The Geneva Papers, **2005**, **30**, (343–351)

www.palgrave-journals.com/gpp

The Economic System as Catalyst for Evolving Liability Regimes*

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The article makes a case for the evolving system of liability regimes being driven by fundamental changes in our socio-economic fabric. The evolution of increasing liability costs, especially prominent in the U.S., can easily spread to other countries as the same preconditions are found there and systemic contagion takes place. This will pose important challenges to the insurance industry, which will have to better comprehend the key drivers and fundamental mechanisms involved. Provided informed and cautious underwriting takes place, this development represents an interesting opportunity.
The Geneva Papers (2005) **30,** 343–351. doi:10.1057/palgrave.gpp.2510032

Keywords: liability regimes; economic system; U.S. legal system

Introduction

Responsibility for one's actions – and sometimes even inaction – is part of the basic rules that have defined human social relations virtually since the beginning of our history. Hard on the heels of responsibility follow the concepts of liability and compensation. We have developed these in great detail and in all advanced economies many laws deal with them exhaustively. Today, the concept of liability has become an intrinsic part of our social and economic fabric. With the advent of a new service economy that places greater emphasis on performance over time and results of usage rather than on possession of goods, liability and the ability to bear it has become a key issue. To deal with the risk exposure of an actor's (potential) liability, liability insurance was invented. However, its existence was far from uncontroversial at the outset and, in the introduction to the *International Encyclopedia of Comparative Law*, André Tunc writes "At the beginning of the 19th century, liability insurance would have been unthinkable. It would have been considered as immoral."[1] This has changed since then, although it is not legal in many countries to cover certain liability exposures such as, for example, punitive damages or those related to criminal acts.

The question of whether liability insurance itself is desirable was dealt with prominently by Steven Shavell in his Annual Lecture for The Geneva Association in

* The contribution is based on the activities of The Geneva Association's PROGRES Research Programme on Regulation, Supervision and Legal Issues as well as the initiatives of the insurance industry's joint Liability Regimes Planning Board where The Geneva Association collaborates with five leading international insurance companies (Munich Re, RSA, SCOR, Swiss Re and Zurich Financial Services).
[1] André Tunc (1974, p. 50).

the year 2000. He comes to the conclusion "[…] that such insurance is socially desirable. The reason that liability insurance is socially desirable can be expressed in two ways. One is that the incentives to reduce risk are not subverted by liability insurance in the manner that some writers too readily assume. For insurance policies tend to be structured in order to induce insureds not to cause losses. The other way to explain the desirability of liability insurance is to observe that, by setting the level of liability equal to harm, society accomplishes the internalization of harm (at least under strict liability). Having done that, liability insurance contracts can be regarded as contracts that are made in the absence of externalities; as such, liability insurance contracts should raise social welfare […]."[2] If we follow his conclusion that there are relevant welfare gains in having functioning markets for liability insurance, the recent developments – especially in the U.S. but also in other countries – should be of wider concern.

Problem identification

The insurance industry has been most sensitive to developments in the area of liability as the very dynamic development of liability claims, already since the 1950s, has created rising cost. This in itself would already be enough to unsettle a market, in which premium increases have not been able to compensate for claims inflation and where extraordinary reserve additions have been necessary in a number of cases for previous underwriting years. Add the expectation of most market participants that the trend towards higher liability claims costs is going to continue and it becomes clear why the industry is so unsettled.

Making the underwriting work even more difficult is the fact that much volatility is introduced because of sometimes erratic and "emotional" jury awards, especially at the upper end of the scale, which are hard to predict for anybody. This leads to a complex mix of factors with high uncertainty and makes any estimation of future liabilities and therefore reserving requirements extremely challenging.

Beyond these more technical issues, the insurance industry generally feels misunderstood in its role by society when dealing with liability claims, especially in cases where emotional factors are involved that receive high media attention. Furthermore, insurers consider themselves and the insurance mechanism, with its special dimension of solidarity and risk-sharing, exploited by lawyers, who are viewed as undermining this very mechanism, as misappropriating it for ulterior motives.

