The Influence of Insurance on Liability Issues

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1. Introduction

No one will deny that the phenomenon of liability insurance has a considerable influence on liability issues. Both in legislation, case law and legal doctrine insurance aspects are often taken into account when the liability issues are discussed. Some proposals to reform tort law even go as far as to propose to abrogate tort law altogether, at least in some fields of accident law, to replace it by a generalized system of insurance. These kinds of proposals have especially been formulated in the field of traffic accidents. Most of these and other proposals do not seem to attach much belief to the deterrent function of tort law. The mentioned proposals of generalized insurance stress the need to compensate victims. Victim compensation also seems to be the major goal of tendencies in case law to take into account the availability of insurance to decide upon liability issues.

In this paper I would like to address this increasing influence of insurance on liability issues.

Looking at these problems in a European context one is of course confronted with various legal systems in the national member states that treat these issues to a large extent differently. Therefore, in this paper I will use a methodology that allows me to address the influence of insurance on liability issues on a more abstract level, without discussing the state of the law in one particular country in too much detail. This abstract look on the influence of insurance on liability law can be provided by the economic analysis of tort law. This law and economics approach which is highly popular in the United States since Richard Posner published the first edition of his economic analysis of law in 1973 receives an increasing interest in Europe as well. I will try to demonstrate the usefulness of this economic approach to law by applying it to the influence of insurance on liability law. Especially when looking at a general problem such as this with different solutions in various countries law and economics seems to allow for a more abstract approach. Thus it might contribute to a finding of a common law of Europe. A benefit of the economic approach is also that it allows for a clear analysis that shows how various legal instruments can reach either the deterrence or the compensation goal of tort law and how other instruments might negatively effect the reaching of these goals. Hence, it also allows for a normative use, although one should of course take into account that other values than the one used in the economic approach, being the efficiency criteria, might play a role in the legal system as well. This policy relevance is of course of particular importance in the European context since it allows to analyse already existing European documents in which some aspects of the influence of insurance on liability issues are dealt with. In addition it allows me to address the question whether a further intervention at the European level seems appropriate.

1 I thank Tom Vanden Broeck for helpful research assistance, as well as Jan Rinkel and Sylvia Kuenenmakers for useful comments. This paper is an extension of earlier work with Roger van den Bergh (See Van den Bergh, R. and Puur, M., "De invloed van verspreiding op de civiele aansprakelijkheid: een rechtseconomistische analyse", Van den Bergh, R., Puur, M., Hartniet, T. and Tjittes, R., De invloed van verspreiding op de civiele aansprakelijkheid: Praktijken uitgebreid voor de vereniging voor buitengewelijk recht, Leiden, Koninklijke Vereniging, 1990, 9-53.


Several aspects of the influence of insurance on liability issues will be dealt with in this paper. After this introduction (I) I will give a brief overview of the basic notions of the economics of accident law and of liability insurance (II). Then I will turn to the influence insurance has on the legislator (III), which can mostly be found in the introduction of financial caps on liability (A) and in the introduction of compulsory liability insurance (B). The availability of insurance also plays a considerable role in concrete accident cases. Therefore the influence of insurance on case law will be examined (IV), whereby some examples of this influence will be given (A) and an economic analysis will be provided (B). Attention should of course also be paid to the European perspective. Should the availability of insurance influence the European legislator with respect to liability law and should there be any harmonization in this respect on the European level? Finally a few concluding remarks will be formulated (VI).

II. Some Basic Notions of the Economics of Accident Law and Insurance

A. Economic Principles of Accident Law

The economic analysis of law in general and of accident law more specifically starts from the belief that a legal rule and more in particular a finding of liability will give incentives to potential parties in an accident setting for careful behaviour. Thus, economists tend to stress the deterrent function of tort law. Lawyers, on the other hand, mention this deterrent function sometimes as well, but tend to attach more value to the compensation goal of accident law. This "victim protection"-argument is discussed in the law and economics literature as well. In that respect it is, however, often stressed that the best way of victim protection is to avoid victimisation in the first place. Of course no one will argue that prevention of accidents is not a way of victim protection as well. This difference in accents between both approaches is also characterised as an ex ante versus an ex post vision. While lawyers tend to look at the problem ex post, where there is a victim that needs to be compensated, economists look at the accident problem in an ex ante perspective by asking the question how an ex post finding of liability will influence ex ante the incentives of potential parties in an accident setting for caretaking.

Of course the differences in approaches between lawyers and economists are not really that black and white. There are lawyers that stress the deterrent function of tort law as well and some economists pay attention to compensation issues by stressing that accident law should also aim at an equitable loss spreading. One advantage of the economic approach is that the deterrent function and compensation goal are carefully distinguished so that the influence of various legal mechanisms that one would choose can be evaluated both with respect to the prevention and with respect to the compensation issue. The first scholar to analyse these problems from a law and economics perspective was probably the lawyer (1) Guido Calabresi from Yale Law School. In his well-known book The Costs of Accidents Calabresi makes a careful distinction between primary, secondary and tertiary accident costs. Primary accident costs are the costs of accident avoidance and the damage that finally occurs, secondary costs refer to the equitable loss spreading and tertiary costs are the costs of administering the legal system. Tort law should give incentives to a reduction of total social costs of accidents. Thus the central goal of tort law was given: it should give incentive for a minimisation of accident costs. This notion of Calabresi has been taken up later by economists that have formalised this issue.8

