# Tort Excess 2005: The Necessity for Reform from a Policy, Legal and Risk Management Perspective

by

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***“Now is the time for legislators on Capitol Hill to put partisan politics aside and pass meaningful legal reforms that will bring fairness and common sense to America’s court system.***

***The very livelihoods of America’s workers, employees and families depend on such action.”***

**Lisa Rickard**
**President, U.S. Chamber Institute for Legal Reform**[1]

# Executive Summary


The American legal system remains the most expensive civil justice system in the world, costing more than double that of other industrialized nations. It is also unpredictable and, by many measures, unfair.

The upward trend seen in U.S. liability costs over the past several years is expected to continue in 2005. This will handicap American businesses competing internationally and hinder U.S. economic growth into the foreseeable future. An expensive U.S. justice system is also likely to remain a critical factor in a company's decision of where to locate workers and operations and in corporate decisions to move American jobs offshore.

There are two possible remedies for the problems riddling U.S. civil justice. The first is legislative tort reform at both the state and federal levels. Those advocating such reforms have seen less than desired results, especially at the federal level, with the exception of the passage of class action litigation reform in February 2005. Other much-anticipated federal reforms continue to linger, including bills intended to reform (and cap) compensation in medical malpractice lawsuits and address asbestos litigation.

2004 provided a window to view the impact of the U.S. Supreme Court's opinion in *Campbell vs. State Farm*, the case in which the court suggested that few awards exceeding a "single-digit" ratio of punitive to compensatory damages would satisfy due process. *Campbell* has thus far resulted in the substantial reduction of some truly exorbitant punitive damage awards, but it has not abolished all large punitive damage awards. Nor has the "single-digit" rationale propounded by the Court found acceptance among all state courts addressing that issue.

At the state level, comprehensive reform bills were passed in three states: Mississippi, Oklahoma and Ohio. In the first quarter of 2005, Georgia and Missouri joined the ranks, passing comprehensive reform legislation. Issue-specific reform bills targeting asbestos and obesity litigation, appeal bonds and recovery of non-economic damages, among others, were also successful in 2004. Efforts to bring a more educated demographic to the jury box through jury service reforms remain a major focus in 2005. Other current state-level efforts center on equitably apportioning damages; revising the collateral source rule; punitive damage awards; venue reform and resurrecting the state-of-the-art defense in product liability cases.

Absent lasting and meaningful tort reform, Corporate America's only recourse against the potentially bankrupting costs of U.S. justice is sound risk management via a strong, tall tower of liability insurance. Such insurance must be viable; its underwriter able to pay defense costs, settlements and judgments in possibly catastrophic liability claims that may occur many years after the initial policy is purchased. Often this insurance will also be needed to serve as collateral for the appeal bond that must be posted pending appeal of a large verdict. Many excessive awards are ultimately reduced or overturned on appeal.

In the current insurance marketplace, securing a strong, tall tower of insurance is often easier said than done. Excess casualty capacity remains expensive and relatively scarce. Certain risks are so volatile they are nearly uninsurable. Property/casualty carriers have become insolvent with record frequency, making quality insurance capacity even more rare. Few markets are willing to commit to commercial umbrellas for the long haul, given the excess costs and unpredictable nature of the large-scale liabilities involved. Many that claim devotion to the line don't have the financial strength and specialized underwriting, claims capabilities and litigation resources to make good on that commitment and be there to pay long-tail claims years down the road.

These realities complicate the process of securing ample, reliable commercial liability insurance, yet such a program can be assembled when risk managers focus on four areas:

1. Securing ample limits–even when it means paying more.

2. Demanding a high degree of financial strength throughout a liability insurance program, cognizant of the long-tail nature of liability exposures.

3. Ensuring that their carriers have the underwriting experience to withstand the unprecedented volatility of casualty underwriting and remain committed to the product line long-term.

4. The institutional expertise and external resources a carrier offers to defend claims and mitigate losses.

As Corporate America exercises new diligence in securing commercial umbrella cover, it should also focus resources on advancing legislative tort reform. A coalition within the business community is essential to exercise the political clout necessary to obtain meaningful tort reform. Reform efforts continue state-by-state, act-by-act, yet in 2005, sound, educated insurance purchasing is the only real defense against a justice system that has, in many ways, gone awry.

When it comes time to draw on their tower of liability insurance whether to pay a large settlement or judgment or post bond to appeal a seemingly unjust verdict, America's corporations, their boards and shareholders will appreciate the extraordinary value of a commercial umbrella program that was built smart, built to last, and built with the harsh realities of the U.S. civil justice system in mind.

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## The Necessity for Reform from a Policy, Legal and Risk Management Perspective

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# I. The Litigation Environment

The United States has the world's most expensive tort system. America's civil justice system costs more than double that of other industrialized nations. Over the last 50 years, tort costs in the U.S. have grown more than 100-fold from less than $2 billion in 1950 to $246 billion in 2003.[2] This translates to a cost of $845 per person in 2003, compared to $12 in 1950.[3] At this growth rate, tort costs could approach $1,000 per person by 2006. Gross Domestic Product, by contrast, has grown by a factor of 37; population by a factor of less than two.[4]

The cost of the U.S. tort system increased 5.4 percent to 246 billion in 2003.[5] While this increase represents a reduction from the double-digit trends of 2001 and 2002, it may be reflective of more moderate tort costs in commercial lines, where asbestos-related costs accounted for large increases in 2001 and 2002.[6]

Nonetheless, tort costs do continue to rise. As noted below, 2004 also saw the return of the billion-dollar verdict, which was notably absent in 2003.

## Liability Claim Frequency and Severity

The possibility of a corporation facing a costly, even bankrupting, lawsuit is greater than ever before in the history of U.S. civil justice.

