THE VIEW FROM LAW AND ECONOMICS

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I. Introduction

In this contribution to the project I will try to address the issues mentioned in the questionnaire from a law and economics perspective. This seems very useful since the economic analysis of law has on the one hand paid much attention to the functions of tort liability and on the other hand also examines the influence of insurance issues on tort liability, at least from a theoretical perspective. Hence, as far as possible, the issues mentioned in the questionnaire will be addressed indicating what the law and economics literature has to say with respect to each of them.

However, some of the issues in the questionnaire deal specifically with case law or opinions of the judiciary. These can of course not be answered in this contribution, which has a different nature. Whenever possible I will, however, indicate what the law and economics literature has mentioned concerning each of those issues.

This is of course not the first contribution on the economic analysis of tort law or insurance for the European Group on Tort Law. I would therefore like to refer to some of these earlier publications where the general approach of economics to tort law and insurance is explained.¹ These general issues will therefore not be further debated here. The starting point and basic assumptions of the economic analysis of tort law and insurance can therefore be presumed to be known: tort law is considered as a mechanism to deter accidents worth being deterred on efficiency grounds. The idea of holding the tortfeasor liable after the accident has happened is supposed to give him an ex ante incentive towards prevention. Insurance on the other hand is considered as a mechanism

to provide risk averse persons who are exposed to risk (this can be either the victim or the injurer) with compensation and thus with a protection against their risk aversion. However, since all insurance systems are vulnerable to the well-known risk of moral hazard, economics warns that adequate remedies should be built into the insurance contract to align the interest of the insured party (injuror or victim) with the interests of the insurer. If this optimal control of moral hazard can be achieved in theory, liability insurance can lead to a prevention of accidents in the same way as tort law can.

4 These very basic underlying principles of the economic analysis of tort law and insurance will now be used to address the issues mentioned in the questionnaire.

II. Compulsory and Voluntary Insurance

A. Compulsory Liability Insurance

5 The law and economics literature has paid a lot of attention to the question why the purchase of insurance, more particularly liability insurance, should under some circumstances be made compulsory. There are basically two main arguments that are formulated in favour of compulsory liability insurance, but there are also a few major arguments and warnings against compulsory (liability) insurance.

1. Economic Criteria for Compulsory Liability Insurance

a) Information Problems

6 Information problems might arise in case the potential injurer cannot make an accurate assessment of the risk he is exposed to and the benefits of the purchase of insurance. An underestimation of the risk would in that case lead to the wrongful decision of the injurer not to purchase liability insurance. The legislator could remedy this information problem by introducing a general duty to insure. This information problem is probably a valid argument to introduce a generalised duty to insure for motor vehicle owners. The average driver of a car may underestimate the benefits of insurance. If there were no information problem and the legislator nevertheless introduced a duty to insure because this would be "in the best interest" of the insured, this would of course be mere paternalism.

7 If empirical evidence existed that most injurers greatly underestimate the costs of damage caused by specific risks they may cause, and the probability that they will be held liable for this damage, this would then lead injurers to reserve too few resources to cover their potential liability. If these conditions are met and one can indeed assume that injurers underestimate the cost of acci-

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3 These arguments have also been discussed in M. Faure/D. Crineaud (supra fn. 1), 180–193 with respect to environmental liability insurance.
dents, this information deficiency may be considered an argument in favour of compulsory insurance. But again, the policy argument based on information asymmetry relates merely to the fact that the injurer would underestimate the potential benefits of insurance. There may, however, be another argument why the (uninformed) decision of an injurer not to insure may lead to under-deterrence. This policy argument is precisely related to the insolvency risk.

b) Externalisation through Insolvency

Another reason to introduce compulsory insurance is indeed an argument often used by lawyers, being the insolvency argument. The argument goes that the magnitude of the harm will often exceed the individual wealth of an injurer, whereby a problem of under-compensation of victims will arise. Lawyers would, hence, push forward compulsory insurance as an argument to guarantee an effective compensation to the victim. This – more distributional – argument obviously may play a role in the context of insurance of particular risks as well. Take the example of environmental pollution: if an injurer were found judgement proof and hence e.g. a polluted site would be “orphaned”, the costs would be borne by society.

It is, however, also possible to make an economic argument that insolvency will lead to under-deterrence problems which might be remedied through insurance. Indeed, this so-called “judgement proof” problem has been extensively dealt with in the economic literature. If the expected damage largely exceeds the injurer’s assets, the injurer will only have incentives to purchase insurance up to the amount of his own assets. He is indeed only exposed to the risk of losing his own assets in a liability suit. The judgement proof problem may therefore lead to underinsurance and thus to under-deterrence. Jost has rightly pointed at the fact that, in these circumstances of insolvency, compulsory insurance might provide a better outcome. By introducing a duty to purchase insurance coverage for the amount of the expected loss, better results will be obtained than with insolvency whereby the magnitude of the loss exceeds the injurer’s assets. In the latter case the injurer will indeed only consider the risk as one where he could at most lose his own assets and will set his standard of care accordingly. When the insurer is, under a duty to insure, exposed to full liability, he will have incentives to control the behaviour of the insured. Via the traditional instruments for the control of moral hazard, the

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4 These are discussed infra no. 12.
insurer can make sure that the injurer will take the necessary care to avoid an accident with the real magnitude of the loss. Thus Jost and Skogh argue that compulsory insurance can, provided that the moral hazard problem can be cured adequately, provide better results than under the judgement proof problem. This is probably another explanation why for instance for traffic liability compulsory insurance was introduced. Uninsured and insolvent drivers who have little money at stake which they may lose compared to the possible magnitude of accidents they may cause, may have little incentives to avoid an accident. Insurers might better be able to control this risk and could force the injurer to take care under the threat of shutting him out of the insurance. Thus the insurer comes under a duty to insure the licensor of the activity.

Indeed, this economic argument shows that insolvency may cause injurers to externalise harm: they may be engaged in activities, which may cause harm, which can largely exceed their assets. Without financial provisions these costs would be thrown on society and would hence be externalised instead of internalised. Such an internalisation can be reached if the insurer is able to control the behaviour of the insured. Through risk differentiation, the insurer could set appropriate policy conditions and ask an adequate premium. This shows that if the moral hazard problem can be cured adequately, insurance even leads to a higher deterrence than a situation without liability insurance and insolvency.

Of course, this argument in favour of compulsory insurance relies on a few assumptions and conditions, which will be discussed in further detail below. One is obviously that the argument is only valid if moral hazard can be controlled adequately and insurers also have appropriate incentives to do so. Another condition is that the insurance markets should be competitive. But one can notice that indeed both from a legal and from an economic point of view the potential insolvency of the injurer is a problem since it can lead to both under-deterrence and to under-compensation. Compulsory insurance may remedy both problems since it may provide adequate victim compensation and – if certain conditions are met – remedy the risk of under-deterrence.

2. A Few Warnings

a) Moral Hazard

Firstly, one should remember that with insurance there will always be the moral hazard problem. This means that even if a legislator decides to introduce compulsory insurance, he should not limit the possibilities of an insurer to control the moral hazard problem. Otherwise compulsory insurance will create more problems than it solves. Nevertheless, there seem to be problems in that respect since the legislator often limits the possibilities to expose the insured to risk. Indeed, with compulsory insurance the duty to insure is often equal to the total amount of liability and deductibles are not allowed. Hence, the total risk is shifted to the insurer which means that the only instrument available for the insurer to cure the moral hazard problem is a monitoring of
the insured. If this seemed difficult or very costly, the introduction of compulsory liability insurance might indeed create problems. Shavell even goes as far as to state that if the moral hazard problem cannot be controlled, the only regulatory intervention with respect to insurance should be a prohibition of liability insurance. In any case an introduction of compulsory insurance does seem problematic if the moral hazard problem cannot be controlled adequately.

b) Concentration on Insurance Markets

A second, related, issue is that until now we assumed that insurance markets are perfectly competitive and that thus premiums and policy conditions will be nicely tailored to the individual needs and the behaviour of the insured in order to control moral hazard optimally. In practice, however, many restrictions on insurance markets exist. We will give examples below. If monopolistic premiums can be set, an insurer will have fewer incentives to align his premiums to the individual behaviour of the insured and thus there is less control of the moral hazard problem.

From a policy viewpoint it also seems highly problematic to make liability insurance compulsory on concentrated insurance markets. Indeed, in that case the inefficiencies in the insurance market would be reinforced by making the purchase of insurance compulsory. The interest group theory of government can of course explain why insurers might want to lobby in favour of compulsory liability insurance. If they already can determine the supply-side of the market through monopolistic premium setting, all such insurers should strive for is that every possible injurer should be forced to purchase insurance coverage. Through this regulatory intervention a certain demand is then guaranteed as well.

