

NOTES

A TALE OF TWO THEORIES—IS THE LEGAL SYSTEM RESPONSIBLE FOR THE INSURANCE CRISIS?

INTRODUCTION

The battle lines have been drawn, and the combatants are deeply entrenched, prepared for a long war. On one side of the skirmish line, the insurance industry, allied with the Reagan Administration, recommences its onslaught against the tort law system, which it blames for the current crisis in the availability and affordability of insurance coverage.¹ Supporting the insurance industry's position, the Reagan Administration² established the Tort Policy Working Group,³ which issued a report in 1986 that called for fundamental changes in tort law as the only viable solution to the insurance crisis.⁴

Consumer groups⁵ and some members of the legal profession⁶ oppose

1. The insurance industry attributes the lawsuit "explosion" to recent developments in tort law that have made it easier for plaintiffs to win judgments. See OFFICE OF THE UNITED STATES ATTORNEY GENERAL, REPORT OF THE TORT POLICY WORKING GROUP ON THE CAUSES, EXTENT AND POLICY IMPLICATIONS OF THE CURRENT CRISIS IN INSURANCE AVAILABILITY AND AFFORDABILITY 2 (1986) [hereinafter cited as TORT POLICY WORKING GROUP].

The term "insurance crisis" is used to describe the situation in which manufacturers and other groups cannot obtain affordable and adequate insurance coverage. Concurrently, the insurance industry experiences financial difficulties because of payouts for insureds. See *id.* at 6; INSURANCE INFORMATION INSTITUTE, THE LAWSUIT CRISIS 2 (1986) ("the number of personal injury, product liability or property damage suits has created a crisis").

The current insurance crisis is not the first time that the insurance industry has claimed financial distress of crisis proportions. In 1974, the industry suffered \$5 billion in underwriting losses and \$10 billion in losses on investments in common stock. See Saks, *If There Be A Crisis, How Shall We Know It?*, 46 MD. L. REV. 63, 75, n.46 (1986).

2. The Reagan Administration supports the insurance industry's contention that tort reform is necessary to defuse the insurance crisis. See TORT POLICY WORKING GROUP, *supra* note 1, at 60-75.
3. The agencies involved with the study include the Department of Justice, the Department of Commerce and the Small Business Administration. See TORT POLICY WORKING GROUP, *supra* note 1, at 1-2.
4. In response to the insurance industry's calls for tort reform, the Tort Policy Working Group made eight recommendations. These recommendations include: returning to fault as the primary basis of liability; basing causation on "credible" scientific and medical evidence and opinions; eliminating joint and several liability; establishing in periodic payments for future economic damages; including collateral sources in the determination of damage awards; limiting contingency fees; and developing alternative methods of dispute resolution. See *id.* at 60-75.
5. Ralph Nader exemplified the consumer position in his response to the industry's move to limit damage awards to injuries caused by "dangerous" products: "It scares me when we begin talking about restricting a legal system that gives individuals a right to seek full compensation [only] if a product, chemical, car or anything hurts their bodies." *Congress Looks at Liability Insurers*, N.Y. Times, Feb. 24, 1986, at D1, col. 2.
6. Groups such as the American Trial Lawyers Association, as well as many individual members

this position, arguing that the insurance industry alone is responsible for the coverage crisis. They claim the insurance crisis has been exaggerated by insurance lobbyists to rally support for legislation that would benefit the industry.⁷ Although allegations of frivolous lawsuits and counter-allegations of tragically uncompensated victims abound,⁸ manufacturers and consumers find themselves faced with higher insurance premiums,⁹ higher product costs¹⁰ and a growing scarcity of vital services.¹¹ For these insureds, the crisis is a reality, as it becomes increasingly difficult to obtain or afford adequate coverage.¹²

THE NATURE OF THE CRISIS

Is the insurance crisis the product of the misapplication of tort law, distorted to meet the demands of an overly litigious society, as the

of the bar, believe the insurance industry's bad investment and underwriting practices primarily have caused the industry's financial woes. See Rosenblatt, *Manufactured 'Crisis,' Dumped on Consumer* NAT'L L.J., Sept. 1, 1986, at 12, col. 2 (letter to the editor).

7. See *id.*

8. Some celebrated examples of exaggerated awards later have been revealed to be legitimate. One case involved an allegedly overweight man with coronary disease who was awarded \$1.75 million after suffering a heart attack while trying to start his power lawn mower. In reality, the victim was a 32-year-old doctor with no prior heart trouble. He suffered a heart attack after pulling the mower's cord 15 times. The jury found that the engine's exhaust system failed to meet the manufacturer's own specifications. The plaintiff later agreed to settle for an undisclosed, reduced amount. See Church, *Sorry, Your Policy is Canceled*, TIME March 24, 1986, 16, 24-26.

