


2004

Insuring Liability Risks

Tom Baker

University of Pennsylvania Law School, tombaker@law.upenn.edu

Follow this and additional works at: http://scholarship.law.upenn.edu/faculty_scholarship

 Part of the [Insurance Commons](#), [Insurance Law Commons](#), [Law and Economics Commons](#), [Medical Jurisprudence Commons](#), and the [Other Economics Commons](#)

Recommended Citation

Baker, Tom, "Insuring Liability Risks" (2004). *Faculty Scholarship*. Paper 1527.
http://scholarship.law.upenn.edu/faculty_scholarship/1527

This Article is brought to you for free and open access by Penn Law: Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Penn Law: Legal Scholarship Repository. For more information, please contact PennlawIR@law.upenn.edu.

Insuring Liability Risks

by Tom Baker*

Recent dramatic increases in prices for medical liability insurance, directors and officers insurance, and other lines of commercial liability insurance, together with the exit of some insurers from those lines of business, has placed liability insurance on the public agenda. At the same time, asbestos and environmental losses continue to mount under general liability insurance policies sold long ago, when no one could have predicted the extent or cost of such losses. In combination, these and other related events have raised serious concerns about the insurability of liability risks and have prompted calls for dramatic efforts to roll back the advance of liability law in the U.S. and Europe.

With this “crisis” as the background, this essay represents a preliminary effort to explore insurance for liability risks, with the goal of articulating a framework that will guide more systematic and empirical study. In the main part of this essay I describe a new conceptual framework for analysing liability insurance risks. The framework helps explain why predicting losses can be so difficult in the liability insurance context and why cycles in insurance pricing are more extreme in liability insurance than in other lines of insurance.

Much of this difficulty is already understood to follow from the “long tail” or “duration of liability” problem in liability insurance.¹ The primary contribution of the new framework is breaking apart what I will call “liability developments risk” for separate analysis, facilitating a better understanding of when and why the duration of liability matters. In concluding, I use a brief analysis of medical liability insurance to offer some observations on insurability and to sound the call for systematic empirical research aimed at improving how liability insurance institutions manage liability developments risk.

A conceptual framework for liability risks

Considering an insurance market (or market segment) as a whole, the risks assumed by insurance arrangements can be classified for present purposes into the following four categories: (1) “baseline risk”, which is the existing risk of loss based on past experience, assuming no change; (2) “developments risk”, which is the risk relating to developments that change the rate or cost of loss during the insured period; (3) “contract risk”, which is the risk

* Connecticut Mutual Professor of Law, and Director, Insurance Law Center, University of Connecticut. Thank you to Thomas O. Farrish for research assistance and to Douglas Kysar and Peter Siegelman for comments on an earlier draft.

¹ A “long tail” refers to the potentially long period that elapses between the time the policy is priced and the time that claims are paid. When there is a long tail the insurer cannot know the true cost of the coverage sold until many years after selling it. See Harrington and Danzon (2000) at 291: “[t]he longer the duration of liability, the greater the risk that unanticipated information about hazards or new legal standards will shift the distribution of loss for all outstanding policies”. On the other hand, “the long tail associated with liability claims may allow insurers time to respond gradually to unexpected increases in costs, an option not available for catastrophe property losses”. *Ibid.*, at 292.

relating to the drafting and interpretation of insurance policies; and (4) “financing risk”, which is the risk relating to changes in investment performance and the insurance pricing cycle. Although my subject is liability insurance, this framework can be adapted for use in analysing many forms of insurance. Figure 1 below depicts this framework in a simple table form. Figure 2 “explodes” the framework to depict the constituent parts that I will describe in this essay. As Figure 2 suggests, the primary focus of this essay is liability developments risk and the way that legal developments affect other aspects of liability developments risk.

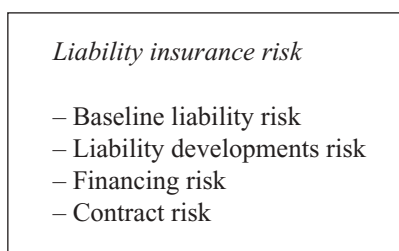


Figure 1

Baseline risk

The baseline risk is the existing risk of loss based on past experience, assuming no changes in the future. Typically, determining the baseline risk is problematic primarily for new kinds of insurance coverage and for very low frequency, very high loss potential events such as earthquakes. In well-established lines of insurance, the baseline risk is the simple projection into the future of the claims history of the past. If the future could be counted on to be just like the past, an insurer could turn a profit simply by pricing on the baseline risk (plus an amount to cover expenses and profit) and employing underwriters to make sure that the risk level of the insured pool matched that of the population upon which the baseline was determined. But of course the future is never just like the past; it is this fact that makes developments risk, financing risk, and contract risk so significant.

Liability developments risk

All types of insurance face “developments risk” of one sort or another. Life insurers must plan for developments that affect mortality. Health insurers must plan for developments in medical technology. Property insurers must plan for developments in building construction techniques and weather patterns. Disability insurers must plan for developments in occupational patterns, and so on. No other form of insurance faces as broad a range of developments risk as liability insurance, however, because almost all the developments that affect other kinds of insurance also affect liability insurance. This is because nearly any kind of harm that can be covered by other kinds of insurance can also be the subject of a liability action. In addition, liability insurance faces its own, unique developments risk.

For present purposes, liability developments risk can be classified into five categories: *injury* developments risk, *injury cost* developments risk, *standard of care* developments risk,

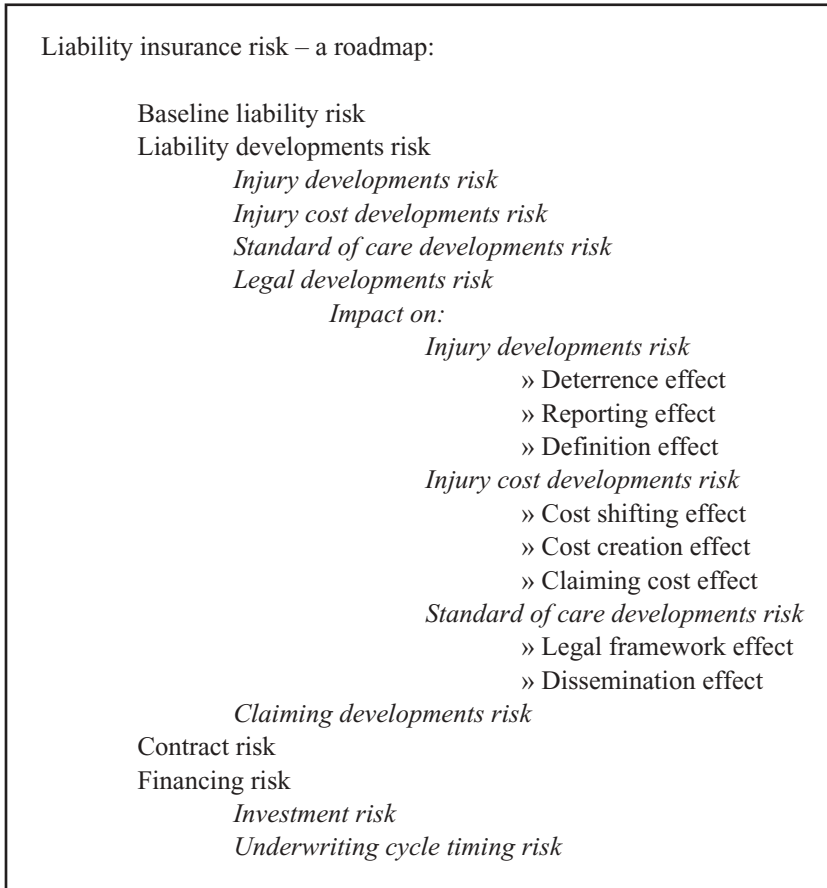


Figure 2

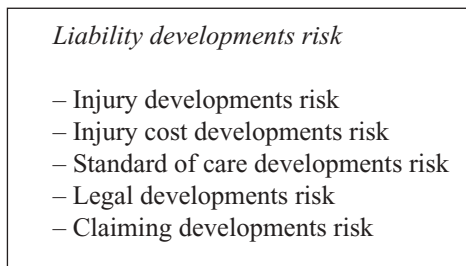


Figure 3

legal developments risk, and *claiming* developments risk. Of these, only standard of care developments risk is unique to liability insurance, but the other four pose special problems in the liability context.