Nevertheless in practice insurers are never enthusiastic concerning compulsory liability insurance. Cousy claims that this is related to the fact that as a matter of law under compulsory insurance the insurer can often not invoke defences against the third party beneficiary of insurance. Moreover there would be problems related to the implementation and actual carrying out of the obligation to insure.

c) Dependence upon the Insurance Market

There are some more reasons to formulate such a cautious warning. One is that the legislator should be aware of the fact that as soon as it introduces compulsory insurance, it becomes dependant upon insurers to fulfil this duty to insure. The practical possibilities of an effective enforcement of a duty to insure will obviously to a large extent depend upon the willingness to insure in that

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particular market. It will ultimately be the insurers who will decide whether they are willing to cover a certain risk. This may ultimately lead to the undesirable situation that the legislator would introduce a duty to take out compulsory insurance, but that the market would refuse to provide such coverage. Introducing a duty to insure leads to a high reliance of the policy maker upon the insurance market. This seems to have lead to problems with the German Environmental Liability Act of 1990 (Umwelthaftungsgesetz) which requires the owner of an installation that can cause significant damage to take out liability insurance or to have sufficient financial guarantees.  

17 One should indeed realise that if one makes the availability of insurance coverage a prerequisite for the operation of an enterprise, insurance undertakings in fact become the licensor of the industry, which may be questionable from a policy point of view. In fact, for instance in the environmental case, the insurer becomes the "environmental policeman". If that means, however, that the insurer, as a "policeman" controls the ecological performance of the insured company, there is of course nothing wrong with that. It may only be problematic if insurance companies will effectively be able to decide which companies may exercise their activities. This problem obviously especially arises in a monopolistic market.

18 This may, moreover, cause practical problems. Imagine that an insurer has stipulated in the policy conditions that coverage will be excluded in case of non-compliance of the insured written mandatory government regulation. This may well be an effective instrument to control moral hazard. If, however, an accident happens under compulsory insurance, the insured will not be able to call on this exclusion ground vis-à-vis the third party beneficiary of the liability insurance policy. The fact that defences in the insurance contract are not opposable to third parties is a well-known problem under compulsory insurance. The insurer will thus have to compensate the victim and may have a (statutory or contractual) legal right of recourse against the insured, provided that the latter is solvent. This is, as we explained, one of the reasons why insurers are reluctant to introduce compulsory insurances.

19 One could obviously argue that these problems can be remedied if a good cooperation takes place between the policy maker and the insurance world, whereby the insurance world would inform the policy maker on the insurability of systemic risks. However, practice has shown that information provided by insurers concerning the insurability of a certain risk or with respect to the available amounts of coverage may not always be reliable.  


10 This point is also made in the Green Paper, 13. See also J. Rogge (supra fn. 8), 40.


12 Infra no. 31, we will provide a few examples.
There seems to be a trade-off in that respect: introducing a duty to insure without any co-operation with the insurance world (which may have been the case in Germany) may lead to the catastrophic result that the government forces industry to take out a certain insurance coverage, whereby the market would not be willing to respond with the provision of such a coverage. However, a close co-operation between the insurers (usually represented via one insurance association) and the government only increases the risk of high concentration in insurance markets.

B. Compulsory First Party Insurance

1. Introduction

Economists have often stressed the blessings of first party insurance schemes. As well-known, in a first party insurance scheme the victim insures himself directly with an insurer or (in a direct insurance scheme) a third party (like an employer) takes insurance directly to the benefit of the victim. It is often held in the economic literature that these first party insurance schemes have as main advantage that they better enable a risk differentiation than liability insurance. The simple reason is that the victim can signal all his characteristics on whether he is a high or a low risk individual directly to the insurer, who can thus better exercise an adequate risk differentiation.\(^{13}\)

These economic lessons have been well understood by insurers. Nowadays one can increasingly find a tendency towards a use of first party insurances, for instance in environmental damage insurance\(^ {14}\) but a tendency towards an increasing use of first party insurances can, sometimes at the policy level, sometimes only in legal doctrine equally be found in the areas of occupational health,\(^ {15}\) traffic accidents and medical malpractice.\(^ {16}\)

However, the question arises whether from an economic perspective these advantages of first party insurance schemes are that high that they merit to be introduced mandatorily. Some indications on economic arguments in favour of such a duty can be found in the literature on social security. Indeed, there is often a small line between on the one hand first party accident insurances or

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\(^{15}\) See for the area of occupational health, M. Faure/T. Hartlieb, Social security versus tort law as instruments to compensate personal injuries: a Dutch law and economics perspective, in: U. Magnus (ed.), \textit{The impact of social security law on tort law} (2003), 253–255.

\(^{16}\) See for the area of medical malpractice J. Dute/M.G. Faure/H. Koziol (eds.), \textit{Liability for and insurability of biomedical research with human subjects in a comparative perspective} (2004).
health insurances and on the other hand social security systems. Without going into this literature in detail one can indicate that at least two economic arguments are traditionally advanced in favour of compulsory insurance.

2. Information Problems

Just as was the case with compulsory liability insurance, also in case of first party insurance or social security could one argue that most potential victims would probably largely benefit from an insurance covering them against risks of, say, hospitalisation. If no insurance were available, the victim would be exposed to enormous costs against which he is likely to be risk averse. Hence, the same information deficiency can be advanced as an argument for making some form of first party insurance (either through private insurance or through social security) mandatory e.g. for major medical risks. The argument then simply is that if victims were fully informed of the benefits of such insurance schemes and if they were fully informed of the risks involved (also the costs of a medical bill), they surely would take out insurance coverage. The information deficiency in this respect is then the motivation for a regulatory intervention.

However, in this respect one should again be cautious. It may probably be assumed that persons are highly averse towards e.g. the risks of having to pay a hospital bill, but it is not sure that this is the case as well for smaller risks, such as a visit to the doctor. Thus one can explain why there would be compulsory insurance for the larger risks, but probably not for smaller (health related) risks.

A second reason why economists would traditionally still be very cautious with generalised duties to purchase insurance coverage is that preferences among individuals in that respect can largely differ. Some potential victims may have a large demand for all inclusive coverage, but others may have a different attitude towards risk and may not have such a demand. An all inclusive duty e.g. for all citizens to purchase mandatory accident insurance may thus lead to a negative redistribution. Some victims may largely benefit from such an insurance, whereas others may not. A generalised duty then forces the good risk to subsidise bad risks. This form of cross subsidisation can be avoided if a first party insurance like accident insurances are largely offered but not imposed compulsorily.

3. Externality

The most important argument probably in case of compulsory first party insurance for e.g. large medical risks is the externality argument. If victims were uninsured (or not covered under social security), they could impose high costs on others, more particularly on society at large if they were hospitalised and unable to pay the bill. Thus uninsured victims could externalise their costs. This is probably the most important reason why ex ante, at least for those larger risks (involving high costs) societies have introduced compulsory first party
insurances, either through private first party insurances or through social security schemes.

4. Further Warnings

The further warnings as they were formulated above concerning compulsory liability insurance apply of course to compulsory first party insurance as well. Also here an adequate control of moral hazard through risk differentiation and sufficient competition in the insurance markets needs to be guaranteed, otherwise adverse results can be generated. The recent debate in the literature, e.g. on the introduction of compulsory insurance for flood risks, can illustrate this point. Victims seem largely to underestimate the risk of being victims of catastrophes such as flooding. Hence, there is a too low demand for disaster insurance. The information deficiency in this respect could thus again be used as an argument e.g. to impose additional disaster coverage on voluntary insurances.\(^1\) However, also in this respect, such a mandatory disaster coverage can be considered efficient only if adequate competition exists also with respect to this disaster coverage and if insurers can adequately control moral hazard through risk differentiation.\(^2\)

C. Monitoring

One of the questions refers to the issue whether the party who fails to comply with its obligation to insure should be subject to sanctions. The answer from an economic perspective is of course that this should be the case. The traditional economic model of crime and law enforcement indicates that appropriate sanctions should be set taking into account the probability of detection and the potential solvency of the wrongdoer. If compulsory insurance is introduced inter alia because insolvency is feared, then monetary sanctions may be inadequate. However, since non-monetary sanctions may be costly to impose economists would suggest increasing the probability of detection.

Indeed, if inadequate monitoring resulted in still many potential injurers exposing others to risks without fulfilling the insurance obligation, the underdeterrence would still follow or they would still be able to externalise their costs upon others. In this respect many differences still seem to exist between even neighbouring European countries. For instance as far as motor vehicle insurance in Belgium is concerned, no driver can obtain a licence plate for his car unless he shows that adequate insurance coverage is available. Moreover, on the occasion of an annual technical control the availability of sufficient coverage has to be shown again. In the Netherlands on the other hand the licence plate belongs to the car and drivers should take out in-

surance coverage, but monitoring is weak. One therefore has the impression that in the Netherlands the problem of uninsured driving is far more serious than in Belgium. This example shows that compulsory insurance needs to be accompanied with an ex ante monitoring system that guarantees as much as possible that no one can exercise the risky activity without the availability of insurance.