Another case the insurance industry has cited to allege the tort system is overly generous involved the explosion of a commercial clothes dryer being used to dry a hot air balloon. Two men took the hot air balloon to a special dryer at an area hospital. The dryer vibrated violently before it exploded and seriously injured the men. They were awarded \$1.26 million for injuries. Although the dryer manufacturer had a patent for a device that would have shut off the dryer when it vibrated, the device was never installed because of the high cost. See *id.*

9. In 1982, 75% of corporations surveyed paid more than \$50,000 for primary insurance. By 1986, the percentage had increased to 90%. In addition, by 1986, one-third of the respondents reported premium increases of 100%, and the number of corporations that paid \$500,000 in premiums had doubled. Deductibles, however, remained relatively stable. The amount paid by one-fourth remained the same, and one-third of the respondents paid less than \$100,000. See CONFERENCE BOARD INSTITUTE, *PRODUCTS LIABILITY: THE CORPORATE RESPONSE* 4-7 (1987).

10. Eventually, the cost of insurance premiums paid by manufacturers resurfaces as increased consumer prices. In a poll of 232 major U.S. manufacturers and non-financial service corporations with minimum annual sales of \$100 million, 43% reported that insurance costs, litigation fees, awards and settlements have combined to raise the price of products and services. Two-thirds of the respondents, however, reported that the increase was one percent or less of the final price; 11% reported the price increase attributable to insurance-related costs to be two percent to three percent. See *id.* at v, 13.

Substantial insurance costs have hit some industries harder than others. The Sporting Goods Manufacturers Association, for example, reports that in 1980, \$11 of a product with a retail price of \$45 could be attributed to insurance-related costs. See *id.* at 13. The private aircraft industry is similarly situated. Beech Aircraft claims that for each aircraft it sells, \$80,000 is allocated for insurance premiums. The director of corporate communications laments, "The owner-pilot market has all but dried up, and one cause is the cost of product liability. It has driven the price of a new airplane out of reach of the average person who wants to buy one." See Church, *supra* note 8, at 16.

11. The inability to obtain adequate insurance has forced many municipalities to reduce services, remove public playground equipment, close public swimming pools, close jails and forgo police protection. Child care centers have become nearly uninsurable because of the potential liability for child abuse. See *id.* at 17-20, 23-24.

12. See TORT POLICY WORKING GROUP, *supra* note 1, at 26. Many business are going "bare" (with no liability insurance) or are forming self-insurance cooperatives because of the unavailability/unaffordability of liability insurance. See *id.* at 56-59.

insurance industry suggests? Or has it been exaggerated by the insurance industry to support changes in tort law that will make it more difficult for plaintiffs to win damage awards? Although both sides claim battlefield victories,¹³ the outcome of the war is still in doubt.¹⁴

The Insurance Industry's Allegations

To illustrate the need for tort reform, the insurance industry frequently claims that product liability cases have increased.¹⁵ The industry argues that the present tort law system has encouraged this increase by moving liability away from a fault-based standard.¹⁶ Hence, insurance-backed manufacturers have become easy deep-pocket defendants.¹⁷ Among the reforms demanded by the insurance industry to address this problem is a higher standard of proof.¹⁸ This would make it more difficult to show liability and, presumably, would decrease the number of successful suits.

13. Legislatures that passed tort reform expecting decreases in premium rates have been unpleasantly surprised at requests for rate increases by insurance companies. States that have yet to pass tort reform legislation are suspicious of the effects the reform will have on premium costs and are reluctant to act upon the insurance industry's requests for reform. See CONFERENCE BOARD INSTITUTE, *supra* note 9, at 18.

14. Uniform Product Liability Act (S. 2760) reported out of the Senate Commerce Committee in 1986. Further attempts at federal tort reform are certain to follow. See *id.*

15. A typical product liability case involves an injured plaintiff suing the manufacturer of a negligently designed or manufactured product. According to Prosser: "Product liability is the name currently given to the area of the law involving the liability of those who supply goods or products for the use of others to purchasers, users, and bystanders for losses of various kinds resulting from so-called defects in those products." W. PROSSER & W. KEETON, *PROSSER AND KEETON ON THE LAW OF TORTS* 677 (5th ed. 1984).

The Tort Policy Working Group report cites a 758% increase in the number of product liability suits filed in federal district courts between 1974 and 1985. TORT POLICY WORKING GROUP, *supra* note 1, at 2. The number of cases filed, however, does not reflect the number of cases that go to trial; approximately 50% of cases filed are settled before trial. See Galanter, *The Day After the Litigation Explosion*, 46 MD. L. REV. 3, 26 (1986) [hereinafter cited as *Litigation Explosion*]. In federal courts, the number of cases terminating in trials has declined, from 15.2% in 1940 to five percent in 1985. See Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (And Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 40 n. 13 (1983) [hereinafter cited as *Litigious Society*].

Neither is filing a measure solely of a plaintiff's eagerness to sue; filing also represents the defendant's refusal to satisfy a dispute. See *Litigation Explosion*, *supra*, at 3, 7. Many parties also use filing as a ploy in negotiations to demonstrate their seriousness. See *id.* at 40 n. 13.

16. See TORT POLICY WORKING GROUP, *supra* note 1, at 30-33. Although the Tort Policy Working Group connects "the movement toward no-fault liability" to the litigation "explosion" and the insurance crisis (see *id.* at 30), the average award to plaintiffs using strict liability as their primary theory of liability (\$549,324) was not significantly different than the average award to plaintiffs relying primarily on a negligence theory (\$559,602) in large-claim cases in 1985. The awards in strict liability cases, however, comprised 62.2% of the total large-claim payments; the awards in negligence cases comprised 32.7% of the total large claim payments. ALLIANCE OF AMERICAN INSURERS, AMERICAN INSURANCE ASSOCIATION, *A STUDY OF LARGE PRODUCT LIABILITY CLAIMS CLOSED IN 1985* 15 (1985) [hereinafter cited as *INSURANCE STUDY*].

