7. Tort law and insurance

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1. INTRODUCTION

In academic theory, the relationship between tort law and liability insurance is quite simple: they are two different things, to be kept strictly apart. First you determine liability and only afterwards, if at all, is liability insurance to be considered. In reality, however, things are – at the very least – a bit more complicated. Apart from some rare intentional torts, where liability insurance is not an issue (neither is compensation, usually, due to the limited resources of the tortfeasor), liability is normally something to be dealt with between liability insurer and injured party, or even between liability insurer and first-party insurer.1

The discrepancy between theory and reality has obvious historical reasons: tort law is one of the oldest areas of law and had been around for thousands of years before liability insurance came into play.2 Even when liability insurance did become an option, usually in the Nineteenth or Twentieth Centuries, it was still a long way to a society where almost every liability risk is insured by almost everyone, as is the case today in Europe and, to a lesser extent, in many countries around the world.

Some of the consequences of the central role of liability insurance in liability scenarios are quite obvious and accepted, as for instance its importance for compensating victims of accidents. Others seem a bit dubious, at least to some of the players involved, like the moral hazards that might arise from the knowledge that carelessness has no direct financial consequences since any potential damage would be covered by liability insurance.

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1 For more on the relationship between insurance and tort law see the Munich Re publication Tort law and liability insurance – an intricate relationship, Ina Ebert and Christian Lahnstein (eds.), Munich 2012; as well as Gerhard Wagner (ed.), Tort law and liability insurance, Vienna 2005.

2. TORT LAW AND INSURANCE

A. Liability Insurance

i. The deep-pockets aspect

a. Liability insurance and the compensation of victims  Tort law systems worldwide are usually based on the principle of full compensation of the victim, provided by the tortfeasor. Apart from minor damage, without liability insurers, this theory would almost always be an illusion. It would drive most tortfeasors into instant insolvency and still leave most victims of torts uncompensated for most of the damage suffered. Hardly anyone can pay the huge amounts of damages that, for example, a single bodily injury case or a negligently caused fire can easily result in, out of their own pocket. On the other hand, many defendants in liability claims would find it hard to defend their case on their own, without their defence costs being covered by their liability insurance.

In real life, it is normally the liability insurer who serves as paymaster, as real defendant of a liability claim: since liability insurance usually includes the coverage of defence costs, it is usually the liability insurer who pays the litigation expenses of the tortfeasor. Even more important, the amount of liability coverage available is one of the first aspects any plaintiff or plaintiff’s lawyer would take into consideration when deciding whom to sue and what amounts to ask for: coverage breeds claims. This is true for almost all kinds of liability insurance. However, it becomes most obvious in areas where the damage easily or even regularly exceeds amounts the tortfeasor, on his own, could ever come up with; that is, all areas involving severe bodily injury or huge amounts of economic loss. Without liability insurance, hardly anyone would dare to drive a car or bother to litigate a case involving medical malpractice or Directors and Officers (D&O) liability: a single case of severe bodily injury usually leads to damages awards of millions of dollars; just about any D&O claim far exceeds the assets of even the wealthiest manager. Therefore, without liability insurance backing up the defendant, it would not be worthwhile to pursue one’s claims, however valid they might be.

This last aspect is especially important in jurisdictions like the US, where contingency fees usually force lawyers to take the risks of litigation costs and thus make them the gatekeepers who decide which cases to bring to court: their investment in the early stages of litigation only makes sense if they can reasonably hope to enforce any damages awards they might achieve. It also explains why damages amounts in settlements of D&O claims tend to be similar or equal to the amount of liability coverage available and why in the US, where the compulsory liability coverage for car drivers is usually very low,3 product-liability claims against car manufacturers (with deeper pockets and higher liability coverage) are quite frequent, while in Europe, where compulsory liability coverage for car drivers is high, such claims are extremely rare.4

Of course, even this rule is not without exceptions: if the tortfeasor himself has extremely deep pockets, as for instance big oil companies after oil spills, the role of liability insurers is much more limited.

