Making Sense of the Liability Insurance Crisis

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I. INTRODUCTION

Complex issues are often debated in simple terms. Simple arguments can pose dramatic questions and draw public attention to the issues involved; but they may also deprive public debate of the depth necessary to an accurate understanding of the problem at hand. Debate about the recent crisis in liability insurance cost and availability has elicited both simple explanations and simple solutions. The simple explanations cite simple causes: the natural progression of the "underwriting cycle" resulting from the decline in interest rates that began in the early 1980s;[1] price gouging by the insurance industry;[2] an explosion in tort liability necessitating dramatic increases in premium rates and making insurance against certain risks impossible;[3] the incentives to initiate tort claims created by our system that make increases in the costs of tort liability and in the liability insurance costs that accompany it inevitable.[4]

Simple solutions also abound: limit price competition through regulatory imposition of "flex" rating to counteract the underwriting cycle;[5] repeal the McCarran-Ferguson Act's exemption of the insurance industry from federal antitrust regulation;[6] return to the tort law of three decades ago;[7] control attorney's fees in tort cases; and adopt the English rule that a losing plaintiff must pay defendant's costs.[8]

These explanations for the crisis and the solutions they generate are not only simple, but simplistic. Standing alone, no single diagnosis can account for more than a portion of the recent crisis, no single explanation can adduce sufficiently complete and compelling data for support, and no single, plausible solution has the power to make the crisis disappear. The causes of the crisis are complex, and there are no easy methods of solving the problem, returning premium rates to their former levels, or obtaining complete assurance that similar crises will not occur in the future. In what follows I set out my own view of the causes and possible cures of the crisis by analyzing the four major explanations cited above, exploring the implications of this

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1. *See* 1 GOVERNOR'S ADVISORY COMMISSION ON LIABILITY INSURANCE, STATE OF NEW YORK, INSURING OUR FUTURE 15 (1986).

2. *See* NATIONAL INSURANCE CONSUMER ORGANIZATION, THE LIABILITY CRISIS IN INSURANCE 1 (1986).

3. *See generally* INSURANCE SERVICES OFFICE, INSURER PROFITABILITY: THE FACTS (1986).

4. I derive this theory from remarks by J. Robert S. Pritchard, Dean of the University of Toronto School of Law, made in Washington, D.C. on Nov. 8, 1986.

5. *See* 1 GOVERNOR'S ADVISORY COMMISSION ON LIABILITY INSURANCE, *supra* note 1, at 93–98.

6. *See* NATIONAL INSURANCE CONSUMER ORGANIZATION, *supra* note 2, at 7.

7. *See* G. PRIEST, THE CURRENT INSURANCE CRISIS AND MODERN TORT LAW (unpublished draft, 1986).

8. *See, e.g.*, the following pamphlets prepared by defense-oriented groups: INSURANCE INFORMATION INSTITUTE, THE LAWSUIT CRISIS 4 (1986); THE BUSINESS ROUNDTABLE, TORT LAW REFORM POLICY STATEMENT 5 (1986); R. MALOTT, AMERICA'S LIABILITY EXPLOSION: CAN WE AFFORD THE COST? 9–10 (1985).

analysis for the solutions that have been proposed, and indicating the points at which satisfactory analysis is impeded by the absence of data about critical issues.

II. THE UNDERWRITING CYCLE

For many decades the profitability of the property/casualty industry and the supply of its product have been subject to rather regular cycles. During the "soft" portion of this underwriting cycle, premiums are comparatively low and coverage is comparatively easy to obtain. During the "hard" portion of the cycle premiums rise, as the capacity of the industry to supply coverage contracts.

The causes of the cycle are complex. One factor is the supply of capital to the industry. The industry's underwriting "capacity"—the amount of insurance it can sell—is both legally and prudentially a multiple of its capital surplus.[9] Surplus can be increased through profits earned in underwriting—when premiums exceed the costs of claims and expenses under policies sold for those premiums. Surplus can also be increased by accumulation of earnings on premiums that are invested prior to the time when claims must be paid. Finally, capacity may be increased even without increasing surplus through the purchase of reinsurance—in effect, the purchase of insurance by an insurer.

