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THE LIABILITY INSURANCE CRISIS

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SUMMARY

Faced with complaints from businesses, professionals, and municipalities about the affordability and availability of liability insurance, Congress appears likely to consider the issue. What a decade ago was seen as primarily a products liability insurance crisis is now viewed as affecting a wide range of those who need insurance against tort liability. Without affordable liability insurance, the threat of lawsuits can make it impossible for businesses and professionals to deliver their products and services.

Both economic and legal factors are being cited as causes of the crisis. Economic factors include insurance market cycles, underwriting practices, and international reinsurance considerations. Legal factors include the alleged litigation explosion and the McCarran-Ferguson Act's exemption of the business of insurance from most Federal regulation.

Insurers claim an inability to price premiums effectively because they cannot evaluate risk. This inability, they claim, results from a litigation explosion, including excessive damage awards in tort suits and court decisions that have expanded the circumstances in which damages may be awarded. The litigation explosion, they contend, has made realistic underwriting (risk assessment and pricing) for commercial liability risks problematic. To remedy the situation, they have urged Congress and the State legislatures to enact various tort reforms.

Trial lawyers and consumer groups, by contrast, dispute the existence of a litigation explosion, and place the blame for the insurance crisis on the insurers themselves. They argue that, in the recent years preceding the present crisis, property-casualty companies priced their policies far below cost to attract funds for investment. Then-prevailing high interest rates on investments compensated for insufficient premiums. Now that interest rates have dropped to the point where investment returns are not able to cover growing underwriting losses, industry critics argue, insurers are attempting with unreasonable rate increases to recoup losses too quickly. Industry critics have also called for repeal or modification of the McCarran-Ferguson Act in order to permit an increased Federal role in the regulation or oversight of the industry. Insurance community spokesmen, however, while favoring tort reform, are wary of regulatory overreaction that will injure the flexibility of a historically successful industry in responding to market conditions.

ISSUE DEFINITION

A wide range of businesses, professionals, and municipalities have urged Congress to take action to alleviate the crisis in the affordability and availability of liability insurance. Without affordable liability insurance, they claim, the threat of lawsuits may make it impossible for them to deliver their products and services. The insurance industry contends that a litigation explosion -- an increase in the number of tort suits brought and in the size of damage awards -- is the primary cause of the liability insurance crisis. Trial lawyers and consumer groups, in contrast, dispute the existence of a litigation explosion and place the blame for the insurance crisis on economic problems caused by the insurers themselves.

BACKGROUND AND ANALYSIS

Economic Factors

With premiums for business liability insurance soaring and coverage difficult to obtain for many lines of business, the commercial insurance industry has been described by many observers as in crisis. This situation has placed severe economic pressures on a wide variety of businesses, professionals, and municipalities, including products manufacturers, health care professionals, long-haul trucking, corporate officers and directors, child care facilities, commercial fishing vessels, and others. It has given rise to a national debate over the nature of the insurance industry, its role in the economy, and the proper role of the Federal Government in overseeing and regulating the industry.

Current insurance problems involving high premium rates and limited amounts of available coverage stem in large part from substantial losses suffered by insurers. The American property-casualty insurance industry and the Lloyd's of London underwriters, who have provided a principal reinsurance market by spreading risks on a worldwide basis, suffered record underwriting losses in 1984 and 1985. The domestic property-casualty industry reported operating losses (a combination of underwriting results and investment income, before payment of taxes) of $3.8 billion in 1984, and $5.4 billion in 1985. The deficit was substantially narrowed, however, by tax credits and capital gains on sales of investment securities. Severe underwriting losses shrunk insurance capacity, which is the amount of working capital on hand, and which determines the volume of business an insurer can legally write. Varying degrees of financial impairment among property-casualty companies have been widely reported, and State regulatory officials report that insurer insolvencies are running at levels unprecedented in the modern history of the industry.

The insurance controversy, for the most part, is limited to commercial liability coverages. Commercial property coverage has also been affected, but to a lesser extent; personal lines coverages continue to be written in a generally competitive environment, with limited price and supply problems. Although commercial liability insurance accounts only for roughly 10% of total property-casualty business operations, this type of coverage has been demonstrated to be vital to the economy. The severe underwriting losses for commercial liability have had a substantial impact on insurers' financial performance and subsequent underwriting and pricing practices.

