THE TORT THREAT

The Tort Threat in 2009: A Changing Liability Landscape

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I. The Changing Legal Landscape

Introduction

The United States has a reputation as the world leader when it comes to litigation. The 2007 filing of a $54 million lawsuit against a dry cleaner over a missing pair of pants is a good example of the excessive litigation culture in the U.S. History shows that mass tort claims related to asbestos and environmental pollution have forced companies into bankruptcy and cost insurers billions of dollars in payouts over the years and with every day it seems the media brings another danger to the public's attention. Whether it's lead paint in toys or homes, salmonella-contaminated food, suspected toxic drywall, airborne or work-related benzene exposure, the next potential mass tort or liability exposure is lurking. Political forces can have a powerful influence on the tort system. In 2009 the combination of a new administration and a reshaped Congress, as well as a deteriorating economy is changing the liability landscape for insurers and will present some substantial challenges in the months ahead. Areas to monitor include liability for CO_2 emissions after the Environmental Protection Agency (EPA) confirmed in April 2009 that greenhouse gases are air pollutants that may endanger public health and welfare. The EPA's announcement followed a 2007 U.S. Supreme Court decision giving the agency the right to regulate greenhouse gas emissions. Expanding products liability for businesses is another concern given the March 2009 Supreme Court ruling that even approval of a drug warning label by the Food and Drug Administration (FDA) does not shield a manufacturer from state lawsuits.

1. Litigation Cost Overview

Tort issues are a persistent threat for insurers everywhere. Over the course of decades the abuse of the U.S. legal system has had a direct and tangible impact on insurer operations. The average jury award for all plaintiffs' verdicts in personal injury cases more than doubled to $1.2 million in 2007, the latest year for which data are available, up from $601,926 in 1998 (Fig. 1 and 2).[1]

The return to an average jury award level in excess of $1 million in 2007 followed a one-year respite when the average jury award fell by 6 percent in 2006. The two years prior (2004 and 2005) the average jury award also reached in excess of $1 million.

[1] Jury Verdict Research data, *Current Awards Trends in Personal Injury*, 48th Edition, 2009.

Average Jury Awards, 1998 - 2007

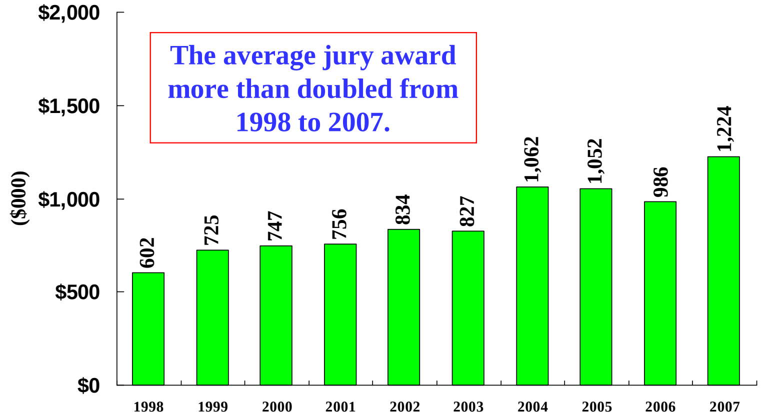


Fig. 1

Source: Jury Verdict Research; Insurance Information Institute (I.I.I.)

Average Jury Awards 1998 vs. 2002 and 2007

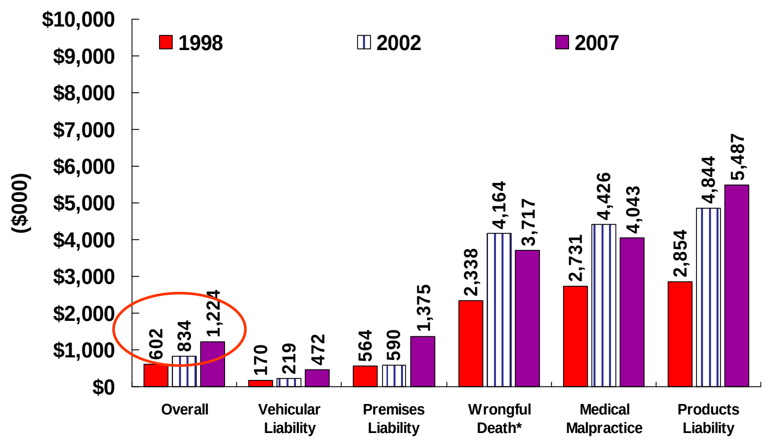


Fig. 2

Source: Jury Verdict Research; Insurance Information Institute (I.I.I.)

*Award trends in wrongful deaths of adult males

Latest estimates from the Tillinghast unit of Towers Perrin put the cost of the U.S. tort system at about $275 billion in 2009 in direct costs, or $898 per person, and many billions of dollars more in indirect costs.[2] U.S. tort costs increased an estimated 53 percent from 2000 to 2009 (Fig. 3).

[2] 2008 Update on U.S. Tort Cost Trends, Towers Perrin

Cost of U.S. Tort System ($ Billions)

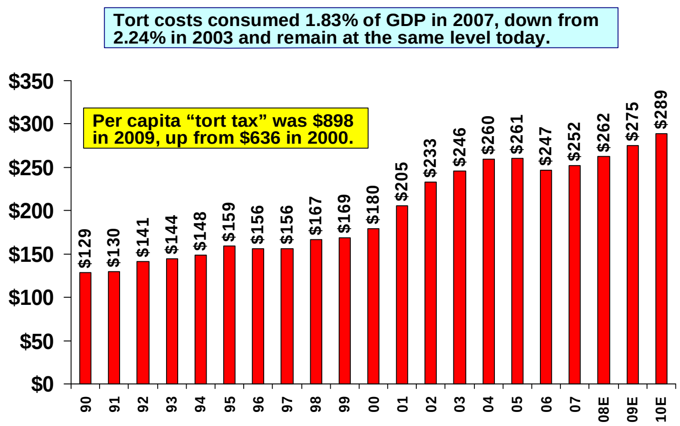


Fig. 3

Source: Tillinghast Towers-Perrin, 2008 Update on U.S. Tort Cost Trends

After an extended period of rapid escalation that began in the 1950s, tort costs as a percentage of Gross Domestic Product (GDP) fell and then leveled off. Tort costs consumed 1.83 percent of GDP in 2007, down from 2.24 percent in 2003 and remain roughly at that same level today (Fig. 4). However, since 1950 growth in tort costs has exceeded growth in GDP by an average of approximately 2 percentage points.

Tort System Costs and Tort Costs as a Share of GDP, 2000-2010F

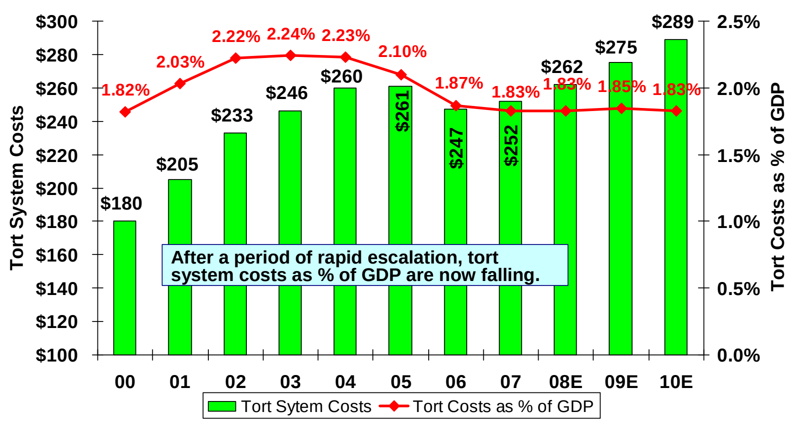


Fig. 4

Source: Tillinghast Towers-Perrin, 2008 Update on U.S. Tort Cost Trends

Tort costs rose by 2.1 percent in 2007 -- after a brief decline of 5.6 percent in 2006 -- fueled by the largest increase in personal tort costs since 2003. The increase in personal tort costs in 2007 was the result of a rise in auto accident frequency, the first such rise since 1999.

