

EXECUTIVE SUMMARY

California and the rest of the nation face a liability insurance crisis unparalleled in economic consequences since the oil shortage of the 1970s. This crisis has struck every type of business and governmental agency with drastic increases in premiums and reductions in coverage. Due to the widespread nature of the crisis, the Commission on California State Government Organization and Economy initiated a study in November 1985 to identify its major causes and to present recommended solutions. The Commission held two public hearings and conducted extensive research into the underlying problem areas. Based on the research, the Commission found that the overriding problem which has driven the current crisis is the uncertainty in predicting risk in the insurance industry. This uncertainty is the result of the following five major interrelated factors:

- o Evolution of tort law--during the past 25 years, the basis of liability has been expanded enormously in a series of judicial decisions;
- o Lack of predictability in risk assessment--the process of determining the outcome and settlement amount for a particular policy or group of policies has become more difficult in the past ten years;
- o Unsound rate-setting practices in the insurance industry--the insurance industry has engaged in unsound business practices with respect to the process of establishing adequate rates to cover losses and ensure underwriting profitability;
- o Withdrawal of the reinsurance market--in the last several years there has been a significant increase in both the number and size of the largest liability awards and settlements which have primarily been paid by reinsurers; and
- o The Insurance Commissioner's lack of authority and leadership in the rate-setting process--the Insurance Commissioner does not have authority to control rate increases in California and has not exercised his discretionary powers to the setting of rates or the availability of insurance.

Although Proposition 51 has addressed a portion of the problem relating to non-economic damages, it will not, in and of itself, solve the problem. Instead, each of these five major interrelated factors must be addressed.

The following sections describe the major findings in each chapter of the report. This is followed by a listing of the recommendations of the Commission to address these problems.

CHAPTER II - EFFECTS OF THE LIABILITY INSURANCE CRISIS

FINDING #1 - Liability Insurance is Unaffordable for Many Groups Resulting in the Denial of Necessary Goods and Services to the People of California. In the last two years, liability premiums for both public and

private entities have increased by as much as 100 to 9000 percent rendering insurance unaffordable for many groups. In addition, many entities cannot obtain insurance, leaving them with the option of either "going bare" or going out of business. In either case, consumers must pay more for purchasing goods or services.

FINDING #2 - Liability Insurance Coverage is Not Available for Many Public Entities. The number of cities, counties, and special districts that are unable to obtain liability insurance is increasing drastically. However, this availability problem for public entities does not appear to be a result of actual claims history over the past several years.

CHAPTER III - EVOLUTION OF TORT LAW

FINDING #3 - The Basis of Liability in Tort Has Expanded and Exposed "Deep Pockets" to New Risks. Over the last 40 years, the judiciary in California has expanded the grounds for holding defendants liable in tort. This progressive expansion of liability has made it increasingly difficult for parties to predict risk and insure against that risk.

FINDING #4 - The Average Size of Jury Awards and Settlements Have Increased Due to "High Stakes" Cases. While the number of lawsuits filed and the great majority of awards have remained relative constant when adjusted for inflation and population increase during the last 25 years, the average size of jury awards has risen dramatically in recent years. This has been due almost exclusively to a fifteen-fold increase in multi-million dollar verdicts. It is also reasonable to infer that this increase has had a similar impact on cases settled prior to trial.

FINDING #5 - The Joint and Several Rule That Was Partially Repealed by Proposition 51 is Unfair to Low-Fault Defendants. The Commission has determined that the operation of the rule of joint and several liability has been inconsistent with the proportionate fault system adopted in California in 1975. As a result, "deep pocket" defendants found either minimally at fault or less at fault than the plaintiff suffer major inequities when they are required to pay more than their proportionate share of the judgement. The recent passage of Proposition 51 addresses part, but not all, of this inequity.