Injury developments risk

Injury developments risk is the risk of developments that change the frequency or magnitude of injuries that are subject to compensation through insurance. Most obviously, these include developments in injury-causing activities, such as the introduction of a new product or an increase in the sales of an existing product. All other things being equal, the greater the rate of change in the underlying activity insured, the greater the injury developments risk. For example, one reason why medical liability losses are more difficult to predict than automobile liability losses is the comparatively rapid rate of change in medical technology and practice.

Significantly, injury developments also include developments that affect the understanding of what an injury *is*. In the bodily injury context such developments include new imaging or other diagnostic techniques or new psychological theories that, for example, transform the “deviant” (e.g. “malingerers”) into the “sick”. In the property damage context, these developments would include a new understanding of the dangerous properties of a material commonly present in buildings, such as happened with asbestos and appears to be happening at the moment with at least some forms of mold.

Concepts like “injury” or “harm” or “damage” or, indeed, almost any other insurance trigger (except, perhaps, death), are not constants like the speed of light or the value of π . They have meanings that change over time in response to social circumstance. This socially constructed nature makes these concepts much more interesting objects of study. At the same time, however, it makes predicting the frequency and severity of almost all kinds of insurance claims problematic. The objects under observation – the injuries that serve as the foundation for claims – mutate over time in response to changes in any number of institutions that produce, measure or otherwise have a meaningful connection with them.

All forms of insurance face the risk of developments that affect the frequency or magnitude of the injuries for which they provide protection. Liability insurance is unique, however, in the importance that legal institutions play in the social construction of those injuries. This special role of legal institutions will be addressed in the legal developments risk section below.

Injury costs developments risk

Injury cost developments risk is the risk of developments that affect the costs of injuries that are subject to compensation through insurance. Some forms of insurance, such as life and disability insurance, generally pay a fixed amount for injury and, thus, do not face injury cost developments risk. Other forms of insurance, however, promise to cover specified types of injury costs; changes in those costs will vary future claim payments from the baseline. For example, health insurance commonly covers the costs of “medically necessary services”, and property insurance commonly covers the costs to “repair or replace” damaged property. Not surprisingly, changes in the cost of medical services are among the most significant developments that affect health insurers, and changes in construction costs are among the most significant developments that affect property insurers.

As presently offered in the insurance market, liability insurance differs fundamentally

from other forms of insurance in the open-ended nature of the kinds of injury costs that it covers. Liability insurance protects the policyholder from having to pay damages to a third party. This means that any cost that can be included in a damage award is at least potentially covered by liability insurance. Damage awards include almost any kind of cost that is covered by any other form of insurance, plus kinds of injury costs that are not covered by any other form of insurance presently available. Most notoriously, the injury costs that are covered only by liability insurance include difficult-to-quantify losses such as pain and suffering and loss of enjoyment of life, and in some jurisdictions, punitive damages.² The injury costs covered only by liability insurance also include “out of pocket” losses for which there is not presently a first-party insurance market, such as long-term rehabilitation and loss of income for partial disability. As a result, the range of injury cost developments that can affect liability insurance exceeds the range of cost developments that can affect other forms of insurance presently available.

Standard of care developments risk

Standard of care developments risk is the risk of developments that affect the standard of care that determines whether injuries are subject to compensation through a liability action. Other leading forms of insurance, such as property, life, disability and health insurance, apply whenever there is an injury of the designated kind, regardless of how or why the injury occurred. In contrast, liability insurance only applies when an insured is legally liable for an injury. Liability of the sort that is subject to liability insurance generally requires establishing fault.³ As a result, liability insurance generally compensates only for injury that results from “unreasonable” behavior, which is to say, behavior that did not meet the accepted standard of care for the activity in question.

Standards of care are not static. They advance with technological and social developments. The greater the rate of change in the range of activities that are covered by a given line of insurance, the greater the standard of care developments risk in that line of insurance. Each advance has the potential to sweep a new range of injuries into the liability insurance net. There will always be people who do not adopt any new practice, and the injuries that result from their failure to adopt the new practice will, at least theoretically, be compensable through liability insurance.

In a sense, standard of care developments *create* liability claims, by affixing a new, blameworthy label on injuries that formerly would have been regarded as blameless. For example, introducing a new, life-saving drug could lead to more medical malpractice claims, as the families of patients who did not receive the drug (and may or may not have died as a result) begin to blame doctors who did not prescribe it. Perhaps ironically, the more lives that the new drug saves, the more medical malpractice claims it could create (because the better the drug works, the more successful medical malpractice claims based on the failure to prescribe the drug will be).

² See Baker (1998).

³ The range of true “strict” tort liability in U.S. law is small. Apart from manufacturing defects, even products liability requires proof of fault (see Henderson, 2002). Despite early concerns, the strict liability approach adopted in the environmental clean-up area has not been extended to other areas. Although there are forms of insurance that insure against breaches of certain kinds of contracts (a truly “no fault” or “strict” form of liability), by convention those forms of insurance, such as credit insurance and surety bonds, are not classified as liability insurance. Once there is truly strict liability, there would no longer be standard of care development risk.

Legal developments risk

The discussion so far has introduced three aspects of liability developments risk: injury developments risk, injury costs developments risk, and standard of care developments risk. These aspects of liability development risk follow from the nature of the legal liabilities that are the subject of liability insurance. Liability generally requires an *injury* that is caused by a breach of the *standard of care*; and the damages that are assessed for that liability ordinarily are expected to cover the *costs of injury*. Thus, injury, injury cost, and standard of care developments risk could easily be labeled as aspects of legal developments risk.

Nevertheless, I have chosen to use the term “*liability developments risk*” for the general category and the term “*legal developments risk*” for a subcategory. In doing so I mean to draw a distinction between the broad range of social developments that affect the frequency and magnitude of liability insurance claims, on the one hand, and the aspects of those developments for which legal institutions are the central actors, on the other. As we will see, it can be difficult to draw a line between those aspects of liability developments that are potentially attributable to legal developments and those that are not, but there is value to attempting to draw the line nevertheless.

The legal developments that most affect liability insurance can be classified into three main categories: those affecting the requirements for liability in a given range of activity (“*liability rules*”), those affecting the type and amount of damages that are paid because of liability (“*damages rules*”), and those affecting the procedures for asserting liability and obtaining damages (“*procedural rules*”). To appreciate the full scope of legal developments risks, it is helpful to remain conscious of that fact that legal institutions act, not only through formal legal rules (“*law on the books*”), but also through “*law in action*”. The concept of law in action refers to behavior of legal actors that is sufficiently regular or systematic that it is possible to say that this behavior “*is*” law for the people who are subject to it.

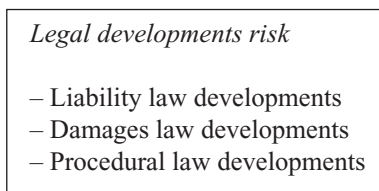


Figure 4

An example of a formal *liability rule* is the comparative fault doctrine, according to which parties are held responsible for an accident according to their proportionate fault. For example, in a rear-end automobile collision, the driver in front, who slammed on the brakes too quickly, and the driver in back, who was following too closely or reacted too slowly, would each be responsible for the resulting harm according to their relative faults. An example of liability law in action would be the common understanding among automobile insurance adjusters that, in a simple two car rear-end collision, the party who hits the car from behind is generally to be regarded as the (only) driver at fault. As this example suggests, many aspects

of liability law in action are simplified, more easily administrable versions of liability law on the books.⁴

An example of a formal *damages rule* is the rule that the plaintiff's damages in an ordinary negligence case are to be determined according to the harm to the plaintiff, without regard to the wealth of the defendant. An example of damages law in action would be the common practice in ordinary personal injury litigation in which defendants are permitted to settle out of a case in return for payment of the limits of their liability insurance policies, even when the value of the harm to the victim was much greater and even when the individuals have additional assets.⁵ As this example suggests, not all aspects of liability law in action can be explained as simpler versions of law on the books. Indeed, in this example the law in action contradicts the law on the books (by taking into account the defendant's assets in assessing the plaintiff's compensatory damages, and by treating insurance assets differently from other assets).