Let us address the first goal of tort law, the minimisation of primary accident costs; the cost of an accident and the expected damage. Indeed, from a social point of view accidents do not only cause costs from the moment an accident occurs and harm is suffered; potential parties in an accident setting, both injurers and vicims make investments in care to avoid the occurrence of an accident. Sometimes costs of caretaking are very clear and visible. We can refer for instance to the investments made by firms to reduce environmental pollution by investing in water cleaning equipments or the investment to install safety controls to avoid product defects. But also the mere fact that in a traffic accident case both injurers and victims are limited in their freedom of movement for instance because they have to drive or work carefully is considered as a cost by economists. A difference is further made between so-called unilateral accidents in which only the care taken by one of the parties (the injurer) can influence the accident risk on the one hand and bilateral accidents in which the behaviour of both parties can influence the accident risk on the other hand. In a bilateral accident situation the goal of accident law should therefore be to give incentives to minimise the total costs of caretaking by the potential injurer and the potential victim and the expected damage that will occur in case of an accident.9

Economists use classic cost/benefit analysis to determine what the level of care is that will lead to such a minimisation of the social costs of accidents. Not surprisingly this can be found where the marginal costs of caretaking equal the marginal benefits in accident reduction.10 Indeed, since caretaking has its price as well a legal rule should not give incentives to avoid every possible accident that could occur, but only accidents that could be avoided by investments in care of which the marginal costs are lower than or equal to the marginal benefits of additional care. It could be that extremely high care could additionally contribute to a reduction of the accident risk but the marginal costs of caretaking in that case might well be much higher than the additional benefit in accident reduction. Investments in care would in that case be inefficient and scarce resources would be spoiled.11 These levels of care where marginal costs of caretaking equal marginal benefits in accident reduction are referred to in the literature as optimal or efficient care levels.12 Liability law should therefore give an incentive to potential parties in the accident setting to adopt this optimal care level. Looking at a unilateral accident situation one can state that two legal rules would give the injurer incentives for taking optimal care. If there would be no liability at all clearly the injurer would have no incentive for caretaking; therefore in a no-liability situation the externality will not be internalised and an inefficient outcome will follow. If a negligence rule is adopted the injurer will take optimal care, provided the due care required in the legal system is equal to the optimal care as defined in the model.13 This can be easily understood. If the judicial system sets the due

4 This tendency is partially explainable through the case method used in common law countries for law teaching; it focuses very much on solving one particular case, sometimes neglecting the consequences of the solution in view for the number of other parties and thus of safety in general.
9 This distinction has been made by Shavell, S., Economic Analysis of Accident Law, Cambridge, Harvard University Press, 1987, 7.
10 Ibidem.
11 Ibidem.
12 This finding only holds in a risk neutral setting. In case of risk aversion higher investments in care might well be efficient since a reduction of accident risk will in that case also remove the disutility of risk from a risk averse person.
care standard correctly the inquirer can avoid liability by taking due care. Thus he will have to spend care to avoid the accident, but if he does so he can avoid to pay the expected damage. Of course the inquirer could take more care than the legal system requires him to do under a negligence rule, but he will have no incentive to do so since he can already escape liability by following the due care standard. Of course the inquirer could also spend less on care than the legal system requires him to. In that case he will have lower costs of caretaking, but he will have to pay damages in case an accident occurs. Since the optimal care standard was defined as exactly that level of care where the marginal costs of care equal the marginal benefits in accident reduction, taking less than the due care standard will be interesting for the individual inquirer since it will increase his total expected costs. Thus a negligence rule will lead to an efficient outcome as long as the legal system defines the due care as equal to the optimal care of the model.

Also a strict liability rule will lead to the optimum. The reason is quite easy. A strict liability rule basically says that the inquirer has to compensate in any case no matter what care he took. It is sometimes argued that this will lead the inquirer to take excessive precautions or to take no care at all since he is liable anyway. Neither of these statements seems true. By making the inquirer strictly liable in fact the social decision is shifted to the inquirer. In a unilateral accident case it simply means that he has to bear all the social costs of accidents, being his own costs of caretaking and the expected damage. Therefore, he will take exactly the same decision, being to minimise his total expected accident costs. We discussed in the model that this can be reached at the optimal care level. Therefore, the inquirer will take optimal care since this is the way to minimize his total expected costs. Spending more on care would increase his costs of caretaking inefficiently and spending less on care would increase the expected damage inefficiently.

This leads to the conclusion that in a unilateral accident setting both a negligence and a strict liability rule will lead to a minimisation of the social costs of accidents. Of course there remain differences between both rules as far as the secondary and tertiary costs are concerned. Under a negligence rule in principle no cases of liability could be found since an inquirer would always follow the due care standard required in the legal system and would thus never have to compensate his victim. Under a strict liability rule on the other hand victims would always receive compensation. If the assumption of risk neutrality is relaxed and if only one of the two parties were risk averse, for instance the victim, the choice between negligence and strict liability could result in a preference for one of these rules depending upon which party is risk averse. Also administrative and information costs of both rules differ. The strict liability rule seems to have the disadvantage that a legal case will follow with every accident since the inquirer is always bound to compensate. Court costs can therefore be expected to be high. On the other hand, the negligence rule seems to have high information costs for the judge since he will have to determine in a particular case what the marginal costs and marginal benefits of caretaking were.15

The analysis of course can be much more refined for instance if one goes into the bilateral accident situation. In that case a contributory or comparative negligence defense has to be added to a strict liability rule to give victims an incentive as well to take optimal care. The advantage of the negligence rule in this case is that the victim will anyway assume to have to bear the loss, so he will always have an incentive for taking optimal care. A further refinement can be found when attention is given to other factors than care that can influence the accident risk. In the literature attention has especially been paid in that respect to the influence of the activity level. Within the scope of this paper that focuses on the influence of insurance on liability law it does not seem necessary to discuss these refinements of the model in detail.

