

Puzzles of the Tort Crisis

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The tort crisis, sometimes called the insurance crisis, still afflicts us. Although today some commentators are claiming that the crisis has subsided,¹ they are confusing the recent softening within some insurance lines with the long-term, perhaps permanent, changes in underlying insured activity that has made possible the softening. The playground equipment removed from public parks² and the diving boards removed from city schools³ have not been replaced. The large numbers of products withdrawn from consumer markets⁴ remain withdrawn. The huge premium increases of early 1986 are largely intact,⁵ thus, necessitating continued price increases and sustaining diminished consumer demand for insured products and services. Many manufacturers, service-providers, and, especially, municipalities no longer openly complain about insurance unavailability because they have continued operations either without market insurance by self-insuring or by joining mutual insurance groups. This adjustment, however, no more than delays the impact of increased tort liability. These entities have chosen to put off paying advance premiums equal to expected liability only to suffer actual liability once it occurs. .

The single most important phenomenon of the recent tort crisis, crucial for its diagnosis, is the withdrawal of the insurance industry from the business of insurance. The withdrawal of the industry is obvious with respect to those few insurance lines for which market insurers have refused to offer coverage altogether: nurse-midwives, day care, municipal liability. But the withdrawal from the insurance business is reflected in other, more widespread, changes in commercial casualty insurance offerings. In particular, the adoption of the claims-made as the basic commercial casualty policy, the general increase in retention (insured deductibles), the decline in levels of aggregate coverage, and the introduction of specific coverage exclusions reflect such changes.

The now-universal adoption of the claims-made policy in place of the occurrence policy represents a decline in insurance coverage. Occurrence policies offer coverage of all losses occurring during the policy period. In contrast, claims-made policies offer coverage only of those claims filed during the policy period. Thus, the claims-made policy cuts off insurance for losses resulting from the current activities of the insured that become manifest at some later period after the insurance policy has expired. In addition, modern claims-made policies often incorporate separate

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1. See Wash. Post, Jan. 5, 1987, at 18, col. 1-4; Wash. Post, Jan. 15, 1987, at A20, col. 1 (editorial); N. WEBER, *PRODUCT LIABILITY: THE CORPORATE RESPONSE* 4-7 (Conf. Bd. 1987) [hereinafter Conf. Bd.].

2. *Sorry, Your Policy Is Cancelled*, TIME, Mar. 24, 1986, at 24.

3. GOVERNOR'S ADVISORY COMM'N ON LIABILITY INSURANCE, *INSURING OUR FUTURE* 24 (1986) (New York City Schools).

4. Conf. Bd., *supra* note 1, at 15-16. See *infra* text accompanying note 19.

5. *Id.* at 4-7; Wash. Post, Jan. 5, 1987, at 18, col. 1; Glaberson, *Liability Rates Flattening Out As Crisis Eases*, N.Y. Times, Feb. 9, 1987, at 1, col. 5; Wall St. J., Jan. 6, 1987, at 6, col. 2 (malpractice insurance costs continue to rise despite tort reform).

“retrodate” provisions which cut off coverage of losses occurring prior to some specified date in the past for which claims are filed during the policy period. Together, these provisions shift to the insured the risk of potential future tails of tort liability and the risk of unknown or unappreciated past tails of tort liability.⁶

Other recent changes in commercial casualty coverage have similar effects. Policy deductibles have been widely increased,⁷ thereby making the insured responsible for some set of lower-value claims⁸ previously covered by the policy. Levels of aggregate insurance coverage have been reduced generally,⁹ shifting to the insured risks of larger liability levels. Specific coverage exclusions have been newly introduced into commercial casualty policies,¹⁰ thus directly reducing the substantive range of insurance coverage.

The substantial reduction in the total level of market insurance coverage is a genuine indication of crisis. There are various non-crisis reasons that the output of a product or service may decline, either because of an increase in supply costs or a reduction in demand. Neither of these reasons, however, would explain the dramatic changes in the commercial casualty insurance industry over the last two years. The basic costs of insurance administration have not changed substantially in recent years. There are no reasons to believe that the costs of underwriting, premium investment, or claims processing have increased dramatically.

