Study of the Impact of the 1986 Reforms on Liability Insurance in Hawaii

A Report to the Governor and the Legislature of the State of Hawai'i

Report No. 94-26
December 1994

THE AUDITOR
STATE OF HAWAI'I

The Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawaii State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

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OVERVIEW

THE AUDITOR
STATE OF HAWAII

Study of the Impact of the 1986 Reforms on Liability Insurance in Hawaii

Summary

Act 2 of the 1986 Special Session made reforms to both the tort system and the insurance regulatory system in order to alleviate a "crisis" in the availability and affordability of liability insurance in Hawaii.

The *tort-related reforms* included modifying the law of "joint and several liability," setting a cap on damages for pain and suffering, requiring increased arbitration of tort claims, and other changes. The *insurance reforms* included rate reductions in 1986, 1987, and 1988 for commercial liability insurance to reflect anticipated savings from the tort provisions.

Certain provisions of Act 2 are scheduled for repeal on October 1, 1995. Act 238 of 1993 directed the State Auditor to submit findings and recommendations relating to Act 2 to the 1995 legislative session. The Office of the Auditor and the firm of Ernst & Young LLP conducted the study. The study sought to determine the effects of Act 2 on the availability and affordability of liability insurance in Hawaii and to identify factors that contribute to availability and affordability.

We focused on commercial liability insurance, which Act 2 defined as coverage to protect businesses against losses from injuries or property damage sustained by other persons. This includes general liability and professional liability insurance. Our study did *not* include automobile no-fault reform, automobile insurance, or homeowners' personal liability insurance.

We found that the rate reductions imposed by Act 2 were among many factors that have improved availability and affordability of commercial liability insurance since 1986. Many forces affect availability and affordability. Foremost is the property and casualty insurance cycle, a historical pattern of fluctuations in pricing and profitability. The liability insurance "crisis" of 1984-1986 is believed to have been caused by highly competitive pricing resulting in rate inadequacies and underwriting losses, an increasingly litigious society resulting in larger jury awards and greater liability claims losses, and a decrease in previously high interest rates that resulted in decreased investment income for insurers. Many other factors can affect availability and affordability including inflation, stock market fluctuations, catastrophes, and insurer insolvencies.

The "crisis" of 1984-1986 was already beginning to abate prior to Act 2 because of improving financial performance in the insurance industry. Although only the 1986 rate reduction was implemented, we believe the reduction of 10 percent, coupled with very favorable financial results through 1988, contributed to increased availability and affordability in the liability insurance marketplace in Hawaii.

We also found that some of the tort provisions in Act 2 may have had a slight impact on reducing insurers' loss costs. Loss costs are the cost of insurance claims and include both indemnity payments to injured plaintiffs and payments to defense attorneys. Tort provisions that may have helped restrain costs include those on arbitration, joint and several liability, damages for pain and suffering, and loss of earning capacity.

However, we emphasize that we can only estimate the impact of the tort provisions. Any reductions in the cost of insurance are uncertain. Furthermore, any savings are small relative to the benefits desired from tort reform. The link to insurance availability, affordability, and rates, while it exists in theory, is not easily demonstrated in practice because of the many factors and variables that affect avauilability, affordability, and rates.

Recommendation

We recommend that the Legislature consider deleting the October 1, 1995 repeal date for various sections of Act 2, thereby making the entire act permanent.

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Conducted by

The Auditor
State of Hawaii
and
Ernst & Young LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

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Foreword

In its Special Session of 1986, the Legislature passed Act 2, Relating to Liability. The act made reforms to both the tort system and the insurance regulatory system. Certain provisions of Act 2 are scheduled for repeal on October 1, 1995.

This study responds to Act 238 of the Regular Session of 1993, which directed the State Auditor to submit findings and recommendations relating to Act 2 to the 1995 legislative session. The study was conducted by the Office of the Auditor and Ernst & Young LLP.

We wish to express our appreciation for the cooperation and assistance extended by officials and staff of the Department of Commerce and Consumer Affairs, the Judiciary, and other organizations and individuals that we contacted during the course of the study.

Marion M. Higa
State Auditor

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Chapter 1
Introduction

Finding a crisis in the availability and affordability of liability insurance in Hawaii, the Legislature in its Special Session of 1986 passed Act 2, Relating to Liability. Act 2 sought to alleviate the crisis by reforming both the tort system and the insurance regulatory system. This study examines the impact of the 1986 reforms.

Torts are civil (noncriminal) wrongs or injuries for which the courts can provide a remedy in the form of damages and that do not involve a breach of contract. An example is a personal injury claim based on an allegation of negligence. *Tort-related reforms* in Act 2 modified the law of "joint and several liability," set a cap on damages for pain and suffering, required more arbitration of tort claims, and made many other changes. *Insurance reforms* reduced rates for commercial liability insurance over a three-year period to reflect anticipated cost savings from the tort provisions.