III. The Influence of Liability Insurance on Court Decisions in Tort Cases

A. Insurability

1. Legislation

In many cases insurability issues seem to influence discussions at the legislative level. During parliamentary debates one often hears discussions concerning the insurability of certain risks, whereby well intending politicians even consult insurers to ask for information concerning the insurability of particular risks. There is some reason to doubt that the limited capacity in the insurance market should, from an economic perspective, influence the legislator’s decision with respect to liability (a). Moreover, one on the other hand notices also that industry will often lobby in favour of a financial cap on liability, arguing that unlimited liability would be uninsurable (b). Finally, we will briefly address a few other features of tort liability that do influence insurability and that hence could play a role at the legislative level (c).

a) Limited Capacity and Public Policy Towards Insurance

Let us now first address the question what the influence is of the fact that insurance companies will not be able to cover every damage resulting from large risks, simply because their capacity is limited. We will argue below that capacity may obviously be limited, but this should not necessarily lead to all kinds of legislative interventions, e.g. to limit the liability of enterprises. First, we will argue that it is very difficult to provide accurate information on the actually available amounts of capacity; second, one should not only look at traditional insurance markets when judging capacity. If capacity on traditional insurance markets is limited and enterprises remain exposed to liability, this may give them an incentive to develop other financial mechanisms to cover risks. Third, limiting the liability of enterprises would not solve but only shift the problem. In that case the financial consequences of risks would not be borne any longer by those who caused them, but the damage would still be there. In other words, as a result of a limitation, the damage costs would then be shifted to the public at large (the general tax payers) which can hardly be seen as an adequate solution.

19 For an impression of alternatives to (liability) insurance to cover risks see M. Radetzki, Private arrangements to cover large-scale liabilities caused by nuclear and other industrial catastrophes, [2000] GPRI, 180–195 and M. Faure, Alternative compensation mechanisms as remedies for uninsurability of liability, [2004] GPRI, to be published.
The high possible magnitude of the expected damages does not make a certain risk as such uninsurable. One should remember that competitive insurance markets have worked out all kinds of devices to cope with relatively large risks as well. Tyran and Zweifel report for instance that if today an earthquake of the magnitude of the 1906 San Francisco earthquake happened, there would be insurance coverage available up to 39.5 billion US dollar\textsuperscript{21}. As far as environmental insurance is concerned, Ranson reported that the current insurance capacity in the European market would be € 100 million per insurance policy\textsuperscript{21}, which is quite substantial as well. More fundamentally we can refer to the discussion on caps below where it will be argued that the capacity problem is not an argument to introduce a financial limitation on liability. The individual insurer can always limit insurance coverage up to the amount for which he is willing to provide coverage, either himself or in combination with co-insurance, re-insurance or pooling. The capacity problem is therefore not a reason to argue that certain risks would be uninsurable; the capacity will only define the amount of coverage available which will be determined in contractual limitations. It is of course possible that the magnitude of the harm could still be larger than the insured amounts (even with pooling and re-insurance). This may then be an argument to examine whether alternative compensation mechanisms could provide for larger amounts than insurance.

Moreover the capacity to cover systemic risks depends on a variety of complex elements and not only upon the individual reserves of one insurer or his capacity to obtain reinsurance. For instance, the method of coverage in time may have a far more important influence on the insurability.\textsuperscript{22}

It is, at the policy level, dangerous to infer anything from the possibly limited capacity for covering systemic risks, since it appears to be extremely difficult to obtain reliable information on insurability in general, but more particularly on the capacity, from the insurance market. This difficulty is connected with the fact that insurance markets in countries are relatively highly concentrated. Lobbying theories have predicted that when an industrial sector has been well organised (e.g. in a cartel) their transaction costs will be low and their potential success in the field of lobbying may be large. This justifies the question whether the extent of liability should be judged on the basis of information provided by monopolistic insurers concerning insurance possibilities. If the argument that liability should be "insurable" is taken seriously, it is obviously of high importance for the policy maker to require reliable information on the actual insurability of certain risks (which is of course not limited to the actual availability of insurance in a particular country). Therefore, a well-functioning

\textsuperscript{21} This remarkable statement is a literal quote from D. Ranson, Verzekering van milieu-eenheid, [2000] Milieu- en Energierrecht (MER), 66–73, esp. 72.
\textsuperscript{22} For a summary of the literature in that respect see M. Faure/D. Grineaud (supra fn. 1), 166–170.
competitive market is of importance, so that the policy maker could e.g. consult with several companies what the precise possibilities of insurance coverage are.

36 Experience with the nuclear field has taught that the information provided may be unreliable if the policy maker becomes completely dependant upon information provided by a monopolistic insurer. Take the example of nuclear insurance which is dominated in every country by the so-called nuclear pools. In the Netherlands the Dutch government relied almost blindly on information provided by the Dutch nuclear pool on the availability of coverage for liability insurance when fixing the liability limit in the Dutch Act on Nuclear Liability of 26 June 1991. Minister Kok declared during the parliamentary debate that “during the whole preparation of the draft negotiations have taken place with the nuclear pool. In all cases the nuclear pool could agree with the proposals. There has hence been an optimal involvement of the sector”23. Critical voices have asked the question whether at the time the liability limit for the licensee of a nuclear power plant had to be set at the amount of 500 million Dutch guilders (approximately € 250 million) and should not be tested periodically according to the increasing possibilities of coverage in the private insurance market24, but the availability of insurance remained fully based on information provided by the nuclear pool25.

37 The fact that the policy maker often relies on information provided by monopolistic insurers to judge the capacity of the insurance market is obviously not merely a Dutch phenomenon. Precisely the same took place when the Belgian Act of 22 July 1985 concerning the liability of the licensee of a nuclear plant was discussed in parliament. Also in Belgium the government contacted the Belgian nuclear pool Syban, with the question whether an amount of more than 4 billion Belgian Francs (approximately € 100 million) would be available in third party liability coverage. Syban, the nuclear pool in Belgium, fiercely denied this. Later it turned out that the nuclear power plant itself is insured in first party insurance (property insurance) for an amount of more than 40 billion Belgian Francs. It is obviously relatively unclear why the nuclear pool only had an amount available for third party liability insurance of 4 billion Belgian Francs, whereas the damage to the nuclear installation itself could apparently be insured for 40 billion Belgian Francs26. This Belgian act has, by the way, meanwhile been changed, since the parliament accepted a legislative proposal to increase the amount of the licensee of a nuclear power plant to 12 billion Belgian Francs (approximate-

ly € 300 million)\(^2\). But that obviously does not change the points made here: again the amount was based on the insurability according to insurers.

These “nuclear” examples obviously also have importance for the question whether the legislation should take into account opinions of insurers on insurability when deciding on liability issues. The examples show that one should be careful with judging the “insurability” of a particular risk, more particularly concerning the capacity aspect, on the basis of information provided by insurers, at least when there is a high degree of concentration in this insurance market. It is striking that, with respect to the nuclear insurance, all national pools do not compete (in order to increase the capacity) but again co-operate. The national nuclear pools indeed only insure the nuclear installations on their own territory, so that there is no competition between these pools. This example shows that in the nuclear case the pooling takes the restrictions of competition further than would be necessary to increase the insurability of the nuclear liability risk.

This discussion shows that one has to be very careful with the argument that capacity may be limited. The policy one can recommend is to allow co-operation between insurers on the condition that it increases competition, which is precisely the spirit of the report of the European Commission of 12 May 1999 on the operation of the exemption regulation number 3932/92. Discussions on capacity obviously often play a role in justifying a financial cap on liability. We will, however, argue below that a limited capacity (regardless of how difficult it may be to judge this) should not necessarily lead to a limitation of the liability via financial caps but may eventually lead to a limitation on the amount of coverage provided by an individual insurer.

b) Financial Caps to Increase Insurability?

i) Capacity as Insurability Problem

We can now turn to the question whether statutory caps on liability are a necessary tool to guarantee the insurability of risks. This argument is often advanced in the context of compulsory insurance. Often the legislator introduced compulsory insurance (as a result of international conventions) and consequently argued that the amount of compensation in tort liability should be limited to make the particular risk insurable.

Generally one can argue that within liability insurance it is usually not (only) the amount of the expected damage that causes uninsurability of risks, but
more often the unpredictability of certain risks\textsuperscript{28}. The insurability question is indeed analysed by looking both at the probability and the magnitude of the risk. The amount is not necessarily the main problem since competitive insurance markets have worked out all kinds of devices to cope with large risks as well. Reinsurance, co-insurance, or pooling of risks are well-known phenomena that allow insurers to provide large amounts of insurance coverage. The high magnitude of the risk itself therefore does not make certain industrial accidents uninsurable per se. Moreover, as we shall discuss below, by adjusting the policy conditions the insurer can limit the amount for which he is willing to provide coverage.

42 Usually the problem of insurability of major risks refers to the “hard to predict” character of those risks which may make insurers both ambiguous and averse towards these risks. They might respond to insurer ambiguity\textsuperscript{29} by requiring an additional risk premium. The insured, however, may not be willing to pay the additional risk premium if they do not recognize the ambiguity an insurer is confronted with\textsuperscript{30}.

ii) Contractual Limits as Alternative

43 More principally, one can also argue that even in cases where there is a limited availability of insurance coverage (which is already hard to judge for the legislator, if possible at all) this should not necessarily lead to a limitation of the liability of the injurer who causes the particular systemic risk. If it appears indeed that the possibilities to obtain liability insurance coverage are limited to a certain amount, there is no reason to limit the liability itself to that same amount. A clear alternative would be to introduce a duty to insure up to the available amount of insurance coverage, but to keep the liability of the injurer unlimited. This will on the one hand have the advantage that the duty to insure is limited to realistic amounts, whereas on the other hand the incentives for the injurer to take care remain at least partially in existence because the injurer is still exposed to risk in case the magnitude of the harm would be higher than the insured amount.