B. Economic Principles of (Liability) Insurance

Let us now turn to liability insurance and discuss how insurance influences the above discussed principles of accident liability. Liability insurance comes into the picture as soon as one leaves the assumption of risk neutrality and risk aversion of the inquirer is accepted. The utilitarian approach with respect to insurance has demonstrated that risk creates a disutility for people with risk aversion. Their utility can be increased in case of loss spreading or if the small probability of a large loss is taken away from the inquirer in exchange for the certainty of a small loss. The latter is of course exactly the phenomenon of insurance. The risk averse inquirer has a demand for insurance; he prefers the certainty of a small loss (the payment of the insurance premium) whereby the probability of a larger loss is shifted to the insurance company, thereby increasing the utility of the inquirer.16 It is remarkable that in this utilitarian approach of insurance liability insurance is in the first place regarded as a means to decrease the utility of a risk averse inquirer, not so much as a means to protect victims as is sometimes argued by lawyers.

The reason an insurance company can take over the risk of the inquirer is well-known: because of the large number of participants the risk can be spread over a larger group of people. The insurer only has to pay attention that he builds relatively small risk groups in which the premium is as much as possible aligned to the risk of the members of that group. If the risk groups would be too large the average premium would be relatively high for low risk members that would leave the group. This is the well-known problem of adverse selection that has been described in the seminal paper of Akerlof on the market for lemons.17

In addition to this adverse selection problem the insurer should also control the well-known moral hazard problem. Moral hazard is the phenomenon that the behaviour of the insured person (and of every insured for that matter) will change as soon as risk is removed from him. That is precisely the problem with liability insurance. The disutility the inquirer suffers because of exposure to risk is exactly needed to give him correct incentives for caretaking.

If risk is fully removed from the inquirer and shifted to the insurer the inquirer will indeed miss the incentive for caretaking that was exactly given to him by the deterrent effect of having to pay compensation in case of an accident. Marc Paulys, has, by the way, indicated that in fact this behaviour of the inquirer is not immoral but simply rational since he simply reacts to varying costs for his behaviour.18 For the insurer of course the problem arises how never to lose 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. In the literature two ways of controlling the moral hazard problem are indicated.19 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 solution is a detailed control of the insured.\textsuperscript{22} 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 according to certain groups of risk. This can either be an ante screening with a higher premium for certain high risk groups or an ex post premium increase or change of policy conditions based on previous loss experience. This is the so-called experience rating.

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 insurer. Exposing the insured to risk will mean that some degree of risk aversion will remain. This has on the other hand the advantage that the insured will bear the loss in case the damage exceeds the insured amount.

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 insurance products, costs, but also on the value of the insurance policy.\textsuperscript{23} 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. If moral hazard is controlled optimally through the use of the above mentioned devices the insurer will again behave as if no insurance coverage were available, with the benefit that the actuarial risk of insurance companies is reduced.

Let us now take these general principles and apply them to the central questions in this paper, that is, how the mechanism of liability insurance influences liability issues.

III. The Influence of Insurance on the Legislator\textsuperscript{24}

In many cases the legislator intervenes in competitive insurance markets. Some of these interventions have a direct influence on liability; other interventions are more directed at the functioning of the insurance market. A first question is whether problems of insurability should lead to a limitation of liability by the legislator (A); a second phenomenon that will be addressed is the tendency in legislation to limit the freedom of insurance by introducing a duty to purchase liability insurance (B).

A. Financial Caps on Liability as a Remedy for Uninsurability?

The argument is often heard that very large risks can not be covered by classic insurance schemes.\textsuperscript{25} The arguments see especially the potential magnitude of the harm as the reason for a possible uninsurability of a certain risk. This argument has led the legislator in many countries (but also in international conventions) to put a financial limit on the amount of compensation to be paid by the insurer. It is by the way noteworthy that financial caps are often introduced as soon as compulsory insurance is required. The argument is of course that the legislator can only impose a duty to insure if the risk is indeed insurable. But also outside the field of compulsory insurance financial caps on liability can be found. In many areas of tort law where jurisprudential innovations can be found with instance with respect to environmental and professional liability financial caps are advanced as a means to keep the risk insurable.