Act 2 took effect on August 4, 1986. The act scheduled certain provisions for repeal on October 1, 1989. To permit a longer period for evaluating Act 2, the Legislature in 1989 extended the repeal date to October 1, 1991, and in 1991 extended it again to October 1, 1993.[1]

In 1993, Act 238 made the rate reduction provisions permanent and extended to October 1, 1995, the provisions that had been scheduled for repeal. Act 238 also directed the State Auditor to submit findings and recommendations relating to Act 2 to the 1995 legislative session.

This study was conducted by the Office of the Auditor and Ernst & Young LLP.

Background on Act 2

Act 2 focused on problems in liability insurance. Liability insurance is sold by the property and casualty insurance industry to protect policyholders from costs resulting from injuries to other persons or property. For example, contractors, employers, homeowners, landlords, physicians, hospitals, manufacturers, and others can purchase liability insurance to cover the costs of claims and lawsuits charging them with negligence.

Liability insurance "crisis"

In the period leading up to Act 2, there was growing national concern that some types of liability insurance were becoming very costly or unavailable at any price. Many insureds were paying higher premiums with larger deductibles, lower coverage limits, and more exclusions. Others went uninsured. Annual insurance premiums for commercial liability and professional liability doubled for many policyholders during this period.

Hawaii was not immune to these problems. Much of the testimony preceding Act 2 centered on the high cost and unavailability of insurance for physicians, hospitals, others in the medical community, counties, and small businesses. Many policyholders reported paying double and triple premiums upon renewal for less coverage. At the time, it was widely believed that a crisis in insurance availability and affordability existed in the nation and Hawaii.

Enactment of Act 2

Act 2 was enacted during a period when many other states were also enacting tort reform laws. Act 2 sought to achieve the widest possible availability of liability insurance at reasonable rates, a stable market for liability insurers, and a means to adjust insurance premium rates based on anticipated cost savings from tort reform legislation.

The act was controversial; it reflected a compromise. Most of those testifying on the measure in 1986 favored reform; representatives of the plaintiffs' attorneys and consumer advocate Ralph Nader testified in opposition to the measure.

Few believed the act would have much impact. Representatives of the insurance industry, the medical and legal professions, and other business organizations saw the final measure as too diluted by exceptions and limitations to substantially affect availability and affordability. Nevertheless, almost all testifiers praised the measure as a step in the right direction.

The floor debates show that some legislators felt the act did not go far enough and contained exceptions that made it deceptive to the public. Others felt that tort reform was not the solution to rising insurance rates; that it benefited tort defendants at the expense of plaintiffs; and that it could make liability insurance even less available.

Objectives of the Study

Our study had the following objectives:

1. To determine the effects of Act 2, Special SLH 1986 (as amended), on the availability and affordability of liability insurance in Hawaii.

2. To identify factors that contribute to the availability and affordability of liability insurance.

3. To make recommendations based on findings in these areas.

Scope of the Study

Our study focused on Act 2. We did not assess the impact of other laws affecting insurance and torts, such as automobile no-fault reform.

The study was limited to *commercial* liability insurance because the rate reductions in Act 2 applied only to this type of insurance. Under Act 2, commercial liability insurance means coverage to protect businesses against losses from injuries or property damage sustained by other persons. It includes but is not limited to policies providing coverage for errors and omissions and professional malpractice. Consistent with Act 2, commercial liability insurance in this report includes the following:

- General liability coverages (other than professional liability) for: (1) premises and operations of owners, landlords, and tenants, and of manufacturers and contractors, and (2) products/completed operations (coverage for claims from defective products or work). In the insurance industry and elsewhere in this report, these coverages are sometimes referred to as "other liability" insurance.
- The liability portion of commercial multiple peril insurance. This is a combination policy of property and liability insurance for businesses.
- Professional liability and errors and omissions insurance.

We did not include motor vehicle insurance, which was specifically excluded from the rate reductions in Act 2 and is dealt with by other laws, or homeowners' personal liability insurance, which does not come within the scope of Act 2.

Method of Study

Our study included a survey and limited comparative analysis of tort law reform in other states, interviews with knowledgeable persons, analysis of insurance claims experience and rate and loss cost filings in Hawaii (estimates of future losses filed by insurers with the Insurance Division of the Department of Commerce and Consumer Affairs, or DCCA), a review of insurer financial measures, and other activities.

We conducted our study in three main phases. The first phase consisted of a review and evaluation of Act 2. We also reviewed literature on similar tort reform legislation in other states.

In the second phase, we interviewed 22 individuals in Hawaii who were familiar with Act 2 including officials of the following agencies and organizations: the DCCA including the Insurance Division; the

Department of the Attorney General; the Judiciary including the Court-Annexed Arbitration Program; the Hawaii Insurers Council; the Hawaii Insurance Bureau, Inc.; and the Hawaii Academy of Plaintiffs Attorneys. We also interviewed representatives of several insurance companies, two law professors, and a private attorney.

