed the rest of the stock market is no indication that this industry is profitable. Investors expect improvements in rates of return for property/casualty insurers, but investor expectations are merely that—*expectations*. They do not guarantee results.

Signs of a firming in insurance premiums (especially for commercial lines) began to emerge at the end of 1984. This price strengthening continued throughout 1985 and shows no sign of abatement in 1986. It is clear that sophisticated institutional investors believe that insurers have regained control of their financial destinies and that earnings will improve. But investor expectations do not guarantee future results, and investor behavior does not necessarily correlate with future earnings of the industry.

**CHARGE:** Property/casualty insurers had net income of \$75 billion over the last 10 years. This is a huge amount of money to make. And they paid no taxes.

Note: The \$75 billion figure in the critics' charge is based on a fact sheet prepared for the House Ways and Means Committee by the General Accounting Office. The GAO produced a chart that contained the following figures for the property/casualty insurance industry.

<b>1975-1984 (in billions)</b>	
<b>Underwriting Gains (Loss)</b>	<b>(\$ 45.8)</b>
<b>Investment Gains</b>	<b>121.0</b>
<b>Net Gains</b>	<b>\$ 75.2</b>

**THE FACTS:** The \$75 billion figure is not net income. It *excludes* policyholder dividends paid and *includes* unrealized capital gains. Net income after taxes averaged \$5.1 billion per year, for an average return on net worth of 10.9%. The 10.9% figure is lower than that of the Fortune 500 companies. And insurers' tax credits are based on underwriting losses and the tax status of their investments.

Some critics have used the GAO's figures to reach erroneous conclusions. The underwriting loss shown excludes policyholder dividends paid, and since policyholder dividends are a cost of doing business, they must be deducted from income. (See page 20.)

Investment gains, as shown, include unrealized as well as realized capital gains. Unrealized capital gains flow directly to surplus and do not affect income until realized. A restatement of the 1975-84 totals, with the proper adjustments for policyholder dividends and unrealized capital gains, follows:

<b>PROPERTY/CASUALTY INSURANCE INDUSTRY INCOME, 1975-1984 (in billions)</b>	
<b>Underwriting Gain (Loss) After Policyholder Dividends</b>	<b>(\$ 60.0)</b>
<b>Investment Income</b>	<b>103.7</b>
<b>Operating Income</b>	<b>\$ 43.7</b>
<b>Realized Capital Gains</b>	<b>7.7</b>
<b>Net Income (Before Federal Income Tax)</b>	<b>\$ 51.4</b>

Property/casualty insurers received a total of \$125 million in federal income tax credits during 1975-1984. Thus, industrywide net income after tax for the 10-year period averaged \$5.1 billion per year, not an excessive return. Over the 10-year period 1975-1984, returns on net worth ranged from 1.7% to 19.0%, averaging 10.9%. A comparison with other industries follows:

#### RETURNS ON NET WORTH, 1975-1984

	P/C Insurance	Diversified Financial	Banks	Fortune 500
<b>Low:</b>	1.7%	8.3%	11.5%	10.7%
<b>High:</b>	19.0	17.5	14.1	15.9
<b>Range:</b>	17.3	9.2	2.6	5.2
<b>Average:</b>	10.9	12.8	12.6	13.2

The property/casualty insurance industry has had the lowest average return, while experiencing the greatest variability of all the industries listed. (See chart 25.) This occurs despite the economic theory that increased variability should be rewarded with greater average returns.

While some critics have argued that the property/casualty insurance industry is a low-to-average risk business, the Majority Report of the Advisory Committee to the NAIC Task Force on Profitability and Investment Income (January 1983) concluded that "the property-casualty insurance business is riskier than the average business in the American economy."

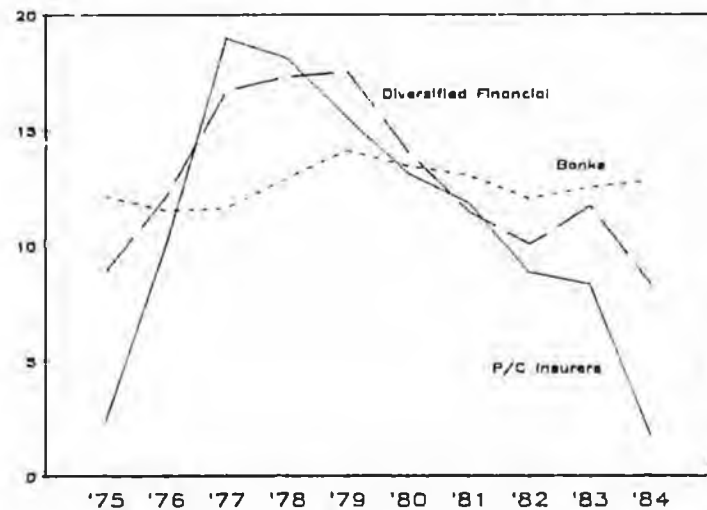
Although property/casualty insurers received a total of \$125 million in federal income tax credits during 1975-1984, they paid \$21 billion in state and local taxes, licenses, and fees other than payroll taxes. The 1985 federal

income tax credit is estimated at under \$2 billion, while state and local taxes paid are estimated at over \$3 billion.

Net federal income tax credits have accumulated for several reasons. In eight of the past 10 years, the industry posted underwriting losses. Since the 10-year underwriting loss was \$60 billion, the positive net income of \$51 billion came from investment gains. In achieving this income, property/casualty insurers, like other businesses, benefited from various incentives provided by the federal tax system to help the country achieve certain economic objectives.

For example, to help state and local governments raise money through the sale of bonds, Congress has determined that interest

## 25, INDUSTRY RETURNS ARE VOLATILE OVER TIME



**Return on Net Worth: Property/Casualty Insurers vs. Other Industries (%)** Returns on net worth for property/casualty insurers are much more variable than those for other industries. Over the past 10 years, the average rate of return for property/casualty insurers (10.9%) has been below that of the Fortune 500 companies (13.2%), while exhibiting much more variation.

on such bonds is exempt from federal taxes. This enables such bonds to be sold with interest rates below the market rate, reducing interest costs ultimately paid by state and local taxpayers. Insurers could have earned higher interest income (on taxable bonds) and paid taxes on that interest income, inflating their federal tax bills but leaving state and local governments without a source of low-cost financing.

Over the last six years, 40% of the industry's net investment income has come from non-taxable bonds. Favorable tax treatment also exists for dividends on equities held by insurers, which have accounted for 20% of the industry's net investment income. In addition, property/casualty insurers (like all investors) benefited from reduced tax rates on realized capital gains.

It is inappropriate to criticize insurers for acting in compliance with tax laws and public policy.

**CHARGE:** This is a typical cycle. The property/casualty industry will recover quickly, just as it has in past cycles.

**THE FACTS:** This cycle is clearly not typical. The results of the recent past demonstrate that the industry is experiencing anything but a "typical" cyclical period. Underwriting losses, operating losses, combined ratios, the number of insolvencies and the number of companies targeted for immediate regulatory attention were all at record highs in 1984, while the industrywide return on net worth was at an all-time low. And reinsurers, on whom insurers depend as never before, have been seriously weakened.

The 1984 underwriting loss was \$21.5 billion. Prior to this cycle, the record underwriting loss was \$4.2 billion in 1975. (See chart 26.) The 1984 operating loss was \$3.8 billion. The previous record was \$0.3 billion in 1975. (See chart 27.) The 1984 combined ratio was 118.0. Prior to this cycle, the record was 107.9, again in 1975. (See chart 28.)

In 1969, the National Committee on Insurance Guaranty Funds began to collect data on

insolvencies that trigger state guaranty funds. Until last year, the record number of insolvencies in any two-year period was 25. During 1984-85, there were 40 insolvencies; and the books on 1985 insolvencies are not yet closed. (See chart 29.)

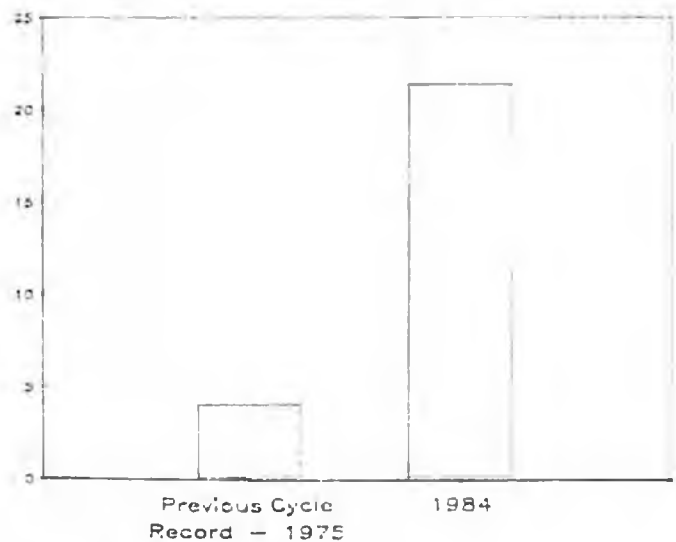
The National Association of Insurance Commissioners (NAIC) developed an early warning system to alert regulators to potential insolvencies. In discussing the 1985 test results, Iowa Insurance Commissioner Bruce W. Foudree, former President of the NAIC, said that 215 property/casualty insurers had been targeted as being in need of immediate regulatory attention under the NAIC early warning system—"the most ever and a 73% increase over last year."

On the basis of bottom-line results, the 1984 return on net worth was 1.7%, despite a record \$4.8 billion of realized capital gains and tax credits. The previous low return on net worth of 2.4% occurred in 1975, when the sum of tax credits and realized capital gains was only \$0.7 billion.

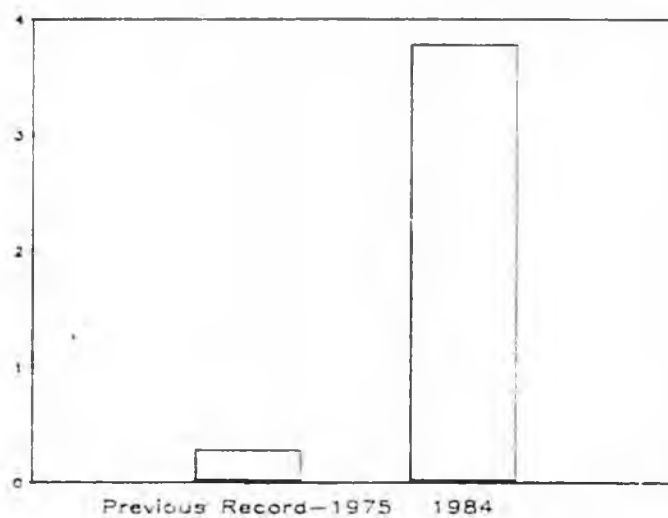
One of the most important differences between this down cycle and all previous ones is its length. This time, the combined ratio worsened for seven consecutive years beginning in 1978. Previously, the longest continuous

## A TYPICAL CYCLE?

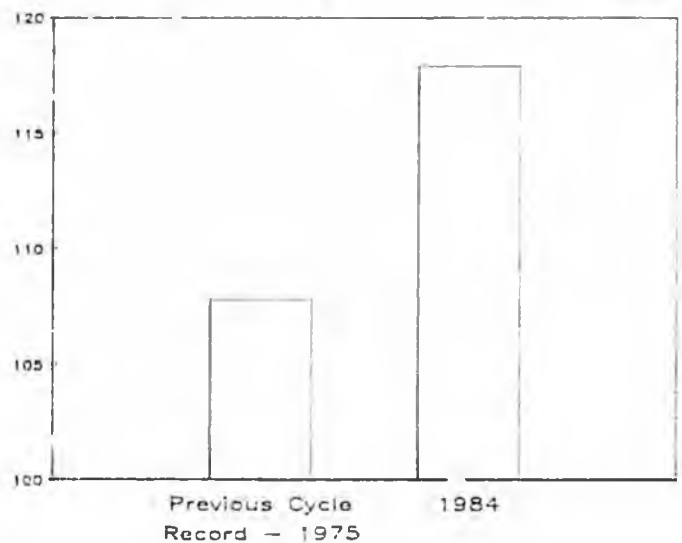
By several measures — underwriting loss, operating loss, combined ratio, and insolvencies — it is clear that the cycle that bottomed in 1984 was far more severe than any previous one



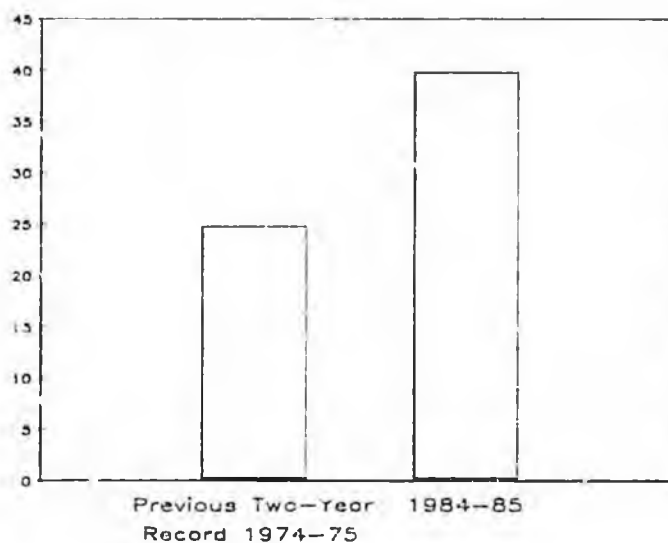
**26**  
Underwriting  
Losses (\$ Billions)



**27**  
Operating Losses  
(\$ Billions)



**28**  
Combined Ratios



**29**  
Insolvencies Cov-  
ered by State Guar-  
anty Funds

period of deteriorating combined ratios was for the five years 1960 through 1964. During that period, however, the combined ratio worsened by only five points; in this cycle, it deteriorated by 21 points.

Another indicator of the depth of this cycle is the number of insurers receiving reductions in any year from their A.M. Best rating of A+. That number increased from 23 in 1982, to 61 in 1983, to 80 in 1984 and finally to 149 in 1985. (See chart 30.) In 1985, only 24% of the companies rated received an A+, compared with an average of 39% in 1976 and 1977 following the last adverse underwriting cycle.

The property/casualty insurance industry is now more dependent on the reinsurance mechanism<sup>4</sup> than ever before. During 1979-1984, reinsurance recoverable (monies owed to

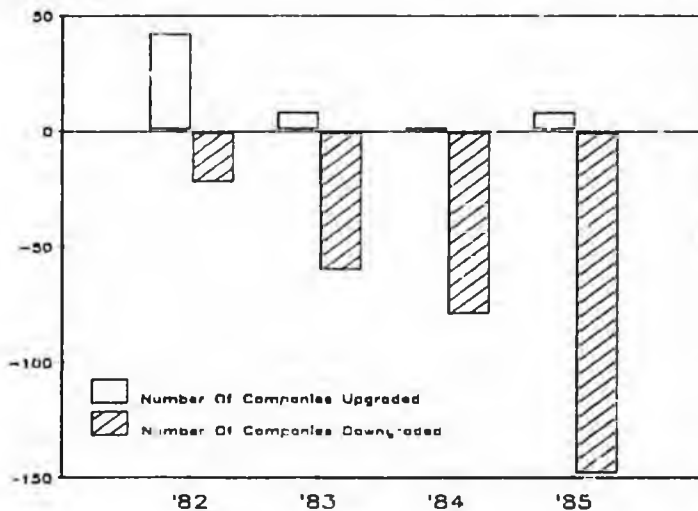
insurers by their reinsurers) more than doubled, while surplus grew 50%. (See chart 31.) For reinsurers themselves, the amount recoverable from their reinsurers more than tripled during this period, while their surplus grew 73%. (See chart 32.) During this period, premiums for the industry increased 30%, while reinsurance premiums increased 54%. At the same time as dependence on reinsurance rapidly increased, reinsurers' financial condition seriously eroded. The 1984 return on net worth for the entire insurance industry was nearly 2%, while it was negative 10% for reinsurers. In 1985, A.M. Best lowered the ratings of half the reinsurers rated.

For the past two decades, reinsurers' combined ratios have closely paralleled those of the property/casualty industry with the gap never exceeding 4½ points, except for the 6-point gap in 1965, the year of Hurricane Betsy. (See chart 33.) As recently as 1982, the two combined ratios were only one-tenth of a point apart. The gap grew to 6 points in 1983 and then to 13 points in 1984, though this gap has begun to narrow in 1985. Reinsurer combined ratios are still substantially higher than those for the entire property/casualty industry.

Historically, personal and commercial lines results have been similar. Between 1967 and 1982, the difference between the combined ratios never exceeded 6 points. (See chart 34.) As recently as 1981, the ratios were only 2 points

<sup>4</sup>For a more thorough discussion of reinsurance, see the Appendix.

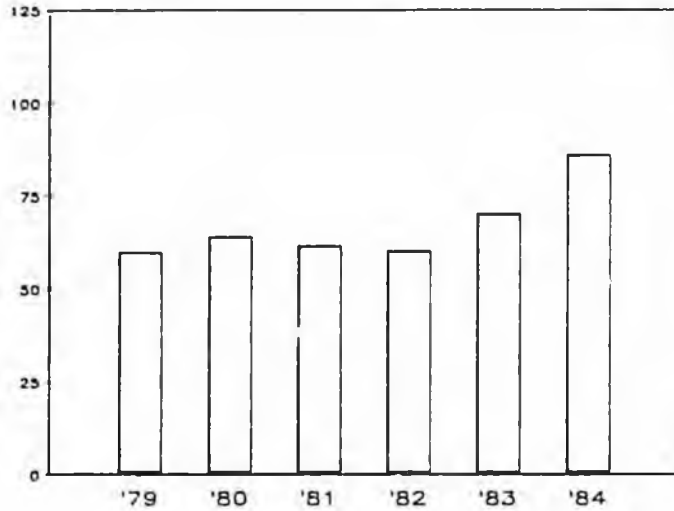
### 30 INSURERS' FINANCIAL RATINGS DOWNGRADED



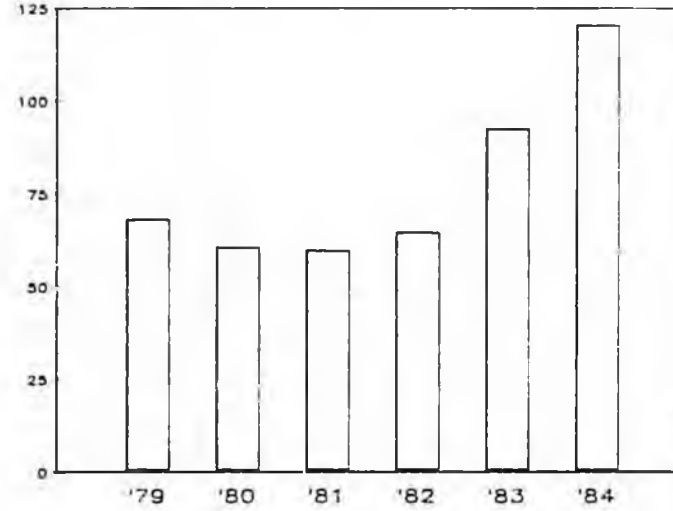
**A.M. Best's A+ Rating Reductions**  
A.M. Best's highest rating is an A+, which it gives to companies that it considers to be the most financially secure. In the last two years, A.M. Best has removed 229 companies from this category, while upgrading only 11.