17. A deep-pocket defendant is one with sufficient assets to ensure that a successful plaintiff can collect the award. The insurance industry claims that manufacturers face increasing lawsuits because their liability insurance coverage assures award recovery to the limit of the policy coverage. See generally Miller & Sarat, *Grievances, Claims, and Disputes: Assessing the Adversary Culture*, 15 L. & SOC'Y REV. 525 (1981).

18. See TORT POLICY WORKING GROUP, *supra* note 1, at 61, 62.

Actual product liability filings in federal and state courts, however, support the argument that the litigation explosion has been exaggerated.¹⁹ Although data provided by the Administrative Office of the United States Courts²⁰ show that product liability case filings have increased,²¹ there is no evidence of an astronomical increase in overall product liability case filings.²²

Areas of Product Liability Filing Increases

First, the increases seem to be specific to particular types of cases. For example, although case filings have increased substantially²³ in the areas of contracts, torts to land, property damage, and airline, marine and motor vehicles,²⁴ the area with the greatest singular increase between

19. Some commentators suggest that the insurance industry, using a multi-million dollar advertising campaign, is attempting to capitalize on the present availability/affordability crisis to enact legislation favorable to the insurance industry:

Risky investment or the vicissitudes of the market seem to play the largest part in whether insurance companies make or lose money. However much the industry might wish to pass legislation guaranteeing high returns on investment, that cannot be done. So one tries to change what can be changed: tort law. . . . If the public already is primed to believe that the problem is too many unwarranted lawsuits, greedy lawyers, crazy laws, and malingering plaintiffs, that can be used as the theme of an advertising campaign.

Saks, *supra* note 1, at 75. See also *The Manufactured Crisis*, 51 CONSUMER REP. 544, 545 (1986) (insurance industry spent \$6.5 million on an advertising campaign to convince the public to adopt its views).

20. Director of the Administrative Office of the United States Courts, Annual Report [hereinafter cited as [Year] ANNUAL REPORT[s]].

Beginning in 1974, the agency began recording product liability cases separately from other tort cases. The product liability categories include contract actions, torts to land, property damage, and the personal injury categories of airline, marine and motor vehicle. See 1974 ANNUAL REPORT at 218, 237; 1975 ANNUAL REPORT at 218; 1976 ANNUAL REPORT at 195; 1977 ANNUAL REPORT at 212; 1978 ANNUAL REPORT at 204; 1979 ANNUAL REPORT at 230; 1980 ANNUAL REPORT at 236; 1980 ANNUAL REPORT at 236; 1981 ANNUAL REPORT at 219; 1982 ANNUAL REPORT at 106; 1983 ANNUAL REPORT at 130; 1984 ANNUAL REPORT at 148, 150, 151; 1985 ANNUAL REPORT at 151, 154. The personal injury section was amended in 1975 by the introduction of a category named "other" to include product liability cases not represented by the existing sections. See also 1974 ANNUAL REPORT at 218, 237. This subsection was, in turn, amended in 1984 to separate asbestos cases from this category. 1984 ANNUAL REPORT at 148, 150, 151. For analysis, see *Litigation Explosion*, *supra* note 15, at 20-23.

21. 1975 ANNUAL REPORT, *supra* note 20, at 218. Product liability case filings in state courts have increased 272% from 2,886 in 19 to 10,745 in 1984. See 1984 ANNUAL REPORT, *supra* note 20, at 148, 150, 151; *Litigation Explosion*, *supra* note 15, at 21.
22. The present trend in litigiousness is not unprecedented. Several studies suggest that a higher per capita rate of civil litigation occurred in the colonial period, as well as in 19th and early 20th century America. See McIntosh, *150 Years of Litigation and Dispute Settlement: A Court Tale*, 15 L. & SOC'Y REV. 823 (1980-81), noted in *Litigation Explosion*, *supra* note 15, at 5 n. 12. See also generally M. SELVIN & P. EBENER, *MANAGING THE UNMANAGABLE: A HISTORY OF CIVIL DELAY IN THE LOS ANGELES SUPERIOR COURT 32-34* (1984), noted in *Litigation Explosion*, *supra* note 15, at 5. Regarding litigiousness in colonial America, see D. KONIG, *LAW AND SOCIETY IN PURITAN MASSACHUSETTS: ESSEX COUNTY, 1629-1692* (1979).
23. See *Litigation Explosion*, *supra* note 15, at 24. Case filings in this area increased 60% from 1,278 in 1975 (See 1975 ANNUAL REPORT, *supra* note 20, at 218) to 2,049 in 1985 (See 1985 ANNUAL REPORT, *supra* note 20, at 151, 154).
24. See 1974 ANNUAL REPORT, *supra* note 20, at 218, 237.