The third phase of the study consisted of a review and analysis of available information, including available Hawaii tort claims experience, prior closed claims studies and other studies on Act 2, reports on personal injury actions, reports of the DCCA insurance commissioner, general liability rate filings prepared by the Hawaii Insurance Rating Bureau, Inc., and loss cost filings prepared by the successor Hawaii Insurance Bureau, Inc.[2]

The bureau is a private organization that previously filed proposed rate changes with the insurance commissioner for its affiliated insurance companies. We examined bureau rate filings, but not agency rate filings or independent rate filings. In agency filings, individual insurers affiliated with the bureau could file for deviations from the bureau rates. In independent filings, individual insurers not affiliated with the bureau could do the same. Because of a 1990 statutory amendment, the bureau no longer files proposed rate changes. Instead, it files loss cost filings of its affiliated insurers with the insurance commissioner. The affiliated insurers then individually submit rate filings using their own expenses, profit needs, and the loss cost filings prepared by the bureau. The bureau's new name reflects the change.

In the third phase of our study, we reviewed financial statistics of five Hawaii insurers writing commercial multiple peril and "other liability" insurance. We examined professional liability loss ratios (incurred losses divided by earned premiums), and proposals for rate changes submitted by the bureau. We also examined several economic indicators in Hawaii.

Our conclusions concerning the availability and affordability of commercial liability insurance in Hawaii are estimates for various points in time. Precise measurement was not feasible, mainly because actuarial and other literature revealed no distinct measures of availability and affordability. Furthermore, much historical data was not available. We based our estimates on testimony at the 1986 hearings preceding Act 2, interviews, and various "indicators" of availability and affordability over a period of several years beginning in the mid-1980s. These indicators included insurers' earned premiums, incurred losses, loss ratios and other statistics that influence insurers' decisions about pricing, coverages to offer, and market penetration. For example, declining loss ratios tend to make insurance more available and increasing loss ratios tend to make it less available. Other indicators included requests for changes in general liability rates by the Hawaii Insurance Rating Bureau, Inc. and its successor, the Hawaii Insurance Bureau, Inc., as compared with rate changes actually approved.

Ernst & Whinney, which performed 1987 and 1988 studies of the impact of Act 2 for the Hawaii Insurance Rating Bureau, Inc.,[3] is the predecessor firm of Ernst & Young LLP, which conducted the present study. The earlier Ernst & Whinney studies were reviewed for this report, but the results and conclusions reached in this report are independent of results and conclusions in the previous reports.

Our work was performed from July 1994 through November 1994.

Chapter 2

Impact of Act 2 on the Availability and Affordability of Commercial Liability Insurance

This chapter describes some of the factors that affect insurance availability and affordability and assesses the impact of Act 2. We conclude that Act 2 may have played a small role in improving the availability and affordability of commercial liability insurance in Hawaii.

Summary of Findings

1. The rate reductions imposed by Act 2 were among many factors that improved the availability and affordability of commercial liability insurance in Hawaii since 1986.

2. Some of the tort provisions of Act 2 may have helped to restrain costs in a very small way.

Mandating Rate Reductions Contributed to Improvements in Availability and Affordability

Many factors affect availability and affordability of liability insurance. The effects of Act 2 cannot be isolated. Nevertheless, we believe that the provisions for mandatory rate reductions in Act 2, although not fully implemented, affected the insurance marketplace in Hawaii. The provisions helped to stabilize premiums and contributed to improving the availability and affordability of commercial liability insurance.

Many forces affect availability and affordability

Availability of insurance means the extent to which the supply of insurance coverages is sufficient in terms of the coverage amounts, restrictions (such as policy limits, exclusions, and deductibles), and price. *Affordability* means the perceived reasonableness of rates that are adequate to cover insurers' costs and expenses, not excessive, and not unfairly discriminatory.

The price of liability insurance (premiums) should be sufficient to cover the loss costs (the cost of claims) and expenses of the insurance company (the insurer). Loss costs include indemnity payments to injured plaintiffs and payments to defense attorneys. Expenses include the insurer's cost of operations. In addition to loss costs and expenses, the price of insurance should include a margin for risk (the insurer's profit). A measure of profitability used by insurers is the insurer's combined ratio—that is, incurred losses plus incurred expenses divided by earned premiums.

The property and casualty insurance industry, which sells liability lines of insurance, has historically followed a pattern of fluctuations in pricing and profitability. The fluctuations are commonly referred to as the insurance cycle or the underwriting cycle. Since 1926, the property and casualty industry has experienced ten distinct cycles. The cycles have generally been six to eight years in duration. Some view the liability insurance "crisis" of the mid-1980s as a particularly severe manifestation of the insurance cycle.

The specific causes of these cycles are the subject of much research, debate, and theory. Many factors affect the pricing and profitability of insurers and the insurance cycle. The interaction of these factors is complex—much depends on the actions and reactions of insurers, insureds, and government regulators. Accordingly, analyzing or attempting to predict the specific impact of a particular factor on the cycle is subject to many uncertainties. Nevertheless, it is important to consider how the insurance cycle operates in order to understand how certain factors might affect the cycle and through it the availability and affordability of insurance.