Of course, insurance indemnity costs, *i.e.*, claims payouts, have increased with the expansion of modern tort law. But the rise in tort-generated indemnity costs will increase rather than reduce the demand for market insurance by the manufacturers and service providers subject to tort liability judgments. Insurers are financial intermediaries between insureds and their victims. Under any plausible hypothesis of the corporate demand for insurance—because corporations face real costs of selling assets to pay liability judgments, or are risk averse (which amounts to the same thing), or because corporations want claims adjustment or risk monitoring services¹¹—the increase in expected tort liability will make market insurance more attractive relative to its price.

This point is often ignored, especially by those who would attribute the decline in insurance availability to the increase in legal uncertainty, or in what is called

6. Of course, given the adoption of a claims-made policy, the retrodate provision is necessary to cull out applicants who know that they are about to face claims based on past activities.

7. For example, the insurance deductible for the city of Baton Rouge, Louisiana increased from \$100,000 in 1985 to \$500,000 in 1986. The Kennestone Hospital in Marietta, Georgia faced an increase in deductible from \$1 million to \$2 million. See *Sorry, Your Policy Is Cancelled*, *supra* note 2, at 18.

8. But note that the term “lower-value” can sometimes mean millions. See *id.*

9. The city of Mississauga, Ontario recently suffered a doubling of its premium along with a reduction of its coverage from \$15 million to \$7 million. Insurers recently cut coverage for the city of Hartford, Connecticut from \$31 million to \$4 million. *Toronto Star Field*, Feb. 20, 1986, at A7; *Sorry, Your Policy Is Cancelled*, *supra* note 2, at 17. Note also that other insurers have effectively lowered aggregate coverage by amending policies to charge legal expenses in defending claims against the policy limit.

10. See, *e.g.*, *Bus. Ins.*, Dec. 17, 1984.

11. For a more complete discussion of the corporate demand for insurance, see Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 *YALE L.J.* 1521, 1560–63, 1578–82 (1987).

“socio-legal risk” related to the expansion of corporate tort liability.¹² Without some conception of the corporate demand for insurance, the attribution of the recent crisis to increased legal uncertainty is not helpful. Insurance, like any other labor, capital, or financial input in the process of production and sale, can be provided internally within a firm by self-insurance or by contract from some supplier. A corporation will purchase market insurance whenever the market insurer has a comparative advantage to the potentially-insured firm itself in the provision of risk spreading services. The principal puzzle of the tort crisis, and the key to understanding what can be done to solve it, is the explanation of how the expansion of modern tort law has reduced the comparative advantage of market insurers.

Here it is necessary to examine the effects of the expansion of corporate liability more carefully. The expansion of tort law has been justified on grounds of providing insurance to victims.¹³ But the expansion of liability is more accurately described as shifting rather than as generating new insurance obligations. Since the 1960s, the vast majority of the American population has possessed first-party health and disability insurance or has been covered by government health and disability plans chiefly designed for the poor.¹⁴ Of course, there remain individuals who do not possess health and disability insurance and who, because they possess assets, do not qualify for government assistance. Most commonly, such individuals are occasional workers or transients. Tort law may provide a form of compensation insurance that these persons would not possess through first-party insurance markets.¹⁵ But no one claims or can believe that the recent insurance crisis has been caused by the tort recoveries of occasional workers and transients, who are not only less likely to sue, but also less likely to recover large judgments because of low expected future incomes. As a consequence, the principal effect of the expansion of corporate tort liability has been to shift insurance delivery to a third-party mechanism for the vast majority of individuals who already possess first-party insurance.

Are there reasons that the shift of insurance delivery from a first-party to a third-party mechanism would impair insurance markets? There are very clear reasons. First, tort law third-party insurance provides coverage in excessive amounts relative to consumer demand. It has been estimated that the third-party insurance payment through tort law, on average, is 2.6 times the amount that a consumer would voluntarily purchase.¹⁶ In addition, loading or administrative costs are much greater of third-party than of first-party insurance by an estimated magnitude of 2.75 to 5.75

12. See Professor Abraham's article elsewhere in this symposium; P. DANZON, *MEDICAL MALPRACTICE* (1985); R.A. WINTER, "CRISES" IN COMPETITIVE INSURANCE MARKETS (Hoover Institution Working Papers in Economics E-86-74, Dec. 1986).

13. See Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. LEGAL STUD. 461 (1985). See also Priest, *supra* note 11, at 1534-39.

