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**AN ESSAY ON LIABILITY INSURANCE AND  
ACCIDENT COMPENSATION**

**and**

**FIVE PAPERS ON LIABILITY INSURANCE**

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**Submitted for the award of Ph.D.**

**by**

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**September 2001**

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# AN ESSAY ON LIABILITY INSURANCE AND ACCIDENT COMPENSATION

## INTRODUCTION

There is little academic literature on the subject of liability insurance or, to be more precise, there is little literature where liability insurance provides the main focus and is not just an ancillary issue. Material of latter sort is abundant. As one might expect, there are many references to the role of liability insurance in the large corpus of work that deals with tort law and accident compensation. In this literature the importance of liability insurance as a component of accident compensation systems is usually acknowledged. However, little attention has been paid to the way in which this form of insurance operates, the technical and other problems it presents for insurers and the dynamics of the market in which it is written. Again, whilst there are numerous ‘histories’ of marine, fire and life insurance, and one or two that deal with accident insurance as a whole, none is devoted to liability insurance as such.

The paucity of academic comment on liability insurance is rather surprising, given its importance. Liability insurance is viewed, almost universally, as an integral part of compensation systems that depend on tort liability. Indeed, one of the most respected judges of his generation described the liability insurer as the *deus ex machina* of the tort system,<sup>1</sup> the hidden force that controls and regulates the development of this branch of the law. Unfortunately, however, regulatory mechanisms can sometimes fall short of divine perfection, and the mechanism of the tort/liability insurance system has sometimes become unbalanced, as in the North American ‘insurance crisis’ of the mid-1980s, when a shortage of affordable liability insurance caused some dislocation of business activity.<sup>2</sup> On the few occasions when this has happened academic interest in the topic has become heightened and the device of liability insurance (and the enterprises that provide it) have come in for criticism along with the tort system itself. However, a shortage of liability insurance at any given time

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<sup>1</sup> Diplock, Rt. Hon. Lord Kenneth ‘Conventions and Morals’, 1 *JMLC* 525 (1990).

<sup>2</sup> There was also a more specific ‘crisis’ over the availability of product liability insurance in the US in the years 1975-6.

does not necessarily indicate that the whole system is flawed. It might equally be taken as salutary signal that an otherwise sound system needs some adjustment and, perhaps, that too quick an expansion of liability rules, or a general uncertainty about where the law is going, needs to be addressed. Nevertheless, much academic comment on the tort/liability insurance system has been critical. It is frequently argued that the mechanism is inefficient, expensive and potentially unreliable. Furthermore, insurers also regard liability insurance as unattractive in business terms. This is because most lines of liability insurance, in most markets, at most times, have been loss makers. In some cases the losses have been spectacular, as in the case of the huge deficits on liability insurance accounts in the United States that contributed more than anything else to the near collapse of Lloyd's in the late 1980s. A recent survey of all UK companies that write liability business, conducted by the author, reveals just how diffident insurers are where this form of insurance is concerned. The results of the survey, which are discussed in more detail in Part 6 of this essay, make one wonder how insurers came to write this class of insurance in the first place and why they do so still. Dealing with the first part of the question – the reasons for the evolution of liability insurance as a separate and highly problematic class of business – it is clear that the process was largely fortuitous. As we shall see, liability insurance was initially an incidental by-product of the first party 'accident' insurance classes that emerged as a consequence of industrialisation in the nineteenth century. By a gradual and somewhat random process it developed into a class in its own right – and one that sometimes provided much wider cover than other forms of insurance. Indeed, it is most curious that insurers, through the medium of liability insurance, have assumed risks that were regarded, and are still regarded, as uninsurable as first party risks. There is no single answer to the second part of the question – why insurers should persist in writing perennially unprofitable liability business. However, the author's research suggests that most insurers continue to underwrite this line mainly for tactical reasons and, in particular, to support insurance business, such as property and life, that is more likely to be rewarding.

The link between liability insurance and tort law has already been mentioned: clearly, the two are so closely related that they stand or fall together. However, they do not form a complete system. They are merely part of a yet wider scheme through which



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society seeks to compensate the victims of misfortune. This wider scheme employs other devices to deliver compensation, including private first party insurance and a variety of social security benefits offered by the state. Compared with these, tort plus liability insurance can appear remarkably costly and inefficient. Yet, despite all its problems and deficiencies the tort/liability insurance system has continued to grow, develop and evolve. Almost without exception, efforts to abolish or replace it have failed.<sup>3</sup> Attempts to prune back one area have often simply stimulated new growth in another. For example, the world-wide adoption of workers' compensation schemes as a cost-effective and, perhaps, more equitable alternative to employers' liability has never entirely satisfied the demands of all those who are injured at work. The employers' liability risk continues to develop in many countries and, where it remains restricted, injured workers have simply sought alternative targets for liability claims. Typically, these include manufacturers and producers of hazardous machinery or dangerous substances found in the workplace and, to a lesser degrees, the directors and professional advisers of the firms concerned. The reason for this phenomenon, which might be called 'claims displacement', is obvious. Restriction or abolition of liability rules in selected areas only (such as work injuries) create imbalances by treating groups of accident victims differently, encouraging those who are (or feel) discriminated against to seek alternative remedies. Again, no-fault alternatives to liability systems, whether they are general or selective schemes (such as workers' compensation), spread compensation more widely and, as an inevitable result, spread it more thinly. Thus, whilst all accident victims within such schemes receive compensation none is compensated in full. This 'some for all, not all for some' approach may satisfy an accident victim if he himself, or nobody, is at fault. However, it is less likely to do so if another is to blame. Victims of negligence, or more egregious wrongdoing, often feel that they deserve more, and wish to distinguish themselves from those who have suffered by pure mischance. This desire for 'full' compensation, and for the formal recognition of wrongdoing that an award of tort damages implies, creates a powerful incentive to probe channels of

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<sup>3</sup> The New Zealand accident compensation scheme – a *cause célèbre* for opponents of the tort system – is the most notable exception. Tort liability has also been replaced, or partly replaced, by no-fault workers' compensation and road accident schemes in some countries.



compensation where liability rules can still be exploited.<sup>4</sup> Furthermore, there is evidence of a markedly increased readiness to exploit tort remedies in many Western countries at the present time. This phenomenon, loosely described as the ‘compensation culture’, is also explored later in this essay. Evidence suggests that the desire of potential defendants in tort cases to spread the risk through insurance is equally deep-rooted.<sup>5</sup> As we shall see, efforts to curtail the use of liability insurance on grounds of public policy have been consistently outflanked by business people. The latter, driven by commercial necessity, have insisted on the right to insure. Equally, when the ‘moral hazard’ that liability insurance presents has been weighed against the uncompensated harm that insolvent and uninsured tortfeasors are likely to inflict, on the roads and elsewhere, insurance has usually seemed the lesser of the two evils.

The central issue for the tort/liability insurance system is one of stability: if it is to function effectively, a compensation system that depends on liability insurance, or uses liability insurance as a substantial component, must produce outcomes that are reasonably predictable for all concerned. Stability and predictability are necessary from the perspective of potential and actual claimants. If they are to plan their activities, and balance the risks of everyday life (such as taking a job, travelling in a car or aircraft or buying a product), they must have assurance that appropriate compensation will be available if they suffer loss or injury. It is also necessary for policyholders who, in choosing (or being obliged) to diversify risks through insurance markets, must know that insurance will be available at a reasonably stable price over the long term, and that such insurance will respond to losses and liabilities incurred in a predictable way. Failing this, budgeting becomes impossible. Finally, of course, it is necessary for insurers who, in order to attract the capital that is necessary to support their business, must be able to measure the production costs of insurance, price their policies accurately and give their shareholders an adequate return. Of course, there

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<sup>4</sup> Of course, for an accident victim, the decision to sue is an entirely subjective one. Arguments about economic inefficiency, administrative inconvenience and fundamental flaws in fault-based liability systems, no matter how well founded, are unlikely to affect an individual accident victim’s decision to pursue a tort remedy.

<sup>5</sup> For a discussion of liability insurance as a social good see Shavell, S. (2000) ‘On the social function and the regulation of liability insurance’ *The Geneva Papers on Risk and Insurance* Vol. 25, No. 2, pp. 166-179.



are other stakeholders in the tort/liability insurance system, including consumers (since insurance cost and availability affects the cost and availability of most products and services) and governments which, increasingly, use liability insurance as a means of extending social security systems.

Sources of instability provide a major focus for the exploration of liability insurance, and the tort/liability insurance system of which it is a part, that is carried out in this essay. Rapid expansion of tort law, steep rises in damages awards and inherent problems of moral hazard are some of the potentially destabilising factors that are considered. It will also become apparent that the path along which liability insurance has developed has led insurers to assume risks that generate the most intractable technical problems. Because these difficulties have not been addressed successfully, liability insurance has become a class of insurance that few general insurers wish to write in isolation from other, more profitable, insurance business and many do not wish to write at all. Recently, we have seen the collapse of the only major UK insurer that appeared to have found a formula for the successful exploitation of liability insurance in recent years – *Independent Insurance*. This has brought the problems of this class of insurance, and the fragility of some parts of the market, into sharp relief.

This essay aims to provide an analysis of all the key issues surrounding the practice of liability insurance, including those mentioned above. It attempts to trace systematically the development of liability insurance, to evaluate its role, analyse the key problems that insurers face in writing this form of insurance and consider the impact of all this on accident compensation systems. In the course of the analysis the author draws upon, links and summarises the themes of five published papers on the subject of liability insurance. The essay expands upon a number of issues raised in these papers and presents some reasoned arguments in their support.

The papers, which are included in Volume II, Appendices II–VI are:

- 1 ‘Employers’ liability insurance – how secure is the system?’ *Industrial Law Journal*, Vol. 28, No. 2, June 1999, pp. 109-132.

- 2 'Compensation and insurance for injuries at work: a European perspective', *International Journal of Insurance Law*, Part 3, July 1999, pp. 214-233.
- 3 'Industrial injuries and employers' liability – a search for the cure', (Monograph) *Chartered Insurance Institute*, 1999. Awarded Morgan Owen medal and prize for best research work by a member of the CII.
- 4 'Compensating psychiatric illness: issues of liability and insurance' *Journal of Insurance Research and Practice*, Vol. 16, Part 1, January 2001, pp. 14-26.
- 5 'Managerial liability, risk and insurance: an international view' *International and Comparative Corporate Law Journal* Vol. 3, Issue 1, 2001, pp. 1-31.

*N.B. When reference is made to the papers in this essay they are cited in an abbreviated form, as follows: 1 'How Secure is the System?', 2 'European Perspective', 3 'The Cure', 4 'Psychiatric Illness' and 5 'Managerial Liability'.*

This essay is intended to be broad in scope. Therefore, inevitably, it touches on some issues which are not explored in detail in the articles listed above and which, for reasons of space, cannot be given the detailed attention they deserve here. There is much scope for further research.<sup>6</sup>

The essay is structured in six parts. Part 1 traces the historical development of liability insurance as an outgrowth of accident insurance, a broad miscellaneous class with its own origins in the revolutionary changes in industry, trade, and transport that began as the eighteenth century drew to a close. Part 2 analyses the problems that began to emerge once liability insurance became a class of insurance in its own right. This section shows, in particular, how liability insurers came to assume long-tail risks,

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<sup>6</sup> For example, and in no particular order: moral hazard in the lawmaking process and in the placing and underwriting of liability insurance, risk segmentation and adverse selection in liability insurance, the nature and extent of the 'compensation culture', alternative policy triggers for employers' liability insurance, the relationship between liability insurance and legal expenses insurance and between the markets that provide them.



exposures of a kind that were always regarded as uninsurable in the context of first-party insurance. Part 3 looks at how insurers have responded to these difficulties and examines the technical problems they face in attempting to design contracts that satisfy both the security requirements of policyholders and their own need to price liability risks accurately and reduce their uncertainties to manageable proportions. Part 4 examines behavioural aspects of liability insurance and the issue of moral hazard: the possibility that the granting of insurance cover might promote opportunistic behaviour or modify human actions in a way that adversely affects the interests of insurers, or society as whole, or both. It is argued that this phenomenon takes on extra dimensions in the context of liability insurance, creating additional layers of uncertainty for insurers and greater potential instability for liability insurance systems. Part 5 examines a connected issue: the relationship between liability insurance and liability rules, especially those of tort law. Here we consider the extent to which the existence or availability of insurance impacts upon judicial and legislative policy, and the extent to which it should properly do so. The essay concludes, in Part 6, with a summary of the issues explored and an assessment of possible future developments in liability insurance markets. As part of this assessment the perceptions of the major stakeholders in the systems that employ liability insurance are considered, including liability insurers, the Government, the general public and the lawmakers. It is observed that these perceptions – as to the proper role of liability insurance, and what can be achieved effectively through its use – differ widely. The author concludes that all would benefit from a better informed and, perhaps, more realistic assessment of what liability insurance can do, and what it cannot. If the system is to remain stable, there is a need for a greater understanding of the problems of liability insurance, and the limits of its effectiveness, amongst all stakeholders in the tort/liability insurance system, including the lawmakers, the Government, the public at large and insurers themselves.

## 1 **ORIGINS: FROM ACCIDENT TO LIABILITY**

The class of insurance business now known as liability insurance has its roots in the early nineteenth century, or even a little before. Its growth was encouraged by rapid developments in industry, trade and transport around this time. Hitherto, only three forms of insurance were commonly available. They were marine insurance, life insurance and fire insurance, the regular practice of which, in Europe, dates (approximately) from the fifteenth, sixteenth and seventeenth centuries respectively.<sup>7</sup>

It is important to understand that what we, on this side of the Atlantic, now call liability insurance originally formed part of a broad and miscellaneous class known as ‘accident insurance’. This name was used to describe any form of insurance that was neither marine, life, nor fire and which covered losses arising from some sudden harmful event, unintended and unexpected by the insured, such as a burglary, explosion, or road or rail accident. These risks were assumed initially by specialist insurers, the ‘accident offices’. However, in the first quarter of the twentieth century many of these were bought up by the large fire insurance companies, which thus became ‘composite’ insurers. Nowadays, the term ‘accident insurance’ is almost obsolete, though the term ‘personal accident’ is still used to describe policies that cover accidental bodily injury.

An alternative term, ‘casualty insurance’ (which seems to have originated in the United States), originally had a meaning that was roughly equivalent to that of accident insurance. However, it has now come to be associated with liability insurance in particular. Thus, general (non-life) insurances are now often classified as either ‘property’ or ‘casualty’. Under this categorisation theft insurance, originally a form of accident insurance, now falls in the ‘property’ class.

Though the terminology can be confusing, it is clear that the early accident insurers did not regard the liability risk – financial loss arising from an obligation to pay

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<sup>7</sup> The point has often been made that the rise of Britain as an industrial power in the eighteenth and nineteenth centuries was partly attributable to the ready availability of marine and fire insurance in the London market.



damages – as different in quality from other losses that might arise from an accident, such as damage to the insured's own property. The essence of the matter was the accident itself, the sudden event that caused loss to the insured. Insurers were not concerned with losses that arose from gradual processes, such as pollution or gradually developing disease. Indeed, the early accident insurers can hardly have imagined that risks of this sort would eventually become the subject of insurance through the medium of liability insurance or that the latter would become a class in its own right, with its own principles and own peculiar problems.

The origins of some branches of liability insurance are not well documented and hence rather obscure, but it is evident that this type of insurance developed in a rather fragmented way. The sections that follow trace the development of the main classes.

## 1.1 MARINE LIABILITIES

Marine insurers were the first to assume liability risks, although the precise date of their beginning to do so remains in doubt. The initial subject matter was the 'running down' risk, that is, the obligation to pay compensation that arises as a consequence of a collision between two or more ships. The English law relating to collisions at sea has very ancient origins<sup>8</sup> and included a rule, common to the whole maritime world for more than eight hundred years, that required the whole damage to be divided equally between the owners of two ships in cases where both were at fault.<sup>9</sup> In *De Vaux v. Salvador*,<sup>10</sup> where two vessels had collided in the Hoogly river, the application of this rule required the sailing ship *La Valeur* to pay a balance to the steamer *Forbes*, both being at fault and the latter having suffering greater damage than the former. Lord Denman, in the Court of King's Bench, held that this sum was not recoverable from the marine insurers of *La Valeur*. The issue was seen primarily

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<sup>8</sup> The original principles are contained in the Black Book of the Admiralty (circa 1350). This itself is a compilation of earlier medieval codes, including the Rolls of Oleron (circa 1160).

<sup>9</sup> Article XIV of the Rolls of Oleron provides that, in the event of a collision: 'the whole damage shall be in common and be equally divided ... and the master and mariners of the vessel that struck or grappled with the other, shall be bound to swear on the Holy Evangelists, that they did it not willingly or wilfully. The reason why this judgement was first given being, that an old decayed vessel might not purposely be put in the way of a better, which will the rather be prevented when they know that the damage must be divided.'

<sup>10</sup> (1836) 4 A. & E. 420.



as one of causation. According to the judge, the obligation to pay the owners of the other ship was ‘neither a necessary nor a proximate effect of the perils of the sea’ but a consequence of the Admiralty rule: ‘an arbitrary provision in the law of nations from views of general expediency, not as dictated by natural justice, nor (possibly) quite consistent with it’. This judgement effectively drew the limits of the ordinary marine insurance contracts of the time, confining their scope to first-party losses: payments to third parties, due as a consequence of the operation of the general law had to be specially insured.<sup>11</sup> Following *De Vaux v. Salvador* London market insurers began to introduce cover for collision liabilities under what was then known as the Running Down Clause (RDC).<sup>12</sup> However, there were examples of collision liability coverage well before that date, a London insurance company (the *Indemnity Mutual Marine Insurance Co.*) having drawn up a similar clause when it commenced business in 1824.<sup>13</sup> Furthermore, there is evidence that some of the mutual ‘Hull Clubs’, the forerunners of the Protecting and Indemnity (P&I) Clubs, covered liability for collisions at an earlier date still.<sup>14</sup> This is apparent from *Delanoy v. Robson* (1814).<sup>15</sup> This case is discussed in more detail in Section 4.2. However, we can note here that the court in *Delanoy* addressed itself, amongst other things, to the legality of insurance against damages that a ship owner had to pay as a consequence of his vessel colliding with another, providing an early discussion of the particular moral hazard associated with liability insurance. It seems that Lloyd’s underwriters shared these concerns. Economic and technological change (including the advent of steam navigation) brought increases in the size, complexity and value of vessels as the century progressed and this, in turn, raised the demand for ‘running down’ cover,

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<sup>11</sup> Around the same time as *De Vaux v. Salvador* the Supreme Court of Massachusetts ruled to opposite effect in *Peters v. Warren Insurance Co.* (1840) 39U.S. 99. A later judgement, *General Mutual v. Sherwood* (1852) 55U.S. 352, followed *De Vaux v. Salvador* and brought American law into line with English law.

<sup>12</sup> Now known as the Collision Liability Clause.

<sup>13</sup> See O’May, D. (1993) *O’May on Marine Insurance*, p. 213.

<sup>14</sup> A coal factor who gave evidence to the 1810 Select Committee on Marine Insurance (BPP (226) 1810 IV 247) suggested that there were two such clubs in London and around twenty in the northern ports, including Scarborough, Whitby, Sunderland, Shields, and Newcastle. The clubs in the north apparently refused membership to owners of ‘bad ships’, obliging the latter to buy dearer insurance at Lloyd’s coffee house or from one of the two chartered companies then in existence. Apart from the cost, this was a great inconvenience, because the distance from London made it impossible for ship owners to question underwriters personally in order to establish their soundness and integrity. This remoteness necessitated the use of insurance brokers, whose own probity was sometimes doubted at the time.

<sup>15</sup> (1814) 5 Taunt. 605.



which was added to the old S.G. form of marine policy. Some Lloyd's underwriters thought that this form of insurance might make the masters of ships less careful, and petitioned the Government in 1850 and again in 1854 to procure legislation restricting the granting of collision cover. As O'May notes: 'The Government declined to intervene but these moves were indicative of the general antipathy of underwriters to such insurances, and the doubt as to their legality'. As we shall see, the fears concerning liability risks of these nineteenth century Lloyd's underwriters were fully realised in the late twentieth century, when colossal losses on US liability business delivered harsh lessons to their less cautious successors, bringing the 300 year old insurance market to its knees. In the event, and in the absence of Government intervention, marine insurers of the time attempted to deal with the problem by agreeing amongst themselves to restrict cover to three-quarters of the collision liability, thinking that this would encourage careful navigation.<sup>16</sup> However, any beneficial effect on the quality of seamanship that such a restriction might have achieved was quickly negated, because ship owners responded simply by insuring the remaining one-quarter of the risk with the Protecting and Indemnity Clubs mentioned above. Indeed, as the potential liability of ship owners increased in the nineteenth century,<sup>17</sup> the P&I clubs assumed an increasingly important role as marine liability insurers. In addition to the uncovered one-quarter of collision expenses and any excess liabilities above the value of the vessel<sup>18</sup> they eventually came to insure many other third-party risks, including those arising from damage to fixed and floating objects, injury to passengers and crew,<sup>19</sup> damage to cargo and pollution.

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<sup>16</sup> O'May *op cit* note 13 p. 215. See also the discussion in the Insurance Institute of London, *Historic Records Committee Report H.R. 3* p. 2.

<sup>17</sup> Apart from rising ship values, and general legislation such as The Fatal Accidents Act 1846 and Employers' Liability Act 1880, there were measures that affected ship owners specifically, including the Harbours, Docks and Piers Clauses Act 1847. This allowed harbour authorities to recover for damage to port works even in the absence of negligence on the part of the ship owner.

<sup>18</sup> The Marine Insurance Act 1745 prohibited owners from insuring against their liabilities for sums in excess of the value of their ships. A statute of 1854 set a limit of liability that was based on tonnage, but assumed that all vessels were worth £15 per ton, whereas many were worth much less. Thus, ship owners often faced claims for amounts greater than the value of their own vessels.

<sup>19</sup> *Taylor v. Dewar* (1864) 5 B. & S. 58 established that insurance against collision did not cover liability for loss of life, which had to be insured separately.

Apart from anything else, the growth of the P&I Clubs in the nineteenth century is part of a recurring theme in the history of liability insurance, in which moves to restrict or suppress the device on grounds of moral hazard, or for other reasons, have been regularly outflanked – on the one hand by persons who remained anxious to protect themselves from liabilities that might devolve upon them and, on the other, by victims who insisted on the right to sue. We will return to the issue of moral hazard, and the general relationship between liability insurance and liability rules in Parts 4 and 5 of this essay.

## 1.2 FIRE RISKS

As we have seen, some of the earliest liability insurance covers grew out of an existing class, marine insurance. It would not be surprising to find this pattern of development repeated in the case of fire insurance, the other main form of general insurance at the time. For example, a parallel development might have occurred as a consequence of claims for spreading fires. Such fires were very common at the time and, if a property owner incurred liability as a consequence of fire spreading from his premises, he might well have looked to his fire insurers for an indemnity. He would argue, of course, that the liability to compensate his neighbour was proximately caused by the fire against which he was insured. In fact, there appears to be no case where this precise issue was raised. However, an analogous situation arose in *Re Wright and Pole*<sup>20</sup> where an innkeeper failed to recover from his fire insurers for loss of custom and the cost of hiring other premises whilst his inn was under repair. The court held that the object of a fire policy was to indemnify the insured against loss of the subject matter of insurance and a loss such as this, which was merely consequential on the loss of the subject matter, was not within its scope. Following this case, and that of *De Vaux v. Salvador*,<sup>21</sup> decided two years later, any attempt to extend fire insurance to include liability risks was probably doomed to fail. In any event, damages claims for spreading fires were probably quite rare, because liability

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<sup>20</sup> (1834) 1 Ad. & El. 621.

<sup>21</sup> Note 10.



would generally depend on proof of negligence, a branch of the law that was undeveloped at the time.<sup>22</sup>

In fact, the next line of liability insurance to emerge – the forerunner of motor insurance – developed quite independently of any existing class.

### 1.3 DRIVERS' POLICIES – '*CHEVAL ET VOITURE*'

Whilst British insurers are generally recognised to have been the innovators in the commercial development of fire<sup>23</sup> and life insurance, 'accident' insurance, including the insurance of non-marine liability risks, was practised first in France, fifty years earlier than in England. This fact is hardly acknowledged in British insurance literature.<sup>24</sup> The initial impetus was provided by an ordinance of the Paris *Préfet de Police* on 23 August 1821 which required the *cochers* of Paris to pay the sum of twenty centimes per day into a central fund, for the compensation of third-party victims of driving accidents. This inspired the formation of a company, *L'Automédon*, which offered, from 1825 onwards, policies covering the third-party liability of horse and carriage drivers. Other insurers quickly offered to cover the same risk.<sup>25</sup> Predictably, many people denounced this form of insurance on grounds of public policy, and their opposition slowed its development. One of the early companies, *La Parisienne*, struggled regularly from 1829 onwards with attempts to suppress its issuing of policies '*chevaux et voitures*' and only in 1845 were such

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<sup>22</sup> The Fires Prevention (Metropolis) Act of 1774 excluded liability for fires that were accidental in origin. The fact that the defendant brought highly inflammable things onto his land made no difference, until *Rylands and Fletcher* (1865) LR 3 HL introduced a rule of strict liability that was extended to such situations (see *Jones v. Festiniog Ry.* (1866) LR 1 Ex 265, *Powell v. Fall* (1880) 5 QBD 597 and *Musgrove v. Pandelis* [1919] 2 KB 43).

<sup>23</sup> Although it is unlikely that fire insurance was a British invention: for example, a German fire insurance mutual was established by farmers in the Süderuendorf as early as 1537, long before the first British fire insurance companies were formed. See also note 58 (Michel Albert's view about the Alps as the 'cradle' of non-marine insurance and Trennery's research on fire insurance amongst the medieval guilds of Flanders).

<sup>24</sup> '... tandis que nos premiers assureurs Incendie et Vie n'avaient été que les bons élèves des assureurs britanniques, les pionniers français de l'assurance Accidents été véritablement des initiateurs. La France a devancé à cet égard les pays voisins' (Richard, P. J. (1956) *Histoire des Institutions D'Assurance en France* p. 68).

<sup>25</sup> Including *La Prévoyance*, *La Seine* and *La Parisienne*, all of which issued policies from around 1830. See Richard, *op cit* note 24 at p. 68.

insurances declared to be legally valid by a senior tribunal.<sup>26</sup> Despite their being aware of developments in France, and increasing congestion of horse-drawn vehicles in London and other big cities, British insurers did not offer similar policies until 1875. Once they had begun to do so, one early insurer,<sup>27</sup> perhaps conscious of the debate about moral hazard, introduced a novel ‘Coachman’s Good Conduct Bonus’. Under this scheme a sum was to be set aside each year for distribution to drivers who held certificates of good conduct ‘as an encouragement for good servants and careful driving’. However, it appears that the main aim of this early version of the familiar ‘No Claims Bonus’ was to save the carriage owner’s valuable horses from injury.<sup>28</sup> Of course, before the turn of the century motor cars began to appear on the roads of Europe and drivers’ policies were quickly adapted to the risks, including liability exposures, associated with this new form of transport. In the course of the twentieth century motor insurance would grow to become the biggest class of general insurance by far.<sup>29</sup>

#### 1.4 STEAM POWER AND THE RAILWAYS

Steam carriages appeared occasionally in the 1830s, but it was on the railways rather than the roads that steam was fully exploited as a cheap and speedy means of transport. In the early years the accidents that occurred, though rather less frequent than many imagine,<sup>30</sup> often took many lives at once, and were widely publicised. This alarming new risk, or at least the public perception of it, led insurers to offer protection. However, whilst the railways gave birth to personal accident insurance – first-party fixed benefits cover for death and bodily injury – their contribution to the development of liability insurance was much less significant. The pioneer in the field,

<sup>26</sup> A decision of the *Tribunal de Commerce de la Seine* declared drivers’ policies void, as contrary to public order, on 21 August 1844. However, a group of eminent jurists effectively overturned this judgement in a declaration of the *Cour de Paris* a year later, on 1 July 1845. See Richard, *op cit* note 24 at p. 69 and Dinsdale, W.A. (1954) *History of Accident Insurance in Great Britain* p. 178.

<sup>27</sup> The *London and Provincial Horse and Carriage*.

<sup>28</sup> See Dinsdale *op cit* note 26 p. 180.

<sup>29</sup> Motor insurance now accounts for about 40% of world non-life premium income.

<sup>30</sup> In the five years 1852-56 there were 2,400 railway fatalities, an average of 480 per year. However, during this period there were, on average, 4,157 deaths each year due to mechanical injuries, 3,826 deaths from drowning, 3,046 from chemical injuries, 1,107 killed by horses or horse conveyances and 985 coal mining fatalities. (Cornelius Walford (1871) *The Insurance Cyclopaedia*).



and one of very few companies to flourish, was the *Railway Passengers*, established by private Act of Parliament in 1849. The Act provided for passengers to be insured against fatal accidents for fixed amounts of £200 for third-class passengers, £500 for second-class and £1,000 for first-class, only the latter having the luxury and relative safety of a covered carriage in which to travel. In the case of non-fatal injury, a sum was to be paid (not exceeding the fatal benefit) ‘as shall be deemed a reasonable and liberal Compensation for such Injury, as well as for the Pain of Mind and Body and the Loss of Time and Money consequent thereon’.<sup>31</sup> With the agreement of the Railway Clearing House cover was provided by means of specially printed ‘insurance tickets’. These were issued by booking clerks who were rewarded by means of commission. To encourage their support station masters were allowed to take up to ten shares in the company. However, a few railway companies were reluctant to join the scheme, fearing that offers of insurance might alarm their passengers rather than make them feel secure. It is interesting to note that the *Railway Passengers* attempted to counter this argument by suggesting that, if they were insured, injured passengers would be less likely to sue for damages, and claims by dependants of those who were killed (under the recently-introduced Fatal Accidents Act 1846) might also be less frequent. However, Parliament clearly anticipated this argument and effectively weakened it: Section 36 of the act that established the *Railway Passengers* providing that compensation paid by the Company was in no case to be taken in diminution of damages otherwise recoverable at Common Law or under Statute. Since they could not shift the cost of these claims back onto their customers, the railway companies themselves raised the possibility of liability insurance, suggesting in the course of negotiations about insurance tickets that the *Railway Passengers* might also indemnify them against claims under the 1846 Act. However, the insurer declined to do so, having been advised by its Parliamentary agents that there would be objections to such insurance, as being contrary to public policy. This view was then strongly held by the Board of Trade, and the fact that Sir William Huskisson, a past President of the Board, had been killed in a railway accident in 1830 may have helped to dissuade the *Railway Passengers* from challenging it.<sup>32</sup> Attitudes to liability

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<sup>31</sup> See Dinsdale *op cit* note 26 p. 54.

<sup>32</sup> Huskisson achieved the dubious distinction of becoming the first ever railway fatality. Whilst talking to the Duke of Wellington, at the opening of the Liverpool and Manchester Railway, he stumbled beneath the wheels of carriages drawn by Stephenson’s *Rocket*.



insurance may have started to change by 1855, because the *Railway Passengers* did in fact offer one railway company such insurance in that year. It is also recorded that one of its competitors, the lugubriously styled *Accidental Death Insurance Company*, insured the Scottish Railway Companies against liability risks (including injury to employees) for a period of time, before abandoning the business as unprofitable.<sup>33</sup>

The coming of the railways thus had only a limited effect on the development of liability insurance. However, during the railway era, steam power was increasingly used for other purposes and, especially, to power the machinery of manufacturers. Limited technical knowledge and the virtual absence of appropriate safety legislation meant that the explosion of steam boilers was quite common, especially in the industrial North. Many lives were lost in these explosions,<sup>34</sup> and criticism of safety standards, often attached to coroner's verdicts, forced industrialists to act. A group of them met in Manchester on 15 August 1854 with a view to improving safety and, ten days before a second meeting on 19 September 1854, the need for action was brought home, when a boiler explosion at a weaving shed in nearby Rochdale killed ten people. No doubt this expedited the group's decision to form an association of steam users with the object of preventing such accidents, consistent with the economical use of steam power. The *Manchester Steam Users' Association (MSUA)* was formally established with these aims on 23 January 1855. Its first line of attack was to arrange for the regular inspection of steam boilers by competent persons, something that eventually became a legal requirement.<sup>35</sup> The possibility of insurance, as an adjunct to inspection, was often raised in the Association and was at first bitterly opposed on the familiar grounds of public policy.<sup>36</sup> However, the Chief Inspector of the *MSUA*, a strong supporter of insurance, resigned on account of this opposition in 1858 to found a specialist company, the *Steam Boiler Assurance Co.* This company offered both insurance and an inspection service, the granting of the former being dependent on the

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<sup>33</sup> See Dinsdale, *op cit* note 26 p. 177.