44 From an economic point of view there are therefore very few convincing reasons to limit the amount of compensation due to the victim of a systemic risk. If insurability problems exist, they can be solved by limiting the duty to insure. Recent examples have also shown that, with respect to the nuclear liability conventions, some countries have introduced a duty to insure up to a limited amount, but have left the liability of the licensee of the nuclear power plant


\textsuperscript{30} These problems have been discussed extensively in M. Faure/P. Fenn, [1999] IRLE, 487–500.
itself unlimited. This has been done for instance in Austria, Germany, Japan, Switzerland and Sweden. The advantage of this approach is that in those cases where injurers have assets at stake that outweigh the limited amount for which they had to purchase insurance coverage, they will still have incentives to further reduce the accident risk. A generalized limit on liability does not take into account the differing financial possibilities of injurers and their insurers.

Although there are thus very few arguments in favour of a generalized statutory limitation of liability, this does not mean that there may be no reasons for a contractual limitation in insurance policies, covering systemic risks. In many insurance policies these limitations already exist since an insurer will hardly ever provide unlimited coverage for the particular risk concerned.

iii) Moral Hazard

There is another argument related to insurance which can be put forward against financial caps introduced in legislation. Statutory limitations could be contrary to the insurer’s interests, since they eliminate one way of reducing the moral hazard problem, which we will discuss in further detail below. There we will indicate that this remedy consists in exposing the insured party to risk for the uninsured top slice of liability. It should apparently be in the insurer’s interest to have a system of unlimited liability, where a partial exposure to risk may be used by the insurer as a device to control moral hazard and where on the other hand the insurer may put contractual limitations on the amount of coverage (in the absence of a duty to insure up to a certain amount) depending upon the demand for insurance of the particular injurer and the willingness to provide coverage of the insurer. Thus contractual limitations seem a better device which allow for an optimal differentiation of risk, thus providing optimal control of moral hazard.

iv) An Interest Group Perspective

So far we have argued that financial caps introduced in legislation might cause efficiency problems since they dilute the deterrent effect of tort rules, especially in those accident cases where the expected amount of the loss exceeds the limited amount of the cap. Caps would only make sense in a bilateral setting if one would argue that the victim’s care cannot be sufficiently controlled through a contributory negligence defence that he should still be exposed to risk. That seems, however, doubtful, given risk aversion of victims. If the leg-

islation which introduced financial caps were to pursue a public interest goal, one would therefore in principle expect them to abstain from the introduction of those caps. Reality is, however, often very different. For instance in the area of the nuclear risk, some countries have seriously limited the liability of the licensee of a nuclear power plant. For instance in Belgium the limitations were that low that the victim’s right to compensation is reduced to less than 1% of the average costs of an accident.34

The reason that these caps are often introduced can be found in interest group theories. Indeed, until now we have adopted the relatively unrealistic assumption that politicians act in the public interest and will therefore promulgate legislation with respect to liability rules and safety regulations only if this is welfare maximizing. Reality, however, shows that financial caps are not in the public interest. Especially the victim-protection argument which is sometimes used to defend the financial caps is a very weak defence for the existing liability schemes, e.g. with respect to a risk such as nuclear liability.35 Given the low limitations in some of the national implementation legislation one can conclude that in some cases the victims were better “protected” before the implementation of the nuclear liability legislation than after.36 These inefficiencies can be explained by public choice theory which regards regulation as the product of demand for regulation by interest groups and the supply by wealth maximizing politicians.37

How did this lobbying take place for instance with respect to the nuclear liability conventions? In the 1950s the nuclear industry feared that the future of nuclear power could be endangered by unlimited liability. In the preparatory documents preceding the Paris Convention on Nuclear Liability it can clearly be read that the goal of the regulation of nuclear liability was not so much the protection of victims, but the protection of the nuclear industry itself.38 There is qualitative evidence of the influence of the nuclear industry both in drafting the international conventions and especially in the national implementing legislation.39 Both insurers and the nuclear industry lobbied in a joint profit maximizing strategy for the limitation of liability. Indeed, some have argued that the object of these nuclear liability and oil pollution conventions was not so

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34 For estimates see M. Faure, Economic Models of Compensation for Damage Caused by Nuclear Accidents: Some Lessons for the Revision of the Paris and Vienna Conventions, [1995] European Journal of Law and Economics (EJLE), 29–31. As a result of recent changes the amount has, however, been increased. See T. Vanden Borre (supra fn. 27), 47–48.
36 This point has been made by M. Faure/R. Van den Bergh, [1990] IRLE, 241.
38 This has been convincingly proven in the recent dissertation by T. Vanden Borre (2001), 101–111 and 225–246.
much to increase protection for the victim, but to limit the risks of, for example, a nuclear power plant operator.\(^{50}\)

One can wonder why both insurers and nuclear power plant operators lobbied in favour of a limitation of compensation. The interests of industry are clear: financial caps lower the exposure to liability and (in case of insurance) the insurance premiums. Industry will lobby in favour of limiting its liability to the insured amount available. In that case the licensee of a nuclear power plant would bear no liability apart from the insured amount. At first glance it might seem strange that the insurance industry, for instance in Belgium, also favoured a reduction of the liability of the operator of a power plant. We already indicated that this may reduce the possibilities for the insurer to control moral hazard; in addition it also reduces the demand for insurance. However, one can clearly note in many national parliaments that the insurance industry lobbied for a limitation of the third-party liability of the operator to the “insurable” amount. One possible explanation is that, because of the unpredictability of the loss, premium calculation in a profit-maximizing manner is impossible, whereas premiums in other classes of insurance are profitable. Indeed the insurer of the nuclear risk prefers to cover property damage instead of third-party liability. One possible reason for this preference might be the fact that administrative costs can be much higher in a third-party nuclear insurance. This seems to be a plausible additional explanation for the lobbying in favour of a reduced third-party liability by the insurance industry. Hence, the influence of industrial pressure groups in the process of drafting legislation explains to some extent why financial caps have been introduced nevertheless.

Notice, in the European context, that the European Product Liability Directive had the optional possibility to put a financial ceiling on the liability of manufacturers in case of serial damage.\(^{51}\) However, only Germany, Spain and Portugal made use of this option.\(^{42}\) Now the Green paper has opened the debate to increase the option for a ceiling to € 140 million,\(^{43}\) but the question is equally asked whether the existence of financial limits is strictly justified.\(^{44}\) Hence, apparently the limit in the product liability directive is now put on the agenda for reform.

\(^{41}\) See, for instance, G.E. Van Maanen, Pleidooi voor verbetering van de rechtspositie van slachtoffers van kermongevallen, [1986] Nederlands Juristenblad (NJB), 1342; and G.E. Van Maanen, De civierechtelijke aansprakelijkheid voor kermongevallen naar Nederlands Recht, in: M. Faure (ed.), Aansprakelijkheid voor het Nucleaire Risico (1993), 19. Note, however, that both with respect to oil pollution and nuclear accidents, there is a tendency to amend the existing conventions to increase the available amounts as a result of political pressure. See, for the nuclear conventions, T. Vanden Borre, [2000] MER, 40–42.

\(^{42}\) Art. 16 of the Product Liability Directive.

\(^{43}\) See the overview of the transposition in domestic law of the Product Liability Directive, provided in the Green Paper on liability for defective products, 35–36.

\(^{44}\) It was set at 70 million ECU in art. 16 of the Directive for damage resulting from death or personal injury if it was caused by identical items with the same defect (serial damage).

\(^{45}\) Green paper on liability for defective products, 26.
v) Summary

52 The conclusion is relatively simple: although we realise quite well that the capacity of insurance and financial markets may be lower than the damage which may be caused by large risks, there seem to be relatively few reasons to introduce financial caps for those risks. Even if liability insurance were not available, the appropriate policy answer hardly seems to be the introduction of a cap, given risk aversion of victims. The better option seems to be to agree on the optimal amount of compensation via contract, which is, however, only possible when transaction costs are low, e.g. when victim and injurer stand in a relationship to each other via the price mechanism.

