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Moral Hazard in Liability Insurance

by Christopher Parsons*

This article considers moral hazard in the specific context of third-party risks. It argues that in the case of liability insurance, moral hazard takes on dimensions that are generally absent in first party insurance and that this, in turn, generates extra layers of uncertainty which contribute substantially to the difficulties that insurers experience with liability exposures.

For the purpose of the discussion, moral hazard is divided into four forms, which are described as "policyholder hazard", "claimant hazard", "jurisprudential hazard" and "underwriting hazard". Policyholder hazard refers to the possibility that the policyholder, knowing that he is insured, will change his behaviour in a way that produces undesirable outcomes: in particular, he may become more careless. This is moral hazard in the classic sense, and is the form that led early commentators to question the legality of liability insurance and attempt to suppress it on grounds of public policy. Claimant hazard concerns the effect that the existence of liability insurance might have on actual or potential claimants, i.e., third parties. For example, they may be encouraged to target those who are insured in preference to those who are not, collude with policyholders in order to tap insurance funds, or launch unmeritorious suits in the hope that insurers will pay rather than risk incurring heavy defence costs. Jurisprudential hazard concerns the extent to which lawmakers, including courts of law and legislative assemblies, might be influenced in the application, modification or expansion of liability rules by the existence of liability insurance in a particular case, or by the general availability of such insurance. Underwriting hazard is the risk that, in the case of some liability exposures, such as long-tail risks, underwriters may be encouraged to lower their normal standards.

The article concludes that moral hazard, in the way that we have defined it, arises in particularly acute and complex forms in the case of liability insurance. It is argued that, as a consequence of this, some areas of the tort/liability insurance system are likely to be inherently unstable.

1. Introduction

It is well known that liability insurance is rather unpopular with many insurers. Of course, it is unpopular because it is often unprofitable: in the U.K. and many other markets, most lines of liability insurance, at most times, have been loss makers. In some cases the losses have been spectacular, as in the case of the huge deficits on liability insurance accounts, mainly comprising U.S. business, that contributed as much as anything to the near collapse of Lloyd's of London in the late 1980s.

The continuing problems of liability insurance in the U.K. are illustrated in Table 1. This shows the 1999 claims experience of the major offices for the two most important U.K. liability lines: employers' liability (EL)[1] and general liability (GL). Once expenses are taken into account these figures will translate into huge trading losses, even allowing for investment

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[1] Outside the U.K., where workers' compensation systems predominate, employers' liability is often of little importance. However, in the U.K. it is the biggest liability line, accounting for around half of all premium income for the class.

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Table 1:
Claims experience of major U.K. liability insurers 1999

Company	**Category**	**Gross earned premiums £million**	**Claims ratio %**
Eagle Star (Zurich)	Employers' liability	114	115.3
	General liability	26	83.4
CGNU (Aviva)	Employers' liability	111	108.4
	General liability	151	92.2
Royal and	Employers' liability	97	95.7
SunAlliance	General liability	155	83.4
Iron Trades (QBE)	Employers' liability	57	87.7
	General liability	14	81.2
Independent	Employers' liability	46	61.2*
	General liability	55	35.8*
AXA U.K.	Employers' liability	20	116.3
	General liability	70	61.1

Source: Insurance Intelligence Unit and FSA annual returns, 2001.
* In the light of Independent's subsequent collapse, these figures are literally incredible.

income. Furthermore, the figures given for the now defunct Independent Insurance tell their own story, because we now know that an apparently healthy reported claims ratio masked what were in reality unfathomable losses, especially for employers' liability. Indeed, a key factor in the failure of Independent to raise the capital necessary to survive was the inability of the group's actuarial consultant, Watson Wyatt, to put a figure on the firm's losses through the EL account.

A recent survey of all U.K. companies that write liability business, conducted by the author, also revealed just how diffident insurers are where liability insurance is concerned.[2] When asked to comment on the general attractiveness of liability insurance in business terms, only 14 per cent of respondents regarded liability insurance as "attractive" in its own right and none regarded it as "very attractive". The majority (53 per cent) regarded liability business as "unattractive", 14 per cent rated it "very unattractive" and the remaining 19 per cent rated liability insurance as "average" in terms of its appeal: see Figure 1.

No major insurer featured in the small group that described liability business as "attractive", with the exception of one office specializing in directors' and officers' (D&O) liability insurance and associated lines. One should also emphasize that all the respondent

[2] In early 2001 the author submitted a questionnaire to all U.K. insurers that write liability insurance business, 101 in number at the time of the survey. The insurers ranged from the largest U.K. liability insurer, Royal and SunAlliance Group, with a 1999 gross written liability insurance premium of £ 371 million, to marginal participants, some of which wrote less than £ 100,000 in liability business in the same year. The response rate was reasonable, replies being received from 52 per cent of the insurers surveyed, including all the major offices.

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Very attractive	0 %
Attractive	14%
Average	19%
Unattractive	53%
Very unattractive	14%

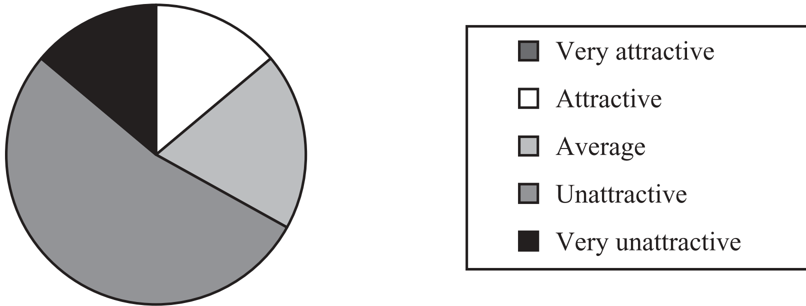

Figure 1: How U.K. insurers regard liability insurance in business terms

companies were active underwriters of liability insurance to some degree; if the survey had included *all* general insurers, including those that choose *not* to write liability business at all, this negative stance would surely have been even more marked.

The answers to a connected question in the survey – why *do* insurers write liability insurance – drew a predictable response, 35 per cent of respondents writing liability business only in order to support other lines of insurance and 45 per cent writing it mainly in order to do so: see Figure 2.

Because it is attractive in its own right	10%
Mainly to support other business	45%
Only to support other business	35%
Historical or other reasons	10%

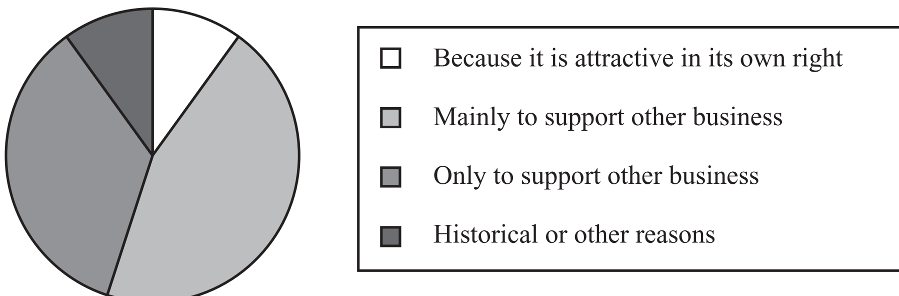

Figure 2: Reasons given by U.K. insurers for writing liability business

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Many of the difficulties that liability insurers have encountered stem from a failure to price liability risks accurately. Of course, pricing is always likely to be difficult when so many liability risks are long-tail: this is well understood. However, alongside the technical difficulties of pricing and reserving, there is a connected problem that has received rather less attention: that of the moral hazard. It is argued in this article that in the case of liability insurance moral hazard arises in a particularly acute form. Or rather, it is argued that moral hazard arises in a number of *different* forms that, acting in combination, add greatly to the uncertainties and potential instabilities of the tort/liability insurance system. These different forms of moral hazard, and some wider behavioural aspects of liability insurance, provide the major focus for this article. However, before we explore the concepts associated with the term "moral hazard" we must consider its definition.

