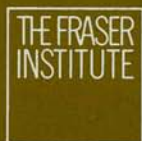


**LIABILITY
INSURANCE
CRISIS
IN SUPPLY**

DAVID GILL



LIABILITY INSURANCE

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Canadian Cataloguing in Publication Data

Gill, David.

Liability insurance

Includes bibliographical references.

ISBN 0-88975-100-5

1. Insurance, Liability — Canada. 2. Insurance,
Liability — United States. I. Fraser Institute (Vancouver,
B.C.) II. Title.

HG9990.4.C2G54 1987 368.5'00971 C87-091051-5

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Printed in Canada.

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ACKNOWLEDGEMENT

I gratefully acknowledge helpful conversations with Mike Walker, Walter Block, Edward Belton, David Hammes, Tom Hodson, Karen Sharlow and the research assistance provided by Sandy Burrows.

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David Gill was born in 1953 in New Westminster, British Columbia. In 1976 he received his B.A. (Economics) from Simon Fraser University and in 1978 his M.A. (Economics) from the University of California at Los Angeles. Mr. Gill also holds a law degree from the University of British Columbia (May 1982) and was a law clerk to the B.C. Supreme Court (1982-1983) before completing the remainder of his articles at the Vancouver law firm of Shrum, Liddle and Heberton. Mr. Gill was called to the B.C. Bar in February 1984 and was most recently with the Bureau of Competition Policy in Ottawa. He is presently writing a book for the Fraser Institute on the market for legal services.

Mr. Gill wrote "More on Expected Inflation and Unemployment," for the *Atlantic Economic Journal* in 1976 and is co-author of *Tax Facts 3* published by the Fraser Institute in 1982.

I. INTRODUCTION

Evidence of the Crisis

Effect on the medical profession

The price of diphtheria-pertussis-tetanus (DPT) vaccine has risen from \$4.29 (U.S.) in 1985 to its current price of \$11.40 because the largest producer in North America was unable to find an insurer.¹ While an outright shortage of the vaccine was averted when the producer decided to self-insure rather than withdraw from production altogether, the product price rose by nearly \$8.00 so that a reserve could be built against possible litigation.

For fifteen months, The Institut de Armand Frappier of Montreal, a supplier of measles, mumps and rubella vaccine in Canada has looked unsuccessfully for a new insurer. If it cannot find an insurer in the near future, production of the vaccine may be discontinued.

In a recent address, Dr. William Vail, President of the Canadian Medical Association said medical malpractice awards had reached crisis proportions.²

The Canadian Medical Protective Association which provides an insurance function for physicians spent \$9.1 million to defend its members against lawsuits in 1985 compared with \$7.4 million in 1984. Annual fees charged by the association to obstetricians, orthopedic surgeons, anesthesiologists and neuro-surgeons have risen steeply — from approximately \$2800 in 1984 to nearly \$5000 by 1986.³

In British Columbia one orthopedic surgeon in five has a suit waiting settlement.⁴

1. *Globe and Mail*, July 7, 1986.

2. *The Vancouver Sun*, July 4, 1986, p. A1.

3. *Ontario Task Force on Insurance*, May 1986, Appendix 17.

4. *The Vancouver Sun*, July 5, 1986, p. A8.

Effect on municipalities and manufacturers and lawyers

The physicians and pharmaceutical producers are not alone in their insurance troubles.

A survey of Canadian Manufacturers' Association members indicated that nearly half their respondents suffered a doubling of their liability insurance premiums for 1986 and a reduction in coverage.⁵

Day care centres, truckers, bus and transit operators, accountants, directors and officers, hospitals, recreation groups, lawyers, architects and municipalities have all reported premium increases or difficulties in finding liability insurers.

Bus and transit operators were hit with premium increases that sometimes ranged from 1000 percent to 2000 percent while hospitals in Ontario suffered a 362 percent increase in insurance cost between 1985 and 1986.

The city of Mississauga recently experienced a doubling of its premium and a reduction of its insurance coverage from \$15 million to \$7 million and there have been many stories of municipalities going "bare" — entirely without insurance.⁶

Lawyers in B.C. paid \$1750 for errors and omission insurance in 1986 as compared to \$921 in 1985, a 90.0 percent increase.⁷

Proposals have been made to impose levies on real estate transactions to provide a fund for self-insurance as it is real estate transactions which give rise to a disproportionate number of professional negligence claims against lawyers.

In Ontario the scarcity of coverage for sudden and accidental pollution prompted the provincial government, acting in concert with 25 insurers, to create a "Limited Pollution Liability Insurance Pool." The pool supplies protection to a maximum of \$1 million for those persons who are unable to obtain pollution coverage.

Reactions to the Crisis

In response to the scarcity of liability insurance, a Toronto-based brokerage firm recently announced it would seek to raise approximately \$25 million

5. *Task Force*, p. 38 *et. seq.*

6. *Toronto Star Field*, February 20, 1986.

7. Law Society of British Columbia.

to establish a private mutual insurance company that would provide insurance to its owner members. Under the proposed plan, members would obtain the first \$10 million in coverage through other sources and could then arrange an additional \$25 million through the mutual.⁸

The seriousness of the insurance problem was such that the Ontario government founded a task force (“Task Force”) in January 1986 to inquire into the “solutions for cost and capacity problems in the property and casualty insurance industry in Ontario.” Early in May, the Task Force recommended that the province’s tort system be scrapped and replaced with a no-fault system.⁹

The seriousness was also highlighted by the record \$1.26 billion underwriting loss in 1985 for property and casualty insurers.¹⁰

North American Scope

Nor is the problem limited to Canada. If anything, reports from south of the border suggest that American insurance problems are worse. Some ski areas increased the price of lift tickets by \$2 to \$3 a day as ski operators faced premium increases of up to 400 percent.¹¹ The cost of a Beech aircraft rose by \$80,000 to cover insurance expenses.¹² Approximately 3,000 of 24,500 obstetricians gave up their specialty because of rising premiums.¹³ Some municipalities were facing premium increases of up to 1000 percent.¹⁴ A survey was conducted in 1985 of 39 U.S. cities; over half the cities quoted premium increases of over 100 percent. Grocers, architects, engineers, toy manufacturers, household appliance manufacturers, automobile repair shops, biotechnology firms, oil and gas drilling operations and aviation producers all reported hefty increases in premiums.

8. *Globe and Mail*, July 23, 1986.

9. *Task Force*, p. 105.

10. Insurers’ Advisory Organization of Canada, based on Catalogue No. 61-006, Statistics Canada.

11. *Time*, March 24, 1986.

12. *Ibid.*

13. *Ibid.*

14. Office of the U.S. Attorney General, *Report of the Tort Policy Working Group on the Causes, Extent and Policy Implications of the Current Crisis Insurance Availability and Affordability*, February 1986.

Responding to the concern, the U.S. government established a Tort Policy Working Group and asked it to examine the “rapidly expanding crisis in liability insurance availability and affordability.” The report that issued February 1986 recommended a number of reforms to the U.S. civil law and rejected the solution of government-provided insurance.¹⁵

In June 1986 the U.S. Senate Committee on Commerce, Science and Transportation approved legislation that would reform laws governing the award of compensation to persons injured by defective products; the bill would place a cap on recovery for pain and suffering and impose liability for attorneys who file frivolous suits as well as institute an expedited settlement system.

II. EXPLANATIONS FOR THE INSURANCE PREMIUM ESCALATION

High Interest Rates Lead to Improper Underwriting

Introduction: The argument

Critics of the industry relate the insurance supply problem to the movement of interest rates. Allegedly, insurers wrote up too many risky insureds during periods of high interest rates and are now trying to recoup their losses. This process is alleged to operate as follows.

Insurers are required by law to hold liquid, interest bearing assets. When interest rates are high, it is suggested that insurers would be tantalized by the interest income to be earned by writing additional policies and would, therefore, shoulder inappropriate risks. Naturally, these risks would eventually translate themselves into losses that could not be covered by interest income after interest rates fell to lower levels. These losses, the argument runs, must therefore be recouped by substantial premium increases and retrenchment.

In effect, the public is paying for the past mistakes of insurers.

As support for this thesis, there is an observed negative relationship between premium income and interest rates.¹⁶ Presumably, when interest rates are high, premium income grows more slowly due to price competition between insurers for customers. Although each individual insurer seeks to in-

15. *Ibid.*

16. *Ibid.*, p. 25 *et seq.*

crease sales revenue by reducing price; in the aggregate such competition — according to the theory — only serves to reduce total premium income.

Expected relationship between interest rates and premiums

Is the reaction of insurers to shifting interest rates then the reason for the abrupt increases in premiums experienced by a variety of industries across North America?

Had we not looked at the evidence, we still would have expected a relationship to obtain between interest rates and premiums. In a competitive industry, the premium reflects the cost of providing insurance. This cost includes the cost of administering claims and policies, settlement costs, damages, legal fees and other claims related costs and the costs of managing investment portfolios. However, these costs are partly defrayed by investment income. In giving a price to a customer the insurer will take into account the expected claims cost (being some evaluation of the loss discounted by the probability that loss will occur) and the costs of administration. He will also take into account the investment income he expects to gain from selling the policy.

In a competitive industry every insurer calculates its premiums keeping in mind the investment income to be earned. Any insurer who fails to do so quickly loses customers to rivals who offer insurance for less. In the absence of collusion, the premium would, therefore, reflect the true cost of supplying insurance and that true cost includes defrayal by the investment income generated by writing the policy.