*Nearly, one of every six jury awards now tallies $1 million or more*.[7] In some states, juries return million dollar-plus verdicts in one out of every four or five cases. Over 7 percent of businesses experienced a liability loss of $5 million or more over the past five years.[8] The top 10 jury awards of 2004 illustrate the severity of liability claims at the highest levels:

**Top Ten Jury Awards in 2004**[9]

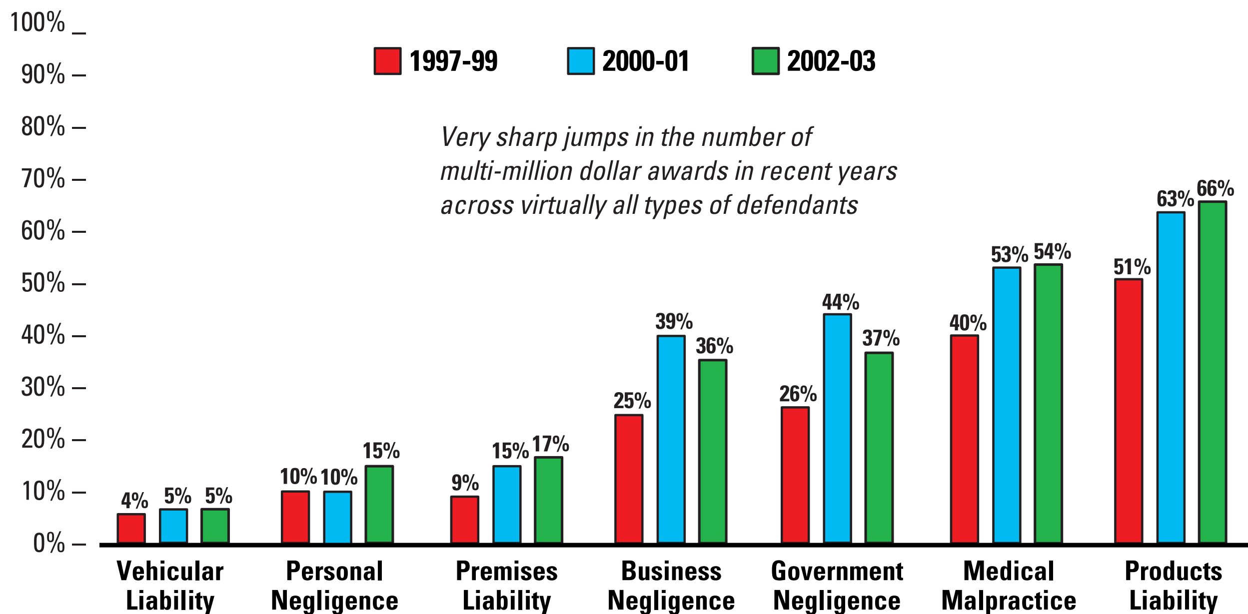
| Value | Issue | Venue |
|---|---|---|
| $1.6 billion | Fraud (insurance agent)/Negligence (insurance company) | Alabama |
| $1 billion | Product Liability (fen-phen) | Texas |
| $776 million | Wrongful Death (murder of sheriff) | Georgia |
| $570 million | Patent Infringement (medical device manufacturer) | Tennessee |
| $368 million | Product Liability (SUV rollover) | California |
| $366 million | Defamation/Breach of Contract (doctor's reputation) | Texas |
| $156 million | Wrongful Death (charities tied to terror organizations) | Arizona |
| $111 million | Medical Malpractice (birth defects) | New York |
| $105 million | Product Liability (car accident) | Tennessee |
| $105 million | Wrongful Death (police brutality) | Maryland |

After seeing no billion-dollar verdicts in 2003, 2004 returned to the trend of preceding years with two, billion-dollar verdicts leading off the list. In fact, the decline in damages in 2003's top 10 list was countered by an equally dramatic increase in 2004. Each one of the top 10 verdicts in 2004 was larger than the verdict in the corresponding position last year. This year's sixth largest verdict was higher than last year's worst verdict. Moreover, all 10 were over $100 million, putting the average of the top 10 verdicts far higher than last year. Even more striking, the median award is more than twice that of any of the previous seven years.

As always, the awards were generated from varied case types including: product liability awards of $1 billion to a fen-phen plaintiff; $368 million for an SUV rollover case; $105 million for a child killed in a car accident when a seat collapsed on him. Additional cases included a medical malpractice award of $111 million for birth defects against an obstetrician; $366 million for defamation and breach of contract against a hospital and three doctors; and a $570 million patent infringement award for an inventor against a manufacturer of medical devices.

*The increase in the frequency of multi-million dollar awards is evident across virtually all types of defendants*. This includes those in vehicular liability, negligence, medical malpractice and products liability cases. According to Jury Verdict Research, the average jury award in business negligence cases rose approximately 20 percent per year through much of the 1990s; the average in product liability cases soared some 363 percent from 1997 to 2003, the latest year for which data is available.[10]

**Trends in Million Dollar Verdicts**[11]

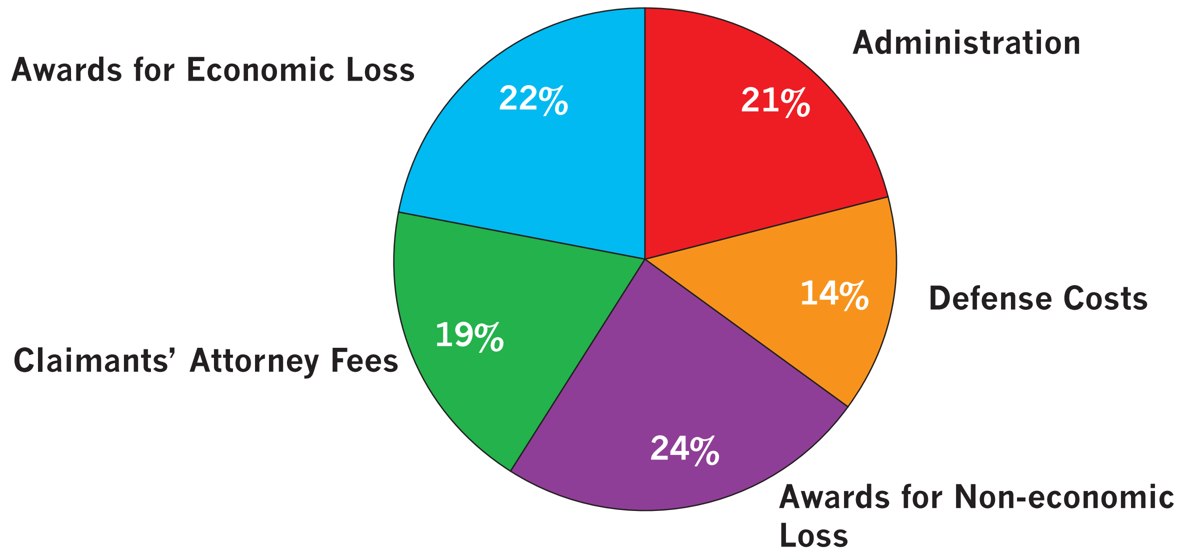


## System Inequities

The inequities of the U.S. legal system are just as shocking as its inefficiencies.

