March 27, 1986

THE LIABILITY INSURANCE CRISIS: WHAT WASHINGTON CAN DO TO HELP

INTRODUCTION[1]

Foreigners long have remarked on the penchant of Americans to sue each other to redress a grievance. Perhaps no society on earth has been as quick to litigate as the American. Until recently, this was simply an interesting quirk. Now it threatens to damage the American economy seriously and to reduce the goods and services available to the American consumer, while increasing their prices. The very existence of whole industries and tens of thousands of jobs (if not more) are at risk.

The culprit is the upheaval in the American tort system--that process by which injuries inflicted by one person against another are compensated through the courts. Recent years have seen the volume of litigation increase substantially and the size of awards skyrocket. Meanwhile, the courts have slowly and steadily increased the number of wrongs compensable through the system and chipped away at the defenses available to defendants.

Many of these changes have been to the good, allowing persons wrongfully harmed by others to be fully compensated for that harm and thereby deterring future misconduct. But courts also have allowed compensation to injured plaintiffs even where the defendant's conduct could not reasonably be called wrongful.

The cost of tort law changes long went largely unnoticed. The losers in the system were usually large corporations or insurance

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1. This is the first in a series of studies examining the liability insurance crisis. Future Backgrounders will look at the medical malpractice coverage problem and at the burden imposed on consumers by the liability insurance crisis.

companies which, many felt, easily could afford to pay the increasingly large and frequent judgments. In recent months, however, the real costs to the U.S. as a whole have begun to bite. Stung by such a costly and unpredictable system, insurers have been increasing premiums dramatically. In many cases, moreover, they have had to drop coverage entirely.

What the U.S. now faces is a liability insurance crisis. It affects all segments of society: shopkeepers, hospitals, cities, corporate directors, and even day care centers. Examples:

o Schaghticoke, New York (pop. 7,090), has not been sued in its entire history. Nevertheless, this town recently lost its liability coverage when its insurer, Utica Mutual, withdrew from all municipal coverage. The only replacement policy that Schaghticoke could obtain was at a premium increase of 400 percent for only one-third the coverage.

o The proprietor of a day care center in Rockland County, New York, learned last summer that her liability premium was being increased by 1000 percent. The center had never filed a claim of any kind. Her insurance agent has advised her to close the center.

o Eight of the ten members of the Armada Corporation Board of Directors resigned early this year, after receiving notices that the company's director's and officer's liability insurance was being cancelled. Increasingly, insurance companies are refusing to write such policies.

o Reuben and Proctor, an 80-member law firm in Chicago, lost its insurance coverage in 1985. The reason: increased legal malpractice suits.

These are not isolated cases. The Chamber of Commerce recently reported that 20 percent of its membership had not been able to renew their liability insurance. Over 40 percent recently have faced increases of 100 to 500 percent.[2]

To an extent, the timing of this liability crunch stems from the general fall in interest rates over the last few years. While interest rates were high, insurers were able to use investment income to cushion the mounting costs of the tort system. Today that can no longer be done, and consumers are beginning to have to carry the load.

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2. Rick Berman, Statement of the Chamber of Commerce of the United States, Testimony before the Senate Committee on Commerce, Science, and Transportation, February 19, 1986, p. 2.

Fundamental reform of the tort system is needed to end this insurance crisis. Reform, of course, must not merely let defendants off the hook; those who have been wronged should be fully compensated. But many fundamental changes are needed. Among them:

1) The tort law must strengthen the role of fault in determining liability. Defendants should be held liable because of their wrongful actions, not because of their perceived wealth.

2) Standards or limits should be placed on "noneconomic" damage awards, such as for pain and suffering, for which no objective valuation can be made.

3) Punitive damages should be paid to the court or some other entity, rather than to the plaintiff, since their purpose is to punish rather than compensate.

4) The "joint and several liability" rule must be modified, so that those only peripherally involved with an injury do not have to shoulder the full burden.

5) "Comparative negligence" rules must be modified, so those injured primarily by their own negligence cannot hold others responsible.