The cycle is characterized by rising and falling prices and profits. When operations are profitable, insurers may attempt to increase profits by reducing their rates to attract more policyholders and increase sales, thereby increasing their premium volume. This may lead to the practice of cash flow underwriting. In this strategy, insurers may sell new policies at a loss if the investment income derived from the premiums exceeds the underwriting losses (the excess of loss costs and expenses over premiums) on these policies. At this point, insurance becomes widely available and affordable.

Because of the high level of competition among insurers, other insurers follow suit in order to maintain their market share. This often leads to rates being reduced to the point where insurers' profits decline.

Consumer demand for insurance is generally "inelastic" or insensitive to price changes. That is, businesses buy insurance even if prices go up. On the other hand, even if prices go down, businesses will not necessarily increase their insurance. The net result for the industry then is a decline in both premiums and profitability.

Eventually, insurers are forced to raise prices because of their eroding financial base. At the same time, because of declining profitability, insurers will issue fewer policies in order to reduce risks and maintain their financial soundness. At this point, insurance becomes less affordable and available. Eventually profitability is restored and insurance becomes available again, leading to a new cycle.

The foregoing is a general scenario. During the 1984-1986 period, liability insurance became less available and affordable. It had become increasingly costly, restricted in its coverage, or unavailable at any price. The "crisis" of the mid-1980s is believed to have had the following principal causes:

- highly competitive pricing resulting in rate inadequacies and underwriting losses;
- an increasingly litigious society resulting in larger jury awards and greater liability claims losses; and
- a decrease in previously high interest rates which resulted in decreased investment income for insurers.

These factors, and probably others to a lesser degree, led to a severe erosion of profitability that interacted with the insurance cycle to create a "crisis" in availability and affordability in the property and casualty insurance industry.

Other factors that could affect availability and affordability include:

- inflation;
- stock market fluctuations;
- random loss occurrences (catastrophes);
- profitability or losses of other lines of insurance;
- uncertainty or variability of losses (claims);
- excessive risk taking by insurers;
- unpredictable legal changes;
- availability of reinsurance (the insurer insures itself against loss or liability by reason of the original insurance);
- ease of entry and exit in new lines of insurance;
- dramatic unexpected increases in mass torts (for example asbestos and environmental hazards); and
- insurer insolvencies.

Legislative and regulatory actions can affect the insurance marketplace through such mechanisms as rate regulation to moderate underpricing or overpricing of policies; legislative measures to limit the frequency, size, and variability of damage awards; and solvency regulations to control inadequate pricing and excessive premium growth. Any actions taken, however, could also have negative impacts. For example, limiting rate increases could result in insurers withdrawing from unprofitable lines, thus making insurance less available. Predicting the impact of specific actions is subjective and uncertain due to the complexity of the factors and parties involved.

Rate reductions were partially implemented

A key element of Act 2 was rate regulation. We found that the three-year schedule of rate reductions for commercial liability insurance was not fully implemented. The first-year rate reductions for general liability ("other liability") insurance took place, but the second- and third-year reductions did not. The insurers' requests for rate increases were denied. However, for professional liability (medical malpractice) coverage for physicians, surgeons, and dentists, a substantial rate increase was granted in 1987.

Act 2 took effect on August 4, 1986. The act imposed an immediate moratorium on rate increases for commercial liability insurance. In addition, it required rate reductions in specific percentages over a three-year period to reflect anticipated savings from the tort reform provisions of the act. The insurers were to implement a 10 percent rate reduction commencing October 1, 1986 (except for motor vehicle and medical malpractice policies). Subsequent rate reductions of 12 percent and 15 percent were to take place on October 1, 1987 and October 1, 1988 respectively (except for motor vehicle policies). Insurers could avoid the reductions by convincing the insurance commissioner that the lower rates would be inadequate. Act 231 of 1987 exempted from the 1987 and 1988 reductions medical malpractice policies issued by mutual or reciprocal insurers.

Based on available information, it appears that the first-year rate reduction of 10 percent took place for general liability ("other liability") insurance. In the second and third years, the Hawaii Insurance Rating Bureau, Inc. requested rate increases. The bureau submitted studies that indicated the tort amendments in Act 2 would have little or no effect on insurers' losses and expenses and that projected major increases in losses and expenses. After reviewing this information, the insurance commissioner decided not to reduce or increase rates but to maintain the existing rates for general liability insurance, except for a 1.5 percent reduction in 1988 for defective products or work. In 1987, however, the insurance commissioner granted a rate increase of 71.9 percent for professional liability coverage for physicians, surgeons, and dentists. Information for 1988 was not available.

Rate reductions contributed to an already improving market

The liability insurance "crisis" of 1986 was already beginning to abate prior to Act 2 because of improving financial performance in the insurance industry. We believe that the 1986 rate reduction and the subsequent stable rates, coupled with very favorable financial results through 1988, contributed to increased availability and affordability in the liability insurance marketplace in Hawaii.

Using various indicators, we estimated the availability and affordability of commercial liability insurance in Hawaii from 1984 through 1992. Exhibit 2.1 presents our evaluation. We believe that availability and affordability evolved as follows.