Each of these factors seems to have figured in the most recent cycle. First, toward the end of 1984 European reinsurers reduced the amount of coverage they were willing to offer the American property/casualty industry. This decision may have been due partly to the strength of the dollar against European currencies. But it also seems to have been caused by these reinsurers' growing concern over the expansion of their exposure by American rules of tort liability.

Second, between about 1978 and 1983, when high interest rates prevailed, it was possible for insurers to incur sizeable underwriting losses and still show an operating profit by earning high returns on invested premiums. During this period competition in the property/casualty industry was stiff, and premium levels remained at the same level or (in certain cases) declined. Proponents of the underwriting cycle theory suggest that as interest rates declined after 1983 it was inevitable that premiums would rise, because investment profit could no longer offset previous levels of underwriting loss.

This explanation has some force. However, the magnitude of recent increases has been far greater than one would expect if a drop in interest rates alone were responsible. If changes in interest rates roughly parallel changes in the inflation rate, and the components of tort recoveries follow the inflation rate, then one would expect little impact on premiums from changes in the interest rate. This is because any gain or loss in prospective investment income would be offset by a prospective loss or gain in underwriting results. Changes in the interest rate should affect premium rates significantly only when the interest rate does not change as quickly as the inflation rate. In fact, due to fears about future inflation, United States interest rates did

9. *See* INSURANCE INFORMATION INSTITUTE, BASIC CONCEPTS OF ACCOUNTING AND TAXATION OF PROPERTY/CASUALTY INSURANCE COMPANIES 48 (1984).

not decline as quickly after 1983 as did inflation. A premium increase therefore could have been expected once the difference between these rates narrowed.

Such an increase, however, would have been comparatively modest. Take the extreme situation: a long-tail line of liability insurance such as medical malpractice or products liability, in which the average claim is not paid for six to eight years after a policy is sold and in which investment income is therefore a large component of the operating profitability of the line. In this case one would expect, very roughly, that premiums might have increased a maximum of fifty percent when the gap between the interest and inflation rates narrowed, because of the loss of an "extra" three to five percent annual investment profit over six to eight years. Even this hypothesis supposes that in setting their premium rates early in the 1980s insurers were betting against the capital market's fear that inflation (including inflation in jury awards) would return later in the decade.

Any premium increases above this fifty percent estimate even in long-tail lines cannot be ascribed to the interest-rate effect; and in shorter-tail lines, in which investment income comprises a smaller portion of operating profit or loss, one would expect the effect to have been even smaller. The withdrawal of reinsurance capital therefore seems a much more probable cause of the market's entry into a hard portion of the cycle late in 1984 than does the decline in interest rates. Even both factors together, however, seem unlikely to account for the severity of the problem that occurred thereafter.

III. THE CONSPIRACY THEORY

The conspiracy theory rejects more innocent explanations for the crisis, and attributes the large increases in the price of liability insurance that struck in 1985 and 1986 as evidence of price gouging by the property/casualty insurance industry.[10] Because the industry is largely exempted from the federal antitrust laws, the theory suggests that price competition can be avoided and rates can be raised above competitive levels. Proponents of the theory cite evidence that sizeable premium increases in the past have been followed by periods of high profitability. They find the data marshalled by the industry in support of current price increases inconclusive and therefore self-serving, and they occasionally charge that recent price increases are intended to recover losses suffered in previous years.

The weakness of the conspiracy theory is that it cannot explain how a market that recently was characterized by intense price competition has turned anticompetitive. During the four years prior to 1983, for example, commercial liability insurance was widely available at level prices, notwithstanding the double digit inflation that prevailed during the period. Maintaining a nationwide cartel in an industry as unconcentrated as property/casualty insurance would be extremely difficult, as this recent history suggests.[11] Moreover, in a competitive market the recapture of past

10. *See* NATIONAL INSURANCE CONSUMER ORGANIZATION, *supra* note 2.

11. For discussion of the degree of concentration in the industry, see UNITED STATES DEP'T OF JUSTICE, TORT POLICY WORKING GROUP, AN UPDATE ON THE LIABILITY CRISIS, app. 9–10 (March, 1987).

losses through current price increases is impossible, since past losses are in effect sunk costs that do not burden potential new entrants.