### REINSURANCE RECOVERABLES GROWING

The entire property/casualty industry and reinsurers themselves have become more dependent on reinsurance. For the industry, reinsurance recoverable represented 85% of surplus in 1984, doubling in value from \$26 billion in 1979 to \$55 billion in 1984. For reinsurers, recoverables represented 120% of surplus in 1984, tripling in dollar value since 1979.



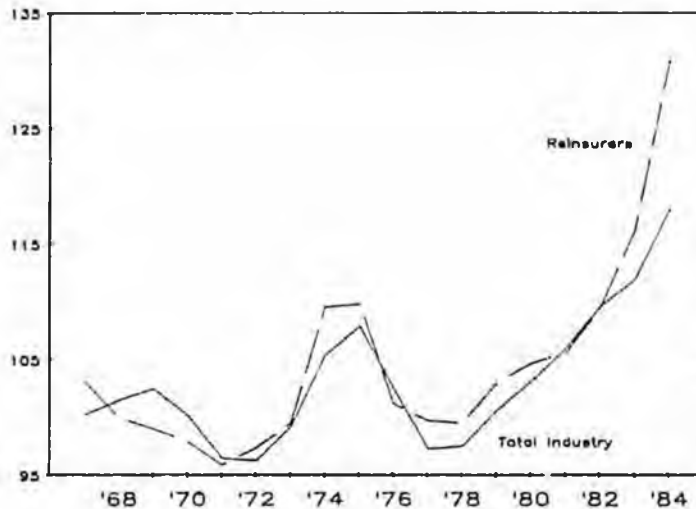
**31**  
Industry Reinsurance Recoverable (% of Surplus)



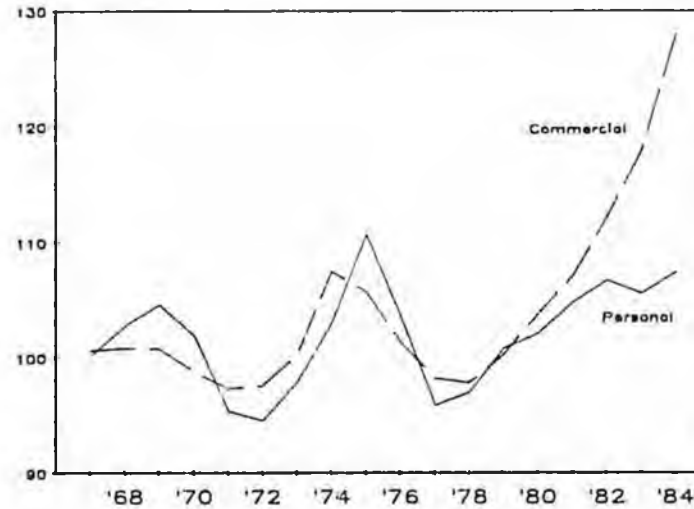
**32**  
Reinsurers' Reinsurance Recoverable (% of Surplus)

### DETERIORATION GREATEST IN COMMERCIAL LINES AND REINSURANCE

Reinsurers have experienced significantly more severe combined ratios than the industry as a whole since 1983, a marked contrast to past cycles. Likewise, commercial lines combined ratios have skyrocketed recently, while those for the personal lines have been more stable.



**33**  
Combined Ratios: Reinsurers vs. Total Property/Casualty Industry



**34**  
Combined Ratios: Personal Lines vs. Commercial Lines

apart. Then in 1983, the gap grew to 12.5 points. In 1984, when it grew to over 20 points, those insurers writing predominantly commercial lines had a negative return on net worth. In 1985, the gap began narrowing but still stood at nearly 15 points for the year ended September 30, 1985.

An even greater concern for commercial lines insurers and reinsurers is that their combined ratios may be understated due to reserve inadequacy. Because of this, the combined ratios for these insurers could be worse than the record highs recorded.

Richard E. Stewart, former Superintendent of Insurance of the State of New York, discusses the current cycle in a December 1985 Marsh & McLennan *Commentary* article. In it, he writes, "...this is not just a routine turn in the underwriting cycle. It has structural as well as cyclical causes." He further notes, "Whereas economic inflation drove the casualty insurance crises of the mid-seventies, the current one is driven by terrible events and by changes in liability law." And he adds, "Insurance has met liability problems before. These are liability disasters. No exclusion is reliable, no excess level out of reach."

All these elements strongly support the conclusion that this is not just a "typical cycle" for the property/casualty insurance industry. Because reinsurers and commercial lines insurers have been hit harder, premium increases will fall unevenly, with some commercial liability policyholders experiencing very large increases. Because the industry's downturn lasted longer than ever before and because the depth of the downturn was worse than ever before, the recovery must be longer and stronger in order to achieve an adequate level of profitability for the industry.

## ACCUSATION

**Insurance is too expensive.**

**CHARGE:** The total insurance bill in the U.S. will rise from 11.1% to more than 12% of disposable income in 1985—more than \$300 billion—displacing personal federal income taxes as the third largest expense in the nation's budget. Only food and housing cost Americans more than insurance.

**THE FACTS:** These statistics are misleading. The \$300 billion figure includes life, health, and accident insurance premiums as well as all property/casualty insurance premiums. The costs of life, health and accident insurance do not belong in a discussion of property/casualty insurance. Moreover, the inclusion of business insurance expenses is inappropriate when making comparisons to disposable income, which is a measure of personal income only.

Personal lines insurance premiums (for private passenger automobile and homeowners insurance) are estimated to be \$64 billion in 1985, which would represent 2.3% of disposable income, the amount of 1985 personal income after taxes.

Insurance is not even the largest expense associated with owning either a car or house. In 1984, the Federal Highway Administration conducted a study on the cost of owning and operating typical vehicles in suburban Baltimore, Maryland. The study concluded that insurance was the third largest cost—behind vehicle cost depreciation, and gas and oil for most cars. For large and compact cars, it ranked fourth—behind vehicle cost depreciation, gas and oil, and also maintenance, accessories, parts and tires.

A 1983 countrywide study by the U.S. League of Savings Associations showed that the cost of insurance represents less than 3% of the monthly housing expenses faced by home purchasers in the United States. Insurance costs came in fourth—behind mortgage payments, real estate taxes and utilities.

There are many items that cost Americans more than insurance. One way to analyze relative costs is to examine the components of the nation's personal consumption expenditures, which are included in GNP. According to the Department of Commerce, personal consumption expenditures represent the market value of purchases of goods and services by individuals and non-profit institutions and the

value of food, clothing, housing, and financial services received by them. Therefore, the components of personal consumption should be compared with personal lines premiums as follows:

**1985 AMOUNT SPENT (\$ BILLIONS)****PERSONAL CONSUMPTION COMPONENT**

<b>Food &amp; Beverages</b>	<b>474</b>
<b>Housing</b>	<b>403</b>
<b>Motor Vehicles &amp; Parts</b>	<b>168</b>
<b>Clothing &amp; Shoes</b>	<b>156</b>
<b>Furniture &amp; Appliances</b>	<b>129</b>
<b>Gasoline &amp; Oil</b>	<b>92</b>

**INSURANCE PREMIUMS**

<b>Personal lines insurance premiums<sup>5</sup></b>	<b>64</b>
<b>Total property/casualty insurance premiums</b>	<b>142</b>

The table indicates six components which are a greater proportion of consumer spending than property/casualty personal lines premiums.

<sup>5</sup>It should be noted that personal lines insurance premiums do not include premiums written on non-profit institutions. However, inclusion of premiums written on non-profit institutions with personal lines premium would have a minor impact and would not raise the total above any of the six personal consumption items listed above.

**CHARGE:** Property/casualty insurance premiums written rose by \$24.6 billion in 1985, from \$117.7 to \$142.3 billion, while coverage decreased substantially. This works out to an increase of \$105 per person for substantially less coverage.

**THE FACTS:** These figures are misleading. A.M. Best's estimate of the \$24.6 billion increase is for all property/casualty premiums, not just personal lines premiums.

Personal lines premium (for the coverages purchased by individuals to protect their autos and homes) increased \$6.7 billion, or 11.7% in 1985, an increase of \$28 per person, not \$105. The 11.7% increase in personal lines premiums in 1985 approximated the 13% increase in personal lines losses. ISO estimates that personal lines paid losses and loss adjustment expenses increased \$5.5 billion in 1985, equivalent to an average \$23 payment per person. After all losses and expenses, insurer underwriting loss for personal lines was over \$1 billion more in 1985 than in 1984.

There do not appear to be significant marketplace problems in the personal lines. Large premium increases are the exception rather than the rule, and restrictions in coverage have been rare.

Most of the 1985 written premium increase was in commercial lines, which increased \$17.8 billion or 30%, as the industry reacted to the growth in losses for these lines.

These increases in commercial insurance loss costs are a matter of concern, since they are outpacing the costs of other goods and services. It is precisely this point that has led industry leaders, businesspersons, legislators, regulators and consumers to investigate methods of reducing the upward spiral in insured losses.



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# APPENDIX

## DISCUSSION OF REINSURANCE

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Reinsurance is essentially an insurance transaction whereby the reinsurer, for a premium, agrees to indemnify the ceding insurer or reinsured against all or part of the loss which the latter may sustain under its policies of insurance. It is often described as the insurance of insurance companies because it provides reimbursement for an insurer's losses under policies covered by the reinsurance contract. Reinsurance is purchased by the primary or excess ceding insurer for its own benefit so that it can spread its risks and limit its own liability from large or catastrophic losses. The usual reinsurance contract does not involve the policyholder, who looks only to its insurer for defense and indemnity against loss.

Reinsurance was developed to provide capacity essential to the continued growth of the direct insurance industry. In addition to

capacity, reinsurance is purchased by a primary insurer to (1) reduce exposure to liability on particular risks, (2) protect against accumulations of losses arising out of catastrophes, (3) reduce total liabilities to a level appropriate to its premium volume and capital, (4) reduce exposure to certain and possibly more hazardous lines of business or alter its "mix" of business, (5) help stabilize operating results, and (6) obtain assistance with new concepts and lines of insurance.

Reinsurance contracts are shaped to meet the specific needs of the ceding insurer . . . There are no standard reinsurance contracts; there are two basic types which are used and adapted to accommodate the buyer's business. A reinsurance *treaty* is a broad and often automatic agreement that covers some portion of a particular class or classes of business, i.e., the ceding insurer's entire workers' compensation

or property book of business. In contrast, a *facultative* agreement covers a specific risk of the ceding insurer and requires the insurer and reinsurer to agree on terms and conditions on a contract-by-contract basis. Both treaties and facultative agreements may be based on a *pro-rata* distribution where the two parties share proportionately in premiums and losses. The agreements may also be written on an *excess* basis, where only the losses of the insurer in excess of a predetermined amount, known as the "retention", are reinsured.

*Reinsurance Association of America statement before the House Subcommittee on Commerce, Transportation and Tourism, September 19, 1985.*

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Gentlemen:

You have requested our opinion on the appropriate accounting by property and liability insurance companies for (1) dividends to policyholders and (2) realized gains and losses on investments. Our opinions expressed herein do not relate to assessment enterprises or fraternal benefit societies which may employ different accounting principles.

Generally accepted accounting principles for property and liability insurance companies are set forth in the Statement of Financial Accounting Standards No. 60 (the Statement), "Accounting and Reporting by Insurance Companies". The Statement contains the guidance for our views on the transactions set forth above which are:

Dividends to Policyholders

In our opinion, generally accepted accounting principles for property and casualty insurance companies require that dividends to policyholders be charged to operations.

Realized Gains and Losses on Investments

In our opinion, generally accepted accounting principles for property and casualty insurance companies require that realized gains and losses on all investments (including, but not limited to, stocks, bonds, mortgage loans, real estate and joint ventures) be reported in the income statement below operating income and net of applicable income taxes.

Very truly yours,

*Coopers & Lybrand*

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**Report of the Tort Policy Working Group  
on the Causes, Extent and Policy  
Implications of the Current Crisis in  
Insurance Availability and Affordability**



*February 1986*

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INTRODUCTION  
AND  
EXECUTIVE SUMMARY

In October of last year the Attorney General established the Tort Policy Working Group, an inter-agency working group consisting of representatives of ten agencies and the White House. One of the tasks the Working Group was asked to undertake was to examine the rapidly expanding crisis in liability insurance availability and affordability.

The following is the report of the Tort Policy Working Group on the causes, extent and policy implications of this crisis. The primary contributing agencies included the Department of Justice, the Department of Commerce and the Small Business Administration.

Chapter 1 of the report (The Crisis in Insurance Availability and Affordability) describes in detail the significant problems many businesses, professionals and municipalities are having obtaining liability insurance. The Chapter documents a dramatic change in the last two years in the availability, affordability and adequacy of liability insurance. Where insurance is available (and in some areas it simply is not), premium increases of several hundred percent over the last year or two have become commonplace. Few if any private or public entities that rely on liability insurance have escaped the problems generated by this crisis.

Part A of Chapter 2 (The Causes of the Crisis in Insurance Availability and Affordability) reviews the current financial condition of the insurance industry, and the economic factors leading to that condition. The property-casualty industry in the past two years has suffered significant underwriting losses (\$21 billion in 1984; \$25 billion in 1985) which have limited its ability to offer as much insurance as its customers desire, and have made it reluctant to insure high risk activities which may expose it to further substantial underwriting losses. These underwriting losses appear to be largely a result of coverage written in the late 1970's and early 1980's which may have been underpriced due to the industry's desire to obtain premium income to invest at the then prevailing high interest rates.

Nonetheless, there is little to suggest that the recent massive increases in premiums is related solely to these losses, or that the cost of liability insurance will decline significantly as the industry limits its underwriting losses and restores its desired level of overall profitability. To the contrary,

indications are that developments in tort law are a major cause for the sharp premium increases. 1/

Part B of Chapter 2 reviews the contribution of tort law to the insurance availability/affordability crisis. The Working Group found that in the past decade there has been a veritable explosion of tort liability in the United States. Four specific problem areas are identified and discussed:

- ° The movement toward no-fault liability, which increasingly results in companies and individuals being found liable even in the absence of any wrongdoing on their part.
- ° The undermining of causation through a variety of questionable practices and doctrines which shift liability to "deep pocket" defendants even though they did not cause the underlying injury or had only a limited or tangential involvement.
- ° The explosive growth in the damages awarded in tort lawsuits, particularly with regard to non-economic awards such as pain and suffering or punitive damages. And,
- ° The excessive transaction costs of the tort system, in which virtually two-thirds of every dollar paid out through the system is lost to attorneys' fees and litigation expenses.

The Working Group was particularly struck by the extraordinary growth over the last decade of the number of tort lawsuits and the average award per lawsuit. A few examples amply illustrate this point:

- ° Between 1974 and 1985 there has been a 758% increase in the number of product liability lawsuits filed in federal district court.
- ° The number of medical malpractice lawsuits per 100 physicians doubled between 1979 and 1983, and tripled during that period for obstetricians/gynecologists.
- ° According to a jury verdict reporting service, between 1975 and 1985 the average medical malpractice jury

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1/ The Working Group also considered whether state regulation of the insurance industry may be a cause of the crisis, and found little compelling evidence that state regulation is a major cause of these problems.

verdict increased from \$220,018 to \$1,017,716, and the average product liability jury verdict increased from \$393,580 to \$1,850,452. 2/

- o A survey of punitive damage awards in Cook County, Illinois indicates that the average personal injury punitive damage award (measured in constant 1984 dollars) increased from \$40,000 in 1970-74 to \$1,152,174 in 1980-84.

The above data demonstrates that the insurance industry was selling coverage at constant or even reduced cost over a period of years during which tort liability was undergoing a dramatic expansion. This suggests that a major factor underlying the availability/affordability crisis is the industry's attempt to bring premiums quickly back into line with rapidly growing liability risks. 3/ The high -- and in some areas unaffordable -- insurance premiums reflect the fact that tort law is now placing a massive compensation burden on the private sector.

A second important contribution of tort liability to the availability/affordability crisis is the tremendous uncertainty that has been generated by rapidly changing standards of liability and causation. The "rules of the game" have become so unpredictable that the insurance industry often cannot assess liability risks with any degree of confidence. This appears to have severely exacerbated the problem.

Chapter 3 of the report (Recent Insurance Industry Developments) summarizes a number of responses of the insurance industry, its customers and state regulators to the crisis. These developments include the use of claims-made policies, the inclusion within policy limits of all or part of defense costs, the increasing use of self-insurance and captives, and more exacting state regulation.

In Chapter 4 of the report (Tort Law Reform) the Working Group concludes that while some of the above recent developments in the insurance industry, along with a likely improvement in the industry's financial condition, should relieve some of the current availability/affordability problems, it is unlikely that these changes will provide long-term, systemic relief without

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2/ For purposes of comparison, the dollar lost approximately half of its purchasing power during this period.

3/ While some have suggested that the dramatic premium increases are an attempt by the industry to recoup its past underwriting losses, for the reasons discussed in the report such a theory makes little economic sense.

some fundamental reforms of tort law. Indeed, there are good reasons to believe that absent such reforms, particularly the insurance affordability problem will remain a long-term fixture of the American economy.

The Working Group recommends eight reforms of tort law that should significantly alleviate the crisis in insurance availability and affordability. The Working Group does not at this time recommend how these reforms should be implemented (whether at the federal or state level, or through legislative or judicial modification of the law); nor are these reforms meant to be an exhaustive list of potential reforms. The recommended reforms are:

- ° Return to a fault-based standard for liability.
- ° Base causation findings on credible scientific and medical evidence and opinions.
- ° Eliminate joint and several liability in cases where defendants have not acted in concert.
- ° Limit non-economic damages (such as pain and suffering, mental anguish, or punitive damages) to a fair and reasonable maximum dollar amount.
- ° Provide for periodic (instead of lump-sum) payments of damages for future medical care or lost income.
- ° Reduce awards in cases where a plaintiff can be compensated by certain collateral sources to prevent a windfall double recovery.
- ° Limit attorneys' contingency fees to reasonable amounts on a "sliding scale."
- ° Encourage use of alternative dispute resolution mechanisms to resolve cases out of court.

