Texas House/Senate Joint Committee on
Liability Insurance and Tort Law and Procedure

The Joint Committee Report to the 70th Legislature of the State of Texas

January 22, 1987

Hon. William P. Clements, Governor
Hon. William P Hobby, Lt. Governor
Hon. Gibson D. Lewis, Speaker of the House

In accordance with the provisions of HCR 138, Acts of the 69th Legislature, Regular Session, 1985, transmitted herewith is the report of the House/Senate Joint Committee on Liability Insurance and Tort Law and Procedure.

Respectfully submitted,

Senator Grant Jones, Co-Chair
Representative Mike Toomey, Co-Chair
Senator Kent Caperton *(unsigned)*
Senator Ray Farabee
Senator Bob McFarland
Representative John Gavin
Representative Dudley Harrison
Representative James Hury *(unsigned)*
Representative John Willy

INTRODUCTION

This publication encompasses the majority report of the House/Senate Joint Committee on Liability Insurance and Tort Law and Procedure. A minority report will be presented in a separate publication.

Included in the majority are recommendations for carious changes and additions to the state's law that are designed to remedy the problems that the joint committee has studied for the past 12 months.

Numerous persons and organizations have provided testimony and other information and materials to assist the committee during its deliberations. The joint committee would like to thank each of them for their assistance and participation in this study.

The joint committee would particularly like to thank the State Board of Insurance, its members and staff for the considerable amount of time and effort spent in administering the closed claims study, giving testimony at several of the committee's meetings, and providing endless hours of research and consultation.

The Insurance Services Office in New York City provided the committee with much valuable assistance in gathering data and information relating to the liability insurance industry in Texas and countrywide and in traveling to Texas to present the data gathered. The joint committee wishes to express its sincere appreciation to the Insurance Services Office and its staff for their assistance,

The National Conference of State Legislatures provided much valuable information to the committee through its special publications updating the liability insurance crisis throughout the United States and assisted the committee and its staff in

gathering specific information relating to a number of issues considered during this study. The joint committee would like to thank Brenda Trolin and the staff of the N.C.S.L. for all their efforts.

Randy Fritz spent many weeks sifting through the testimony and materials gathered by the joint committee's report. The joint committee appreciates the long hours that Mr. Fritz devoted to this effort and the work that he did in preparing the report.

Finally, the joint committee would like to thank its staff, Sarah Haynie and David Kramer, Committee Counsels, and Shelly Burkhalter and Harry Ingram, Committee Clerks, for the many hours they spent during the past 12 months gathering information, organizing hearings, working with the committee, and carrying out other activities for the committee.

EXECUTIVE SUMMARY

The Joint Committee on Liability Insurance and Tort Law and Procedure, appointed by Lieutenant Governor William P. Hobby and House Speaker Gibson D. "Gib" Lewis early in 1986, was charged with "studying the availability and cost of commercial, professional, and governmental liability insurance and the impact of the tort recovery process on the insurance industry." This executive summary is a highly abridged presentation of the joint committee's findings and recommendations.

The joint committee's report is organized as follows:

Part I. (Charge and approach): Lays out the joint committee's approach, describes its membership, and lists the witnesses who testified.

Part II. (Support for the existence of a liability insurance crisis): Defines the liability insurance crisis through an examination of the available statistical data.

Part III. (The insurance industry's financial structure): Analyzes ratemaking, and the liability insurance industry's cyclicity; addresses criticisms of the industry's financial practices; describes the State Board of Insurance's "closed claims study"; and lays out current examples of liability insurance unavailability and unaffordability.

Part IV. (The case for tort reform): Establishes the importance of predictability in the civil justice system; and examines the impact of judicial activism on underwriting predictability.

Part V. (The social impacts): Documents the undesirable effects of the liability insurance crisis is having on medicine, local government, school districts, non profit human service organizations, and child care services,

Part VI. (Recommendations): Addresses the critics' arguments that tort reform will not work; presents the joint committee's recommendations for reform of the civil justice system and the insurance industry.

Part VII. (Recent insurance and tort reform activity): Describes the other state and national responses to the liability insurance problem

The existence of a liability insurance crisis has been well documented over the past 18 months by attention that has focused on the impact on health care providers, local governments, day care centers, school districts, nonprofit human services organizations, and others of rising liability premiums and shortages of certain types of coverage. Most people now know that there is a serious problem with the liability insurance system and that some sort of legislative response is required. The joint committee's year-long

investigation reflected a belief that both the insurance industry and the civil justice system had to be carefully studied and where necessary, changed.

After gathering testimony and evidence at six hearings that included 48 hours of testimony from 86 witnesses, the joint committee defined the liability insurance crisis as a crisis of unacceptably volatile industry profitability driven by two structural forces: the cyclical nature of liability underwriting, exacerbated by a practice known as "cash flow underwriting"; and the unpredictability of the civil justice system. The joint committee's recommendations address the effects of those two problems.

Liability insurers make money through profitable underwriting (i.e., premium income exceeds the cost of claims) and the investment of premium income in interest-bearing financial instruments. Insurance companies can sustain financial viability through profitable underwriting, profitable investing, or a combination of the two.

During the early part of this decade, when interest rates were high, liability insurers lowered their premium rates to attract new customers for the purpose of generating more funds for investment. This approach is known as "cash flow underwriting." When interest rates fell, the premium subsidy created by strong investment income deteriorated, and insurers had to raise their rates to keep their balance sheets in the black. This cycle of falling insurance associated with rising interest rates, and higher insurance prices associated with falling interest rates, disrupts the flow of premiums and causes periodic shortages or restrictions of certain types of liability coverage.

Because the legislature cannot alleviate the problem of cash flow underwriting through manipulation of interest rates or regulation of the investment markets, the joint

committee's insurance recommendations are necessarily designed to mitigate the effects of the industry cycle (policy cancellations or nonrenewals, the increasing importance of unregulated or "surplus line" companies, ect.) and enhance the regulatory oversight of the insurance industry and the medical profession.

The overall financial status of Texas liability insurance industry will be much cleaner after the State Board of Insurance presents its "closed claims study" to the legislature in mid-January. The need for additional approaches to insurance regulation or legislative oversight may become apparent after the SBI report, which will document trends in Texas paid losses.

The following are the abbreviated joint committee insurance reform and medical discipline recommendations:

Recommendations 1, 3, 19, 22: The legislature should impose certain types of requirements on liability insurers and the State Board of Insurance (SBI) relating to rate filings, submission of statistical data, information gathering, ect.

Recommendation 2: The Legislature should place statutory cancellation and nonrenewal restrictions on Texas liability insurers.

Recommendation 4: SBI should be required to certify risk managers.

Recommendation 5: State law should be amended so that companies who must operate with state permits or certificates can buy their coverage from a "surplus-lines" (unregulated) insurer.

Recommendations 6-7: Insurance pools for local governmental entities, school districts, and junior college districts should be created or expanded.

Recommendation 8: The legislature should authorize the creation of a reinsurance exchange similar in concept to those being created in other states.

Recommendations 9-12: The legislature should adopt rules to afford a certain amount of protection to persons who buy their coverage from surplus line insurers.

Recommendations 13-14: SBI should enhance its activities on behalf of liability insurance consumers.

Recommendation 15: A joint underwriting association should be formed for nonprofit organizations that qualify under Sections 501(c) (3) and (4) of the Internal Revenue Code.

Recommendation 16: Liability rates should be based on Texas data, insofar as it is available.

Recommendation 17: Additional SBI staffing and funding to carry out the joint committee's recommendations should be authorized.

Recommendation 18: Statutory authority for the market assistance plan should be provided.

Recommendation 20: Life insurance companies should be authorized to provide reinsurance.

Recommendation 21: Liability insurers should be required to provide on request accident prevention services.

Recommendation 23: Mandatory reporting of any physician conduct that would constitute ground for the denial or revocation of a medical license should be provided.

Recommendation 24: All physician licensees should be required to report to the Texas State Board of Medical Examiners any sanctions taken against them during the preceding year.

Recommendation 25: Immunity from civil liability should be granted to any health care provider who makes a charge of incompetent professional behavior against a licensed Texas physician based on reasonable evidence.

Recommendation 26: Persons who comply with the mandatory reporting requirement, and are subsequently the victims of some form of professional retaliation, should have the right to sue for actual and punitive damages.

While the liability insurance crisis is partly the result of cash flow underwriting, the industry has also been a victim of fundamental changes in tort law over the past several years. Significant changes in tort law fueled by far-reaching decisions by the Texas Supreme Court, thereby redefining the parameters of risk and liability, have eroded the ability of insurers to accurately predict the frequency and magnitude of their losses. Without reasonable predictability in the law, stability, availability, and affordability in the liability insurance market remain elusive goals.

The liability insurance crisis also impacts economic development. Rapidly rising insurance premiums raise the costs of doing business and consume financial resources that otherwise would be available for growth and expansion. The unavailability of adequate coverage at reasonable rates compels existing businesses to reduce or discontinue manufacturing certain product lines. At the other end of the business life cycle, eight out of 10 new businesses fail within the first five years. While many factors affect business failures, the rising cost of liability insurance exacerbates the economic

mortality rate. At a time when Texas must promote economic development to diversify its economy, the liability insurance crisis dampens economic growth and business and job creation. By passing meaningful tort reform, Texas could create a business climate that attracts new business and encourages the growth and expansion of existing enterprises.

The need for restored predictability in the Texas civil justice system is underscored by a sharp increase in statewide nonautomotive personal injury district court civil cases. According to the Texas Office of Court Administration, the total number of general district court civil case filings increased 15.1 percent between 1980 and 1985, almost perfectly matching a 15.04 percent population increase during the same period. Conversely, <u>non automotive personal injury filings (general liability)</u> increased by 43.9 percent, almost <u>triple</u> that of the growth in population.

The appropriate legislative response is selective reform of tort laws. This position is corroborated by the United States Justice Department's Tort Policy Working Group (TPWG), which consists of high-ranking personnel from 10 federal agencies and the White House. In its report, TPWG writes:

"The excesses of the tort system present a very real opportunity to address a major cause of the insurance crisis while sensible and appropriate reforms. And while some of the changes in the insurance marked currently under consideration probably will relieve some availability/affordability problems, it seems unlikely that these changes will provide long-term, systematic relief without fundamental reforms of tort law.

Tort law (should be returned) to credible and fault-based compensation that provides a fair and reasonable level of (recovery) to deserving plaintiffs through a more predictable and affordable liability-allocating mechanism."

Restoration of predictability to the Texas civil justice system must be the ultimate objective of any proposed tort reforms. Specifically, legal interpretations of fault and compensation should once again be based on consistent application of historical precedents, and the legislature must firmly reestablish its prerogative to make, regulate, and define liability law.

Article II of the Texas Constitution, incorporated in the Constitution of the Republic of Texas, 1836, and in all subsequent constitutions, provides for the separation of powers between the executive, legislative, and judicial departments. It states that the "powers of the Government of the State of Texas shall be divided into three distinct departments, each of which shall be confided to a separate body of magistracy, to wit: Those which are Legislative to one, those who are Executive to another, and those which are Judicial to another…." The Texas Supreme Court itself has repeatedly interpreted this article to establish a clear separation of powers among the judicial and legislative branches, finding the duty of the courts is to interpret and enforce laws as made by the legislature without regard to their wisdom, practicality or expediency. See, e.g. Vaughan v. Southwestern Surety Ins. Co., 206 S.W. 920 (1919); Texas National Guard Armory Board v. McCraw, 126 S.W.2d 627 (1939); Insurance Commissioners of the State Board of Insurance v. Betts, 315 S.W. 2d 279 (1958).

Despite this clear-cut and fundamental provision of the constitution, the Texas Supreme Court has exhibited a recent tendency to venture beyond its proper role of interpreting law. This has mad apparent the need for thoughtful and sensible tort reform. A brief examination of just one important case, Sax v. Votteler, 648 S.W. 2d 66 (Tex. 1983), aptly illustrates this.

In the Sax case, the court held that the medical statute of limitations was unconstitutional under the "open courts" provision of the Texas Constitution. The court explicitly refused to reject the statute by citing either the equal protection or due process guarantees embodied in the Fourteenth Amendment to the U.S. Constitution. Instead, the court expanded the meaning of the open courts provision by ruling it "accords Texas citizens additional rights" over and above those enumerated in the federal constitution.

The Sax decision had a number of important consequences for liability underwriting. First, it injected a considerable amount of unpredictability into certain types of coverage, especially health care and day care policies. The absence of a reasonable stature of limitations means that liability policies involving children can remain active for as long as 20 years, during which time liability laws could be repeatedly amended or expanded. It is not surprising, therefore, that Texas day care centers are largely unable to find regulated insurers who are willing to assume their risks, or that numerous Texas family physicians have stopped delivering babies.

Second, by expanding the meaning of the open courts provision, the Sax ruling created the possibility of future supreme court decisions circumventing the legislature's rightful authority over common law causes of action. If the legislature permits the supreme court to arbitrarily reverse historical tort precedents, liability underwriters will be unable to accurately foresee the nature of the legal environment in the future. Long-term stability cannot be restored to the Texas liability insurance market unless lawmakers seize the initiative and reassert their control over tort law.

The Sax decision is hardly an isolated example of supreme court activism that has expanded legal definitions of compensability, increased underwriting unpredictability,

preempted the legislature's right to make law, or pushed up liability insurer paid losses. The following is a highly abbreviated listing of other Texas Supreme Court decisions that have similar effects:

---Sanchez v. Schindler (1983): This decision which allowed non economic damages (loss of society) in wrongful death cases involving a child, was rendered at the same time the legislature was considering a bill (CSHB 800) that would have had the same effect.

---Duncan v. Cessna Aircraft (1984): Notwithstanding the legislature having enacted a "modified" comparative negligence statute (1973), under which a plaintiff found to be more that 50 percent negligent cannot recover damages, the supreme court changed Texas law for product liability cases, including cases in which negligence is involved, to "pure" comparative causation, whereby a plaintiff is barred from recovery only if found to be 100 percent responsible.

---Cavnar v. Quality Control Parking (1985): Permitted the awarding of prejudgment interest in the amount of 10 percent interest compounded daily on claims.

---Poole v. El Chico (1986): Despite the legislature's repeated rejection of "dram shop" legislation, the supreme court affirmed a lower court ruling that bar operators owe a duty to the public not to knowingly sell alcoholic beverages to an intoxicated person.

---Nixon v. Mister Property Management, Inc. (1985): In this case, the court held that the owner and manager of a vacant apartment complex could be held liable for the criminal behavior of an unknown person even though the conduct began on other property.

---Yowell v. Piper Aircraft (1986): The supreme court for the first time allowed recovery of damages for the highly speculative "loss of inheritance."

The joint committee believes it is the legislature's role to make the law and the court's role to interpret the law. Legislative tort policy is formulated by a bicameral body (181 members) in a process that includes public hearings, open debate, and approvals by the governor. Judicial tort policy is formulated by five court members (a majority of a nine-member court) without the procedures inherent in the legislative process.

The following tort reform recommendations, which fully preserve the rights of injured persons to seek relief through the courts, are intended to bring long-term stability to the liability insurance market through the restoration of underwriting predictability:

Recommendations 1-4: Penalties and administrative sanctions should be imposed against those who file frivolous suits.

Recommendation 5: The venue statutes should be amended so that suits cannot be filed in jurisdictions that would give an unfair advantage to either party.

Recommendation 6: The statute of limitations for injury to a minor should be shortened to eight years.

Recommendation 7: The legislature should establish a uniform system of comparative responsibility.

Recommendation 8: Joint liability should be abolished.

Recommendation 9: Except in certain instances, attorneys' contingency fees should be based on a sliding scale.

Recommendation 10: All future damage awards exceeding $100,000 in civil cases should be paid out over time in periodic installments.

Recommendation 11: Actual economic damages, which should be statutorily defined, should be recoverable without limit.

Recommendations 13-15: Situations in which punitive damages can be awarded should be defined, and the damages should be capped and distributed in a manner that is consistent with the purpose of punishment (i.e., 25 percent to the claimant, 25 percent to the claimant's attorney, 50 percent to the state).

Recommendation 16: Awards should be reduced to the extent that plaintiff has collateral benefits.

Recommendations 17-19: Exemption from liability except for intentional acts in the performance of duties is recommended for public officials and directors of charitable institutions.

Recommendation 20: Under certain circumstances, owners or occupants of real property should be granted immunity from liability for the actions of persons using that property for profit or recreational purposes.

Recommendation 21: Recovery in actions taken against childhood vaccine manufacturers should be limited to specific actual and projected reasonable expenses.

Recommendation 22: All municipal activity (proprietary and governmental) should be subject to liability for negligence only to the extent articulated by the Texas Tort Claims Act.

Recommendation 23: Governmental sovereign immunity should be maintained in emergency situations unless the action violates state or local laws.

Recommendation 24: The Texas Tort Claims Act should be clarified so that liability arises only for injuries or death proximately caused by a condition or use of tangible property.

Recommendation 25: Governmental immunity should be extended to any person working under contract with the Texas Department of Health.

Recommendation 26: Assessment of prejudgment interest on damage awards should be prohibited.

Recommendation 27: All legislative actions relating to the awarding of damages should apply to cases in the judicial system in which a final judgment has not been rendered.

Recommendation 28: If any of the proposed tort legislation is found to be unconstitutional by a county or district court, the Texas Supreme Court should grant direct review of the decision in a timely and expeditious manner and a declaratory judgment.

Recommendation 29: A constitutional amendment should be adopted under which the legislature should have the authority to define or regulate tort procedures or statutes to the fullest extent permitted by the United States Constitution.

Recommendation 30: Charitable immunity should be restored. Support for selective and thoughtful tort reform is far from unanimous. Tort reform opponents support their position with a number of arguments normally directed at the liability insurance industry. The joint committee's findings and recommendations address those contentions. The following is a brief description of each major argument against tort reform and the joint committee's response:

1. Premiums have been collusively and unfairly increased to recapture profits lost during the "excessive competition" that occurred when interest rates were high.
Response: First, the liability insurance industry is very competitive and it is unlikely that insurers could effectively participate in a collusive price-fixing scheme. The industry's competitiveness is substantiated by two published reports and the growing number of liability insurance companies that are policyholder-owned. Second, there is strong evidence that higher paid losses are pushing up premium rates. Third, unprecedented underwriting losses have occurred in the last several years.

2. The omission of both realized and unrealized capital gains from operating income is a deceptive accounting practice that hides the true financial strength of liability insurers.
Response: Incorporating realized or unrealized capital gains into operating income flatly contradicts generally accepted accounting principles.

3. The insurance industry's strong showing in the stock market proves that the problems of unaffordability and unavailability are either exaggerated or a fraud based on deceptive industrywide financial practices.
Response: The performance of the property and casualty stocks in the stock market is no indication of either profitability or financial health. It reflects either a growing expectation among investors that liability insurers will be more profitable in the future, or a belief that the current crisis of profitability is suppressing the industry's natural competitiveness, leading to the possibility of even higher premium income in the near future. Also, as any student of the stock market knows, investor expectations are no guarantee of future events.

4. Canada has already adopted most of the tort reforms proposed, and therefore tort reform in the United States will not affect rates.
Response: Canada's tort law does not include the reforms proposed. Additionally, the Canadian tort system is, in many ways, as unpredictable as the United States tort system. Damages are increased for "gross up" (to account for income taxes on the recovery), and new elements of damages, such as "loss of competitive advantage," have recently expanded liability. Insurers cannot predict their losses in Canada any better than they can in the United States.

The joint committee's recommendations reflect a balanced approach that respects plaintiff's rights, and recognizes that changes in both tort law and insurance regulation and oversight are required. If the legislature adopts the committee's proposals, it will restore industry stability, predictability will return, and underwriting capacity will be improved. That will prevent future occurrences of widespread liability insurance

availability or affordability problems, which will, in turn, mitigate the undesirable effects that are currently being felt by doctors, local governments, nonprofit organizations, school districts, day care centers, and others.

REPORT

OF THE

HOUSE/SENATE JOINT COMMITTEE

ON

LIABILITY INSURANCE AND TORT LAW AND PROCEDURE

Part I: Charge and Approach, Report Overview

This report encompasses the findings and recommendations of the House/Senate Joint Committee on Liability Insurance and Tort Law and Procedure, referred to in this report as the joint committee. The 10-member joint committee, consisting of five representatives and five senators, was charged with "studying the availability and cost of commercial, professional, and governmental liability insurance and the impact of the tort recovery process on the insurance industry."

The joint committee was created in response to the existing liability insurance crisis. This crisis is manifest in a number of ways: the lack of availability of certain types of liability insurance coverage at any cost; shortages of liability policies written by admitted companies; the availability of certain types of liability policies only from unregulated companies; shortages of adequate coverage (only policies of limited coverage are available); skyrocketing premiums; and negative societal impacts caused by the preceding problems, affecting, among other areas: health care, local government, child care, education, industry, business, and the professions.

Although the existence of a widespread problem is virtually impossible to deny, a clear consensus over the causes and potential solutions has failed to emerge. In fact, it would be difficult to conceive of a current policy issue in which the advocates and opponents of reform are more at odds than the liability insurance crisis. The joint committee was created to clarify some of the elements and forces affecting liability insurers and their customers and to recommend possible legislative approaches and remedies.

In a broad sense, the joint committee's objectives were twofold: to analyze the forces driving the current liability insurance market and recommend alternatives that could mitigate the current affordability and availability problems; and, operating from a long-term perspective, to propose reforms that could reduce the cyclical price shocks and gyrations that periodically afflict the liability insurance industry.

This report should be approached with the understanding that, although the impacts of the liability insurance crisis are often easy to identify, the underlying causes of the problem are subtle and frequently difficult to discern. The joint committee's observations and recommendations are the result of an intensive yearlong effort.

The liability insurance crisis in Texas is the product of a number of distinct forces that interact in ways that are complex and sometimes impossible to predict. Those forces are: the unique and complicated cyclical economic structure of the liability insurance industry; the presence and tremendous effect of international reinsurance on capacity and the actuarial process; the unpredictability of the civil justice system (especially in the judicial branch of government); and the volatility of the capital and investment markets.

Any comprehensive and realistic legislative approach to the liability insurance crisis must start with the presumption that both the liability insurance industry and the civil justice system must be scrutinized and, where necessary, modified. If only civil justice reforms, or "tort reforms" as they are more commonly called, are enacted, the legislature will fail to achieve long-term liability insurance industry stability. If only insurance reforms are passed, underwriting predictability will continue to be periodically rocked by unanticipated legal redefinitions of liability and compensability

The Joint Committee's Composition

The House/Senate Joint Committee on Liability Insurance and Tort Law and Procedure is an interim study committee jointly appointed by Lieutenant Governor William P. Hobby and Speaker of the House Gibson D. "Gib" Lewis. The following is a brief description of the committee members:

Senator Grant Jones (cochairman): Attorney; Democrat from Abiline elected to the senate in 1972 following eight-year's service in the house; chairman of the Finance Committee; member of the Administration Committee, Economic Development Committee, Education Committee, Legislative Budget Board, Legislative Library Board, Legislative Audit Committee, and Legislative Education Board.

Representative Mike Toomey (cochairman): Attorney; Republican from Houston elected to the house in 1982; budget and oversight chairman for the Judiciary Committee; member of the Appropriations Committee.

Senator Ray Farabee: Attorney; Democrat from Wichita Falls elected to the senate in 1974; chairman of the State Affairs Committee; member of the Criminal Justice Committee, Finance Committee, Administration Committee, Legislative Budget Board, and Legislative Audit Committee.

Senator Kent Caperton: Attorney; Democrat from Bryan elected to the senate in 1980; chairman of the Criminal Justice Committee; member of the Finance Committee, Education Committee, and Administration Committee.

Senator Bob McFarland: Attorney; Republican from Arlington elected to the senate in 1982 following six-year's service in the house; member of the Nominations Committee, State Affairs Committee, Criminal Justice Committee, and Finance Committee.

Senator Cindi Krier: Attorney; Republican from San Antonio elected to the senate in 1984; member of the Education Committee, Jurisprudence Committee, and Natural Resources Committee.

Representative John Gavin: Insurance Businessman; Democrat from Wichita Falls elected to the house in 1980; chairman of the Insurance Committee; member of the State Affairs Committee and the Task Force on the Premium Tax.

Representative Dudley Harrison: Businessman; Democrat from Sanderson elected to the house in 1982; vice-chairman of the Judiciary Committee; member of the Criminal Jurisprudence Committee and the Local and Consent Calendars Committee.

Representative James Hury: Attorney; Democrat from Galveston elected to the house in 1982; vice-chairman of the Judiciary Committee; member of the Criminal Jurisprudence Committee and the Local and Consent Calendars Committee.

Representative John Willy: Businessman; Republican from Angleton elected to the house in 1984; member of the County Affairs Committee and the Ways and Means Committee.

The Joint Committee's Work Cycle and Witnesses

The joint committee met for a total of 48 hours on the following dates during 1986 to hear public testimony and gather information: January 18, February 8, March 1, March 31, July 26, and October 25.

The joint committee heard testimony from 86 witnesses representing a wide range of opinion, expertise, and political interest, and a number of those individuals testified more than once. The following are the names and affiliations of the committee witnesses (a number in parentheses indicates the number of times that person appeared before the committee).

Gilbert Adams: Texas Trial Lawyers Association

Tani Adams (3): Texas Center for Rural Studies

Morris Atlas: Atlas & Hall

Damon Ball: Texas Association of Defense Counsel

Carol Barger (3): Consumer's Union

Ted Blevins: Residential Contract Program Counsel

Sue Bolens: Texas Center for Rural Studies

Tom Bond: National Association of Independent Insurers

Dr. Jim Bob Brame: Texas Medical Association

Donald Branham: Montgomery County Mayors Association

Dr. G. B. Brindley Jr.: Texas State Board of Medical Examiners

David Burrow: Texas Trial Lawyers Association

Joe Byrd: Texas Association of Business

Debbie Cartwright: Texans for Victims' Rights

Joe Chilton: Texas Medical Liability Insurance Underwriting

Sam Clonts (2): Texas Association of Counties

John Collins: Texas Trial Lawyers Association

Doyle Curry: Texas Trial Lawyers Association

Gaylon Daniel: State Board of Insurance

Dr. Tad Davis: Texas Medical Association

Nub Donaldson (2): Texas Civil Justice League

Margarita Fournier: Alliance for Legal and Insurance Equity

Randy Fritz

Catherine Fryer: State Board of Insurance

Richard Geiger: Association of Fire and Casualty Companies of Texas

Jack C. Goodman: Texas Society of Professional Engineers

Steve Hacker: Professional Insurance Agents of Texas

Joe Hairston: Texas Association of School Boards

Dane Harris: Texas Association of Business

Charles W. Havens III: U.S. representative of Lloyd's of London

Joseph Hawkins: Texas Trial Lawyers Association

John Hildreth: Common Cause of Texas

Dr. Donald House: Texas Medical Association

Michael Hudson: Texas Maternal & Child Health Coalition

William Huff: Association of Fire and Casualty Companies of Texas

Allen Hyman: Texas Municipal League

Cynthia Jenkins: Texas State Board of Medical Examiners

The Honorable Lowell Junkins: former Iowa Senate majority leader, speaking on behalf of the Texas Trial Lawyers Association

Mack Kidd: Texas Trial Lawyers Association

Rebecca Lightsey (2): Alliance for Legal and Insurance Equity

Andre Misonpierre: President, Reinsurance Association of America

John Marks: Texas Trial Lawyers Association

Jim Mattox: Attorney General of Texas

Mike McCrary: Association of Fire and Casualty Companies of Texas

Tom McGarity: The University of Texas Law School

Sidney McLemore: Texas Licensed Child Care Association

Phillip Miller: Insurance Services Office

Jerry Don Moody: Off Road Equipment Operators Association

Jack Murphy: American Physicians Insurance Exchange

Dr. Perry Nadig: Trans-Texas Medical Devices

Dr. Charles Neglett: Texas Medical Association

Neil Nichols

Lyndon Olson (3): Chairman, State Board of Insurance

F. Bruce Pegelow

Oliver Pennington: Houston Chamber of Commerce

David Perry: Texas Trial Lawyers Association

David P. Petersen: National Association of Solvent Recyclers

Robert Quirk: Texas Surplus Lines Association

Richard Roach: Individual Insurance Agents of Texas

Gretchen Seitsinger: Newark Maternity Hospital (El Paso)

T. Darrington Semple, Jr.: American Reliance Insurance of New York

Jessica Shahin: Public Citizen of Texas

J. Robert Sheeny: Texas Association of Defense Counsel

Earl Simburger

Haskell Simon

Robert Simpson: American Insurance Association

Tom Smith (2): Public Citizen of Texas

Paul Spell: Texas Association of School Boards

Broadus Spivey: Texas Trial Lawyers Association

Robert Stluka: National Foundation of Independent Business

Stephanie Thomas: Coalition for Texans with Disabilities

David Thornberry: State Board of Insurance

George Vorpahl: Temple East-Tex, Inc.

Mavis Walters: Insurance Services Office

Lee Ware: Texas Association of Defense Counsel

Dr. E. Don Webb: Texas Medical Association

Tom Webb: Texas Trial Lawyers Association

Dr. Peter Watson: Texas Association of Obstetricians and Gynecologists

Al White: Texas General Agency

Andrew Whitman: Texas Trial Lawyers Association

Dr. Drew Williams: Texas State Board of Medical Examiners

Ted Willis (2): Texas Municipal League

Dr. James Winn: Texas Medical Association

Sam Winters: Association of Fire and Casualty Companies of Texas

Paul Zuconni: Texas Medical Liability Insurance Underwriting Association

Almost all of the information presented in this report originated, in some form, from the oral and written testimony received by the joint committee. Specific examples of liability insurance affordability or availability problems presented in this report have been independently verified, and the statistical data has been subjected to a reasonable test for accuracy and verisimilitude. The recommendations represent the majority opinion of the joint committee, and committee members have been given the opportunity to publish dissents at the conclusion of the report.

Part II: The Liability Insurance Crisis

The Crisis Defined

The notion that the liability insurance industry is in a state of crisis has gained wide acceptance over the past 18 months. The contentiousness that surrounds the issue rarely has to do with the question of whether a serious public problem exists. Even the

most vociferous critics of the insurance industry or of tort reform will usually agree that today liability insurance costs too much or is insufficiently available. Instead, the proponents and opponents of change disagree over the root causes of the problem. If there is a disagreement over the causes, there must also be disagreement over the solutions.

Before the underlying causes of the problem can be analyzed, the idea of a liability insurance crisis must first be defined. When policymakers express an interest in solving the liability insurance crisis, they are usually referring either to identifiable problems in the insurance market, such as shortages or price shocks, or to the specific and quantifiable effects of those market problems on society.

Is this the correct approach? Do the problems relating to affordability and availability of liability insurance and the resultant societal repercussions define the liability insurance crisis, or are they the unpleasant consequences of a structural breakdown in the liability industry? Or, to put the question another way, do the visible effects of the liability insurance crisis embody the quandary, or are they the outward symptoms of something deeper and more complex?

To answer that question, the joint committee solicited and heard testimony from a variety of insurance experts, including members of the State Board of Insurance, and senior actuarial officers of Insurance Services Office, Inc. (ISO).

ISO is a nonprofit and non-lobbying corporation that is licensed to provide a variety of statistical, actuarial, policy, and rating services to insurers. It is also a source of casualty insurance statistics. ISO is not an advocate for any specific proposals.

Although the financial structure and profitability of the insurance industry in general, and the liability insurance portion of the industry in particular, are clouded by complexity and a dearth of reliable public information, there is no reason to presume that the data provided to the joint committee by the State Board of Insurance, GAO, or ISO are skewed or flawed. All three organizations can reasonably be assumed to be objective, non partisan, and reliable. Their testimony and published material are the basis of the joint committee's conclusions concerning the profitability of the liability insurance industry.

The intent of this part of the report is to define the liability insurance crisis on the basis of the available evidence. Based on the statistical information that will follow, the joint committee has chosen to define the liability insurance crisis as a "crisis of unacceptably volatile industry profitability" caused by two generic forces: a cycle of aggressive competition to take advantage of lucrative investment opportunities followed by steep premium increases to recoup the losses of the unrealistically low premiums increases to recoup the losses of the unrealistically low premiums collected during the period of aggressive competition, and a highly unpredictable underwriting environment characterized by unforeseen changes in the frequency and expense of personal injury claims as well as enlarged judicial concepts of plaintiff's rights. The cyclical nature of the insurance industry will be examined in Part III of this report, and unpredictable risk will be evaluated in Part IV.

There is no inherent reason why the Texas Legislature should care about a "crisis of unacceptably volatile…. profitability" in any business or industry. Occasional or even permanent lapses in profitability are a fact of life in any capitalist economy. The liability

insurance crisis, as defined above, is a public policy problem because of a series of subtle casual links between the financial viability of the insurance industry as measured byu the bottom line and societal necessities such as health care, child care, local governmental service and education. A chronically unprofitable insurance market will be marked by insolvencies and reduced competition, which will in turn lead to shortages of coverage and high premium costs. Additionally, the public as consumers of goods and services must pay increased premiums that result from insurers having to guess at what their losses may be in the future. The negative societal impacts that will be documented in Part V of this report are, in turn, a consequence of liability insurance availability and affordability problems.

Before the causes of the liability insurance crisis can be examined, the possible remedies formulated, it is necessary to substantiate the existence of a "crisis of….. profitability."

The National Situation

Any assessment of profitability must originate with the clarification of a number of key concepts. According to Mavis Walters, ISO senior vice-president, the most important component of insurers' net income after taxes is operating income, which is the sum of underwriting income and investment income. It is the clearest and most straightforward indication of the economic health of insurance operations.

All insurance companies generate revenue through two different but related activities: collecting premiums from customers, and investing those premiums in a variety of income-generating financial instruments (including stocks, bonds and interest-

bearing certificates). Underwriting income is the difference between premiums collected and the sum of claims, expenses, and policyholder dividends. Investment income is defined as income generated only though the retention of those income-generating financial instruments (i.e., dividends or interest). On the basis of that definition, profits derived from the sale of stocks or bonds are considered capital gains, not investment income (although they obviously enhance overall profitability). It is clear that the exclusion of capital gains from operating income is appropriate under generally accepted accounting principles.