1974 and 1985 involved asbestos cases.²⁵ Asbestos cases counted for approximately thirty-one percent of all product liability case filings in 1985.²⁶ They contributed to almost twenty-five percent of all product liability case filings in the previous decade.²⁷ It is also possible that other major product liability suits, such as the Dalkon Shield²⁸ and DES²⁹ cases, have artificially inflated the numbers of case filings.³⁰

Federal court case filings should be distinguished from state court case filings.³¹ Only two percent of all civil litigation occurs in federal courts; the remaining ninety-eight percent occurs in state courts.³² Data suggest that the increase in the number of case filings in state courts between 1978 and 1984 paralleled the population growth.³³ Per capita filings increased by nine percent, while the population increased by eight percent. Two conclusions may be drawn from this evidence. First, state tort filings have increased less dramatically than tort reform advocates claim. Second, the increase in filings does not stem from an increase in litigation.

AWARDS AND JUDGMENTS

The legal reforms advocated by the insurance industry also include demands that the size of awards be limited. As evidence of this need, a 370% increase in the average jury award in product liability cases between 1975 and 1985 is frequently cited.³⁴ This figure, however, must be examined in context in order to understand its significance. First, most tort cases are settled out of court for sums much smaller than the verdict amounts.³⁵

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25. Asbestos cases were included in the "other" category until 1984. See 1979 ANNUAL REPORT, *supra* note 20, at 23. For a history of asbestos litigation, see generally D. HENSLER, W. FELSTNER, M. SEVEN & P. EBNER, *ASBESTOS IN THE COURTS: THE CHALLENGE OF MASS TOXIC TORTS* (1985); P. BRODEUR, *OUTRAGEOUS MISCONDUCT, THE ASBESTOS INDUSTRY ON TRIAL* (1985).
 26. *Litigation Explosion*, *supra* note 15, at 24, 25. It is estimated that during the 11-year period between 1974 and 1985, approximately 16,000 asbestos cases were filed in federal courts—a quarter of the 60,508 product liability case filings during this period.
 27. See *id.*
 28. See M. MINTZ, *AT ANY COST: CORPORATE GREED, WOMEN, AND THE DALCON SHIELD* 240 (1985).
 29. DES, or diethylstilbestrol, is a synthetic female hormone used since 1937 as a chemical substitute for estrogen. It was found to cause cancer in approximately one to four per 1,000 DES daughters and to reduce fertility in males. See Comment, *DES and a Proposed Theory of Enterprise Liability*, 46 *FORDHAM L. REV.* 963, 964 n.5 (1978), as noted in Dworkin, *Product Liability of the 1980s: "Repose is not the Destiny" of Manufacturers*, 61 *N.C.L. REV.* 40 (1982).
 30. See *Litigation Explosion*, *supra* note 15, at 25.
 31. See *id.* at 6. See generally NAT'L CENTER FOR STATE COURTS & CONFERENCE OF STATE COURT ADM'RS, *STATE COURT CASELOAD STATISTICS: THE STATE OF THE ART* (1978).
 32. See *Litigation Explosion*, *supra* note 15, at 7. Thus, the Tort Policy Working Group's extrapolation that state court case filings have increased at the same rate as federal court filings is questionable. See TORT POLICY WORKING GROUP, *supra* note 1, at 45.
 33. See TORT POLICY WORKING GROUP, *supra* note 1, at 6.
 34. See JURY VERDICT RESEARCH, INC., *INJURY VALUATION: CURRENT AWARD TRENDS* No. 304 (1986) (1986 data incomplete and subject to revision).
 35. In a sampling of medical malpractice cases for 1974-76, for example, the average verdict award was four times the size of the average settlement. P. DANZON, *MEDICAL MALPRACTICE: THEORY, EVIDENCE AND PUBLIC POLICY* 25 (1985). Plaintiffs in asbestos-related claims that went to trial received 2.28 times the compensation of similar claims that settled before trial. INSTITUTE FOR CIVIL JUSTICE, *THE RAND CORP., AN OVERVIEW OF THE FIRST SIX PROGRAM YEARS* 64 (1986) [hereinafter cited as *ASBESTOS STUDY*].

Only five percent to ten percent result in jury verdicts.³⁶ Of these, many are overturned or reduced on appeal or in post-verdict settlements.³⁷

Furthermore, the "average" figure does not present an accurate picture because it is skewed by unusually high awards.³⁸ Jury awards tend to be much lower than the "average." In Cook County, Ill., for example, 87.7 percent of all jury awards in 1983 were below the average figure given for that year.³⁹ In addition, a sudden variation in the average figure may not reflect a pattern in overall tort claim payments.⁴⁰ Large verdicts may be representative only of a particular type of case (such as an asbestos case) or an unusually serious case.⁴¹

The Tort Policy Working Group's report attributes the increase in jury awards solely to increases in non-economic compensation, such as pain and suffering awards.⁴² But the increases have other reasonable explanations. First, they might reflect rising medical costs, which quadrupled between 1967 and 1985.⁴³ The fall in interest rates during the 1980s

36. *Litigation Explosion*, *supra* note 15, at 7. The number of jury trials has also decreased in recent years. See, e.g., M. SHANLEY & M. PETERSON, CIVIL JURY VERDICTS IN SAN FRANCISCO AND COOK COUNTY 1959-80, 19, 20 (1983). Factors related to the likelihood of trial in asbestos-related injuries include:

1) the type of injury. Mesothelioma claims went to trial at a rate of 14%, compared with seven percent for other types of asbestos-related injuries;

2) the state in which the claim was filed. Claims filed in Missouri, for example, were much more likely to go to trial (about one-third of those filed) than those in California or New Jersey (one percent or less);

3) the number of plaintiffs. In this sample, no claims involving 50 or more plaintiffs went to trial. See ASBESTOS STUDY, *supra* note 35, at 64.