Chapter 5 of the report (Government Insurance: A Non-Solution) details the reasons why government insurance or indemnification would be highly undesirable and would do nothing to remedy the problems underlying the availability/affordability crisis. Such a federal insurance or indemnification program would not only be extremely expensive, but also could exacerbate the problems of tort law by making the "deep pocket" of the taxpayer available in many cases. In addition, such a program could undermine public health and safety, require more extensive government regulation of private sector activities, involve the government in substantial litigation, lead to increased federal involvement in state insurance regulation, and inhibit the ability of the private sector to adapt insurance services to changing economic and social conditions.

The Conclusion to the report lists five conclusions as to the appropriate response of the federal government to the current crisis in insurance availability and affordability. In sum, the Working Group concludes that while there are a number of factors underlying the insurance availability/affordability crisis, tort law is a major cause which the federal government can address in various sensible and appropriate ways. As for some of the other factors underlying the crisis, such as the insurance industry's recent large underwriting losses, there is little the federal government can or should do to remedy these problems.

In that both the tort liability and insurance developments in this report are highly dynamic, and because more detailed data and other studies undoubtedly will become available, the Working Group will continue to follow developments in this area, and, where appropriate, supplement its conclusions and recommendations.

Richard K. Willard  
Chairman  
Tort Policy Working Group

Robert L. Willmore  
Chairman  
Task Force on Liability  
Insurance Availability

February, 1986

## CHAPTER 1

### THE CRISIS IN INSURANCE AVAILABILITY AND AFFORDABILITY

Liability insurance is a linchpin in the operation of the United States economy, yet many American businesses, professionals and municipalities, both large and small, are encountering serious insurance problems arising from premium increases, policy cancellations and refusals to underwrite certain activities.

The liability insurance crisis has three separate but related faces that individually or in various combinations make it difficult for many entities to obtain the desired liability insurance. These problems are availability of insurance, affordability of insurance coverage and adequacy of coverage.

This Chapter describes the current nature and extent of these problems. The Chapter focuses, first, on the problems encountered within the various lines of insurance, and, second, on the effect of those problems on different sectors of the economy.

#### I. INSURANCE COVERAGE SUMMARIES

The following are insurance summaries taken predominantly from insurance industry reports prepared by the Alliance of American Insurers or published in Business Insurance.

##### Environmental Impairment Liability Insurance ("EIL")

EIL covers pollution incidents stemming from gradual pollution exposures (as opposed to "sudden and accidental" pollution, which traditionally has been covered under general liability coverage). Two major companies dropped out of the market in 1935, and by the end of the year only two companies were offering EIL coverage. Forty-seven companies were forced to close hazardous-waste management facilities for lack of EIL coverage. Most hazardous waste businesses currently are looking toward captives and self-insurance. Brokers expect significant price increases on the limited insurance still available.

##### Sudden and Accidental Pollution Coverage

Coverage for sudden and accidental pollution traditionally has been provided as part of general liability coverage. New general liability forms, however, specifically exclude all pollution liability. This is due to court decisions interpreting "sudden and accidental" coverage as also covering gradual and intentional pollution. (See Chapter 3 for a discussion of the new policy forms.) The London market currently is excluding pollution coverage from the large risks it insures.

### Directors and Officers Liability ("D & O")

Premiums in 1985 rose 50% to 500%, and include larger deductibles, lower limits, more restrictive endorsements and shorter policy durations. Industries particularly affected include financial institutions, electric (nuclear) utilities, new high technology business, wildcat oil and gas companies, research and development enterprises, real estate developers, highly leveraged businesses, petrochemical companies and the steel industry. Capacity constrictions have hurt larger risks more than smaller risks. Traditional primary and reinsurance capacity has been reduced, but Lloyd's of London, which has in the past not been active in this line, is offering primary coverage up to \$20 million. Not surprisingly, business with Lloyd's of London is up to 100% to 200%. Much of the reinsurance market for such coverage has virtually dried up.

### Bank Fidelity Bond Coverage

Premiums are up about 300%. A group of fifty banks are creating a mutual insurer to provide D & O and bankers blanket bond coverage.

### Motor Carrier Liability Coverage

Bus and trucking companies are having severe difficulties obtaining the insurance coverage required by federal law. The Motor Carrier Act of 1980 requires insurance minimums of from \$750,000 for carriers of non-hazardous cargo to \$5 million for carriers of hazardous waste and most hazardous materials carried in bulk. The Bus Regulatory Reform Act of 1982 set insurance minimums from \$1.5 million to \$5 million, depending on the passenger capacity of the bus. Capacity is limited both in the primary and reinsurance markets. Small trucking firms and independent owner-operators have the most difficulty getting insurance.

### Liquor Liability Coverage

Liquor liability coverage may be available as part of a commercial lines package, but is severely constrained and virtually nonexistent in some parts of the country as monoline coverage. This line has been affected by the bankruptcy of one of the largest dram shop insurers, Ideal Mutual Insurance Company.

### Medical Malpractice Insurance

Availability problems are being encountered by nurse/midwives, obstetricians/gynecologists, pediatricians and dentists. Premiums are being raised and coverage limits are being reduced, sometimes by as much as 50%. Reinsurers are also restricting coverage in this line. St. Paul's Insurance Company, the largest medical malpractice insurer, has placed a moratorium on new policies. St. Paul's writes coverage for approximately 20%

of the Nation's doctors, and wrote an estimated \$600 million in malpractice business in 1985. It had a pure loss ratio (excluding loss adjustment expenses and operating expenses) of 81.3% in 1984. Doctor-owned mutual insurance companies account for more than half of the medical liability coverage in the country.

### Commercial General Liability ("CGL")

Commercial general liability insurance has undergone significant premium increases. The Insurance Services Office ("ISO"), the property-casualty insurers' statistical and ratemaking organization, has filed a new CGL form which will limit coverage and which contains certain exclusions and policy limitations (see Chapter 3).

### Excess Coverage

Excess coverage capacity has been sharply reduced. This coverage currently is offered primarily on a claims-made basis, which may or may not mesh with the primary, reinsurance and other excess layers.

### Reinsurance

Reinsurance capacity for the United States market has been severely limited, particularly with regard to Lloyd's of London, which has faced both its own problems and a disillusionment with the American market. This capacity problem is expected to ease somewhat in 1986, but is likely to remain a problem for some time longer.

## II. SECTORAL SUMMARIES

The following are summaries of the effect of the insurance availability/affordability crisis on various sectors of the United States economy. This information was obtained from surveys conducted by business groups, articles in the trade press and materials prepared by trade associations or provided by industry representatives. While the following does not include all of the available information, it summarizes the major findings.

### Municipalities

Municipalities are among the hardest hit groups by both affordability and availability problems. Local officials preparing their budgets for the next fiscal year report that the market for public entities is "extremely limited" and "diminishing to nothing." Those cities able to secure bids are finding insurance companies' offers prohibitively expensive. Renewal rates have climbed by as much as 400% -- and often for lower coverages with higher deductibles. Some cities are facing premium increases of up to 1,000%.

The United States Conference of Mayors conducted a survey of 39 cities in the summer of 1985. Over half the cities were quoted premium increases of over 100%, and 16 were quoted increases greater than 200%. In addition, a recent report by the Wyatt Company, Public Officials Liability Insurance: Understanding the Market (1986), notes that local governments have reported premium increases of 200% to 300% in the insurance purchased for their officials.

Rather than renew, many cities have decided to "go bare." All cities have been forced to reevaluate and sometimes limit the services they provide their communities. Finally, in the wake of policy cancellations, a number of city and county officials have resigned, fearing personal exposure to lawsuits stemming from their official duties.

#### Transportation

The American Public Transit Association, the nation's largest organization of transit operators, reports that premiums for those companies able to obtain insurance this year have gone up 500% to 1,000%, and sometimes more. In Los Angeles, the Southern California Rapid Transit District's annual premium jumped from \$67,000 to \$1.7 million, while coverage was reduced. Transit problems were compounded by the bankruptcy of one of the largest companies involved in insuring mass transit systems. Some local transit systems have had to suspend operations.

#### Publishing

Newspaper and magazine publishers are finding it more difficult to obtain libel insurance.

#### Nurse-Midwives

The American College of Nurse-Midwives represents 2,500 members, 1,400 of whom were covered under a blanket policy through the association. The policy was cancelled on July 1, 1985. The association has been unable to obtain other coverage and has been attempting to create a captive insurer. The captive was to have started operation by April 1, 1986, but that deadline will not be met.

#### Grocers

A survey by the National Grocers Association found that its members' liability insurance premium rates had recently increased from 25% to 500%. The survey covered 161 retailers and 20 wholesalers.

#### Architects and Engineers

Most architectural and engineering firms, and particularly smaller firms, are experiencing severe availability and affordability problems. Insurance premium rate increases of

200% to 300% have become the norm. Roughly 30% to 40% of smaller firms are going bare. Engineering firms involved in asbestos or other toxic substances abatement activities face extreme difficulties in obtaining insurance, with rate increases, where insurance is available, of 5,000% not uncommon.

#### Day Care Centers

The National Association for Education of Young Children conducted a survey of day care providers. They covered family day care providers who care for children in a home setting, day care centers and headstart programs. The survey found that 40% of the respondents had had their insurance cancelled or not renewed and the majority of those with coverage had premium increases, most of which rose 200% to 300%.

#### Toy Manufacturers

The Toy Manufacturers of America recently surveyed its 243 members on insurance cost and availability problems. Final results will not be available until April, but initial responses are:

<u>Members</u>	<u>%Increase in premiums</u>
21	50
9	50-100
12	100-150
2	150-200
11	300-500
7	500-1000
1	over-1000
2	cannot obtain insurance

Companies that normally had three to four months to negotiate a policy renewal have been given only 72 hours to do so this year. This permits insufficient time for policy shopping. The association reports that it had recommended a captive to its members a few years ago. Commercial insurers reduced prices upon learning of the proposal, eliminating industry interest in a captive.

#### Household Appliance Manufacturers

The household appliance industry has seen sharp reductions in available coverage, and the Association of Home Appliance Manufacturers has lost group coverage it had arranged in 1983. Many companies have been able to obtain only about one-third of the coverage sought for product liability, and the cost of that coverage is increasing. Member companies are having similar problems obtaining D & O insurance.

### Automobile Repair

The Automotive Services Councils, an association representing automobile repair shops and garages, conducted a survey with 104 responses. Average premium increases were 70% to 80%. Some 13% of the membership reported purchasing an average of 30% less coverage. Approximately 41% had experienced policy cancellations and 26% were unable to find new carriers.

### Medical Equipment

The medical equipment industry has had a captive, MedMarc, an affiliate of the Health Industry Manufacturers Association, since 1979. The captive started with 35 companies and has recently reached 100 member companies. The rate of growth increased in 1985 as the result of cancellations by commercial insurers of about 20% of the Association's members and premium increases of five to ten-fold.

### Biotechnology

Biotechnology companies are having a particularly difficult time in the tight market because they are generally new, small companies dealing mostly in research and development in a field largely unknown to insurers. Their inability to obtain coverage causes them difficulty in obtaining bank financing, which, in turn, causes some of these companies to sell out or forego promising research. The industry is exploring the creation of a captive.

### Oil and Gas Drilling

The International Association of Drilling Contractors represents 1,500 contractors operating drilling rigs. It estimates maritime liability premium increases of 300% to 700% and inland liability premium increases of 100% to 150%.

### Construction Contractors

Constructor magazine (October 1985) estimates average increases in general liability coverage of 40% to 75%. For contractors who were able to negotiate significant discounts in past years increases currently are running up to 300%. In 1985 premium increases for umbrella coverage were approximately 300% for less coverage.

### Natural Gas Transportation

The National L-P Gas Association represents 4,100 firms that prepare and transport liquefied petroleum gases for residential and industrial users. According to a spokesman, as many as 25% of the transporters are operating with less than the \$5 million in insurance coverage that is required of motor carriers by federal law. Difficulties are attributed to unavailability and prohibitive costs of umbrella insurance.

## General Manufacturing

The Machinery & Allied Products Institute ("MAPI") recently conducted a survey of 81 companies producing a broad range of products in the manufacturing industries and obtained an 80% response rate. The typical respondent experienced increases for every type of insurance covered in the survey. The survey covered general liability, D & O, environmental impairment liability, products and other property and casualty coverages. The size of the increases varied with the date of the renewal; consequently, the survey results understate the problem since many of the respondents are not up for renewal until early this year. Significant survey results are shown in the table below.

### MAPI Survey Results on Liability Coverages

<u>Premiums</u>	<u>% Higher</u>	<u>% Change (Median)</u>
CGL-Primary	73	40
CGL-Excess	100	250
D & O	72	300
EIL	94	60
Products	95	116
Other	87	40

<u>Lower Limits</u>	<u>% Lower</u>	<u>% Change (Median)</u>
CGL-Primary	13	-36
CGL-Excess	66	-50
D & O	27	-25
EIL	59	-50
Products	33	-50
Other	18	-25

<u>Deductibles &amp; Exclusions</u>	<u>% Higher Deductible</u>	<u>% More Exclusions</u>
CGL-Primary	34	97
CGL-Excess	25	96
D & O	49	95
EIL	50	89
Products	50	100
Other	28	100

In addition to the foregoing, 35% of the MAPI respondents indicated that their general liability coverage excluded "sudden and accidental" pollution coverage, while 49% indicated that it was excluded in some layers and included in others. Some 65% of the respondents indicated that they had some coverages cancelled since January 1, 1985.

### Machine Tool Manufacturers

The National Machine Tool Association represents 300 to 400 businesses that manufacture heavy machinery which cuts, shapes and forms metal. Preliminary results of a survey indicated product liability premiums have doubled since 1984, and that about half of the respondents have been or expect to be put on claims-made policy forms.

### Battery Recycling & Smelting Companies

Battery recycling companies are typical of many industries where processes create toxic wastes. Recycling 50 million scrap batteries accounts for up to 50% of the annual lead smelter production. If the batteries are not recycled, they will be disposed of in landfills, leading to more serious toxic exposure. One major smelting company was offered a \$10 million policy with a \$2.5 million deductible at a cost of \$650,000. While it deems the policy uneconomic, it has not found an alternative. The problem is widespread with smelters of various metals. The uncertainty of the risk and size of pollution liabilities has led to substantial reductions in coverage with sharp increases in deductibles and premiums.

### Power Equipment Manufacturers

Outdoor power equipment manufacturers had been reporting premium increases of from 50% to 70% during the past year. At the end of the year, with many renewals coming due, some have experienced increases of 400% to 600%. The Association once again is considering establishment of a captive.

### General Aviation Manufacturers

The General Aviation Manufacturers Association reports that the cost of liability insurance per aircraft was \$51 for the 6,778 business, commuter and private aircraft delivered in 1962, and increased to \$211 for the 9,774 delivered in 1972. Currently, for the 2,000 planes delivered in 1985, the liability insurance cost has increased to \$70,000 per plane. The cost of liability insurance to air frame manufacturers in 1985 was about \$135 million, with a total cost of \$175 to \$200 million for the entire industry that includes manufacturers of engines, electronics and parts.

### Ski Operators

Liability insurance premium increases of up to 400% have been reported by the National Ski Areas Association. Some small ski areas have closed, and the average price of lift tickets has increased substantially.

### Aerospace Equipment Manufacturers

Aerospace equipment manufacturers are increasingly concerned that the escalating cost of product liability insurance and other associated costs are causing them to lose their ability to compete with overseas manufacturers of similar equipment.

### III. THE NATURE AND EXTENT OF THE INSURANCE AVAILABILITY/AFFORDABILITY CRISIS

The above examples of insurance availability, affordability and adequacy problems demonstrate the broad scope of the liability insurance crisis in the mid-1980's. In a similar crisis in the mid-1970's, the problem areas were largely confined to medical malpractice and product liability. Medical malpractice coverage has been a continuing problem, with almost half that coverage currently underwritten by doctors' and hospitals' mutuals and other alternative markets. Product liability coverage, however, was readily available at declining cost during the late 1970's and early 1980's.

A growing capacity shortage over the last year or more has caused commercial insurers to review carefully their underwriting standards and pricing policies in order to determine where insurance capacity can be utilized most profitably. The inevitable result of this reevaluation has been a severe disruption for insurance buyers.

#### Insurance Availability

Availability problems are occurring in certain specialty commercial insurance markets. These include pollution, day care, municipal, liquor, motor carrier and D & O liability coverages. The bankruptcies of some specialty insurers, particularly in the lines of motor carrier and liquor liability, have affected the capacity in these coverages.

In each of these lines, insurers have perceived the possibility of significant losses based on highly publicized verdicts and settlements. General line insurers who ordinarily would fill the gap left by specialty carriers are unwilling to do so because they can use their scarcer dollars in less volatile and more profitable lines.

#### Insurance Affordability

Premiums are increasing in virtually all commercial coverages. Examples of affordability problems include nurse-midwives and general aviation manufacturers, both of which face premium costs which may be warranted by the experience, but are too expensive for the buyers. Solutions to problems like these appear to lie outside of the insurance system.

#### Insurance Adequacy

Problems of insurance adequacy are being experienced across all commercial lines of coverage. The main problem seems to lie with the fact that many buyers are unable to buy as much

insurance as they desire. This is particularly true for large firms which seek large amounts of excess and higher limits coverage. These problems appear related in part to a capacity crunch created both by the insurance cycle and the withdrawal of capacity by the overseas reinsurers. The lack of capacity related to the insurance cycle shows signs of abating as the corner of the cycle has turned and surplus is increasing. But many firms may have to use alternative market mechanisms for at least a couple of years until this capacity fully returns. It may take much longer to get reentry by overseas reinsurers who have grave concerns about the American tort liability system. A second area of inadequacy lies in the growth of exclusions, deductibles and other policy limitations that are just now being introduced into the market. These are discussed in Chapter 3.