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3 See also below under b.
4 See Mathias Reimann, Product Liability, in this volume.
b. The impact of minimum coverage In Europe, expanding the European Union and its regulation (especially the 5th Motor Insurance Directive) to less wealthy countries has opened the doors to sharp increases in the amounts of damages awarded after car accidents, as new member states have to adjust their minimum coverage levels to EU standards. This is most clearly so in regard to awards for pain and suffering, since these, unlike other heads of damages, are not necessarily linked to national economic standards. Even though this usually has no impact on liability law ‘in the books’ – the principle of full compensation was in place before and left untouched – the rise in minimum coverage limits certainly helps to make full compensation a reality.

c. Fault and insurance The existence and degree of fault of the tortfeasor and potential comparative negligence of the victim are usually important aspects of assessing liability under tort law. In those areas of tort law, however, where compensation is almost always completely taken care of by a liability insurer, the rules of tort law about splitting the fault are frequently substituted by presumptions based on the experience of the liability insurers. The common practice of allocating fault and causation between participants of a traffic accident by motor liability insurers is the best example of this (e.g. the assumption that if two cars driving one behind the other crash, the driver of the car at the rear is at fault). Since most accidents never go to court but are finally decided by the insurer(s) involved, liability insurance thus in a way shapes tort law, if not ‘in the books’, then at least ‘in practice’.

Also, due to liability insurance coverage, the victim of a tortfeasor and the tortfeasor himself have the common interest of avoiding any verdict that establishes that the tortfeasor acted intentionally: while liability insurance usually covers all degrees of negligence, intentional acts are excluded. Therefore, not only the tortfeasor, who wants to avoid criminal sanctions or having to pay the damage himself, but also his victim, who is interested in receiving full compensation from the liability insurer instead of the normally very limited compensation the tortfeasor could provide himself, have a strong economic interest in proving that the tortfeasor acted merely negligently.

On the other hand, fault of the liability insurer can, at least in some legal systems, lead to an increase in the amount of compensatory damages awarded. For example, under German law, severe and unjustified delays when it comes to paying out compensation for pain and suffering after an accident is a well-established reason for sharply increasing the amounts of compensation for non-pecuniary loss: it is accepted that having to wait for the damages the victim of the accident legitimately demands increases their suffering and therefore justifies more money as compensation.

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5 Directive 2005/14/EC, now repealed by Directive 2009/103/EC.
6 More on this in the Munich Re publication, Compensation for pain and suffering – new trends in Europe and the USA, Ina Ebert (ed.), Munich 2012, p. 46.
d. Reduction clauses  Some legal systems, as for instance those of Switzerland and Finland, give judges the option to reduce the amounts of damages a tortfeasor has to pay, if the injury was not caused intentionally nor grossly negligent and having to pay full compensation would cause him hardship.8 Similarly, German tort law offers the option of considering the financial situation of the tortfeasor and reducing the amount of damages awarded, if liability is only based on equity, not fault.9 If, however, the injury is covered by the liability insurance of the tortfeasor, there is no danger of such hardship. Therefore the reduction clauses are not applicable and the victim can be sure to receive full compensation.

ii. Liability insurance and the deterrence function of tort law

a. Liability insurance as a way of enabling or preventing dangerous activities  The existence, or at least availability, of liability insurance gives legislators the option to introduce strict liability and courts the option to impose extremely stringent duties of care or shifts in the burden of proof without having to face scruples for driving liable parties into insolvency. While in the US this phenomenon is mainly limited to product liability,10 it is especially important in all non-common law countries. The de jure or at least de facto almost strict liability of parents for small children or the unlimited own liability of slightly older children would not, for instance, be as well established as it is in many European jurisdictions, were legislators and courts not able to find comfort in the knowledge that almost all families are covered by liability insurers. Also, the strict liability of car drivers would hardly be enforceable without (compulsory) liability insurance. In particular, this variety of strict liability is unlimited, while usually (as for instance in product liability in Europe) introducing strict liability is combined with caps limiting the maximum amounts for which someone can be held liable, at least for certain heads of damage. Of course, this function of liability insurance brings new challenges to courts and tort law, if in rare exceptional cases a defendant is not covered by liability insurance and his actions still have to be evaluated based on standards developed for people protected by liability insurance.