The combined ratio is another useful analytical tool used to measure relative underwriting profitability. The combined ratio is the ratio of losses (including loss adjustment expense) and all other expenses to earned premiums plus the ratio of underwriting expense to written premiums. A combined ratio above 100 reveals an underwriting loss and a ratio below 100 shows an underwriting gain.

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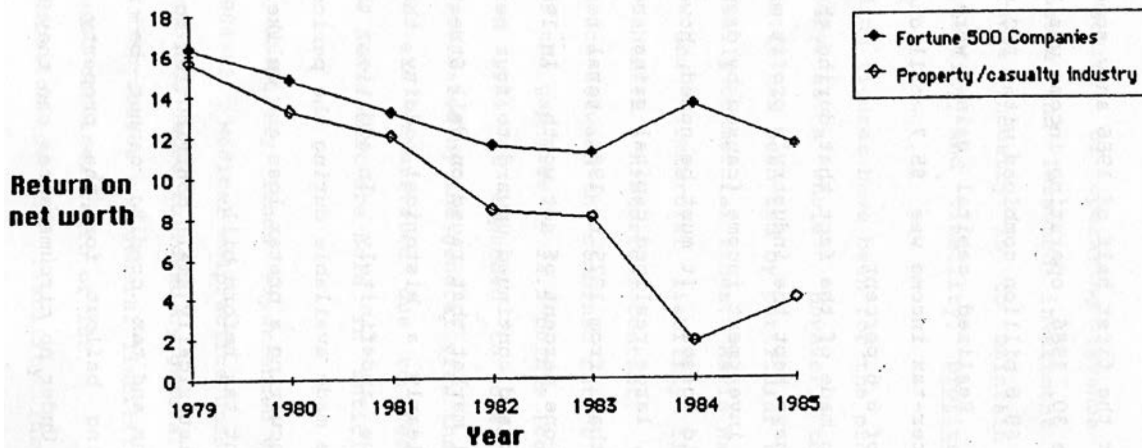
The final measure of insurer profitability is the rate of return on net worth. This measure includes operating income, realized capital gains, tax credits, and other forms of miscellaneous income. It is frequently used to compare the profitability of insurance underwriting with other dissimilar industries.

Figures released by ISO and GAO indicate that property and casualty insurers have suffered underwriting losses for each year since 1979 (the losses incurred between 1979 and 1985 total $79.7 billion). The most significant underwriting losses occurred in 1984 ($21.7 billion) and 1985 ($24.7 billion). Until 1984, investment income exceeded underwriting losses for each year. According to the testimony of Philip Miller, ISO vice-president, the 1984 operating loss was $3.8 billion, and a record $5.4 billion shortfall was recorded in 1985. Only massive and nonrecurring realized capital gains and tax credits kept the industrywide books from dropping into the red during the past two years ($3.1 billion in capital gains and $1.7 billion in tax credits for 1984; $5.5 billion and $2 billion respectively for 1985).

On the basis of return on net worth, 1984 was the worst year ever for the property and casualty insurance industry. (See Chart II-1.) The industrywide return on net worth was 1.7 percent on total earnings of $1.3 billion. That figure grew to 3.9 percent in 1985. On the other hand, insurers that concentrate in commercial lines have done considerably worse with a minus three percent return in 1984. Given the inherent riskiness of the property and casualty insurance business, the industry's average net rate of return should, ideally, be higher than other large corporations. However the facts point to the opposite situation. The Fortune 500 companies' median return on net worth in 1984 was 13.6 percent, and it never fell below 10 percent during the period 1974-1984.



The figures for the first half of 1986 show some improvement. At the end of June 30, 1986, operating income was $2 billion (an underwriting loss of $8.6 billion combined with $10.6 billion in investment income). Realized capital gains were a hefty $3.5 billion. The net after-tax income was $5.7 billion, yielding a return on net worth of 6.6 percent.

Much has been made of the fact that during the past several years capital gains have kept the industry's profit margin in the black despite lower investment income (caused by dropping interest rates) and rising paid losses. It must be noted, however, that, in a historical context, large realized capital gains are an anomaly. ISO figures show that from 1975 to 1982, total realized capital gains never exceeded one percent of net worth. In 1983, the ratio grew to three percent and continued upward to four percent in 1984. The phenomenal bull market that raged on Wall Street between 194 and mid-1986

was clearly a historical oddity that cannot be expected to continue indefinitely. In addition, the substantial tax credits that were made available during the period 1984-85 to liability insurers incurring a pretax loss are unlikely to continue in light of the recent tax reform bill.

Given their historically small contribution to total profit, realized capital gains and tax credits cannot be relied on to provide an continuing bailout for the property and casualty insurance industry. Under no circumstances can they be thought of as dependable sources of operating revenue to offset higher underwriting losses and lessened investment income. If the liability insurance industry is to maintain a stable level of long-term profitability and viability, profits must come from operating income.

The preceding figures have been for the property and casualty insurance industry as a whole. However, the deterioration in underwriting results has been led by particular types of liability insurance, especially commercial lines. Mavis Walters of ISO notes that personal and commercial liability lines have closely paralleled each other in a historical context. Between 1967 and 1982, the difference between the combined ratios never exceeded six points. In 1983 the gap grew to 12.5 points (commercial exceeding personal), and in 1984 it expanded to over 20 points. The difference is exacerbated by the general view that commercial lines combined ratios are understated due to reserve inadequacies (reserves are the funds that are held in anticipation of future claims).

Commercial liability lines experienced very unsatisfactory results during 1984-85. Medical malpractice underwriting, at 170, had the worst combined ratio followed by general liability at 152. ISO presents the malpractice and general liability results for 1985 as a single averaged combined ratio of 168.

A final indication of the liability insurance industry's precarious financial situation is the number of companies that have been downgraded by the A. M. Best Company (a highly regarded insurance statistical evaluator that is, among other things, a source of statistical information to the GAO). Best annually conducts a specialized financial analysis of most U.S. insurance companies and expresses its evaluation in the form of a nonnumerical rating. All companies rated "excellent" are considered to be outstanding and have no materially unfavorable variances from Best's average industry standards. Lower ratings reflect increasingly unfavorable variances. An "excellent" rating is considered essential if an insurer wishes to do business with large corporations, municipalities, or government contractors.

From 1982-1983, 30 companies were upgraded to "excellent" while 78 were downgraded. In 1984, there were 38 upgrades and 150 downgrades, and the 1985 ratings changes were 25 and 331, respectively.

Based on the preceding substantiation, the "crisis of unacceptably volatile industry profitability" (for the past three years) can be summarized by the following statements: sharply negative operating income has been ameliorated by nonrecurring tax credits and nonrepeatable realized capital gains (with the firs half of 1986 showing some overall improvement in the bottom line); general liability and medical malpractice insurance have had the poorest results, as reflected in dramatically worse combined ratios than the property and casualty insurance industry as a whole; the return on net worth for the property and casualty industry as a whole, and commercial lines in particular, has been far below the Fortune 500 averages; and the industrywide performance ratings have been trending noticeably downward.

Although the bookkeeping evidence of a profitability crisis is virtually impossible to refute, some critics have alleged that the crisis is a hoax manufactured by dissembling industry wide accounting procedures. Specifically, they charge that underwriters have misrepresented their true operating income by deliberately overestimating the reserves that must be held in anticipation of future losses.

It is certainly true that loss reserves are insurer-calculated estimates of future debts arising from claims that have not yet been settled. State insurance commissioners, charged with overseeing the solvency of insurers, encourage future liabilities to be reported at their full ultimate value. The question of future reserves is particularly relevant for the "long-tailed" liability lines, in which the final cost of all payouts is normally not known for many years (the concept of "long-tailed underwriting," which has to do with the time interval between the occurrence of a compensable incident and payment of all possible claims relating to that incident, will be examined in Part IV). It is theoretically possible, therefore, for insurance companies to collusively manufacture a profitability crisis by unfairly ballooning their projections of probable future losses.

In reality, however, the over-reserving charge has no credible basis in fact and actually contradicts the consensus opinion of financial analysts who believe that current losses are being understated. A recently published ISO study concluded that:

> Year-end 1982 industrywide loss reserves were deficient by more than 10%. Subsequent ISO analyses indicate that no significant strengthening occurred in industry loss reserves through year-end 1984. Furthermore, experience has now shown that property/casualty industry loss reserves were seriously understated at the time of the last "crisis" in 1976.
>
> The reserves set aside at year-end 1976, for all claims incurred to that date, were $47.1 billion. As of year-end 1984, $48.6 billion had been paid out on

> those initial pre-1977 claim reserves. And an additional $8 billion was still held in reserve for the same group of claims—for a total payment of $56.6 billion rather than the $47.1 billion originally expected. The nearly $10 billion difference represents an initial reserve deficiency of 20%.
>
> The 1976 loss reserves were not unique. For example, the 1979 reserve for liability lines was $65.3 billion at the year-end 1979. As of year-end 1984, $53.8 in reserve—an initial deficiency of more than $4 billion or 6%.

The pattern of under-reserving can also be documented in two particularly long-tailed lines: general liability and medical malpractice. According to the same ISO document:

> In 1976, general liability claim payments already made, plus the reserves carried for future payments on policies written though that year, totaled $24 billion. At year-end 1984, the estimated costs for those same claims had risen to $28 billion, of which $26 billion had already been paid (a minimum deficiency of at least $4 billion).
>
> For medical malpractice, the estimate for payments on the policies written for 1976 initially totaled $1.9 billion. The year-end 1984 estimates for those same medical malpractice losses had risen to $2.3 billion, of which $1.9 billion had already been paid (a minimum reserve shortfall of at least $400 million).

In addition to the statistical evidence, there is a logical argument against the over-reserving allegation. The natural tendency of reserves for long-tailed coverages will be toward deficiency rather than excess because unforeseen technological advances uncover new sources of exposure to personal injury, and the concepts of legal compensability have been significantly expanded in the past 10 years. Reserves cannot plausibly be set aside for future claims arising from unanticipated or unexpected expansions of legal liability or advances in technology. The concept of over-reserving is hard to defend in the face of a dynamic and changing legal and scientific environment.

Other critics contend that the current profitability difficulties are a harsh but nevertheless predictable period in the insurance industry's fiscal cycle. Instead of a crisis, they argue that the insurance industry is only suffering through a worse-than-usual

cyclical downturn. Of course, that is an allegation that can only be proven as right or wrong retrospectively. The numerical evidence, however, tends to undermine this argument.

The statistical record of all-time high underwriting losses, operating losses, and combined rations, combined with all-time low return on net worth, provides cyclical crisis of profitability. Until 1984, the largest number of insurance company insolvencies in any two-year period was 25. During 1984-85, there were at least 40 insolvencies. IN 1985, the National Association of Insurance Commissioners (NAIC) targeted 215 property and casualty insures as being in need of immediate regulatory attention under the NAIC early warning system. That represented a 73 percent increase from the previous year. Finally, this downward cycle is worse than any previous cyclical downturn in terms of length and diminishing profitability. Beginning in 1978, the annual combined ratios have worsened each year. Previously, the longest consecutive period of deteriorating combined ratios was for the five-year period 1960-1964. During that period, the ratio worsened by five points; during the current cycle, it has deteriorated by 21 points.

Richard Stewart, former superintendent of insurance of the state of New York, discusses the current downturn in a December 1985 Commentary article. He writes:

> This is not just a routine turn in the underwriting cycle. It has structural as well as cyclical causes. Whereas economic inflation drove the casualty insurance crises of the mid-1970s, the current one is driven by terrible events and by changes in liability law.

Based on the available statistical information, the joint committee believes a strong case can be made for a nationwide liability insurance crisis of profitability. As the

following section will show, the nationwide crisis is mirrored by a Texas liability insurance market that is conceivably worse.

The Texas Situation

Broadly speaking, the state of the Texas liability situation is similar to that of the national market. The most fair and accurate generalization that can be made is that, compared to the national market described in the previous section, in the aggregate Texas is doing worse.

To corroborate the existence of a statewide problem, the research and information services division of the State Board of Insurance (SBI) conducted a number of research projects for the joint committee. One project analyzed the profitability of several lines of liability insurance in Texas in 1984 as expressed by the combined ratios. To enhance the credibility of the overall results, two separate sets of data were employed. One set was created by SBI from information received from insurers licensed to do business in Texas (not included are data from county mutuals, farm mutuals, or non-admitted companies. The other set comes from A. M. Best and consists of information received from all companies willing to submit their annual statements to Best.

The following table lists 1984 Texas and nation wide policyholder dividend-adjusted combined ratios (100 is the break-even point; a ratio above 100 indicates an underwriting loss):

Table II-1: 1984 Dividend-Adjusted Combined Ratios

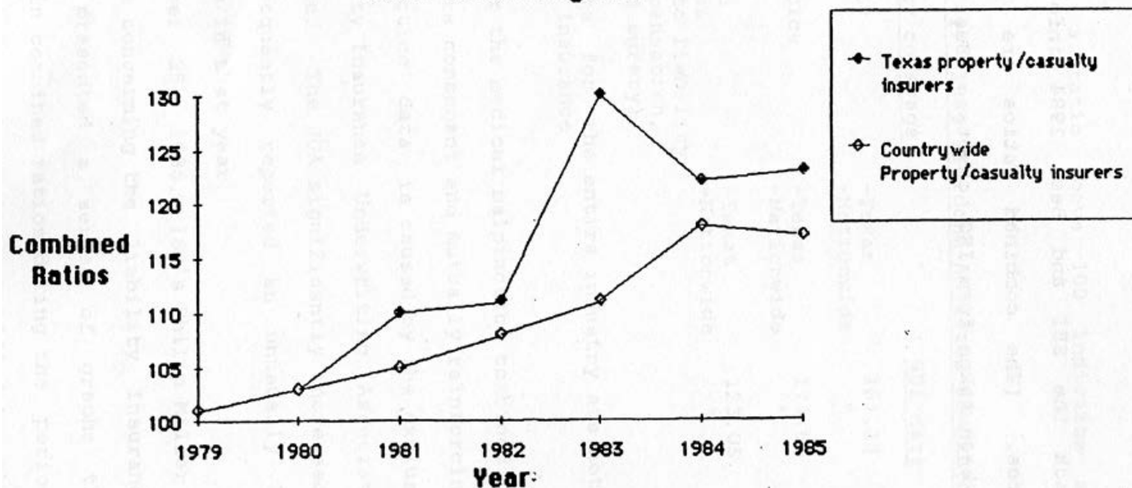
Type of Liability coverage		SBI data	A. M. Best data
General Liability	Texas	161.13	161.9
	Nationwide	*	136.15
Medical Malpractice	Texas	174.67	149.99
	Nationwide	*	159.82
All Property and Liability Lines (including auto liability, workers compensation, fidelity, and surety)	Texas	123.05	122.82
	Nationwide	*	119.34

Except for the medical malpractice combined ratios, the SBI and Best data are consonant and mutually reinforcing. The variance in the malpractice data is caused by the exclusion of the Texas Medical Liability Insurance Underwriting Association (JUA) from Best's database. The JUA significantly increased its reserves in 1984 and consequently reported an unusually large amount of incurred losses in that year.

On October 25, 1986, ISO's Philip Miller testified to the joint committee concerning the liability insurance situation in Texas. He presented a series of graphs that compare the deterioration in combined ratios during the period 1979-1985 for Texas and the U.S. as a whole. The ISO data, which are presented in Table II-2, track the SBI and Best 1984 information to a satisfactory degree. (The combined ratios are round numbers because thy have been taken from ISO charts. See charts II-2, II-3, and II-4.)

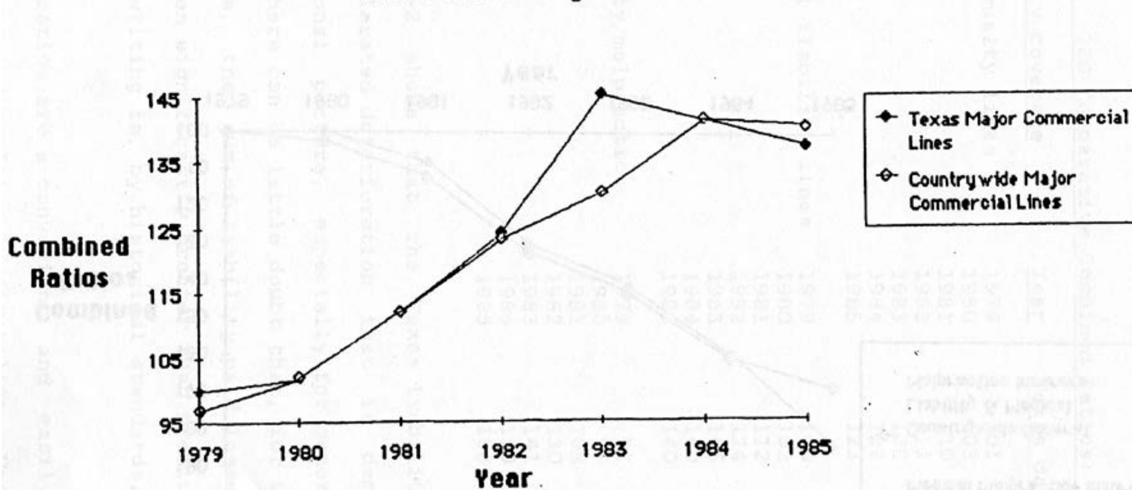
CHART II-2

Combined Ratios for Property/Casualty Insurers: Texas vs. Countrywide



(Chart prepared from Insurance Services Office data)

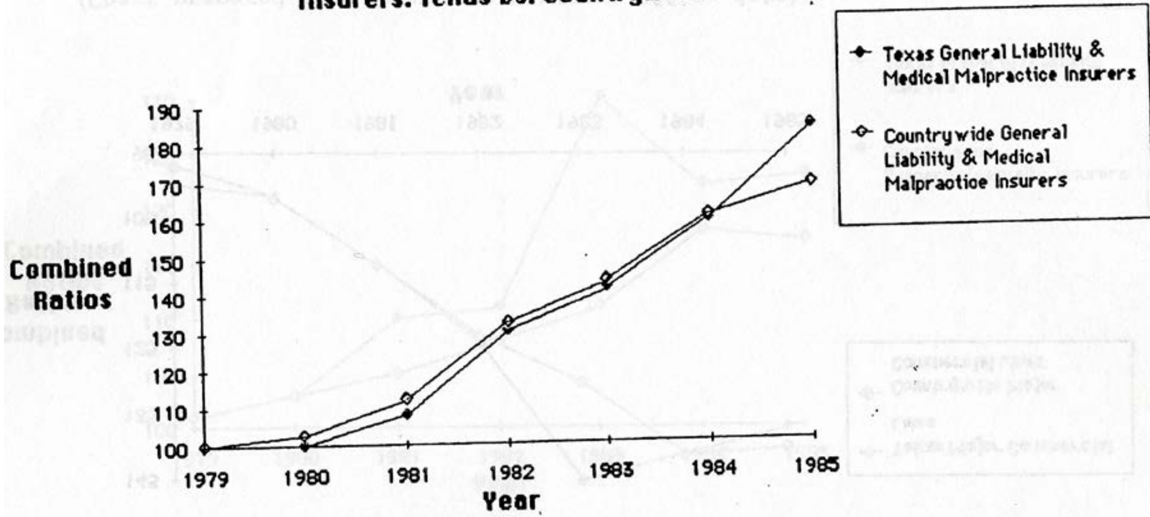
Combined Ratios for Major Commercial Lines: Texas vs. Countrywide



(Chart prepared from Insurance Services Office data)

CHART II-4

Combined Ratios for General Liability/Malpractice Insurers: Texas vs. Countrywide



(Chart prepared from Insurance Services Office data)

<u>Table II-2: ISO Comparative Combined Ratios: 1979-1985</u>

Type of liability coverage	Year	Texas data	U.S. data
All property/casualty lines	1979	101	101
	1980	103	103
	1981	110	105
	1982	111	108
	1983	130	111
	1984	122	118
	1985	123	117
Major commercial liability lines	1979	100	97
	1980	102	103
	1981	112	112
	1982	124	123
	1983	145	130
	1984	140	141
	1985	140	137
General liability/malpractice	1979	92	98
	1980	95	103
	1981	108	112
	1982	130	132
	1983	141	143
	1984	159	160
	1985	183	168

Table II-2 shows that the Texas liability market is in a pattern of accelerated deterioration that is demonstrably worse than the national picture, especially for general liability and malpractice. There can be little doubt that, for the past several years in Texas, the sum of liability paid losses, reserves, and expenses has been significantly greater than premium income. Texas liability underwriting is, by historical standards, abnormally deep in the red.

Combined ratios are a convenient and easily understandable way of describing underwriting profitability. Unfortunately, they do not reflect the pattern of overall insurer profitability (e.g., operating income) because they do not incorporate investment income.

To remedy that deficiency for 984, SBI took the Best data presented in Table II-1, incorporated investment income as a percentage of premiums, and then subtracted from the original combined ratios. The modified combined ratios that summarize operating income (excluding capital gains according to generally accepted accounting principles specifications) are reproduced in Table II-3.

Table II-3: 1984 Dividend-Adjusted Combined Ratios Modified to Reflect Allocated Investment Income

Type of liability coverage		A.M. Best Combined Ratios	Ratios with Investment Income
General Liability	Texas	169.9	122.11
	Nationwide	163.15	118.77
Malpractice	Texas	149.99*	96.47*
	Nationwide	159.82	96.57
All Property& Liability Lines	Texas	122.82	108.61
	Nationwide	119.34	101.35

*Excludes the record losses recorded by the JUA for 1984

If Table II-3 had included the JUA losses incurred in 1984, it would have been obvious that no general or professional liability line in Texas made an operating profit in 1984. That pattern is further substantiated by the negative 1984 rates of return on net worth as presented in Table II-4 (malpractice figures again fail to account for JUA losses).

Table II-4: 1984 Rates of Return on Net Worth*

Types of liability coverage		Return on net worth excluding capital gains
General Liability	Texas	-2.70%
	Nationwide	-0.40%
Malpractice	Texas	8.70%
	Nationwide	8.50%
All Property & Liability Lines	Texas	-3.50%
	Nationwide	4.60%

*Based on data provided by A.M. Best

The available statistical information, as presented in the preceding four tables, shows that Texas liability insurers have failed to avoid the crisis of unacceptably volatile industry profitability that has hurt the rest of the country. If anything, the situation in Texas, particularly in terms of general liability combined ratios and return on net worth, is even less encouraging.

It has already been suggested in this report that a chronically unprofitable insurance market will be marked by insolvencies and reduced competition. The recent failure of a significant number of admitted (regulated) Texas liability insurers to sustain profitable operating income is manifested by a growing number of insurance company failures or insolvencies.

The following is a partial list of insurance companies doing business in Texas that have been put into receivership since January 1, 1983. Underwriters that do not write property and casualty insurance of any kind have been omitted from the list. The information was compiled from the last annual statements filed prior to receivership.

Table II-5: Insurance Company Insolvencies in Texas Since 1983

Name	Texas Insureds	Admitted Assets	Premiums in Texas
ADCO Fire/Casualty	Unknown	475,492	Unavailable
Oklahoma Fire Ins. Co.	1090	3,559,426	28.10%
Pacific American Ins. Co.	5478	8,421,336	22.70%
Excalibur Ins. Co.	50	29,174,996	4.80%
Surety Ins. Co.	404	3,235,614	1.00%
Independent Standard Ins.	5000	51,870	Unavailable
Southeast Indeminty Co.	Unknown	965,067	100%
Ideal Mutual Ins. Co.	1061	160,886,527	8.10%
Commercial Standard Ins.	3405	19,701,218	0.47%
Early American Ins. Co.	107	40,535,446	8.30%
Eastern Indemnity	1212	11,227,705	23.10%
Columbus Ins. Co	950	8,258,976	28.80%
American Ins. Group, Ltd.	1484	32,467	Unavailable
United Employers Ins. Co.	Unknown	1,017,940	100.00%
Christian Organizations Med.	1844	104,272	Unavailable
Union Indemnity Ins. Co.	206	62,912,418	75.00%
Transit Casualty Co.	1644	141,093,826	6.20%
Carriers Ins. Co.	150	72,431,951	4.10%
American Fidelity Fire Ins.	153	38,286,393	17.10%
Great Global Assurance Co.	Unknown	17,379,522	3.90%
Texas Fire & Casualty Co.	Unknown	19,005,462	5.90%
Midland Ins. Co.	697	81,839,413	4.40%
Allied Fidelity Ins. Co.	Unknown	52,910,276	3.60%
National Allied Ins. Co.	4000	7,148,772	93.70%
Dexter Lloyds Ins. Co.	Unknown	609,368	100.00%

Source: State Board of Insurance

On the basis of deteriorating combined ratios, negative return on net worth, unprofitable operating income, and a growing number of insolvencies, the joint committee has concluded that liability insurers in Texas are losing their struggle to maintain financial viability and stability. Unfortunately, the preceding information fails

to tell the complete story. As the following section will show, reinsurers (providing "insurance for insurance companies") are in the most serious financial trouble. Since the prudent management of risk that is the heart of liability insurance would be virtually impossible without reinsurance, this is very bad news for Texas liability insurers and their customers.

The Reinsurance Situation

Reinsurance is an insurance transaction between a reinsurer and an insurance company that wants to manage and spread its operating risk. The insurance company pays a premium to a reinsurer. In return, the reinsurer agrees to assume liability for all or part of the financial loss that could accrue from policies the reinsurer reinsures for the insurance company. Reinsurance is purchased so that insurance companies can protect themselves from large or catastrophic losses. The typical reinsurance contract does not involve the policyholder who looks to his insurer for indemnity against loss.

According to Andre Maisonpierre, president of the Reinsurance Association of America (RAA), reinsurance contracts are custom written to meet the specific needs of various insurance companies. Despite the fact that there are no standard reinsurance agreements, it is possible to identify two basic types of contracts that are adapted to accommodate particular transactions.

A reinsurance treaty is a broad agreement that covers some portion of a particular class of business, e.g., the ceding insurer's entire book of workers' compensation or general liability insurance. On the other hand, a facultative contract covers a specific risk and requires the insurer and reinsurer to agree on each term and condition. Both treaties

and facultative agreements may be based either on a pro rata distribution (the two parties share premiums and losses proportionately) or on excess terms (where only the losses of the insurer in excess of a predetermined amount are reinsured),

The U.S. property and casualty reinsurance market is substantial. In 1984, domestic property and casualty reinsurers received approximately $10.9 billion in premiums, which is about 10 percent of all premiums received by all property and casualty companies, and unlicensed foreign reinsurers were paid an additional $3 billion in reinsurance premiums.

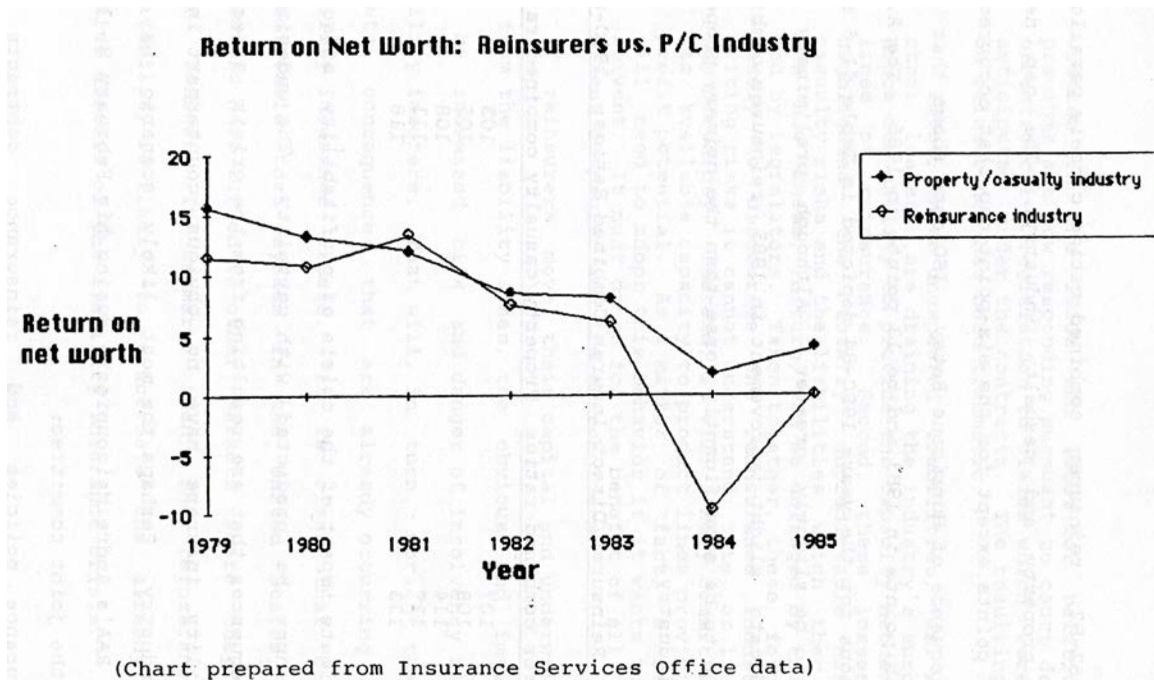
Reinsurance was developed to provide the capacity and protection essential for the financial health of the direct insurance industry. Reinsurance allows primary insurers to keep their premium volume and operating capital, as well as reduce their ultimate exposure to particular types of risk. It should be obvious that a healthy and viable reinsurance industry is a virtual prerequisite to a healthy and viable direct insurance market.

Because reinsurers indemnify primary insurers for losses paid under their direct policies, reinsurers who protect liability underwriters are affected by the same legal developments affecting the property and casualty industry as a whole. Any unforeseen development, legal, scientific, or otherwise, that increases the frequency and amount of paid losses will worsen the financial situation of the reinsurance industry. In fact, the overall effect on reinsurers is likely to be more pronounced.

In this light, it would be reasonable to expect the reinsurance industry to be experiencing profitability problems at least as bad as those in the primary liability market. That is, in fact, the case. By every reliable measure, the profitability and overall financial

stability of reinsurers has deteriorated over the past several years a t a considerably faster rate than the primary insurance market.

Perhaps the most telling statistic is the extremely poor rate of return on net worth recorded during the period 1984-85. While the rest of the insurance industry was lagging far behind the average Fortune 500 companies, reinsurers, who write even riskier policies, were lagging far behind primary insurers. (See Chart II-5.) According to Philip Miller of ISO, the rate of return on net worth for reinsurers was minus 10 percent in 1984 and zero percent in 1985, compared to 1.7 percent and 3.9 percent respectively for direct property and casualty insurers. The sharp improvement for 1985 was a consequence of restructured coverages, including more extensive use of contract exclusions and restrictions, and even sharper premium hikes than those levied by primary insurers. Despite the improvement, however, about half of the reinsurers evaluated by A.M. Best had their ratings lowered in 1985.



(Chart prepared from Insurance Services Office data)

From 1962-82, reinsurer combined ratios closely paralleled those of the property and casualty industry. The gap never exceeded 4.5 points except for the six-point gap that occurred in 1965 as a consequence of Hurricane Betsy. ISO data shows that the gap grew to six points in 1983 and to 13 points in 1985. The A.M. Best comparisons for the years 1980-84 depicted in Table II-6 show the variances to be slightly greater. Although preliminary ISO estimates indicate slight improvement in 1985, reinsurer combined ratios continue to be significantly worse than the primary property and casualty industry.

Table II-6: Reinsurer/Direct Insurer Combined Ratios: 1980-1984

Year	Reinsurer combined rates	Property/casualty combined ratios
1980	107	103
1981	108	105
1982	114	108
1983	119	111
1984	133	118

The ultimate impact of the crisis of profitability affecting reinsurers cannot be predicted with certainty. The undesirable societal consequences that are resulting from the crisis affecting primary liability insurers have no obvious counterpart in the reinsurance industry. Perhaps the most likely scenario is that described by RAA's Andre Maisonpierre during his February 8, 1986, testimony to the joint committee:

> Insurance policies and reinsurance contracts written in the 1950's and 1960's for relatively low premiums are now responding pursuant to court decisions or retroactive legislation to claims which were never anticipated under the contracts. The resulting impact on reinsurance has been traumatic.
>
> First, those unexpected liabilities, as well as other losses, are draining the industry's surplus and hence its ability to provide the capacity needed in all lines of reinsurance. Second, these losses have highlighted the totally unpredictable nature of casualty risks and the liabilities which they create and how these, in turn, can be enlarged by the courts and by legislators. Taken together, these forces are likely to discourage the reinsurance industry from writing risks it cannot understand, rate, or limit with any certainty. Instead, it will likely commit most of its available capacity to product lines providing some profit potential. As a matter of fact, a reinsurer will need to adopt this behavior if it wants to remain

solvent. It must do so for the benefit of all of its client companies and its shareholders.

If reinsurers move their capital and underwriting capacity away from the liability lines, the obvious and immediate effect will be increased risk and danger of insolvency for all primary liability insurers. That will, in turn, worsen the undesirable societal consequences that are already occurring because of an unpredictable tort system in the United States, international reinsurers have turned to other markets where they can predict their losses. In summary, then, the reinsurance crisis of profitability is likely to exacerbate the already identifiable negative effects of the liability insurance crisis.

Conclusion

To say that the current liability insurance situation in Texas is a "crisis of unacceptably volatile industry profitability" does not mean that the industry is doomed, and Texans must learn how to cope without the protections of liability insurance. Such a scenario is not foreseeable. Regardless of what action the 70th Legislature chooses to take, liability insurance will continue to be written at some price. The only pertinent public policy question is whether the benefits of legislative inaction outweigh the obvious societal costs: the identifiable and quantifiable problems related to affordability and availability of liability insurance.

If predictability is not restored to the civil justice system, and if liability insurers are not subjected to closer scrutiny and more thorough regulation, the current crisis of profitability can only be partially solved though still higher premiums and even more exclusionary policies. The longer term goals of industrywide financial viability and stability will continue to elude liability underwriters and their customers.