Therefore, when interest rates rise, we would expect premiums to fall (reflecting the effective reduced cost of supplying insurance); and when interest rates fall we would expect premiums to rise.

That there exists an inverse relationship between interest rates and premiums is not worrisome. Insofar as insurance contracts are made for short terms, new contracts must reflect underlying changes in the costs of supply as do, for example, new contracts to purchase oil and gas.

If all we are experiencing is an ordinary market reaction to falling interest rates, “the problem” does not rest with the insurance industry — but with fiscal and monetary policies that determine the course of interest rates.¹⁷

17. It is, of course, debatable whether the impact of macroeconomic policies was harmful in an overall sense.

Over-reaction due to bad management

Critics of the industry allege, however, that the industry has over-reacted to the extremely high interest rates that prevailed over recent years. Premiums fell excessively and they are now rising excessively to recoup past losses. Moreover, inappropriate risks were underwritten.

Three separate aspects of the argument alleging over-reaction are examined below: (1) whether bad management caused the industry to over-react; (2) whether past losses arising from bad management (or arising unavoidably from unexpected changes in interest rates) can be recovered; and (3) whether insurers would alter their risk portfolios to chase particularly risky insureds in response to rising interest rates.¹⁸

The bad management argument essentially asserts that the insurance industry as a whole was poorly managed; an assertion which strains our credibility as common sense dictates there ought to be both bad and good managers in every occupation. Surely, some proportion of the industry must have been aware it was not good business to offer insurance at below cost.

The argument is further weakened by the widespread scope of the insurance supply problem: not only must the Canadian industry have been mismanaged but the American industry as well. Indeed, since reinsurance markets have an international nature, the argument implies European managers also underpriced their premiums.

If any good managers exist (as common sense suggests they must) their firms would not need to subsequently raise premiums and hence they would grow at rapid rates appropriating business from their more foolish competitors.¹⁹

18. It may seem to the careful reader that for every level of risk there is an appropriate premium, thereby rendering the concept of risky insureds economically inaccurate. Consider, however, the situation where an insurer separates insureds into three classes: male, female and a high-risk group. Suppose that the appropriate premium for high-risk group members is such that members of that group choose to self-insure or go without insurance. The question can then be asked: would the insurer, in response to rising interest rates, seek out customers by redefining his risk classes so as to incorporate high-risk members into the male and female groups?

19. This assumes an atomistic market (consistent with the evidence below). Each individual firm would, therefore, face a potentially very large market. The extent to which superior competitors would grow depends upon the rate at which marginal costs increase as the number of policies written increased; there are reasons to believe that marginal cost would not increase too rapidly: the infrastructure in the insurance market (head office, agents, numerous brokers)

Instead, we have observed almost uniform increases in premiums for liability insurance along with problems in availability.

Evidential difficulties with bad management argument

The bad management argument must also cope with the fact that equity held in the Canadian insurance industry has grown over the past 15 years at an annual compound rate of 11.2 percent from \$958 million in 1970 to \$5.7 billion in the third quarter of 1985.²⁰ Nor are share prices for firms in the insurance industry noticeably depressed. These are not signs of bad management.

Over-reaction due to loss recoupment

In whatever fashion losses arise — whether from bad management or unavoidably as the consequence of unexpected changes in interest rates, to recoup such losses the industry must be able to price present premiums at above cost. In a competitive industry, this is impossible. (Below, we see there are good reasons to believe the industry is competitive.) Rivalry between competitors will bring prices down to costs. This is so — even if every competitor has suffered past losses — since each individual competitor could gain tremendous market share (and earn healthy profits) by simply undercutting the price marginally. Unless behaviour in the industry is co-operative, prices will be bid down to costs including a profit which is insufficient to attract further competitors.

If prices remain above costs, there will be an incentive for newcomers to enter the liability insurance market (who naturally have not suffered past insurance losses) and under-cut prices. In addition, there would be an incentive for insureds to self-insure through mutuals or captives.

Over-reaction due to lags

Although it therefore appears that insurers are not recouping underwriting losses by charging excessive premiums, nothing that has been said precludes premiums from over-shooting their long-run levels due to market lags in responding to such shocks as changes in interest rates. Such lags are inevitable because it is costly (if not impossible) to ascertain the magnitude

is such that many more policies could be written before organizational costs began to have an adverse impact.

20. *Task Force*, Vol. 1, p. 30.

and duration of key changes, such as changes in interest rates, and it is costly for insurers to alter their behaviour in response to such changes.

For example, as interest rates change, there will be a lag before the change is recognized as sufficiently enduring to alter premiums. After all, there is a cost to changing a price and an insurer would not logically react to every minor interest rate fluctuation. The Task Force observed that rating manuals would need to be changed, that brokers and agents would have to be informed and that new rates would only become effective when existing insurance contracts expired.²¹

Where such lags exist, prices and outputs will not instantly adjust to changes in underlying market conditions and so forecasting is required, creating the possibility of dynamic adjustments where prices under or overshoot their long-run marks.

Such dynamic adjustments do not mean past losses can be recouped. On the contrary, premiums must only reflect present and future risks and interest rates. No surcharge can be added for past losses. Nor are price increases “excessive” in the sense that better management would reduce them since they are based upon the real costs of operating markets.²²

The evidence is consistent with the view that prices may have overshot their long-run marks and are due to decrease.

Plotting underwriting gain/loss as a percentage of earned premiums over time, it is evident that industry profitability has varied in a cyclical fashion.

The Insurers’ Advisory Organization monitors the balance between supply and demand by creating a variable equal to equity (proxy for supply) as a share of GNP (proxy for demand). This measure is also cyclical; indeed, the supply/demand monitor and underwriting results appear to be closely related. (See Graph 1)

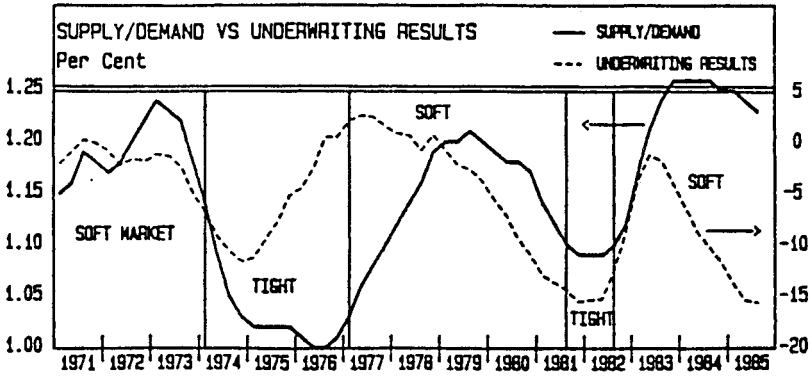
A glance at Graph 1 reveals that we have recently experienced a soft market and falling industry profits. In the next period, we should accordingly experience increasing profitability and, in fact, the latest statistics for 1986 confirm that expectation.

During the first quarter of 1986, earned premiums grew 17.2 percent for the property and casualty insurance industry, while losses incurred grew only 7.2 percent. The loss ratio for the first quarter of 1986 (incurred losses/earned premiums) was 76.1 percent — significantly below the 83.2 percent loss ratio that prevailed during the first quarter of 1985 or the average loss ratio of 82.5 percent for that year.

21. *Ibid.*, p. 25.

22. Such as information and transactions costs.

GRAPH 1



Source: Statistics Canada, Financial Institutions, Cat. No. 61-006 and National Income and Expenditure Accounts, Cat. No. 13-201; and Insurers' Advisory Organization.

Liability insurance showed the greatest improvement. Earned premiums increased 71 percent in the first quarter of 1986 over the same period last year while losses increased only 11.9 percent bringing the loss ratio down to 64.5 percent, the lowest level since the third quarter of 1981.²³

The evidence therefore establishes a cycle. In due course, we might expect premium increases to improve profitability and encourage an expansion in supply that would eventually bring premiums down again as the cycle entered its next phase.

The effect of interest rates on insurers' risk portfolios

(i) *Economics of insurance*

Contrary to claims by critics of the industry, there is no satisfactory explanation why insurers would take on risky insureds when interest rates

23. Insurers' Advisory Organization of Canada, *The Quarterly Report*, Vol. V, No. 1.

are high. To see this, a closer examination of insurance operations is required.

Briefly, insurers undertake contracts to indemnify persons for monetary losses, the probability of whose occurrence is less than certain. They are able to offer such indemnity by aggregating a number of uncorrelated risks: risk spreading. In doing so, insurers face the difficulty of assessing individual risks.

Ideally, a separate premium would be charged each insured reflecting the risk underwritten. However, it is obviously costly to gather information on each individual; instead, for rating purposes, insurers lump individuals into sets defined on the basis of a limited number of observable characteristics that are statistically associated with claims experience.

In many instances, the individual insured may, therefore, know more about the potential risk (for himself) than the insurer. The insurer is at a partial informational disadvantage. And this disadvantage is even greater where the risk is significantly controlled by the actions or inactions of the insured.

Therefore, the premium will likely diverge from the insured's internal estimates of the risk. For any particular rating class, there will be high-risk members who are paying less than they would pay in a world of perfect information and there will be disgruntled low-risk members. Since the low-risk members have the option to self-insure or form co-operative insurance ventures with other identifiable low-risk members, there is a limit to the amount by which the insurer's risk estimate can diverge from that of the insured.