Finally, the current crisis not only involves the *affordability* of coverage, but its *availability* as well. Liability insurance for certain risks—directors and officers, nurse-midwives, day-care centers, bars and restaurants, obstetricians practicing in certain settings—was unavailable at any price for months at a time in some states during 1986. As George Priest has suggested,[12] it would be a strange cartel indeed that exercised its monopoly power by refusing to sell its product to some of those who wished to purchase it, even at very high prices. In short, the conspiracy explanation for the liability insurance crisis is both theoretically implausible and empirically unproven.[13]

Despite the weakness of the conspiracy theory as a general explanation for the crisis, I think it likely that some companies took advantage of the crisis and raised premiums to levels higher than they would have raised them had there not been widespread turmoil. Here I have in mind the lines sold in states where—because the market is thin and the costs of entry are high—the one or two insurers who write coverage have a niche that cannot be immediately undercut. For example, a medical malpractice insurer which sells ninety percent of the coverage in a state with only two thousand physicians may be able to double its premium rates for certain classes of physicians without facing serious rate competition in the short run.[14] In many states where there is open price competition in most commercial lines, regulatory approval of rate increases is nonetheless required for niche-market lines such as medical malpractice. But the difficulty of predicting liability exposure makes assessing the justification for a rate increase in such lines a highly speculative exercise.[15] Regulatory disapproval of proposed rate increases in such lines therefore is not as common as might be expected.[16]

A final issue that fits most comfortably in a discussion of the conspiracy theory is the insurance industry's role in promoting the tort reform legislation that has been adopted by many states in response to the insurance crisis. Although it may seem unsurprising to find the industry favoring limitations on tort liability, that stance in fact proves more complicated to explain than a superficial look at the issue might suggest. One would think that property/casualty insurers would favor the expansion of tort liability, because the greater the threat of liability, the greater the demand for liability insurance. Why might it be in the interest of insurers, then, to support tort reforms that limit the incidence and scope of tort liability?

There are three plausible reasons, only one of which smacks of something like conspiracy. First, the industry may recognize that there are practical limits on the percentage of individual and corporate income that can be spent for insurance. When

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12. *See* G. PRIEST, *supra* note 7.

13. *See* 1 GOVERNOR'S COMMISSION ON LIABILITY INSURANCE, *supra* note 1, at 9.

14. In the long run, competition may develop either from the commercial market or through the establishment of medical mutuals.

15. *See infra* Part IV.

16. For a discussion of the problems faced by state insurance commissioners see K. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 38–41 (1986).

insurance prices exceed these limits, responses that are not in the industry's interest may be triggered. Risk retention and self-insurance alternatives that would not otherwise be considered may come into play,[17] more stringent regulation may be proposed, and the insurance industry may be blamed for the escalation of the costs of the tort system. Self-interest may therefore suggest that tort reform be favored, notwithstanding that reform would limit demand for the industry's product. But this is hardly conspiracy against the interests of the insuring public.

Second, even apart from the above considerations, all expansions of tort liability are not necessarily in the insurance industry's long-term interest. An industry that relies on the certainty afforded by the law of large numbers may favor slow, steady, and predictable expansion of tort liability. But when the choice is between expansion that creates exposure that is difficult to predict with precision, and limitations on tort liability that facilitate predictability, the latter are likely to be preferable. Whatever one concludes about the wisdom of this posture, its motive is not the desire to engage in price gouging.

A third explanation for the industry's support of tort reform, however, is consistent with the conspiracy theory. This view suggests that the industry simply has shorter-term interests in mind in favoring reform. Having calculated premiums based on the supposition that tort liabilities would remain steady or expand, the industry then argued for reforms that will reduce its cost base and produce greater profits than its earlier calculations would have anticipated. In the long-run this approach may also reduce total revenue, but over the short-term it improves profitability. Moreover, if tort liability again begins expanding some years after enactment of the reforms, then revenue increases will have been delayed, but not denied.