Part III: The Liability Insurance Industry's Financial Structure Liability Insurance Ratemaking

Liability insurance rates are determined through a complex procedure that includes sophisticated financial estimates, complicated formulas, and, usually in the case of admitted companies, statutory guidelines and state regulation.

Admitted companies in Texas are insurance companies that have complied with the requirements of state law and are authorized to write policies in Texas under the purview and regulatory powers of the State Board of Insurance (SBI). Insurers desiring to be admitted to the Texas market apply to the SBI, and the SBI admits those companies that conform to certain statutory requirements. These admitted carriers on being authorized to operate in the state must adhere to certain rate and policy requirements. Also, the financial condition of an admitted carrier is carefully monitored so that its solvency can be assumed with a reasonable degree of confidence. Liability insurance consumers who buy their policies from admitted carriers enjoy clear-cut price, coverage, and safety benefits.

Surplus lines insurers are not admitted to write insurance in Texas and consequently are not regulated or scrutinized. The fact that they are unauthorized does not mean that it is illegal for them to sell policies to Texans who wish to buy them. It only means that they are considered a peripheral or outside market with certain implied price and risk disadvantages. Surplus lines insureds often have to pay high prices for minimal levels of coverage and their policies may lack the solid financial strength inherent in coverage bought from regulated admitted companies. Surplus lines

companies do not write policies in Texas on a regular basis and those who buy coverage from them do so because they have been refused coverage from admitted companies.

In terms of the admitted market, the following types of liability coverage being considered by the joint committee fall under state ratemaking authority: most general liability lines, medical malpractice, and commercial automobile liability. Except for medical malpractice, professional liability policies are exempt from rate regulation.

The SBI figures the rates for those categories listed above that are under state regulation on the basis of the following general considerations: expected losses of the insurer (based on past and prospective underwriting experience); expected insurer expenses; and a reasonably profitable return on net worth, including premiums, probable investment income, ect. The rates have to be reasonable and adequate (i.e., sufficient to maintain insurer solvency), nondiscriminatory, and nonconfiscatory to any class of insurer.

In contrast, surplus lines insurers base their rates only on those factors or data that the insurers believe to be reliable and in their own best interests. These insurers are not required to set rates that are, in any manner or form, reasonable or adequate.

Differing systems are employed under state law for adopting or approving various types of insurance rates. The following are brief descriptions of the systems that are currently being used for some of the liability coverages under examination by the joint committee:

General Liability Coverage: Admitted general liability insurers are regulated under a prior approval system. Insurers, or the rating organizations to which they subscribe (such as the Insurance Services Office, or ISO), file their proposed rates with

the SBI. After receiving a rate filing, SBI staff reviews the proposed rates together with any supporting data, and makes recommendations to the board. The SBI must approve or disapprove the proposed rates within 30 days after they are filed or the rates will automatically be approved. However, the board has the right to extend the period of consideration for an additional 30 days. The approved rates constitute the basic rates to be used by general liability insurers.

Exceptions can be made to the basic rates. For some larger risks, an insurer may decline coverage under the approved rate and may instead offer to write the policy under a "consent to rate" method. When this technique is used, the insurer and the insured sign a consent-to-rate form agreeing to a higher rate.

Medical Malpractice Coverage: Malpractice rates are filed and approved in basically the same manner as general liability rates. The only noticeable difference is that the individual malpractice insurance company will usually file its proposed rates directly with the SBI while the general liability insurer normally employs a rating organization.

Commercial Automotive Liability Coverage: Commercial auto liability rates are set by the SBI under a state-promulgated system. The insurance board, with the assistance of its staff and an industry advisory organization, calculates its auto liability rates using data that must be filed by the insurers and other statistical information gathered by the board. The rates mandated by the board must be used by each insurer unless the insurer uses deviated rates under procedures authorized by the SBI's statutes and rules.

One of the most important financial aspects of liability insurance ratemaking is the estimating of future losses associated with a particular coverage or line of business. Insurers establish individual case loss reserves whenever a new claim is filed. The dollar amount that is set aside is a subjective estimate based on past experience and it reflects particular assumptions about changes in laws, court decisions, inflation and interest rates.

Loss reserves appear as liabilities in the annual statement filed with insurance regulators. These loss reserves, which usually constitute the insurer's single largest liability, have tremendous impact on the financial well-being and profitability of an insurer. Failure to maintain adequate reserves for future payment of claims can place an insurer in financial jeopardy and in some cases, actually threaten its solvency. Also, inadequate reserves can impact on premiums for which consumers ultimately pay. On the other hand, overestimated reserves can eventually lead to the temporarily ballooned profitability that, in turn, leads to the ability to reduce premiums. Premiums that are unrealistically low have the potential of causing sever future underwriting losses.

Insurance Industry Cyclicity

The financial stability of the liability insurance industry in determined by a number of dynamic forces: the level of interest rates, the strength of the equity and bond marked, the competitiveness of the industry as mirrored in the premium rates, the frequency and expense of claims, and judicial interpretations of compensability and fault. This part of the report examines the financial components, and Part IV will examine the impact of the civil justice system on underwriting profitability.

In theory, it is unimportant whether earnings are generated primarily through underwriting profits or investment income, so long as the industry's financial resources and liquidity are sufficient to meet all potential obligations. If there is an ideal insurer strategic approach to ensuring profitability, it can be summed up this way: profits should be maximized to the extent that the long-term viability of the company is not compromised.

The insurance industry's ability to offset underwriting losses with investment income plays an important role in the way insurance is priced. Johnny C. Finch, senior associate director of the U.S. General Accounting Office (GAO), testified before the House Committee on Ways and Means on April 28, 1986, and described the interaction of investment income and underwriting losses this way:

> For a number of years, many (property/casualty) companies have employed a pricing strategy known as "cash flow underwriting." Basically, companies have been willing to accept lower premiums for certain insurance lines in order to encourage sales and obtain funds for investment. In essence, <u>the strategy has been to sacrifice underwriting gains for investment gains</u>. (Emphasis added)
>
> The companies, however, have taken this risk because they expected to make up the premium shortfall thorough investment income. Through the increased volume of premiums resulting from (cash flow underwriting), companies were able to generate a larger amount of net cash flow which they could then invest to earn additional investment income.

"Cash flow underwriting" has been largely invisible, since the public's only direct interaction with insurance industry finance occurs through the payment of premiums and the collection of claims. While it is true that insurance is a commodity that is offered at a specific price, there is often a considerable disparity between that price and the real cost of the commodity.

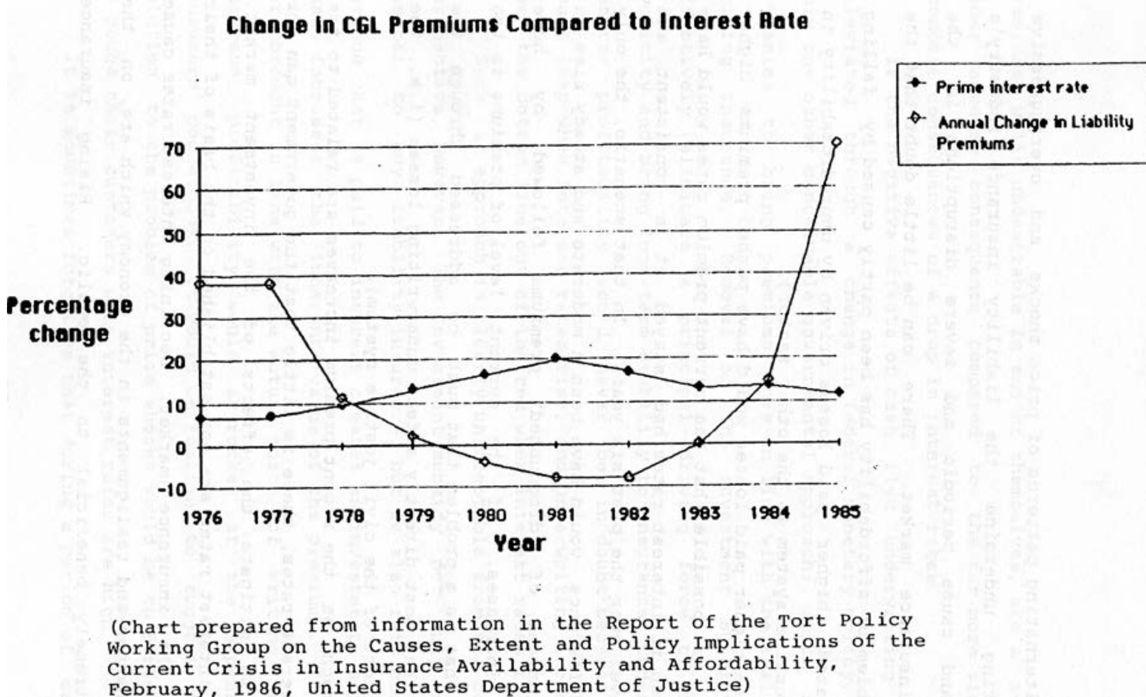
Because the public does not generally realize that underwriting losses incurred thorough discounted premiums can be more than offset by the profits earned through investment of those premiums when interest rates are high, it is natural to assume that the consumer's cost of buying insurance (i.e., the premium) reflects the trye cost of writing insurance. This misconception causes the "price shock" that occurs when investment income drops as a consequence of falling interest rates and the premium "discount" has to be abruptly ended.

The role of interest-bearing investments in the financial structure of the liability insurance industry can hardly be overstated. When interest rates are high and insurance companies can earn a substantial return on their underwriting revenue, the falling price of insurance implies a significant investment subsidy. Conversely, when interest rates fall and investment income drops, the subsidy shrinks and premiums must rise so that they are more consistent with the actual costs of operation.

Thus, it is clear that there is an inverse relationship between interest rates and the change in premium prices: as interest rates rise, premiums will tend to fall; and as interest rates drop, premiums will have to increase. This inverse relationship is illustrated by the accompanying chart (See Chart III-1), which compares the prime interest rate from 1976-85 to the annual percentage change of the Commercial General Liability (CGL) premiums written by the insurance industry during those years.

The inverse relationship between interest rates and insurance prices results in an industry cycle with unattractive ramifications. The public feels the worst effects of the cycle when premiums have to be steeply increased to offset steadily deteriorating investment income. The insurance industry feels the worst impacts of the cycle when

interest rates rise and the consequent investment opportunities drive the industry into a fierce competitiveness that pushes premiums down to an unrealistically low level.



(Chart prepared from information in the Report of the Tort Policy Working Group on the Causes, Extent and Policy Implications of the Current Crisis in Insurance Availability and Affordability, February, 1986, United States Department of Justice)

The alternating patterns of price shocks and overaggressive price cutting undermine the liability insurance industry's stability and cause periodic and severe disruptions in the liability insurance market. There can be little doubt that the current problem of affordability has been partly caused by falling interest rates (higher paid losses driven by unpredictability in the civil justice system is the other factor).

Because higher paid losses would have pushed premiums higher anyway, it is possible that the current premium rates would have resulted even if interest rates had stayed at a consistent and moderate level over the past six years. In that scenario, the only consumer difference would have been a moderate and steady rise in premiums instead of "discounted" premiums followed by huge percentage increases. If the current

level of premiums is too expensive, that is a problem that must be addressed through the mechanisms that most directly affect underwriting losses (i.e., the various aspects of the civil justice system).

Inasmuch as the recent premium increases are related to the drop in interest rates, there is little that the government can (or should) do to mitigate the effects of the investment market. Certainly, interest rates are not established on the basis of their impact on the insurance market. Declining interest rates cause numerous changes and realignments in the economy which are, on the whole, extremely beneficial to the public. Rising insurance premiums, while undesirable and in and of themselves, are a relatively minor adverse consequence compared to the far more significant economic consequences of a drop in interest rates.

If the negative effects of cash flow underwriting are not alleviated though a change in federal monetary policy, there is only one other conceivable governmental approach: force insurance companies to bring premiums more in line with the real costs of writing insurance. Removal of the investment subsidy would effectively eliminate a principal driving force of insurance cyclicity and bring long-term stability to insurance underwriting. Insurer profitability would never be in doubt because earning would leap when interest rates rise, and underwriting income would keep the bottom line out of the red when interest rates fall.

Such an approach is clearly unacceptable from the consumer's perspective, however. The investment subsidy not only makes it cheaper to buy liability insurance, but is also fair because the revenue that is paid to insurers creates an investment opportunity that increases the inherent value of the premiums. If premiums were brought

in line with the actual costs of writing insurance, insurers' profitability would skyrocket at the expense of the consumer's pocketbook. It would be foolish to suggest that one solution to the problem of price shocks would be to force insurers to gouge their customers when interest rates are high.

It is sometimes forgotten that during a period of cash flow underwriting, consumers receive a bargain on liability insurance because of this investment subsidy.

The argument that the government should not relieve the undesirable effects of cash flow underwriting through a modified approach to monetary policy, or making premiums consonant with underwriting expenses, does not imply that there are no appropriate or potentially effective legislative approaches the legislature could take with regard to the insurance industry.

The legislature could determine, through enhanced statistical gathering and research, whether there are specific elements of underwriting procedure that exacerbate the problems of availability and affordability. This is currently being accomplished with the closed claims study conducted by the State Board of Insurance (described later in this part of the report). Also, lawmakers can work to relieve the negative impacts of unwarranted or abrupt policy cancellations or nonrenewals, and adopt innovative approaches to underwriting (e.g., joint underwriting associations, self-insurance, ect.) that represent possible solutions to the systemic problems of the insurance marketplace. Recommendations along these lines will be presented in Part VI.

Addressing Particular Criticisms of Insurance Industry Finance

One of the most common criticisms of the liability insurance industry is that underwriters have dramatically increased premiums to recapture profits that were lost during the high interest rate period of the early 1980's. That criticism implies two things: prices are unfairly high at the current time, and increasing losses are not a primary cause of higher rates. Neither implication appears to be grounded in fact.

It is hard to logically support the argument that losses incurred by excessive competition have now pushed premiums up to unreasonably high levels. The liability insurance industry is very competitive, and it would be hard to realistically imagine how insurers could effectively participate in a collusive price-fixing scheme, particularly with the proliferation of reciprocal-type companies and mutuals that are not owned by their insureds. Artificially high prices are not sustainable in any industry that possesses a reasonable degree of competitiveness and has few barriers to market entry.

Even if excessive premiums were being charged by some insurers to recover past losses, other insurers could be expected to maintain their rates at levels that are consistent with market considerations and solvency requirements. Clearly, that would be the case with reciprocals and mutuals because the shareholders of those companies are also the people who pay the premiums. Reciprocal shareholders would have absolutely no incentive to burden themselves with unnecessarily high premium costs. Given a reasonable degree of industrywide competitive pressure, it would be only a matter of time before those insurers charging unfair rates would be forced either to lower their rates to the appropriate level or to tempt insolvency because of significant loss of a share of the market.

The overall competitiveness of the property and casualty industry was substantiated by the 1977 report of the Federal Task Force on Antitrust Immunities, published by the Justice Department under the title “The Pricing and Marketing of Insurance,” which reads, in part: “The property/liability insurance industry appears to possess an atomistic market structure (i.e., it is composed of many small entities). Restrictions to entry do not appear significant and (the) industry structure favors competition.” The report goes on to say that 20 insurance groups account for 53 percent of the written premiums in the property and casualty industry, no single group accounts for a major share of the market. This view of the competitiveness of liability insurance is corroborated by a 1985 study of the Florida malpractice insurance market. The report, titled “Medical Malpractice Policy Guidebook” (H. Manne, 1985), found the medical malpractice market in Florida to be “substantially and effectively competitive.”

The contention that paid losses are not forcing liability premiums higher is repudiated by a variety of statistical indexes. The ISO reports that the Gross National Product (GNP) grew 50 percent during 1979-84 while written premiums grew only 34 percent—2.4 points per year slower than annual GNP growth. Conversely, paid losses grew 76 percent—3.4 points per year faster than GNP. The Administrative office of U.S. Courts reports that product liability suits filed in U.S. district courts increased from 1,600 in 1974 to more than 13,500 in 1985 a growth rate of 22 percent a year. Very large awards have also become more common. According to Jury Verdict Research Inc., the number of million-dollar verdicts in the U.S. increased from 24 in 1974 to over 400 in 1984 (a 10-year increase of 1,566 percent). Defense costs have also increased dramatically. ISO figures show that the total legal defense bill paid by insurers on behalf

of policy holders was $5.1 billion in 1984, representing a 100 percent increase from 1979. The rising ride in liability insurer paid losses in documented in greater detail in Part IV of this report.

Some insurance industry critics have argued that the omission of both realized and unrealized capital gains from operating income is a deceptive accounting practice that obfuscates the true financial strength of liability insurers. They say that any revenue that is generated through the investment of premiums, including actual or potential profits from the sale of stocks or bonds (i.e., realized and unrealized capital gains), should be added to the investment side of operating income so that a complete picture of overall profitability can be attained.

Incorporating realized or unrealized capital gains into operating income would flatly contradict generally accepted accounting principles. Those principles, as written in the Financial Accounting Standards, state that gains and losses accrued from the sale of any investment (including, but not limited to, stocks, bonds, mortgage loans, real estate, and joint ventures) should be reported in the income statement below operating income and net of applicable income taxes. Similarly, changes in unrealized gains and losses cannot be included in the summation of net income. The underlying rationale is that if unrealized capital gains or losses were included in net income, violent fluctuations in profitability that have no basis in completed transactions would result.

On the face of it, a plausible argument can be made that the omission of capital gains from the investment income component of operating income results in an incomplete rendering of overall insurer profitability, but because generally accepted accounting principles specify that operating income should not include realized or

unrealized capital gains, the argument is moot. Additionally, as was shown in Part II, capital gains are not a dependable or consistent source of revenue. If they were included in operating income, the actual result would be a somewhat distorted picture of the long-term financial strength of the insurance industry.

Skeptics of the liability insurance crisis say that the industry's recent showing in the stock market is evidence that the industry's recent showing in the stock market is evidence that the problems of affordability and availability are either exaggerated, or the consequence of industry wide profit and loss manipulation or deceptive financial practices. To put it another way, they say that the strong rise in insurance stocks reveals the liability insurance crisis as a fraud.

Specifically, they point out that property and casualty stocks rose in value by 50 percent during 1985, double the increase of the Dow Jones Industrial Average. A.M. Best characterized this leap as "the most spectacular performance by a component of Best's Insurance Stock Index" and further stated that this advance "showed renewed confidence by investors after lesser gains" in 1984.

The fact that property and casualty stocks have significantly outperformed the broader market is no indication that the industry is either profitable or financially healthy. It does mean that investors apparently anticipate future improvement in the rates of return for property and casualty companies, but that is not surprising considering how low the rates of return were in 1984 and 1985. Still it is important to emphasize that investors' expectations are merely that: expectations. They do not mirror the status quo as it currently exists, nor do they imply the certainty of future renewed profitability.

The argument that a strong showing by a particular industry in the stock market proves that that industry is healthy revels a fundamental misunderstanding of the dynamics that drive equity trading. Investors buy particular stocks because they assume that the prices of those stocks will eventually go up. If the price of a stock fully captures the underlying value of that company, purchasing the stock would be an act of foolishness. Fully valued stocks generally have nowhere to go but down. On the other hand, if an investor believes that the fortunes of a beleaguered company or industry are in the process of being turned around, the investor will buy that stock because its price will, in all probability, rise.

The fact that the stocks of property and casualty insurers have outperformed the broader market merely reflects the following three possibilities: the stocks were substantially underpriced relative to their full potential, based on assumptions that the insurance market was stronger or that profits would rebound; some investors assumed that the worst of the profitability crisis was behind them; and other investors may have believed that the crisis of profitability meant that premium revenue could rise even further because the naturally strong competitive pressures of the liability insurance industry were being partially suppressed. It is possible that liability insurers are moving in the direction of renewed profitability, and the industry is on the brink of a strong cyclical rebound. But that does not in any way imply that the crisis of volatile profitability has been exaggerated. Nor does it prove that the negative effects of liability insurance affordability or availability problems are the result of an industrywide fraud.

The Texas Closed Claims Study

It became apparent to the joint committee early in the hearing process that accurate statistical information concerning the paid losses of Texas liability insurers was available only on a very limited basis. Consequently, the joint committee requested that the SBI undertake a study that would render a more complete picture of liability underwriting losses in Texas. The SBI agreed to formulate a closed claims study. The study is in its final stages and the SBI has promised that the results will be made available to the legislature by January 15, 1987.

The closed claims are liability claims that have been concluded (i.e., the claim has been closed). The claim has been paid, settled out of court, or dropped by the plaintiff, or a court judgment has been finalized. A closed claims study accumulates information from individual claims files and addresses questions related to litigation, settlement trends, and claims costs.

According to testimony given by SBI Chairman, Lyndon L. Olson, Jr., the closed claims study is not directly related to liability insurance availability or affordability problems. Similarly, it cannot answer why a particular risk or class of risks is vied a s undesirable by liability underwriters. It is also not a financial analysis of the liability insurance industry.

The closed claims study does answer questions related to venue (location of claims filings); joint and several liability; the amount paid in defense costs; the actual amounts of prejudgment interest and punitive damages on settlements; the percentage of cases involving attorneys; the state of the legal system that most frequently results in settlements or awards; the average settlement or award; the scope and frequency of

noneconomic damages; and whether any of these factors are different for the liability insurance classes that have reported the most difficulty with availability.

Approximately 150 liability insurance companies are participating in the closed claims study, representing 73-75 percent of the total liability insurance market in Texas. The study encompasses claims closed during the period 1983-86. The following list indicates the parameters of the claims eligible for the SBI's research:

1. Lines of insurance coverage (only bodily injury claims will be reported);
    a. General liability
    b. Medical malpractice (hospitals only)
    c. Commercial auto
2. Time periods: all eligible claims filed during the months of November through February for the period 1983-86 and the months of July through October 1986.
    a. Size of claim payment:
        i. General liability and medical malpractice claims of $25,000 or greater will be collected for all of the periods; all claims, regardless of size, will be reported only for September and October 1986.
        ii. Commercial auto claims of $25, 000 or greater will be collected for all the periods.
    b. Defense costs: when the claim payment threshold eliminates a claim, another threshold of $10,000 in defense costs will be used to make that claim eligible (so that a wide cross-section of defense costs will be

used to make that claim eligible (so that a wide cross-section of defense costs can be accumulated).

The actual extent and scope of liability insurer paid losses in Texas will be much more in focus after the closed claims study is submitted to the legislature. The insurance recommendations listed in Part VI reflect the joint committee's current understanding of the financial underpinnings and underwriting procedures of the liability insurance industry. The need for additional approaches to insurance regulation or legislative oversight may become apparent after the SBI report has been sufficiently reviewed. However, it must be emphasized by the joint committee that regardless of the results of the closed claims study, the tort reform recommendations contained in this report are necessary to restore loss predictability, inject fairness and fault-based compensation into the tort system, provide a stable legal environment in which reinsurers can place their capital, and reestablish the constitutional prerogative of the legislature to make tort law.

The Liability Insurance Crisis in Texas: The Availability Problem

The medical malpractice insurance crisis in the mid-1970's was basically an availability problem: numerous doctors whose insurance was canceled could not locate other sources of coverage. Because of prior legislative action (e.g., the joint underwriting association), the current availability quandary is not as dramatic. In most instances, given the proper use of the available market or state resources, liability insurance consumers can eventually find at least basic levels of coverage. The current availability problems relates to shortages of certain kinds of policies written my admitted carriers, or lapses in coverage that occur when policies are summarily canceled or not renewed.

Texas liability insurance consumers who are unable to obtain coverage from the admitted market, and are forced to buy their policies from surplus lines insurers, frequently pay higher premiums and must sometimes cope with unsatisfactory limited or restricted amounts of coverage. Additionally, there is always justification for a lack of complete confidence in the capacity of surplus lines insurers to fulfill their contractual responsibilities.

Some of the effects of the lack of availability of liability insurance are being manifested through substantially increased use of surplus lines carriers. Liability insurance consumers buy their coverage from surplus lines companies only when they are effectively barred from buying coverage in the admitted market. The growing use of the surplus lines market is a clear indication that the admitted market is becoming increasingly restrictive.

The total volume of surplus lines premiums written for 1983 (all lines) was $244,660,205, increased to $278,984,944 in 1984 and skyrocketed to $478,860,441 for 1985. In percentage terms, surplus lines volume rose by nine percent in 1984 and 67 percent in 1985. The SBI cannot determine the actual amount of surplus lines coverage written for commercial general liability lines because its surplus lines data is not recorded by underwriting category. Nevertheless, the fact that the entire surplus lines market increased by two-thirds in 1985 has to reflect growing constraints on the admitted liability insurance market.

Another sign of the growing unavailability of certain types of liability insurance is the use of the Texas Commercial Liability Market Assistance Program (MAP). The MAP was created by the State Board of Insurance on March 18, 1986, and it is a

temporary partial solution to the liability insurance availability problem. The MAP is a voluntary market of last resort for placement of general liability and commercial auto insurance for the following risks: governmental liability, excluding pollution risks; day care centers; directors and officers; medical malpractice risks not eligible for the joint underwriting association (JUA); product liability; liquor liability; nonprofit organizations; commercial automobile coverage required by law and unavailable through the Texas Assigned Risk Plan.

The MAP concept is quite simple: any Texas business, individual, or governmental entity that falls within the definition of one of the above categories, and that has been refused coverage by at least three insurers, including one surplus lines agent, may apply for MAP liability insurance assistance. The MAP cannot guarantee coverage because it is strictly an assistance program and not a liability insurer. In addition, it is assumed that there may be some liability risks that are uninsurable, given the current insurance and civil justice conditions.

Since its inception, the MAP has received 108 applications for assistance. The following is a breakdown of the applications by type of coverage requested:

--Product liability coverage: 30
--Directors and officers liability: 19
--Governmental entities: 16
--Commercial auto liability: 14
--Day care centers: 8
--Other: 21

The SBI reports that the two liability insurance classes that appear to be having the greatest difficulty obtaining coverage at the present time are directors and officers, and governmental entities.

The need for the MAP program and the increasing use of surplus lines carriers indicate a broad-based problem of availability in the admitted liability insurance market. As more and more insureds are forced to turn to alternative methods of coverage, overall insurance costs will rise even higher and undesirable policy restrictions, such as exclusions or tighter limits on coverage will become more common.

The Liability Insurance Crisis in Texas: The Affordability Problem

The liability insurance affordability problem is a subtle concept and one that is difficult to precisely define. Liability insurance that is not affordable is not insurance whose cost literally prohibits purchase. Liability insurance continues to be bought by a wide variety of entities and individuals even though its cost is extremely high because protection against unpredictable potential losses is a necessity.

The affordability problem is that the price of the coverage some of the more obvious and problematic affordability situations that currently exist in Texas.

List 1: The average chance in medical malpractice premiums in Texas
(Source: Opinion Analysts*)

Category	1985	1986	Increase
All respondents	5,450	6,660	22%
Anesthesiology	10,010	13,380	34%
Family/General	3,730	4,460	20%
Internal Medicine	1,990	2,450	23%
Neurosurgery	17,200	20,110	17%
OB/GYN	12,060	14,280	18%
Orthopedic Surgeon	13,330	15,500	16%
Other Surgery	8,620	10,540	22%
Pediatrics	1,810	2,480	27%
Other	3,280	4,060	24%

*This information is derived from a major survey of Texas physicians described

The rate changes for the Texas Medical Liability Insurance Underwriting Association (JUA) have been considerably worse across all specialties. The JUA is a self-supporting and non-profit residual market for malpractice insurance made up of

every insurer authorized to write malpractice insurance in Texas. The JUA assumed 11.9 percent of the medical malpractice insurance written in Texas during 1985. The JUA is not intended to compete with the voluntary malpractice market but is rather a market of last resort for physicians who, because of a past history of claims, cannot purchase insurance from any other carrier. Consequently, the rates are much higher than those charged in the voluntary market (generally 25-40 percent higher, depending on practice specialty, liability limits, or location of practice).

The JUA was granted an emergency 50 percent rate increase in May 1985. It requested a 153 percent increase in 1986 and was granted approximately a 100 percent increase. In other words, the physicians who are forced to insure through the JUA have experienced a 150 percent increase in their malpractice premiums over a 16-month period. That is clearly outside any reasonable definition of affordability.

The average premium rate changes presented in List 1 are not nearly so dramatic, but in certain instances the value of the 1986 premium represents a potential operating expense that is not affordable. The most evident example of an affordability problem from List 1 is the 1986 OB/GYN premium of $14,280. That premium is charged against any physician who delivers babies (family doctor or full-time obstetrician). It would be hard to imagine how a family doctor operating in a nonmetropolitan area could absorb the difference between Family/General premium and the OB/GYN premium that is incurred by a marginal obstetrics practice.

League's Liability Insurance Program (Source: TML)

City	Population	FY 85 premium	FY 86 premium	Increase
Addison	6,217	80,953	258,620	219%
Alice	21,974	57,196	184,188	222%
Baytown	61,370	179,908	454,244	152%
Beasley	486	2,214	5,575	152%
Blanco	1,245	6,419	16,371	155%
Borger	17,470	56,379	121,664	116%
Brownwood	19,715	81,821	258,078	215%
Childress	5,912	24,803	67,318	171%
Cleburne	20,149	93,461	198,527	112%
Deer Park	23,981	152,686	288,012	89%
Dripping Sprgs.	678	1,717	5,180	202%
Euless	26,779	72,832	198,604	169%
Grey Forest	408	9,304	45,297	387%
Hidalgo	2,467	14,705	40,955	179%
Katy	8,159	53,220	103,943	95%
Killeen	50,559	138,744	333,585	140%
La Grange	4,360	22,621	48,561	115%
Laredo	99,874	241,363	598,532	148%
Lockhart	8,379	34,786	140,755	305%
Marble Falls	3,669	17,230	48,169	180%
Mineola	4,854	7,813	20,929	168%
New Braunfels	23,810	40,566	151,381	273%
Odessa	102,465	336,023	847,337	152%
Orange	24,278	105,746	227,389	115%
Pantengo	2,457	24,769	92,145	272%
Paris	25,483	87,011	206,533	137%
Pflugerville	866	8,216	23,105	181%
Port Aransas	2,212	33,455	64,512	93%
Rancho Viejo	198	2,861	8,301	190%
Robstown	12,948	25,091	55,322	120%
San Benito	19,270	37,096	102,776	177%
Stratford	1,891	8,372	18,672	123%
Vernon	12,808	45,199	84,390	87%
Webster	2,596	23,456	71,103	203%
Willow Park	1,323	2,152	11,659	442%
Winnsboro	3,576	17,647	33,170	157%

List 2 is abbreviated and fails to render a complete picture of the effect of the liability insurance crisis on local government. Nevertheless, it does demonstrate that the impact of liability insurance price shock is not restricted to a particular geographic region of the state, nor is it limited to municipalities of a particular size or composition. City councils all across the state are being severely affected.

According to Texas Municipal League testimony, 151 of the cities participating in its liability insurance program experienced liability insurance increases of at least 50 percent in 1986. The populations of the affected municipalities ranged from 198 (rancho Viejo) to 123,477 (Beaumont). Over the past four years, 109 municipal governments have had their liability insurance premiums increased by a cumulative percentage in excess of 120 percent.

Nonprofit organizations are also feeling the effects of the liability insurance affordability problem. For instance, Lila Coughran, of the Capital Area Easter Seal Rehabilitation Center (CAESRC) in Austin, told the joint committee that the CAESRC saw its professional liability premiums increase 100 percent and its van insurance almost quadruple during the past year. Nine other Texas Easter Seal Society affiliates in Texas have also had their various liability insurance policies increased by percentages ranging from 54 percent to 1,000 percent during the past 12 months. The Gulf Coast Easter Seal Society's transportation liability increase was so severe that the organization was forced to discontinue its shuttle service. As a result, approximately 50 clients are now unable to get to their therapy or recreation programs. It should be noted that none of the Texas Easter Seal Society affiliates have had trouble with lawsuits during their 40-year histories.

The legislature should not be concerned about liability insurance affordability or availability simply because it is wreaking havoc with certain health care providers, municipal governments, day care centers, or nonprofit organizations. The legislature should be concerned because liability insurance affordability and availability is harming

society as a whole in vary specific ways. Those harms are documented in Part V of this report (along with other examples of the affordability problem).

Part IV: The Liability Insurance Crisis and Tort Reform

The Importance of Predictability

While the problems plaguing Texas liability insurers and their customers are partly the result of aggressive competition and the cyclical nature of the industry, as described in Part III of this report, the industry has also been a victim of fundamental changes in tort law over the past several years. Unusually high jury award, court construction of liability policies far beyond their original intent, and activist courts have created a legal environment of unpredictability. Far-reaching decisions by the Texas Supreme Court, redefining the parameters of risk and liability, have eroded the ability of insurers to accurately predict the frequency and magnitude of their losses. Without reasonable predictability in the law, stability, availability and affordability in the liability insurance market remain elusive goals.

Unlike other forces that affect the liability insurance industry over which the legislature has no control, such as the fluctuations of the stock and bond market or the income earned on insurance industry investments, the legislature can play a crucial role in restoring a reasonable amount of predictability to the civil justice system. Changes in the law can directly affect both the number of suits brought and the potential value of those suits. While fully respecting the rights of injured persons, the legislature can do much to force down the number and cost of future liability claims by enacting "tort reforms."

Liability insurers face a particularly complex problem of predicting the frequency and cost of future obligations under the best of conditions because of the occurrence-type

coverages, a liability insurer must make predictions that begin with all incidents that may occur during a policy period and end with the filing of all claims related to those incidents.

According to the Reinsurance Association of America, only 25 percent of the losses that will eventually arise out of a given policy year are normally paid in the first three years after the end of the policy year. Only about half of the losses will be paid after five years. On average, it takes about 10 years for all possible claims to be file against an occurrence-based liability insurance policy. This means that current pricing or coverage decisions are not proven financially beneficial or harmful until many years have passed.