Why liability regimes?

Why is The Geneva Association as a leading insurance research institution interested in the issues surrounding liability regimes? It is certainly a very relevant issue for the insurance industry and has a global dimension to it. It is furthermore very important to the future development of our economic and social systems, where a general shift

[2] Steven Shavell (2000, p. 166).

towards more responsibility and longer time frames can be observed. The mechanisms for assessing damages, especially when they are non-physical, and their subsequent compensation are not only an insurance problem; this concerns everybody. For the insurance industry, it touches the core of the market participants who underwrite such risks, but most other industries would not be able to function properly without adequate solutions to the liabilities they incur as part of their productive activities. The problems involved are more often than not also of a strategic nature, both for the insurer as well as the insured.

We believe that the current level of knowledge and understanding of the manifold and highly complex problems that arise from the liability sphere is inadequate. The discussion about how to tackle the challenges, to arrive at solutions that satisfy everybody directly or indirectly involved in liability cases, has to be reinforced. The creation of a special Liability Regimes Planning Board and the setting up of a conference cycle are aimed at achieving this in an integrative way, encouraging the dialogue with all concerned parties. It is not only the insurance industry that can – and has to – do something about the liability claims problem. More stakeholders have to be brought into this process.

Tom Baker, with whom The Geneva Association has collaborated in the past few years on this issue too, wrote a plea for more investigation in the January 2004 issue of the Geneva Papers and called specifically for more research on the following:

- Why/when people claim – the process of naming, blaming and claiming.
- Tort litigation statistics – what we do and do not know about the extent of tort litigation.
- Study of tort institutions – how the norms and social structures of the personal injury bar shape tort litigation; likewise with regard to the norms and social structures of liability insurance institutions.
- Econometric studies linking legal rules, accident rates, and claiming behaviour – attempts to measure the effects of changes in legal rules on behaviour.
- Tort in media/popular culture – how tort law is portrayed in the media and popular culture and how do those portrayals feed back into approaches to claiming, settlement and litigation.
- Legal history – examining the development of liability institutions over time.[3]

The U.S. trend in liability

In insurance markets there is today a generally more sensitive perception about the increasing frequency and volume of liability claims. Swiss Re estimates in its recent Sigma publication "[t]hat the costs of general liability claims grew faster than the overall economic activity in most major economies. Long-term estimates suggest that claims are growing 1.5 to 2 times as fast as nominal GDP […]."[4] It is the U.S. system that

[3] Tom Baker (2004, p. 146).
[4] Swiss Re (2004): The Economics of Liability Losses – insuring a moving target. In: Sigma, no. 6/2004. Published in November 2004, the issue is available on Swiss Re's website (*www.swissre.com*)

apparently has the highest liability claims costs worldwide. Swiss Re maintains that "commercial liability claims, as a share of GDP, are 2–3 times higher in the U.S. than in Europe." It cites National Insurance Supervisory Authority (NISA) data, which estimates the U.S. share of the general liability claims in the 10 largest non-life insurance markets worldwide at 80 per cent (US$67 billion out of a total of US$84 billion) and the motor liability share at 57 per cent (US$86.4 billion vs. US$151.9 billion).

Tillinghast-Towers Perrin analysed the costs of the U.S. liability system. In their latest update, they write "At current levels, U.S. tort costs are equivalent to a 5 per cent tax on wages. The U.S. tort system cost $233 billion in 2002, which translates to $809 per person, or $87 more than in 2001. This compares to a cost of $12 per person in 1950."[5] They estimate the year-on-year growth rate in 2001 of U.S. tort costs at 14.4 per cent and for 2002 at 13.3 per cent, far outstripping GDP growth. They further write: "When viewed as a method of compensating injured parties, the U.S. tort system is highly inefficient, returning less than 50 cents on the dollar to the people it is designed to help and returning only 22 cents to compensate for actual economic loss." It is this point that disenchants many people and leads to frequent comments about the failures of the system and the need for reform.