In one sense this argument is irrefutable. The reduction in insurers' esposure under policies already sold that would result from tort reform cannot be an entirely unpleasant prospect for them. It is therefore not surprising that, in light of this prospect, some state legislatures demanded rollbacks in premium increases as a condition of the enactment of the 1986 reforms.[18] In another sense, however, the argument infers a conspiratorial motive from behavior that could just as plausibly be construed as innocent conduct. If the 1985-1986 premium increases resulted from what insurers perceive as an increasingly unpredictable expansion of tort liability, then the industry's support of tort reform can be primarily ascribed to its desire that this expansion be controlled. Any windfall gained through the reduction of exposure under pre-existing policies should be seen as a mere side effect of reform, albeit a welcome one. On the other hand, if the 1986 premium increases were the result of anticompetitive price gouging, why would the industry then support legislative reduction in the demand for its product, having already proved itself capable of taking monopoly profits? Why kill the goose that laid the golden egg?

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17. For discussion of the increasing use of alternatives to the commercial market, see *Business Insurance*, Jan. 26, 1987, at 14–16.

18. Florida is the most publicized example. For discussion of the legislation that produced this rollback, see Schulte, *Availability, Affordability, and Accountability: Regulatory Reform of Insurance*, 14 FLA. ST. U.L. REV. 557 (1986).

The available answers are none too persuasive. Perhaps the industry's support for tort reform was a colossal fraud, designed to deceive those who questioned the premium increases that prompted legislative consideration of reform. According to this view the industry supported reform, but did not actually favor it. Or perhaps the industry's support for tort reform was simply another example of its supposed preference for short-term over long-term advantage. Under this view the industry chose to capture the gain from reduced liabilities under pre-existing policies rather than continuing to maximize its monopoly profits. However, the persuasiveness of this explanation depends not only on the assumption that it was a cartel which raised premiums above competitive levels, but also that, having maintained the solidarity necessary for the price increase, the cartel "members" then agreed through their trade associations to favor their short-term rather than long-term interests by supporting tort reform. A consensus on such a strategically complex choice would be highly improbable in the absence of any indication of the attending debate finding its way into the public record.

While these suppositions may be possible, they are speculative and highly unlikely. Yet their implausibility depends at least in part on the credibility of the alternative explanation for the industry's support for tort reform—that the growth of enterprise liability has made the prediction of tort liability and the pricing of insurance against the risk of that liability increasingly difficult. I now turn to that explanation.

IV. Enterprise Liability And The Predictability Problem

Although the parameters of the growth in tort liability over the past decade have not been definitively quantified, there is little doubt that it has been substantial. There are two ways to measure the magnitude of this growth. The first method is to measure increases in the cost of items that are components of tort recoveries. By this measure, the increases have been sizeable. Between 1975 and 1984, for example, inflation was eighty-three percent, real per capita income grew seventeen percent, and real health care costs increased twenty-three percent.[19] Based on these factors alone, one would expect an increase in the cost of liability insurance of approximately one hundred percent during this period.

The second method of measuring increases is a direct comparison of payouts. This measure also reflects a significant growth in liability. Since 1981, for example, the average annual increase in amounts paid in non-automobile liability claims has been seventeen percent, and the average annual increase in counsel fees for insured defendants in such cases has been fifteen percent.[20] During the same period, the average annual increase in the Consumer Price Index was seven percent. New York City, which is self-insured for tort liability, experienced a four hundred percent increase in amounts paid in tort settlements and judgments between 1978 and 1985.[21]

19. *See* M. Cooper, Trends in Liability Awards: Have Juries Run Wild? (Consumer Federation of America, May 1986).

20. *See* J. Kakalik & N. Pace, Costs and Compensation Paid in Tort Litigation (Rand Institute for Civil Justice, 1986).

21. *See* Governor's Advisory Commission on Liability Insurance, *supra* note 1, at 5.

In addition, between 1979 and 1984 the Gross National Product grew by about fifty percent, while losses covered by commercial liability insurance increased one hundred thirty percent.[22]

It is no surprise that increases of this magnitude in tort costs would affect liability insurance premium levels. What is surprising, however, is that the increases were so sudden. A partial reason for the precipitous increases may lie in the underwriting cycle. The cutthroat competition that resulted in "cash-flow" underwriting early in the decade may have delayed the impact of increased tort liability on premiums for several years, until the forces of competition for market share finally had to yield to more rational pricing. Nonetheless, the premium increases of 1985 and 1986 were so dramatic and, in some cases, so enormous, that prudence suggests a search for other explanations as well.