It is remarkable that the insurability argument refers as such only to the magnitude of the expected harm. This is of course only one of the aspects of uninsurability.\textsuperscript{26} In fact the possibility to control moral hazard and adverse selection might be far more important to decide upon uninsurability than the expected magnitude of the harm as such. The fear that liability insurance would alter the behaviour of the potential insurer and thus that moral hazard would be uncontrollable was exactly the reason why in the 19th century liability insurance was prohibited in Western Europe and was prohibited in the former Soviet Union as well.\textsuperscript{27}

The magnitude of the harm is as such a problem of the capacity of the individual insurer. More seriously however, is the low and uncertain probability of the accidents occurrence. For catastrophic risks usually no reliable loss statistics exist. Insurers of course prefer accidents risks with a relatively high probability and lower damage, which makes premium calculation easier. The question, however, arises whether the high magnitude of the harm as such makes a certain risk uninsurable. First, one should remember that competitive insurance markets have worked out all kinds of devices to cope with large risks as well. Reinsurance, coinsurance or pooling of risks are well-known phenomena that allow insurers to provide large amounts of insurance coverage. Tyran and Zweifel report for instance that even the 1989 San Francisco earthquake caused damage up to an insured amount of 39.5 billion US $. It is remarkable that these actual possibilities to provide large amounts of coverage often remain undiscussed when the need to introduce a financial limitation on liability is discussed, e.g. in parliament. A problem in that respect is that a legislator is often dependent upon information given by a few insurers on the limits of insurability. As far as markets are competitive is does not seem a problem to let the insurability depend upon the willingness to insure on a competitive insurance market, taking into account possibilities of pooling and reinsurability. This becomes, however, more problematic if insurance markets are not competitive, which is for instance the case with respect to nuclear liability insurance. In that case one can hardly rely upon


\textsuperscript{24} Some of the issues addressed in this section have been dealt with by Roger van den Bergh and myself in our paper "Compulsory Insurance for Professional Liability?", Geneva Papers on Risk and Insurance, 1989, 308-310.

\textsuperscript{25} For an overview of financial caps in Dutch liability legislation see De Vries, F., Wetelijke Limitering van Aansprakelijkheid, Zwolle, Tentoon Willems, 1990.

\textsuperscript{26} See Arrow, J., o.c., 1965, 54-55.

\textsuperscript{27} See, for instance, 214-235.

declarations made by a monopolistic insurer about the limited availability of insurance coverage to introduce a financial cap on liability.

In general, one should therefore warn the legislator that he should not attach too much belief to declarations of insurers concerning insurability if markets are not competitive. In addition, the insurability should be judged on the basis of a good actuarial study, taking into account all the possibilities to get coverage on a competitive market.

A fundamental question is of course whether the limited availability of insurance coverage (which is already hard to judge for a legislator, if possible at all) should lead to a limitation of the liability of the injurer. Indeed, in this respect one can point at the fundamental objective of an exposure to liability, being to give incentives for careful behaviour. There also exists a linear relationship between the magnitude of the harm and the efficient care to be taken to avoid that accident. Hence, the greater the amount of expected damage, the higher the care should be. If a limitation of liability is introduced this can lead to a problem of underdeterrence.6 Indeed, if the real magnitude of the harm is substantially lower than the limited amount of liability, the problem will arise that the injurer will consider the accident only as one with a magnitude equal to the limited amount of liability. Thus, he will only take the necessary care to avoid an accident with a magnitude of the statutorily limited amount. The efficient care to be taken to avoid the accident with the real magnitude of the harm might therefore be much larger. A limitation of liability is therefore inefficient as soon as the statutory limit is lower than the real magnitude of harm caused by the accident. In that case a problem of underdeterrence will arise. In addition to this efficiency argument against financial caps one can also point at a fairness argument. From a corrective justice point of view it could be argued that a potential victim whose injurer is found liable for the accident is entitled to full compensation and not just to a statutorily limited amount. A financial cap will therefore not only lead to underdeterrence, but also to undercompensation of victims.

Most important one should note is that the insurability argument as such, whether realistic or not, should of course not be an argument to introduce a financial limitation on liability. 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 caretaking by the injurer remain at least partially into existence because the injurer is still exposed to risk in case the magnitude of the harm would be higher than the insured amount. In sum, from an economic point of view there are very few convincing reasons to limit the amount of compensation due to the victim. Moreover, the insurability problems lay probably more in adverse selection and moral hazard than in the absolute magnitude of the harm. If insurability problems exist they can be solved by limiting the duty to insure.

Of course, one could wonder why nevertheless statutory limits on compensation can often be found, although they seem to be inefficient. An answer can probably be found in the influence of interest groups on legislation. Obviously the industry would lobby for a financial cap on liability since it limits their exposure to risk. The insurability argument might therefore even be most useful for the industry in a plea for a financial limit of liability. It is, however, remarkable that this plea for a financial limit by the industry is often supported by insurers who are ready to argue that higher amounts of liability would be uninsurable. At first blush one could not understand why insurers would lobby for a financial limit on liability since it would reduce the demand for insurance. One should, however, note that pleas for a limit of liability are often supported by the fact that insurers prefer to insure the value of the industrial property itself in a first party insurance. This argument has for instance been heard in discussions in the Belgian parliament concerning the limitation of nuclear liability. The monopolistic insurer, SYRIAN, argued that an amount of more than 44 billion Belgian francs would be uninsurable in liability insurance. However, much higher amounts were insured in first party liability insurance. Indeed, the value of nuclear power plants themselves was insured up to amounts of 40 to 50 billion Belgian francs. Insurers often prefer to devote the available insurance coverage to first party property insurance instead of liability insurance, given the high administrative costs with liability insurance.