53 The basic argument against financial caps assumes that the injurer has assets at stake which exceed the amount of the financial cap and that the expected amount of the damage will be higher than the cap. However, a judgement proof problem may still arise. In that case the appropriate answer is not to limit liability to the amount the injurer has available, but to seek insurance coverage. Through diversified contractual arrangements between the insurer and the injurer an optimal amount of coverage can be determined in an individual case. The incentives can then be controlled via the risk differentiation in insurance and unlimited liability can apply for the excess, in case the expected loss would (ex post) be higher than the insured amount and the injurer would still have assets at stake. In some cases compulsory insurance might be an appropriate mechanism to control the judgement proof problem, but even compulsory insurance is no reason to introduce financial caps in legislation. The duty to purchase insurance coverage can be limited to a certain amount, but liability could remain unlimited.

c) Other Issues

54 There are, however, other ways in which the legislator, fixing the scope of liability, can take into account insurability issues. Indeed, some legislative decisions can increase the insurability of certain risks, whereas others will have the opposite effect. These concern more particularly the introduction of retroactive liability (i), shifting the risk of causal uncertainty (ii), joint and several liability (iii) and the channelling of liability (iv). Again, these issues have already been discussed in other contributions for the Group dealing with the economic analysis of tort law.\(^{45}\) Therefore here only the major results will be summarised. These other issues are important in the sense that these elements can indeed have an important bearing on liability and therefore the legislator could take important decisions to improve the insurability of specific risks.

i) Retroactive Liability: Uninsurable

55 It has been often stated in the economic analysis of law that, since tort law is a system aiming at providing incentives for future behaviour, a retroactive

\(^{45}\) See *inter alia* M. Faure/D. Grineaud (supra fn. 1), 160–179.
change of the liability system should be avoided since it can never affect the future incentives. The question whether a change in the liability regime can also affect the insurability can be answered relatively easily since a retrospective liability is no longer foreseeable and therefore collides with a principle requirement of insurance, being predictability of risks.

If the insurer were not aware that the behaviour of his insured party might potentially have been considered wrongful, at the time no premium would have been charged for this risk, no preventive measures would have been required in the policy conditions and no reserves against losses would have been set aside. Therefore it has often been held that a real retroactive liability where any change in the law was not foreseeable will pose problems for insurers. At the policy level one can therefore, as far as this issue is concerned, come to an easy conclusion: if the legislator wishes to increase the insurability of risks, retrospective liability should be avoided.

ii) Shifting the Risk of Causal Uncertainty

One of the major challenges in liability today is the issue how to deal with causal uncertainty. Often there is uncertainty concerning injurers or victims. With a view on victim protection the risk of causal uncertainty is often shifted to enterprises/injurers in general. Earlier I argued that this may be counter to the principles of liability law but it may also endanger the insurability of risks. The danger of shifting the burden of causal uncertainty to the enterprise is that the insurer of the specific employer or producer will be required to compensate for damage which, on the whole, had probably not been caused by the insured party. Unless a proportionate liability rule is followed, it is not possible to cover a risk if that would mean that the insurer would not only cover the damage of his own insured parties but also the damage that might possibly have been caused by another party. The upshot of these trends is that enterprises would be liable for risks that they have not caused themselves (in the case of causal uncertainty) or for risks that were not foreseen at the time when the tort was committed (in the case of retrospective liability). These tendencies stem largely from a hidden redistributive agenda: the wish to provide victim protection no matter what it may cost. These trends may be problematic from an insurability point of view.

At the policy level again the conclusion is simple: if there should be any influence of insurability on decisions of the legislator with respect to liability law, a proportionate liability rule should be preferred.


iii) Joint and Several Liability

There are other features which depart from the principle that an insurer can only be held liable for damage caused by the party insured by him. Joint and several liability is another departure from that principle. In that case the insurer can also be held liable for damage that another party may have caused. Although it has been advanced in the literature that joint and several liability may have a beneficial effect on prevention since it may lead to mutual monitoring by potential injurers, this benefit only remains valid if there is no insolvency of these injurers. 48 From an insurance perspective, joint and several liability may be dangerous for the simple reason that the insurer is then no longer merely insuring the risk posed by his insured party (which he can still control), but also the risk caused by all the others. 49 The welfare losses resulting from such a system of joint and several liability may be large. Mutual monitoring may ex ante not always be possible and the transaction costs involved (also in the systems of redress) can be huge. Hence, on balance it is doubtful that joint and several liability will have positive incentive effects. The insurance effect is, obviously, as the case of causal uncertainty illustrated, that an insurer will be held liable for the risks that his insured party never caused. The example of the DES-case, where the Dutch Supreme Court applied a joint and several liability rule de facto, may be recalled. This means that any victim can claim full compensation from any of the manufacturers. The insurer of the particular manufacturer then becomes de facto the insurer of the whole market. This trend towards joint and several liability seems therefore to endanger insurability. 50

At the policy level the conclusion is again easy: if insurability issues were to be taken into account by the legislator, the legislator should be careful with the introduction of a so-called joint and several liability.

iv) Channelling of Liability

There is another feature of some statutes and/or conventions dealing with risks like environmental or nuclear risks which again departs from the principle that only the injurer who caused the damage should be held fully liable for the loss. This is the so-called channelling of liability. Whereas with joint and several liability a victim can in principle claim full compensation from any of the multiple insured, under channelling the liability is channelled to one party who then becomes fully liable for the damage. This channelling, which indicates which party will be held liable for the loss, is often exclusive, meaning that the victim can only sue the “channelled injurer” and not another party who might have contributed to the loss as well. Channelling can be found again in international conventions concerning nuclear liability and oil pollu-

48 This issue has equally been further developed in M. Faure (supra fn. 46).
49 See H. Coucy (supra fn. 8), 235.
50 A. Monti, [2001] ERPL, 51–79. And see L. Bergkamp (supra fn. 47), 154 who argues that under joint and several liability, civil liability becomes unpredictable and hence uninsurable.
tion. In nuclear liability conventions, the liability is channelled to the licensee of a nuclear power plant; in the conventions concerning damage caused by marine oil pollution there is a channelling to the tanker owner.

It has been argued that this channelling is inefficient because it has perverse effects on the incentives to take care when the liability applies exclusively to one operator.\textsuperscript{51} This is the case if channelling means that victims no longer have the right to sue another party who could influence the accident risk as well. Excluding that third party from liability is inefficient since his incentives to take preventive measures would be diluted. This effect is obviously reduced if the licensee or operator who would be held liable still has a right of recourse against the third party or if liability could be passed on e.g. on the basis of contract. In that case, one could argue that the liability is simply transferred and that such a reallocation complies with the principles of the Coase theorem\textsuperscript{52}. However, this private reallocation of liability may not always be possible and some of the conventions, moreover, even restrict the possibilities of a right of recourse. Channelling can hence hardly be considered as an efficient mechanism for the prevention of accidents.

The reason that we discuss channelling within this paper on the relationship between liability and insurability is that some have argued that channelling might improve the insurability of risks. Some have held that e.g. as far as nuclear liability is concerned channelling has the advantage that only the licensee of a nuclear power plant would have to take out insurance coverage.\textsuperscript{53} Also, channelling in oil pollution cases is defended by arguing that it would reduce insurance costs since only the tanker owner would have to take out insurance coverage.\textsuperscript{54} This insurance argument is wrong\textsuperscript{55}. Let us assume that parties other than the licensee or tanker owner would be held liable; they could obviously purchase liability insurance as well. Otherwise as with an exclusive channelling, the insurer of the channelled operator would have to cover accidents also in case these have not been caused by his insured, but are allocated to him because of the channelling. Channelling thus creates a greater risk exposure for the operator and therefore creates higher uncertainty for the insurer. If the channelling has any effect on insurability, it is more likely to decrease insurability than to make liability more insurable, as is sometimes


\textsuperscript{55} So T. Vandeven Borre (supra fn. 51), 366-367.
argued. In sum, there seem to be few arguments in favour of a channelling of liability. This may dilute the incentives for prevention and could even endanger insurability.

2. Case Law

Also the issue whether insurance and insurability issues should influence tort decisions by courts has been discussed in the law and economics literature. To be very clear: as a starting point economists would argue that the choice between a strict liability and a negligence rule should not primarily be made on the basis of insurability arguments, but on the basis of economic arguments and criteria for strict liability, as they have been developed in the economic literature. Moreover, economists believe that a finding of liability ex post will affect the incentives of victims and injurers ex ante. Simply taking into account the actual availability of insurance does therefore not fit into the economic model. Economists would even argue that such an ad hoc policy, based on availability of insurance, could lead to perverse incentives, e.g. not to insure if one knew that this mere fact could give rise to liability.