2. Moral hazard: theory and practice

What is meant by moral hazard? In fact, on this point, there is some difference between the understanding of academic insurance economists and that of insurance practitioners. Economists define moral hazard (in the context of insurance) as a phenomenon whereby the obtaining of insurance tends to alter an individual's incentives to prevent loss or to take specific actions; for example, to take care. As a result, changes occur in the probability and magnitude of losses underlying the calculations of insurers. Alternatively, and more simply, it is the risk that the availability of insurance will promote opportunistic behaviour in the insured. It is essentially an incentive problem, arising from asymmetric information of agents and the difficulty that insurers have in discriminating between the actions of the insured on the one hand, and exogenous uncertainty on the other. Because the insurer cannot precisely observe and control the insured's behaviour it is impossible to reach a Pareto-optimal risk allocation. Only a "second-best" solution is possible, representing a compromise between the conflicting goals of risk spreading and providing appropriate incentives to the insured.[3] Apart from the difficulties that moral hazard creates for insurers, economists are also concerned with its wider effects on society and the misallocation of resources that may result.[4]

In what (for want of a better expression) we may call the "practitioner literature", moral hazard often carries a meaning that is rather broader and rather more vague. Practitioners tend to distinguish between "physical hazard", on the one hand, and "moral hazard", on the other. The former, roughly speaking, relates to aspects of insurance risks that are not affected by the vagaries of human behaviour and the latter to those that are.[5] Thus, most practitioners would deem moral hazard to be present if a policyholder was innately accident-prone, congenitally careless, cussed by nature or, for that matter, criminally inclined from birth. Economists, on the other hand, would talk less readily of moral hazard here, because the granting of insurance would make little difference to the behaviour of such individuals. Again, most insurance

[3] See Stiglitz (1977, 1983) and Eisen (1981).

[4] See Arrow (1970).

[5] For example: "Moral hazards are those conditions that increase or decrease the probability, frequency or severity of loss because of the attitude and character of either an insured person or some other person" (Litton, 1988, p. 3); "Moral hazard is an expression of the influence of human activity and its impact on insurance, either by its presence or its absence" (Alport, 1988, p. 79). Webster's dictionary more or less follows the "practitioner" definition: "The possibility of loss to an insurer arising from the character, habits or attitudes of the insured."

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practitioners take only a limited interest in social effects arising from the misallocation of resources that can result from moral hazard; they are concerned almost exclusively with its potential effect on the profitability of their accounts, which is quite understandable. Finally, practitioners tend to be less concerned with the general tendency of insurance to promote opportunistic behaviour than with identifying, in advance, the individuals who are most likely to succumb to temptation. Thus insurers look for indicia of moral hazard ("red flags") and talk, for example, of the moral hazard associated with certain occupational groups and (at least in the past) with some social classes.[6]

The "practitioner" approach might be questioned on the grounds that the distinction it makes between "physical" and "moral" hazard is sometimes unworkable.[7] Again, there is sometimes a tendency in the practitioner literature to confuse the *results* of moral hazard, such as dishonest claiming or carelessness, with *indicators* of a propensity to behave improperly, such as the following of a particular occupation or a bad claims record. However, the economists' approach, though more precisely focused, is itself not entirely satisfactory. This is because the "economics" literature focuses almost exclusively on the incentives that the possession of insurance might generate in the insured. Much less account is taken of incentives generated in *other persons* whose behaviour might have a bearing on the outcome of the insurance contract and on the risk. There is a key difference between first-party insurance and liability insurance in this respect.[8] In the case of the former the insured and the claimant are one and the same but, in the case of the latter, they are not. With liability insurance the claimant is not the insured but a third party who has fallen victim to the insured's negligence. Nevertheless, the fact that the wrongdoer has liability insurance may influence the claimant's behaviour quite strongly. This may, in turn, affect the outcome of the insurance contract and the extent of the risk assumed by the insurer.[9] Again, the extent and magnitude of the risks that liability insurers assume depend to a great extent on the legal environment in which insurance operates and, specifically, on the rules of tort law. Legislative assemblies and the judiciary develop these rules, and the behaviour of their members may, in turn, be influenced by the availability of liability insurance in general or its existence in a particular case. Finally, it is possible that the peculiar nature of liability insurance might influence the actions of insurance personnel, including brokers and underwriters, leading to opportunistic, or at least imprudent, behaviour on their part too.

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[6] "When I started work 25 years ago . . . for motor underwriters the expression 'moral hazard' had the status of technical terminology. I soon came to understand that to them it was the generic term for people whose occupations indicated, they believed, characters which could not be trusted to play fair, take eight hours sleep a night and never make insurance claims – to wit: furriers, turf accountants, journalists, scrap merchants, general dealers, market traders, publicans and anyone vaguely connected with showbiz. Nowadays a good deal of what the general public – including furriers, turf accountants, etc. understand as moral hazard has surfaced in Lloyd's, hitherto the institutional embodiment of moral rectitude, so the term has rather fallen into disuse in insurance circles." – A motor underwriter's view quoted by Litton (1988, p. 71) who characterized the statement as "cynical".

[7] For example, should one classify the temptations of alcohol to which publicans and bar staff are constantly exposed as moral or physical hazards?

[8] There is an (almost) complete absence of literature on moral hazard in the context of liability insurance. Exceptions include papers by Richardson (2000) and Cummins and Tennyson (1996).

[9] The third party may even be able to enforce the contract in his own name. In England this is possible in the event of policyholder insolvency (under the Third Parties (Rights Against Insurers) Act 1930) and, more widely, against third-party motor insurers. In some jurisdictions (e.g., France) an *action directe* is available against liability insurers generally.

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In order to encompass this wider perspective, "moral hazard" is broadly defined, for the purpose of this article, as the risk, or possibility, that the existence or availability of (liability) insurance will cause one or more of the parties involved in the insurance transaction to modify their behaviour. It is also assumed that the change in behaviour will have undesirable outcomes for insurers, or for society generally, or for both.

3. Forms of moral hazard

For the purpose of the discussion, we will divide moral hazard into four forms, which are described as "policyholder hazard", "claimant hazard", "jurisprudential hazard" and "underwriting hazard".

Policyholder hazard refers to the possibility that the policyholder, knowing that he is insured, will change his behaviour in a way that produces undesirable outcomes: in particular, he may become more careless. This is moral hazard in the classic (economists') sense, and is the form that led early commentators to question the legality of liability insurance and attempt to suppress it on grounds of public policy.

Claimant hazard concerns the effect that the existence of liability insurance might have on actual or potential claimants, i.e., third parties. For example, they may be encouraged to target those who are insured in preference to those who are not, to collude with policyholders in order to tap insurance funds, or to launch unmeritorious suits in the hope that insurers will pay rather than risk incurring heavy defence costs. This is similar to moral hazard in the classic sense, but not precisely the same, because the position of the claimant is not exactly analogous to the insured under a first-party insurance.[10]

Jurisprudential hazard concerns the extent to which lawmakers, including courts and legislative assemblies, might be influenced in the application, modification or expansion of liability rules by the existence of liability insurance in a particular case, or by the general availability of such insurance. Arguably, this could give rise to moral hazard in the classic sense, because the shape and extent of (tort) law may not be entirely exogenous to any particular insurance contract or to the practices of insurers generally. Furthermore, the existence of insurance might promote decidedly opportunistic behaviour. For example, a judge might find that imposing liability on an insured, as opposed to an uninsured, wrongdoer increases his own utility. Clarke (1997a, p. 284) notes the case, which came before a U.K. (Crown Court) judge in 1994, of an 82-year old man who had shot and injured a young intruder who persistently broke into his garden shed. The judge awarded damages to the young victim and, to counter public outrage and press criticism, noted (apparently with some amusement) that the old man was insured. Would he have been so ready to find the old man liable had there been no insurance to provide an excuse for his actions?[11]

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[10] In fact, the sharp distinction between first-party insurance and third-party insurance can sometimes become blurred. For example, when liability is strict, policy conditions are tightly controlled by law and insurance is compulsory, liability insurance looks very much like first-party insurance which accident causers are required to purchase for the benefit of their victims. Some motor and workers' compensation regimes have this ambiguous quality.

[11] One might add that the judge was on dangerous ground here. A more perceptive press and public would not have been mollified by the judge's explanation, since they would have realized that the damages that he awarded were coming out of their own insurance premiums, and not the old man's pocket.

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Again, persons who influence legislative processes might choose to avoid public opprobrium, and so advance their own careers, by favouring legislation that generates funds for compensation through the mechanisms of private liability insurance rather than (say) through unpalatable direct taxation, even when the latter would be more efficient.[12] There has been little study of moral hazard in legal and political processes, but this does not mean that it does not exist. At this point we begin to touch upon a much wider issue – the general relationship between liability insurance and the law. Because of its broad scope, only a superficial treatment of the topic is attempted in this article.

Underwriting hazard is the risk that, in the case of some liability exposures, such as long-tail risks, underwriters may be encouraged to lower their normal standards. This might not be viewed as moral hazard in the classic sense, because imprudent underwriting does not directly affect the probability or magnitude of loss.[13] However, it will be argued that the perverse incentives that liability insurance can generate for underwriters might have a similarly destabilizing effect on insurance portfolios.

It will become clear from our discussion that moral hazard, in the sense that we have defined it, arises in a particularly acute form in the case of liability risks and takes on dimensions that are absent in most other types of insurance. The various forms of moral hazard described above are now each examined in turn.