### Where the Tort Dollar Goes

*The majority of dollars moving through the U.S. tort system never reach plaintiffs who suffered damages.* Just 22 cents of the tort dollar compensates victims for economic loss; 24 percent pays non-economic losses. More than half of every tort dollar—at least 54 percent—never reaches the victim.[12]




*The likelihood of a case ending with a catastrophic damage award varies drastically by venue.* A defendant's entire future can turn on where its case is heard. The *U.S. Chamber of Commerce States Liability System Ranking Study* ranks all 50 states' liability systems based on a number of indicators, including treatment of class action suits, punitive damages, and jury predictability and fairness.

Ranking in the top ten in 2005, with legal systems perceived to be most fair, were:

1. Delaware
2. Nebraska
3. North Dakota
4. Virginia
5. Iowa
6. Indiana
7. Minnesota
8. South Dakota
9. Wyoming
10. Idaho

Ranking 41-50, with the least fair legal systems, were:

41. Hawaii
42. Florida
43. Arkansas
44. Texas
45. California
46. Illinois
47. Louisiana
48. Alabama
49. West Virginia
50. Mississippi*

*It should be noted that Mississippi's sweeping tort reform legislation should improve its rating in future rankings.

When venues are evaluated down to the county level, several counties are perceived to be so drastically unfair to corporate defendants and insurers that those advocating tort system reforms brand them "judicial hellholes." Given the history of plaintiffs' awards in these locales, they are the last places on earth a corporation would want to defend a liability lawsuit. These include:[13]

- Madison County, Illinois
- St. Claire County, Illinois
- Hampton County, South Carolina
- West Virginia (entire state)
- Jefferson County, Texas
- Orleans Parish, Louisiana
- South Florida
- Philadelphia, Pennsylvania
- Los Angeles County, California

*There are more plaintiffs in asbestos-related lawsuits in some of these counties than there are residents.*

*Lack of consistency*. Virtually any jury, any place, any day, can deliver a catastrophic liability verdict. Even staid, conservative venues sometimes deliver wholly unexpected results.

*Even if a defendant is found to be just one percent at fault, it can be left with 100 percent of the damages*. Cases like the tragic Rhode Island nightclub fire, which claimed some 100 lives, ignite frenzy within the plaintiffs' bar to identify any product, material, and workmanship on which to place blame. In this case, targeting a radio station that advertised the event at which the fire occurred is an example. This is an effort to gain access to deeper pockets through a one percent theory of negligence. Once triggered under this theory, all of a defendant's assets, including its entire liability insurance tower, can be vulnerable to 100 percent of the ultimate loss.

*While some litigants (and their lawyers) are awarded enormous sums, others with the same claims win far less*. Similar accident scenarios, yielding similar damage to victims, can yield sharply different outcomes from different juries. In one of the most glaring examples, separate but similar truck rollover incidents garnered damages of $225 million from one Texas jury; less than $20 million from another.

## From the Inequitable to the Absurd

Numerous cases can be cited to illustrate U.S. tort outcomes that are nothing short of ridiculous. A few follow:[14]

- A class action was brought in Alabama on behalf of 700,000 people with mortgage escrow accounts held at a large bank. A settlement was reached resulting in $8.5 million in attorney's fees and a small award for class members. To pay the fees however, the class members had a deduction to their bank accounts of between $80 and $100. One class member received an award of $2.19 but had his account debited $91.33 for attorney's fees, costing him $89.14.

- In a class action suit against a food company over a food-additive in a popular cereal, with no evidence of injury to any consumers, lawyers were paid nearly $2 million in fees, which worked out to approximately $2,000 per hour. Consumers in the class received coupons for a free box of the cereal.

- After one of the nation's largest tax-preparation firms was accused of accepting kickbacks from a bank that issued loans to its tax-preparation customers, the company agreed to settle the case by paying $49 million to the class action lawyers. The 700,000 class members will be eligible for coupons and discounts on tax software and future tax preparation services; about 6 percent are expected to actually use these coupons. An earlier proposed settlement of similar federal litigation would have paid class members $30 in cash and lawyers $4 million, but was rejected for not providing adequate compensation to class members. By moving the case to Texas state court, plaintiff's lawyers were able to craft a deal that was far better for themselves and far worse for their clients.

- In a settlement agreement reached with a large video retailer, trial lawyers received $9.25 million in fees and expenses. Plaintiffs received two free movie rentals and $1-off coupons. The settlement involved class action lawsuits filed in Texas that alleged unfair charges for over due video rentals. Faced with 23 class actions in unfriendly county courts selected by the trial lawyers, the defendant settled the cases.

Developments with Big Tobacco are perhaps most indicative of the bizarre contortions of the U.S. tort system. Since the 1998 master settlement in which tobacco companies agreed to pay more than $250 billion to states over 25 years, the tobacco industry has suffered several brutal courtroom defeats. All were dwarfed, however, in 2002 when a California jury awarded $28 billion in a single-plaintiff products liability lawsuit against tobacco-maker Phillip Morris, now Altria Group, Inc.

The following year brought another staggering judgment—$10.1 billion in a class-action consumer fraud lawsuit heard in Madison County, Illinois, one of the aforementioned "judicial hellholes." Altria said posting the $12 billion surety bond required pending appeal of this extraordinary verdict could drive it to bankruptcy, and the state of Illinois and Altria subsequently attempted to have a cap placed on appeal bonds in Illinois. Other states have done likewise. *States working to spare the industry they sought to so severely punish just a few years earlier*. What would explain such a paradoxical and seemingly hypocritical effort? Only a financially healthy Altria can continue pumping funds from the 1998 settlement into the state coffers. Without these much-anticipated funds, states already struggling under severe budget deficits would be forced to cut back even further on programs, jobs and wages, and/or raise taxes. Fortunately, the Illinois Supreme Court subsequently amended the applicable statute to allow for a reduced appeal bond in such exceptional circumstances.