As for preventing politically undesirable activities, the almost non-existence of genetically modified food in Germany, not completely independently of the widespread reluctance of the insurance industry to cover liability risks in that context, illustrates how liability insurers can increase the deterrence function of tort.

b. Liability insurance and moral hazard  Probably the most obvious impact of liability insurance on the preventive function of tort law, however, is the moral hazard aspect: if potential tortfeasors know that any potential damage they might (negligently) cause will be covered by liability insurance, this reduces their related financial risk and thus the incentive to try to avoid such damage. The cost of liability insurance is usually

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8 Art. 44 of the Swedish Law of Obligations, Chapter 2, Section 1 of the Finnish Tort Liability Act.
9 § 829 of the German Civil Code (BGB).
10 Another example would be strict liability under the US Oil Pollution Act, 33 U.S.C.S. §§ 2701–2761.
too low to compensate for this reduction in the deterrence effect of tort law. It is virtually impossible to fully individualize the premium charged. Especially in motor insurance, the premiums the insured has to pay are determined by very general criteria, such as the numbers of miles the car is driven per year. In regard to accidents caused by the insured, only the number of accidents is taken into consideration when fixing the premium, not the severity of the accident and the amounts of damages paid to the victims.

This moral hazard aspect is less dangerous in areas of tort law where sanctions of criminal and administrative law and a connection between being negligent towards others and risking one’s own life and health take over the deterrence function of tort law, as for instance in the context of road traffic accidents. It is, however, not unproblematic in other liability scenarios, especially if tort law allows for punitive damages, which is one of the reasons why some US states\(^\text{11}\) prohibit covering punitive damages under liability insurance.

iii. Liability, coverage and reputational risks

After some accidents, tort law ‘in the books’ is just that: theory, not something suitable for finding a satisfactory solution or restoring peace and justice. Sometimes it is unavoidable that the tortfeasor goes above and beyond what tort law requires him to compensate to avoid severe reputational damage. This is frequently the case after serious accidents causing bodily injury to a wide range of people or substantial damage to the environment like oil spills, aviation or train accidents, and product or pharmaceutical liability. The pressure to pay more than liability law demands is usually increased severely if children are among the victims, if there is intensive media coverage, or if it is a cross-border case with victims from different jurisdictions and the scope of compensation provided for in the national liability systems involved varies considerably (e.g. some providing high amounts of compensation for bereavement in wrongful death cases and others providing no compensation for this at all).

In other scenarios it seems undesirable to hold someone liable, even though this would be possible under tort law: bringing claims against your neighbours or friends for not having supervised their child sufficiently to prevent damage; litigating against your employer or colleagues because of damage that has occurred because of their negligence.

In both cases insurance coverage can help to compensate the victim, by extending the scope of liability insurance or first-party insurance coverage, by substituting liability risks with accident insurance, or by covering measures to avoid or reduce reputational damage along with liability risks.

B. First-Party Insurance

Even though the influence of liability insurance on tort law is the most obvious way in which insurance and tort law interact, it is not the only line of insurance business that

shapes tort law. If private or social first-party insurance is easily available, the role of liability and tort law is limited accordingly. A good example of this is employer’s liability in Germany, which is almost exclusively reduced to (rare cases of) liability for discrimination and harassment, since social insurance takes care of the vast majority of unintentionally caused work-related accidents and illnesses.