Looking ahead, growth in U.S. tort costs is expected to reach around 4.0 percent in 2008, with slightly higher growth of 5.0 percent forecast in 2009 and 2010.

Tillinghast identifies a number of key issues that it expects to determine future trends in U.S. tort costs, as follows:

- Gasoline prices – The increase in the price of gasoline resulted in a decrease in miles driven in 2008. Whether the public's reaction to the price is a temporary or permanent shift in driving habits will have an impact on future personal auto liability costs.

- The credit crunch and subprime loan crisis – Fallout from the crisis has led to significant ongoing litigation activity particularly on a class action level. Government involvement in financial firms will undoubtedly lead to further litigation going forward.

- Medical malpractice – Tort costs from medical malpractice claims have decreased in inflation-adjusted dollars since 2004, due in part to tort reforms at the state level. However, some of these reforms have been overturned or are currently being challenged in the courts.

- Options backdating – While significant settlements have been made to resolve allocations of improper options backdating, this category of tort costs may have peaked.

- Employment practices liability (EPL) – Recent battles on EPL issues related to whistleblower retaliation, compliance with the Fair Labor Standards Act, etc, have been won by the employee side which could trigger additional activity in this area.

- Products liability suit restrictions – The March 2009 U.S. Supreme Court decision in *Wyeth v. Levine* that Food and Drug Administration (FDA) approval of a drug warning label does not shield the manufacturer from state lawsuits may lead to a shift in product liability litigation.

- November 2008 elections – The change in administration and potential shifts in the U.S. Congress may lead to modifications in the federal government's behavior and attitudes towards commercial litigation.

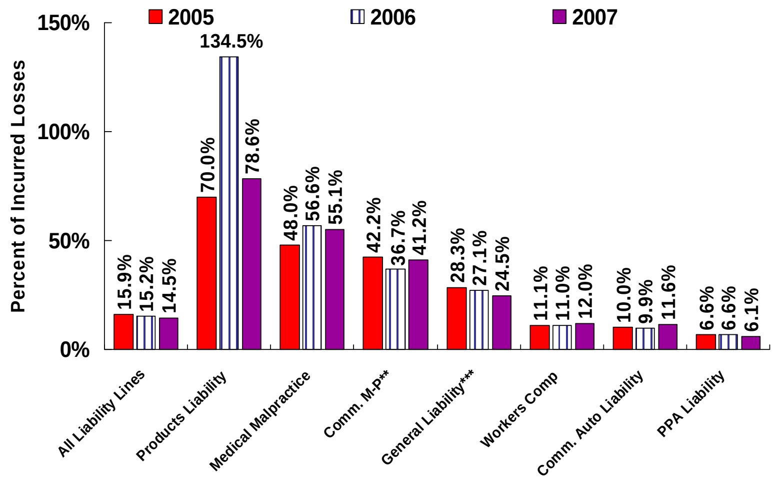
- Other emerging issues – Global warming and obesity continue to be potential areas for significant tort costs. Claims related to data security breaches have also surfaced.

Business Impact

While good liability risk management can reduce the chances that a company will be sued, the risk of a lawsuit can never be entirely eliminated. At best lawsuits may present businesses with significant defense costs and at worst they can bankrupt an organization.

Insurers are required to defend their policyholders against lawsuits and pay out billions of dollars in defense costs each year. Figures show that insurers' defense costs as a percentage of incurred losses in commercial casualty lines fell from 2006 to 2007, though they remain generally above 2005 levels and are particularly high in products liability and medical malpractice lines (Fig. 5).

Insurer Defense and Cost Containment Expenses as a Percent of Incurred Losses, 2005 to 2007*



*Net of reinsurance, excl. state funds. **Liability portion only. ***Excludes products liability.

Fig. 5

Source: National Association of Insurance Commissioners (NAIC) Annual Statement Database, via Highline Data, LLC; Insurance Information Institute.

The current financial crisis and economic woes are adding to the litigation threat. According to the Fifth Annual Litigation Trends Survey from international law firm Fulbright & Jaworski, U.S. companies are preparing for a rise in litigation amid the economic downturn.

Some 34 percent of in-house counsel at U.S. firms now expects to see an increase in the number of legal disputes faced by their company in the year ahead, while 25 percent expect an uptick in the number of regulatory proceedings on the horizon. Financial firms feel the most at risk, with 50 percent expecting more disputes, followed by education (43 percent predicting increase), health care firms (40 percent), retailers (39 percent) and insurers (36 percent) (Fig. 6).

Litigation Risk by Industry

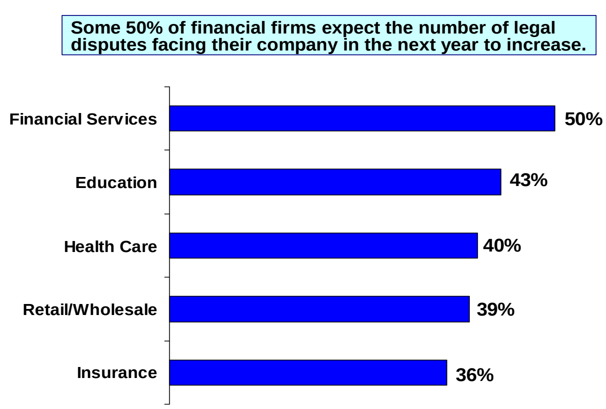


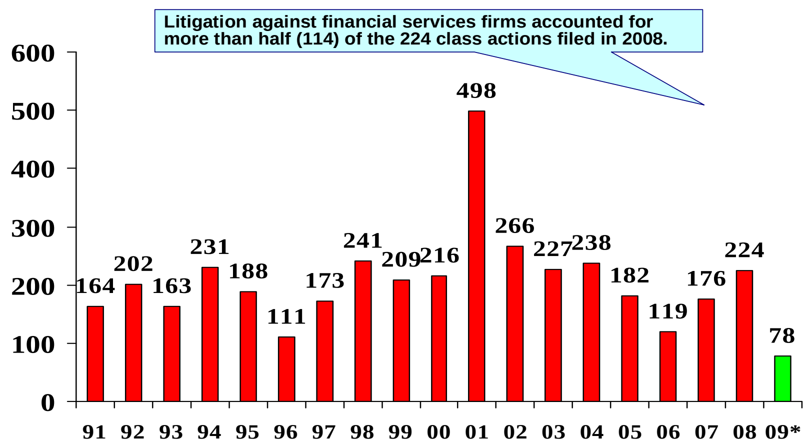
Fig. 6

Source: Fulbright & Jaworski, Fifth Annual Litigation Trends Survey, 2008

It is worth noting that insurers themselves were the number one target for litigation in the past year. The report shows that two-thirds of insurers faced at least six new lawsuits, including 29 percent facing more than 50 new actions.