## System Drivers

The tort cost explosion was not ignited by any single event, but rather by a series of factors over time. These factors include:

*The Plaintiffs Bar*. Many plaintiffs' attorneys have a sincere desire to help injured people; others manipulate the justice system to their personal advantage. These plaintiffs' attorneys have become extremely adept at crafting litigation strategies to overcome tort controls and maximize awards—and attorneys' fees. They unabashedly steer litigation to plaintiff-friendly jurisdictions. Why else would a large tire manufacturer be forced to defend its case in a plaintiff-loving county in which it has no operations and no ties—except that one of its dealers advertises along a local highway? In addition, lawyer advertising has pushed new limits. On February 16, 2005 *The New York Times* featured a full page advertisement for a prominent plaintiff's attorney headlined, "Guess What A Big 4 Accounting Firm Did After I Beat Them In A $185 Million Corporate Conflicts Case? They Hired Me, Of Course." The ad goes on to claim, "If you have a billion dollar set of facts, call the man the National Law Journal has recognized as one of the nation's top litigators."

Information sharing has become big business among plaintiffs' attorneys. They use the successful strategies of other plaintiffs as a springboard to success, exchanging "killer" documents that can be used to construe inconsistencies in practices and previous courtroom testimony of corporate defendants. Certain judges allow these attorneys to introduce evidence of prior bad acts with no relevance to the case, helping to paint a defendant corporation as an "evil empire."

*Culture of Fault*. There are no accidents—or so American society and American juries have come to believe. When something unfortunate occurs and innocent people are injured, jurors are pre-disposed to hold someone responsible. The predominant thinking is that some human (or corporate) error must be to blame and somebody must make amends.

*Deep Pockets Syndrome*. Many plaintiffs' attorneys purposefully seek out those with the ability to pay large settlements or damage awards (i.e. large corporations and their insurers) over less financially able defendants, regardless of where actual blame lies.

*The Media*. The higher the verdicts, the larger the headlines. The media shapes jurors' perceptions of "just" awards and can literally make or break a new exposure. Had it not picked up and run with the notion of "toxic" mold, one wonders if mold would have become the multi-billion dollar issue it is today.

*Class Action Abuse*. The definition of "class" has been stretched to the great detriment of defendants. In an effort to force large settlements, plaintiffs' attorneys pool cases that individually would not even merit action. Some judges allow class action lawsuits even if the individuals comprising a "class" are not homogeneous. Fighting a class certification can be extremely costly, making this strategy all the more effective in pressuring a defendant to pay.

*Corporate Wrongdoing*. The historic pro-plaintiff, anti-business slant of juries has been exacerbated by corporate scandals. The average American is suspicious of Corporate America and amenable—

even eager—to hand down giant awards against big business. When *The Wall Street Journal* asked prospective jurors whether they agreed with the statement "Corporate executives will lie to increase their profits," 67 percent agreed.[15]

A full 75 percent of respondents to a study conducted by Harris Interactive and The Reputation Institute graded the image of big corporations as not good or terrible.[16] The public's low opinion of Corporate America coincides with a demand for greater accountability of businesses straining the long-standing ties many firms have had with communities in which they operate.

*Social Inflation*. A million dollars is not what it used to be. American wealth boomed in the 1990s. Many Americans won't even wait on line for a lottery ticket unless the prize reaches tens of millions of dollars. Meanwhile, news headlines tout exorbitant damage awards (but rarely alert the public when an award is lowered or a decision reversed on appeal). As a result, juries and judges have been desensitized to the value of the dollar and often feel that only a stratospheric award will "send a message" effectively.

*The Erosion of Tort Reform*. Much of the legislation intended to reduce the frequency and severity of lawsuits at the state level has been watered down by resourceful trial attorneys or judicially changed. Additionally, in some states, courts have stricken portions of tort reform legislation or thrown it out completely.

*Medical Costs & Care*. Advancing medical science and ongoing medical inflation add fuel to the tort cost fire. With individuals living longer even in extremely critical conditions, damages more frequently contemplate the catastrophic costs of long-term critical care for an injured plaintiff. Moreover, because non-economic awards are often assessed as a multiple of economic damages, the higher costs associated with rising medical expenses result in non-economic awards that are higher still.

***"No man's life, liberty or property is safe while the Circuit Court of Madison County, Ill. is in session."***

-U.S. House Judiciary Committee Chairman James Sensenbrenner, during an address at the National Association of Manufacturers headquarters in Washington, D.C.[17]

## II. The Impact of Tort Abuse

Tort abuse reverberates throughout the United States, adversely affecting the nation's economies and communities in the form of higher prices, lower wages and fewer jobs—and leaving American businesses handicapped and vulnerable to foreign competitors with more rational tort systems.

### National and State Economies:
### *Stunted Economic Growth*

Having the world's most expensive tort system places the American economy at a significant disadvantage internationally. Tort costs have consumed, on average, 2 percent of GDP annually since 1990. While it is impossible to accurately predict future increases in tort costs, it does seem reasonable to assume that, without sweeping structural changes to the U.S. tort system, annual

increases will be in the 5 percent to 8 percent range for the next several years.[18] At this rate of increase, tort costs could approach $1,000 per U.S. citizen by 2006—representing a new quadruple-digit benchmark.

State economic growth is also adversely impacted by the nation's' tort system. The results of an econometric analysis, published by The U.S. Chamber Institute for Legal Reform, concluded "the impact of a state's legal system on economic growth is statistically significant. A state that imposes a capricious or arduous court system on businesses is likely stunting its growth compared with a state that offers a more reasonable structure." States that have less fair legal regimes would attract less business and therefore generate less income.[19]

Companies can and do avoid doing business in counties with legal systems perceived to be inequitable. This costs states jobs, taxes, wages and investment. Roads are not built, classrooms are overcrowded, and the general quality of life is reduced by local legal practices. The prospect of moving American facilities—and American jobs—offshore has become increasingly appealing to companies seeking to escape the unpredictable and potentially catastrophic consequences of the U.S. tort system.