37. The Rand Corporation estimates that the average total compensation paid per tort lawsuit in 1985 was between \$24,000 and \$29,000. J. KAKALIK & N. PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION 69 (1986).

38. P. DANIELS, PUNITIVE DAMAGES: A STORM ON THE HORIZON? PRELIMINARY REPORT OF THE PUNITIVE DAMAGES PROJECT 13 (1986). Although the *average* award has been increasing, the median jury award has not increased faster than the inflation rate. This indicates that at least half of all jury awards involve very small amounts.

39. See Localio, *Variations on \$962,258: The Misuse of Data on Medical Malpractice*, 13 L. MED. & HEALTH CARE 126 (1985).

40. "Large" claims (in excess of \$100,000) represent only one percent to two percent of all product liability claims. They account for 50% to 60% of insurers' product liability payments, however. See INSURANCE STUDY, *supra* note 16, at 4.

41. Some studies indicate the cases that go to trial are more serious than cases settled out of court. See P. DANZON, *supra* note 35, at 26; Wittman, *Price of Negligence Under Differing Liability Rules* 29 J.L. & ECON. 151, 162 (1986).

42. See F. BELLOTTI, J. VAN DE KAMP, L. THORNBURG, J. MATTOX, C. BROWN & B. LAFOLLETTE, AN ANALYSIS OF THE CAUSES OF THE CURRENT CRISIS OF UNAVAILABILITY AND UNAFFORDABILITY OF LIABILITY INSURANCE 28, 40 (1986) [hereinafter cited as NAT'L ASS'N OF ATTORNEYS GEN. REP.], noted in Phillips, *To Be or Not to Be: Reflections on Changing Our Tort System*, 46 MD. L. REV. 55 (1986). The report of the attorneys general states:

The data shows substantial fluctuations in average verdict size from year to year rather than huge or sudden increases in the most recent years. For example, the Justice Department Report documents an increase of only 10% in average jury awards for medical malpractice victims during the last 3 years. This increase is comparable to the rate of inflation during that time period. In fact, the yearly average jury verdicts actually decrease in some years.

Id. at 28. See also TORT POLICY WORKING GROUP, *supra* note 1, at 37 (chart D for 1982-85), 38 (chart E for 1976, 1979, 1980, 1984).

43. See NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 29; BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1987, at 155 (106th

also might have affected the size of awards. Lost future earnings, for example, must be increased accordingly when interest rates drop.⁴⁴ Finally, the unprecedented double-digit inflation of the late 1970s might have distorted future-earnings valuation.

ECONOMICS

Premiums, Investments and Price Wars

Consumer groups point to considerable evidence that the insurance industry has brought on its own financial woes.⁴⁵ During the 1970s, insurance companies engaged in competitive price wars to collect the maximum number of premium dollars from the public, which they in turn invested to take advantage of the unusually high interest rates of the period.⁴⁶ Liability insurance lines were particularly susceptible to this trend because of the long lag time between premium payments by the insured and the insurance company's ultimate payment on a claim.⁴⁷

Although the public benefited in the short run from the cheaper rates, many critics now link the current crisis to this prolonged period of price undercutting. In its eagerness to acquire premium dollars, it appears the industry failed to price premiums adequately to meet future needs.⁴⁸

ed. 1986); BUREAU OF LABOR STATISTICS, U.S. DEPARTMENT OF LABOR, *THE HANDBOOK OF BASIC ECONOMIC STATISTICS* 5 (1986).

The rise in the Consumer Price Index between 1975 and 1985 was 97.6%. Although the average payment *per claimant* for large product liability claims increased 150%, the average payment *per incident* was comparable to the increase in the CPI, at 99.4%. Similarly, from 1979-85, the CPI rose 46.3%. The average payment per claim increased 52.3%, while the average payment per incident increased 52%.

The difference in the increases per claim and per incident between 1975 and 1985 is explained by the difference in the number of claimants per incident in the two periods. In the 1975 study, there were 1.4 claimants per incident; in the 1979 and 1985 studies, there were 1.12 claimants per incident. Because the number of claimants per incident is lower in the later studies, the average payment per claimant represents a higher percentage of the average payment per incident. See *INSURANCE STUDY*, *supra* note 16, at 6.

44. This is because a lump-sum payment earns less interest in future years. See *NAT'L ASS'N OF ATTORNEYS GEN. REP.*, *supra* note 42, at 29.

45. See *id.* at 38.

46. Interest rates soared to 21.5% in late 1980 and early 1981. See *TORT POLICY WORKING GROUP*, *supra* note 1, at 21-22 (construing data printed in *INSURANCE SERVICES OFFICE, FINANCIAL CONDITION OF THE INSURANCE INDUSTRY—AN UPDATE* (1985)).