#### The Insurance Availability/Affordability Crisis

Finally, it should be noted that the crisis in insurance availability and affordability does not appear to be a crisis for the insurance industry. While the industry (as discussed in Chapter 2) is suffering substantial underwriting losses, the Working Group does not perceive this crisis to be a major threat to the financial viability of the industry. Rather, it is a crisis for the insureds who cannot obtain or afford the insurance they believe necessary for their on-going activities. And, to the extent that entities are forced to operate without insurance or with inadequate insurance, it is a crisis for victims of tortious conduct who may find that liable defendants cannot pay them their damages.

## CHAPTER 2

### THE CAUSES OF THE CRISIS IN INSURANCE AVAILABILITY AND AFFORDABILITY

A number of reasons have been proffered for the crisis in the availability, affordability and adequacy of liability insurance. Many of these reasons relate to the economic decisions and performance of the insurance industry over the past decade. Other reasons focus on recent developments in tort law. While the two in fact are closely related, this Chapter discusses each of these areas separately. Part A deals with the general economic reasons for the current crisis; Part B reviews the contribution of tort law. 1/

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1/ There have been suggestions that the availability/affordability crisis may be caused by certain aspects of state regulation. While some regulatory measures may have aggravated the problem, the Working Group has found little compelling evidence that the crisis is the result of a regulatory failure, either in the sense of insufficient or inadequate regulation, or in the sense of ill-conceived regulation. In this regard, it is worthwhile noting the 1977 report of the Department of Justice to the Task Group on Antitrust Immunities on The Pricing and Marketing of Insurance, which concluded that "in the commercial lines . . . state regulatory schemes are largely illusory and that insurers are generally free to set their own prices." Id., at vii. The report further indicated that rigid state rate regulation, such as is found in automobile insurance, may in fact aggravate an availability problem. Id., at vi.

In this regard, it is worth noting the conclusion of the Medical Malpractice Policy Guidebook (1985), prepared by Henry Manne (general editor) and Barry Anderson, Patricia Danzon, Clark Havighurst, Charles Phelps and Frank Sloan (principal authors) for the Florida Medical Association. The Guidebook concluded that it was difficult to fault the state insurance regulatory system for the high medical malpractice insurance premiums in Florida. Id., at 11. The report concluded that premium increases lag claims costs, and that "malpractice premiums are almost certainly not 'too high' compared to the increases in claims costs emerging over recent years." Id., at 149-50.

Some have pointed to state insurance reserve requirements as a cause of the insurance availability/affordability crisis, to the extent that they believe these requirements to have exacerbated capacity constraints. While the Working Group did not analyze whether state reserve requirements are too high or too low, it should be noted that these requirements exist to ensure the solvency of insurance carriers, and thereby to protect insureds. It also should be noted that the only way that state insurance reserve requirements conceivably could be modified to

(CONTINUED)

## A.

## I. INSURANCE INDUSTRY PERFORMANCE

Recent news accounts have presented a seemingly conflicting view of the economic performance of the property-casualty insurance industry. In order to understand the financial condition of the industry itself and of some of its specific lines of business, it is useful to compare the condition of the industry as a whole to what has been happening to premiums in the lines which present significant availability/affordability problems.

The table below presents premium and loss data for the property-casualty insurance industry for the period 1981 through 1985.

Year	Net Premiums Written (000)	Loss and LAE (000)	Expenses (000)	Statutory Under- writing Loss after Policyholder Dividends (000)
1981	\$ 98,805,725	\$75,764,229	\$27,132,052	\$- 6,523,534
1982	103,115,653	82,152,241	28,996,122	-10,415,751
1983	107,802,698	87,719,055	30,799,231	-13,285,049
1984	117,743,957	103,720,652	32,980,082	-21,455,300
1985*	142,300,000	126,846,220	37,353,750	-25,200,000

\*Estimated

Source:Best's Insurance  
Management Reports

The most striking number in the table, of course, is the \$25 billion underwriting loss estimated for 1985. This number represents the difference between premiums written and expenses, policyholder

1/ (FOOTNOTE CONTINUED)

produce lower premiums would be if the reserve requirements were relaxed. It would be difficult to justify relaxing reserve requirements, however, in light of the fact that both insurance company insolvencies and the number of insurance companies reported to be in financial difficulty have increased substantially in the last two years.

The Working Group is continuing to review the contribution, if any, of state regulation to the insurance availability/affordability crisis.

dividends, 2/ estimated losses and loss adjustment expenses ("LAE").

The underwriting loss, however, while significant, represents only part of the industry's overall financial picture. Since premiums are collected well in advance of any anticipated payout, they are invested and earn income. In addition, other income is generated which also must be considered in reviewing the industry's financial condition. Overall income in 1985 resulted in the industry showing a \$7.6 billion gain in policyholders' surplus (the equivalent of net worth), 3/ on an underwriting loss of \$25.2 billion and net investment and other income of \$32.8 billion. Thus, the industry appears to have made an overall profit in 1985, though at a lower rate than historical levels or other sectors of the economy.

In discussing the overall financial review of the property/casualty industry, Best's reported that:

Investor interest in the property-casualty industry cannot be denied. While the Dow Industrial Average had made headlines by surpassing the 1500 mark (a 25% gain for the year), Best's Index of property/casualty companies has jumped 50% at this writing, and security analysts specializing in insurance-- and cognizant of 1985's underwriting losses-- nevertheless continue to be optimistic about the industry's prospects. 4/

Two factors must be taken into account in assessing the role of the insurance industry's financial performance in the insurance availability/affordability crisis. First, even though the industry currently is making a profit, that profit is well below the profitability of most other major industries, as well as the insurance industry's historical average. For example, in 1984 the property-casualty insurance industry produced an annual rate

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2/ Questions have been raised as to whether or not the \$2.1 billion paid out in policyholder dividends should be included in the underwriting loss. Policyholder dividends are offered to some policyholders in some lines, and reduce the net cost of their insurance coverage. Consequently, any reduction in such premiums simply increases the net cost to policyholders.

3/ Policyholders' surplus is the difference between insurers' assets and liabilities. It is considered "the financial security that stands behind every insurance policy and is that which provides the cushion to support the shock of major catastrophe, stock market declines and loss of reserve inadequacies." ISO, Financial Condition of the Insurance Industry -- An Update (1985).

4/ Best's Insurance Management Reports (December 30, 1985).

of return on net income after taxes as a percent of net worth of 1.8%, whereas the median for Fortune 500 companies was 13.6%. 5/ The comparable rate of return for the property-casualty insurance industry from 1975 to 1984 was 10.9%. 6/

Second, the insurance availability/affordability crisis has not manifested itself across the entire spectrum of insurance services, but only in specific lines. These lines account for a relatively small portion of the industry. For example, the entire property-casualty insurance market accounts for only approximately one-third of the overall insurance market in terms of written premiums. 7/ The two property-casualty lines that have been the primary source of availability/affordability problems -- general commercial liability and medical malpractice -- amounted to only 7% of all the property-casualty lines in terms of 1984 written premiums. 8/ (These two lines thus represent approximately 2.5% of the entire industry's written premiums in 1984.) But, as can be seen in Subsection II, about one-fifth of the property-casualty industry's \$21.5 billion 1984 underwriting loss came from these two lines. And in 1985, the two lines accounted for almost one-quarter of the property-casualty industry's estimated \$25.2 billion underwriting loss. These two lines, as well as the Commercial Multiple Peril line, 9/ are discussed in greater detail in Subsection II.

## II. UNDERWRITING RESULTS BY MAJOR LINES

While the industry overall has been profitable, certain lines have made major contributions to the underwriting losses. This section examines the major commercial lines in which availability and affordability problems have been most prominent.

### Commercial Multiple Peril

Commercial Multiple Peril ("CMP") is related to the general liability line of insurance in that it is a packaged line of business which includes some commercial general liability coverage and its long-tail losses; that is, losses which may be

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5/ Insurance Information Institute, 1985-86 Property/Casualty Factbook, page 22.

6/ Id. The comparable statutory accounting rate of return was 11.9%. Id.

7/ Congressional Quarterly Weekly Report, page 150 (January 25, 1986).

8/ Insurance Information Institute, 1985-86 Property/Casualty Factbook, page 16.

9/ If the Commercial Multiple Peril line is taken into account, approximately 14% of the property-casualty industry (in terms of 1984 written premiums) accounted for about one-third of its underwriting losses in both 1984 and 1985. Id.

reported many years after the policy year. CMP experience over the past five years is reflected in the chart below.

#### Commercial Multiple Peril

Year	Net Premiums Written (Billions)	Loss and LAE (Billions)	Under- writing Expenses (Billions)	Statutory Under- Writing Loss After Policyholder Dividends (Billions)
1981	\$6.8	\$4.6	\$2.5	\$-0.5
1982	6.9	5.3	2.7	-1.2
1983	7.2	5.9	2.9	-1.7
1984	8.2	7.9	3.2	-2.9
1985*	11.7	10.4	4.1	-3.0

\*Estimated

Source: Best's Insurance Management Reports 12/30/85

While the underwriting losses for CMP rose to \$3 billion in 1985, it is readily apparent that until recently there had been little premium growth in the line. Best's predicts that the short-tail, non-liability portion of CMP should provide the ability for a fast turnaround for this line. It also notes that ISO's new CGL claims-made form will be added to the standard CMP form, but that market pressures should assure the availability and affordability of the smaller businessowner's package. 10/

#### Commercial General Liability

Commercial General Liability ("CGL") coverage includes most of the commercial sectors which are experiencing serious availability/affordability problems. It covers product liability, municipalities, day care centers and other commercial coverages. It is the line for which ISO has introduced its new claims-made form. The experience of this line over the past five years is summarized below.

#### General Liability

Year	Net Premiums Written (Billions)	Loss and LAE (Billions)	Under- writing Expenses (Billions)	Statutory Under- Writing Loss After Policyholder Dividends (Billions)
1981	\$6.0	\$5.1	\$1.8	\$-1.0
1982	5.6	5.4	1.8	-1.7
1983	5.7	6.0	1.8	-2.1
1984	6.5	7.8	1.9	-3.2
1985*	11.1	13.2	2.7	-4.6

\*Estimated

Source: Best's Insurance Management Report

10 Best's Insurance Management Reports (December 30, 1985).

As is apparent, written premiums dropped in 1982 and 1983 and rose slightly in 1984. The figures for 1985, however, show a dramatic increase of 72% over the 1984 premium. Increases are continuing to occur in the line as policies come up for renewal. Losses increased throughout the period, but did so at a relatively even pace until 1984, when losses increased by over \$1 billion dollars over the previous year's losses.

### Medical Malpractice

Medical malpractice represents only about 1.8% of property/casualty insurance written, but has been the source of major availability/affordability problems. The following chart summarizes the experience of the line over the past five years.

Medical Malpractice				
Year	Net Premiums Written (Billions)	Loss and LAE (Billions)	Under- writing Expenses (Billions)	Statutory Under- writing Loss After Policyholder Dividends (Billions)
1981	\$1.3	\$1.6	\$0.2	\$-0.5
1982	1.5	2.0	0.2	-0.7
1983	1.6	2.1	0.2	-0.8
1984	1.8	2.8	0.3	-1.1
1985*	2.6	3.6	0.3	-1.4

\*Estimated

Source: Best's Insurance  
Management Report

Medical malpractice experience is receiving considerable attention at the state level. Unlike many lines of coverage such as product liability, rates are based on state claims rather than national data.

### III. PREMIUM TRENDS

The recent rapid growth in premiums has been a major element in the current availability/affordability crisis. This section examines this trend. The following data was provided by the ISO.

Cash-flow underwriting is generally acknowledged to have played a role in causing the large underwriting losses presently being experienced in the commercial lines. According to ISO, the industry's current underwriting losses are a result of "a

prolonged period of underpricing and rapidly expanding tort liabilities." 11/ In this regard, the ISO report states:

For the better part of seven years, the insurance industry has been engaged in a brutal price war. During the early 1980's, the price for commercial insurance was decreasing, sometimes sharply, as insurers vied for premium dollars to invest at the high interest rates then in effect. At the time, commercial customers did not complain. Indeed, many realized that commercial insurance in the United States was being sold below cost, even when investment income was considered. 12/

Chart A, based on ISO data, tracks commercial line premiums in constant 1967 dollars. As can be noted from the chart, 1984 marked the first real increase in premiums (in constant dollars) after five consecutive years of declining written premiums. But 1984 written premiums were almost 20% less than premiums collected in 1978, the year preceding the dramatic decline in premiums. At the same time, losses and expenses in 1984 were at an all-time high. 13/

A similar comparison of the general liability premiums written, premiums earned and line outgo over the past ten years (not in constant dollars) is shown in Chart B.

Analyzing this data, the Best's report notes that during the relevant period (1975 - 1985):

. . . the inflation of liability awards could have been no secret to any underwriter. Had the ascending line of premiums written that was established in 1975 through 1978 continued to rise, the general liability losses of \$13 billion incurred in the last six years largely would have been avoided. 14/

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11/ ISO, Financial Condition of the Insurance Industry -- An Update (1985).

12/ Id.

13/ Id.

14/ Best's Insurance Management Reports (December 30, 1985).

# CHART A

## WRITTEN PREMIUM vs. LOSSES & EXPENSES COMMERCIAL LINES IN CONSTANT 1967 DOLLARS

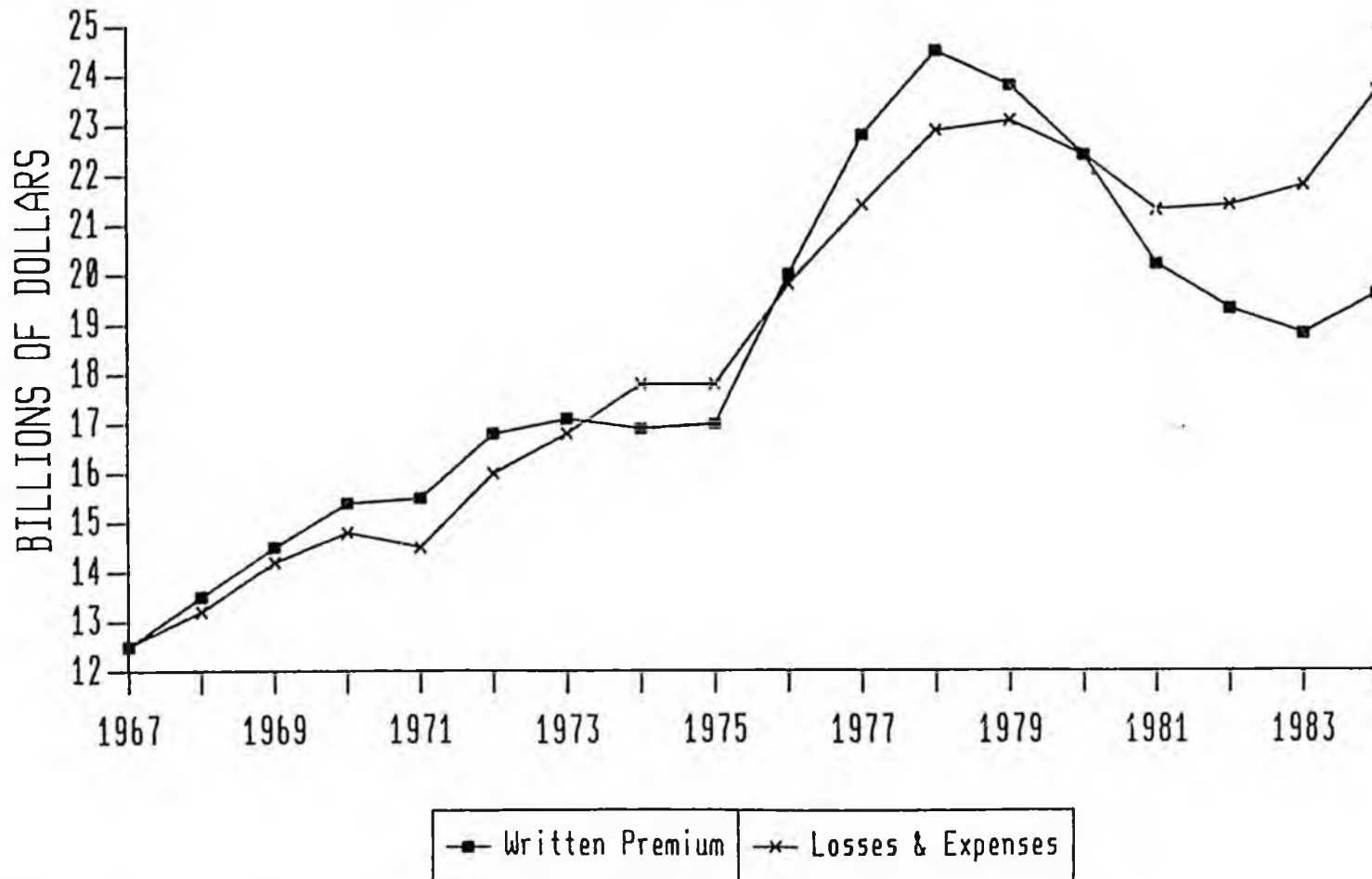
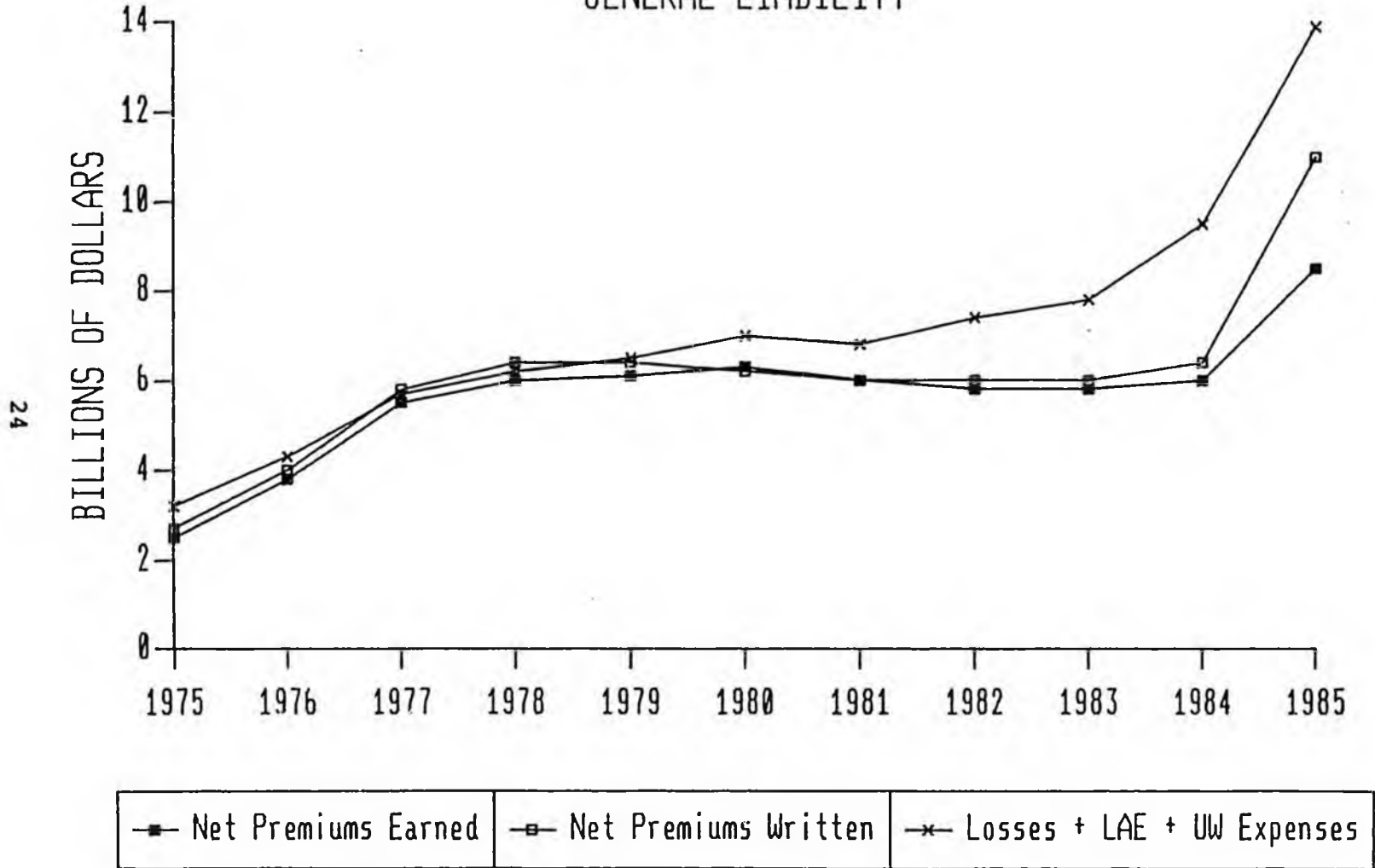


CHART B  
GENERAL LIABILITY



#### IV. THE ECONOMIC CAUSES OF THE INSURANCE AVAILABILITY/AFFORDABILITY CRISIS

The above discussion indicates that during the late 1970's and early 1980's the insurance industry engaged in significant premium reductions while claim losses increased steadily. The result, not surprisingly, has been massive underwriting losses in recent years.