B. The Theory of Compulsory Liability Insurance

As mentioned above in legal doctrine compulsory liability insurance is often advanced as a means to protect the innocent victim. The duty of an injurer to purchase liability insurance would be a good way to protect victims against the insolvency of the injurer. Economists on the other hand see different benefits of liability insurance. It is an instrument to increase the utility of a risk averse injurer. Whereas economists would therefore see liability insurance mainly as an instrument to serve the interests of the injurer, lawyers tend to rely more on the victim protection argument. Of course these views do not necessarily contradict each other. Sometimes they can go in the same direction in favour of a duty to introduce liability insurance. Let us now address the question under what circumstances the purchase of liability insurance should be made compulsory.

I. Increasing the Expected Utility

A first way to look at this question could be to turn back to the basic utilitarian literature on the benefits of insurance.6 If insurance is indeed beneficial since it removes risk from risk averse persons and thus increases their utility are not these benefits that large that they warrant the introduction of compulsory liability insurance? A problem with this argument is that the degree of risk aversion varies. A Rockefeller will probably not be averse to losing US $ 1000, but a low income family father probably would be. The low income father will therefore probably have a demand for insurance against this risk of a loss of US $ 1000, whereas a Rockefeller probably would not. This straightforward example makes clear that the introduction of a duty to insure might be inefficient in as far as it forces some people to purchase liability insurance that would normally not have a demand for insurance. Insurance does not increase their expected utility. A generalised duty to insure might therefore create a social loss. Whether this is the case will of course depend upon the number of people that is actually harmed by the introduction of a duty to insure. This might indeed be outweighed by the fact that others will certainly have a benefit from insurance. This, however, does in itself not justify the need to introduce a duty to insure. These risk averse individuals might indeed have purchased insurance coverage anyway. This means that the simple fact that insurance increases utility can as such not justify the introduction of a duty to insure as long as we assume that all individuals are perfectly informed about the risk to which they are exposed and the availability of insurance.


2. Informational Asymmetry

A second, related, argument could be a lack of information. Information problems are often advanced by economists as grounds for regulatory intervention in the market system. Information problems might arise in cases the potential insurer cannot make an accurate assessment of the risk he is exposed to and the benefits of the purchase of liability insurance. An underestimation of the risk would in that case lead to the wrongful decision of the insurer 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 generalized duty to insure for motor vehicle owners. The average driver of a car underestimates the benefits of liability insurance. If there would be no information problem and the legislator would nevertheless introduce a duty to insure because this would be "in the best interest" of the insured, this would of course be mere paternalism.

3. Insolvency

The third reason to introduce compulsory liability insurance is the argument mainly used by lawyers, being the insolvency argument. The argument goes that the magnitude of the harm will often exceed the individual wealth of the injured, whereby a problem of under-compensation of victims will arise. It is noteworthy that one could also make the economic argument that insolvency will lead to underdetermination problems that might be remedied by liability insurance. Indeed, if the magnitude of the harm would largely exceed the value of the injured’s assets he will consider the accident as only one with a maximum magnitude equal to his assets. He will therefore only take the appropriate care to avoid an accident with a magnitude equal to his assets and he will not take the care that is necessary to avoid the total accident. This is precisely the underdetermination caused by the judgement proof problem. If the insurer is able to control the behaviour of the insured through policy conditions and an adequate premium setting the deterrence might be higher with than without liability insurance.

Hence, both from an economic and from a legal point of view the potential insolvency of the injured is indeed a problem since it can both lead to underdetermination and undercompensation. The question, however, arises whether compulsory liability insurance is the best instrument to remedy the insolvency problem. Indeed, several alternatives exist that might be able to cure the insolvency problem at lower costs. A first obvious alternative would be to introduce (compulsory) first party insurance instead of third party liability insurance. If undercompensation of the victim is the problem why should we not address the problem where it occurs, being with the victim? In fact, first party victims insurers exist in all kinds of ways in most Western European countries. One can think of all the disability and health care insurance whether they are provided by the private insurance sector or through a social security system. A major advantage of first party insurance is that the insured victim can demand an insurance policy that perfectly aligns his individual wishes for insurance coverage. Hence, a narrow definition of risk groups is possible. The victim will indeed be able to pass on all the information on the individual risk he causes to his insurer (e.g. instance age, profession, income, etc.). Thus, it has often been argued that first party insurance much easier allows for a control of the adverse selection problems.

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In many cases, it has been argued that compulsory liability insurance will therefore add little to these already existing first party insurance schemes. In many, cases only "pain and suffering" is not covered under first party insurance, but one can of course wonder whether only this component of the damage is enough a justification to introduce a highly costly system of compulsory liability insurance. One consequence of this cumulation of compulsory first party and third party insurances is that many tort claims in court are now fought between a first party insurer who is subrogated in the rights of the victim he compensated and exercises a right of redress against the liability insurer of the injured, using all kinds of legal rules that were designed in the first place to protect the victims.