<sup>34</sup> A memorandum presented to the Home Secretary in 1869 states that boiler explosions were then running at about 50 per year, killing 60 to 70 persons, compared with only about 20 railway passenger fatalities.

<sup>35</sup> The Boiler Explosion Act 1882 provided for compulsory reporting of explosions and the Factory and Workshop Act 1891 introduced mandatory inspection.

<sup>36</sup> 'The committee are of the opinion that there is neither expediency nor utility in boiler assurance; on the contrary, they are of the opinion that such a course would tend to increase

taking up of the latter. Several companies of this type were set up in the second half of the century. Eventually the combination of insurance and safety inspection came to be the norm, most objections to the former being overcome by its being combined with inspection – an example of what we would now describe as active risk management by the insurer. However, it is worth noting that opposition to insurers and their surveyor-engineers came not just from those who thought that the insurance element of the contract might lower safety standards. Sometimes it came from employees also. Although they themselves were at risk from explosions, they nevertheless resented the meddling by outsiders that the inspection element entailed.<sup>37</sup> This is consistent with a phenomenon observed by liability insurers and scholars alike: the tendency of some workers to oppose safety measures that dent their (especially masculine) pride in taking risks or threaten to drive wages down. Liability insurers often express concern at the ‘macho’ risk-taking culture on construction sites and elsewhere and, evidently, the phenomenon is an old one. For example, Engels, writing in 1844-5, records the observations of a physician who examined many of the 2,500 grinders working in Sheffield in the 1830s. The doctor reported that the hazards of their work left some – the ‘dry’ grinders – with a life expectancy of only about 30 years. Nevertheless, after covered grinding stones and dust extractors were installed they sometimes destroyed these safety devices to stop more workers coming and keeping wages down. As Engels observed ‘they are for a short life and a merry one.’<sup>38</sup>

By the last quarter of the century most boiler policies covered the liability risk in respect of damage to surrounding property and, in some cases, liability for injury to third parties. The business of insuring boilers eventually evolved into the large modern class of engineering insurance. In the course of this evolution third-party risks other than those associated with boiler explosions also came to be insured. For example, towards the end of the century policies were issued that covered liability towards persons injured in accidents involving passenger lifts, which became

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rather than diminish accidents, as it would induce a carelessness which the committee think should be punished rather than rewarded.’ (MSUA Jubilee Book, p. 27).

<sup>37</sup> See Dinsdale *op cit* note 26 p. 40.

<sup>38</sup> Engels, *The Condition of the Working Class in England 1844*, Panther, p. 231.



increasingly common as new building techniques led to the construction of taller public buildings.<sup>39</sup>

## **1.5 EMPLOYERS' LIABILITY AND WORKERS' COMPENSATION**

Work-place risk is a key area of accident compensation, largely because in every country the work-place is one of the most common sources of accidents and ill-health, if not the most common. For scholars, this risk provides a focal point for debates on accident compensation. Academic interest is enhanced by the fact that, whilst efficient industrial injuries' compensation is a social priority for nearly all governments, no two countries have adopted precisely the same means of achieving it. The result is an extraordinary diversity of schemes, differing widely in their legal bases, methods of financing, operation and security systems. They include fault-based liability systems, pure no-fault schemes and almost every variation in between, backed by varying combinations of first and third party insurance. Insurance itself is offered by a wide range of providers, including private insurers, self-insurers and state social security departments. There are also many variations in terms of benefit structure, treatment of different sorts of injury and relationship with other compensation sources. Among all this variety, the English system is particularly unusual by the reason of the prominent role that it gives to liability insurance. In no other country is private employers' liability insurance such an important part of the system and in no other country is this line of insurance business so highly developed. The evolution of employers' liability insurance and its no-fault alternative, workers' compensation insurance, is now considered briefly.

Compensation systems for work injuries began to emerge in the nineteenth century. A number of factors contributed to their development. The most obvious was growing industrialisation in Europe and elsewhere. This was followed, in due course, by a mounting concern about the human cost, in accidents and illness, of the 'factory system' to which industrialisation had given birth and associated developments in the

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<sup>39</sup> The Employers' Liability Insurance Corporation issued a policy covering liability in respect of a lift in 1888 (Cockerell, H. & Green, E. (1994) *The British insurance business – a guide to its history and records*, 2<sup>nd</sup> edition, p. 89.)

use of mechanical power, including steam. Pressure generated by social reformers and the increasingly powerful and well-organised labour unions moved governments to act, persuading them to introduce systems that gave priority to injuries that were inflicted in the work-place. Of course, whether systems that provide special compensation to people who are injured in the course of their employment can be justified on economic or moral grounds is a moot point.<sup>40</sup>

Historically, there are three main phases in the early development of work injury compensation systems. However, one phase or another has been omitted in some countries and there are many variations in matters of detail. The three phases are:

- 1 A 'Common Law' period, when work injury compensation, to the extent that was available at all, was governed by the ordinary principles of tort law.
- 2 A period of employers' liability law, when the Common Law was modified or replaced by more specific tort-based rules imposing liability upon the employer.
- 3 A period of workers' compensation law, either in addition to or in substitution for employer' liability law. As we shall see, this workers' compensation law was also, in some cases, effectively an insurance law.

During the first, 'Common Law' period, the chance of an injured worker actually obtaining compensation was often, in reality, almost non-existent. The lack of adequate remedies was a consequence of the undeveloped state of tort law in many jurisdictions, and the availability in some countries of defences that an employer could use easily to defeat the claims of injured workers.

In the second phase, legislatures typically aimed to mitigate the harshness of the Common Law by introducing specific rules of employer liability or, at least, weakening the effect of the defences mentioned above. The Employers' Liability Act of 1880, discussed in more detail below, achieved this in England. However, England

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<sup>40</sup> See *The Cure* pp. 8-9.



was not the first country to enact such a law, somewhat similar legislation having been introduced earlier in Germany (1871) and Switzerland (1877).

Rules based on employers' liability, whether those of the Common Law or based on specific legislation, proved inadequate in every case. Workers remained restive and pressure for compensation systems that did not depend on fault or negligence persisted. Thus, before long, a third phase of development began – that of workers' compensation. In swift succession, workers' compensation laws were passed in Germany (1884), Austria (1887), Norway (1895), Denmark and England (1897), Finland and Italy (1898), and France, Spain and Switzerland (all 1899). The United States, which at this time tended to follow European practices (and, in legal matters, the Common Law of England) were remarkably slow to follow. The first employers' liability statute of any kind was adopted by Alabama in 1885, followed by Massachusetts in 1887, and in later years by many other States, but no single State adopted a workers' compensation law until long after every major European country had such a law in full operation. Only from 1911 onwards did workers' compensation begin to replace employers' liability in the United States.

### **1.5.1 Insurance of work-place risk**

In England and France, initially, the employer was required to make workers' compensation payments and was given the privilege to insure against this liability or not, as he saw fit. On the other hand, insurance was compulsory in most other countries, so workers compensation laws were, in effect, insurance laws. However, the very first insurances of work-place risk date from well before the phase of workers' compensation. The earliest developments were again in France. There, in 1861, a mutual society, *La Présératrice*, was created by one Hippolyte Marestaing, who devised a combined policy that would provide fixed benefits to injured workers – effectively a collective form of personal accident insurance – combined with liability cover in favour of the employer. This latter element was designed to indemnify the employer in cases where an injured worker refused to forfeit his right to sue in exchange for fixed compensation and sought full compensation from the employer, on grounds of fault. *La Présératrice* appears to have experienced difficulties in the

early years, but another society, *La Sécurité Générale*, formed with similar objects in 1865, seemed to have achieved some success in offering both individual and collective policies for accidents of any sort, including those at work. At a later date it also offered to cover the civil liability of employers for work accidents. In France, as in many European countries, initiatives of this sort were eventually curtailed by the introduction of state workers' compensation programmes. This trend which, as mentioned above, began with Bismarck's pioneering workers' compensation scheme of 1894, left private insurers in many countries with only a limited role in the field of industrial injuries.

However, in England the pattern of development was somewhat different from most of Continental Europe. When the French societies, mentioned above, were founded personal accident insurance in England was largely confined to railway passengers. Broader covers eventually became available, including policies that covered disablement through sickness,<sup>41</sup> but the early (and hopelessly optimistic) dream of selling this sort of insurance to industrial workers, individually or collectively, never materialised. Instead, insurers began to aim their products at the professions and the middle classes, whose members remain the principal buyers of personal accident, sickness and, indeed, 'health' insurance covers of all sorts. In the event, British insurers became involved with industrial injuries not through first-party accident insurance but through employers' liability insurance.

This class of business developed quite late, even though the Industrial Revolution – a period beginning around 1770 in England – quickly brought a heavy burden of accidents and occupational diseases in the mines and factories, on the railways and elsewhere.<sup>42</sup> At first, employers saw no need for insurance because the defences available to them, mentioned earlier, meant that an injured worker had little legal protection and few rights to compensation.<sup>43</sup> Pressure for reform grew from the

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<sup>41</sup> See Raynes, H. E. (1964) *A history of British insurance*, pp. 278-9.

<sup>42</sup> See note 30.

<sup>43</sup> In particular, the Common Law supposed that in contracting with his employer the worker had freely accepted the risks inherent in his job. Thus, a claim in tort could often be defeated by a plea of *volenti non fit injuria* (see *Bartonshill Coal Company v. Reid, McGuire* (1858) 3 Macq 266 & 300) or contributory negligence, the latter being a complete defence until 1945. In fact the efficacy of *volenti* in the context of employment injuries was weakened considerably by



middle of the century, eventually resulting in the Employers' Liability Act 1880, also mentioned above. Although the Act introduced no new principle of liability it did weaken some of the defences previously available to the employer.<sup>44</sup> Compensation was linked to earnings, the maximum that could be awarded by a County Court being an amount equivalent to three years' pay. In the same year the *Employers' Liability Assurance Corporation* was formed to cover this new liability. The first policy was issued in 1881, covering liability under the Act only. In the years that followed policies covering Common Law liability also were issued.

The 1880 Act was not a great success. Negligence was difficult to prove, and although the Act gave rise to much litigation, which absorbed a large portion of the premium for those who insured, the amounts recovered in damages through the courts were small.<sup>45</sup> As a result, pressure grew for legislation that would allow a workman to recover compensation for employment injuries as of right; that is, for any accident which was not caused by his own gross and wilful default. In 1897 the Workmen's Compensation Act was passed. The Act, largely the work of Joseph Chamberlain, allowed claims by employees without proof of negligence.<sup>46</sup> Compensation went according to fixed scales and the amount for death, for instance, was based on three years' earnings, with a maximum of £300 and a minimum of £150. Half-earnings were payable during disablement up to £1 per week. Many companies were formed to provide employers with insurance cover around this time, including 51 new

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*Smith v. Baker* [1891] AC 325 where it was held that a decision on the part of an employee to remain in a job when he had knowledge of the risks involved was not in itself sufficient to establish the consent necessary for the defence to succeed. Where an employee was injured by a fellow worker the employer bore no responsibility, since the principle of vicarious liability did not extend to two employees who were in 'common employment'. See *Priestley v. Fowler* (1837) 3 M & W. The defence of common employment is sometimes known as the 'fellow servant' rule. The Fatal Accident Acts of 1846 and 1864 allowed claims to be brought on behalf of certain dependants of a deceased workman, but they otherwise created no new rights against an employer.

<sup>44</sup> In effect, the employee could now sue for an injury caused by a defect in the employer's premises or plant provided such defect, or the failure to discover and remedy it, arose from the negligence of the employer or of a fellow employee who had been entrusted with the duty of properly maintaining it.

<sup>45</sup> In 1893, for instance, less than £8,000 was awarded. Cases were often settled out of court, but a large portion of the proceeds went into the pockets of the solicitors who vigorously encouraged their clients' actions. The decision in *Griffiths v. Earl of Dudley* (1882) 9 QBD 357 weakened the Act further. The case established that an employee might contract out of its provisions, a facility that was often abused by employers.

<sup>46</sup> The Act applied initially to the more hazardous occupations only (e.g. railways, factories, mines and quarries) but was extended to include agricultural workers in 1900.



companies in the year 1898 alone. The Workmen's Compensation Act 1906 extended benefits to workmen generally (including most non-manual workers) and, for the first time, compensation benefits applied to certain specified industrial diseases. Eventually, 25 such illnesses were included. The scope of the Acts was extended over the next thirty years or so<sup>47</sup> and they were eventually consolidated in the Workmen's Compensation Act 1925. Although the majority of employers insured their liability under the Act, or joined mutual schemes, insurance was not generally compulsory at this time. However, mining was a particularly hazardous trade and, to avoid hardship to those miners whose employers had become insolvent and were therefore unable to meet their obligations under the 1925 Act, the Workmen's Compensation (Coal Mines) Act 1934 was introduced. Insurance (or, alternatively, a special trust fund supplemented by insurance) was thereby made compulsory for colliery businesses. The heavy risk led insurers, in turn, to arrange reinsurance through a special Colliery Pool.

Whereas the compensation available under the Workmen's Compensation Acts remained relatively small (despite periodic increases), claimants who sought damages at Common Law were beginning to secure substantial damages, and the number of such claims increased in the 1930s.<sup>48</sup> However, at the end of this period a major restructuring of the whole system was signalled by the Beveridge Report (1942). Beveridge recommended that compensation for industrial injuries should be added to existing social insurance schemes (which covered pensions, health and unemployment) as part of a new unified scheme of social insurance. Benefits would be drawn from a central fund maintained by contributions paid by employers,

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<sup>47</sup> Weekly rates of compensation were raised in 1917 and 1919 to reflect the general increase in wages. The 1914-18 war also saw an increase in the number of accidents, since women and young boys, unfamiliar with the work, were often employed in the place of men who had gone to fight. Because of the heavy liabilities imposed on employers by the new legislation Parliament acted to prevent, as far as possible, the failure of insurance companies which underwrote them. The Assurance Companies Act 1909 required a deposit of £20,000 to be lodged by insurers, revenue accounts of employers' liability business to be submitted and adequate reserves to be maintained. The benefits of the 1906 Act were again extended in 1923. An enhanced death benefit was now payable where the deceased had children under the age of 15, although weekly benefits were actually reduced.

<sup>48</sup> This process was accelerated by legislation: the Factories Acts 1937-48 extended the scope for claims for breach of statutory duty and, following the Law Reform (Contributory Negligence) Act 1945, contributory negligence no longer provided a complete defence in tort. The old



employees and the state and the scheme was to be administered by a Ministry of Social Security. Accordingly, the National Insurance (Industrial Injuries) Act 1946 was enacted, becoming operative on 5 July 1948. From that date the Employers' Liability Act 1880 and the Workmen's Compensation Acts were abolished. The liability to pay compensation under these acts was effectively lifted from the employer and transferred to the state under a system of National Insurance. At the same time, and as a result, a major class of commercial insurance ceased to exist. However, it was decided<sup>49</sup> that employers should remain liable in damages at Common Law for accidents to employees arising out of and in the course of their employment. This turned out to be a fateful decision, the retention of the 'alternative remedy' of a tort claim against the employer separating Britain from those countries that chose 'exclusive remedy' workers' compensations schemes. Demand therefore still existed for commercial insurance, which now reverted to its old name – employers' liability. The potential value of a claim against the employer at Common Law was already growing in the 1930s and the transfer of workmen's compensation business to a state scheme after Beveridge did not reverse this process. The number and size of employers' liability claims has continued to increase to the present day and, as a result, this line of insurance has now assumed an importance that is greater than in any other country. Nowadays, a person who is injured in the course of his employment can often expect to recover far more in an action for damages against his employer than he is likely receive under the state compensation scheme. Thus, if an employer lacks the financial means to satisfy a claim by an injured employee the latter risks losing his major source of compensation. For this reason Parliament extended the requirement for compulsory insurance (which already existed in respect of the coal mines) to virtually all employers via the Employers' Liability (Compulsory Insurance) Act 1969.<sup>50</sup> The development of employers' liability insurance is a subject to which we will return in Section 2.1, where we trace the emergence of 'long-tail' risks.

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doctrine of common employment was also finally abolished by the Law Reform (Personal Injuries) Act 1948.

<sup>49</sup> Following the recommendations of the Monckton Committee. These are discussed in more detail in Section 2.1.

<sup>50</sup> See *How Secure is the System?* pp. 110-112 for further background to the 1969 Act.

## 1.6 PUBLIC (GENERAL) AND PRODUCT LIABILITY INSURANCE

Nowadays, public (or general) liability insurance is a broad residual class, intended to cover liabilities not insured by more specific types of contract. As Dinsdale suggests,<sup>51</sup> public liability insurance in the UK grew up in a rather piece-meal way, only emerging as a distinct class towards the end of the nineteenth century. As we have seen, liability insurance was initially provided only for specific risks, such as railway or driving accidents or the explosion of steam boilers. In the UK, the first public liability insurances for general trade risks were written towards the end of the nineteenth century, following the enactment of the Employers' Liability Act 1880. This Act not only gave birth to employers' liability insurance but simultaneously created a demand for wider cover, since accidents in the workplace could cause injury to persons other than employees, such as visitors or passers-by. The success of claimants who were injured at work also encouraged people to seek compensation for non-work accidents.<sup>52</sup> Initially employers' liability policies were simply amended to cover liability for injury to persons *not* in the employment of the insured and the cover was known as 'outside risk' insurance. Because of the obvious dangers that their activities present to the public, builders and contractors were among the first to make use of the cover. Special policies were still devised from time to time to cover the liabilities associated with particular trades or activities, such as property owners' indemnities, scholars' indemnities (covering liability for injury to school pupils) and special policies for innkeepers, farmers and the like. However, there was a growing tendency for insurers to issue contracts that could be adapted to cover almost any sort of business or occupation. The public liability contracts in use today have thus developed through cover, which was originally requested in respect of particular risks only, gradually becoming more general in scope.

This pattern of development was repeated in relation to the class of business known as product liability insurance where, in the early years, calls for cover arose periodically in connection with particular risks. For example, in 1900 there was a poison beer

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<sup>51</sup> *Op cit* note 26 pp. 175-198.

<sup>52</sup> The publicity surrounding the damages awarded to road accident victims probably had a similar effect. Improving standards of education, and the legal facilities provided by the emerging Trade Union movement also played their part.



scare, prompting the *Ocean* to offer special policies to indemnify brewers against liability arising from arsenic in their beer, and in 1908-9 insurers offered to cover grocers and others against claims for ptomaine food poisoning, following a spate of such incidents. Demand for liability cover in respect of dermatitis arose in 1924, when a number of furriers, who sold rabbit skins imported from China as ‘coney seal’ or under some other exotic name, were sued for damages by customers affected by the irritant dyes with which the skins were treated. Again, cases of typhoid fever from infected milk led some insurers to offer dairy farmers cover against contamination in the 1930s. Of course, legal developments, in the form of statute law or court decisions that create new duties, can stimulate demand for liability insurance. In the case of product liability, the famous case of *Donoghue v. Stevenson*,<sup>53</sup> which established that a manufacturer might owe a duty of care to the ultimate consumer of its goods, undoubtedly encouraged the spread of liability insurance from the retail to the manufacturing sector. All this led insurers to devise broad product liability covers, which could insure almost any type of business and any party in the distribution chain, from the producer of raw material through to the retailer. Nowadays, insurers usually combine the ‘product’ and ‘public’ liability covers in one contract, but the risks are priced and underwritten separately, and the two are generally regarded as separate lines of business.

## 1.7 ‘PROFESSIONAL’ LIABILITIES

The term ‘professional liabilities’ is a convenient expression to describe the subject matter of several forms of liability insurance that developed (mainly) in the twentieth century. They include professional indemnity (PI) insurance, directors’ and officers’ (D&O) liability insurance and a number of associated classes. At this point, it can be argued, liability insurance began to take on a new form, now having little or no connection with ‘accidents’ or the old category of accident insurance. In these new classes the risk insured did not arise directly from the making or selling of things, or the physical movement of people or goods, but rather from the provision of advice and the organisation of business activity. At the same time, losses were more likely to arise from negligent words than negligent acts. They were also likely to come in the

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<sup>53</sup> (1932) A.C. 562.

form of compensation claims for financial loss, rather than for bodily injury or damage to material property. With the growth of the 'service economy' in wealthy nations, in which an increasing percentage of the working population is engaged in intellectual tasks associated with the design, development and financing of goods and services, and a diminishing number are involved in their physical production and delivery, liability insurance of this type has become increasingly important. Thus, professional indemnity insurance, discussed briefly below, is now a major class of insurance business rather than a specialty line. The same is true of directors' and officers' liability insurance though, perhaps, to a lesser degree. As we shall see, the nature of the risks covered by these forms of insurance, and the nature of the losses typically incurred, have brought new problems for liability insurers in the design of contracts and the pricing of the risks insured.

### **1.7.1 Professional indemnity insurance**

Turning first to professional indemnity insurance, it seems that doctors were the first among the professional classes to seek insurance in the UK, though the first scheme was a mutual one. Thus, following a number of actions against members of the profession, the *Medical Defence Union* was founded in 1885 to establish and administer a mutual indemnity scheme, which is still in operation. The first commercial insurance scheme was developed in 1896 when the *Northern Accident* devised a druggists' indemnity scheme and solicitors' indemnities were offered early in the 20th century. Architects' indemnities were underwritten at Lloyd's from 1922 onwards and cover is now available for the 'established' professions in all fields, including, medicine, law, finance, property and engineering.

Recent years have seen the emergence of many 'new' professions in the fields of the media, information technology and telecommunications, leading to a major expansion in this line of insurance. Growth in the demand for professional indemnity insurance has also been stimulated by an expansion of liability in the twentieth century, especially in the field of tort law,<sup>54</sup> a general erosion of the various immunities and

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<sup>54</sup> Most notably in the line of cases leading from *Hedley Byrne v. Heller and Partners* [1964] AC 465.



defences that some professions once enjoyed<sup>55</sup> and the growth of a culture in which legal action against a professional person is no longer viewed as an extreme measure. As a consequence, professional indemnity cover is now mandatory in all the major professions.

### 1.7.2 Directors' and officers' liability insurance (D&O)

D&O insurance was the last major line of liability insurance to develop. Its invention has been attributed to the British insurance broker Minet, which introduced the idea to the London insurance market following the Wall Street crash of 1929, an event that prompted legal action against directors of a number of firms that failed. A few D&O policies covering US risks were written in the London market during the 1930s but this form of insurance was rare, even in the United States, until the late 1960s and virtually unknown outside the US until ten years later. However, the 'D&O system' (managerial liability supported by D&O insurance) is now firmly established in all the world's major economies. The rapid spread in the use of D&O insurance calls for some comment.<sup>56</sup> Even in the 1960s there was much scepticism about D&O insurance. Directors were expected to take risks on behalf of shareholders and the latter were assumed to understand the fundamental laws of investment, whereby levels of risk and expected rates of return on capital are linked. Investors who shouldered these business risks could diversify them by constructing well-varied portfolios. As a corollary, directors – undiversified risk bearers – expected to be forgiven for those business decisions that ultimately proved erroneous and to face liability only in the case of positive wrongdoing, such as fraud or dishonesty. To put it simply, mere negligence was rarely enough to fix a director with liability. In a world such as this there was little place for liability insurance, because the ground between the beginnings of liability and the beginnings of uninsurability (fraud, criminality etc.) was so small.<sup>57</sup> However, since the 1960s that territory has undoubtedly expanded, in the US and elsewhere. In the US an expansion of directors'

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<sup>55</sup> For example, as a consequence of the Unfair Contract Terms Act 1977.

<sup>56</sup> See, generally, *Managerial Liability* for a full analysis.

<sup>57</sup> See, for example, Bishop's seminal academic paper on D&O insurance: Bishop Jr., J. W. 'Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers' (1968) *Yale Law Journal* 1078.



personal liability has occurred on several fronts, including liability to shareholders, employees and other third parties. Equity shareholdings comprise much of the country's wealth and are a major vehicle for personal savings. In a country such as the US, where social security is limited, personal security and corporate security are closely linked, leading to a culture that promotes fierce protection of investors' interests. At the same time a growing realisation of the power wielded by large corporate enterprises, and of their influence on almost every aspect of human life, including health and environmental issues, has led to calls for greater transparency on the part of big corporations and greater accountability of their human agents, not just to stockholders, but to employees and to society as a whole. The development of D&O insurance in the US can be seen as a response to these trends. Its growth outside the US is attributable to a number of factors. These include relentless 'globalisation' of business activity, which has effectively exposed directors of firms in Europe and elsewhere to the US legal environment, the economic downturn suffered by a number of countries from the 1990s onwards and privatisation trends worldwide. These trends have fuelled the growth in demand for D&O coverage as the directors of what were previously state-owned enterprises now contemplate personal liabilities which their predecessors rarely had to face. In short, the world-wide adoption of D&O insurance reflects the triumph of capitalism and the market economy. More particularly, it reflects the apparent triumph of Anglo-Saxon style capitalism over that of the Rhine valley and, in terms of insurance philosophy, the Maritime over the Alpine model.<sup>58</sup> In the last ten years there has been a further surge of world-wide interest in issues of corporate governance, leading to calls for even greater accountability on the part of those charged with the stewardship of business

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<sup>58</sup> The distinction between the 'Alpine' and 'Maritime' insurance model is expounded by Michel Albert in *Capitalism against Capitalism* (1991, English translation 1993), Chapter 5. Albert sees two cradles of insurance, the upper Alpine valleys and the sea. The Alpine model is characterised by conservatism, stability, tight regulation, mutuality, the promotion of social solidarity and risk spreading without fine segmentation. Its modern spiritual home is the triangle formed by Munich (*Munich Re.*, *Alliantz* etc.), Zurich (*Swiss Re.*, *Zurich et al*) and Trieste (*Generali*). Lloyd's and the London market are the living symbols of the Maritime model, which is aggressive, entrepreneurial, flexible, (short-term) profit oriented, litigious, lightly regulated and given to extreme segmentation of risk. Not surprisingly (in view of his Presidency of *Assurance Générales de France* (AGF)) Albert holds out French insurance as an ideal synthesis of these models. We should also note that a leading authority on the early history of insurance suggests that the medieval guilds of Flanders – hardly maritime and definitely non-Alpine – were amongst the earliest exponents of insurance techniques. (See



enterprises. As a consequence, there is a strong general legislative trend in Europe, and most other jurisdictions, towards greater shareholder rights, with more rigorous standards of corporate governance, accounting and financial disclosure.<sup>59</sup> All of this has enhanced the potential for legal action against directors and encouraged a more widespread adoption of D&O insurance.

## **1.8 OTHER RECENT DEVELOPMENTS**

The twentieth century has seen the development of a number of specialist lines of liability insurance including, in no particular order, pension trustee liability insurance (PTL), employment practices liability insurance (EPL) environmental impairment liability insurance (EIL) and various others. They call for no particular comment as most are simply extensions and developments of existing lines or hybrid products that combine existing covers in a novel way.

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Trennery, C. F. (1926) *The origin and early history of insurance, including the contract of bottomry* Chapter xxiii).

<sup>59</sup> The introduction of the Euro is likely, in itself, bring about increased transparency in the reporting of company affairs.

## **2      THE LIMITS OF LIABILITY: SOME CONTEMPORARY PROBLEMS**

We have seen in the first part of this essay that liability insurance developed as an offshoot of a broad first-party class known as accident insurance, which was intended to cover the costs that resulted from sudden loss-causing events other than fires or marine casualties. However, as already intimated, the nature of liability insurance began to change during the twentieth century. Gradually the defining quality that preserved its link with accident insurance – the sudden and unexpected event that caused loss to the policyholder – began to be lost, and the subject matter of the contract increasingly came to be seen not as accidents but as legal liability. At this point liability insurance began to emerge as a class in its own right. However, as part of this process insurers began to assume responsibility for losses that were not attributable to accidents in any real sense at all. These included risks of injury and damage that arose from continuous industrial processes where the harm caused was not sudden but gradual. Again, it was not always patent, but sometimes latent. Liability for pollution and environmental damage, and for gradually developing industrial disease provide examples that sometimes exhibit both characteristics. Also, as we have seen, liability insurance was being extended to cover non-industrial activities where, by definition, accidents were rare but gradually accumulating financial loss arising from the negligent provision of professional services was common. The scene was now set for the emergence of ‘long tail’ risks; that is, risks where there is a long time period between the underwriter’s assessment and pricing of the risk and the final settlement of claims that arise from the period of insurance in question.

In the next section we will consider in more detail the problems posed by long-tail risks, and possible solutions to them. However, we can note at this stage that long-tail risks present severe problems of pricing and also of moral hazard. The protracted time span over which claims develop can make their ultimate cost almost impossible to quantify in advance. Furthermore, the nature of some losses (such as gradual pollution) makes it hard to draw a clear distinction between that which is fortuitous



and that which is not, and very difficult to design policies that include the former whilst excluding the latter.

We must note at this point a curious fact. Underwriters of first party risks – in effect, property insurers – have *always* regarded long-tail risks as uninsurable, for the reasons briefly set out above. They have eliminated these risks from their portfolios in two ways. They have either framed their policies so that coverage is limited to specified perils that, by definition, cannot operate gradually (e.g. fire, explosion, storm, theft, impact etc.) or, alternatively, when writing cover on an ‘all risks’ basis, they have excluded loss or damage from gradually operating causes.<sup>60</sup>

This raises a very basic question. How, in the first place, did liability insurers come to assume risks that property insurers have traditionally regarded as uninsurable? This question – the divergence in practice between property and liability insurers – is an intriguing one, not least because the two branches of the general insurance industry have been closely linked, almost from the beginning.<sup>61</sup> For insurers the assumption of these risks seems to make no sense at all, given the uncertainties involved. The toils and reverses at Lloyd’s over the last 15 years, which we will touch upon shortly, make this point forcibly. Moreover, and quite apart from the intractable problems that long-tail exposures present for insurers, funding these risks by a system of tort-based liability backed by insurance seems to make little sense for society as a whole. As a consequence of very high transaction costs, injured victims and the public at large have in fact secured only limited collateral benefit from the huge losses suffered by insurers on these risks. Routine liability business generates an expense ratio of around 50%,<sup>62</sup> which is bad enough, but for long-tail classes the expense ratio is

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<sup>60</sup> The exclusions used on commercial ‘all risks’ insurances are far too long and complex to quote in full here. However, a common UK commercial ‘All Risks’ form excludes, amongst many other things: ‘inherent vice, latent defect, gradual deterioration, wear and tear ... faulty or defective design or materials ... corrosion, rust, wet or dry rot, shrinkage, evaporation, loss of weight, dampness, dryness ... change in temperature, colour, flavour, texture, or finish ... loss or damage caused by pollution or contamination ...’

<sup>61</sup> The specialist ‘accident offices’ that first wrote liability insurance contracts were quickly bought up the large fire insurance companies, leading to the formation of the familiar British composite insurer. Separate ‘fire’ and ‘accident’ departments were maintained for some time, but most companies eventually combined these to create divisions that dealt with particular types of customer, e.g. public authorities, commercial firms or private buyers of insurance.

<sup>62</sup> For example, the Holman Gregory Report (1920) found an expense ratio of 52% for Workmen’s Compensation insurers (albeit with a large profit element to the insurer), and



likely to be even higher. For example, according to some estimates, only about 30% of Lloyd's insurance payments in respect of asbestos-related disease have reached the victims concerned<sup>63</sup> and only about 20% of US 'Superfund' payments made by insurers have actually been used to clean up polluted land.<sup>64</sup> In short, the assumption of long-tail risks into the tort/liability insurance system has resulted in a massive waste of resources. There have no substantial gains except, perhaps, to a small body of specialists drawn from the law and a few other professions.

In general, it is clear that insurers assumed long-tail liability risks inadvertently rather than by design. It should be emphasised, again, that this was part of a process whereby the 'liability' or 'third-party' risk gradually became detached from 'accident business' – i.e. insurance that covered the financial consequences of *accidents*. It became a distinct form of insurance that covered, or was at least intended by insurers to cover, liability for loss, injury or damage that was simply *accidental*. The former, original, concept of liability insurance is explained by Baker Welford, writing in 1932 about the general principles of liability insurance:

'The liability insured against is, from the nature of the insurance, a liability arising out of accident; but the insurance is not, in practice, a general insurance, conferring a universal protection against liability for all kinds of accidents. It is an indemnity against the liabilities arising out of particular kinds of accident; and, therefore, a description of the particular kinds of accident contemplated forms an essential part of the description of the subject matter of insurance.'<sup>65</sup>

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Beveridge (1942), Ison (1967) and the Pearson Commission (1978) reported figures of 46.5%, 49% and 45% respectively for liability insurance generally.