4. Policyholder hazard

There are two aspects of this form of moral hazard to discuss. The first concerns the implications of liability insurance for public policy. Is this form of insurance, "insurance against carelessness", likely to provoke behaviour that is so at odds with the requirements of public order that it should be banned by law? The second concerns the implications for insurers. If the law does allow this form of insurance, how can insurers reconcile the nature of the risk, "insurance against carelessness", with the obvious need to encourage care on the part of their clients? These questions are closely connected. However, to the extent that they can be separated, the issue of legality and public policy is examined first.

As is well known, the development of liability insurance in the early years was impeded by concern over the effect that such insurance might have on the behaviour of persons who obtained it.[14] It was feared that policyholders, secured by insurance against claims for compensation, might become careless, and the lives and property of others would then be put at risk. In fact, the general practice of insurance had been condemned on a similar basis long before underwriters first assumed liability risks. For example, almost from the beginning marine insurance was criticized on the grounds that its availability encouraged enterprises

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[12] The U.S. "Superfund" legislation comes to mind here. Targeting anonymous European (re)insurers to pay for clean-ups is unlikely to be politically contentious in the U.S.; Targeting U.S. business exclusively might be a different matter.

[13] On the other hand, it could do so; because an imprudent underwriter may draw cover too widely, encouraging careless behaviour on the part of the insured.

[14] For example, the French insurance companies that began to cover liability for driving accidents in the 1820s – the first non-marine liability insurers – struggled regularly with attempts to suppress their issuing of policies *"chevaux et voitures"*. Only in 1845 were such contracts declared legally valid by a senior tribunal. For an account of the historical development of liability insurance see Parsons (2002a).

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that were excessively risky, reduced the incentive to construct strong and safe vessels, produced careless navigation and even encouraged masters to scuttle their ships. All of this put the lives of sailors at risk.[15] However, with liability insurance the argument carried extra force, because careless injury to others was the very risk that was insured. At the same time, and in a more abstract sense, insurance against the consequence of "wrongful" acts was seen as morally offensive, because it blunted the deterrent and retributive effect of the law. Thus, Tunc (1974) observes that: "At the beginning of the nineteenth century, liability insurance would have been unthinkable. It would have been considered as immoral." Tunc may be wrong in one sense, because liability insurance was probably not only contemplated but actually practised before the 19th century began, at least among marine insurers.[16] However, Tunc is certainly right in that the legality of such insurance was an issue from the start. In the earliest English legal reference to liability insurance traced by the author, *Delanoy v Robson* (1814),[17] the court considered a motion to move the venue of a "running down" action[18] from London to Durham where, it must be assumed, the incident had occurred. The Solicitor-General (Shepherd) objected on grounds that it would be impossible to find an impartial jury there. He noted that:

> "... in the County of Durham were numerous societies of persons, who insured each other's vessels,[19] not only against sea risks, but also against all sums which the owners might be obliged to pay for damages done by their vessels: and that the Defendant's ship was insured by them, and the Plaintiff could scarcely have there a jury, which would not be interested to prevent his recovering."

Sergeant Best, for the defendant, contended that this liability "was not an insurable risk, therefore the jury could have no interest".

The reporter's account of the court ruling is brief but very interesting:

> *"Per Curiam*. It would be an illegal insurance to insure against what might be the consequences of the wrongful acts of the assured. But the peculiar character of these persons answers the Plaintiff's objection. They are assureds as well as assurers, and are as much interested to extend this principle of loss, as to restrain it. Here is not enough interest in this case, to prevent our sending it to the venue to which the Defendant is entitled otherwise to remove it."

This tells us much about attitudes to insurance prevailing at the time and, indeed, which prevail today. First, the court recognizes that liability insurance might technically be illegal whilst acknowledging, coolly, that the practice exists. In fact, a wide gap between legal theory

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[15] The famous English diarist Samuel Pepys wrote of marine insurance fraud as early as 1663, having attended the trial of a ship's master for this offence at the London Guildhall. Thereafter, the temptations of marine insurance were regularly condemned in newspapers and pamphlets. They tended to be lurid in title and style. See, for example, the (anonymous) broadsheet of 1700, *The case of Assurances as they now Stand: and the Evil Consequences thereof to the Nation,* and James Ballingall's 1834 tract, *The Pernicious effects of Sea Insurance*.

[16] See *Delanoy v Robson*, note 17 below and accompanying text.

[17] (1814) 5 Taunt. 605.

[18] That is, a dispute arising from the collision of two or more ships.

[19] These insurance societies or "clubs" were the forerunners of the P&I associations of today. A coal factor who gave evidence to the British Government's Select Committee on Marine Insurance (1810) suggested that there were two such clubs in London and around 20 in the northern English ports.

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and practical application has always existed in insurance law.[20] Second, the court recognizes the mutual character of the insurance under discussion: the parties concerned are "assureds as well as assurers". The court acknowledges that in this case there are not, in reality, separate categories of victim, wrongdoer, and insurer but, at various times, they are all one and the same. For the parties concerned the commercial need for risk-spreading, by whatever form of insurance, then takes precedence over the need for deterrence and retribution, making the issue of legality largely redundant. This is only a few steps away from a very modern view, espoused by the "Yale lawyers",[21] whereby liability rules (in effect, those of tort law) become little more than a means of providing insurance to victims. Under this construct, the legality of liability insurance can hardly be questioned, because it is the very basis upon which tort liabilities are founded. This theory is considered briefly in section 6.

As we have already seen, moral hazard of the sort now under discussion was raised as a basis to challenge the legality of liability insurance throughout the 19th century. Indeed, even in the 20th century, the arguments were sometimes repeated.[22] However, these objections are now rarely heard, being heavily outweighed by opposing views in favour of liability insurance. The positive, countervailing arguments are many and various.

First, it is commonly observed that the need for liability insurance as a means of guaranteeing compensation to victims of tortious injuries should, as a matter of policy, take precedence over the need to deter wrongdoing through tort liability. This argument looks particularly strong where mass injuries are concerned, such as those that occur on the road; indeed, it has led to the almost universal adoption by governments of compulsory third-party motor insurance schemes. Challenging this proposition, some commentators suggest that, whilst a pattern of mass injuries and (potentially) insolvent injurers points to the need for risk-spreading though insurance, it does not necessarily indicate a need for *liability* insurance. They maintain that private *first-party* insurance (or social insurance for that matter) can provide an adequate, and possibly cheaper, substitute.[23] Now, of course, the relative simplicity and efficiency of first-party insurance hinges on the absence, in most cases, of any need for legal adjudication on questions of fault or quantum and on the limited range of losses that are generally covered by such insurance. First-party insurance does not attempt to mimic the sophisticated compensation principles of tort law and, for this reason, does not provide an exact substitute for liability insurance. In the end, society must decide how much in the way of resources it wishes devote to accident victims (such as road casualties), how it should be distributed, and what weight should be given to questions of causation and fault. In the field of road accident compensation the variations are legion, with fault and no-fault schemes, and various combinations of first-party, third-party and social insurance. Compulsory *liability* insurance is certainly not the only choice of insurance system and it may not be

[20] For example, the statutory requirement for insurable interest, introduced in England for marine business in 1745, has never been fully observed by insurers. Insurers simply introduced PPI ("Policy Proof of Interest") contracts to circumvent the statute, and continue to do so. The practical importance of modern insurance law is also much reduced in the U.K. as a consequence of agreements amongst insurers which extend, modify or reduce strict legal rights. Generally, the law has condoned these market practices and, indeed, the government itself has frequently become a party to the agreements concerned. See, for example, Lewis (1985).

[21] The phrase is borrowed from Stapleton (1995, p. 833).

[22] See Tunc (1974, pp. 50–52) and Shavell (2000, p. 166). Both note, amongst other things, that there was a complete ban on liability coverage in the former Soviet Union.

[23] See, for example, Shavell (2000, p. 166).

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the best, but it is a perfectly rational one, at least where the provision of "full" compensation for at least some victims is seen as a priority.