An example of a formal *procedural rule* is the rule that allows a plaintiff to bring a single legal claim against all the people who contributed to the plaintiff's injuries. An example of procedural law in action is the general practice of filing separate legal claims when there is a wealthy defendant with a lower degree of moral culpability. For example, in a case involving a rape or shooting or other highly culpable act in a shopping mall or apartment buildings plaintiffs prefer to bring a separate "premises liability" claim against the owner of the premises, in order to de-emphasize the role of the (presumably judgment proof) rapist or shooter.⁶

The effect of legal developments on liability developments risk

Because of the pervasive role of legal institutions in liability insurance practice, legal developments affect each of the other aspects of liability developments risk.

Injury developments risk. Legal developments can affect injury developments in three main ways. First, as economic theory suggests, increasing liability can decrease the level of activities that cause injuries, and decreasing liability can increase the level of those activities, as actors adjust their behavior to respond to the resulting incentives. Call this the deterrence effect.

Second, legal developments can change claimants' incentives to report injuries, independent of how many injuries actually occur.⁷ Call this the reporting effect. Increasing the compensation for an injury tends to increase the likelihood that the injury will be reported and, conversely, decreasing the compensation tends to decrease the likelihood that the injury will be reported.⁸ Reporting effects are not always so straightforward, however. For example, the decision by a leading automobile insurance company in Connecticut to change the amount of damages it would pay to settle minor impact, soft tissue claims (e.g. whiplash), reportedly

⁴ See Ross (1970). This is the classic study of liability law in action.

⁵ See Baker (2001). For an excellent and highly readable case study of medical malpractice litigation, explaining this and many other aspects of law in action, see Werth (1998).

⁶ This "law in action" has been prevented in some jurisdictions by a rule allowing one defendant to bring another defendant into the action. See, e.g. *Bhinder v Sun Co., Inc.*, 263 Conn. 358, 819 A.2d 822 (2003). N.B. The *Bhinder* rule subsequently was changed by statute in Connecticut. See Conn. Gen. Stat. 52-572h(o).

⁷ Cf. Harrington and Danzon (2000) at 305 (noting that injury rates, as opposed to claim rates, are "unobservable").

⁸ See Butler and Worrall (1991).



Figure 5

led plaintiffs' lawyers to invest time and effort in understanding these injuries and the use of new medical diagnostic tools. As a result, accidents that formerly would have been understood to involve only soft tissue injuries, were now alleged to involve slipped or herniated discs.⁹ This is an example of a reporting effect produced by a change in damages law in action.

To a degree, deterrence and reporting effects can be offsetting. Increasing liability for injury-causing activity tends to decrease the level of that activity, while simultaneously increasing the likelihood that injuries are reported. Similarly, decreasing liability for injury-causing activity tends to increase the level of that activity, while simultaneously decreasing the likelihood that injuries are reported. These offsetting effects complicate efforts to evaluate the deterrent effect of liability and explain why some researchers focus their efforts on fatal injuries (in the belief that fatalities are less likely than other injuries to be affected by the reporting effect).¹⁰

Despite the potential for the deterrence and reporting effects to be offsetting, legal developments seem likely to produce reporting effects more quickly than deterrence effects, particularly when the legal development relates to ongoing activity. Unless the harmful product or activity is immediately withdrawn from the market and from use, there will be a lag between a new liability and a reduction in injuries, while new lawsuits for existing injuries can be filed almost immediately. Similarly, it takes time for the elimination of liability to spur production and increase injury, while the elimination of liability would produce an immediate and dramatic reduction in litigation. Thus, in the short term at least, the apparent impact of a legal development affecting an ongoing activity may well be exactly the opposite of that predicted by deterrence theory, with the result that legal developments that make the world

⁹ Personal communication, Thomas Farrish, former Safeco Claim Analyst, July 2003 (expressing the belief that many of these claims were fraudulent and exploited the high rate of false positives on MRI films).

¹⁰ See e.g. Loughran (2001).

safer for consumers place financial stress on liability insurers, and legal developments that provide financial relief to liability insurers tend to make the world less safe for consumers.

Legal developments also can affect what we understand to be an injury. Call this the injury creation effect. Ordinarily we might think of the definition of injury as being within the competence of the medical and allied professions (in the bodily injury context) or engineers (in the property damage context), but liability actions require courts to make decisions about the existence of injuries, sometimes long before scientists or engineers have reached a consensus. Regardless whether science eventually agrees, those decisions “create” injuries. Silicon breast implant litigation provides a dramatic, if cautionary, example. Before the litigation, silicon breast implant surgery was understood as a medical procedure. The litigation, however, framed this surgery, or at the very least the resulting presence of the implants in the body, as an injury.¹¹ Although subsequent medical research suggests that silicon breast implants in fact do not cause injuries of the sort claimed in the class action,¹² thousands of women in fact were compensated for this “bodily injury”.

A related injury creation effect occurs when legal entrepreneurs link a health problem or issue with legally actionable behavior and identify the problem as a harm that can be monetized for the purpose of assessing damages. Fear of cancer and related medical monitoring costs incurred by individuals with minor, non-impairing asbestos injuries surely are the most expensive example of this phenomenon in recent years. This legal development “created” an enormous number of injuries, as people with no functional impairment and who are aware only that they have been exposed to asbestos are tested to determine whether they have developed scars on their lungs.¹³ Of course, this legal development did not cause the scars to be there in the first place, but it did determine whether, or at the very least when, people learned of their existence.

Injury cost developments risk. Legal developments also can lead to injury cost developments. Legal developments can shift existing injury costs to (or away from) defendants, thereby bringing those costs into (or out of) the liability insurance pool. Call this the injury cost-shifting effect. Almost any liability law development can shift costs. Indeed, from an economic perspective, cost-shifting is the basic function of liability. Legal developments shift costs not only when the scope of liability is expanded or contracted, but also when there are changes in the kinds or proportion of injury costs that can be shifted in a liability action. “Law on the books” examples of the latter include changes in the rules affecting the relationship between liability insurance and other forms of insurance (e.g. subrogation rules and the collateral source rule), as well as changes in the rules regarding recovery for emotional injuries (e.g. the popular U.S.\$ 250,000 cap on non-economic damages). Law in action examples would include systematic changes in settlement or litigation behavior, or in case screening procedures by contingent fee lawyers.¹⁴

¹¹ The silicon breast implant insurance coverage litigation expressly addressed the question whether the surgery itself was “bodily injury” within the meaning of the liability insurance policies of the manufacturers. The court deferred to the jury decision that the injury occurred at the time of the implant. *In re Silicon Implant Ins. Coverage Litig.*, 667 N.W.2d 405, 416 (Minn. 2003).

¹² *Ibid.*

¹³ See Carroll *et al.* (2002) at 23. See also, *Norfolk & Western Railway v Ayers*, 123 S. Ct. 1210 (2003).

¹⁴ For example, one explanation for the increase in average severity among medical malpractice claims over the past ten years is that plaintiffs’ lawyers have become more focused on litigating more serious claims and more systematic about weeding out smaller claims. According to some plaintiffs’ lawyers this change is a reaction to the 1980s tort reforms.