<sup>63</sup> See Gunn, C. *Nightmare on Lime Street* Smith Gryphon 1993 p. 51. Wikeley, in the course of a wide-ranging review of compensation for latent (and especially asbestos-related) disease, is a little more sanguine. He concludes that asbestos litigation in the US is inefficient in the sense that it carries even higher transaction costs than other forms of tort litigation and is slow and costly in terms of judicial administration. However, he found that the US system was more successful in mobilising potential claims. By contrast, the British system was rather less inefficient, slow and costly than the US system, but also less successful in the advancement of claims (Wikeley, N. J. (1993), *Compensation for industrial disease*, p. 55).

<sup>64</sup> Acton, J. P. and Dixon, L. S. analysed the payments made by four major insurers in respect of 'Superfund' liabilities in *Superfund and transaction costs – the experience of insurers and very large industrial firms* (1992) Rand/Institute for Civil Justice (USA). They found that, on average, transaction costs accounted for 88% of insurers' total expenditure, with a range between 80% and 96% and an average figure of 69% for closed claims. Of this 88%, approximately 42% arose from coverage disputes and 39% from the cost of defending policyholders.

<sup>65</sup> Baker Welford, A. W. *The law relating to accident insurance*, second edition, Butterworth, 1932, p. 443.



The general thrust is clear. However, the absence of an indefinite article in ‘arising out of accident’ creates a slight ambiguity. This, perhaps, reflects developments that had already taken place in the field of employers’ liability and workers’ compensation insurance. Today, employers’ liability insurance is the most important line of liability insurance in the UK, accounting for approximately 50% of UK premium income for the class as a whole. It is also a major source of long-tail claims – specifically, for gradually developing diseases. We now return, briefly, to the evolution of employers’ liability insurance in order to show how these risks were assumed.

## 2.1 LONG-TAIL EMPLOYERS’ LIABILITY RISKS

As explained earlier, the origins of employers’ liability insurance can be found in the Employers’ Liability Act of 1880. This act weakened the defences available to employers at Common Law and, in limited circumstance, made them liable for accidents to employees caused by negligence. As we have seen, insurance companies were quickly formed to cover liability under the new act.<sup>66</sup> However, potential liability for claims in respect of disease did not arise until the passing of the Workmen’s Compensation Acts, which ran from 1906 to 1925. These Acts applied only to injuries ‘caused by accident’, but a disease attributable to a particular accident fell within this definition<sup>67</sup> and, from 1906 onwards, certain specified diseases due to the nature of employment were added. These diseases were *deemed* to be personal injuries by ‘accident’,<sup>68</sup> without any need to prove that a particular accident had caused them. Insurers that covered liability under the Workmen’s Compensation Acts were thus exposed, for the first time, to claims for diseases that could develop gradually. However, there was no real long-tail risk, because the Acts required the disease to have been contracted within the twelve months prior to the date of the

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<sup>66</sup> See Section 1.5.1.

<sup>67</sup> See, for example, *Brintons Ltd. V. Turvey* [1905] A.C. 230 where the House of Lords held that a wool-sorter who contracted anthrax had suffered ‘injury by accident’ following the entry of the anthrax bacillus into his body, probably through the eye. Other examples include *Ismay, Imrie and Co. v. Williamson* [1908] A.C. 437, where a stoker on board a steamer died of heatstroke, *Sheering v. Clayton* [1910] 2 I.R. 105, C.A. where a workman contracted a chill whilst working in water, leading to an inflammation of the kidneys, and *Scott v. Pearson* (1916), 9 B.W.C.C. 229, C.A. where a servant employed to feed calves was infected with cattle ringworm: all were held to have suffered an ‘accident’.

<sup>68</sup> Workmen’s Compensation Act 1925 s.43.(1)

disablement of the worker, as confirmed by the certifying surgeon for the district,<sup>69</sup> or his suspension from work,<sup>70</sup> or his death.<sup>71</sup> The person liable to pay compensation was the employer who last employed the workman in the activity giving rise to the disease or, where the disease had been contracted by a gradual process, all employers who had employed the workman during the preceding twelve months. For insurers the ‘tail’ of liability was thus, at most, one year. Furthermore, the law gave them powerful weapons to repudiate claims by workers who failed to tell their employers, on entering employment, about an existing disease that afterwards incapacitated them.<sup>72</sup> Besides their liability under the Workmen’s Compensation Acts, employers also faced potentially liability under the Fatal Accidents Act 1846, the Employers’ Liability Act 1880, and at Common Law. Insurers covered these liabilities also. Thus, in theory, insurers could face claims for disease made against the employer at Common Law, if not under the 1880 Act.<sup>73</sup> However, such claims were extremely rare, for a number of reasons. First, the introduction of the Workmen’s Compensation Acts had dramatically reduced the incidence of Common Law claims generally, and it was only towards the end of the 1930s that a marked increase in such claims began. Second, the doctrine of election prevented an employer from claiming damages at Common Law in addition to statutory compensation and, third, cover was restricted to diseases contained in the schedules of the Workmen’s Compensation Acts, even if made at Common Law: there was no coverage for ‘non-scheduled’ diseases.

In practice, the potential for significant numbers of long-tail claims arose only after the post-war ‘Beveridge’ reforms and the consequent restructuring of the industrial injuries compensation system. As stated earlier, the Workmen’s Compensation Acts and Employers’ Liability Act 1880 were abolished<sup>74</sup> as part of this process and replaced by a state workers’ compensation system (the Industrial Injuries Scheme). For private insurers, workers’ compensation and employers’ liability insurance had

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<sup>69</sup> Workmen’s Compensation Act 1925 s.43.(1)(i)

<sup>70</sup> Workmen’s Compensation Act 1925 s.43.(1)(ii)

<sup>71</sup> Workmen’s Compensation Act 1925 s.43.(1)(iii)

<sup>72</sup> Workmen’s Compensation Act 1925 s.43.(1)(b); *Scott v. Summerlee Iron Co.* [1931] AC 37.

<sup>73</sup> In practice, the Employers’ Liability Act 1880 limited claims to accidents, since liability attached only in respect of injuries sustained by a workman in consequence of a defect in the condition of the ways, works, machinery or plant connected with or used in the business of the employer (s. 1 (1)).



been very profitable.<sup>75</sup> Having lost the first (workers' compensation) element to the state, insurers were anxious not to lose the latter. Thus they campaigned, along with the TUC and others, for retention of the 'alternative remedy' of a Common Law claim for damages; which would, of course, support the continuation of employers' liability insurance. This was secured following the recommendations of the Monckton Committee. In its final report,<sup>76</sup> the Committee rejected both the arguments for an 'exclusive remedy' state workers' compensation system and those for a form of compromise, adopted in many European countries,<sup>77</sup> whereby tort actions would be retained only in the case of intent or gross negligence on the part of the employer. Instead the Committee recommended that the employee's right to claim at Common Law on the basis of ordinary negligence should be retained. Amongst other things, it also recommended that civil liability for breach of statutory duty should never be strict, and that employers should be excused in every case where it was not reasonably practicable to avoid or prevent the breach. The first recommendation was adopted in legislation but the second was not. This has led to the present, rather absurd, combination of a state no-fault workers' compensation scheme supplemented by tort liability that is itself often strict, with obvious implications for the stability of the system should the former component contract and the latter expand as a consequence.

In retrospect, and in the light of the massive losses made by employers' liability insurers in recent years, their enthusiasm for the retention of tort liability looks misplaced. However, decisions made in the drafting of the new policies that were now required would prove equally fateful. First, a decision was made to break the link with workers' compensation insurance and cover liability in respect of *any* form of injury or illness and, hence, any disease – not just those diseases scheduled under

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<sup>74</sup> By the National Insurance (Industrial Injuries) Act 1946 (which became operative on 5 July 1948).

<sup>75</sup> According to the report of a Departmental Committee appointed in 1919 to inquire into the workmen's compensation system private insurers made an average underwriting profit of 15.2% in the 1911-1918 period (Holman Gregory Report (1920) p. 13). Subsequently the Accident Offices Association entered into an agreement with the Home Office to cap their profits by issuing rebates to policyholders when the loss ratio fell below 60% (later 70%).

<sup>76</sup> Monckton, Sir Walter, *Final Report of the Departmental Committee on Alternative Remedies* (the 'Monckton Report') (1946) Cmd. 6860.

<sup>77</sup> Including France and Italy. See *European Perspective* 221.

the new Industrial Injuries Scheme. Second, cover was granted without limit<sup>78</sup> (perhaps, in this case, because liability under the old Workmen's Compensation Acts was unlimited) and, third, a 'causation' trigger<sup>79</sup> was introduced. Thus all the conditions were now in place for the emergence of long-tail risks, from the 1960s onwards. It was propelled by additional factors. These included a relative decline in the value of state benefits under the Industrial Injuries Scheme, which made tort claims increasingly attractive;<sup>80</sup> advances in medicine that enhanced our understanding of the aetiology of several diseases, facilitating tort claims;<sup>81</sup> and, more recently, perhaps the beginnings of a US-style compensation culture. As a consequence of all this, employers' liability insurers now find themselves in a curious bind. They are well aware that the basis on which they do business is unsatisfactory, but face substantial obstacles in trying to change it. These obstacles are discussed later.

## 2.2 PUBLIC (GENERAL) LIABILITY AND ASSOCIATED CLASSES

As we have seen, public liability insurance developed in a piece-meal way in the UK, emerging as a separate class towards the end of the nineteenth century. Again, we should remind ourselves that early underwriters viewed this cover merely as a form of accident insurance. This was reflected in the wording of early policies which, typically, indemnified the insured only against liability for accidents of a defined type, or accidents that were caused in a particular way. These might include the exploding of a boiler, the failure of a mechanical passenger lift or an accident caused through the use of a vehicle. Cover was usually limited to an amount 'in respect of any one accident'. Used as a noun, the word 'accident' appears to have a clear temporal quality – to refer only to events that happen at a particular point in time. With wordings of this sort there would seem to be little chance of an insurer having to indemnify a policyholder in respect of an injury that was latent, or which had been sustained gradually. However, it soon became clear that where the amount of cover

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<sup>78</sup> Until 1994, when pressure from reinsurers in the wake of the *Piper Alpha* disaster forced primary employers' liability insurers to cap their coverage.

<sup>79</sup> This form of wording, and policy triggers generally, are discussed in Part 3.

<sup>80</sup> See *The Cure* pp. 17-18.



granted, as well as the indemnity itself, hinged on the happening of an accident, there could be accumulation of risk, because each injury that resulted from a mishap could be regarded as a separate ‘accident’. Thus, for example, in *South Staffordshire Tramways Co. v. Sickness and Accident Assurance Association*,<sup>82</sup> where a tram operated by the insured overturned, injuring 40 passengers, the court held that each passenger had suffered an accident. Since the policy gave cover of £250 in respect of any one accident, the insurer’s maximum potential liability for the crash thus became £10,000,<sup>83</sup> rather than the maximum of £250 that was doubtless intended. Furthermore, this case shows that there was already a tendency on the part of the judiciary to strip the word ‘accident’ of its temporal quality.<sup>84</sup> Decisions of this sort may have influenced liability underwriters in their decisions to move the focus of coverage away from *accidents* as such, towards the *injuries* that resulted from them. The triggering event now became the injury sustained by the victim of the insured’s wrongdoing rather than the accident itself. However, in order to limit moral hazard and preserve the element of fortuity that insurance required, policies typically provided that the injury should be *accidental*. Of course, in substituting *accidental* for *accident* – adjective for noun – the temporal quality of the triggering event is lost, or at least blurred still further. It was at this time that insurers began to make use of the word *occurrence*, or its adjectival form *occurring*, as a substitute for accident when designing their policies.

The meaning of the words ‘occurrence’ and ‘occurring’ in the context of insurance policies have been litigated intensively up to the present day, and their unguarded use has certainly cost the insurance industry dearly. The possible permutations of the words ‘injury’, ‘damage’, ‘accident’, ‘accidental’, ‘occurrence’ and ‘occurring’ and their synonyms in the insuring clause of a liability policy are huge, and there is not

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<sup>81</sup> For example the establishment of a clear link between exposure to high noise levels and hearing loss, and between exposure to asbestos fibres and mesothelioma.

<sup>82</sup> [1891] 1 QB 402.

<sup>83</sup> In fact the policy was subject to an additional limit of £1,500 for payments in any one year.

<sup>84</sup> See, for example the words of Bowen L.J. (at 407): ‘When we look to the policy, it limits the words of the proposal by adding the words “in respect of accidents.” The question is, What is the meaning of those words? ... I should not think any one would suppose, having regard to the proposal, otherwise than that *the word “accident” was there used in the sense of injury accidentally caused to the person.*’ See, also, Fry, L.J at 408: ‘It seems to me plain that “*accidents caused by vehicles*” there means “*injuries accidentally caused by vehicles to person or property*”’. (emphasis added by author).

space here to provide an exhaustive analysis of so-called ‘occurrence’ wordings and their effects. However, it can be said that by the 1930s the transition from specific accident insurance that, incidentally, covered third party liabilities to occurrence-based liability insurance covering general risks was almost complete. Thus a standard form of public liability insurance, in use by the early 1930s, indemnified the insured against all sums which he became liable to pay:

‘as damages ... as compensation for (a) Accidental bodily injury to any person ... ; (b) Accidental damage to property not belonging to the insured ... which happens within Great Britain or Ireland during the period (of insurance) set forth in the (policy) schedule ... ’<sup>85</sup>

Once wordings of this sort were in common use, and their scope had been broadened to include liability for products supplied by insured firms, all the necessary conditions were present for the entry into general, and especially product liability insurance portfolios, of long-tail risks. These risks began to emerge from the 1950s onwards, most notoriously in the form of claims for asbestos-related illness and other gradually developing diseases, pollution and environmental damage and injury caused by pharmaceutical products. Of course other changes, besides those in insurance wordings, were necessary to bring this about. These included the scientific advances, mentioned earlier, that enabled links between cause and effect to be made more easily in cases of latent or gradually-occurring injury or damage, legal developments, especially in the field of tort law, and changes in society that demanded greater accountability on the part of large and powerful corporations.<sup>86</sup>

## 2.3 THE LLOYD’S EXPERIENCE

Lloyd’s recent disastrous loss experience provides the most dramatic illustration of the potential impact of long-tail liability risks on insurance markets. This episode in

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<sup>85</sup> Taken from the Appendix of Forms in Baker Welford, A. W. *The law relating to accident insurance*, second edition, Butterworth, 1932, p. 601.

<sup>86</sup> For example, the rise of the ‘consumer protection’ movement post-Nader, and of ‘Green’ politics in response to public concern over prominent environmental disasters, including the Minamata Bay mercury poisoning (Japan, 1956), the *Torrey Canyon* and *Santa Barbara* oil spills (1967 and 1969), release of toxins from chemical plants at Seveso (Italy, 1976) and Bhopal (India, 1984), the Chernobyl nuclear reactor fire (Ukraine, 1986) and the *Exxon Valdez* disaster (Alaska 1989).



Lloyd's history has been well documented, but a brief description is included here to show the central role that liability insurance played in the process and to demonstrate how the trends described in the previous section led to such a catastrophic *dénouement*.

In order to understand the nature of the problem that the underwriting of liability insurance created at Lloyd's, it is necessary to understand the nature of Lloyd's itself, including something of its history. As is well known, after 1689 the London insurance market began to develop at Lloyd's Coffee House, which attracted a clientele connected with the sea. Marine insurers began to congregate there, accepting personal responsibility for the insurance they transacted and spreading large risks by dividing them amongst a number of individual underwriters. Marine insurance was believed to be highly profitable and companies began to be formed in order to transact it. In consideration of a large payment made by their promoters to the king, the Bubble Act 1720 conferred on two such companies, the Royal Exchange Assurance and the London Assurance, an exclusive right to transact marine insurance as companies. However, this was without prejudice to the right of individuals to act as insurers and, since these two new companies insured only small amounts, individual underwriters continued to prosper. It was not until 1824 that other companies were allowed to compete for marine business.<sup>87</sup> By this time Lloyd's had developed, in size and sophistication, to such an extent that its position as the premier world insurance market looked impregnable. However, towards the end of the nineteenth century competition from insurance companies, both British and overseas, was intensifying, threatening to reduce Lloyd's to no more than 'a venerable institution inhabited by elderly gentlemen with distant memories of tea clippers'.<sup>88</sup> Lloyd's found a saviour in Cuthbert Heath, the 'father of Lloyd's' who single-handedly introduced non-marine insurance to the market, including a number of new risks which had never before been made the subject of insurance. Thereafter, Lloyd's nurtured its reputation for innovation in the tradition of Heath. It would insure risks that could not be placed elsewhere, including the unique, the unconventional and the

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<sup>87</sup> The object of the 1810 Select Committee on Marine Insurance mentioned earlier (note 14) was to establish whether the oligopolistic nature of the marine market was restricting the ready supply of insurance.

<sup>88</sup> Brown, A 'Hazard Unlimited' 1987 LLP, p. 49.

ultra-hazardous. In this way Lloyd's preserved its status as a world leader in insurance, despite its antiquated apparatus for raising capital and placing risks and despite its reliance on a web of brokers to bring business to the market, which had no branch network to support its operations. Indeed, these apparent drawbacks were turned to advantage, because in a pre-electronic age, they gave Lloyd's a flexibility and economy of operation that could not be matched by the big insurance companies, British or international. However, by the 1930s the rest of the world was catching up and the pre-eminence of Lloyd's was under threat again. The US had been a lucrative source of business ever since America 'discovered' Lloyd's in the aftermath of the San Francisco Earthquake of 1906. To American eyes Lloyd's presented an appealing combination of innovation, individual enterprise and security – the latter having been established after the 1906 earthquake when London insurers, unlike many of their American and European Continental rivals, paid on the nail. However, by the 1930s America's own insurers were making large inroads into Lloyd's business.

Liability insurance provided a useful weapon with which Lloyd's could retaliate, because it was still a relatively new product with much scope for innovation.<sup>89</sup> Lloyd's was now prepared to offer its American customers liability insurance on the broadest of bases. This, in turn, reflected the traditions of the Lloyd's market, which was accustomed to writing on an all risk, all perils basis – perhaps as a consequence of its long experience with marine contracts, which provided indemnity against all perils of the sea.<sup>90</sup> Thus, from the early 1930s Lloyd's wrote, on a direct basis, catastrophe policies covering the general liability risks of large industrial corporations that were otherwise self-insured, including utilities, oil companies and railway operators.<sup>91</sup> In the domestic market of the US, by contrast, the development of liability insurance coverage had been restricted by the conservatism of insurance regulators and insurance underwriters in the form of the National Association of Insurance Commissioners (NAIC) and National Bureau of Casualty Underwriters

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<sup>89</sup> One example, already mentioned, was the invention by Lloyd's broker Minet of an entirely new class, Directors' and Officers' Liability insurance.

<sup>90</sup> This approach was also exemplified in the Jewellers' Block policy which Lloyd's successfully marketed to American customers.

<sup>91</sup> These policies were a natural development of the excess of loss reinsurance contracts pioneered by Guy Carpenter in the 1920s. Of course, the companies insured were also of a



(NBCU) respectively. Their preference was to develop separate policies for individual types of accident or hazard – essentially the approach of British insurers in the nineteenth century. By 1941, however, the Americans had developed their own broad liability policy in the form of the Comprehensive General Liability (CGL) policy launched in January 1941. The policy covered liability for all hazards not specifically excluded but, in spite of its wide in coverage, was subject to a number of restrictions. In particular, cover was restricted to bodily injury (rather than personal injury, which might include damage to reputation, hurt feelings and the like) and the damage in question had to be ‘caused by accident’. In order to compete Lloyd’s had, in effect, to go one better, by offering cover on a broader basis still.

This trend reached its zenith in the Umbrella<sup>92</sup> liability policies that Lloyd’s offered to its US customers from 1949 onwards. In the post-World War II era Lloyd’s (and the London market companies) could, in effect, only sell insurance to American companies that American insurers could not or would not provide. Under the Surplus Lines Law, Lloyd’s, as a non-admitted insurer, was restricted to new or unusual risks, risks for which there was insufficient local capacity and those that were undesirable or unacceptable to local insurers. The Umbrella liability policy satisfied this requirement by providing excess legal liability for American industry. It was the product of a broker alliance between the American firm Marsh & McLennan,<sup>93</sup> the British firm Price Forbes<sup>94</sup> and a French-Canadian broker Guy de Repentigny. The Umbrella has been described as a ‘marketing weapon deployed by this broker alliance to gain lucrative American accounts.’<sup>95</sup> The Umbrella was designed to sit above and supplement the primary liability insurance coverage afforded by US domestic insurers, typically via policies such as the CGL form described above. The breadth and extent of coverage under some early policies was truly staggering. Liability cover was provided on an ‘all risks’ basis in respect of damage to property (not always

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type most likely to generate long-tail claims for pollution, gradually-developing disease and the like.

<sup>92</sup> ‘Umbrella’ is a rough acronym for the full name for the policy: ‘Broad Form Excess Comprehensive Liability.’ Apart from its useful symbolic quality ‘Umbrella’ also met the requirement for brevity necessitated by cable traffic.

<sup>93</sup> Now part of Marsh Inc.

<sup>94</sup> Subsequently part of the Sedgwick group and, now, Marsh Inc.

<sup>95</sup> *The Underwriting of Unlimited Risk: The London Market Umbrella Liability Policy 1950-1970*. Unpublished paper by Randolph M. Fields.

restricted to material property) and personal (not bodily) injury. The term 'occurrence' was substituted for the expression 'caused by accident'. In the early years the policy was often silent on what precise aspect of this 'occurrence' had to take place in the period of insurance for the policy to respond. This opened up the possibility of claims for injury or damage that was intentional in nature<sup>96</sup> and, even more worryingly, for claims whose origin or reporting fell outside the policy period.<sup>97</sup> There was no exclusion relating to seepage or pollution.<sup>98</sup> Again, there was no aggregate limit of indemnity, so it was possible for an insured to have one hundred loss 'occurrences' in one policy year arising from, say, one hundred individual waste sites, thereby multiplying \$10 million coverage into £1 billion. Finally, the policy had a unique 'drop down' characteristic whereby it became primary coverage (subject, say, to a self-insured retention of \$25,000) in the event of the exhaustion or non-existence of underlying coverage. Since, as we have seen, the underlying coverage was typically narrower than the Umbrella, the Umbrella effectively filled in gaps in the primary coverage and, in any case, it responded if for any reason the primary insurers were not able to pay.

The first Umbrella was written for Gulf Oil in June 1949 and demand accelerated rapidly from 1952, when many American writers of excess liability business withdrew from the market. However, as early as 1954 losses were beginning to mount at an alarming rate, with claim payments and reserves already exceeding premium income and many noted claims with no reserves established. Brokers put this down to poor claims handling, freak conditions and the like. Most underwriters accepted their assurances, tempted by the large chunks of premium that were generated by Umbrella business, which was now being written on a three-year basis. As Fields notes 'Underwriters were now faced with the classic offer of bread today, jam tomorrow ... What underwriters would cut and run now? The answer was that few did, perhaps preferring to believe the blandishment of brokers that mistakes had been learned from and it was now time to make money'.<sup>99</sup> Attempts were made to limit the scope of

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<sup>96</sup> But subject, of course, to the general insurance law on losses caused deliberately.

<sup>97</sup> Leading to potential 'stacking' of limits, for which see note 114 and accompanying text.

<sup>98</sup> Pollution exclusions were not introduced generally by Lloyd's until 1970, when NMA clauses 1683, 1684, 1685 and 1686 were deployed.

<sup>99</sup> Fields *op cit* note 95 p. 19.



Umbrella coverage in 1960 when some restrictions were introduced, but pressure from brokers (who threatened to take the business to allegedly eager American insurers) meant that cover remained broad until 1970. The effects of this, of course, are still being felt in Lloyd's today, with losses still being generated by forty year old policies. The 'Umbrella' was certainly not the only source of Lloyd's losses, but it contributed a significant part and its genesis illustrates how Lloyd's, through the medium of liability insurance and the dynamics of its own peculiar position in the insurance market, was led down such a dangerous road. We will return to the subject of Lloyd's and the London market, and, in particular, the behavioural aspects of liability underwriting, in Section 4.4, which deals with moral hazard in this context.

In this part of the essay we have seen how liability insurers began to face serious difficulties in the second half of the twentieth century. The response of insurers, and their attempts to solve to these problems by changes in underwriting practice and contract design are considered next.

### **3      REACTION AND RESPONSE**

How have insurers responded to the problems outlined in Part 2, above? Before we can answer this question it is necessary to consider some of the issues already raised in rather more depth. To do this we must explore some technical aspects of liability insurance.

#### **3.1      THE CLAIM TRANSACTION**

It should be apparent by now that many problems stem from the extended period of time over which liability claims develop. In fact, the progress of a liability claim can be broken down into a number of stages, as follows:

- 1      an initial act of negligence, or the commission of some other legal wrong;
- 2      some form of injury, loss or damage resulting from the act;
- 3      manifestation of the injury, loss or damage;
- 4      the establishment of a causal link between the damage and the conduct of the policyholder;
- 5      the claim against the policyholder;
- 6      notification of the claim to the insurer;
- 7      the final settlement of the claim.

Some liability claims advance swiftly. For example, in the case of claims arising from motor accidents, stages 1, 2, 3 and 4 usually occur simultaneously, with 5 and 6 following shortly after. However, in other cases the process can be very much prolonged. In fact, there is potential for a time lag, perhaps of many years, between each stage, as in the following examples.

##### **Between stage 1 and 2**

Delay between the original act of negligence and the loss or damage that flows from it is common in the case of claims against professional firms, when negligence occurs in the provision of advice or professional services, but the advice is not fully



implemented for some time. For example, the negligence of an architect in drawing up plans for a building is unlikely to cause loss until the structure is complete, perhaps many years later. Similarly, the negligence of a lawyer in drafting a defective will is unlikely to cause loss until it is executed, often at a much later date.

#### Between stage 2 and 3

The phenomenon of latent injury or damage is well known and requires little explanation here. Suffice it to say that latency periods can be very long indeed. For gradually developing diseases a latency period of 40 years is not uncommon.<sup>100</sup> Very slow migration of pollutants from industrial sites to underground water resources can generate equally long latency periods in the case of claims for pollution and environmental damage.

#### Between stage 3 and 4

A further time lag can occur between the date of manifestation and the date when the policyholder becomes aware that the injury is, or may be, his responsibility. For example pollution of a town's water supply may be identified long before it is traced to a leak in an underground pipe for which the policyholder is responsible. In some cases the policyholder may not become aware of the damage until a formal claim for compensation is made (see below).

#### Between stage 4 and 5

Of course, legal systems typically allow victims of wrongful acts fairly generous time periods in which to commence their actions. For example, under English law the basic limitation period for personal injury is three years and for property damage six years.<sup>101</sup>

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<sup>100</sup> The average latency period, from date of first exposure to diagnosis, is 35 years for asbestosis and 40 years for silicosis.

<sup>101</sup> The law in this area is currently under review by the Law Commission.

### Between stage 5 and 6

Although liability insurance policies, like insurance contracts generally, require prompt notification of claims or incidents that may give rise to them, late notification is extremely common. For example, in the case of work-place accidents, it is common for employers to continue paying the wage or salary of injured employees in the hope that no claim for damages will be made, and to tell their insurers of the accident only when the employee initiates proceedings. In this case (employers' liability) the law prevents the insurer from denying liability on the grounds of such late notification,<sup>102</sup> in other cases insurers may be reluctant to take the point for commercial reasons.

### Between stage 6 and 7

Again, it hardly needs stating that liability claims, particularly for personal injury, take a long time to settle. For a serious injury the settlement period is typically between three and seven years in the UK. Of course, this is owing to the slowness of legal processes and to the fact that damages cannot be finally determined until the medical condition of the victim has stabilised and his or her future needs have been clearly established.

Whilst delay at any stage of the claim transaction can create difficulties, the most problematic long-tail claims arise in cases where the injury, loss or damage lies hidden for some time, or occurs gradually. Sometimes these two characteristics – latency and gradual onset – may be combined. As already stated, the most extreme examples of protracted liability claims are those for diseases that are contracted gradually, where the whole process may span 40 years or more, and gradual pollution, where, in one recent case, the time span was over 100 years.<sup>103</sup> The classes of insurance most likely to be affected are employers' liability and workers'

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<sup>102</sup> Regulation 2(1)(a), Employers' Liability (Compulsory Insurance) Regulations 1998 (S.I. 1998 No. 2573.).

<sup>103</sup> The case involved pollution from a creosote works built by a US railroad company in the late nineteenth century. The creosote had been needed to treat the timbers of a bridge that carried the railroad over a lake.



compensation, public (general) and product liability. The time span for claims against company directors and professional persons may also be long but, for reasons that are discussed later, these fields have proved less problematic, at least for insurers.

A full analysis of the problems of long-tail claims is beyond the scope of this essay. However, they can be summarised briefly according to whether they impact primarily upon the injured claimant, the (defendant) policyholder, or the insurer of the latter.

For the claimant, the greatest problems are associated with the establishing of liability and the gaining of access to insurance funds. To begin with, the defendant may no longer exist by the time the damage manifests itself or injury is diagnosed because, for example, the employing firm has gone out of business. Alternatively, it may simply be impossible to trace the identity of the wrongdoer. If the defendant can be found liability is often difficult to establish because witnesses cannot be traced and records have disappeared. Even if this barrier can be overcome and a judgement is secured, it may turn out to be worthless if the defendant is insolvent and had inadequate insurance, or no insurance, at the time of the exposure. If coverage does exist, the law may allow a direct claim against the insurers concerned. However, even then the identity of the insurers on risk at the relevant time (which depends on the design of the policy, see Section 3.1 below) may be difficult to establish. Again, several insurers may have been on risk during the period of exposure, and each may dispute its liability. Various techniques have been developed to deal with these problems, including legal mechanisms to facilitate direct claims against insurers, guarantee funds to provide a safety net when insurance fails and market agreements to secure co-operation by insurers. However, these devices have proved, at best, to be ponderous and expensive to operate and, at worst, simply ineffective.<sup>104</sup> Long-tail claims create similar problems for policyholders. Insured firms face the prospect of

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<sup>104</sup> The principal mechanism for bringing direct claims under English law, the Third Parties (Rights Against Insurers) Act 1930 is narrow in scope (applying only in cases of insolvency) and extremely ponderous in its operation. See *How Secure is the System?* pp. 122-125 for a critique. However, the 1930 Act is under review and insurers have also recently agreed to a code of conduct intended to make it easier for victims of industrial illness to identify the insurer that was on risk at the relevant time. Under the new (Association of British Insurers') code insurers must provide a central contact for inquiries, conduct a full search of their records, and respond to requests for information within 28 days. If a search is unsuccessful the



becoming embroiled in litigation that, for reasons given above, is likely to be complex, prolonged and expensive. Inadequate records may make it equally difficult for the policyholder to trace the insurer(s) that were on risk at the relevant time. Again, coverage limits may be inadequate and there may be gaps in the insurance programme.

The complexities outlined above mean that long-tail claims are likely to be expensive and difficult to handle for insurers also. However, for insurers there are even more serious problems. Quite simply, the longer the time period between the underwriting of an insurance risk and the payment of claims associated with it, the more difficult it becomes to insure that risk efficiently. Pricing and reserving become extremely difficult, because the time span over which claims develop makes it difficult to assess their ultimate cost. Existing loss data used to calculate the 'risk' (or 'pure') premium is likely to be unreliable, because it may relate to circumstances that obtained many years ago rather than to those of the present day. At the same time, assumptions that must be made when adjusting the risk premium, such as those concerning future inflation levels, interest rates, investment yields, and expense levels are far more likely to prove wrong when they relate to the distant rather than the immediate future.<sup>105</sup> Then, crucially, there is the 'development risk' – the possibility that there will be shifts in the underlying probabilities upon which premiums are based. For example, advances in scientific knowledge or unforeseeable changes in the law can easily make claims more frequent or more expensive to settle. Scientific developments in the medical field, such as in the understanding of the aetiology of disease, have often led to a surge in claims,<sup>106</sup> and the legal environment has sometimes proved unstable or even hostile, at least from the perspective of insurers. The latter issue – the relationship between liability insurance and the law – is

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<sup>105</sup> case must be referred to the ABI, which will contact all other EL insurers, which must in turn respond within a further 28 days. Under the code insurers must maintain records for 60 years. Of course, levels of reserves for outstanding claims will be much higher for liability business generally than for other classes. In the UK liability claims reserves typically stand at about 375% of annual premium income. This means that considerable investment income can be generated on liability business, allowing insurers with an underwriting margin of between minus 10% and minus 20% (depending on investment yields) to break even. However, delays in claim settlement are not beneficial to insurers because, in recent years, the rise in the cost of court awards for personal injury has usually outstripped the investment yield on insurers' technical funds.