If assumptions about the future prove reasonably correct, the stability and solvency of the liability insurance industry is sustained. If, because of unforeseeable changes in the civil justice system or unprecedented largess on the part of juries, the assumptions prove to be inaccurate, both the stability and solvency of the industry is threatened. The end result may be shortages of coverage and sharply higher premiums. In order to avoid being overwhelmed by unforeseen losses, liability insurers must be able to rely on a reasonable degree of predictability within the civil justice system.

When one examines the generic process of insurance underwriting, it quickly becomes apparent that no concept is more important than predictability. Insurers base their projections of future losses on the historical record. Estimates on future losses are predicated on the assumption that the past is a reasonable predictor of the future. If future loss patterns are frequently disrupted by increases in the number of claims, or by

changes in the nature of those claims, the whole notion of insurance (i.e., the management of risk) becomes risky itself.

Far-reaching decisions by the Texas Supreme Court have redefined many of the basic tenets of the tort law in a way that has increased the unpredictability of the Texas civil justice system. As a consequence, the availability and cost of liability insurance has been adversely affected. Insurers are concerned about potential unforeseen past liability, the magnitude of future liability based on the possibility of more redefinitions of tort law by the supreme court, and the increasing propensity of the supreme court to push tort law in a direction opposite to that clearly indicated by the legislature.

As long as insurers are unable to predict the frequency and magnitude of their future losses with a reasonable degree of confidence, stability and affordability in the liability insurance market remain elusive goals. This is why restoration of predictability to the Texas civil justice system must be the ultimate objective of legislative attempts to contain the serious and negative effects of the liability insurance crisis.

Specifically, the following aspects of Texas' civil justice system should be addressed through well-considered reforms of tort law: the steady increase in the frequency and cost of personal injury suits should be slowed or halted, legal interpretations of fault and compensation should once again be based on consistent application of historical precedents, and a reasonable balance of influence over changes in tort law should be achieved between the legislative and judicial branches.

The liability insurance crisis also impacts economic development. Rapidly rising insurance premiums raise the costs of doing business and consume financial resources that otherwise would be available for growth and expansion. The unavailability of

adequate coverage at reasonable rates compels existing businesses to reduce or discontinue manufacturing certain product lines. At the other end of the business life cycle, eight out of 10 new businesses fail within the first five years. While many factors affect business failures, the rising cost of liability insurance exacerbates the economic mortality rate. At a time when Texas must promote economic development to diversify its economy, the liability insurance crisis dampens economic growth and business and job creation. By passing meaningful tort reform, Texas could create a business climate that attracts new businesses and encourages the growth and expansion of existing enterprises.

The Case for Change: Increases in Frequency and Cost of Liability Claims

The Texas state agency that monitors court activity is the Office of Court Administration (OCA). The OCA tracks civil cases through a statewide filing system that divides personal injury cases among those involving a motor vehicle, those not involving a motor vehicle, and workers' compensation. The following table shows the growth of district court civil cases filed between 1980 and 1985.

Year	Auto per. Injury	Other per. Injury	Worker's Comp.	Total Civil
1980	14,750	12,767	7,847	322,546
1981	14,167 (-4%)	13,495 (+5.7%)	8,455 (+7.7%)	335,020 (+3.9%)
1982	14,700 (+3.8%)	14,565 (+7.9%)	8,269 (-2.2%)	342,146 (+2.1%)
1983	15,835 (+7.7%)	45,580 (+7%)	8,702 (+5.2%)	344,956 (+.8%)
1984	16,754 (+5.8%)	16,387 (+5.2%)	7,750 (-10.9%)	357,576 (+3.7%)
1985	18,126 (+8.2%)	18,352 (+12%)	8,130 (+4.9%)	371,024 (+3.8%)
Change 1980-85	22.90%	43.90%	3.60%	(-15.1%)

Table IV-1 demonstrates the disproportionate increase in non-motor-vehicle personal injury cases relative to the other types of injury cases and the civil docket as a whole. To put numbers in proper perspective, they must be compared with the rise in state population during that period. According to the census bureau, the Texas

population grew from 14,299,191 in 1980 to 16,370,000 in 1985 – an increase of 15.04 percent. The growth in all civil cases is virtually identical to the growth in total state population. However, nonautomotive personal injury filings—the cases that would directly affect the cost and availability of the lines of liability insurance under consideration by the joint committee—increased threefold when compared to the population during the five-year period.

Table IV-1 provides convincing evidence that the number of liability filings in Texas is growing at a disproportionate rate relative to the population and all other civil cases. However, this does not necessarily prove that the cost of writing liability insurance—the paid losses—has also increased at a disproportionate rate. If the sharp rise in the number of filings did not result in a commensurate rise in paid losses, it could not be argued that the changes in the civil justice system are a basic cause of the liability insurance industry crisis.

The most appropriate measure of comparison with paid losses is the growth of the economy as reflected in the Gross National Product (GNP). The GNP indicates relative strength of the economy in terms of output and purchasing power. When paid losses grow much faster than the purchasing power inherent in the economy, shortages and affordability are almost inevitable.

Data from the Insurance Services Office, Inc. (ISO), show that paid losses in the United States have risen at rates that are definitely out of sync with the increase in GNP. During the period 1979-1985, the GNP grew approximately 59 percent, while total property and casualty paid losses grew 100 percent. The liability lines fared considerably worse. Commercial liability paid losses increased 179 percent during the period, and

general liability lines increased 234 percent – almost quadruple the growth of the economy.

The situation in Texas is even worse. The ISO compared Texas paid losses to countrywide paid losses and GNP growth. The data is presented in Table IV-2.

TABLE IV-2: TEXAS PAID LOSSES 1979-85

Insurance type	GNP growth	Growth in U.S. paid losses	Growth in Texas paid losses
All property/casualty	59%	100%	140%
Commercial liability	59%	179%	258%
General liability	59%	234%	395%*

The validity of comparing Texas figures to national economic growth was verified by examining the growth in retail sales in Texas and the United States as a whole. Over the six-year period, Texas retail sales grew 60 percent while countrywide retail sales grew 53 percent. Although the Texas economy showed greater purchasing power than the country as a whole, the difference is smaller than the difference between U.S. and Texas paid losses.

The largest portion of the enormous rise in Texas general liability paid losses occurred between 1982 and 1985. During those three years, paid losses nearly tripled. 1984 was a particularly harsh year, with paid losses jumping over 70 percent.

A Case for Change: High Court Activism

Justice Oliver Wendell Holmes once said, "the tendency of the law must always be to narrow the field of uncertainty." The clearest-cut obstacle the insurance industry faces in its efforts to "narrow the field of uncertainty" in the Texas civil justice system appears to be the Texas Supreme Court.

The activism of the Texas Supreme Court over the past several years in restructuring the Texas civil justice system has already increased its unpredictability. On

more than one occasion, the court in one day has overturned a hundred years of established law.

Traditionally, the separation of powers doctrine provides that the legislature makes law and the courts interpret law. Critics of the current supreme court allege that the court has strayed too far into the business of making, rather than interpreting, law.

The issue of whether the court has become too active in making law is of fundamental importance to the system of checks and balances that the Texas Constitution creates between the executive, legislative, and judicial branches of government. Laws are to be written and enacted by elected representatives and senators, approved or vetoed by the governor, and interpreted as necessary by the supreme court. The public is granted access to the legislative process not only by electing representatives and senators, but also by participating in the full legislative process: public hearings, testimony, correspondence, personal visits, membership in interest groups. Additionally, the public has the right to provide input to the governor on whether a veto should be exercised. When the supreme court engages too frequently in lawmaking of its own, citizens have no opportunity to participate, and the checks and balances inherent in a bicameral legislative system with executive veto powers are circumvented. Many of the changes in the civil justice system adopted by the supreme court in recent years failed to clear the roadblocks inherent in the legislative system.

Major changes in the law are constitutionally intended to come about through the elaborate legislative process and not by the vote of supreme court justices. Citizen control over the legislative process, which is at the heart of the democratic process, is dangerously eroded when the supreme court decides to legislate. To assure the viability

of the tort reforms recommendations and to guarantee that the proper hearings and public debate that exist in the branch of government that should make the law are not ignored, a constitutional amendment is recommended by this committee in part VI of this report.

The following four cases, which have significantly changed legal concepts of compensability, are frequently cited as examples of unwarranted supreme court intrusion into the legislative arena. They are also cases that have had a clearly negative impact on liability insurance underwriting.

1. Sanchez v. Schindler, 651 S.W.2d 249 (Tex. 1983)

Eugene and Angelica Sanchez brought a wrongful death action against Charles Schindler and his parents for the death of their minor son, Johnny Sanchez, arising out of a collision between the plaintiff's motorcycle and the defendant's pickup. Although the jury found that Mr. and Mrs. Sanchez had not sustained any economic loss from the death of their son, the jury nevertheless awarded them $102,500 for mental anguish.

The district court would not allow the damages for mental anguish, and the court of appeals affirmed the district court's ruling. The seminal question of the case, as argued before the Texas Supreme Court, was whether Texas should continue to observe the pecuniary loss rule, providing that damages other than for economic loss are not allowed for the wrongful death of a child.

The supreme court reversed the rulings of the lower courts. Justice Spears, writing for the majority, held that: "a plaintiff may recover under the wrongful death statute for loss of companionship and society and damages for mental anguish for the death of his or her minor child; recovery in such cases is no longer governed by the

pecuniary loss limitation . . . ." The decision reversed the interpretation of the Texas Wrongful Death Act, adhered to for more than a century, initially take by the supreme court in March v. Walker, 48 Tex. 372 (1877). The court reasoned: "It was logical for the Texas Supreme Court to now act I response to the needs of a modern society, and to abolish that antiquated rule [pecuniary loss rule] in favor of recovery of loss of society and mental anguish; the responsibility of changing recover under the wrongful death statue did not belong to the Texas legislature."

Those who criticize the Sanchez decision do not necessarily favor the pecuniary loss rule. Indeed, a very good case can be made for mental anguish compensation in a wrongful death action involving a child. Rather, critics say that the court clearly trespassed on the legislature's territory. Justice Spears addresses this contention in his opinion as follows:

> The legislature has attempted to amend the Texas Wrongful Death Act to allow damages for loss of society and mental anguish; however, none of the bills have passed. This court should not be bound by the prior legislative inaction in an area like tort law which has traditionally been developed primarily through the judicial process.

Justice Spears emphasizes his point by citing a Michigan court case: "A legislature legislates by legislating, not by doing nothing, not by keeping silent."

This argument by the majority of the supreme court that the court has the right to make law if the legislature refuses to act mystifies the court's critics. To them, it is an open admission that the court is, in fact, improperly legislating.

What weakens the court's argument is that the Sanchez decision was rendered at the very time the legislature was considering legislation that would have amended the wrongful death statute to allow for noneconomic damages in the event of a child's death.

The court's decision was published April 27, 1983. On April 6, 1983, the House Judiciary Committee passed C.S.H.B. 800 by a vote of 8-0 and one present and not voting. C.S.H.B. 800 was being considered on the house floor the very day the supreme court made its ruling.

A reading of C.S.H.B. 800 makes it clear that the legislation would have had the same effect as the Sanchez decision. The following is an excerpt from the bill:

> [Section 2b] In a suit . . . brought by a parent for the death of an unmarried child younger than 22 years of age, the parent is entitled to recover, in addition to actual damages, damages for mental anguish, emotional pain and suffering, and loss of companionship, comfort, protection, attention, advice, counsel, love, and affection resulting from the death of the child. In a suit . . . for the death of a husband or wife, the spouse is entitled to recover, in addition to actual damages, damages for mental anguish, emotional pain and suffering, and loss of companionship, comfort, protection, attention, advice, counsel, marital care, consortium, love, and affection resulting from the death of the husband or wife.

It is clear that the court was aware of the pending legislation, because the legislation is specifically referred to in the dissent by Chief Justice Pope: "House Bill 800 has been reported favorably from a House committee. While the majority may be impatient with what they consider a less desirable statutory policy, I would adhere to settled principles of statutory construction." The supreme court simply chose to preempt the legislature by ignoring it, and forging ahead with their own lawmaking.

The chief justice, with Justices McGee and Barrow concurring, goes considerably further with his argument against the court's position that legislative inaction is an invitation to courts to become involved in legislative policy matters. He writes:

> This rule assumes that repeated unfruitful efforts to amend the Texas Wrongful Death Statue . . . are proof of inaction . . . . The legislature's refusal to vote on the many proposals to change the measure of damages is an opinion of that branch of government that there is no pressing need to change the present law. Legislatures act affirmatively and negatively; but in either instance, the

> legislative will is expressed. For us to ignore defeated legislation is as misleading as it would be for a court to reject from our common law decisions those cases which hold for the defendant.
>
> The new rule authorizes judicial resolution of policy matters of great public import without benefit of or compliance with ordinary checks and balances, open meetings limitations, public hearings, democratic legislative debate, a bicameral consideration, and executive veto, or other legislative safeguards. It is one thing for a court to decide that an interpretation of a statute is erroneous; it is quite another and more serious matter for a court to decide that a statute is unwise. I would respect the separation of powers and exercise judicial restraint before entering a policy field where our judgment is at best a minority subjective decision. [Emphasis added]

Chief Justice Pope's dissent demonstrates that the court considered the matter of legislating by court decision during consideration of the Sanchez case. The chief justice's arguments, combined with the peculiar timing of the decision (coming during house consideration of H.B. 800), strongly support the notion that Sanchez was, at best, an imprudent exercise of judicial authority and, at worst, a clear usurpation of the legislature's lawmaking prerogative.

Sanchez is also a serious blow to predictability in liability insurance. The decision made liability underwriting less predictable not because it expanded plaintiff compensability but because it demonstrated the supreme court's refusal to abide by legislative checks or respect historical precedents. Insurance actuaries are less able to confidently predict future losses not because the pecuniary loss rule is no longer applicable—in fact, it is reasonable to assume that the insurance industry had a good inkling that changes in the wrongful death statute were probable during the 68th Legislature—but because they cannot foresee the probable effects of future supreme court rulings on civil justice law.

Predictability cannot be restored to liability insurance underwriting as long as the supreme court renders decisions based on the notion that legislative inaction confers on a majority of the court the right to make law. Supreme court rulings may be abrupt, dramatic, and entirely unforeseen. Insurance company actuaries simply cannot foresee a decision like Sanchez. Reasonable interpretations of historical precedents, combined with the obvious prerogative of the legislature to amend the wrongful death statute, made such a decision highly unlikely. Nevertheless, it occurred.

The next three cases are similar to Sanchez in their adverse impact on predictability in liability underwriting and the balance of power between the judicial and legislative branches. These three cases reverse the explicit will of the legislature, create new law, redefine compensability or liability, and erode the ability of insurance companies to operate in a stable financial environment of foreseeable paid losses.

2. Cavnar v. Quality Control Parking, 696 S.W. 2d 549 (Tex. 1985)

On November 17, 1978, Geraldine Cavnar was hit by a car driven by a valet in a nightclub parking lot. She sustained serous injuries that resulted in her death eight days later. Her children brought suit under both the Texas Wrongful Death Statute and the Texas Survival Statute. The jury awarded approximately $1.5 million to the Cavnar children and the Cavnar estate. The trial court refused to allow damages for loss of companionship and prejudgment interest. However, the court stated in its judgment that it would have allowed recovery for both items if such damages had been recoverable under Texas law. The court of appeals reversed the denial of damages for loss of companionship but upheld the finding on prejudgment interest. The plaintiffs appealed the denial of prejudgment interest.

Justice Gonzalez, writing for the majority, upheld the noneconomic damages (citing Sanchez) and further held that: "Decedent's children were entitled . . . to . recover prejudgment interest on damages awarded for decedent's medical, hospital, funeral and burial expenses and for pain and mental anguish she suffered prior to her death . . ." Specifically, prejudgment interest is recoverable for the interval between the accrual of the cause of action and the date of judgment and is compounded daily at the prevailing rate that exists on the date of judgment. Prejudgment interest is not applicable to punitive or future damages.

A footnote to the majority opinion notes that prejudgment interest laws vary from state to state according to scope, rate of interest, date of accrual, and other factors. The footnote adds: "Most of the states that allow prejudgment interest do so by legislative enactment." [Emphasis added]

House Bill 2023, relating to interest on damages awarded in court actions, was filed during the 67th Legislature. Although the provisions in the bill relating to interest rates and time intervals differ from those adopted by the supreme court, the bill clearly provided for prejudgment interest in civil suits. The bill was read on March 17, 1981, and referred to the House Judiciary Committee, where no further action was taken.

A similar but more restrictive bill, H.B. 1050, was also filed during the 67th Legislature. It was reported favorably from the House Judiciary Committee on March 31, 1981, and was subsequently passed on third reading by a 105-35 house vote. The bill was engrossed and referred to the Senate committee on Jurisprudence where it died. There have been no subsequent similar legislative efforts.

3. Poole v. El Chico, 713 S.W. 2d 955 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.)

Mr. and Mrs. A. Bryan Poole filed a wrongful death action against the El Chico Corporation, alleging that the restaurant's employees negligently sold drinks to an intoxicated person, Rene Saenz, who was subsequently involved in an automobile accident that killed the Pooles' son. El Chico successfully moved for summary judgment by arguing that Texas law recognizes no duty on the part of a bar owner to the motoring public fur injuries that may be caused by patrons who are sold drinks after becoming intoxicated. The 14th District Court of Appeals reversed the summary judgment, holding that bar operators owe a duty to the motoring public not to knowingly sell alcoholic beverages to an intoxicated person. The supreme court, without issuing an opinion, summarily affirmed the decision of the court of appeals finding no reversible error.

The court, while recognizing that the statutory prohibition against selling alcoholic beverages to an intoxicated or insane person did not provide a cause of action in favor of the plaintiffs, stated that "it is up to civil courts to change concepts of duty as social conditions change." The court then held that the "bar operator owes a duty to the motoring public to not knowingly sell an alcoholic beverage to an already intoxicated person."

In response to the defendant's claim that it should be the responsibility of the legislature, and not the courts, to impose tort liability on bar owners, Judge Junell, citing Sanchez, wrote; "Texas courts 'should not be bound by the prior legislative inaction in an area like tort law which has traditionally been developed primarily through the judicial process.'"

It is difficult to support a claim of inaction on the part of the legislature in the area of the liability of a bar owner, or "dram shop liability," as it is more commonly known. Dram shop bills have been introduced in the legislature during three of the previous five legislative sessions. House Bill 1726 and Senate Bill 926 were filed during the 65th Regular Session, on March 10, 1977, and died in committee. During the 66th Regular Session, Senate bills 725 and 945 were filed. The former bill died in committee and the latter bill was reported out of committee but never reached the floor. Finally, during the 68th Regular Session, House Bill 708 was filed, but died in subcommittee.

Chief Justice Pope, in his dissent in Sanchez c. Schindler, pointed out that legislatures can act either affirmatively or negatively. Not only did all five dram shop bills fail to be enacted, none of them were debated or voted on. The legislature acted clearly and decisively, although in a negative fashion, with regard to bar owner liability. It is simply inaccurate to characterize the legislature's position on dram shop laws as indifference expressed through inaction; rather, the legislature's attitude toward dram shop legislation is accurately described as hostility expressed through inaction.

When the supreme court upheld the decision of the court of appeals in Poole v. El Chico, its decision reversed the clear and repeatedly expressed will of the legislature.

Chief Justice Paul Nye of the 13th district Court of Appeals in Corpus Christi wrote a strong dissent in Evans v. Joleemo, Inc., 714 S.W. 2d 394 (Tex. App.—Corpus Christi 1986), another case dealing with the issue of a bar owner's liability in a drunk-driving wrongful death. He spoke to the issues raised by Poole v El Chico:

> Saloon keepers and bar keepers may be largely unloved and considered fair legal game. Perhaps into that same category ought to be placed groceries, restaurateurs, and others, who in any way, however small, deal with intoxicants of any quantity.

> It must be remembered that what is done today reaches far beyond this one class of business. [These are] questions of enormous import to the law of the State of Texas. . . Almost any business, which sells any type of good and many of the professions, by a logical extension of the majority's doctrine, may now be subject to liability. These complex problems are best left for the legislature to address and the courts to interpret in the classic function of our form of government.
>
> Until the legislature acts, this Court should not presume to take it upon itself, as the majority of the Court has done . . . to abrogate the common law by making wide-sweeping policy decisions, which, in my belief, should be reserved to our legislature.

4. Whitworth v. Bynum, 699 S.W.2d 194 (Tex. 1985)

The Texas Automobile Guest Statute is designed to prevent fraudulent collusion between an insured party and a person who is related and traveling in the insured party's automobile without charge. The lawsuit in this case arose from an automobile collision in which the plaintiff was injured while traveling in the defendant's car. Whitworth sued Bynum, but because Whitworth was married to Bynum's niece, the trial court on the basis of the Texas Automobile Guest Statute rendered summary judgment fro Bynum. The court of appeals affirmed the decision. The supreme court reversed the rulings of the lower courts, holding that the guest statute is unconstitutional under Articles I and III of the Texas constitution because the classifications contained in the law are not "rationally related to legitimate state interest."

During the past 15 years, the logic underlying the Texas Automobile Guest Statute and the guest statutes of other states has been repeatedly attacked as unfair or unreasonable. Of the 29 states that originally enacted guest statutes, only Texas and four other states still retain them. (Half of these statutes were repealed legislatively and half were struck down as unconstitutional.)

As with the other causes, the question is whether the expansion of liability by the supreme court is a legitimate interpretation of existing law or a usurpation of the legislature's lawmaking responsibility. The issue is not whether the underlying logic of the Texas automobile guest Statute is rational or defensible.

The guest statute has been closely examined by the legislature over the past two decades. The law was significantly amended in 1973 after two similar bills were introduced in 1969 but failed to pass. In 1971, Senate Bill 158, which would have repealed the guest statute, did not pass. In 1983 and 1984, bills were introduced that would have codified the guest statute without substantive change under a tort recodification. The 1983 bill (H.B. 1186) was vetoed and the 1984 bill (H.B. 53, 2nd Called Session) did not pass.

The issues raised by Whitworth v. Bynum are addressed by Chief Justice Hill in his dissent (with Justice McGee concurring):

> We must be acute in deciphering what legislative acts truly trammel constitutional rights and what legislative acts are merely unwise in our own judgment, in Smith v. Davis, 426 S.W. 2d 827, 831 (Tex. 1968), we said "[A] mere difference of opinion, where reasonable minds could differ, is not a sufficient basis for striking down legislation as arbitrary or unreasonable. The wisdom or expediency of the law is the Legislature's prerogative, not ours."
>
> Under the rational basis test, I cannot say that [the guest statute] is not rationally related to the prevention of collusive lawsuits. The legislature is empowered to deal with problems like this.
>
> That the legislature may have drawn the lines imperfectly when considered with the purported ends is of little importance to us in reviewing the rationality of the statute. . . . If I were a legislator, I would have voted to abolish the guest statute, but as a member of the judiciary it is not within my sphere of duties to substitute my judgment on this subject for that of the legislature. [Emphasis added]

The Erosion in Civil Justice Continuity

In each of the preceding four cases, the Supreme Court of Texas reversed the obvious will of the legislature as expressed through refusal to pass specific legislation, interpreted by the court as "inaction." Contrary to the current position adopted by the supreme court, the judicial branch has no legal or inherent right to act in a legislative capacity, regardless of the merits of its views or positions. The restrictions imposed on the judicial branch are contained in the Texas constitution (Articles II and III) and have been made explicit in Texas Natural Gas Utilities v. City of el Campo, 135 S.W. 2d 133 (Tex. Civ. App.—Galveston 1939), cert. Denied 310 U.S. 629, 84 L.Ed 1400, which states (at p. 137) that "the courts have no legislative power."

Apart from any possible constitutional misgivings, the decisions of the supreme court in the preceding four cases are open to argument and question by the joint committee. Each decision throws out longstanding precedent to expand liability. Each decision injects still more unpredictability into the business of writing liability insurance. The principles articulated in the opinions are certain to result in greater paid losses. The court decides cases as presented and does not necessarily consider the costs to the public of its dramatic changes in public policy.

This section of the report documents more examples of judicial activism that further diminish the ability of liability actuaries to accurately predict future losses. The joint committee is not necessarily taking a stand regarding the merits of the decisions. Rather, the rulings are examined for their impact on a portion of an industry whose financial stability is being seriously threatened. If lawmakers are to successfully attack the undesirable social consequences of the liability insurance crisis, they must be made

cognizant of all recent changes in civil justice law that have materially impaired the fiscal integrity and actuarial predictability of the liability insurance industry.

These cases have all been decided in the last five years.

Case 1: Burk Royalty v. Walls, 616 S.W. 2d 911 (Tex. 1981): The supreme court changed prior law relating to the appellate review of jury findings of gross negligence. While the court did not change the definition of gross negligence, which is the finding a jury must make in order to award punitive damages, it did abolish the long-established "some care" test of the correctness of a jury finding of gross negligence.

Before Burk Royalty, a jury could only find gross negligence on the part of the defendant if the defendant exhibited an "entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference . . . ." Evidence of some care on the part of the defendant justified an appellate court overturning a jury finding of gross negligence, because if there was some care on the part of the defendant, the defendant should not have acted with an entire want of care. After Burk Royalty, a finding of gross negligence by a jury must be upheld on appeal if there is some evidence of an entire want of care.

In abolishing the "some care" test, the court overruled prior supreme court cases and numerous lower appellate court decisions. In 1981, the court abruptly changed decades of established law relating to gross negligence and the award of punitive damages. The dissent by Justice McGee states:

> By changing the manner of review, this definition [of gross negligence] would be significantly changed. . . . this results in an abandonment of the long settled definition of "gross negligence."
>
> "Entire want of care" is now a misnomer. By changing the scope or review for gross negligence, we have also changed the way that we define grow negligence. . . . The

established distinction between ordinary negligence and gross negligence has disappeared. [Emphasis added]

Case 2: In the past, an occupier of premises was only liable for defects that caused injury to an invitee on the premises when he either had actual knowledge of the defect, or should have had knowledge of the defect through exercise of "reasonable care" (also known as "constructive" knowledge). In Corbin v. Safeway Stores, Inc., 648 S.W. 2d 292 (Tex. 1983), the company running a grocery store was found liable even though there was no evidence that the company had either actual or constructive knowledge of the defect causing the injury.

Case 3: Nixon v. Mister Property Management, Inc., 690 S.W. 2d 546 (Tex. 1985): The issue was whether the owner and manager of a vacant apartment complex could be held liable for the criminal conduct of an unknown person. The crime, which involved the rape of a minor, began with an abduction that took place in another location, although the actual rape took place in one of the vacant apartments.

The central legal issue in determining the liability of the owner and manager was foreseeability: could the owner and manager foresee the criminal conduct? The court held that they could. Consequently, the owner of any office complex, garage, apartment building, restaurant, store, etc., can now be held liable for the acts of an unknown person committing a crime, originating off the premises but accomplished on the property, because the owner should have realized the probability of a violent crime.

Case 4: Otis Engineering Corporation v. Clark, 668 S.W. 2d 307 (Tex. 1983): this case sets a precedent by allowing recovery of damages in an incident that stretches commonsense definitions of fault or breach of duty. The supreme court, in a 5-4 decision, allowed a suit to proceed against an employer for making a drunk employee go

home (the employee was subsequently involved in a fatal automobile accident). The employer neither furnished the liquor nor participated in the act of getting the employee drunk. The employer merely told the employee he could not stay at work in his drunken condition. The employee left and was later involved in a car accident that killed the wives of the plaintiffs. In his majority opinion, Justice Kilgarlin writes: "This case presents the court with the opportunity to conform our conception of duty to what society demands." The opinion the defines new areas of negligence:

> While a person is generally under no legal duty to come to the aid of another in distress, he is under the situation. . . . One who voluntarily enters an affirmative course of action affecting the interests of another [such as telling an intoxicated employee that he must go home because his behavior on the job is unacceptably dangerous] is regarded as assuming a duty to act and must do so with reasonable care.

The court's decision reinforces the lack of predictability of the Texas tort system and furthers a system of recovery not tied to fault.

In order to protect himself from liability, an employer must guess how the supreme court will answer such questions as:

Must an employer physically restrain an intoxicated employee from driving in order to avoid liability? Will he then face liability for false imprisonment?

What if an employee with a history of heart trouble is sent home to rest, and on the way, he has an accident? Is the employer now liable?

An employee forgets his glasses and is sent home by his employer to get them. On the way his has an accident. Is the employer now liable?

The dissent by Justice McGee states:

> In an attempt to do justice in this one case, the majority has placed an impractical and unreasonable duty upon <u>all</u> employers.

> The result the majority reaches in this case will no doubt reinforce cynical public attitudes that tort liability is not based upon fault, but upon ability to satisfy a judgment. . . . Further, by allowing the Clarks [the plaintiffs] to shift the burden of liability from Matheson's estate [the employee] to Otis [the employer], the majority erodes the concept that an individual is responsible for his or her own actions.
>
> <u>No court in any jurisdiction has ever held that an employer who has not contributed to an employee's state of intoxication will be liable for that employee's off-duty, off-premises torts.</u> [Emphasis added]

Case 5: <u>Madisonville I.S.D. v. Kyle</u>, 658 S.W.2d 149 (Tex. 1983): The supreme court expanded the elements of recoverable damage to include "loss of companionship and society" (separate from past and present "mental anguish"). In doing so, the court established the compensability of two separate types of noneconomic damage that are, in practical fact, intermingled. There is no obvious way to make a perfect and explicable distinction between the psychological pain of "mental anguish" and the pain of "loss of companionship and society."

Case 6: In <u>Yowell v. Piper Aircraft</u>, 703 S.W.2d 630 (Tex. 1986), the supreme court for the first time allowed "recovery for loss of inheritance." The concept of "loss of inheritance" is highly speculative and adds greatly to the unpredictability of the tort system.

Case 7: In <u>Moore v. Lillebo</u>, 29 Tex. Sup. Ct. J. 513 (July 12, 1986) the supreme court allowed for the first time recovery for mental anguish in a wrongful death case without requiring some sort of physical manifestation. Additionally, the court recognized both mental anguish, and loss of society and companionship as separate injuries for which damages can be covered. The dissent, by Justice Spears, concluded: "With improper definitions, such as the majority's, mental anguish and loss of society and companionship

issues ask jurors the same question: how much emotional distress has the plaintiff suffered? Asked the same question twice, jurors will give the same answer—twice."

Case 8: In Sax v. Votteler, 648 S.W.2d 661 (Tex. 1983), the parents filed a medical malpractice suit alleging that a physician had mistakenly removed from their child a fallopian tube instead of the appendix. The suit was filed more than two years after the time the physician stopped treating the child. Under what was at that time Article 5.82, Texas Insurance Code, the forerunner of the statute of limitations contained in the medical Liability and insurance improvement Act of Texas, the suit was barred. The trial court granted summary judgment in favor of the physician against both the parents and the 11-year-old child. The supreme court reversed in relation to the cause of action of the minor, holding the statute of limitations unconstitutional under Article I, Section 13, of the Texas Constitution, the open courts provision. In effect, the case extended the period in which a minor can file a lawsuit from two up to as many as 20 years.

Case 9: the law of strict product liability in Texas was dramatically altered by the decision of the Texas Supreme Court in Duncan v. Cessna Aircraft Co., 665 S.W.2d 414 (Tex. 1984). The court adopted a system of comparative causation independent of the system set up for negligence cases by the legislature. It also altered rules governing defenses, contribution, and indemnity in the product liability context. Unlike the legislative scheme for negligence cases in which a plaintiff found to be 50 percent negligent is barred from recovery, a plaintiff in a strict liability lawsuit will be barred from recovery only if the jury finds that he is 100 percent at fault.

Additionally, in the legislative scheme for negligence cases, a defendant who is less negligent than the plaintiff is not jointly liable for all damages awarded the plaintiff. The court-made doctrine for strict liability cases provides that each defendant found to have been a cause of the plaintiff's injuries is jointly liable for all damages awarded the plaintiff.

Case 10: In Acord v. General Motors, 669 S.W.2d 111 (Tex. 1983), the supreme court held for the first time in a product liability case that an instruction to the jury that the manufacturer of the product is not an insurer or a quarantor of the perfect or accident-proof product is harmful error.

Judicial Activism in Other States

Texas is by no means the only state experiencing dramatic shifts in civil justice law arising from judicial reinterpretation of legal precedents.

Victor Schwartz is one of the nation's foremost authorities on tort law and procedure. He is the coauthor of the leading U.S. torts casebook, [1] has chaired the American Bar Association's committee on product liability, and is the author of approximately 100 articles in the fields of torts and insurance law. In his September 10, 1986, testimony before the U.S. Senate Judiciary committee, Mr. Schwartz enumerated a number of recent court cases that have had the effect of sharply increasing the unpredictability of liability underwriting in particular states:

> How can one have a rational insurance pricing mechanism if the rules about [liability and compensability] are in constant change and ferment? In the past year, for example, the Supreme Court of Louisiana broke all precedent and held that totally innocent manufacturers would have to pay full tort damages. [2] The highest court of Maryland held that a gun manufacturer would have to pay damages when someone was hurt even though the gun performed exactly as it

> was intended. [3] Curiously, a California federal court held exactly the opposite [with the same defendant as the Maryland case]. [4] A federal court in Mississippi held that someone could recover money simply because he worried about suffering an illness he might get in the future. [5] Most recently, the Supreme Court of Oklahoma decided that a woman could recover a substantial tort judgment because she noticed [as opposed to touched] a piece of "Good-n-Plenty" candy in a soda bottle. [6]
>
> A number of witnesses today have pointed to the to the "absence of claims data" as a good reason to take "no action" to reform the tort system. But what good is claims data in an area where the future has relatively little to do with the past? Tort law is not like life insurance or accident insurance where the past tells us a lot about what will happen in the future. We are in an ever-changing and uncharted sea.