A second alternative to remedy the insolvency problem would be the instalment of a compensation fund. This fund could be financed e.g. through levies or taxes on potential insurers and could pay damages in case an injured (or his insurer) appears to be insolvent. It might thus be more a guarantee fund that only intervenes in case the normal compensation mechanisms have failed. From an economic point of view there is a lot to say in favour of these funds. One advantage is that tort rules will remain to have their deterrent effect on the insurer. The fund only pays in case of insolvency. Thus the administrative costs should not be excessive either. In many legal cases those funds are used now especially in combination with compulsory liability insurance, whereby the fund intervenes e.g. when an insurer disappears or in case an accident is caused by an uninsured motorist. Of course a potential insurer could still take liability insurance, but he will remain free to do so taking into account his individual degree of risk aversion. In sum, one could say that compulsory liability insurance could be an adequate means to remedy the insolvency problem, but other legal mechanisms are available that might be able to cure that problem at lower costs.

4. Moral Hazard

After having discussed these three basic criteria for compulsory liability insurance two other points cannot remain to be undecided either. First, one should remember that with liability insurance there will always be a moral hazard problem. This means that even if a legislator decides to introduce compulsory liability insurance he should not

33. Following the basic article of Akerlof on adverse selection this point has especially been developed with respect to insurance markets by George Priest (Priest, G., "The Current Insurance Crisis and Modern Tort Law," Yale Law Journal, 1987, 1531–1590).
34. For a negative answer to this question see Adams, M., "Warum kein Erbe für Nichtvermögenschäden?" Schäfer, H. B. and Ott, K., (Eds.), Allokationsoffensive in der Rechtsordnung, 1989, 219–217.
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ance phenomenon actually influences liability cases is of course difficult to measure. Sometimes it is simply argued in legal doctrine or case law that one of the two parties would have been "the best insurer" and should therefore carry the accident risk, no matter whether he purchased insurance coverage in that particular case. Even further going is the idea that the fact that one of the two parties in the accident setting purchased liability insurance is implicitly or explicitly used as an argument to make him liable. Obviously one recognizes here the easy "deepest pocket" argument that if a judge should decide for or against a poor and uninsured victim or an insured injured the choice is easy, let the anonymous insurance company pay!

In this paragraph I would like to address some of these issues from an economic point of view. First I would like to give a brief overview of some cases in a few member states where some influence of the insurance issue in a liability case can be felt (A). Then I will address this influence of insurance on case law from an economic point of view (B) by making a distinction between on the one hand the classic tort case and on the other hand a contractual setting.

A. A Few Examples

The influence of insurance on the liability issue and on the law of obligations in general has long been studied by lawyers. One of the first to study this phenomenon was probably A. Ehrenreitz in his study on "Assurance obliges". In many legal systems scholars have devoted an interest of influence of insurance on tort case law, even if this influence was only theoretical.

In Belgium this influence has been studied by W. van Gerven and D. Simoons. Explicit decisions where the availability of insurance is taken into account can, however, with an opinion of the justice of the peace of Merksem as a notable exception, hardly be found in Belgian tort law. The availability of insurance is on the other hand a decisive issue to consider the possible liability of the mentally disabled person who causes a tort. According to art. 1386bis of the Belgian Civil Code someone who is mentally disabled in such a manner that he lacks the blameworthiness requirement under tort law can nevertheless be held to compensate on equity grounds. The mentally disabled person has a higher chance of being held liable as soon as an insurance policy covers his liability. Hence, in the case of the "Equity-liability" of the mentally disabled person the availability of insurance coverage is explicitly taken into account in Belgian case law as a ground for liability.

Also in other legal systems examples can be given of the influence of the availability of insurance on tort cases. The availability of insurance always receives a lot of attention in Dutch case law. The topic was first addressed in the inauguration address of H. Driou and

IV. The Influence of Insurance on Tort Case Law: Assurabilidad or Assurance Oblige

No one who is studying the case law in tort law during the past decades in most western European countries will deny that the phenomenon of liability insurance has had a considerable influence on the evolution of this case law. The exact extent to which the insur-

41 Quist, H., "Herziening van aansprakelijkheidsrecht", Inauguration address at the Economische Hogeschool Rotterdam on 2 October 1935, Den Haag, Martina Nijs.
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German case law concerning the validity of non-liability clauses in standard form contracts the insurance issue is an important criterion.

B. Economic Analysis

1. Assurability Oblige

A first way in which the influence of insurance on liability issues appears is that the judge could take into account the insurability of a certain risk. This could be indicated as "assurable obligie". 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 cost of insurance" argument, which 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 be victimized.

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 fact that the judge in a tort case is to examine whether all the parties involved took sufficient 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. This would then be an argument in favour of strict producer liability. The insurability argument in this context is, however, wrong. We mentioned above that in principle victims are "better insurers" than insurers. First party victim insurance does indeed better enable 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 in favour of negligence than in favour of strict liability as is often heard. Negligence will indeed lead to a first party victim insurance whereas strict liability will lead to third party liability insurance by injured.

2. 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 "insurance obligie" more or less bluntly states that the one who is insured should be held liable. 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 first place it should be mentioned that an automatic finding of liability of the insured person negates 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 this will
reduce his incentives for caretaking. 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 spend 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 might on 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 view point 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. On 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 raise 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 is causing an accident, but the risk that he will hit an uninsured party. This, of course, makes a probability calculation highly complicated.

3. Assurance Oblige in a Contractual Setting

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 Price Winner Ronald Coase indicated that if transaction costs are zero an optimal allocation of resources will always take place, whatever the legal role 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.

uct. 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 (which equals the well-informed consumer would know that he bears the 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 his 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 would bear 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, as is apparently the case in the German case law concerning standard form clauses.