FINDING #6 - The Law Encourages Collusive Settlements at the Expense of Remaining Defendants. The judiciary has consistently refused to credit non-settling defendants with a settling defendant's proportionate share of the fault when the non-settling defendant is found partially at fault. This practice, intended to promote quick settlements with defendants of limited means, is open to abuse on two counts. First, the risk of an undervalued settlement is borne by the defendant who is not a part of the settlement, rather than by the plaintiff. Second, a settlement with one of a number of defendants may be conditioned on that defendant actively aiding the plaintiff (commonly referred to as a "Mary Carter" agreement). This form of agreement can lead to collusion between plaintiffs and settling defendants.

FINDING #7 - The Plaintiff's Burden of Proof is Too Low to Control Increasing Punitive Damage Awards. The current burden of proof required

of the plaintiff to justify an award of punitive damages against a defendant is lower than the burden of proof required in other quasi-criminal cases. The Commission believes that the current burden of proof, among other factors, allows and encourages misapplication and misuse of punitive damages.

FINDING #8 - The Collateral Source Rule Can Result in Double Payments to Plaintiffs. The shift in tort law emphasis from deterrence to the compensation of injured plaintiffs has undermined the doctrinal bases for the collateral source rule. Application of this rule has resulted in double payment of losses to some plaintiffs, particularly with respect to public benefits. While the law should encourage people to carry their own insurance, and not penalize them for doing so, the same policy considerations do not apply to public benefits like social security, Medicare, and welfare benefits.

FINDING #9 - The Cost of Administering the Civil Justice System is Excessive and Creates a Burden to Plaintiffs and Defendants. The cost of administering the civil justice system has reached an intolerable level. The Commission found that nearly 54 cents of every premium dollar paid by an insurance company goes to cover the total of plaintiff's and defendant's legal costs, irrespective of other administrative costs. Moreover, legal costs of the tort system are increasing even faster than the average size of jury verdicts. This increasing legal cost is the result, in part, of the complexity of trials and the use in some cases of wasteful, unnecessary, and frivolous pre-trial motions. These costs have subtracted from plaintiff's recoveries for injuries and placed a great strain on liability carriers.

FINDING #10 - Payment of Lump Sum Awards for Future Damages at the Time of Judgement Hurts Both Parties. Testimony and evidence gathered by the Commission indicate that payment of future damages in a single lump sum at the time of judgement is not in the best interest of either party. Payment of a large future damage award places a heavy burden on the defendant or his insurer and compensates the plaintiff for damages not yet suffered. Periodic payments of future damages would increase the probability that the plaintiff will have funds available to meet future expenses.

CHAPTER IV - POLICIES AND PRACTICES OF THE LIABILITY INSURANCE INDUSTRY

FINDING #11 - The Liability Insurance Industry is Cyclical Which Results in Periodic Affordability and Availability Problems. The liability insurance industry is affected by an interest-sensitive rate-making structure and unique accounting practices. The full cost of liability coverage is borne by a changing combination of customer premiums and interest earned from the investment of those premiums. A number of accounting practices unique to the liability insurance industry, particularly in the definition and calculation of profits and losses, contribute to the cyclical nature of the insurance industry. As a result, there have been and probably will continue to be periodic problems of affordability and availability. Due to forces affecting the industry and the effects of prior unsound underwriting practices, the next cycle may be even more extreme and prolonged.

FINDING #12 - A Significant Number of Reinsurance Underwriters Have Withdrawn from the Market thus Limiting Insurance Availability. One of the major reasons the current crisis is so widespread and acute has been the withdrawal, between January 1984 and December 1985, of approximately 45 percent of the total number of companies offering reinsurance, or "insurance for insurers," from the market. This withdrawal has significantly reduced insuring capacity in many lines, particularly in the area of public entity coverage. There is currently no reliable indicator of when, or even if, this vital part of the industry may recover.

CHAPTER V - THE INSURANCE COMMISSIONER'S ROLE IN PROVIDING STABILITY IN THE INSURANCE MARKETPLACE

FINDING #13 - The State Insurance Commissioner's Regulatory Powers in California are More Limited Than in Other States. The balance between regulation and the free market in the insurance industry in California is unlike that of any other major industry. The industry is exempt from all federal and state anti-trust laws, and unlike in other states, is not required to either file rates or seek prior approval for them. As a result, the insurance industry has considerably less regulation and accountability than other industries.