Litigation against financial services firms also dominated securities class action filings in 2008, according to the latest data from Stanford Law School and Cornerstone Research. Of the total 224 federal securities class actions filed in 2008, more than half (114 class actions) involved firms in the financial services sector (Fig. 7).

Shareholder Class Action Lawsuits*



*Securities fraud suits filed in U.S. federal courts; 2009 figure is current through 06/02/09.

Fig. 7

Source: Stanford University School of Law (securities.standford.edu); Insurance Info. Institute

American businesses continue to commit significant financial resources to legal disputes, according to the survey, with 45 percent of U.S. companies spending $1 million or more annually on litigation (excluding cost of judgments or settlements). Some 16 percent of U.S. firms spend at least $5 million annually and litigation is a major line item for billion-dollar companies with 72 percent reporting an annual budget of $1 million or more.

Another barometer of the legal landscape is a list of the highest liability awards across the U.S. According to the latest report from Lawyers Weekly USA, the size of the top 10 jury awards rose dramatically in 2008, reversing the declining trend of recent years. The sum of the top 10 jury awards more than doubled to $1.3 billion in 2008, from $615.5 million in 2007, after decreasing 88 percent since 2004 (Fig. 8).[3]

[3] Lawyers Weekly USA, Top Ten Jury Verdicts 2008, http://www.lawyersweeklyusa.com/index.cfm/archive/view/id/432613

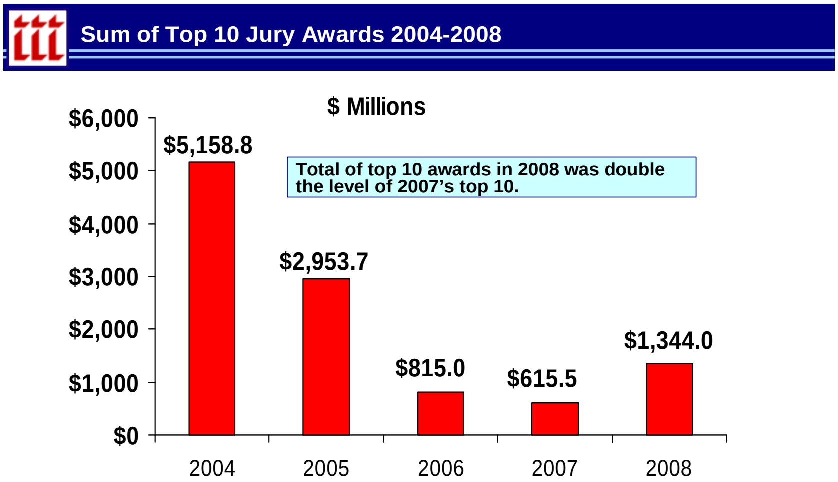


Fig. 8

Source: Insurance Information Institute (I.I.I.) from LawyersWeekly USA, January 2005, 2006, 2007, and 2008

The top verdict in 2008 was for $388 million, more than triple 2007's top award of $109 million (Fig. 9). The average award also increased sharply driven by three verdicts of well over $100 million during the year. The average award for 2008 more than doubled to $112 million from just under $51 million in 2007.

2008 Top Ten Verdicts

Value	Issue	State
$388 Million	Fraud, Intentional Infliction of Emotional Distress	Nevada
$316 Million	Breach of Contract	Georgia
$188 Million	Defamation	New York
$85 Million	Premises Liability	Pennsylvania
$84 Million	Negligence, Personal Injury	Texas
$66 Million	Breach of Fiduciary Duty	Oklahoma
$60 Million	Insurance Bad Faith	Nevada
$55 Million	Negligence	California
$54 Million	Wrongful Death	Georgia
$48 Million	Negligence	Indiana

Fig. 9

Source: LawyersWeekly USA, January 15, 2009

On a positive note, for the third year running the top verdicts of 2008 did not include any $1 billion-plus awards. However, the sharp increase in the average award for 2008 could signal a return to rising severity in liability awards in future years. In contrast to prior years the top verdicts of 2008 did not include any medical malpractice cases either. This could be the result of a successful campaign by doctors in many states in recent years to cap awards for noneconomic damages.

Data also indicates the frequency of multi-million dollar awards is increasing across virtually all types of defendants (includes awards for products liability, medical malpractice, government negligence, business negligence, premises liability, personal negligence and vehicular liability). According to Jury Verdict Research, across all liability types million dollar-plus awards rose from 13 percent of all awards from 2001-2003 to 17 percent in 2006-2007 (Fig. 10). The largest increases between 2001 and 2007 were in medical malpractice and government negligence.

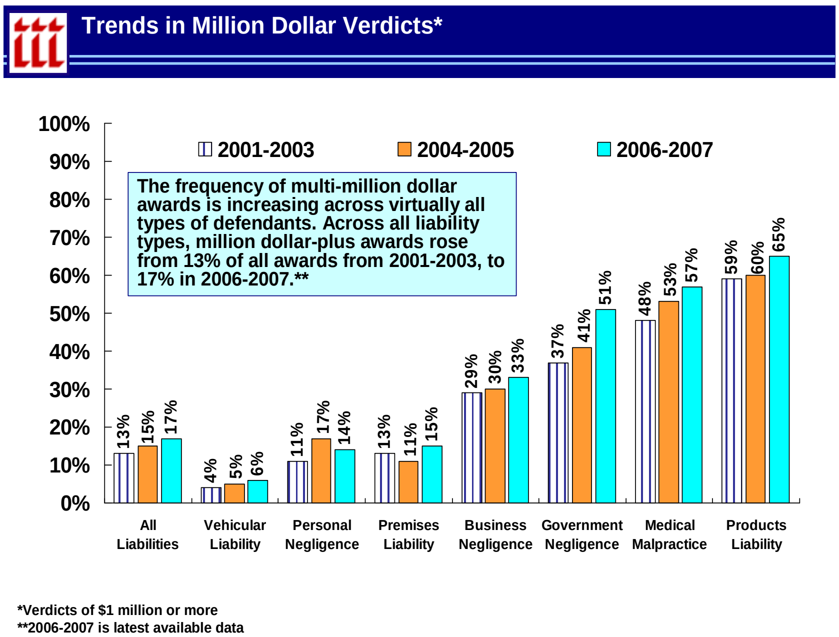


Fig. 10

Source: Jury Verdict Research; Insurance Information Institute (I.I.I.)

Not All Equal

The volatile costs associated with the U.S. tort system are magnified by the inefficient and inconsistent way in which it works.

In fact, the majority of the dollars moving through the U.S. tort system never reach plaintiffs who have suffered damages.[4] In addition to losses, there are two other components of tort costs: defense costs and administrative expenses. While the relative share of total insured tort costs attributable to administrative expenses generally declined from the 1950s through the 1970s, the portion has increased slightly since 1980 (Fig. 11).

[4] Tort Excess 2005: The Necessity for Reform from a Policy, Legal and Risk Management Perspective, U.S. Chamber of Commerce.