## Consumers:
## *The "Litigation Tax"*

At current levels, U.S. tort costs are equivalent to a "litigation tax" of $845 per U.S. citizen. Growth in U.S. tort costs since 1950 has far exceeded the U.S. population growth. Tort costs per person have risen by a factor of 70 from 1950 ($12 per person) to 2003 ($845 per person). Only part of this increase is due to inflation. Even after adjusting for changes to the consumer price index, tort costs per person have risen by a factor of more than nine since 1950.[20]

The high cost of liability, even the specter of litigation, can also rain on an individual's retirement plans by deflating the value of a company's stock—and of individuals' 401(k)s or stock portfolios.

In areas of particularly severe liability, such as medical implants or construction defects, securing liability insurance has become nearly impossible. As a result, doctors have gone on strike, potential construction projects are derailed, and other needed services and fruitful commerce has ceased.

## Businesses:
## *Managing the Risks of an Unmanageable System*

The U.S. tort system places an overwhelming burden on American businesses. Even a groundless lawsuit can place excessive strain on a corporation's human and financial resources. Commercial umbrella insurance has traditionally been the main line of protection against catastrophic liability loss, yet it has become difficult in many cases for companies to secure ample quality protection for the scale of today's risks.

Central to the problem is that much of the cost of the U.S. tort system is already passed along to the insurance industry. Personal and commercial lines insurers shoulder nearly $165.8 billion of America's tort system costs each year.[21] Carriers are left in many cases paying out for risks they never anticipated (or charged for) during underwriting. In the case of asbestos, for example,

insurers underwrote the risk for essentially no premium decades ago, because asbestos was believed benign. With total costs estimated at $200 billion, asbestos is now the greatest liability exposure of all time—with insurers and businesses being hit up to pay astronomical losses on these decades-old policies.

## The State of the Insurance Industry

Rising rates and more disciplined underwriting have boosted the property-casualty insurance industry's performance in recent years. The industry turned in its first underwriting profit in more than a quarter century in 2004. As of this writing, the industry's combined ratio, the ratio of losses and expenses to premiums, is projected at 98.9 in 2005, little changed from the 98.7 estimated for 2004, and well below the 115.7 recorded in 2001.

While 2004 was by many indicators a good year for insurers, the detrimental impact of torts continued to exact a toll. Insurers continued to take substantial charges against reserves for certain liability lines in 2004, as they did in the three prior years. In 2003 (most recent available), adverse reserve development of about $14 billion pushed the industry into an underwriting loss and consumed more than one-third of the industry's $40 billion increase in earned premiums.[22] The charges added more than 3 points to the property/casualty industry's combined ratio in 2003.[23]

More ill effects are sure to follow, given that the industry remains under-reserved by an estimated $59 billion.[24] As tort costs continue rising, reserves will continue to develop unpredictably and adversely in 2005 and into the foreseeable future. This will add several points to the industry's combined ratio; create a perpetual drag on industry earnings; and continue to keep the insurance industry in a vulnerable financial state for the foreseeable future.

The magnitude and frequency of liability awards have also amplified the uncertainty surrounding reinsurance recoverables, adding an additional element of instability. While in the past, reinsurers were content to "follow the fortunes" of primary companies, many reinsurers, having tightened their underwriting practices to protect their own weakened balance sheets, are now taking a harder line on certain losses.

With over 200 insurers failing in the last decade, insurer solvency certainly remains a significant concern.[25]

## Challenges to Insurance Buyers

The unpredictable and catastrophic nature of U.S. tort exposures, coupled with the continued uncertainty of the property/casualty insurance market, has made insuring large-scale liability risks substantially more challenging.

*The cost of liability insurance has risen considerably with the increased exposure and will continue upwards*. High loss ratios in many casualty lines indicate the continued need for disciplined pricing going forward. In addition, defense costs as a percentage of incurred losses remain very high.

*The future insurability of some types of liability risks is in doubt*. Many carriers have already ceased writing certain liability risks and capacity continues to disappear from vital liability lines. Despite a modest increase in excess liability market capacity in 2004, capacity remains 25 percent below its 2000 peak.[26]

In areas such as construction defects, pharmaceuticals, medical malpractice, and asbestos, the scarcity of coverage has reached critical proportions. Of the large insurers that remain in the market, few are willing and able to commit $50 million in lead capacity; most have reduced available capacity and raised attachment points.

*When reinsurers reduce limits and restrict coverage terms, ceding companies abruptly pull back on underwriting*. In response to rising tort costs, reinsurers continue to tighten treaty terms and slash limits, causing insurers reliant on reinsurance treaty capacity to do the same. As a result, a corporation can find its insurer providing capacity one day and not the next—and be left “high and dry” with virtually no warning. Insurers underwriting commercial umbrella on a net basis—and their insureds—are insulated from this volatility. However, few insurers have the financial wherewithal to write these risks net of reinsurance.

*Carriers retract from the occurrence market*. Rather than pulling out of particularly difficult classes of business, committed insurers are providing creative, claims-made style alternatives for risks that have otherwise become nearly impossible to insure. Unlike occurrence coverage, which allows the buyer to purchase limits for the unknown exposures, loss trends, and litigation climates of the future, claims-made coverages allow buyers to purchase limits and coverage based on current liability trends and allow experienced insurers to fully comprehend the risk being assumed.

Alternative structures are also cropping up. An example is an occurrence policy with a “sunset” clause, which enables a company to secure coverage for a reasonable time period and an insurer to limit its otherwise boundless liability.

*Insurer quality and commitment is more vital, and more uncertain*. Finding an insurer with the requisite financial strength and longevity to underwrite this complex line is difficult. The expertise needed to handle high-value liability claims effectively is also in alarmingly short supply.

## III. Solutions: Reform and Risk Management

Relief from the burdens of the U.S. tort system can only come from two sources: legislative tort reform at both the state and federal levels and effective risk management.

### Tort Reform

Civil justice reform legislation aims to return integrity to the U.S. legal system, abolish incentives for abuse now endemic in the system, and redirect the system on an efficient, timely, predictable and fair course. When such reform happens, it can and does work. The General Aviation Revitalization Act of 1994 exemplifies such success. This federal legislation was passed to control the product liability exposure that had essentially put the U.S. light aircraft industry out of commission. Before

the act's passage, production of new single-engine aircrafts had plummeted, U.S. aircraft manufacturers closed plants and some 100,000 workers lost jobs.[27] After, thousands of new jobs were created when plants opened and reopened.