FINDING #14 - The Insurance Commissioner Does Not Have the Authority to Collect Adequate Data to Monitor Trends in the Insurance Industry. Although the Commissioner collects adequate data to determine whether a carrier is financially solvent, the Commissioner does not collect, nor does he have the legal authority to collect, adequate data regarding the construction of insurance rates. Data is submitted by insurance carriers on a nationwide basis, rather than on the basis of experience in California. Additionally, no data is presented regarding the cost of legal judgements and settlements, with the exception of product liability and worker's compensation lines. Thus, the Commissioner is unable to carry out his statutorily mandated function to determine if a rate is "excessive, inadequate, or unfairly discriminatory."

FINDING #15 - The Insurance Commissioner Does Not Fully Utilize His Authority to Make Insurance Available. The Commissioner currently has sufficient legal authority to establish voluntary programs to provide insurance to all entities at a more affordable price. However, the Commissioner, except in one instance to date, has chosen not to exercise this power. A request for voluntary solutions from the industry by the Commissioner may result in needed relief. If not, additional authority to mandate solutions may be needed by the Commissioner.

FINDING #16 - The Insurance Commissioner Does Not Have Legal Authority to Control Rates. Liability insurance carriers are not required to gain approval of rates from the Commissioner prior to implementation, nor to file them with the Commissioner. In addition, the Commissioner does not have the authority to mandate that any licensed insurer underwrite a particular classification of risk, with the sole exception of the Automobile Assigned Risk Plan. Finally, the penalties and fines for noncompliance with the authority that the Commissioner does have are so minor that they are not adequate deterrents. In fact, since 1948 the

Commissioner has never imposed a penalty on a carrier for use of excessive or inadequate rates.

CHAPTER VI - CONCLUSIONS AND RECOMMENDATIONS

The Commission has developed a comprehensive set of recommendations to address the findings of its report. These recommendations include:

1. Establish a \$500,000 cap on compensatory damage awards for pain and suffering, with a cost of living adjustment.
2. Prohibit collusion between plaintiffs and settling defendants.
3. Establish a stricter burden of proof as the standard for punitive damage awards.
4. Prohibit a person from obtaining damages for injuries incurred while in the process of committing a felony.
5. Place limitations on the cost of the civil justice system including:
 - o Limit plaintiff's attorney fees to one-third of the recovery.
 - o Develop a mechanism for limiting defendant's attorney fees.
 - o Establish penalties for frivolous claims and defenses.
6. Modify the collateral source rule to offset plaintiff's recovery by the amount of any public benefits received.
7. Require periodic payments for all future damages over \$100,000.
8. Establish a statewide reinsurance pool for carriers writing coverage for public entities.
9. Provide the Insurance Commissioner with the authority to form voluntary market assistance plans, joint underwriting authorities, and FAIR plans. If voluntary participation is inadequate, consider providing the Commissioner with the authority to compel insurers to participate.
10. Require insurance carriers to take individual prior practices and claims history into account when establishing rates and coverage.
11. Conduct a review of the Insurance Commissioner's Office and the Department of Insurance aimed at determining whether barriers exist in California which unnecessarily prevent competition in the marketplace.
12. Require insurance companies to fully disclose loss data on a line-by-line and state-by-state basis.
13. Consider requiring prior approval of rate insurance increases in excess of 15 percent by the Insurance Commissioner.

14. Increase fines and penalties for non-compliance with Insurance Code requirements.
15. Should consider establishing a bipartisan, five-member Insurance Commission to replace the Insurance Commissioner.
16. Require the Insurance Commissioner to continue to monitor federal actions regarding product liability.

The Commission believes that these recommendations address the various interrelated causes of the crisis, and will protect individual businesses and public entities that are struggling to afford or obtain liability insurance, while maintaining the rights of individuals to seek fair compensation for damages.