Exhibit 2.1

Estimated Availability and Affordability of Commercial Liability Insurance in Hawaii
Calendar Years 1984 through 1992

Calendar Year	Availability Grade	Affordability Grade
1984	Average	Good
1986	Below average	Below average
1988	Very good	Average
1990	Very good	Good
1992	Average	Average

In 1984, our indicators suggest that availability was average. Affordability was good, but rates may have been inadequate.

Major changes occurred from 1984 to 1986. The total dollar volume of premiums written by the insurers rose 220 percent. The rise was partially due to increased rates or a combination of increased rates and volume of insurance sold. With premiums rising so greatly, many insured would have considered insurance unaffordable. At the same time, it appears that as a reaction to previous rate inadequacies, insurers were curtailing the amounts of coverages offered. Thus both availability and affordability were below average by 1986.

However, the seeds of improvement in availability—the beginning of the end of the liability insurance "crisis"—were already being planted during 1984-1986 because of the large increase in the dollar volume of premiums. During this period, insurers' losses declined, loss ratios (losses divided by premiums) decreased by almost half, and profitability doubled. As a result, availability was very good by 1988.

With revenues from premiums increasing, affordability could have continued to decline. However, the rate reduction provisions of Act 2 helped prevent this in two ways. First, the 10 percent rate reduction in 1986 was implemented. Second, although the subsequent two reductions did not occur, provisions on reductions in Act 2 probably made it easier for the insurance commissioner to deny the rate increases requested by the Hawaii Insurance Rating Bureau, Inc. in 1987 and 1988. With no rate changes in 1987 and 1988, except for the medical malpractice insurance rate, rates stabilized and affordability improved to average by 1988.

By 1990, no increases in rates had occurred for at least four years, except in medical malpractice insurance. Availability was very good and affordability was good. Continuing profitability coupled with stabilization in premium volume indicated that liability insurance was available at reasonable prices.

In 1992, Hurricane Iniki struck Hawaii and caused property loss ratios to reach very high levels. Although liability loss ratios remained low, we believe that the availability of commercial liability insurance declined to average at this point because the hurricane resulted in poor overall financial results including insolvencies in the Hawaii property and casualty insurance industry. As a result, commercial multiple peril insurance, which combines property and liability coverages, became less available. As a result of the foregoing events, we believe the affordability of commercial liability insurance also declined to average by 1992.

Medical malpractice insurance, which is a relatively small component of commercial liability insurance, followed a somewhat different pattern. Loss ratios were very high from 1984 through 1986. Since 1986, however, they have been low or negative, suggesting that rates may have been excessive and hard to afford. This may have resulted from the significant rate increase in 1987.

Tort Provisions May Have Helped Somewhat

During the mid-1980s, Hawaii and many other states sought to alleviate the liability insurance "crisis" by enacting tort reform laws to control the number of tort lawsuits and the size of claims paid. The theory was that controlling the frequency and severity of claims would reduce insurers' loss costs and improve the availability and affordability of insurance. More than 40 states enacted some type of tort reform between 1985 and 1991.

However, tort reform has been controversial with no consensus on its impact. We found that some tort provisions in Act 2 may have helped to restrain costs slightly.

Tort reform is controversial nationally

The case for tort reform in the 1980s was made in a U.S. Department of Justice report in February 1986 that identified the civil justice system, specifically the tort laws, as the main culprit in the crisis of availability and affordability of certain kinds of liability insurance.[1] The report did not go unchallenged. For example, in 1986 a group of state attorneys general laid the blame on the insurance industry, questioning sharply the value of tort reform, which would limit the rights of injury victims, in improving availability and affordability.[2]

Similar debate still continues over the results of tort reform nationally. According to a Harvard University study, the reforms saved an estimated $2.7 billion in insurance premiums nationally between 1985 and 1988.[3] Other literature, however, suggests that the impact of tort reform on premiums is unclear because of the many variables involved.[4] For example, little is known about the underlying injury rate and about the significance of trends in the frequency and size of tort judgments.

Little action in tort reform has occurred nationally since 1991. Many of the previously enacted reforms have been under constant attack and scrutiny. Courts in seven states struck down caps on noneconomic damages on constitutional grounds while five other states upheld such statutes.

Some Hawaii provisions may have constrained costs slightly

Act 2 made many adjustments in tort law. Several of these provisions may have had a slight impact on reducing insurers' loss costs. These include provisions on arbitration, joint and several liability, damages for pain and suffering, and loss of earning capacity. We include the arbitration provision because it is included in the tort segment of Act 2 and covers tort cases, even though some might not consider it part of "tort reform" per se.

We wish to emphasize that we can only estimate the impact of the tort provisions. Any reductions in the costs of insurance are uncertain. Furthermore, any savings are small relative to the benefits desired from tort reform. The link to insurance availability and affordability and rates, while it exists in theory, is not easily demonstrated in practice because of the many factors and variables that affect availability, affordability, and rates.