6) Losing parties in lawsuits should be required to pay the attorney's fees of the winning parties in certain situations.

The Reagan Administration is now considering a package of reforms for the tort system. Though not perfect, these proposals should help focus and inform debate on this issue. For the most part, the tort crisis is a matter of state law. In some areas, however, including product liability law and federal court rules, Washington does have a role to play, in which it could help resolve the liability insurance crisis.

THE EXPLOSION OF LIABILITY AWARDS

The upheaval in the liability system in recent decades is reflected in the changes that have occurred in both the number of lawsuits and size of awards.

Number of Lawsuits

The number of tort claims filed has increased substantially over the last decade. Most striking is the number of product liability

cases filed in federal district courts,[3] jumping from 1,579 in 1974 to 13,554 in 1985, a 758 percent increase.[3] Claims in state courts also have been increasing. Example: in 1975, New York civil courts handled 12,842 liability cases; by 1984, this number had reached 19,613.[4]

A similar trend affects medical malpractice cases, where claims filed against physician-owned companies increased from 10,568 in 1979 to 23,545 in 1983. One major insurance company, with 14.6 percent of the national medical market, reported 5,870 claims in 1983--up 2,757 from 1979. Further, the frequency of claims reported nationwide has increased from 3.3 claims per 100 doctors in 1979 to 5.4 in 1983.[5]

The Size of Awards

The amounts of court awards have been soaring, even after adjusting for inflation, for the last two decades. While national totals for awards are not available, the Rand Corporation's Institute for Civil Justice recently examined court awards in San Francisco, California, and Cook County (Chicago), Illinois. It found that the average award in San Francisco almost tripled over the past 25 years, rising from $49,000 in the early 1960s to $130,000 per award in the late 1970s (in constant 1979 dollars). Similarly, awards in Cook County doubled during the period studied.[6]

Interestingly, the median award in both jurisdictions (the level at which there is an equal number of larger and smaller awards) stayed almost the same in both jurisdictions during the period. So the increase in average awards was caused almost entirely by the increase in the size of the largest awards. This is illustrated dramatically by the number of awards of $1 million or more. In the early 1960s, only 0.3 percent of all San Francisco awards, less than one in 300, was for $1 million or more (in 1979 dollars). By the late 1970s, 2.3 percent, or about one in 43, reached that mark.[7]

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3. Figures from the Administrative Offices of the United States Courts.

4. Fred Bayles, "Insurance Drought, Part III: Suing 'Deep Pockets,'" Associated Press, November 20, 1985.

5. American Medical Association, Special Task Force on Professional Liability and Insurance, "Professional Liability in the '80's," 1984, p. 10

6. Michael G. Shanley, Mark A. Peterson, "Comparative Justice: Civil Jury Verdicts in San Francisco and Cook Counties, 1959-1980" (Rand Corporation, 1983), pp. 29, 30.

7. Ibid.

These million dollar awards have an enormous impact on the legal system. During the 1960s, the relatively rare million dollar verdicts accounted for only 8 percent of all the money awarded.[8] By the late 1970s, they accounted for 48 percent of all the money awarded. Thus, although the very large award is still fairly rare, it accounts for a tremendous portion of the funds distributed through the legal system.

Punitive Damages

Punitive damage awards, intended to penalize the defendant for egregious conduct, rather than compensate the plaintiff for injury, similarly have increased. The Rand Corporation found that, while Cook County and San Francisco averaged one and three punitive damage awards per year respectively in the early 1960s, they now average nine and eighteen per year. More striking, even after discounting for inflation, the average punitive award increased from $54,000 to $395,000 in San Francisco, and from $4,000 to $489,000 in Cook County--an increase of over 12,000 percent.[9]

"Deep Pockets"

Certain defendants pay more in damages than others. Defendants perceived by the jury as having substantial assets, what lawyers call "deep pockets," are generally assessed much more in damages than others. Corporations in Cook County, for instance, generally pay 30 percent more than individuals in cases involving modest injuries. In cases of serious injury, the gap is enormous: corporations pay over four times as much as individuals.[10] Taxpayers suffer too, since local governments also are considered to have "deep pockets."