The causes of the liability insurance crisis are many. The inability of insurers to price premiums when they cannot define the extent of risk is said to be of major importance. The insurance industry contends that realistic underwriting (risk assessment and pricing) for commercial liability risks is problematic largely because of case law developments (as opposed to statutory changes) in the field of tort litigation and because of the extent of monetary damages awarded. Tort law determines who is responsible and what damages shall be paid when injuries are claimed. Cost uncertainties engendered by the legal system have, according to the insurance industry, made true liability costs difficult to calculate or project when insurers cannot measure or predict what degree of liability they may face in future years. This is particularly the case for risk exposure that may not now be apparent and for which the courts may eventually hold insurers liable.

The insurance industry has been accused of blaming the tort system for its problems in order to divert attention from the industry's own poor management record. Property-casualty companies in recent years priced their policies far below cost to attract funds for investment. Then-prevailing high interest rates on investments compensated for insufficient premiums. Now that interest rates have dropped to the point where investment returns are not able to cover growing underwriting losses, industry critics argue, insurers are trying to recoup losses too quickly with unreasonable rate increases and are seeking government protection through tort law reform. Industry critics are also concerned that much economic data on the industry can come only from industry sources and have expressed discontent concerning the degree of industry control and interpretation of industry financial information. Several insurance data reporting requirements bills were introduced in the 99th Congress but did not advance.

In the United States, insurance has traditionally been regulated at the State level, with limited Federal oversight of the adequacy and effectiveness of such regulation. Consequently, insurance problems are now an important issue for State legislatures and officials and much remedial activity is in progress. But because of the severity of the insurance crisis and because insurance problems are national in scope, congressional interest and scrutiny have grown accordingly. There appears to be increased public awareness that liability insurance is an essential financial service and mounting concern that the market for this insurance lacks a reasonable degree of stability. The periodic "boom-and-bust" market cycles that typically and historically have characterized property-casualty insurance industry operations have been shown to be seriously disruptive to the economy. During the legislative focus on insurance issues in the 99th Congress, some expressed the view that insurance-related problems should be addressed on a national scale, and that the public, as well as the business community, requires the maintenance of an orderly and reliable insurance mechanism.

Legal Factors

Although insurers blame the insurance crisis largely on a litigation explosion, representatives of consumers and trial lawyers dispute the existence of such an explosion and contend that the present tort system is necessary both to compensate injured parties and to furnish an incentive for potentially liable parties to engage in safer conduct, such as manufacturing safer products and providing more careful medical treatment.

There are recent studies on both sides of the issue of whether there has been a litigation explosion. To cite just a few, the Tort Policy Working Group, established by Attorney General Meese, concluded that there has been an "explosive growth in tort damages awards over the last decade." The Consumer Federation of America, in contrast, concluded "that awards have not grown out of proportion to social and economic changes," such as inflation, real income growth, life expectancy, and medical costs, all of which affect the size of damage awards. The Rand Corporation's Institute for Civil Justice concluded that, in most cases, civil jury "verdicts have remained relatively constant at a modest level," but that "large awards are increasing rapidly." Although the latter group "constitutes a small fraction of the number of cases, it represents the lion's share of total dollars awarded at the trial court level."

Tort law is primarily State law, but insurers have been urging both Congress and the State legislatures to enact tort reform. Congress apparently would have the constitutional power to preempt State tort law. Proponents of tort reform generally support the following reforms, among others:

Place Caps on Damages for Pain and Suffering

It has been proposed that ceilings be placed on the amount recoverable in damages for pain and suffering, which is ordinarily set by the jury. Some proposals call for unconditional caps, some for caps applicable only when the plaintiff is unwilling to settle his case, and others for compensation schemes giving plaintiffs the benefit of no-fault recovery if they agree to caps. Several States have enacted caps on non-economic damages, some applicable to all tort suits and some only to specific types, such as medical malpractice. Proponents of caps on pain and suffering argue that unlimited jury discretion results in unpredictability for insurers; opponents argue that caps punish only the most severely afflicted tort victims.