Mr. Schwartz's examples give a brief but telling glimpse at the national trend toward judicial reinterpretation of traditional tort law concepts. But to further show that Texas is not the only state where liability insurance predictability is being consistently eroded by court decisions, it is useful to look at the recent history of two specific states that have been active in the tort reform controversy: Washington and California.

The following are a selected sample of Washington court decisions rendered since 1972 that have significantly expanded tort liability and compensability and reduced the certainty with which liability underwriters can predict their future losses in that state:

Case 1: Freehe v. Freehe, 81 Wn.2d 183, P.2d (1972): A husband sought and received compensation for personal injury caused by his wife's negligence. The decision struck down the doctrine of interspousal immunity because of the potential for collusion. Now one spouse can sue the other just as he or she could sue any other defendant.

Case 2: Helling v. Carey, 84 Wn.2d 514, P.2d (1974): In this case, the Washington Supreme court significantly raised the standard of care required for health care providers, without actually defining a new standard of care. This had the effect of changing the

legal definition of medical care negligence. Prior to the Helling decision, doctors were required to practice the degree of skill and learning possessed by other members of the medical community. Helling reasoned that the "standard practice" is not necessarily a reasonably safe one, and reasonable prudence may require more than simple adherence to customary procedures.

Case 3: Grimsby c. Samson, 85 Wn.2d 52 (1975): Traditionally, a third party could not recover for emotional distress and accompanying physical manifestations unless he was in the "zone of danger" (i.e., being physically within a certain distance of a personal injury scene). The Grimsby decision decreed that the plaintiff onlooker need not be in the "zone of danger" and emotional distress did not have to be manifested by physical symptoms.

Case 4: Merrick v. Sutterlin, 93 Wn.2d 411 (1980): historically, children in the state of Washington have been barred absolutely from suing their parents. The Merrick decision reversed that rule and held that a minor child injured by the negligence of a parent in an automobile accident could sue that parent.

Case 5: Harbeson v. Parke-Davis, 98 Wn.2d 460 (1983): this case created the doctrine of "wrongful birth" in Washington. The plaintiff, who was taking a drug for her epilepsy, was informed by her doctors that the drug could cause cleft palate and temporary hirsutism if she became pregnant. The plaintiff, relying on her doctors' advice, subsequently gave birth to two girls with serious birth defects. Based on Harbeson,

parents of a child with birth defects can now recover damages for a health care provider's breach of duty that is a proximate cause of the birth. The court also articulated the tort of "wrongful life" (a child born with a defect may also recover special damages).

Case 6: Pimental v. Roundup Company, 32 Wn.App. 647 (1984): In this case, the court held that a patron injured by a dangerous condition in a self-service establishment need not prove that the owner had actual or constructive knowledge of the condition. Prior to the decision, the plaintiff in a slip-and-fall case had to prove that the owner actually knew of the condition causing the fall.

Case 7: McKennan v. Aasheim, 102 Wn.2d 411 (1984): In this case, the Washington Supreme Court recognized the tort of "wrongful conception." The court held that the plaintiff, who gave birth to a normal and healthy child following a sterilization operation, could recover for the expense, pain, suffering, and loss of consortium association with the failed tubal ligation.

Case 8: Martin v. Abbot Labs, (no citation available): Traditionally, to prove negligence on the part of the defendant, a plaintiff must prove a duty, breach of that duty, actual and proximate cause of that breach, and the damages resulting from the breach of duty. This remarkable decision allows plaintiffs to recover from multiple manufacturers even if there is no proof that shows which one actually or proximately caused the plaintiff's injuries.

California is another state where liability insurers are having a difficult time anticipating changes in tort law arising from judicial decisionmaking. The following cases are a sampling of recent California rulings that have appreciably expanded tort liability and compensability:

Case 1: Brown v. Merlo, 8 Cal.3d 855 (1973): This case, in which the California guest statute was struck down, is very similar to the Texas case of Whitworth v. Bynum described erlier in this part of the joint committee's report.

Case 2: Rodrigues v. Bethlehem Steel Corp., 12 Cal.3d 382 (1974): The California Supreme court overruled previous decisions that had refused to grant compensation for loss of consortium due to the injuries of a spouse. The court allowed a wife to recover damages for the loss of consortium due to the personal injuries of her husband.

Case 3: American Motorcycle Association v. Superior Court, 20 Cal.3d 578 (1978): In this case, the court analyzed the question of how fault should be apportioned among multiple defendants. The court retained the principle of joint and several liability, and altered indemnity principles by abolishing the "active-passive" distinction. In layman's terms, this decision paved the way for "deep pocket" liability in which any entity that is only slightly negligent can be held accountable for the entire injury suffered by the plaintiff without having the right to shift the loss to the entity that was primarily responsible for the harm.

Case 4: Coulter v. Superior Court, 21 Cal.3d 144 (1978): A social host was held liable for furnishing alcoholic drinks to a driver who subsequently ran into a highway abutment. The court held that the passenger in the car had a cause of action against the social.

Case 5: Molien v. Kaiser foundation Hospitals, 27 Cal.3d 916 (1980): in this case, the California supreme court held that a plaintiff no longer needs to prove physical injury as an element of a cause of action for the infliction of emotional distress. This abolished the previous doctrine that required a physical manifestation of emotion distress.

Case 6: Turpin v. Sortini, (no citation available): The court held that a child may bring a "wrongful life" action against a health provider who negligently fails to advise the child's parents of the possibility of hereditary congenital birth defects. The court also recognized a tort of "wrongful birth" defects. The court also recognized a tort of "wrongful birth" for the child's parents.

Case 7: Bigbee v. Pacific Telephone and Telegraph Company, 665 P.2d 947 (1983): In this case, the user of a telephone booth, sho was injured when an automobile driven by an intoxicated driver jumped a curb and struck the telephone booth, brought a tort action against the phone company alleging negligence in the way the booth was designed and installed. The California supreme Court upheld the decision in favor of the plaintiff, holding that "one may be held accountable for creating even the risk of a slight possibility of injury if a reasonably prudent person would not do so." [Emphasis added]

Mr. Schwartz's testimony, combined with preceding examples of cases in California and Washington, establishes a clear recent trend among state courts in this country to modify and expand tort doctrine in ways that are beneficial to plaintiffs and detrimental to defendants and their insurance companies. Those who argue that the Texas Supreme court has not had a significant impact on insurance profitability cannot reasonably make that argument by pointing to the experience of other states.

SUMMARY

Thus far in this report, the joint committee had defined the liability insurance crisis and substantiated its existence, examined the financial and cyclical characteristics of the insurance industry, and made a case for legislative modification of civil justice law as it is currently applied. The next part of this report shows that the liability insurance crisis is affecting a number of socially necessary services, organizations, and professions in ways that are undesirable and unacceptable.

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[1]Prosser, Wade and Schwartz, Cases and Materials on Torts.

[2]Halphen v. Johns-Manville Sales Corp., 484 So.2d 110 (La. 1986).

[3]Kelley v. R.G. Industries, Inc., 397 A.2d 1143 (Md.App. 1985).
A gun manufacturer was found to be "strictly" liable for injuries sustained by a victim in an attempted robbery. The gun was found to be "abnormally dangerous" not because of defective design but because the "product's chief use is for criminal activity."

[4]Moore v. R.G. Industries, Inc., 781 F.2d 394 (9th Cir. 1986)

[5]Jackson v. Johns-Manville Sales Corp., 781 F.2d 394 (5th Cir. 1986)

[6]Ellington v. Coco Cola Bottling Co. of Tulsa, 717 P.2d 109 (Okla. 1986)

Part V: the Impacts of the Liability Insurance Crisis

Overview

It would not be an exaggeration to characterize liability insurance as a necessity of modern life. It would be difficult to think of a single activity, be it related to business, charity, government, recreation, or transportation, that can safely be conducted without the benefit of liability insurance. Liability claims: and, in the aggregate, it is the only guaranteed source of recompense for those who are injured through the action or inaction of another.

It would be hard to imagine a modern world where the availability or affordability of electricity, water, or transportation was seriously in doubt. If, for any reason, those basic necessities were suddenly put out of reach because of shortages or increased costs, the consequence would be intolerable societal hardship. Government leaders would have the responsibility to act.

This scenario describes the current situation regarding the availability and affordability of liability insurance in Texas. State lawmakers would have no valid reason to intervene in the current liability insurance crisis if the only pertinent issue were the profitability of insurance companies. Government has no obligation to prevent financial insolvencies of competitive companies. Rather, government has a responsibility to contain the liability insurance crisis because its costs and effects are having an intolerable impact on society as a whole.

The status quo poses two obvious threats that require no explanation.

(1) Individuals or organizations risk financial catastrophe if they are unable to purchase adequate liability protection because of unavailability or excessive cost.

(2) Similarly, seriously injured victims who sue persons or organizations lacking sufficient liability coverage have almost no chance of ever receiving their full recompense. The unacceptable risks inherent inherent in these two examples would alone constitute a sufficient rationable for government involvement.

But the most compelling justifications for government intervention in the liability insurance crisis are the numerous and identifiable societal costs that inevitably result when businesses, professionals, nonprofit organizations, and governmental entities are forced to take drastic and negative steps to control their legal liability.

Many of those societal costs are well known by now. Women and children are being exposed to unacceptable medical risk as family doctors, particularly in rural and underserved areas, abandon their obstetrics practices. Cities and o=counties, reacting to dramatic premium increases, are being forced to choose between property tax increases or restrictions in their public services. Nonprofit organizations, like the Boy Scouts or the Easter Seals organization, or having to curtail their activities. The potentially high risk of insuring day-care centers means that many parents are being forced either to absorb sharp premium increases or to cope with a growing shortage of day-care services resulting from the closure of those centers unable to obtain insurance.

As the following sections demonstrate, the problems related to the availability or affordability of liability insurance are widespread and serious. There can be little doubt that if the legislature's consideration of insurance and civil justice reforms results in demonstrably positive effects, virtually every citizen of Texas will experience, either directly or indirectly, tangible benefits.

The Impact on Health Care

The statistical evidence used to support the claims of this section is derived from two independent studies of the impact of medical professional liability on the cost of and availability of health care in Texas. The studies, both of which are based on comprehensive surveys mailed to randomly selected Texas physicians, were conducted by individuals with no direct interest in tort or insurance reform. In no instance did any member of an organized medical group or association directly participate in the production or publication of the final research product (financial sponsorship not being defined as "direct participation").

There are methodological differences between the two studies, including the makeup and size of the survey populations, the time period during which the survey occurred, and the informational scope of the survey instruments. Yet, with only a few exceptions, the final statistical results are strikingly similar. That care to indigents and high-risk or obstetrics patients, reinforces the credibility of each study.

The first survey (called $1 for the purposes of this report) was commissioned by the Texas Medical Association (TMA) and executed by Opinion analysts of Austin. Four thousand surveys were mailed in August 1986 to a random sample of active TMA members currently involved in direct patient care. A prompter postcard was mailed to all potential respondents during the first week of September 1986.

Of the surveys mailed, 35.5 percent were returned; 19 percent of the respondents were family physicians; 18 percent were involved in some form of surgery; seven percent were obstetricians or gynecologists (OB/GYNs); and 13 percent practiced internal medicine. Sixty-three percent of the respondents were doctors with fewer than 20 years

of experience. The stated purpose of the study was to "measure the impact of professional liability insurance rates on the medical profession in Texas."

The second study (called S2 in this report) was executed and published by Randy Fritz, who at the time of publication was a graduate student at The University of Texas Lyndon B. Johnson School of Public Affairs. The centerpiece of the report, which was written to satisfy a degree requirement, was a survey sent to a randomly selected group of 1,000 licensed Texas doctors during November 1985. The mailing list was computer generated from a Texas State board of medical Examiners data base consisting of the names and addresses of all know Texas physicians with currently active licenses. The list was produced without preference to location, board certification, specialty, or affiliation with a professional medical organization.

Of the S2 surveys mailed, 45 percent were returned (approximately 13 percent of those were discarded because they were submitted by nonpracticing physicians). Forty-three percent of the family doctors responded, as did 47 per of the general surgeons and 49 percent of the OB/GYNs; the majority of the respondents (53 per) had been in medical practice between 20 and 40 years. The primary purpose of the study was to determine the extent to which the cost of malpractice premiums and the growing risk of being sued have affected the availability of medical care in Texas (particularly obstetrics).

The Impact of the Malpractice Crisis on the State's medical Well-Being

There is probably no liability issue more emotional or far-reaching than medical professional liability. The potential impacts of reform—-whether stronger medical discipline, tort reform, or insurance reform—reach into some of the most important areas

of human experience. The concepts of fault, negligence, and fair compensation are magnified when liability issues involve irreversible physical harm inflicted on a child, or the decision of an experienced and competent family physical to stop delivering babies.

Texas physicians no longer have to deal with the problem of being unable to purchase sufficient liability protection at any price. The joint underwriting association (JUA), described in Part III of this report, has effectively solved the availability crisis. Rather, the current crisis in medical liability is caused by unaffordability and an increasing likelihood of being sued. Physicians are being forced to endure skyrocketing premiums and a greater likelihood of having their patients seek legal redreses in the event of a less-than-optimal medical outcome. Consequently, physicians are taking various steps to protect their incomes and professional well-being.

Perhaps the most obvious step being taken by physicians is raising medical fees. It is evident that medical costs are likely to rise whenever the fixed costs of practicing medicine increase. Medical malpractice premiums are one of those fixed costs. A strong case can be made that higher liability insurance rates tend to push health costs up and physicians' incomes down. That contention is d=supported by $1, which reports that Texas doctors have raised their fees by an average of 4.5 percent over the past two years in response to higher malpractice premiums.

The $1 study, like other national statistical studies, indicates that the estimated increases in medical fees-for-service attributable to malpractice premium increases do not come close to matching the percentage increases in premiums. That is not surprising since malpractice insurance, while it is getting much more costly, is not the most significant fixed cost of medical practice. Although physicians are angry about rising

premiums, they are not likely to abruptly modify their fee structures every time their liability premiums increase.

Additionally, most theories of economic behavior indicate that increases in fixed costs are never fully passed through to the consumer. The extent to which the costs are passed through is dependent on the elasticity of demand or the nature of the market. Because the recent growth of the physician population in urban areas exceeds the growth in patient population—in fact, some observers foresee an impending nationwide doctor glut—it would be fair to characterize the market for physicians' services as beingsoft, or price elastic. That, in turn, would imply that malpractice premium pass-throughs are going to be relatively small.

Another reactive step is the practice of defensive medicine, i.e., ordering potentially superfluous medical tests or treatments to lessen the probability of legal action in the event of a negative outcome. In a report issued by the American Medical Association's committee on Professional Liability, the annual nationwide costs of practicing defensive medicine is estimated to approach $15 billion.

The $1 study divided the practice of defensive medicine into categories: more lab tests; more X-rays; more frequent consultations; and more hospitalization. The study reveals that the most common defensive practice is ordering additional consultations (30 percent of all respondents said they "always" do that, while 51 percent said they "sometimes" do), followed closely by more lab tests and more X-rays. Thirteen percent of the responding physicians said they "always" order additional hospitalization, while 39 percent said they "sometimes" do. Those statistics are compatible with the $2 findings.

The $1 responding physicians estimated that between 10 percent and 16 percent of the average patient's bill could be attributed to the practice of defensive medicine.

On its face, the practice of defensive medicine would appear to be an identifiable and undesirable consequence of the liability insurance crisis. However, the problem with this concept quickly becomes evident when one attempts to quantify the frequency and cost of the phenomenon. That problem is the lack of a meaningful consensus over what constitutes defensive medicine. It is virtually impossible to articulate a medical standard that could be used to differentiate between truly wasteful medical actions and those that have potentially beneficial effects.

As a means of illustration, consider the following scenario: Two physicians, faced with a head injury to a child, order an X-ray—one to make sure that serious injury has not occurred, and the other primarily to avoid the possibility of a lawsuit. Regardless of the motivation for ordering the test, if the scan shows a significant abnormality, it has clearly proved its worth. On the other hans, a negative finding could later by characterized as wasteful defensive medicine in both cases. In other words, defensive behavior can only be discerned with certainty retrospectively. There is no conceivable means of identifying purely defensive behavior prospectively.

Thus, in the absence of a meaningful definition or standard, it must be recognized that the AMA's figure is little more than an intelligent guess, and one that cannot be supported with objective empirical data. The responses of physicians to $1 and $2 must also be evaluated with skepticism.

If sharply higher malpractice premiums and the increasing risk of being sued are not significantly driving up health care costs (either through pass-throughs or defensive

medicine), what is the societal crisis in medical professional liability? The crisis is an identifiable, quantifiable, and growing threat to the medical well-being of children, pregnant women, and poor persons.

Escalating premiums and a rising incidence of lawsuits are creating a powerful deterrent to indigent patient care, particularly care of poor, pregnant women. To assess the extent to which indigents are suffering as a consequence of the current professional liability environment, the $1 survey instrument posed the following question: "How much have suits or claims [resulting from care to indigent patients not under continuing care] caused you to limit your service to indigent patients?" Forty-nine percent of the responding OB/GYNs have limited their services to some extent (35 percent indicated that they have reduced indigent care "a great deal" and 14 percent marked "some"). Thirty-eight percent of responding family doctors indicated cutbacks in indigent care (that response was divided evenly between "a great deal" and "some"). Thirty-three percent of all the responding $1 physicians revealed cutbacks in indigent care (16 percent marked "a great deal" and 17 percent marked "some"). It should be noted that $1 physicians practicing in rural areas are more likely to restrict their care to indigents than their city colleagues (18 percent checked "a great deal" and 20 percent checked "some" compared to 15 percent and 16 percent respectively for urban doctors).

To further substantiate the causal link between liability concerns and indigent care, $1 also asked physicians: "Would some degree of charitable immunity increase your availability to treat indigent patients?" forty-seven percent of all responding physicians checked "yes," compared to 23 percent who marked "no" (25 percent responded "not applicable"). A larger percentage of rural physicians than urban indicated

that charitable immunity would restore their willingness to provide care to nonpaying patients (53 percent compared to 45 percent).

To measure the impact of the malpractice insurance crisis on indigent care, $2 asked the randomly selected physicians to respond to the following statement: "In light of current medical professional liability concerns [defined as rising premiums and greater risk of being sued], it is better to see fewer indigent patients." Twenty-seven percent of all respondents "strongly agreed" with the statement, while 15 percent "agreed." Twenty-five percent had no opinion. Fifty percent of the responding family physicians indicated agreement with the statement (28 percent "strongly" and 22 percent with no qualifies), and 55 percent of OBN/GYNs expressed some type of agreement (33 percent "strongly agrees," compared to 22 percent who "agreed").

Superficial analysis of the evidence might lead to the conclusion that physicians are abandoning their care to indigents for selfish reasons. Specifically, their motivation might be either a desire to actively vent their frustration with a liability system that they perceive as unfair or unreasonably costly, or an approach to containing financial losses that are being exacerbated by rising premiums (financial losses being defined as professional time "wasted" on nonpaying patients).

A more thoughtful examination of the underlying causes leads to a more plausible explanation. Increasing numbers of physicians are restricting their care to indigents as a means of risk management. In other words, physicians are acting on a growing realization that indigent patients pose legal risks that are frequently greater than those related to paying patients who receive regular and routine medical attention.

The clearest example of that occurs with obstetric care. Poor, pregnant women are generally considered, as a group, to be medically high-risk patients. Poor women are statistically the most likely to suffer birth abnormalities for a number of reasons, including malnourishment, failure to secure adequate prenatal car, untreated health problems, and diabetes. Doctors who deliver the babies of indigent women are performing an admirable and indispensable service. They are also assuming a serious legal risk.

As the frequency of medical malpractice suits increases and premiums rise commensurately, doctors have little choice but to examine their practices and, where possible, diminish their legal risks. One of the most obvious ways that a family physician or obstetrician can significantly reduce the chance of a lawsuit is by cutting back, or eliminating, care to indigent, pregnant women. Similarly, other types of physicians are also feeling the pressure to hold back services, especially emergency services, to nonpaying persons who are not under their continuing care. A growing number of physicians are apparently succumbing to that pressure.

Although indigents are the population group that is most likely to suffer in the current medical professional liability environment, paying patients are also susceptible to negative impacts. Without question, the most undesirable overall effect of the malpractice insurance crisis at present is the growing propensity of physicians to give up obstetrics.

Both surveys reveal that a large and growing percentage of physicians (both family doctors and OB/GYNs) are no longer delivering babies, in response to higher malpractice premiums and a greater likelihood of being sued. Before the numbers are

given, however, they should be put in the proper human perspective by looking at the experience of several health care providers.

Newark maternity Hospital is a charity hospital in El Paso run by the Methodist Church. It has provided obstetric services to the poor and disenfranchised population of south El Paso for 64 years. Earlier this year, Newark maternity was forced to close its doors because of the increased potential of lawsuits against the Methodist Church. The agency of the El Paso church that owned the hospital property decided that the medical characteristics of obstetric services for poor patients (many of whom had little or no parental care) represented an intolerable risk for the church.

In her testimony before the joint committee, Gretchen H. Srigley-Seitsinger, the executive director of Newark Maternity for seven years until it closed during the summer, related case histories that illustrate the problems the hospital was having with the liability system (particularly with regard to the rule of joint and several liability).

> Case history 1: A baby was born at Newark Maternity in 1972 by C-Section-Cephalopelvic disproportion. The baby was proven to be genetically and prenatally handicapped. (All the siblings of the baby are also genetically handicapped). Suit was brought against Newark maternity in 1985 and settled out of court for $500,000. The delivering physician had no insurance, so the hospital was held jointly and severally liable.
>
> Case history 2: A baby was born to a woman who had had a bilateral tubal ligation as a means of permanent contraception. The patient signed an informed consent form which outlined the one percent possibility of recanalized fallopian tubes resulting an unwanted pregnancy. The pregnancy occurred and she filed suit. The case involved a notably bizarre twist, however. Before the case was heard, the plaintiff was involved in a fire in which all of her other children—except for the infant involved in the suit—were burned to death. In spite of that, the hospital settled out of court on the advice of its legal counsel.
>
> Case history 3: A baby was delivered at Newark maternity in 1972 by a private physician with no liability insurance. Subsequently, the child was diagnosed as having progressive degenerative brain dysfunction. Files from

> another hospital indicate that the baby's skull was fractured at some later time (possibly the result of child abuse). Nevertheless, the hospital has been included as defendant in the suit recover for this injury. The case, which was not settled out of court, has yet to be tried.

Ms. Srigley-Seitsinger emphasized that the church would probably have allowed Newark Maternity to remain open if some form of tort relief had existed—particularly charitable immunity or abolition of joint and several liability. The indigent patients who were welcomed at Newark Maternity are now either seeking obstetric care through alternative means, such as midwives, or turning to the El Paso public hospital, which is run at taxpayer expense.

The difficult professional and medical decision to abandon obstetrics is illustrated by the experience of two representative family physicians practicing in the area of the state that is now being hit hardest by cutbacks in medical service motivated by the malpractice insurance crisis: the Ro Grande Valley.

The first physician is in a group practice located in Edinburg. In a recent letter describing the difficult decision he and his partners were forced to make, he writes:

> Two years ago the malpractice fees for our group practicing obstetrics, surgery, and general medicine was $12,000. Last year, the premium jumped to $100,000 fro the same coverage and we were told that this year the premium would be $160,000 to $200,000.
>
> At that point, after doing obstetrics for 20 years, my partners and I decided to stop obstetrics, leaving only one doctor—where there had been 13 doctors delivering babies in this community. Since we have stopped doing obstetrics in June, 1986, four babies, which were delivered by midwives, came to the emergency room dead on arrival. A large number of ladies have come in with complications after they have been in labor for an extended period of time with midwives. I feel that the situation has deteriorated even to the point that the only doctor left in Edinburg doing obstetrics is considering leaving.
>
> In view of all of this, I do not see how this can be considered a step forward in the medical care of the indigent. Three years ago we were, charging

> $350 for each delivery and today the doctor's fees for delivery in this community are $1,600.

There is a footnote to that doctor's letter. Less than a month after it was written, the only remaining physician in Edinburg practicing obstetrics decided to quit. On October 10, 1986, the Edinburg General Hospital posted notice that its obstetrics department was closed until further notice. In less than two years, all 13 Edinburg physicians decided that the costs and legal hazards of obstetric care outweighed the benefits.

The second doctor practices near Rio Grande City. After 36 years of obstetric practice and between 6,000 and 7,000 births, this doctor quit delivering babies because of "skyrocketing increases for coverage in malpractice liability premiums . . . and the many cases of alleged malpractice that were being filed against physicians who were doing obstetrics." He writes:

> From the beginning [1950], obstetrics was a significant portion of my practice both through choice and because of need. We [converted a little clinic] into a small hospital, open 24 hours a day and providing mostly maternity care. Our fees, of necessity, were very low, but the clinic was a convenience to us and to our patients and it enabled us to provide a better quality of care than was possible with home births.
>
> In [1975] my associate and I bought land close to the Starr County Memorial Hospital and built a new office there with a maternity clinic. We continued to offer maternity services there as we used to in [our old clinic]. We would keep maternity patients in the clinic for 24 hours or less. Patients would then be discharged and followed up at home. For this type of service we charged a fee which was a fraction of what the fee would have been if a patient elected to go to the hospital locally or at a nearby community. (These services were intended for patients of limited means and who did not have any type of insurance).
>
> This obstetrical clinic continued until December 31, 1983. At that time, because we saw signs of an inability or difficulty to continue to obtain liability insurance for the clinic, we closed the maternity clinic and continued to practice obstetrics at the hospital.

Shortly thereafter, the physician decided to quit obstetrics completely for the reasons given above. He reiterates that, under the present circumstances, resumption of his obstetrics practice is not a realistic possibility. However, with appropriate legislative changes leading to more reasonable and stable premium rates, and a diminished probability of being sued, his willingness to deliver babies might change. There is no question that his desire to resume his former obstetrics practice still remains. He concludes his letter as follows:

> I do miss my [obstetrics] patients. To many of us, delivering babies has been one of the most satisfying and memorable portions of our practice. The relationship that is established between a physician, the moter, the father, and the baby is one that cannot be described and which is full of emotions.

The study S1 asked physicians: "Has the cost of professional liability insurance caused you to eliminate or limit the procedures you perform in practice? If so, what effect has this had in [specific medical specialties]?" thirty-three percent of all respondents specified some form of practice limitation. The group reporting the greatest percentage of cutbacks was family physicians (69 percent indicated some type of restriction, including 54 percent who reported limitation or elimination of minor surgery). The most significant finding, however, was that 37 percent of family physicians said they had eliminated obstetrics, and 11 percent reported limiting their obstetrics practice. Of the OB/GYBs responding, 14 percent said they had stopped delivering babies altogether while 21 percent reported limiting their obstetric practices.

The results of S2 were more dramatic. The surveyed doctors were asked: "If you have eliminated any procedures from your current practice because of professional liability, please specify them." Over 40 percent of all doctors reported that they had

eliminated at least one procedure, normally high-risk, from their current practices. Over 75 percent of the responding family doctors said they had cut back on at least one procedure, including <u>65 percent who said they no longer delivered babies</u> and 45 percent who had eliminated minor surgery. Thirty-three percent of OB/GYNs reported the elimination of high-risk obstetrics from their practices.

Both studies show that the greatest proportion of family physicians who have eliminated obstetrics from their practices live in small towns or rural areas. The impact on people living in nonurban areas is even greater because, according to both studies and the Texas Medical Association, only 15-20 percent of OB/GYNs (the only obstetric alternative to family doctors) practice outside metropolitan regions. A pregnant woman living in an urban area will probably have an acceptable number of obstetric choices, even considering the percentage of family doctors and OB/GYNs who have stopped delivering babies. But pregnant women living in rural areas have limited prenatal/obstetric options. Rural communities that lose the obstetric services of their family doctors are experiencing the most significant negative effects of the malpractice insurance crisis.

It is hard to overestimate the potential harm of such a situation. But because the estimated numbers are so high, is it possible that some statistical aberration could be distorting the results of either or both surveys? An explanation of the way malpractice insurers set their rates lends plausibility to the numbers.

Each physician is actuarially classified by the greatest risk procedure that he practices. Since a disproportionate number of suits result from alleged malpractice

during delivery, obstetrics is considered a high-risk procedure. Doctors who deliver babies are billed for their malpractice premiums accordingly.

Generally, a family doctor only has to deliver on baby a year to be charged the obstetric rate. In fact, some underwriters consider family physicians who only occasionally deliver babies to be greater overall risks than OB/GYNs for whom obstetrics is a normal part of their daily routine. According to both studies, the average malpractice insurance premium for obstetricians in Texas is triple that of family doctors. However, a family doctor who decides to deliver babies has to generate, on average, between $8,000 and $10,000 in prenatal and obstetric income just to break even on the higher cost of malpractice insurance.

Family physicians, who generally charge modest fees (particularly those practicing in nonurban areas), have an obvious economic disincentive to deliver babies. That disincentive, combined with the intangible costs of maintaining an obstetrics practice (long hours, calls at 3 a.m., inadequate hospital emergency resources, etc.), convincingly explains why such a high percentage of family doctors have now concluded that the costs of maintaining an obstetrics practice exceed the benefits.

Some persons have argued that, because family physicians are unfamiliar with the most refined and up-to-date obstetric techniques, it is not a bad thing that many of them no longer deliver babies. That argument fails to acknowledge the real needs of mothers and children living in nonmetropolitan regions of Texas. Family doctors, even if they are less advanced technologically than their OB/GYN counterparts, represent the only realistic professional source of prenatal and obstetric care to women who wish to avoid,

or cannot afford, the increased expense, inconvenience, and medical risk of commuting to obtain medical care during pregnancy.

Both surveys furnish convincing evidence that a significant and growing number of Texas physicians are reacting to the malpractice insurance crisis by altering their practices in ways that are socially undesirable. The implications for the medical well-being of the state provide strong support for legislative reforms.

The Impact on Local Government

The services of local government, including public safety utility, road maintenance, and health services, differ from private sector activities in one obvious respect: they are essential and cannot be discontinued without unacceptable implications for the common good when liability insurance becomes unavailable or prohibitively expensive.

According to Allen f. Hyman, director of insurance services for the Texas Municipal League, liability insurers are increasingly intimidated by the legal risks arising from police, fire, and ambulance services, electric and water/wastewater activities, and public construction (including roads). Most insurers have completely stopped writing policies for landfills and solid waste sites because of the potential for suits involving hazardous or toxic wastes.

When local government officials are forced to deal with the shock of a sharp premium increase or an unexpected lawsuit, they are confronted with a set of choices that inevitably have negative repercussions for the common good. In many cases, the dilemma can be simplified to a choice between absorbing steep premium hikes through property tax increases or diminishing potential legal liability through the restriction of

some form of public activity. In most cases, cities and counties cannot reduce their liability insurance costs by cutting back on public safety or public health. Those activities are essential and embody the responsibility local government has to protect its citizens. Other services, like recreation or transportation, can be cut back, but not without a consequent diminution of the overall public well-being.

The Texas Municipal league (TML) analyzed the recent liability insurance history of 207 cities for which consistent data are available. Those cities show a 130 percent increase in the total number of lawsuits filed between 1983 and 1985. The cumulative value of those lawsuits jumped from $12.7 million in 1983 to $162 million in 1985, while the total amount of claims paid went from $438,000 to $3 million (a 500 percent increase). The current rate of litigation averages out to one lawsuit filed against a municipal government every day.

The sharp jump in litigious behavior against municipal governments translates into higher premiums that are, in turn, pushing up ad valorem taxation in various Texas cities. It is a simple matter to verify the negative impact that the liability insurance crisis is having on Texas property taxpayers. The following examples are provided by the TML:

> Example 1: during fiscal year 1986, the city of Brownwood spent 16 percent of its total property tax revenue on liability insurance coverage (not including liability costs related to health activities).
>
> Example 2: The city of Lockhart spent one-third of its total ad valorem tax collections during the current fiscal year on liability insurance that jumped 336 percent, from $44,000 annually to $144,000.
>
> Example 3: The city of runaway Bay's liability insurance premiums increased during the past year by 109 percent. (That increase does not include park and marina coverage, which was canceled. The mayor reports that the city

has been unable to find a carrier willing to assume the risk of insuring the park and marina.)

Example 4: the following cities all reported 100 percent-plus hikes in their liability insurance costs over the past year (the list is not all inclusive). The increased costs will obviously have to be absorbed either by property tax increases or reductions in service to compensate for the budget shortfall: Addison—222 percent; Baytown—154 percent; Brownwood—215 percent; Lake Jackson—205 percent; Loredo—148 percent; Orange—116 percent; Pearland—109 percent; and Webster—208 percent.

Three Texas cities—Dallas, Houston, and Odessa—have opted for self-insurance in the face of unbearable premium increases accompanied by reductions in overall coverage. Dallas's situation illustrates the problem. In 1984, Dallas had liability insurance coverage which cost $157,000. The policy included a city deductible of $2 million. The insurance policy covered all claims over $ 2 million up to a $50 million limit. In the spring of 1985 Dallas put its liability insurance policy renewal out for bid. It received only one bid, requiring a $1.5 million annual premium and specifying a reduction in the maximum coverage to $15 million. The bid also had eight liability exceptions, including claims for discrimination or accidents at city parks. After evaluating the situation, the city decided to become self-insured.

The liability situation for county governments is no better. In May 1985 the Texas Association of Counties (TAC) surveyed its membership regarding liability insurance issues. Perhaps the most significant finding of the study was that 39 percent of county officials consider the liability insurance crisis to be their single most pressing problem (exceeding, in those instances, such long-standing problems as generating adequate revenue and dealing with increased regulatory actions on the part of state government).

Ten percent of the responding counties indicated that they were without liability coverage. Those counties were Clay, Denton, Jack, Knox, Motley, Williamson, Colorado, McCullough, Taylor (self-insured), El Paso, Haskell, Hardin, and Crane.