14. See SEN. SUBCOMM. ON THE AGED, 99TH CONG., 2D SESS., WORKING PAPER NO. 1: A PROFILE OF HEALTH BENEFITS AND THE UNINSURED (Subcomm. Print Oct. 17, 1986) [hereinafter SEN. SUBCOMM. ON THE AGED].

15. Although it may not, since those lacking insurance because of their wealth or income levels are likely to qualify for public assistance if they become injured. See *id.*

16. See Priest, *supra* note 11, at 1555. For another estimate of this difference, see Danzon, *Tort Reform and the Role of Government in Private Insurance*, 13 J. LEGAL STUD. 3 (1984).

times.¹⁷ Finally, and perhaps most importantly, third-party insurance is provided in a manner that makes it extremely difficult for the insurer to segregate high-risk insureds from low-risk insureds.

Although all of these differences are important, the increased difficulty of segregating high-risk from low-risk insureds through third-party tort law insurance is most crucial for explaining the recent crisis. It is central to any successful insurance enterprise to segregate risks, as much as possible, into separate, narrowly defined risk pools in order to prevent adverse selection, when low-risk members of a pool drop out because the premium is greater than the risk they bring to the pool. Obviously, in any insurance pool, the premium must be set according to the average level of risk brought to the pool. The wider the range is between high-risk and low-risk pool members, the greater the difference is between the average risk and the risk of low-risk members. If the disparity between the premium and the risks added by low-risk members becomes too substantial, low-risk members are likely to drop out of the pool because they find alternative means of protection cheaper than market insurance.¹⁸

It is much more difficult to segregate risks into narrow risk pools in the context of third-party rather than first-party insurance. In first-party insurance contexts, through the insurance application process, the insurer can obtain detailed information about the insured, which is useful for precise risk segregation. For example, in the context of insuring non-preventable injuries from auto use, the first-party insurer can create separate driver pools by age group, by levels of driving, by accident experience, and by moving violations within some previous period. In contrast, the auto manufacturer who must buy third-party liability insurance for those injured in its cars can implement none of these distinctions. Some auto models may be more or less attractive to teenagers or commuters, but except for these crude distinctions, the auto manufacturer must provide insurance to all purchasers, both high-risk and low-risk alike. Hence, the variance of risks is likely to be substantially greater within third-party liability insurance pools than within first-party pools. It follows that the pressures will be commensurately greater for low-risk members to drop out of third-party pools, either by refusing to purchase the product or by self-insuring.

The varied phenomena represented in the recent crisis are all manifestations of the effects of adverse selection in existing third-party insurance pools. For example, a recent Conference Board survey of the nation's 500 largest corporations showed that twenty-five percent had removed products or services from markets in response to increased corporate tort liability.¹⁹ A firm must remove a product from the market when it is unable to pass along the increased liability insurance premium in the product price, that is, when consumers do not value the product with the added premium. By declining to purchase the product at the higher price, consumers are dropping out of the product risk pool. Similarly, an accelerating shift has occurred toward self-insurance at the corporate level through the formation of captive off-shore insurance subsidiaries or voluntary mutual insurance groups, for example, of doctors

17. Priest, *supra* note 11, at 1560.

18. For a more complete discussion, see *id.*

19. See Conf. Bd., *supra* note 1, at 15–16.

within specific medical subspecialties.²⁰ These developments also are examples of adverse selection within provider risk pools.²¹

The various changes in commercial casualty insurance policies, described above, represent the efforts of insurers to try to retain low-risk insureds within existing pools. Increasing provider deductibles and lowering aggregate policy limits cull out high-risk members to make the pool more attractive to low-risk members. These changes make the commercial casualty policy more valuable at its price to those members less likely to have to incur the deductible or to exceed the policy limit. Similarly, the introduction of specific coverage exclusions, such as the exclusion of coverage of toxic damage in a municipal government policy or the exclusion of coverage of claims relating to mergers and acquisitions in a directors' and officers' policy, culls out high-risk insureds to make the basic policy more attractive to those cities never involved with toxic disposal or those directors inactive in the market for corporate control.

It is only when these policy amendments are unavailing that the market insurer must refuse to offer coverage altogether. The refusal of insurance companies to engage in the insurance business signifies that the increased variance resulting from the expansion of corporate tort liability has thwarted the sustainability of any risk pool. Put differently, refusing to offer coverage is a confession by the insurer that it cannot identify any set of insureds with risks sufficiently similar to support a pool.