REFORMING THE SYSTEM

It is clear that the tort system--designed to provide for the compensation of those wrongfully injured by others--has gone seriously awry. Liability rules have been stretched to the point where fault is almost a secondary issue. The system now has more of the hallmark of a lottery to enrich plaintiffs and their lawyers, rather than of a means to right wrongs.

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8. Ibid., pp. 27-29.

9. Mark A. Peterson, Punitive Damages: Preliminary Empirical Findings (Rand Corporation, 1985), p. 11.

10. Audrey Chin and Mark A. Peterson, Deep Pockets, Empty Pockets: Who Wins in Cook County Jury Trials (Rand Corporation, 1985), p. 43.

In considering reform, however, policy makers should not look simply for ways to make it more difficult for legitimate plaintiffs to win, or artificially limit the amounts they can receive, for the problems in the tort system stem from its failure to differentiate between meritorious and unmeritorious claims and to allocate costs fairly. Reform should address these problems rather than simply the plight of defendants as a group.

Thus policy makers should resist the temptation to put an absolute limit on the amount in damages that a plaintiff can receive. A person who has been wronged should not be denied full recovery simply because the amount of his damages is high. Similarly, recovery should not be denied simply because the plaintiff was insured for the loss. The assets of the plaintiff, as are those of the defendant, are irrelevant to the degree of damage.

Further, reformers should not limit the use of the contingent fee system for attorney's fees. Under the contingent fee system, plaintiff's attorney's fees are set as a percentage of the eventual award in the case. No money is paid before the award is made, and if the plaintiff does not win, the attorney is not paid at all. Through this simple voluntary arrangement, the legal system provides legal representation to every person with a reasonable claim, regardless of wealth.[11] Prohibition or limitation of such fee arrangements would, of course, reduce the number of lawsuits in the courts, but would not improve the legal system.

There are several reforms, however, that could improve the system. The most important of these is simply to change the substantive rules of liability to strengthen the roles of fault and responsibility. While the specific changes required vary according to the particular area of law involved, policy makers should:

o Give more weight to manufacturer's warnings to plaintiffs.

Many of the more questionable recent product liability cases concern the extent of a manufacturer's duty to warn of danger. One case, for instance, involved a man injured when his car battery exploded after he lit a match to check the fluid level. Although the battery was embossed with large letters warning of "EXPLOSIVE GASES" and urging users to keep sparks, flame, and cigarettes away, a federal court held that a jury still could hold the manufacturer liable for failing to warn adequately of the danger.[12]

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11. See, James Gattuso, "New Ways to Provide Legal Services to the Poor," Heritage Foundation Backgrounder No. 496, March 19, 1986, p. 3.

12. Rhodes v. Interstate Battery Systems of America, 722 F.2d 1517 (11th Cir. 1984).

Manufacturers who do not warn adequately of a product's danger should be held responsible. However, the standard is too often applied inconsistently and stretched unreasonably to find defendants liable. It should be applied more fairly.

o Restore abuse, alteration, and misuse of a product as sound defenses in product liability cases.

Absurd results have been reached in states where such defenses are not recognized. For example, in one recent case, a 41-year-old bodybuilder entered a footrace with a refrigerator strapped to his back. During the race, one of the straps came loose, he was injured, and he later sued the refrigerator manufacturer and strap maker. The jury awarded the man $1 million, although neither the refrigerator nor the straps were intended to be used in such a way.[13] Tort law should not hold manufacturers liable for injuries caused by such misuse of their products.

o Define "foreseeable" injury in a more rational manner.

While tort law has never imposed liability on defendants when the injury resulting from their action was unforeseeable, the foreseeability test is sometimes bizarrely applied.