Entry into the industry will not extinguish this divergence as it is based upon an informational disadvantage reducible only by expenditures that exceed the generated benefits.²⁴

This disadvantage is somewhat reduced, however, as time affords the insurer the opportunity to observe individual members of each rating class. But there is a limit to this reduction. Firstly, given the long lags between the event which gives rise to the claim and the initiation of judicial process, the informational value of a claims-free record for short periods is rather low. That is one reason why insurers cry out for effective limitation periods beyond which actions cannot be commenced.²⁵ Secondly, given the random nature with which claims occur, it will remain difficult to separate

24. We are assuming entrants have no special advantage in assessing risk. Of course, those entrants that have such advantages will soon come to dominate a niche in the industry.

25. See the report of the general counsel, *85th Annual Report* of the Canadian Medical Protective Association.

the randomness from evidence of a real difference between individuals in any rating class.

So the insurer rates the whole spectrum of risks, from low to high, assigning appropriate premiums to each.

(ii) Incentive on insurer to define rating class narrowly

The insurer has an incentive to define each rating class as narrowly as is feasible given the costs as that will minimize the number of disgruntled low-risk members who will drop out to self-insure. Recall that it is the low-risk members who are being offered the sour deal as their premiums are identical to those paid by higher-risk members of the same rating group.²⁶ This problem arises because the insurer, as discussed, cannot perfectly identify the low-risk members.

Suppose that interest rates rise. The costs of classifying each rating class are unaffected. There is no incentive for the insurer to widen group membership to include higher-risk insureds. If anything, the desirability of attracting the self-insuring low-risk members has increased, giving the insurer additional incentive to narrow group membership.

Acting rationally then, the insurer would not take on a disproportionate number of risky insureds. Naturally, he would reduce the premium in response to a fall in interest rates and that would attract new members to each risk class; however, there would be no special incentive to reclassify each class so as to take on more risky insureds. To attract business, it would suffice to lower premiums.

Conclusion

In sum, an explanation based upon excessive reaction to interest rates does not seem very cogent. It is predicated upon the existence of pervasive bad management and collusion — for which there is no evidence. Nor does it explain why insurers would underwrite a disproportionate number of bad risks when interest rates are high.

26. This problem of adverse selection in insurance markets was discussed in George Priest, “Modern Tort Law and the Current Insurability Crisis,” (unpublished).

Collusion

The unlikelihood of conspiracy

(i) Entry

Is the insurance industry conspiring to create a crisis and raise premiums?

The short answer: collusion is practically impossible. It is impossible because it would require the co-operative action of numerous small firms. In the U.S., there are over 900 companies in the property liability insurance market. The industry is not very concentrated: twenty insurance groups account for only 53 percent of written premiums. In Canada, there were 243 companies offering general liability insurance and applying one ordinary measure of concentration — the largest four firms held only a combined market share of 18.7 percent.²⁷

Moreover, substantial variation in policy terms would make it difficult for the many insurers to agree on a common price.

Even if the Canadian insurance industry managed to collude, it would face the prospect of U.S. and European competitors entering the Canadian market in response to the monopoly price. And since entry into the insurance industry as a whole is relatively easy, capital would also be attracted from other industries.

Monopoly prices simply would not be sustainable given the ease with which competitors could enter the market.²⁸

(ii) No evidence of collusion

In addition, the evidence does not point to collusion. Policy terms and conditions vary as do prices. There is evidence of rate competition in that earned premiums for liability insurers fell 28.9 percent in real terms between 1979 and 1984.²⁹

And there is evidence that other forces might be at work. For example, New York city, a self-insurer, paid \$24 million in 1977 to settle personal injury claims; by 1985 the figure had climbed to \$114 million, a 375 per-

27. Trebilcock, "The Insurance-Deterrence Dilemma of Modern Tort Law," May 1986, p. 9 (unpublished).

28. The *Task Force* also reaches the same conclusion; Vol. 1, p. 17.

29. *Ibid.*, Vol. 2, Appendix 7, p. 12.

cent increase over a period when the U.S. Consumer Price Index increased by only 77.5 percent.³⁰

It can be safely concluded that collusion is not the explanation for the insurance supply problem.

Rising Liability Claims

Overview: Size and number of claims

There are good reasons to suppose that recent events are not wholly the consequence of macro-economic phenomena. Such phenomena do not account for the virtually complete withdrawals from certain lines of liability insurance; they do not explain why deductibles would be raised and coverage reduced. They leave unexplained the differential impact upon liability insurance premiums in contrast to other types of property and casualty insurance premiums.

A glance at Table 1 outlines these differences. Earned premium for liability insurers increased by a hefty 102.0 percent between 1979 and 1985 while premiums for property and automobile insurance increased by only 67.6 percent and 73.9 percent, respectively. Over the same period, the consumer price index increased by only 57.6 percent. Even so, liability insurers did not fare very well: incurred losses grew 187.7 percent during those years — twice as fast as incurred losses for property insurers.

According to the Task Force, liability insurance represents 5 percent of the premiums written by the insurance industry while accounting for 8.8 percent of the underwriting losses.³¹

A closer look at the experience of the liability insurance industry is therefore warranted.

Whether one looks to Canada or the U.S., all indicators suggest that both the size of awards and the number of claims have been increasing.

In the U.S. the average medical malpractice jury verdict increased from \$220,018 in 1975 to \$1,017,716 in 1985, a 363 percent increase.³² The number of very large awards has also increased; in 1975 there were three medical malpractice verdicts exceeding one million dollars; by 1984, there were 71 such verdicts. The number of claims against municipal and county officials increased 141 percent between 1977 and 1985. The number of pro-

30. Manhattan Institute for Policy Research, *Manhattan Report*, Vol. VI. No. 2, p. 16.

31. *Task Force*, Vol. 1, p. 39.

32. Trebilcock, *op. cit.*, p. 19 *et seq.*

TABLE 1
Earned, Premium, Incurred Losses and Loss Ratio by Major Class

	Property		Automobile		Liability	
	Earned Premium	Incurred Losses	Earned Premium	Incurred Losses	Earned Premium	Incurred Losses
1979	413,628	270,393	544,864	422,700	66,951	48,952
	434,190	249,778	569,063	382,587	71,818	47,265
	440,017	239,106	584,896	443,044	71,334	48,217
	514,913	353,615	577,657	510,760	93,865	64,904
	<u>1,802,748</u>	<u>1,112,892</u>	<u>2,276,480</u>	<u>1,759,091</u>	<u>303,968</u>	<u>209,338</u>
1980	434,586	320,140	567,424	469,940	75,251	45,567
	451,319	329,412	581,677	400,559	80,891	42,633
	473,269	330,672	620,161	510,289	76,067	51,442
	572,481	435,598	632,363	596,244	83,931	44,185
	<u>1,931,655</u>	<u>1,415,822</u>	<u>2,401,625</u>	<u>1,977,032</u>	<u>316,140</u>	<u>183,827</u>
1981	483,422	386,500	623,476	583,748	82,675	49,490
	505,441	334,397	657,622	503,658	86,881	52,104
	541,086	403,245	697,594	597,215	85,444	49,764
	605,221	476,848	726,649	697,139	98,708	102,339
	<u>2,135,170</u>	<u>1,600,990</u>	<u>2,705,341</u>	<u>2,381,760</u>	<u>353,708</u>	<u>253,697</u>
1982	561,503	465,521	749,301	663,489	94,494	68,794
	595,584	397,750	792,078	543,280	102,513	90,431
	617,832	381,238	837,958	585,099	106,219	84,893
	656,778	402,386	895,821	689,727	117,659	119,823
	<u>1,926,347</u>	<u>1,646,895</u>	<u>3,275,158</u>	<u>2,481,595</u>	<u>420,885</u>	<u>363,941</u>
1983	621,687	381,229	860,396	572,892	110,960	90,191
	673,370	375,811	878,266	571,240	119,186	110,565
	682,974	425,088	902,544	647,878	116,843	102,120
	722,123	430,611	960,145	864,494	113,611	159,650
	<u>2,700,154</u>	<u>1,612,739</u>	<u>3,601,351</u>	<u>2,656,504</u>	<u>460,200</u>	<u>462,526</u>
1984	684,648	424,989	901,099	711,290	116,288	115,287
	687,288	431,509	915,580	668,530	112,932	115,339
	708,726	448,316	954,637	780,537	116,031	117,191
	760,839	502,950	946,882	949,573	142,034	178,419
	<u>2,841,501</u>	<u>1,807,764</u>	<u>3,718,198</u>	<u>3,109,930</u>	<u>487,285</u>	<u>526,236</u>
1985	718,333	502,999	921,932	839,328	120,235	118,820
	739,497	538,518	957,689	806,910	132,505	123,934
	763,232	504,089	1,014,234	875,490	140,275	130,971
	800,257	506,402	1,065,250	1,181,079	221,108	228,569
	<u>3,021,319</u>	<u>2,052,008</u>	<u>3,959,105</u>	<u>3,702,807</u>	<u>614,123</u>	<u>602,294</u>

Source: Insurance Bureau of Canada

duct liability cases filed in the federal district courts increased by 758 percent from 1,579 in 1974 to 13,554 in 1985.

In Canada, data from the Canadian Medical Protective Association show that legal defence costs, the number of writs served against doctors and damages awarded against physicians have all risen steeply. (See Graphs 2,3,4,5.)