<sup>106</sup> See note 81 and accompanying text.



considered in more detail in Part 5. Again, social trends may result in a greater propensity on the part of accident victims to sue. This phenomenon, loosely described as the ‘compensation culture’ is also explored later, in Part 6.

Finally, we should note the extreme moral hazard that can arise with long-tail risks. In some cases the damage in question may have been *deliberately* created by parties who calculated that they could make a tidy profit from the activity that caused the loss and then render themselves judgement-proof before the harm was discovered. This ‘hit and run’ phenomenon has been styled ‘looting’ by Akerlof and Romer, who analysed the use of strategic bankruptcy as a means of appropriating rents in the context of the US savings and loan crisis.<sup>107</sup> Mason and Swanson<sup>108</sup> suggest that this phenomenon is one of the primary causes of long-tail risks and provide a number of examples. In particular, they discuss the problems associated with toxic waste disposal sites in the US and elsewhere, where absence of effective regulation encouraged the establishment of firms for the single purpose of providing landfill sites for the disposal of problematic waste. As the authors note:

‘These firms often existed with few assets other than the land on which the disposal occurred. After years of dumping, and before detection of any leaks, the firm would then dissolve its corporation and disappear, leaving others to incur the deferred costliness of its operation. ... This is the essence of looting: operation of a firm in a context in which it is possible to incur benefits today while postponing the associated costliness until the future, with dissolution and liquidation occurring in the interim. The necessary conditions for looting are therefore a) the availability of unlimited liability; b) the capacity to create deferred costliness; and c) the structure that renders liquidation the optimal strategy to pursue.’<sup>109</sup>

Of course, there is no reason why such a firm would want to have liability insurance in its post-operational phase, but it is very likely to have such cover when still a going concern. If the insurance is written on a causation<sup>110</sup> or occurrence basis<sup>111</sup> then, of course, the insurer concerned may well be liable to meet the loss, despite the

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<sup>107</sup> Akerlof, G. A. & Romer, P. M. (1993) ‘Looting: the economic underworld of bankruptcy for profit’, *Brooking Papers on Economic Activity*, 2, 1-60.

<sup>108</sup> Swanson, T. & Mason, R. ‘Long-tail risks and endogenous liabilities: regulating looting’ *The Geneva Papers on Risk and Insurance*, 23 (no. 87 April 1998), 182-195.

<sup>109</sup> *Op cit* note 108 at 183.

<sup>110</sup> See Section 3.2.1.1 below.

policyholder's liquidation, because a direct action against the insurer will be available in most jurisdictions. The insurer's only hope will be to establish that the damage was not 'accidental' but, as we shall see shortly (in Section 3.3.2 below), this may be very difficult. There is a further problem, not identified by Mason and Swanson. Even if an insurer, by careful underwriting, manages to avoid opportunistic 'looting' clients and covers reputable firms only it might still have to pay for losses caused by the former. This obligation could arise under a regime of joint and several liability such as that of the US 'Superfund' legislation. Under such a regime any extant firm can be called upon to pay for the whole of a loss, even though its own contribution to the damage was trivial compared with that of firms which are now defunct, unidentifiable or otherwise judgement-proof. It is easy to imagine how 'looting' behaviour could produce long-tail claims outside the field of environmental liability. For example, 'looters' could generate both employers' liability and product liability claims by skimping on safety precautions that would prevent the onset of gradually-developing diseases in their employees or latent harm to users of their products. It is difficult to see how private liability insurance can operate effectively when such perverse incentives exist.<sup>112</sup>

Since long-tail risks can create problems for every party involved in the claim transaction – claimant, policyholder and insurer – there is a need for insurance products that balance the interests of the parties and work in a way that is reasonably fair to all. Essentially, equilibrium must be maintained between the need for security on the part of the policyholder and the claimant, and the need for a reasonable degree of certainty on the part of the insurer. Claimants and policyholders must have the security that derives from sufficiently broad coverage combined with a guarantee that insurance funds will always be available, at whatever date compensation becomes due and indemnity is needed. On the other hand, insurers must be able to price their products with an accuracy that is sufficient to guarantee a reasonable, steady return on

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<sup>111</sup> See Section 3.2.1.2 below.

<sup>112</sup> With respect, the recommendations of Swanson and Mason are not appealing. They suggest that 'looting' behaviour might be controlled by a combination of mandatory liability insurance with a life extending 10-20 years beyond the event of liquidation as a condition of limited liability status with the residual amount of endogenous liquidation to be managed by the state. This would effectively deny insurers the use of 'claims-made' contracts for the very risks where (in the opinion the insurance industry) they are most essential.



the capital that supports their business. Unfortunately, it has proved extremely difficult to design liability insurance contracts that reconcile these different needs. Problems of insurance contract design are considered next.

## **3.2 LIABILITY INSURANCE CONTRACT DESIGN**

### **3.2.1 Policy triggers**

The most crucial element in a liability insurance contract is the policy ‘trigger’ – the thing that must happen in the period of insurance if the policy is to respond. Very different effects are achieved according to whether the trigger point is placed towards the beginning of the period over which the claim develops, towards the end, or somewhere in the middle. Although there are many variations there are, in essence, three basic types of policy trigger: *causation* (or acts committed), *occurrence* and *claims made*. The first (‘causation’) has been described as a ‘past tense’ trigger, since losses tend to fall on old policies and the last (‘claims-made’) as a ‘present tense’ trigger, since claims fall on current insurances. ‘Occurrence’ basis liability insurance falls between the two. Generally, there has been a tendency for insurers to move the trigger point forward in time as liability insurance has developed as a class. Each form of trigger is considered in turn.

#### **3.2.1.1 ‘Causation’ or ‘acts committed’ triggers**

In this case the insurer agrees to indemnify the policyholder in respect of compensation that he is required to pay for injury, loss or damage caused in the period of insurance. Liability to meet a claim thus falls upon the insurer that was on risk when the original negligent act, error or omission giving rise to the injury or loss took place (i.e. stage 1 in the claim transaction as set out above).

In the UK this trigger is associated with employers’ liability business in particular. Because the trigger point is set at the beginning of the time scale and, hence, furthest in time from the payment of the claim, the arrangement creates maximum uncertainty for the insurer, sometimes creating prospective liabilities that are virtually

unquantifiable. From the point of view of the policyholder and claimant it provides adequate security in some respects, but not in others. There is security in one sense, because, once in place, the cover never ends. Provided insurance was in force at the time (or over the period) when the injury was caused it will always be in force, no matter when a claim is made. On the other hand, the need to claim on policies issued many years ago may bring its own problems because, as explained earlier, that cover may be inadequate, incomplete or untraceable. Furthermore, in the case of claims in respect of damage or injury that was gradual in its onset (and not merely latent) there may be many potential defendants (e.g. firms that had employed a victim of industrial disease) backed by several different insurers, leading to even greater complications.

### **3.2.1.2 'Occurrence' triggers**

In this case, liability to meet the claim falls upon the insurer that was on risk when the accident, loss, damage or injury occurs or when it becomes manifest, depending on the precise wording and its interpretation. This could be stage 2, 3 or 4, or indeed all of them.

Occurrence type wordings have been used for many lines of liability business including motor, general and product liability. A major weakness lies in the fact that these wordings do not work well if the loss, damage or injury occurs gradually (e.g. gradually developing diseases, gradual pollution or gradual financial loss). In this case it will be difficult, if not impossible, to pinpoint exactly when the loss occurred. As a result a single loss may spread over several periods of insurance<sup>113</sup> leading to 'stacking' of policy limits<sup>114</sup> and complex disputes where more than one insurer is involved. Broadly speaking, occurrence policies are subject to the same limitations as causation policies, described above. Indeed, where the damage is caused and sustained contemporaneously, gradually or otherwise, there is no difference between the two. Only where the cause of the damage and its being sustained are divorced in

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<sup>113</sup> i.e. under the 'triple trigger' or 'continuous trigger' theory endorsed by courts in the US.

<sup>114</sup> i.e. where an insurer limits coverage to, say, £10 million for any one period of insurance and the loss 'occurs' over 10 years, making the insurers liable for up to £100 million. Since the loss spreads out 'horizontally' reinsurers providing cover on an excess of loss basis may benefit, because big losses are less likely to penetrate layers of reinsurance cover.



time is there a distinction:<sup>115</sup> in this case an ‘occurrence’ wording moves the trigger forward in time. Like causation-based contracts, occurrence policies do not offer full security for the insured, because claims may still fall on very old policies. Indeed, there is an added risk, because if the loss, injury or damage occurs after the policy has been cancelled there will be no cover at all, even though the negligent act that led to the damage happened when the insurers were on risk.<sup>116</sup>

For insurers the potential uncertainties are much the same as with causation-based contract and so require no further discussion here. As we have seen, the effect of an occurrence wording generally is to move the policy trigger forward in time, thus shortening the ‘tail’ of late claims and reducing uncertainty. However, whilst *prospective* liability will be reduced *retrospective* liability may be introduced at the same time, because insurers may become liable to meet claims for damage that occurred in the period of insurance but was caused earlier, prior to the date when the risk was assumed. Thus, when writing insurance on an occurrence basis the underwriter must look back in time as well as forward into the future in order to measure the risk. In fact, it is arguable that looking back (to what may have happened) is easier than looking forward (to what might happen yet), particularly when the underwriter can put some of the burden of investigation on the insured via the law on disclosure. This point is pursued in the next section, where we deal with claims-made wordings. Finally, we should remind ourselves that the casual introduction of loose occurrence-type wordings, and the failure of insurers to foresee the adverse construction that the courts might put upon them, were major factors in introducing long-tail claims into liability insurance portfolios and in the ensuing problems at Lloyd’s and elsewhere.

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<sup>115</sup> For example, the case suggested earlier, where negligent design work by an architect leads to the construction of a building that fails many years later.

<sup>116</sup> See *Psychiatric Illness* p. 21 for a discussion of this problem.

### 3.2.1.3 'Claims made' triggers <sup>117</sup>

As the name suggests, claims-made contracts are those whereby the insurer agrees to indemnify the policyholder in circumstances where the claim itself, rather than the negligence or damage that led to it, arises in the period of insurance. Generally, the insurer that is required to pay is the one on risk when the claim of the third party (the victim) is made *against* the insured (stage 5), although in some markets it is the claim for indemnity *by* the insured for indemnity under his policy (stage 6) that triggers coverage.<sup>118</sup>

This trigger has been used for professional indemnity insurance for many years and, more recently, for legal expenses insurance, directors' and officers' liability insurance, environmental impairment liability insurance and some other classes. For insurers, claims-made wordings appear to provide a good solution to the problems of latent and gradually occurring losses, because there is no prospective liability beyond the period of insurance under a claims-made policy in its purest form. When the period of insurance expires all cover ceases, unless the policy is renewed. Assuming that the policy runs for one year only, insurers are able to re-price the contract annually and re-assess the other terms of cover at the same time. Certainly, there is potential for retrospective liability, as explained above; and, even if there is a retrospective date fixed at the inception of the contract (i.e. a provision whereby the insurer accepts no liability for any loss caused before the date when the policy was opened) this retrospective liability will build from year to year as the policy is repeatedly renewed. Nevertheless, most underwriters would agree that looking back is easier than looking forward – that it is easier to carry out a careful audit of a firm's past activities than to predict the future effect of its current activities and, at the same time, assess the legal climate within which those activities might be judged. In any case, as suggested earlier, underwriters can reduce the burden of investigating the past by requiring the insured to disclose material facts relating to past activities. On the

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<sup>117</sup> For good general discussions of claims-made policies see Spier, J. (1998) 'Long tail (liability) risks and claims made policies, *The Geneva Papers on Risk and Insurance*, 23 (No. 87, April 1998), 152-168 and Schoorens, G. & Van Schoubroeck, C (1998) 'Insuring the uninsurable? The appeal of the circumstances clause', *The Geneva Papers on Risk and Insurance*, 23 (No. 87, April 1998), 169-177.



other hand, for obvious reasons, they cannot require the insured to predict the future: that burden remains firmly with the underwriters. Taking all things together, we can conclude that claims-made wordings create maximum certainty for the insurer. It is not surprising that some underwriters write liability insurance *only* on this basis, effectively restricting themselves to modern lines of business, such as professional indemnity and directors' and officers' liability, where the claims-made basis is accepted market practice.<sup>119</sup>

Unfortunately, the inevitable corollary of maximum certainty for the insurer is reduced security for the policyholder. In particular, if problems from the past begin to emerge, there is a risk that the insurer will impose excessively harsh terms at the renewal of a claims-made policy or, in an extreme case, refuse to renew at all. In this case the insured may find it very difficult to secure substitute cover. In practice this problem is alleviated in two ways. First, insurers always agree to indemnify policyholders, not only in respect of claims made against them during the period of insurance, but also for claims arising from incidents, events or occurrences notified in the period of insurance which *subsequently* give rise to a claim, even if the policy has been cancelled by the time the claim actually arrives. Second, insurers normally give the insured an 'extended reporting period' (ERP) of up to a year combined with the right to buy cover for a longer period (up to six years) at an agreed price if the policy is cancelled. However, these extensions operate only for claims arising from events which took place when the insurers were originally on risk: there is no cover for claims arising from any wrongful act after cancellation. It is this – the less than perfect security granted to the insured by a claims made policy – that has led courts and legislatures in at least three European countries to cast doubt upon their validity at various times.<sup>120</sup> Of course, there are some compensating benefits for the insured

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<sup>118</sup> E.g. Spain, in the context of professional indemnity insurance.

<sup>119</sup> For example the underwriter R. E. Brown, a well-known figure in the London market.

<sup>120</sup> The issue has been resolved in a reasonably satisfactory way in two of these countries (Belgium and Spain) but there are continuing difficulties in France, where some major French insurers have pulled out of the professional indemnity insurance market, making it difficult for professions such as medicine to obtain suitable cover. The root of the problem is the tendency of the French judiciary to modify and reinterpret liability insurance contracts, which began in 1990 when the *Cour de Cassation* demanded the substitution of an 'occurrence' trigger in the interpretation of a claims-made policy. French insurers and their major clients want greater freedom to negotiate the terms of liability insurances, meanwhile many of the latter are turning to London for cover.

under a claims-made policy. There is the opportunity to review the adequacy of an insurance programme from year to year and increase (or reduce) cover as required. Again, since claims are made against the current insurer, there is little risk of the insurer being untraceable or no longer in business when the claim comes in.

All in all, it can be seen that no policy trigger provides a perfect solution to long-tail risks, or even a solution that is likely to satisfy all parties involved. On balance, the claim-made trigger provides the optimum arrangement for insurers, and it is not surprising that underwriters have sought to extend its use in recent years. However, their success in this regard has been limited. During the exceptionally hard insurance market that prevailed following the 1984-86 liability insurance crisis in the US claims-made wordings were used more extensively for some lines (e.g. product liability) but little further progress has been made. Most significantly, attempts to apply this form of cover to employers' liability insurance in the UK have foundered in the face of legal and technical difficulties. These are discussed in more detail in Section 4.4.

### **3.2.2 Exclusion of non-accidental losses**

There is a further major problem in the design of liability insurance contracts, in this case associated with the exclusion of 'non-accidental' losses. Fundamental principles of insurance require that insurers should pay only for losses that are accidental, or 'fortuitous'. Failure to observe this principle creates extreme moral hazard, because any incentive on the part of the insured to take care will be greatly weakened if insurers are prepared to pay for losses without regard to how the policyholder behaves. Insurers attempt deal with this issue by including appropriate restrictions in their policies. One such restriction, common in UK liability policies, is a stipulation to the effect that the insurer will provide an indemnity only in respect of injury, loss or damage that is 'accidental'. An alternative provision, more common in the US, denies coverage where the liability of the insured is in respect of injury, loss or damage that was 'expected or intended' by him. When the harm for which the insured is responsible arises in connection with an *accident*, that is, a sudden event such as an explosion, fire, fall or injury involving machinery, these provisions can



usually be interpreted with little difficulty. In this case attention generally focuses on the incident in question, the claimant's actions immediately prior to the accident and the policyholder's own behaviour in relation to it: were the actions of the policyholder merely careless (in which case the policy will respond) or were they reckless or actually calculated to cause harm (in which case cover will usually be denied)?<sup>121</sup> However, where the injury, loss or damage has occurred or accumulated gradually the interpretation of such policy provisions is likely to be much more difficult, because in this case there is no accident or sudden event to provide a focus. Instead it will be necessary to consider the general behaviour of the insured over a long period of time and, in particular, what the insured *knew* during this period. Claims for gradual pollution and environmental damage, discussed already in the context of 'looting', provide good examples. Quite often the insured is aware that pollutants are being released in the course of his business activities. If, following the slow migration or accumulation of toxins, a claim is made against him the availability of coverage will inevitably hinge on whether the insured expected this to happen. Of course, the insured will always deny that he anticipated this result, leaving the insurers to adduce evidence that he did. Because of the time scale involved and the abstract nature of what must be proved, disputes of this kind are notoriously complex, often focusing on whether or not a particular state of mind can be inferred from the insured's behaviour, or that of his servants. They are, to adopt the American lawyer's jargon 'fact intensive', generating mounds of evidence and of course, massive expense.<sup>122</sup>

It will be apparent from the foregoing that liability insurance has developed in such a way as to generate technical problems of the most intractable kind, mainly associated with the long time period over which liability claims develop, and the difficulty of designing contracts that operate in a satisfactory way under such circumstances. However, there are further difficulties and further sources of instability. These arise

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<sup>121</sup> Of course, there is a large body of case law on this topic. The classic English decision is *Gray v. Barr* [1971] 2 QB 554. See, generally, Birds, J. & Hird, N. J. (2001) *Modern insurance law*, 5<sup>th</sup> Edition, pp. 218-220 and 239-244 and Clarke, M.A. (1997) *The law of insurance contracts*, 3<sup>rd</sup> edition, pp. 443-453.

<sup>122</sup> To cite just one bizarre example, in the prolonged litigation surrounding the alleged pollution by the Shell Oil Company of the US Rocky Mountains a huge amount of evidence accumulated in connection with the 'dead duck defence' – a submission that the employment by Shell of personnel to collect and dispose of wildfowl killed by the toxins they had produced was sufficient evidence that the pollution was 'expected or intended' by the insured.

from the effects that the provision of liability insurance might have on human behaviour – and not just that of the policyholder, but also the behaviour of other parties who can influence the volume and cost of claims. These other parties include the claimant himself and the lawmakers who determine the rights of claimants. Here we are concerned with behavioural aspects of liability insurance, moral hazard, and an associated issue: the relationship between liability insurance and the law. As we shall see, behavioural issues and moral hazard take on extra dimensions in the case of liability insurance. The second problem, the potentially destabilising effect of an uncertain legal environment, is also unique to this class.



#### 4 MORAL HAZARD AND BEHAVIOURAL ASPECTS OF LIABILITY INSURANCE

This part of the essay considers moral hazard and wider behavioural aspects of liability insurance. We then move on, in Part 5, to a connected topic: the relationship between liability insurance and the law – especially tort law. Moral hazard is important, because it is a further potential source of instability in the tort/liability insurance system. However, before we explore the concepts associated with the term ‘moral hazard’ we must consider its definition.

What is meant by moral hazard? In fact, on this point, there is a major difference between the understanding of academic insurance economists and that of insurance practitioners. Economists define moral hazard (in the context of insurance) as a phenomenon whereby the obtaining of insurance tends to alter an individual’s incentives to prevent loss or to take specific actions; for example, to take care. As a result, changes occur in the probability and magnitude of losses underlying the calculations of insurers. Alternatively, and more simply, it is the risk that the availability of insurance will promote opportunistic behaviour in the insured. It is essentially an incentive problem, arising from asymmetric information of agents and the difficulty that insurers have in discriminating between the actions of the insured on the one hand, and exogenous uncertainty on the other. Because the insurer cannot precisely observe and control the insured’s behaviour it is impossible to reach a Pareto-optimal risk allocation. Only a ‘second-best’ solution is possible, representing a compromise between the conflicting goals of risk spreading and providing appropriate incentives to the insured. Apart from the difficulties which moral hazard creates for insurers, economists are also concerned with its wider effects on society and the misallocation of resources that may result.<sup>123</sup>

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For alternative definitions and general discussions of the topic see Arrow, K. J. (1970) ‘Insurance, risk and resource allocation’ *Essays in the theory of risk bearing*, pp. 134-144; Eison, R. (1981) ‘Information and observability – some notes on the economics of moral hazard and insurance’, *The Geneva Papers on Risk and Insurance*, 21 (October 1981) pp. 21-33 and Stiglitz, J. E. (1983) ‘Risk, incentives and insurance: the pure theory of moral hazard’, *The Geneva Papers on Risk and Insurance*, 8 (No. 26, January 1983), 4-33.



In what (for want of a better expression) we may call the ‘practitioner literature’ moral hazard carries a meaning that is much broader and much vaguer. Practitioners tend to distinguish between ‘physical hazard’ on the one hand and ‘moral hazard’ on the other. The former, roughly speaking, relates to aspects of insurance risks that are not affected by the vagaries of human behaviour and the latter to those that are.<sup>124</sup> Thus, practitioners deem moral hazard to be present if a policyholder is innately accident-prone, congenitally careless, cursed by nature or, for that matter, criminally inclined from birth. Economists, on the other hand, would not talk readily of moral hazard here, because the granting of insurance would make little difference to the behaviour of such individuals. Again, insurers take little interest in social effects, arising from the misallocation of resources, that might result from moral hazard; they are concerned almost exclusively with its potential effect on the profitability of their accounts – which is understandable. Finally, insurers are less concerned with the general tendency of insurance to promote opportunistic behaviour than with identifying, in advance, the individuals who are most likely to succumb to temptation. Thus insurers look for indicia of moral hazard (‘red flags’) and talk, for example, of the moral hazard associated with certain occupational groups and even some social classes.<sup>125</sup>

The ‘practitioner’ approach is intellectually unsound, not just because the distinction it makes between ‘physical’ and ‘moral’ hazard is often unworkable<sup>126</sup> but because it

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<sup>124</sup> For example: ‘Moral hazards are those conditions that increase or decrease the probability, frequency or severity of loss because of the attitude and character of either an insured person or some other person’ (Litton, R. A. (1988) *Moral Hazard and insurance fraud*, Chartered Insurance Institute, p. 3; ‘Moral hazard is an expression of the influence of human activity and its impact on insurance, either by its presence or its absence’ (Alport, A. E. B. (1988) *Risk and behaviour: some notes towards a definition of moral hazard*, Chartered Insurance Institute, p. 79. Webster’s dictionary more or less follows the ‘practitioner’ definition: ‘The possibility of loss to an insurer arising from the character, habits or attitudes of the insured.’

<sup>125</sup> “When I started work 25 years ago ... for motor underwriters the expression ‘moral hazard’ had the status of technical terminology. I soon came to understand that to them it was the generic term for people whose occupations indicated, they believed, characters which could not be trusted to play fair, take eight hours sleep a night and never make insurance claims – to wit: furriers, turf accountants, journalists, scrap merchants, general dealers, market traders, publicans and anyone vaguely connected with showbiz. Nowadays a good deal of what the general public – including furriers, turf accountants etc. understand as moral hazard has surfaced in Lloyd’s, hitherto the institutional embodiment of moral rectitude, so the term has rather fallen into disuse in insurance circles.” – a motor underwriter’s view quoted by Litton (*op cit* note 124 p. 71) who characterised the statement as ‘cynical’.

<sup>126</sup> For example, should one classify the temptations of drink to which publicans and bar staff are constantly exposed as moral or physical hazards?



also tends to confuse the *results* of moral hazard, such as dishonest claiming or carelessness, with *indicators* of a propensity to behave improperly, such as the following of a particular occupation or a bad claims record. However, the economists' approach, though more rigorous, is itself not entirely satisfactory. This is because the 'economics' literature focuses, almost exclusively, on the incentives that the possession of insurance might generate in the insured. Little account is taken of incentives generated in *other persons* whose behaviour has a bearing on the outcome of the insurance contract and on the risk. There is a key difference between first party insurance and liability insurance in this respect.<sup>127</sup> In the case of the former the insured and the claimant are one and the same but, in the case of the latter, they are not. With liability insurance the claimant is not the insured but a third party who has fallen victim to the insured's negligence. Nevertheless, the fact that the wrongdoer has liability insurance may affect the claimant's behaviour quite strongly. This may, in turn, affect the outcome of the insurance contract and the extent of the risk assumed by the insurer.<sup>128</sup> Again, the extent and magnitude of the risks that liability insurers assume depend to a great extent on the legal environment in which insurance operates and, specifically, on the rules of tort law. Parliament and the judiciary develop these rules, and the behaviour of their members may, in turn, be influenced by the availability of liability insurance in general or its existence in a particular case. Finally, it is possible that the peculiar nature of liability insurance might influence the actions of insurance personnel, including brokers and underwriters, leading to opportunistic, or at least imprudent, behaviour on their part too.

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

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<sup>127</sup> There is an (almost) complete absence of literature on moral hazard in the context of liability insurance. Exceptions include a working paper by Hugh Richardson (2000) 'Why is there liability and liability insurance' and an article by Cummins and Tennyson (see note 163).

<sup>128</sup> The third party may even be able to enforce the contract in his own name. This is possible in England under the Third Parties (Rights Against Insurers) Act 1930 and, more generally, in the case of third party motor insurance. In some jurisdictions (e.g. France) an *action directe* is possible under all liability insurance contracts.

## 4.1 FORMS OF MORAL HAZARD

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

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

Claimant hazard concerns the effect that the existence of liability insurance might have on actual or potential claimants, i.e. third parties. For example, they may be encouraged to target those who are insured in preference to those who are not, to collude with policyholders in order to tap insurance funds, or to launch unmeritorious suits in the hope that insurers will pay rather than risk incurring heavy defence costs. This is similar to moral hazard in the classic sense, but not exactly the same, because the position of the claimant is not exactly analogous to the insured under a first party insurance.<sup>129</sup>

Underwriting hazard is the risk that, in the case of some liability exposures, such as long-tail risks, underwriters may be encouraged to lower their normal standards. This might not be viewed as moral hazard in the classic sense, because imprudent underwriting does not directly affect the probability or magnitude of loss.<sup>130</sup> However, it is suggested that the perverse incentives that liability insurance can

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<sup>129</sup> In fact, the sharp distinction between first party insurance and third party insurance can sometimes become blurred. For example, when liability is strict, policy conditions are tightly controlled by law and insurance is compulsory, liability insurance looks very much like first party insurance purchased by accident causers for the benefit of victims. Some motor and workers’ compensation regimes have this ambiguous quality.

<sup>130</sup> On the other hand, it could do so; because an imprudent underwriter may draw cover too widely, encouraging careless behavior on the part of the insured.



generate for underwriters might have a similarly destabilising affect on insurance portfolios.

Jurisprudential hazard concerns the extent to which lawmakers, including the courts and the legislature in the UK, might be influenced in the application, modification or expansion of liability rules by the existence of liability insurance in a particular case, or by the general availability of such insurance. Arguably, this could give rise to moral hazard in the classic sense, because the shape and reach of (tort) law may not be entirely exogenous to any particular insurance contract or to the practices of insurers generally. Furthermore, the existence of insurance might promote decidedly opportunistic behaviour. For example, a judge might find that imposing liability on an insured, as opposed to an uninsured, wrongdoer increases his own utility.<sup>131</sup> Again, persons who influence Parliamentary processes might choose to avoid public opprobrium, and so advance their own careers, by favouring legislation that generates funds for compensation through the mechanisms of private liability insurance rather than (say) through unpalatable direct taxation, even when the latter would be more efficient.<sup>132</sup> There has been little study of moral hazard in political processes, but this does mean that it does not exist. Of course, at this point we begin to touch upon a much wider issue – the general relationship between liability insurance and the law. Because of its broad scope, this topic is addressed in a separate section of the essay (Part 5), as mentioned above.

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

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<sup>131</sup> See, for example, the remarks of the judge in the case discussed in note 184. Lord Denning also comes to mind in this context.

<sup>132</sup> The 'Superfund' legislation comes to mind here. Targeting anonymous European (re)insurers to pay for clean-ups is unlikely to be politically contentious in the US. Targeting US business would be a different matter. See also Section 5.2, p. 100.

## 4.2 POLICYHOLDER HAZARD

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

As we have already seen, the development of liability insurance in the early years was impeded by concern over the effect that such insurance might have on the behaviour of persons who obtained it. It was feared that policyholders, secured by insurance against claims for compensation, might become careless, and the lives and property of others would then be put at risk. In fact, the general practice of insurance had been condemned on a similar basis long before underwriters first assumed liability risks. For example, almost from the beginning marine insurance was criticised on the grounds that its availability encouraged enterprises that were excessively risky, reduced the incentive to construct strong and safe vessels, produced careless navigation and even encouraged masters to scuttle their ships. All of this put the lives of sailors at risk.<sup>133</sup> However, with liability insurance the argument carried extra

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For example, Samuel Pepys writes of marine insurance fraud in his *Diary* for 30 November/1 December 1663, having attended the trial of a ship’s master for this offence at the London Guildhall. A little later, the temptations of insurance were condemned in the (anonymous) broadsheet of 1700 *The case of Assurances as they now Stand: and the Evil Consequences thereof to the Nation*, the general flavour of which is given by the following: ‘... there has been very great Abuses put on the Assurer, by Old and Decayed Ships, sent for Africa, and other Parts, where the Worms eat them, where having made great Assurances on the Ships here, they have detained them in Ports on purpose, so long til their bottoms have been eaten up, or at least so as not fit to go to sea ...’. In 1834 James Basinghall of Kirkaldy condemned the practice of marine insurance in another tract, *The Pernicious effects of Sea Insurance* where, amongst other things, he exploits the perennial myth that insurers have an interest in more, rather than fewer, accidents and claims: ‘... it is a received maxim in Marine Insurance, that ‘high risks and high premiums, are preferable to low risks and low premiums,’ and every effort is used to keep up premiums. The loss of human life attendant on speculation, never enters for a moment into consideration.’ Even at the end of the nineteenth century, similar voices were heard. For example, at this time one Captain Fround, secretary of the



force, because careless injury to others was the very risk that was insured. At the same time, and in a more abstract sense, insurance against the consequence of 'wrongful' acts was seen as morally offensive, because it blunted the deterrent and retributive effect of the law. Thus, Tunc observes that: 'At the beginning of the nineteenth century, liability insurance would have been unthinkable. It would have been considered as immoral.'<sup>134</sup> Tunc may be wrong in one sense, because, at least among marine insurers, liability insurance was not only contemplated but, in all probability, actually practised before the nineteenth century began.<sup>135</sup> However, Tunc is certainly right in that the legality of such insurance was an issue from the start. In the earliest legal reference to liability insurance traced by the author, *Delanoy v. Robson*<sup>136</sup> (1814) the court considered a motion to move the venue of a 'running down' action from London to Durham where, it must be assumed, the incident had occurred. The Solicitor-General (Shepherd) objected on grounds that it would be impossible to find an impartial jury there. He noted that:

'... in the County of Durham were numerous societies of persons, who insured each other's vessels,<sup>137</sup> not only against sea risks, but also against all sums which the owners might be obliged to pay for damages done by their vessels: and that the Defendant's ship was insured by them, and the Plaintiff could scarcely have there a jury, which would not be interested to prevent his recovering.'

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

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

*Per Curiam.* It would be an illegal insurance to insure against what might be the consequences of the wrongful acts of the assured. But the peculiar character of these persons answers the Plaintiff's objection. They are assureds

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Shipmasters' society of London, argued: 'A good deal of the recklessness and apathy shown by shipowners and speculators is to be accounted for by the possibility of insuring in full against loss of ship, cargo and even unsecured freight. Indeed, unlimited insurance has unquestionably done much toward cheapening life upon the ocean.'

<sup>134</sup> Tunc, A., 1974 'Introduction', in *International Encyclopedia of Comparative Law*, Chapter 1 of Vol. 11 (Torts). The Hague: Mouton.

<sup>135</sup> See *Delanoy v. Robson*, note 136 and accompanying text.

<sup>136</sup> (1814) 5 Taunt. 605.