It is useful in considering the contribution of such economic factors to the insurance availability/affordability crisis to distinguish two different effects which frequently are confused. The first is the inflationary effect on premiums of the recent decline in interest rates. The second is the premium cutting which took place in the late 1970's and early 1980's as a consequence of the industry's desire to take advantage of high interest rates available during that period.

As to the first effect, there is an obvious inverse relationship between premiums and the prevailing interest rate. A significant portion of an insurer's profits stem from the return on the premium income it invests between receipt of the premium and payout of the incurred liabilities. When interest rates are high, premiums tend to be lower since more of the insurer's income comes from such return on investment; and when interest rates are low, premiums will tend to be higher since the insurer is more dependent on the premium principal to cover the anticipated payout. Thus, as interest rates fall -- as they have in the mid-1980's -- insurance premiums inevitably increase.

This inverse relationship is illustrated by Chart C, which compares the prime rate in 1976 through 1985 to the annual percentage change of the total Commercial General Liability (CGL) premiums written by the insurance industry in each of those years. <sup>15/</sup> Chart C graphically demonstrates that the rate of growth of the written premiums changes inversely with the movement of the prime interest rate.

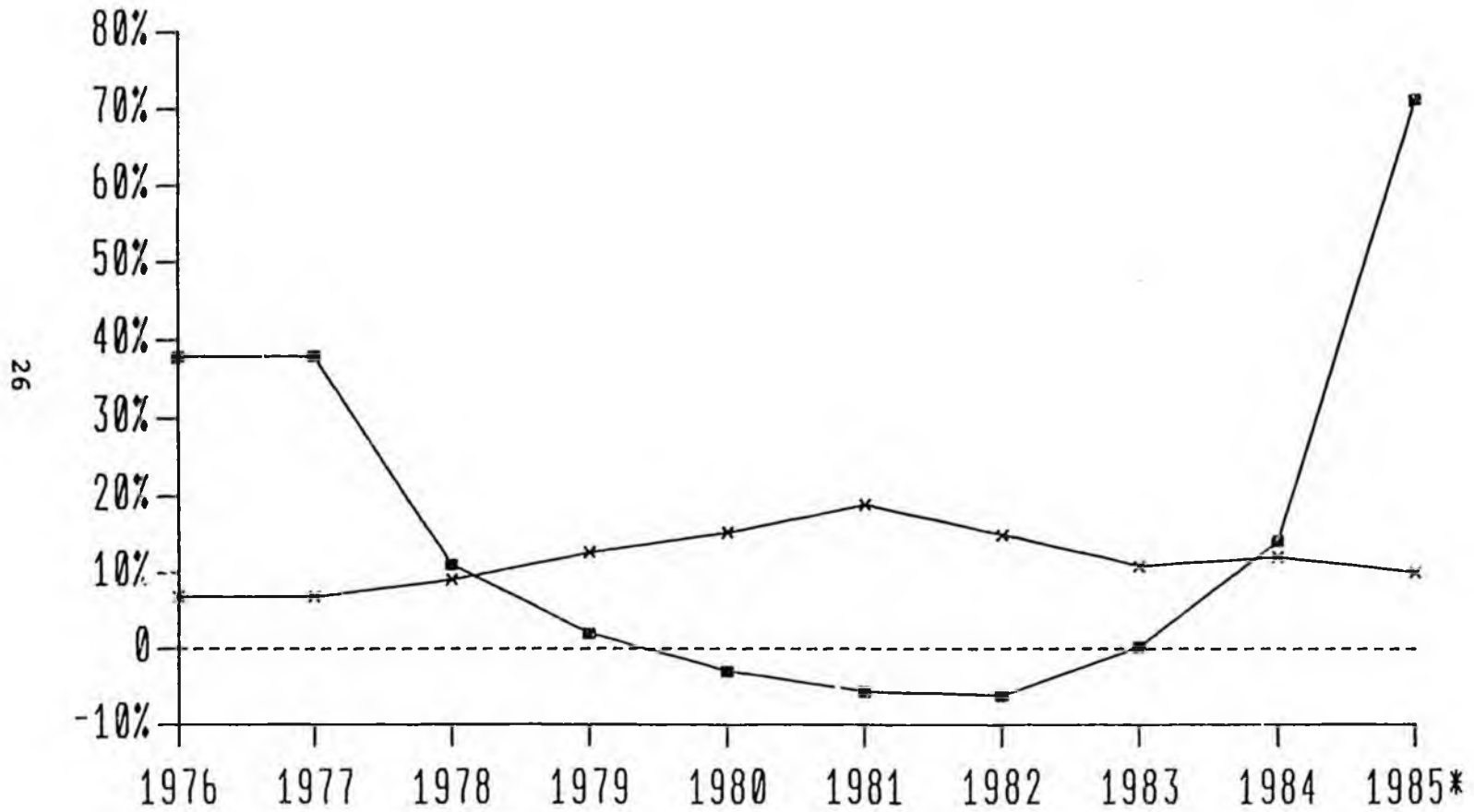
To the extent that the recent sharp premium increases are related to the drop in interest rates, there is little the federal (or any) government can or should do to mitigate this market effect. Declining interest rates cause innumerable economic realignments which, on the whole, are quite beneficial to the economy. An increase in insurance premiums resulting from such a reduction in interest rates, while of itself undesirable, is a relatively minor side effect to the far more significant economic consequences of a drop in the interest rate.

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<sup>15/</sup> The percentage change in 1976 through 1984 is obtained from the Insurance Information Institute's most recent Property/Casualty Factbook. The estimate for 1985 is obtained from the ISO data discussed supra.

CHART C

PERCENTAGE CHANGE IN GCL PREMIUMS COMPARED TO INTEREST RATE



—x— PRIME INTEREST RATE	—■— ANNUAL % CHANGE IN WRITTEN GENERAL LIABILITY PREMIUMS
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\*1985 Data Estimated

Moreover, there is little that can be done to address this source of premium volatility. It would be absurd to try to keep interest rates high simply to keep insurance premiums as low as possible. But as long as interest rates fluctuate, premiums necessarily will reflect such changes.

A second economic factor related to interest rates is the extent to which high interest rates may have triggered "excessive competition" in the insurance industry which led the industry to sell its product too cheaply. For one thing, even assuming one accepts the concept of "excessive competition," it is unclear how such losses in fact contribute to the insurance availability/affordability crisis. As discussed later in this Chapter, such losses are "sunk costs" which the industry cannot recoup simply by charging higher premiums. If premiums in fact are higher than the insured risks and the currently available investment return dictate, either other sources of capital (including insurers who have suffered no losses or lower losses) should offer the same insurance at a lower price, or insureds will retain these "excess profits" for themselves through self-insurance or the formation of captives. The fact that there appears to be little insurance coverage being made available by new or expanding underwriters, and that many insureds are highly reluctant to self insure or form captives (even though many with serious availability problems may have no alternative), strongly indicates that recoupment of losses is not a particularly compelling explanation for the current insurance availability/affordability crisis.

It is particularly puzzling that the proponents of this theory advocate the abolition of the insurance industry's antitrust immunity contained in the McCarran-Ferguson Act (Public Law 79-15) as an appropriate response to the asserted problem of the industry's cash-flow "mismanagement." It is hard to reconcile the argument that the current problems of the insurance industry stem from "excessive competition" with the proffered solution of removing the industry's antitrust immunity. Since the goal of antitrust law is to enhance competition, if one truly believes that the problems of the insurance industry are a result of too much competition, the last thing one would advocate is a legal change which would increase the level of competition. While the Working Group did not review and takes no position on the continuing validity of the industry's antitrust immunity, 16/ it is readily obvious that the suggestion that allegedly "excessive competition" can be cured by even more competition is patently absurd.

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16/ Despite the assertions of some, the Working Group found no evidence to suggest that the industry's antitrust immunity is a significant factor in the insurance availability/affordability crisis. It should be noted, however, that the immunity has been criticized for a variety of other reasons. See the 1977 report of the Task Force on Antitrust Immunities, footnote 1, supra.

The reasons why the loss recoupment (or excessive pricing) theories advocated by some make little economic sense can briefly be summarized as follows:

- ° Insurers, like all profit maximizing companies, charge the price which maximizes their profits. Past gains or past losses are irrelevant to setting the price today which will maximize profits tomorrow. The argument that insurers are charging higher premiums to recoup past losses suggests that absent such losses their premiums would be lower -- that is, that they would not be charging premiums that maximize their profits. That makes little sense.
- ° Even if excessive premiums were being charged by some insurers to recoup their past losses, for the reasons discussed, other insurers would offer the same coverage at lower prices reflecting the actual risk, or insureds would retain such excess profits for themselves through self-insurance or the formation of captives. 17/
- ° The commercial lines of insurance, which are at the center of the availability/affordability crisis, in fact are relatively competitive. For example, the 1977 report of the Task Force on Antitrust Immunities (see footnote 1, supra) found that the property-liability insurance industry "appears to possess an atomistic market structure," including over 900 companies. Id., at 7. 18/ The Task Force also found that the restrictions to entry do not appear significant in the property-liability insurance industry, id., at 9, and that there appears to be price competition in this line as a result of "an industry structure that favors competition." Id., at 27-28. 19/ It is, of course,

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17/ Many insurance companies are mutuals, meaning that they are owned by their policyholders. The suggestion that they are charging their policyholder-owners unnecessarily high premiums makes even less sense, since any such excess profits must be rebated through policyholder dividends.

18/ The report states that 20 insurance groups account for 53% of written premiums, and that no single group accounts for a major share of the market. Id., at 8. This is consistent with the analysis of the Medical Malpractice Policy Guidebook (H. Manne, 1985), which found the medical malpractice insurance market in Florida to be "substantially and effectively competitive." Id., at 166.

19/ See also page 348 of the report summarizing the Task Force's  
(CONTINUED)

difficult to conceive how premiums are being kept at artificially high levels for a line of insurance in which prices appear to be competitively determined.

- ° Finally, many of the strongest proponents of the loss recoupment theory also contend that these losses were the result of excessive price competition in the industry. Obviously, it is difficult to reconcile these arguments. 20/

In sum, to the extent that purely economic factors underlie the insurance availability/ affordability crisis, they do not appear to be the type of problems which can be cured by different or more intensive forms of government regulation -- either at the state or federal level -- of the insurance industry. There, however, is a cause of the availability/ affordability crisis at the very heart of that crisis which the government is well placed to address in a variety of constructive ways. That cause is tort law, and its role in the crisis is discussed in Part B of this Chapter.

#### B.

The above discussion has focused largely on the current financial condition of the insurance industry, and the economic factors leading to that condition. The following discussion examines the state of tort law, and its central role in the insurance availability/affordability crisis.

Unlike the above related economic data on the insurance industry, it is difficult to obtain good empirical data indicating precisely what has happened to tort liability in

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#### 19/ (FOOTNOTE CONTINUED)

conclusion that the "industry is structured in a manner conducive to competition." It should be noted that these conclusions did not appear to apply to some other lines of insurance such as life insurance.

20/ These same points apply equally well to arguments that premiums are set excessively high to recoup losses resulting from mismanaged investment portfolios. Just as past losses are irrelevant to determining the premiums which will maximize profits, investment portfolio losses should have no bearing on premiums. In this regard however, it should be noted that the property-casualty industry made \$32.8 billion from net investment and other income in 1985. See supra.

recent years. 21/ It is plain even to the most uninitiated that tort law has changed dramatically in recent years -- from a relatively quiescent legal backwater into one of the most important and dynamic areas of the law today. 22/ Moreover, a growing body of case examples and empirical data suggest that the current tort system has serious problems and is operating quite poorly. The insurance availability/affordability crisis is one symptom -- albeit the most dramatic and acute symptom -- of the dislocations and problems generated by a malfunctioning tort system.

#### I. PROBLEM AREAS IN TORT LAW

In attempting to understand what has happened to tort liability in the United States, the Working Group has focused on four interrelated areas: fault, causation, damages and transaction costs. Each is discussed separately below.

##### The Movement Toward No-Fault Liability

One of the most disturbing aspects of the current tort system is the degree to which it has moved toward no-fault liability. While this movement began in earnest over twenty years ago, it appears to have accelerated dramatically in recent years.

Beginning in the early to mid-1960's it became fashionable to reject the twin pillars upon which tort law historically had been constructed -- deterrence and compensation -- in favor of seemingly more enlightened theories based largely on concepts of societal insurance and risk spreading. 23/ While many of these

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21/ The Rand Corporation, through its Institute for Civil Justice, has produced the best empirical data and analyses available in the area. While the Institute has only been able to research discrete areas of civil justice, the conclusions drawn from those analyses are invaluable to understanding many broader problems. The recently published five-year overview of the Institute's program offers an excellent summary of the research, results and continuing work of the Institute's staff.

22/ For example, at the end of fiscal year 1975, what is now the Torts Branch of the United States Department of Justice contained 39 attorneys, who handled or supervised about 4,000 cases totalling approximately \$1 billion in claims. At the end of fiscal year 1985, the Torts Branch had grown to 124 attorneys handling or supervising about 11,000 cases totalling approximately \$200 billion in claims.

23/ One of the most explicit statements of such a theory can be found in the decision of the New Jersey Supreme Court in Beshada v. Johns-Manville Products Corp., 90 N.J. 191, 447 A.2d 539 (1982), in which the Court expressly denied defendants

(CONTINUED)

theories were couched in terms of economic efficiency, they represented the beginning of a devastating, and to this day, continuing challenge to the role of fault as a predicate of tort liability. The long-term effect of this development has been less to promote a more efficient or sensible tort system, 24/ than to undermine the importance of fault (or wrongdoing) as a moral and doctrinal justification for and limitation on tort liability. As this limitation has been removed or undermined in certain areas of tort liability, tort law increasingly has come to rest only on the pillar of compensation, with compensation often awarded merely for the sake of compensation.

As the tort system moves away from fault it increasingly imposes liability upon persons and companies that have done nothing wrong. This has been accomplished in a variety of ways: by directly reducing or even eliminating the fault requirement; by

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23/ (FOOTNOTE CONTINUED)

the opportunity to raise a "state of the art" defense. The Court held that even if the danger at issue was scientifically unknowable at the relevant time, defendants nonetheless were still liable for having failed to warn of an unknowable risk. As justification for its holding, the Court relied heavily on risk spreading. In the words of the Court, "manufacturers and distributors . . . can insure against liability and incorporate the cost of the insurance in the price of the product." 447 A.2d at 547. The Court went on to opine that the likely increase in premiums to compensate for unanticipated risks was "not a bad result." Id.

24/ The belief that tort liability should be no-fault so as to serve as a risk spreading mechanism for all injuries is in fact quite anti-consumer. Such a view of tort liability effectively would mean that the price of every product and service would include an insurance surcharge for the risk of any injury related to the product or service. It has long been understood, however, that because of the extraordinarily high transaction costs of the tort system, such compulsory insurance through the tort system would be among the most inefficient and costly ways for consumers to purchase insurance. Thus, for every \$1 of compensation, the tort system requires the consumer to pay approximately \$3 in premiums (assuming, as discussed infra, two-thirds transaction costs), while that same \$1 of compensation can be obtained through first-party health and disability insurance for only \$1.25. H. Manne, Medical Malpractice Policy Guidebook 143 (1985). It is highly ironic that many proponents of no-fault liability argue that such liability is in the best interest of consumers. In fact, since consumers ultimately pay the premiums of whatever compensation scheme is devised, quite the contrary is the case. See also Epstein, "Products Liability as an Insurance Market," 14 J. Legal Stud. 645 (1985).

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defining new duties that effectively create fault where no fault existed previously; and, by engaging in after-the-fact analyses that "find" fault wherever there has been an injury. 25/ The ultimate effect of these developments has been the same -- to shift liability for compensation to "deep pocket" defendants that have the resources to compensate plaintiffs generously. 26/

Fault has not, however, been openly (or completely) rejected as part of our tort law. One reason is that fault remains the only vehicle in tort law capable of distinguishing wrongful (or undesirable) from beneficial (or desirable) conduct. If fault were rejected altogether, it would mean that desirable activities would be just as likely to incur liability as wrongful conduct. An open rejection of fault thus necessarily would result in a sweeping transformation in the public's attitude toward tort law, which continues to be bottomed on the concept of tort liability as a form of justified redress for wrongful conduct. A second reason why fault continues to be part of tort law (and why courts often will engage in amazing distortions of relevant facts or legal doctrines to find fault rather than simply reject the principle of fault) is that fault is the basis of much of the structure and process of tort law.