The most plausible explanation for the size and suddenness of the premium increases is a decline in the property/casualty insurance industry's confidence that it could predict the scope of the liabilities it would face under the policies it sold after 1985. Thus, on top of the increases that can be ascribed to the operation of the underwriting cycle and to predictable increases in tort liabilities, an additional premium was assessed to cover insurers against the risk that their liabilities would escalate in unanticipated ways. This "unpredicability risk premium" is probably responsible for the remaining component of the recent round of increases.

There is little evidence to explain why insurers' confidence dropped so precipitously in 1985. Surely the severe tightening of the reinsurance market at the end of 1984 is part of the answer, although this only pushes the inquiry a step backward. In any case, there may well have developed a kind of communal mind-set among primary insurers that is not entirely inconsistent with some of the suppositions of the conspiracy theory. But there is no way to determine whether this mind-set was symptomatic of paranoia or of realism until the claims lodged against the holders of policies issued during the past two years accumulate in the years to come. It is possible, however, to pinpoint a number of legal developments that are likely to have shaken insurers' confidence in their ability to predict future liabilities.

First, scientific advances have made it possible to connect exposure to hazardous materials to an increased long-term probability of contracting certain diseases. The result has been the proliferation of claims for long-latency diseases allegedly caused by such exposures. Instead of rendering liability for such diseases more insurable, however, these scientific advances often have produced the opposite effect. Experts are sometimes able to retrospectively identify the cause of the claimant's disease with sufficient certainty to support the imposition of liability. But science has not progressed sufficiently to enable the accurate prediction of the probability and severity of the occurrence of diseases that may be associated with a particular product or material in order to correctly price insurance against liability for these diseases.

This problem is especially severe in attempting to calculate premiums for "occurrence" coverage, which insures against liability arising out of the insured's

22. *See* INSURANCE SERVICES OFFICE, INSURER PROFITABILITY: THE FACTS 25–27 (1986).

activities during the policy period, regardless of the year when injuries allegedly caused by these activities manifest themselves. In pricing occurrence coverage the insurer must predict all liabilities that may eventually be incurred because of this year's activities by the insured. When these liabilities include an uncertain quantity of long-latency disease, making this prediction is especially difficult. An alternative is to offer "claims-made" coverage, which insures against all claims first made during the policy year, regardless of the year when the activity causing the claim occurred. Because the claims-made insurer need predict only next year's claims in setting a price for next year's coverage, its task is much simpler. But claims-made coverage shifts much of the risk of long-term liability onto the insured, and thus provides less real insurance protection than occurrence coverage. For this reason, the industry encountered serious opposition to its effort to introduce a claims-made policy form in commercial liability lines in 1986.

A second factor contributing to unpredictability is legal change. Although the expansion of liability need not automatically undermine predictability, recent legal changes have done so in several ways. Because many of the expansions of tort liability that have occurred during the past decade were not anticipated by insurers, they have become wary of their ability to predict future expansion. The role played by this kind of wariness should be emphasized, even though it cannot be documented statistically and sometimes seems unwarranted. Insurance underwriters have become highly distrustful of courts and juries. This distrust can often obscure relevant distinctions between states with narrow and those with liberal rules of recovery, and between standards adopted by obscure trial courts and those endorsed at the appellate level. There is little, aside from several years without major legal surprises, that is likely to neutralize this wariness.

The kinds of legal decisions about which insurers are most concerned are those that create new forms of exposure that are much less predictable than those they supplement or displace. Several examples are worth noting, because they illustrate the manner in which new forms of liability that sometimes seem logical from the standpoint of the tort system can severely hinder insurability. Many of these standards do not yet and may never represent mainstream principles of tort liability; but the prospect that they may take hold cannot be ignored by insurers.