<sup>137</sup> See note 14 for details of the 'clubs' in the northern ports.

as well as assurers, and are as much interested to extend this principle of loss, as to restrain it. Here is not enough interest in this case, to prevent our sending it to the venue to which the Defendant is entitled otherwise to remove it.

This tells us much about attitudes to insurance prevailing at the time and, indeed, which prevail today. First, the court recognises that liability insurance might technically be illegal whilst acknowledging, coolly, that the practice exists. In fact, a wide gap between legal theory and practical application has always existed in insurance law.<sup>138</sup> Second, the court recognises the mutual character of the insurance under discussion – the parties concerned are ‘assureds as well as assurers’. The court acknowledges that in this case there are not, in reality, separate categories of victim, wrongdoer, and insurer but, at various times, they are all one and the same. For the parties concerned the commercial need for risk spreading, by whatever form of insurance, then takes precedence over the need for deterrence and retribution, making the issue of legality largely redundant. This is only a few steps away from a very modern view, espoused by the ‘Yale lawyers’,<sup>139</sup> whereby liability rules (in effect, those of tort law) become little more than a means of providing insurance to victims. Under this construct, the legality of liability insurance can hardly be questioned, because it is the very basis upon which tort liabilities are founded. This theory is considered in the next section.

As we have already seen, moral hazard of the sort now under discussion was raised as a basis to challenge the legality of liability insurance throughout the nineteenth century. Indeed, even in the twentieth century, the arguments were sometimes repeated.<sup>140</sup> However, these objections are now rarely heard, being heavily

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<sup>138</sup> For example, the statutory requirement for insurable interest, introduced for marine business in 1745, has never been fully observed by insurers. Insurers simply introduced PPI (‘Policy Proof of Interest’) contracts to circumvent the statute, and continue to do so. The practical importance of modern insurance law is also much reduced as a consequence of agreements amongst insurers which extend, modify or reduce strict legal rights. Generally, the law has condoned these market practices and, indeed, the Government itself has frequently become a party to the agreements concerned. See Lewis, R.K. ‘Insurers’ agreements not to enforce strict legal rights: bargaining with government and in the shadow of the law’ (1985) 48 *M.L.R.* 275.

<sup>139</sup> The phrase is borrowed from Jane Stapleton. See ‘Tort, Insurance and Ideology’ (1995) 58 *M.L.R.* 820, 833.

<sup>140</sup> See Tunc *op cit* note 134 pp. 50-52 and Shavell *op cit* note 5 p. 166. Both note, amongst other things, that there was a complete ban on liability coverage in the former Soviet Union.



outweighed by opposing views in favour of liability insurance. The positive, countervailing arguments are many and various.

First, it is commonly observed that the need for liability insurance as a means of guaranteeing compensation to victims of tortious injuries should, as a matter of policy, take precedence over the need to deter wrongdoing through tort liability. This argument looks particularly strong where mass injuries are concerned, such as those that occur on the road: indeed, it has led to the almost universal adoption by governments of compulsory third party motor insurance schemes. Challenging this proposition, some commentators suggest that, whilst a pattern of mass injuries and (potentially) insolvent injurers points to the need for risk-spreading through insurance, it does not necessarily indicate a need for *liability* insurance. They maintain that private *first party* insurance (or social insurance for that matter) can provide an adequate, and possibly cheaper, substitute.<sup>141</sup> The arguments become complex at this point, because the relative simplicity and efficiency of first party insurance hinges on the limited range of losses that are generally covered by such insurance and the absence, in most cases, of the need for legal adjudication on questions of either fault or quantum. Thus, in particular, first-party insurances generally do not cover non-economic losses, such as the pain and suffering of an accident victim. Critics use this point, in turn, to mount a further broad attack on liability insurance and tort liability itself. They argue that the tort/liability insurance system, in purporting to provide 'full' compensation, including non-economic losses, restricts personal autonomy. It does this by making victims pay for insurance of losses that they would not choose to insure themselves, given the option – payment, of course, being extracted by businesses that pass on their liability insurance premiums to consumers through higher charges for goods and services. However, whether victims actually *choose* not to insure these risks is a moot point. Certainly, cover is not generally available in the market, and this absence may result from a lack of demand. However, it may be that the risk is simply too difficult to insure, so the market has never been tested. Provision of 'full' compensation (including non-economic losses) along the lines of the tort system *could* be duplicated by first party insurance, but not without loading that first-party insurance with most, if not all, the costs of the tort system. This is



because reference to tort principles and, quite frequently, legal adjudication, would be necessary to quantify the ‘full’ compensation to which the first-party insured would be entitled. And why should insurers wish to market a product with such potential for conflict with its *own* policyholders? The potential for conflict over the quantum of compensation always exists in liability insurance, but in this case the insured and insurer are, on most occasions, at least on the same side! For these reasons, it is submitted that first party insurers cannot, in practice, offer products that mimic the sophisticated compensation principles of tort law.<sup>142</sup> Hence, in practice if not in theory, first party insurance cannot provide an exact substitute for liability insurance.<sup>143</sup> In the end, society must decide how much in the way of resources it wishes devote to accident victims (such as road casualties), how it should be distributed, and what weight should be given to questions of causation and fault. In the field of road accident compensation the variations are legion, with fault and no-fault schemes, and various combinations of first party, third party and social insurance. Compulsory *liability* insurance is certainly not the only choice of insurance system and it may not be the best, but it is a perfectly rational one, at least where the provision of ‘full’ compensation for at least some victims is seen as a priority.<sup>144</sup>

In fact, it is likely that the adoption in most countries of compulsory third party motor insurance has, in itself, dampened concerns over moral hazard and helped to promote a more general acceptance of liability insurance. Few people see anything wrong in insuring their own personal liability for road accidents and, by extension, are unlikely to question the application of liability insurance elsewhere. However, we should

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<sup>141</sup> See for example Shavell *op cit* note 5 at 166.

<sup>142</sup> In fact, the French insurance association (FFSA) has recently devised a new policy ‘*Garantie des Accidents de la Vie*’ (GAV) which is intended to cover any accident, domestic or otherwise, which is not work or road-related. Eight million French people suffer domestic accidents each year and 400,000 remain handicapped. Over 80% of injuries are self-inflicted, ruling out recovery from a third party. The new policy purports to provide ‘full’ compensation with payments calculated according to principles of tort law, as though a third party were responsible.

<sup>143</sup> Once again, we observe the phenomenon of insurers providing coverage, through liability insurance, of risks that are uninsurable under first-party insurance.

<sup>144</sup> In any event, where liability is strict (as it is for motor accidents in most countries), third party cover is compulsory and restrictive policy conditions are limited by law, the gap between third party and first party insurance begins to disappear, liability insurance becoming almost equivalent to first party insurance bought for the benefit of the victim.



point out that compensation regimes for road accidents are, in effect, ‘closed’ systems in which most participants are both potential causers of accidents and potential victims of them. Potential injurers and the potentially injured are not separate classes but, broadly speaking, members of a single body of road users, with a common interest in avoiding accidents. A collision that causes injury to a third party is almost as likely to injure the wrongdoer himself, so, regardless of whether the third party risk is insured, the potential wrongdoer has every incentive to be careful, particularly when there is no coverage for the wrongdoer’s own injuries. At the same time, the risks of vehicle use are such that a very small mistake by a driver can result in catastrophic injuries and huge personal liability.<sup>145</sup> No driver, however skilled, can be entirely confident of removing this risk simply by taking care. Thus, the nature of the risk, and its essential mutuality, is such that few would challenge the use of liability insurance on the basis that it might reduce safety standards on the roads, or on broader moral grounds.<sup>146</sup> However, the same mutuality does not exist in other fields of accident compensation where liability insurance is used, such as industrial injuries or product liability. Here, potential injurers and the potentially injured are members of separate groups, with interests that do not necessarily coincide so closely.<sup>147</sup> However, this distinction between third party motor insurance and other liability risks is not immediately obvious, and it is submitted that an almost universal acceptance of liability insurance in the context of road accidents has hastened its acceptance elsewhere.

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<sup>145</sup> See, for example, the freak circumstances of the recent Selby rail crash, note 271.

<sup>146</sup> Arguably, the abandonment of a system of tort-based liability backed by compulsory third party insurance in favour of true no fault-scheme, where all road accident victims are compensated (by first party insurance or otherwise) might lower safety standards, since careless drivers who injured themselves as well as others would be ‘rewarded’ with compensation. There is evidence of this happening in Quebec.

<sup>147</sup> Mutuality of interest may exist in a different sense. For example, in the field of product liability it is conventionally pointed out that cost of injuries resulting from defective products is passed on to consumers, liability insurance costs being reflected in the price of the goods they buy. Theoretically, this mechanism internalises accident costs and helps to produce optimum levels of product safety, in which we all have an interest. Stapleton, (*op cit* note 139 at 837) in the course of attacking arguments for the abolition of tort liability for non-economic loss, suggests that some victims of defective products stand outside the circle. She cites Mrs Donoghue – the injured non-buyer – as an example of a person whose interests differ from general community of consumers. However, this assumes that the Mrs Donoghues of this world never buy a round of drinks!



In a second line of defence, proponents accept that liability insurance may slightly dilute the deterrent effect of tort law, but argue that this dilution is unlikely to have a very marked effect on policyholders' behaviour. They say it is unlikely to do so simply because other, more powerful, deterrents will always remain in place. These include the sanctions of the criminal law which, unlike tort damages, often strike directors, managers and employees of insured firms, and not just the corporate enterprises themselves. They also include quantifiable accident costs that are not recoverable from liability insurers. Often these uninsured costs will far outweigh those that are insured.<sup>148</sup> Some costs to which accidents give rise, such as harm to personal reputation or business image, may be difficult to quantify but powerful nevertheless in their deterrent effect.<sup>149</sup>

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

Public concern and the interests of insurers coincide exactly at this point. Everything hinges on the effective application of standard underwriting techniques to liability insurance. Is liability insurance any different from other classes in this respect? Here it must be acknowledged that at least *some* of the standard mechanisms used to mitigate moral hazard in insurance are less easy to apply in the case of liability lines. For example, for at least some classes of liability business, a requirement to share the

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<sup>148</sup> For example, the UK Health and Safety Executive has suggested that for a firm paying employers' liability insurance premiums of £1 million (and, inevitably, recovering claim payments of rather less than this figure in most cases), the true cost of the risk is likely to be in the range of £8 million to £36 million (Health and Safety Executive (1994), *The Cost to the British Economy of Work Accidents and Work Related Ill Health*).

<sup>149</sup> For example, the threat of litigation and potential stigma of a finding in negligence can still have a powerful deterrent effect on the employer, even when the employers' liability risk is fully insured. This point has been made forcibly by Owen Tudor, former Legal Services Officer for the UK Trades Union Congress (TUC), in conversations with the author.



risk by means of a policy excess or deductible cannot easily be imposed on the insured,<sup>150</sup> and nor can some restrictive terms and conditions.<sup>151</sup> Again, restricting cover to what we have described as ‘ordinary’ negligence may not be as easy as it sounds. As we have already seen in Section 3.2.2, it can sometimes be very difficult to design an insurance contract that effectively excludes losses that result from recklessness or deliberate wrongdoing. Furthermore, insurers may find that they are required to pay even when recklessness can be proved, especially when liability insurance is compulsory.<sup>152</sup> Generally, there is clash of different policy goals in this area – a tension between a desire not to ‘reward’ wrongdoing and the need to ensure that innocent injured victims receive insurance money, however egregious the wrong may be. The result is a rather uneasy compromise between the rights to compensation of accident victims and the rights of insurers to protect the integrity of their underwriting systems and maintain equity amongst members of their risk communities.<sup>153</sup> Furthermore, there is worrying lack of consistency in some key areas of accident and insurance law, as the author has demonstrated elsewhere.<sup>154</sup>

Again, can liability insurers, with the same ease as other insurers, segregate the risk pool, observe the behaviour of their policyholders and charge accurate differential premiums either *ex post* or *ex ante*? The ability of liability insurers to do this

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<sup>150</sup> Particularly in the case of compulsory lines of liability insurance where, in order to protect the third party from the risk of policyholder insolvency, the use of deductibles may be forbidden by law. For example, the regulations governing employers’ liability insurance in the UK do just this – although an agreement whereby the insured pays the third party and claims reimbursement from the policyholder is not outlawed and can be used in place of a deductible. See Employers’ Liability (Compulsory Insurance) Regulations 1998 (S.I. 1998 No. 2573.).

<sup>151</sup> The regulations governing employers’ liability insurance (note 150 above) and various provisions in the Road Traffic Act 1988 limit the use of restrictive policy conditions in employers’ liability insurance and motor insurance respectively. See *How Secure is the System?* pp. 118-122.

<sup>152</sup> For some forms of liability insurance reckless conduct by the insured will debar coverage. Recklessness will amount either to a breach of the standard ‘reasonable precautions’ condition or allow the insurers to refuse indemnity on more general grounds of public policy – see *Gray v. Barr*, note 121 above. However, it has been suggested that in the case of third party motor insurance, and possibly employers’ liability insurance, – the compulsory lines – only deliberate criminal conduct could possibly prevent an insured from enforcing a claim in respect of personal injury. See Birds, *op cit* note 121.

<sup>153</sup> For example, some areas (such as the use of trade warranties in employers’ liability insurance) are governed by rather vague ‘understandings’ between the Government and the insurance industry.

<sup>154</sup> For example, is not obvious why the statutory regimes for motor and employers’ liability insurance allow insurers to rely on restrictive policy conditions in some cases but not others.



effectively has often been called into question and, whilst the author believes that critics often underestimate the sophistication of liability insurance underwriting,<sup>155</sup> it must be conceded that some risks, and especially long-tail exposures, present severe problems. For example, a key difficulty lies in the fact that experience rating is impractical for some liability risks. This technique – pricing a risk on the basis of its own loss history – is without question the most efficient method for insurers, the fairest for policyholders and the most beneficial in controlling moral hazard. However, long time delays in some liability claims mean that current loss experience may not accurately reflect the present state of the risk, making the device ineffective.<sup>156</sup> Furthermore, as we have seen, there is the possibility that some risks may be the product of *deliberate* ‘looting’ behaviour, evincing moral hazard in its most extreme form.

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

### 4.3 CLAIMANT HAZARD

The claimant is, of course, the ‘third party’ in the familiar liability insurance triangle. To what extent does the existence of liability insurance condition the behaviour of actual or potential claimants – i.e. accident victims? Are such victims likely to target those who are insured in preference to those who are not, collude with policyholders to tap insurance funds, fake injuries, or launch speculative suits in the hope that

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See, generally, *How Secure is the System?*, which explores inconsistencies between the statutory regimes for motor and employers’ liability insurance.

<sup>155</sup> See *Managerial Liability* pp. 24-25 and Parsons, C. (2000) ‘Directors and officers’ liability insurance: a target or a shield?’ *The Company Lawyer*, Vol. 21, No. 3 p. 84.

<sup>156</sup> See *The Cure* p. 37.



insurers will settle rather than risk heavy defence costs? The first question looks quite easy to answer. Common sense suggests that a rational accident victim is unlikely to pursue a case against a defendant who has no means to pay. In fact, very few tort actions are brought against persons who are uninsured. The Pearson Committee estimated that 88% of tort personal injury claims, representing 94 % of total value, were against defendants who were backed by insurance, with most of the balance against self-insurers.<sup>157</sup> More recent figures from the US suggest that liability insurers make an almost identical 93.5% of tort liability payments.<sup>158</sup> However, this in itself proves nothing. However unlikely, the prevalence of liability insurance amongst tort defendants *might* simply reflect the fact that potential causers of accidents (such as manufacturers of consumer goods, employers in the UK and motorists generally) are more inclined to buy liability insurance than persons who engage in more innocuous activities. In fact, the existence of *compulsory* liability insurance in some of the main spheres of tort liability makes these ‘chicken and egg’ discussions redundant in many contexts. In the case of compulsory schemes, liability insurance (or a surrogate in the form of a guarantee fund) is a given fact, so accident victims are unable to choose between insured and uninsured defendants and the latter generally have no choice but to insure. For this reason, those areas where liability insurance is *not* compulsory provide more fruitful fields of exploration. ‘Managerial’ liability provides a good example. Here there is quite abundant evidence that the development of a relatively new class of insurance, directors’ and officers’ liability insurance (D&O), has prompted claims that otherwise would not be made. This is evidenced by the phenomenon of D&O ‘strike suits’, especially in the US. These are cases where plaintiffs (often law firms) buy small parcels of shares in failing companies with a view to tapping D&O insurance funds through speculative attacks on the failing firms’ directors. The assumption they make is that insurers will pay rather than risk losing even more money through the heavy costs of defence. In this case D&O insurance coverage is clearly the key asset of the failing firm that attracts such speculators to buy a few shares and proceed against its management. In the absence of D&O insurance such a purchase would be completely irrational, except

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<sup>157</sup> *Report of the Royal Commission on civil liability and compensation for personal injury* (Pearson Commission) 1978, Cmnd. 7054-II vol. 2 para. 509.

perhaps by *bona fide* managers of recovery funds.<sup>159</sup> Of course, what attracts claimants is not liability insurance *per se* but the money it represents. This is what Clarke describes as the ‘magnetic effect’ of money,<sup>160</sup> or the ‘deep pocket’ by another name.<sup>161</sup>

We should also remember that some of the most relentless pursuers of insured tortfeasors are insurance companies themselves, proceeding by way of subrogation. In such cases the real (though not the nominal) plaintiff is typically a property insurer seeking to recover its outlay in respect of a first party claim or another liability insurer seeking contribution. For reasons that are obvious, insurers do not, as a rule, throw good money after bad by pursuing uninsured tortfeasors. The one decision that is commonly cited as evidence that insurers *do* pursue uninsured defendants, the notorious *Lister* case, turns out, on closer examination to show nothing of the sort, only that the plaintiff insurers were mistaken in their belief that the defendant was in fact insured.<sup>162</sup>

Of course, it is not in the least surprising that accident victims should favour insured wrongdoers. This hardly qualifies as moral hazard, even from the perspective of the insurer, since it is entirely predictable by the underwriters concerned. However, deliberate fraud by accident ‘victims’, and positive collusion between such victims and liability insurance policyholders is a different matter. Although moral hazard of this type (claims fraud) is generally associated with first-party insurance, there is

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<sup>158</sup> See Shavell *op cit* note 5, p. 166 citing O’Connell *et al* (1994) ‘Blending reform of tort liability and health insurance: a necessary mix’, *Cornell Law Review*, 79 pp. 1303-1338.

<sup>159</sup> A good contemporary example is found in the US ‘vulture funds’ that have bought into bonds issued by Barings Bank. In this case the target is Baring’s auditors, Coopers and Lybrand (now part of PricewaterhouseCoopers (PwC)) and their professional indemnity insurers, the former having failed to pick up Nick Leeson’s ‘rogue trading’. These funds were instrumental in the recent narrow voting down of a £84 million offer to settle, forcing a £1 billion court action to proceed.

<sup>160</sup> Clarke, M. *Policies and perceptions of insurance* (1997) p. 273.

<sup>161</sup> Of course, money appeals to lawyers also. Assuming that all are equally attracted by it, the most able are likely to get the job of probing the deepest pockets. More insurance may thus lead to better arguments that insurers should pay, requiring insurers to employ equally sophisticated and expensive defence counsel.

<sup>162</sup> *Lister v. Romford Ice and Cold Storage* [1957] AC 555. See *How Secure is the System?* note 83 pp. 130-131 for discussion of the insurance background.



evidence that it exists at a high level in liability insurance also.<sup>163</sup> For example, the non-existent trip or slip and the dubious back injury are now common currency for liability claims handlers. Furthermore, employers' liability insurers frequently deal with claims for injuries that are genuine, but which occurred well outside the sphere of work. Again, liability claims in respect of intentional, self-inflicted, injuries are not unknown.<sup>164</sup> Liability insurers are very attractive targets for fraudulent schemes of this sort because the payoff from a successful claim typically includes not only compensation for reported economic losses but for pain and suffering also.<sup>165</sup> Furthermore, a third party claim allows the perpetrator to defraud an insurance company without having, himself, to buy any insurance at all! Also common are collusive claims: that is, cases where the policyholder accepts responsibility for damage to the property of another, often a friend or colleague, in order to fund the latter's loss through his own liability insurance and, perhaps, share the proceeds. Again, liability insurance is particularly vulnerable to claims fraud of this sort. It may well be easier to accomplish and more profitable than fraud against a first party insurer because, quite apart from the availability of pain and suffering awards in injury cases mentioned above, third party cover is often wider. For example, the need to secure accident victims against the potential insolvency of the insured means that liability insurance policies are rarely subject to an excess or deductible – a standard device to control moral hazard in first party insurance.<sup>166</sup> Again, liability policies generally provide cover on a complete 'all risks' basis: loss or damage of *any* sort is insured, provided the policyholder is (or appears to be) legally responsible for it. Unlike many first party policies, there are typically no restrictions as to the perils that cause the loss or the location where the loss occurs.<sup>167</sup>

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<sup>163</sup> See, for example, Cummins, D. J. & Tennyson, S. (1996) 'Moral hazard in insurance claiming: evidence from automobile insurance' *Journal of Risk and Uncertainty* Vol. 12, Part 1 and also, generally, Zalma, B. (1996) *Liability claims fraud investigations*, Thomas Investigative Publications.

<sup>164</sup> The author has personal experience of fraudulent liability claims for self-inflicted injuries amongst textile workers in the North of England, some of which are too gruesome to describe.

<sup>165</sup> Cummins and Tennyson (1996) conclude that the incentive for bodily injury liability fraud stems primarily from the possibility of receiving pain and suffering awards. See 'Moral hazard in insurance claiming: evidence from automobile insurance' *Journal of Risk and Uncertainty* Vol. 12 pp. 29-50.

<sup>166</sup> Although liability insurance claim payments *are* potentially subject to reduction on account of contributory negligence – a restriction that does not apply to first party insurance.

<sup>167</sup> To take a simple example, first party insurance on personal possessions or business property is often restricted to losses that occur in the home or place of business whereas, in the case of

Sometimes liability insurers have created moral hazard and invited collusive claims through ineptitude, or at least lack of forethought, in policy design. D&O insurance provides a good example. Here it is customary to include as insured persons not only individual directors and managers but the corporate entity itself, on the grounds that the latter may be obliged to indemnify the former in some circumstances and third party suits may be brought against either or both. The possibility of collusive *internal* liability claims was not fully considered until, in the early 1980s, a number of US banks that had lost money through incautious lending sought to recoup their losses by dismissing, and then suing on grounds of negligence or breach of contract, employees who authorised the loans in question. As a result, trading losses that no first party insurer would regard as remotely insurable became the subject of D&O liability claims. These actions gave rise to much litigation and resulted in the introduction by D&O insurers of ‘assured *versus* assured’ exclusions in an attempt to eliminate the problem. However, the enforcement of these exclusions has proved problematic and, at the present time, they have become relaxed, despite the potential for reintroducing collusive claims.<sup>168</sup>

Some consequences of the ‘claimant hazard’ explored in this section, such as the potential for claims fraud, are not unique to liability business. However, it should be clear from the foregoing that liability insurance has a unique potential for influencing the behaviour of a persons who are not party to the insurance contract, and that this generates problems that are greater in dimension and complexity than those found in other insurance classes.

#### 4.4 UNDERWRITING HAZARD

One would imagine that the peculiar hazards of liability insurance, described above, would produce extra caution on the part of liability underwriters. However, this has

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liability insurance, the place where the damage occurs is usually irrelevant to coverage. Again, first party insurance often covers only specified perils (e.g. fire, theft etc.) whereas liability insurers do not usually impose restrictions of this sort.

<sup>168</sup> Especially in markets such as Germany, where the two-tier board structure makes assured *versus* assured exclusions unworkable. See *Managerial Liability* p 12.



not always been the case. Indeed, it is arguable that liability insurance, particularly in its long-tail guise, generates perverse incentives for underwriters that have no parallel in other forms of insurance or, at the very least, creates traps and temptations that do not exist in other classes. For one thing, the long time span over which liability claims develop means that the incautious underwriter may not be faced immediately with the full consequences of his actions. Current losses can be blamed on a previous generation of underwriters and, by the time the full claims cost of his own book of business is known, perhaps forty years hence, the guilty underwriter of today may be living in comfortable retirement, if not deceased – perhaps a further potential source of the ‘looting’ phenomenon explored in Section 3.1. A property insurance underwriter, by contrast, is rather more like Doctor Johnson’s condemned man: he will find that the possibility of a rapid claims build-up (if not the prospect of being hanged in a fortnight)<sup>169</sup> will concentrate the mind wonderfully. Of course, it is not suggested that the incautious liability underwriter can always, in the ordinary course of his business, put off the day of reckoning for so long. However, experience has proved that underwriters can be tempted all too easily by large chunks of liability insurance premium into accepting what are essentially unquantifiable risks.<sup>170</sup> Again, even when notifications do begin to trickle in, the underwriter may be easily persuaded that actual claims will not materialise, or they can be legally challenged, or that they are merely freak occurrences. By contrast, there is nothing so concrete, immediate and indisputable as a large fire. Perhaps, in the final analysis, the phenomenon of liability underwriters continuing to put loss-making liability business on their books can only be explained as a manifestation of classic gambling behaviour: the temptation to plunge when on a losing streak in the hope of recouping past losses.

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<sup>169</sup> ‘Depend upon it, sir, when a man knows he is to be hanged in a fortnight, it concentrates the mind wonderfully.’ Boswell (1791) *A life of Samuel Johnson*.

<sup>170</sup> This has led, from time to time, to frenzies of ‘cash flow underwriting’ or ‘writing for premium’, which might be regarded as no more than a name for grabbing the money and hoping for the best. It is based, in theory, on the assumption that any shortfall in the premium collected can be made good by a rich harvest of investment income that ripens during the long period of time over which claims develop, and their settlement is delayed. However, a strategy based on generation of investment income can easily come unstuck if investment yields drop, or fail to match the rise in damages awards, or liability increases as a result of legal change – all of which have happened in recent years. At the very least, this strategy adds extra layers of risk over and above the insurance risks that underwriters assume.



As we have seen in connection with the *débâcle* surrounding their Umbrella policies,<sup>171</sup> Lloyd's has certainly not been immune from this ostrich-style underwriting.<sup>172</sup> However, there is another dimension to the Lloyd's near-disaster. This is the role of the broker which, of course, extends beyond Lloyd's to the whole of the London market and is not confined to liability insurance. The London market relies on brokers, not only to bring in business but also, in many cases, to design the products that are to be 'manufactured' by the underwriters. We see this in the case of many forms of liability insurance, which have often been products of broker innovation. Examples include D&O insurance and the 'Umbrella' liability policies discussed in Section 2.3. The broker's role is to sell his product, not only to the client insured but also to the underwriter. Thus, the underwriter has to price a product that is not only designed by another (the broker) but which varies in its production costs according to the characteristics of a person or business (the insured) that is selected and proposed by that other. The London market insurance underwriter is in the hands of the intermediary to an extent that is found in no other industry. In fact, the broker has every incentive to understate the extent of the risk that he presents, because his primary duty is to his client insured.<sup>173</sup> As a result, underwriters, and not just policyholders, can become victims of mis-selling. Of course, if a broker oversteps the mark and conceals the truth, or misrepresents facts relating to the risk, then he can be called to account and held legally responsible for his wrongdoing. But what protection does this accountability give to the underwriter? The answer is very little, because the London insurance market stands behind the broker as well. Certainly, if the latter is negligent he may be liable in damages, either to his client insured (if his negligence is attributable to the latter and a claim is lost), or to the insurers (if the negligence is attributable to the broker alone). However, it makes little difference in either case because, of course, the broker is insured. Thus, the mechanism of liability insurance (professional indemnity insurance in this case) will simply propel the loss back into the very market that the broker has offended, if not back to the very same

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<sup>171</sup> See Section 2.3.

<sup>172</sup> The plaintiffs in the *Jaffray* litigation (*Society of Lloyd's v. Jaffray* [1999] 1 Com All ER 354, QBD and (No. 2) 2 Comm All ER 181, QBD) argued that Lloyd's underwriters had succumbed to a form of moral hazard going beyond ostrich-like obtuseness. They alleged positive fraud, saying that Names had been recruited in the knowledge that long-tail liability claims were on the way, and concealed this fact from the individuals concerned – the so-called 'recruit to dilute' policy. The plaintiffs lost in the High Court, but there may be an appeal.



underwriters. Obviously, the protection that the broker receives comes at a cost, in the form of the professional indemnity insurance premiums that are paid. However, the burden of assessing and pricing this risk rests, again, on the underwriter. In essence, the underwriter is required to price not only the potential negligence of the insured, but also that of the intermediary who introduces him. The entrepreneurial approach to insurance that we find in the broker-driven London market is, of course, part of its strength, but only when entrepreneurship combines with cool-headed underwriting, scientific rigour in the assessment of risk, and an eye for the long term. Sadly, where liability insurance is concerned – where short-termism is doubly dangerous – this rigour has often been lacking.<sup>174</sup>

The inherent problems of the liability insurance market have been demonstrated already. However, the nature of liability insurance can also make it very difficult for insurers to extract themselves from difficulties once they arise, or to modify the arrangements that gave rise to the problem in the first place. Employers' liability insurance provides a good example. It is universally recognised that benefits to insurers, and probably to policyholders and claimants, would accrue if the 'causation' basis on which this business is written were changed to the modern 'claims-made' basis. However, abandonment of the old basis, unsatisfactory though it is, would put the major employers' liability insurers at a disadvantage. On switching to a new system they would still be left with a legacy of long-tail business that would take many years to run off. This would make it difficult for them to compete with new insurers who entered the market without the same burden of liability under old contracts. Major employers' liability insurers are thus locked into an unsatisfactory system. This curious bind may help to explain why there has never been sufficient will to switch to a claims-made basis, even though the ABI has investigated the possibility on more than one occasion in recent years. Clearly, existing insurers have

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<sup>173</sup> And, of course, because the broker is a distribution channel and not a risk carrier.

<sup>174</sup> Albert (*op cit* note 58 pp. 87-8), writing in 1990 noted '... Lloyd's is currently (and notoriously) in the throes of a crisis stemming largely from the Names' loss of confidence in their agents, too many of whom are apparently underwriting huge, ill-judged risks. Again we see the effects of the 'fame and finance' syndrome: brokers were only too happy, in the short term, to sign any deal, no matter how speculative, in order to take whopping commissions and enhance their visibility in the market. Unfortunately for their investors, the long term is about to catch up with the high rollers. Lloyd's, like America, faces a bleak day of reckoning in the not-too-distant future.'

the most to lose from such a change and, since they have the most influence in the market, no change has taken place.<sup>175</sup> Furthermore, the need to run off old risks means that liability insurers cannot simply ‘cut and run’ – in the sense of cutting their losses and making a clean and speedy exit from the market. This may partly explain why many liability insurers persist in writing a class of business that is acknowledged to be highly unsatisfactory in business terms. This general issue – the rationale for writing liability business in the present state of the market – is discussed in the final part of this essay.

#### 4.5 JURISPRUDENTIAL HAZARD

Finally, we turn to what has been styled jurisprudential hazard. Here we are concerned with the extent to which lawmakers, including the judiciary and Parliament in the UK, are likely to be influenced in the application, modification or expansion of liability rules by the existence of liability insurance, either in a particular case, or by the general availability of such insurance. We have already raised the question of moral hazard in legal and political processes; the possibility that judges, or our Parliamentary representatives, might adopt policies that tap insurance funds in order to avoid the public censure that alternative, and more efficient, solutions might generate. One does not wish to impugn the integrity of our lawmakers. However, when they face difficult fund-raising problems, liability insurance must often present them with an appealing and convenient line of least resistance.<sup>176</sup>

In any event, if, for whatever reason, the existence of insurance affects judicial or legislative policy in ways that are unpredictable, liability insurance portfolios will become subject to an extra layer of uncertainty that is unique in insurance generally. Besides all the other risks that insurers face, including the primary ‘insurance risk’ of accidents, investment and other financial risks, there will be potential for a shift in the

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<sup>175</sup> See *The Cure* pp. 38-42.

<sup>176</sup> The possible ‘privatisation’ of the Industrial Injuries Scheme, which has been on the agenda for some time now, may be a case in point. It is doubtful whether a privately-insured alternative could operate as economically as the IIS, which has an expense ratio of only 11%, but this has not deterred those who wish to relieve the Government of its burden. See *The Cure* pp.16-17.



underlying probabilities upon which insurance premiums are based. This shift, the product of legal uncertainty, would be very difficult for underwriters accommodate.