In fact, it is likely that the adoption in most countries of compulsory third-party motor insurance has, in itself, dampened concerns over moral hazard and helped to promote a more general acceptance of liability insurance. Few people see anything wrong in insuring their own personal liability for road accidents and, by extension, are unlikely to question the application of liability insurance elsewhere. However, we should remind ourselves that compensation regimes for road accidents are, in effect, "closed" systems in which most participants are both potential causers of accidents and potential victims of them. Potential injurers and the potentially injured are not separate classes but, broadly speaking, members of a single body of road users, with a common interest in avoiding accidents. A collision that causes injury to a third party is almost as likely to injure the wrongdoer himself, so, regardless of whether the third-party risk is insured, the potential wrongdoer has every incentive to be careful, particularly when there is no coverage for the wrongdoer's own injuries. At the same time, the risks of vehicle use are such that a small mistake by a driver can result in catastrophic injuries and huge personal liability.[24] No driver, however skilled, can be entirely confident of removing this risk simply by taking care. Thus, the nature of the risk, and its essential mutuality, is such that few would challenge the use of liability insurance on the basis that it might reduce safety standards on the roads, or on broader moral grounds.[25] However, the same mutuality does not exist in other fields of accident compensation where liability insurance is used, such as industrial injuries or product liability. Here, potential injurers and the potentially injured are members of separate groups, with interests that do not necessarily coincide so closely.[26] However, this distinction between third-party motor insurance and other liability risks is not immediately obvious, and it is submitted that an almost universal acceptance of liability insurance in the context of road accidents has hastened its acceptance elsewhere.

In a second line of defence, proponents accept that liability insurance may slightly dilute the deterrent effect of tort law, but argue that this dilution is unlikely to have a very marked effect on policyholders' behaviour. They say it is unlikely to do so simply because other, more powerful, deterrents will always remain in place. These include the sanctions of the criminal law which, unlike tort damages, often strike directors, managers and employees of insured firms, and not just the corporate enterprises themselves. They also include quantifiable accident costs that are not recoverable from liability insurers. Often these uninsured costs will far outweigh those that are insured.[27] Some costs to which accidents give

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[24] As, for example, in the freak circumstances of a train crash at Selby in the north of England on 28 February 2001 where a lapse in concentration on the part of a motorist led to a collision between two trains, the loss of ten lives and claims for compensation in the region of £ 50 million. See the comment in *The Times* of 2 March 2001, "Why accidents don't happen any more".

[25] Arguably, the abandonment of a system of tort-based liability backed by compulsory third-party insurance in favour of true no-fault scheme, where all road accident victims are compensated (by first-party insurance or otherwise), might lower safety standards, since careless drivers who injured themselves as well as others would be "rewarded" with compensation. See Cummins, Weiss and Phillips (1999).

[26] Mutuality of interest may exist in a different sense. For example, in the field of product liability it is conventionally pointed out that the cost of injuries resulting from defective products is passed on to consumers, liability insurance costs being reflected in the price of the goods they buy. Theoretically, this mechanism internalizes accident costs and helps to produce optimum levels of product safety, in which we all have an interest.

[27] For example, a report by the U.K. Health and Safety Executive (1994) suggested that for a firm paying employers' liability insurance premiums of £1 million (and recovering claim payments of rather less than this figure in most cases), the true cost of the risk is likely to be in the range of £ 8 million to £ 36 million.

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rise, such as harm to personal reputation or business image, may be difficult to quantify but are powerful nevertheless in their deterrent effect.[28]

Third, it is argued that, in any case, the deterrent effect of tort law need not be blunted substantially by the purchase of liability insurance because the terms of the insurance contract, and the law relating to liability insurance, can together preserve the incentive to take care. Thus, either by the general law, or the terms of contract, cover can be restricted to "ordinary" negligence. Deliberate wrongdoing and, perhaps, reckless conduct can be excluded. Equally, the pricing structure of liability insurance can be used to penalize both risky activities and careless behaviour that leads to injuries, thus preserving deterrence.

Public concern and the interests of insurers coincide exactly at this point. Everything hinges on the effective application of standard underwriting techniques to liability insurance. Is liability insurance any different from other classes in this respect? Here it must be acknowledged that at least *some* of the standard mechanisms used to mitigate moral hazard in insurance are less easy to apply in the case of liability lines. For example, for at least some classes of liability business, a requirement to share the risk by means of a policy excess or deductible cannot easily be imposed on the insured,[29] and nor can some restrictive terms and conditions.[30] Again, restricting cover to what we have described as 'ordinary' negligence may not be as easy as it sounds. It can sometimes be very difficult to design an insurance contract that effectively excludes losses that result from recklessness or deliberate wrongdoing.[31] In any event, insurers may find that they are required to pay even when recklessness can be proved, especially when liability insurance is compulsory.[32] Generally, there is a clash of different policy goals in this area: a tension between a desire not to "reward" wrongdoing and the need to ensure that innocent injured victims receive insurance money, however egregious the wrong may be. The result is a rather uneasy compromise between the rights to compensation of accident victims and the desire of insurers to protect the integrity of their underwriting systems and maintain equity amongst the members of their risk communities.[33]

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[28] For example, the threat of litigation and potential stigma of a finding in negligence can still have a powerful deterrent effect on the employer, even when the employers' liability risk is fully insured. This point has been made forcibly by Owen Tudor, former Legal Services Officer for the U.K. Trades Union Congress (TUC), in conversations with the author (1998).

[29] Particularly in the case of compulsory lines of liability insurance where, in order to protect the third party from the risk of policyholder insolvency, the use of deductibles may be forbidden by law. For example, the regulations governing employers' liability insurance in the U.K. do just this, although an agreement whereby the insured pays the third party and claims reimbursement from the policyholder is not outlawed and can be used in place of a deductible. See Employers' Liability (Compulsory Insurance) Regulations 1998 (S.I. 1998 No. 2573.).

[30] The regulations governing employers' liability insurance (note 29 above) and various provisions in the U.K. Road Traffic Act 1988 limit the use of restrictive policy conditions in employers' liability insurance and motor insurance respectively. See Parsons (1999a).

[31] See note 38 below.

[32] For some forms of liability insurance reckless conduct by the insured will debar coverage. Recklessness will amount either to a breach of the "reasonable precautions" condition that is found in most liability insurance contracts or allow the insurers to refuse indemnity on more general grounds of public policy; see, for example, the U.K. case of *Gray v Barr* [1971] 2 QB 554. However, it has been suggested that in the case of third-party motor insurance and, possibly, employers' liability insurance – the main compulsory lines in the U.K. – only deliberate criminal conduct could possibly prevent an insured from enforcing a claim in respect of personal injury. See Birds and Hird (2001, pp. 218–20 and 239–44) and Clarke (1997b, pp. 443–53).

[33] For example, some areas (such as the use of restrictive trade warranties in employers' liability insurance) are governed by rather vague "understandings" between the U.K. Government and the insurance industry.

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Furthermore, there is a worrying lack of consistency in some key areas of accident and insurance law, as the author has demonstrated elsewhere.[34]

Again, can liability insurers, with the same ease as other insurers, segregate the risk pool, observe the behaviour of their policyholders and charge accurate differential premiums either *ex post* or *ex ante*? The ability of liability insurers to do this effectively has often been called into question[35] and, whilst the author believes that critics often underestimate the sophistication of liability insurance underwriting,[36] it must be conceded that some risks, especially long-tail exposures, present severe problems. For example, a key difficulty lies in the fact that experience rating is often impractical for such risks. This technique, pricing a risk on the basis of its own loss history, is without question the most efficient method for insurers, the fairest for policyholders and the most beneficial in controlling moral hazard. However, long time delays in liability claims mean that current loss experience may not accurately reflect the present state of the risk, making the device ineffective.[37]

Finally, we should note that a peculiar and extreme form of "policyholder" moral hazard can arise with long-tail liability risks: in some cases the damage that triggers insurance coverage may, in effect, have been *deliberately* created. That is, it may have been intentionally brought about by parties who calculated that they could make a tidy profit from the activity that caused the loss and then render themselves judgment-proof before the harm was discovered. This "hit and run" phenomenon has been styled "looting" by Akerlof and Romer (1993), who analysed the use of strategic bankruptcy as a means of appropriating rents in the context of the U.S. savings and loan crisis. Mason and Swanson (1998, p. 183) suggest that this phenomenon is one of the primary causes of long-tail risks and provide a number of examples. In particular, they discuss the problems associated with toxic waste disposal sites in the U.S. and elsewhere, where absence of effective regulation encouraged the establishment of firms for the single purpose of providing landfill sites for the disposal of problematic waste. As the authors note:

> "These firms often existed with few assets other than the land on which the disposal occurred. After years of dumping, and before detection of any leaks, the firm would then dissolve its corporation and disappear, leaving others to incur the deferred costliness of its operation . . . This is the essence of looting: operation of a firm in a context in which it is possible to incur benefits today while postponing the associated costliness until the future, with dissolution and liquidation occurring in the interim. The necessary conditions for looting are therefore (a) the availability of unlimited liability; (b) the capacity to create deferred costliness; and (c) the structure that renders liquidation the optimal strategy to pursue."