An examination of general liability bodily injury loss settlements by a large Canadian insurer also shows increases in the number of large claims. (See Graph 6.)

Further evidence of the increasing size of claims comes from a study of reported Ontario legal decisions: the results indicate that general damages grew at an annual rate of 18 percent between 1981 and 1985. Non-pecuniary damages grew at an annual rate of 27 percent from 1982 to 1985 while total pecuniary damages grew at a rate not less than 30 percent per annum for the same period.³³

The average annual growth rate of claims for liability insurance was 24.4 percent (1980-1984) as compared to an average of 10.0 percent for all classes of property and casualty insurance combined and 10.6 percent for automobile insurance.³⁴

Turning to Ontario architects, the incidence of claims has increased 50 percent in the past three years compared to a previous three-year period.³⁵

In Alberta, the number of civil actions per capita commenced in the court of Queen's Bench have increased substantially. (See Graph 7.)

Changes in U.S. law

In looking for reasons why claims growth has increased, it is natural to enquire if legal rules have changed in such a way as to increase or extend liability.

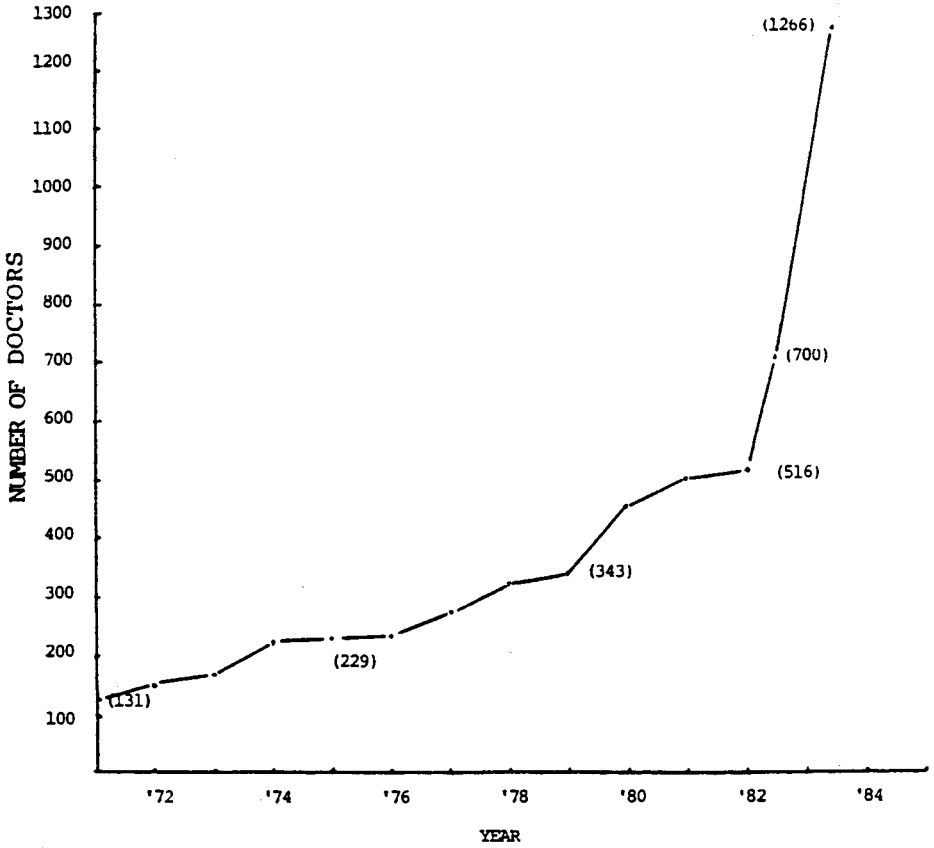
In the U.S., commentators have noticed a trend towards extension of liability. In the case of product liability, there has been a marked movement (beginning in the early 1960s) away from requiring fault before liability is found towards a realm of strict liability where the defences to liability are much more limited. This extension of liability is principally founded upon the notions that: (1) manufacturers can more efficiently insure against injuries resulting from the use of their products; (2) manufacturers ought

33. Eric Keen, Reinsurance Research Council, Toronto, Ontario.

34. *Task Force*, Vol. 2, Appendix 7, p. 31.

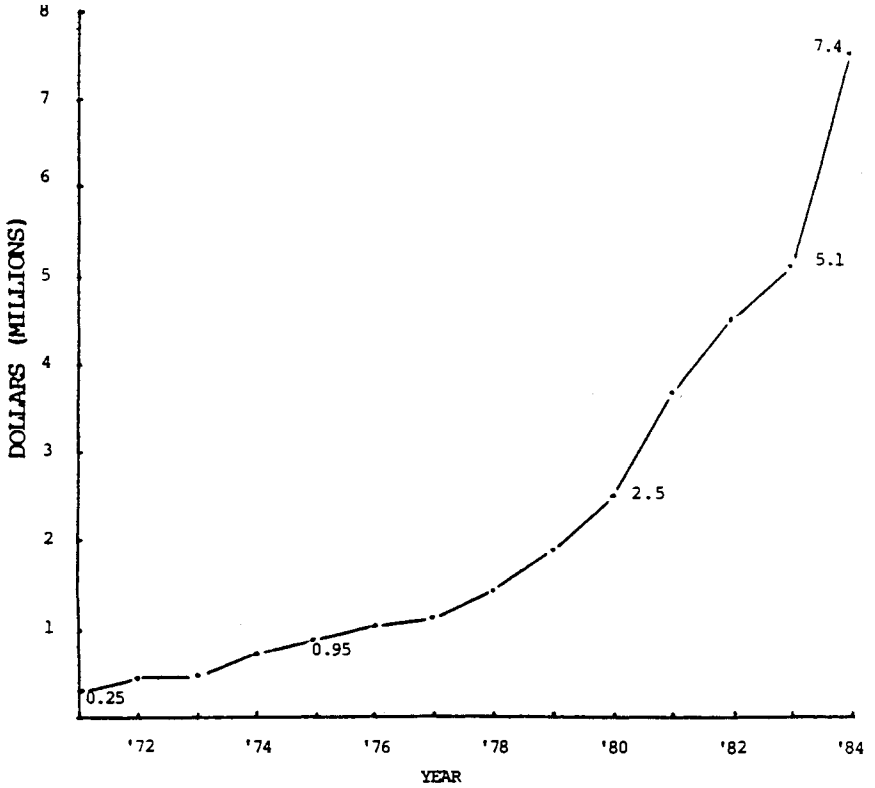
35. Ontario Association of Architects.

GRAPH 2
WRITS Served Against Doctors



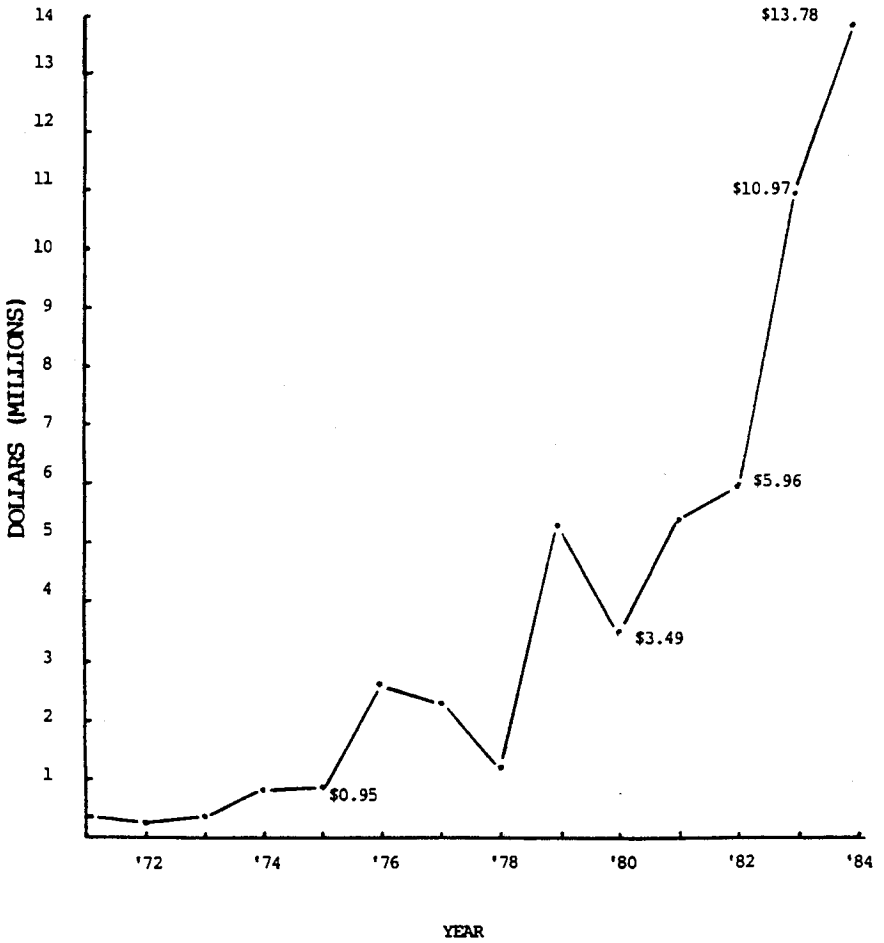
Source: Task Force, Appendix 17, Appendix VI.