In addition to *shifting* injury costs, legal developments can also *create* (or eliminate) injury costs, by affecting what people do to recover from injury. Call this the injury cost creation (elimination) effect. For example, some jurisdictions in the U.S. experimented in the mid-20th century with hybrid fault/no-fault automobile liability statutes. Under these statutes people with less serious injuries could only be compensated by their own automobile insurance companies on a “no-fault” basis (and were prohibited from bringing a tort action), while people with serious injuries had the option of bringing a tort action against the responsible driver. In those states in which the seriousness of the injury was determined according to the dollar value of medical expenses incurred because of the injury, people injured in automobile accidents increased the frequency and intensity of their medical treatments in order to get over the threshold. In part as a result, automobile insurance premiums in these states increased rather than decreased. Eventually, these “dollar threshold” no-fault statutes were repealed in some states. These repeals were directed at the elimination of compensation costs that were attributable to the incentives created by the dollar threshold.¹⁵

Legal developments also can increase or decrease *claiming costs*. Call this the claiming cost effect. Developments that decrease claiming costs facilitate cost-shifting and, in an important sense, reduce injury costs, while developments that increase claiming costs inhibit cost-shifting and increase injury costs. Properly understood, the true social cost of a legally actionable injury includes the claiming costs involved in shifting that cost to the legally responsible party. Developments that reduce claiming costs to the point where the injury cost-shifting becomes possible (such as class action innovations) therefore reduce the costs of injury, even if those developments increase the price of liability insurance by increasing the share of injury costs shifted from victims to liability insurers. Similarly, developments that increase claiming costs to the point where they inhibit cost-shifting increase the costs of injury even though those developments might well decrease the price of liability insurance.

Standard of care developments risk. Finally, legal developments also can lead to standard of care developments. Occasionally, there are developments in the basic legal framework governing the determination of the standard of care. Examples include the shift from the community standard of care to a national standard of care in medical malpractice and the changes in the standard of care for products liability adopted in Second Restatement of Torts.¹⁶ On the whole, however, the legal rules governing the determination of the standard of care, such as the requirement in ordinary negligence actions that the behavior must be “reasonable”, tend to be relatively stable over the time periods that matter to liability insurers.¹⁷

The more significant effect that legal developments have on standards of care lies not in the occasional change in the broad legal framework, but rather in disseminating advances in the standards of care that were developed by actors, outside of courts, in the relevant field of action. Here, we can think of legal institutions as accelerating the rate of change, as actors adopt new techniques and procedures to avoid liability. One illustration of the potential effect of this kind of legal development on the standard of care comes from a recent paper written by members of the Harvard School of Public Health medical malpractice research team (Mello

¹⁵ Loughran, Note 11 above, at 7. For a discussion of reasons for repeal, see e.g. Connecticut General Assembly, 1993. For effects of the repeal see e.g. Carroll and Abrahamse (2001).

¹⁶ See *Sheeley v Memorial Hospital*, 710 A.2d 161 (R.I. 1998) (rejecting locality rule in favor of national standard); Restatement (Second) Torts § 402A (adopting a new approach to products liability).

¹⁷ This is yet another area in which asbestos may present a contrast case, because of the extremely long latency period for asbestos injuries.

et al., 2003). They caution the developers of the “leapfrog” standards for medical safety to be aware that the aspirational standards that they propose for hospitals may be used (misused, in the researchers’ view) in medical malpractice litigation as mandatory minimum standards of care. As this suggests, medical malpractice litigation can accelerate the dissemination of advances in the standard of care.

Claiming developments risk

A final aspect of liability developments risk, claiming developments risk, is both important and elusive. Given some existing propensity to claim, developments of the sort discussed so far can be expected to affect claiming behavior in a fashion that bears some relationship to how these developments affect the costs and benefits of claiming. Changes in claiming behavior that result from these other developments would not be claiming developments as I am using that term. “Claiming developments” are developments that affect the propensity to claim, conceptually independent of other aspects of developments risk.

All types of insurance face claiming developments risk. Fundamentally, this risk is traceable to the fact that there never can be a perfect match between the population eligible for insurance benefits and the population that makes a claim for the benefits. If all eligible people always applied, and no ineligible person ever applied, the claiming rate would correlate perfectly with the events that were insured against, and there would be no claiming developments risk. But, there are always some eligible people who do not make claims, and there are always some ineligible people who do. Changes in either direction lead future claim costs to vary from the baseline.

There are many reasons why people who are eligible do not make an insurance claim. Their lives may be in disorder. There may be stigma or other social costs associated with making a claim, so that making a claim does not seem like an ordinary or usual thing to do. They may choose not to interrupt their lives to do what is necessary to make a claim: a “sick” person may choose not to go to a doctor or a “disabled” person may prefer to keep working. They may not know that they are eligible, either because they do not know about the insurance or because the circumstances that trigger the right to the benefits may be ambiguous.

Similarly, there are many reasons why people who are not eligible do make an insurance claim. They may mistakenly believe they are eligible, either because the circumstances that trigger the right to the benefits are ambiguous or because they are poorly informed about the requirements. In addition, some claimants may be aware that they are not eligible, but file a claim nevertheless, in the hope that the insurer does not notice or else relaxes the eligibility requirements in their case.¹⁸

These examples suggest the following regularities with regard to claiming developments risk. The greater the stigma or other social costs associated with making a claim, the greater the number of eligible people who will not claim and the smaller the number of ineligible people who will claim. Conversely, the more ordinary or usual making a claim is understood to be, in other words, the decision to claim depends on how people believe that others feel about claiming. As a result, an increase in claiming may lead to a reduction in stigma, which leads to more claiming, and so on. In addition, the more ambiguous the eligibility

¹⁸ The social meaning of such knowingly “excess” claims is a complicated topic that lies beyond the scope of this essay. Insurers are likely to regard all such situations as fraudulent, but the subjective moral position of such applicants can vary over a wide range. Cf. Stone (2002).

requirements are, the more ineligible people will claim and the more eligible people will not. Finally, the greater the economic need of the population in question, the more ineligible people will claim and the fewer eligible people will not. Thus, changes in the social meaning of claiming, changes in the precision of the criteria for, and the quality of the information about, eligibility, and changes in general economic conditions, are all sources of claiming developments risk.²¹ Further investigation is sure to identify additional sources.

Contract risk

Insurance involves the exchange of money for a promise. Because the insurer's promise will not (and cannot) be performed until the future, no one can be absolutely sure about the precise meaning of that promise at the point of contract. Several features of insurance arrangements exacerbate this "contract risk". First, in most lines of insurance it is impossible to articulate with precision the conditions that trigger the obligation of the insurer to pay a claim. Insurance contracts use terms with commonsensical meanings like "property damage", "bodily injury", "medically necessary services", and "disability" that, as insurers have learned from experience, can be imprecise at the point of claim. Even if insurers were to replace broad, commonsense triggers with detailed descriptions of specific claim situations, they would regularly confront claims situations that are difficult, if not impossible, to predict in advance, placing stress on the application of the contract language. Second, in most lines of insurance, managing moral hazard requires insurers to draft exclusions to the coverage that is provided.¹⁹ The combination of a broad grant of coverage and a series of exclusions crafted to manage moral hazard provides fertile ground for differences of opinion over contract meaning. Third, there is a tension between the sales and claims functions of insurance organizations that tends toward a broadening of the insurance promise at the point of sale and a narrowing at the point of claim. As a result, there are (at least) two sets of images and discourse that parties and courts can access when determining whether a claim is covered.²⁰ Finally, the societal interest in compensation contributes to uncertainty in the application of insurance contract language.

All other things being equal, this "contract risk" is proportional to the dimensions of the conceptual space between the risks of a given type that are faced by the insured, on the one hand, and the risks of that type that the insurance underwriter consciously intended to assume, on the other. After all, it is the gap between harm and coverage that motivates the insured to use the legal process to expand the insurer's understanding of the promise. The greater the gap is, the larger the motivation will be. In addition, the greater the rate of change in either the activities insured or the terms of the insurance contract, the greater the contract risk. Change in either the contract or the activities to which it applies means that there is no longer a settled contextual meaning of the contract upon which the parties can rely.