V. Influence of Insurance on Liability in a European-Policy Perspective

So far I have sketched possible influences of insurance both on the legislator (III) and on tort-case law (IV) in general. Both influences were critically discussed, applying the law and economics approach. The question now of course arises how these issues should be dealt with within the single European market. As far as the influence of insurance on the legislator is concerned I indicated that legislative interventions such as the introduction of financial caps and a duty to insure might create inefficiencies. If law and economics were to be used normatively it could provide an argument to be cautious with such legislative interventions also at the level of the European Union. In this section we will have a brief look at the attitude towards the mentioned issues in some recent European documents (A). As far as the influence of insurance on case law is concerned the question of course arises whether there is a need for a European intervention to prohibit a finding of tort liability merely on the basis of the availability of insurance coverage (B).

A. The Influence of the European Legislator

The two most noteworthy influences discussed in this paper, being the introduction of financial caps and a duty to insure have been introduced in several international documents long before the European Community took any initiative with respect to liability or insurance. Traditional fields that have both legal instruments are nuclear liability and liability for damage caused by oil pollution at sea. In the case of nuclear accidents the limi
The Influence of Insurance on Liability Issues

Dying environmental damage" problems several problems with the current legal instrument to remedy environmental damage are discussed and several alternatives are suggested. The problem of limitation of liability is explicitly discussed in the green paper. It is explicitly noted in the green paper that "limits on liability" could reduce incentive for prevention and transfer the burden of restoration costs above those limits to the tax payer, thus interfering with the "polluter pays" principle. The green paper further states that any limit on liability should be set at a high level so as not to undermine the prevention function of strict liability. The problem of insurability and compulsory insurance is discussed as well. The green paper rightly refers to the moral hazard problem by indicating that if the insurer links the availability of insurance to an enterprise's risk management, it may have a deterrent effect in promoting better accident prevention. On the other hand, the green paper also recognises the problems that might arise with compulsory insurance. Some European documents, such as the proposed directive for civil liability for damage resulting from waste require the liability of the producer and the eliminator to be covered by insurance or any other financial security. The green paper notes that compulsory insurance raises several concerns. If insurance is compulsory, enterprises must be able to obtain coverage on the market for the required amount, but coverage may not be available. In addition, under compulsory insurance, insurers might become "licensors" of the industry by providing or withholding insurance coverage according to whether the licensee is considered a good or a bad risk.

Another document that needs to be mentioned in this respect is the Convention of Lugano on Civil Liability for Damage Resulting from Activities Dangerous to the Environment of 21 April 1993, concluded within the framework of the Council of Europe. Whereas the green paper is merely a consultative document that indicates some directions for European environmental policy in the future, this Convention on civil liability for environmental damage of course has binding force as well as a sufficient number of parties has signed this Convention. The Convention has no explicit provision concerning financial caps, but there is a provision concerning "compulsory financial security schemes". Art. 12 states that each party shall ensure that there are payable, taking due account of the risks, operators conducting a dangerous activity on its territory be required to participate in a financial security scheme or to have and maintain a financial guarantee up to a certain limit, of such type and terms as specified by national law, to cover the liability under this Convention. Hence, no explicit reference to compulsory insurance is made and the signatory parties still have the freedom to require whatever financial security system they deem appropriate.

B. Harmonisation of the Influence on Liability

In section IV I have given a brief overview of some cases in which the availability of insurance apparently is taken into account to decide the liability issue. Although I just gave a

61 See also Dekterelaar, M., 199, 306-308.
64 See De Boer, J., 199, 230.
few examples one can understand that this might play a more serious role in some member states than in others. Within the context of the single European market the question inevitably comes up whether this issue should be harmonised at the European level.

 Until now the European Union has not been very enthusiastic in the harmonisation of general tort rules although the argument could of course always be made that differences in local liability laws cause differences in marketing conditions and hence hamper a full market integration. The approach Europe has taken so far has been mainly to look at specific areas of liability for harmonisation. In this respect we can of course once more refer to the product liability directive of 25 July 1985, but also to other directives on the liability for services and the liability for waste. One can therefore already state that it would be somewhat contrary to the tradition of European legislation to interfere via e.g. a directive to harmonise the influence of insurance on liability issues.

The basic question is of course whether this issue needs to be harmonised at all. First, one could refer to the economic literature on federalism and constitutional economics indicating that a full harmonisation of legal rules is not a necessary condition for market integration. Indeed, the goal of a European Union does not necessitate a complete harmonisation of all legal rules. Second, also lawyers increasingly point at the necessity to respect the legal culture in every member state and hence to keep some legal areas reserved for the law of the member states. Thirdly, one should note that in many areas where harmonisation of liability law was aimed at this could not be reached since the directive, for instance with respect to product liability law, came mainly in addition to the already existing national legal systems. In the Product Liability Directive this is defined as follows: Article 13 of the Directive provides that the Directive shall not affect any rights which an injured person may have according to the rules of the law of contractual or non-contractual liability. The same is true for a special liability system which would exist at the moment when the Directive is notified, being July, 30th 1985.  