Tort Costs: Administrative Expense Portion 1950s-2000s

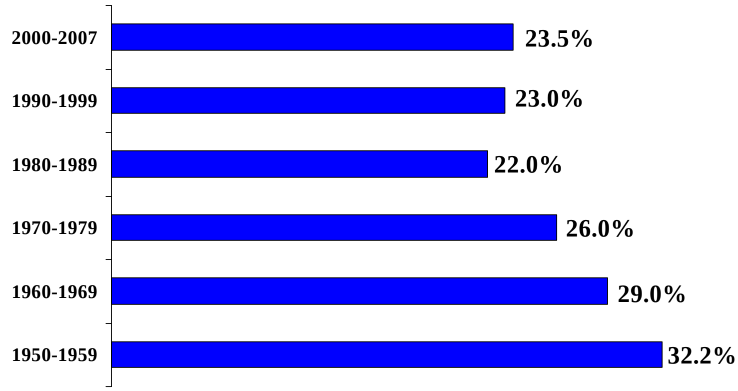


Fig. 11

Source: Tillinghast-Towers Perrin

How the tort system operates across the U.S. can also vary significantly by venue. In its annual assessment of state liability systems, the U.S. Chamber of Commerce Institute for Legal Reform (ILR) ranks the liability system in all 50 states based on a number of factors, including: treatment of class action suits, punitive damages, non-economic damages, judges' impartiality and competence, and juries' predictability and fairness.[5]

According to the 2008 report, Delaware still has the best legal climate in the country, holding the top spot for the seventh consecutive year, while West Virginia is ranked in last place for the third year running.

The top 10 states with the best legal climates in 2008 are: Delaware, Nebraska, Maine, Indiana, Utah, Virginia, Iowa, Vermont, Colorado, Kansas. The bottom 10 states with the least fair legal systems are: West Virginia, Louisiana, Mississippi, Alabama, Illinois, Hawaii, California, South Carolina, Florida, and Texas (Fig. 12).

[5] U.S. Chamber of Commerce Institute for Legal Reform (ILR), *Lawsuit Climate 2008: Ranking the States*.

Business Leaders Ranking of Liability Systems for 2008

Best States	Worst States
1. Delaware	41. Texas
2. Nebraska	42. Florida
3. Maine	43. South Carolina
4. Indiana	44. California
5. Utah	45. Hawaii
6. Virginia	46. Illinois
7. Iowa	47. Alabama
8. Vermont	48. Mississippi
9. Colorado	49. Louisiana
10. Kansas	50. West Virginia

Best States: *New in 2008* CO, IN, KS, VA, VT; *Drop-Offs* MN, NH, TN, WI

Worst States: *New in 2008* FL, SC; *Drop-Offs* AR, AK

Fig. 12

Source: U.S. Chamber of Commerce 2008 State Liability Systems Ranking Study; Insurance Information Institute (I.I.I.)

Overall the report found that just over half (55 percent) of the senior attorneys surveyed view the state court liability systems in the United States as only fair or poor, while 41 percent view the fairness and reasonableness of the systems as excellent or good. An important caveat is that the ILR report asks respondents to evaluate the state as a whole though courts and localities within a state may vary a great deal in fairness and efficiency.

Another study by the American Tort Reform Association (ATRA), illustrates that intra-state variability. In its Judicial Hellholes 2008/09 report, ATRA identifies the places where certain judges systematically apply laws and court procedures in an unfair and unbalanced manner, generally against defendants in civil lawsuits. ATRA notes that these so-called "judicial hellholes" may be located in a state where the majority of the courts are fair and the negative publicity is because of a few bad apples.

In 2008/2009, ATRA ranks perennial hellholes West Virginia, South Florida and Cook County, Illinois as its top three. The remainder of ATRA's list is made up of relative newcomers Clark County, Nevada and Atlantic County, New Jersey; while Los Angeles County, California, and Alabama's Macon and Montgomery counties return to the spotlight after respective absences (Fig. 13).

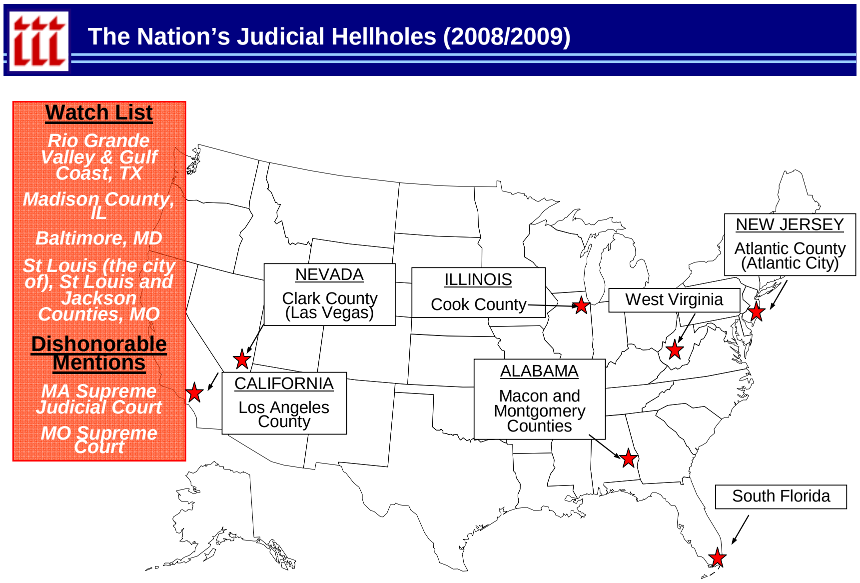


Fig. 13

Source: American Tort Reform Association (ATRA); Insurance Information Institute (I.I.I.)

The report also calls attention to several additional jurisdictions that bear watching for suspicious or negative developments in litigation, histories of abuse, or laudable efforts to improve themselves. The jurisdictions viewed as being on the cusp of either hellhole abyss or rising to the promise of equal justice under law in 2008/2009 are:

- the Gulf Coast and Rio Grande Valley, Texas;
- Madison County, Illinois (ranked as a judicial hellhole from 2002 through 2006);
- Baltimore, Maryland;
- St. Louis (the City of), and St. Louis and Jackson counties, Missouri.

Businesses take into account the legal climate of jurisdictions and avoid doing business in those states and counties where the system is deemed to be unfair. A majority (63 percent) of senior counsel surveyed for the 2008 Institute for Legal Reform (ILR) study said that the litigation environment in a state is likely to impact important business decisions at their company, such as where to locate or do business, up from 57 percent in 2007. Such decisions have a resulting negative economic impact on employment and investment in a state (see later section on Tort Reform).

2. Political Winds of Change

A number of factors have the potential to influence U.S. tort costs in future and to redraw the liability climate in which insurers operate. The change in administration following the November 2008 elections is a key issue.

The Change in Administration

The potential impact of America's newly elected President Barack Obama and a Democratic-led Congress on the country's legal climate could be significant. Commentators note that the change in administration as well as shifts in the U.S. Congress may lead to modifications in the federal government's behavior and attitude toward commercial litigation.[6] Others observe that while the relation between political regimes and tort is not simple, changes in political regime that favor a more progressive, plaintiff perspective could reverse limitations on lawsuits established in a more conservative, business-oriented regime.[7]

These concerns are not new. The reality is that every four or eight years a new administration has the opportunity to make substantial changes to the legal framework of the country by appointing judges and heads of federal agencies, shaping the courts and by signing or vetoing new laws. This happens regardless of whether the party in power is Democrat or Republican.

Shaping Courts and Federal Preemption

One area of potential influence of the new administration is on the federal judiciary. An article in the UK newspaper *The Guardian* published November 5, 2008, reported that Barack Obama could have an influence on the American legal system that far outlasts his tenure in the White House.[8] It noted the impact an Obama presidency would have on the make-up of the U.S. Supreme Court with as many as three Supreme Court justices likely to retire in the next four years. The planned retirement of Supreme Court Justice David Souter announced May 1 gives President Obama his first opportunity to make such an appointment.