Of course, there is no reason why such a firm should want to have liability insurance in its post-operational phase, but it is very likely to have such cover when still a going concern. If the insurance is written on a causation or occurrence basis then, of course, the insurer concerned may well be liable to meet the loss, despite the policyholder's liquidation, because a

[34] For example, it is not obvious why the statutory regimes for motor and employers' liability insurance in the U.K. allow insurers to rely on restrictive policy conditions in some cases but not others. See, generally, Parsons (1999a) for a discussion of inconsistencies in this field.

[35] See, for example, Priest (1987, p. 1583) and Finch (1994, p. 894).

[36] See Parsons (2000) and (2001).

[37] See Parsons (1999b, p. 37).

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direct action against the insurer will be available in most jurisdictions. The insurer's only hope will be to establish that the damage was not "accidental", but this can often be very difficult.[38]

There is a further problem, not identified by Mason and Swanson. Even if a liability insurer, by careful underwriting, manages to avoid opportunistic "looting" clients and covers only reputable firms it might still have to pay for losses caused by the former. This obligation could arise under a regime of joint and several liability such as that of the U.S. "Superfund" legislation. Under such a regime any extant firm can be called upon to pay for the whole of a loss, even though its own contribution to the damage was trivial compared with that of firms which are now defunct, unidentifiable or otherwise judgment-proof. It is also easy to imagine how "looting" behaviour could produce long-tail claims outside the field of environmental liability. For example, "looters" could generate both employers' liability and product liability claims by skimping on safety precautions that would prevent the onset of gradually-developing diseases in their employees or latent harm to users of their products.[39] It is difficult to see how private liability insurance can operate effectively when such perverse incentives exist.[40]

In summary, it can be stated that the aspect of moral hazard explored in this section, described as "policyholder hazard", is no longer a ground upon which the basic rationale of liability insurance can be challenged successfully. The value and social function of liability insurance, though still questioned from time to time, is firmly established. However, there is still a need for insurers to exercise vigilance and to ensure that the standard insurance techniques for combating moral hazard are deployed effectively. As we have seen, for some risks, and particularly for long-tail exposures, there are likely to be very severe problems in achieving this end.

5. Claimant hazard

The claimant is, of course, the "third party" in the familiar liability insurance triangle. To what extent does the existence of liability insurance condition the behaviour of actual or potential claimants, i.e., accident victims? Are such victims likely to target those who are insured in preference to those who are not, collude with policyholders to tap insurance funds, fake injuries, or launch speculative suits in the hope that insurers will settle rather than risk heavy defence costs? The first question looks quite easy to answer. Common sense suggests that a rational accident victim is unlikely to pursue a case against a defendant who has no

[38] When the harm for which the insured is held responsible arises in connection with an *accident*, that is, a sudden event such as an explosion, fire, fall or injury involving machinery, insurance policy provisions requiring that losses should be "accidental" can usually be interpreted with little difficulty. Here attention focuses on the incident in question, the claimant's actions immediately prior to the accident, and the policyholder's own behaviour in relation to it: were the actions of the policyholder merely careless (in which case the policy will respond) or were they reckless or actually calculated to cause harm (in which case cover will usually be denied)? However, where the injury, loss or damage has occurred or accumulated gradually interpretation is likely to be much more difficult, because in this case there is no accident or sudden event to provide a focus. Instead it will be necessary to consider the general behaviour of the insured over a long period of time and, in particular, what the insured *knew* during this period.

[39] See, for example, Barney, Edwards and Ringreb (1992).

[40] With respect, the recommendations of Swanson and Mason might be difficult to implement successfully. These authors suggest that "looting" behaviour might be controlled by a combination of mandatory liability insurance with a life extending 10 to 20 years beyond the event of liquidation as a condition of limited liability status with the residual amount of endogenous liquidation to be managed by the state. This would effectively deny insurers the use of "claims-made" contracts for the very risks where (in the opinion the insurance industry) they are most essential.

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means to pay. In fact, very few tort actions are brought against persons who are uninsured. The report of the U.K. Pearson Commission (1978, Vol. 2, para. 509) estimated that 88 per cent of tort personal injury claims, representing 94 per cent of total value, were against defendants who were backed by insurance, with most of the balance against self-insurers. More recent figures from the U.S. suggest that liability insurers make an almost identical 93.5 per cent of tort liability payments.[41] However, this in itself proves nothing. However unlikely, the prevalence of liability insurance amongst tort defendants *might* simply reflect the fact that potential causers of accidents (such as manufacturers of consumer goods, employers in the U.K. and motorists generally) are more inclined to buy liability insurance than persons who engage in more innocuous activities. In fact, the existence of *compulsory* liability insurance in some of the main spheres of tort liability makes these "chicken and egg" discussions redundant in many contexts. In the case of compulsory schemes, liability insurance (or a surrogate in the form of a guarantee fund) is a given fact, so accident victims are unable to choose between insured and uninsured defendants and the latter generally have no choice but to insure. For this reason, those areas where liability insurance is *not* compulsory provide more fruitful fields of exploration. "Managerial" liability is a good example. Here there is quite abundant evidence that the development of a relatively new class of insurance, directors' and officers' liability insurance (D&O) has prompted claims that otherwise would not be made. This is evidenced by the phenomenon of D&O "strike suits", especially in the U.S. These are cases where claimants (often law firms) buy small parcels of shares in failing companies with a view to tapping D&O insurance funds through speculative attacks on the failing firms' directors. The assumption they make is that insurers will pay rather than risk losing even more money through the heavy costs of defence. In this case D&O insurance coverage is clearly the key asset of the failing firm that attracts such speculators to buy a few shares and proceed against its management. In the absence of D&O insurance such a purchase would be completely irrational, except perhaps by *bona fide* managers of recovery funds.[42] Of course, what attracts claimants is not liability insurance *per se* but the money it represents. This is what Clarke (1997a, p. 273) describes as the "magnetic effect of money", or the "deep pocket" by another name.[43]

We should also remember that some of the most relentless pursuers of insured wrongdoers are insurance companies themselves, proceeding by way of subrogation. In such cases the real (though not the nominal) plaintiff is typically a property insurer seeking to recover his outlay in respect of a first-party claim or another liability insurer seeking contribution. For reasons that are obvious, insurers do not, as a rule, throw good money after bad by pursuing uninsured torteasors.[44]

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[41] See Shavell (2000, p. 166) citing O'Connell *et al.* (1994, pp. 1303–38).

[42] A good contemporary example is found in the U.S. "vulture funds" that bought into bonds issued by Barings Bank. In this case the target was Baring's auditors, Coopers and Lybrand (now part of PricewaterhouseCoopers (PwC)) and their professional indemnity insurers, the former having failed to pick up fraudulent activity by Nick Leeson, the "rogue trader" who built up huge positions trading financial derivates in Singapore, leading to the collapse of the bank. These funds were instrumental in the narrow voting down of a £ 84 million offer to settle, forcing a £1 billion court action to proceed. See *The Times*, 8 May 2002.

[43] Of course, money appeals to lawyers also. Assuming that all are equally attracted by it, the most able are likely to get the job of probing the deepest pockets. More insurance may thus lead to better arguments that insurers should pay, requiring insurers to employ equally sophisticated and expensive defence counsel.

[44] The one U.K. decision that is commonly cited as evidence that insurers *do* pursue uninsured defendants, the notorious *Lister* case (*Lister v Romford Ice and Cold Storage* [1957] AC 555) turns out, on closer examination, to show nothing of the sort, only that the plaintiff insurers were mistaken in their belief that the defendant was in fact insured. See Parsons (1999a, pp. 130–1) for discussion of the insurance background.