A more widespread problem than liability insurance availability is the problem of affordability. The following list indicates the percentage increases for renewal of the previous year's liability insurance policy for a representative sample of county governments: Bell—100 percent; Callahan—100 percent; Grayson—600 percent; Hardeman—300 percent; Jones—150 percent; Madison—100 percent; Potter—200 percent; Shackelford—300 percent; Tarrant—100 percent; Travis—300 percent (including a sizeable change in coverage); Trinity—300 percent; Waller—500 percent; and Wichita—100 percent.

One of the principal causes of the increased rate of litigation against cities and counties is considerably broadened liability exposure. Nowhere is that more evident than in the area of joint and several liability. That legal doctrine makes local governments particularly vulnerable because many public activities are integrated with those of private parties involved in personal injury or property damage actions. Additionally, the perception that cities or counties have sizeable financial resources (deep pockets) that could be tapped has contributed to an increased plaintiff willingness to sue local governmental entities.

The following are several examples of the potential that exists for abuse of the joint and several liability doctrine against cities:

> Case history 1: In an action involving the city of Bryan, an individual was riding in a car driven by an intoxicated driver. The person was injured when the car ran off the road and struck a tree. The plaintiff sued Bryan, alleging that the

> city was negligent in not removing a tree that was too close to the shoulder of the road.
>
> Case history 2: An individual attended a wrestling event at the Lubbock city arena. During one of the matches, he became agitated, jumped from his seat into the aisle, and heckled a wrestler. He was subsequently struck and injured by the wrestler. The plaintiff sued the city, claiming that the city was negligent in not doing more to protect him from the threat of injury.
>
> Case history 3: The survivors of an individual who ran a stop sign and was broadsided by a vehicle driven by a drunk and uninsured motorist sued the city of Odessa for $7 million, claiming that the deceased had failed to see the stop sign because it had been improperly erected.

All three cases are pending, so it is not possible to say that any of the cities have, in fact, been found liable for the plaintiff's injuries. Nevertheless, the incidents serve as examples of the increasing number of lawsuits being brought against cities under the doctrine of joint and several liability, and even if each city is found not to be liable, the taxpayers will still be responsible fro paying the considerable costs of legal defense.

The legislature must now consider whether it is good public policy to perpetuate the status quo, thus allowing sharp premium increases followed either by increases in the financial burdens of homeowners and businesses or by reductions in local government services.

The Impact on Schools and Nonprofit Groups

The effects of the liability insurance crisis have not been confined only to for-profit businesses, professional services, and city and county governments. School districts and nonprofit organizations are also being jolted by a surge of liability insurance cancellations and premium increases. In the case of school districts, the impacts to the public are similar to those of other local governments. School boards are being forced to choose between program reductions (or eliminations when particular activities are

excluded from coverage) and increases in school ad valorem taxes. Nonprofit organizations usually have little choice but to restrict their client services. Frequently, those affected clients are the poor, disadvantaged, or abused.

Over the past three years, Texas school districts have been sued with increasing frequency, and the paid losses of the successful suits have also risen. Consequently, school districts are having to absorb premium increases that, in many instances, exceed 100 percent. More significantly, however, only two insurers currently offer school liability coverage. When the number of insurers willing to underwrite liability coverage becomes so limited, a lower price because of competition is eliminated, and the available coverage options in terms of incidents covered and total financial risk are similarly diminished.

The joint committee heard testimony from the Texas Association of School Boards (TASB). TASB categorizes the increasing number of suits that are being brought against Texas school districts in the following manner: frivolous suits (primarily suits that do not appear justifiable under the Texas Tort Claims Act); student discipline suits (usually stemming from corporal punishment, dismissals, or suspensions); civil rights suits; and H.B. 72, or education reform, suits (normally relating to the career ladder or no pass, no play sanctions).

The Texas Tort Claims Act grants immunity to school districts in bodily injury actions not involving the use of motor vehicles. Therefore, according to a strict reading of the law, school districts cannot be forced to pay compensation in bodily injury cases arising from alleged negligence unless a motor vehicle is part of the action. However,

nothing in the Texas Tort Claims Act prevents a suit from being brought against a school district in a personal injury action not involving a motor vehicle.

In spite of the fact that state courts have repeatedly dismissed personal injury suits against school districts on the basis of statutory immunity, school districts continue to be sued in personal injury actions. Although the suits rarely, if ever, result in plaintiff victories, the school districts must still commit financial resources for lost employee time due to depositions or testimony and for legal defense.

The following TASB examples of frivolous suits show that statutory immunity has not deterred plaintiffs from attempting to collect damages from school districts in nonautomotive personal injury actions:

> -- A child was injured when he rode his bicycle into an elementary school jungle gym. The school district was sued.
>
> -- A school district and its football coaches were sued for injuries sustained in an after-school practice.
>
> -- A student who injured his hand in an industrial shop accident sued his school district for over $500,000.
>
> -- The parents of a student struck in the face by a discus sued the school district for over $1 million.

The litigation experience of school districts is compounded by civil rights actions over which the legislature cannot exercise any control.

Civil rights suits against school districts usually fall under Section 1983 of the federal civil rights act (normally relating to alleged employment discrimination or wrongful termination). In the past several years, civil rights actions against Texas school districts have been trending sharply upward.

-- In 1983, a school district was assessed $900,000 in damages in a wrongful termination suit.

-- In 1984, a court awarded over $500,000 in a school district case alleging denial of due process.

-- In 1985, a district was sued for over $30 million in an employment discrimination suit. The case was settled out of court for $84,000 to avoid publicity that might have prompted other similar suits.

The recent trends in civil rights act ions, frivolous personal injury suits, H.B. 72 suits, and student discipline suits, have elicited two basic responses from insurers who underwrite school district liability policies.

The most predictable response has been an increase in premiums. According to TASB: "Less than five years ago, the average liability premium for school districts ranged from [$300-500] for small districts to perhaps [$3,000-5,000] for large districts. In 1985, the average premiums for small districts increased to [$2,000-5,000] and the contribution for large districts increased to as much as $250,000." As rates have been increasing, another response has been that policy coverages have become more restricted. The restrictions are primarily written as policy exclusions and higher deductibles. This has broadened the exposure of the school districts and their employees.

A more serious problem at the present time, however, is the drastic reduction in the number of insurers writing school district liability policies. In 1984, the following companies offered school liability coverage: Pacific Employers (INA); St. Paul; International Surplus Lines; Hartford; Republic; Fremont; Nationwide; Utica Mutual; National Casualty/Scottsdale; Emcasco; CAN; First State; National Union; and a TASB insurance plan. Over the past 20 months, 12 companies have withdrawn from the market and now only National Union and TASB sell liability policies to school districts.

The rationale for such a dramatic wholesale market withdrawal can be inferred from INA's experience. James G. Stewart, a CIGNA underwriter, reported that as of August 1985 Pacific INA had realized a 651 percent loss ratio in its experience with Texas school liability coverage. In other words, the company had paid out $6.51 in claim costs for each dollar it had received in premiums.

The assumption of risk for all Texas school districts by a mere two companies is undesirable for a number of reasons. First, it virtually eliminates any remaining vestiges of price competition (the only realistic market barrier to further premium increases). Second, if one of the two remaining companies decided to leave the market for any reason, the other company would be placed in a very precarious position. The almost certain consequence would be reduced coverage, further use of policy exclusions, and higher deductibles. The most serious possibility, however, is that if one of the companies left the market, the other company would respond to the increased pressure by also withdrawing. The implications of that scenario are clearly unacceptable.

Nonprofit organizations like the Boy Scouts, United Way, and Easter Seals are experiencing many of the same problems as school districts: a dearth of companies willing to underwrite liability policies; increasing use of policy exclusions; and unacceptably large premium increases.

Consider the following examples:

> Example 1: The Young Women's Christian Association of Metropolitan Dallas (YWCA) saw its liability insurance premium jump over 100 percent during 1986 at the same time the policy coverage was slashed from $10 million to $3 million.
>
> Example 2: The Dallas-based Circle 10 Boy Scout Council reported the following liability premium bills for the past two years: 1985--$18,846; 1986--

$23,424. Their insurance company is projecting a 1987 bill of $56,432. The deductible for the current policy increased from $250 in 1984 to $10,000 for 1986.

Example 3: The Boys Club of Greater Dallas had its liability premiums rise from $15,000 last year ($10 million coverage) to approximately $41,000 this year ($1.5 million coverage). The new policy excludes horseback riding and recreational or competitive sports activities at facilities not owned by the Boys Club. Specifically, that means that the boys cannot play soccer or baseball at city parks or complete in Golden Gloves boxing matches at non-Boys Club gyms.

Example 4: Girls' Adventure Trails, a therapeutic camping program for troubled girls, experienced a 100 percent-plus increase in total liability insurance costs for the current year. At present, roughly 20 percent of the program's operating budget is consumed by insurance costs.

Example 5: The Gulf Coast Easter Seal Society discontinued its transportation department after its liability premiums shot up 143 percent (from $28,000 to $68,000). The San Antonio Easter Seal Society did not cut services despite a 100 percent jump for the current year. Similarly, North Texas and Waco Easter Seals did not cut services despite hikes of 140 percent and 152 percent respectively. (It is important to note that the premiums have been raised despite the fact that only one claim has been filed against any of the 10 Texas Easter Seal agencies in 40 years).

Example 6: The Capital Area Easter Seal Society has seen its liability premiums leap from $7,000 in 1985 to $37,315 for the current year. The policy would have cost an additional $4,500 if the Easter Seals staff who come in contact with children had not paid for their own premiums (the organization absorbed that cost in 1985 as part of the $7,000 package).

When liability insurance premiums for nonprofit human service agencies are more than doubled, the agency directors are presented with a variety of options, all of which are undesirable: cut back or eliminate those client services that are particularly responsible for pushing up insurance costs; allocate a larger portion of the operating budget to insurance costs and consequently diminish the financial resources available for direct-service client programs; or allocate greater amounts of staff time to fund-raising and soliciting.

Nonprofit groups like the Easter Seal Society, Boy Scouts, and the YWCA provide public services of inestimable value. It is unreasonable to assume that their commitment to client-oriented direct services will continue to be strong if they are forced to make drastic adjustments in their operating budgets or service programs every time they renew their liability insurance. The legislature should consider taking steps that will afford nonprofit organizations and school districts protection from regular premium shocks or cancellations.

The Impact on Child Care

The sexual transformation of the American work force is well known by now. More and more women, either by choice or out of economic necessity, have entered or are entering the job market. Many of those newly employed women have young children. As greater numbers of mothers become employed outside the home, day care for preschool children becomes an obvious societal necessity and concern.

The liability insurance crisis is having a sharply negative impact both on the directors and owners of child care centers and on the parents of preschool children who, out of necessity, must rely on day-care services. The problem of affordability is obvious. Annual premium increases of 100-200 percent are commonplace and tenfold increases have occurred. Those costs, if they do not make small child-care operations (especially in rural areas) financially untenable, are largely passed on to the parents through higher tuition fees.

The problem of availability is more subtle but just as worrisome. According to Jim Strickland, who is a member of Human Services Risk Management Exchange (a national risk management coalition of child care centers), the overwhelming majority of

child care centers in Texas must purchase their liability coverage from surplus-line or offshore (non-American) companies. The problems with an insurance market that is dominated by surplus-line or nonadmitted companies have been described in Part III of this report.

The child care insurance market is considered to be a highly unattractive risk by so many admitted carriers not because of a high incidence of lawsuits or the losses arising from those suits. In fact, on the basis of filings and paid losses, the child care industry would appear to be one of the best liability risks. A recent study conducted by Human Services Risk Management Exchange showed that roughly 88 percent of all insured child care operations in Texas have never been sued. Of the 12 percent that have been sued, the average cost of settling the claim was approximately $1,500.

It is the extremely "long-tailed" nature of child care liability underwriting, rather than paid losses, that drives both the availability and affordability problems in Texas. The statute of limitations for suits arising from child care incidents expires only after the injured child reaches the age of majority. When one considers the extreme difficulty of estimating future losses in the current environment of civil justice unpredictability, it is not hard to understand why most insurance companies blanch at the thought of writing occurrence-based child care contracts that remain viable for up to 15 years.

The following examples are a representative sample of child care operations that have experienced problems related to liability insurance in the past year (compiled by James Strickland and the joint committee staff):

> Example 1: A large Dallas child care operation (including day-care centers, home care, and child care referrals) was slapped with a 422 percent premium hike this year (the 1985 premium was $6,700 for a $1 million policy while this year's renewal for the same coverage cost $35,000).

Example 2: A small rural day-care center in central Texas (serving about 25 families) had its insurance increased from $800 to $1,800 recently. Shortly after the premium was more than doubled, the insurance company canceled the policy. No claim has ever filed against the day-care center.

Example 3: A large Austin child care operation (serving 1,200 children) paid about $3,000 for $500,000 coverage in 1984. In 1986 it paid about $30,000 (a 900 percent increase) for the same coverage. The owner, who is very familiar with the child care insurance market, anticipates having to spend $57,000-$60,000 to renew the policy in 1987.

Example 4: A large day-care operation in El Paso had its liability premiums jump from $6,000 in 1984 to $12,000 in 1985. Midway through the year, the policy was cancelled. The only American company willing to sell the same amount of coverage offered a policy for a $100,000 premium. The operation finally purchased liability coverage for $60,000 from an offshore underwriter.

Example 5: A Head-Start program in Corpus Christi had to shut its doors for several months at the end of 1985 when it could not find liability insurance. It reopened earlier this year after it successfully purchased another policy at "a substantial increase."

In addition to the obvious problems of higher child care costs driven by premium increases and the risk of day-care centers in underserved areas being forced out of business by intolerable premium increases or outright insurance unavailability, there is another reason why the legislature should be concerned with the liability insurance crisis impact on child care: the cost to the Title 20 program. The Title 20 program subsidizes day-care expenses for low income working parents who enroll their children in qualified centers (the Austin and El Paso operations described above are eligible). The program, which is intended to remove families from welfare dependency, is obviously affected by higher child care operating costs. When tuition fees are raised in response to higher liability premiums, Texas state government must shoulder part of the burden.

Conclusion

When one surveys the impact that the liability insurance crisis is having on a wide variety of business and social functions (including health care and child care, local government, education, and nonprofit human services), it is hard to conceive of any Texas community that is not being hurt by higher liability premiums or an insurance market that is clouded by problems of availability. The mandate for state legislature action is apparent. Part VI of this report will outline the joint committee's recommendations to the legislature designed to ameliorate the problems that have just been described.

Part VI: The Joint Committee's Recommendations

Tort Reform Proposals

The joint committee's proposed solutions for the liability insurance crisis are divided into three categories: changes in the state's justice laws (tort reforms); reform and increased regulatory oversight of the insurance industry; and enhancement of medical professional discipline.

Those who advocate selective tort reform in Texas maintain that restoration of a reasonable degree of predictability to the civil justice system is the most beneficial action the 70th Legislature can take to reverse the undesirable social effects of the liability insurance crisis. They contend that the problems of availability and affordability will continue to plague liability policyholders as long as the profitability of liability underwriters is undermined by unforeseeable redefinitions or expansions of liability.

Those who oppose any type of tort reform maintain that changes in civil justice law will lessen the rights of an injured plaintiff to collect damages without mitigating the undesirable effects of the liability insurance crisis. To put it simply, they argue that tort

reform will not work. They support that argument by pointing to recent examples of civil justice modifications in Florida and Ontario, Canada, that have apparently failed to stabilize premiums or alleviate availability problems. Tort reform opponents generally agree that some sort of crisis exists in the liability insurance industry. Their proposed solutions, however, are exclusively limited to insurance reform or improved professional discipline.

Is it reasonable to predict that tort reform will bring a measurable degree of predictability and financial stability to the liability insurance industry? After hearing all the evidence presented and examining the experiences of other states, the joint committee is confident that tort reform will reduce paid losses and significantly restore underwriting predictability in Texas.

Before the tort reform proposals are presented, however, it is necessary to briefly address the experiences of other jurisdictions. Tort reform is as complex and open-ended an issue as, for example, concepts like "criminal justice reform," "tax reform," and "welfare reform." The consequent benefits of any tort reform package will necessarily reflect the degree of imagination and care that went into its creation. It is fallacious to predict the success or failure of the joint committee's recommendations on the basis of tort reform in another state or country.

If tort reform has failed to fully live up to its expectations in Florida or Ontario, it is because the specific approaches taken there were flawed, not because tort reform, in a generic sense, is not effective. In some cases, the modifications were too weak to be effective. In other instances, the changes have been circumvented.

The following is a brief examination of the Florida tort reforms:

-- Joint and several liability: Rather than eliminating this doctrine, the Florida Legislature modified it in a way that maintains the status quo for a large number of cases. This substantially lessens the impact of the reform on paid losses. Joint and several liability is retained for economic damages in all cases in which the damages do not exceed $25,000.

-- Limits on punitive damages: This reform, while it may have been needed from a legal standpoint, has no effect on liability paid losses because punitive damages are not insurable in Florida.

-- $450,000 cap on noneconomic damages: In a recent letter to the joint committee, a property/casualty insurer wrote that "the cap is set at a level too high to affect a significant number of [our] cases." Specifically, the insurer's policy limits are primarily at or below $500,000. Most cases that pay more than $450,000 also involve at least $50,000 in economic damages. Consequently, the limits in the policy cut off coverage before the cap becomes effective. The proper argument based on the insurer's statement is not that caps on noneconomic damages are necessarily ineffective in reducing paid losses and restoring predictability; rather the proper argument is that caps set at certain levels may not affect the policies of particular underwriters.

-- Sunset repeal in four years: The Florida reforms are subject to sunset repeal on July 1, 1990. The statute of limitations for bringing actions in Florida is four years. Consequently, any tort action which may be significantly affected by the reforms could conceivably be delayed until after the law reverts to its original form (if the legislature chooses not to renew it). Predictability cannot be restored as long as there is the potential for repeal of the provisions before the statute of limitations expires.

The following is a brief examination of the tort reforms in Ontario, Canada:

-- Joint and several liability: Although Canada has not adopted the American rule of joint and several liability, a similar doctrine is codified in the Ontario Negligence Act. The act provides that when a judge or jury finds it impractical to apportion the liability for harm to a plaintiff, damages may be equally divided among all the defendants regardless of their relative degrees of fault. The American and Canadian doctrines are similar in that both may require a defendant to pay damages disproportionate to the degree of fault.

-- Caps on awards for pain and suffering: In 1978, the Supreme Court of Canada limited awards for pain and suffering to $100,000. Adjusted for inflation, the limitation is currently $184,000. It has been circumvented, however, by new definitions of noneconomic or intangible loss that did not exist prior to the limit on pain and suffering. Currently, the most common substitute for pain and suffering is "loss of future competitive advantage."

-- In 1978, the Ontario Legislature enacted the Family Law Reform Act, which significantly altered the law providing for the recovery of damages by the spouse, dependents, siblings, and parents of an injured person. The most common form of noneconomic loss claimed under the Family Law Reform Act is the loss of support and companionship, which is not subject to any limitation.

-- Punitive damages are rare in Canada not because of any tort reforms, but rather because social attitudes apparently preclude them. There are no statutory prohibitions against punitive damages.

-- In 1978, when the Canadian supreme court limited the amount that could be awarded for pain and suffering, it went further and reasoned that a lump-sum payment would be invested and earn taxable interest. To guarantee that the plaintiff received the full net value of the award after taxes, the court invented the concept of "gross-up." Gross-up means that a particular amount of money can be added to an award to make up for future taxes. At the present time, gross-up has the potential of increasing lump-sum awards in Ontario between 50 percent and 300 percent, depending on the type of case.

-- Contingency fees in Ontario are prohibited, but that does not mean that attorneys there do not have the opportunity of collecting a fee based on a successful performance. Attorneys and their clients decide on a particular fee for a case. In the event of an extremely favorable award, Ontario lawyers can also collect a bonus of 10 to 20 percent above the agreed-upon fee.

Clearly, as proponents of tort reform argue, Canada has not restored predictability to its tort system and therefore would be expected to experience a liability insurance crisis.

The Joint Committee's Recommendations for Tort Reform

Recommendation 1: Adopt Rule 11 of the federal rules of civil procedure to require the attorney or party filing a suit to certify that the suit is well grounded in fact, warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. Allow courts to impose appropriate sanctions if the suit is found to be frivolous, including an order to

pay to the other party the amount of the reasonable expenses, including costs, incurred because of the filing of the pleading, a reasonable attorney's fee or witness fee, and deposition expenses.

Rationale: At the present time, for all practical purposes, Texas courts do not have the authority to allow defendants named in a frivolous suit to recoup their defense costs. The joint committee has studied the federal rule against frivolous suits and concluded that it works and should be made applicable to Texas state courts.

Courts should be given the power to reimburse defendants in frivolous suits because, according to the Insurance Services Office (ISO), defense costs are skyrocketing. Those costs are frequently borne by liability insurers. Every time an insured person is named in a lawsuit, the costs associated with defending that person must be paid by the insurer. Suits that are not well grounded in fact are an unjustifiable increase in the cost of claims.

ISO figures show that in 1984 (the last year for which figures are available), the total legal defense bill incurred by insurers on behalf of policyholders was $5.1 billion (a 100 percent increase from 1979). Of that, 2.7 billion was for defense costs in general liability actions. In 1984, 36 percent of incurred losses went to pay for defense expenses. Stated another way, for every dollar insurers paid or set aside to reimburse an injured party in 1984, 36 cents had to be allocated for legal defense.

It is impossible, of course, to stop nonmeritorious suits from being filed. But this recommendation provides a strong disincentive against frivolous suits and shifts the burden of defense costs away from the defendants named in those suits and the insurers of those defendants.

Recommendation 2: A defendant in a civil suit should be allowed to file an affidavit of noninvolvement. If the court determines that the defendant has been sued without legal merit, and if the plaintiff has not dropped the defendant from the suit, the court should award reasonable attorney's fees and related costs to the defendant.

Rationale: At the present time, it is not unusual for medical malpractice suits to name as defendants doctors who are not involved in any way that can be reasonably construed as contributing to the personal injury of the plaintiff. The costs of defending these doctors unjustifiably increases the paid losses of the insurers.

This proposal provides a disincentive for brining noninvolved health care providers into a medical malpractice action, as well as granting financial relief to physicians or insurers named in a nonmerirtorious action.

Recommendation 3: If a suit is brought against a county, municipality, nonprofit organization, school district, or junior college, and that suit is subsequently found to be frivolous or without foundation in law or fact, the court should award to the defendant reasonably attorney's fees and costs.

Rationale: This proposal represents a public policy position by the joint committee that certain governmental entities and nonprofit organizations should have statutory relief if they are the victims of a nonmeritorious action.

This relief is particularly appropriate in the case of school districts. It was noted in Part V of this report that school districts continue to be sued in personal injury actions despite the fact that state courts have repeatedly dismissed those suits on the basis of statutory immunity. Even though the suits rarely, if ever, result in plaintiff victories, the

school districts must still commit financial resources for lost employee time and legal defense.

Recommendation 4: Current law provides that in a civil suit against a school district or one of its officers or employees, the court may award costs and reasonable attorney's fees if the court finds that the suit is frivolous, unreasonable, or without foundation and the suit is dismissed or judgment is for the defendant. However, suits under the workers' compensation law, suits based on civil rights violations, personal injury or death actions, and suits challenging the validity of a school board policy are all exempted.

The joint committee recommends that the law be amended so that any civil suit against a school district or one of its officers or employees is subject to an award of costs and reasonable attorney's fees if found frivolous or dismissed as being frivolous.

Rationale: This recommendation is intended to enhance and improve the legislation pertaining to frivolous lawsuits filed in connection with H.B. 72 (the education reforms).

Recommendation 5: Current law permits, in certain circumstances, a plaintiff to file a suit in the county in which he resides or in any county in which the defendant has an agency or representative. If the defendant is a railroad corporation, however, the plaintiff may file suit in any county through which the railroad extends or operates.

The venue statutes relating to insurance, breach of warranty by manufacture, railway personal injuries, corporations and associations, and foreign corporations should be amended so that the proper venue for a suit is the county in which the plaintiff resided at the time the accident accrued or in the county in which the accident occurred.

Rationale: The joint committee believes that it is unfair for a plaintiff to have the opportunity, where it exists, to file a lawsuit in a county in which juries have been known to grant unusually large awards, such as Matagorda County. Restricting the venue to the county of the plaintiff's residence at the time the cause of action accrued removes the possibility that either the plaintiff or the defendant can take unfair advantage of the historical tendencies of juries in a particular locale.

Recommendation 6: Limit the time in which a minor can bring an action to eight years following the accrual of the cause of action. Clarify the right of the parent, guardian, or conservator of the minor to bring the action on behalf of the minor within the eight-year period.

Rationale: In Sax v. Votteler, 648 S.W.2d 661 (Tex. 1983), the parents filed a medical malpractice suit alleging that a physician had mistakenly removed from their child a fallopian tube instead of the appendix. The suit was filed more than two years after the time the physician stopped treating the child. Under what was at that time Article 5.82, Texas Insurance Code, the forerunner of the statute of limitations contained in the Medical Liability and Insurance Improvement Act of Texas, the suit was barred. The Texas Supreme Court, however, allowed the suit, holding the statute of limitations unconstitutional in relation to a minor.

The lack of a reasonable time limit within which a lawsuit involving a minor must be filed is one of the principal reasons that certain kinds of liability underwriters in Texas cannot predict their future losses with confidence. Underwriting predictability is unattainable when liability policies remain enforceable for longer than a decade and the

negative impact of that situation is being felt most acutely in the child care and health care fields.

It was noted in Part V of this report that insurers consider the child care market to be very unattractive not because of a high incidence of lawsuits or excessive paid losses, but rather because child care liability is a long-tailed risk. Most insurance companies are not interested in writing occurrence-based child care contracts that have the potential of remaining viable until two years after a child turns 18.

Similarly, medical malpractice underwriters cannot effectively manage their risks or accurately determine the necessary size of their reserves when policies involving obstetric care (including obstetricians, gynecologists, family physicians, and anesthesiologists) remain active for as long as 20 years. How can an insurance company, in 1987, anticipate and provide for claims that may be filed in 2007?

The joint committee believes that the undesirable effects of the liability insurance crisis in the child care and health care fields can be partially mitigated by a reasonable statute of limitations. An eight-year statute of limitations provides ample time for a lawsuit to be filed, even if the consequences of the cause of action are not immediately identifiable, while enabling insurers to better manage their risks and predict their future losses.

Recommendation 7: Establish a uniform system of comparative responsibility for all cases in which a person seeks damages for personal injury, property damage, or death, regardless of the legal basis of recovery, including an action based on negligence, strict tort liability, products liability, or breach of warranty. Provide that the trier of fact determine the percentage of responsibility of each claimant, each defendant, and any

other person alleged to have been a factor causing the personal injury, damage to property, or death whether or not the person is a party to the action, has settled with or been released by any person, or is immune from liability. Allow a claimant to recover damages only if the percentage of responsibility attributed to the claimant is less than or equal to the combined percentage of responsibility attributed to all other persons.

Rationale: Section 33.001, Civil Practice and Remedies Code, first enacted in 1973, provides for a system of modified comparative negligence. Before the enactment of this statute, Texas courts followed the rule of contributory negligence, where the plaintiff could not recover if he was partially responsible for the injury. Any fault on the part of the plaintiff completely barred recovery. Under the rule of modified comparative negligence, the current statutory rule in Texas, a plaintiff may recover damages from a defendant if the plaintiff's negligence is not greater than that of the defendant. If a plaintiff and defendant are equally negligent, the plaintiff may still recover; if the plaintiff is more negligent than the defendant, the plaintiff is not allowed to recover damages. When there is more than one defendant, Section 33.013, Civil Practice and Remedies Code, provides that the plaintiff's negligence is to be compared against all the defendants, rather than to each defendant in turn.

The modified comparative negligence approach was originally adopted by the legislature because it represents a workable compromise between the harsh common law rule that says that the plaintiff cannot recover if the plaintiff is at fault to any extent, and the pure comparative negligence concept that grants recovery to the plaintiff even if the plaintiff is found by the court to be primarily responsible for the injury.

It is important to note, however, that Section 33.013 does not apply to an action based on strict liability in tort. (The Texas Supreme Court limited Section 33.013 to cases involving negligence defendants in General Motors Corp v. Simmons, 558 S.W.2d 855,862 (Tex. 1977).) Unlike a case based on a theory of negligence, in a strict liability case the fault or conduct of the defendant is not an issue; the plaintiff must only show the harm caused by the defendant's product.

The law of strict products liability in Texas was dramatically altered by the decision of the Texas Supreme Court in Duncan v. Cessna Aircraft Co., 665 S.W.2d 414 (Tex. 1984). In Duncan, the Texas Supreme Court adopted pure comparative apportionment for cases in which at least one defendant is found liable on a strict liability theory. This scheme allows the plaintiff to recover the percentage of his damages attributable to the defendants despite being more at fault or being a greater cause of the harm than all other defendants combined. The plaintiff's damages are reduced only be the percentage of causation attributed to the plaintiff, regardless of how large or small that percentage may be. Unlike the statutory scheme for negligence cases in which a plaintiff found to be 51 percent negligent is barred from recovery, a plaintiff in a strict liability lawsuit will be barred from recovery only if the jury finds that the plaintiff is 100 percent responsible.

The joint committee believes that the underlying principle of Section 33.013 – recovery is barred if the plaintiff is the primary cause of the plaintiff's injuries – is sound, equitable, and fair. This principle should be applied to any action in which a person seeks damages for personal injury, property damage, or death, regardless of the legal basis of recovery. The use of a modified comparative responsibility approach for all negligence,

strict liability, products liability, and breach of warranty actions will result in procedural uniformity and enhance the overall predictability of the civil justice system.

Recommendation 8: Abolish joint liability so that a defendant is liable to a claimant only for the percentage of the damages equal to the percentage of responsibility attributed by the trier of fact to the defendant with respect to the personal injury, damage to property, or death for which damages are allowed.

Rationale: A defendant who is found jointly liable for the injuries of a plaintiff is liable for the entirety of the damages awarded in favor of the plaintiff even if he is only partly responsible for the injuries.

In cases involving only negligence, Section 33.013 provides that each defendant is jointly and severally liable for the entire amount of the judgment awarded the plaintiff, except that a defendant whose negligence is less than that of the plaintiff is liable to the plaintiff only for that portion of the judgment that represents the percentage of negligence attributable to that defendant.

Under Duncan, an action based on strict liability in tort, a defendant is jointly and severally liable to the plaintiff even if the defendant is only minutely responsible for the damages. A defendant found to be five percent responsible is liable for not just five percent, but for 100 percent of the damages, regardless of the size of the verdict. For example, if a plaintiff is found to be 51 percent responsible for his own injury, and if the plaintiff's damages are found to be $1 million, the five-percent-responsible defendant is nevertheless liable for $490,000. The plaintiff, 51 percent responsible for his own injuries, can therefore collect a large sum of money from a person who is just barely responsible.

The five-percent-responsible defendant would have the theoretical right to collect the money from the other defendants. That right is meaningless if the other defendants are insolvent or simply do not possess sufficient assets to cover their rightful share of damages.

Proponents of the joint and several rule frequently point out scenarios like the ones just described are, if not nonexistent, at least extremely rare. Nevertheless, the fact remains that they are possible given the current conditions of the law, and that possibility seriously undermines the predictability of liability paid losses.

Joint and several liability became a part of common law long ago when the idea of comparative responsibility did not exist. Because there were no determinations made regarding the percentages of responsibility attributable to the plaintiff and each defendant, it was not possible to apportion the damages among the parties. Hence, the concept of joint liability was necessary, even if less than fair.

The joint committee believes that the joint and several liability rule is not necessary, given the existence of comparative responsibility and the requirement that juries determine the percentage of responsibility of each defendant. Indeed, in the opinion of the joint committee, a joint and several liability rule is inconsistent with the nature and purpose of a comprehensive system of comparative responsibility of the kind called for in Recommendation 7 above. Further, the joint committee is unwilling to allow the possibility of egregiously unfair assessments of damages to continue. It concludes that joint liability should be abolished.

Recommendation 9: Except for representation related to workers' compensation law or the Crime Victims Compensation Act, attorneys' contingency fees should be

structured according to the following schedule: 40 percent of the first $100,000; 33.3 percent of the next $200,000; 25 percent of the next $200,000; and 10 percent of any amount exceeding $500,000. The attorney should be allowed to limit services rendered under the contingency fee contract, including counsel in connection with an appeal. Contingency fees in excess of the statutory schedule should be allowed if it can be shown by clear and convincing evidence that a greater fee is justified. The attorney general should be granted the power to enforce compliance with the rate schedule.

Rationale: In theory, the contingency fee system promotes fairness (attorneys are only compensated when they win), equity (injured plaintiffs have access to qualified legal counsel, regardless of their ability to pay for it), and gives plaintiff attorneys an obvious incentive to reject claims that are clearly without merit.

In many cases, a 33 percent contingency fee, or 40 percent after trial, is appropriate given the fixed costs of litigation and the reasonable compensation to which a qualified attorney is entitled. But a 40 percent fee is hard to justify when the award exceeds $500,000. The reasonable expenses and compensation of a liability case do not justify a percentage fee that is inflexible relative to the size of the judgment. Without a sliding scale, plaintiff attorneys have the potential of reaping substantial windfalls. Additionally, the plaintiff who has been judged by the trier of fact to have suffered excessive injuries (as demonstrated by the size of the award) is subjected to an unreasonably large deduction that cannot be justified either in terms of "reasonable costs" or "reasonable attorney's fees." Further, when an insurance company "tenders the policy limits" after only a limited amount of time, the attorney reaps a sum disproportionate to

his efforts. A $1 million policy tendered to a severely injured plaintiff could reap the attorney $400,000 for limited effort and time.

The joint committee recognizes, however, that occasionally certain cases require unusually large expenditures of time and resources on the part of the plaintiff attorney. In those cases, additional recovery of attorney's fees would not constitute an unfair windfall and they should be permitted.

The joint committee does not necessarily contend that plaintiff attorneys routinely collect unjustifiably large contingency fees. As with the potential unfairness of the joint and several liability doctrine, it is the potential for unfairness that the joint committee finds unacceptable. A sliding scale contingency fee system that allows additional attorney compensation when justified removes the potential for unfairness without harming the injured claimant or imposing unreasonable financial sacrifice on plaintiff attorneys.