47. This lag time is also known as "long tail." For example, the claim on a product-related injury may not be paid until five years after final judgment is rendered. The insurer can invest this premium money and earn interest in the interim. Long-tailed liability lines thus have provided attractive investment opportunities. See *NAT'L ASS'N OF ATTORNEYS GEN. REP.*, *supra* note 42, at 11.

48. *INSURANCE SERVICES OFFICE, 1985, A CRITICAL YEAR* 5 (1985). The industry, in fact, admitted as much. The ISO report stated, "In an attempt to generate cash flow for investment, insurers competed aggressively for premium dollars, knocking prices more and more out of line with loss costs." *Id.* at 4. The report concluded that "[p]ricing that failed to keep pace with loss costs and lagged the nation's overall economic growth has brought insurers into their current predicament." *Id.* at 6.

Dennis Jay, spokesman for the Professional Insurance Agents Trade Association, also said he believes insurance companies "did not underwrite the business as well as they should have. . . . [I]t is very tempting to get the money in today to earn 21 percent and worry about the losses later." *The Manufactured Crisis*, 51 *CONSUMER REP.* 544 (1986) [hereinafter cited as *Manufactured Crisis*].

Until recently, there had been little premium growth in either of the two liability lines in the center of the crisis: the commercial multiple peril line⁴⁹ and the commercial general liability line.⁵⁰ Although some members of the insurance industry acknowledge a role in premium price undercutting,⁵¹ the industry as a whole, together with the Tort Policy Working Group, generally explains the rise and fall of premium prices as a natural result of market fluctuations. The Tort Policy Working Group's report claims there is an "obvious inverse relationship between premiums and the prevailing interest rate."⁵² This is because a significant share of the insurer's profits consists of a return on the premium income it invests between receipt of the premiums and payout of incurred liabilities. Thus, when interest rates rise, premiums fall, and vice versa.⁵³

The Tort Policy Working Group argued that "there is little the federal (or any) government can or should do to correct this situation."⁵⁴ In contrast, the Governor's Advisory Commission on Liability Insurance in New York stated that insurance regulators can and should take a more active role "to keep prices on an even keel, discouraging both excessive and artificial cyclical price cuts."⁵⁵

It also appears insurance companies succeeded in using investment income during the 1970s and early 1980s to offset huge underwriting losses caused by the underpriced premiums. Although investors took an \$80 billion cumulative net underwriting loss from insurance operations from 1981 to 1985,⁵⁶ the same years brought the most substantial increases

49. Commercial multiple peril consists of a "packaged" line of business insurance, which includes commercial general liability coverage and its long-term losses (losses reported many years after the policy years. TORT POLICY WORKING GROUP, *supra* note 1, at 19, 20.

Sluggish premium growth is confirmed by statistics from premiums written in the commercial multiple peril line, in billions of dollars:

1970	\$1.331	1979	6.667
1975	3.176	1980	6.886
1976	4.052	1981	6.870
1977	4.891	1982	7.009
1978	5.830	1983	7.293

BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1987, 512 (106th ed.1986) [hereinafter cited as STATISTICAL ABSTRACT]. See also TORT POLICY WORKING GROUP *supra* note 1, at 20.

50. See *Manufactured Crisis*, *supra* note 48, at 547. Commercial general liability includes major commercial sectors, as the airline industry, municipalities and day-care centers. The Tort Policy Working Group reports net premiums for 1981-85, in billions of dollars, as:

1981	\$ 6.8
1982	6.9
1983	7.2
1984	8.2
1985	11.7

See TORT POLICY WORKING GROUP, *supra* note 1, at 19, 20.

51. See INSURANCE SERVICES OFFICE, *supra* note 48, at 5.

52. See TORT POLICY WORKING GROUP, *supra* note 1, at 25.

53. See *id.*

54. *Id.*

55. *Manufactured Crisis*, *supra* note 48, at 548. The commission recommended upper and lower limits on prices that insurers may charge. This would avoid the extreme swings in premium prices but permit flexibility, because insurance companies periodically could request changes in the permitted price arenas. See *id.* at 546.

56. OFFICE OF THE COMM'R OF INS., STATE OF WIS., FINAL REPORT OF THE SPECIAL TASK FORCE ON PROPERTY AND CASUALTY INSURANCE 28 (1986) [hereinafter cited as SPECIAL TASK FORCE].

in investment income the industry has seen in recent history.⁵⁷ This may explain why there was no "liability crisis" until 1984; although the industry experienced billion-dollar losses, investment gains also continued to yield net incomes in the billions. Thus, when interest rates dropped to single digits in 1984, investment income failed to exceed underwriting losses for the first time since 1968.⁵⁸

Allegations and Underwriting Losses

The insurance industry defends the recent premium increases in the commercial multiple peril and commercial general liability lines as necessary to reflect new, higher risks. The industry asserts that it has suffered staggering underwriting losses as a result of an increase in the number of product liability lawsuits and the size of awards levied against insureds in these lines.⁵⁹

Although the existence of underwriting losses is uncontroverted,⁶⁰ their significance is disputed. Evidence indicates these figures alone do not completely or accurately portray the industry's financial health. First, they fail to include the income insurers have earned from premium investments. This omission is crucial; investments traditionally provide insurance companies with vital income when premium revenues are insuf-

57. *Id.* at 28.