GRAPH 3
Legal Defence Costs
CMPA



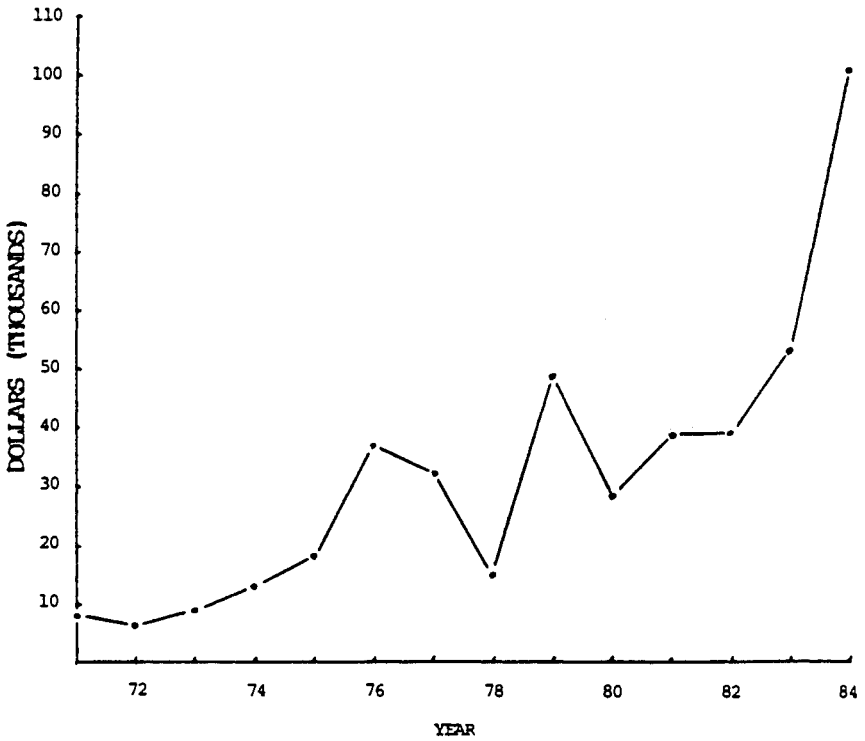
Source: Task Force, Appendix 17, Appendix IV.

GRAPH 4
Damages Awarded Against Physicians
CMPA

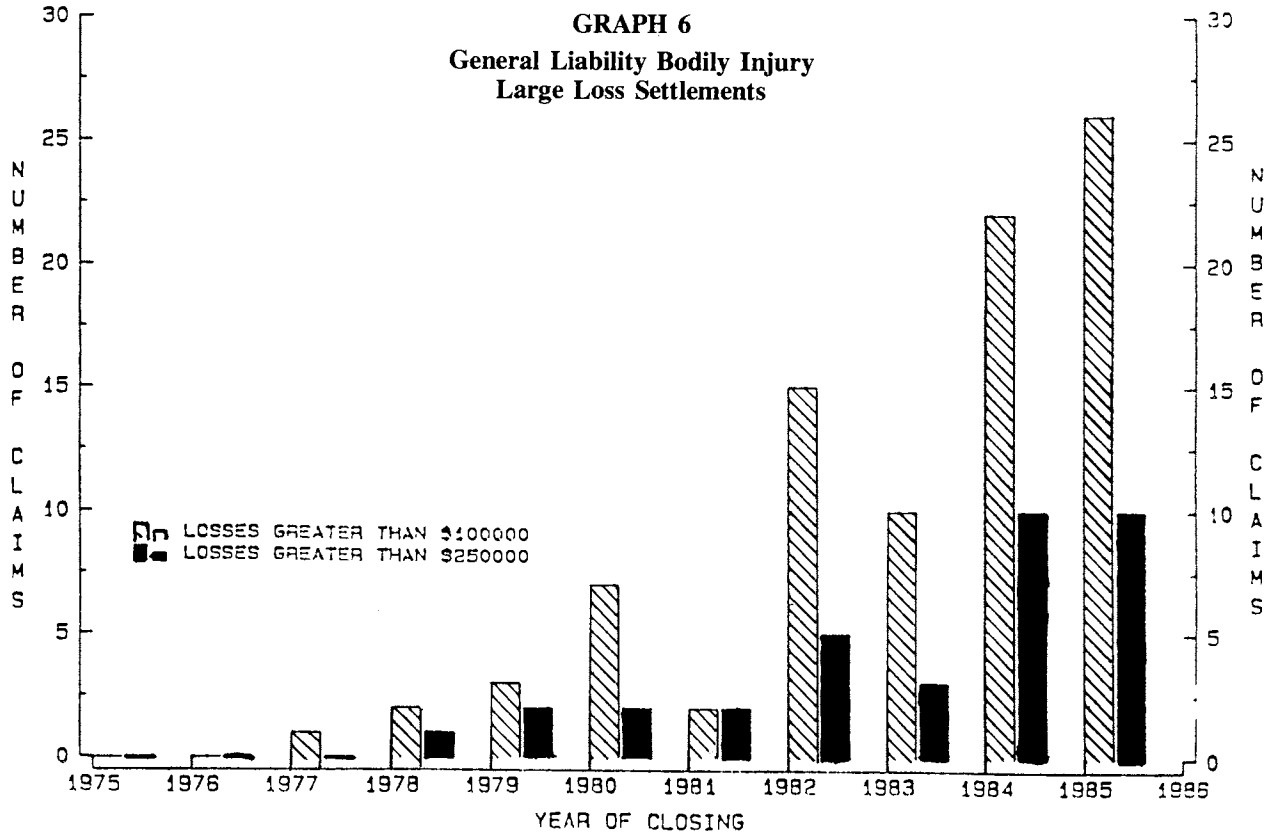


Source: Task Force, Appendix 17, Appendix III.

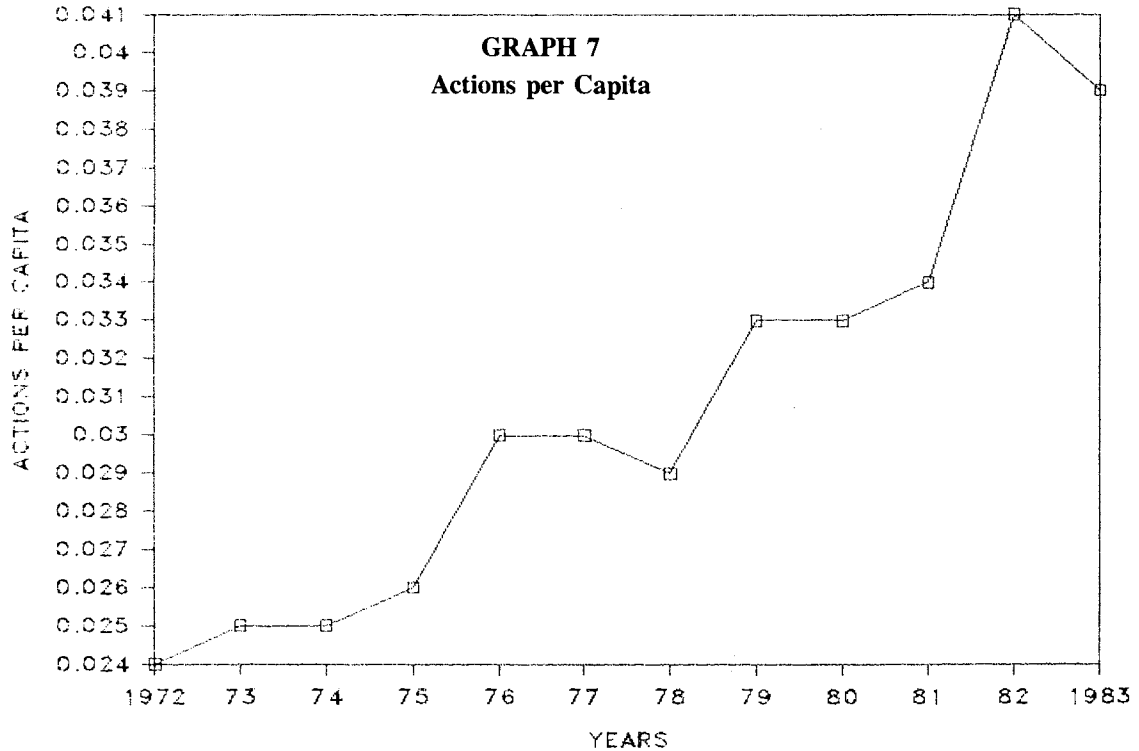
GRAPH 5
Average Awards and Settlements
CMPA



Source: Ontario Task Force on Insurance, Vol. 2, May, 19 Appendix 17, Appendix II.



Source: Trebilcock, "The Insurance-Deterrence Dilemma of Modern Tort Law," May, 1986, p.23 (unpublished).