Recent research from Vanderbilt University similarly observed how the United States court system, especially the Supreme Court and the Court of Appeals, could dramatically change under the new administration.[9] Vanderbilt professor of law and political science Tracey George said the likelihood was that as many as three Supreme Court justices could leave office while Obama is in office.

George also noted there are currently 13 vacancies on the courts of appeals and an additional 41 vacancies on the district courts and that the number of openings may quickly rise because the change in party in power may prompt Clinton and Carter appointees to step down soon to ensure a like-minded replacement. Another factor to consider is that with a Democratic majority in Congress, President Obama's appointees are unlikely to be challenged.

President Obama has also restored the American Bar Association's (ABA) role of vetting possible choices for the federal judiciary, reversing a decision made eight years ago under then President George W. Bush. Recent research by political scientists at the University of Georgia, Georgia State University and Emory University indicated that the ABA may have a liberal bias when it comes to vetting nominees. It found that most liberal nominees had a 62.3 percent chance of receiving a "well-qualified" rating from the ABA, compared to a 35.5 percent chance for the most conservative nominees.[10]

U.S. Supreme Court decisions have the ability to change the course of entire categories of litigation. For example an important case recently decided by the court, *Wyeth v. Levine*, determined that a state law tort action challenging labeling on a Wyeth drug is not pre-empted by federal law. The defendant's

[6] 2008 Update on U.S. Tort Cost Trends, Towers Perrin.
[7] *General Liability: Staying Relevant (and Profitable) in the New World of Risk*, Conning, 2009.
[8] *Obama presidency could impact make-up of supreme court*, by Daniel Nasaw, guardian.co.uk, November 5, 2008.
[9] *Politics and the changing face of the Supreme and appellate courts*, by Tracey George, Vanderbilt professor of law and political science, January 15, 2009.
[10] *The ABA's BFF: Why Obama wants lawyers to rate judges*, Opinion, The Wall Street Journal. April 21, 2009.

position was that Food and Drug Administration (FDA) approval of the label protected them from such suits.

The principle of federal preemption – the concept that where state law conflicts with valid federal law, the federal law is supreme – underpins this case. The Court's decision not to uphold preemption in the case is of huge significance not just for pharmaceutical companies, but for the broader business community, including insurers. The opinion effectively opens the floodgates to a tide of potential product liability tort suits against pharmaceutical companies at the state level. Indeed, a recent report forecast that the outcome of this case could lead to a shift in product liability litigation.[11]

It is important to note that determinations of the Supreme Court are not always final. In many cases the Court's opinions can be reversed by legislation passed by Congress. The potential for a Democratic-led Congress to introduce legislation reversing recent Supreme Court decisions is another concern as insurers survey the liability landscape in 2009.[12]

Legislative and Regulatory Change

The combination of a Democratic president and a Democratic majority in both the House and Senate heralds a period of legislative and regulatory change that is poised to alter the legal landscape in which insurers operate.

Under the Democratic-led Congress innumerable legislative initiatives may create opportunities to undermine existing tort reforms and develop new theories and channels of liability against businesses. Historically, these have been very costly to the property/casualty insurance industry.

A poll conducted by the Institute for Legal Reform found that some 79 percent of voters in the November election believe that if Congress passes legislation allowing more lawsuits, this will have a negative impact on the U.S. economy.

A number of legislative activities are afoot that have the potential to expand liability for businesses in certain areas. An era of increased regulatory activity may also increase potential liability to the extent that businesses fail to comply with new rules. Here are some examples:

- **Consumer Protection**: Under an Obama administration tougher regulations can be expected from federal agencies that oversee a variety of industries, including consumer products, environmental policy and workplace safety, according to an article in the *Wall Street Journal* published November 19, 2008.[13] Overhaul and appointments at the head of two key agencies, the Consumer Product Safety Commission (CPSC) and the Food and Drug Administration (FDA), have already been announced. The new leadership is expected to strengthen their regulatory approach and result in greater industry oversight.

  An example is the recent outbreak of salmonella that sickened at least 575 people in 43 states following the sale of contaminated peanut butter from a plant in Georgia. The incident, reported to be the largest food contamination case in U.S. history, has increased the spotlight on the

[11] *2008 Update on U.S. Tort Cost Trends*, Towers Perrin.
[12] *Lawmakers Seek to Return Right to Sue Device Makers*, by Barry Meier, New York Times, February 19, 2009.
[13] *Obama Signals Tougher Regulations at Federal Agencies*, by Elizabeth Williamson, Melanie Trottman and Stephen Power, The Wall Street Journal, November 19, 2008.

FDA and renewed calls for increasing regulations on food companies. In March 2009, President Obama announced plans to restructure the food safety system and the creation of a Food Safety Working Group that will advise him on which laws and regulations need to be changed.[14]

- **Credit Crunch and Financial Crisis**: Against the backdrop of the continuing economic downturn and in response to the credit crisis the new administration is working to implement plans that would tighten regulation of the financial services sector. Changes may include stricter federal rules for hedge funds, credit rating agencies and mortgage brokers, as well as increased oversight of complex financial instruments such as credit default swaps (CDS).

  In his address to the Joint Session of Congress February 24, 2009 President Obama called on Congress to move quickly on legislation to reform the outdated regulatory system.[15] "It is time to put in place tough, new common-sense rules of the road so that our financial market rewards drive and innovation, and punishes short-cuts and abuse," President Obama said.

  The Securities and Exchange Commission (SEC) is widely expected to take an increasingly aggressive approach to regulation and enforcement in the wake of the credit crisis and recent high-profile fraud scandals.

  Under a reinvigorated SEC, oversight of financial markets and enforcement of securities laws will be stepped up and it is conceivable that this could trigger rising numbers of lawsuits in future. That said, with increasing government involvement in financial firms, it remains to be seen how securities litigation settlements arising from the credit crisis will be handled.

- **Employment Practices:** The *Lilly Ledbetter Fair Pay Act of 2009* – the first bill signed into law by President Obama – reverses a 2007 Supreme Court decision (*Ledbetter v. Goodyear Tire & Rubber Co.*) that limited a worker's ability to sue an employer for pay discrimination. The Act eliminates the 180-day statute of limitations on discrimination claims so that a worker can sue in federal court for alleged pay discrimination years later.

  According to legal experts, the law could have substantial implications for employers. This is because it makes it easier for employees to bring and to litigate formerly stale discrimination claims and potentially exposes employers to liability for alleged discriminatory acts occurring years, possibly decades prior.[16]

  Another key bill, the *Paycheck Fairness Act* (companion legislation to -- but not included in -- the *Lilly Ledbetter Fair Pay Act of 2009*) would remove existing statutory caps under the Equal Pay Act and allow for unlimited compensatory and punitive damage awards, even without proof of discriminatory intent. By lifting limits on damage awards, it appears inevitable the bill will trigger increasing lawsuits.

  Large-scale layoffs in the current economic downturn could serve as fuel for employment practices liability (EPL) suits. Latest data from the U.S. Equal Employment Opportunity Commission (EEOC) show that workplace discrimination complaints soared to an unprecedented level of 95,402 during fiscal year 2008, a 15 percent increase from the previous year. Charges based on age and retaliation saw the largest annual increases, while allegations based on race, sex and retaliation continued as the most frequently filed charges. The EEOC attributed the surge in filings to multiple factors, including economic conditions. Meanwhile, the

[14] *President Promises to Bolster Food Safety*, by Gardiner Harris, New York Times, March 14, 2009.
[15] Remarks of President Barack Obama – Address to Joint Session of Congress, February 24, 2009.
[16] *What the New Ledbetter Pay Act Means for Employers*, by Sherrard Lee Hayes and Shafeeqa Watkins Giarratani, Fulbright & Jaworski, February 2009.

latest Bureau of Labor Statistics (BLS) survey notes that the unemployment rate rose to 8.9 percent in April 2009. Since the recession began in December 2007, 5.7 million jobs have been lost, according to the BLS.