Arbitration

Section 21 of Act 2 required the Hawaii Supreme Court to adopt rules to implement a Court-Annexed Arbitration Program (CAAP) effective January 1, 1987. CAAP was to be a mandatory, nonbinding arbitration program for tort cases with a probable jury verdict value of $150,000 or less. CAAP was actually an expansion of a limited, experimental arbitration program that had been implemented five months earlier in Hawaii. The experimental program handled cases under $50,000 and had arbitrated only a handful of cases prior to CAAP.

CAAP was intended to increase court efficiency, lower system costs, reduce delay, and increase fairness. It was hoped that CAAP would speed up the process and reduce gridlock in the courts. Studies completed shortly after Act 2 was enacted—by Tillinghast (for the insurance commissioner) and by Hamilton, Rabinowitz & Alschuler and Ernst & Whinney (both for the Hawaii Insurance Rating Bureau, Inc.)—concluded that CAAP would reduce insurers' loss costs.[5] Subsequent studies have found that CAAP has reduced litigation costs and increased efficiency in the courts. However, whether these translate into reductions in insurance premium rates or increases in the affordability and availability of liability insurance has yet to be demonstrated.

A March 1992 study by several professors at the University of Hawaii evaluated whether CAAP was achieving its goals, including reducing litigation costs and improving the resolution process.[6] The study concluded that the program was meeting its goals. Pretrial discovery costs and litigation costs had been reduced, the pace of litigation had increased, and litigants were provided with a fair, just, and satisfactory day in court.

The study also concluded that CAAP encouraged early and less expensive settlements, increased the percentage of cases that terminated, and may have reduced the number of trials. The study indicated pretrial discovery costs could be reduced by as much as 32 percent, although savings in the overall cost of litigation would be minor. The average CAAP settlement was estimated to be $3,868 less than the average non-CAAP litigation case. The report estimated total litigation expenses using CAAP to be less than non-CAAP litigation by $921 per case. A 1993 update to the study gave a revised estimate of $61 per case based on a change in assumptions as to the ratio of settlements to awards and appeal rates of awards.[7]

Studies done elsewhere, however, gave mixed reviews on the cost impact of court-annexed arbitration and other alternative dispute resolution ("ADR") programs. A recent nationwide survey suggested savings in legal costs between 5 percent and 15 percent, without a corresponding increase in award amounts.[8] A second study indicated that approximately 75 percent of plaintiffs electing trial after ADR received reduced awards. However, a recent survey suggests that ADR may be inefficient for more complex cases and may add one more step to a long and costly process.[9]

Recently, the Judicial Arbitration Commission in Hawaii made recommendations to streamline and improve the CAAP process and to gather data from insurers to study its cost impact. The commission has requested the insurance companies to report their experience with CAAP to date, particularly with respect to its impact on litigation defense costs and insurance premiums.

Based on our review of the reports and studies mentioned, we estimate that CAAP could, at most, reduce loss costs by 2 percent.

Joint and several liability

In a tort case, the plaintiff may sue more than one defendant whose negligence is alleged to have contributed to the plaintiff's injury. Joint and several liability is a legal doctrine under which any defendant found liable—regardless of the defendant's degree of fault compared to that of other defendants—can be made to pay all of the plaintiff's damages. This often is the defendant who is wealthier or more heavily insured—the "deep pocket" defendant.

Opponents of the doctrine of joint and several liability say this encourages more lawsuits and results in higher liability insurance costs. Without the doctrine, losing defendants would pay the plaintiff in proportion to their degree of fault. This would reduce the incentive to sue and help to hold insurance costs down.

Section 17 of Act 2 "abolished" the joint and several liability doctrine but allowed many exceptions including: economic damages (those that are specifically measurable such as medical expenses and lost wages) in cases involving injury or death; economic damages and noneconomic damages (such as those for pain and suffering) in a wide range of cases such as toxic and asbestos-related torts and environmental pollution; noneconomic damages where the defendant's degree of negligence is 25 percent or more; and noneconomic damages in motor vehicle accidents relating to the maintenance and design of highways if the defendant had reasonable prior notice of a similar previous occurrence.

To date, 32 states have modified joint and several liability law ranging from complete abolition of the doctrine to limiting damages to a percentage of the defendant's degree of fault. Hawaii is similar to ten other states in abolishing the doctrine for low-fault defendants. Like Hawaii, most states have modified the doctrine for noneconomic damages only. But few states provide for as many exceptions as Hawaii, such as motor vehicle accidents involving highway design and maintenance and toxic torts.

Prior studies estimated the Hawaii provision to reduce costs by 0.2 percent and 0.4 percent.[10] Studies in other states suggest that total reform of the joint and several liability doctrine could further reduce costs by 3 to 5 percent.

Other studies show little impact. One study found that the joint and several liability doctrine has been used sparingly; the doctrine has been claimed in less than 0.4 percent of recorded civil cases since 1963.[11] A study in 1986 concluded that partial abolition of the rule had not affected incentives for pursuing deep pockets.[12] Furthermore, economic damages generally are still subject to the doctrine since the reforms mostly affect noneconomic damages.

The *Personal Injury Judgments Hawaii* reports[13] make reference to several cases where the jury was instructed not to apply joint and several liability to noneconomic awards. It is unclear whether this influenced the juries' decisions.