Liability insurance does not appear to differ systematically from other forms of insurance in most of these regards. Where liability insurance does differ, however, is in the pressure exerted by the societal interest in compensation. This pressure follows from the fact that, from a societal perspective, liability claimants are important beneficiaries of liability

¹⁹ See Heimer (1985). Cf. Baker (1996).

²⁰ See generally, Baker (1994).

²¹ cf. Donahue and Siegelman (1991) (explaining increase in employment discrimination claims during the period from 1970 to 1989 despite the apparent decline in discrimination).

insurance contracts. It is liability insurance that makes liability law a risk-spreading system, and a liability insurance contract does not spread risk unless it pays claims.²² Thus, liability claimants are, in an important (but not necessarily formal legal) sense, third-party beneficiaries of liability insurance contracts.

Other types of insurance contracts also regularly have third-party beneficiaries. But the third-party beneficiaries of these other insurance contracts tend to have formal relationships with the policyholder, typically contractual or familial (such as an employer, spouse or parent). The existence of these formal relationships strengthens the equitable position of the insurer seeking to strictly enforce the insurance contract. A contractual relationship between the third-party beneficiary and the policyholder gives the beneficiary the possibility of control over the policyholder's choice of insurance contracts. And a familial relationship between the beneficiary and the policyholder is typically (even if sometimes wrongly) understood to mean that the policyholder is acting in the best interests of the beneficiary in selecting the insurance. This possibility of control or apparent alignment of interest allows a strict construction of these other insurance contracts to rest more easily on the bedrock of consent that remains so important to contract law (cf. Kessler, 1993).

In contrast, the injured parties who are the beneficiaries of liability insurance contracts only rarely are in a contractual or familial relationship with the policyholder and, thus, will not be understood to have had the possibility of control or an alignment of interest. Thus, strict construction of liability insurance contracts against the interests of these third-party beneficiaries rests less easily on the bedrock of consent. As a result (all other things being equal), liability insurers can be less confident about the meaning of their insurance contracts in any particular context unless and until the contracts have been tested in litigation over the meaning of the contract in that context.²³ Changing either the contract or the context leads the contract risk to reappear.

Financing risk

The discussion so far has focused on risks that affect the liability side of the insurance business. To recap, the baseline risk is the risk of loss based on past experience, assuming no change; developments risk is the risk of change in the rate or cost of loss during the insured period; and contract risk is the risk that the definitive legal meaning given to the insurance contract in the future will vary from that assumed by the insurer at the time of sale.

Insurers also face substantial risks on the asset side of their business. The category of "financing" risk encompasses that asset-side risk. Two important aspects of financing risk are investment risk and underwriting cycle timing risk. Undoubtedly, there are other asset-side risks that I have overlooked.

Investment risk. Insurers receive money, today, in return for the promise to pay claims in the future, and they invest that money in the meantime. This leads to investment risk, which is

²² It is commonplace for economic analysts to note that first-party insurance is a more efficient approach to risk-spreading (i.e. compensation) than liability insurance and then to focus exclusively on the deterrence (cost internalization) aspects of liability. See e.g. Shavell (2000) at 178. A realistic account of liability insurance, however, must acknowledge that compensation is widely regarded as one of the primary goals of liability law.

²³ The "all other things being equal" caveat should be taken seriously. For example, compare the uncertainty faced in litigating one of the many relatively untested exclusions in a commercial property insurance policy with the uncertainty faced in litigating standard liability insurance exclusions (which have been tested in countless court cases).

the risk related to changes in the value of, or income earned on, invested funds. Insurance premiums are based, not only on the baseline risk and a projection of developments risk, but also on projections regarding the value of assets in which the money is invested and the income that is earned on those investments (as well as administrative costs, which this essay otherwise ignores).

All other things being equal, the investment risk will be proportional to the amount of assets under investment and the length of time between collecting premiums and paying claims. As compared to many other forms of insurance, liability insurance requires insurers to invest premiums for a longer period, thereby exposing them to greater investment risk.²⁴ Property, health, and term life insurers make the vast majority of their claim payments within 12 months after the end of a one-year policy period;²⁵ as long as these insurers match their assets to their liabilities, they should have comparatively little investment risk. In contrast, liability insurance claims tend to be slower to come in and slower to resolve, with the result that there is a much longer time between collecting premiums and paying claims. This pattern varies considerably among lines of liability insurance, with automobile liability insurance claim payment patterns looking much more like property insurance claim payment patterns than general liability or medical liability insurance.

Underwriting cycle timing risk. Partly as a consequence of cycles in investment returns, and for other reasons that relate to the uncertainty that is inherent in taking money today to pay claims in the future, there are cycles in the pricing of insurance, commonly referred to as “underwriting cycles” (Harrington and Niehaus, 2000; Cummins *et al.*, 1991). During some periods, competitive dynamics in the market lead insurers to charge premiums that are below cost (the “soft” part of the cycle) and, during other periods, insurers are able to charge premiums that are above cost (the “hard” part of the cycle). In the long run, premiums must cover costs, but insurance policies typically are priced on a year-by-year basis, so that the contracts sold in any particular year will involve an underwriting cycle timing risk. The underwriting cycle timing risk is the risk that the price charged for the insurance will either be above or below cost because of the “position” of the insurance underwriting cycle at the time the insurance was sold.

The precise causes of insurance underwriting cycles are poorly understood. The leading causes suggested by economists are interest rate cycles and capital shocks (e.g. catastrophe losses), but it is generally acknowledged that these factors only partially explain the cycle and that they provide better explanations for the “hard” part of the cycle than the “soft” (Harrington and Niehaus, 2000). Industry observers have tended to rely on behavioral explanations such as herd behavior and the winner’s curse, which provide more complete (but difficult to test) explanations for the cycle, and for the soft part of the cycle in particular (Stewart, 1984; Fitzpatrick, 2003; cf. Harrington and Danzon, 1994).

The analysis of liability developments risk above lends credence to the behavioral explanation. The forms of liability insurance with the most extreme underwriting cycles (e.g. medical malpractice and products liability) are also those that face the greatest developments

²⁴ For bonds held to maturity and matched to liabilities, the only investment risk will be insolvency risk. Other assets cannot be matched as closely to liabilities. For these other assets, the longer the duration of liability, the greater the investment risk.

²⁵ The exception for property insurance policies are catastrophes, which require property insurance companies to hold large reserves for infrequent, very expensive events. These reserves may explain the fact that property insurance underwriting cycles are more severe than life and health insurance underwriting cycles. See Jaffee and Russell (1997) for an illuminating discussion of why insurers may not hold adequate catastrophe reserves.

risk and, thus, the greatest uncertainty at the time of sale about the ultimate costs of the insurance. The greater the uncertainty, the more room there is for the behavioral pressures of the underwriting cycle to influence assumptions about the future, hence the wider the swings of that cycle.

Conclusion: liability insurance and insurability

As noted in the introduction, prior work has done much to explain the uncertainties of liability insurance in terms of the duration of liability: the longer the duration of liability (the longer the “tail” in the language of the trade), the longer the time between pricing the insurance coverage and discovering what providing that coverage actually costs. Yet it is not the duration of liability, *per se*, that creates the uncertainty. After all, life insurance contracts have a much longer duration of liability than liability insurance contracts (apologies for the double use, and meaning, of the word “liability” but I did not invent these terms), yet life insurers tend not to worry very much about developments risk, in marked contrast to liability insurers. On the other hand, life insurers tend to worry much more about investment risk than liability insurers, because life insurers attempt to squeeze more competitive advantage out of asset management.

As this suggests, extending the duration of liability does not create risks; it magnifies them. A long duration of liability matters because it magnifies developments risk, contract risk, and financing risk. A long duration of liability creates *insurability* problems only to the extent that insurers lack confidence in their ability to manage those risks over that duration.