More recently, highly targeted federal legislation has emerged to provide relief in certain areas critical to society, enabling companies that produce childhood vaccines, medical implants, and anti-terrorism technologies to benefit from special protections against catastrophic liability.

Some states are waking up to the adverse impact an inequitable tort system has on the local economy and inching toward local reforms. Even some of the country's most notorious "judicial hellholes" are taking corrective actions. In 2004, Mississippi enacted comprehensive tort reform aimed at capping non-economic damages for all cases, abolishing joint and several liability, limiting punitive damages and curbing plaintiff forum shopping.

Achieving meaningful and widespread tort reform, however, remains complicated by America's maze of federal and 50-state tort laws and rigorous opposition from a well organized and well funded plaintiff's bar. In light of political realities, reforms are fought jurisdiction-by-jurisdiction, issue-by-issue. A coalition within the business community is needed to exercise the political clout necessary to obtain meaningful tort reform at both the state and federal levels.

## Prospects at the Federal Level

2005 heralded the long anticipated passage and signing into law by President Bush of the Class Action Fairness Act. The Act permits the transfer of large interstate class action lawsuits to federal courts, significantly reducing "forum shopping" by plaintiffs' attorneys. The Act will give the federal courts, which are presumed to be more protective of defendants' rights and better equipped to handle complex issues, jurisdiction over most large interstate class actions.

Specifically, the Act provides:

- A right to remove to federal court any state class action or "mass action" (100 or more plaintiffs) in which there is "minimal diversity" (at least one member of the proposed class is from a different state than at least one defendant) and the amount in controversy is more than $5 million, when you total all claims of proposed class members.

- Exceptions for federal jurisdiction if the case is filed in a real defendant's home state where at least two-thirds of the class is also from the defendant's home state. If between one-third and two-thirds of the class is from the defendant's home state the federal court has discretion to decline jurisdiction.

- New settlement rules requiring increased scrutiny of coupon settlements or settlements in which class members could sustain a loss due to payment of fees to class counsel.

- Standards for the award of attorney's fees to class counsel.

It should be noted, however, that the Act does not eliminate class actions, but brings most large class action into the federal district court. There are 94 district courts in the United States and

its territories, with multiple judges within each district. With that number and regional diversity, a potential for real disparity among the courts exists. Therefore, the application of consistent relief by the federal bench is uncertain. Depending on the class action at issue and the jurisdiction involved, a state court could still provide a better forum for the adjudication of a class action dispute. It remains to be seen what impact this newly minted legislation will have on the class action landscape.

*Funding Asbestos-Related Disease Claims*. Asbestos defendants, insurers, labor and the trial bar continue to actively negotiate a solution to the nation's largest tort problem, asbestos. Optimally, any asbestos legislation would:

- Establish criteria for determining loss, including requiring the manifestation of asbestos-related disease before a claim is lodged
- Create a single venue for asbestos litigation, eliminating forum shopping
- Cap legal fees in asbestos cases

These measures would go a long way to halting a problem that has already bankrupt dozens of companies, cost thousands of American jobs and benefited trial lawyers far more than anything else. Passage of any reform however, remains uncertain.

*National Medical Malpractice Reform*. Modeled after California's successful Medical Injury Compensation Reform Act, H.R. 534 and S. 354 aim to speed resolution of medical malpractice claims and cap punitive and non-economic damages in these cases. The bill requires claims for injury to be brought no later than three years post-injury or one year after the injury is discovered. It would also limit non-economic and punitive damages to $250,000 and establishes a sliding scale for attorneys' fees. The current outlook for movement on this bill in 2005 is similarly uncertain.

In April 2003, a notable development came in efforts to control punitive damages. The U.S. Supreme Court released its opinion in the case of *Campbell vs. State Farm* and called the $145 million punitive damage award in this 22-year-old insurer bad faith case excessive. The court observed that few awards exceeding a "single-digit" ratio of punitive to compensatory damages would satisfy due process and when compensatory awards are substantial a punitive damage award equal to the compensatory award may be appropriate. When issued, the ruling was viewed as an extremely positive step toward establishing firm guidelines for juries to use when doling out punitive damages nationwide.

As the ruling approaches its two-year anniversary, it appears that courts nationwide are making an effort to adhere to the "single-digit" multiplier guidelines set forth by the Supreme Court in this decision. By April 2004 (the one-year anniverary of the Supreme Court's opinion), over 70 decisions had been issued in which federal and state trial and appellate level courts had addressed the *Campbell v. State Farm* decision in revising punitive damages awards. Of the 70 plus decisions during that period, approximately 50 percent (37) of the cases in which courts reviewed the ratio of compensatory to punitive damages upheld ratios in excess of 4:1; nearly 30 percent (21) upheld greater than single-digit ratios.

Since April 2004, there have been at least 45 additional decisions addressing this issue. At least 36 of the 45 courts that have applied the *Campbell* criteria during this period have upheld punitive damage awards bearing single-digit ratios. Of the remaining nine decisions, four permitted awards bearing ratios in excess of 10:1. The remaining five struck down the punitive damage award entirely. Despite greater adherence to the *Campbell* guidelines overall, however, relatively few punitive damage awards utilize the 1:1 ratio espoused by the Supreme Court as an appropriate measure of damages when compensatory damages are substantial.

Although the effects of *Campbell* appear demonstrable, there is reason to suspect that *Campbell* alone may not ultimately have the desired effect of uniformly limiting punitive damages in all cases and all jurisdictions. Additional reform may be needed to alleviate the risk of excessive punitive damage awards.

## Focus at the State Level

The majority of U.S. tort dollars are generated at the state level, and it is at this level that the most difficult battles for reform must be fought. While some limited reform success came in 2004, monumental changes continue to be needed. Current efforts at state level tort reforms generally focus on a few critical areas:

1. *Capping non-economic damages*. The concept of capping non-economic damages has been endorsed by a dozen or more states. In some states, laws now limit the exposure of defendants in liability suits by limiting recovery of a particular type of damages (usually non-economic damages, such as pain and suffering); by restraining the total amount of damages recoverable; or by placing an absolute cap on liability. Reform measures may apply to all tort suits or only specific types, such as medical malpractice.

Bills limiting recovery of non-economic damages were passed in Colorado, Mississippi and Oklahoma in 2004 and in Georgia and Missouri in the first quarter of 2005.