As a starting point in court decisions, insurance and liability issues should therefore, at least from an economic perspective, be separated. Two different situations can be distinguished here: on the one hand sometimes arguments are heard that enterprises, manufacturers and in general companies would be better risk bearers and would thus better be able to insure their risks than victims or consumers. This argument can be called "assurabiliteit oblige" and needs some attention (a). On the other hand one could also decide in case law that the fact that one of the two parties in the accident setting purchased insurance is implicitly or explicitly an argument to make that party liable. That "assurance oblige" argument needs some attention as well (b). However, taking into account the famous Coase Theorem, economists would argue that the situation might be different in a contractual setting. Except for the product liability case (or perhaps medical liability) this will, however, rarely be the case in tort law. We, however, explicitly address the contractual case separately (c).

a) Assurabiliteit oblige

i) Cheapest Insurer

A first way in which this influence of insurance on liability issues appears is that the judge could take into account the insurability of a certain risk. This

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57 More particularly by M. Trebilcock. The role of insurance considerations in the choice of efficient civil liability rules, [1988] Journal of Law, Economics and Organisation (JLEO), 243–265, although the following analysis is somewhat different than the one by Trebilcock.
could be indicated as “assurabilité oblige”. The judge would thus examine which party can best purchase insurance coverage and should thus be held liable. This can also be referred to as “the cheapest insurer”-argument. What can be said with respect to this insurability argument from an economic point of view? Sometimes it is argued, for instance with respect to product liability, that the liability should rest with the manufacturer since he can purchase insurance coverage at lower costs than all the individual consumers who might become victims. 59

Hence, it is an argument which is often heard, being that enterprises would better be able to spread risks than individual consumers or victims. This “better risk spreader” argument takes different forms. Sometimes it is suggested that enterprises would better be able to obtain insurance than victims. Usually this is then presented as an argument in favour of strict enterprise liability.

ii) Wrong Focus

Firstly one could mention that it will often be impossible for a judge in a specific accident situation to look for the party that could have insured at the lowest costs. One should indeed not forget that the first task of the judge in a tort case is to examine whether all the parties involved took efficient care and to hold them eventually liable when the due care standard was not met. The risk of just looking for “the cheapest insurer” would be that the judge would not focus any more on the actual level of care of the parties involved in the accident. Moreover, it will be impossible for a judge to examine which party could have better insured unless one does so in very general terms mentioning for instance that a producer will always better be able to get insurance coverage than a poor victim.

iii) Who is “Better Insurer”?

The argument that producers/enterprises would better be able to carry risks and thus would be the “better insurer” would hint in the direction of strict (producer) liability. However, the insurability argument presented in this manner is simply wrong. Indeed, above it was already indicated that economic literature points at the fact that first party insurance better enables a risk differentiation than third party liability insurance. First party victim insurance better enables the narrowing of risk pools than third party liability insurance. If the insurability of the risk should therefore be an argument that should be taken into account in the liability case, it would rather be an argument against a strict producer liability. Indeed, from an insurance perspective victims are “better insurers” than injurers, given the advantages of first party insurance.

This obviously has implications at the liability level. Indeed: a strict liability rule will, assuming that the injurer is fully solvent, not lead to a demand for insurance with the victim, since the (presumably risk averse) victim will be fully covered through the strict liability rule. Strict liability will, however, lead to a demand for third party liability insurance by risk averse injurers. Negligence on the other hand does not lead to a demand for liability insurance with injurers since in the ideal case, injurers will always follow the optimal care standard in order to avoid liability. Hence, if the economic model works optimally, injurers will not have a demand for insurance coverage under negligence. This however has as effect that under negligence the victim in principle is not compensated. Risk averse victims will therefore have a demand for first party insurance under negligence.

If one therefore believes that the insurability should be taken into account at all at an abstract level of deciding which liability rule should be preferred, the economic reasoning is contrary to the legal intuition: since negligence leads to first party insurance by victims and strict liability to third party insurance by injurers, a negligence rule would be preferred since this better enables the risk differentiation through first party insurance. That is a standard result of economic literature\(^\text{60}\).

b) \textit{Assurance oblige: The Tort Case}

Sometimes legal doctrine or case law even goes one step further by deciding the liability in tort not just on the basis of a theoretical better insurability, but by taking the availability of insurance in a particular case into account in the liability issue.

This second approach of “assurance oblige” more or less bluntly states that the one who is insured should be held liable. Of course one can clearly recognize a “deepest pocket” argument here, which seeks a redistribution from the rich insurer to the poor victim. However, many objections can be made against this tendency especially if one believes that liability rules should have a deterrent effect as well. Moreover, one can also question whether this tendency can be upheld as “just”.

In the \textit{first} place it should be mentioned that an automatic finding of liability of the insured person neglects the deterrent function of tort law. If a non-insured knows that he will be fully compensated if he gets involved in an accident with an insured, this will reduce his incentives for taking care. Moreover, in bilateral accident situations both parties have to take efficient care to reach an optimal reduction of the accident risk. Thus also the “victim” should take efficient care to avoid the accident. An automatic finding of liability of the insured will therefore not give the correct incentives to potential victims and

\(^{60}\text{ See in this respect especially the publications by Epstein mentioned in fn. 13.}\)
might in the long term lead to an increase of the accident risk. It will indeed lead to a reduction of the incentives to take care of non-insured.

Secondly, it can be argued that the aforementioned tendency does not only negatively affect the victim’s incentives to take care, but also the incentives of the potential injurer. If the injurer knows ex ante that he will always be held liable because he is insured, this might also lower the deterrent effect of tort rules. Thus it will become even more complicated for an insurer to control the moral hazard problem via policy conditions.

Thirdly, it can be argued that, from a policy viewpoint, this tendency in case law has the strange effect of punishing a risk averse injurer that has been cautious enough to purchase liability insurance. He will indeed be sanctioned with liability if he has the bad luck of getting involved in an accident with a non-insured party. In the long run this might even give wrong incentives not to purchase liability insurance. A risk-averse party would even prefer not to purchase liability insurance to reduce the risk to be held liable automatically.

Fourthly, the idea to hold the insured party liable seems to be based on wrong ideas on the functioning of insurance. A finding of liability will of course lead to an ex post sharpening of policy conditions by the insurer such as the raising of premiums. Thus the consequences of the accident will be shifted to the injurer even though he might not have been able to take efficient care to avoid the accident. On the other hand, the imprudent victim who purchased no first party insurance is rewarded for his imprudence by getting the compensation paid by the injurer’s liability insurance. Here, once again, judges often seem to neglect that victims are already protected by compulsory first party insurance mechanisms designed by the social security system. An automatic finding of liability of the insured injurer will once more only lead to a right of redress of the first party health insurer of the victim against the injurer. Thus one could also argue that such an automatic finding of liability based on the principle “assurance oblige” is not only inefficient but also unjust.

Finally, it could be argued that it gets very complicated for the insurer to make an accurate actuarial assessment of the risk. In this case the insurer is indeed not covering any more the risk that his insured causes an accident, but the risk that he will hit an uninsured party. This, of course, makes a probability calculation highly complicated.

In sum, the conclusion of the economic literature on this point is relatively clear: the actual availability of insurance should not play any role in a tort case. The influence of the availability of insurance on liability issues may, on the contrary, even have adverse effects.
c) The Contract Case

Until now we assumed that we were dealing with the influence of insurance on tort liability; in that respect we claimed that, from an economic point of view, the availability of (or possibility to purchase) liability insurance should not influence tort liability issues. This outcome might, however, change if we are not merely discussing tort liability but liability for damage caused in a contractual setting. The main difference between the two systems is that in a contractual system free negotiations on risk between both parties are possible. Noble Prize Winner Ronald Coase indicated that if transaction costs are zero, an optimal allocation of resources will always take place, whatever the legal rule is. In for instance a product liability setting this means that if a purchaser of a product is fully informed of the possible defects and the product risk, he will always take into account the expected damage and add this to the market price to decide whether or not to purchase the product. The well-informed consumer will always take into account the full price of the product, which includes the expected damage. In that case the agreement on the distribution of risk might be reflected in the contract price. The price mechanism can have this signaling function to the consumer. If the market price reflects the expected damage, the consumer can know that the producer bears the accident risk. If, however, the market price only reflects the cost price of the product and not the expected damage, the well-informed consumer would know that he bears the accident risk himself.

This will of course also have an influence on the demand for insurance. If the price reflects the fact that the producer is going to bear the accident risk, a risk-averse injurer will purchase liability insurance and the consumer will in principle be compensated for his damage via the producer or the insurer. If, however, the price reflects that the consumer bears the risk himself, the risk-averse consumer might purchase first party insurance.

Thus, in a contractual setting the influence of the availability of insurance is a totally different one. The question is not so much which of both parties might be “the best insurer”, but what party can be assumed to bear the accident risk, taking into account the price of the service or product. In some case law it is argued that given the low price it cannot be assumed that it has been agreed that the producer bears the accident risk. This case law seems to follow the aforementioned line of reasoning. Also the fact that one of both parties purchased liability insurance can, in a contractual setting, indeed be considered as an indication that that party is assumed to bear the accident risk. Thus, as long as parties can be assumed to be reasonably well-informed on the accident risk, there seems to be an argument for case law to take into account the availability of insurance in a contractual setting.

3. Cost and Benefits of Insurance

Above, we discussed the issue mentioned in the questionnaire whether courts should base their judgment on the objective of risk spreading. We argued that from an economic perspective, it seems dangerous to base either decisions on an optimal liability rule or (especially) specific decisions in a liability case on this idea of risk spreading. If risk spreading is considered a relevant policy consideration, one instrument to reach this (but there are many other alternatives available as well) is insurance. Thus potential injurers and potential victims can take out insurance coverage and there is no a priori reason to believe that e.g. enterprises or producers would be in a better position to insure against a risk than consumers or potential victims. On the contrary, strictly speaking, victims and consumers are even in a better position to insure against risks since they can purchase first party insurance which enables a better risk differentiation. In this respect, we can refer to the discussion above.

B. Standard of Care

The economic notion of moral hazard is of course the core of insurance economics. Moral hazard is the well-known phenomenon that the behaviour of the insured injurer (and every insured for that matter) will change as soon as the risk is removed from him. This is precisely the essential contradiction in liability insurance. The disutility the injurer suffers because of his exposure to risk was precisely needed to give him correct incentives for taking care.