First, a few judicial decisions have imposed what amounts to retroactive strict liability for product defects for the failure to warn users or consumers of products about risks that were not and could not have been known at the time a warning could have been given.[23] The difficulty of predicting liability for failing to discover or to warn of risks that could not have been known at the time a product was made is obvious. Pricing an occurrence policy under such circumstances is an exercise in speculation. Pricing claims-made coverage is easier, since the injuries or diseases not anticipated in the past will have begun to materialize when a price must be fixed. But

23. *See, e.g.*, Dart v. Wiebe Mfg., Inc., 147 Ariz. 242, 709 P.2d 876 (1985); Elmore v. Owens-Illinois, Inc., 673 S.W.2d 434 (Mo. 1984); Beshada v. Johns-Manville Products Corp., 90 N.J. 191, 447 A.2d 539 (1982).

because the insured activity has already occurred when a claims-made approach is used, it may be troubled by adverse selection.

Second, some courts have expanded the scope of joint and several liability among independent tortfeasors, either directly or by shifting burdens of proof.[24] The Federal "Superfund" statute[25] has a similar effect in creating liability for the costs of cleaning up hazardous waste disposal sites.[26] Predicting the magnitude of a particular insured's potential joint and several liability is particularly difficult for two reasons: whether an insured will be liable at all and how much damage will occur hinge partly on the behavior of other parties, and the portion of any judgment an insured must pay depends on the assets available from the other defendants. Yet these other parties often will be unidentifiable at the time an insurance pricing decision is made.

Third, courts in several jurisdictions have begun to allow awards of noneconomic damages to individuals exposed to danger before they suffer any physical harm. Thus far these awards have taken the form of medical monitoring expenses.[27] But plaintiffs are now beginning to claim compensation—even apart from these losses—for the mere exposure to risk.[28] The class of individuals who either are exposed to risk and may therefore need medical monitoring, or fear that they will contract disease, is much larger and less determinate than those who actually do suffer physical harm from a given course of conduct. Consequently, predicting the scope of liability that may be imposed for these new kinds of claims is considerably more difficult than predicting the scope of more traditional forms of liability.

Fourth, there may be a move to incorporate into tort law the very broad standards used to assess liability for the costs of cleaning up hazardous waste sites under the Superfund Act. Personal injury actions brought in the vicinity of Superfund sites at Times Beach, Love Canal, and Woburn, Massachusetts suggest the prospect of this development, as do others.[29] Superfund liability is generally categorized as retroactive, strict, and joint and several;[30] a move to adopt these cleanup liability standards in tort would cause new insurability problems for several of the reasons already discussed.

But the Superfund liability analogy, if fully implemented, would add another difficulty as well. Under the Superfund Act, liability for clean-up costs is imposed not only on the present and past owners or operators of hazardous waste disposal sites, but also on the parties whose industrial processes generated the waste and on the

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24. *See, e.g.*, Borel v. Fibreboard Paper Prod. Corp., 493 F.2d 1076 (5th Cir. 1973), *cert. denied*, 419 U.S. 869 (1974).

25. 42 U.S.C. §§ 9601–9615 (1982 & Supp. III 1985).

26. *See* United States v. Chem-Dyne Corp., 572 F. Supp. 802, 810 (S.D. Ohio 1983).

27. *See, e.g.*, Friends For All Children, Inc. v. Lockheed Aircraft Corp., 87 F.R.D. 560 (D.D.C. 1980) (Court granted preliminary injunction ordering defendant to provide interim medical treatment). In a subsequent proceeding, the court ordered the defendant to provide diagnostic examinations but refused to order the defendant to pay for interim medical treatment. Friends For All Children, Inc. v. Lockheed Aircraft Corp., 587 F. Supp. 180, 184–86 (D.C.), *aff'd*, 746 F.2d 816, 831 (D.C. Cir. 1984).

28. *See, e.g.*, Payton v. Abbott Laboratories, 386 Mass. 540, 437 N.E.2d 171 (1982); Ayers v. Township of Jackson, 189 N.J. Super. 561, 461 A.2d 184 (1983). For a proposal that compensation be awarded on the basis of risk, see Robinson, *Probabilistic Causation and Compensation for Tortious Risk*, 14 J. LEGAL STUD. 779 (1985).

29. *See, e.g.*, Kenney v. Scientific, Inc., 204 N.J. Super. 228, 497 A.2d 1310 (1985).