2. *Modifying the joint and several liability rule*. Under this rule, defendants minimally responsible for injury can be required to pay the full amount of damages in a case. In other words, a defendant found only one percent liable could be forced to bear 100 percent of the liability. Efforts are underway to more fairly apportion damages. How this reform will ultimately take shape remains a question. The joint and several liability rule could, for example, be abolished completely or limited in its application. For example, it is now prohibited in many states to apply the rule to non-economic damages, such as pain and suffering. Reform measures might also apply to all tort actions or only a specific type, such as medical malpractice; it may exclude one or more key areas in which joint and several liability is frequently applied, such as auto, pollution and medical malpractice cases.

Bills abolishing joint and several liability were passed in Mississippi (2004), and Georgia (in the first quarter of 2005). Bills limiting the application of joint and several liability were passed in Oklahoma (2004); and Missouri and South Carolina (in the first quarter of 2005).

3. *Restricting punitive damage awards*. Punitive damages were originally intended to punish defendants for engaging in extremely egregious conduct. However, they are no longer limited to

these cases and frequently soar far above the compensatory damages awarded in courts. More than half the states have already passed laws limiting the imposition of punitive damages. Future reform measures may require some part of punitive damage awards to be paid to the state (as is already the case in some states); set limits on the amount that may be awarded in total or relative to compensatory damages; limit the type of case in which punitive damages may be awarded; or require hearings to establish a case for punitive damages before allowing them to be pursued in court.

4. *Establishing minimum medical requirements for filing asbestos or silica claims*. Increasing numbers of asbestos suits are being filed more than 25 years after workplace use of asbestos was halted. Many, if not most of the present suits are brought on behalf of “unimpaired” plaintiffs demonstrating no present physical impairment. These suits drain judicial resources; adversely impact businesses often having no genuine connection to the manufacture, sale or use of asbestos products; necessitate increased defense expenditure by insurers and divert available insurance proceeds from genuinely injured plaintiffs.

Reform bills establishing minimum medical criteria for filing asbestos, silica or mixed dust claims were passed in Ohio in 2004 and in Georgia in early 2005. Additional states, including Texas, have introduced bills modeled on the Ohio legislation.

5. *Revising the collateral source rule*. This rule of evidence bars the introduction of any information indicating a person has been compensated or reimbursed by any source other than the defendant. Approaches to modifying it include: permitting consideration of compensation or payments received from some or all collateral sources and requiring that any award be offset by the amount of collateral source payments. About one-third of the states have thus far approved laws that would significantly alter this rule.

6. *Barring recovery for obesity-based lawsuits*. Following a series of well publicized lawsuits in which plaintiffs sought damages for undesired weight gain from eating certain types of food (i.e., McDonalds), at least 10 states—Arizona, Colorado, Florida, Georgia, Idaho, Missouri, South Dakota, Tennessee, Utah and Washington—passed laws generally exempting from civil liability manufacturers, sellers, distributors and advertisers of food when the claim is for weight gain or other health conditions resulting from the long-term consumption of food.

7. *Jury Service Reform*. Trial by a jury of one’s peers is central to the American judicial system, yet loopholes in the jury service process, including the exception of certain professionals and hardship exceptions, plus the prospect of lengthy trials with little compensation discourage large segments of society from being represented in jury pools. Efforts are underway at the state level to improve the quality of juries and encourage more educated professionals to serve. These higher educated professionals are likely to have a greater capacity to comprehend complex issues, to more skillfully identify where blame should be laid, and to assign a rational range of punishment to those at fault in cases.

Reform bills regarding jury service were passed in the following states in 2004: Colorado, Mississippi, Missouri and Oklahoma. These measures generally establish stricter criteria for jurors to be excused from service and provide for increased compensation to jurors.

8. *Appeal bond reform*. Bills were passed in six states: Georgia, Iowa, Minnesota, Nebraska, South Carolina and Virginia. These laws continue a trend around the country to limit the amount a defendant can be required to pay to secure the right of appeal.

9. *Reinstating the state-of-the-art defense*. Who may sue and who may be sued for damages when a product injures someone? The lack of clear and uniform laws governing manufacturers' liability allows lawsuits to erupt against any and all firms involved in the chain of distribution of an allegedly defective product. As a possible means of limiting manufacturers' liability, experts cite the state-of-the-art defense, which applies if the manufacturer made the safest product possible at the time, complied with government standards and included adequate safety warnings.

Awareness-raising at the "grass roots" level is key to advancing reform, particularly among states. An example of such an effort is a national advertising campaign launched by the U.S. Chamber of Commerce and U.S. Chamber Institute for Legal Reform, which spotlights America's best—and worst—state legal systems, based on the results of a Harris Interactive® poll. Such information is useful in helping businesses to identify states with fair legal environments—and steer clear of those with the most excessive and inequitable environments. The campaign reminds readers and states what an out-of-control liability system really costs, namely local jobs, wages, taxes and investment.

Other reform efforts supported by various business and private interests include:

- Examining the role of the trial bar and the business community in selecting judges and setting public policy.
- Promoting arbitration and mediation alternatives.
- Cracking down on "junk science" that helps to create enormous liability exposure where there is little actual proof of harm.
- Curtailing municipal bond investment in venues that continue unfair litigation practices.

While there is hope for reform, there is little expectation that the U.S. tort system will change drastically in the near future. It seems far more likely that tort costs will continue to rise, fueled by the erratic behavior of juries; increasing frequency and severity of claims; newly emerging and re-emerging exposures; and growth in medical costs. Hence, it remains essential to the very viability of American business that prudent risk management be applied to shield corporate and shareholder assets against potentially debilitating liability costs.

## Managing Liability Costs

Absent meaningful reform, the traditional insurance market remains the most effective way for consumers and businesses to protect against the unpredictable and potentially catastrophic financial impact of tort costs. This discussion focuses on the application of insurance to the commercial sector.