In fact, this whole issue can best be addressed by examining the wider relationship between liability insurance and the law. How *does* liability insurance affect the extent and shape of liability rules, and how *should* it affect them? This is considered in the next part of the essay.

## 5 LIABILITY INSURANCE AND THE LAW

The main subject matter of this part of the essay is the relationship between liability insurance and tort law. It considers, especially, the extent to which the former influences the latter, and the extent to which it should properly do so. The boundaries of the discussion can be marked out by reference to two extreme views.

The first view holds that liability insurance has, and should have, very little to do with the shape and reach of the law. Deterrence and retribution are seen as the prime functions of tort law and the provision of compensation as secondary. According to this perspective, the content of liability rules should be governed largely, if not wholly, by ideological considerations that involve moral and political judgements. Insurance can have little part to play in the formation of such judgements. It is merely a commercial practice, deriving from the fact of tort liability, that moulds itself, like plasticine, to the contours of the law without affecting its shape.

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



lead inexorably to a call for the retrenchment of tort liability.<sup>177</sup> For example, consistency with sound insurance principles requires that tort defendants should not have to pay damages for non-economic loss, such as pain and suffering, on the basis that people generally do not choose to buy first party insurance for such losses – a point that has been touched upon already.<sup>178</sup>

Few commentators accept, without reservation, either of the arguments set out above. For most, the truth about the relationship between insurance and tort law lies somewhere in between. They see many linkages between tort law and insurance practice, but only limited influence of the latter on the former. In this context a useful distinction can be made between the development of the law by courts and judges, where evidence of the influence of insurance is somewhat ambiguous, and development via legislation, where the influence of insurance and insurers is rather more clear. The author explores the subject on the basis of this distinction. However, we should also note that ‘tort’ is not a single, coherent body of rules governed by universal principles.<sup>179</sup> It is something of a rag-bag, as a study of its history shows. Since tort law lacks uniformity any search for the ‘true relationship’ between tort and insurance is almost bound to fail, because the relationship will inevitably vary in different branches of tort law and in different fields of application. In some areas, such as work-place risk, the ‘realities of insurance’ are very plain to see. For example, in many countries, though not the UK, insurance has not just influenced tort law but actually displaced it. Thus, in countries such as Germany the tort liability of the employer has been abolished<sup>180</sup> in favour of an exclusive remedy workers’ compensation insurance system. Here, ‘insurance’ has not just moulded tort liability but unceremoniously dumped it!<sup>181</sup> In other areas, such as product liability, the traces

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<sup>177</sup> *Op cit* note 139 at 820.

<sup>178</sup> See Section 4.2.

<sup>179</sup> Hence the preference of many writers for the appellation (law of) ‘torts’, not ‘tort’.

<sup>180</sup> In fact, the tort liability of the employer has not been entirely extinguished: employees can still sue, for example, in cases of intent.

<sup>181</sup> Of course, tort can always bite back. Exclusive remedy workers’ compensation systems tend to encourage product liability claims by injured workers and, worldwide, employers’ liability appears to be in the ascendant once more: see *European Perspective* pp. 221-223.

of insurance influence are present but rather more faint,<sup>182</sup> and in others, such as the deliberate torts, they are virtually non-existent.

As suggested above, we can best explore the subject by making a distinction between the influence of insurance in the courts and the influence of insurance on legislation, even though there will be some occasions when the two are not easily separated.

## 5.1 LIABILITY INSURANCE AND THE COURTS

Beginning with the courts, a number of connected questions must be addressed. First, will the knowledge that a *particular* (alleged) tortfeasor has liability insurance, or is very likely to have such insurance, increase the possibility that a court will find against him or award a higher amount in damages – and should it do so? Second, has the general availability, or otherwise, of liability insurance had an impact on judicial policy that has significantly affected the shape and structure of tort law? Again, should it have such an impact? Third, do the courts pay any attention to the efficiency of insurance arrangements by, for example, promoting legal structures that are likely to exploit or encourage one sort of insurance rather than another?

As far as the first question is concerned the answer should be in the negative, because a court (at least in the UK) is required, in theory, to ignore the existence of insurance when determining liability and fixing damages in any particular case.<sup>183</sup> In fact, this rule has not always have been followed to the letter and the extent to which judges have deviated from it has generated some debate.<sup>184</sup> Stapleton, in a wide-ranging

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<sup>182</sup> Some commentators see the influence of liability insurance in s.402A of the (US) Second Restatement of Torts and in the 1985 European Directive on Product Liability.

<sup>183</sup> Viscount Simond's pronouncement that when a court determines people's duties 'the fact that one of them is insured is to be disregarded' (*Lister v. Romford Ice and Cold Storage Co. Ltd* [1957] AC 555, 576-7) is often cited as the *locus classicus* of this doctrine.

<sup>184</sup> For example, Clarke notes the case, which came before a Crown Court judge in 1994, of an 82 year old man who had shot and injured a young intruder who persistently broke into his allotment shed. The judge awarded damages to the young victim and, to counter public outrage and press criticism, noted (apparently with some amusement) that the old man was insured. As Clarke notes: 'What he (the judge) did not know, it seems, is that judges are not supposed to know this sort of thing. That is theory; in practice, they often do.' Clarke, M. *Policies and perceptions of insurance* (1997) p. 284. One might add that the judge was on dangerous ground here. A more perceptive press and public would not have been mollified by



review of judicial responses to the existence, or otherwise, of liability insurance,<sup>185</sup> argues strongly that courts in the UK, with very few exceptions, have generally ignored the insurance factor. The exceptions she cites – cases where the courts have taken insurance considerations into account in determining liability – are nearly all drawn from the Denning era, and include many judgements of Lord Denning himself, whom many would regard as a maverick. However, it cannot be said that insurance considerations have had no effect whatever on decisions in particular cases. The number of exceptions quoted by Stapleton is uncomfortably high – perhaps too high to prove the rule – and other writers, particularly in jurisdictions outside the UK, have identified many more.<sup>186</sup> Furthermore, in some jurisdictions the right of a court to take insurance into account in particular cases is explicitly recognised. For example, in Sweden and the Netherlands courts have the power to consider the economic circumstances of the parties when fixing damages, but no mitigation is permitted if the defendant is covered by liability insurance.<sup>187</sup> Nevertheless, the actual existence of liability insurance in a particular case clearly cannot have more than a very marginal influence on its outcome. As Stapleton observes: ‘... it would seem morally incoherent for the liability insurance factor to have any independent force, for it would mean that there would be cases, for example, in which the fact that tipped the balance in favour of the defendant being held liable would simply be that he had or could have had liability insurance cover, while an equally culpable but uninsured or uninsurable actor would escape.’ This point can be illustrated by reference to deliberately inflicted injuries. These are, of course, actionable in tort but generally uninsurable as liability risks. It would indeed be curious if the law allowed negligent (or indeed non-negligent) drivers to be sued in tort for the injuries they inflicted but not murderers or perpetrators of a deliberate assault. It could be argued that, in practice, the ‘insurance factor’ *does* prevent the latter being sued in most cases. But it

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the judge’s explanation, since they would have realised that the damages that he awarded were coming out of their own insurance premiums, and not the old man’s pocket.

<sup>185</sup> *Op cit* note 139.

<sup>186</sup> See, for example, Gill, M., ‘The expansion of liability and the role of insurance - who’s the chicken’ *International Journal of Insurance Law* (1999) Part 1, pp. 27-40 for a general discussion of the topic.

<sup>187</sup> See Pfennigstorf, W. with Gifford, D. G. *A Comparative Study of Liability Law and Compensation Schemes in Ten Countries and the United States* (1991) Insurance Research Council, pp. 64-5.



does not do so in all cases,<sup>188</sup> and it would be an affront to society if the right to sue was removed by the absence of insurance, even though the value of that right may be largely symbolic.

Moving on to the second question – the *general* effect of insurance considerations on judicial and legislative policy – there is no doubt that the general availability, or otherwise, of insurance has played at least some part in shaping the law. Stapleton suggests that the influence has been very limited and, in support of her argument, looks at some key areas where insurance is generally regarded to have been an influential factor. One such area is pure economic loss where, with relatively few exceptions, English tort law does not impose liability on the defendant. The classic example is the ‘disruption of utilities’ case (e.g. interruption of business through the negligent severing of a supply cable by a defendant contractor). Here the law permits recovery only by those parties who have suffered physical damage: those who suffer economic loss only are denied a claim, under English law at least.<sup>189</sup> This rule can be readily explained by reference to the near impossibility of insuring the risk of such pure economic losses as a liability exposure, because of the potential for accumulation of risk, together with the reasonable possibility of the injured party protecting himself via first-party insurance,<sup>190</sup> or simply retaining the risk. Stapleton, however, prefers to explain the rule on the grounds of indeterminacy of liability, saying that the rule exists simply because it is ‘unfair’ to impose liability on defendants who cannot quantify the risk in advance. With respect, it can be argued that tort liability is frequently indeterminate to a greater or lesser degree and, for that matter, is frequently ‘unfair’ for other reasons, for example when liability is strict. In the cases under discussion the key and unique factor is the potential for multiplication of claims. Surely, it is ‘unfair’ to impose liability here only because insurance is not available to cover such losses. We do not regard it as ‘unfair’ that a motorist should be required to pay £9.4 million damages<sup>191</sup> to a disabled victim with exceptionally high earning capacity or as much as £100 million for a train crash that he has caused through

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<sup>188</sup> For example, the case of Peter Sutcliffe the ‘Yorkshire Ripper’.

<sup>189</sup> But not in some other jurisdictions, including Italy and the Netherlands.

<sup>190</sup> Business interruption policies can be extended to include the risk of disruption of utilities.

<sup>191</sup> A record sum recently awarded to a Dutch student who was disabled in a motor accident in the UK and which was, of course, met by the tortfeasor’s motor insurers.



momentary inattention.<sup>192</sup> However, we would almost certainly do so if insurance were not available to cover the risk.

Of course, pure economic loss is an area where, at one time, the law appeared to be undergoing rapid development, along with a general expansion in the duty of care in negligence. In support of Stapleton, we can note that there is little evidence that this was driven by the ‘realities of insurance’.<sup>193</sup> For example, the high water mark of this expansion was reached in 1982 with *Junior Books*,<sup>194</sup> which appeared to impose liability for pure economic loss in tort well outside the boundaries of the established *Hedley Byrne* rule. The decision imposed liability upon a firm of contractors that would not have been covered by their liability insurance at the time, since cover for pure economic loss was never provided under public (general) and product liability insurances.<sup>195</sup> In fact, following decisions such as this, a market for what became known as ‘financial loss cover’ did develop in the UK in response, but in this case insurance was clearly a resultant egg rather than a productive chicken. Furthermore, it is unlikely that the subsequent retrenchment of the law in the so-called ‘retreat from *Anns*’ was greatly influenced by insurance unavailability for, by this time, capacity for financial loss cover had been built in the market.<sup>196</sup>

Another area, examined by Stapleton and various other writers, is vicarious liability. This doctrine has sometimes been explained by reference to insurance and, in particular, the relative efficiency of different insurance arrangements. Thus, in the domain where vicarious liability is most prominent, the employer is seen a ‘better insurer’ than the employee in respect of whose tort he becomes vicariously liable. The former is better placed to arrange insurance and better able to distribute the cost of accidents amongst clients and consumers, by incorporating insurance costs in the price of goods and services. Stapleton attacks this thesis by pointing out that the ‘insurance’ rationalisation of vicarious liability does not explain why the principle is

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<sup>192</sup> The bill for the recent Selby train crash, apparently caused by a motorist who fell asleep at the wheel, is likely to be in this region. See note 271 for a further discussion of this case.

<sup>193</sup> See also Clarke *op cit* note 160, page 277.

<sup>194</sup> *Junior Books Co. v. The Veitchi Co* [1983] AC 520.

<sup>195</sup> Of course, cover has always been available for professional firms, under professional indemnity (PI) policies.

restricted largely to torts committed in the course of employment and does not extend to other relationships, such as parents of children and occupiers of land. However, there is an insurance rationalisation here, at least for the lack of vicarious liability in the parent-child relationship. The absence of vicarious liability does not in fact force children – ‘inefficient insurers’ – to buy liability cover because liability for children’s torts can be easily met by insurance arranged and paid for by the parent. Thus, private liability insurance, generally part of a home insurance package, always extends to children and other members of the insured’s family who live at home. There is no need for vicarious liability to achieve the desired effect of placing the risk with the parent – the ‘better insurer’ – because maternal or paternal love will secure this: few parents would attempt to exclude children from their policies in order to get cheaper cover. On the other hand, employers tend to be rather less protective where their employees are concerned: not all firms would want to buy liability insurance for their staff if vicarious liability did not compel them to do so. In any case, children are at best a fairly marginal case. There is a much larger category that is readily explicable in terms of insurance and insurability – that of principal and contractor. Here, subject to a few exceptions, the law does not hold the former liable for the torts of the latter. This absence of vicarious liability is difficult to justify on moral or ideological grounds. Theories based on an assumption that a lower degree of control is exercised in the principal/contractor relationship than in the employer/employee relationship hardly stand up in the light of modern working relationships. Nowadays a principal often has a far greater degree of control over his (nominally independent) contractor than an employer has over his (nominally dependent) employees. However, absence of vicarious liability is eminently explicable in terms of insurance. Imposing vicarious liability on the principal would often require him to effect a special insurance whenever he engaged a contractor to do some work. The risks associated with each particular contract would have to be assessed and underwritten separately, but would often be outside the principal’s own sphere of knowledge. Furthermore, in most cases the risks associated with the contracted work would be entirely different from those of the principal’s own regular occupation or business, and could not be predicted when insurance for the latter was first effected. Thus, for example, an

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It must be conceded that these so-called ‘financial loss’ covers were, and remain, rather narrow, with high deductibles and a variety of exclusions.



ordinary householder would have to arrange cover individually in respect of the builders who constructed a small extension for him, the tree surgeon who lopped his trees, and so forth. It would not be possible to write all possible risks of this sort into the householder's own home insurance, because the range and variety of services that *might* be provided to him is simply too great. In any case, imposing vicarious liability on the principal would not relieve the builder of the need to insure liability risks, because he would still require cover for accidents not connected with any particular contract, such as those that might happen in or about his own premises. Vicarious liability would thus lead to needless duplication of insurance and militate against precise risk assessment. Clearly, it is much more efficient for all risks associated with his activities to be carried by the builder or the tree surgeon himself. These risks can be insured under one continuing liability insurance contract, covering one type of work or activity, underwritten only once and on the basis of information well within the contractor's own knowledge. In short, the contractor is a 'better insurer' than the principal by a country mile.<sup>197</sup>

It must be conceded at this point that attempts to frame the law in such a way as to place the risk of loss on the most 'efficient' insurer can often be fraught with difficulty, and judges who proceed on this basis might soon find themselves in very deep water. Common and fairly basic assumptions about insurance efficiency often turn out to be less straightforward than might first appear. For example, it is often suggested that the law should favour first party over third party insurance (because it is thought to be cheaper and more efficient), should seek to avoid multiplication and duplication of insurance and should spread losses over as few insurers as possible. However, many complexities arise when one attempts to apply these apparently

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<sup>197</sup> Of course, principal and contractor are often in a position to bargain, allowing the parties to allocate risks as they please, regardless of whether vicarious liability is imposed by the Common Law. However, the bargaining position of the principal, such as the householder mentioned above, may be weak, or he may simply lack information about the risks involved, in which case vicarious liability could put him in an extremely vulnerable position. It is also worth noting that insurance considerations often lead contracting parties to exclude tort liability altogether and to substitute first party insurance for liability insurance as a risk spreading mechanism. Thus, it is common for building contracts to stipulate that neither party shall be liable to the other for any damage to the contract works; e.g. buildings under construction, materials on site etc. Instead, the parties insure this property in joint names under a material damage insurance (fire and 'perils' or contractors 'all risks').



simple precepts. This can be seen in the case of bailees, such as warehouse keepers who have temporary charge of goods belonging to a number of clients. A rule of law that exempted the bailee from liability and placed the risk on the owners of the bailed goods might be simultaneously attacked on the grounds that it encouraged multiplication of first party insurances and defended on the basis it that removed the need for the bailee to secure liability insurance. However, neither argument is strong, because the owners of the goods would probably buy first party insurance in any case (to cover losses that occur when the goods are in their own hands) and the bailor would probably secure liability insurance in any event (to cover liability to persons other than customers). Equally, placing the risk wholly or partly on the warehouse keeper would probably make no difference to the number and types of insurance required.<sup>198</sup> Arguments on the relative efficiency of alternative insurance arrangements in terms of their transaction costs are likely to be equally inconclusive. Would a large loss be more cheaply spread over a number of first party insurers (those of the bailees) or a single liability insurer (that of the bailor)? Comparing transaction costs is very difficult and, as Clarke suggests when discussing this problem in the context of carriage by sea, the argument between relative efficiency of first party and third-party insurance in this regard is far from having been resolved.<sup>199</sup>

In fact, conclusions about the proper shape and scope of legal rules based on the relative efficiency of first party and liability insurance are often questionable, because these two forms of insurance are essentially different in nature and function. They are rarely simply alternatives.<sup>200</sup> To add to these difficulties, there is a yet another complication: however rules of law are framed, the commercial practice of insurers may change their effect or even render them irrelevant. For example, in 1877 an English court was asked to rule on a case<sup>201</sup> involving merchants (Rodocanachi) who had deposited grain which was their property at a granary owned by wharfingers

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<sup>198</sup> In fact, it is quite likely that the bailee and each of the bailors will have both first party and liability insurance.

<sup>199</sup> *Op cit* note 160 page 292.

<sup>200</sup> Liability insurance cover is narrower in one sense, in that it responds only to damage for which the insured is legally responsible, but often wider in another, since the physical means by which the damage is caused is usually unrestricted. See also Stapleton *op cit* note 139 at p. 831.

<sup>201</sup> *North British and Mercantile Insurance Co. v. London, Liverpool and Globe Insurance Co.* (1877) 5 Ch. D. 569 the 'King and Queen Granaries' case.



(Barnett). The wharfingers, as bailees, had insured the grain, for which they were strictly liable by custom of trade. The owners too had insured. The wharfingers' insurers paid a claim following damage to the grain by fire and sought to recover a contribution from the owners' insurers. Recovery was denied on the grounds that the interests insured by the two policies (that of a bailee and that of an owner) were different. The wharfingers, as bailees, were liable in law for the loss and their insurers were required to bear it in full. The law as it appears from the case, strict liability on the part of bailees supported by a denial of contribution rights to their insurers, looks quite sound in terms of 'insurance efficiency'. However, all is not as it seems because, following the case, fire insurers agreed amongst themselves to simply ignore the decision and allow contribution between insurers in any event, thus spreading losses of this sort between two, or perhaps amongst many, insurance offices.<sup>202</sup> Agreements of this sort, whereby insurers nullify rules of law or change their practical effect, are extremely common. Thus, for example, tort law would generally require the driver of a car to fully compensate the owner of a lamp standard with which he negligently collides – on the basis that fault is unlikely to lie with the owner of lamp-post. However, insurers have agreed amongst themselves that in cases such as this one-quarter of the cost should be spread amongst the providers of street furniture, whose property insurers will generally meet that portion of the loss. Again, if motorists A and B collide, injuring C, tort law allocates C's compensation to A and B according to their respective degree of fault, whereas the motor insurers will simply divide the cost fifty-fifty, unless it is very large. Yet again, if A borrows B's car and negligently injures C, the law requires the motor insurers of A and B to share the cost, assuming that each covers A's liability, whereas insurers themselves have decided that B's insurers alone should pay in such a case.<sup>203</sup>

The simple point here is that legal rules that are framed with a view to bringing about a particular pattern of insurance, loss allocation and risk spreading may not always achieve the effect intended, because insurers have considerable power to dictate patterns that *they* regard as efficient. Of course, both insurers and their clients have a strong interest in 'efficient' insurance. So, provided the decisions taken by insurers in

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<sup>202</sup> Via an agreement between members of the Fire Offices Committee.

<sup>203</sup> See Lewis, *op cit* note 138 for a discussion of some other agreements of this type.



exercise of this power reflect commercial needs and commercial reality – and not merely self-interest – all should be well.

## 5.2 LIABILITY INSURANCE AND LEGISLATION

As suggested earlier, the influence of insurance in the framing of legislation is rather more important, or at least more obvious, than its influence in the courts. Of course, Parliament, Government ministries and reforming bodies such as the Law Commission are far better placed to take a considered, strategic view of insurance matters than the courts, where issues of law arise at random, time is limited and knowledge of insurance is often hazy. In turn, the insurance industry is quite well placed to influence Parliament, through representative bodies such as the Association of British Insurers and through individual members with insurance interests, in the framing of legislation that might impact upon insurance markets.<sup>204</sup> Evidence of the lobbying power of the insurance industry is seen clearly in the shape of the regulatory framework within which it operates. Here, the Government has often been persuaded to accept self-regulation in lieu of statutory control and, in some cases, to grant exemption from general legislation that would otherwise apply.<sup>205</sup> Again, Government ministers, the Law Commission and various other bodies regularly consult the insurance industry about the effect of their proposals on the cost and availability of insurance. As a result, statutory liability is often limited to a figure that reflects the availability of liability insurance cover.<sup>206</sup> This pattern is repeated outside the UK where, for example, the Dutch civil code specifically provides for the imposition, by regulation, of limits on recoverable damages reflecting the limited availability of insurance coverage. The influence of insurance is also seen in some legislation of a much more general kind. A notable example is the Unfair Contract

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<sup>204</sup> See Clarke *op cit* note 160 at p. 281. He notes that in the Register of Members' Interests for 1997 one member in ten declared financial links with the insurance industry.

<sup>205</sup> Including, of course, the controversial exemption of insurance contracts from the Unfair Contract Terms Act 1977.

<sup>206</sup> Clarke (*op cit* note 160 at pp. 281-282) notes that the Hague Rules on the carriage of goods by sea provide a clear example of the influence of insurance. Where legislation relates directly to insurance the influence of the industry, and its practices, are even more obvious, as one would expect. Thus, for example, the very low minimum figure set in 1998 for compulsory employers' liability insurance (£5 million in respect of any one occurrence) was a concession to the (re)insurance industry's concerns following the massive accumulation of claims arising from the Piper Alpha disaster: see *How Secure is the System* pp. 115-17 for a discussion.



Terms Act 1977, by virtue of which the ability of contracting parties to protect themselves by insurance is a factor which the court must take into account in considering the 'reasonableness' of contract terms purporting to restrict or shift liability.<sup>207</sup>

Legislation of the sort discussed so far does not mark any expansion in liability law and should not give rise to any concern on the part of insurers. However, the availability of insurance has on occasion influenced Parliament in its decisions to amplify tort liability. For example, it has been suggested that the Law Reform (Contributory Negligence) Act 1945, by virtue of which negligence on the part of the claimant ceased to be a complete defence, secured the necessary support in Parliament partly as a consequence of the spread in use of liability insurance.<sup>208</sup> Even more obviously, the Law Reform (Husband and Wife) Act 1962, which abolished the Common Law rule that prevented one spouse suing another in tort, was clearly posited on the fact that the negligent spouse would be able to recover from a motor or household (liability) insurer in most cases. Under the Act the court may stay the action where no substantial benefit would accrue to either party, a power clearly meant to cover situations where no liability insurance exists.

In summary, it seems likely that the availability of insurance, or its potential availability, has encouraged the expansion of liability rules, via the courts and Parliament, to a limited degree. However, whether this should properly be regarded as a form of 'moral hazard' for insurers, and hence a cause of concern for them, is a different question. Insurance markets can deal with the expansion of liability rules, and rising claims, provided that change is progressive and incremental rather than sudden and radical, and provided that new rules are imposed prospectively rather than retrospectively. Even then, there will always be an element of uncertainty about the law in any particular field, but this can be accommodated too, provided the degree of uncertainty is not too high.<sup>209</sup> In fact, evidence suggests that changes in the

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<sup>207</sup> Unfair Contract Terms Act 1977 s.11(4).

<sup>208</sup> Clarke, *op cit* note 160 page 283.

<sup>209</sup> See, generally, Faure, M and Hatlief, T (1998) 'Remedies for expanding liability', 18 *OJLS*.

substantive rules of tort law, though potentially problematic, are of less concern to liability insurers than current trends in damages.<sup>210</sup>

In any event, the content of liability rules is only one of many factors that determine the level of liability insurance claims. For example, it has been estimated that the incidence of product liability claims in the US is around fifty times higher than in Europe generally:<sup>211</sup> clearly, this massive disparity cannot be explained by reference to differences in the tort liability regimes of these two territories. Much of it is attributable to other matters, including the limited extent of social insurance provision in the US, differences in court structures and procedures for the administration of justice and broader cultural and social factors. Studies that focus narrowly on the *internal* working of the tort/liability insurance system by, for example, attempting to correlate trends in the expansion or contraction of tort liability with the availability of private liability insurance, can certainly be very interesting.<sup>212</sup> However, there is a risk that they will draw our attention away from the bigger picture and lead us to ignore significant *external* factors, such as those mentioned above, that may bring about an expansion or contraction in the tort/liability insurance system *as a whole*. In particular, it is evident that the tort/liability insurance component of an accident compensation regime (e.g. for work injuries) is likely to expand if public provision of benefits, through social insurance or otherwise, should contract for any reason. The reverse is also true: resort to tort remedies and private insurance will diminish if public provision of accident compensation benefits expands. Thus, some of the most radical changes in tort law have been brought about by legislation that was not aimed primarily at tort reform for its own sake, but at substituting state social security payments or benefits provided by semi-public social insurers. In cases such as this changes in tort law are a by-product of the whole process, not its *raison d'être*. The state workers' compensation programmes that are found world-wide provide the best

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<sup>210</sup> See the results of the author's survey of liability insurers, Section 6.1.1.4.

<sup>211</sup> Atiyah suggests that the level of claims may be as much as 350 times higher, based on figures from the 1970s on the number of product suits filed in the US and UK (Atiyah, P. (1987) 'Tort law and the alternatives: some Anglo-American comparisons', 198 *Duke LJ* 1002, 1013.

<sup>212</sup> For example, Davies argues that expansion and contraction in the duty of care in negligence has been shaped by the availability of liability insurance, which increased from around 1880 onwards and contracted after 1984 (Davies, M. (1989) 'The end of the affair: duty of care and liability insurance' (1989) 9 *Legal Studies* 67. See also the comments of Stapleton *op cit* note 139 on this topic at pp. 827-828.



illustrations of this phenomenon, along with some more radical schemes, such as those that include road traffic injuries, and the celebrated New Zealand accident compensation scheme, which virtually abolishes tort liability for personal injury. Certainly, considerations as to the availability, cost and efficiency of private insurance have played a part in the design and subsequent reform of these systems, but it cannot be said these have been the only factors. There are other issues at play and, in particular, political considerations as to the proper role of the state in the management of a nation's affairs. Broadly speaking, confidence in the ability of the government to plan and manage a nation's economy has normally been matched and accompanied by confidence in the state's ability to provide for the victims of misfortune through social security and other public programmes. This has led, in many cases, to a suppression of tort liability and a reduced role for liability insurance. Conversely, scepticism about state intervention in economic affairs and increased confidence in market mechanism has generally resulted in less ambitious social security schemes, greater reluctance to restrict tort liability, more reliance by accident victims on private remedies and an amplified role for liability insurance. For, example, the current expansion in employers' (tort) liability world wide is more readily attributable to the ascendancy of economic liberalism than anything else. It certainly does not flow from an increased availability of employers' liability insurance, since insurers now have little appetite for this risk. In the light of all this, a study of the relationship between the prominence of tort/liability insurance and the political complexion of the government in power at any given time might prove more fruitful than one which focuses purely on links between tort and insurance.<sup>213</sup>

In the final part of this essay the relationship between social insurance and private insurance, and current government attitudes to both, are considered in more detail. Other external factors, including public perceptions on accident compensation, are also considered. Nevertheless, we can conclude at this stage that there *is* a need for governments and legislators to take full cognisance of insurance considerations in

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<sup>213</sup> There is certainly a strong correlation here, with right-wing liberal regimes placing far greater reliance on tort remedies and liability insurance than socialist states, where tort is often suppressed and liability insurance undeveloped, or even banned, as in the old Soviet Union. However, there are also exceptions and anomalies, including the suppression of the injured employee's tort remedy in the otherwise tort-litigious US.

reforming and developing the law, whatever drives that reform. If they do not, there is an even greater risk that legal expansion will be uncontrolled and unpredictable, insurance markets will be destabilised and disruption of economic activity will result.

Finally, we should remember that much new law is now laid down at international level, through international treaties or supra-national organisations such as the EU. This complicates matters further, because international law that is intended to create uniformity sometimes fails to do so, and may differ substantially in its effects from one territory to another. For example, new health and safety law enacted at European level, intended to harmonise European work-place safety standards, has a much more dramatic impact on liability insurance claims in the UK than in Germany.<sup>214</sup> Of course, insurance is an international business too and, in planning legal reform, a government may have less regard for the sensitivities of foreign insurers than those of its own domestic insurance industry. For example, the US federal Government might have been less ready to enact the 'Superfund' legislation if a greater portion of the resulting liability insurance claims had rested with domestic insurers and fewer had flowed across the Atlantic to Lloyd's and the London market. Governments usually see the point of not destroying their own insurance industry, but may show less compunction when bankrupting that of another.

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<sup>214</sup> Because regulations implementing EU health and safety directives generate civil liability in the UK, but not in Germany, where employers are effectively immune from tort claims by employees. See *International perspective* pp. 219-221 and also Parsons, C. 'Liability rules, compensation systems and safety at work in Europe' *Geneva Association, Etudes et Dossiers*, No. 248, December 2001 pp. 30-33.



## **6 CONCLUSIONS**

Having traced the evolution of liability insurance up to the present day and explored some contemporary problems, what predictions can we make about the future development of this class of insurance and of the market that provides it? How will developments in tort law and social security systems impact upon liability insurance markets and vice versa? And what factors will shape accident compensation systems generally and the market for liability insurance in particular? In this concluding part of the essay we analyse trends that might provide some answers to these questions. To provide a framework for discussion we will examine briefly the stance and perceptions of the major stakeholders in accident compensation systems – insurers, the government, the public, and the lawmakers.

### **6.1 INSURER PERCEPTIONS**

We begin by considering how liability insurers presently view their own function. It is interesting to note that academic research into the role of liability insurance has rarely, if ever, made use of this rather obvious source of data – the opinions of liability risk carriers themselves.<sup>215</sup> To remedy this omission, the author recently conducted a survey of UK insurers with a view to establishing their fundamental views on liability insurance. The results of the survey provide a point of departure for this section.

#### **6.1.1 The insurer survey**

A questionnaire<sup>216</sup> was sent to all UK insurers that write liability insurance business,<sup>217</sup> 101 in number at the time of the survey. The insurers ranged from the largest UK liability insurer, Royal and SunAlliance Group, with a 1999 gross written liability insurance premium of £371 million to marginal participants, some of which

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<sup>215</sup> For example, much academic ink has been spilled over the 1984-86 US ‘liability insurance crisis’ in an effort to discover why liability insurers shut up shop for some risks and raised rates sky-high for others. Nobody (as far as the author is aware) seems to have taken the rather obvious step of asking insurers why they behaved in the way they did.

<sup>216</sup> See Appendix I for a copy of the questionnaire and analysis of the responses.

wrote less than £100,000 in liability business in the same year. The response rate was reasonable, replies being received from 52% of the insurers surveyed, including all the major offices.<sup>218</sup> The object of the survey was relatively simple. Its aim was to establish how insurers view the various types of liability insurance in business terms and to identify what they regard as the major problems for the class as a whole. The conclusions are briefly summarised below. A more detailed analysis is contained in Appendix I.

**6.1.1.1 Liability insurance is unpopular with insurers**

It has always been known, or at least suspected, that insurers do not favour liability insurance. What is surprising is the vehemence with which respondents reinforced this thesis. When asked to comment on the general attractiveness of liability insurance in business terms, only 14% of respondents regarded liability insurance as ‘attractive’ in its own right and none regarded it as ‘very attractive’. The majority (53%) regarded liability business as ‘unattractive’, 14% rated in ‘very unattractive’ and the remaining 19% rated liability insurance as ‘average’ in terms of its appeal.

No major insurer featured in the small group that described liability business as ‘attractive’, with the exception of one office specialising in directors’ and officers’ (D&O) liability insurance and associated lines.<sup>219</sup> We should also emphasise that all the respondent companies were active underwriters of liability insurance to some degree – if the survey had included *all* general insurers, including those that choose *not* to write liability business at all, this negative stance would surely have been even more marked.