Source: Office of the Attorney General, Alberta; Statistics Canada 11-003E and calculations.

to bear the costs arising from the use of their products, including the costs of injuries (internalizing social costs) thereby providing them with appropriate incentives to design safer products. This approach towards liability has sometimes been termed “enterprise liability.”³⁶

Along with expansion in the area of product liability, there has been a noticeable extension of the fields where negligence has been found. This extension has been documented elsewhere and includes the imposition of increased liability on landlords, municipalities, pharmaceutical manufacturers, psychiatrists, tavern owner’s (who fail to prevent drunken guests from driving home), nursing homes (child abuse), directors, and police forces (for failing to provide adequate protection).³⁷ It has been suggested that the expansion of liability in negligence might be predicated upon the same principles (noted above) that influenced the shift towards strict liability in product liability cases.³⁸

Increases in the average size of awards in the U.S. have also outpaced inflation and real growth in GNP.³⁹

Strictly speaking, the “enterprise liability” approach would not imply increases in the size of awards. After all, damages are compensatory; they are set to reflect the costs arising from an accident and such costs are independent of who is bearing them — whether it be a manufacturer or consumer. In practice, however, there is evidence that the same kind of thinking which inspires the imposition of liability on “deep pocket” defendants may also affect quantum. A recent study of jury awards in California automobile accident cases reveals that when the defendant is a business firm (as opposed to an individual), the award tends to be four times as large.⁴⁰

Although one might more readily accept a subjective bias on the part of juries, one cannot assume that judges are uninfluenced by the “enterprise liability” approach in determining quantum. As noted earlier, there is evidence that the size of awards is growing in both Canada and the U.S. Moreover, it is within the power of the judiciary to influence quantum in

36. Trebilcock, *op. cit.*, p. 32; Priest, *op. cit.*, p. 6; Priest, “The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law,” (1985), 14 *Journal of Legal Studies* 61.

37. Trebilcock, *op. cit.*, Priest, “Modern Tort Law and the Current Insurability Crisis.”

38. Priest argues this position in “Modern Tort Law and the Current Insurability Crisis,” note 26.

39. Trebilcock, *op. cit.*, p. 45.

40. Donald Wittman, “The Price of Negligence under Differing Liability Rules,” (1986), 29 *Journal of Law & Economics* 151, p. 157.

the case of general and non-pecuniary damages where the subjective element is evident. Even in the case of such pecuniary elements of damages as prospective wage loss, there is scope for subjective opinion since the judge must determine the probability a defendant would have followed a particular career as well as forecast the vagaries of future wages.⁴¹

Judicial bias: Canada

In Canada, there appears to have been a similar process of liability extension perhaps founded upon the desire to compensate the uninsured accident victim.

Consider the remarks made by Mr. Justice H. Krever (Ontario Court of Appeal) on what judges sometimes tell themselves:⁴²

This is a case in which everybody agrees damages should be paid to the plaintiff. I know that nothing can be paid to the plaintiff unless I find fault, so I am going to find fault.

I know perfectly well that if I find fault even though the evidence intellectually applied doesn't enable me to find fault, the Court of Appeal will not interfere with my finding of fault because it is a finding of fact made by a trier of fact who saw the witnesses. So I can get away with it. I am therefore able to find R so and so was negligent.

This is evidence that judges occasionally stretch legal rules to find liability where their sympathy lies with the plaintiff, in presumably those instances where the injured plaintiff would otherwise be uncompensated.

Changes in Canadian law

A detailed review of the Canadian jurisprudence is beyond the scope of this paper. However, commentators have noticed legal developments which parallel those south of the border. Three provinces have passed legislation which imposes strict liability upon manufacturers of defective products; there appears to have been a shift towards strict liability principles in two decisions relating to manufacturers' warning defects; there is a Quebec deci-

41. It would also be interesting to know whether the level of care offered accident victims has risen; this is another variable within judicial control. For example, pecuniary damages would be critically affected by the decision that home care — rather than institutional care — would best compensate the plaintiff.

42. Canadian Medical Protective Association, *85th Annual Report*, August 1986, p. 12.

sion relating to latent defects in an automobile that effectively imposes strict liability upon the manufacturer; and there is a decision in an influential English court whose adoption would expand liability for pure economic loss. Moreover, legislation in Ontario imposes strict liability upon polluters.⁴³

Liability for business professionals has also been extended by the notion of concurrent liability whereby a plaintiff may sue a professional either in contract or in negligence. Previously, a plaintiff would have been restricted to suing in contract — and the duties and standard of care imposed upon the professional would be express or implicit in the contract. Suits brought in negligence, however, are less restricted: neither the standard nor the duty are limited by contract. They are imposed by the law of negligence and depend upon a judicial decision as to the level of competence expected from a member of the professional's discipline.⁴⁴

The acceptance of concurrent liability may extend the effect of limitation periods because the rule in negligence — unlike contract (which has a six-year limitation in many Canadian jurisdictions) — is that time begins to run only from the date the defendant ought to have known of the damage.⁴⁵

Passage, during the 1970s, of legislation providing for pre-judgment interest has also created an unexpected expense for insurers.

Effect on insurance availability

So it does not appear that the liability insurance crisis is wholly the result of a business cycle or a dynamic reaction to shifting interest rates. Changes in the law — both in Canada and the U.S. — assist in explaining why both the number and the size of liability claims are increasing. The number of claims increases as the courts extend the category of factual circumstances under which insured defendants might be found liable in negligence or generally, in tort. The size of claims could also be related to the same “deep pocket” approach.

One commentator suggests that shifting liability upon providers of goods and services (especially for unpreventable accidents) would affect the dynamic stability of each rating class.⁴⁶ He argues that providers (and their

43. Trebilcock, *op. cit.*, p. 59 *et seq.*; see also *Task Force* Vol. 1, p. 79.

44. *Task Force*, Vol. 2, Appendix 10, p. 19 *et seq.*

45. *Ibid.*, Appendix 10.

46. See Priest, “Modern Tort Law and the Current Insurability Crisis.” Priest speaks of the “unravelling” of risk pools; this is essentially a reference to the dynamic stability of the pool.

insurers) are unable to segregate insurance purchasers on the basis of risk as well as third parties (and their insurers) — insofar as the insurance is purchased with the product or service. To separate purchasers on the basis of risk, providers must resort to such second-best tactics as designing different sets of products with different safety features for commercial or consumer use. He further argues that each rating (or risk) class may become unstable as low-risk members drop out, premiums increase, and more low-risk members fall out. Eventually, so many members may drop out that it becomes unfeasible to offer insurance at all.

Increasing the size of damage awards would also contribute to such instability. Such an increase — without more — would increase the variance of potential damage awards for each class rated by insurers thereby increasing the potential for divergence between the insured's internal evaluation and the evaluation by the insurer. This will encourage relatively low-risk insureds to drop out.

Moreover, the incidence of unexpected changes in legal rules would surely increase the overall uncertainty associated with potential damage outcomes; this uncertainty would cause insurers to consider a wider range of possible outcomes — essentially increasing the variance in each risk class and increasing the opportunities for difference between the insured's and insurer's evaluation of risk.⁴⁷

There are, therefore, reasons to suppose that changes in Canadian and American law might have led to liability insurance becoming scarce and expensive.

47. In passing: Trebilcock suggests (*op. cit.*, p. 47) that a legal system which predicates liability on the basis of the existence of liability insurance will not produce determinate results because the courts do not control who will insure and to what extent.

Excess Supply of Lawyers

Introduction

The relationship between the market for lawyers and the size and number of damage awards is one whose complexity exceeds the scope of this paper. There is only time here for a preliminary examination of the issues and the evidence.

The existence of a relationship between the number of underemployed lawyers and damage awards has been doubted.⁴⁸ Trebilcock poses the question: “if lawyers were predisposed to act unscrupulously in tort claims, why did they wait until so recently to indulge this apparently highly rewarding penchant. And moreover, why did courts only recently become such easy marks for trumped-up claims and grossly inflated awards?” He further notes there is no evidence to show that it is the underemployed new entrants into the labour force who are responsible for “any significant portion of the additional claims.”⁴⁹

Below it will be shown there are theoretical reasons to suppose that an oversupply of lawyers would be positively related to the pace of legal developments. This relationship will obtain whether or not the long-run equilibrium supply of lawyers exceeds demand; it is necessary only to posit an excess supply in the short term. Nothing, therefore, is said about the long-run supply of lawyers — although one observer found there were actually fewer than the long-run equilibrium quantity of lawyers in the U.S. despite the signs of a short-run excess supply.⁵⁰

The theory

(i) *The effect of brand-name*

Is there any reason that lawyers may work harder on each file, increase the complexity of their cases and settle less often during periods of excess supply for legal services? A simple theory can be constructed — consistent with the evidence — that would generate those implications.

48. Trebilcock, *op. cit.* footnote 32.

49. Trebilcock, *op. cit.* footnote 32, pp. 13-14.

50. Peter Pashigian, “The Market for Lawyers: The Determinants of the Demand for and Supply of Lawyers,” (1977), 20 *Journal of Law & Economics* 53.

The theory is based upon the recognition that a lawyer's greatest asset is his brand-name (or if you prefer: reputation). Brand-name, in the present context, includes the precedents and further knowledge that the lawyer amasses from handling the file (which is positively related to the time he expends on the file) as well as the high quality of the product that will attract future clients or obtain repeat business from the present client.

Brand-name is a critical factor of production in legal services. This is so because the client is at an informational disadvantage when it comes to dealing with a lawyer. Even for the moderately well-informed client, it is costly to supervise and adjudge the quality of legal services: such costs can be reduced by choosing lawyers with good brand-names. These lawyers may in turn delegate work to other lawyers who have inferior brand-names — supervising the work and attaching their name to it.

Naturally, brand-name plays a relatively more important role in complex cases where the informational disadvantage is greatest; those are cases where a client may be disappointed either by a lawyer's competence, by the amount of attention he pays to a file or by intentional deception. Purchasing more brand-name is like purchasing more insurance: the client reduces his probability of a loss. After all, bad legal advice (however inexpensive) often gives rise to costs — costs which may never be recovered if the advice was not given negligently, only inexpertly, or if the file is so complex the client never perceives that anything is amiss.