In one 1983 California case, the companies responsible for the design, location, installation, and maintenance of a telephone booth were sued when an intoxicated driver drove off the street, across a parking lot, and into the phone booth, injuring the person in it. The California Supreme Court ruled that a jury could find the accident was foreseeable, and hold the defendants responsible, because they failed to protect the booth from such an occurrence.[14]

Statutes can be drafted by legislators to achieve these reforms. Since the most serious problems involve the application of law to particular cases, however, change also must be pursued by judges in state and federal courts. Effective reform cannot be achieved as long as judges continue to consider the tort system a mandatory insurance system, in which the actions and responsibilities of the parties are secondary. Such a change in judicial attitudes may take time, but it is necessary.

There are also a number of changes legislators should make regarding the calculation and apportionment of damages and the distribution of the burden of attorney's fees:

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13. Jill Andresky, "A World Without Insurance?" Forbes, July 15, 1985, p. 40.

14. Bigbee v. Pacific Telephone & Telegraph Co., 34 Cal. 3d 49 (1983).

Limit "noneconomic" damages.

Noneconomic damages are intangible injuries on which no accurate dollar value can be placed, such as pain and suffering or loss of a loved one. Certainly, the justice system should provide compensation for such injuries, as they are as real as injuries that can be measured in conventional ways. However, juries have very few standards as to how much to award for injuries of this kind and are given almost complete discretion in determining the level of such awards. They are often influenced, moreover, by factors other than the proper amount of compensation for a particular injury. A major influencing factor indeed seems to be deep pockets--the amount the defendant is able to pay.

Standards for awards in these cases are urgently needed. These standards could take several forms. A dollar limit, of perhaps $250,000, could be placed on noneconomic damages.[15] Or they could be limited to some multiple of the measurable damages. Such limitations, of course, should not apply to measurable injuries.

Pay punitive damages to the court.

Punitive damages are damages assessed against a defendant, above the amount of actual harm caused to a plaintiff, to punish and deter the defendant from committing the wrong again. The legal standards for punitive damages have stayed fairly constant over the years. In most jurisdictions, such damages are to be applied only in cases of "wilful, wanton, or malicious" conduct. Yet punitive damages are being applied with increasing frequency, reflecting changes in jury attitudes, rather than an increase in wilful conduct.

There are several ways to address this problem. Punitive damages could be capped. This, however, would make it difficult to assess adequate punishment for truly egregious conduct. Better, they could, be limited to a certain percentage of the defendant's assets or income, although there is a chance that this might prevent sufficient deterrence in some cases.

The best solution may be to have punitive damages paid to the court or some other disinterested body. Although punitive damages are not meant to compensate the plaintiff for injuries suffered, many juries now assess large punitive damage awards in an effort to aid defendants who seem particularly needy, regardless of whether the facts call for punishment. Were these funds paid to a third party,

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15. Several states, including California, have already adopted such limits in medical malpractice cases.

the jury's decision would more likely be based on the only relevant factor: the conduct of the defendant.

Modify "joint and several liability" rules.

Many problems in the tort system stem from the way in which damages are apportioned among defendants. Under the doctrine of "joint and several liability," defendants in many jurisdictions can find themselves liable for huge amounts of damages, despite minimal negligence on their part.

The concept of joint and several liability means simply that in cases where two or more defendants are found liable for an injury, each is responsible for the entire amount of damages, rather than just their proportionate share. The plaintiff, of course, can recover only once--but can choose from which defendant to collect. The theory underpinning this is that, if the negligence of a defendant causes an accident, his liability is not reduced just because others were also negligent.

In practice, however, applying the joint and several liability doctrine can lead to very unfair results. Example: in San Diego, a man was injured while in a friend's car. The driver was found to be 90 percent at fault because he had been drinking and smoking marijuana and was speeding at the time of the accident. The County of San Diego was found 10 percent at fault for failing to install curve markers on the road. But since the driver had no insurance, the County ended up paying the entire $2.5 million in damages.[16]

The joint and several liability rule has been particularly important in cases involving deep pocket defendants. In many of these cases, the party primarily to blame for an injury has limited wealth, making it impossible to collect a large judgment against him. So the plaintiff brings suit against others, who may be only peripherally connected to the injury, but who have the money to pay a huge judgment. Until recently, big corporations were the principal losers. But now losers include states, counties, local school boards, hospitals, and other organizations viewed as wealthy or having access to wealth.[17]

The joint and several liability rule could be altered to lessen the inequities it causes. A "threshold" level of negligence could be

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16. Bayles, op. cit.