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Of course, it is not in the least surprising that accident victims should favour insured wrongdoers. This hardly qualifies as moral hazard, even from the perspective of the insurer, since it is entirely predictable by the underwriters concerned. However, deliberate fraud by accident "victims", and positive collusion between such victims and liability insurance policyholders is a different matter. Although moral hazard of this type (claims fraud) is generally associated with first-party insurance, there is evidence that it exists at a high level in liability insurance also.[45] For example, the non-existent trip or slip and the dubious back injury are now common currency for liability claims handlers. Furthermore, employers' liability and workers' compensation insurers frequently deal with claims for injuries that are genuine, but which occurred well outside the sphere of work. Again, liability claims in respect of intentional, self-inflicted, injuries are not unknown.[46] Liability insurers are very attractive targets for fraudulent schemes of this sort because the payoff from a successful claim typically includes not only compensation for reported economic losses but for pain and suffering also.[47] Furthermore, a third-party claim allows the perpetrator to defraud an insurance company without having, himself, to buy any insurance at all! Also common are collusive claims: that is, cases where the policyholder accepts responsibility for damage to the property of another, often a friend or colleague, in order to fund the latter's loss through his own liability insurance and, perhaps, share the proceeds. Again, liability insurance is particularly vulnerable to claims fraud of this sort. It may well be easier to accomplish and more profitable than fraud against a first-party insurer because, quite apart from the availability of pain and suffering awards in injury cases mentioned above, third-party cover is often wider. For example, the need to secure accident victims against the potential insolvency of the insured means that liability insurance policies are rarely subject to an excess or deductible – a standard device to control moral hazard in first-party insurance.[48] Again, liability policies generally provide cover on a complete "all risks" basis: loss or damage of *any* sort is insured, provided the policyholder is (or appears to be) legally responsible for it. Unlike many first-party policies, there are typically no restrictions as to the perils that cause the loss or the location where the loss occurs.[49]

Sometimes liability insurers have created moral hazard and invited collusive claims through ineptitude, or at least lack of forethought, in policy design. D&O insurance provides a good example. Generally, D&O insurance is designed to meet "external" claims, brought by shareholders and various other third parties against company directors and managers. The possibility of collusive *internal* liability claims was not fully considered until, in the early 1980s, a number of U.S. banks that had lost money through incautious lending sought to recoup their losses by dismissing, and then suing on grounds of negligence or breach of contract, employees who authorized the loans in question. As a result, trading losses that no first-party insurer would regard as remotely insurable became the subject of D&O liability

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[45] See, for example, Cummins and Tennyson (1996).

[46] The author has personal experience of fraudulent liability claims for self-inflicted injuries amongst textile workers in the north of England, some of which are too gruesome to describe.

[47] Cummins and Tennyson (1996) conclude that the incentive for bodily injury liability fraud stems primarily from the possibility of receiving pain and suffering awards.

[48] Although liability insurance claim payments *are* potentially subject to reduction on account of contributory negligence, a restriction that does not apply to first party insurance.

[49] To take a simple example, first-party insurance on personal possessions or business property is often restricted to losses that occur in the home or place of business whereas, in the case of liability insurance, the place where the damage occurs is usually irrelevant to coverage. Again, first-party insurance often covers only specified perils (e.g., fire, theft, etc.) whereas liability insurers do not usually impose restrictions of this sort.

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claims. These actions gave rise to much litigation and resulted in the introduction by D&O insurers of "assured versus assured" exclusions in an attempt to eliminate the problem. However, the enforcement of these exclusions has proved problematic and, at the present time, they have become relaxed, despite the potential for reintroducing collusive claims.[50]

Some consequences of the "claimant hazard" explored in this section, such as the potential for claims fraud, are not exclusive to liability business. However, it should be clear from the foregoing that liability insurance has a unique potential for influencing the behaviour of claimants who are not themselves a party to the insurance contract, and that this will generate complex problems for liability underwriters.

6. Jurisprudential hazard

Next, we turn to what has been styled jurisprudential hazard. Here we are concerned with the extent to which lawmakers, including judges and legislative assemblies, are likely to be influenced in the application, modification or expansion of liability rules by the existence of liability insurance, either in a particular case, or by the general availability of such insurance. This, in itself, is a massive topic, so only a superficial review is attempted here.

We have already raised the question of moral hazard in legal and political processes: the possibility that judges, parliamentary representatives and other legislators might adopt policies that tap insurance funds in order to avoid the public censure that alternative, and more efficient, solutions might generate. One does not wish to impugn the integrity of our lawmakers. However, when they face difficult fund-raising problems, liability insurance must often present them with an appealing and convenient line of least resistance.[51]

In any event, if, for whatever reason, the existence of insurance affects judicial or legislative policy in ways that are unpredictable, liability insurance portfolios will become subject to an extra layer of uncertainty that is unique in insurance generally. Besides all the other risks that insurers face, including the primary "insurance risk" of accidents, investment risks and other financial uncertainties, there will be potential for a shift in the underlying probabilities upon which insurance premiums are based. Inevitably, this shift, the product of legal doubt and instability, will be very difficult for underwriters to accommodate.

How then does liability insurance affect the extent and shape of liability rules, and how should it affect them? In fact, the boundaries of the discussion can be marked out by reference to two extreme views. The first view holds that liability insurance has, and should have, very little to do with the shape and reach of the law. Deterrence and retribution are seen as the prime functions of tort law and the provision of compensation as secondary. According to this perspective, the content of liability rules should be governed largely, if not wholly, by ideological considerations that involve moral and political judgments. Insurance can have

[50] Especially in markets such as Germany, where the two-tier board structure makes "assured versus assured" exclusions unworkable: see Parsons (2001, p. 12).

[51] The possible "privatization" of the U.K. state workers' compensation programme (the Industrial Injuries Scheme), which has been on the agenda for some time now, may be a case in point. It is doubtful whether a privately-insured alternative could operate as economically as the IIS, which has an expense ratio of only 11 per cent, but this has not deterred those who wish to relieve the U.K. Government of its burden. See Parsons (1999b, pp. 16–17). Of course, in Europe as a whole, governments are aiming to shift accident costs away from the state and to use liability insurance as a means of extending or replacing social security programmes.

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little part to play in the formation of such judgments. It is merely a commercial practice, deriving from the fact of tort liability, that moulds itself, like plasticine, to the contours of the law without affecting the law's shape.

The second view, at the opposite pole, places insurance and insurability at the heart of the tort system. Or, rather, it views tort merely as a mechanism within *insurance* systems. The function of these insurance systems is to provide people with compensation in a way that is effective and consistent with certain other criteria, such as minimization, or optimization, of accident levels. The driving force is economic efficiency. Under this construction, tort law becomes little more than a mechanism for providing people with insurance, or distributing compensation through insurance. Accordingly, it is tort law that should be moulded to comply with the shape and structure of best insurance practice. For example, it should be structured so as to impose liability on "the best insurer", the party that is able to secure insurance in the most efficient and economical way. It should also operate in a way that is consistent with insurance principles and should not, for example, force people to "buy insurance" in respect of risks that, given a free choice, they would not choose to insure against. According to this second interpretation the basis of tort law is itself primarily economic, and its aim is the optimum allocation of resources. Moral and political judgments become of secondary importance.

Few commentators accept unreservedly either of the arguments set out above. For most, the truth about the relationship between insurance and tort law lies somewhere in between. They see many linkages between tort law and insurance practice, but only limited influence of the latter on the former. In the context of the U.K. a useful distinction can be made between the development of the law by courts and judges, where evidence of the influence of insurance is somewhat ambiguous, and development via legislation, where it is rather more clear. The author explores the subject largely on the basis of this distinction. However, we should first note that "tort" is not a single, coherent body of rules governed by universal principles.[52] It is something of a rag-bag, as a study of its history shows. Since tort law lacks uniformity any search for the "true relationship" between tort and insurance is almost bound to fail, because that relationship will inevitably vary in different branches of tort law and in different fields of its application. In some areas, such as workplace risk, the influence of insurance is very plain to see. For example, in many countries, though not the U.K., insurance has not just influenced tort law but actually displaced it. Thus, in countries such as Germany the tort liability of the employer has been abolished[53] in favour of an exclusive remedy workers' compensation insurance system. Here, "insurance" has not just moulded tort liability but unceremoniously dumped it![54] In other areas, such as product liability, the traces of insurance influence are present but rather more faint,[55] and in others, such as the deliberate torts, they are virtually non-existent.

[52] Hence the preference of many writers for the appellation (law of) "torts", not "tort".

[53] In fact, the tort liability of the employer has not been entirely extinguished in Germany: employees can still sue, for example, in cases of intent.

[54] Of course, tort can always retaliate. "Exclusive remedy" workers' compensation systems tend to encourage product liability claims by injured workers and, worldwide, employers' liability appears to be in the ascendant once more: see Parsons (2002b, pp. 364 and 366).

[55] Some commentators see the influence of liability insurance in s. 402A of the (U.S.) Second Restatement of Torts and in the 1985 European Directive on Product Liability.