- **Environmental Liability**: Environmental policy on climate change is a high priority issue in the new administration and in Congress this year.

  In his address to the Joint Session of Congress February 24, 2009 President Obama called on Congress to send him legislation that places a market-based cap on carbon pollution and drives the production of more renewable energy in America.[17]

  Progress in Congress on a climate bill is expected before the next round of United Nations climate negotiations scheduled for the end of the year.[18] Congressional hearings on landmark climate legislation – The American Clean Energy and Security Act of 2009 – were underway before the House Energy and Commerce Committee in late April 2009 with the goal of creating a U.S. carbon trading market by 2012.

  Regulation of emissions moved a step closer when the Environmental Protection Agency (EPA) confirmed in April 2009 that carbon dioxide and other greenhouse gases are air pollutants that may endanger public health and welfare.[19] The new approach follows a landmark Supreme Court ruling in April 2007 that determined greenhouse gases fit well within the Clean Air Act's definition of air pollutant and that the Act gives the EPA the authority to regulate emissions of carbon dioxide and other greenhouse gases.

  Increased environmental laws and regulations at the state level are also expected. On January 26, 2009 President Obama ordered the EPA to consider allowing states, including California, to regulate the emissions of greenhouse gases from autos. Legislative initiatives like this ultimately may increase the environmental risk and responsibility facing many businesses.

Presidential and Congressional Politics and P/C Insurance

Whatever the various shifts in the country's legal landscape from a new administration and Democratic Congress, I.I.I. research indicates that neither the party of President nor the make-up of Congress have more than a marginal bearing on the overall profitability of the property/casualty industry.

In an analysis of the industry's return on equity (ROE) by Presidential party affiliation from 1950 to 2008, the I.I.I. found that the overall record during those years was an ROE of 8.05 percent for Democrats and 7.88 percent for Republicans (Fig. 14).

[17] Remarks of President Barack Obama – Address to Joint Session of Congress, February 24, 2009.
[18] *White House Seeks Bill on Climate by December*, by Mark Peters, The Wall Street Journal, April 14, 2009.
[19] *E.P.A. Clears Way for Greenhouse Gas Rules*, by John Broder, New York Times, April 17, 2009.

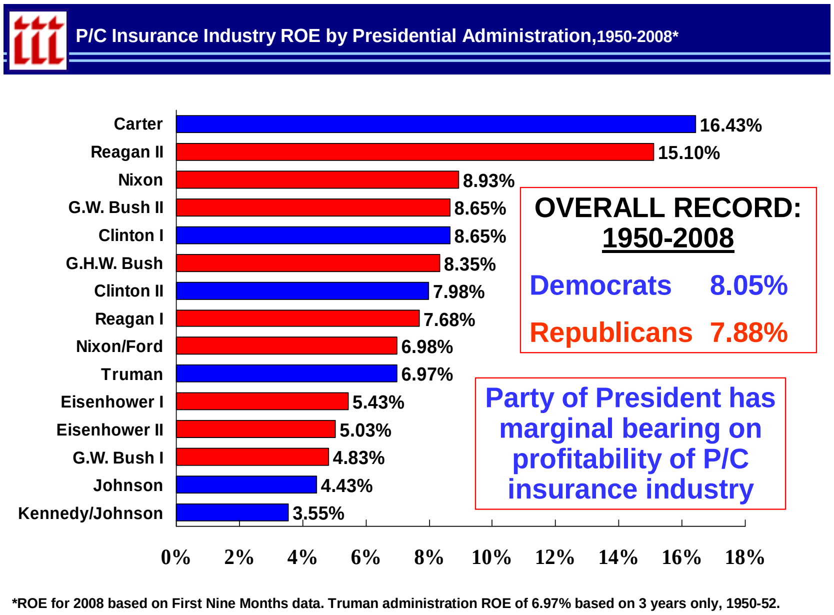


Fig. 14

Source: Insurance Information Institute (I.I.I.)

The top average industry ROEs were produced during the Carter (16.43 percent), Reagan II (15.10 percent) and Nixon (8.93 percent) Administrations. At the opposite end of the scale the worst average industry ROEs were produced during the Kennedy/Johnson (3.55 percent), Johnson (4.33 percent), and G.W. Bush I (4.83 percent) Administrations (Fig. 15).

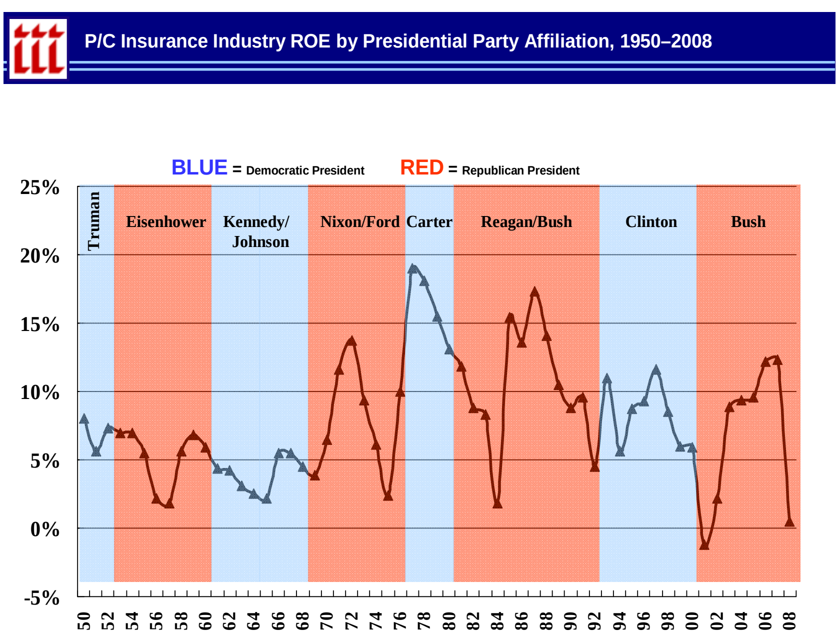


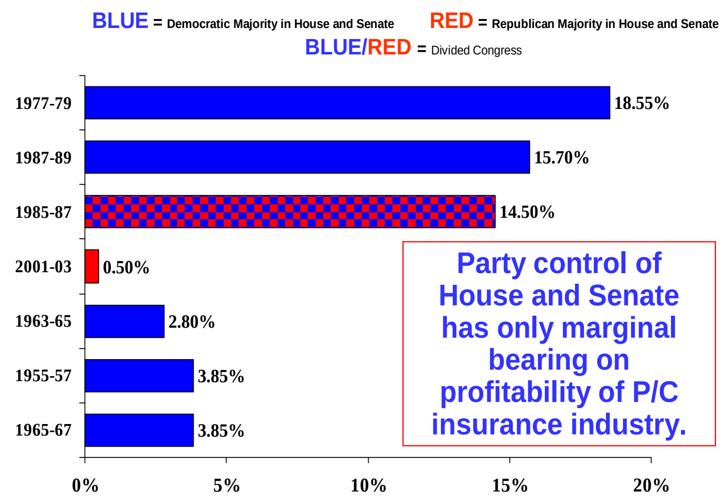
Fig. 15

Source: Insurance Information Institute (I.I.I.)