If risk is fully removed from the injurer and shifted to the insurer, the injurer will indeed miss the incentive for taking care that was exactly given to him by the deterrent effect of having to pay compensation in case of an accident. Marc Pauly has, however, indicated that in fact this behaviour of the injurer is not immoral but completely rational since he simply reacts to varying costs for his behaviour. For the insurer of course the problem arises how nevertheless incentives can be given to the insured to behave in exactly the same way as if no insurance were available. This is of course the goal of an optimal control of moral hazard.

1. Remedies

a) Monitoring

In the literature two ways of controlling the moral hazard problem are indicated. The first is a control of the insured and an appropriate adaptation of the premium; the second is exposing the insured partially to risk. A first best

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solution is a detailed control of the insured\textsuperscript{66}. In that case the premium conditions would be exactly adapted to the behaviour of the insured and the premium would reflect the care taken by the insured. In an optimal world this should give the insured incentives to behave exactly as if no insurance were available and the premium would reflect the true accident risk. Of course this first best solution is only possible in the ideal world where control by the insurance company would be costless and information on the behaviour of the insured readily available. In practice this is of course not true. There are, however, some means for a control of the insured and a differentiation of premium conditions is possible according to certain groups of risk. This can either be an \textit{ante} screening with a higher premium for certain high risk groups or an \textit{post} premium increase or change of policy conditions, based on previous loss experience. This is the so-called experience rating. Much of insurance legislation is also aimed at reducing moral hazard. Think in this respect e.g. of the prohibition, contained in many insurance laws, to insure accidents which are caused with intent\textsuperscript{67}.

b) Exposing the Insured to Risk

A second best solution is exposing the insured partially to risk. This is considered second best because insurance should ideally exactly aim at removing risk from the injurer. Exposing the insured to risk means that some degree of risk aversion will remain. This has on the other hand the advantage that the insured injurer will still have some incentives for taking care although he is insured. This exposure to risk can be either at the lower level of damage or at the higher level. One could indeed think of a system with a deductible whereby a lower threshold applies or one could introduce an upper limit on coverage whereby the insured bears his own loss in case the damage exceeds the insured amount.

c) Combination

In practice one will of course see a combination of both systems of the control of moral hazard. Usually there is some degree of differentiation within the policy conditions, a deductible and an upper limit on coverage. Of course the methods used depend upon the information costs, but also on the value of the insurance policy\textsuperscript{68}. Obviously an insurer will more readily tend to invest resources in making a nicely tailored insurance policy for a large company that pays a substantial premium than in case of consumer risks.


2. Result

If moral hazard is controlled optimally through the use of the above mentioned devices, the insured will again behave as if no insurance coverage were available, with the benefit that the disutility of risk is removed from him. The incentives for taking care are in that case no longer given by liability law since the threat to have to pay compensation to a victim is shifted to the insurance company. In case of insurance that the injurer takes care is achieved through an appropriate adaptation of the policy conditions to the behaviour of the individual insured. This also explains that liability insurance has a very important social function. Under liability insurance the insurer has to guarantee that the insured will take efficient care and thus have an incentive to avoid accidents. This makes clear that an appropriate control of moral hazard is not only in the interest of the individual insurer, but also of society. If there was no efficient control of moral hazard, insurance would on the whole do more bad than good. In sum, if moral hazard can be controlled optimally through insurance, the availability of liability insurance should have no influence at all on actual care levels. If there were such an influence, this would mean that moral hazard has not been controlled optimally.

3. Other Issues Influencing Care Levels

As we have argued above, the mere fact that the defendant is insured should, from an economic perspective, have no influence at all on the standard of care required from him, nor should it have any influence on the determination of comparative negligence. In this respect, we can refer to the discussion above.

Also the fact that the victim would be covered through a first party insurance should, from an economic perspective, have no influence at all on the care level required from the injurer. If the reverse were true, this would mean that a defendant would be rewarded for the fact that his victim had a first party insurance. From an economic perspective, that would give wrong signals to the injurer whose incentives for prevention would be negatively affected. Hence, economists would hold that injurers should be held fully liable (of course if the efficient conditions for such a liability are met), irrespective of the availability of first party cover by the victim. If, however, a victim were already fully covered by his first party insurer, this should not have an influence on the level of care, but it can of course have an influence on the level of damages. In order to avoid a double compensation of the victim, the right procedure would be that the first party insurer who has compensated the victim exercises a right of recourse against the injurer. The rationale for the necessity of a right of recourse by private and social insurers vis-à-vis the injurer who is liable in tort is simple: the injurer who creates the risk has to be exposed to the full cost. The absence of a right of recourse would lead to under-deterrence of the injurer.\(^{69}\)

\(^{69}\) See further on the economic rationale of the right of recourse M. Fiure/T. Hartlief (supra fn. 15), 255–263, nos. 86–109.
C. General Duty to Insure

92 The question is asked whether, according to economics, there should be a general duty on parties to obtain insurance coverage which should be sanctioned in case of non-compliance. Generally, economics is, as was indicated above, careful with suggestions towards compulsory insurance. Moreover, the most important reason for imposing such a duty could be found in market failures such as information deficiencies or externalities. In the absence of market failures, economists would not generally argue that there should be a duty to obtain insurance coverage. Moreover, market failure would lead to a preference for a legislative intervention and not for corrections by a judge in a tort case, as is suggested in the questionnaire.

93 The underlying assumption in the questionnaire is that a party had failed to obtain liability insurance, would therefore be found insolvent and would thus be punished for this failure of obtaining insurance coverage. This reasoning is, however, from an economic perspective rather strange. The issue of liability should, again, be treated differently from the question whether a risk averse person might have a demand for insurance. The liability issue in itself should therefore never be decided only on the basis of the availability of insurance. From an injurer’s perspective this also becomes rather strange: on the one hand, lawyers would argue that someone is liable because he failed to take insurance coverage; on the other hand, the fact of having insurance coverage might precisely lead to a finding of liability as well (assurance oblige). This illustrates that the availability of insurance in itself is no meaningful criterion to decide the liability issue.

94 Moreover, the question whether an injurer should or should not take out liability insurance depends upon a number of factors, one of them being his attitude towards risk. One may not forget in this respect that for economists, liability insurance is a mechanism to protect a potentially liable injurer against disutility suffered from risk aversion. It is not primarily an instrument to guarantee compensation to the victim. If one would, at the policy level, desire a victim compensation, mandatory first party insurance by victims would be the better alternative. If, on the other hand, the absence of insurance by the injurer constituted a market failure, the appropriate remedy would seem to be a legislative intervention forcing the potential injurer to take out insurance coverage. Deciding that an injurer be held liable solely on the basis of the fact that he did not take out insurance coverage seems odd. The issue of liability should be decided in itself upon the relevant criteria. If the court comes to the conclusion that the injurer should be held liable and then finds that there is insolvency because of the failure to take out insurance coverage, a second finding of liability does not seem to be a very effective remedy.

95 As far as the issue is concerned whether employers should be under a duty to take out liability insurance covering the torts of their employees, again the general principles mentioned above can be applied: if there were generally an
information deficiency concerning the advantages of liability insurance or if there were a serious insolvency risk whereby employees of employers could cause damage largely exceeding the employer’s wealth, this would mean that employers could, through their insolvency, externalize costs. That would be a general argument in favour of compulsory liability insurance. But again, the general warnings (appropriate control of moral hazard and sufficient competition in insurance markets) need to be taken into account as well.

Remember, moreover, that it has been indicated in the literature that specifically for the issue of occupational health, a direct insurance of the employer to the benefit of employees who suffer occupational hazards might be more efficient than an outright system of employer’s liability. Again, such a direct insurance might better enable risk differentiation and would therefore be preferred\(^{70}\).

D. Insurance and Damages

1. General

The issue whether the availability of insurance with the defendant should affect the assessment of damages was briefly touched upon above: in principle, economics would hold that an injurer should be exposed to the full costs of the risk he created which will provide the correct incentives to follow the optimal care standard in order to prevent the risk. The fact that through liability insurance the risk has subsequently been shifted to an insurer, in principle makes no difference. In that case the optimal level of care will not be induced through liability rules directly, but through the efficient control of moral hazard by the insurer\(^{71}\). Hence, there is from an economic perspective prima facie no reason to be more lenient or strict with the assessment of damages as a result of the mere fact that an injurer is insured. Any decision concerning the assessment of damages will in principle be passed on by the insurer to the insured injurer, e.g. through an adaptation of the premium or other policy conditions. Hence, if one were e.g. to assess the damages at a lower amount because the injurer is insured, the insurer would have less incentives to control the injurer’s behaviour and under-deterrence would follow.

2. Punitive Damages

Some question could be asked on the insurability of punitive damages. It is well known that in particular countries where liability risks for insurers have been expanding, it was more particularly the introduction of punitive damages that was seen as a great danger. Also in the US system, the unpredictability of jury awards and punitive damages cause major headaches to insurers.

\(^{70}\) This issue has been further developed in M. Faure/T. Hartlief (supra fn. 15), 254–255, nos. 82–85.