The practice of law is therefore a matter of trust and trust is a matter of brand-name.

Brand-name is primarily generated by producing work of consistently high quality, by advertising this work (especially through the agency of lawyers with good brand-names), by winning prominent cases and writing books and articles on various legal subjects. One means of producing higher quality work is to work longer hours on files. This is not to say that every legal job is equally amenable to generating brand-name. On the contrary, some simple tasks cannot be very much improved in quality by expending more time; in general, however, many files would yield better quality per unit time expended. The case law can be more thoroughly searched, novel arguments can be attempted, new precedents can be devised, evidence can be gathered, witnesses quizzed, articles read.

Such work, intended to increase the quality of the product, also has the effect of increasing the complexity of files — for file complexity is not a given; rather, it depends upon the number of issues seriously considered and the depth with which each issue is canvassed. File complexity is therefore a variable which is partly under a lawyer's control.

By raising more issues and studying them in greater depth, the litigator also renders it more difficult to settle a case: the number of contentious points has increased; so has the uncertainty regarding the outcome if the case were brought to trial. This makes it more difficult to get the plaintiff and defendant to agree on a common sum in settlement. Therefore, during those periods when lawyers spend more time creating brand-name, one would expect file complexity to increase and the percentage of total cases settled to decrease.

(ii) The classic case: reduce fees

In the classic situation, lawyers are assumed to operate in a competitive market at rates which are determined by market forces outside of their individual control. A single lawyer, (or his firm) can obtain all the work they want at a market determined hourly rate. Under this scenario, lawyers are never idle: during bad times, the hourly rate will fall, increasing the quantity of services demanded so as to equate supply and demand.

From the comments already made, one can see there are two ways in which lawyers can earn income over time: either by investing their time in work which renders an immediate return or by spending time in generating brand-name. Of course, these activities are not entirely mutually exclusive; yet, in general, there is a trade-off.

A lawyer who is seeking to maximize the present value of his wealth over time will allocate his time between the two activities until the marginal revenue of time spent doing straight work is equal to the marginal revenue of time spent generating brand-name.

What would happen if hard times struck and the hourly rate charged for work declined?

The marginal revenue of straight work would have decreased. An hour allocated to straight work would earn more by being expended on generating brand-name. Time would be re-allocated to generating brand-name until once again, marginal revenues were equal. This extra allocation of time to brand-name would have the effects already outlined above: increasing case complexity and decreasing the percentage of cases settled.

(iii) Modification: Idleness

The model can be modified. Suppose that we do not believe lawyers' fees are much reduced during bad times or we believe there are lags in reducing them so that lawyers suffer unwanted idleness. We may further suppose that lawyers have a stock of existing files and a flow of new files and that

during bad times the flow begins to dry up, reducing the maximum number of billable hours available to a lawyer. There is forced idleness; in effect, the lawyer finds himself unable to do the amount of straight work he chose to do during better times. Logically, he would re-allocate this extra time which is not producing present value income to an activity such as generating brand-name where it would increase his wealth. Such re-allocation would have the same effects on case complexity and settlements as have been discussed.

Conclusion

That fewer cases are settled and more cases are complex does not imply that more cases are won since defendants' lawyers would have similar incentives to successfully defend actions; however, if one posits an inherent bias in favour of uninsured plaintiff litigants, an expansion of liability becomes a natural result. The same is true if one posits an inherent logic in the law (flowing from such classic authorities as *Donaghue v. Stevenson*) that leans towards expanding the categories of negligence.

Are lawyers in excess supply?

Evidence for recent years (the years in which underwriting losses have ballooned) show that the numbers of lawyer UIC claimants have increased sharply in B.C., Alberta, and Ontario (Tables 2,3,4) as well as the number of members reporting themselves unemployed to the B.C. Law Society. (Table 5)

There are, therefore, reasons to believe that an excess supply of lawyers may not be wholly unrelated to insurers' poor claims experience.

III. POLICY PRESCRIPTIONS

Regulation

Would the public benefit if insurance companies were required by law to provide insurance at lower prices?

From our review of the insurance industry, it is clear that insurers are not pricing insurance above costs: we have every reason to believe the industry is competitive. Insurance premiums have risen for all or some of the many reasons that were canvassed, including the increase in the number and size of liability awards in North America, falling interest rates (raising the net cost of providing insurance), conditions in the market for lawyers and the insurance industry cycle. These underlying causes would be unaffected by the regulation of prices.

TABLE 2
Unemployment Insurance Claimants
Lawyers and Notaries
B.C./Yukon Territory Region

Quarterly Average

<u>Year</u>	<u>Quarter 1</u>	<u>Quarter 2</u>	<u>Quarter 3</u>	<u>Quarter 4</u>
1976	9	9	14	15
1977	14	14	29	31
1978	22	27	33	40
1979	32	35	46	31
1980	17	23	35	28
1981	18	15	17	16
1982	19	32	77	81
1983	72	67	83	84
1984	74	70	106	114
1985	97	86	87	83
1986	79	81		

NOTE: Data Includes only Regular type claims.

Source: Regional Economic Services Branch, Employment and Immigration Canada, E50640.

TABLE 3
Quarterly Averages
Active Unemployment Insurance Claimants
Alberta, Q4 1979 — Q2 1986

LAWYERS AND NOTARIES

<u>QUARTER</u>	<u>AVERAGE U.I.</u> <u>ACTIVE CLAIMANTS</u>
4th Q 1979	9
1st Q 1980	9
2nd Q 1980	6
3rd Q 1980	6
4th Q 1980	6
1 Q 1981	--
2 Q 1981	3
3 Q 1981	7
4 Q 1981	6
1 Q 1982	7
2 Q 1982	10
3 Q 1982	21
4 Q 1982	26
1 Q 1983	25
2 Q 1983	25
3 Q 1983	37
4 Q 1983	41
1 Q 1984	35
2 Q 1984	34
3 Q 1984	39
4 Q 1984	40
1 Q 1985	36
2 Q 1985	34
3 Q 1985	44
4 Q 1985	43
1 Q 1986	34
2 Q 1986	43

Source: Canada Employment and Immigration U.I. Statistics (unpublished).

TABLE 4
Unemployment Insurance
Claimant Data
(Annual Averages)
for Ontario

		1978	1979	1980	1981	1982	1983	1984	1985
2343	Lawyers-Notaries								
	Total	102	111	124	125	190	242	210	194
	Union Hiring Hall								
Total	Total	102	111	124	125	190	242	210	194
	Union Hiring Hall								

Source: C.O.P.S. Databank, employment and Immigration Canada

TABLE 5
Unemployed or Inactive Lawyers, British Columbia

Date	Unemployed or inactive	Total Membership
Apr/82	74	4605
June/83	164	5027
June/84	179	5389
July/85	196	5617
Aug/86	247	5842

Source: The Law Society of British Columbia.

Therefore, it is unlikely that a forced price decrease would help resolve the problem. And indeed, there are reasons to believe that it would exacerbate the crisis. Prices rose to clear the market, as insurers withdrew, unwilling to supply insurance at premium rates which would not secure a competitive return to their equity. If premiums have over-shot their long-run equilibrium levels (due to lags in response), the very increase in insurance rates will elicit an increase in supply.⁵¹ If higher premiums accurately reflect the long-run costs of supply, lower premium rates will only make insurance more scarce because insurers must be assured competitive returns to equity or their equity will leave the insurance industry.

And indeed, there is some evidence that such regulation has made insurance more scarce. Legislation in Florida rolled back insurance rates by 40 percent. The result: several insurance companies have announced that they will no longer write policies in that state.⁵²

The regulation of prices does not seem an answer.

Reform of the Legal System

Introduction

The law of tort provides redress to individuals from the effects of actions by others. Redress is not provided for all actions: you are entitled to unintentionally and non-negligently run over your neighbour.

An examination of the nature of those actions which give rise to liability serves to demonstrate the link between tort and criminal law; there are few (if any) acts proscribed by the criminal law which do not give rise to liability in tort. This link undoubtedly springs from moral concepts; and it is easy to reach the conclusion that one important defining characteristic of tortious actions is slight (or great) moral reprobation.

51. It may be thought that a regulator could even out-price fluctuations in an industry by setting prices at their "proper" level, thereby circumventing response lags. However, these lags are not artificial phenomena: they exist because of a real scarcity in information or because of real costs in changing prices. There is no reason to suppose a regulator would be in any better position to forecast unexpected changes in critical variables (such as the number and size of liability suits); nor would the regulator be able to reduce the costs of changing prices — by changing them too often he would actually effect an increase in the cost of providing insurance.

52. *Globe and Mail*, August 14, 1986.

Tort law, therefore, seeks to fully compensate individuals for the harmful consequences of actions to which some moral disapproval attaches by imposing the costs of those consequences upon the party engaged in the disapproved acts.⁵³

Tort reform, on the other hand, is legislative restrictions on the compensation offered to tort victims for the purpose of reducing damage awards and the costs of insuring defendants.

For example, 18 states have limited awards for non-economic damages, such as for pain and suffering; nine states have put limitations on punitive damages; nine states have granted municipalities immunity from lawsuits; in eight states collateral sources of compensation (such as disability insurance) to the plaintiff must be subtracted from total damages.

Some of the reforms instituted in the U.S. are unnecessary in Canada. For example, the Supreme Court of Canada has already imposed a limitation on awards for pain and suffering.⁵⁴ Moreover, punitive damages are rarely awarded in Canada.