In discussing insurability, it is helpful to keep in mind the pragmatic observations of Walter Karten in *The Geneva Papers*, who emphasized that “insurability knows no basic formula” and “insuring risks is not a matter of general laws, [but] rather a problem of deciding” (Karten, 1997, at 516). In other words, insurability cannot be determined by careful application of neutral principles to objective facts (even assuming that there are such things), because nothing is insurable unless and until there is an insurer willing to accept the risk at a price that the entity bearing the risk is willing to pay. This does not mean that nothing useful can be said about the conditions affecting insurability, simply that all such statements must be regarded as provisional and that there is an unavoidably subjective element to insurability.

For liability insurance, it is only developments risk, and the magnification of the effects of that risk through the underwriting cycle, that appears to raise significant insurability concerns at present. While baseline risk, contract risk, and investment risk are, of course, very important to an overall understanding of liability insurance arrangements, they do not pose a threat to insurability. If the baseline risk is high, then the value of insurance is sure to be high, and the only “insurability” problem is affordability. Demonstrating that contract risk does not pose a threat to insurability is less straightforward, but aside from hyperbolic statements based on a misunderstanding of insurance contract law,²⁶ there does not appear to be concern about

²⁶ See e.g. Karten (1997) at 521 (“I doubt that any single insurer or association will ever succeed in wording covenants that withstand [*sic*] before a U.S.-American jury”). In the U.S. legal system, juries do not interpret contracts, judges do. While U.S. judges are responsive to the contract risk factors addressed in the text, a careful analysis of U.S. insurance law decisions reveals a picture that is inconsistent with the image of lawless, ad hoc and reflexively pro-policyholder decision-making apparently held by some insurance company executives. See generally, Baker (1994), especially at pp. 1416-1418 and notes 77 and 78.

While it is undeniably the case that U.S. judges, on very rare occasions, refuse to give effect to exclusionary language in standard form insurance policies, those decisions almost invariably can be justified on the basis that

the ability of insurers to manage contract risk.²⁷ Contracts need to be priced to take account of the contract risk factors addressed above; and continual attention must be paid to the treatment of contract language by the courts. But for insurability purposes, we can set those issues aside. Similarly, although investment risk is hardly irrelevant to the liability insurance business, I am aware of no suggestions that it poses an insurability problem.²⁸

What we find instead are suggestions that liability developments risk threaten the ability of liability insurers to offer certain kinds of insurance, most notably in the U.S. at present, medical liability insurance.²⁹ According to some sources, claim costs are increasing so rapidly and surprisingly that insurers lack confidence in their ability to price the risk (GAO, 2003). While claims of this sort are always subject to professional doubt,³⁰ examining the medical liability insurance situation helps illustrate the challenge posed by development risks to liability insurance (and in the process shows how the framework developed in the main part of this essay can be used to compare the risks posed in different fields of activity).

Medical liability developments risk

In considering the insurability of medical liability risks, it is worth asking “compared to what?” A good place to start the comparison is automobile liability, the largest liability insurance line in the U.S., and one that, absent extreme political interference in rate-setting, seems not to pose insurability problems.

It is commonly and casually observed that medical liability insurance has a longer tail (duration of liability) than automobile liability insurance and that this explains the difference in the relative stability of auto insurance prices as compared to medical liability insurance. That medical liability insurance has a longer tail is certainly true when medical liability insurance is sold on an occurrence basis. Occurrence-based liability insurance coverage generally provides protection against claims that arise out of harm that occurred during the policy period, regardless of when a claim based on the harm is made. And the nature of medical liability is such that insurers often do not learn about claims until many years after

insurers sold the insurance policies in question in a manner that reasonably led consumers to believe that they would have insurance to cover the risk in question: see e.g. *C Fertilizer, Inc. v Allied Mutual Insurance*, 227 N.W. 2d 169 (Iowa 1975). Alternatively, insurers may have led the insurance regulators that approved the form to believe that the exclusion would not apply to the kind of claim in question: see e.g. *Morton International v General Accident Ins. Co. of America*, 629 A.2d 831 (N.J. 1993). These two cases represent the most extreme examples of “judicial activism” in insurance contract interpretation in the U.S. In my view, both are correct decisions. Whether I am right or not, however, a careful analysis of these cases and the far more numerous cases adopting a formal approach to insurance contract interpretation should alleviate concerns about the ability of insurers to manage insurance contract risk.

²⁷ Even in the asbestos arena, the problem for insurers was not contract risk. While insurers are understandably disappointed with some of the asbestos insurance coverage decisions of the courts, these results are attributable in large part to the fact that the insurance contracts were not drafted (or priced) with massive asbestos-type liabilities in mind. Thus, it cannot be said that the courts have interpreted the contracts contrary to insurers’ intent, because the insurers could have had no specific intent with regard to these unforeseen risks.

²⁸ In a recent issue of *Sigma*, Swiss Re reports that no reinsurer has ever failed because of asset side risks (Swiss Re, 2003).

²⁹ See e.g. Swiss Re presentation at Geneva Assembly, June 2003; cf. Holsboer (1995) at 410.

³⁰ See e.g. Faure (1995) at 459; see also Cane (1989).

the harm began.³¹ In contrast, insurers almost always learn about automobile liability claims relatively shortly after the harm.³² Thus, with the occurrence form of medical liability insurance coverage, medical liability insurance has a longer duration than automobile liability insurance (because of the longer delay between the policy period and the time claims are made).³³

The switch to the “claims-made” form of medical liability insurance eliminates this difference, however.³⁴ A claims-made policy provides coverage only for claims made during the policy period, so all of the medical liability claims covered under a claims-made policy must be made during the policy period. Thus, with a claims-made policy medical liability insurance, the period between the time of the negligent act and the time of the resulting claim no longer matters to the duration of liability. Yet automobile liability policies continue to cover claims arising out of an automobile accident, regardless of when the claim is made, so on that count at least automobile liability insurance would seem to have the longer duration of liability.

There remains a crucial difference between automobile and medical liability claims that cuts in the opposite direction. Most automobile liability claims are resolved relatively soon in time after they are made, while most medical liability claims take several years or longer to resolve.³⁵ In large part this is because most auto liability claims are for relatively minor injuries, with relatively small amounts of damages,³⁶ and there appears to be a well-functioning system for settling those claims quickly. In addition, when the damages from an automobile accident are very substantial, the relatively low automobile liability policy limits purchased by many consumers means that the insurer pays the policy limit to the victim relatively quickly (as compared to medical liability cases at least). Thus, in order for an automobile liability claim to take very long to resolve, one of two conditions must hold. Either there is a breakdown in the local understanding among insurance companies and personal injury lawyers about the valuation of automobile injuries, or there is the combination of a serious injury and a large automobile insurance policy. Medical liability claims, in contrast, are almost never paid without litigation and are almost never brought by experienced lawyers

³¹ Reasons for this include the fact that some injuries do not become apparent until years after the acts that caused them (which extends the period during which a claim legally can be brought) and that it can be very difficult to find a lawyer willing to bring a medical malpractice action. This latter fact is contrary to industry lore; some of the reasons why it is difficult to find a lawyer are explored in Werth (1998).

³² Because injuries from auto accidents are obvious, an automobile insurer can be completely certain that all of the claims from a given policy year will be made within the number of years that corresponds to the statute of limitations in the given jurisdiction, and experience suggests that most of the claims will be made within the first year after the accident, in part because it is so easy to find a lawyer willing to bring an automobile case.

³³ Recent insurance industry loss statistics illustrate this point. The industry estimates that it will ultimately pay U.S. \$ 51.2 billion to indemnify its policyholders from automobile accidents that occurred in 1998. Of that U.S. \$ 51.2 billion, U.S. \$ 40.7 billion, or nearly 80 per cent, was settled and paid by the end of 2000. By contrast, the industry settled and paid only 17.5 per cent of estimated liabilities from occurrence-based medical malpractice policies over the same time period: A.M. Best (2001), at 232–243.