The Council of Economic Advisors wonders in its report of April 2002 "Who pays for Tort Liability Claims?", writing that "with conservatively estimated annual direct costs of $180 billion, or 1.8 per cent of GDP, the United States tort system is the most expensive in the world, more than double the average of other industrialized nations."[6]

From a strictly technical point of view, raising compensation costs in themselves is not a problem to insurance companies, provided they can (a) estimate the future development, and (b) reserve properly against adverse developments. One can even argue that the liability arena presents many opportunities as it is an area of the economy that grows much faster than the average, hence opening up additional space for future activities.

What concerns the insurance industry is that the development of liability claims costs is much more dynamic than anybody anticipated, especially at the moment of writing business that has a very long tail. The surprise at the intensity of this development and consequently the under-reservation for risks has led to notable problems for some insurers. In addition, the volatility of sometimes erratic, "emotional", and very costly jury awards is negative for the business environment.

Additonally, the legal environment has fundamentally changed. The tort system in the U.S. has in some cases moved away from the traditional approach of fault and reimbursement. Newer and increasingly more widely accepted principles include the following:

- "Liability without fault" (beyond the concept of implicit endangerment), for example, asbestosis claims against unsuspicious buyers of properties.
- "Damages without harm", for example, on financial markets through the concept of "fraud against the market".
- "Quantum of damages without reason", for example, based on contact with asbestos without further medical indication or pathological development.

[5] Tillinghast-Towers Perrin (2003).
[6] Council of Economic Advisors (2002, p. 1).

Some observers of the U.S. legal system contend that it is moving away from a system of fault and recompense to one concerned chiefly with wealth distribution.

Besides the above, however, the most important change that is of concern is the nature of the legal production system in itself. Whereas in a traditional set-up, a case was looking for a solution, today a solution is looking for potential cases. The U.S. law firms, especially, and also others in increasingly more parts of the world, have restructured their business model. They regard themselves as entrepreneurs that use the same instruments and processes as other industries: standardization of products and services, economies of scale, administrative cost reduction, marketing efforts, business development, and strategic investment planning, to name but a few. They now reinvest the proceeds of earlier exploitations and have become as aggressive and efficient as other branches in identifying new business opportunities. With the marginal cost of the addition of another case to a large class action suit being negligible, this has become one of the preferred instruments in the legal arena. This revolution of their production system is as important to the legal professions as Taylorism was to the automotive industry, with similar consequences for our economies.

A U.S. legal system that allows ''venue shopping'' and other techniques to maximize awards has boosted claims costs. Nowadays, one of the most important variables as to how a case will be resolved and what damages will be awarded is the venue. No wonder the contending party spends increasing efforts in picking or avoiding certain localities. The development of the legal system through judges and juries, who are not generally trained in economic affairs, and much less in insurance, is problematic. When the framework for future activities (and exclusions!) is set by persons who – because the system is not set up adequately – often do not understand enough the larger implication of certain decisions they make, we should not be surprised that the outcome is suboptimal.

Liability claims cost environment: the new legal production system

We have to realize that we operate in an increasingly different environment in which economic agents display a changing set of expectations and priorities when interacting. It is not only the legal sphere that has changed but the whole economy. It is the emancipation from the physical goods' production and a new emphasis on performance over time that has led to the New Service Economy.[7] Today, customers and business partners expect more service, maintenance intensity is growing, leasing arrangements are more common, and usage rights coupled with service are more important than ownership. The quality of services has arguably increased over the past decades and the performance over time is more significant than the pure delivery of goods. Guarantees and ''promises'' are inherent parts of business relations, opening up grey areas for future disputes. Outsourcing and globalization make value-producing chains longer and more international, technological advances make them more

[7] For further information on this shift, see Giarini and Liedtke (1997ff) and Giarini and Stahel (2000).

complex, and the importance of the quality cascade is now fully understood by all relevant partners. At the same time, business relationships are increasingly more contract reliant and, perhaps as a consequence, everybody is more willing to sue. Better documentation of business processes facilitates more lawsuits, especially through the use of email, which is now widely adopted and where singular information can be retrieved for legal proceedings, sometimes creating problems of interpretation years after their inception.