Investment Income (in billions)

1968 -	\$1.5	1977 -	\$ 5.8
1969 -	\$1.7	1978 -	\$ 7.3
1970 -	\$2.0	1979 -	\$ 9.3
1971 -	\$2.4	1980 -	\$11.0
1972 -	\$2.8	1981 -	\$13.2
1973 -	\$3.3	1982 -	\$14.9
1974 -	\$3.9	1983 -	\$16.0
1975 -	\$4.1	1984 -	\$17.6
1976 -	\$4.8	1985 -	\$19.531

The insurance industry calculates that when underwriting loss is offset by investment income and realized capital gains, a net gain of \$51.4 billion for 1975-84 results. INSURANCE SERVICES OFFICE, *INSURER PROFITABILITY—THE FACTS* (1986). The U.S. General Accounting Office arrived at the same figure for 1976-85, resulting in a net gain of \$51 billion. *Profitability of the Property/Casualty Insurance Industry: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 99th Cong., 2d Sess. (Apr. 28, 1986)* (statement of Johnny C. Finch, Senior Associate Director, General Government Division, U.S. General Accounting Office) [hereinafter cited as *Insurance Hearings I*], cited in NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 13.

58. According to the industry, statutory underwriting losses increased (after policy dividends) from \$1 billion in 1981 to an estimated \$4.6 billion in 1985. See TORT POLICY WORKING GROUP, *supra* note 1, at 19-20.

59. The Tort Policy Working Group admits the increased premiums may not be "related solely to these [underwriting] losses" and hence will not necessarily "decline significantly as the industry limits its underwriting losses and restores its desired level of overall profitability." TORT POLICY WORKING GROUP, *supra* note 1, at 1-2.

60. See TORT POLICY WORKING GROUP, *supra* note 1, at 1. Underwriting losses represent the difference between premiums received by an insurance company and claims paid (plus administrative expenses) in a given accounting period. When claims and expenses exceed premiums, losses occur. See NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 10.

ficient to cover claims and expenses.⁶¹ The net underwriting loss data also omit income from capital gains realized on assets that have been sold. Many of the property/casualty industry's assets have appreciated enormously since 1981 because of the drop in interest rates.⁶²

The insurance industry also receives numerous federal income tax credits, which it uses to offset federal taxes owed for past and future years. These tax credits are not subtracted from the underwriting loss total before its public reporting. The omission is significant. From 1975-84, the property/casualty industry received credits totaling \$125million.⁶³ In 1985, the industry received \$1.9 billion in federal tax credits.⁶⁴ The result, when taken into account with investment income and realized capital gains, produced a \$1.7 billion gain for the property/casualty industry for 1985.⁶⁵

Furthermore, insurance companies are permitted federal income tax deductions for excess loss reserves.⁶⁶ Insurance companies routinely fail to discount these reserves; thus, they are able to take inflated deductions. The result is that insurance companies rarely pay federal income tax.⁶⁷ As

61. General liability coverage represented "only about 6% of total industry premium" in 1984-85; however, this 6% "accounted for approximately 14% of the industry's investment gains." *Profitability of the Property/Casualty Insurance Industry: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 99th Cong., 2d Sess. (Mar. 3, 1986)* (statement of William J. Anderson, Director, General Government Division, U.S. General Accounting Office) [hereinafter cited as *Insurance Hearings II*].

62. This is because of the industry's heavy investment in the bond market. In 1984, for example, 54% of the industry's portfolio was made up of bonds investment. BEST'S AGGREGATE & AVERAGES, PROPERTY/CASUALTY INSURANCE EDITION 2 (1985). Bonds have fixed interest rates; therefore, bonds purchased while interest rates are high appreciate in value when interest rates fall. Although realization of gain in these periods is "to be expected from a reasonable investor," such gain is not taken into account when underwriting loss is calculated. See NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 13. In fact, the Insurance Services Organization and the Insurance Information Institute have reported that the property/casualty industry realized capital gains of \$5.3 billion in 1985. INSURANCE SERVICES ORGANIZATION, INSURER PROFITABILITY—THE FACTS 22-23 (1986). The General Accounting Office has recommended to Congress that, when calculating the industry's profitability, investment gains should also include unrealized capital gains (stocks that have appreciated in value). The GAO reasons that "it is well within a company's control to manage its investment portfolio so as to realize these gains while the investments are profitable." *Insurance Hearings I, supra* note 57, at 5. The property/casualty industry registered \$1.2 billion in unrealized capital gains in 1985. BEST'S INSURANCE MANAGEMENT REPORT 1 (1985); BEST'S REVIEW, PROPERTY/CASUALTY INSURANCE EDITION 6 (1986), *cited in* NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 15.

63. GENERAL ACCOUNTING OFFICE, INSURANCE TAX CONFERENCE 5 (1985) (address by Natwar M. Gandhi), *cited in* NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 14.

Significantly larger results are produced by shifting the reporting period by one year. For the 1976-85 period, the tax credit figure rose to \$1.5 billion. The increase has been attributed to losses reported for tax purposes in 1985. See *Insurance Hearings II, supra* note 61, at 14.