17. See, Walter Olsen, "A Naderite Backflip on Liability," The Wall Street Journal, March 11, 1986, p. 30.

established, of perhaps 20 or 25 percent, below which the defendant would be liable only for its proportionate share of the damage bill.[18] Thus, in the above example, San Diego County would pay for only 10 percent of the injuries.

A statewide initiative to be voted on in California this June would attack the problem in a different way. Known as the "deep pocket initiative," Proposition 51 would abolish joint and several liability for noneconomic damages, but continue it for actual economic damages, thus striking a balance between the needs of plaintiffs and defendants.

Modify "comparative negligence" rules.

The unfairness arising from the joint and several liability rule has been exacerbated by adoption of the "comparative negligence" rule in most jurisdictions. Under the traditional common law, a person could receive compensation for his injuries caused by the negligent actions of others only if he himself was not negligent. Thus, if a person were hit by a speeding car while crossing the street, that person could not recover damages from the driver of the car if it were shown that he was not paying sufficient attention to the traffic.

In many cases, "contributory negligence" caused unjust results--many plaintiffs were denied all compensation when there was only minimal negligence on their own part. Reacting to these inequities, the courts of many states have adopted a new standard, known as "comparative negligence." Under this rule, the damages to which a plaintiff is entitled are reduced in proportion to his degree of negligence. Thus, if a plaintiff is found 50 percent at fault for his own injuries, he can still be compensated, but his recovery is reduced by 50 percent.

Comparative negligence, however, has created as many problems as it has solved, since plaintiffs primarily responsible for their own injuries can recover compensation from others. For example, if comparative negligence principles had been applied in the example cited above, the County of San Diego would have been liable not only for the injuries of the car's passenger, but also for 10 percent of the injuries to the intoxicated and speeding driver.

The problem with the comparative negligence standard could be reduced by the adoption of a new rule under which a plaintiff is not to collect from a defendant less at fault than the plaintiff himself.

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18. Such modified joint and several liability rules are already in effect in ten states. Three have abolished the doctrine entirely.

Thus a plaintiff who is more than 50 percent at fault could not collect damages from others for his injury.[19]

Pay attorney's fees to the winning party.

One reason for the immense amount of litigation in the United States is the system for allocating attorney's fees. In U.S. courts, unlike those in Great Britain and most other Western countries, each party in a lawsuit pays his own attorney's fees, regardless of the outcome of the case. Thus a defendant who is the subject of a meritless suit may be able to successfully vindicate his position in court but find himself significantly out of pocket--or even financially ruined--after paying attorney's fees.

Such a rule not only is unfair, but is bad policy. It encourages litigants to press claims that are not meritorious. Knowing it will cost the other side a substantial amount to defend, the plaintiff can anticipate an out-of-court settlement, assuming his attorney asks for less than the defendant's expected legal costs. Corporations are subject to many such suits, when it is simply not worth the cost of a defense.

Of course, requiring losers to pay the attorney's fees in all cases may seem inequitable in many instances. The law in the U.S. is currently so vague and unpredictable that it is often impossible for litigants to know beforehand whether their cases are meritorious or not. In such situations, it would not be fair to require the eventual loser to bear the entire cost of litigation. Nevertheless, for litigants who can be held responsible for bringing a clearly unmeritorious case, courts should be allowed to routinely assess attorney's fees against the plaintiff.