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25/ The duty to warn has been a particularly fertile ground for such after-the-fact compensation oriented findings of fault. It is all too easy after the occurrence of an injury to postulate a warning that might have influenced the plaintiff to be more careful or to reconsider his action, no matter how fanciful or unreasonable such a warning might appear prior to the injury. Such analyses have been a major factor in the medical malpractice and product liability litigation explosion.

26/ A recent and almost classic example of such compensation oriented liability findings is the California Supreme Court's decision in Bigbee v. Pacific Tel. & Tel. Co., 34 Cal.3d 49, 665 P.2d 947 (1983). In that case, a man was injured when an allegedly intoxicated driver lost control of her car, veered off the street into a parking lot, and crashed into a telephone booth in which the man was standing. Suit was brought against the companies responsible for the design, location, installation, and maintenance of the booth. The Court, in an opinion authored by Chief Justice Rose Bird, found that the risk that someone might veer off the road and crash into the phone booth was not unforeseeable as a matter of law. The Court also determined that it was of no consequence that the harm to plaintiff came about through the negligent or reckless acts of an allegedly intoxicated driver. In a concluding footnote, Chief Justice Bird stated that "there are no policy considerations which weigh against imposition of liability" against the defendants even though their "conduct may have been without 'moral blame,'" and referred specifically to "the probable availability of insurance for these types of accidents . . . ." 665 P.2d at 953 n. 14.

If fault were no longer a central element in determining liability, the current tort system would in many ways be wasteful, inefficient and unfair in the extreme. 27/

Tort law thus has gradually (with a marked acceleration in recent years) been moving in the direction of no-fault liability without an adequate acknowledgement of either the existence or the implications of this development. The result is an increasingly common and perverse combination of fault-based levels of compensation based on no-fault liability.

#### The Undermining of Causation

Tort law traditionally has sought to place liability only upon those actors whose wrongful conduct actually caused an injury. This principle is found in the concept of "proximate cause," which requires a reasonable relationship between a given cause and effect. For some time, however, proximate cause has been under systematic attack. No single doctrinal change can be identified as the primary vehicle for this attack. Rather, the challenge has come through a variety of questionable practices and doctrinal innovations.

One such development has been the increasing use of joint and several liability to shift the cost of compensation to "deep pockets." Joint and several liability developed in the context of defendants acting in concert. 28/ Over the years, however, it increasingly has been used to make a defendant with only a limited role in causing an injury bear the full cost of compensating plaintiff, even in some cases where the plaintiff may have been largely responsible for his own injury. 29/ The result has been that joint and several liability in the absence of concerted action can and does lead to highly inequitable

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27/ For example, the way in which damages are measured and awarded can only be justified, if at all, on the basis of redressing wrongful conduct. Once wrongdoing is removed as an element of liability, many of the principles involving damages become grossly unfair.

28/ See generally Prosser and Keeton on Torts (5th ed. 1984), Chapter 8. As may be obvious, as with so many other aspects of tort law, fault remains a central and essential justification for joint and several liability.

29/ The application of joint and several liability in cases where there in fact is no concerted action is discussed in some detail in Speiser, Krause & Gans, The American Law of Torts § 3:7 (1983). It is interesting to note that the English courts apparently have maintained the traditional common law basis for joint and several liability, and have refused to apply such liability in the absence of concerted action. Id.

treatment of defendants, particularly "deep pocket" defendants. 30/

A related development is the way in which joint and several liability has been applied by some courts to theories of "enterprise" or "market share" liability for injuries caused by generic products (e.g., DES). "Market share" liability, in its pure theoretical sense, allocates liability among manufacturers of a generic product on the basis of their share of the relevant market. While there can be some serious problems and inequities with this approach, as long as all relevant manufacturers (and their respective market shares) are accounted for, and the product is truly generic in nature, such an allocation of liability may be the only way plaintiffs in some cases can obtain compensation for injuries caused by wrongdoing on the part of the manufacturers of such a product. Serious problems with this approach arise, however, when not all relevant manufacturers are accounted for, or where the product is not truly generic in nature. Even more troublesome is the approach of several courts which use some industry liability allocation formula, but then apply joint and several liability to all defendants. See, e.g., Abel v. Eli Lilly & Co., 418 Mich. 311, 343 N.W.2d 164, cert. denied., 105 S.Ct. 123 (1984); Collins v. Eli Lilly Co., 116 Wis.2d 166, 342 N.W.2d 37 (1984). This, in fact, represents a clear abuse of joint and several liability, and cannot be justified on the basis of the unique difficulties plaintiffs sometimes face in identifying the manufacturer of an injury causing generic product.

A third means that has been used to undermine causation -- increasingly common in toxic torts cases -- is the use of presumptions or burden-shifting techniques to force the defendant to prove the lack of causation in order to avoid liability. 31/ Frequently, this amounts to asking the defendant

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30/ The legal doctrine of contribution in theory could serve to mitigate some of those inequities. In certain areas of the law, such as antitrust law, where joint and several liability generally tends to be applied to established businesses, contribution appears to function quite well. (And, in any event, joint and several liability in antitrust cases is virtually always based on concerted action -- the traditional basis for such liability.) In personal injury cases, however, many multi-defendant cases involve a "deep pocket" and one or more defendants who are either judgment proof or have limited assets or insurance coverage. In such cases, the belief that contribution serves as a mitigating factor is largely illusory.

31/ A particularly dramatic example of such a practice can be found in Allen v. United States, 588 F.Supp. 247 (D. Utah 1984), a low-level radiation exposure case in which the court shifted to the government the burden of proving that particular cancers were not caused by radiation exposure.

to meet an impossible burden of proving the negative.

Another way in which causation often is undermined -- also an increasingly serious problem in toxic tort cases -- is the reliance by judges and juries on noncredible scientific or medical testimony, studies or opinions. It has become all too common for "experts" or "studies" on the fringes of or even well beyond the outer parameters of mainstream scientific or medical views to be presented to juries as valid evidence from which conclusions may be drawn. The use of such invalid scientific evidence (commonly referred to as "junk science") has resulted in findings of causation which simply cannot be justified or understood from the standpoint of the current state of credible scientific and medical knowledge. <sup>32/</sup> Most importantly, this development has led to a deep and growing cynicism about the ability of tort law to deal with difficult scientific and medical concepts in a principled and rational way.

These are but four developing areas that are causing defendants to be found liable for injuries they did not cause. The one common attribute of these developments is that the defendants to whom liability is shifted almost invariably happen to be those with the deepest pockets.

#### The Explosive Growth in Damage Awards

Another area of great concern is the explosive growth in tort damages awards over the last decade. A few statistics will illustrate this point.

Jury Verdict Research, Inc., publishes data on the average jury verdict in product liability and medical malpractice cases. The service's latest report <sup>33/</sup> shows that the average medical

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<sup>32/</sup> An instructive decision in this regard is the district court opinion in Johnston v. United States, 597 F.Supp. 374 (D. Kansas 1984). The court there exhaustively reviewed the theories and credentials of a number of plaintiffs' experts on the effects of low-level radiation, and rejected their testimony as biased, contradictory and totally without scientific merit. Of particular interest is the court's frustration that these same experts had played prominent roles in major radiation cases such as Silkwood and Allen, and that their testimony was being used in numerous cases throughout the country. The court noted its disappointment that such "so-called experts can take such license from the witness stand [to] say and conclude things which . . . they would not dare report in a peer-reviewed format." Id. at 415.

<sup>33/</sup> Jury Verdict Research, Inc., Injury Valuation: Current Award Trends No. 304 (1986). The 1985 data provided by the service is incomplete, and is subject to refinement. The

(CONTINUED)

malpractice jury verdict increased from \$220,018 in 1975 to \$1,017,716 in 1985 (see Chart D), a 363% increase. 34/ Average product liability jury verdicts during this same period increased from \$393,580 to \$1,850,452, a 370% increase (see Chart E). 35/

Interestingly, much of this increase can be attributed to a remarkable growth in verdicts above \$1 million. In 1975 there were three million-dollar medical malpractice verdicts and nine million-dollar product liability verdicts reported by Jury Verdict Research, Inc. In 1984, the numbers had grown to 71

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33/ (FOOTNOTE CONTINUED)

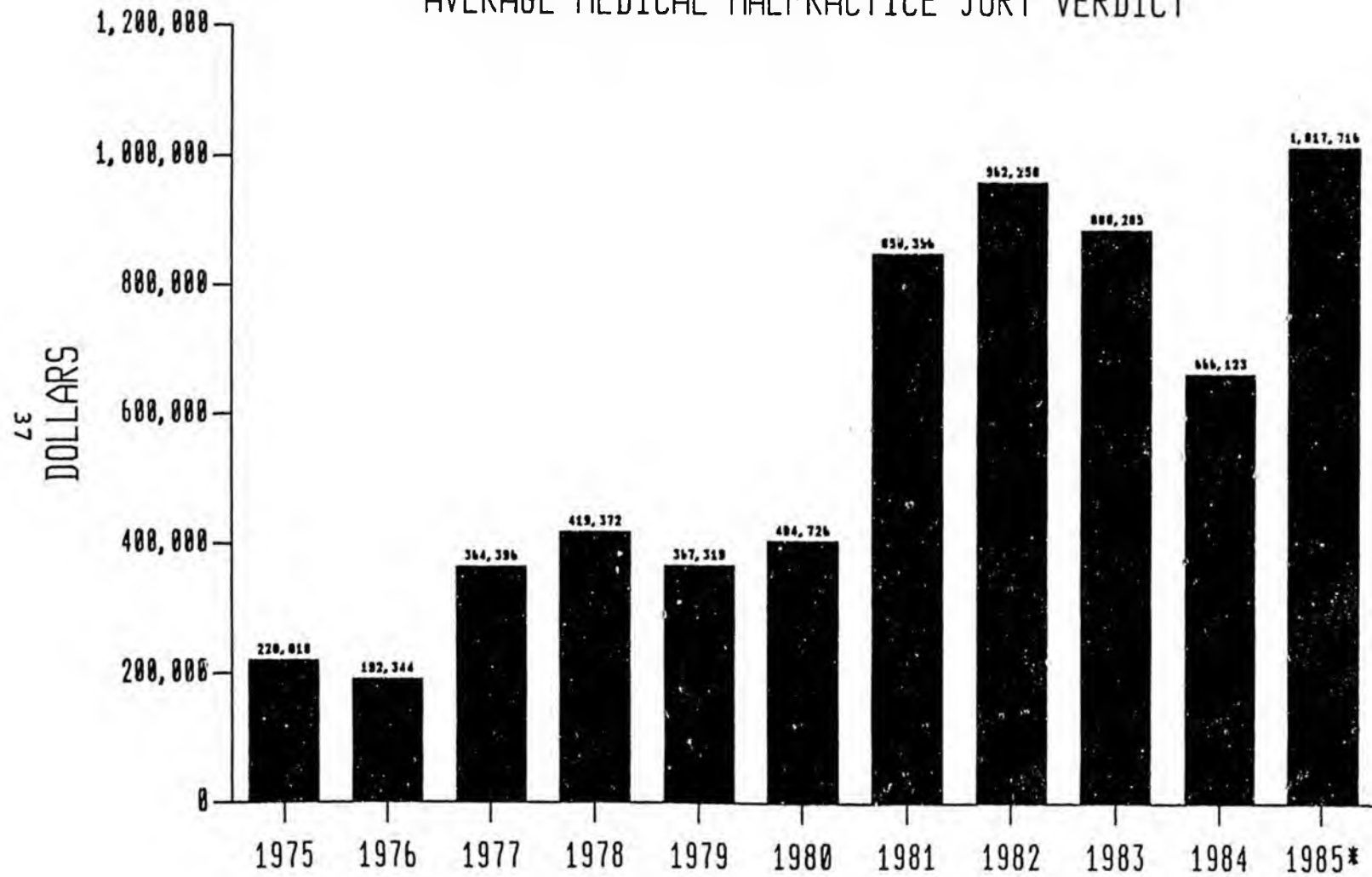
service indicates that it bases "its findings, values and probabilities upon collected verdicts using accepted statistical methods in their analysis and application." Nevertheless, the reported average annual verdicts are not used by the Working Group as an accurate statement (though they may very well be) of the average jury verdict in any particular year. Rather, the Working Group found the Jury Verdict Research data useful for purposes of showing the trend in jury verdicts over the last decade. In this regard, it should be noted that the service has used the same basic methodology since well before the relevant reported years. Moreover, while there are different estimates of average jury verdicts for particular areas and years, a number of other sources that have collected such data -- including the Institute for Civil Justice -- corroborate the overall trends reported by Jury Verdict Research, Inc.

34/ This percentage increase is consistent with a survey of California Superior Court medical malpractice verdicts. That survey shows the average medical malpractice award as increasing from \$152,970 in 1975 to \$649,210 in 1983, a 324% increase. American Medical Association Special Task Force on Professional Liability and Insurance, Professional Liability in the '80s (October 1984). Because the \$250,000 cap in California on awards for non-economic damages in medical malpractice cases was only recently affirmed as constitutional (see Chapter 4), it is unclear what effect, if any, the cap has had on malpractice verdicts in California. It is worth noting, however, that the recent insurance problems for medical malpractice have been far less serious in California than in many other states, and that in California the insurance crisis primarily has affected areas other than medical malpractice (e.g., municipal liability).

35/ This remarkable increase is also reflected in the Institute for Civil Justice study of civil jury verdicts in Cook County, Illinois. For example, the average wrongful death award in Cook County increased (in constant dollar terms) from \$166,000 in 1970-74 to \$336,000 in 1975-79, a doubling over roughly half a decade. M. Peterson, Compensation of Injuries: Civil Jury Verdicts in Cook County 54 (1984).

CHART D

AVERAGE MEDICAL MALPRACTICE JURY VERDICT

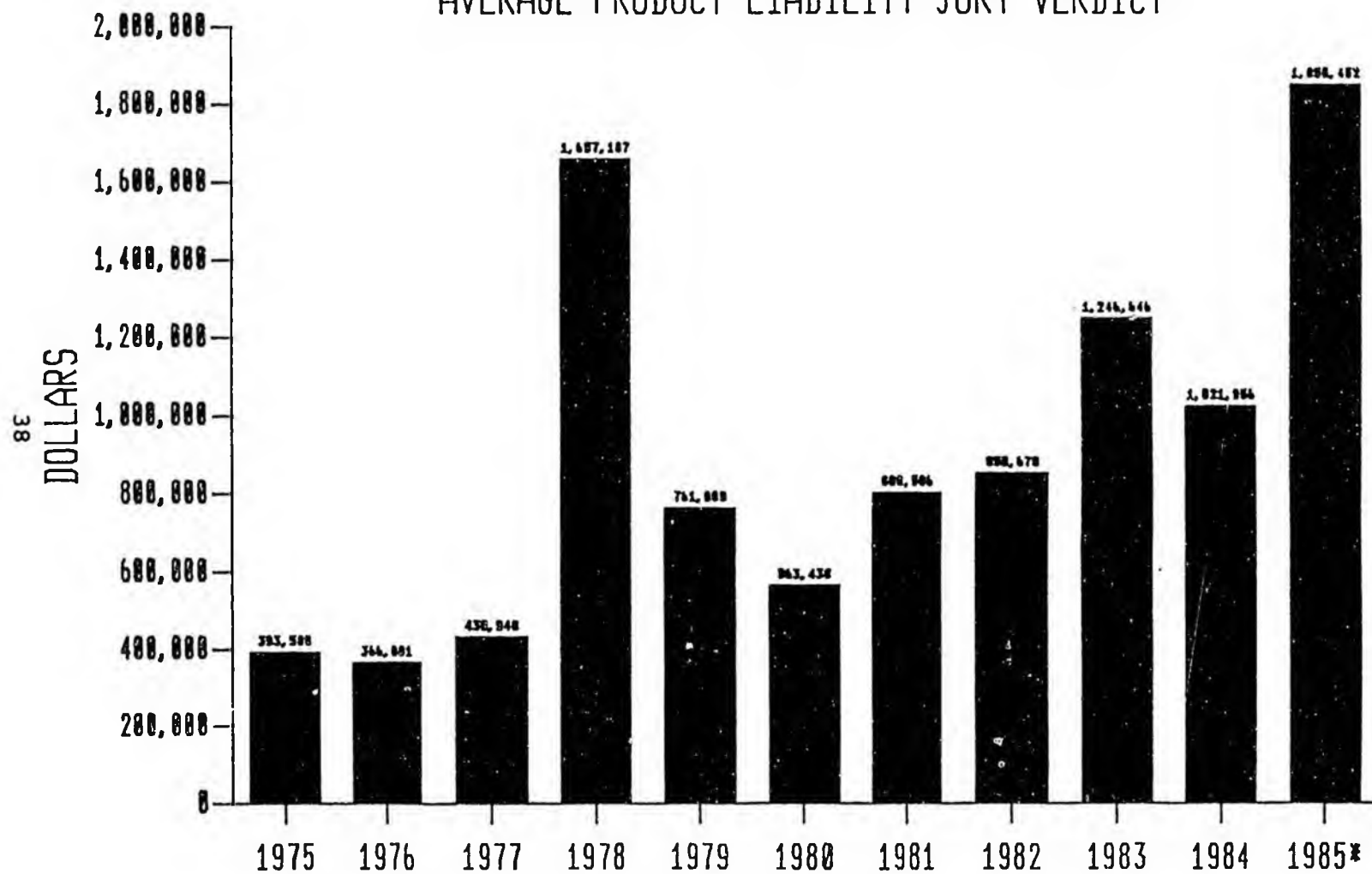


Source: Jury Verdict Research, Inc.

■ 1985 Information Not Complete

### CHART E

## AVERAGE PRODUCT LIABILITY JURY VERDICT



Source: Jury Verdict Research, Inc.

■ 1985 Information Not Complete

million-dollar medical malpractice verdicts and 86 million-dollar product liability verdicts (see Chart F), an increase of over 1200% in the number of such verdicts. 36/ If these million-dollar verdicts are deleted, the increase in average verdicts is reduced sharply. For example, the increase in the average medical malpractice jury verdict from 1975 to 1985 drops to 26% and the comparable average product liability verdict jury increase is 87%. 37/ This clearly suggests that the explosion in damages has come largely at the high end of the awards scale.