Overall, we estimate that the joint and several liability provision could reduce loss costs by less than 1.0 percent.

Damages for pain and suffering

Section 20 of Act 2 sets a $375,000 cap on noneconomic damages for pain and suffering in tort lawsuits. This is intended to limit the amount of monetary awards and to make them more predictable. The cap has a limited effect because it applies only to noneconomic damages for pain and suffering, and it is high relative to caps in some other states.

In 1986 and 1987, eight states placed caps on awards for noneconomic damages. The caps ranged from $250,000 to $500,000. Most caps contained some form of exception, such as physical impairment or disfigurement. In addition, courts could exceed the caps based on clear and convincing evidence. Only Kansas had a cap on pain and suffering similar to Hawaii's.

Savings due to caps have been estimated to be about 20 percent in medical malpractice loss costs with greater savings for the lower caps. The $250,000 cap on noneconomic damages in California is reported to have contributed to decreased malpractice awards and lower premium costs.[14]

Again, however, other studies gave mixed reviews. A study of caps on noneconomic damages from 1976-1984 showed that despite these reforms, insurance rates increased dramatically.[15] Yet another study, using data from 1975 to 1984, showed that awards decreased within two years of these reforms.[16] Other data suggested that malpractice rates had decreased, perhaps by as much as one-third, during the 1980s—mostly due to caps.[17]

Previous studies in Hawaii estimated Section 20 would have no cost impact.[18] Studies in other states suggest that caps for noneconomic damages may have limited impact on loss costs. Based on data in the Insurance Services Office's *Closed Claim Survey for Commercial General Liability: Survey Results, 1991*, we estimate that the $375,000 cap could reduce total losses by less than 4 percent.

Based on these various sources, we estimate that the cap on noneconomic damages for pain and suffering only, could reduce total losses on commercial liability claims by less than 1 percent.

Loss of earning capacity

When plaintiffs win a tort case, part of the award may be for lost future earnings due to their injury. These awards are not subject to taxes. Section 18 of Act 2 requires courts to adjust future earnings awards to reflect probable taxes that the defendant would have had to pay on the earnings. This provision is designed to reduce awards and reduce insurance costs.

Early studies showed no savings from the provision and little has been written about such provisions nationally. In *Personal Injury Judgments Hawaii*, we found a number of cases involving future earnings estimates, suggesting a potential for savings from the cap. However, we could find no jury instructions related to tax adjustments. Accordingly, it is unclear what impact this provision has had. Nevertheless, due to the potential for savings and the frequency of future earnings awards, we estimate the cap provision could reduce loss costs by less than 0.5 percent.

Other provisions seem insignificant

Based on our reviews of previous studies in Hawaii and studies in other states, we believe the following tort provisions in Act 2 have had little or no effect on reducing loss costs of commercial liability insurance in Hawaii:

- Section 8 - Punitive damages regarding insurance contracts
- Section 11 - Limitations on attorneys' fees
- Section 13 - Frivolous defense
- Section 14 - Periodic payments for governmental agencies

- Section 15 - Statute of limitations with respect to minors
- Section 16 - Liens against collateral sources
- Section 22 - Emotional distress arising from property damage

Conclusions

Most of Act 2 is already permanent. The only sections scheduled for repeal are Sections 2 (definitions), 4 (excessive rates; rebate or credit), 5-7 (cancellation and renewal of policies; prohibition), 17 (abolition of joint and several liability), and 20 (cap on damages for pain and suffering).

In view of certain benefits of Act 2 and the absence of any indications of negative impacts on availability and affordability of commercial liability insurance, we suggest that the Legislature consider making all of Act 2 permanent.

The availability and affordability of commercial liability insurance have improved since 1986 for many reasons and Act 2 may have helped somewhat. The mandatory rate decrease enacted in 1986 and the State's subsequent denial of rate increase filings stabilized premiums and improved affordability. Availability has also improved since 1986 primarily as a result of improved loss ratios. The Court-Annexed Arbitration Program and some of the other tort-related reforms may also have helped control insurers' loss costs and expenses, even if only slightly.

Recommendation

The Legislature should consider deleting the October 1, 1995 repeal dates for Sections 2, 4, 5, 6, 7, 17, and 20 of Act 2, Special Session Laws of Hawaii 1986, thereby making the entire act permanent.

Notes

Chapter 1

1. Act 300, SLH 1989; Act 62, SLH 1991.

2. The information included the following:

   Tillinghast, *State of Hawaii, 1986 Closed Claim Study*, Los Angeles, December 1987.

   Tillinghast, *State of Hawaii, 1987 Closed Claim Study*, Los Angeles, December 1988.

   Hamilton, Rabinowitz & Alschuler, Inc., *The Probable Cost Impact of the 1986 Hawaii Tort Law Amendments: A Closed Claim Study*, Los Angeles and New York, 1987.

   Ernst & Whinney, *Report to Hawaii Insurance Rating Bureau, Inc., Re: Hawaii Tort Reform Act*, New York, June 29, 1987.

