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How to Manage the Risk of Product Liability Insurance

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Résumé de l'article

Aux États-Unis, l'évolution du droit de la responsabilité civile découlant des produits, autrefois basée sur la notion de faute, s'appuie maintenant sur le concept plus étroit de la responsabilité stricte. Une vive controverse est apparue à ce sujet entre les groupes de consommateurs et les industriels. Cette situation ne peut laisser indifférents les fabricants étrangers qui notent l'augmentation importante des poursuites et surtout l'ampleur des dommages alloués par les tribunaux, de constater les auteurs. Ceux-ci ont tenté de répondre globalement à la question suivante : « Comment gérer le risque de la responsabilité de produit ?; ». Si l'étude traite du risque de responsabilité du fabricant d'un produit exporté (le cas des États-Unis dans le cadre du libre-échange), nous avons choisi de publier ici la deuxième partie, consacrée à l'assurance de la responsabilité des fabricants.

How to Manage the Risk of Product Liability Insurance[1]

by

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and

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[1] Ce texte a paru dans la *Revue générale de droit.* Il a été préparé à l'occasion du colloque tenu le 18 octobre 1989 à l'Université d'Ottawa, sous le thème « Comment maîtriser les risques dans les contrats internationaux ». Nous le reproduisons avec l'autorisation de Me Louis Perret, vice-doyen de la faculté de droit de l'Université d'Ottawa, et celle de M. Ernest Caparros, directeur de la *Revue générale de droit.*

[2] Font partie respectivement de Radon & Ishizumi, New York et de Rechtsreferendar, Bonn.

[3] "In 1985, 13,554 product liability suits were filed in federal district courts, compared with 1,579 in 1974, a 758% increase. The average product liability award rose from $393,580 in 1975 to $1,850,452 in 1984, a 370% increase (see Berger, *The Impact of Tort Law Development on Insurance*, 37 Am. U.L. Rev. 285, 292 (1988)."

Part II – Product Liability Insurance

The broad application of strict liability not only in manufacturing flaw-cases, the rejection of state-of-the-art defense in the area of design defects by some courts, and the almost incomprehensible broad range of the duty to warn demonstrate the high financial risk manufacturers and sellers are facing. This development has already had a major impact on companies in the United States. Firms from a wide range of industries like aerospace, pharmaceutical, chemical, food processing, plastics, farm equipment, packaging, machinery, computer, pesticides are reported to have stopped developing some

of their new products because potential liability risks were too high. Other companies have started removing established products from the market out of the same fear.(4) The threat is not so much caused by anticipating that some of the company's goods might be defective due to a manufacturing flaw. What really concerns the American industry is that, in defective design cases, even if proper attention has been given to the technological know-how existing at the time the product is developed, a court applying strict liability may still retrospectively deem the product unsafe.(5) Furthermore, even compliance with state or federal safety rules and receiving official approvals from security agencies are no safeguard against liability.(6) The whole question of liability is thereby left to the court system whose decisions are sometimes perceived by the defendant companies as ordeals, i.e. hard, completely unpredictable and stemming from an incomprehensible logic. To safeguard against these high financial risks acquiring insurance coverage is nothing, if not a must.

1. The Negotiating Process

Insurance companies themselves have given the advice that one should start negotiating at least three months before the date insurance coverage is needed. The same amount of time should also be taken into account prior to the expiration of a current insurance policy.(7) Only in theory, insurance agents/brokers have access to all insurance offered. Since insurance companies have limited the num-

(4) *Insight Magazine*, August 29, 1988, at 38.

(5) Id. supra, at 39-40.

(6) *Rumsey v. Freeway Manor Minimax*, 423 S.W. 2d 387 (Tex. App. 1968) ; *Joncscuc v. Jewel Home Shopping Service*, 306 N.E. 2d 312, 316 (Ill. App. 1974).

(7) Larsen, "Alternatives to Traditional Product Liability Insurance," in *Product Liability : Weathering the Storm*, 86, 87 (1986).

ber of agencies with whom they work, the bidding process is best started by engaging several brokers/agents.

Every negotiating process aims at acquiring insurance both for prospective damage awards and for claim settlements as well as litigation expenses. Because nowadays insurance companies in the field of product liability do not use any form of standardized contract, all details of the insurance contract have to be negotiated. Special attention should be paid to the amount of insurance to make sure that possible liability claims as well as attorney fees are adequately covered.