There are many ways to do this. A modified English rule could be adopted under which attorney's fees would be assessed against the losing party if the judge specifically found that the plaintiff's claim was not reasonable.[20] Conversely, the fees could automatically be assessed unless the court specifically found that the claim was reasonable, as is now the rule in Alaska. Such a rule would provide the necessary disincentives to unreasonable claims, while protecting those who unsuccessfully, but reasonably, pursued their claims.

There are, of course, many other reforms that policy makers should consider. Among these are separating the liability and damage phases of trials in order to reduce prejudice to defendants, requiring

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19. Such a rule has already been adopted in Idaho and Wisconsin.

20. While most states now allow attorney's fees to be awarded in some cases, usually the case must have been brought in "bad faith," a higher standard.

damage awards for future injuries to be paid in installments, rather than a lump sum, and increasing court fees to eliminate the taxpayer subsidy of private disputes. Further, reforms to reduce the cost of litigation, possibly through increased use of alternative dispute resolution systems, should be explored.

For the most part, the necessary reforms must be executed at the state level, since tort actions are generally under state law. Congress, nonetheless, has an important role to play. In some areas, such as product liability, the 50 sets of state tort law disrupt interstate commerce; a uniform federal standard may be necessary. Further, important reforms, such as shifting the payment of attorney's fees, might be legislated by Congress for federal courts. Since many cases involving state tort law are tried in federal courts, such reform could have a substantial effect.[21]

THE ADMINISTRATION'S PROPOSAL

The Reagan Administration is now developing a package of recommendations for state, federal, and judicial action to resolve the liability crisis. It appears that the package will recommend: restoration of the role of fault and causation in the system; limiting noneconomic and punitive damages to a set dollar amount; periodic, rather than lump sum, payments of awards for future damages; the use of alternative dispute resolution systems; abolishing joint and several liability; limiting the recovery of plaintiffs who are covered by insurance; and limiting contingency fees under a state mandated "sliding scale."[22]

There are some problems with this package. As explained above, limits on contingency fees and reductions in awards when the plaintiff is insured would be inadvisable. Nevertheless, the package has many merits. Strengthening the role of fault and causation in the system, limiting noneconomic damages, and requiring periodic payment of awards would go far toward relieving the tort crisis. Perhaps more important, the package could serve as a springboard for debate on this issue.

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21. Under the Constitution, matters of state law involving citizens of two or more states can be tried in federal court. Although state tort law must be applied in such cases, the federal courts apply their own procedural rules.

22. Report of the Tort Policy Working Group on the Causes, Extent and Policy Implications of the Current Crisis in Insurance Availability and Affordability, February 1986.

CONCLUSION

The problems in the U.S. tort system are deep and far-reaching. They are not the result of any single law or any particular court decision--they are, rather, the consequence of decades in which legal changes slowly eroded traditional defenses, decreased the importance of individual responsibility, and made the system more vague and unpredictable. The result is that the U.S. tort system is less a process of compensation for wrongs and more a huge national lottery.

For years, the consequences of these changes were hidden. The biggest losers were, for the most part, those who could be expected to enjoy little public sympathy: big corporations, insurance companies, rich doctors. Now the impact of changes in the tort system is felt by the general public. As the risks of liability grow larger and more unpredictable, insurance becomes harder to obtain. Beneficial products then are withdrawn from the market, obstetricians stop delivering babies, child care centers close, and taxes rise to cover municipal liability claims.

The solution is not simply to make it more difficult to win compensation through the tort system. Persons who have been wronged must be able to receive adequate compensation through civil justice. Instead, the system must be reformed to allow it to determine exactly who has been wronged, to determine the appropriate level of compensation, and to prevent abuse by those without meritorious claims. Reforms should include limits on noneconomic damages, payment of punitive damages to a third party, modification of the joint and several liability and comparative negligence rules, and payment of attorney's fees by the losing party in certain cases, in addition to generally reforming the rules of liability to reemphasize the role of fault.

There is no quick fix. Rehabilitation of the tort system will take a long time. Nevertheless, the first steps must be taken soon, or the liability explosion will wreak serious damage to many central elements of U.S. society.

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