The Jury Verdict Research data is of only limited value on the absolute number of million-dollar payments, since in all likelihood the vast majority of such payments are through settlements rather than verdicts. The data is highly relevant, however, in that it shows that the percentage rate of increase of verdicts is far higher for large verdicts than for small or medium-size verdicts. Since a significant distinguishing factor between large verdicts and small or medium-size verdicts is that large verdicts tend to be composed to a far greater extent of non-economic damages, 38/ this strongly suggests that non-economic damages play a major role in the explosive growth in large verdicts (as compared to the much more moderate growth in small and medium-size verdicts).

While it is not possible to quantify precisely how much particular elements of damages have contributed to this explosion, it appears that non-economic damages are a substantial factor. Such damages include non-pecuniary compensatory damages for intangible injuries such as pain and suffering and mental anguish, as well as punitive damages. Such non-economic damages are inherently open-ended and subjective, and, therefore, easily susceptible to dramatic inflation. Of interest in this regard is a recent preliminary study by the Institute for Civil Justice which indicates that the average punitive damage award in Cook County, Illinois, increased from \$63,000 in 1970-74 to \$489,000 in 1980-84 (see Chart G). 39/ Of

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36/ Jury Verdict Research, Inc., supra. The trend toward million-dollar verdicts is also documented by the Institute for Civil Justice. M. Shanley & M. Peterson, Comparative Justice: Civil Jury Verdicts in San Francisco and Cook Counties, 1959-1980 26-30 (1983).

37/ Jury Verdict Research, Inc., supra.

38/ H. Manne, Medical Malpractice Policy Guidebook 138-39 (1985). The study shows that for medical malpractice awards between \$100,000 and \$200,000, non-economic damages account for approximately 27% of the total award, while for awards above \$600,000, the non-economic share increases to 54%.

39/ M. Peterson, Punitive Damages: Preliminary Empirical

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CHART F

MILLION DOLLAR JURY VERDICTS

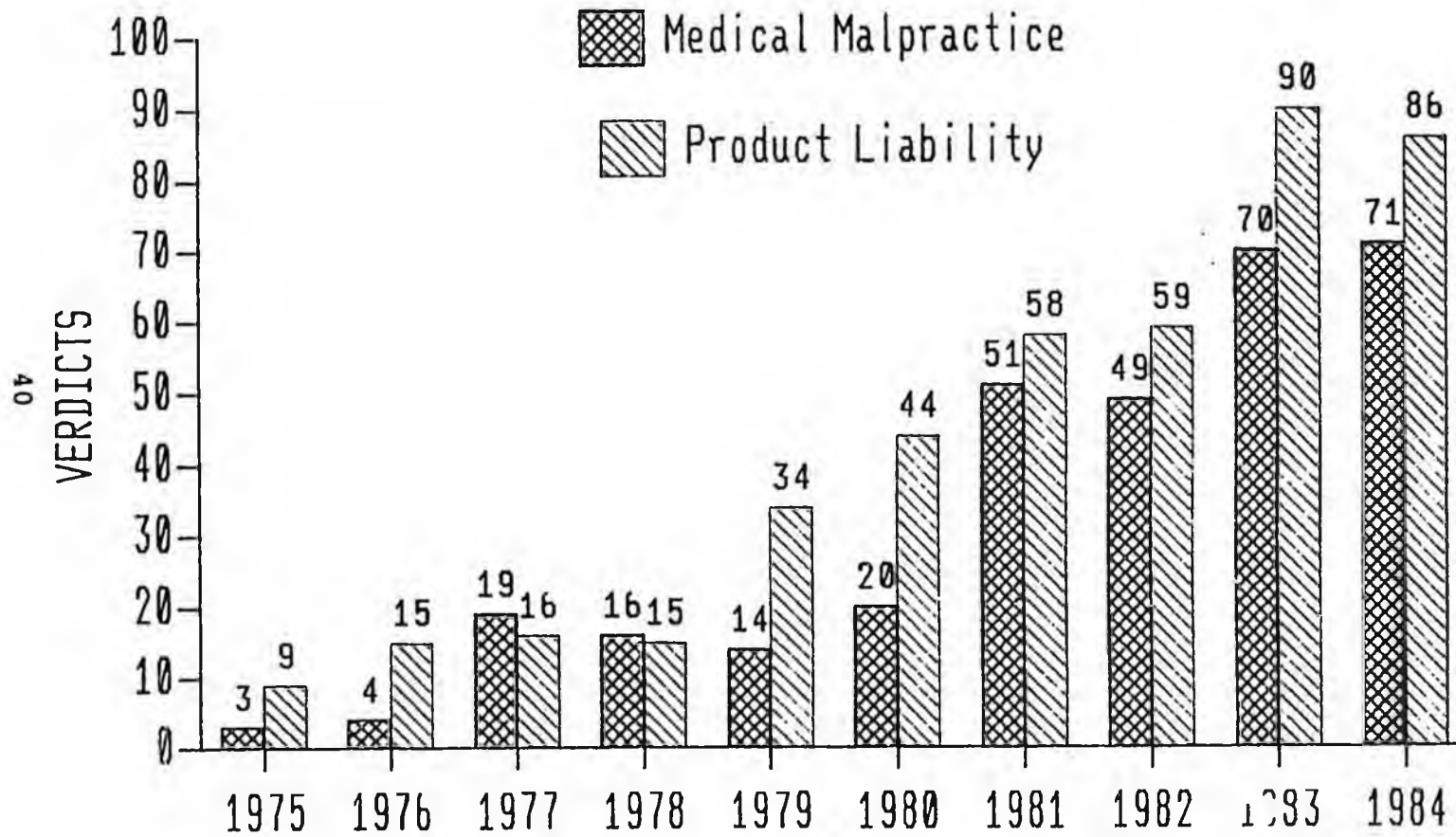


CHART G

AVERAGE PUNITIVE DAMAGE AWARD IN COOK COUNTY\*

\$63,000  
(25 Awards)

\$135,000  
(39 Awards)

\$489,000  
(90 Awards)



1970-74

1975-79

1980-84

particular interest is that the average Cook County punitive damage award in personal injury cases increased from \$40,000 in 1970-74 to \$1,152,174 in 1980-84 (see Chart H). 40/

This explosion in damage awards, particularly in the case of non-economic damages, is vastly in excess of the rate of inflation over the comparable period. 41/ For whatever reasons, tort damage awards have suddenly soared in the United States without any apparent justification.

#### Excessive Transaction Costs

Another serious problem of the tort system is its extraordinarily high transaction costs. A study by the Institute for Civil Justice of the asbestos litigations shows that out of every dollar paid out by the asbestos manufacturers and their insurers as a result of the asbestos litigation, 62 cents on the average is lost attorneys' fees and litigation expenses (see Chart I). 42/ This does not include the transaction costs borne by the courts in adjudicating these claims.

It also is worthwhile viewing the transaction costs from the

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#### 39/ (FOOTNOTE CONTINUED)

Findings 13 (1985). These averages were adjusted for inflation and are stated in terms of the 1984 dollar. The study's analysis of punitive damage awards in San Francisco also showed an increase in such awards, though of lesser magnitude than in Cook County.

40/ Id., at 25 (also adjusted for inflation). Peterson notes that personal injury punitive damage awards in Cook County between 1980-84 amounted to over half of all punitive damages awarded in all case categories by Cook County juries from 1960-84.

41/ For purposes of comparison, one dollar in 1985 had approximately half the buying power of one dollar in 1975.

42/ J. Kakalik, P. Ebener, W. Felstiner, G. Haggstrom & M. Shanley, Variations in Asbestos Litigation Compensation and Expenses xviii (1984). These costs, of course, include both plaintiffs' and defendants' litigation expenses. In comparing the costs attributable to defendants' litigation expenses to the costs attributable to plaintiffs' litigation expenses it is useful to remember that defendants incur such costs whether or not they prevail, and, indeed, may incur substantial costs defeating even clearly frivolous claims. Measurements of plaintiffs' litigation expenses (such as in Chart I), reflect only those cases in which plaintiffs prevail, while defendants' litigation expenses include all cases, whether or not plaintiffs prevail.

CHART H

AVERAGE PERSONAL INJURY PUNITIVE DAMAGE AWARD IN COOK COUNTY\*

\$40,000  
(5 Awards)

\$217,000  
(6 Awards)

\$1,152,000  
(23 Awards)



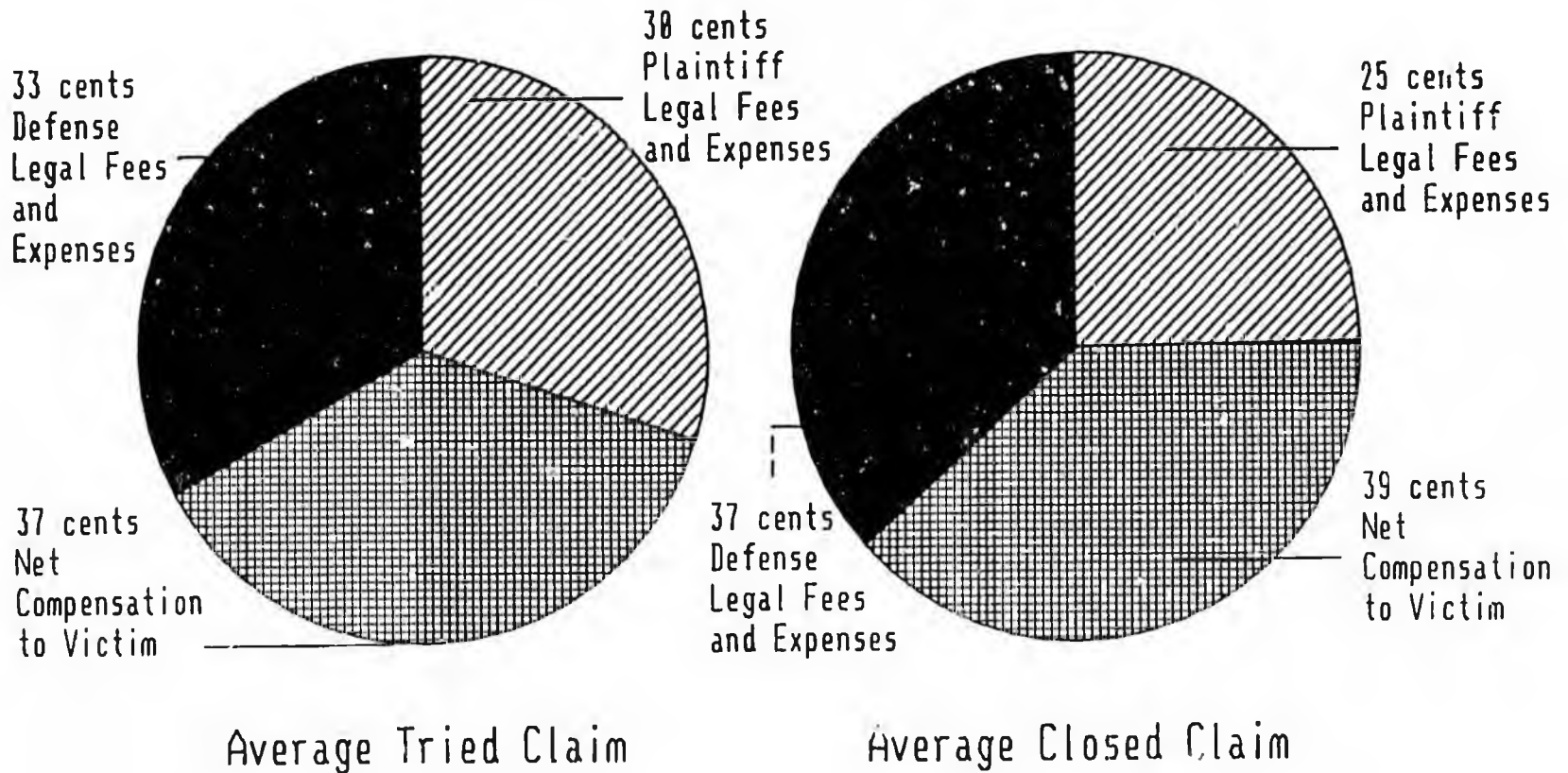
1970-74

1975-79

1980-84

CHART I

ALLOCATION OF EVERY DOLLAR PAID OUT IN ASBESTOS CLAIMS



perspective of the prevailing plaintiff. The study also shows that for every dollar awarded to plaintiff, 34 cents on the average is lost to legal fees and an additional 5 cents is lost to legal expenses. 43/ In some cases, legal fees alone amounted to as much as 45% of plaintiff's award. 44/

It is difficult to justify such extraordinary transaction costs. But it is particularly difficult to justify such costs when the costs often are borne largely by the seriously injured and by consumers who ultimately must pay for these costs through higher prices for goods and services. The only clear beneficiaries of this system appear to be lawyers.

## II. BURGEONING TORT LIABILITY AS A MAJOR CAUSE OF THE INSURANCE AVAILABILITY/AFFORDABILITY CRISIS

The above discussion describes a tort system that in recent years has dramatically increased in scope. One way of measuring that increase is in terms of the increase in the number of tort lawsuits and in the level of damages awarded in such lawsuits. While the available data is limited, and by no means perfect, it clearly confirms that there has been a substantial increase in recent years in both the number of tort lawsuits and awarded damages.

The growth in the number of product liability suits has been astounding. For example, the number of product liability cases filed in federal district courts has increased from 1,579 in 1974 to 13,554 in 1985, a 758% increase (see Chart J). 45/ There is no reason to believe that the states courts have not witnessed a similar dramatic increase in the number of product liability claims.

A similar trend can be found in medical malpractice, where claims 46/ filed against physician-owned companies increased from 10,568 in 1979 to 23,545 in 1983, a 123% increase in four

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43/ Id., at 84. For tried claims, these costs increase to 39 cents and 6 cents respectively. Id.

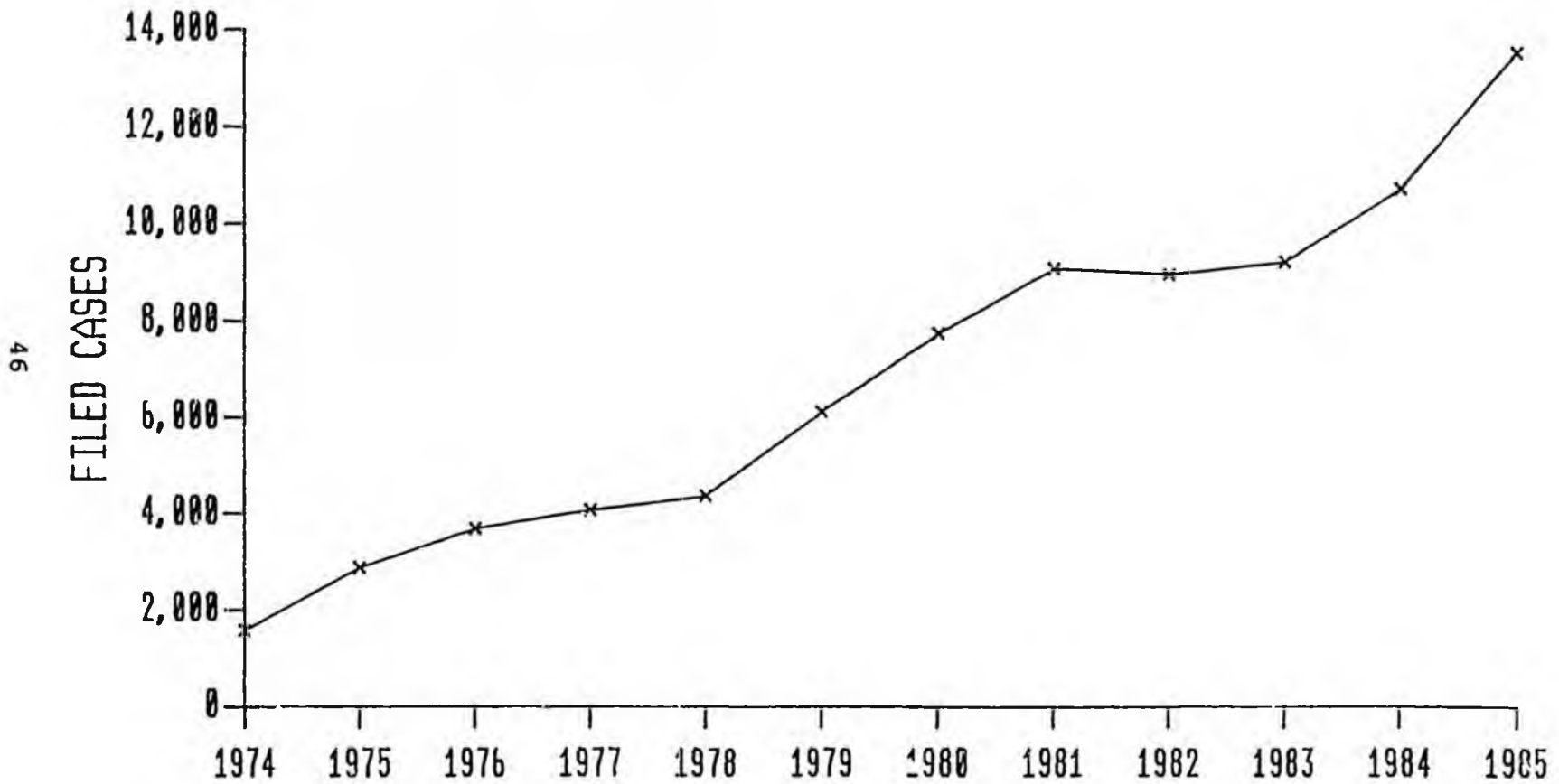
44/ Id. With legal expenses of 5%, prevailing plaintiffs in such cases receive only half of the awarded verdict.

45/ Administrative Office of the United States Courts.

46/ Claims do not, of course, translate directly into lawsuits, since most claims are resolved prior to the filing of litigation. But a substantial increase in claims almost certainly means a corresponding substantial increase in litigation.