A critical question is whether punitive damages are also insurable. This is permitted in 21 american states. Though only a small fraction of product liability cases result in punitive damages, they have been awarded with increasing frequency.(8) In some states, e.g. California, courts have granted punitive damages even in strict liability cases. Punitive damages awards depend on the reprehensible conduct and the wealth of the defendant.(9) In some court decisions, several millions of dollars were awarded.(10) Therefore, bigger corporations are confronted with very costly premiums if they want to acquire insurance coverage for punitive damages.

The rising number of product liability law suits and damage awards during the last ten years have caused huge underwriting losses in the insurance industry and quite a number of insolvencies of liability insurers.(11) This development has triggered a debate on whether product liability insurance is still affordable and available and effectively questions the traditional assumption that affordable insurance is readily available.(12) Nevertheless, in most areas, insurance coverage is still provided. Fields in which insurance is difficult

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(8) Berger, supra note 3, at 314.

(9) *Morris v. Parke, Davis & Co., a Div. of Warner-Lambert*, 573 F. Supp. 1324 (1983).

(10) *Dorsey v. Honda Motor Co., Ltd.*, 655 F.2d 650, 857-58 (5th Cir. 1981) ($5 million ; the court found manufacturer consciously disregarding known design defects) ; *Grimshaw v. Ford Motor Co.*, 119 Cal. App. 3d 757, 174 Cal. Rptr. 348 (1981) ($3.5 million because manufacturer consciously marketed product with design defect) ; *Tetuan v. A.H. Robins Co.*, 241 Kan. 441, 738 P.2d 1210 (1987) ($7.5 million).

(11) Total underwriting losses between 1979 and 1984 were $55 billion ; during the two year period of 1984/1985, at least forty insurance companies became insolvent (Berger, supra note 3, at 317).

(12) See e.g. Berger, supra note 3, at 315-321.

to obtain are pollution liability, medical malpractice and municipal liability.(13)

2. How Are Insurance Premiums Determined

The principle idea of insurance is risk-sharing. Each member (policyholder) of a specific group is facing the same kind of economic risk. Each member then contributes a certain amount (premium) that is less than the policyholder would lose if the risk materializes.(14) Insurance companies have therefore established thousands of different classes in order to form homogeneous groups of more or less similar risks. A potential policyholder is placed into one of these classifications depending upon the characteristics of the risk and the coverage needed.(15)

The premium each individual policyholder has to pay is based on the losses of all policyholders in that specific class. Since only some class members are supposed to suffer losses while the majority is expected to be free from losses, premiums will nevertheless increase for the class if the number of claims, lawsuits and damage awards turns out to be higher than foreseen.(16) Thus, premiums, which are generally calculated on a nationwide basis(17), reflect the rising number of lawsuits, damage awards and settlement costs in the U.S. litigation system.(18)

Whether the individual claims record of a (prospective) policyholder influences the insurance rate to be paid depends on the size of the insured's business. For small policyholders, their individual claim record is too limited to draw any conclusions for the future, even if their past experience is measured over several years. Therefore, their premium is based on the average loss experience of all similar small policyholders.(19) Only the claim record of the largest policyholders can be used to estimate their future losses. In this case,

(13) "Questions and Answers on Insurance Availability," in *Product Liability : Weathering the Storm*, 61, 74 (1986).

(14) Supra note 13, at 66.

(15) Supra note 13, at 71.

(16) Supra note 13, at 69.

(17) Berger, supra note 3, at 313.

(18) It is stated that premiums on the U.S. market are twenty times higher than in Western Europe (Schwartz & Bares, *Federal Reform of Product Liability Law : A Solution that Will Work*, 34 Def. L.J. 19, 22 (1985).

(19) Supra note 13, at 70.

the premium may be fixed on a purely individual basis. The rates of most policyholders are usually based on an average figure and are readjusted according to the individual claims experience. Therefore, if the individual policyholder's experience turns out to be better than anticipated, the premium will (or, at least, should) be reduced. Similarly, if it is worse, the premium will be increased.[20] This shows that, in order to lower insurance costs, policyholders are well advised to design and manufacture their products in the safest way under the existing circumstances and to issue warnings and instructions on how to use the product.

[20] Supra note 13, at 70.