Similarly, in countries with a comprehensive public healthcare system (e.g. Germany and England), the relevance of medical malpractice liability mainly depends on subrogation practices, not tort law: in these jurisdictions social insurance programmes or private first-party insurers cover most of the damage a medical malpractice victim might have. Therefore any liability claims of the victim against the doctor or hospital are transferred to his private first-party insurer or social insurance carrier. So it is not the victim, but the (private or social) insurer who has the right to subrogate against the tortfeasor and his liability insurer. Until a few years ago, social insurance carriers in particular made only limited use of this option. Recently, however, budget cuts have frequently changed this practice and made subrogation claims more common. Only claims for pain and suffering have not been affected by this conflict between first-party and liability insurance, since these heads of damage are normally not covered by social insurance schemes or first-party insurance. Consequently, medical malpractice liability litigation in Germany is usually limited to pain and suffering claims.

In countries where medical malpractice claims play a more important role, as for instance in the US, the desire to limit exploding health insurance costs can directly impact the scope of medical malpractice liability. Caps for pain and suffering awards in the healthcare sector, like those that exist in many US states, illustrate this: if damages awards for medical malpractice are frequent and substantial, paying them or, usually, paying premiums for medical malpractice liability insurance covering them, can significantly contribute to the total expenses for healthcare. Therefore, introducing caps, at least for non-economic damages, can help to considerably limit the costs involved and make healthcare more accessible.

On the other hand, if first-party insurance is more difficult to obtain or if subrogation rights are executed more vigorously, because first-party insurance losses become too frequent or substantial to ignore these options, this can open the door to new scenarios.

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13 However, such caps are not always considered to be constitutional, see e.g. Supreme Court of Alabama, Medical Center v. Hodgen, 884 So.2d 156 (Ala. 2003); Supreme Court of Illinois, LeBron v. Gottlieb Memorial Hospital (Ill. February 4, 2010) and Best v. Taylor Machine Works, 689 N.E.2d 1057 (Ill. 1997), or even prohibited by state constitutions such as e.g. Art. 2, § 31 Arizona Constitution; Art. 5, § 32 Arkansas Constitution; § 54 Kentucky Constitution; Art. 1, § 19a Ohio Constitution; Art. 23, § 7 Oklahoma Constitution; Art. 10, § 4 Wyoming Constitution.

for the application of tort law: those who suffer damage without being sufficiently covered by first-party insurance have to look elsewhere for deep pockets. First-party insurers and publicly financed or subsidized health insurers will feel an increased pressure to subrogate against potentially liable third parties if budgets become tight while expenses increase sharply. Consequently, liability claims after natural catastrophes, as we have seen after Hurricane Katrina, wildfires in California and Australia or in the climate change context, are no longer limited to a few professional indemnity cases. Instead, the ‘deep pockets’ of liability insurers are used to compensate losses that traditionally would be covered by first-party insurance. Claims against airlines or financial institutions after terrorist attacks have a similar background.

Finally, first-party insurance can take over the function of liability insurance if tort law has to surrender to new technologies: causation issues, difficulties in enforcing national tort law in a global scenario and other legal obstacles in the cyber liability context, force many actors in the cyber world to insure the risks involved in becoming the victim of a cyber tort through first-party insurance.

3. CONCLUSIONS

Tort law and insurance interact in many ways. The interaction is not restricted to, but is most obvious in, the context of liability insurance. Without liability insurance, full compensation for tort victims would often be an illusion. Liability insurers are the paymasters of tort law. Therefore, the amount of insurance coverage available frequently functions as a de facto liability cap. It determines who sues whom and for what amount. Liability insurance also limits the deterrence function of tort law and helps to channel the financial consequences of negligent torts by shifting the risk of having to pay compensation from the individual potential tortfeasor to smaller or larger groups of similar risk takers. On top of that, the availability or non-availability of (optional or compulsory) liability insurance can serve as a helpful tool for legislators, both to prevent or limit dangerous or otherwise politically undesirable activities or to enable dangerous but politically desirable ones.

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15 This phenomenon was discussed at the 15th International Liability Forum at Munich Re. See Is there a potential shift from first-party insurance claims to liability insurance as a consequence of natural catastrophes?, Ina Ebert (ed.), Munich Re, Munich 2012.