\(^{71}\) See supra no. 12.
Here again, the general principles apply. Of course for every insurance scheme, it is crucial that the insurer possesses accurate information on the likelihood that the event will occur (the probability) and on the possible magnitude of the damage once the accident occurs. These expectations on probability and magnitude of the loss are essential for the insurer to be able to calculate his so-called actuarially fair premium. Increased with the so-called loading costs (for among others administrative expenses) and, depending on the market structure, a profit margin, this will constitute the premium to be paid by the insured.

If the insurer ideally has ex ante perfect information on the predictability of the probability and the magnitude of the damage, we call the particular risk insurable. It is precisely on the basis of statistics that the insurer will acquire information on the likelihood that the risk will occur with a particular insured; statistics may also provide information on the possible magnitude of the damage. Both these requirements may, however, be a problem in the case of the insurance of punitive damages. Several elements may negatively influence the ex ante predictability of the risk. The ex ante information on the predictability of the risk is often low, given the unpredictable nature of the imposition of punitive damages. Reliable statistics may sometimes be missing both with respect to the probability of the event occurring (the imposition) and with respect to the amount of the punitive damages. Hence, there may not be a “law of large numbers” to be applied. This obviously is not only a problem for punitive damages, but occurs in every case where insurers are confronted with relatively new risks, where reliable data may be missing. As far as for instance natural resource damage is concerned, a problem lies in the fact that generally accepted measurement techniques to quantify environmental damage may be lacking.

A similar problem may arise with punitive damages. In that case, both the likelihood that e.g. a jury or court will impose punitive damages may be difficult to assess and the same may be true for the precise amount. This may make insurability more difficult, but it must not necessarily make the risk uninsurable. Indeed, the question therefore arises whether the predictability of the liability risk can be increased, even in the absence of reliable statistics or whether in that case the particular risk should be judged as uninsurable. The literature has indicated that uncertainty concerning the probability or the damage is of course an element with which the insurer can – in principle – take account ex ante. If there is uncertainty because of a lack of reliable statistics, this should not necessarily lead to the conclusion that a particular risk is uninsurable. We are then dealing with the concept referred to as “insurer ambiguity”

Monte rightly points out that the fact that there may be both factual and legal uncertainty: A. Monte, [2001] ERPL, 51–79.

The unpredictability of punitive damages, especially when awarded by juries was recently confirmed in an empirical research by J. Hersch/W.K. Viscusi, Punitive Damages: How Judges and Juries Perform, [2004] 33 JLS, 1–36.

White Paper on environmental liability, 23.
addressed by Kunreuther, Hogarth and Meszaros\textsuperscript{13}. They argue that the insurer can react to this uncertainty concerning either the probability of the event or the magnitude of the damage by charging a so-called risk premium to account for this unpredictability. Hence, an insurer can in principle also deal with a “hard to predict” event, by charging an additional premium. Hence, on the basis of this analysis, one can argue that even a “hard to predict” risk like punitive damages should be insurable, but that an additional risk premium should be charged. The alternative is obviously that insurers would simply \textit{ex ante} exclude coverage for punitive damages.

3. Non-Pecuniary Loss

As far as the relationship between insurance and non-pecuniary loss is concerned, again one can argue that the fact that a liable injurer has third party insurance should not affect the amount of the damages awarded for non-pecuniary losses. From an economic perspective, non-pecuniary losses are to be compensated to provide deterrence to injurers. It remains important to expose injurers to the full costs of their activity and this may also include exposure to non-pecuniary losses. However, note that several economists have stressed that as such, there would be no (first party) demand for the compensation of non-pecuniary losses. It is for that reason that economists stress that it is particularly for the deterrent effect of tort law that non-pecuniary losses should be compensated, but not for the compensatory function\textsuperscript{16}.

E. Privileges

The issue of privileges has also been addressed from an economic perspective in the report on fault\textsuperscript{17}.

Economists generally argue that everyone should be held to the efficient level of care, even if that would mean that some individuals with lower capacities were not able to reach that efficient level of care. Economists would then hold that the liability will give them incentives to change their activity. However, for persons who are totally incapacitated, a liability rule would make no sense for the simple reason that liability could never positively affect their incentives for care. Remarkably in some legal systems, such as e.g. in Belgium, mentally disabled persons have a greater chance of being held liable as soon as an insurance policy covers their liability\textsuperscript{18}. These are cases (probably also in other legal systems) where insurability is explicitly taken into account. In case of the availability of insurance, the privilege for the mentally disabled person apparently no longer applies.


\textsuperscript{16} This argument is further developed in my contribution to the Liber Amicorum for Helmut Koziol (M. Faure, Compensation of non pecuniary loss: an economic perspective, in: U. Magnus/J. Spier (eds.), European tort law, Liber amicorum for Helmut Koziol (2000), 143–159.)


F. Insurance and Agreements to Limit or Exclude Tort Liability

In this respect, we can be brief and refer to the discussion above. There it was argued that in a contractual case, where there is thus an implicit or explicit agreement to exclude or limit tort liability it does make sense to take the availability of insurance into account. In the contract case, parties can (if we assume away information problems) negotiate on the optimal level of care to be taken, the liability in case of non-performance and the allocation of damages. This can result in an implicit agreement on who should take out insurance coverage and on the price to be paid.

IV. Concluding Remarks

In this contribution to the project on the relationship between tort liability and insurance, the influence of liability law and insurance and vice versa was addressed from an economic perspective, following as far as possible the questionnaire. Attention was paid to influences on the legislator and on case law.

The fear of insolvency of the injurer has led several legislators to take steps to guarantee an effective compensation to the victim. One of these steps has traditionally been the introduction of a statutory duty to insure. In that case apparently the fear that a tort judgment could not be executed leads to an interference in insurance markets by making the purchase of liability insurance coverage compulsory in some cases. But exactly this phenomenon of compulsory insurance has also led several legislators to limit tort liability because unlimited risks would be uninsurable. Hence, the insurability itself influences the amount of compensation due under tort law. These types of influence between insurance and tort law can also be found in case law where the insurability or even the availability of insurance is taken into account to decide upon the liability under tort law.

The introduction of compulsory insurance can be justified by the lack of information on the benefits of insurance on the part of some injurers and as a means to cure the externality caused by the insolvency problem. However, in many cases other mechanisms exist that might cure the insolvency problem at lower costs. Especially the possibilities of a compensation fund or first party victim insurance need further examination in that respect. If insurance markets are not competitive and/or the moral hazard problem cannot be controlled, the introduction of a duty to insure will probably cause more problems than it solves; therefore the legislator should always be extremely cautious with the introduction of compulsory insurance. Nevertheless, one can note that the legislator often introduces either a limitation of liability or a duty to insure if the economic conditions for these interventions are not met. In those cases these interventions can be explained as the result of lobbying by interest groups.

As far as the influence on case law is concerned, one can note an increasing tendency to take into account both the possibility to insure (assurabilité oblige) and the availability of insurance (assurance oblige) to decide tort law
cases. This “insurability argument” is not very useful since, contrary to what is often assumed, victims will often be the better insurers than providers of services or products since victims can purchase first party insurance. This allows better for a narrowing of risk pools than third party liability insurance. Also the tendency in case law to hold the party who has insurance coverage liable does not fit into the economic model of accident law. It neglects the deterrent function a liability suit has. This tendency can also be criticized from a corrective justice point of view since it punishes the careful party who purchased insurance coverage with a finding of liability and thus with an ex post premium increase. Taking into account the availability of insurance makes, however, more sense in a contractual setting, where a victim and injurer can in principle ex ante negotiate on the distribution of risk among others via the price mechanism. The price mechanism could give an indication of which of the parties was supposed to bear the risk in case of an accident. In such a contractual situation the availability of insurance might also be one of the indications on the agreed distribution of risk between the parties.

We have, however, indicated that if the legislator wished to increase the insurability of certain risks, there would certainly be specific elements that the legislator could take into account when drafting liability legislation. Law and economics can provide a few clear tips in that respect: avoid the introduction of retrospective liability, introduce, in case of causal uncertainty, a proportionate liability rule and be careful with the introduction of joint and several liability. These are all elements where the risk exists that one would depart from the principle that the insurer should only be held to compensate for the damage caused by his insured injurer. It should therefore be avoided that he be held liable as well for damage that his insured injurer has not caused or that could not be influenced by his insured (like in the case of retrospective liability). Channelling of liability on the other hand has sometimes been advanced as an instrument to increase insurability, but we have argued that it is very doubtful that channelling does improve insurability. It may, on the contrary, have negative effects on prevention.

In this paper I have also tried to demonstrate generally the usefulness of the economic analysis of legal rules. By making a clear distinction between the various goals of tort law, such as deterrence and compensation, the economic methodology can indicate what legal instruments can be used to reach those goals. Law and economics can also point at some negative and unexpected effects of legislative and or jurisprudential interventions. Of course, law and economics remains in the first place a positive theory that attempts to explain the existing legal rules as they are. But if, however, efficiency is considered as one of the goals of European policy, law and economics can also provide some useful insights that can be used when new legislative instruments such as financial caps or compulsory insurance are considered.