**6.1.1.2 Liability insurance is accommodation business**

The answers to a connected question – why *do* insurers write liability business – drew a predicable response, 35 % of respondents writing liability business only in order to

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<sup>217</sup> Excluding Lloyd’s.  
<sup>218</sup> As noted above, the survey included quite a large number of marginal players from whom, perhaps understandably, the response rate was rather lower.  
<sup>219</sup> Chubb Insurance (Europe).



support other business and 45% writing it mainly in order to so. The point here is that insurers are often asked to quote for the whole of a client's insurance business, particularly for small and medium size risks, where 'package' policies are issued or, at least, brokers feel that the involvement of several insurers is not worthwhile. Thus, insurers are often obliged to quote for liability insurance if they are to get any business at all from the source in question. In the case of larger exposures the risk is usually divided amongst a number of primary insurers. However, the power of large international insurance brokers is such that insurers may still be obliged to take a portion of the liability business if they are to gain a slice of that which is more attractive.<sup>220</sup> A small number of respondents (10%) stated that they wrote liability insurance because they viewed it as attractive in its own right, but none of the major offices expressed this opinion. Furthermore, most respondents among this 10% qualified their view by noting that only certain lines were attractive, such as D&O and general liability. A few offices (10%) gave other reasons for running a liability account, the most common being the company's history, in the course of which liability insurance had traditionally featured as a core business.

#### **6.1.1.3 Employers' liability and long-tail lines are least attractive**

Not surprisingly, the survey revealed that the least favoured lines of liability business are those most likely to generate late claims. Employers' liability insurance, traditionally written on a causation basis,<sup>221</sup> proved to be especially undesirable. Of the offices writing employers' liability business, 67% regarded EL as the least attractive class and 100% as either the least or second least attractive. Environmental Impairment Liability (EIL), a relatively recent and highly specialised line with potential for long-tail claims,<sup>222</sup> found no favour with any of the few offices that write it, most of which (80%) regarded EIL as even less attractive than employers' liability. Relatively speaking, the most appealing class was public (general) liability, regarded by 79% of respondents as the most attractive line and by 100% as either the most

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<sup>220</sup> See Parsons, C. 'Consolidation and strategy in the insurance broking sector', *Journal of European Financial Services*, (forthcoming) for a discussion of the current balance of power between insurance companies and insurance brokers.

<sup>221</sup> And, in all probability, necessarily so. 'Occurrence' or 'claims made' basis EL insurance might be illegal – see *The Cure* p. 39.

attractive or second most attractive. The recent claims experience of the major insurers for employers' liability and public liability, summarised in Section 6.1.1.5 below, lends substance to these opinions. Public liability is, of course, largely short-tail business, with the vast majority of claims arising from accidents rather than gradual processes.<sup>223</sup>

Insurers were also relatively optimistic about modern lines that are written on a claims-made basis, such as directors' and officers' (D&O) liability insurance and, to a lesser extent, professional indemnity (PI) insurance. Compared with the number that offer employers' liability and public liability insurance, relatively few offices write these classes<sup>224</sup> but, of those that do, 40% regarded D&O as the most attractive class and 28% cited PI as the most attractive.

Generally, the message is clear. Business that generates late-reported claims is generally unattractive to underwriters and employers' liability, with all its inherent difficulties, is deeply unattractive, indeed, almost on the margins of insurability. By contrast, modern lines of liability business where there is an established practice of writing on a claims-made basis, which allows more accurate pricing, are seen as reasonably viable.

**6.1.1.4 Major problems**

The survey suggests that the greatest current concern for liability insurers is the upward trend in damages for personal injury: 33% of respondents regarded this as their main problem and 81% as either the most serious or second most serious

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<sup>222</sup> For this reason EIL is nearly always written on a claims-made basis.

<sup>223</sup> Most risks with a potential for generating long-tail claims are excluded from public liability policies. The only real exception is product liability, which is generally included within this class: late claims can arise in connection with some products, most notably pharmaceuticals. However, changes in the law relating to liability for psychiatric illness, proposed by the Law Commission, could introduce long-tail claims into motor and general liability accounts. See, generally, *Psychiatric Illness*.

<sup>224</sup> Employers' liability insurance is, of course, compulsory for virtually all businesses and public liability, though not compulsory, is essential in practice. Insurers that wish to offer 'package' insurances for small and medium-sized businesses must therefore write both lines. By contrast, relatively few small firms wish to buy D&O insurance and PI cover is required only in cases where professional advice or treatment is given for a (separate) fee.



difficulty. Long-tail claims were seen as almost equally problematic, being regarded as the most serious problem by 42% of respondents and either the most serious, or second most serious, by 66% of respondents. The uncertainty of liability rules was seen as a rather less pressing concern: only 6% of respondents ranked this as their major concern and only 24% as either the most, or second most serious, problem. A few respondents identified volatility of liability business as a serious problem. Several respondents volunteered the 'compensation culture' as a specific difficulty. A similar number identified as serious problems inadequate pricing by liability insurers in the past, and the difficulty of sustaining adequate insurance rates in a market where the naïvety of new entrants led them to under-price the risk.

#### **6.1.1.5 The market is highly concentrated, and very unprofitable**

In 1999, the latest year for which results are available, 49% of all UK liability insurance business was written by just five offices<sup>225</sup> and 66% by the top ten. The demise of the Independent Insurance Group, third on the list with a 9% share, will probably increase this concentration further, since most of Independent's business is likely to be absorbed by the large offices, with a very big share going to the market leader, RSA. In the case of employers' liability insurance this concentration is greater still.<sup>226</sup>

Liability insurance is generally unprofitable. Losses doubled in 1998 with the market reporting a collective underwriting loss of nearly £400 million, representing 21% of net written premium. There was some improvement in 1999, but an overall claims ratio of 84% and an underwriting ratio of 119.4% still represents a trading loss of about 5%, allowing for investment income of around 15%. In recent years employers' liability has been especially problematic, a 1994 report by Smith New Court suggesting that, even allowing for investment income, no major insurer had made any profit on this line of business since 1987. Recent results confirm this pattern, most major EL insurers reporting claims ratios well in excess of 100%, as shown in the

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<sup>225</sup> Royal and SunAlliance (13%), CGNU (12%), Independent (9%), New Hampshire (UK) 9%, (Zurich) Eagle Star 6%.

<sup>226</sup> Over 50% of EL risks are written by the three top offices and about 70% by the top six.

table below. These will translate into huge losses once expenses (about 35% of premium income) are added. It is also apparent from the table that the results for employers' liability insurance are far worse than those for the other major line, general (public) liability insurance.

**Major liability insurers' UK claims experience 1999**

*Source: Insurance Intelligence Unit and FSA annual returns*

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

*\* In the light of Independent's subsequent collapse, these figures are literally incredible.*

It is clear from the points made in this section, and all that has been said previously on the subject, that liability insurance cannot work efficiently unless the insurance contract is constructed in a way that enables insurers to price the risk with reasonable accuracy. For long-tail risks causation-based contracts create levels of uncertainty which are intolerable for insurers and which threaten the viability of the whole system of which liability insurance forms a part. The position with regard to employers' liability insurance is particularly dire. The inherent difficulties of this class have been touched on by the author at various points in this essay and analysed elsewhere in



more detail.<sup>227</sup> Suffice it to say here that the UK system for compensating work injuries is inherently unstable and, in the long term, possibly unsustainable. Furthermore, it is completely out of line with systems elsewhere in Europe, making the prospect of harmonisation at European level very remote indeed.<sup>228</sup> Nor does the employers' liability system, which is so unsatisfactory for insurers, even manage to provide complete security for injured employees, as the author has demonstrated elsewhere.<sup>229</sup> There is even less cause for optimism now that the Independent Insurance Group, the only major insurer to report apparently healthy claims ratios for liability business, has gone into liquidation, with its past chairman blaming the decision to enter the employers' liability insurance market for the company's demise.<sup>230</sup> A major factor in the failure of the company to raise the capital necessary to survive was the inability of the group's actuarial consultant, Watson Wyatt, to put a figure on the firm's losses through its employers' liability account. Elsewhere the author has analysed various possible 'cures' for the ailments of the liability insurance market and for employers' liability in particular. They include a radical proposal, based on the systems operating in Belgium, Portugal and Finland, whereby the risk of work-related disease would be removed from the private insurance market and retained by the state. This proposal is founded on the author's belief that the state is likely to be the most efficient provider of compensation for disease that develops slowly and progressively.<sup>231</sup> Indeed, it might be argued by analogy that the state is likely to be the best provider of compensation for almost any form of injury or

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<sup>227</sup> See, generally, *The Cure*.

<sup>228</sup> See, generally, *European Perspective*.

<sup>229</sup> See, generally, *How Secure is the System?*

<sup>230</sup> *The Times*, Friday June 15 2001.

<sup>231</sup> The core of the argument is that a very long development period makes it impractical to put the burden of compensation on the original causers of the disease. First, because problems of causation and proof are likely to make the exercise uncertain and prohibitively expensive and, second, because the accompanying private liability insurance mechanisms, which are subject to a legal requirement for losses to be funded in advance by the insurer, do not work efficiently. Furthermore, there is little deterrent or retributive value in 'punishing' a corporate entity (if it still exists) for acts committed by its agents many years ago. Taking compensation for disease out of the tort/liability insurance system and confining it to state would remove most of the costs and inefficiencies of the former. Furthermore, the state would not be required to pay 'full' compensation and would be free to set benefits at levels which were felt to be appropriate and which society could afford. The state (unlike the private insurance market) would also be free to fund benefits for disease on a 'pay as you go' basis, making adjustments in tax or levels of contribution from time to time, as necessary. Funding 'long-tail' disease claims in this way may result in current contributors having to pay for the unsafe working practices of previous generations, but solidarity between the generations is no bad thing.



damage that is latent or occurs gradually, including, perhaps, gradual pollution – why waste resources chasing ghosts of the past through the tort system? Reform of the current system, at least for compensating industrial injuries, is presently being considered in discussions between the Government and the insurance industry. However, there is little sense of urgency and, if the author has read the situation correctly, there is little taste for radical reform at Government level. Government perceptions of liability insurance are considered next.

## **6.2 GOVERNMENT PERCEPTIONS: LIABILITY INSURANCE, SOCIAL SECURITY AND GOVERNMENT POLICY**

The diffidence with which insurers regard liability business is not matched by any reticence on the part of recent governments in making use of it. On the contrary, there is a steady upward trend in the deployment by governments of private liability insurance as a means of extending social security systems.<sup>232</sup> In fact, this is part of the current world-wide trend of economic liberalisation, supported by increasing confidence in market mechanisms to meet human needs. Governments, almost everywhere, are anxious to cut welfare spending. Ideology apart, the desire to trim ambitious social security schemes has arisen as a result of demographic factors, with ageing populations, rising dependency ratios<sup>233</sup> and increasing public demand for sophisticated and costly health care. With regard to the latter, there is a growing disparity between what is feasible in medical terms and what is financially possible via the public purse. In Europe, at least, the trend has been reinforced by specific political factors, including the need for Member States with generous social security systems to cut public spending in order to meet the convergence criteria for Monetary Union and to comply with ongoing public spending constraints to which all Members States are pledged. In this climate, it is not surprising that governments should look more closely at the relationship between social security systems and private insurance mechanisms. This has led, on one hand, to increased emphasis on the use of private first party insurance to supplement or replace the public funding of pensions and

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<sup>232</sup> Generally, see Cane, P. *Atiyah's Accidents, Compensation and the Law*, Sixth Edition, (1999) pp. 199-208.

<sup>233</sup> See Liedtke, P. M. (2001) 'Driving potential pension solutions' *Journal of Insurance Research and Practice*, Vol. 16, Part 2 p. 40.



health care and, on the other hand, to greater scrutiny of the relationship between public funding of accident costs, tort rights and private liability insurance. The latter is our immediate concern.

In theory, there should be a logical relationship between the 'public' and 'private' elements of an accident compensation system. Thus, where social security benefits are generous, we should expect to find that tort liability for accidents has been cut back, to leave only a limited role for liability insurance. Conversely, where social insurance benefits are modest, we should anticipate liability laws that are much less restrictive, giving liability insurance a much more prominent role. However, this pattern is by no means universal: some countries restrict civil liability for injury whilst offering only modest social security benefits in return, whereas others combine generous social security with unlimited liability. Lack of co-ordination has occurred because public and private systems have often developed in parallel, without influencing each other significantly. However, in the current economic climate states are increasingly reluctant to allow accident victims to accumulate social insurance benefits and tort compensation recovered from a person, or the liability insurer of a person, who caused the accident.<sup>234</sup> Double recovery of this sort is increasingly denied, not just to prevent 'unjust enrichment' of the victim but to ensure that public funds are used in the most economical way. To achieve this, social insurance benefits may simply be deducted from the damages payable by the wrongdoer, without any recovery by the social insurer;<sup>235</sup> in other cases, the victim may be required to choose one remedy or the other.<sup>236</sup> Most common of all, however, is a system of reduction *plus* recovery: i.e. a mechanism whereby the damages claim of the victim is extinguished or reduced to the extent of the social insurance payments that he has received, and where the social insurer is allowed to recover its outlay, either from the wrongdoer or his liability insurer. The recovery, which may be total or partial, can take various legal forms – e.g. an independent claim or subrogation to the congruent

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<sup>234</sup> Again, there are exceptions. For example, some states (including Russia and Cyprus) allow the accumulation of tort damages and state workers' compensation benefits.

<sup>235</sup> Deduction without recovery is a logical solution when the both parts of the system - private and public - are funded from the same source: for example, where employers that are exposed to direct tort claims by employees also fund the public worker's compensation system.



claim of the accident victim. Of course, there is a need to keep the costs of recovery to a minimum, otherwise the economic benefits of subrogation will be lost. This has led to extreme rationalisation in Germany, where subrogation usually takes place through collective or ‘wholesale’ settlement agreements between social security carriers and liability insurers (*Teilungsabkommen*, or loss-sharing agreements).<sup>237</sup>

In the UK we have certainly seen a tightening of such recoupment schemes in recent years. For example, there has been a progressive extension in the powers of the Compensation Recovery Unit (CRU) of the Department of Social Security to recover from private liability insurers the value of benefits paid to injured employees under the state worker’s compensation system (the Industrial Injuries Scheme), when an employee succeeds in a tort-based claim against his employer.<sup>238</sup> More recently, the CRU has been given enhanced powers to recover from motor insurers the costs incurred by public hospitals in treating road accident victims.<sup>239</sup> In future, public hospitals may be given a right to recover from wrongdoers, or their insurers, the treatment costs of accident victims generally, including people injured at work.<sup>240</sup> As suggested above, the UK trend of recoupment of accident costs by the Government is mirrored in many other countries. For example, in the Netherlands existing rights of redress against injurers and their liability insurers have been extended recently<sup>241</sup> and further expansion is under discussion.<sup>242</sup> Even Sweden, a country committed by

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<sup>236</sup> For example, ‘election’ between a damages claim against an employer and workers’ compensation benefits – the English system until 1948 – still applies in a number of countries. However, the worker’s compensation carrier is not always a social insurer.

<sup>237</sup> i.e. agreements whereby the liability insurer pays an agreed standard percentage of any claim reported by the social insurance carrier based on an accident in which one of the liability insurer’s clients was involved. Payments are made regardless of fault or causation unless the claim exceeds an agreed ceiling (e.g. DM30,000) in which case there is a full evaluation of the facts and the law. There are, apparently, about 1800 individual wholesale agreements in Germany: see Pfennigstorf, W. with Gifford, D. G. *op cit* note 187 pp. 131-139.

<sup>238</sup> See the Social Security (Recovery of Benefits) Act 1997. The recoupment powers of the CRU are very significant, because the tort liability of employers is highly developed in the UK and private employers’ liability insurance is compulsory.

<sup>239</sup> See the Road Traffic (NHS Charges) Act 1999, Road Traffic (NHS Charges) Regulations 1999, SI 1999 No. 785 and Road Traffic (NHS Charges) Reviews and Appeals Regulations 1999, SI 1999 No. 786.

<sup>240</sup> See the Law Commission Consultation Paper 144 *Damages for Personal Injury: Medical, Nursing and Other Expenses*.

<sup>241</sup> For example, a right of recourse has been introduced for the employer who is forced to pay the wages of his employee during his absence through illness or injury (Article 6:107A BW).

<sup>242</sup> For example, removal of the restriction on rights of redress where the injurer belongs to the same family as the victim (which has parallels in France and Germany) or is an employer or



tradition to generous and all-embracing social security provision, the discouraging of tort actions and limited use of liability insurance, is rethinking its position. At the present time the Swedish Government is actively considering, for the first time, the granting of subrogation rights to social insurance carriers and other public bodies.<sup>243</sup>

How much further could this process of switching accident costs from public to private sector be taken? For example, could agencies such as the police and fire brigades, and inspectorates such as the UK Health and Safety Executive, be given powers to recover costs from those who cause the accidents that occasion their attendance, and from the liability insurers of the latter? Arguably, this would make for a more efficient allocation of resources, even though the liability insurer is beginning to look like a tax gatherer once we reach this stage.

Of course, quite apart from strengthening the recovery rights of their social insurers, many governments have, at the same time, actually reduced the scope of social insurance programmes that are offered by the state. Some countries, such as the Netherlands, have adopted quite radical measures in recent years, completely dismantling major elements of their social insurance schemes.<sup>244</sup> Although some components of state provision, such as the Industrial Injuries Scheme, have been identified as a potential candidate for abolition or 'privatisation'<sup>245</sup> there has been no such radical change in this country. Instead, the UK Government has generally adopted a less drastic and, politically, less contentious option: that is, to avoid major structural changes and simply prune back existing social security provision gently and progressively, on the assumption that the tort system will automatically take up the

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colleague of a victim-employee. See Faure, M Hatlief, T (2000) 'Social security versus tort law as instruments to compensate personal injuries: a Dutch Law and Economics perspective', working paper, Maastricht University Faculty of Law, pp. 39-40.

<sup>243</sup> Address by Goran Skögh to the 9<sup>th</sup> Joint Seminar between the International Association for the Study of Insurance Economics (the Geneva Association) and the European Association of Law and Economics (EALE), Copenhagen, April 6 2001. See also Parsons, C. 'Subrogation by Social Insurance Carriers under European Law: a Comment on *Caisse de Pension des Employés Privés v. Kordel and Others*' *International Journal of Insurance Law*, April 2000.

<sup>244</sup> See Faure, & Hatlief *op cit* note 242, pp. 21-25 for a description of recent changes in the Netherlands.

<sup>245</sup> The possible abolition of the Industrial Injuries Scheme, the main plank of state provision for work-place accidents, has been under discussion since 1994. This would almost certainly promote an expansion in the fields of tort liability and employers' liability insurance, unless a

slack. Cuts in the Industrial Injuries Scheme, most of which took place in the 1980s, provide a good example.

In sum, it is clear that most governments have, at least for the time being, given up any attempt to abolish or radically restrict accident litigation and fill the gap with public programmes. In many countries it is the latter that are under threat. The atmosphere now is very different from that of the 1970s, when the expansion of social security looked a real possibility. For example, writing in 1979 on the evolution of the tort of negligence, the legal historian Baker noted:

‘... a recent report has recommended the retention of actions in tort based in negligence or strict liability, but that there should be a shift of emphasis towards social security, which should be recognised as the principal means of compensation for injuries. It is too early to say whether the recommendations will be implemented, but it is difficult to resist Professor Millner’s conclusion<sup>246</sup> that the shadow of its decline has fallen upon the concept of negligence in the very moment of its triumph.’<sup>247</sup>

Twenty years on, the report in question – that of the Pearson Commission – gathers dust, and contemporary accounts of the imminent demise of negligence appear much exaggerated. Despite a gentle application of the brakes by the English courts during the 1980s, tort law runs on. Recent governments, well aware that liability insurance must accompany it, seem happy to make a virtue of that necessity.

This section has explored what may be loosely described as the ‘privatisation’ of social security, i.e. its partial replacement by tort law and private insurance. Arguably, this trend is being mirrored, and counter-balanced, by the beginnings of another movement – the ‘socialisation’ of tort law. By this we mean a growing public perception that tort compensation is not a luxury, not a supplement to public provision for misfortune available only in exceptional cases and subject to strict preconditions, but an automatic corollary of any injury, however slight and however caused. This is considered next.

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privately-insured workers’ compensation scheme were introduced to replace the state programme. See, generally, *The Cure*.

<sup>246</sup> In Millner, M.A. *Negligence in modern law*, (1967) p. 234.



## 6.3 PUBLIC PERCEPTIONS

### 6.3.1 Towards a 'compensation culture'?

There is a very large body of literature on the failings of the tort system. Critics focus on three main weaknesses. First, the system is alleged to be ineffective, because only a tiny proportion of accident victims actually manages to obtain compensation through it.<sup>248</sup> Second, there is inefficiency, shown by long delays and very high transaction costs. Third, there is inequity: it is argued that the tort system undercompensates those who suffer serious injuries and overcompensates those who suffer trivial ones, favours some groups of victims unfairly over others<sup>249</sup> and operates regressively by paying out more to wealthy claimants.<sup>250</sup> In any case, it is argued, the tort system depends on concepts of fault that are fundamentally unsound.

These deficiencies (which are not confined to the UK and Common Law countries), together with the relative generosity of EU social security systems, are traditionally cited as reasons for the fairly low level of tort claiming in Europe compared, in particular, with the US. However, it has been suggested that the relatively slow development of accident litigation in Europe is not attributable solely to a combination of defective tort regimes and reasonably effective social security systems. A general lack of 'claims consciousness' – a lack of awareness of tort rights and a reluctance to blame others – has often been cited as an additional, independent, factor, particularly in the case of some potential claimants, such as victims of unsuccessful medical treatment or of occupational disease.<sup>251</sup>

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<sup>247</sup> Baker, J. H. (1979) *An introduction to English legal history*, Second Edition, Butterworth, pp. 349-350.

<sup>248</sup> According to the Pearson Commission only about 10.5% of those suffering 'reportable' injuries at work receive tort compensation. The figure supplied for accident victims generally is lower (about 6.5%) and for road traffic victims rather higher (24%).

<sup>249</sup> For example, those injured at work and on the road over other accident victims, the employed over the self-employed and 'accident' over 'disease' victims.

<sup>250</sup> Because wealthy victims take more out of the tort system in damages but do not, generally, pay more into it by way of liability insurance premiums.

<sup>251</sup> In relation to occupational disease Wikeley, *op cit* note 63 at p. 32.

Now, in the last few years there has been a marked expansion in tort claiming for many types of harm, in the UK and in many other countries. For example, the number of disease claims submitted to UK employers' liability insurers has increased quite dramatically in recent years<sup>252</sup> and the contribution of (tort) employers' liability claims to the aggregate of all industrial injuries' compensation has risen from around one-third in the 1980s to over one-half at the present time.<sup>253</sup> Again, the rate of claiming for clinical negligence has risen sharply, by around 7% each year in the 1990s.<sup>254</sup> The trend has been just as dramatic in a number of European countries, including Spain, Italy<sup>255</sup> and, perhaps most notably, the Netherlands. For example, in the last-mentioned country (tort) employers' liability claims were uncommon until quite recently and claims for diseases, such as those related to asbestos, were very rare indeed. Now a mere trickle has developed into a substantial flow.<sup>256</sup>

Some of this rise in tort claiming can be attributed to substantive changes in tort law,<sup>257</sup> some to advances in medical science (e.g. those that have led to a greater understanding of the aetiology of occupational diseases) and some to cuts in social security programmes.<sup>258</sup> However, it has been suggested in many quarters that there has also been change in public perceptions. It is argued there is no longer a *lack* of 'claims consciousness' on the part of many accident victims, but the beginnings of the exact opposite – a 'compensation culture', meaning a marked readiness to sue, even for trivial injuries and even in the absence of real need.

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<sup>252</sup> The number of disease claims submitted to employers' liability insurers increased by around 50% between 1986 and 1993, accounting for 56.6% of all claims in 1993. The level of disease claims dropped to 41.3% in 1995 but the contribution of disease claims to total employers' liability claims cost remained steady at around 25%. Source: *ABI Statistics Bulletin*, December 1996.

<sup>253</sup> See *How Secure is the System?* p. 113 and *The Cure* pp. 17-18.

<sup>254</sup> See note 267 and accompanying text.

<sup>255</sup> See *International Perspective* p. 222.

<sup>256</sup> See Faure & Hatlief *op cit* note 242 pp. 25-27.

<sup>257</sup> For example, in the case of the Netherlands, a general reversal in 1997 of the burden of proof concerning the fault of the employer, (art. 7:658BW); a reversal by the Dutch Supreme Court of the burden of proof in the case of causal uncertainty concerning the precise date of exposure to asbestos fibres (*Cijsouw v. De Schelde*, 25 June 1993, [1993] *Nederlandse Jurisprudentie*, 686) and a determination by the same court that there can be no reduction of an employer's liability on the grounds of contributory negligence unless there is gross negligence on the part of the employee, subsequently interpreted as requiring intent or wilful recklessness by him. (Dutch Supreme Court 9 January 1987, [1987] *NJ* 948, 27 March 1992, [1992] *NJ* 496 and 20 September 1996, [1997] *NJ* 198.)

<sup>258</sup> Especially in the Netherlands, where the cuts have been most dramatic. See Faure & Hatlief *op cit* note 242 pp. 23-25.



‘Compensation culture’, and the harsher alternative ‘blame culture’, are pejorative terms, but it does not follow that a general rise in the level of litigation is necessarily a bad thing. The optimum level of tort litigation in any society is very unlikely to be nil, and there is no proof that the optimum level has been reached in the UK, let alone exceeded. However, the point is that a sharp rise in the propensity of accident victims to sue is a destabilising factor in an insurance system, because the added uncertainty that it brings makes liability insurance pricing and reserving more difficult. This, in turn, may result in a loss of confidence on the part of insurance underwriters and also on the part of investors in insurance enterprises that write liability business, leading to potential insurability in extreme cases. For this reason the issue of a ‘compensation culture’ is important for insurers. But, if there are indeed the beginnings of such a culture, then what is the cause?

Faure and Hatlief, who point out that the Dutch Government has now explicitly acknowledged the potential problems of a ‘compensation culture’,<sup>259</sup> suggest that the public frame of mind characterised as the ‘compensation culture’ has developed in the Netherlands partly as consequence of cuts in social programmes. They argue that victims of misfortune have been led to assume that tort compensation, which now fills the enlarged gaps in social security programmes, must be available on the same basis as the benefits that have been withdrawn. That is, it should be available as of right, without special preconditions and, if necessary, available to fulfil basic needs rather than as a ‘luxury’ or a supplement to what the state provides. This seems a plausible explanation. However, in the view of the author there may be other factors at play. These are discussed in the sections that follow. First, it is argued that the very concept of an ‘accident’, in the sense of an incident for which no-one is to blame, has narrowed. Second, it is argued that a poor understanding of risk has added to the propensity to sue and, third, it is suggested that developments in the administration of justice, combined with changes in insurance practice, have helped to disguise the true hazards and true costs of litigation.

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<sup>259</sup> See Faure & Hatlief *op cit* note 242 p. 28. The Government document they cite is published in *Handelingen II*, 1998/99, 26630 nr. 1.

### 6.3.2 The end of accidents?

On a number of occasions in this essay we have made the point that liability insurance emerged in a rather hap-hazard way, as an incidental by-product of accident insurance, which was designed to cover the unfortunate effects of sudden and unforeseen mishaps. We have seen how it then grew into a class in its own right and came, again by a somewhat random process, to cover risks that were traditionally regarded as uninsurable. The term 'accident insurance' has now become obsolete and, in a curious parallel, the scope of the term 'accident', has also been much reduced. Indeed, the very concept of an accident, and not just the penumbra of its meaning, has become attenuated: it seems to be fast disappearing in a world where causes are confidently attributed to every mishap and culpable human agents routinely sought for almost every cause. Arguably, as a result, 'liability' and 'fault' are steadily supplanting the notion of 'accident' as the main public perspective on misfortune.

In an interesting study on the attitude of society towards accidents, Green<sup>260</sup> suggests that 'accident' and 'accidental' first became meaningful concepts towards the end of the seventeenth century. At this time, belief in magic and the divine will – which left little room for accident – was being steadily replaced by a new scientific rationalism.<sup>261</sup> This new rationalism was able to account for an increasing number of phenomena in terms of material causes that could be explained. Expanding knowledge of the physical universe was also accompanied by a new-found confidence in the ability of man to control his environment. 'Accident' was the name given to a marginal, but still fairly large, category of misfortunes lying at the edge of this new rational universe. An accident was a mishap for which there was, no doubt, some rational explanation, but where such explanation temporarily eluded man's grasp. The inscrutable nature of these 'accidental' events meant that the law was reluctant to impose responsibility for them. Legal responsibility was mainly confined to damage

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<sup>260</sup> Green, J. (1997) *Risk and misfortune: the social construction of accidents*, UCL Press.

<sup>261</sup> Even the greatest scientist of this, or perhaps any age, kept a foot in both camps. The writings of Isaac Newton (1642-1727) on alchemy, metaphysics and religion far exceed his 'scientific' works in volume. See, for example, White, M. *Isaac Newton: the last sorcerer* (1999) Helix books.



or injury that was caused deliberately.<sup>262</sup> However, with the advance of scientific knowledge in the nineteenth century the marginal category of accidents diminished in scope, more mishaps became attributable to human failings<sup>263</sup> and, as a corollary, the concept of negligence as a basis of liability developed and broadened. Now, at the beginning of the twenty-first century, public confidence in the ability of science to establish the causes of things and to control events is almost unlimited. Whilst scientists themselves often observe that the world becomes ever more mysterious as knowledge advances, there is a popular perception that ‘science’ can account for everything. It is submitted that, as a result, victims of misfortune are now simply less willing to accept that circumstances might exist where no human actor is to blame for the harm that has befallen them.

This problem, if it is accepted as such, is compounded by the fact that the public generally have a rather poor understanding of the concept of risk: unlike the concept of return, which is well understood. Risk is an area where there has been no real public debate (something that is long overdue), no structured education for the vast majority and no serious attempt to disseminate in a digestible form the wealth of information that is available. Very little is done to systematically counterbalance the (quite understandable) tendency of much of the media to sensationalise and exaggerate what are often quite trivial threats to public health and safety. The odd truism has become lodged in public consciousness (e.g. ‘aircraft provide the safest form of transport’) but otherwise most people have only a weak grasp of the relative dimensions of different risks, the relationship between one risk and another and, in particular, the costs involved in eliminating risk. The recent Hatfield rail crash provides an illuminating case study. After a crash caused by a broken rail – an accident of a very rare type<sup>264</sup> – most of the travelling public accepted as inevitable the ‘need’ to virtually shut down large parts of the rail system for several months in order to ‘eliminate’ the risk in question. As is well known, the effect of the intolerable rail delays that ensued was to decant huge numbers of frustrated travellers

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<sup>262</sup> With certain exceptions, including actions on the case for negligence and the curious concept of *deodand*, whereby the owner was required to forfeit any instrument that caused death.

<sup>263</sup> Of course, industrialisation also meant that more and more injuries arose from dangers that were clearly man-made.

<sup>264</sup> There had been only one accident arising from a broken rail in the previous 40 years.



onto the roads, where the risk of death or injury is far higher than on even the most poorly maintained railway. The rational alternative – to run trains at normal speed while the checking and repair work was done, leaving people to judge for themselves the relative risks of rail and road travel – would certainly have saved many lives. However, this solution was not even contemplated by the rail companies or the Government. The rail companies feared potential liability<sup>265</sup> and both the rail companies and the Government feared damaging accusations of callousness. Both judged, no doubt correctly, that most of the public would not have accepted or even understood such a solution. As a result of all this the risk was not ‘managed’ at all – it was simply shifted to thousands of individual unidentified motorists and, in the process, augmented.

Examples of this phenomenon – poor perception of risk, leading to unrealistic demands for its elimination on pain of liability and compensation – are quite abundant in modern society. The UK health service is a case in point. On the one hand there is public demand for the deployment of the most advanced forms of medicine wherever there is need, often regardless of cost.<sup>266</sup> On the other hand, there is pressure for compensation when treatment fails, again regardless of the effects that such compensation payments might have on the provision of the very services that are desired. Thus, at the time of writing, there is considerable concern about the threat to National Health Service posed by outstanding medical negligence claims for which, according to some estimates, provisions in the region of £4 billion are now required.<sup>267</sup> Furthermore, many commentators believe that fear of legal action has

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<sup>265</sup> Since they now had ‘guilty knowledge’ of defective rails.