From a social point of view, the ethical aspects of conducting business have become more important: It is no longer enough to be technically correct but one has to be regarded as ethically correct (ie honest, fair). Socially responsible behaviour is the key to good relations not only with customers and business partners but also with the media and the legal system. Transparency is the tool with which to push the new economic system. In the new environment, responsibility is no longer linked to the pure business risk. Social responsibility has become a new source of liability, and, as pointed out above, the social affinity to legal procedures is on the increase. There are more informed and proactive customers who have created their own specialist organizations that pursue their interests. The generally easier access to the legal system (which includes the wider availability of legal insurance!) contributes to this development, as does the usage of new tools to reduce the risk (cost) of the claimant in case of a lost case, which lowers the barrier of pursuing rights through a legal path. The new win–loss balance for claimants and their lawyers (esp. through claims aggregation) encourage also more lawsuits. The use of instruments beyond the purely legal now find their ways into the processes: the targeted and extended use of the media to create a certain environment for high-profile cases and the "emotionalization" of legal proceedings aimed at providing an additional dimension to the otherwise rational and contractual analysis.

Insurance and liability: critical reflections and wider concerns

The legal certainty trade-off will always yield fertile ground for lawsuits: there is the eternal balance between the desire for precision, on the one hand, and the need for generalization, on the other. As long as there is some element of generality that is left open to interpretation, there will be a potential legal proceeding looming. At the same time, it has to be noted that insurance also contributes by itself to more lawsuits. The existence of cover for the costs of legal proceedings increases their likelihood, and it is the legal framing of relations that more often than not provides the starting points for procedures. The moral hazard to sue and adverse selection of litigious insureds have similar effects. However, one of the biggest incentives to sue insured parties is the creation of "deep pockets" in the form of insurers' reserves. The funds that are blocked in order to cover a portfolio of risks are often identified as a good target by claimants – and have been regarded as a reference point or even "cheap money" by judges and juries when defining awards – as they are an existing and available source of compensation.

Another critical aspect arises from the existing time lags. Between the conclusion of an insurance contract and the resolution of the claims proceedings for an event can lie many years. While this in itself makes calculations of adequate risk premia difficult, an absence of (at least a basic) legal certainty would make it impossible. The legal

environment may have shifted in the meantime and the original intention of the parties concluding an insurance contract might be treated in a totally different way than anticipated at the time of underwriting the risk. This is particularly apparent where new standards are applied in a retroactive way. An example would be the expansion of environmental liability for manufacturers in the U.S. It is impossible for insurers to operate in an environment where the key variables that define a risk are submitted to change after the risk premium has been calculated and agreed upon.

Liability claims, which are usually capped in most insurance contracts, play an important part in compensating victims. It is, however, one question to determine the triggers for and the value of an insurance contract and quite another to compare them to the general liability that the operator of any system carries. According to general understanding, we, as persons, are liable for any injuries and damages caused in an unlimited way. This is not true for the construction of limited liability entities, including public companies with a limited amount of capital at their disposal. Once this capital is exhausted, there is usually no way in which that organization can be held financially responsible. This problem is partly addressed when requiring (limited liability) companies to insure their operations against justified claims resulting from their operations.

No insurance company is willing or able to take on unlimited risk exposure – unless business continuity is not an aim and it is willing to bet the whole company on the occurrence of an insured event that could result in all its funds being used up, leading to insolvency. Here, we encounter from an economic viewpoint an interesting problem of asymmetry: the difference between a private person who, in principle, faces unlimited liability (up to the point where a legislation might conclude private bankruptcy, which in many countries is not easily attainable) and a company where that liability is limited by the financial strength of its balance sheet.[8] We will have to consider these asymmetries when tackling the problems of the future, especially when it comes to liability issues. We will furthermore have to devise better and more efficient ways to cope with rare and unanticipated events of greater magnitude.