Similarly, when it comes to which party has control of the House and Senate, I.I.I. research shows that the property/casualty industry's ROE is basically unaffected by either Democrat or Republican majorities in Congress.

The top average industry ROEs were produced during the 1977-79 (18.55 percent) and 1987-89 (15.70 percent) Congressional periods when Democrats held the majority in both the House and Senate. The third highest average industry ROE in 1985-87 (14.50%) was produced during a divided Congress, when the Democrats held the House but Republicans held the Senate (Fig. 16).

Highest and Lowest Average P/C Insurance Industry ROEs by Congressional Period*



*Average ROE based on first two years of Congressional period.

Fig. 16

Source: Insurance Information Institute (I.I.I.); http://www.senate.gov/; http://www.clerk.house.gov/

The worst average industry ROE (0.50 percent) was produced in 2001-2003 when the Republicans held the majority in both the House and Senate. The next three lowest average industry ROEs were produced in years when Democrats held the majority in Congress: 1963-65 (2.80 percent); 1955-57 and 1965-67 (3.85 percent, respectively).

It should be noted, however, that Democrats held the majority in 18 of the Congressional periods surveyed by I.I.I., while Republicans held the majority in just eight and party control was split in three of the Congressional periods.

The I.I.I. findings indicate that the major events affecting property/casualty insurance industry profitability, such as manmade and natural catastrophes, are independent of who is in the White House and which party holds the House and Senate.

2. Solutions: Tort Reform and Liability Insurance

1. Tort Reform Threat

The impact of political change in the tort reform arena is a rising concern in 2009. Because trial lawyers contribute more money to political campaigns than any other group this makes their influence with legislators and other elected officials a serious potential threat.

A special report in the D.C. Examiner published February 19, 2009 pointed to the brief or obscure provisions being inserted into various bills in Congress at the behest of the trial bar that have the potential to expand liability in the months ahead.[20] The Institute for Legal Reform has put together a Web site that tracks the legislative priorities of trial lawyers in the 110th and 111th Congress.[21]

A 2008 study by the American Tort Reform Association (ATRA) reported on the coordinated efforts of personal injury lawyers to increase litigation and repeal or chip away at existing tort reform statutes enacted previously by state governments.[22]

It cited nearly 60 of more than 80 separate bills proposed for serious consideration in 2007 in more than two dozen state legislatures across the country. As of the report's publication in March 2008, at least 50 such bills had already been introduced in 19 statehouses last year.

According to ATRA, the personal injury bar's efforts to repeal existing tort reforms and expand liability in state legislatures include:

- explicitly authorizing new types of lawsuits and setting the stage for implied causes of action;
- the deputizing of private lawyers to sue on behalf of the state;
- inflating limits on damage awards;
- broadening the scope of consumer laws;
- the extension or elimination of statutes of limitation and repose.

Economic Impact of Tort Reform

Evidence suggests that over the course of decades tort reform has had a beneficial impact on the U.S. economy, spurring growth. Tort reform also helps to lower insurance costs or at least to curb their rate of growth, and to quell litigation rates.

According to the Pacific Research Institute (PRI), states with a fair, predictable tort system have stronger revenue outlooks, better job growth and more favorable prospects for economic growth.[23] PRI found that:

- States with better tort systems at the beginning of 2006 had better economic performance throughout the year.
- In 2006, job growth was 57 percent greater in the 10 states with the best tort systems than in the 20 states with the worst tort systems. State gross domestic product (GDP) grew 25 percent faster in the 10 best tort states than in the 10 worst.
- In 2006, the top 10 tort states had an average growth rate of tax revenues that was 24 percent greater than the bottom 10. The greater infusion of tax revenue was due to higher economic growth, not higher tax rates. In fact, taxpayers in the top tort states paid 8 percent less in effective tax rates in 2006 than those in the bottom states.

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[20] *Trial Lawyers' Lobbyists Seeking Special Favors from Congress*, by Quin Hillyer, The D.C. Examiner, February 19, 2009.
[21] http://www.triallawyerearmarks.com/
[22] *Defrocking Tort Reform: Stopping Personal Injury Lawyers From Repealing Existing Tort Reforms and Expanding Rights to Sue in State Legislatures*, American Tort Reform Foundation, March 2008; http://www.defendtortreform.com/
[23] *U.S. Tort Liability Index*, 2008 report, by Lawrence J. McQuillan and Hovannes Abramyan.

The report concluded that tort reform increases productivity, employment, output, and earnings; boosts innovation and sales of new products; lowers health-care costs while improving health-care access; and saves lives.

Key Tort Reforms

At the Federal level, the most significant new law on torts to be passed by Congress in recent years is the Class Action Fairness Act of 2005.

The Act expanded federal jurisdiction over certain class actions where there is more than $5 million at stake and subjected class action settlements to increased judicial and regulatory scrutiny. This Act is believed to have helped steer most class action lawsuits into federal court, where the rules for qualification as a class action are more stringent than those of many states.[24]

Key tort reforms at the state level include[25]:

- **Class Action Reform**: Class action lawsuits that bring together a large number of plaintiffs in a single lawsuit have increased significantly in recent years. A key reason for the increase is that laws in many states made it easy to certify a class. As a result, many states have instituted class-action reforms. These include rules that define procedures for certifying a class; permit interlocutory appeal of class certifications; or reform attorney-fee arrangements.
- **Collateral Source Rule**: The collateral source rule prohibits the defense from revealing that a plaintiff has already received compensation from a party not involved in the litigation, such as an insurance company. As a result, plaintiffs may receive double benefits. Reforms include: permitting evidence of collateral source payments to be admissible at trial; permitting a court to reduce awards by the monetary amount of the collateral payments.
- **Joint and Several Liability Reform**: Joint and several liability makes each defendant responsible for the entire amount of damages that a plaintiff is seeking regardless of a particular defendant's proportional fault. As a result defendants only minimally responsible for injury may be required to pay the full amount of damages. Reforms either limit or bar application of the rule of joint and several liability, and generally define liability according to share of responsibility.
- **Non-Economic Damages Reform**: Caps on non-economic damages are enacted in order to limit the amount a jury may award for hard-to-quantify "pain and suffering" or "mental distress". Caps in states work in a variety of ways and may be limited to specific types of cases such as medical malpractice ore make exceptions for certain noneconomic damages.
- **Punitive Damages Reform**: Punitive damages are awarded not to compensate a plaintiff, but to punish a defendant for intentional or malicious misconduct and to deter similar future misconduct. Punitive damages are awarded in excess of compensatory awards. The frequency and size of punitive damage awards has increased greatly in recent years. States use different methods to cap punitive damages, such as: limiting the amount that may be awarded in total or in proportion to compensatory damages; increasing the level of proof and criteria necessary to establish punitive damages.