<sup>266</sup> Denial of expensive treatment to virtually hopeless cases on grounds of cost is invariably greeted by public outrage, usually fomented by the popular press.

<sup>267</sup> A recent report by the National Audit Office, *Handling clinical negligence claims in England*, HC 403, 3 May 2001, suggests that at 31 March 2000 provisions to meet likely settlements for up to 23,000 outstanding medical negligence claims were £2.6 billion, double the figure for 1996-7. In addition, the NAO estimates that a further £1.3 billion will be required to meet probable claims arising from incidents that have occurred but not been reported. They also report that the rate of claims per thousand finished consultant episodes rose by 72% between 1990 and 1998. Academic researchers at Nottingham Business School (Fenn, P. T., Diacon, S. R., & Gray, A. (2000) ‘The current cost of medical negligence in NHS hospitals: analysis of claims database’, *British Medical Journal*, 320, 7249, pp. 1567-1571) described an earlier Auditor General’s figure of £2.8 billion for outstanding claims as ‘deeply misleading’, pointing out that most claimants will receive nothing and that payments to those who are successful will spread out over many years. Nevertheless, these authors concede that the rate of claims rose sharply during the 1990s, at a rate of about 7% per annum. If one accepts that



contributed to a cult of secrecy in the NHS, which serves only to fuel the suspicions of patients who suffer ‘adverse health care events’<sup>268</sup> in the course of clinical treatment. Of course, this is likely to result in yet more litigation and a further closing of the ranks in the medical profession. Perhaps a vicious circle of this sort can only be broken if, in exchange for greater candour by the medical profession, the public is prepared to shoulder more risk, including that which derives from non-culpable errors of judgement.<sup>269</sup> Unfortunately, the prospects for such a trade-off are not very encouraging. As we have suggested, poor understanding of risk often leads to an unwarranted assumption that it can always be eliminated if proper care is taken, coupled with a disregard for the harmful consequences that the high cost of eliminating risk in one sphere might generate elsewhere.

Perhaps, then, the ‘compensation culture’, is not simply the mark of a society that is more acquisitive, more Americanised<sup>270</sup> and less well supported by the state, but also the product of a culture in which there has been little attempt to promote a sophisticated understanding of risk. Ironically, popular awareness of the new ‘science’ of risk management may actually be reinforcing this pattern at the present time, by making the notion of a pure accident appear redundant. We are often encouraged to see mishaps as nothing more than failures on the part of human agents to ‘manage’ risk. From this perspective, responsibility for even the most freakish

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medical knowledge and skills will have advanced during this period, and that levels of negligent conduct by medical staff are unlikely to have changed very much, this increase points, inevitably, to a significant rise in public expectations where medical treatment is concerned, or a marked increase in the propensity to claim, or both.

<sup>268</sup> A term used in the NAO report (*op cit* note 267) to describe events arising during clinical care that cause physical or psychological injury to the patient.

<sup>269</sup> There is evidence suggesting that compensation is not the only, or even the main, desire of those who suffer injury. Studies suggest that an admission of fault, evidence of action to prevent occurrence, a proper investigation and an apology are equally or more important to accident victims. The validity of these studies might be questioned on the basis that accident victims, in order not to appear mercenary, are likely to play down the importance of compensation when questioned on the subject. However, it is not unreasonable to conclude that greater openness on the part of wrongdoers would reduce to some extent the incidence of litigation. See the NAO report, note 267 above, pp. 20-28, Mulachy, (2000) ‘Mediating medical negligence claims: an option for the future’, HMSO and Vincent, C., Young, M. and Phillips, A. ‘Why do people sue doctors? A study of patients and relatives taking legal action’, *The Lancet*, June 1994.

<sup>270</sup> Of course, the American culture of blame makes sense, or is at least explicable, in a land where the state does little for accident victims. It makes less sense when transplanted to Europe, where social security systems are highly developed, despite recent cuts in many countries.



occurrence, and hence liability, must fall somewhere. It is simply a question of identifying the parties who could, and should, have managed the risks in question.<sup>271</sup> Now 'risk management' may be useful as a descriptive label for the activities of those who seek to measure risks, prioritise them and provide mechanisms to mitigate the effect of financial uncertainty. However, in the view of the author, 'risk management', is very dubious as a thesis to be taken literally.<sup>272</sup> Of course, insurance companies and brokers, facing competition and new threats in their traditional domain,<sup>273</sup> are anxious to become the high priests of this new cult. They now purport to offer not just insurance but comprehensive programmes of 'integrated', 'holistic' or 'total' risk management. There is irony in the fact that in doing so, in proclaiming the tractability of risk, insurers might be indirectly promoting the very 'compensation culture' that they are often so quick to condemn.

Of course, extravagant demands are often toned down once people see a price label and know who is paying. Politicians and commentators might thus do well to

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<sup>271</sup> The current investigation into the recent Selby rail crash provides a good example. It is difficult to conceive of a more freakish occurrence, a single vehicle which left the road a considerable distance from the railway having ended up on the line and derailed two trains. Nevertheless, every spokesman confidently vowed that investigations would continue until 'the cause' was found, 'lessons would be learned' and 'steps would be taken to ensure that it cannot happen again.' At the time of writing a prosecution has been launched against the driver concerned, who may have fallen asleep at the wheel and lost control of his vehicle. But in what sense can it be said that he 'caused' the complex matrix of events that precipitated the disaster? Even if the law determines that he did, and criminal responsibility triggers civil liability, the case will simply reinforce one of Atiyah's prime 'counts' against negligence liability – the fact that a mere peccadillo can lay responsibility for a catastrophe at one's door.

<sup>272</sup> There is an inherent contradiction in the idea of 'managing' risk. Risk connotes uncertainty, which can sometimes be reduced, perhaps to certainty, but cannot be 'managed' whilst at the same time retaining its quality of riskiness.

<sup>273</sup> General insurance is a low-growth or even a no-growth area. Large commercial clients now use their size to justify buying less insurance rather than more. They retain more exposures, take bigger deductibles, and increasingly use captives and other corporate vehicles in preference to full commercial insurance. In many cases, they are committed to a philosophy of sophisticated financial risk management, and look for risk transfer techniques that combine traditional insurance risks and traditionally uninsurable risks. They now require not just insurance products but a broad range of complementary risk management services. To survive in this environment, major insurance firms have had to adapt, diversify and equip themselves with new skills. They must now be able to offer clients a whole portfolio of risk-related services, which might include environmental, product and workplace safety audits, captive management, legal services, advice on corporate governance, employee benefits consulting and the assembly of sophisticated Alternative Risk Transfer (ART) structures. However, in these new spheres of activity they face much competition from new entrants who already have some or all of the necessary competencies. These include accountancy firms, investment banks, Internet companies, legal firms and specialist consultants. Many of these firms have large pools of talent and formidable specialist skills. Some of them, most notably the investment banks, also have ready access to investors.



emphasise the links, in some key sectors, between rising compensation demands, declining standards of public service and the reduced quality of life that can result from vain attempts to produce a sterile, risk-free environment.<sup>274</sup> On the same basis, insurers might also attempt to make it clear that compensation has another cost, by emphasising the link between the ‘compensation culture’ and the steeply rising premiums that are necessary to fund more frequent claims, higher damages and increased transaction costs. Unfortunately, compensation costs, translated into liability insurance premiums, are usually lost in the general price of goods and services produced by firms that insure. It is, perhaps, only in the sphere of motor insurance that there is any real opportunity to bring the point home, this being the only form of liability insurance that large numbers of ordinary people buy out of their own pockets. Perhaps, when motor insurers increase prices they might indicate, at least in broad terms, what portion of the increased cost is attributable to third party injury claims and what to other factors. Greater transparency of this sort would do no harm and might at least help to raise public consciousness as to the economic realities of compensation and its inevitable costs. On the other hand, injured claimants cannot be expected to view these issues objectively: knowing how much they have paid into the pot will hardly encourage the injured to take out less.

In fact, though insurers frequently complain about the ‘compensation culture’ the messages they transmit are often confused. We have suggested already that insurers’ espousal of the ‘risk management’ concept may contribute to this confusion. The stance of the insurance industry in the current debate surrounding insurance schemes to support personal injury litigation is equally equivocal. In the author’s view, this is another area where the actions of the insurance industry have done little to combat the ‘compensation culture’ and may actually be reinforcing it. This is considered next.

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<sup>274</sup> Witness, for example, the recent highly-publicised attempts of the notoriously risk-averse Norwich City Council to fell a magnificent line of chestnut trees, prompted by fear of litigation should any child be injured when collecting conkers.

### 6.3.3 'Risk-free' litigation?

We have suggested that the 'compensation culture' may be linked to contemporary public perceptions of risk, the (somewhat simplified) popular view being that risk is inherently manageable and that it should be borne entirely by those who provide goods, services, transport, employment and the like. In other words, that life should be 'risk free' for ordinary people. This, we have suggested, has led at least some accident victims to assume that compensation must be an automatic corollary of any injury. However, it does not follow that the *causers* of accidents should accept the same proposition. On the contrary, unwillingness on the part of victims to accept any personal responsibility for their injuries is likely to be matched by a similar obduracy on the part of alleged injurers, by an equal unwillingness to accept blame. It goes without saying that liability insurers will often take a similar view so, inevitably, a large number of claims will be contested, and some will be litigated.

Now, of course, dispute resolution is expensive and litigation extremely so. Faced with the prospect of losing, and paying heavy legal costs, many rational accident victims would simply not take the risk, especially if their injuries were relatively trivial and could be borne without personal hardship. Until relatively recently legal aid was available in many cases but, of course, this was effectively 'privatised' in the recent reforms of the civil justice system – a further example of the switching of accident costs from the 'public' to 'private' sector explored earlier. This, in turn, created opportunities for a new breed of entrepreneur in the claims field: specialist accident compensation recovery agencies (unkindly dubbed 'claim farmers' by the insurance industry), operating on a no-win, no-fee basis.<sup>275</sup> As a result, accident victims were encouraged to accept another illusion – that litigation could be risk free and cost free. In fact, the preservation of this illusion depended on insurance, in this case legal expenses insurance<sup>276</sup> against the possibility of losing and having to pay the defendant's own legal costs. However, this illusion was soon shattered for many

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<sup>275</sup> 'Claims Direct' being the best known.

<sup>276</sup> Legal expenses (LE) insurance is not liability insurance but a form of first party pecuniary loss insurance. This was confirmed recently in *Tarbuck v. Avon Insurance*, forthcoming in [2001] Lloyd's Rep IR where the judge adopted arguments set out by Nick Stanbury in (1996) 92



successful claimants. They found that most of the compensation they would have otherwise received was absorbed in the insurance premium, which the 'claim farmers' could not recover from the defendant and were therefore obliged to deduct from their clients' own compensation. This might be viewed as a salutary lesson in the economics of compensation. However, the matter recently went to law in *Callery v. Gray*<sup>277</sup> where the House of Lords held that, in principle, the legal expenses insurance premium should be recoverable. At the time of writing there are still uncertainties as to the precise effects of this decision. However, it appears, on the face of it, that the illusion of risk-free, cost-free litigation may be preserved. Risk-free and cost-free, of course, it is not. The costs will simply be absorbed by insurance markets and passed on in the form of higher premiums. In this form the costs are effectively disguised, perhaps reducing the chances of a proper debate about the balance that needs to be preserved between 'access to justice' and the risk of fostering a corrosive and economically damaging culture of blame.

It is very interesting to observe insurers' own reactions to all this. One much-advocated solution, essentially a 'marketing' response by insurers intended to defeat the 'claim farmers', is to add legal expenses cover to all personal insurance contracts (principally motor and household), so that no injured victim holding such a policy need fall into their clutches. This is a dubious proposal, roughly equivalent (from the perspective of the insurance industry) of arming both sides in a conflict. The effect would be to raise premium levels significantly for the main lines of personal insurance. This would lead, in the case of motor insurance, to an increase in the number of uninsured drivers (the UK already has far more than any other European country except Greece),<sup>278</sup> greater strain on the funds of the Motor Insurers' Bureau and, inevitably, yet higher insurance costs for the remainder who do insure. Since there is, as yet, no obvious way of distinguishing between those who are likely to suffer injury and those who are not and, especially, between the litigious and the non-litigious, it would be difficult to charge differential premiums for this risk. As a result, the non-litigious would inevitably pay rather more than they should for a cover

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BILA Journal 26. The case established, amongst other things, that the Third Parties (Rights Against Insurers) Act 1930 does not extend to legal expenses insurance.

<sup>277</sup> *The Times* July 18, 2001.

<sup>278</sup> It is estimated that 1 in 20 UK motorists is uninsured.



that was in any case undesired, doubly enhancing what would otherwise be a small propensity to sue. Inevitably, the result would be more liability claims and a further fostering of the very ‘compensation culture’ that insurers often condemn. It is difficult to resist the conclusion that, on this particular issue, the insurance industry is left facing in all directions at once.<sup>279</sup>

#### 6.4 THE JUDICIARY AND THE LEGISLATURE

The relationship between liability insurance and the law has been explored in some detail in Part 5, so only a brief comment on the stance of the lawmakers is necessary here. In the current climate, described in the previous section, there is certainly some pressure on both the judiciary and the legislature to expand liability law and increase damages awards, but there are few clear maps to guide the lawmakers. It is easy to say that laws should be framed to reflect the moral values, priorities and wishes of society at large but, as we have seen above, public opinion on matters of liability and compensation can be fickle, contradictory, ill-informed and easily manipulated.<sup>280</sup> Distrusting public opinion as irrational and subjective, lawmakers might turn to the economists, whose analysis of law one would expect to be both reasoned and objective. Certainly, there has accumulated since the 1960s a growing body of literature on the economic basis of legal rules, including many analyses of tort and accident law. The aim of all this literature is to establish a rational basis for legal rules, based on the premise that such rules should be structured so as to encourage the optimal allocation of resources in society. Typically, this literature acknowledges the importance of insurance in the operation of tort law and holds that its rules should be structured in such a way that insurance works efficiently. Lawyers and lawmakers have gained some valuable insights from the work of these economists but, as yet,

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<sup>279</sup> See Stanbury, N (2002) ‘Advance and be recognised: how legal expenses insurance is gaining in stature’ *Journal of Insurance Research and Practice*, Vol. 17, Part 1 for an analysis of recent developments and current issues in the field of legal expenses insurance.

<sup>280</sup> As Lewis observes: ‘The use of “vox pop” to justify changes in the tort system is fraught with danger. The use of simple, basic questions can produce predictable responses. It would be no surprise to find that people would award more compensation to those with serious injuries, just as they would have “the Government” increase the wages of nurses, double the value of old aged pensions, and waive contributions to residential care. Lewis, R. K. (2001) ‘Pain and suffering in the Court of Appeal’ *Journal of Insurance Research and Practice* Vol. 16 pt 2, p. 21, also (2001) ‘Increasing the price of pain: damages, the Law Commission and *Heil v. Rankin*, 64 *Modern Law Review* 100, 106.



their influence has been limited, at least in Europe. As previously discussed, few judges, or lawyers generally, have the training to speak out confidently on matters of economics generally or insurance in particular and it is not surprising that they should show some diffidence when presented with arguments based on economic or insurance principles.<sup>281</sup> In fact, the intricacies of insurance and its commercial practices will often make it difficult for courts to make a proper assessment of the 'insurance factor' in any particular case. Usually the court will have only limited expertise and information. On the basis that a little knowledge can be a dangerous thing, one might argue for a return to the strict 'traditional' approach. This emphasises the deterrent and retributive role of tort liability and pays strong homage to moral and ideological principles in which insurance and insurability have little or no part to play. This tradition is by no means dead. However, it is too late to go back now. Insurance has penetrated so many spheres of commercial life and private activity that its presence is now impossible to ignore. Every judge knows that insurance companies pay all but a fraction of tort claims and, in many cases, that the wrongdoer has been compelled to insure. On the whole it must be best that courts should acquaint themselves as fully as possible with insurance practice, so that they can at least be aware of the complex issues that arise where judgments about insurance are concerned and avoid simplistic conclusions about its effects.

## 6.5 FINAL REFLECTIONS

The device of liability insurance has provided the principal focus of this essay. We have traced the genesis of liability insurance, examined its development, considered the intricate technical problems that it poses and explored the dynamics of the market in which it is sold. However, it should be abundantly clear that liability insurance cannot be examined in isolation. Perhaps more than any other class of insurance, liability insurance must be studied in its wider legal, economic and social context if a full understanding is to be gained. This requires an analysis of the relationship between liability insurance and tort law and, going beyond that, an appreciation of

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<sup>281</sup> There have been exceptions, as Clarke notes, Lord Diplock 'strode with confidence into the realms of economics' *Policies and perceptions of insurance* (1997) p. 289.

how both relate to other elements within the systems that have evolved to compensate victims of misfortune.

It is clear that in most countries, and certainly in the UK, the various component parts of accident compensation systems have developed in a haphazard fashion, without much co-ordination, and without one part exercising much influence on another. For example, until relatively recently, social insurance schemes have developed with only limited regard for private law remedies, and the reverse has also been true. Only in the last thirty years have there been serious attempts by scholars, practitioners and governments and to look at accident compensation systems as a whole, to analyse the linkages between their various elements, and to challenge the logic of their structure. At the same time, the dialogue between the main human protagonists, including lawyers, government officials and insurance personnel has been quite poor. Most have been content to absorb and apply the long-received wisdom of their respective professions and to have little communication with those outside their own discipline. This has been an impediment to change and a barrier to progress. At the same time, popular appreciation of the issues surrounding accident compensation, and its costs, appears exceptionally poor. Obviously, one should not expect to find a highly sophisticated understanding of such arcane matters amongst members of the general public. Nevertheless, given that all compensation comes ultimately from the pockets of ordinary people, it is sad to observe signs that a potentially damaging and essentially alien US 'compensation culture' may be starting to take root in Europe.

Insurers themselves do not emerge well from our analysis. At the time of writing general insurance, as a business, is in the doldrums. Profits are unsatisfactory, insurers have a poor image, and the industry is unattractive to investors. Most people view life insurance as a far better business, despite all the scandals of mis-selling and despite strong competition for personal savings from other financial firms. As we have seen, liability insurance has often been a disaster area. However, a large part of the blame must be laid at the door of liability insurers themselves. The Lloyd's *débâcle* at the end of the 1980s was, to a large extent, the product of narrow vision and complacency amongst insurers that spread well beyond Lloyd's and the London market. There was a failure to properly analyse the wider environment – the complex



and shifting social, political, scientific and legal *milieu* of liability insurance – and a failure to think strategically, to plan for long-term profit rather than immediate premium income. To a large extent, this failure was one of management. As we have seen, some of the most unwise (and for insurers, most expensive) excursions into the further reaches of liability insurance have been ‘marketing’ responses to perceived problems. By this we mean solutions that seek to remedy flagging (or non-existent) profits by developing new products and selling them to new customers, in the hope that both will prove better than the old ones. Insurance personnel in the sales and marketing field (including the broker sector) will always see this – selling more – as the optimum solution, simply because the reward structure of the insurance industry encourages them to do so. As we have seen, liability insurance – still a relatively new field – offers much scope for marketing initiatives of this sort. Set against the zeal of sales and marketing staff is, or should be, the innate conservatism and scepticism of the underwriter – who is, or should be, judged not by sales but the loss ratio on his account. It is the task of insurance managers to balance these forces and keep them in check, to ensure that neither is allowed to dominate the other. As we have seen, in the context of liability insurance the balance has often been lost. All too often underwriters have been allowed, and perhaps even encouraged, to accept the blandishments of colleagues in the sales function, often with dire consequences. Arguably, there has been a further management failure, in this case in training and education – a failure to ensure that key decisions have been made by qualified persons with a comprehensive understanding of their business, rather those who seem, so far, to have displayed good luck and good judgement. Lloyd’s, for example, has traditionally viewed academic degrees and technical diplomas with some suspicion, favouring ‘experience’<sup>282</sup> over knowledge, family connections, the *dilettante* and the gentleman *amateur*. As a result, until relatively recently, the active underwriter of a Lloyd’s syndicate provided a rare example of a person who could speculate with vast sums of investors’ money not only largely free of regulatory control, but also unburdened by qualifications.<sup>283</sup> The insularity of the British insurance market has

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<sup>282</sup> In the context of insurance, ‘experience’ has been memorably defined as ‘knowledge gained too late’.

<sup>283</sup> This has recently changed, and evidence of some study is now required, in the form of an Associateship diploma of the Chartered Insurance Institute (ACII) at least. Horses and stable doors come to mind. Moreover, professional insurance qualifications remain worryingly



been another damaging factor. It may seem strange to use this term in connection with a business that has, in the past, exported its products with some success but, unfortunately, the trade in ideas has been all one way. British insurers have typically shown a massive indifference to foreign (and especially European Continental) practice, regarding insurance, quite wrongly, as a British fiefdom and British practices as innately superior. However, ten years on from Albert's analysis, it is the British 'Maritime' model that looks vulnerable and the more conservative 'Alpine' approach that seems more likely to endure.<sup>284</sup>

At present, and as a consequence of the process of evolution described in this essay, parts of the liability insurance market are fragile, and subject to forces that still make for potential instability. Employers' liability has been identified as a key example, together with certain other risks.<sup>285</sup> These are, perhaps, areas where the device of liability insurance has been over-extended, its limits in terms of usefulness and efficiency have been exceeded, and where some retrenchment may be necessary. Should they wish to do so, insurers can drive the agenda here: for example, the state can compel businesses to buy employers' liability insurance, but it cannot force insurers to sell it, and cannot provide an exact substitute. This is one area where insurers have it in their power to force tort reform. In the view of the author, they should do so. Whether or not this happens, liability insurance will still have a substantial role to play, and all stakeholders in accident compensation systems will retain an interest in a sound, healthy and competitive insurance market. However, if this is to be achieved there are a number of weaknesses that need to be addressed. Where insurers themselves are concerned there is a need is for a wider vision, a better grasp of the environment in which this form of insurance operates, better management, greater realism and less passivity. There is also a need for insurers to communicate more effectively with those outside the industry. As we have seen, there is a substantial mismatch between insurers' own diffident views on liability insurance, and the perceptions of other stakeholders, which tend to be over-optimistic. Most of the latter would also benefit from a better understanding of the mechanisms

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narrow in their scope, focusing on UK practice, technical detail and 'product knowledge'. The broader environment of insurance business is still neglected.

<sup>284</sup> See note 58 and accompanying text.

<sup>285</sup> Including environmental risks.



of liability insurance, an appreciation of the peculiar problems it generates and of the limitations of the technique – of what can be achieved efficiently through liability insurance, and what cannot.

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**APPENDIX I**

**QUESTIONNAIRE ON LIABILITY INSURANCE**

**(All information supplied will be treated in strict confidence and no insurance company will be identified by name in any publication based on this research)**

**NAME OF COMPANY** .....

**1 Which lines of liability insurance does your company write and, of these, which are regarded as the most attractive in business terms?**

*(for the liability classes that your company writes please enter 1 against the most attractive class, 2 against the second most attractive, etc.)*

- Employers' liability ☐
- Public/product liability ☐
- Environmental Impairment Liability ☐
- Professional Indemnity ☐
- D&O liability ☐
- Other (please specify) ..... ☐

**2 What other lines of general insurance does your company write?**

*(please tick as appropriate)*

- Property/BI ☐
- Motor ☐
- Personal lines ☐
- Other (please specify) ..... ☐
- None ☐

**3 In business terms, how does your company regard liability insurance generally?**

*(please tick one)*

- Very attractive ☐
- Attractive ☐
- Average ☐
- Not attractive ☐
- Very unattractive ☐



4      **For what reasons does your company write liability business?**

*(please tick as appropriate)*

- Because it is attractive in its own right ☐
- Mainly to support other business ☐
- Only to support other business ☐
- Other reasons (please specify) ..... ☐
- .....
- .....

5      **What do you regard as the main problems for liability insurers?**

*(please rank in order of importance, i.e. 1 for the most important problem, 2 for the second most important, etc.)*

- Long-tail claims (e.g. disease, pollution) ☐
- Uncertainty of liability rules ☐
- Damages trends ☐
- Volatility of liability business ☐
- Other (please specify ..... ☐
- .....
- .....
- .....

6      **Do you have any further comments to expand on the points above?**

.....

.....

.....

.....

.....

.....

.....

**Name and position in company** .....

.....

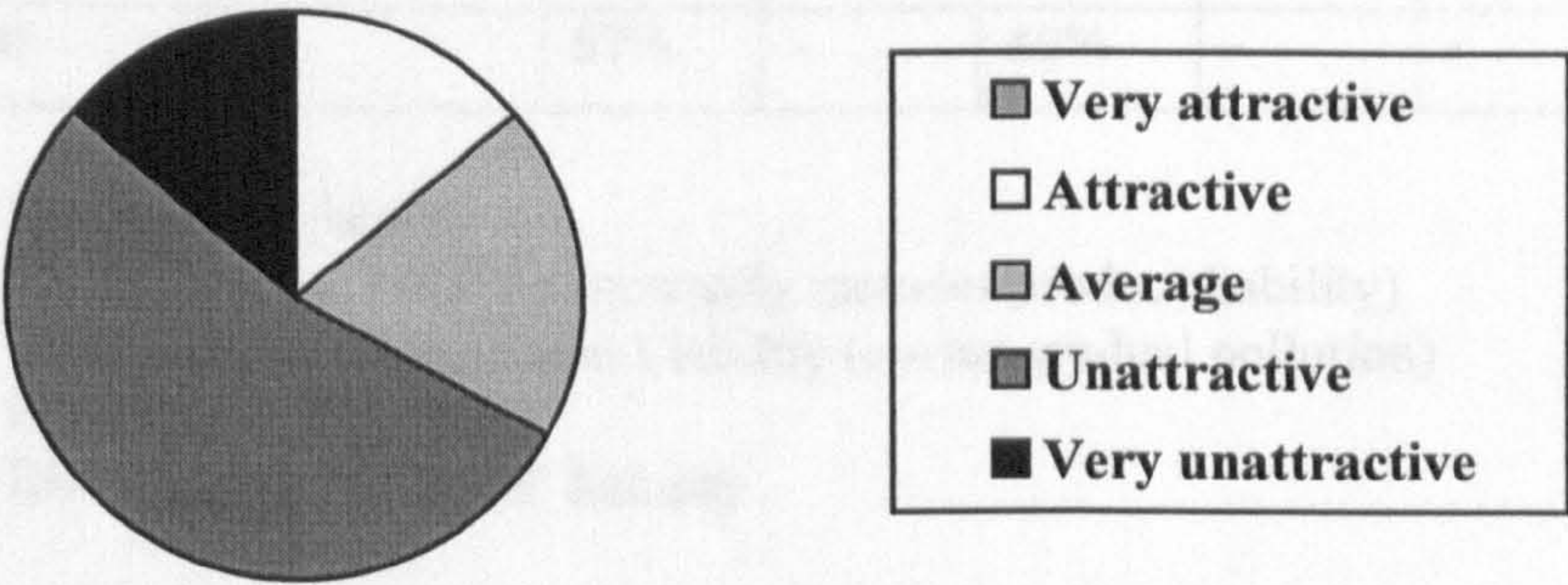
Thank you for your help. Please return the questionnaire (SAE provided) to Chris Parsons, City University Business School, Frobisher Crescent, Barbican Centre, London EC2Y 8HB.



**SURVEY OF LIABILITY INSURERS: ANALYSIS**

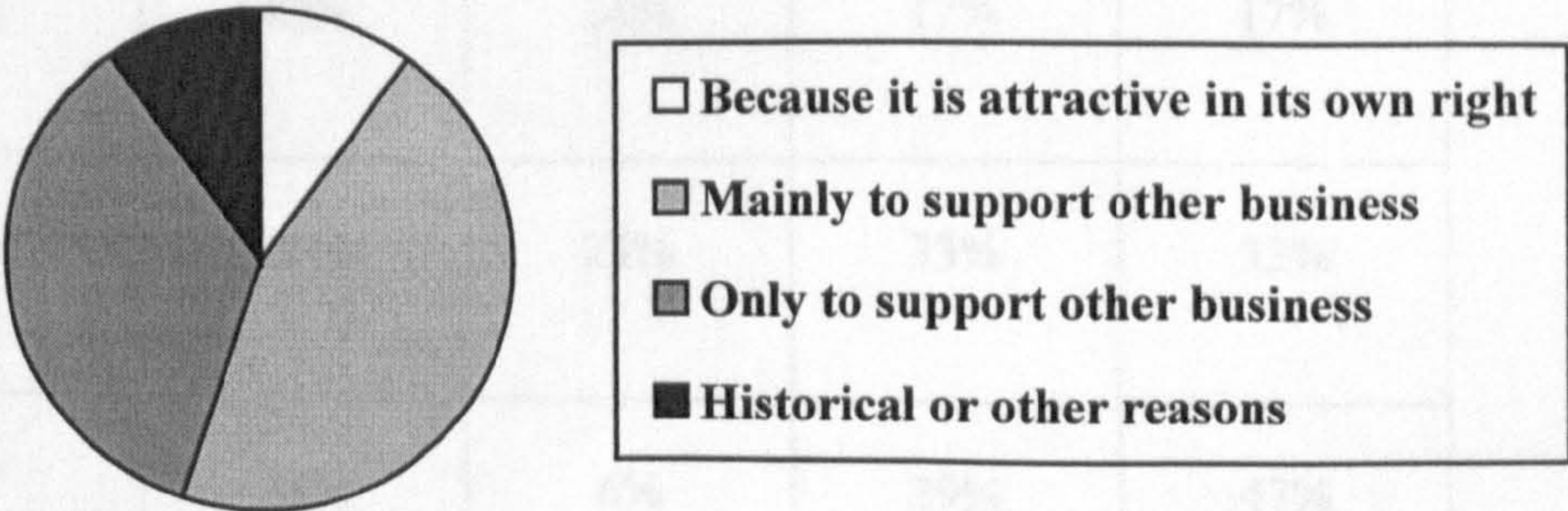
**How insurers regard liability insurance in business terms**

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



**Reasons for writing liability business**

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





**Relative attractiveness of different lines of liability business**

| Class of insurance (see key)            | EL  | PL  | EIL | PI  | D&O |
|---|-----|-----|-----|-----|-----|
| Number of respondents writing this line | 36  | 40  | 10  | 14  | 10  |
| Ranked 1 (most attractive)              | -   | 79% | -   | 28% | 40% |
| Ranked 2                                | -   | 21% | -   | 44% | -   |
| Ranked 3                                | -   | -   | -   | 28% | 60% |
| Ranked 4                                | 33% | -   | 20% | -   | -   |
| Ranked 5 (least attractive)             | 67% | -   | 80% | -   | -   |

**Key**    **EL**                      Employers' Liability  
          **PL**                      Public/General Liability (normally includes product liability)  
          **EIL**                     Environmental Impairment Liability (covers gradual pollution)  
          **PI**                      Professional Indemnity  
          **D&O**                  Directors' and Officers' liability

**The main problems for liability insurers**

|                              | Number of<br>offices that<br>acknowledge<br>the problem | Problem<br>ranked 1<br>(most serious) | Problem<br>ranked 2 | Problem<br>ranked 3 | Problem<br>ranked 4<br>(least serious) |
|------------------------------|---|---------------------------------------|---------------------|---------------------|--|
| <b>Damages<br/>trends</b>    | 46  | 33%                                   | 48%                 | 19%                 | -                                      |
| <b>Long tail<br/>Risks</b>   | 46  | 42%                                   | 24%                 | 17%                 | 17%                                    |
| <b>Legal<br/>uncertainty</b> | 40  | 11%                                   | 23%                 | 33%                 | 33%                                    |
| <b>Volatility</b>            | 37  | 18%                                   | 6%                  | 29%                 | 47%                                    |

## **FIVE PAPERS ON LIABILITY INSURANCE**

- APPENDIX II**      ‘Employers’ liability insurance – how secure is the system?’ *Industrial Law Journal*, Vol. 28, No. 2, June 1999.
- APPENDIX III**    ‘Compensation and insurance for injuries at work: a European perspective’, *International Journal of Insurance Law*, Part 3, July 1999.
- APPENDIX IV**    ‘Industrial injuries and employers’ liability – a search for the cure’, (Monograph) *Chartered Insurance Institute*, 1999.
- APPENDIX V**     ‘Compensating psychiatric illness: issues of liability and insurance’ *Journal of Insurance Research and Practice*, Vol. 16, Part 1, January 2001.
- APPENDIX VI**    ‘Managerial liability, risk and insurance: an international view’ *International and Comparative Corporate Law Journal*, Vol. 3, Issue 1, 2001.



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