30. *See* 42 U.S.C. § 9607 (1982).

parties who transported it to disposal sites.[31] These are liabilities unknown at common law. More importantly, if the generators and transporters of toxic waste are subjected to retroactive, strict, and joint and several liability for personal injuries caused by exposure to material leaking from sites in which these parties once deposited waste, calculation of their liability insurance premiums will be fraught with risk. Their insurers will have to assess not only the riskiness of their own insureds' conduct, but also the volume, toxicity, tendency to migrate, and durability of the waste deposited in a site by other parties, for these factors will influence the extent of any given insured's potential tort liability should the site leak. Such liability is very likely to be uninsurable.

Each of the foregoing developments has expanded the liability of insured enterprises in a manner that makes predicting the extent of their potential liability more difficult. A very different form of legal change, however, also has undermined predictability. In a variety of settings courts have interpreted liability insurance policies to afford insurance against events that insurers had not anticipated covering. For example, judicial interpretations of policy provisions governing whether there was an "occurrence" within the meaning of a policy,[32] whether cleanup costs are covered by a Comprehensive General Liability policy,[33] the applicability of the "pollution exclusion,"[34] the number of insured "occurrences" resulting from events taking place over a period of years,[35] and the insured "events" triggering coverage against liability for long-latency diseases[36] all have produced coverage obligations which insurers had not anticipated.

Insurers can react to novel judicial interpretations by either raising the price of future coverage provided under identically phrased policies, or by changing the language of these policies to clarify their coverage obligations. Unfortunately, however, neither of these reactions is satisfactory protection if the courts continue to adopt readings which, in the insurers' view, rewrite policy provisions rather than interpret them. The climate of uncertainty surrounding the drafting and interpretation of insurance policies is thus another factor that contributes to the unpredictability that influenced the dramatic escalation of insurance premiums that occurred in 1985 and 1986.

Each of the foregoing developments lends support to the unpredictability hypothesis. Unfortunately, the very nature of the liability insurance business makes verification or refutation of the hypothesis impossible without psychoanalyzing those responsible for the actuarial calculations that precede rate-setting. Only the future will tell us whether recent increases have been excessive or whether, on the contrary, the

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31. 42 U.S.C. § 9607(a) (1982).

32. *See* Buckeye Union Ins. Co. v. Liberty Solvents and Chem. Co., 17 Ohio App. 3d 127, 131–32, 477 N.E. 2d 1227, 1233 (1984).

33. *See* Chemical Applications Co., Inc. v. Home Indem. Co., 425 F. Supp. 777 (D. Mass. 1977).

34. *See* Jackson Township Mun. Utils. Auth. v. Hartford Accident & Indem. Co., 186 N.J. Super. 156, 164–66, 451 A.2d 990, 994–95 (Law Div. 1982).

35. *See* Jackson Township Mun. Utils. Auth. v. American Home Ins. Co., No. L-29236-8 (N.J. Super. Court, Law Div. 1984) (appeal pending).

36. *See* Keene Corp. v. Ins. Co. of North America, 667 F.2d 1034 (D.C. cir. 1981), *cert. denied*, 455 U.S. 1007 (1982).

industry's apparent fears about the explosion of tort liability reflect the prescience for which the industry strives.

V. Incentives to Litigate

The fourth theory I shall examine takes a comparative approach. This theory suggests that the incentives to litigate personal injury cases in the United States are so strong that the long-term trend will ineluctably be toward more tort liability and greater liability insurance costs. This theory does not contradict the other three; it merely denigrates their importance. The theory does not purport to explain the dynamics of the recent liability insurance crisis. Rather, it sees recent developments as blips on a graph that traces a steadily upward course toward higher costs.

The theory points to three features of the American tort system that create distinctive incentives to litigate: the availability of contingent fees for plaintiffs' attorneys, the "American rule" that a losing party is not obligated to pay his adversary's costs, and the absence of the widespread, generous forms of social insurance prevalent in other Western democracies. The contingent fee system and the American rule make the instigation of a tort claim much less risky for the American plaintiff, because he risks so much less than potential plaintiffs in other systems. In effect, the plaintiff sells a portion of his claim to his attorney in return for counsel fees, and he does not risk liability for his opponent's fees. The absence of generous sources of social insurance also creates incentives to sue for losses not otherwise compensated, and knowledge of the probable absence of full first-party insurance protection by the victim makes juries more sympathetic to plaintiffs' claims than they would be under other circumstances.