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For the purpose of our discussion two main questions must be addressed. First, will the knowledge that a *particular* (alleged) wrongdoer has liability insurance, or is very likely to have such insurance, increase the possibility that a court will find against him or award a higher amount in damages – and should it do so? Second, has the *general* availability, or otherwise, of liability insurance had a significant impact on the shape and structure of tort law? And should it have such an impact?[56]

As far as the first question is concerned the answer should be in the negative, because a court (at least in the U.K.) is required, in theory, to ignore the existence of insurance when determining liability and fixing damages in any particular case.[57] In fact, this rule has not always been followed to the letter and the extent to which judges have deviated from it has generated some debate. Stapleton (1995) in a wide-ranging review of judicial responses to the existence, or otherwise, of liability insurance, has argued strongly that courts in the U.K., with very few exceptions, have generally ignored "the insurance factor". However, other writers, particularly in countries outside the U.K., argue that judges' decisions are very often influenced by insurance considerations.[58] Furthermore, in some jurisdictions the right of a court to take insurance into account in particular cases is explicitly recognized. For example, in Sweden and The Netherlands courts have the power to consider the economic circumstances of the parties when fixing damages, but no mitigation is permitted if the defendant is covered by liability insurance.[59]

Moving on to the second question – the *general* effect of insurance considerations on judicial and legislative policy – there is no doubt that the general availability, or otherwise, of insurance has played at least some part in shaping the law. In the U.K. the influence of insurance in the framing of legislation is certainly rather more important, or at least more obvious, than its influence in the courts. Of course, legislative assemblies, government ministries and law reforming bodies (such as the U.K. Law Commission) are far better placed to take a considered, strategic view of insurance matters than the courts, where issues of law arise at random, time is limited and knowledge of insurance is often hazy. In turn, the insurance industry is quite well placed to influence legislators in the framing of legislation that might impact upon insurance markets. Influence can be exerted through representative bodies (such as the Association of British Insurers in the U.K.) and through individual government members and other politicians who have insurance interests. Evidence of the lobbying power of the insurance industry is seen clearly in the shape of the regulatory framework within which it operates in the U.K. There, the government has often been persuaded to accept self-regulation in lieu of statutory control and, in some cases, to grant exemption from general legislation that would otherwise apply.[60] Again, U.K. Government ministers, the Law Commission and various other bodies regularly consult the insurance industry about the effect of their proposals on the cost and availability of insurance. As a result, statutory liability is

[56] There is also a third question, too big to address here: do the courts pay any attention to the efficiency of insurance arrangements by, for example, promoting legal structures that are likely to exploit or encourage one sort of insurance rather than another?

[57] Viscount Simond's pronouncement that when a court determines people's duties "the fact that one of them is insured is to be disregarded" (*Lister v. Romford Ice and Cold Storage Co. Ltd* [1957] AC 555, 576–77) is often cited as the *locus classicus* of this doctrine in the U.K.

[58] See, for example, Gill (1999, pp. 27–40) for a general discussion of the topic.

[59] See Pfennigstorf with Gifford (1991, pp. 64–65).

[60] Including the controversial exemption of insurance contracts from the Unfair Contract Terms Act 1977.

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often limited to a figure that reflects the availability of liability insurance cover.[61] This pattern is repeated outside the U.K. where, for example, the Dutch civil code specifically provides for the imposition, by regulation, of limits on recoverable damages reflecting the limited availability of insurance coverage.

Of course, the political weight of the insurance industry will not always enable it to resist unpalatable new laws that extend liability rules and increase the potential for claims. On the contrary, there are many instances where it has failed to do so. For example, it has often been suggested that the U.K. Law Reform (Contributory Negligence) Act 1945, by virtue of which negligence on the part of the claimant ceased to be a complete defence, secured the necessary support in Parliament partly as a consequence of the spread in use of liability insurance.[62] Even more obviously, the Law Reform (Husband and Wife) Act 1962, which abolished the common law rule that prevented one spouse suing another in tort, was clearly posited on the fact that the negligent spouse would be able to recover from a motor or personal liability insurer in most cases. Under the Act the court may stay the action where no substantial benefit would accrue to either party, a power clearly meant to cover situations where no liability insurance exists.

We should also remember that much new law is now laid down at international level, through international treaties or supra-national organizations such as the E.U. This complicates matters further, because international law that is intended to create uniformity sometimes fails to do so, and may differ substantially in its effects from one territory to another. For example, new health and safety law enacted at European level, intended to harmonize European workplace safety standards, has a much more dramatic impact on liability insurance claims in the U.K. than in Germany, so legal reform that appeals to German insurers might be deeply unattractive to their British counterparts.[63] Of course, insurance too is international. Risks emanating from one jurisdiction are routinely insured in another, where the insurers concerned cannot hope to have much influence over the (foreign) laws that inform the liability risks they underwrite. Furthermore, whilst a government may pay some regard to the concerns of its own domestic insurers when planning legal reform, it is much less likely to accommodate the sensitivities of foreign insurers. For example, would the U.S. Federal Government have been so ready to enact the "Superfund" legislation if a greater portion of the resulting liability insurance claims had rested with domestic insurers and fewer had flowed across the Atlantic to Lloyd's and the London and wider European insurance markets?

In summary, it seems likely that the availability of insurance, or its potential availability, has encouraged the expansion of liability rules to some degree. However, whether this should properly be regarded as a form of moral hazard for insurers, and a cause of serious concern for them, is a different question. Insurance markets can deal with the expanding liability and rising claims, provided that change is progressive and incremental rather than sudden and

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[61] Clarke (1997a, pp. 281–82) notes that the Hague Rules on the carriage of goods by sea provide a clear example of the influence of insurance. Where legislation relates directly to insurance the influence of the industry, and its practices, are even more obvious, as one would expect. Thus, for example, the very low minimum figure set in 1998 for compulsory employers' liability insurance in the U.K. (£ 5 million in respect of any one occurrence) was a concession to the (re)insurance industry's concerns following the massive accumulation of claims arising from the *Piper Alpha* disaster: see Parsons (1999a, pp. 115–17) for a discussion.

[62] Clarke (1997a, p. 283).

[63] Because regulations implementing E.U. health and safety Directives generate civil liability in the U.K., but not in Germany, where employers are effectively immune from tort claims by employees. See Parsons (2002b, pp. 378–79).

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radical, and provided that new rules are imposed prospectively rather than retrospectively. Even then, there will always be an element of uncertainty about the law in any particular field, but this can be accommodated too, provided the degree of uncertainty is not too high.[64] However, if levels of uncertainty about where the law is going are to remain tolerable for insurers, judges and legislators must have at least a reasonable understanding of how their actions might affect insurance markets. In fact, there is no doubt that the judiciary, and lawyers generally, are rather more conscious of economic issues and insurance matters than they were in the past. However, there are still but a few who have the training to speak out with real confidence on such topics. Furthermore, the complexities of insurance and its intricate commercial practices will often make it very difficult for courts and legislatures to make a proper assessment of how their decisions might affect insurance markets in any particular set of circumstances.[65] Therefore, it is not in the least surprising that lawyers should often react with diffidence to arguments based on economic or insurance principles.

We can conclude that the species of risk discussed in this section, "jurisprudential hazard", remains at least a potential source of instability in the insurance system. The information flows between insurers and persons whose actions influence the shape and reach of tort law remain imperfect and a healthy community of interest between these, and other players in the system, is not always present. It therefore seems likely that the law will retain its capacity to deliver unpleasant surprises to insurers from time to time.

7. Underwriting hazard

One would imagine that the peculiar hazards of liability insurance, described in the preceding sections, would produce extra caution on the part of liability underwriters. However, it seems that this has not always been the case. Indeed, it is arguable that liability insurance, particularly in its long-tail guise, generates perverse incentives for underwriters that have no parallel in other forms of insurance or, at the very least, creates traps and temptations that do not exist in other classes. For one thing, the long time-span over which many liability claims develop means that the incautious underwriter may not be faced immediately with the full consequences of his actions. Current losses can be blamed on a previous generation of underwriters and, by the time the full claims cost of his own book of business is known, perhaps 40 years hence, the guilty underwriter of today may be living in comfortable retirement, if not deceased![66] Again, the underwriter that starts to write long-tail business (such as employers' liability in the U.K.) for the first time must face an enormous temptation to underprice the risk. This is because the level of claims that he experiences in the early years will be relatively low when compared with those of insurers who have been in the market for some time. Essentially, they will relate only to traumatic injuries – to accidents. Disease claims (which may eventually account for 50 per cent of the total) will arrive much later.[67] In these circumstances the temptation to undercut the competition must be consid-

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[64] See, generally, Faure and Hatlief (1998).

[65] Because, for one thing, the practical effects of what appear to be clear rules of law are often changed quite radically by the plethora of voluntary codes and internal market agreements that we find in insurance.

[66] Perhaps a further potential source of the "looting" phenomenon explored earlier?

[67] This is assuming that the insurance is written on the conventional causation/occurrence basis. Different considerations apply in the case of claims-made cover. Here the underwriter could face claims for disease straight away, unless a retrospective date in the policy excluded claims arising from injuries caused prior to the inception date.

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erable.[68] A property insurance underwriter, by contrast, is rather more like Doctor Johnson's condemned man: he will find that the possibility of a rapid claims build-up (if not the prospect of being hanged in a fortnight) will concentrate the mind wonderfully.[69]

Of course, it is not suggested that the incautious liability underwriter can always, in the ordinary course of his business, put off the day of reckoning for so long. However, experience has proved that underwriters can be tempted all too easily by large chunks of liability insurance premium into accepting what are essentially unquantifiable risks.[70] Again, even when notifications do begin to trickle in, the liability underwriter might be persuaded easily that actual claims will not materialize, or they can be legally challenged, or that they are merely freak occurrences. By contrast, for a property insurer, there is nothing so concrete, immediate and indisputable as a large fire.