The failure of the insurance enterprise is a sign of crisis because it appears to be an artifact of the form of insurance delivery. The final puzzle of the recent crisis is that there is no indication in any of the affected insurance lines that the underlying injury rate has increased. Indeed, in virtually all product and service contexts, the injury rate has been steadily declining over time.²² Of course, some new products have been introduced only later to be discovered to be injurious (the Dalkon Shield, for example). But claims involving these products have not dominated tort litigation. Again, the principal effect of the expansion of corporate tort liability on insurance grounds has been to shift insurance delivery from a first-party to a third-party delivery mechanism. The asbestos cases, which have been given great attention, are a good example. The number of asbestos-related injuries has been steadily accumulating, but has not accelerated. What has increased is the extent to which the third-party tort system, in contrast to the first-party workers' compensation system, has been called upon to provide recovery to workers suffering asbestos-related diseases.

Perhaps the greatest irony of the shift from first-party to third-party insurance delivery is the incidence of the effects of the shift among the consumer population. Courts expanded tort liability on insurance grounds expressly to provide coverage to the poor who they believed might not otherwise possess first-party insurance coverage.²³ This judicial rationale, of course, was developed prior to the expansion

20. N.Y. Times, Mar. 7, 1986, at D1, col. 3 and D4, col. 1. Patricia Danzon reports that 40% of physicians in hospitals are now insured through small mutual insurance groups. P. DANZON, *supra* note 12, at 93.

21. For further examples, see Priest, *supra* note 11, at 1569-81.

22. T. SCHELLING, *An Economist Looks at Risk and Liability*, in RISK, COMPENSATION, AND LIABILITY: THE POLICY CHOICES 53-55 (1986).

23. See generally Priest, *The Invention of Enterprise Liability*, 14 J. LEGAL STUD. 461 (1985).

of public health and disability assistance, although there are no current signs that the judiciary is sensitive to these underlying institutional changes. Nor is there evidence that the judiciary has ever been concerned with a careful counting of the number of those in our society who fail to possess some recourse to medical services should they be injured. This number, in fact, is quite low.²⁴

The irony, however, is that the expansion of third-party tort law insurance directly harms the poor among the consumer population. Obviously, the general price increase consequent to the expansion of liability affects those with low levels of resources most seriously. More importantly, the benefit low-income consumers receive from the addition of the liability insurance premium to the price of a product or service is worth less to them than its price. Again, the liability insurance premium tied to the sale of a product or service must be set according to the average expected liability payout. Tort judgments comprise medical expenditures, which are typically greater for higher income patients; past and future lost income; and damages representing pain and suffering, which are highly correlated with lost income.²⁵ The high correlation of these damage elements with income, however, means that the premiums set equal to the average damage payout will undercharge high income consumers and overcharge low income consumers. The provision of liability insurance tied to the sale of products and services requires the low income to subsidize the high income.

This regressive redistributive effect is glaringly inconsistent with judicial intentions as well as with any coherent and defensible social policy. It is equivalent to charging each worker in the society the same premium for disability insurance, but compensating those previously earning high incomes more than those previously earning low incomes. It is equivalent to charging all homeowners the same fire insurance premium regardless of home value. It is equivalent to not merely the repeal of the progressive income tax, but also to the repeal coupled with the provision of higher governmental benefits to those with high incomes.

Thus, the expansion of tort liability on insurance grounds has both undermined commercial insurance markets and directly harmed low income consumers. Both of these effects, however, can be reversed by removing the insurance component from tort law. Tort law, however defined, has two principal economic effects: it creates incentives to reduce the accident rate and, to the extent it establishes liability for accidents that cannot be prevented, it provides compensation insurance. It is only this compensation insurance effect that is counterproductive. By removing the compensation insurance component from tort law and concentrating attention on the goal of accident reduction, courts could at once return stability to commercial insurance markets and remove the regressive liability tax from modern products and services.

24. See SEN. SUBCOMM. ON THE AGED, *supra* note 14.

25. M.A. PETERSON, COMPENSATION OF INJURIES: CIVIL JURY VERDICTS IN COOK COUNTY 21-28 (RAND Corp. Report No. R-3011-ICJ, 1984).