Recommendation 10: All future damage awards exceeding $100,000 in civil cases should be paid out over time in periodic installments. The court should specify the dollar amount of the installments and, if the defendant is underinsured, order the posting of security sufficient to ensure full payment of the damages. If the recipient of the periodic payments dies, compensation awarded for future loss of earnings unpaid at the time of death should be paid to the designated heir in a single lump sum (adjusted for inflation), but future medical expenses and other expenses would lapse.

Rationale: Future damages are meant to replace income or financial advantages that would have eventually accrued to the plaintiff absent the compensable injury. For example, an award for loss of future earnings is meant to compensate the plaintiff for the loss of the capacity to support himself through gainful employment.

Future earnings, by definition, accrue over the plaintiff's working life. It is unnecessary, therefore, that the amount of money the jury or judge awards as compensation for loss of future earnings be paid in a single lump sum. It would be fairer and more reasonable that all awards made for future damages be paid in a manner coincident with the normal accrual of that income.

Spreading out judgments for future damages over time would not only be fairer; it would result in several obvious benefits to liability underwriters and their reinsurers: companies would be able to manage their risks more effectively and efficiently if they did not have to set aside reserves for future damages payable in a large lump sum, and spreading damages out over time reduces the actual cost of insurer-paid losses because the value of money decreases over time. Those benefits should stabilize the liability insurance industry, which would presumably be reflected in more favorable premium rates.

Recommendation 11: The joint committee recommends that no limit be placed on the amount of actual economic damages that a plaintiff may recover. Actual economic damages should be objectively verifiable financial loss caused by personal injury, property damage, or death. The elements of actual economic loss should be limited to: medical expenses, loss of earnings, burial costs, loss of property, cost of repair, cost of obtaining substitute domestic services, loss of employment, and loss of business or employment opportunities. Loss of anticipated inheritance should not be allowed as an element of damages.

Rationale: The joint committee believes that it would be fundamentally unfair to limit actual economic damages. Those damages represent the real and verifiable costs of the compensable event to the claimant and they should be fully recovered.

The joint committee also believes, however, that if underwriting predictability is to be improved, the actual nature of economic damages must be clarified through statute. This recommendation does that, as well as precluding the introduction by the judicial branch of categories of compensation that do not reasonably fit into the definition of "economic damages."

Recommendation 12: The amount that a plaintiff may recover over and above actual economic damages or punitive damages should be limited to $250,000.

Rationale: Although the joint committee strongly supports the concept that actual economic damages should be recoverable to the fullest extent that they can be verified, it does believe that noneconomic damages should not be unlimited.

Noneconomic damages are, by definition, subjective and nonverifiable. In many ways, they exceed economic damages by a significant amount. Because they are subjective and inherently impossible to predict on a case-by-case basis, they represent a serious impediment to underwriting predictability. A limit on noneconomic damages would make them predictable to the extent that they could not exceed a particular amount. The joint committee believes that a limit of $250,000 allows for the recovery of a substantial amount of money in the event of significant noneconomic injury while still providing for a reasonable degree of civil justice predictability.

Recommendation 13: Punitive damages should be awarded only if there is clear and convincing evidence of fraud, malice, or total absence of care (i.e., conduct that

disregards the rights or safety of other persons). Additionally, the "same care" test shall be restored with regard to appellate review to punitive damage awards.

Rationale: Traditionally, punitive damages in Texas have been awarded only in those cases in which gross negligence or total absence of care could be proven. The plaintiff had to show that the defendant exhibited conscious indifference to the rights of the plaintiff.

This was substantially changed in Burk Royalty Co. v. Walls, 616 S.W.2d 911 (Tex. 1981). In that case, the Texas Supreme Court allowed, in effect, a jury to award punitive damages based on a showing by the plaintiff of some degree of absence of care.

This recommendation will not only restore the awarding of punitive damages to its historically correct position; it will increase the predictability of the civil justice system.

Recommendation 14: Punitive damages assessed against a defendant should be limited to $100,000 or three times the amount of actual economic damages, whichever is greater. Except in a survival or wrongful death suit, punitive damages should not be awarded against a defendant more than once for a single occurrence, regardless of the number of affected plaintiffs.

Rationale: The rationale for this recommendation is virtually identical to the argument in favor of capping noneconomic damages. Punitive damages, like noneconomic damages, are subjective and nonverifiable. They increase the unpredictability of the civil justice system because they are inherently impossible to predict on a case-by-case basis. Further, the same type of conduct, in a different case can result in a far different award of punitive damages because the defendant is different or is

the type of defendant that in unpopular with the public. Because punitive damages constitute a penalty and are not in any sense related to the nature of the plaintiff's injuries, the joint committee believes that the limits specified in this recommendation are appropriate.

Recommendation 15: Punitive damages should be distributed as follows: 25 percent to the plaintiff; 25 percent to the plaintiff's attorney; and 50 percent to the state general revenue fund.

Rationale: Punitive damages are similar to the fines imposed in criminal cases in that they are intended to punish socially unacceptable behavior. They should therefore be payable to the government and not to any particular individual.

However, the joint committee recognizes that if punitive damages are made entirely payable to the state, there is no incentive for plaintiffs or their attorneys to go to the extra effort of proving them. The joint committee believes that allocation of punitive damages according to the above formula constitutes a reasonable compromise: plaintiffs and their attorneys still have the motivation to prove them, but a reasonable portion of the penalty benefits to the state.

Recommendation 16: Damages awarded in a civil suit should be reduced by the court to the extent that a plaintiff has collateral benefits (i.e., Medicare, health insurance, etc.). Suits brought under workers' compensation laws are exempted. The reduction should be offset by any amount the plaintiff has paid to secure the collateral protection. Specifically, if the collateral benefit is an insurance policy, the court should credit the plaintiff for the cost of the insurance coverage that applied when the compensable event

occurred. Monetary damages should not be reduced to the extent that subrogation rights exist.

Rationale: Judgments in liability cases are meant to provide fair compensation for the cost of personal injury, including economic and noneconomic damages. If, however, a plaintiff possesses nonsubrogated collateral sources of coverage that apply to particular costs of an injury, the plaintiff could reap a windfall. The joint committee considers this unacceptable.

The following scenario illustrates the problem posed by nonsubrogated collateral benefits: a man is seriously injured in an automobile accident in which he is less than 50 percent at fault. His automobile insurance policy provides for personal injury protection of $25,000. In addition, he has a major medical policy with a $100,000 limit. He successfully sues the driver who is primarily responsible for his injuries. Without the collateral source reduction specified in this recommendation, the man could legally collect money for his medical expenses his automobile insurance company, his major medical insurer, and the defendant's liability insurer (a triple recovery). This recommendation prevents the possibility of this type of windfall.

Recommendation 17: Directors and officers of nonprofit charitable institutions should be exempted from liability except for intentional acts in the performance of their duties.

Rationale: Part V of this report documented the undesirable impact that the liability insurance crisis is having on various Texas nonprofit organizations that are exempt from federal income tax under Sections 501(c)(3) and (4) of the Internal Revenue Code. The joint committee considers the services of these organizations to be of

inestimable value and, as a matter of public policy, believes their directors and officers should be protected from future liability insurance quandaries. It is important to note that immunity is not provided, however, in the event of intentional acts.

Recommendation 18: Corporate shareholders should be allowed to limit the liability of the officers and directors of the corporation to the shareholders for ordinary negligence in the performance of their duties.

Rationale: Current Texas law does not allow the shareholders of a corporation to grant to the officers and directors of the corporation limited immunity from certain kinds of shareholder lawsuits. For example, if the shareholders of a company, either through vote or the articles of incorporation, want to make the officers and directors of the corporation immune from shareholder lawsuits charging mismanagement, they would be barred from doing so.

The joint committee believes that shareholders should be able to grant limited immunity to their officers and directors. A potential added benefit of this recommendation would be to enhance the attractiveness of Texas to new corporations and businesses.

Recommendation 19: Public officials should be exempted from liability except for intentional acts in the performance of their duties.

Rationale: Part V of this report documented the undesirable impact that the liability insurance crisis is having on local government entities. As a matter of public policy, the joint committee believes that concrete steps should be taken to protect public officials from future problems related to liability insurance. It is important to note, however, that immunity is not granted to public officials for intentional acts.

Recommendation 20: An owner or occupant of real property who allows another person to come onto the property for recreational purposes (with or without payment) should be granted immunity from liability for any injury caused by the person to whom permission is granted if the yearly fees collected are equal to or less than twice the amount of assessed ad valorem taxes.

Rationale: The joint committee heard testimony that owners of Texas property who made their property available for recreational purposes (primarily for hunting) were being subjected to an unreasonable degree of personal liability, especially when their actions could be construed as "nonprofit" (i.e., either the property owners or the occupants charged nothing for the use of the land or only charged an amount sufficient to defray their expenses).

The joint committee agrees that property owners or occupants who grant access to their land without intending to run a commercial enterprise should have immunity from suits arising out of that situation. The joint committee believes that if the fees collected for the recreational use of a piece of property are equal to or less than twice the ad valorem taxes paid on that property, it is safe to assume that a profit is not being earned on the recreational use of that land. (The formula is twice the amount of taxes because of the differences in local ad valorem formulas that exist throughout Texas.)

Recommendation 21: Recovery in a suit filed against a manufacturer of childhood vaccines for a vaccine-related injury should be limited to the following actual and projected reasonable expenses: medical care; developmental evaluation; special education; vocational training; physical, emotional, or behavioral therapy; and residential and custodial care and service. However, if the plaintiff can show that a vaccine

manufacturer was out of compliance with applicable federal requirements (licensing, approvals, or other standards) and that noncompliance caused the injury, additional recovery of noneconomic damages and loss of earnings should be allowed.

Rationale: It would be hard to imagine an industry that does more to promote the well-being of the public than the manufacturers of childhood vaccines. Massive childhood vaccination benefits society as a whole by reducing the general incidence of disease (affording added protection even to shoe who have not been immunized because outbreaks of disease occur much less often) and individually protecting each child who has been immunized from life-threatening disease.

The DTP vaccine immunizes children against diphtheria, tetanus, ad pertussis (whooping cough). State law requires students to have the series of five DTP shots before entering school. The vaccine is widely credited with dramatically reducing the incidence of childhood fatalities related to those diseases. For example, whooping cough was once a leading cause of death among American children. Before a vaccine was available in the 1940's, as many as 265,000 cases and 7,000 deaths from whooping cough occurred annually. In contrast, 18 cases of pertussis were reported in Houston last year (none fatal).

The joint committee received information showing a clear connection between the cost and availability of the DTP vaccine and the liability insurance crisis. The liability problem arises because the vaccine may produce severe reactions in a statistically minute number of immunized children. Estimates are that one in 310,000 vaccinated children will have a severe reaction, possibly even a fatal brain or nervous system injury. Publicity

about the vaccine's risks, mixed with rising liability insurance costs, resulted in a temporary DTP shortage between December 1984 and April 1985.

In 1986, the liability-associated problem with the DTP vaccine shifted from being a shortage to a price shock. Lederle Laboratories increased the price of its DTP vaccine in June from $4.29 a dose to $11.40 a dose because of a large increase in liability claims filed against the company. According to company officials, 100 lawsuits were filed against Lederle last year alleging injury from the DTP vaccine (more than the total number of suits filed during the preceding three years). Connaught Laboratories also increased its price from $4 to $11.23 for similar reasons.

The consequences of this situation are being felt by private physicians and the state. The Texas Department of Health will have to boost its DTP spending from $72,000 in 1984 to more than $2 million during 1986. Pediatricians in private practice must pass much of the vaccine's increased cost through to their patients (the vaccine currently costs between $15 and $40 a shot, depending on the physician's locale).

State health officials fear that the soaring cost of privately administered immunizations will either force a much greater use of the state's health clinics or, worse, motivate some parents to stop immunizing their children. Public health clinics in Houston have reported a 14 percent increase in the number of publicly administered vaccinations in 1986 and officials expect the number to further increase in 1987 as the full impact of the price hike is felt.

The joint committee considers the DTP situation to be a critical public policy problem. It also recognizes that children who are hurt because of the vaccine must be compensated for their injury. This recommendation is meant to strike a balance between

mitigating the intolerable impact on public health caused by the rising tide of suits against DTP manufacturers and protecting the legitimate right of a family to recover damages in the event of a vaccine-related injury.

Recommendation 22: Under current law, a municipality that engages in proprietary functions is liable for negligence in a manner comparable to a private entity. But if it is carrying out a governmental function, it is liable for its negligence only to the extent provided by the Texas Tort Claims Act. The joint committee proposes that a municipality engaged in either proprietary or governmental functions should be liable for negligence only to the extent provided by the Texas Tort Claims Act.

Rationale: The joint committee believes that the court-created distinction between the proprietary and governmental functions of a municipality, and the liability that attaches depending on whether a particular municipal activity is classified as proprietary or governmental, is both confusing and arbitrary. For example, the construction of a wastewater sewer system has been classified by the courts as a governmental function; a municipality is therefore liable for its negligence only as provided by the Texas Tort Claims Act. The construction of a storm sewer system, however, has been classified by the courts as a proprietary function; a municipality is therefore liable to the same degree as a private corporation.

The joint committee firmly believes that the legislature must reassert its authority to define and determine the extent to which the governmental entities of the state are protected by sovereign immunity. This recommendation returns the regulation and definition of municipal liability to the legislature.

Recommendation 23: The judgment of the Texas Supreme Court in Black v. Nueces Rural Fire Prevention, 695 S.W.2d 562 (Tex. 1985), should be reversed by legislation providing that the state does not forgo its sovereign immunity for the action of an employee who is responsible to an emergency situation unless that action violates a state or local law applicable to emergency situations.

Rationale: This is primarily a technical correction of the law. The current law retains sovereign immunity for a governmental entity in an emergency situation if an employee of that entity is observing local ordinances relating to emergency situations. The law assumes that local ordinances relating to emergency situations exist. If they do not, as is the case with rural fire prevention districts, which do not have ordinance-making power, the governmental entity may risk liability based on the actions of its employees in an emergency situation. This recommendation clarifies the language so that all local governmental entities can preserve their immunity in emergency situations as long as their employees do not break the law.

Recommendation 24: Courts have been inconsistent in their interpretations of the section in the Texas Tort Claims Act providing that the state is liable for personal injuries or death proximately caused by a condition or use of tangible property. The Texas Tort Claims Act should be amended by defining "use of tangible property" to clarify the circumstances in which the state waives its sovereign immunity.

Rationale: When the legislators adopted the Texas Tort Claims Act in 1969, it waived to a limited extent and under certain defined circumstances the sovereign immunity of the state and its political subdivisions. A determination of the precise extent of this waiver of immunity is crucial to establishing some predictability for the insurers of

municipalities and other governmental entities. The recommendation is intended to clarify an area of the law in which there has been an abundance of litigation and a variety of diverse judgments by the courts.

Recommendation 25: Governmental immunity should be extended to any person working under contract with the Texas Department of Health.

Rationale: Individuals who are performing services to the public through contract work with the department of health (physicians working under the Indigent Health Care and Treatment Act, for example) are, in a real and legitimate sense, working in a governmental capacity. It is fair that governmental immunity extend to their actions in the same manner as other governmental employees.

Recommendation 26: The judgment of the Texas Supreme Court in Cavnar v. Quality Control Parking, Inc., 695 S.W.2d 549 (Tex. 1985), should be reversed by prohibiting prejudgment interest on all damage awards including an award of punitive damages.

Rationale: A recent study by the Rand Corporation has shown that juries make their awards in terms of current (nondepreciated) dollars. The size of the award represents the total sum that the jury believes to be appropriate based on the evidence and the nature of the injury or death. On that basis, prejudgment interest appears to be an unnecessary court-imposed gratuity.

Additionally, there is reason to believe that, at the very least, prejudgment interest does not encourage the timely resolution of disputes and, at the very worst, actually provides an incentive (on the part of the plaintiff) to slow down the judicial process.

Recommendation 27: Tort legislation that relates to the imposition of liability and awarding of damages (including limitations) should apply to cases in the judicial system in which a final judgment has not been rendered.

Rationale: The effect of legislation should be prospective. Any case in the judicial system that has not yet reached a final judgment is still open and should therefore be susceptible to prospective changes in or reinterpretations of the law. This will assure timely impact of reforms recommended by the joint committee on the present tort liability crisis in this state.

Recommendation 28: If any of the proposed tort legislation is found to be unconstitutional by a county or district court, the Texas Supreme Court should grant direct review of the decision in a timely and expeditious manner. Also, a declaratory judgment procedure should be authorized for a speedy appellate review of the reforms.

Rationale: If the joint committee's recommendations are passed by the legislature in whole or in part, the ultimate impact of enhanced civil justice predictability and probable reduced losses on liability insurance affordability and availability could be forestalled indefinitely if the Texas Supreme Court does not rule on the legislation's constitutionality in a timely manner.

Unacceptable delay by the court system in resolving a challenge to a particular civil justice reform has occurred in the past. The Medical Liability and Insurance Improvement Act of Texas, passed in 1977, contained a limitation on damages of $500,000, exclusive of medical expenses. The cap was subsequently challenged and rejected by the Texas Court of Appeals in Beaumont in Baptist Hospital of Southeast Texas, Inc. v. Baber, 672 S.W.2d 296 (Tex. App. – Beaumont 1984). The case was

appealed to the Texas Supreme Court. Approximately two years later (October 1986), the supreme court sent the case back to the lower court without ruling on the constitutionality of the cap (714 S.W.2d 310 (Tex. 1986)). Almost 10 years have elapsed since the cap was passed by the legislature, and a definitive judicial decision concerning its constitutionality has yet to be made.

The joint committee is convinced that if its proposed reforms are to have their intended effect, the supreme court must be compelled to directly rule on their constitutionality (bypassing the lower appellate court) within a reasonably short period of time. This recommendation serves that purpose.

Recommendation 29: The legislature should have the authority to define or regulate any procedures or statutes relating to liability that result in personal injury or death, to the fullest extent permitted by the United States Constitution. The joint committee believes some tort reform measures can be enacted immediately without serious concern over adverse judicial pronouncements as to their constitutionality. But, in order to assure implementation of the full range of needed reform, a constitutional amendment should be sought that reads as follows: "Notwithstanding any other provision in this constitution, the legislature may regulate any procedural or substantive aspect of an action to recover damages resulting from injury or death including the amount of exemplary damages that may be recovered."

Rationale: This recommendation directly addresses the concerns of Part IV of this report, which documents the recent judicial activism of the Texas Supreme Court.

On a number of recent occasions, the Texas Supreme Court has expanded its interpretation of part of Article I, Section 13, of the Texas Constitution: "All courts shall

be open, and every person for an injury done him, in his lands, goods, person or reputation, shall have remedy by due course of law" (the "open courts" provision). The court has used this provision to give it the right to reject certain actions of the legislature. This has contributed, in part, to a growing sense that the legislature's sole prerogative to make law is being steadily eroded.

On a very general level, the open courts provision declares the fundamental principle that the courts shall be open and affords a remedy for any wrongs that are recognized by the law of the land. It means, for instance, that the courts may not be closed by military order and the governor cannot deprive access to the courts through a declaration of martial law unless there is a dire emergency in a case of actual warfare.

In 1932, the Texas Supreme Court ruled that the provision guarantees that Texas citizens bringing common law causes of actions cannot be unreasonably denied access to the courts. (Hanks v. City of Port Arthur, 48 S.W.2d 944 (Tex. 1932).) In a 1955 case, Lebohm v. City of Galveston, 275 S.W.2d 951, 954 (Tex. 1955), an ordinance absolving Galveston from all damages arising from public improvements was found to be unconstitutional because the open courts provision prohibits "legislative bodies from arbitrarily withdrawing all legal remedies from on having a cause of action well established and well defined in the common law . . ."

A major change in the supreme court's attitude toward the provision occurred in 1983, however, with Sax v. Votteler, 648 S.W.2d 661 (Tex. 1983). In that case, the court held that the statute of limitations specified in the Medical Liability and Insurance Improvement Act of Texas was unconstitutional under the open courts provision. The court explicitly refused to reject the statute by citing either the equal protection or due

process guarantees embodied in the Fourteenth Amendment to the U.S. Constitution or in Article I, Section 19, if the Texas Constitution.

Instead, by making its argument through the open courts provision, the court seized the opportunity to expand the meaning of the provision by ruling that the state constitution provides rights to its citizens over and above those in the federal constitution. The Sax opinion reads, in part, that the open courts provision "does accord Texas citizens additional rights."

The supreme court's reinterpretation of the open courts provision obviously has important ramifications for the balance of power between the legislature and the judicial branch, as well as for the liability insurance crisis. The Sax ruling makes it unclear whether the legislature has the sole right to regulate, define, or abridge common law causes of actions, assuming that such legislation does not amount to an arbitrary denial of due process. Without constitutional clarification, the issue will continue to be clouded in uncertainty. The joint committee's proposal is meant to provide that constitutional clarification.

Ultimately, this recommendation addresses the question of whether the laws in Texas should be formulated by 183 elected individuals vested with constitutional authority in a bicameral system that is responsive to the electorate, or by five individuals who can turn their opinions into law without public hearings, testimony, or the threat of an executive veto. Numerous tort reform recommendations made by this joint committee are not open to serious constitutional challenge under existing precedent, but the Texas Supreme Court's activism in recent years has been such that its response to the full range of needed reform is difficult to predict. Therefore, although the joint committee believes

that as many of its legislative recommendations as possible should be enacted at the same time as the constitutional amendment process is being initiated, both approaches – statutory reform and constitutional assurance – are important to fully address the present tort liability crisis in this state. This recommendation sends a clear message that the legislature is not willing to relinquish its constitutional authority to write the tort laws of this state.

Recommendation 30: Charitable immunity should be restored for corporations exempt under Section 501(c)(3) or (4) of the Internal Revenue Code.

Rationale: Public policy dictates additional protection to charitable institutions. The supreme court has previously declared charitable immunity invalid as against public policy. This recommendation will restore this charitable immunity.

Insurance Reform Proposals

Recommendation 1: All insurers that write liability insurance in Texas should be required to provide data relating to their claims, reserves, and losses, when they file their annual reports with the State Board of Insurance (SBI). The format should be similar to that used by other states. Additionally, the SBI should be authorized to continue collecting the same type of data currently being gathered through the closed claims study. The data should subsequently be made available to the legislature and the public. Actual raw data submitted by the insurance companies for closed-claims purposes should remain confidential.

Rationale: The joint committee had a difficult time securing reliable data relating to claims, court actions, claims payments, and reserves in Texas. The only data that are available are figured on countrywide basis. The SBI is conducting a one-time closed-

claims study and the Insurance Services Office (ISO) has prepared some relevant data for the joint committee. However, this information will be useful only for a limited period of time. It will not provide for a continuing flow of information that could be used by the legislature in the event of future problems with liability insurance affordability or availability.

The only statistical information that the SBI regularly collects relates to the solvency of admitted insurance companies in Texas. It is not very useful in monitoring the forces affecting liability insurance affordability and availability. It is important that the SBI collect pertinent data on a permanent basis so that the effectiveness of the proposed solutions to the liability crisis can be determined, and future liability problems can be detected before they reach crisis proportions.

Recommendation 2: The legislature should be place statutory cancellation and nonrenewal restrictions on Texas insurers who write commercial, professional, or governmental liability insurance. During the first 60 days of a new policy, insurers would be allowed to cancel for any reason. Subsequently, midterm cancellations would be allowed only for fraud, nonpayment of premiums, or change in risk. Insurers would be required to provide written notice of cancellation or nonrenewal at least 60 days before the effective date. If the cancellation or nonrenewal notice is not sent in a timely fashion, the insurer would be required to maintain the policy for an additional year at the premium rate charged for the previous year's coverage.

Rationale: One of the major complaints heard by the joint committee during its public hearings was the failure of insurers to give adequate notice of liability insurance cancellation or nonrenewal. Additionally, some cancellations were occurring long before

the end of the full policy term. In response, the SBI has adopted a rule requiring 45 days' notice of cancellation or nonrenewal. That length of time is frequently insufficient for the insured to locate an alternative source of coverage.

The joint committee believes safeguards against cancellation or nonrenewal should be statutory and based on the presumption that insureds deserve a reasonable degree of protection against abrupt cessations of coverage. In addition, the joint committee believes insureds should be afforded ample time to find other sources of insurance in the event of a cancellation or nonrenewal.

Recommendation 3: The SBI should automatically review on an annual basis rates for all commercial, professional, and governmental liability insurance.

Rationale: This annual review of rates would allow the legislature to determine if the laws adopted pursuant to this study are serving as an effective deterrent to future liability problems, and will permit the SBI to make any necessary adjustments in premiums and coverage.

Recommendation 4: The SBI should be required to certify risk managers except risk managers employed by insurance companies authorized to do business in Texas who are acting in their employment capacity.

Rationale: During the joint committee's July hearing, SBI members testified that the current liability crisis has resulted in the proliferation of "risk managers" who evaluate risks for liability insurance consumers. These "risk managers" are currently unlicensed and are not required to possess any special qualifications. Liability insureds who wish to minimize their risks should have some objective means by which they can assess the competence of persons claiming to be risk managers. That could be

accomplished by requiring risk managers not employed by insurers providing the coverage to be SBI certified.

Recommendation 5: The state laws that require businesses to have insurance coverage from and admitted company as a precondition to receiving a state permit of certificate should be amended so that those businesses can buy their coverage from an unregulated (surplus lines) insurer who is in compliance with laws and rules of the State Board of Insurance.

Rationale: SBI members testified that in a number of state-regulated areas statutes require that a license or permit applicant must purchase liability insurance from an insurer authorized to do business in the state before the license or permit can be issued. This poses a problem in a number of these regulated areas because the applicants can no longer find admitted insurers willing to write liability policies. The joint committee recommends that applicants be allowed to purchase their liability coverage from surplus lines carriers. This is the only realistic solution to the problem of availability.

Recommendation 6: The joint committee recommends that separate excess liability insurance pools be created for cities, counties, school districts, and junior college districts to provide excess liability coverage for those entities.

Rationale: Local governments presently have a difficult time obtaining excess liability insurance to cover large amounts of liability above a basic benchmark figure. During the last several years, excess liability coverage for many local governmental entities has become either unavailable or unaffordable. The joint committee proposes that separate self-insurance pools be created for each of these entities so that they can address

their excess liability coverage problems in a self-insured capacity. This approach would give local governments a viable alternative when no other excess coverage is available or affordable. Such a pool should also provide for larger coverage limits at lower premium costs.

Recommendation 7: The legislature should authorize separate basic liability insurance pools for school districts and junior college districts. Each pool would be similar to the pool authorized for counties by the 2nd Called Session of the 69th Legislature.

Rationale: Unlike counties and cities, school districts and junior college districts have limited access to viable alternatives for liability coverage. Many times this coverage is either unavailable at any price, or is prohibitively expensive. This recommendation would give school districts and junior college districts the opportunity of joining workable self-insurance pools for basic liability coverage.

Recommendation 8: The legislature should authorize the creation of a reinsurance exchange similar in concept to those being created in other states.

Rationale: A number of witnesses told the joint committee that a significant cause of the liability crisis is the unwillingness of reinsurers, particularly in the international market, to reinsure liability risks in the United States. The shrinking availability of reinsurance over the past several years has reduced the overall underwriting capacity of primary liability insurers. The joint committee proposes that a reinsurance exchange, similar in approach to those being created in other states, be created to provide an alternate source of reinsurance in the Texas liability market.

Recommendation 9: Insurance agents who sell surplus lines liability coverage should be required to provide in the written disclosure for a surplus lines policy notice that the coverage being purchased is not backed by the casualty insurance guaranty fund and that the SBI does not audit the finances or review the solvency of the surplus lines insurer. The notice should be given in 10-point type, and the purchaser should be required to sign an acknowledgment of notice.

Rationale: The increasing unavailability of liability coverage written by admitted carriers has resulted in growing use of unregulated surplus lines companies. A substantial number of complaints regarding the ability of surplus lines companies to adequately perform on the contracts they write are being registered with the SBI. The SBI has no authority to protect surplus lines insureds from contracts that fail t o perform due to insolvencies or dishonest business practices. Although a person who purchases surplus lines coverage receives notice that the coverage is purchased from a surplus lines company, the person may not realize that the surplus lines company, unlike an admitted company, is not covered by the guaranty fund in the event of insolvency and that the SBI does not regulate its financial activities through audits and review of items that reflect on its solvency. To assure that disclosure is adequate, the joint committee proposes that the disclosure notice include information relating to the guaranty fund and to solvency. Also, the committee suggests that the disclosure be given in 10-point type so that it is easily readable. To further assure that the insured reads the notice carefully, the joint committee recommends that the insured be required to acknowledge receipt of the notice.

Recommendation 10: The legislature should require a surplus lines insurer that writes coverage in this state to be an admitted insurer in at least one state of the United States.

Rationale: Testimony before the committee indicated that the liability crisis has forced many more insureds to seek liability coverage from the surplus lines market. Many of the companies that write this coverage are not admitted insurers in any other state of the United States, and thus no regulatory review of the insurers' solvency and business practices is provided. With regulation by at least one state, there is some assurance that at least very minimum requirements are imposed on an insurer operating only as a surplus lines carrier in Texas that will provide some protection for Texas insureds.

Recommendation 11: The legislature should authorize the SBI to adopt rules and regulations for and to monitor the activities of surplus lines insurers to the extent necessary to protect the public interest.

Rationale: The increased use of surplus lines carriers to provide liability coverage to persons who have experienced availability and affordability problems has intensified the complaints with regard to some surplus lines carriers who engage in questionable business practices or who are either insolvent or who are in questionable financial condition. Presently, the only control over surplus lines carriers is through the agents who place the coverage. Some of the complaints lodged against surplus lines carriers constitute threats to the public interest. To attempt to remedy these more serious complaints while maintaining a viable surplus lines market, the joint committee proposes that the SBI be authorized to adopt regulations that are necessary to protect the public

interest and to monitor the activities of surplus lines carriers as necessary to protect the public interest.

Recommendation 12: The legislature should authorize the SBI to impose administrative penalties for violation of regulations proposed by Recommendation 9, 10, and 11.

Rationale: The joint committee has made three proposals to provide some type of minimum protection to purchasers of surplus lines insurance coverage. To assure that the SBI has the authority to promptly and effectively respond to violations of this new regulatory authority, the joint committee proposes that the SBI be given authority to impose administrative penalties for violations.

Recommendation 13: Insurers writing commercial, professional, and governmental liability policies should be required to provide on request to an insured information relating to a claim that is paid by the insurer on behalf of the insured. The information should be sent within 30 days after the insurer receives a written request. The request by the insured and the insurer's reply should be made by certified mail, return receipt requested.

Rationale: The joint committee heard testimony that, in many cases, insureds are unable to learn of the disposition of claims by their liability insurers. This recommendation would provide a procedure by which the insured could obtain the desired information.

Recommendation 14: The legislature should strengthen the SBI's consumer complaint activities and enhance the SBI's ability to quickly respond to consumer complaints through enhanced levels of staffing and funding.

Rationale: A number of witnesses and associations have asked the joint committee to provide for more effective consumer protection of liability insureds. The joint committee recognizes that the SBI can only meet these needs through increased funding and staffing of its consumer complaint activities.

Recommendation 15: A joint underwriting association should be formed for nonprofit organizations that qualify under Sections 501(c)(3) and (4) of the Internal Revenue Code.

Rationale: Nonprofit associations and organizations (e.g., Boy Scouts, March of Dimes) have had a particularly difficult time securing adequate liability coverage at an affordable price. A nonprofit self-insurance pool is not feasible because of the limited assets of most nonprofit groups. In spite of the fact that most of these organizations have had no claims filed against them, they still have a problem obtaining affordable coverage. To solve this problem, the joint committee recommends creation of a joint underwriting association similar to the one formed in 1975 for medical malpractice coverage.

Recommendation 16: Rates for commercial, professional, and governmental liability coverage should be based on available and creditable Texas data.

Rationale: At the present time, a combination of Texas and nationwide data is used to figure liability rates in Texas. This happens despite the obvious difference in liability problems and conditions from state to state and the fact that nationwide data are not always representative of liability risks in Texas. It is unreasonable and illogical for Texas rates to be derived, at least in part, from national data that do not accurately reflect the risks of Texas insureds. The joint committee proposes that SBI-approved liability rates be based solely on available and creditable Texas data.

Recommendation 17: The legislature should authorize necessary staffing and funding for the SBI to carry out the recommendations made in this section.

Rationale: The joint committee has recommended a number of changes in and additions to the regulatory authority of the SBI. Many of these changes and additions to be effectively implemented will require additional staff and additional funds.

Recommendation 18: The legislature should amend the Insurance Code to provide clearer statutory authority for the creation and operation of the market assistance plan.

Rationale: The SBI under its rulemaking authority created the market assistance plan in early 1986 to provide assistance to persons seeking liability insurance coverage who have been otherwise unable to locate such coverage. The market assistance plan has been an effective tool for finding coverage for many who could not locate liability coverage through any other source. It is the desire of the joint committee to provide a more permanent basis for the market assistance plan to assure its availability in the future. Thus, the joint committee proposes that the Insurance Code be amended to provide specific statutory authority for the creation and operation of the market assistance plan.

Recommendation 19: The SBI should be required to hold public hearings before any changes can be made in policy forms and endorsements for commercial, professional, and governmental liability insurance for which the board approves or adopts policy forms and endorsements.

Rationale: The SBI currently has a procedure through which it will approve changes in policies and endorsements to policies through administrative action without holding a public hearing. Under such a procedure insureds and potential insureds have no

direct voice in the board's consideration of any changes to be made in policies and endorsements. For the areas of commercial, professional, and governmental liability insurance this procedure can have a considerable impact since the type and extent of insurance coverage can have as big an impact on the insured as the amount of the premium. To assure that insureds as well as insurers have an adequate opportunity to express views on and influence the types of policies that will be available, the joint committee recommends that when policies are to be changed by the SBI, the SBI hold a public hearing on those changes to give the insureds and potential insureds an opportunity to present their views to the board.