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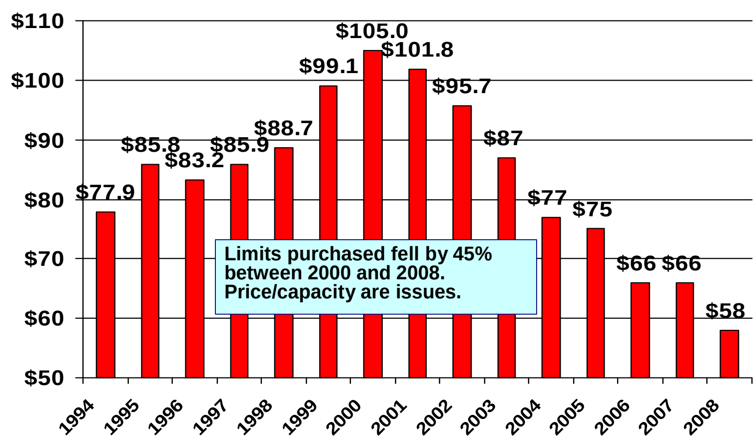
[24] The U.S. Liability Report of 2006, Guy Carpenter.
[25] *Ibid*.

2. Insurance and Liability Protection

Liability insurance works hand in hand with tort reform enabling businesses to better manage their exposure and providing protection against the significant financial impact of tort costs. Given the potential frequency and severity of liability claims, and the unpredictable nature of these exposures, it is increasingly important for businesses to have adequate insurance coverage.

A recent study by Marsh indicates that the average total excess liability limits purchased by U.S. companies in 2008 declined by 11.6 percent compared to 2007, at $58 million. Since reaching a high of $105 million in 2000, the average limit purchased has decreased by 45 percent (Fig. 17). These results are likely influenced by the changing survey population over time, which has included an increasing number of smaller firms. Smaller companies tend to buy lower limits which drags the overall average down.

Average Total Limits Purchased by All U.S. Firms* ($ Millions)



*Includes underlying primary limits

Fig. 17

Source: Limits of Liability, 2008, Marsh Inc.

Average limits purchased vary by revenue group. According to the study, U.S. firms with revenues of $501 million to $1 billion maintained limits purchased between 2007 and 2008. Some larger firms increased their limits purchased, with U.S. firms with revenues of $5.001 billion to $10 billion increasing limits purchased by 14 percent.

The availability of capacity in the insurance markets influences the price of coverage and price continues to be a determining factor in how much liability coverage companies buy. In 2008 the average price per $1 million of coverage dropped for the fourth consecutive year, falling 15.6 percent to $9,582, below 2003 levels but still high above the $7,106 average in 2002. Again, Marsh notes that this likely reflects the changing population.

Overall capacity in excess liability markets has grown over the past few years, with carriers entering or reentering the market. Capacity declined by about 19 percent from 2000 to 2007, after peaking in 2000 at just over $2 billion (Fig. 18). In 2008 capacity increased by 21.4 percent on 2007 after additional capacity entered the market in the second half of the year. Capacity is once again back to 2000 levels.

Excess Liability Market Capacity – North America

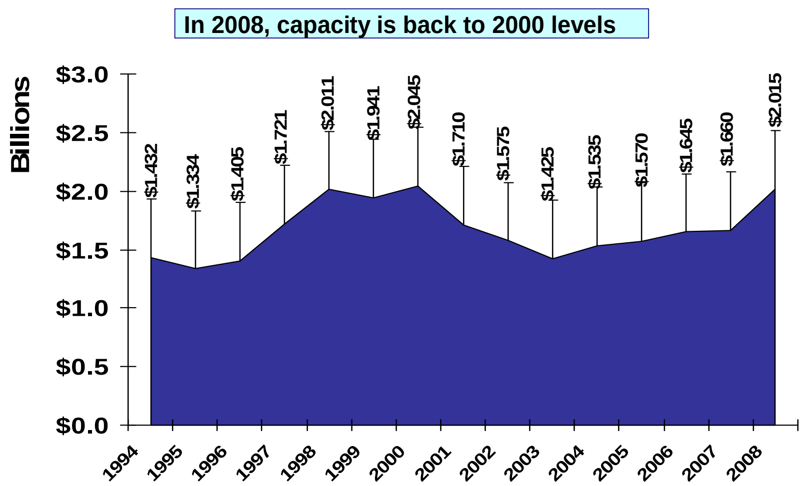


Fig. 18

Source: Limits of Liability, 2008, Marsh Inc.

The report also shows that the amount of limits purchased and the prices paid vary widely by industry. Among 23 industry groups in Marsh's 2008 survey, the average limits purchased ranged from a high of $91 million in Mining, Energy to a low of $27 million in Health Care. Limits declined in 19 industry groups in 2008 compared with 2007, and rose in four.

The average price per $1 million of coverage ranged from a high of $36,037 in Health Care to a low of $4,428 in Printing, Publishing. The average price per $1 million of coverage declined in 16 industry groupings and rose in seven.

Similarly, a recent survey by the Risk and Insurance Management Society (RIMS) found that the total average liability cost per $1,000 revenue for all companies in 2007 was essentially flat ($3.27 in 2007, compared to $3.06 in 2006).

Nevertheless, liability costs were the single largest contributor to the total cost of risk (TCOR) for companies in 2007. In terms of how the risk dollar is spent, total liability costs also account for about 30 percent of the risk dollar (Fig. 19).

How the Risk Dollar is Spent (2007)

Total liability costs account for about 30% of the risk dollar

Firms w/Revenues < $1 Billion **Firms w/Revenues > $1 Billion**

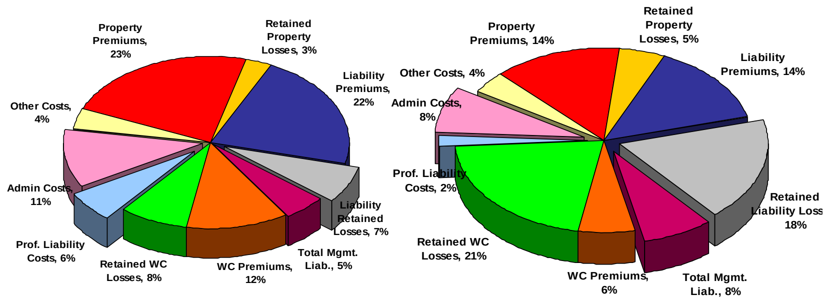


Fig. 19

Source: RIMS (2007); Insurance Information Institute

A recent report by Conning noted that price has been a significant driver of growth for general liability insurers over the years. After annual price increases in double-digit levels from 1999 through early 2003, prices have been easing for at least two years. It forecast that general liability insurers will see a moderation in premium reduction in the next couple of years, mostly price-driven.

However, losses and expenses are forecast to grow more quickly, with a resulting rise in combined ratios reaching 107 percent by 2010. According to Conning, there is reason to believe that losses will begin to accelerate further as the recession ends. While this is due in part to a cyclical increase observed in the years following previous recessionary periods, Conning also pointed to a longer-term secular trend, based on changing principles of liability and on societal and political changes underway in the country. The two effects may be enough to produce a sustained increase in losses for general liability insurers over a significant part of the next decade.[26]

Conclusion

In recent years, considerable successes at tort reform at both the federal and state level appear to have had a restraining influence on the rate of growth of U.S. tort costs. However, after a brief decline of 5.6 percent in 2006, tort costs are on the rise again. Against the backdrop of the financial crisis and the downturn in the economy, the change in political regime following the November 2008 elections heralds a sustained period of increased regulatory and legislative activity. These factors, combined with the plaintiff-friendly legal system that exists in the U.S., are causing the tort pendulum to swing against businesses and their insurers once more. Such changes will reshape the liability landscape and present insurers with growing liability risk management challenges in the months and years ahead.

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[26] *General Liability: Staying Relevant (and Profitable) in the New World of Risk*, Conning, 2009.