The consequence of these incentives, according to the theory, is two-fold. Not only are more tort claims filed and higher judgments awarded, but plaintiffs and their attorneys also are continually challenging the limits of liability, and the occassional success in pushing back those limits (either legal or monetary) sets a precedent, creates publicity, and encourages more litigation. This self-reinforcing cycle provides the impetus behind the increased costs of liability and liability insurance.

The weakness of this theory, of course, is that it is too general to be of any use in understanding what has happened to the liability insurance market in the past year or two. On the other hand, its strength is that it points to systemwide characteristics that may well have more influence over the long-term than any of the more "local" considerations I have canvassed thus far. The theory is a sober warning against quick-fix solutions: superficial doctrinal modifications, renewed regulatory attention to insurance rates, controls on contingent fee levels. Such reforms may rachet down costs temporarily, but costs will continue to rise if the theory is correct. The theory suggests that even application of the antitrust laws to the insurance industry, regulatory attempts to mitigate the underwriting cycle, and retrenchments in modern tort liability doctrine are unlikely to eliminate the fundamental cause of the insurance crisis. To obtain substantial savings in the cost of liability insurance, the theory argues, there will have to be substantial reduction in the incentives our system provides injured parties to litigate their claims.

VI. CONCLUSION

Each of the four theories I have examined has elements of plausibility. Indeed, I accept them all, with the caveats that I have noted. Standing alone, however, no single theory is capable of explaining the causes behind the liability insurance crisis that has recently struck the country. Taken together, the accurate elements of each begin to provide a satisfactory explanation for the causes of the crisis.

Fashioning a cure for the crisis is, unfortunately, more difficult than explaining it. More focused regulatory attention on the thin and niche markets where competitive forces do not adequately restrain premium rates would help neutralize monopolistic behavior where it does exist and the underwriting cycle will inevitably progress on its own. Therefore, the availability crisis will probably abate, as both underwriting capacity increases and new entrants into markets where coverage has been unavailable offer it, albeit at higher prices. For example, the trade publications have recently noted that nurse-midwives and day-care centers are locating sources of coverage that was simply unavailable during much of 1986. Other tight markets should loosen up in a similar fashion.

But these are short-term solutions. The longer-term problems of unpredictability and litigation incentives pose fundamental issues that are not so easily resolved. While insurance markets are probably more flexible and resilient than many critics of modern tort liability suggest, these markets possess neither infinite resilience nor infinite flexibility. Ultimately there is a tension between the predictability that produces stability in insurance markets and the risk-reducing, cost spreading goals that undergird so much of modern tort liability. If there is to be stability in the insurance markets that are so important to our economic well-being, we may have to place some limits on the scope of tort liabilities. Without such limits, uncertainty may continue to operate like a broad-based, undiscriminating liability insurance tax that simply drives up costs across-the-board.

How is this "uncertainty" tax to be eliminated? In his *General Theory*, John Maynard Keynes suggested that "[p]ractical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."[37] It may be that the present generation of jurists and juries is the slave of outdated legal theories, and that only a generational shift can bring a change in the legal climate. In any event, the tendency of judges and juries to treat defendants' insurance coverage like social insurance for victims is unlikely to be neutralized by tort reform alone. In the long-term, doctrinal reform probably cannot successfully solve the tort system's problems until alternative sources of compensation are available as substitutes for tort recoveries. Otherwise, reforms likely will follow the defense of those who must implement them through individual lawsuits; judges and juries simply will manage to circumvent the new limits on liability and reinstate the old system.

Until new, or at least broadened forms of compensation outside the tort system are developed, the compensation/entitlement mentality is likely to dominate personal

37. *See* J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 383 (1936).

injury litigation. The "new compensation" that is necessary might take a number of different forms—catastrophic health insurance, expanded private disability insurance, special-purpose administrative compensation funds, or more generous tax-financed social security protection. Discussion of the strengths and weaknesses of these different approaches is beyond the scope of this article; but the liability insurance problem is unlikely to abate until these two issues—compensation and insurability—are recognized as opposite sides of the same problem.