Recommendation 20: The legislature should authorize life insurance companies to reinsure commercial, professional, and governmental liability insurance.

Rationale: Considerable testimony was presented to the committee regarding the importance of reinsurance to the availability and affordability of liability insurance. Reinsurance serves a vital function in the liability insurance capital market. The joint committee believes that additional reinsurance capacity must be encouraged to assist in solving the liability crisis. Therefore, the joint committee recommends that life insurance companies be authorized by law to reinsure commercial, professional, and governmental liability insurance.

Recommendation 21: Insurers providing commercial, professional, and governmental liability insurance should be required to provide on request to insureds and potential insureds accident prevention services.

Rationale: Currently, accident prevention services are required to be provided to workers' compensation insureds. These services can be very beneficial for both insurers

and insureds in minimizing the risks to be assumed under insurance policies. The joint committee believes that accident prevention services provided to liability insureds by their insurers would have a positive effect in reducing the risks currently being insured by commercial, professional, and governmental liability insurance and would eventually have a real impact on the availability and affordability of such insurance. Therefore, the joint committee proposes that insurers that provide commercial, professional, and governmental liability insurance also provide accident prevention services to their insureds and potential insureds.

Recommendation 22: The legislature should require that data and information submitted to the SBI to support rate filings for commercial, professional, and governmental liability insurance be open records available for public inspection.

Rationale: The joint committee has heard allegations that there has been some difficulty in obtaining rate filing information. Since these data and information a re the principal source of justification for rates charged to insureds, the public has a strong interest in having this information available for examination. The joint committee proposes that to avoid further problems with regard to the availability of such data the legislature mandate by law that the data and information be public information.

Professional Discipline Proposals

Recommendation 1: The Medical Practice Act should be amended to provide for mandatory reporting of any physician conduct that would constitute grounds for the denial or revocation of a medical license issued by the Texas State Board of Medical Examiners (the medical board). Any licensed physician, or any member of the governing body of a hospital, long-term care facility, health maintenance organization, or other

health care institution, would be subject to the mandatory reporting requirement. Failure to report would be a Class A misdemeanor.

Rationale: A physician or other medical care provider who has reasonable cause to believe that a licensed Texas physician has acted in a medically dangerous or incompetent manner has no statutory responsibility to report that conduct. The medical board is apprised of adverse or dangerous physician behavior through only two channels: voluntary public or professional reports of questionable physician conduct, and mandatory insurance company notification of malpractice claims. The medical board's director, Dr. Brindley, told the joint committee that the number of suits brought against a physician is a frequently unreliable indicator of competence. The voluntary reports, especially when they are made by medical professionals, are a much more useful and reliable method of identifying undesirable physician conduct.

The joint committee was warned that unless health care providers are required to report incompetent behavior, the incidence of reporting will continue to lag far behind the estimated incidence of actual unacceptable behavior. This recommendation is designed to give the medical board the necessary statutory authority to maintain a high degree of professional competence in the Texas medical profession.

Recommendation 2: The Medical Practice Act should be amended to require that all licensees report to the medical board any sanctions taken against them during the preceding year. Failure to report sanctions on the application for renewal would be a Class A misdemeanor.

Rationale: Physicians who are licensed to practice in Texas must file annual applications with the medical board for renewal of their licenses. Mandatory doctor self-

reporting through these annual applications would provide for an additional source of information that could be used by the medical board to upgrade the level of professional quality among licensed physicians in Texas and protect the public from dangerously incompetent physicians.

Recommendation 3: The law should be amended to grant immunity from civil liability to any person who makes a charge against a licensed Texas physician of incompetent professional behavior based on reasonable evidence. Any person who makes such a report from reckless or malicious motives, and not out of compliance with the mandatory reporting under the Medical Practice Act, would not have immunity from civil liability.

Rationale: A number of witnesses advised the joint committee that any mandatory reporting requirement would have to be linked to immunity to be truly effective.

Recommendation 4: A person who complies with the mandatory reporting requirement and is subsequently the victim of some form of retaliation (i.e., suspension or termination of employment) would be entitled to sue for actual and exemplary damages.

Rationale: The joint committee believes that persons who report incompetent physician behavior must be protected from retaliation just as they must be protected from retaliatory lawsuits.

Part VII: Recent Nationwide Liability Insurance and Tort Reform Activity

State-by-State Activity

The liability insurance crisis is a national phenomenon; the problems of affordability and availability are not restricted to particular states or geographic regions.

It is a crisis that varies by degree from state to state. Most observers of the liability insurance industry believe that legislative reform, where it is required, should occur in statehouses rather than congress.

The preamble to the tort and insurance legislation approved earlier this year by the 49th Washington Legislation is worth quoting because it demonstrates that Texas in not the only state that has had to struggle with the problems associated with liability insurance cost and availability.

> Tort law in this state has generally been developed by the courts on a case-by-case basis. While this process has resulted in some significant changes in law, including amelioration of the harshness of many common law doctrines, the legislature has periodically intervened in order to bring about needed reforms. [These reforms are meant] to create a more equitable distribution of the cost and risk of injury and increase the availability and affordability of insurance.
>
> The legislature finds that counties, cities, and other governmental entities are faced with increased exposure to lawsuits and awards and dramatic increases in the cost of insurance coverage. These escalating costs ultimately affect the public through higher taxes, loss of essential services, and loss of the protection provided by adequate insurance. In order to improve the availability and affordability of quality governmental services, comprehensive reform is necessary.
>
> The legislature also finds comparable cost increases in professional liability insurance. Escalating malpractice insurance premiums discourage physicians and other health care providers from initiating or continuing their practice or offering needed services to the public and contribute to the rising costs of consumer health care.
>
> The legislature also finds that general liability insurance is becoming unavailable or unaffordable to many businesses, individuals, and nonprofit organizations in amounts sufficient to cover potential losses. High premiums have discouraged socially and economically desirable activities and encourage many to go without adequate insurance coverage.

Since tort reform has been a major state legislative issue this year, the joint committee examined the various approaches taken by lawmakers in other state capitals. Tort and insurance reform activity throughout the country was tracked with the assistance of the National Conference of State Legislature (NCSL). This section of the report summarizes the most important legislation that was passed in 1986 in those states that tackled various aspects of the liability insurance crisis. Only those bills that represent significant or notable alterations from the status quo are presented. What follows is an edited but comprehensive compendium of 1986 tort and insurance reforms.

Alabama:

SB 239: Authorizes two or more counties to form a self-insurance fund.

HB178: Grants immunity to members of the Board of Medical Examiners and the Medical Licensure Commission.

Alaska:

SB 377: Caps noneconomic damages at $500,000; mandates periodic payment for certain kinds of damages; modifies joint and several liability so that contributory fault (the fault attributed to the claimant) diminishes the total liability of all defendants; limits the liability of nonprofit directors, municipal citizen advisory committees, and directors of public or nonprofit hospitals.

HB 506: Allows municipalities, school districts, and regional educational districts to jointly self-insure or purchase group coverage.

Arizona:

HB 2375: Creates a temporary joint underwriting association (JUA) for all liability lines; allows nonprofit boards of directors and school districts to self-insure; grants authority for corporations to protect directors and officers against certain kinds of liability.

HB 2377: Institutes penalties for frivolous suits.

HB 2418: Creates a permanent JUA to provide medical malpractice coverage to licensed midwives and registered nurses.

California:

Proposition 51: Eliminates joint and several liability in all suits seeking noneconomic damages (passed by a margin of 62 percent to 38 percent).

AB3785: Enhances consumer protection by placing time limits on midterm cancellations, nonrenewals, policy limits, or premium increases in excess of 25 percent.

AB3357: Mandates the collection of information about judgments and settlements in tort cases so that the state can evaluate whether insurance rates are excessive.

A sliding scale for plaintiff attorney contingency fees, previously passed by the legislature, was upheld by the U.S. Supreme Court.

Colorado:

SB 67: Caps damages for pain and suffering at $250,000 unless the court finds "clear and convincing evidence" for raising the limit to $500,000; provides that the cap does not apply to compensatory damages for physical impairment or disfigurement; generally eliminates awards for derivative noneconomic loss; provides that an action against an architect, engineer, or land surveyor must be certified by similar professionals; reduces damages by the amount of any collateral sources.

SB 69: Consolidates the statutes of limitations in various kinds of civil actions, making most subject to a limitation of three years (tort actions must generally be brought within two years).

SB 70: Eliminates joint and several liability and limits liability of a defendant to a proportionate share of negligence.

SB 76: Extends "good Samaritan" laws to restrict the liability of individuals or entities when they volunteer their time without pay or enforce a policy or regulation that protects other individuals.

SB 86: Caps at $150,000 the liability of persons who sell liquor in actions involving an intoxicated patron or minor.

HB 1192: Limits the liability of firearms manufacturers.

HB 1193: Lengthens notice requirements for midterm cancellations of commercial and medical malpractice policies to 90 days; cancellations of commercial and medical malpractice polices to 90 days; cancellations and coverage deductions are permitted only for just cause.

HB 1196: Clarifies the immunity of public entities and other employees.

HB 1197: Mandates that punitive damages not exceed actual damages and specifies that two-thirds be paid to the injured party and one-third be paid to the state general revenue fund; authorizes a court to disallow or reduce punitive damages to the extent that the deterrent effect has been accomplished or the wrongful conduct has stopped; permits a court to increase the punitive damages if the wrongful conduct persists.

HB 1201: Limits liability for mental health professionals if they adhere to an accepted standard of conduct or care but fail to anticipate a patient's violent behavior.

HB 1205: Limits a homeowner's liability if the property is entered illegally.

Connecticut:

Public Act 86-338 accomplishes the following insurance reforms:

--Lengthens the notice period for nonrenewals or premium and coverage changes to 60 days.

--Prohibits policy cancellations except for enumerated causes including nonpayment of premiums, material misrepresentations, and substantial loss of reinsurance.

HB 6134 accomplishes the following civil justice reforms:

--Modifies joint and several liability.

--Mandates reduction of awards by the value of any collateral benefits.

--Allows penalties for filing suits in the absence of probable cause.

--Provides for periodic payments of future economic and noneconomic damages in excess of $200,000.

--Imposes a schedule for contingency fees.

--Provides that defendants are liable only for their respective percentages of fault.

--Grants immunity to directors, officers, or trustees of nonprofit organizations for noncompensated services, provided that the services are within the scope of official duties.

Delaware:

SB 533: Limits personal liability of corporate directors in cases in which shareholders allege violation of duty of care.

HB 444: Changes cancellation and nonrenewal notice requirements so that notices must be delivered a minimum of 60 days prior to the effective date of the cancellation of nonrenewal; cancellations or nonrenewals are allowed for only 10 specific reasons (e.g., premium nonpayment, fraud, or breach of contractual duties).

HB 470: Mandates expanded disclosure of information by property and casualty insurers on a line-by-line basis.

Florida:

The Tort Reform and Insurance Act of 1986 accomplishes, among other things, the following:

--Freezes rates for all commercial property and liability policies from July 1, 1986, until January 1, 1987, at the rates in effect May 1, 1986.

--Requires a 40 percent rollback of insurance premiums applicable to one-fourth of the policy term premium for all commercial liability policies, prorated for the period from October 1, 1986, until January 1, 1987.

--Permits insurers to escape the rollback provisions if they can prove that the resulting rates would be inadequate or impair their solvency.

--Requires that the new rates to be implemented on January 1, 1987, would be based on 1984 rates and be adjusted upward or downward as justified to comply with actuarial principles by each insurer.

--Authorizes creation of a commercial property and casualty joint underwriting association.

--Expands the authorized fields of self-insurance to include certain types of health care providers, CPAs, architects, engineers, veterinarians, land surveyors, and insurance agents.

--Modifies the doctrine of joint and several liability.

--Limits pleading of punitive damages, specifies how punitive damages are distributed, and caps the amount of punitive damages in certain cases.

--Caps noneconomic damages at $450,000.

--Requires that, in certain situations, damages exceeding $250,000 be paid over a period of time.

Insurers and three industry trade groups are challenging the constitutionality of the laws limiting premium rates.

Georgia:

SB 369 & SB 440: Authorize local governments and school boards to jointly secure liability insurance.

SB 384: Requires that insurers file annual itemized reports.

HB 1146: Allows defendants to recoup attorney's fees and costs incurred by frivolous suits.

HB 1471: Clarifies municipal sovereign immunity.

HB 1503: Restricts the right of insurance companies to cancel or fail to renew policies.

HB 1549: Establishes immunity for governmental employees and officials.

Hawaii:

All of the following measures were passed during a special session:

--A closed claims study, that could result in rebates or credits to insureds if premiums are deemed to be excessive.

--With the exception of enumerated exemptions, insurers are prohibited from canceling policies prior to normal expiration or one year from the policy renewal date.

--Limits are imposed on attorney's fees for both the plaintiff and defendant.

--In any medical malpractice action, contingency fees are subject to the approval of the court.

--Penalties are specified for frivolous suits (the plaintiff must pay if the suit is frivolous; the defendant must pay if the defense is frivolous).

--Damages are to be paid over time if the award exceeds $1 million and the defendant is the state, a political subdivision of the state, or any governmental agency.

--The statute of limitations in medical malpractice actions is narrowed.

--Joint and several liability is abolished except for four specific situations.

--Noneconomic damages are capped at $375,000.

--The cause of action for serious emotional distress arising from damages to property or material objects is abolished.

<u>Idaho</u>:

SB 1439: Limits dram shop and social host liability.

HB 1469: Limits attorney contingency fees.

<u>Illinois</u>:

SB 1200, passed on the final day of the session, accomplishes the following:

--Joint liability is retained in cases of medical malpractice, environmental concerns, and medical costs. Otherwise, defendants who are less than 25 percent at fault for an injury cannot be held jointly liable for damages.

--Any judgment against a defendant must be reduced by insurance reimbursements to the plaintiff that are above $25,000.

--A plaintiff who is more than 50 percent responsible for his own injury is barred from recovery in cases of negligence or product liability.

--Broad immunity from liability suits is granted to municipalities.

--Present or former public employees are exempted from punitive damages in cases arising from official duties.

--90 days' notice must be sent to the state if an insurer discontinues writing any line of insurance in the state.

--60 days' notice is required when policies are cancelled or not renewed, or premiums are increased 30 percent or more.

<u>Indiana</u>:

SB 85: Clarifies dram shop liability (i.e., licensed sellers are not liable for the actions of their customers unless they know that customers who are making purchases are intoxicated).

SB 393: Grants authority to judges to define frivolous suits and assess penalties for those suits.

<u>Kansas:</u>

SB 512: Outlaws cancellation of business and professional liability insurance policies except in specific circumstances (e.g., nonpayment of premiums, material misrepresentations, etc.).

HB 2661: Limits awards against health care providers at $1 million; caps noneconomic damages in medical malpractice suits at $250,000 (with a cost of living adjuster); requires all settlements to be paid periodically.

Louisiana:

Act 18: Specifies that those who sell, serve, or furnish alcoholic beverages are generally not liable for damages caused by purchasers or those served.

Act 548: Requires property and casualty insurers to furnish additional information in their annual reports.

Act 754: Prohibits midterm cancellation or change in insurance coverage.

Maine:

Public Law 671: Prohibits midterm policy cancellations except for nonpayment of premiums, fraud, breach of contract, or potential insurer insolvency; 10 days' notice must be given of cancellation and 30 days' notice of nonrenewal.

Public Law 804: Shortens the statute of limitations for medical and legal professional liability suits.

Maryland:

SB 558: Caps noneconomic damages at $350,000.

SB 899: Requires that liability coverage be made available to licensed operators of in-home day care facilities.

SB 1015: Allows pooling and self-insurance for certain types of casualty risks (particularly local governments and nonprofit groups).

Massachusetts:

HB 6172 accomplishes the following regarding medical malpractice:

--Eliminates the collateral source rule.

--Caps noneconomic damages at $500,000 except when the plaintiff is substantially impaired or disfigured.

--Imposes a sliding scale for contingency fees.

--Shortens the statute of limitations.

Michigan:

HB 4676: Orders health facilities with medical staff (including HMOs) to report to the appropriate licensing board and the Michigan Department of Health any disciplinary action taken against a member of the medical staff and the circumstances of that action.

HB 5154: Limits noneconomic damages in medical malpractice cases to $225,000 (subject to a cost-of-living escalator) except in the following circumstances: death; intentional tort; foreign object wrongfully left in the body; injury involving the reproductive system; fraudulent conduct; wrongful removal of a limb or organ; loss of bodily function.

HB 5154 also accomplishes the following:

--Permits a person who is named as a multiple defendant in a medical malpractice action to file an affidavit of noninvolvement.

--Allows to be admitted after the verdict and before the judgment is entered evidence that a collateral source exists; credit is given for the expense of securing the collateral source.

--Mandates structured paymnents for future damages exceeding $250,000 in present cash value.

--Modifies joint and several liability so that a person cannot be made to pay an amount that exceeds his percentage of fault.

HB 5163: Clarifies the liability of municipal entities, political subdivisions, and the state (its agencies, departments, and employees).

Minnesota:

SF 2078: Creates a state-run joint underwriting association for day care providers, foster homes, group homes, and sheltered workshops.

HB 1950: Caps intangible losses at $400,000; provides for automatic reduction of damages for payments made by collateral sources; authorizes penalties for frivolous suits.

Missouri:

SB 663: Caps medical malpractice noneconomic damages at $350,000.

Montana:

SB 22: Revises and clarifies limits on tort recovery against public entities.

HB 16: Establishes an insurance market assistance plan and, if necessary, a joint underwriting association.

New Hampshire:

HB 479: Clarifies regulation of surplus lines insurance companies.

HB 513 accomplishes the following:

--Limits awards for pain and suffering to $875,000.

--Shortens the statute of limitations from six to three years.

--Bars policy cancellations unless 60 days' notice is given.

--Permits recovery of costs and attorney's fees associated with frivolous lawsuits or frivolous defenses.

New Jersey:

SB 1678: Grants immunity to unpaid volunteer athletic coaches who have participated in league-established safety and training programs.

New Mexico:

HB 178: Provides lower-cost insurance coverage to school districts and clarifies statutes related to public school insurance authority.

HB 244: Limits liability for incidents related to alcoholic beverage sales or service: $20,000 for property damage; $50,000 for injury or death of one person; $100,000 for injury or death of two or more persons for each occurrence.

New York:

SB 9351-A and A-10663 accomplish the following:

--Offsets awards by collateral sources of benefits.

--Allows up to $10,000 for recovery of court costs and attorney's fees for frivolous suits and defenses.

--Limits liability of directors, trustees, and officers of nonprofit organizations to gross negligence.

--Creates a "flex rating" system to replace open, competitive ratemaking.

--A joint underwriting association for troubled commercial, governmental, and professional liability lines is authorized pursuant to an insurance department determination of lack of availability.

--Bars unwarranted policy cancellations.

--Permits municipalities, school districts, and other public entitites to self-insure.

--Allows certain nonprofit, charitable, and religious organizations to collectively purchase property and casualty coverage.

--Expedites access to excess or surplus lines of liability insurance.

North Carolina:

SB 873 does the following:

--Requires insurers to provide additional data to support rate increase requests.

--Requires 45-day notice of policy cancellations, nonrenewals, and premium increases.

The legislature also gave the insurance commissioner the authority to establish joint underwriting associations on a standby basis.

Ohio:

SB 366: Grants immunity, with certain exceptions, to volunteers of nonprofit or charitable associations.

HB 875: Permits political subdivisions to participate in joint liability insurance pooling arrangements.

Oklahoma:

SB 488 accomplishes the following:

--Requires the 10 largest property and casualty insurers to submit annual reports on premiums, losses, settlements, judicial dispositions, etc., for 11 coverage categories.

--Requires the 50 largest property and casualty insurer to submit annual data on a less detailed, more restricted basis.

--Defines a stricter standard for allowing the consideration of punitive damages.

--Allows recovery, up to $10,000, for attorney's fees and court costs associated with frivolous actions.

Pennsylvania:

HB 1391: Requires 30 days' notice for cancellation and 60 days' notice for premium increases.

HB 1625: Grants immunity to referees.

South Dakota:

SB 216: Establishes self-insurance pools for public entities.

SB 281: Calls for structured payments for awards greater than $100,000.

SB 282: Caps medical malpractice awards (all damages) at $1 million.

Tennessee:

SB 1702: Except for wanton or gross negligence, grants immunity to members of boards, commissions, agencies, authorities, and other governmental entities or bodies.

HB 1940: Grants immunity to directors of nonprofit organizations.

Utah:

SB 64: Repeals joint and several liability.

SB 91: Establishes a market assistance plan and a joint underwriting association.

SB 111: Limits noneconomic damages in medical malpractice suits to $250,000.

SB 155: Establishes structured settlements for medical malpractice judgments.

SB 182: Establishes $100,000 and $300,000 caps and a two-year statute of limitations for dram shop liability.

Vermont:

HB 8641: Authorizes insurance pooling for municipal governments.

HB 8657: Authorizes the insurance commissioner to establish a joint underwriting association for a broad array of unavailable lines of liability insurance.

Washington:

SB 4541: Changes notice requirements associated with cancellation or renewal of liability policies.

SB 4630 accomplishes the following:

--Caps noneconomic damages according to the following statutory formula: .43 X the average annual wage (currently $18,029) X plaintiff's life expectancy (not less than 15 years); at present, the cap could range between $117,000 and $493,000.

--Abolishes joint and several liability except for the following causes of action: hazardous waste and solid waste disposal sites; business torts; manufacturers of generic products.

--Shortens the statute of limitations for contractors.

--Authorizes structured settlements for all judgments greater than $100,000.

--Establishes a voluntary market assistance plan requiring the participation of 25 admitted or nonadmitted underwriters.

HB 1972: Allows local governments to self-insure.

HR 2080 & 2083: Authorize a joint underwriting association and a self-insurance mechanism for day care providers.

West Virginia:

SB 3: Limits noneconomic damages in suits involving political subdivisions to $500,000.

SB 714: Caps noneconomic damages in medical malpractice judgments at $1 million per incident.

HB 149: Eliminates joint and several liability for defendants who are 25 percent or less at fault.

Wisconsin:

The legislature passed the following medical malpractice reform legislation during a special session:

--Noneconomic damages are limited to $1 million.

--A sliding scale for contingency fees is set.

--Pretrial screening panels are replaced with voluntary, non-binding mediation.

--The notice period for mid-term cancellations is increased from 30 days to 60 days.

Wyoming:

SF 17: Repeals doctrine of joint liability.

SF 21 & SF 26: Create state and local government self-insurance programs.

SF 69: Prohibits midterm cancellations subjects to certain exceptions (nonpayment of premiums, fraud, etc.).

HB 13: Grants immunity to individuals legally supplying alcoholic beverages from liability for damages caused by persons who consume the beverages.

HB 15: Allows individuals who are clearly not involved in a tortious occurrence to file an affidavit of noninvolvement.

HB 38: Statutorily defines unfair insurance claims practices.

HB 39: Grants immunity to officers, commissioners, or board members of governmental or nonprofit entities.

HB 40: Establishes pretrial screening panels for medical malpractice suits.

SUMMARY

Availability Remedies:

Formation of market assistance plans – 27 states

Authorization of joint underwriting associations – 13 states

Authorization of self-insurance – 23 states

Insurance Regulation:

Expanded data collection mandated – 16 states

Changes in cancellation, nonrenewal, or premium change notices – 18 states

Cancellation or nonrenewal allowed only with just cause – 9 states

Rate review power expanded – 6 states

Flex rating required – 1 state

Premium rollbacks – 4 states

Civil Justice Reform:

Sanctions against frivolous suits – 13 states

Reductions in damages for collateral sources – 9 states

Grants of immunity and limits on liability – 22 states

Caps on awards – 17 states

Modification of joint and several liability – 15 states

Structured settlements – 14 states

Restrictions on attorney's fees – 8 states

Clarification or modification of liquor liability statutes – 16 states

Additionally, 31 states (including Texas) are currently conducting interim studies of the liability insurance crisis.

National Activity:

Although a fair number of tort reform and risk management bills were introduced during the 99th Congress, the vast majority of those bills were never heard by committee. At this time, it is unlikely that congress will pass any major tort reform legislation, because the issue is not as easy to solve on a national scale as it is at the state level. Almost all of the legislative consideration that has been given to the liability insurance crisis has occurred on the state level, and there is strong evidence that congressional action would be both inappropriate and ineffective.

The one recent federal initiative that is worth noting is the report of the Justice Department's Tort Policy Working Group (TPWG). The TPWG (chaired by Assistant Attorney General Richard K. Willard) was created in October 1985 and consisted of high-ranking personnel from 10 federal agencies and the White House. Its report and recommendations were released on March 19, 1986.

In addressing the various reforms recommended by the TPWG, the report's preface includes this disclaimer: "The Working Group does not at this time recommend how these reforms should be implemented – whether at the federal or state level, or through legislative or judicial modification of the law; nor are these reforms meant to be an exhaustive list of potential reforms." This would suggest that the report's recommendations would be appropriate items for consideration by the Texas Legislature.

The TPWG concluded that there is an inherent causal link between the liability insurance crisis and the continuing changes in the tort law. Specifically, the TPWG identified four problem areas. (The phrases or words in quotation marks are taken from the report.):

1. The steady movement toward no-fault liability, "which increasingly results in companies and individuals being found liable even in the absence of [proof of] any wrongdoing on their part."

2. The erosion of the judicial principle of causation through a variety of "questionable practices and doctrines" that shift liability to "deep pocket" defendants – even when those defendants are "only tangentially involved" in the cause of injury or death.

3. The "explosive growth in the damages awarded" in civil lawsuits, particularly with regard to "noneconomic awards such as pain and suffering or punitive damages."

4. The "excessive transaction costs" of the tort system, in which "virtually 2/3 of every dollar paid out through the system is lost to attorneys' fees and litigation expenses."

In its chapter on recommended civil justice reforms, TPWG asserts:

> There appears to be little that can or should be done by the federal or any other government to "remedy" the economic factors that underlie the current availability / affordability crisis. The excesses of the tort system, however, present a very real opportunity to address a major cause of the insurance crisis with sensible and appropriate reforms. And, while some of the changes in the insurance market currently under contemplation probably will relieve some availability / affordability problems, it seems unlikely that these changes will provide long-term, systematic relief without fundamental reforms of tort law.
>
> [The TPWG] identified [a number of] tort reforms which, if implemented, should return tort law to a credible fault-based compensation system that provides a fair and reasonable level of compensation to deserving plaintiffs through a more predictable and affordable liability-allocating mechanism. While these reforms undoubtedly will be resisted by some, they are, in fact, quite modest and should not dramatically alter the basic principles of tort law as they have existed for centuries.

The following are the TPWG's suggested civil justice reforms:

Recommendation 1: Retain fault as the basis for liability.

The TPWG concludes that fault is the "only mechanism in tort law" that makes it possible to distinguish desirable conduct from that which is undesirable. Without the concept of fault, it is extremely difficult to avoid arbitrary or unfair assessment of damages in cases involving injury or death.

The TPWG contends that negligence should remain the applicable standard of fault in non-product liability cases. A strict product liability standard that does not force an unfair burden of proof on the plaintiff, while still allowing for a reasonable fault-based

system of liability, should be articulated. It would be characterized by the following elements:

> --Liability should be predicated on the existence of a defect that renders a product "unreasonably dangerous."
>
> --Defendants should only be held responsible for products that are used in a reasonable or foreseeable manner. Manufacturers should not be considered liable for products that are altered or used in an unforeseeable or prohibited manner (including the failure to provide required maintenance or observe safety standards).
>
> --Manufacturers should be free from liability for defects that have been the "subject of an adequate warning or which are readily apparent to the reasonable consumer."
>
> --Liability should only grow out of the state of industrial knowledge that exists at the time of manufacture of the product. Manufacturers should not be responsible for unknowable (given the state of technology) hazards or defects.

Recommendation 2: Eliminate joint and several liability.

Judicial apportionment of fault or responsibility in multiple defendant liability actions has made the doctrine of joint and several liability highly questionable. The TPWG has concluded that "joint and several liability frequently operates in a highly inequitable manner," allowing recovery from "deep pockets" (i.e., individuals or organizations that have considerable financial assets or insurance coverage), even in the absence of a reasonable degree of fault. Consequently, the TPWG recommends that the doctrine be preserved only in those situations where it can be shown that the defendants acted in concert to cause the claimant's injury.

Recommendation 3: Limit noneconomic and punitive damages to a fair and reasonable amount.

The TPWG argues that noneconomic damages are suitable for limitation because they are subjective, cannot be quantified, and are extremely unpredictable from an underwriting standpoint. Although plaintiffs deserve to be compensated for intangible harm, that compensation should be kept within reasonable bounds. Specifically, the TPWG suggests a limit of $100,000 (including punitive damages).

The TPWG is skeptical that punitive damages are warranted, even in cases involving actual malice, because punishment of misconduct has traditionally been a function of the public law enforcement system. Nevertheless, it does not recommend prohibiting them so long as the possibility of a deterrent effect continues to exist. However, if it is shown that punitive damages cannot be feasibly capped with noneconomic damages, the TPWG recommends that they be abolished.

<u>Recommendation 4: Provide for periodic payment of future economic damages.</u>

The TPWG supports this recommendation with several arguments:

--The capacity of defendants (or their insurance companies) to absorb large judgments is substantially improved through installment payments (similar to the principle of making large capital purchases with debt);

--Plaintiffs are given a guaranteed source of income and cannot squander their award within a short time;

--The cost is reduced because the award is paid out over time with depreciated dollars;

--Periodic payment of future damages means that compensation is rendered in a manner that is consistent with the way the damages are, in fact, incurred.

<u>Recommendation 5: Reduce awards by collateral sources of compensation for the same injury.</u>

The collateral source rule was created at a time when most collateral sources of income were financed principally by the claimant. It has become an anachronism,

however, because most plaintiffs today have collateral sources of benefits that are provided by the government (Social Security) or third parties (e.g., employers who furnish health insurance). This recommendation prevents the plaintiff from obtaining a windfall of double or triple recovery for damages.

Recommendation 6: Schedule contingency fees.

The TPWG does not advocate abolition of the contingency fee system because "such fees are the only means available to the poor to afford an attorney and obtain access to the legal system." A problem emerges, however, when "awards become very high and a flat rate becomes excessive. Contingency fees should be scheduled to decrease as awards increase."

Specifically, the TPWG recommends the following schedule: 25 percent for the first $100,000; 20 percent for the next $100,000; 15 percent for the next $100,000; and 10 percent for any award in excess of $300,000. In the event of a $500,000 award, the plaintiff's attorney would receive $80,000 rather than $166,666 (assuming a 33 percent flat rate), and an award of $1 million would result in a $130,000 fee rather than $333,333.

The TPWG cites the following justifications for scheduled contingency fees:

> --Verdicts are "often inflated by judges and juries to compensate plaintiffs for what is well understood to be high attorneys' fees." The fees are passed on to the insured population through more costly premiums. "It is difficult to justify placing such a burden on American consumers for the purpose of paying what often amounts to exorbitant attorneys' fees."
>
> --Flat contingency fees can "often become a major impediment to settlement since defendants may balk at paying a higher than justified award in order to compensate plaintiffs for exorbitant attorneys' fees."

--Contingency fees may lead "plaintiffs' attorneys to hold out for high noneconomic damages" (allowing for a huge return on only minimal additional work), "while the clients may be best served with obtaining economic damages and more limited noneconomic damages as promptly as possible."

--The Federal Tort Claims Act specifies a 25 percent cap on attorney's fees for lawsuits filed under the act and a 20 percent cap for settlements obtained within the administrative claims process. The Social Security Act also has a 25 percent limit. None of these caps appears to have had "any significant effect on the ability of persons suing the government to obtain adequate legal representation. In fact, the number of lawsuits filed under both Acts has increased substantially in recent years."

Recommendation 7: Develop alternative dispute resolution mechanisms.

Alternative dispute resolution possibilities "range from binding arbitration to mediation, and include such procedural innovations as mini-trials and expedited discovery techniques." Actual legal experimentation is the only way that the various methods could be tested and refined. The TPWG believes that state government represents an "excellent laboratory in which to develop and explore these various alternative dispute resolution proposals."

Conclusion

The joint committee's yearlong fact-finding effort has resulted in a number of important and interrelated conclusions. First, the liability insurance crisis is real, and it is having a demonstrably negative effect on many activities in this state. Second, those negative effects make the profitability of the liability insurance industry a public policy problem that mandates a governmental response. Third, the legislature, and not the judicial branch, is the proper constitutional mechanism to effect that response. Finally, the best legislative response cannot be exclusively limited to one particular set of reforms. Lawmakers must look at the full range of their options, including tort reform,

insurance reform, enhanced regulatory oversight of the insurance industry, and enhanced medical professional discipline, and choose those solutions that are most likely to improve the situation.

The insurance proposals emerge from a consensus among the committee members that there are legislative approaches that can be recommended now, even in the absence of more substantive Texas data concerning paid losses. After the State Board of Insurance presents the results of its closed claims study, the need for stronger or more diversified legislation might become apparent.

On the other hand, there is no need for further substantiation of a fundamental breakdown in the predictability of the civil justice system. The urgent need for restoration of predictability in the civil justice system is apparent to the joint committee, and its tort reform recommendations are largely meant to address that need.

The joint committee was fully aware of the importance of formulating tort reforms that achieve their objectives without compromising the fundamental rights of persons injured through their actions of others to obtain relief from their injuries through the court system. The tort reform proposals strike a reasonable balance between sensible and much-needed change and the preservation of basic American rights.

Since the tort reforms are targeted at the forces that are pushing paid losses higher and higher, there is good reason to believe that the reforms will be effective in stabilizing

the profitability of the liability insurance industry. Stability, in turn, should bring lasting relief to the doctors, day care center owners, local government officials, nonprofit directors, and others who are having a difficult time maintaining the quality and affordability of their services and products in the face of the liability insurance crisis.