It is clear from the *débâcle* surrounding "Umbrella" policies[71] and other injudicious excursions into the outer limits of liability insurance, that Lloyd's and the London market have certainly not been immune from this ostrich-style underwriting.[72] However, there is another dimension to the Lloyd's near-disaster. This is the role of the broker which, of course, extends beyond Lloyd's to the whole of the London market and is not confined to liability insurance. The London market relies on brokers, not only to bring in business but also, in many cases, to design the products that are to be "manufactured" by the underwriters. We see this in the case of many forms of liability insurance, which have often been products of broker innovation. Examples include D&O insurance and the "Umbrella" liability policies mentioned earlier.

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[68] Indeed, in the author's survey of liability insurers mentioned earlier, a number of respondents identified as a serious problem not just inadequate pricing by liability insurers in the past, but the extreme difficulty of sustaining adequate insurance rates in a market where naïvety or rashness on the part of new entrants often led them to underprice the risk.

[69] "Depend upon it, sir, when a man knows he is to be hanged in a fortnight, it concentrates the mind wonderfully", Boswell (1791), *A life of Samuel Johnson*.

[70] This has led, from time to time, to frenzies of "cash flow underwriting" or "writing for premium", which might be regarded as no more than a name for grabbing the money and hoping for the best. It is based, in theory, on the assumption that any shortfall in the premium collected can be made good by a rich harvest of investment income that ripens during the long period of time over which claims develop, and their settlement is delayed. However, a strategy based on generation of investment income can easily come unstuck if investment yields drop, or fail to match the rise in damages awards, or liability increases as a result of legal change, all of which have happened in recent years. At the very least, this strategy adds extra layers of risk over and above the insurance risks that underwriters assume.

[71] In the post-World War II era Lloyd's and the London market companies could, in effect, only sell insurance to U.S. companies that U.S. insurers could not or would not provide. Lloyd's, as a non-admitted insurer, was restricted to new or unusual risks, risks for which there was insufficient local capacity and those that were undesirable or unacceptable to local insurers. The "Umbrella" liability policy satisfied this requirement by providing excess legal liability cover for American industry. The policy, essentially a marketing weapon deployed by an alliance of insurance brokers to gain lucrative American accounts, was designed to sit above and supplement primary liability insurance coverage afforded by U.S. domestic insurers, typically under CGL policies. The breadth and extent of coverage under some early policies was truly staggering and as early as 1954 losses were beginning to mount at an alarming rate. Brokers put this down to poor claims handling, freak conditions and the like. Apparently most underwriters accepted their assurances, tempted by the large chunks of premium generated by Umbrella business. The effects of this are still being felt in Lloyd's today, with massive losses still being generated by 40-year-old policies. Randolph M. Fields gives a good account of the history of the Umbrella policy in an unpublished paper "The Underwriting of Unlimited Risk: The London Market Umbrella Liability Policy 1950-1970".

[72] The claimants in the *Jaffray* litigation (*Society of Lloyd's v. Jaffray* [1999] 1 Com All ER 354, QBD and (No. 2) 2 Comm All ER 181, QBD) argued that Lloyd's underwriters had succumbed to a form of moral hazard going beyond ostrich-like obtuseness. They alleged positive fraud, saying that underwriting members ("Names") had been recruited in the knowledge that long-tail liability claims were on the way, and that this fact had been concealed from the individuals concerned, the so-called "recruit to dilute" policy. However, the plaintiffs lost their claim in the U.K. High Court.

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The broker's role is to sell his product, not only to the client insured but also to the underwriter. The latter then has the task of pricing a product which is not only designed by another (the broker) but which varies in its production costs according to the characteristics of a person or business (the insured) that is selected and proposed by that other. On the face of it, the broker has every incentive to understate the extent of the risk that he presents, because his primary duty is to his client insured.[73] As a result, underwriters, and not just policyholders, can become victims of mis-selling. Of course, if a broker oversteps the mark and conceals the truth, or misrepresents facts relating to the risk, then he can be called to account and held legally responsible for his wrongdoing. But what protection does this accountability give to the underwriter? The answer is very little, because the London insurance market stands behind the broker as well. Certainly, if the latter is negligent he may be liable in damages, either to his client insured (if his negligence is attributable to the latter and a claim is lost), or to the insurers (if the negligence is attributable to the broker alone). However, it makes little difference in either case because, of course, the broker is insured. Thus, the mechanism of liability insurance (professional indemnity insurance in this case) will simply propel the loss back into the very market that the broker has offended, if not back to the very same underwriters. Obviously, the protection that the broker receives comes at a cost, in the form of the professional indemnity insurance premiums that are paid. However, the burden of assessing and pricing this risk rests, again, on the underwriter. In essence, the underwriter is required to price not only the potential negligence of the insured, but also that of the intermediary who introduces him. The entrepreneurial approach to insurance that we find in the broker-driven London market is, of course, part of its strength. However, the dynamics of the market also create risks that are likely to be especially acute for underwriters of liability lines.[74]

8. Conclusion

Liability insurance is a class that is notoriously difficult to write with success. The premium income that it generates for insurers is relatively small, less than 10 per cent of the total for non-life insurance in the U.K., but the problems that it generates are often on the grand scale. Thus, for example, it was difficulties with liability insurance in the U.K. that played the central role in the demise of the specialist local government insurer Municipal Mutual, the near collapse of Lloyd's in the late 1980s, the recent failure of Independent Insurance and, indeed, in other many unhappy chapters of insurance history, in the U.K. and elsewhere.

The problems that insurers experience in this field arise, in part, from the complex external environment surrounding liability risks. Underwriters often have to deal with high levels of uncertainty on a variety of legal, medical, scientific and business issues. Of course, this uncertainty is apt to be magnified by the long time-span over which many liability claims develop. However, we have suggested in this article that a number of these uncertainties are

[73] And, of course, because the broker is a distribution channel and not a risk carrier.

[74] Albert (1991, p. 87) is particularly critical of the short-termism that, he claims, was typical of Lloyd's at the time: ". . . Lloyd's is currently (and notoriously) in the throes of a crisis stemming largely from the Names' loss of confidence in their agents, too many of whom are apparently underwriting huge, ill-judged risks. Again we see the effects of the 'fame and finance' syndrome: brokers were only too happy, in the short term, to sign any deal, no matter how speculative, in order to take whopping commissions and enhance their visibility in the market. Unfortunately for their investors, the long term is about to catch up with the high rollers. Lloyd's, like America, faces a bleak day of reckoning in the not-too-distant future."

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not entirely external to liability insurance contracts and liability insurance markets, but linked to them through patterns of human behaviour that are far more complex than those which affect first-party insurance. Certainly, liability insurance shares with first-party insurance many conventional moral hazard problems associated with the behaviour of the policyholder, including a possible inclination on the part of the latter to become more careless. However, we have seen that in the case of liability insurance the standard techniques that first-party insurers employ to mitigate this form of moral hazard are much less easy to apply. Their use is impeded by technical problems (associated, for example, with the long-tail nature of some liability exposures) and subject to restrictions grounded in public policy, which will always tend to promote the interests of accident victims over the underwriting preferences of liability insurers. Going beyond this, we have seen that moral hazard takes on additional and unique dimensions in the case of liability insurance. One such dimension, explored in this article, is the effect of liability insurance, or the money that it represents, on potential (third-party) claimants, whose actions, in most respects, are well beyond the reach of the underwriter. Another aspect, which we have been able to touch on only briefly, is the potential effect of liability insurance on the behaviour of judges and legislators and, by extension, its effect on the legal processes by which liability laws are created and modified. Finally, we have observed that the peculiar nature of liability insurance can create traps and temptations for insurers themselves, demanding of them extra levels of discipline and vigilance.

Because liability insurance involves a wider range of interests and a greater number of active human participants than other forms of cover it will, inevitably, produce patterns of human incentive, action and response that are especially intricate. It is also clear that the notorious instability of liability insurance markets arises, at least in part, from this complexity. In the view of the author the patterns of behaviour that we have explored, loosely grouped under our "moral hazard" caption, merit further study. It may not be possible to model them with a degree of accuracy and refinement that is sufficient to reduce significantly the uncertainties that liability underwriters face. However, a deeper appreciation of the peculiar moral hazards associated with liability insurance should, at the very least, help us to understand its limitations as a risk-spreading mechanism.

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