³⁴ There remains a substantial amount of occurrence based medical liability coverage in the U.S. market (A.M. Best, 2001, at 216). The following discussion applies only to claims-made coverage.

³⁵ The insurance industry settled nearly 80 per cent of its 1998 automobile liabilities by the end of 2000: see Note 32 above. It settled and paid only 51.5 per cent of its claims-made medical malpractice liabilities in the same period (A.M. Best, 2001, at 232–243).

³⁶ In 1996 the insurance industry paid U.S. \$ 45.1 billion to settle 13.8 million private passenger automobile claims – an average of only U.S. \$ 3,478 per claim (A.M. Best, 2001, at 237). Many automobile liability insurance claims are for property damage only.

unless the injuries are substantial,³⁷ with the result that the average time between making a claim and making a payment is much longer (see e.g. Werth, 1998).

On average, then, the duration of liability remains longer in medical liability insurance than in auto liability insurance, even with the shift to claims-made medical liability insurance coverage.³⁸ But that difference disappears for larger automobile liability claims paid under automobile insurance policies with higher limits. Indeed, for the most serious automobile accident claims and the highest value policies, the duration of liability is likely to be longer for automobile liability. Lawyers tend to delay filing suit in serious injury cases until they are able to determine the full extent of permanent disability. This means that up to the full period of the statute of limitations needs to be added to the period required to resolve the claim in order to determine the duration of liability for serious automobile liability claims.

Yet there is no talk of “crisis” in high-limit auto liability insurance policies,³⁹ apparently because insurers are sufficiently confident of their ability to price auto liability developments risk. Working through the liability developments risk framework helps explain why. The comparatively stable automobile technology means low injury and standard of care developments risk. The comparatively stable state of automobile accident law (both on the books and in action) means low legal developments risk. And a mature and widespread automobile claiming system means low claiming developments risk.

By contrast, medical technology and practice are advancing, creating significant injury and standard of care developments risk. Medical liability law appears to be in the process of changing in a number of directions, creating significant legal developments risk.⁴⁰ And the ratio between medical malpractice claims and medical malpractice incidents is so low,⁴¹ and the future social norms about medical claiming so uncertain, that claiming developments risk may well be the most significant aspect of liability developments risk of all.

The only aspect of liability developments risk that appears to be roughly similar for medical liability and serious automobile liability claims is injury cost developments risk. Although medical malpractice damage awards traditionally have been higher than automobile or products liability awards for similar injuries (Dewes *et al.*, 1995, at 100), the current debates over medical malpractice reform has not produced evidence that the gap is changing. Moreover, there is no obvious reason for the gap to have increased.⁴² Yet, ironically, injury costs development risk is the focus of efforts to address the rising cost of medical liability insurance, namely the effort to enact a statutory cap on the amount of damages that can be

³⁷ The median medical malpractice payment in 1996 was U.S. \$ 72,500, more than 20 times greater than the average automobile liability claim: Div. of Practitioner Databanks, U.S. Dep’t of Health & Human Servs., National Practitioner Databank Public Use Data File (March 2003), available at <http://www.npdb-hipdb.com/publicdata.html>.

³⁸ See Note 35 above.

³⁹ It is always difficult to prove a negative. If there were such a crisis it would affect personal lines umbrella insurance policies first.

⁴⁰ An example of a “law on the books” legal development is the partial erosion of the special rule in medical malpractice cases in which the standard of care is determined only by reference to customary practices in the medical field (Mello *et al.*, 2003). An example of a “law in action” legal development is more effective case selection by existing medical malpractice specialists (allegedly in response to the 1980s era tort reforms) which is one explanation for the higher average size of settlements (discussion at roundtable sponsored by Insurance Law Center and The Geneva Association at New York University Law School, August 2002). This latter development is almost certainly going to draw other personal injury lawyers into the field.

⁴¹ See e.g. Weiler *et al.*, 1993.

⁴² Given the other developments in the medical liability area and the continuing effects of the 1980s era tort reforms, the increase in severity among medical malpractice claims is more plausibly explained by greater selectivity among plaintiffs’ lawyers as well as medical price inflation.

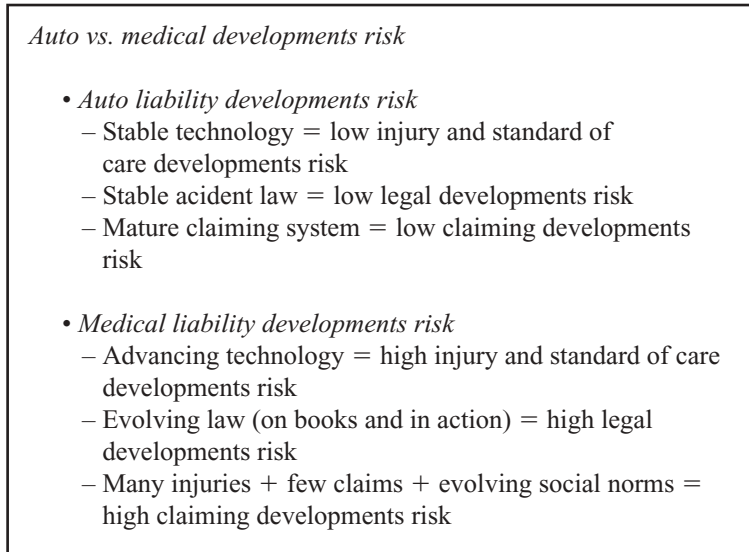


Figure 6

awarded for pain and suffering (GAO, 2003). If pain and suffering damages really posed such a threat to insurability, then there would be cost and availability problems in the high-limit automobile liability insurance market as well. The situation calls to mind that of the homeowner who, when asked why he was using a hammer to fix a leaking pipe, replied “That’s the only tool that I have”.

A call for research

If liability insurers are to move beyond hitting leaking pipes with hammers, they need a better understanding of liability developments risk and what they can do to manage that risk. For that they need more research, particularly more research on liability law in action. Most people associate legal research with an effort to discover what legal rule governs or should govern a particular type of situation. Without denigrating that type of “law on the books” research, which remains very relevant to legal practice, there are other types of legal research that are more relevant to insurers attempting to create and price liability and related types of insurance. These other aspects of research are more directed at law in action. This “socio-legal” research attempts to describe tort and compensation as a social field, with less concern about what tort law ought to be and more concern about the scope, extent and social meaning of tort law as it exists in the world (e.g. Saks, 1992).

Some of the topics addressed in socio-legal research include:

- why/when people claim: the process of naming, blaming and claiming;
- tort litigation statistics: what we do and do not know about the extent of tort litigation;
- study of tort institutions: how the norms and social structures of the personal injury bar

shape tort litigation; likewise with regard to the norms and social structures of liability insurance institutions;

- econometric studies linking legal rules, accident rates, and claiming behavior; attempts to measure the effects of changes in legal rules on behavior;
- tort in media/popular culture: how tort law is portrayed in the media and popular culture and how those portrayals feed back into approaches to claiming, settlement and litigation;
- legal history: examining the development of liability institutions over time.

This research is highly relevant to understanding and predicting legal risk. Many people are familiar with research on the U.S. civil justice system by RAND, at least some of which has been funded by insurers.⁴³ There is more research out there by people who, although they might initially be suspicious of the insurance industry, would welcome support as long as it was not conditioned on biasing their research. (If the goal is to study and predict legal development risk, biasing the research would be counterproductive.)

While there are many potential obstacles to serious insurance industry support for socio-legal research, the most significant one may well be ideological. As a long-time observer of the insurance industry, for most of that time from an outsider perspective (e.g. as a young lawyer, my first insurance case was in the consolidated asbestos insurance coverage cases in California, in which my firm represented a large U.S. manufacturer), I have come to the conclusion that, with regard to legal developments risk, insurance industry leaders are blinded to some degree by ideology.