Although the product liability directive was also based on the harmonization article 100 and the considerations preceding the directive stated that it was necessary to reach a harmonisation because different market conditions might hamper market integration, the mentioned provision in the directive leaves all the existing differences between the member states into existence. Fourth, even more recently the European Union itself has realised that a European Union does not necessarily mean that everything should be regulated or harmonised at the European level. This wisdom, which is commonly known as the "subsidiarity principle" had already been introduced for environmental matters in the Single European Act in 1987 and has been expanded to all community areas with the Treaty of Maastricht. If one thus takes this subsidiarity principle into account one can seriously question whether any community action is necessary with respect to the influence of insurance on liability cases. In that respect one should also note that within the broad area of liability law this influence of insurance is of course just an issue of relative minor importance. Although implicitly many judges might be influenced in their decision by the fact that one of both parties is insured, only rarely can one find an explicit reference to the availability of insurance. Thus one could easily state that there are probably other areas of higher priority where the differences between member states are of greater importance than with respect to the issue discussed here. Moreover one could also wonder whether an effective regulation would be at all possible. Such a regulation, whether on the European or on the national level would state that a tort case cannot be decided merely upon the availability of insurance of one of the parties involved. But obviously such a rule could easily be circumvented if the judge would not state in his judgement that he has been influenced by the availability of insurance of one of the parties.

In sum, although I strongly believe that a judge should not take into account the availability of insurance when he decides a tort case, this is not a reason for a general prohibition neither on the European level nor on the level of the member states because such a prohibition might lack effectiveness because of its unenforceability.

VI. Concluding Remarks

In this paper I addressed a fundamental question in insurance and liability law, being how insurance influences liability law and vice versa. In this respect I paid attention to two types of influences: inferences on the legislator and influences on case law. The fear of insolvency of the insurer has lead 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 judgement 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 lead several legislators to limit tort liability because unlimited risks would be uninsurable. Hence, the insurability itself influences the amount of compensation due under case law. These types of influences 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.

Some of these influences were examined in this paper. Thereby I used the economic analysis of law to be able to look at these issues at a more abstract level that trespasses the boundaries of the separate legal systems.

First the general principles of the economic analysis of accident law were outlined, thereby indicating that the economic goal of accident law can be stated as the minimization of the total social costs of accidents, being both the costs of care taking and the expected damage. A legal rule was called efficient if it lead to incentives for both parties in the accident setting to take efficient care. This level of efficient care could be found exactly where the marginal costs of care equal the marginal benefit in reduction of accident costs. In an unilateral accident situation, being a case where only the injurer can influence the accident risk both negligence and strict liability will give incentives for efficient care taking.

Then I turned to the phenomenon of insurance and explained how under liability insurance the incentives for accident prevention are no longer given through the deterrent effect of tort law but through an efficient insurance policy. Insurance will, however, only be efficient if both the moral hazard and adverse selection problem can be controlled.

These basic principles of the economics of tort law and insurance were then applied to the question of insurability on tort law. Starting with the influence of the legal insurability argument of large risks was critically examined. Of course the availability of insurance should always be examined on a world wide market, taking into account pos-
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In this paper I 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 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.

List of References

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The Doctrine of Utmost Good Faith in Insurance Contracts

Ray Hodgin

Introduction

In England insurance contracts taken out by the general public appear to create more confusion and unconvincing than ever before. The doctrine of the utmost good faith holds that place as being the greatest stumbling block to consumer satisfaction. The doctrine of Precedent, a signpost of the common law system, whereby similar cases should be decided alike so that certainty in the law can be achieved also presents serious drawbacks. Precedents which no longer reflect the socio-economic needs of the present era are difficult to remove. While it is possible for the House of Lords to overrule earlier precedents and while it is possible for Parliament to do the same, it is not common to see any great activity from either source in the area of insurance law generally. In fact such inactivity gives rise to greater confusion in that a court who faced with an earlier precedent which the court would prefer to avoid but cannot overrule will sometimes choose to 'distinguish' or perhaps 'doubt' thereby possibly achieving 'justice' in the case before them but creating further confusion for those cases that do not follow.

Historical Background

It is said that the duty of disclosure dates from at least the 14th Century. For English law the foundation case dates from 1766. All later cases and all leading academic writing refer to the judgment of Lord Mansfield, perhaps the founding father of much of English insurance law, in Carter v. Boehm. In setting out his views on the requirement of good faith in insurance declarations he drafted a careful judgment which attempted to weigh the problems and the responsibilities which faced both parties during insurance negotiations. He said:

"The specific facts upon which the contingent chance is to be computed lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation and proceeds upon a confidence that he does not keep back any circumstance in his knowledge to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risk as if it did not exist. The keeping back of such circumstances is fraud and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the underwriter is deceived and the policy is void; because the risk run is really different from the risk understood and intended to be run at the time of the agreement.

It can be readily understood that insurers have been quick to refer to this extract from the judgment to support their interpretation that English Law places very heavy responsibilities.

1 See the greatly expanding workload of the Insurance Ombudsman Bureau 1981-1993 Annual Reports.
2 Although, as discussed below, the problem is not restricted to consumer contracts.
4 3 Burr 1905; 1 Black Rep. 593; for a full report of many of the decisions in this paper see: Legal Decisions Affecting Insurance, edited by R. W. Hodgin (Butterworths). This case appears in Vol. 1, p. 1.