64. See INSURANCE SERVICES ORGANIZATION, *supra* note 62, at 24.

65. INSURANCE INFORMATION INSTITUTE, THE EXECUTIVE LETTER SPECIAL REPORT 2 (1986); 5 NATIONAL INSURANCE CONSUMER ORGANIZATION NEWSLETTER 9, 10 (1986). Another insurance industry source calculates the 1985 net gain at \$2 billion. See BEST'S REVIEW, PROPERTY/CASUALTY INSURANCE EDITION 14 (1986), *cited in* NAT'L ASS'N OF ATTORNEYS, GEN. REP., *supra* note 42, at 14, 15.

66. When a policyholder files a claim, the insurance company makes an estimate of the ultimate payment and sets that money aside in a "loss reserve." Although the money may not actually be paid out for years, it is deducted as an "expense" for tax purposes. See *Manufactured Crisis, supra* note 48, at 547.

67. See NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 13.

concluded in the report of the attorneys general: "It is clear that to obtain a complete and accurate picture of the current profitability of the property/casualty industry, one must look beyond underwriting income alone." Although the property/casualty industry suffered a \$46 billion underwriting loss from 1975 to 1984, it also experienced a \$121 billion investment gain. The result was a net gain of \$75 billion for the 1975-84 period.⁶⁸

Other indicators of the insurance industry's overall financial health exist. Policyholder dividends rose steadily between 1975 and 1984.⁶⁹ In 1985, property/casualty stocks increased fifty percent, twice the growth rate of the Dow Jones industrial average.⁷⁰ The insurance industry's consolidated net after-tax income for 1985 totaled \$2 billion, a \$1.2 billion increase over 1984.⁷¹ Finally, the insurance industry showed a net cash surplus of \$75 billion between 1975 and 1984.⁷²

CONCLUSION

The insurance industry's battle cry of "tort reform" should not be met with the white flag of legislation favoring the industry. The past fifteen years have proved to be a period of high inflation, large cost-of-living increases and astronomical increases in medical costs, which have combined to adversely affect the insurance industry's premium forecasting and juries' damage award assessments. In spite of this uncertain economic atmosphere, the insurance industry has remained profitable, and profit margins have experienced wide fluctuations. The insurance industry's

68. See *Insurance Hearings II*, *supra* note 61, at 4. Figures for 1980-84 show a \$45 billion registered underwriting loss and an \$82 billion investment gain, producing a net gain of \$37 billion. See *Insurance Hearings I*, *supra* note 57, at 5.

Based on insurance industry estimates, the General Accounting Office predicts net gain before taxes for 1986-90 to be \$90 billion. See *Insurance Hearings I*, *supra* note 57, at 7-8; *Insurance Hearings II*, *supra* note 61, at 8-9, cited in NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 19.

69. Policyholder dividends (in millions):

1970	\$ 504	1979 -	\$1,324
1975 -	\$ 633	1980 -	\$1,622
1976 -	\$ 630	1981 -	\$1,824
1977 -	\$ 815	1982 -	\$1,987
1978 -	\$1,252	1983 -	\$2,234

See STATISTICAL ABSTRACT *supra* note 49, at 512.

70. BEST'S REVIEW, PROPERTY/CASUALTY INSURANCE EDITION 21 (1986), cited in NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 19. Best's Review called this leap "the most spectacular performance last year by a component of Best's Insurance Stock . . . (and) show(ed) renewed confidence by investors. . . ." *Id.*

Salomon Brothers, the investment analysis firm, expects property/casualty profits to rise at a yearly rate of 25% from 1985-89. See *Insurance Hearings II*, *supra* note 61, at 8-9; *Insurance Hearings I*, *supra* note 57, at 7-8, citing SALOMON BROTHERS, INC., PROPERTY/CASUALTY INSURANCE ORGANIZATION, FIVE-YEAR REVIEW AND OUTLOOK, 1985 EDITION (1985), reprinted in NAT'L ASS'N OF ATTORNEYS GEN. REP., *supra* note 42, at 19. But see SPECIAL TASK FORCE, *supra* note 56, at 29, 35 ("Net return on equity in the recent past has been far below the level necessary to attract investment capital.") The Special Task Force also notes that surplus would have declined had 1985 capital gains and new funds been at their 1979-84 levels. See *id.* at 32.

71. See SPECIAL TASK FORCE, *supra* note 56, at 32.

72. U.S. GENERAL ACCOUNTING OFFICE REPORT, INFORMATION ON HOW THE PROPERTY/CASUALTY INSURANCE INDUSTRY IS TAXED, chart 2 (1985), noted in Conference Board Institute, *supra* note 9, at 5.

refusal to disclose financial records, however, makes accurate prediction concerning the industry impossible. Before bowing to the insurance industry's demand for tort reform, legislatures should demand full financial disclosure from the industry.

The available evidence points to the complexity and uncertainty of the insurance crisis. A resolution that constricts available tort law remedies is drastic and may result in the exclusion of legitimate and needy victims. It has not been proved that the source of the crisis lies solely or primarily in the existing legal system. Before that system is fundamentally altered, the reasons for doing so should be examined carefully. Otherwise, after the war has ended and the smoke has cleared, the insurance crisis debate will reveal that consumers, hurt by higher product costs and diminished remedies under tort law, will be the real casualties.

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