Each such reform puts in jeopardy the function of tort law to provide full compensation to the victim and to optimally deter egregious conduct.

Examination of reforms

Pain and suffering is a real cost to the victim; a cap on such awards reduces the ability of the tort system to bring the costs of activities to bear upon the party who could make accident prevention investments at least cost. It also reduces the ability — from a moral standpoint — to compensate the victim.

It is sometimes argued that a limit on pain and suffering awards can be justified by the inability of money damages to alleviate non-pecuniary distress. However, it is clear that many occupations engaged in for pecuniary gain involve the risk — and sometimes the certainty — of pain and suf-

53. Ernest Weinrib takes this position in “Toward a Moral Theory of Negligence Law,” (1983), 2 *Law and Philosophy* 37 and “The Insurance Justification and Private Law,” (1985), 14 *Journal of Legal Studies* 68. Tort and criminal law can also be seen as the means to regulate costly interactions between human beings with a view to minimizing the net value of such costs. For example, Richard Posner points out that the law of negligence appears to incorporate a rule that liability is assigned whenever the costs of taking precautions to avert an accident is less than the expected accident cost: “A Theory of Negligence,” (1972), 1 *Journal of Legal Studies* 29.

54. The maximum is approximately \$185,000.

fering. Individuals demonstrate their willingness to trade pain and suffering for monetary gain; hence money damages may in some instances be effective in compensating for non-pecuniary losses. Of course, where such damages are not effective, there is no point in awarding them; for instance, where the victim is comatose.

However, a limit on pain and suffering awards might be justified on the practical grounds that the costs involved in more accurately assessing such awards are outweighed by the benefits. More accurate assessment would generate greater moral hazard problems, it would result in greater variability of awards, more judicial time reviewing such awards and more time spent in emotional appeals to judges and juries.

Limitations on punitive damages are usually justified by reference to the compensatory function of tort law. According to the argument, tort damages should not punish, they should simply compensate. Such an argument ignores the real psychic costs associated with certain tortious acts that flagrantly offend the victim's sense of expected moral behaviour. When a person feels as if another has maliciously pursued a wrongful course of action, thinking they could get away with it — there is a blow to the ego. There is obvious psychic distress. In the case of a trespass, for example, the victim might be willing to voluntarily sell (at market value) the right to use his property to anybody except the tortfeasor. A principle of full compensation would require that some notice be taken of such costs and in effect, by awarding such damages in rare circumstances where the tortious conduct is particularly offensive, our courts have taken these costs into account.

Moreover, there may be instances where optimal deterrence is achieved through awards which are some multiple of compensatory damages.⁵⁵

It is more difficult to justify the deduction of collateral sources from the damage award. Where insurance is purchased privately or provided by an employer, it is a private contract — like any other — for which the victim paid in cash or reduced wages. Deduction of such benefits from the damage award essentially forces the victim to insure the tortfeasor — a manifestly unfair result. And from a deterrence aspect, such deduction would evidently be sub-optimal. In the case of publically funded collateral sources, the victim pays for the insurance through his taxes; there is no barrier to a collective political decision to legislate subrogation rights that would effectively eliminate “double recovery” and reduce insurance costs.

There has also been the suggestion that limitation periods be amended

55. Trebilcock, *op. cit.*, p. 53; in cases of fraudulent concealment by a manufacturer of the dangerousness of his product or in cases of reckless conduct.

so that the period of liability for all professionals would run from the date of the last professional service instead of from the date of “discovery.”⁵⁶ Any limitation period interferes with the principle of full compensation. Such a limitation can be explained by the costs that are imposed upon defendants if they are to be prepared for suits many years after the actual service had been performed and by the possibility key witnesses may be dead or unavailable or suffer from failing memories (i.e. the determination of the facts may be difficult and hence, the quality of the judicial decision may be lowered). The present regime balances these costs and benefits by imposing a six-year limit for tort commencing from the date the injury ought to have been discovered. Even so, there are many cases where the injury would not have been discovered through reasonable attentiveness until many years after the advice or care. Professionals are therefore burdened with the costs of preparing for litigation for a long, uncertain period after closing a file. A compromise solution would be to retain the “discovery” criterion with a maximum period beginning from the time of the last professional service which is set at (for example) fourteen years, thereby reflecting the need for professionals to have a fixed limitation, while recognizing the deterrence and morally corrective features of tort law.

No-Fault Liability

Definition

The Ontario Task Force recommended the institution of a no-fault liability scheme for automobile insurance.

Under no-fault schemes, insurance is provided for injuries arising from a class of activities — without regard to fault. Unlike the tort system which has its underpinnings in the administration of corrective justice, no-fault schemes only offer insurance. Moreover, they offer insurance to a wider set of persons, namely, those persons who would have been found at fault for the accident and those persons suffering the consequences of blameless accidents. It is the latter feature and the alleged lower costs of administering such schemes (in contrast to the courts) that render no-fault liability attractive.

56. *Task Force*, Vol 1., p. 83.

Examination of costs and benefits

The costs and benefits of moving to a no-fault system in Ontario were analysed in a recent paper by Jack Carr⁵⁷. His results are summarized below, beginning with the costs.

Firstly, Carr estimated that accident costs would increase by \$267 million per year if the number of accidents increased in Ontario by as much as they had in Quebec after the institution of a no-fault scheme.⁵⁸

Secondly, Carr estimated that claims costs would increase by \$818 million per year if compensation was extended to negligent parties. Supposing that one half of all automobile accident victims go uncompensated (being negligent parties), Carr doubled the figure for third party bodily injury claims to obtain a rough estimate of total claims costs.

Thirdly, Carr noted the unfairness that would arise from the elimination of a forum where victims would have the satisfaction of seeing tortfeasors ordered to pay damages. Under a no-fault system, innocent injured parties are treated identically to those at fault.

Carr calculated the benefit of a no-fault scheme as solely arising from a reduction in litigation costs; such a reduction results because it is costly to determine fault.

Carr estimated the reduction in litigation cost to be 5 percent of premium.⁵⁹ When this figure is applied to total premium income for bodily injury in Ontario, it yields a savings of 31 million dollars per year.

Clearly, the monetary costs of no-fault liability exceed the monetary benefits; total estimated costs are \$1.085 billion per year while total benefits are \$31 million per year.

57. Jack Carr, "The Automobile Insurance Industry and No-Fault: An Economic Analysis," July 1986 (unpublished).

58. Marc Gaudry, DRAG, *Un modèle de la Demande Routière des Accidents et de leur Gravité appliqué au Québec de 1956 à 1982*. Cahier 8432, Université de Montréal, 1984. Gaudry found that accidents increased by 17 percent in Quebec as the consequence of a no-fault scheme. The number of accidents can be expected to increase due to the elimination of the deterrent feature of tort law.

59. This is based on a 1984 Woods Gordon report that surveyed eighteen Ontario insurers and found legal costs were 2.1 percent of premiums. Given that defense costs may be somewhat less than that of the plaintiff, Carr used 5 percent as an estimate of total costs.

There is, however, one non-pecuniary benefit touted by proponents of no-fault liability which was ignored by Carr: satisfaction of the desire that accident victims receive something in excess of minimum social assistance.⁶⁰

In essence, this is no more than a desire to provide increased social assistance to accident victims and ought to be discussed within that context. Such a desire does not necessarily imply that full compensation be awarded through wholesale replacement of the tort system with concomitant increases in monetary costs and loss of a forum for corrective justice.

It therefore appears that the costs of a no-fault scheme outweigh the benefits. Tort law arose out of a need. It was not a need to provide insurance: it was the need to provide a forum for corrective justice and to regulate costly interactions between human agents. This need is no lesser today than in an earlier age. No monetary savings from abandoning the tort system accrue, given the evidence of increased accident cost. And the social welfare concern that persons suffering from disability be provided assistance can be met in other ways.

Conclusions

The evidence is consistent with two explanations for the insurance crisis: (1) the reaction of the insurance markets to changing economic conditions (interest rates) and (2) a market reaction to a changing legal environment.

Insofar as the insurance crisis is the result of lags in response to changing economic circumstances the crisis does not require public action, being the consequence of normally functioning markets. Prices will eventually adjust to achieve their long-run levels. Regulation will only serve to exacerbate the situation. The Task Force suggests that a solution lies in collecting statistics on new lines of insurance (such as pollution).⁶¹ However, this will not reduce the kind of uncertainty which accounts for rising

60. Philosophically, one might ask whether accident victims can be distinguished from the victims of accidental birth disorders — and indeed, from persons suffering the accident of family circumstances or the accident of the intelligence with which they were endowed. Once the tort system's rationale of redistributive justice is abandoned in favour of an insurance scheme based on nothing more than the participation of individuals in an activity, it becomes increasingly difficult to avoid justifying (apart from practical grounds) a wider compensation net that quickly turns into a social welfare scheme. Of course, if social assistance is the true motivation for no-fault liability, it would be better to legislate increases in social welfare payments.

61. *Task Force*, Vol. 1, p. 26 *et seq.*

premiums — that uncertainty associated with unexpected changes in the law or economic conditions.

Insofar as the insurance crisis arises from a changing legal environment, the solution rests in publicizing the costs of offering social compensation to uninsured plaintiffs through the tort system; part of that cost is the increasing price and unavailability of insurance with all the ramifications described in the introduction to this paper.