Why worry in Europe and elsewhere?

If this is chiefly a U.S. phenomenon, why worry in Europe and elsewhere? Because of the pervasive and important U.S. influences everywhere. The transmission of significant tort activity around the world is fostered by a combination of exported U.S. principals interacting with the domestic jurisprudence of individual countries. There seems to be a (still slow) replication of the economic drivers of the U.S. liability system in Europe. Take, for example, the use of claims aggregation techniques under domestic law, which can serve as practical alternatives to class actions. Or consider the tolerance of the courts and the political systems for behaviour modification in the legal profession, allowing highly leveraged rewards for the claimant's counsel. In addition, there is the need – and incentive – for U.S. lawyers to expand into new growth markets.

[8] Note: A business model like that of the airline industry that goes bankrupt after having its operations interrupted for only a short period of time is clearly a point of great vulnerability in the economic system.

There are also more pervasive U.S. influences in the economic sphere. They are not only linked to the immediate effects of globalization where producers interact more closely and customers become more involved in international trade. The spread of the new business model with stronger customer centrism and the service-orientation of customers coupled with increasing customer rights are creating the preconditions for more liability claims in Europe. Longer guarantee periods for products and services, such as, for example, the new EU legislation, extend the time period over which liability issues can arise and the increasing producer responsibilities extend their scope.

The necessary preconditions for a liability explosion in the legal sphere are increasingly in place in Europe as the social and economic environments are gradually shifting towards a more liability-prone system. If the currently still existing obstacles of culture are removed and the refinement of techniques continues, the commercial world and the insurance industry must begin to worry as much about the loss potentials for Europe as is now the case for the U.S. The insurance industry has, as of yet, not protected itself enough from these developments and consequently the loss potential for insurers is considerable.

Looking forward

However, there is also good news: growing markets are generally good for business. At the same time, markets with no or too little volatility are not good for insurance. Consequently, the liability crisis in the U.S. and its export into other areas of the world could provide business opportunities for insurance companies who understand the drivers of this development. One can observe that changes in the legal system and practice are not totally exogenous to a country and can be predicted over time, a necessary prediction for the insurability of risks. However, these risks have to be made manageable, that is, the aim has to be to guarantee the control of the downside.

Still, some problems remain, namely the fear of killer risks for insurance that were not predicted (predictable) and do not allow enough time for a controlled exit. Crucial in this respect is the time lag and its control. For liability risks, one could say, ''the time lag is the killer''. From these reflections, we can derive some challenges to insurers interested in the liability markets. They have to:

- Better understand the legal developments in the U.S. and possible transfer mechanisms to other regions (direct or indirect).
- Immunize operations against high/excessive volatilities.
- Reduce the temporal lags in insurance portfolios.
- Segment risks into more controllable classes to allow for more precise underwriting.
- Use claims-made clauses to control exposure and reduce uncertainty over time.[9]
- Better align the interests of the insured and insurance.

[9] Although this can be very difficult to impossible as certain legal environments such as the French experience in 1990 with claims-made triggers showed, when a court overruled the application of a claims-made trigger in a construction liability policy (garantie décennale). Since the adoption of the ''Amendement Hunault'' in 2003, the situation in France is different again.

- Formulate exit strategies as hedge against exploding claims developments.
- Intensify the cooperation with the different pillars of the legal system.
- Overcome the public misperception that insurance payouts do not generate costs to society.

Insurance and the liability challenge is a fascinating topic. It is highly complex and will demand new solutions for many years to come. We are tackling one of the aspects of our economic system that is characterized by a new set of responsibilities of actors and new mechanisms in finding solutions as to how best to protect interests and what to do in those cases where they are hurt. Since the implications for our societies and the efficient functioning of our economic system are so important, a thorough effort as to how to create fair and sustainable solutions that will balance the different needs has to be made.

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