CHART J

PRODUCT LIABILITY CASES FILED IN FEDERAL DISTRICT COURT



Source: Administrative Office of the United States Courts

years. 47/ The number of medical malpractice lawsuits per 100 physicians more than doubled from 1976 to 1981, and for obstetricians/gynecologists actually tripled during this period. 48/ In federal courts, which contain only a fraction of all medical malpractice claims, such claims have increased almost three-fold in the last decade (see Chart K). 49/

A similar increase can be found in claims filed against municipal and county officials. A survey of over twelve hundred local governments found that such claims had increased by 141% between 1979 and 1983. 50/ Tort claims against municipalities also have increased dramatically in recent years. For example, New York City witnessed a 375% increase from 1977 to 1985 in personal injury claims, with a corresponding 345% increase in average settlement cost. 51/ The City's long-term liability for tort claims already filed is projected to be \$1.5 billion. 52/

The explosive growth in damages over the past decade has already been related in detail. Suffice it to say that the increase in the average tort award appears to have outpaced even the extraordinary increase in the number of such lawsuits. The extent of some of these increases are difficult to comprehend. For example, one verdict reporting service found that the average jury verdict in personal injury lawsuits had increased by approximately 25% or more in three separate years (24.5% in 1980, 30.49% in 1981 and 27.54% in 1983). 53/ The average annual increase in such awards since 1975 has been over 15%. 54/ A subcategory of damages that dramatically illustrates this development is the average jury verdict for the wrongful death

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47/ American Medical Association Special Task Force on Professional Liability and Insurance, Professional Liability in the '80s 6 (November 1984).

48/ H. Manne, Medical Malpractice Policy Guidebook 18 (1985).

49/ Administrative Office of the United States Courts.

50/ Wyatt Co., Public Officials Liability Insurance: Understanding the Market (1986), page 22 (the provided 1984 data is incomplete, see pages 9-10, and therefore is not used for comparison).

51/ Statement by Mayor Edward I. Koch before the Governor's Advisory Commission on Liability Insurance, February 21, 1986.

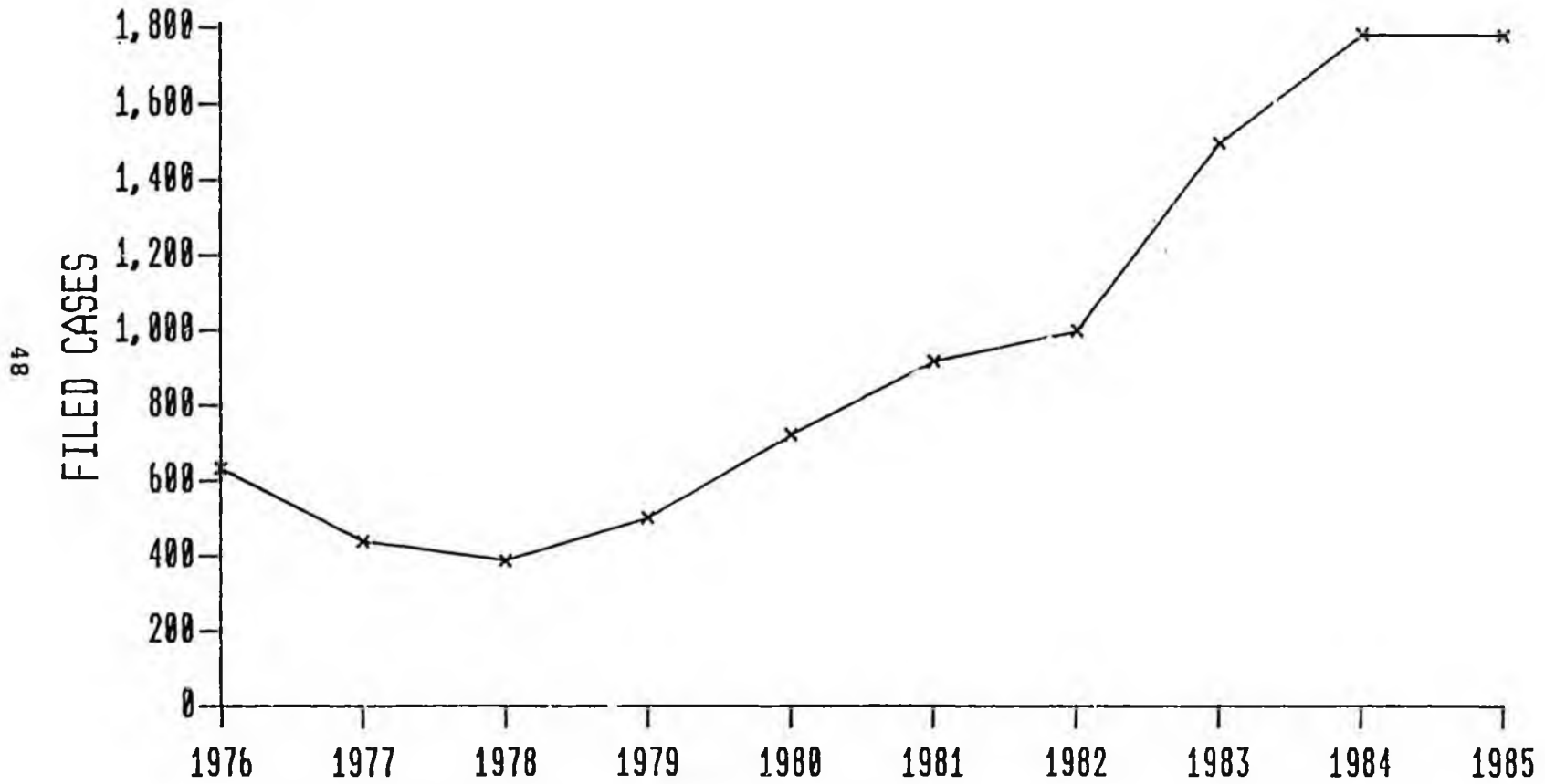
52/ Id.

53/ Jury Verdict Research, Inc., supra.

54/ Id. This is more than double the average annual CPI increase during the same period. Id.

CHART K

MEDICAL MALPRACTICE CASES FILED IN FEDERAL DISTRICT COURT



Source: Administrative Office of the United States Courts

of an adult male. The average award increased from \$223,259 in 1975 to \$946,140 in 1985, a more than four-fold (324%) increase in ten years (see Chart L). 55/

The increase in the number of tort lawsuits and the level of awarded damages 56/ (or settlements) in and of itself has an obvious inflating effect on insurance premiums. To illustrate, assuming all other factors are held constant, 57/ if the number of lawsuits against a company or person doubles in ten years, and if the average damage award (or settlement) doubles over this same period, that company or person will experience at least a four-fold increase in insurance premiums over those ten years. As noted above, however, for both medical malpractice and product liability the last ten years have witnessed much more than a doubling in lawsuits and average awards.

The above observation leads to an important but troubling insight into the current insurance availability/affordability crisis. Some have speculated that the crisis is the result of the attempt by the insurance industry to recoup losses resulting from its underpricing in the late 1970's and early 1980's. If this theory is correct, then it would seem likely that as such losses are recouped, premiums would decline. The above analysis, however, suggests that while the insurance industry may have underpriced its product for a period of time, the current explosion in premiums results in large part from the fact that now that the insurance industry is facing substantial underwriting losses, it must price coverage to reflect the actual risks presented by tort law. In other words, for a variety of reasons, the insurance industry appears to have kept prices constant or engaged in price reductions in a period during which the risks generated by tort liability increased

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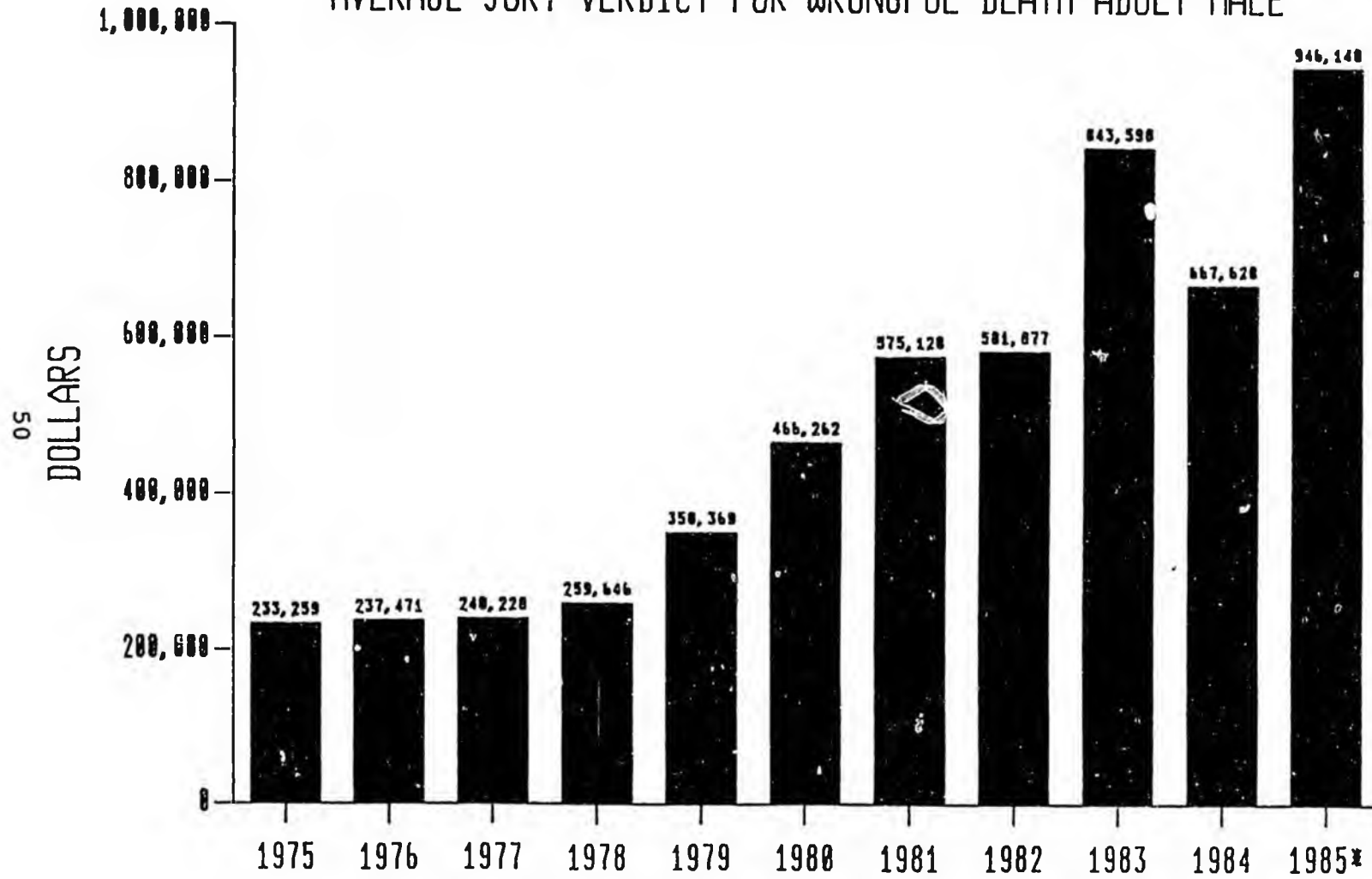
55/ Id.

56/ Jury verdicts, of course, represent only the tip of the claims resolution process. Most claims are resolved before trial. However, settlements by their very nature reflect the range of verdicts available to the plaintiff. Thus, as jury verdicts skyrocket, so do settlements. Settlements also reflect the plaintiff's likelihood of success. As tort law becomes more and more favorable to plaintiffs -- particularly in reducing or even eliminating plaintiff's burden of showing causation -- settlements further increase. Accordingly, in addition to the obvious effect on settlements of increasing jury verdicts, liberalized standards of fault and causation increase the percentage of claims resolved favorably to plaintiff and increase the size of settlements.

57/ Of course, all factors are not held constant. For example, if there is an increase in the percentage of claims resolved favorably to plaintiffs, premiums would have to be increased correspondingly.

CHART L

AVERAGE JURY VERDICT FOR WRONGFUL DEATH ADULT MALE



Source: Jury Verdict Research, Inc.

\* 1985 Information Not Complete

dramatically. Now that the industry is attempting to match premiums to risk, there appears to be a dramatic, pent-up increase in premiums to bring premiums back into line with rapidly growing liability risks.

The above analysis, if correct, is troubling in that it suggests that even after the insurance industry's underwriting profitability is restored, premiums are likely to remain relatively high. That is, while the more extreme availability problems may be resolved once the industry controls its underwriting losses, affordability problems may remain as a long-term fixture absent significant reforms of tort law.

There is, however, another important contribution of recent developments in tort law to the availability/affordability crisis which goes beyond the number of lawsuits and size of damage awards. The changing standards of liability and causation have generated tremendous uncertainty. The "rules of the game" of tort liability have changed so dramatically and rapidly in recent years that few are willing to speculate on what those rules will be even a few years hence. Invariably, however, those rules seem to have been changed to the prejudice of parties with pockets sufficiently deep to bear increasingly generous awards of compensation.

This uncertainty as to what the rules of tort liability applicable to any particular company, person or activity will be in future years makes it extremely difficult for the insurance industry to assess risk (and establish appropriate premiums) with any degree of confidence. This undoubtedly exacerbates the affordability problem, and may be a major factor underlying the availability problem. Simply put, insurance, like other business activities, operates most efficiently within a stable legal regime. Tort law, unfortunately, over recent years has been anything but stable.

The recent explosion in tort liability and the lack of legal certainty is a particularly noxious combination that seems to react almost synergistically in promoting the insurance availability/affordability crisis. The rapidly accelerating growth in both the number of tort lawsuits and the size of damage awards in and of itself significantly increases future liability risks. But that risk is magnified by the perception -- based in large part on the lack of a stable legal regime -- that this accelerating growth will continue unabated. The insurance industry thus appears to be extrapolating the massive liability surge of recent years into the future, and seems to be setting its rates in part on the assumption that the on-going deterioration of tort law will continue for some time. Simply put, assessments of future liability risks reflect not only the recent rapid growth in such risks, but the perceived likelihood

that past excesses will be outpaced by the excesses yet to come. 58/

In conclusion, the current problems of tort law can be summarized as follows:

- ° Too many defendants are found liable (or forced into settlements) where there should be no liability, either because they engaged in no wrongful activity, or because they did not cause the underlying injury.
- ° Damages have become excessive, particularly in the area of non-economic damages such as pain and suffering, mental anguish and punitive damages. And,
- ° Transaction costs are far too high.

The ways in which these aspects of the tort system are contributing to the current insurance availability/affordability crisis can be summarized as follows:

- ° The private sector is being asked to carry a compensation burden which in some instances it simply cannot afford to carry without substantial economic dislocations. Thus, even where insurance is available, in order to carry this compensation burden, it often is priced at unacceptable levels.
- ° The affordability/availability problem is greatly exacerbated by the lack of a stable legal regime which would allow the insurance industry to assess liability risks with some degree of confidence.

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58/ A recent Administration study of the childhood vaccine industry, for example, found that uncertainty as to tort liability was a major factor underlying the severe insurance availability problems facing the industry and jeopardizing the childhood vaccination program. See the Report of the Working Group on Vaccine Supply and Liability (April, 1985).

## CHAPTER 3

### RECENT INSURANCE INDUSTRY DEVELOPMENTS

The insurance availability/affordability crisis has led both the insurance industry and its customers to consider various changes to the ways in which liability risks are insured. The following is a description of the most significant of these developments and their immediate implications.

#### I. COVERAGE CHANGES

One of the most important of these changes has been the development of new commercial policy forms by the Insurance Services Office ("ISO"), the statistical and rate-making organization for the property-casualty industry. While these new forms have been filed with each state insurance department, most states have not yet acted on the new submissions.

These new policy forms are more limited in scope than the old forms in that they are written on a claims-made basis and permit certain coverages to be excluded entirely.

#### Claims-Made Policies

General liability insurance, including product liability coverage, traditionally has been written on an occurrence basis; that is, the policy applies to all injuries and damages that occur during the policy period irrespective of when claims are presented. Under claims-made coverage, the policy covers injuries and damages which occur during the policy period and for which claims are filed during the policy period.

The ISO submission provides that a policyholder can purchase unlimited tail coverage (the period during which claims are covered after termination of the policy) for a cost of up to 200% of the original premium. In addition, a five year extended claims reporting period for known claims is provided for situations where no other insurance is applicable. There is still disagreement over the reinstatement of aggregate policy limits for tail coverage and the effect of defense cost inclusions.

A claims-made policy covers claims occurring after the "retroactive date," ordinarily, the inception date of the policy. Under some circumstances, insurers will be permitted to advance the retroactive date, necessitating the purchase of tail coverage for incidents occurring during the prior period. The retroactive date may be advanced when: (1) there is a change of insurer, (2) there is a change in the insured's operation, (3) if the insured fails to inform the insurer of risks he knew or should have known about, or (4) with the consent of the insured.

The ISO has indicated that it does not intend to limit the use of claims-made policies to specific problem areas such as long-tail or latent injury exposures.

The claims-made forms have not yet been approved by the states, and twelve states have expressly disapproved them as filed. The ISO is working with the Insurance Commissioners to resolve differences.

The insurance industry has indicated that it wishes to use claims-made policies. In general, 1986 is viewed as a transition year during which insurers will train their personnel in the use of the new policy forms and adapt their computers to accommodate the changes. Insurers have indicated that in states where the new forms are not insured, they may use non-admitted subsidiaries or surplus lines carriers to provide the coverage to their clients on claims-made basis for large complex risks and risks in "volatile" classes, or else simply not provide coverage to those risks.

Claims-made policies and other limited coverages also are being adopted by reinsurers. Lloyd's of London has introduced a new claims-made form, as have Weavers and Trenwick American Reinsurance. Each policy is somewhat different. Trenwick, a United States reinsurance company, has stated that it will not write any general liability reinsurance on an occurrence basis after January 1 of this year. Trenwick also has written a claims-made form for use by its ceding companies for "difficult" risks. Other reinsurers have indicated they would reinsure both occurrence and claims-made policies, but would strongly encourage the use of claims-made for heavy casualty risks. As indicated in Chapter 1, some businesses already have been asked to take claims-made coverage for their excess limits coverage. Because of the many different claims-made forms currently being used, this is likely to cause gaps in coverage.

#### Laser Endorsements

The ISO policy form also includes "laser endorsements" which can be used to limit coverage. These provisions permit an insurer to exclude claims from a specific incident, product or period of time. Several Insurance Commissioners have objected to this provision and stated that, at a minimum, it should be revised to require the signature of the insured indicating an awareness of the exclusion. The inclusion of a laser endorsement would necessitate either the insured's purchase of tail coverage for that product or incident, or the insured's "going bare" for that liability.

#### Pollution Exclusion

Both the new ISO and Lloyd's of London claims-made commercial general liability policies specifically exclude pollution