Place Restrictions on Punitive Damages

Punitive damages are damages designed to punish the defendant for outrageous conduct -- intentional or reckless disregard for the safety of others that goes beyond negligence. Punitive damages constitute an award for the plaintiff in addition to damages to compensate him for his injuries. Among the restrictions suggested for punitive damages are that they be prohibited, that caps be placed on them, that the circumstances in which they may be awarded be more narrowly defined, that the plaintiff be required to prove by "clear and convincing" evidence that he is entitled to them (instead of being held only to the usual "preponderance" of the evidence standard), that the number of plaintiffs entitled to punitive damages for the same wrong be limited, and that punitive damages be paid to the government or to a fund rather than to the plaintiff. Advocates of restrictions on punitive damages claim that their amounts have escalated to astronomical figures. Opponents claim that they protect public safety and argue that they should be made uninsurable so they will be more effective deterrents of inexcusable conduct.

Eliminate Joint and Several Liability

In most States, if two or more defendants are partially responsible for the same accident, they are both held 100% liable, and the plaintiff may choose the one from whom to collect his damages. A defendant who pays more than his proportionate share of the judgment is usually permitted to recover from other liable defendants, but such other defendants may not have money. Joint and several liability helps ensure that the victim of an accident will recover fully, but it results in some defendants paying for more than their share of the judgment. In recent years, nearly half the States have abolished or modified their joint and several liability laws, in some cases making them applicable only to economic damages.

Eliminate the Collateral Source Rule

This traditional rule prohibits deducting from a plaintiff's damages any compensation he receives from a source, such as health insurance, other than the defendant. The basis for the rule is the belief that the victim rather than the wrongdoer should profit from the victim's prudence (in buying health insurance) or good fortune (in having some other collateral source available). Eliminating the collateral source rule might also reduce the deterrent effect of tort suits. On the other side, damages awarded that duplicate collateral source payments may be viewed as a windfall for the plaintiff.

Limit Lawyers' Contingency Fees

A contingency fee is one in which a lawyer agrees, in exchange for representing a client, to accept a percentage of the recovery in the event of a successful prosecution of the action. Such percentage frequently amounts to more than the attorney would earn if he charged the prevailing hourly rates for his services; the lawyer's entitlement to this greater fee generally is justified on the basis of the risk he takes of earning less than prevailing rates in some cases and of earning nothing for his time in the event he loses the case. Because contingency fees are derived exclusively from a client's winnings, they enable injured persons who otherwise could not afford to hire a lawyer to do so.

Those who would limit contingency fees argue that at their present levels they prompt lawyers to take non meritorious cases and prompt juries to inflate verdicts to compensate plaintiffs who juries know will have to pay a substantial percentage of their recovery to their lawyers. Opponents of limits on contingent fees argue that they deter lawyers from taking non meritorious cases because the lawyer gets no fee if he does not win. They also note that it is defendants' lawyers who, because they work on an hourly or a salaried basis, have an incentive not to settle claims.

Require Periodic Payments of Future Damages

Plaintiffs in tort cases are often awarded future damages -- damages for future medical care, loss of employment, pain and suffering, and the like. Traditionally, unless the parties agree otherwise, the defendant must pay all future damages in one lump-sum payment. Requiring periodic payments would aid defendants because they could purchase an annuity rather than paying a large sum at once. It would, however, decrease a plaintiff's flexibility in managing his award. Some proposals would be disadvantageous for plaintiffs because all or a portion of periodic payments would terminate upon the plaintiff's death.

McCarran-Ferguson Act

Some suggest that the insurance crisis would be eased by an increased Federal role in the regulation or oversight of the insurance industry. Federal regulation is now largely precluded by the McCarran-Ferguson Act, which Congress enacted in 1945. The McCarran-Ferguson Act expresses the view of Congress "that the continued regulation and taxation by the several States of the business of insurance is in the public interest." Specifically, the Act provides that no Federal statute shall preempt a State statute that regulates or taxes the business of insurance, unless the Federal statute specifically relates to insurance; and that Federal antitrust law (the Sherman Act, the Clayton Act, and the Federal Trade Commission Act) shall not apply to the business of insurance to the extent that such business is regulated by State law. All States regulate the business of insurance; therefore, insurance companies are permitted to engage in some collective activities that, if engaged in by other industries, would violate Federal antitrust law. (An exception in the McCarran-Ferguson Act makes the business of insurance subject to the Sherman Act to the extent the Sherman Act proscribes boycotts, coercion, and intimidation.)