Perhaps it is a case of over-identification with their clients, but there is a sense that the insurance industry has a moral obligation, over and above its financial interest, to stand as a bulwark against the “litigation explosion”, the “compensation culture”, and “consumerism” in general. I am left with the distinct impression that industry leaders believe that these trends are to be resisted, not understood, and that to attempt to understand them is to affirm them.

Personally, I happen to disagree that these trends are entirely, or even largely, unfortunate. I will not try to convince you here, but my basic reason turns on the need in a market economy to have liability regimes that require organizations to internalize costs (whether of deceptive sales practices by life insurance companies or defective products sold by manufacturers with liability insurance policies). This is not to say that there are not some excesses – breast implant litigation may be one – but liability can be a very healthy process of holding people responsible.

Regardless of who is right about the moral and social merits of these trends, however, they exist and they need to be understood. As the ongoing medical malpractice situation in the U.S. has demonstrated, tort reform has not worked to eliminate or even dampen the liability insurance underwriting cycle, and if established liability insurance companies walk away from substantial risks, economic actors will find alternative ways to transfer those risks, which is not in the long-term interests of existing liability insurers.

REFERENCES

- A.M. BEST CO., 2001, *Aggregates and Averages Property/Casualty*.
 BAKER, T., 1994, “Constructing the Insurance Relationship: Sales Stories, Claims Stories and Insurance Contract Damages”, *Texas Law Review*, 72, pp.1395–1433.
 BAKER, T., 1996, “On the Genealogy of Moral Hazard”, *Texas Law Review*, 75, pp. 237–292.

⁴³ This research can be found at www.rand.org.

- BAKER, T., 1998, "Reconsidering Insurance for Punitive Damages", *Wisconsin Law Review*, pp. 101–130.
- BUTLER, R.J. and WORRALL, J.D., 1991, "Claims Reporting and Risk Bearing Moral Hazard in Workers Compensation", *Journal of Risk and Insurance*, 58, p. 191.
- CANE, P., 1989, "Liability Rules and the Cost of Professional Indemnity Insurance", *The Geneva Papers on Risk and Insurance*, 14, pp. 347–359.
- CARROLL and ABRAHAMSE, 2001, "The Frequency of Excess Auto Personal Injury Claims", *American Law & Economics Review*, 3, p. 228.
- CARROLL, S.J. *et al.*, 2002, "Asbestos Litigation Costs and Compensation", *Rand Inst. for Civil Justice*.
- CONNECTICUT GENERAL ASSEMBLY 1993, Public Hearings on Insurance and Real Estate, 1993 Sess., pp. 357–502.
- CUMMINS, J.D., HARRINGTON, S.E. and KLEIN, R.W., 1991, "Cycles and Crises in Property/Casualty Insurance: Causes and Implications for Public Policy", Kansas City: National Association of Insurance Commissioners.
- DEWES, D., DUFF, D. and TREBILCOCK, M., 1996, *Exploring the Domain of Accident Law: Taking the Facts Seriously*. New York and Oxford: Oxford University Press.
- DONAHUE, J.J. and SIEGELMAN, P., 1991, "The Changing Nature of Employment Discrimination Litigation", *Stanford Law Review*, 43, pp. 983–1033.
- EISENBERG, T., GOERDT, J., OSTROM, B., ROTTMAN, D. and WELLS, M.T., 1997, "The Predictability of Punitive Damages", *J. Legal Studies*, 26, p. 623.
- EISENBERG, T., LAFOUNTAIN, N., OSTROM, B., ROTTMAN, D. and WELLS, M.T., 2002, "Judges, Juries and Punitive Damages: An Empirical Study", *Cornell Law Review*, 87, p. 743.
- FAURE, M.G., 1995, "The Limits to Insurability from a Law and Economics Perspective", *The Geneva Papers on Risk and Insurance*, 20, pp. 454–462.
- FITZPATRICK, S., 2004, "Fear is the Key: Observations on Underwriting Cycles", *Connections Insurance Law Journal*, forthcoming.
- GENERAL ACCOUNTING OFFICE, 2003, "Medical Malpractice: Implications of Rising Premiums on Access to Health Care", GAO-03-836. Washington, D.C. U.S. GAO.
- HARRINGTON, S.E. and DANZON, P., 1994, "Price Cutting in Liability Insurance Markets", *Journal of Business*, 67, pp. 511–538.
- HARRINGTON, S.E. and DANZON, P., 2000, "The Economics of Liability Insurance", in G. Dione, *Handbook of Insurance*. Boston, Dordrecht, London: Kluwer Academic.
- HARRINGTON, S.E. and NIEHAUS, G., 2000, "Volatility and Underwriting Cycles", in G. Dione, *Handbook of Insurance*. Boston, Dordrecht, London: Kluwer Academic.
- HEIMER, C.A., 1985, *Reactive Risk and Rational Action: Managing Moral Hazard in Insurance Contracts*. Chicago: U. Chicago Press.
- HENDERSON, J., 2002, "Echoes of Enterprise Liability in Product Design and Marketing Litigation", *Cornell Law Review*, 87, pp. 958–999.
- HOELSBOER, J.H., 1995, "Insurability and Uninsurability: An Introduction", *The Geneva Papers on Risk and Insurance*, 20, pp. 407–413.
- JAFFEE, D.M. and RUSSELL, T., 1997, "Catastrophe Insurance, Capital Markets and Uninsurable Risks", *Journal of Risk and Insurance*, 64, pp. 205–230.
- KARTEN, W.T., 1997, "How to Expand the Limits of Insurability", *The Geneva Papers on Risk and Insurance*, 22, pp. 515–522.
- KESSLER, F., 1943, "Contracts of Adhesion – Some Thoughts About Freedom of Contract", *Columbia Law Review*, 43, pp. 629–42.
- LOUGHRAN, D.S., 2001, "The Effect Of No-Fault Automobile Insurance On Driver Behavior And Automobile Accidents In The United States", *13 Rand Inst. for Civil Justice*.
- MELLO, M.M., STUDDERT, D.M. and BRENNAN, T.A., 2003 "The Leapfrog Standards: Ready to Jump From Marketplace to Courtroom?" *Health Affairs*, 22, pp. 46–59, March/April.
- ROSS, H.L., 1970, *Settled Out of Court* Chicago: Aldine Press.
- SAKS, M.T., 1992, "Do We Really Know Anything about the Behavior of the Tort Litigation System – And Why Not?" *University of Pennsylvania Law Review*, 140, p. 1147.
- SHAVELL, S., 2000, "On the Social Function and the Regulation of Liability Insurance", *The Geneva Papers on Risk and Insurance*, 25, pp. 166–179.
- SPIER, J., 1998, "Long Tail (Liability) Risks and Claims Made Policies", *The Geneva Papers on Risk and Insurance*, 23, pp. 152–168.
- STEWART, B.D., 1984, "Profit Cycles in Property-Liability Insurance", in J.D. Long, *Issues in Insurance*. Malvern: American Institute for Property and Liability Underwriters.
- STEWART, B.D., STEWART, R.E. and RODDIS, R.S.L., 1991, "A Brief History of Underwriting Cycles", in

- Cummins *et al.*, *Cycles and Crises in Property/Casualty Insurance: Causes and Implications for Public Policy*. Kansas City: National Association of Insurance Commissioners.
- STONE, D., 2002, "The Moral Opportunity of Insurance", in T. Baker and J. Simon, *Embracing Risk: The Changing Culture of Insurance and Responsibility*. Chicago: University of Chicago Press.
- SWISS RE, 2003, *Sigma*. July.
- SYVERUD, K., 1994, "On the Demand for Liability Insurance", *Texas Law Review*, 72, pp.1629–1654.
- WEILER, P.W., HIATT, H.H., NEWHOUSE, J.P., JOHNSON, W.G., BRENNAN, T.A. and LEAPE, L.L., 1993, *A Measure of Malpractice: Medical Injury, Malpractice Litigation, and Patient Compensation*. Cambridge, MA: Harvard U.P.
- WERTH, B., 1998, *Damages*. New York: Random House.