Only with a strong, reliable and tall tower of liability insurance can most companies resist and indeed survive a catastrophic liability lawsuit. The unpredictable nature of liability exposure and the continued rising cost of liability insurance make it difficult to gauge just how much liability coverage a company should purchase—or how high to build the tower. While limits will vary widely depending

on a company's particular circumstances, it is safe to say that most companies should be buying more than they are. According to a recent study, the average total liability limits purchased by businesses fell in 2004 for the third consecutive year. Small and mid-sized businesses, in particular, are skimping on the amount of insurance they purchase, probably to avoid higher insurance bills. U.S. firms with revenues of less than $200 million decreased limits purchased by 11 percent between 2003 and 2004; those with revenues from $201 million to $500 million, the segment most vulnerable to a bankrupting loss, cut limits by 4 percent.[28] While cutting back may seem a rational response to higher prices, the reduction must be considered against the backdrop of a company's level of exposure, which in some areas has likely tripled or even quadrupled in recent years. Viewed in this light, the response seems reckless.

## Building a Tower of Insurance

In order to build a sufficient and effective tower of insurance, a company should ask the following key questions:

*Is it tall enough?* Even the most benign operations are wise to carry primary liability plus a minimum of $50 million in excess limits. If a company has a seemingly low level of liability risk, such as simple commercial auto exposure, it should think upwards from there. (One auto accident with multiple deaths and/or severe injuries can easily burn through a $50 million limit in the current environment.) Other considerations when assessing required limits are the size of a company's operations; its geographic spread; the hazards inherent in its industry; and whether a company has the ability to impact large groups of individuals, making it vulnerable to a class action lawsuit. Insurance buyers should also consider that coverage is not only needed to pay potentially catastrophic judgments or large settlements, but also to serve as the collateral required to post the all-important appeal bond, which is typically the full value of the verdict or more. Many large awards are reduced or altogether reversed on appeal; however, without the ability to post bond, a company is powerless to mitigate its loss on appeal.

*Is it strong enough?* Instilling the highest degree of financial strength possible at every level of the tower is essential. Coverage at the upper levels should not, and most often legally cannot, "drop down" until the lower-level carriers pay their share of the claim. Payouts involving excess liability claims can span many years. It is not uncommon for a basic auto liability lawsuit to take approximately five years to settle or premises liability litigation to require seven years to run its course. Product liability lawsuits can stretch out a decade, and mass tort actions can take two decades or more to reach resolution. Hence, each participating insurer in a corporation's insurance program needs to be strong today and for many years to come.

No company should regret being ultra-conservative when assessing insurer financial strength. "A" used to be an acceptable benchmark for insurer financial strength, but the sudden insolvencies of several once A-rated carriers make it prudent to aim higher. Greater selectivity is also necessary since only 60.3 percent of all carriers rated by A.M. Best held an A- or better as of December 2004, compared to 80 percent a few years ago.[29]

*Is the lead excess carrier experienced*? Companies that have committed to underwriting this complex and volatile line have developed extensive institutional expertise and external resources that they bring to bear in claims. Large-scale liability claims are different and more complex than any other claims. They must be handled as such. Finding carriers with this expertise is not easy. Because of the unpredictable, catastrophic nature of commercial umbrella risks, many carriers come and go from the market and few are able to underwrite it successfully over the long term. A carrier's reliance on reinsurance must also be weighted accordingly; if an insurer depends heavily on treaty capacity to underwrite these risks, its first commitment may be to its reinsurer, not its insured.

*Are terms reasonable?* Any carrier being overly generous with terms and conditions in the current liability environment should be a red flag. While such carriers may provide a one- or two-year "fix," many will be unable to sustain such underwriting and are likely to subject the insured to an abrupt change in underwriting strategy, pricing and/or non-renewal not far down the road. Companies should, however, ensure that a carrier does provide certain pivotal coverage extensions, such as offshore punitive damages coverage and post-incident coverages.

## Defending the Tower

Once built, the insurance tower is precious, finite and to be defended vigorously, lest it be depleted when it is needed most. In order to effectively defend the tower, companies should:

- Anticipate indemnity agreements or transactions that might necessitate granting additional insured status to third parties. Losses arising from indemnity contracts will erode policy limits. Insureds have even seen unlimited indemnification agreements evaporate all of the limits available to them—paying instead for liability arising out of the conduct of others. Extending coverage in this manner should be done cautiously and should be considered when the tower is built.

- Recognize a possible catastrophic loss early—before it escalates—and notify the excess carrier immediately. Once involved, an effective excess carrier can assign skilled resources to help mitigate the loss and bring the right attorneys to a company's defense immediately. Despite the stark headlines and statistics on liability exposures, defendants are winning high-stakes liability cases; experienced insurers and defense attorneys know the strategies that win and the resources that work even in the worst venues. Putting these resources to work as early as possible in a crisis is critical.

A scenario that faced a large, publicly held, industrial manufacturer defending a single-plaintiff wrongful death claim in Jefferson County, Texas, illustrates the value of a strong, sturdy and well-preserved tower of commercial umbrella coverage. The jury handed down $163 million in compensatory damages against this company; the plaintiff had demanded approximately $39 million and sought no punitive damages. The plaintiff was well insured, with $3 million in primary and $150 million in excess liability cover. Its primary carrier, however, was the once A-rated and now insolvent Reliance National. As a result, the insured was forced to foot the full first $3 million of the loss itself in order to trigger its excess layer. Its excess cover, while not enough to encom-

pass the entire verdict, covers the lion's share, and the company is large and liquid enough to also bear this additional cost on its balance sheet. Importantly, its tower is tall enough to enable it to post the $140 million bond required to appeal.

This company's risk manager could never have envisioned the extraordinary verdict his company faced. Yet he built his company's tower tall, knowing the soaring and unpredictable nature of liability costs. His company, its board and shareholders are surely glad he did.

## IV. A Final Note

Tort reform remains an uphill battle in 2005. American companies will continue to carry the awesome and unnecessarily heavy financial burden of an inefficient judicial system. They should do so with the knowledge that the seemingly unmanageable risks of today's U.S. tort system can be tamed—and they should work for needed reforms. At the same time, however, they must work more vigorously than ever to ensure that the insurance carrier they choose has the financial strength, underwriting and claims expertise and commitment to support them in the liability environment that is America's reality now—a climate that is certain to get worse before it gets better.

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***"From people across America, I am hearing that our legal system needs reform. That our courts aren't serving the people, they are serving the lawyers. That frivolous lawsuits are hurting people. Some think this special interest group is too powerful to take on. That money determines everything. This is not an argument; it is an excuse. This cause is not hopeless. But it requires leadership to get results."***[30]

**- George W. Bush**
President, United States of America

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