Congress may consider repealing the McCarran-Ferguson Act to make the business of insurance subject to Federal antitrust law and other Federal regulation, or modifying the Act to alter the nature of the industry's exemption or to establish some form of oversight over the adequacy and effectiveness of State insurance regulation. As the courts have interpreted the Act, any regulation of the business of insurance by a State, regardless of its effectiveness, is sufficient to make Federal antitrust law inapplicable to such business.

The United States is atypical among nations in not supervising its insurance industry at the national level. The U.S. system of insurance regulation may puzzle foreign observers who consider the free movement of trade and commercial services to be one of the prime responsibilities of a central government, and the existence of uniform legal rules for large scale business operations to be an essential condition for that free movement. Insurance is the only large-scale financial service sector not directly regulated at the Federal level. Considerations have also been raised concerning the continued efficacy of State insurance regulation, given the rapidly evolving developments in financial market restructuring.

The quality of State insurance regulation has been characterized as uneven, and the coordination of interstate regulatory activities can be problematic. Critics of State regulative effectiveness emphasize the disadvantages of non- uniformity that result from a multiplicity of State insurance codes and the duplication and inefficiency this engenders. Some critics argue that the business of insurance should be subject to Federal antitrust law to the same extent as other businesses. In defending their Federal antitrust immunity, the insurance industry has long maintained that it is necessary for insurers to perform certain collective activities, especially the pooling of loss data, in order accurately to project future loss potential and, thereby, adequately price insurance coverages. Insurers have historically maintained that continued exemption from Federal antitrust laws is essential to the conduct of their business. Further, they argue, the industry remains intensely competitive, to the benefit of the public.

Opponents of Federal insurance reform initiatives have long and successfully opposed changes to allow increased Federal regulation or oversight. They have contended that a Federal role is not justified with respect to an industry whose performance, by any measure, including social benefit, has historically matched or exceeded most federally regulated industries. The State regulatory system offers, in this view, the flexibility needed for creative responsiveness to varying market conditions and provides the most effective allocation of coverage price and supply. Insurance industry spokesmen now generally concede that a problem exists, but warn against overreaction that may injure the industry's ability to perform responsively and creatively, and note the easing of the current crisis due to responsive workings of the market.

LEGISLATION

The 99th Congress considered many bills designed to address the liability insurance crisis and tort reform. It enacted one statute designed to address the insurance crisis generally, and one aimed at a specific area -- vaccine manufacturers' liability. The former statute was the Risk Retention Amendments of 1986, P.L. 99-563, which amended the Product Liability Risk Retention Act of 1981. The 1981 law was intended to permit product manufacturers, sellers, and distributors to purchase insurance on a group basis or to self insure through insurance cooperatives called "risk retention groups." The 1986 law expanded the scope of the 1981 law to enable risk retention and purchasing groups to provide not only product liability insurance, but all types of liability insurance.

The Childhood Vaccine Injury Act of 1986, P.L. 99-660, requires most persons suffering vaccine-related injuries, prior to filing a tort action, to seek no-fault compensation through a compensation program established by the Act. Under the program, compensation for pain and suffering would be limited to $250,000. A party not satisfied with the compensation awarded under the program could file a tort action under State law, but subject to some limitations. At present, the statute lacks a method for financing the compensation program; it will be up to the 100th Congress to determine how to fund the program.

In the 100th Congress, Senator Metzenbaum has introduced S. 80, a bill to repeal the McCarran-Ferguson Act of 1945. Following a lengthy hearing before the Senate Judiciary Committee on Feb. 18, 1987, it has been reported that revisions to the bill may be considered that would modify only the antitrust provision of the Act. The hearing exhibited an unusual combination of Administration officials and liberal Committee Democrats in agreement on the desirability of reforming the antitrust law exemption for insurance businesses. Other McCarran-Ferguson modifications or repeal measures are expected to be introduced later in the first session of the 100th Congress.

Tort reform bills pending in the 100th Congress are listed in CRS Issue Brief 77021.

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