   Ernst & Whinney, *Report to Hawaii Insurance Rating Bureau*, New York, May 31, 1988.

   Gene Kassebaum, John Barkai, and David Chandler, *Hawaii's Court-Annexed Arbitration Program, Final Evaluation Report*, Honolulu, 1992.

   Monthly *Personal Injury Judgments Hawaii* reports published by Advocates Research Company. These reports provide information about judgments filed in personal injury actions in the federal and four state circuit courts in Hawaii. Judgments in the Court-Annexed Arbitration Program are included. We reviewed Volumes 1 through 5 consisting of judgments dated January 1985 through August 1994.

   General liability and professional liability circulars issued by the Hawaii Insurance Rating Bureau, Inc. and the Hawaii Insurance Bureau, Inc. pertaining to rate filings and advisory lost cost filings, respectively, from 1984 to 1992.

   Report of the Insurance Commissioner of Hawaii for the years 1984 through 1993.

   Annual statements of Hawaii domestic insurers writing commercial multiple peril and "other liability" insurance, 1983-1993.

3. The Ernst & Whinney studies are cited in footnote 2 above.

Chapter 2

1. U.S. Department of Justice, Tort Policy Working Group, *Report of the Tort Policy Working Group on Causes, Extent and Policy Implications of the Current Crisis in Insurance Availability and Affordability*, U.S. Government Printing Office, February 1986.

2. Francis X. Bellotti, et al., *An Analysis of the Causes of the Current Crisis of Unavailability and Unaffordability of Liability Insurance*, prepared for the National Association of Attorneys General, 1986.

3. Paul J. Grant, "Tort Reform in the 1990's, Some feel that the time has come for a change," *Quality*, January 1991, pp. 40-41.

4. Terese Hudson, "Tort Reform Legislation: Can it help hospitals?," *Hospitals*, May 20, 1990, pp. 28-33.

5. Tillinghast, *State of Hawaii, 1986 Closed Claim Study*, Los Angeles, December 1987, p. 5; Tillinghast, *State of Hawaii, 1987 Closed Claim Study*, Los Angeles, December 1988, pp. 6-7; Hamilton, Rabinovitz & Alschuler, Inc., *The Probable Cost Impact of the 1986 Hawaii Tort Reform Law Amendments: A Closed Claim Study*, Los Angeles and New York, June 1987, p. 68; Ernst & Whinney, *Report to Hawaii Insurance Rating Bureau, Inc., Re: Hawaii Tort Reform Act*, New York, 1987, p. 22.

6. Gene Kassebaum, John Barkai, and David Chandler, *Hawaii's Court-Annexed Arbitration Program, Final Evaluation Report*, Honolulu, 1992.

7. Memorandum to Gene Kassebaum and Michael Broderick from John Barkai, Subject: CAAP Statistics, July 15, 1994.

8. Joanne Wojcik, "ADR Savings Depend on Nature of Dispute," *Business Insurance*, September 13, 1993, pp. 1, 34-35.

9. Ibid.

10. Tillinghast, *1987 Closed Claim Study*, p. 7; Ernst & Whinney, *Report to Hawaii Insurance Rating Bureau, Inc.*, p. 9.

11. Joan T. Schmit, et al., "An Analysis of Litigation Claiming Joint and Several Liability," *Journal of Risk and Insurance*, vol. 58, 1991, pp. 397-419.

12. *Report of the Tort Policy Working Group on Causes, Extent and Policy Implications of the Current Crisis in Insurance Availability and Affordability.*

13. These reports are described in footnote 2 of Chapter 1 above.

14. Hudson, "Tort Reform Legislation," pp. 28-33.

15. Thomas O. Depperschmidt, Ph.D., "The Legality of State Limitations on Medical Malpractice Tort Damage Awards," *Hospital and Health Services Administration*, vol. 37, no. 3, Fall 1992, p. 425.

16. Patricia M. Danzon, "The Frequency and Severity of Medical Malpractice Claims: New Evidence," *Law and Contemporary Problems*, vol. 49, 1986.

17. Depperschmidt, "The Legality of State Limitations," p. 425.

18. Tillinghast, *1986 Closed Claim Study*, p. 6; Tillinghast, *1987 Closed Claim Study*, p. 5; Ernst & Whinney, *Report to Hawaii Insurance Rating Bureau, Inc.*, pp. 9-10.

Responses of the Affected Agencies

Comments on Agency Responses

We transmitted a draft of this report to the Department of Commerce and Consumer Affairs and to the Judiciary on December 13, 1994. A copy of the transmittal letter to the department is included as Attachment 1. A similar letter was sent to the Judiciary. The department and the Judiciary did not submit responses.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

December 13, 1994

COPY

The Honorable Clifford K. Higa, Director
Department of Commerce and Consumer Affairs
Kamamalu Building
1010 Richards Street
Honolulu, Hawaii 96813

Dear Mr. Higa:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Study of the Impact of the 1986 Reforms on Liability Insurance in Hawaii.* We ask that you telephone us by Thursday, December 15, 1994, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Wednesday, December 21, 1994.

The Judiciary, Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures